Article Title: ARCHIVE | Criteria | Insurance | Life: Three Changes To U.S. Life Insurance Capital Model Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Analysis Of Insurer Capital Adequacy," which was published on April 22, 2009.)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 three changes to its U.S. life insurance capital model: The convexity risk charge for commercial mortgage-backed securities (CMBS) has been eliminated. A different asset risk charge to the Federal Home Loan Bank's (FHLB) common stock is being applied. There is a new risk factor for reinsurance of workers' compensation carve-out business. These changes are effective immediately and will be implemented for the 2003 year-end valuation of the Standard & Poor's risk-based capital model, together with all the previously announce changes. The interest rate scenarios used to test the convexity risk embedded in MBS will be the same as in 2002. That is, for the 2003 year-end valuation year, the interest rate scenarios will be: up 250 basis points (bps), up 200 bps, up 150 bps, up 100 bps, up 1 bp, down 1 bp, down 100 bps, and down 125 bps. The scenarios did not change because the level of the 10-year U.S. Treasury rate as of Dec. 8, 2003, is similar to the one in December 2002. Standard & Poor's expects no rating actions as a result of these changes. CMBS Standard & Poor's is eliminating the convexity charge for CMBS. The change will be implemented immediately. The current convexity charges for ABS and MBS will remain unchanged. Standard & Poor's research shows that the prepayment and extension risks on CMBS securities are mainly because of credit defaults. Standard & Poor's also recognized that CMBS negative convexity risk is extremely small. As a result, CMBS behave like noncallable corporate bonds, with stable average lives and strong price protection against changes in interest rates. CMBS, which are formed from a pool of commercial mortgage loans, benefit from the stern contractual provisions embedded in these mortgage loans against prepayments (other than defaults). The main four provisions are: Lockout. Protection for prepayment for a specified amount of time. Defeasance. The borrower can substitute risk-free assets as a collateral of the loan instead of real estate. This improves the risk of the loan. Yield maintenance. Similar to a market value adjustment to compensate for any potential loss. Prepayment penalties. Studies also show that the ratings on the CMBS tranches reflect the stress level of defaults and have been a good predictor of the default. The impact of this change is favorable for the companies but minimal in magnitude because the investments in CMBS are relatively small. FHLB Common Stock FHLB stocks are classified as common stocks in the annual statements of insurance companies. As a result, the C1 (asset risk) capital charges for this type of investments had been 15%. Going forward, Standard & Poor's will reclassify FHLB common stock into preferred stock and apply the corresponding C1 charge for NAIC 1 preferred stocks: 101 bps. The impact of this change is favorable for the companies but minimal in magnitude because the investments in FHLB stock are very small. FHLB is a government-sponsored entity, and it has a 'AAA' credit rating. It is organized into 12 regional banks that are committed to supplying low-cost funds to financial institution members that engage in mortgage lending. Only eligible financial institutions can become members of the FHLB and can purchase FHLB common stock. Members are required to hold a minimum amount of stock based on their size, value of mortgage-related investments, and amount of outstanding advances. FHLB common stock has a fixed par value for which members can redeem their stock value. The FHLB consistently pays quarterly dividends on the common stock, and the fixed par value eliminates price volatility in the stock. Therefore, Standard & Poor's recognized that it behaves more like a bond or preferred stock, and it has a lower risk than equity. Table 1 New Risk Charge to FHLB Common Stock OLD CHARGE NEW CHARGE 15% (same as other C1 unaffiliated common stocks charges) 1.01% (same as C1 NAIC 1 preferred stock charges) Reinsurance of Workers' Compensation Carve-Out Business Standard & Poor's is adopting the methodology proposed by the American Academy of Actuaries on capital requirements for the life insurance companies that write reinsurance of workers' compensation carve-out business. Standard & Poor's is implementing the same approach used to calculate the risk-based capital for property/casualty companies that participate in this business. The impact of this change will be slightly unfavorable for life insurance companies because this is a completely new capital requirement. The absolute level of the impact will be small, as this business line tends to be very small in relation to the companies' overall liabilities. Table 2 New Risk Factor for Reinsurance of Workers' Compensation Carve-Out Business RISK C2 RISK FACTOR Net premium written—Workers' compensation 0.15 multiplied by net premium written Unpaid loss and expenses—Workers' compensation 0.09 multiplied by net reserves