Article Title: ARCHIVE | Criteria | Insurance | General: Behind The Ratings: Insurer Capital Adequacy Models Are Revised Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by an article titled "Analysis Of Insurer Capital Adequacy," which was published on April 22, 2009.) Standard & Poor's has revised its capital adequacy models for property/casualty and life/health companies. The changes take effect at year-end 1996. These models form a significant part of the analysis of insurers' capital strength. The following summarizes key elements in the models. PROPERTY/CASUALTY AND REINSURANCE The property/casualty model compares total adjusted capital, minus realistic expectations of potential investment losses and credit losses against a base level of surplus appropriate to support ongoing business activities at a secure rating level ('BBB'). This calculation produces a capital adequacy ratio. An insurer's capital strength is viewed as adequate if its capital adequacy ratio is at least 100%. Various levels of the ratio above 100% correspond to Standard & Poor's standards for good, excellent, and superior capital strength. A ratio of 175% or higher is considered superior capital; 150%-174%, excellent; a 125%-149%, good; 100%-124%, adequate; and below 100%, vulnerable. Total adjusted capital is defined as reported statutory surplus adjusted for certain items that affect the quality of that surplus. By far the largest liability on the balance sheet is loss and loss adjustment expense reserves. Standard & Poor's does its own analysis of loss reserves using various actuarially accepted methods. The result of the methods is combined with analytical judgment to draw a conclusion about the adequacy of a company's reserves. As any deficiency or redundancy affects the quality of capital, the amount of the deficiency/redundancy will be subtracted/added to capital. After reserves are adjusted to adequate levels, included is an adjustment for the effects of the time value of money. This realigns writers of long-tailed business with writers of short-tailed business as to the timing of payments of losses and associated capital needs. Finally, surplus is adjusted for anything that has not already been considered, which will improve or impair the level of available capital i.e., surplus notes, extraordinary necessity for environmental reserves, etc. LIFE/HEALTH The life/health model produces a capital adequacy ratio that compares adjusted capital and surplus minus realistic expectations of potential investment losses, against a base level of surplus appropriate to support liabilities at a secure rating level (i.e., 'BBB' range). The most significant changes to the life/health model are: Revisions of the way Standard & Poor's calculates credit risk charges for commercial and agricultural mortgages, which will reflect more recent experience with this asset class. Elimination of the two-track system for assessing risk charges on group major medical lines of business. There will no longer be any offsetting credit given for the premium stabilization reserves.The model will assess charges based on information that Standard & Poor's requests from companies in its capital model survey, which is not ordinarily available in public financial statements. Introduction of a separate charge for long-term care business, reflecting the sales growth of this type of product. Elimination of the cliff for asset concentration risk. Instead of eliminating 100% of single issuer assets in excess of 10%-15% of capital, charges are now graded. Introduction of charges for a number of asset categories, which previously were not assessed as charges by Standard & Poor's. The capital adequacy ratio is only a starting point for judging capital adequacy. Qualitative and quantitative enhancements are applied as warranted to derive a more complete picture of an insurer's capital position. The analyst plays a critical role in adjusting Standard & Poor's model to best assess those risks that are unique to any given company while still maintaining a standard of comparability between companies. While considerable attention is focused on risk-based capital ratios, Standard & Poor's assessment of capital adequacy is only one of many factors that are used in arriving at a financial strength rating for a company. The rating process will continue to be predicated on the belief that capital adequacy ratios are not a substitute for broad-based analysis of insurer credit quality. Strength or weakness in other key areas such as a company's management and corporate strategy, business profile, operating performance, liquidity, and financial flexibility can more than offset relative strength or weakness in capital adequacy.