April 3, 2008

Related Reports

Methodologies:
Understanding Universal BCAR – A.M. Best's Capital Adequacy Ratio for Insurers

BCAR for Life and Health Insurers - Model Update 2006

Understanding BCAR for Life/Health

Risk Management and the Rating Process For Insurance Companies

Rating Analysts

George Hansen, Managing Senior Financial Analyst/Actuary
+1 (908) 439-2200 Ext. 5469
George.Hansen@ambest.com

Andrew Edelsberg, Vice President
+1 (908) 439-2200 Ext. 5182
Andrew.Edelsberg@ambest.com

This methodology is available at *www.ambest.com/ratings/methodology*

Update to BCAR for Life & Health Insurers

The objective of A.M. Best Co.'s financial strength rating system is to provide an opinion of an insurer's financial strength and ability to meet its ongoing obligations to policyholders. The assignment of an interactive rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile, as compared with A.M. Best's quantitative and qualitative standards.

In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance sheet strength, since it is the foundation for policyholder security. Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. Business profile and operating performance then determine how that balance sheet strength will be enhanced, maintained or eroded over time.

One of the key tools used in evaluating balance sheet strength is Best's Capital Adequacy Ratio (BCAR) model, which provides a quantitative measure of the risks inherent in a company's investment and insurance profile relative to its statutory capital and surplus. A.M. Best notes that, although BCAR is a valuable tool in the rating process, it is not the sole determinant of a rating assignment. BCAR, like other quantitative measures, has its limitations and requires a qualitative overlay. Consequently, capital adequacy should be viewed within the overall context of the operating and strategic issues surrounding a company.

Business profile and operating performance, as well as the quality of the capital that supports the BCAR results, are important rating considerations in evaluating a company's long-term financial strength and viability. Any holding company considerations also will play a key role in evaluating the financial strength of an insurance company.

Exhibit 1
BCAR Risk Charges

NAIC Designation	2006 Preferred Stock	2007 Bonds and Preferred Stock
Class 1	0.0100	0.0080
Class 2	0.0400	0.0250
Class 3	0.0700	0.0600
Class 4	0.1200	0.1200
Class 5	0.2200	0.2500
Class 6	0.3000	0.3000

NAIC Designation	2006 Other Preferred Stock	2007 Other Bonds and Other Preferred Stock
Class 1	0.0150	0.0120
Class 2	0.0600	0.0375
Class 3	0.1050	0.0900
Class 4	0.1800	0.1800
Class 5	0.3300	0.3750
Class 6	0.4500	0.4500

Source: A.M. Best Co.

Model Update

A.M. Best has modified its BCAR model for life and health insurers effective for year-end 2007 to enhance its accuracy in measuring balance sheet strength and operating risk. A.M. Best's BCAR model will continue to quantify the level of capital required for four broad risk categories: asset risk, insurance/morbidity risk, interest rate/market risk and business risk. Changes to the model will be discussed for each of the four categories.

C-1: Asset Risk

A.M. Best's 2007 BCAR model will reflect several changes regarding asset risk:

Unaffiliated Preferred Stock. Similar to recent changes made by the National Association of Insurance Commissioners (NAIC) to its risk-based capital (RBC) formula, default risk charges applicable to unaffiliated preferred stock will be the same as those applicable to long-term bonds. A.M. Best believes that investors expect preferred stock to perform like fixed-income securities with fairly stable valuations, and the credit ratings will reflect the relative subordination within an issuer's capital structure. In the 2007 BCAR model, these risk charges also will be applied to short-term bonds. Prior BCAR models applied cash-type risk charges to short-term bonds. Default risk factors applied to "other" bonds and "other" unaffiliated preferred stock (i.e. Schedule BA assets) will be 50% higher than the factors applied to Schedule D bonds and unaffiliated preferred stock. Affiliated preferred stock will be treated similar to affiliated common stock and assessed a risk charge of 100%, consistent with the A.M. Best Property/Casualty BCAR model (P/C BCAR).

Risk charges will continue to vary by the designated NAIC classes. However, itemization by NAIC class for certain assets is not available from health insurance annual statements. Therefore, for year-end 2007 and beyond, health companies will be asked to provide breakdowns of preferred stock, "other" bonds and "other" preferred stock by NAIC class in A.M. Best's Supplemental Rating Questionnaire (SRQ). **Exhibit 1** summarizes the changes to the risk factors.

Separate Accounts. Beginning with the 2007 model, BCAR will reflect default risk charges on separate-account assets backing nonvariable liabilities. The risk charges applied to these assets will be the same as those applied to similar general-account assets. A.M. Best believes these risk charges are necessary because the company bears risk through crediting rate guarantees on these liabilities. The separate-account assets will not be included in the invested asset total used in the BCAR model to determine spread of risk (SOR) factors. In addition, the SOR factor will not be applied to these risk charges.

Low-Income Housing Tax Credits. The 2007 BCAR model also will include risk charges for guaranteed and nonguaranteed low-income housing tax credits – asset categories recently defined by the NAIC. The risk charges for

A.M. Best Company

Methodology

PUBLISHER, PRESIDENT AND CHAIRMAN
Arthur Snyder

EXECUTIVE VICE PRESIDENT/CHIEF OPERATING OFFICER
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

SENIOR VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty
Rita L. Tedesco, Information Services

ANALYTICAL SERVICES GROUP
John Lafayette, Assistant Vice President
Carole Ann King, Assistant Manager
Stephen Brown Klinger, Senior Business Analyst
Joe Niedzielski, Senior Business Analyst
Brendan Noonan, Senior Business Analyst
Laura McArdle, Business Analyst
Jey Thanapal, Business Analyst
Thomas Dawson IV, Associate Editor

PRODUCTION
Angel M. Negron, Senior Designer

Copies are available through Customer Service: (908) 439-2200, Ext. 5577. The report is also available online at *www.ambest.com/ratings/methodology.html.*

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

these assets will be as follows:

Guaranteed Low-Income Housing Tax Credits	0.6%
Nonguaranteed Low-Income Housing Tax Credits	6.0%

Write-In Assets. A.M. Best's 2007 BCAR model also will include risk charges for "write-in" assets – both invested and non-invested – as well as admitted portions of furniture, equipment and electronic data processing assets. The risk charge for the aforementioned assets is 10%. Although corporate-owned life insurance (COLI) policies typically are reported as write-in invested assets, the 0.8% charge (implemented in 2006) will be maintained. In addition, a 5% risk charge will be applied to health-care receivables, including receivables for uninsured plans. These changes bring the Life/Health BCAR more in line with the NAIC's RBC formula and A.M. Best's P/C BCAR.

Counterparty Risk. The current BCAR model assesses counterparty risk charges to reinsurance ceded reserves and reinsurance recoverable. In the past, these charges were subject to an SOR factor based on the size of a company's invested asset portfolio. Commencing with the 2007 model, the SOR factor will not be applied to reinsurance counterparty risk charges. However, A.M. Best is concerned with companies that may have high dependence on reinsurance. The revised Life/Health BCAR will capture reinsurance dependency using a reinsurance leverage ratio. The reinsurance leverage ratio is defined as the reinsurance ceded reserves and recoverables divided by capital and surplus. The base reinsurance counterparty risk charge (currently 0.80%) will be increased for companies having a reinsurance leverage ratio of 500% or more. **Exhibit 2** illustrates the counterparty risk charges that will be applied to facilitate consistency with the P/C BCAR.

Exhibit 2
Reinsurance Dependency

Reinsurance Leverage Ratio	Counterparty Risk Charge
Less than 500%	0.80%
500%-599%	0.90%
600%-699%	1.05%
700%-799%	1.20%
800%-899%	1.35%
900% or more	1.50%

Source: A.M. Best Co.

C-2: Mortality and Morbidity (Insurance) Risk

Accident and Health. Risk charges for certain health insurance lines of business will be modified in the 2007 BCAR model to incorporate company-specific claims experience in a manner similar to the NAIC RBC calculation. This change will apply to the following lines of business:

- Individual and Group Hospital and Major Medical
- Medicare, including Medicare+Choice
- Medicaid
- Medicare Supplement
- Medicare Part D
- Dental

The resulting net risk charges for the above lines of business will be limited to a range of 80% to 120% of the risk charges determined before applying company claims experience. A.M. Best will continue to monitor claims experience for all health insurance lines of business; this may lead to the inclusion of other lines of business in this methodology. In addition, the range of net risk charges may be modified based on future claims experience.

Workers' Compensation Carve-Out. Additionally, specific risk charges will be applied to workers' compensation carve-out premiums and reserves. Prior models included this line of business in the Other Health segment; as such, lower risk charges were assessed. The revised risk charges are as follows:

Workers' Comp Carve-Out Premiums	40.0%
Workers' Comp Carve-Out Claims	38.6%

Workers' comp carve-out business tends to be concentrated among a handful of large carriers; hence, A.M. Best does not expect this modification to have a substantial impact in aggregate.

C-3: Interest Rate/Market Risk

Interest Rate Risk. A.M. Best's BCAR model includes risk charges for interest rate risks on fixed annuities and for market risks on variable annuities. The primary product feature used in determining interest rate risk for fixed deferred annuities is the level of surrender charge protection. Annuities with market value adjustment (MVA) features in addition to surrender charge protection are assessed slightly lower capital charges in the BCAR model; however, A.M.

Best believes that surrender charge protection is the primary driver of policyholder behavior. For 2007, A.M. Best modified its Life/Health SRQ such that annuity products with MVAs are segregated by year-of-surrender charge protection, rather than based on the MVA protection period.

Market Risk. The market risk incorporated in the C-3 section of the model captures the required capital for variable annuities with living benefit guarantees under the NAIC C-3 Phase II rules, which took effect at year-end 2005. A.M. Best determines an asset-based margin to be added to each company's C-3 Phase II results. The margin depends on the risk profile of the block of business based on factors such as the level of benefits guaranteed, extreme tail risks, risk-mitigation techniques and fund mix. For 2007, A.M. Best will continue to assess an additional asset-based charge of 0.10% to low-risk companies, 0.25% to medium-risk companies and 0.50% to high-risk companies.

Starting in 2007, the model will use the post-tax, company-determined C-3 Phase II results as opposed to the pretax amount. There has been clarity from the NAIC regarding the smoothing transition adjustment allowed and how tax adjustments are handled with the smoothing adjustment. Thus, all companies now should be reporting the tax-adjusted C-3 Phase II amount on a consistent basis.

C-4: Business Risk

Contingent Commitments. BCAR will continue to reflect capital charges on contingent-type liabilities. Starting with the 2007 model, there will be capital charges assessed on contingent commitments as well as on other noncontrolled assets. Contingent commitments will include guarantees for the benefit of affiliates and commitments to joint ventures, partnerships or limited-liability companies. Risk charges applicable to contingent commitments will be 1.50%. Risk charges applicable to noncontrolled assets (securities loaned, pledged as collateral, etc.) will be assessed a risk charge of 0.50%, subject to analyst review.

Required Capital

Covariance. For year-end 2007, the covariance formula used in the BCAR calculation also will be modified to reflect the independence of risks associated with fixed-income assets and liabilities, and risks associated with equities and variable liabilities. Fixed-income C-1 asset-risk charges will be correlated with C-3 interest rate risks, and C-1 equity-type risk charges will be correlated with C-3 market risks. A.M. Best believes these changes will more accurately reflect companies' risk profiles. Again, these changes bring the Life/Health BCAR more in line with the NAIC's RBC formula and A.M. Best's P/C BCAR.

Conclusion

The above changes are intended to reflect more accurately the risks present in today's environment, as well as to facilitate consistency with regulatory capital models and other models A.M. Best uses. A.M. Best will continue to closely monitor industry experience, product trends and regulatory changes impacting the level of capital required to support life and health insurance company operations.

A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
www.ambest.com

A.M. Best Europe Ltd.
12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44) 20-7626-6264
Fax: (44) 20-7-626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.
Unit 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852)-2827-3400
Fax: (852)-2824-1833
www.ambest.com.hk