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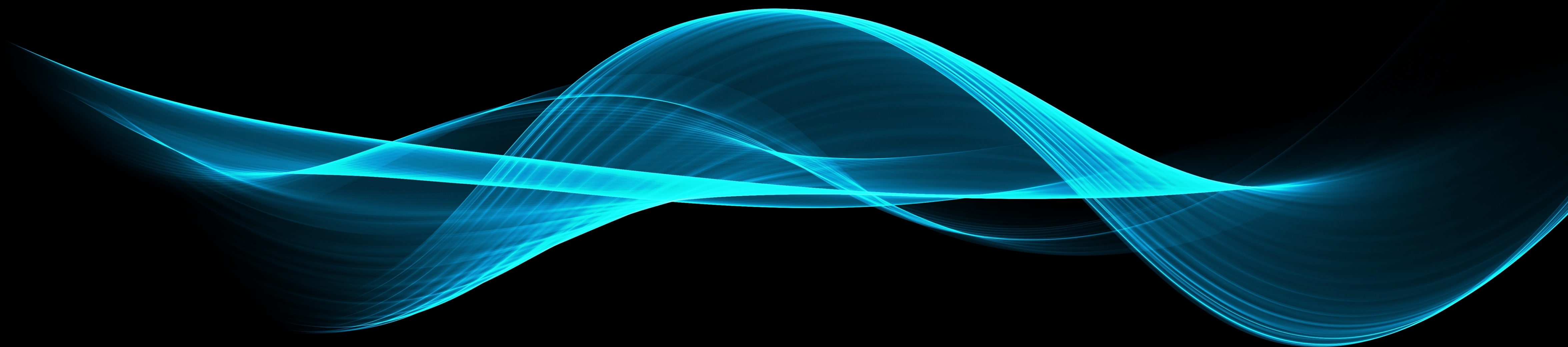
REINSURANCE

S&P CAPITAL MODEL UPDATE

Summary by Lockton Re



- S&P implemented its updated risk-based capital model changes on November 15, 2023
- This comes after an initial Request for Comment (RfC) was issued in December 2021 and a second RfC was issued in May 2023
- Prior to November 15th, rating committees continued to rely on the former capital model
- S&P indicated about 10% of ratings may be affected (including life insurers), the majority of which would be by one notch
- More upgrades than downgrades are expected
- Potentially impacted companies have been placed on Under Criteria Observation (UCO) immediately following the criteria release on November 15th
- S&P does not provide potential rating direction (e.g., positive or negative) to the UCO
- Company ratings with UCO designations are expected to be resolved by the end of February 2024, which could mean that S&P relies on year-end 2022 or interim financials for their review
- While companies placed on UCO will be prioritized, S&P plans to update credit rationales for all companies as soon as practical and will ask companies to provide financial inputs for use in the new model

Key Changes for P&C (Re)Insurers

	Implemented Changes
1. Updated Tolerance Limits for Hybrid Capital and Debt-Funded Capital	• New principles for determining the eligibility of debt-funded capital based on regulatory holdco structural subordination and issue-specific loss absorption features
2. Updated Adjusted Capital Calculation	• Removed haircuts for liability adjustments • No longer deducting non-life DAC • Changed non-life reserve discount rate from 10-year Treasury to the mean term of reserves • Updated approach to unconsolidated insurance subsidiaries, noninsurance subsidiaries, associates, and other affiliates
3. More Conservative Confidence Levels	• Former: 97.2% 99.4% 99.7% 99.9% • New: 99.5% 99.8% 99.95% 99.99%
4. Generally Higher Capital Charges	• Recalibration of capital charges for various risks to reflect more conservative confidence levels • Reserve factors for liability lines are significantly higher
5. Varying Natural Catastrophe Risk Charge Return Periods	• Former: 250-year • New: 200-, 250-, 333-, and 500-year
6. New Natural Catastrophe Risk Charge Assumptions	• Risk charge is pre-tax versus former post-tax view • PMLs are based on a whole account view versus former property-related lines view • Introduction of contingent reinsurance credit risk charge, varying from 0.63% to 1.19% of ceded PML • Receives diversification benefit where there is none in former model
7. Enhanced and Explicit Diversification Benefit	• Explicit correlation benefit for the various risk categories (market risk, credit risk, underwriting risk, CAT risk, pandemic risk) • The addition of CAT risk within the diversification formula serves to offset the higher return period requirement

What are the Potential Implications for Reinsurance Utilization?

- The efficiency of capital relief-driven reinsurance structures such as quota shares and legacy covers will vary based on the interplay of higher premium and reserve capital factors in the new model, which vary by line of business, and offsetting diversification benefits
- For highly diversified companies, the capital relief benefit provided by reinsurance may diminish due to the diversification credit these companies receive
- For companies that intentionally operate at thinner capital levels, the need for catastrophe reinsurance may lessen if managing to the 200-year return period
- For companies that manage to high capital levels and have significant catastrophe exposures, the need for catastrophe reinsurance may increase if managing to the 333-year or 500-year return period
- For companies that did not previously include non-property related exposures in their Cat survey, such as auto, the need for catastrophe reinsurance may increase
- The new contingent credit risk charge will slightly reduce the capital relief benefit provided by catastrophe reinsurance
- There is no change in the treatment of UNL layers versus cat bonds and ILWs, whereby credit is typically applied based on the modeling outputs supplied by the rated entity; basis risk is assessed on a case-by-case basis

Natural Catastrophe Risk Charge

New vs Former Model

How does the updated natural catastrophe risk charge affect the capital requirement under the new criteria?

Factors that lower the Cat risk charge impact in the new model

- New diversification credit applied to the various risk categories (e.g., credit risk, market risk, non-life technical risk) including the Cat risk charge; there was no diversification benefit to Cat risk in the old model
- For companies that manage capital levels at the "moderate" stress scenario (formerly BBB), the applicable return period is lower at the 200-year; compared to the 250-year in the old model for all levels

Factors that increase the Cat risk charge impact in the new model

- Charge is on a pre-tax basis versus a post-tax basis in the old model
- Exposures based on a whole account view versus a property-only lines view in the old model
- Introduction of the contingent credit risk charge that applies to the ceded PML
- For companies that manage capital levels at the "severe" or "extreme" stress scenarios (formerly AA or AAA), the applicable return period is higher at the 333-year and 500-year, respectively; compared to the 250-year in the old model for all levels

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