Article Title: ARCHIVE | Criteria | Insurance | Health: Various Changes To U.S. Health Insurance Risk-Based Capital Model Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Analysis Of Insurer Capital Adequacy," which was published on April 22, 2009.) Standard & Poor's Ratings Services has made various criteria changes to its U.S. health insurance risk-based capital model. The changes include a deduction of goodwill to the calculation of total adjusted capital (TAC) and future adjustments to C-1 (asset) risk. The goodwill deduction will be included in the 2002 valuation year, while the C-1 adjustments will be in force in the 2003 valuation year. The C-1 adjustments are implemented in part to reflect changes in economic environments that affect the long-term assumptions used in the calculations. Standard & Poor's expects no immediate changes in ratings as a result of these changes. However, the capitalization views of some companies can be affected going forward, as some risks are magnified more than in the past. Total Adjusted Capital Effective immediately, goodwill will be excluded from the calculation of TAC. This criteria change affects all insurance companies (life, property/casualty, health, and reinsurance) worldwide. Goodwill has been increasingly viewed as a very soft form of capital, and given the spate of write downs Standard & Poor's has seen, it has been unreliable as a cushion to absorb long-term risks. As a result, goodwill is not an appropriate loss-absorption asset. Globally, Standard & Poor's has been moving away from accepting goodwill as a contributor to capital. In the U.S., TAC is defined as statutory capital and surplus plus asset valuation reserves plus half of the policyholders' dividend liability. All of these components of TAC are based on statutory accounting values. The goodwill embedded in statutory capital and surplus is limited in the U.S. by regulators, and it is substantially lower than the GAAP value of goodwill. As a result, Standard & Poor's expects this criteria change to have a minimal impact on the majority of U.S. insurers. C-1 Credit Default Capital Charges Standard & Poor's will be updating several C-1 credit default capital charges in 2003 to reflect new economic environments. Standard & Poor's looks at the quality of an insurer's investment portfolio to establish a reasonable estimate of expected losses over several years for a secure risk-tolerance level. The present value of these anticipated losses is charged against surplus, but this value is also adjusted for any explicit statutory loss reserves that an insurer might have already set aside. The C-1 capital charges for credit defaults of bonds and preferred stocks are calculated based on long-term assumptions for stress default probabilities, discount rates, and recovery rates. The long-term assumptions used for discount rates have been revised to 6% from 8%. The recovery rates have also been updated to vary with credit ratings of the bonds. The new recovery rates and new C-1 capital charges for credit risks are shown in Table 1. The new factors affect bonds, preferred stocks, schedule BA bonds, and schedule BA preferred stocks. The impact of the changes in C-1 factors would result in a decline in the Standard & Poor's risk-based adequacy ratio. Depending on the company's situation, Standard & Poor's might consider a phase-in period of 12-18 months. Bonds. Gross default losses are assumed to occur over 10 years and are given a present value at a 6% discount rate, starting in Year 2 (no discount is given in Year 1). These gross charges are adjusted for the assumed recovery rate (see Table 1). Standard & Poor's uses a conservative assumption that is indicative of the long-term risk associated with asset class. Preferred stock. Preferred stock is treated like bonds, except that no recovery is expected in the event of default. Commercial and agricultural mortgages. The discount rate assumption used in calculating the capital charge for problem mortgages has been changed to 6% from 8% to be consistent with the long-term assumptions used in the fixed-income default charge calculation. As a result, the separate charge that is applied to actual problem loans plus a watch list is now calculated by taking 6% annual charge applied for three years given a present value at a 6% discount rate starting in Year 2 (no discount is given in Year 1). The final factor for problem mortgages changed to 0.1700 from 0.1670. Mortgage data is extracted from each insurer's response to Standard & Poor's periodic real estate and mortgage questionnaire. A watch list initially totaling the larger of the company watch list or 33% of actual problem mortgages is calculated as a starting point then adjusted as necessary to reflect individual portfolio strengths or weaknesses. Schedule BA (other assets). The risk charges for this category reflect the range of asset types in this schedule. The fixed-income securities, problem mortgages, and preferred stocks in schedule BA would now use the new factors for these asset classes. Separate account assets backing liabilities with general account guarantees. The charges used would depend on the nature of the underlying assets and should correspond to the charges that would be made if the assets supporting guaranteed liabilities were in the general account. The fixed-income securities, problem mortgages, and preferred stocks in separate account backing guaranteed liabilities would now use the new factors for these asset classes. Table 1 Revised Asset Default/Loss-Risk Factors (C-1) RATING DISCOUNT RATE RECOVERY RATE INCIDENT DEFAULT ASSUMPTION OLD FACTOR NEW FACTOR BONDS Exempt Obligations 0 0 0 ‘A’ or higher 6% 50% 0.115% evenly over 10 years (1.30% gross charge) 0.0042 0.0051 ‘BBB’ 6% 45% 0.911% evenly over 10 years (9.11% gross charge) 0.0326 0.0391 ‘BB’ 6% 40% 2.4% years one to five; 1.6% years six to 10 (20% gross charge) 0.0752 0.0936 ‘B’ 6% 40% 5% years one to five; 2% years six to 10 (35% gross charge) 0.1372 0.174 ‘CCC’ 6% 35% 8% years one to five; 2% years six to 10 (50% gross charge) 0.2018 0.2756 In or near default 0.3 0.3 PREFERRED STOCKS Exempt Obligations 0 0 ‘A’ or higher 6% 0% 0.0084 0.0101 ‘BBB’ 6% 0% 0.0652 0.0711 ‘BB’ 6% 0% 0.01504 0.0156 ‘B’ 6% 0% 0.2744 0.29 ‘CCC’ 6% 0% 0.4036 0.4239 In or near default 0.6 0.6 SCHEDULE BA BONDS AND PREFERRED STOCKS Bonds and preferred stocks Use the above factors for the asset category Use the above factors for the asset category SEPARATE ACCOUNT WITH GUARANTEES Bonds and preferred stocks Use the above factors for the asset category Use the above factors for the asset category INTEREST-RATE RISK Assessed for MBS Default factor 0.05 for MBS COMMERCIAL/FARM MORTGAGES Problem 18% gross charge, 6% years one to three 6% discount rate 0.1700; 0.02 times experience adjustment factor Same as bonds, except no recovery in event of default. Net factors are exactly double those for bonds. The Role of Standard & Poor's Capital Adequacy Model Standard & Poor's capital adequacy model plays a significant role in the assessment of the capital strength of a health insurer. The model produces a capital adequacy ratio that compares adjusted capital and surplus—excluding realistic expectations of potential investment losses—with a base level of surplus appropriate to support liabilities at a secure rating level ('BBB' or better). Standard & Poor's standards for extremely strong, very strong, strong, good, adequate, and marginal capital strength are based on this ratio. To be minimally secure ('BBB'), the capital adequacy ratio must be at least 100%. The capital adequacy ratio is only a starting point for judging capital adequacy, however. 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 the model to assess risks that are unique to a company while maintaining a standard of comparability among companies. How the Model Works The numerator of the capital adequacy ratio is TAC (defined below) minus realistic expectations of potential investment losses. The total asset-risk (C-1) charge is adjusted by a portfolio size factor and a factor for any single-issuer concentration risk. The denominator of the ratio is derived by going through the same process for liabilities: applying risk factors to each type of liability (C-2 and C-3 risks). The last ingredient in the denominator is a general business-risk charge (C-4) that is assessed against U.S. premiums. Chart 1 As a result, an insurer's capital adequacy is viewed as good if the CAR exceeds 100%. The ranges of capital adequacy consistent with certain rating levels are shown in Table 2. Table 2 Capital Adequacy Ranges Per Rating Level CAPITAL ADEQUACY RATIO INDICATIVE RATING LEVEL ASSESSMENT OF CAPITAL ADEQUACY Less than 100% BB or lower Various 100%-125% BBB Good 125%-150% A Strong 150%-175% AA Very strong More than 175% AAA Extremely strong Determining TAC. TAC is statutory capital and surplus plus the asset valuation reserve, voluntary reserves, and 50% of the policyholder dividend liability. Analysts may add or subtract to this to include items—such as surplus notes—that meet Standard & Poor's criteria as capital. If surplus notes (or other hybrid instruments being given equity credit) constitute more than 15% of total capital, Standard & Poor's will give less equity credit for the note, in most cases treating the excess as debt. Surplus notes (or other hybrid instruments being given equity credit) are amortized at 20% per year beginning 10 years before maturity or potential call by the holder. As a result, these instruments have no equity credit by the fifth year before maturity. Evaluating Asset Risks Standard & Poor's looks at the quality of an insurer's investment portfolio to establish a reasonable estimate of expected losses over several years. The present value of these anticipated losses is charged against surplus, but this value is also adjusted for any explicit statutory loss reserves that an insurer might have already set aside. Bonds. Charges for credit risks vary with the credit rating on the bond. Gross default losses are assumed to occur over 10 years and are given a present value at a 6% (new rate effective in 2003) discount rate, starting in Year 2 (no discount is given in Year 1). These gross charges are adjusted for the assumed recovery rate (see Table 3). Standard & Poor's uses a conservative assumption that is indicative of the long-term risk associated with asset class. At the analyst's discretion, additional charges could be applied to collateralized bond obligations. These charges are based on the ratings on the tranches, provided the company retains less risk than it would by holding the underlying securities. Analytical judgment is used in determining appropriate charges for bonds of a parent or affiliate company. Standard & Poor's model includes charges for interest-rate risk associated with bonds, particularly MBS, but also includes other negatively convex securities—such as asset-backed securities and commercial MBS to address the noncredit risk that health insurers could face in their investment portfolios. Standard & Poor's assesses a charge of 5.0% for MBS, 2%-4% for home equity and manufactured housing asset-backed securities, and 1% for other asset-backed securities. Preferred stock. Preferred stock is treated like bonds, except that no recovery is expected in the event of default. Equity assets. Standard & Poor's analysis of stock market movements indicates that a 15% risk factor is appropriate for unaffiliated common stock holdings. This represents one standard deviation in the S&P; 500 Stock Index year-to-year change, as calculated since 1945. Commercial and agricultural mortgages. Separate charges are applied to performing and problem loans. The factor for performing commercial and agricultural mortgages is 0.02x an experience adjustment factor, but the minimum factor applied to performing mortgages is 0.01x regardless of experience. The experience adjustment factor is the ratio of the company's problem mortgages to the industry average and is applicable only if the company has a seasoned portfolio of mortgage investments. The factor for performing commercial and agricultural mortgages was derived as an estimate of the present value of the incidence of default, offset by expected recoveries. Problem mortgages include those that are foreclosed, in the process of foreclosure, are 30 days overdue, and that have been restructured or modified. A watch list initially totaling the larger of the company watch list or 33% of actual problem mortgages is calculated as a starting point then adjusted as necessary to reflect individual portfolio strengths or weaknesses. A separate charge is applied to actual problem loans plus the watch list—a 6% annual charge applied for three years and given a present value at a 6% (new rate effective in 2003) discount rate starting in Year 2 (no discount is given in Year 1). Mortgage data is extracted from each insurer's response to Standard & Poor's periodic real estate and mortgage questionnaire. Mortgages currently issued by insurers could carry inherent default rates closer to 18%. The average watch list for companies with interactive financial strength ratings was about 17% of problem mortgages in recent years, but Standard & Poor's believes 33% more accurately reflects the likely extent of watch-list mortgages in the long term. Affiliated common stock. Common stock of a parent is assessed a 100% charge. Insurance subsidiaries are analyzed to determine whether they are strategically important; if so, their assets and liabilities are consolidated into the parent company's capital model. When such risk charges are assessed, the 15% factor for common stocks does not apply, full equity credit is given for the affiliate's stock, and adjustments are made to the parent's TAC to reflect the subsidiaries' asset valuation reserve and policyholder dividend liability. The treatment of affiliates deemed not strategically important involves a C-1 charge. If a stand-alone rating exists, this charge is the capital deemed necessary for the ratings; otherwise, the charge is at the 'BBB' level. The analyst consults with other departments in Standard & Poor's to determine the appropriate capitalization levels for noninsurance subsidiaries. Real estate. Standard & Poor's applies an 18% risk factor to this asset class, reflecting its opinion that real estate, on average, is a greater risk than common stock. Schedule BA (other assets). The risk charges for this category reflect the range of asset types in this schedule. Surplus in nonguaranteed separate accounts. The item is assessed a 10% charge; the factor may be adjusted to reflect the actual risk of the underlying assets. This item includes the expense allowance transfers related to nonguaranteed separate accounts. Assets in separate accounts with guarantees. The charges used would depend on the nature of the underlying assets and should correspond to the charges that would be made if the assets supporting guaranteed liabilities were in the general account. C-1 risk charges on mandatorily convertible securities. For securities that are mandatorily convertible into a different type of security at prices different from the market prices at the time of conversion, the risk charge should equal the statement value multiplied by the higher of the factor appropriate to the securities in the absence of the conversion features or the factor appropriate to the security as a result of the conversion. Size factor. Standard & Poor's incorporates a size factor based on total invested assets, which is multiplied by the insurer's total asset default risk charge, subject to a minimum level of 1x, whereby the largest insurers would still be subject to the full asset charges determined by Standard & Poor's. Concentration risk. All assets with credit risk associated with a single issuer are aggregated to assess concentration risk. Graded charges are assessed when single-issuer concentrations exceed 15% of TAC for investment-grade bonds or 10% for other types of assets. Table 3 Asset Default/Loss-Risk Factors (C-1) RATING INCIDENCE OF DEFAULT ASSUMPTION NET FACTOR BONDS (50% RECOVERY RATE/8% DISCOUNT RATE) Exempt obligations 0% 0 'A' or higher 1.15% gross charge 0.115% evenly over 10 years 0.0042 'BBB' 9% gross charge 0.9% evenly over 10 years 0.0326 'BB' 20% gross charge 2.4% years one to five; 1.6% years six to 10 0.0752 'B' 35% gross charge 5% years one to five; 2% years six to 10 0.1372 'CCC' 50% gross charge 8% years one to five; 2% years six to 10 0.2018 In or near default 30% net charge 0.3 PREFERRED STOCK INTEREST-RATE RISK Assessed for MBS, callable corporates, and other securities, determined individually for each portfolio Default factor 0.045 for MBS, 0.020 for home equity, and 0.010 for asset-backed securities COMMERCIAL/FARM MORTGAGES Problem 18% gross charge, 6% years one to three 8% discount rate 0.1670; 0.02 times experience adjustment factor Performing 2% on average, adjusted for experience relative to industry experience. Adjustment factor equals company problem mortgage percentage divided by 14% 0.5 minimum experience adjustment factor INSURED MORTGAGES In good standing 0.001 90 days overdue 0.002 RESIDENTIAL MORTGAGES In good standing 0.005 90 days overdue 0.01 DUE AND UNPAID TAXES On overdue (90 days) mortgages and mortgages in foreclosure 1 COMMON STOCK Nonaffiliated 0.15 Affiliated Parent: Exclude insurance subsidiary, consolidate all others: 100% (analyst may adjust) 1 REAL ESTATE Investment 0.18 Foreclosed encumbrances 0.15 Property used to deliver health care 0.1 SCHEDULE BA Bonds, preferred, or common Use the factor for the asset category Schedule BA mortgages and real estate 0.2 Other Schedule BA assets 0.3 OTHER ASSETS Surplus in nonguaranteed separate accounts 0.1 ASSETS IN SEPARATE ACCOUNTS BACKING GUARANTEED SEPARATE ACCOUNTS LIABILITIES: PRO FORMA TREATMENT FOR ASSETS AS IF IN GENERAL ACCOUNT Cash, short-term investments, and nongovernment money market funds not qualifying for Schedule DA treatment 0.003 Premium notes, collateral loans., and write-ins 0.05 Noncontrolled assets 0.01 OFF-BALANCE-SHEET ITEMS Long-term leases Present value, discounted at 6% 0.05 Same as bonds, except no recovery in event of default. Net factors are exactly double those for bonds. Multiply asset charges by asset size factor (minimum asset size factor = 1). Size factor = Total weighted dollar amount divided by total invested assets. Size factor = [(First $100 million invested assets times 2.5) plus (next $100 million times 1.5) plus Table 4 Single-Issuer Concentration PERCENTAGE OF TOTAL ADJUSTED CAPITAL FACTOR (MAXIMUM TOTAL CHARGE 1.0) 10%-25% (15%-25%) 0.20 plus base asset factor 26%-50% 0.40 plus base 51%-75% 0.60 plus base 76%-100% 0.80 plus base More than 100% 1 Evaluating Liability Risks For health insurance, Standard & Poor's incorporates liability factors that recognize differences in risk by product (for example, the degree of managed care inherent in medical products). No credit is applied for the premium stabilization reserve. For companies that assume life reinsurance, Standard & Poor's generally applies a surcharge of 25%-50% of the standard applicable factors, reflecting Standard & Poor's opinion that the reinsurer has less control over the risk than the issuing company. The disability insurance factors were determined from an extensive, detailed study of disability claims for 1983-1998 by the Academy of Actuaries and approved by the NAIC. The study showed that the group coverages have a lower risk because of the ability to re-price or cancel the policies. Standard & Poor's risk factors are about a 25% surcharge to the corresponding NAIC charges. These new factors are higher for the riskier products than the previous products, particularly noncancelable individual disability insurance, and for smaller companies. Meanwhile for companies with more than $100 million of annual premium, the Other Individual charge will decrease. Also, the factors are lower for less-risky coverages, such as credit and group long-term disability and, particularly, short-term disability. Table 5 Health Insurance—Liability Risk Factors (Comprehensive Medical and Hospital or Medical Only) FACTOR TRADITIONAL INDEMNITY Earned premium first $25 million 0.17 Earned premium more than $25 million 0.1 INDEMNITY WITH RETROSPECTIVE EXPERIENCE RATING Earned premium 0.1 CONTRACTUAL FEES Earned premium first $25 million 0.14 Earned premium more than $25 million 0.085 BONUS/WITHHOLD ARRANGEMENTS Earned premium first $25 million 0.13 Earned premium more than $25 million 0.075 CAPITATION Earned premium first $25 million 0.075 Earned premium more than $25 million 0.05 NONCONTINGENT SALARIES Earned premium first $25 million 0.055 Earned premium more than $25 million 0.036 ADMINISTRATIVE SERVICES ONLY/CONTRACTS Premium equivalent first $500 million 0.02 Premium equivalent more than $500 million 0.0075 STOP LOSS Earned premium 0.33 FEDERAL EMPLOYEE HEALTH BENEFIT PROGRAM Earned premium 0.04 MEDICARE SUPPLEMENT Earned premium first $25 million 0.12 Earned premium more than $25 million 0.08 DENTAL Earned premium first $25 million 0.1 Earned premium more than $25 million 0.07 HOSPITAL INDEMNITY, ACCIDENTAL DEATH AND DISMEMBERMENT, AND OTHER LIMITED BENEFITS NOT ANTICIPATING RATE INCREASES Earned premium 0.08 OTHER LIMITED BENEFITS ANTICIPATING RATE INCREASES Earned premium 0.12 NON-CANCELABLE INDIVIDUAL DISABILITY INSURANCE PRODUCTS Earned premium first $50 million 0.45 Earned premium more than $50 million 0.18 OTHER INDIVIDUAL DISABILITY Earned premium first $50 million 0.3 Earned premium more than $50 million 0.09 GROUP LONG-TERM Earned premium first $50 million 0.18 Earned premium more than $50 million 0.04 GROUP SHORT-TERM Earned premium first $50 million 0.06 Earned premium more than $50 million 0.04 CREDIT-MONTHLY OUTSTANDING BALANCE Earned premium first $50 million 0.25 Earned premium more than $50 million 0.04 CREDIT-SINGLE PREMIUM WITH UNEARNED PREMIUM RESERVE Earned premium first $50 million 0.12 Earned premium more than $50 million 0.04 CREDIT-SINGLE PREMIUM WITHOUT UNEARNED PREMIUM RESERVE Earned premium first $50 million 0.18 Earned premium more than $50 million 0.04 LONG-TERM CARE (INDIVIDUAL AND GROUP) Earned premium first $50 million 0.25 Earned premium more than $50 million 0.15 CLAIM RESERVES Exhibit 9 individual and group and credit claim reserves 0.05 For traditional indemnity through stop loss, add 2.4% to base factors if rates are guaranteed for 15-36 months; add 6.4% if rates are guaranteed for more than 36 months. General business risk factor. The model incorporates a charge for general business risk that is based on the company's premiums written (excluding premiums or deposits related to separate account products) in the U.S. and separate account liabilities, as reported in the annual statutory statement. Standard & Poor's uses this measurement as a proxy for business risk, mirroring the NAIC's approach. Table 6 Business Risk Factors (C-4) PREMIUMS SUBJECT TO GUARANTY FUND ASSESSMENT FACTOR U.S. life and annuity premiums (excluding separate account deposits) 0.02 U.S. accident and health premiums 0.005 U.S. separate account liabilities 0.0005 How Standard & Poor's Looks at Interest-Rate Risk In the 1990s, health insurers shifted from credit risk to option risk. This was partially because of the performance and liquidity issues for commercial mortgages that surfaced in the real estate downturn and credit-quality concerns brought on by deterioration in credit of high-yield bonds. Another reason was that insurers were trying to maximize their NAIC risk-based capital ratio, which does not have an explicit charge for convexity (i.e., option risk). In fact, interest-rate risk was largely ignored by the insurance industry, swept under the carpet of book-value accounting. Standard & Poor's risk-based capital model captures both asset and liability risks undertaken by health insurance companies. On the asset side, Standard & Poor's capital model has historically charged insurers for credit risk in their bond portfolios, underwriting risk for commercial mortgages and real estate, and market risk for stock equities. In 1994, Standard & Poor's began analyzing insurers' investment portfolios to look at the inherent convexity risk and has now more clearly defined its approach to this category of asset risk. In the model, capital is charged for potential credit defaults based on Standard & Poor's credit default matrices, which show the probability of bonds defaulting. The charge provides a capital cushion for bond defaults. The capital required for option risk is allocated for potential interest rate volatility. Clearly, some change in interest rates is inevitable over the average life of an investment. More important, the level of capital will be specific to a company's overall mortgage portfolio. Not all planned amortization class bonds and sequentials are the same, nor are all companies' risk appetites alike. Large Subsidiary/Affiliate Capital Charge If large subsidiaries/affiliates constitute more than 10% of TAC and are viewed as nonstrategic in Standard & Poor's group ratings methodology, Standard & Poor's will apply its equity volatility charge (as applicable in that market) plus a 15% concentration charge on the total subsidiary investment in a capital model. In the U.S., this means the charge will be 15% equity volatility charge plus 15% concentration charge, equaling a 30% charge on the entire investment in the subsidiary/affiliate. Note that this total charge is a minimum charge, and the analyst can increase the charge if it is believed that there is greater-than-normal volatility in the subsidiary holding, the holding is overvalued, or the holding is expected to devalue significantly. Capital Credit for Subsidiaries with Publicly Traded Minority Interests As a result of several insurers recently deciding to partially spin off subsidiaries, Standard & Poor's has adopted an approach for capital credit for subsidiaries and strategic affiliations with publicly traded minority interests. This approach will apply to subsidiaries and affiliates that are considered core or strategically important according to Standard & Poor's group ratings criteria. Subsidiaries and affiliates considered nonstrategic under Standard & Poor's group ratings criteria are excluded. Those companies that are considered nonstrategic and that have publicly traded minority interests will be included at full market value, just as any other equity investment would be. These investments would be subject to Standard & Poor's capital charge for market volatility (typically 15% globally) and would be subject to Standard & Poor's concentration risk charges if the investment represented more than 15% of group capital. Standard & Poor's permits capital credit to be given in any group capital model under the following guidelines: Capital credit for the market value of a subsidiary or strategic affiliate can only be given if there is a public valuation of shares of the subsidiary. There must be sufficient outstanding shares to constitute a liquid market for the stock with a credible share price (that is, there are a sufficient number of bids or offers to develop a market price). Capital credit for the excess of market value over book value of the subsidiary or strategic affiliate will not exceed credit given by the regulators in the jurisdiction of the parent insurer's domicile (this applies only if regulatory capital guidelines exist). Capital credit for the excess of market value over book value of the subsidiary or strategic affiliate will not exceed 25% of the difference between market value over book value. Capital credit for the excess of market value over book value of the subsidiary or strategic affiliate will not exceed 10% of TAC (including this capital credit) in the group capital model. Adjustments to the Model Standard & Poor's capital adequacy model creates a reasonably consistent initial approach to measuring insurers' capital adequacy. Still, results are primarily guideposts, not absolute benchmarks, by which to gauge capital adequacy. A vital part of the assessment of capital adequacy incorporates both qualitative and quantitative adjustments to the model. These adjustments may consider: A company's ability to generate capital internally and to fund its growth through statutory earnings. All else being equal, Standard & Poor's views companies with long track records of consistently good earnings as having a stronger capacity for reliable surplus development than companies with more volatile performance. Standard & Poor's also considers an insurer's prospective growth plans in conjunction with management's commitment to maintaining or enhancing surplus adequacy. Capital needs of a parent, affiliate, or subsidiaries. Standard & Poor's considers potential calls on capital by affiliates that might look to the rated entity for future capital support or by parent companies that might make increasing demands for dividends. Conversely, a parent's, subsidiary's, or affiliate's ability to provide future surplus support could have a positive effect on how Standard & Poor's views an insurer's capital strength. Amount of reinsurance. Standard & Poor's takes into account any use of reinsurance to support aggressive growth and reported capital strength, along with the expected timing of treaty recapture and the quality of assuming reinsurers. Other contingent liabilities. Bond guarantees or similar contingent liabilities that could warrant a charge against capital are also considered. Although considerable attention is focused on risk-based capital ratios, Standard & Poor's assessment of capital adequacy is only one of many factors used in arriving at a financial strength rating. Standard & Poor's rating process will continue to be based on the belief that capital adequacy ratios are not a substitute for a broad-based analysis of insurer credit quality. Strengths or weaknesses 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 strengths or weaknesses in capital adequacy.