Key changes to S&P's Insurers Rating Methodology: A primer and Litmus guidance.

S&P recently completed a "Request for Comment" ("RfC") period for proposed changes to its Insurance Ratings Methodology*. It is now reviewing the comments and finalising the criteria and the related guidance. While these may therefore differ to an extent from the original RfC proposals covered here, we would be surprised if there were to be material changes overall.

Once formally launched all relevant ratings will reflect the new methodology, although full execution across the rated universe will take some time.

While S&P has noted that only a modest number of near-term rating changes would be expected, there are important issues for S&P rated insurers to consider in terms of ongoing ratings management and S&P communications.

NOTE: The comments below are intentionally brief. For some insurers, issues not covered here may in fact be the most important. To discuss this in more depth, including how it might impact your own rating and communications with S&P, please contact us directly.

1. The role of the S&P capital model.

S&P has long emphasised that the prospective capital model outcome (described by the agency as "Capital Adequacy") is intended as a standardised benchmark input into the "Financial Risk Profile" ("FRP") analysis, and not as the final answer to the question "what is the prospective risk adjusted capital strength of this insurer?"

Indeed, the agency describes a focus on the specific outcome of the model as "false precision".

The new methodology takes this further through the following:

- Increasing the emphasis on analytical judgement in the application of the model outcome within the subsequent "Capital & Earnings" ("C&E") assessment. Hence, there will be more chance that the C&E assessment will differ from the capital model outcome.
- Introducing the assessment of "Risk Controls" into the FRP analysis by combining this with the former "Risk Position" modifier to the C&E assessment (together now called "Risk Exposure").
- Substantially increasing the number of cells within the FRP and BRP ("Business Risk Profile") decision matrix (see Table 1 below) that offer a choice between two anchors. That choice will then reflect S&P's judgement on the relative significance of individual strengths and weaknesses across the issues looked at within the FRP and BRP analyses.

Litmus Guidance: Successful communication around capital strength will require far more than simply a focus on achieving a given capital model outcome. Capital planning for an S&P rating will need to consider how the "non-model" factors are assessed.

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Table 1

Anchor

Business risk profile	--Financial risk profile--							
	1.Excellent	2.Very Strong	3.Strong	4.Satisfactory	5.Fair	6.Marginal	7.Weak	8.Vulnerable
1.Excellent	aa+	aa	aa-	a+	a-	bbb	bb+	b+
2.Very Strong	aa	aa/aa-	aa-/a+	a+/a	a-/bbb+	bbb/bbb-	bb+/bb	b+
3.Strong	aa-/a+	a+/a	a/a-	a-/bbb+	bbb+/bbb	bbb-/bb+	bb/bb-	b+/b
4.Satisfactory	a	a/a-	a-/bbb+	bbb+/bbb	bbb/bbb-	bb+/bb	bb-/b+	b/b-
5.Fair	a-	a-/bbb+	bbb+/bbb	bbb/bbb-	bbb-/bb+	bb/bb-	b+/b	b-
6.Weak	bbb+/bbb	bbb/bbb-	bbb-/bb+	bb+/bb	bb/bb-	bb-/b+	b/b-	b-
7.Vulnerable	bbb-/bb+	bb+/bb	bb/bb-	bb-/b+	b+/b	b/b-	b-	b-

Source: S&P Global

2. “Competitive Position” analysis

For most insurers “Competitive Position” is S&P’s main analytical focus within the wider “Business Risk Profile” (“BRP”) assessment. The impact of the BRP assessment on the “anchor” is shown in Table 1 above. While the “Competitive Position” assessment may be modified by the “Insurance Industry and Country Risk Assessment” (“IICRA”) in finalising an insurer’s BRP, that will typically remain a fairly generic decision by the agency (by the weighting of an insurer’s portfolio across the markets where it is active).

The detail shown within the “Competitive Position” methodology is being substantially reduced via an emphasis on the key credit profile drivers. In practice this will mean those business attributes of an insurer that lead to sustainable profitability and mitigate volatility, or the lack of these. In addition, an analysis of “risk/return” optimisation will now be included in the “Profitability” sub-factor.

Demonstrating sufficient “Competitive Advantage” will be fundamental. An insurer lacking this will typically receive an anchor no higher than “a-“ even with the strongest possible FRP assessment.

Litmus Guidance: “Competitive Position” will remain the part of the S&P ratings process where effective communication most often makes a key difference. It is inherently qualitative and loaded with analytical judgement. Understanding the S&P “mindset” (what it cares about and why) is crucial to optimising the outcome.

3. Enterprise Risk Management (“ERM”)

This will no longer be a separate “post anchor” part of the analysis. Instead, core components of S&P’s current ERM analysis will now be spread across the rest of the methodology. In practice this can lead to these components having more impact on ratings:

- The efficacy of “Risk Controls” will be a key part of the FRP assessment.
- “Strategic Risk Management” will be fundamental to the “Profitability” part of the analysis and hence to the “Competitive Position” assessment.

- “Risk Culture” will be within the “Governance” modifier to the anchor. “Governance” will be assessed as “neutral”, “moderately negative” or “negative”. The latter will lead to a “2 or more” notch reduction from the anchor level.

Litmus Guidance: More than ever, it will be key that different aspects of ERM are clearly presented as central to an insurer’s strategy, capital management, performance management and operations. The independence and strength of the risk management function and team remain fundamental but ERM itself will be considered by S&P as an integral part of different aspects of the firm’s total business management. In their communications with S&P, other professionals should be comfortable discussing key aspects of the insurer’s ERM as they impact their area of operations.

4. The role of peer comparisons

Peer comparisons have long been part of S&P’s analytical approach but Litmus’ discussions with the agency suggest they may well play a greater role in future.

In any given case this could be through the “Comparable Ratings Analysis”. This is a potential one-notch modifier (positive or negative) to the anchor outcome. More generally, with the greater scope throughout for analytical judgement, there is a wider context for S&P’s perspective to be influenced by peer reviews.

Litmus Guidance: For some insurers, S&P’s use of peer comparisons could be crucial to their rating and it is increasingly likely these will set some analytical context, even if not directly seeming to impact the rating. Insurers should seek to understand both who S&P views as its peers, and why, such that they are able to engage with S&P effectively if they feel that the peer selection and/or conclusions drawn from it should be in some way different.

******Other recent S&P RfC’s on its group rating and debt rating methodologies are not covered here.*

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About Litmus Analysis

Litmus Analysis specialises in helping the re/insurance industry understand credit risk, credit ratings and how best to work with ratings agencies. Litmus has conducted over 60 ratings advisory projects for re/insurers, helping them successfully achieve new ratings, rating upgrades or to avoid potential downgrades. The Litmus team of consultant analysts all have a senior rating agency and/or broker market security background.

The LitmusQ re/insurer financial profiling model is being used by re/insurers and brokers, both as a counterparty credit tool and in assisting their reinsurance underwriting, cedant knowledge and business production processes.