Article Title: Criteria | Insurance | Life: Methodology: Capital Charges For Regulatory Closed Blocks Under S&P; Global Ratings' Capital Model Framework Data: (EDITOR'S NOTE: —On Feb. 25, 2021, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) 1. This article presents S&P; Global Ratings' methodology for how it assesses capital charges for U.S. life insurance companies that have established a regulatory closed block (RCB) through the process of demutualization. Our revised methodology incorporates RCBs' dividend flexibility and assets risks in determining timing risk charges, which we previously considered a separate component in performance risk. 2. A RCB consists of participating life insurance policies that represented ownership in a mutual insurance company. The purpose of RCBs is to wall off the participating policies and their assets from the rest of the demutualized company. 3. This article fully supersedes "Optimizing Capital Through A Regulatory Closed Block," published April 20, 2004. SCOPE OF THE CRITERIA 4. These criteria apply to U.S.-based life insurers that have established a RCB segregating their participating insurance liabilities (relating to policies in force) and related assets following a demutualization or conversion to a mutual holding company structure. The criteria do not apply to insurers with closed blocks that are not segregated into a regulatory closed block or are not subject to regulatory reporting requirements. SUMMARY OF THE CRITERIA 5. S&P; Global Ratings is updating its capital charges on regulated closed blocks to better reflect our assessment of RCBs' potential capital needs, which are determined primarily by asset risks, and capacity to absorb investment losses over time. 6. This updated methodology derives capital charges for RCBs based on: Potential investment losses based on asset charges (investment risk), as we define them in our capital model framework; and Insurers' ability to lower RCB policyholder dividends to absorb investment losses. 7. This paragraph has been deleted. 8. This paragraph has been deleted. METHODOLOGY 9. Insurers typically structure RCBs with a dividend mechanism to pass through most deviations in actual investment and insurance experience to policyholders. In a separate analysis that supplements the capital model, we analyze the RCB assets' credit risk, interest rate risk, and market volatility by stressing the RCB investment portfolio at various rating levels (see "Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model," published June 7, 2010). We also examine RCBs' policy lapses and mortality rates to assess to what degree the block has adequate assets and policyholder dividend flexibility to withstand stresses at different rating levels and the likelihood that it would require capital injection from the company using internal or external resources. 10. If the analysis concludes the assets are sufficient to cover all guaranteed obligations over the duration of the entire RCB at a level of stress commensurate with the insurer's financial strength rating, we remove all capital charges related to assets and liabilities of the RCB from our capital adequacy analysis of the insurer, with the exception of operational risk, and replace them with the timing risk component described below. S&P; Global Ratings removes the risk charges because we deem the projected assets and the ability to reduce the policyholder dividend payouts as sufficient to satisfy all contractual obligations without needing additional assets or capital from the open block. 11. We do not remove the capital charges if the analysis concludes that there are inadequate assets to support the insurance obligations within the RCB at a level of stress commensurate with the insurer's financial strength rating, or that there is material adverse deviation of lapse or mortality rates from projected experiences. 12. We typically expect RCBs' regulatory capital and surplus to remain negative, but decline, through most of the blocks' life, with assets and liabilities gradually converging over time. Any positive or negative deviation from the projected funding status (often referred to as the "glide path") is immediately reflected in the company's regulatory capital and surplus under U.S. statutory accounting rules. S&P; Global Ratings generally views this deviation as temporary volatility, and the difference is ultimately reflected in the changing dividend rate to policyholder. Determining The RCB Timing Risk Charge 13. Although our analysis may conclude that the RCB will have sufficient assets to pay off all obligations over the life of the block, on an interim basis the block could face risks that affect the insurer's capital. These risks include a timing risk: adverse investment experience is not immediately offset by a reduction in policyholder dividends. Such experience may cause the funding status of the RCB to deviate significantly from its projected status at a particular point in time. In this situation, while we believe the company will still be able to meet all of its obligations in the longer term, the capital of the company will absorb that deviation temporarily. The timing risk charge is the greater of: 14. "10% of the RCB asset risk charge" or "RCB asset risk charge – 2x annual dividends to policyholders." 15. The formula is based on our assumption that not more than twice the annual policyholder dividend payout would be available to offset the stressed asset risk charge for the RCB. Although future dividends above this amount could offset investment losses, such an approach would exclude the possibility of regulatory action relating to the RCB in the interim, its potential near-term insolvency, and insurers' practice of avoiding large immediate reductions in policyholder dividends. Regulatory Intervention 16. In our experience, companies construct RCBs such that they can reduce dividends to policyholders in order to offset potential investment losses. In the U.S., regulators have tight controls over how companies fund RCBs and monitor the financial health of the blocks by requiring periodic (typically triennial) reforecasts of the glide path. This monitoring ensures that companies can absorb investment losses by adjusting dividends over the remaining life of the block without threatening the solvency of the insurer. However, we expect regulators to require companies to adjust dividend scales more significantly (and before the next triennial review) when large unexpected investment volatility occurs. Observed Company Practice 17. Theoretically, companies can eliminate all future dividends to absorb large investment losses. However, in practice companies are often reluctant to significantly lower dividend rates in a short period, in order to avoid reputational risks or even potential litigation by affected policyholders for breaching an implied promise. In addition, companies typically do not adjust the policyholder dividend scale for relatively small investment fluctuations. Investments gains and losses can fluctuate but companies want to keep policyholder dividend rates stable for a variety of reasons, such as reputational, competitive, and overall stability. We account for this by applying a minimum timing risk charge of 10% of the base RCB asset-risk charge. Adjustments To The Risk Charges 18. Some RCBs have reinsurance agreements in place to mitigate RCB risks, including the timing risks and funding status. We adjust the capital charges to reflect the risk retained, net of reinsurance, to the extent risk has been transferred--in particular timing risks. In addition, other risk mitigation mechanisms may exist, and we would adjust appropriately to reflect the retained risks of the company. REVISIONS AND UPDATES This article was originally published on Oct. 31, 2013. The criteria became effective as of the publishing date. Changes introduced after original publication: Following our periodic review completed on Sept. 22, 2017, we updated the contact information and deleted paragraphs 7 and 8, which were related to the initial publication of the criteria. Following our periodic review completed on Sept. 21, 2018, we updated the contact information. On Feb. 25, 2021, we republished this criteria article to make nonmaterial changes to update the contact information. RELATED CRITERIA AND RESEARCH Related Criteria Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.