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Big Changes Coming to S&P Insurer RBC Model – Convertible Bonds Still Shine

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The Standard & Poor's (S&P) Insurer Risk-Based Capital Adequacy model is undergoing significant changes, including major adjustments to the factors applied to bond holdings. This model is an important tool used to assess the financial strength and solvency of insurance companies rated by S&P. The updates being made to the model reflect evolving market dynamics and aim to provide a more accurate assessment of risk exposure.

Key changes affecting insurer bond holdings will include recalibration of the confidence intervals used to generate capital factors to 99.5%, 99.8%, 99.95%, and 99.99% (previously 97.2%, 99.4%, 99.7%, and 99.9%), addition of more bond sector groups with differentiated factors, improving the process for identifying which ratings bucket to put bonds in (certain bonds were treated punitively in the past if not rated by S&P, even if highly rated by a different agency), and introducing greater consistency into the process for assigning ratings to RMBS and CMBS.

S&P's capital adequacy model features much more granular treatment of bonds than either NAIC RBC or AM Best BCAR. It uses complex grids of capital factors based on bond sectors, ratings, and maturity buckets, so it can be tricky to generalize too broadly about these charges. Despite this extra granularity, the S&P model does resemble the others in that convertible bonds continue to represent a highly efficient vehicle for gaining exposure to equity-like returns relative to the capital charges applied to them.

To illustrate, the table below shows proposed capital charges from S&P's Illustrative Insurer Risk-Based Capital Model (recently released to assist insurers in evaluating the impact of the proposed process changes) for BBB/BB corporate bonds and equity at the 99.99% and 99.95% confidence intervals:

	99.99% Scenario		99.95% Scenario	
Tenor (years)	BBB	BB	BBB	BB
Up to 1	0.90%	2.34%	0.71%	1.85%
1.01 to 5	3.16%	8.74%	2.50%	6.90%
5.01 to 10	5.02%	11.95%	3.96%	9.43%
10.01 to 20	5.86%	12.43%	4.63%	9.81%
More than 20	5.86%	12.43%	4.63%	9.81%
Equity (Listed)	55.00%		50.00%	

Source: S&P

As you can see, a portfolio of predominantly 1-5yr corporate bonds rated in the BBB/BB range (which describes a representative convertible portfolio) receives a capital charge of about 6% on average under the most aggressive 99.99% scenario, while the charge for equity holdings is nearly 10x as large at 55%. For an asset that has returned about 70% as much as US equity over the past 20 years, having a capital charge of only ~10% as much offers an obvious strategy for RBC-efficient investing. Simply put, for any given allocation to equity, an insurer could instead hold a significantly larger allocation to convertibles (potentially several times larger) with a higher overall expected portfolio return, and a material reduction in required capital.

Convertible bonds remain a natural fit for insurers: they receive Schedule D Part 1 bond treatment, issues rated BBB or better are carried at amortized cost rather than market value, they typically capture a large fraction of equity market rallies and a lower proportion of equity market declines, and they represent an established, well-understood corner of the investable universe. Their remarkable

RBC efficiency is just the cherry on top. This will remain true under the proposed alterations to S&P's Insurer Risk Based Capital Adequacy model, perhaps even more so than under other common RBC models.

For more information about S&P's proposed changes to its capital model, or to provide feedback on the proposal prior to June 30, insurers can visit this link:

https://www.spglobal.com/ratings/en/research/articles/230509-criteria-insurance-request-for-comment-request-for-comment-insurer-risk-based-capital-adequacy-methodolo-12693138

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