A.M. Best’s Ratings – Solidité financière des assureurs & réassureurs : évaluation & notation

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No part of this presentation amounts to sales / marketing activity and A.M. Best’s Rating Division employees are prohibited from participating in commercial discussions.

Any queries of a commercial nature should be directed to A.M. Best’s Market Development function.
Agenda

- Understanding Best’s Credit Ratings
- Best’s Rating Analysis: Rating Factors
- Updates to Credit Rating Methodology
- Q&A
Understanding Best’s Credit Ratings
About A.M. Best

Company Overview

• Established in 1899, pioneered the concept of insurer financial strength ratings in 1906

• Worldwide headquarters in New Jersey, USA. Regional centres in London, Hong Kong, Singapore and Mexico City. Representative office located in Dubai

• Specialises in insurance

• Interactive ratings coverage exceeds 3,500 companies, including 200+ captives, in over 85 countries
The rating process starts with an in-depth meeting with senior management.

Ratings are determined by committee – by majority vote.
A.M. Best’s Rating Process

• A formal rating review at least annually
• Review includes a variety of quantitative and qualitative information
• Interactive process will include one or more meetings with senior management
• Ongoing monitoring - material changes will prompt a review and can lead to a rating action
• **Financial Strength Rating (FSR)**
  – An independent opinion of an insurer’s financial strength and ability to meet its ongoing insurance policy and contract obligations

• **Long-term Issuer Credit Rating (Long-term ICR)**
  – An independent opinion of an entity’s ability to meet its ongoing senior financial obligations

• **Issue Ratings (IR)**
  – An independent opinion of credit quality assigned to issues that gauges the ability to meet the term of the obligation; an IR assigned to a specific issue is an opinion of the ability to meet the on-going financial obligations to security holders when due
### Financial Strength Rating and Issuer Credit Rating Translation

<table>
<thead>
<tr>
<th>FSR</th>
<th>ICR</th>
<th>FSR</th>
<th>ICR</th>
</tr>
</thead>
<tbody>
<tr>
<td>A++</td>
<td>aaa</td>
<td>B</td>
<td>bb+</td>
</tr>
<tr>
<td>A+</td>
<td>aa+</td>
<td>B-</td>
<td>bb-</td>
</tr>
<tr>
<td>A</td>
<td>aa</td>
<td>C++</td>
<td>b+</td>
</tr>
<tr>
<td>A-</td>
<td>a+</td>
<td>C+</td>
<td>b-</td>
</tr>
<tr>
<td>B++</td>
<td>bbb+</td>
<td>C</td>
<td>ccc+</td>
</tr>
<tr>
<td>B+</td>
<td>bbb</td>
<td>C-</td>
<td>ccc-</td>
</tr>
<tr>
<td></td>
<td>bbb-</td>
<td>D</td>
<td>c</td>
</tr>
</tbody>
</table>

**FSR** = Financial Strength Rating  
**ICR** = Long Term Issuer Credit Rating  

*Note: Scales E to NR not shown*
Rating Indicators

• **Rating Outlooks**
  – Potential movement in ratings based on current trends
  – Positive / Negative / Stable

• **Under Review**
  – Driven by a recent event or an abrupt change
  – Short-term...typically no longer than six months
  – Positive / Negative / Developing
Best’s Rating Analysis: Rating Factors
A.M. Best rating methodology – key rating factors

Insurance Company Financial Strength

- Balance Sheet Strength
- Operating Performance
- Business Profile

Enterprise Risk Management + Country Risk

Rating
Interaction of Rating Factors

Operating performance and business profile are leading indicators of future balance sheet strength

Strong operating performance builds balance sheet strength

Strong business profile drives strong and sustainable operating performance

Weak operating performance erodes balance sheet strength
Best’s Capital Adequacy Ratio (BCAR) and ERM

- **Weak Risk Management**
- **Strong Risk Management**
- **BCAR Guidelines**

<table>
<thead>
<tr>
<th>BCAR</th>
<th>Exposure to Earnings and Capital Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>High</td>
</tr>
</tbody>
</table>

BCAR Guidelines: 28 November 2016 Solidité financière des assureurs & réassureurs : évaluation & notation 15
Balance Sheet Strength

- Risk-adjusted Capitalisation as measured by Best’s Capital Adequacy Ratio (BCAR)
- Capital structure
- Financial flexibility
- Quality/soundness of reinsurance
- Adequacy of loss reserves
- Quality/diversification of assets
- Liquidity
Operating Performance

• Profitability
  – Historical
  – Prospective

• Revenue composition/quality of earnings

• Sustainability of earnings

• Ability to meet plan
Business Profile

- Market risk
- Competitive advantages
- Diversification
- Event risk
- Regulatory risk
- Management experience and objectives
Enterpris Risk Management

- ERM is the process through which insurers identify, quantify, and manage risk on an enterprise wide, holistic basis

- A.M. Best’s approach is non-prescriptive

- A company’s risk management capabilities are evaluated in light of its risk profile

- Risk management is not a box ticking exercise
Non-Rated Affiliate Analysis

- Determine if the non-rated affiliate exposes group to material risk and volatility
- Use consolidating income statement/balance sheet
  - e.g. Intercompany loans are eliminated in the consolidation
- Determine if risk is captured in parent analysis
  - If not, conduct more detailed analysis of affiliate
Typical Documentation Requests

- Audited financial statements – company and consolidated
- Strategic business plans
- Details of potential or proposed significant events
- Internal and external actuarial reviews
- Internal guidelines – Underwriting, Investment, Reserving, etc
- Details of performance and expense allocation by class of business
Key Rating Methodologies

Best’s Credit Rating Methodology

That includes:

• Risk Management and the Rating Process for Insurance Companies
• Understanding Universal BCAR
• Rating Members of Insurance Groups
• Catastrophe Analysis in A.M. Best Ratings
• Insurance Holding Company and Debt Ratings
• Equity Credit for Hybrid Securities
• Evaluating Country Risk
Best’s Credit Rating Methodology Update
Upcoming Changes to Methodology

Best’s Credit Rating Methodology is being updated

• Elements looked at will remain the same:
  – Balance sheet strength
  – Operating Performance
  – Business Profile
  – ERM

• Changes aimed at improving transparency

• Incorporating changes to Best’s Capital Adequacy Ratio (BCAR) model
The Building Block Approach

- The building blocks themselves will remain the same
- Components of the building blocks are currently being reviewed

A.M. Best’s Rating Process
• **Balance sheet strength** is now broken down into several parts
  – Rating unit balance sheet strength assessment
    – BCAR
    – Other qualitative and quantitative factors
  – Holding company impact assessment
  – Country risk impact

![Diagram showing the components of balance sheet strength assessment](diagram.png)
Summary of Changes to BCAR

• **New Calculation of BCAR**
  – Formula change
  – Difference between Available Capital and Required Capital, as a ratio to Available Capital
  – Better alignment with risk appetite/tolerance statements

• **Five scores calculated – instead of one**
  – Using Value at Risk (VaR) metric
  – VaR levels: 95%, 99%, 99.5%, 99.6%
  – VaR 99.8% also modelled but not included in balance sheet assessment
Additional Balance Sheet Factors

Country Risk

Rating Unit
Balance Sheet
Strength Assessment

Holding Company
Impact Assessment

Balance Sheet
Strength
Baseline

BCAR
Stress Tests
Liquidity
ALM
Quality of Capital
Quality of Reinsurance
Reinsurance Dependence
Appropriateness of Reinsurance Program
Fungibility of Capital
Internal Capital Models
Balance Sheet Strength Assessment

<table>
<thead>
<tr>
<th>Assessment</th>
<th>Key Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongest</td>
<td>The rating unit has the strongest BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also the strongest. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of strongest.</td>
</tr>
<tr>
<td>Very Strong</td>
<td>The rating unit has a very strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also very strong. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of very strong.</td>
</tr>
<tr>
<td>Strong</td>
<td>The rating unit has a strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also strong. It has an appropriate and diverse reinsurance program. Any additional factors are in line with an assessment of strong.</td>
</tr>
<tr>
<td>Adequate</td>
<td>The rating unit has an adequate BCAR score that has been relatively stable. Its quality of capital and ALM are adequate. It has an appropriate reinsurance program. Any additional factors are in line with an assessment of adequate.</td>
</tr>
<tr>
<td>Weak</td>
<td>The rating unit has a weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are weak. Its reinsurance program is weak. Any additional factors are in line with an assessment of weak.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>The rating unit has a very weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are very weak. Its reinsurance program is very weak. Any additional factors are in line with an assessment of very weak.</td>
</tr>
</tbody>
</table>

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.
Holding Company Impact Assessment

Country Risk

- Rating Unit
- Balance Sheet
- Strength Assessment

Holding Company Impact Assessment

- Consolidated BCAR
- Financial Leverage
- Operating Leverage
- Coverage
- Financial Flexibility/Liquidity
- Intangible Assets

Balance Sheet

- Strength
- Baseline
### Holding Company Impact Assessment

- **Financial Leverage**
  - Unadjusted / Adjusted

- **Operating Leverage**

- **Coverage**
  - Interest and Fixed-Charge Coverage

- **Financial Flexibility / Liquidity**
  - Analysis of Sources and Uses
  - Access to Capital
  - Asset Allocation / Investment Risk

- **Intangible Assets**

- **Non-Rated and / or Non-Regulated Affiliates**
### Combined Balance Sheet Strength Assessment

(Lead Rating Unit and Holding Company)

<table>
<thead>
<tr>
<th>Lead Rating Unit</th>
<th>Positive</th>
<th>Neutral</th>
<th>Negative</th>
<th>Very Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongest</td>
<td>Strongest</td>
<td>Strongest</td>
<td>Very Strong</td>
<td>Adequate</td>
</tr>
<tr>
<td>Very Strong</td>
<td>Strongest</td>
<td>Very Strong</td>
<td>Strong</td>
<td>Weak</td>
</tr>
<tr>
<td>Strong</td>
<td>Very Strong</td>
<td>Strong</td>
<td>Adequate</td>
<td>Very Weak</td>
</tr>
<tr>
<td>Adequate</td>
<td>Very Strong</td>
<td>Adequate</td>
<td>Weak</td>
<td>Very Weak</td>
</tr>
<tr>
<td>Weak</td>
<td>Strong</td>
<td>Adequate</td>
<td>Very Weak</td>
<td>Very Weak</td>
</tr>
<tr>
<td>Very Weak</td>
<td>Adequate</td>
<td>Weak</td>
<td>Very Weak</td>
<td>Very Weak</td>
</tr>
</tbody>
</table>
# Overall Balance Sheet Strength Assessment

<table>
<thead>
<tr>
<th>Country Risk Tier</th>
<th>CRT-1</th>
<th>CRT-2</th>
<th>CRT-3</th>
<th>CRT-4</th>
<th>CRT-5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strongest</strong></td>
<td>a+/a</td>
<td>a+/a</td>
<td>a/a-</td>
<td>a-/bbb+</td>
<td>bbb+/bbb</td>
</tr>
<tr>
<td><strong>Very Strong</strong></td>
<td>a/a-</td>
<td>a/a-</td>
<td>a-/bbb+</td>
<td>bbb+/bbb</td>
<td>bbb/bbb-</td>
</tr>
<tr>
<td><strong>Strong</strong></td>
<td>a-/bbb+</td>
<td>a-/bbb+</td>
<td>bbb+/bbb/bbb-</td>
<td>bbb/bbb-/bb+</td>
<td>bbb-/bb+/bb</td>
</tr>
<tr>
<td><strong>Adequate</strong></td>
<td>bbb+/bbb/bbb-</td>
<td>bbb+/bbb/bbb-</td>
<td>bbb-/bb+/bb</td>
<td>bb+/bb/bb-</td>
<td>bb-/b+/b</td>
</tr>
<tr>
<td><strong>Weak</strong></td>
<td>bb+/bb/bb-</td>
<td>bb+/bb/bb-</td>
<td>bb-/b+/b</td>
<td>b+/b/b-</td>
<td>b/b-/ccc+</td>
</tr>
<tr>
<td><strong>Very Weak</strong></td>
<td>b+ and below</td>
<td>b+ and below</td>
<td>b- and below</td>
<td>ccc+ and below</td>
<td>ccc and below</td>
</tr>
</tbody>
</table>

The Baseline Assessment

28 November 2016
The Building Block Approach – Balance Sheet Strength

- Rating unit balance sheet strength assessment
  - BCAR
  - Internal capital models
  - Other qualitative and quantitative factors

- Holding company impact

- Country risk impact
Balance Sheet Only Goes So Far

Impact of Operating Performance and Business Profile on Balance Sheet Strength

- Strong Operating Performance Builds Future Balance Sheet Strength
- Weak Operating Performance Erodes Future Balance Sheet Strength

- Strong Business Profile → Sustainable Operating Performance
- Weak Business Profile → Deteriorating Operating Performance
- Strong Business Profile → Improving Operating Performance
- Weak Business Profile → Sustained Operating Performance Weakness

Current Balance Sheet Strength vs. Future Balance Sheet Strength over Time
## Operating Performance

<table>
<thead>
<tr>
<th>Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Underwriting performance</td>
</tr>
<tr>
<td>Investment performance</td>
</tr>
<tr>
<td>Total operating earnings</td>
</tr>
<tr>
<td>Prospective financial forecasts</td>
</tr>
<tr>
<td>Other considerations</td>
</tr>
<tr>
<td>Unique to LOB, region of operation, structure</td>
</tr>
</tbody>
</table>
Operating Performance

Benchmarks

• Benchmarks ensure operating performance metrics for each insurer are being evaluated in proper framework
• Can be created using:
  – Industry composites/sub-composites
  – ICR composites
  – Other customized parameters
• May be appropriate to compare a rating against >1 benchmark
• Rating Committee has flexibility in determining the appropriate benchmark(s) for each rating unit
• Various insurance organizational types will have differing benchmarking metrics
Baseline Adjusted for Performance

Depending on a company’s operating performance, the baseline can be adjusted up or down

- Using appropriate benchmark
- Looking at level, trend and volatility

<table>
<thead>
<tr>
<th>Operating Performance Assessment</th>
<th>Adjustment (Notches)</th>
<th>Key Operating Performance Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Strong</td>
<td>+2</td>
<td>Historical operating performance is exceptionally strong and consistent. Trends are positive and prospective operating performance is expected to be exceptionally strong. Volatility of key metrics is low.</td>
</tr>
<tr>
<td>Strong</td>
<td>+1</td>
<td>Historical operating performance is strong and consistent. Trends are neutral / slightly positive and prospective operating performance is expected to be strong. Volatility of key metrics is low to moderate.</td>
</tr>
<tr>
<td>Adequate</td>
<td>0</td>
<td>Historical operating performance and trends are neutral. Prospective operating performance is expected to be neutral. Volatility of key metrics is moderate.</td>
</tr>
<tr>
<td>Weak</td>
<td>-1</td>
<td>Historical operating performance is poor. Trends are neutral / slightly negative and prospective operating performance is expected to be poor. Volatility of key metrics is high.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>-2/3</td>
<td>Historical operating performance is very poor. Trends are negative and prospective operating performance is expected to be very poor. Volatility of key metrics is high.</td>
</tr>
</tbody>
</table>

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.
Review key areas including:

<table>
<thead>
<tr>
<th>Sub-Assessment</th>
<th>Positive</th>
<th>Neutral</th>
<th>Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product/Geographic Concentration</td>
<td>Significant diversification of product line /geographies</td>
<td>Moderate diversification of product lines / geographies</td>
<td>Insufficient diversification of product lines / geographies</td>
</tr>
<tr>
<td>Market Position</td>
<td>Increase profitable market share at a sustainable rate</td>
<td>Sustain profitable market share</td>
<td>Unable to sustain profitable market share</td>
</tr>
<tr>
<td>Pricing Sophistication &amp; Data Quality</td>
<td>Provides Competitive Advantage</td>
<td>No Competitive Advantage/Disadv.</td>
<td>Lack of sophistication creates disadvantage</td>
</tr>
<tr>
<td>Product Risk</td>
<td>Low Risk Offerings</td>
<td>Average Risk Offerings</td>
<td>High Risk Offerings</td>
</tr>
<tr>
<td>Degree of Competition</td>
<td>Low Competition</td>
<td>Average Competition</td>
<td>High Competition</td>
</tr>
<tr>
<td>Management Quality</td>
<td>Consistently achieves forecasts &amp; targets</td>
<td>Occasionally falls short of forecasts &amp; targets</td>
<td>Provides unreliable forecasts &amp; targets</td>
</tr>
<tr>
<td>Regulatory, Event &amp; Market Risks</td>
<td>Very Low or Significantly Reduced</td>
<td>Moderate and Stable</td>
<td>Very High or Significantly Increased</td>
</tr>
<tr>
<td>Distribution Channels</td>
<td>Created a significant competitive advantage thru distribution channels</td>
<td>Has not created a significant competitive advantage thru distribution channels</td>
<td>Faces a significant competitive disadvantage with regards to distribution</td>
</tr>
</tbody>
</table>
Baseline Adjusted for Profile

- Sub-assessments are qualitatively combined by analyst into a single business profile assessment
- Ultimate “weights” of each sub-assessment will vary depending on which metrics will have biggest impact on future financial strength

<table>
<thead>
<tr>
<th>Business Profile Assessment</th>
<th>Adjustment (Notches)</th>
<th>Key Characteristics of Business Profile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Favorable</td>
<td>+2</td>
<td>The company's market leadership position is unquestionable, demonstrated, and defensible with high brand recognition. Distribution is seen as a competitive advantage; business lines are non-correlated and generally lower risk. Its management capabilities and data management are very strong.</td>
</tr>
<tr>
<td>Favorable</td>
<td>+1</td>
<td>The company is a market leader with strong business trends and good control over distribution. It has diversified operations in key markets that have high to moderate barriers to entry with low competition. It has a strong management team that is able to meet projections and utilize data effectively.</td>
</tr>
<tr>
<td>Neutral</td>
<td>0</td>
<td>The company is not a market leader, but is viewed as competitive in chosen markets. It has some concentration and / or limited control of distribution. It has moderate product risk but limited severity and frequency of loss. Its use of technology is evolving and its business spread of risk is adequate.</td>
</tr>
<tr>
<td>Limited</td>
<td>-1</td>
<td>The company has a lack of diversification in geographic and / or product lines; its control over distribution is limited and undifferentiated. It faces high / increasing competition with low barriers to entry and elevated product risk. Management is unable to utilize data effectively or consistently in business decisions.</td>
</tr>
<tr>
<td>Very Limited</td>
<td>-2</td>
<td>The company faces high competition and low barriers to entry. It has high concentration in commodity or higher-risk products with very limited geographic diversity. It has weak data management. Country risk may factor into its elevated business profile risks.</td>
</tr>
</tbody>
</table>

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.
Risk Categories:

- Product & Underwriting
- Reserving
- Concentration
- Liquidity & Capital Management
- Reinsurance
- Investment
- Legislative/Regulatory/Judicial/Economic
- Operational
Baseline Adjusted for ERM

- Analyst assessment of the overall risk management framework that is in place
- Analyst assessment of the rating unit’s risk profile relative to its risk management capabilities
- Overall assessment of ERM
  - Evidence of use test, process changes
  - Performance under stressed environments

<table>
<thead>
<tr>
<th>ERM Assessment</th>
<th>Adjustment (Notches)</th>
<th>Key Characteristics of ERM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Strong</td>
<td>+1</td>
<td>The insurer’s ERM framework is sophisticated, time/stress tested and embedded across the enterprise. Risk management capabilities are excellent and are suitable for the risk profile of the company.</td>
</tr>
<tr>
<td>Adequate</td>
<td>0</td>
<td>The insurer’s ERM framework is well developed and is adequate given the size and complexity of its operations. Risk management capabilities are good and are adequate for the risk profile of the company.</td>
</tr>
<tr>
<td>Weak</td>
<td>-1/2</td>
<td>The insurer’s ERM framework is emerging and management is still developing formal risk protocols. Risk management capabilities are insufficient given the risk profile of the company.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>-3/4</td>
<td>There is limited evidence of a formal ERM framework in place. Risk management capabilities contain severe deficiencies relative to the risk profile of the company.</td>
</tr>
</tbody>
</table>

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.
Comprehensive Adjustment

• Evaluation of key rating factors includes parameters which place limits on any one factor
• Recognises a truly uncommon strength/weakness that is not captured through the rating process

<table>
<thead>
<tr>
<th>Comprehensive Adjustment</th>
<th>Adjustment (Notches)</th>
<th>Key Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>+1</td>
<td>The company has uncommon strengths that exceed what has been captured throughout the rating process.</td>
</tr>
<tr>
<td>None</td>
<td>0</td>
<td>The company's strengths and weaknesses have been accurately captured throughout the rating process.</td>
</tr>
<tr>
<td>Negative</td>
<td>-1</td>
<td>The company has uncommon weaknesses that exceed what has been captured throughout the rating process.</td>
</tr>
</tbody>
</table>
Rating Lift/Drag

- A non-lead rating unit may be eligible for rating lift based on benefits it receives from being affiliated with the lead rating unit.
- Rating drag can also occur from negative impact of the lead rating unit on the non-lead unit.

<table>
<thead>
<tr>
<th>Rating Enhancement/Drag</th>
<th>Adjustment (Notches)</th>
<th>Key Characteristics of Rating Enhancement/Drag</th>
</tr>
</thead>
<tbody>
<tr>
<td>Typical Lift</td>
<td>+1 to +4</td>
<td>The non-lead rating unit either receives explicit support from the broader organization or is deemed materially important within the broader organization as demonstrated by its level of integration.</td>
</tr>
<tr>
<td>Neutral</td>
<td>0</td>
<td>The non-lead rating unit does not have explicit support from the broader organization and is not considered materially important within the organization.</td>
</tr>
<tr>
<td>Typical Drag</td>
<td>-1 to -4</td>
<td>The non-lead rating unit is negatively impacted by its association with the weaker affiliates of the broader organization.</td>
</tr>
</tbody>
</table>
A.M. Best’s Rating Process – Worked Example

Rating recommendation of “a”
Rating Implications

• BCRM is NOT a means to change ratings although some ratings may change

• Analyst will communicate any potential rating issues to rated companies as they become apparent during comment period

• Ratings impacted will be placed under review at end of comment period
  – Need to be resolved within 6 months after under review
### Rating Methodology 2017

- **Released for initial comment period on March 10th, 2016**
  - *Understanding BCAR for U.S. Property/Casualty Insurers*
  - *Best’s Credit Rating Methodology*

- **Comment period ended June 30th, 2016**

- **Release of criteria update for further comment on November 14th, 2016:**
  - Revised *Understanding BCAR for U.S. Property/Casualty Insurers* draft
  - Revised *Best’s Credit Rating Methodology*
  - Initial draft of *Understanding BCAR for U.S. and Canadian Life/Health Insurers*
  - Initial draft of *Understanding Universal BCAR*

- **Link to methodologies:** [http://www3.ambest.com/ambv/ratingmethodology/](http://www3.ambest.com/ambv/ratingmethodology/)
Q&A

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