

June 15, 2015

Best's Credit Rating Methodology: Global Life and Non-Life Insurance Edition

I. Introduction

Purpose of Document

Best's Credit Rating Methodology provides a comprehensive explanation of A.M. Best's rating process, including the specific rating criteria employed by A.M. Best in determining Best's Credit Ratings. These include Best's Financial Strength, Issuer Credit and Issue Credit Ratings within the insurance industry. This document describes the rating process in detail, from the types of information typically gathered and reviewed to the key financial metrics and qualitative factors considered in the analytical process.

Given its extensive knowledge of the insurance industry, A.M. Best utilizes a broad and deep portfolio of both quantitative and qualitative measures to analyze rated organizations. These measures and the rating processes are reviewed regularly and enhanced through a formal criteria review process. Processes have been developed to ensure that A.M. Best continuously uses credit rating methodology that is rigorous, systematic and, where possible, results in ratings that can be subject to some form of objective validation based on historical experience.

Best's Credit Rating Process

The foundation of A.M. Best's rating process is an ongoing dialogue with the rated company's management, which is facilitated by A.M. Best's primary credit analysts. Each rated entity is assigned to a primary analyst, who works with a senior member of the team. The primary analyst is charged with managing the ongoing relationship with company management and performing the fundamental credit analysis prescribed in A.M. Best's rating criteria. It is the primary analyst's responsibility to monitor the financial and nonfinancial results and significant developments for each rated entity in his/her portfolio. A rating evaluation can be considered any time A.M. Best becomes aware of a significant development, regardless of the annual review cycle.

This ongoing monitoring and dialogue with management occurs through formal annual rating meetings, as well as interim discussions on key trends and emerging issues as needed. Management meetings afford A.M. Best's analysts the opportunity to review with the company factors that may affect its rating, including strategic goals, financial objectives and management practices. It is during these meetings that a company typically will share information that may be extremely sensitive or proprietary in nature.

The dialogue with management continues throughout the rating process, which is described in more detail below.

1. Compile Information. The rating assessment begins with the compilation of detailed public and proprietary financial information, including annual and quarterly financial statements, regulatory filings, certified actuarial and loss-reserve reports, investment detail and guidelines, reinsurance transactions, annual business plans and Best's Supplemental Rating Questionnaire. The primary credit analyst uses this information to develop a tailored meeting

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SR-2012-399a



agenda for the annual rating meeting. The annual meeting is a key source of quantitative and qualitative information.

2. Perform Analysis. A.M. Best's analytical process incorporates a host of quantitative and qualitative measures that evaluate various sources of risk to an organization's financial health, including underwriting, credit, interest rate, country and market risks, as well as economic and regulatory factors. The analysis includes comparisons with peers, industry standards and proprietary benchmarks, as well as assessments of operating plans, philosophy, management, risk appetite, and the implicit or explicit support of a parent or affiliate.

3. Determine Best's Rating. An initial rating recommendation is developed based on the analytical process outlined above. Each rating recommendation is reviewed and modified, as appropriate, through a rigorous committee process that involves A.M. Best's analysts and senior rating officers who possess relevant expertise. This committee approach ensures consistency of ratings across different business segments and markets, and maintains the integrity of the rating process and methodology. The final rating outcome is determined by one or more rating committees after a robust discussion of the pertinent rating issues and financial data.

Before public dissemination, the rating outcome is communicated to the company to which it is being assigned. A.M. Best reserves the right to release a Rating Action at any time, at its sole discretion (except where prohibited by law). The rated entity, or entity seeking a rating, may be permitted an opportunity to appeal a rating committee determination.

4. Disseminate Best's Rating. The primary distribution for the public dissemination of Best's Credit Ratings is the A.M. Best's website, which in some cases may be republished by a press release. The notification of a rating committee determination to the requesting party serves as the private rating opinion dissemination.

5. Monitor Best's Rating. Once a Best's Credit Rating is disseminated on a public or private basis, A.M. Best monitors and updates the rating by regularly analyzing the company's creditworthiness. A.M. Best analysts continually monitor current developments (e.g., financial statements, public documents, news events) to evaluate the potential impact on a company's rating. Significant developments can result in an interim rating evaluation, as well as modification of the rating or outlook. The primary analyst typically will initiate an evaluation of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action.

Information Requirements

The primary source of information is each company's annual and quarterly (if available) financial statements, as filed with the regulatory agency of the state, province, territory or country in which the company is domiciled. Other sources of information include, but are not limited to: interim management reports on emerging issues; supplemental information requested by A.M. Best; information provided through the annual rating meeting and other discussions with management; and information available in the public domain.

A.M. Best expects all information submitted by a company to be accurate and complete. Information provided by a company during a rating meeting, or other interim discussions, may be extremely sensitive and/or proprietary. A.M. Best analysts are held to the highest standards of ethical and professional conduct in handling such information. A.M. Best has established policies and procedures to prevent unauthorized disclosure of confidential information and ratings before

their release. A.M. Best allows the use of confidential information only for purposes related to its rating activities or in accordance with any confidentiality agreements with the rated company.

Requested Data Items: Property/Casualty & Life/Health Insurance Companies

1. Annual Reports (Latest Five Years)
2. Audited Financial Statement(s) – Consolidated and Parent Only (Annually)
3. Actuarial Report(s), Both Internal and External, When Available (Annually)
4. Organizational Structure for Parent and Subsidiaries
5. Management Structure, Board of Directors and Key Executive Committees
6. Biographical Information on Principal Officers
7. Strategic Business Plans/Five-Year Projections (Assumptions)/Ownership/
Capital Resources
8. Capital Management Strategies/Investor/Sponsor Strategy
9. Enterprise Risk Management Strategies
10. Competitive Advantages/Disadvantages
11. Completed Best's Supplemental Rating Questionnaire (SRQ) (Annually)
12. Reinsurance Contracts
13. Catastrophe Management Strategies (P/C Companies Only)
14. Key Distribution Partners
15. Company's Investment Guidelines
16. Any Other Information Believed to Be Relevant to the Rating Process

Advance notification, including background information, of significant transactions should be provided to the primary credit analyst. This gives the analyst, and A.M. Best's rating committees, an opportunity to evaluate the impact of the transaction on the company's operations, and to render a rating decision in a timely manner, if appropriate. All nonpublic information is considered proprietary, and A.M. Best will hold it in strictest confidence.

Overview of Best's Credit Rating Evaluation

The primary objective of Best's Credit Ratings within the insurance segment is to provide an opinion of the rated entity's ability to meet its senior financial obligations, which for an operating insurance company are its ongoing insurance policy and contract obligations. The assignment of a Best's Credit Rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance, business profile and enterprise risk management, as compared with A.M. Best's quantitative and qualitative standards.

In determining a company's ability to meet its current and ongoing obligations, the most important area to evaluate is its balance sheet strength, since it is the foundation for financial security. Balance sheet strength measures the exposure of a company's equity or surplus to volatility based on its operating and financial practices, and can reflect its capital-generation capabilities resulting from quality of earnings. One of the primary tools used to evaluate an insurer's balance sheet strength is Best's Capital Adequacy Ratio (BCAR), which provides a quantitative measure of the risks inherent in a company's investment and insurance profile, relative to its risk-adjusted capital. A.M. Best's analysis of the balance sheet also encompasses a thorough review of various financial tests and ratios over five-year and in some cases 10-year periods.

The assessment of balance sheet strength includes an analysis of an organization's regulatory filings at the operating insurance company, holding company and consolidated levels. To assess the financial strength and financial flexibility of a rated entity, a variety of balance sheet, income statement and cash-flow metrics are reviewed, including corporate capital structure,

financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical sources and uses of capital.

While balance sheet strength is the foundation for financial security, it provides an assessment of capital adequacy at a point in time. A.M. Best views operating performance and business profile as leading indicators when measuring future balance sheet strength and long-term financial stability.

The term “future” is the key, since ratings are prospective and go well beyond a “static” balance sheet view. Profitability is the engine that ultimately drives capital, and looking out into the future enables the analyst to gauge a company’s ability to preserve and/or generate new capital over time. In many respects, what determines the relative strength or weakness of a company’s operating performance is a combination of its business profile and its ability to effectively execute its strategy.

A company exhibiting strong performance over time will generate earnings sufficient to maintain a prudent level of risk-adjusted capital and optimize stakeholder value. Strong performers are those companies whose earnings are relatively consistent and deemed to be sustainable. Companies with a stable track record and better than average earnings power may receive higher ratings and have lower risk-adjusted capital relative to their peers.

On the other hand, companies that have demonstrated weaknesses in their earnings – through either consistent losses or volatility – are more likely to struggle to maintain or improve capital in the future. For these reasons, these companies typically are rated lower than their counterparts that perform well and usually are held to higher than minimum capital guidelines to minimize the chance of being downgraded if established trends were to continue.

A.M. Best believes that risk enterprise management is the common thread that links balance sheet strength, operating performance and business profile. Risk management fundamentals can be found in the strategic decision-making process used by a company to define its business profile, and in the various financial management practices and operating elements of an insurer that dictate the sustainability of its operating performance and, ultimately, its exposure to capital volatility. As such, if a company is practicing sound risk management and executing its strategy effectively, then it will preserve and build its balance sheet strength and perform successfully over the long term – both key elements of A.M. Best’s ratings and the evaluation of risk management.

Assumptions & Macroeconomic Factors

Based on historical experience and A.M. Best’s transition studies, ratings typically move no more than one to two notches when rating action occurs. However, market influences, including macroeconomic conditions, interest rate movements, inflationary levels, volatility of capital markets, pricing levels and regulatory changes, could result in larger scale movement in the ratings.

Economic

A.M. Best factors the economic and financial system conditions of a country into all of its ratings. A.M. Best defines country risk as the risk that country-specific factors could adversely affect an insurer’s ability to meet its financial obligations, and separates the risks into three main categories: economic risk, political risk and financial system risk.

Economic risk is the likelihood that fundamental weaknesses in a country's economy will cause adverse developments for an insurer. A.M. Best's assessment of economic risk evaluates the state of the domestic economy, labor market conditions, inflation levels and volatility, as well as prospects for growth and stability. The level of economic risk in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

Financial system risk is separated into two parts, insurance risk and non-insurance financial system risk. Non-insurance financial system risk is the risk that financial volatility may erupt because of inadequate reporting standards, weak banking systems or asset markets, or poor regulatory structure. Non-insurance financial system risk considers a country's banking system, accounting standards and government finances, and it assesses how vulnerable the financial system is to external or internal volatility. Included in this analysis are the performances of banks, equity indices and fixed-income securities, as well as an assessment of the depth and volatility of the country's capital markets. Insurance risk is the risk that the insurance industry's levels of development and public awareness; transparency and effectiveness of regulation; reporting standards; and regulatory sophistication will contribute to a volatile financial system and compromise an insurer's ability to pay claims. The level of financial system risk (combining insurance and non-insurance financial system risk) in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

Political risk is the likelihood that governmental or bureaucratic inefficiencies, societal tensions, an inadequate legal system or international tensions will cause adverse developments for an insurer. Political risk comprises the stability of a government and society; the effectiveness of international diplomatic relationships; the reliability and integrity of the legal system and business infrastructure; the efficiency of the government bureaucracy; and the appropriateness and effectiveness of the government's economic policies. The level of political risk in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

The scores for each category of risk are then aggregated and the country is assigned to one of five Country Risk Tiers with the following broad definitions.

- CRT-1: Predictable and transparent political environment, legal system and business infrastructure; sophisticated financial system regulation with deep capital markets; mature insurance industry framework.
- CRT-2: Predictable and transparent political environment, legal system and business infrastructure; sufficient financial system regulation; mature insurance industry framework.
- CRT-3: Developing political environment, legal system and business infrastructure with developing capital markets; developing insurance regulatory structure.
- CRT-4: Relatively unpredictable and nontransparent political, legal and business environment with underdeveloped capital markets; partially to fully inadequate regulatory structure.
- CRT-5: Unpredictable and opaque political, legal and business environment with limited or nonexistent capital markets; low human development and social instability; nascent insurance industry.

In general, as country risk increases (measured by a higher assigned tier), the distribution of ratings migrates down the rating scale as the level of risk approaches CRT-5. While potential volatility already

is contemplated in each Country Risk Tier, unanticipated negative changes to the economic, political and/or financial system conditions could lead to downward pressure on ratings in that country.

Underwriting & Pricing

Reserve Adequacy:

Based on A.M. Best's internal analysis, overall loss and loss-adjustment expense reserves currently are weakening, particularly in longer tail lines of business. As such, A.M. Best's assumption begins with a modest reserve deficiency for ratings that fall into CRT-1 and CRT-2 tiers. For ratings associated with tiers CRT-3, CRT-4 and CRT-5, additional deficiency is applied in the evaluation of reserves. Deficiency levels can be adjusted based on individual company experience and third-party actuarial reviews.

Pricing Expectations:

A.M. Best expects modest improvement in pricing to continue across most markets, with more hardening expected in catastrophe-impacted lines of business. Competition remains above average, which continues to place pressure on rates and reserve adequacy. Local market conditions and actual underwriting experience in a given market are considered in the pricing expectations based on where a specific company operates.

Mortality Risk:

Mortality has been improving globally for the past 20 years as life expectancy has lengthened steadily. A.M. Best expects the increase in life expectancy to moderate over time, based on the influence of potential health concerns. There is no expectation of a pandemic.

Morbidity Risk Expectations:

Medical loss trends have moderated in recent years, and A.M. Best expects this trend to continue over the next 12 months. Local market data are considered in the analysis when available.

Other Factors

Regulatory Changes:

While regulatory changes are not directly tied to the economy, changes may be necessary in response to other factors such as pricing levels and underwriting results. Regulatory changes typically impact selected lines and markets.

Catastrophe Risks:

Recent above-average catastrophe trends are expected to continue over the next 12 months. As a starting point, catastrophe modeling output is utilized in the rating process. A.M. Best assumes appropriate data quality is utilized in management's analysis of exposures. Companies are expected to incorporate their catastrophe exposures into their overall risk management programs.

Best's Credit Rating Approach

A.M. Best assigns various types of Best's Credit Ratings (FSRs, ICRs, and Issue Credit Ratings) to organizations of all different shapes and sizes – from single legal-entity organizations to complex, multinational organizations with diversified insurance and non-insurance operations and multiple intermediate holding companies, all under a publicly traded or privately held ultimate holding company.

The fundamental approach for the assignment of credit ratings is to examine an organization from both the top down and the bottom up. As a result, the analysis performed incorporates an assessment of material sources of risk to the rated entity.

Exhibit 1

Translation Table

FSR	Long-Term ICR	FSR	Long-Term ICR
A++	aaa	B	bb+
	aa+		bb
A+	aa	B-	bb-
	aa-	C++	b+
A	a+		b
	a	C+	b-
A-	a-	C	ccc+
B++	bbb+		ccc
	bbb	C-	ccc-
B+	bbb-		cc
		D	c

Note: 'e/E, f/F and d are non-rating designation status. e/E and f/F are used for insurers, while d is used for non-insurers and securities
Source: A.M. Best

The top-down analysis includes the exposure to risk generated by activities at the parent/holding company, such as the potential strain on the operating entity from debt-servicing requirements related to the parent's borrowings, as well as the benefits of earnings diversification that may come from being a member of a diversified organization. For the nonrated subsidiaries, A.M. Best performs a detailed internal analysis of their risk profile and resulting effect on the rated entities within the group, including A.M. Best's judgment as to the exposure of rated entities to debt or other borrowings at the holding company level.

The bottom-up analysis focuses on an assessment of the risks generated directly by the operations of the rated entity itself, as well as any other rated affiliates. For insurers, this analysis includes an assessment of underwriting, credit, interest rate, market and other risks at the operating company level. The primary objective of this overall approach is to gain a broad understanding of the potential impact on the current and future balance sheet of the rated operating entity - both from its own operations and those of its parent and affiliates - in support of the assignment of an ICR on the rated operating entity, which is referred to as an Operating Company ICR.

The Operating Company ICR is the foundation for the Operating Company FSR (if the rated operating entity is an insurance company) and the Holding Company ICR. The Operating Company FSR is determined using the Rating Translation Table (see **Exhibit 1**), effectively converting the rating from the ICR scale to the FSR scale. If an insurer issues public debt, A.M. Best will assign a rating specific to its view of the credit quality of the debt issue. The Issue Credit Rating is established by reference to the ICR of the issuing entity. For debt issued by an operating insurance company, the rating will reflect the degree of subordination of the debt issue to the senior obligations of the insurer, typically insurance policies and contracts.

A Holding Company ICR reflects the fact that it is a discrete legal entity from the operating insurer. Since a holding company typically does not generate significant earnings independent from subsidiary operations, this legal separation from the operating company represents an added degree of risk, especially in terms of the actual or potential control a regulator may

apply to the movement of funds from an operating insurer to a holding company. Moreover, the policyholders of an operating insurer usually have seniority over creditors of the holding company. The greater degree of risk taken by senior unsecured creditors of the holding company, relative to those of the operating company, is reflected in the holding company typically being assigned a lower ICR than the operating company.

For highly rated operating companies, Holding Company ICRs usually are two or three notches lower. Farther down the rating scale, this may extend to four or five notches. Conversely, for the very strongest organizations, with diversified operations, this notching could be reduced to zero (i.e., if after taking into account the risks highlighted above, the credit profile of the holding company still was consistent with a rating of “aaa”).

Key Quantitative and Qualitative Rating Factors

The assignment of a Best’s Credit Rating involves a comprehensive quantitative and qualitative analysis of a company’s balance sheet strength, operating performance and business profile. The interpretation of quantitative measurements involves the incorporation of more qualitative considerations into the process that may impact prospective financial strength. A.M. Best’s quantitative evaluation is based on an analysis of each company’s reported financial performance, utilizing numerous financial tests and supporting data. These tests, which underlie A.M. Best’s evaluation of balance sheet strength and operating performance, vary in importance depending on a company’s characteristics.

A company’s quantitative results are compared with industry composites as established by A.M. Best. Composite standards are based on the performance of many insurance companies with comparable business mix and organizational structure. In addition, industry composite benchmarks are adjusted from time to time for systemic changes in underwriting, economic and regulatory market conditions to ensure the most effective and appropriate analysis.

Balance Sheet Strength

In determining a company’s ability to meet its current and ongoing senior obligations, the most important area to evaluate is its balance sheet strength. An analysis of a company’s underwriting, financial, operating and asset leverage is very important in assessing its overall balance sheet strength.

Balance sheet strength measures the exposure of a company’s surplus to its operating and financial practices. A highly leveraged or poorly capitalized company can show a high return on equity/surplus, but it may be exposed to a high risk of instability. Conservative leverage or capitalization enables an insurer to better withstand catastrophes; unexpected losses and adverse changes in underwriting results; fluctuating investment returns or investment losses; and changes in regulatory or economic conditions.

Underwriting leverage is generated from current premium writings, reinsurance and loss or policy reserves. A.M. Best reviews these forms of leverage to analyze changes in trends and magnitudes. To measure exposure to pricing errors in a company’s book of business, A.M. Best reviews the ratio of gross and net premiums written to capital. To measure credit exposure and dependence on reinsurance, A.M. Best reviews the credit quality of a company’s reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables-to-surplus. To measure exposure to unpaid obligations, unearned premiums and exposure to reserving errors, A.M. Best analyzes the ratio of net liabilities to surplus.

To assess whether or not a company’s underwriting leverage is prudent, A.M. Best considers a

number of factors unique to the company, including type of business written; spread of risk; quality and appropriateness of its reinsurance program; quality and diversification of assets; and adequacy of loss reserves.

A.M. Best reviews a company's financial leverage in conjunction with its underwriting leverage in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt or debt-like instruments (including financial reinsurance) may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis is conducted at both the operating company and holding company levels, if applicable.

To supplement its assessment of financial leverage, A.M. Best also reviews a company's operating leverage. A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. A.M. Best has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

A.M. Best also evaluates asset leverage, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investment portfolio and the potential impact on its balance sheet strength.

A company's underwriting, financial and asset leverage also are subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR), which calculates the net required capital to support the company's underwriting, investment and credit risks. This encompasses the exposure of its investments, assets and underwriting to adverse economic and market conditions such as a rise in interest rates, decline in the equity markets or above-normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's relative balance sheet strength compared with its operating risks. The BCAR is based on financial statements and supplemental information provided by companies. The BCAR result is an important component in determining a company's balance sheet strength. A.M. Best also views insurance groups on a consolidated basis and assigns a common BCAR result to group consolidations or multiple member companies that are linked together through intercompany pooling or reinsurance arrangements.

Capitalization Tests for Life/Health Companies

- **Change in Net Premiums Written (NPW) and Deposits:** The annual percentage change in net premiums written and deposits. This test is a measure of growth in underwriting commitments.
- **NPW and Deposits to Total Capital:** Net premiums written and deposits related to capital and surplus funds. This reflects the leverage, after reinsurance assumed and ceded, of the company's current volume of net business in relation to its capital and surplus. This test measures the company's exposure to pricing errors in its current book of business.

- **Capital and Surplus to Liabilities:** The ratio of capital and surplus to total liabilities. This test measures the relationship of capital and surplus to the company's unpaid obligations after reinsurance assumed and ceded. It reflects the extent to which the company has leveraged its capital and surplus base.
- **Surplus Relief:** The relationship of commissions and expense allowances on reinsurance ceded to capital and surplus funds.
- **Reinsurance Leverage:** The relationship of total reserves ceded plus commissions and expenses due on reinsurance ceded plus experience rating and other refunds due from reinsurers, plus amounts recoverable from reinsurers to total capital and surplus.
- **Change in Capital:** The annual percentage change in the sum of current-year capital and surplus plus voluntary investment reserves, over the prior year's sum.
- **Best's Capital Adequacy Ratio (BCAR):** The BCAR compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks.

Capitalization Tests for Property/Casualty Companies

- **Change in Net Premiums Written (NPW):** The annual percentage change in net premiums written. A company should demonstrate an ability to support controlled business growth with quality surplus growth from strong internal capital generation.
- **NPW to Policyholders' Surplus (PHS):** The ratio of net premiums written to surplus. This measures the company's exposure to pricing errors in its current book of business.
- **Net Liabilities to PHS:** The ratio of loss reserves and other liabilities to surplus. This measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss-reserve leverage, the more critically a company's solvency depends upon having and maintaining adequate reserves.
- **Net Leverage:** This ratio measures the combination of a company's net exposure to pricing errors in its current book of business and errors of estimation in its net liabilities after reinsurance, in relation to surplus.
- **Ceded Reinsurance Leverage:** This ratio measures the company's dependence upon the security provided by its reinsurers and its potential exposure to adjustments on such reinsurance.
- **Gross Leverage:** This ratio measures a company's gross exposure to pricing errors in its current book of business, to errors of estimating its liabilities, and to its reinsurers.
- **Best's Capital Adequacy Ratio (BCAR):** The BCAR compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks.

Quality and Appropriateness of Reinsurance and Other Risk Mitigation Programs

Reinsurance has an essential role in the risk-spreading process and provide insurers with varying degrees of financial stability. As a result, A.M. Best evaluates a company's reinsurance program to determine its appropriateness and credit quality. A company's reinsurance program should be appropriate relative to its risk appetite, underwriting risks and catastrophe exposures. In addition, a reinsurance program should include reinsurers of good credit quality, since in the event of a

reinsurer's failure to respond to its share of a loss, the reinsured or counterparty would have to absorb a potentially large loss in its entirety.

To be considered adequate for catastrophe protection, a program needs to protect a property/casualty company from impairment or insolvency caused by large shock losses from natural or man-made catastrophes. From those insurers exposed to a series of smaller storm losses that do not trigger recovery from a traditional catastrophe reinsurance program, an aggregate cover may be needed. Beyond spreading risk, reinsurance can enable a company to write more business than otherwise would be possible by allowing the company to leverage its surplus.

Another method of mitigating catastrophe risk is through the issuance of a catastrophe bond, which is a structured debt instrument that transfers risks associated with low-frequency/high-severity events to investors. These instruments typically incorporate either an indemnity trigger (based on an issuing company's actual loss experience) or some form of an index-based, parametric trigger (based on a predefined industry index). A.M. Best recognizes that parametric catastrophe bonds come with "basis risk" that must be considered in the ratings of the companies sponsoring the bond issues. Basis risk, in the context of catastrophe bonds, generally reflects the possibility that a catastrophe bond may not be partially or fully triggered (for covered perils) even when the sponsor of the catastrophe bond has suffered a loss. Through A.M. Best's analysis, a determination is made as to how much basis risk is inherent in a catastrophe bond, which determines how much reinsurance credit will be given to the insurance/reinsurance company that sponsors a catastrophe bond with a parametric trigger.

Sidecars are yet another way for insurers/reinsurers to mitigate risk. A sidecar is a limited-life, special-purpose reinsurance vehicle that generally provides property quota-share reinsurance exclusively to its sponsor. Sponsors of sidecars generally take reinsurance credit for transferring risks to sidecars. While some sidecars may be capitalized to full aggregate limits, others may not be adequately capitalized to absorb losses that deviate from expectations. When capitalization is inadequate, some of the risk originally assumed to be fully hedged by a sidecar ultimately may be borne by the sponsor. This risk is referred to as "tail risk." A.M. Best's analysts will assess tail risk to ensure that the sponsor of a sidecar receives appropriate reinsurance credit.

A reliable reinsurance program must consider sound risk management practices that provide the company with protection against adverse fluctuations in experience. Since these risk-transfer agreements on an underlying policy or policies indemnify the company for insurance risks, prudent evaluation of the economic impact is critical. For life/health companies, incorporating reinsurance to manage a company's financial risk that includes mortality, morbidity, lapse or surrender, expense and investment performance presents a competitive risk to a counterparty's future growth prospects and long-term viability. Therefore, the range of reinsurance must be evaluated with the company's ability to manage its growth relative to demands for life and health insurance coverages under existing economic and regulatory environments.

An insurer's ability to meet its financial obligations can become overly dependent on the performance of its reinsurers. A company also can become exposed to the state of reinsurance markets in general. A significant dependency on reinsurance can become problematic if a major reinsurer of the company becomes insolvent or disputes coverage for claims. It also can become a problem if general reinsurance rates, capacity, terms and conditions change dramatically after an industry event. The more a company depends on reinsurance, the more

vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater this dependency, the greater the scrutiny of a company's reinsurance program to determine its appropriateness, credit quality and permanency.

Adequacy of Loss/Policy Reserves

For property/casualty companies, reserves play an important role in determining the balance sheet strength and flexibility of an insurance carrier, as well as its underlying profitability. The estimation of ultimate reserve requirements is subject to uncertainty. Actuaries who certify a company's reserves typically provide management with a range within which loss and loss-adjustment expense reserves are deemed adequate. The range of reserve adequacy estimated by actuaries can be very significant. For casualty-oriented insurers, a relatively small deficiency in current reserves may have a significant impact on policyholders' surplus and, therefore, weaken its financial position.

For property/casualty companies, A.M. Best evaluates reserving trends through its proprietary loss-reserve model to measure any equity imbedded in a company's loss reserves. A.M. Best's estimate of a company's ultimate loss reserve position then is discounted to determine an economic loss reserve position. Any difference (deficiency or redundancy) between this economic reserve level and a company's carried loss-reserve level then is applied to A.M. Best's proprietary capital adequacy model (BCAR). This loss-reserve equity adjustment, which can be sizable for property/casualty insurers, enables A.M. Best to "level the playing field" within its rating evaluation and better discriminate between companies that historically have under-reserved and those that have strong loss-reserve positions.

Separately, A.M. Best also evaluates a company's ability to monitor premium adequacy and the degree of uncertainty in loss reserves. If the level of reserve uncertainty exceeds any equity in the reserves, or is considered large in relation to net income and surplus, A.M. Best will require a company to maintain a more conservative capital position (i.e., BCAR score) for its rating level. Loss-reserve uncertainty and earnings drag historically have been pronounced in the area of asbestos and environmental (A&E) exposures.

A.M. Best uses both public and nonpublic reserve and paid loss data in calculating several crude benchmarks to identify companies that may have a material exposure to A&E liabilities. A.M. Best's A&E analysis focuses on earnings and surplus drag associated with a company's potential unfunded liabilities. These unfunded liabilities are calculated relative to a company's market share of A.M. Best's industrywide estimate for total A&E costs less the company's cumulative incurred losses recognized to date. A.M. Best's initial analysis also focuses on a company's relative funding status as measured by its survival ratio (reserves to recent paid losses) against prevailing industry levels.

Key Loss Reserve Tests for Property/Casualty Companies

- **Loss and LAE Reserves to Policyholders' Surplus (PHS):** This ratio measures the trend and magnitude of loss reserves to surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer's solvency.
- **Development to PHS:** This ratio reflects the degree to which year-end surplus was either overstated or understated in each of the past several years.

Evaluating the adequacy of an insurer's reported reserves is essential to evaluating its profitability, leverage, capitalization and liquidity. Net income and policyholders' surplus are affected directly by changes in reported reserves. Reserve adequacy opinions of certified actuaries (internal and third party) supplement A.M. Best's review.

A.M. Best reviews the valuations, interest assumptions and degree of conservatism in the establishment of life, health and annuity reserves. A.M. Best also evaluates the degree of uncertainty in policy reserves, recognizing that they are only actuarial estimates of future events. If the degree of uncertainty exceeds any equity in the reserves, and is large in relation to net income and policyholders' surplus, A.M. Best's confidence declines in a company's reported profitability, liquidity and leverage (capitalization).

Quality and Diversification of Assets

The quality and diversification of assets contribute to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The higher the liquidity, diversification and/or quality of the asset portfolio, the less uncertainty there is in the value to be realized upon the sale of an asset and the lesser the likelihood of default. Therefore, a company's investment guidelines are reviewed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large, single investments that exceed 10% of a company's total capital. Companies that hold illiquid, undiversified and/or speculative assets and have a significant underwriting exposure to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions can jeopardize policyholders' surplus.

Liquidity

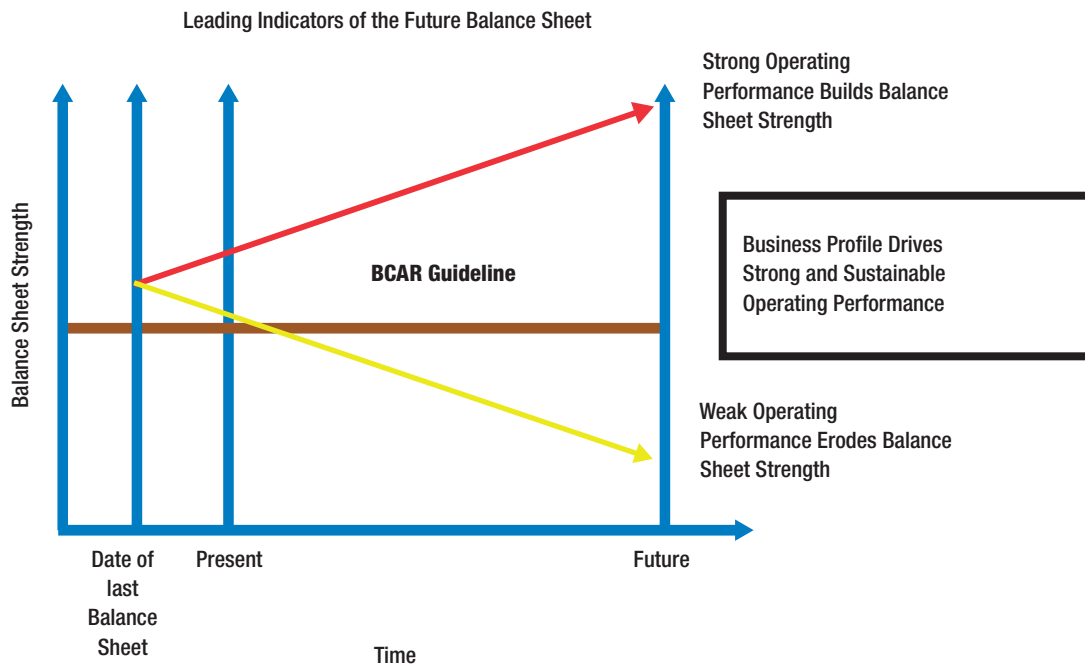
Liquidity measures a company's ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A company's liquidity depends on the degree to which it can satisfy its financial obligations, whether by holding cash and investments that are sound, diversified and liquid, or through operating cash flow. A high degree of liquidity enables an insurer to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

To measure a company's ability to satisfy its financial obligations without having to resort to selling long-term investments or affiliated assets, A.M. Best reviews a company's quick liquidity, which measures the amount of cash and marketable investments that have low exposure to price fluctuations. A.M. Best also reviews current liquidity to measure the proportion of a company's total liabilities that are covered by cash and unaffiliated invested assets. Operational and net cash flows are reviewed since they, by themselves, can meet some liquidity needs, provided cash flows are positive, large and stable relative to cash requirements. Finally, A.M. Best evaluates the quality, market value and diversification of assets, particularly the exposure of large, single investments relative to capital.

Key Liquidity Tests for Life/Health Companies

- **Quick Liquidity:** The ratio of unaffiliated quick assets to liabilities. Quick assets include cash and short-term investments and a percentage of unaffiliated common stocks and unaffiliated, public, investment-grade bonds. This test measures the proportion of liabilities covered by cash and quickly convertible investments. It indicates a company's ability to meet its maturing obligations without requiring the sale of long-term investments or the borrowing of money.
- **Current Liquidity:** The ratio of total current assets to total liabilities. This test measures the proportion of liabilities covered by cash and unaffiliated holdings, excluding mortgages and real estate.
- **Non-Investment-Grade Bonds to Capital:** The sum of non-investment-grade bonds as a percentage of capital and surplus funds. Generally, non-investment-grade bonds carry higher default and illiquidity risks.

Exhibit 2 Impact of Operating Performance and Business Profile on the Balance Sheet



Source: A.M. Best

- **Delinquent and Foreclosed Mortgages to Capital:** The sum of long-term mortgages upon which interest is overdue more than three months or in process of foreclosure and foreclosed real estate as a percentage of capital and surplus funds.
- **Mortgages and Credit Tenant Loans and Real Estate to Capital:** Mortgage loans and credit tenant loans and real estate (home office property, property held for income and property held for sale) as a percentage of capital and surplus funds.
- **Affiliated Investments to Capital:** Affiliated investments (including home office property) as a percentage of capital and surplus funds.

Key Liquidity Tests for Property/Casualty Companies

- **Quick Liquidity:** The ratio of unaffiliated quick assets to liabilities. Quick assets include cash and short-term investments and a percentage of unaffiliated common stocks and unaffiliated, public, investment-grade bonds. This test measures the proportion of liabilities covered by cash and quickly convertible investments. It indicates a company's ability to meet its maturing obligations without requiring the sale of long-term investments or the borrowing of money.
- **Current Liquidity:** The ratio of total current assets to total liabilities. This test measures the proportion of liabilities covered by cash and unaffiliated holdings, excluding mortgages and real estate.
- **Overall Liquidity:** This ratio indicates a company's ability to cover net liabilities with total assets. This ratio does not address the quality and marketability of premium balances, other receivables, affiliated investments and other assets.

- **Operating Cash Flow:** This test measures a company's ability to meet current obligations through the internal generation of funds from insurance operations. Negative balances may indicate unprofitable underwriting results or low-yielding assets.
- **Non-Investment-Grade Bonds to PHS:** This test measures exposure to non-investment-grade bonds as a percentage of surplus. Generally, non-investment-grade bonds carry higher default and illiquidity risks.

Operating Performance

Profitable insurance operations are essential for a company to operate as a going concern. For an insurer to remain viable in the marketplace, it must perpetuate a financially strong balance sheet for its policyholders. When evaluating operating performance, A.M. Best's analysis centers on the stability and sustainability of the company's sources of earnings in relation to the liabilities that the company retains.

A.M. Best reviews the components of a company's statutory earnings over the past five years to evaluate the sources of profits and the degree and trend of various profitability measures. Areas reviewed include underwriting, investments, capital gains/losses and total operating earnings, both before and after taxes. Profitability measures are distorted easily by operational changes; therefore, A.M. Best reviews the mix and trends of premium volume, investment income, net income and surplus. The structure of the company (stock vs. mutual), the length and nature of its insurance liability risks and how these elements relate to the company's operating mission also are important to evaluating profitability. The degree of volatility in a company's earnings and the impact this could have on capitalization and balance sheet strength are of particular interest to A.M. Best.

To supplement the review of profitability, A.M. Best analyzes the company's earnings under generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS) and any other regulatory or accounting reporting to understand the company's forms and measurements of profitability. This review generally extends beyond the scope of publicly traded companies, since an increasing number of nonpublic insurers also prepare, monitor and/or manage to GAAP, IFRS or other forms of accounting reporting. A.M. Best recognizes that a proper assessment of an insurer's current and prospective profitability may involve a review of multiple accounting forms and results to ascertain the true economic picture.

Key Profitability Tests for Life/Health Companies

- **Benefits Paid to NPW and Deposits:** Total benefits paid as a percentage of net premiums written and deposits. Benefits paid include death benefits; matured endowments; annuity benefits; accident and health benefits; disability and surrender benefits; group conversions; coupons and payments on supplementary contracts; interest on policy or contract funds; and other, miscellaneous benefits.
- **Commissions and Expenses to NPW and Deposits:** Commissions and expenses incurred as a percentage of net premiums written and deposits. Commissions and expenses include payments on both direct and assumed business; general insurance expenses; insurance taxes; licenses and fees; increase in loading; and other miscellaneous expenses. Excluded are commissions and expense allowances received on reinsurance ceded.
- **NOG to Total Assets:** Net operating gain (after taxes) as a percentage of the mean of current and prior-year admitted assets. This test measures insurance earnings in relation to the company's total asset base.

- **NOG to Total Revenue:** Net operating gain (after taxes) as a percentage of total revenues. This test measures insurance earnings in relation to total funds provided from operations.
- **Operating Return on Equity:** Net operating gain (after taxes) as a percentage of the mean of current and prior-year capital and surplus. This test measures insurance earnings in relation to the company's policyholders' surplus base.
- **Net Yield:** Net investment income as a percentage of mean cash and invested assets plus accrued investment income, minus borrowed money. This test does not reflect realized and unrealized capital gains or income taxes.
- **Total Return:** The net yield plus realized and unrealized capital gains and losses.

Key Profitability Tests for Property/Casualty Companies

- **Loss Ratio:** This ratio measures the company's underlying profitability, or loss experience, on its total book of business.
- **Expense Ratio:** This ratio measures the company's operational efficiency in underwriting its book of business.
- **Combined Ratio after Policyholder Dividends:** This ratio measures the company's overall underwriting profitability. A combined ratio of less than 100 indicates the company has reported an underwriting profit.
- **Operating Ratio:** The operating ratio measures a company's overall, pretax operational profitability from underwriting and investment activities. An operating ratio of less than 100 indicates a company is able to generate a profit from its core operations.
- **Pretax ROR (Return on Revenue):** This ratio measures a company's operating profitability and is calculated as pretax operating income divided by net premiums earned.
- **Yield on Invested Assets:** This ratio measures the average return on a company's invested assets before capital gains/losses and income taxes.
- **Change in PHS (Policyholders' Surplus):** This ratio measures the annual change in a company's policyholders' surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.
- **Return on PHS:** This ratio measures a company's efficiency in utilizing its surplus on a total-return basis and is calculated using the overall, after-tax profitability from underwriting and investment activities, including unrealized capital gains.

Business Profile

Business profile is a qualitative component of A.M. Best's rating evaluation that directly impacts the quantitative measures. An insurer's business profile impacts current and future operating performance and, in turn, long-term financial strength and the company's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the company's mix of business, an insurer's competitive market position, and the depth and experience of its management.

Lack of size or growth are not typically considered negative rating factors unless A.M. Best believes these issues have a negative influence on the company's prospective operating performance and balance sheet strength.

In addition, business profile issues often increase in importance at A.M. Best's highest rating levels. At the "Superior" level, insurers are expected to have strong balance sheets, solid operating performance and stable operating trends. What distinguishes these companies is the strength of their business profile, which typically translates into defensible competitive advantages.

Key Business Profile Tests

Spread of Risk: A company's book of business must be analyzed by line in terms of its geographic, product and distribution diversification. However, the size of a company, measured solely by its premium volume, cannot be used to judge its spread of risk.

For life/health companies, the mix of business must be evaluated with respect to the distribution and performance of the underlying assets, as well as a company's susceptibility to economic business cycles or regulatory pressures, such as minimum loss ratios, market conduct regulation, or financial services and health care reform initiatives.

For property/casualty companies, the geographic location and concentration of a book of business can have a great impact on its exposure to catastrophic losses, such as terrorist attacks, hurricanes, tornadoes, windstorms, hail or earthquakes. For property insurers, A.M. Best requires a company to perform some degree of natural catastrophe modeling on its book of business.

The geographic location and lines of business written by a company also determine its exposure or vulnerability to regulatory or residual market risks that exist within certain jurisdictions. In addition, the mix of business must be evaluated carefully. Because underwriting experience varies dramatically among lines of business, a company's underwriting risk profile must be reviewed, since high-risk lines with volatile loss experience can impact the financial stability of an insurer, particularly one that is poorly capitalized and/or has poor liquidity.

Revenue Composition: A by-line analysis of net premium volume is important to determine changes in the amount, type, geographic distribution, diversification and volatility of business written by a company, which can have either a beneficial or an adverse effect on its prospective profitability. Underwriting income, investment income, capital gains, asset values and, consequently, surplus can be significantly affected by external changes in economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

Competitive Market Position: Analysis of an insurer's operating strategy and competitive advantages by line is essential to assess a company's ability to respond to competitive market challenges, economic volatility and regulatory change in relation to its book of business. Defensible and sustainable competitive advantages include control over distribution; multiple distribution channels; a low cost structure; effective utilization and leveraging of technology; superior service; strong franchise recognition; a captive market of insureds; easy and inexpensive access to capital; and underwriting expertise within the book of business.

Management: The experience and depth of management are important determinants for achieving success, because the insurance business is based on an underlying foundation

of trust and fiscal responsibility. Competitive pressures within virtually every insurance market segment have amplified the importance of management's ability to develop and execute defensible strategic plans. A.M. Best's understanding of the operating objectives of a company's management team plays an important role in its qualitative evaluation of a company's current and future operating performance. This is particularly true when a company is undergoing a restructuring to address operational issues or balance sheet problems, or is actively raising capital.

Insurance Market Risk: Insurance market risk reflects the potential financial volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sphere within which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e., financial services reform, health care reform, expansion of alternative markets and integration of health care providers). Insurance market risk can be biased either positively or negatively by a number of company-specific business factors.

Event Risk: Event risk can encompass a variety of sudden or unexpected circumstances that may arise and can impact an insurer's financial strength and its Best's Rating. When a sudden or unexpected event occurs, A.M. Best evaluates the financial and market impact to the insurer. Examples include the potential for major business and distribution disruption associated with significant litigation; the potential for a "run-on-the-bank" due to a loss of policyholder/distributor confidence; economic collapse; or the enactment of significant legislation. In addition, constraints imposed by regulators in the form of mandated rate rollbacks, extraordinary assessments and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a company. Event risk may include changes in management, ownership, parental commitment or distribution; a legal ruling; or a regulatory development. Finally, event risks also can be influenced by potential regulatory or legislative reforms, economic conditions, interest rate levels and financial market performance, as well as societal changes. For international companies, as well as domestic insurers operating abroad, political climates and sovereignty risks also may have a significant bearing on event risk.

Holding Company Analysis

The analysis performed in the assignment of Best's Credit Ratings incorporates an assessment of material sources of risk to the rated entity. This includes the exposure to risk generated by activities at the parent/holding company and nonrated affiliates. Understanding the potential effect on a rated entity of the activities of the ultimate parent/holding company is key to developing a comprehensive view of the rated entity's risk profile. As a result, all ultimate parents are reviewed and analyzed to determine, at a minimum, whether the parent's activities reasonably could be expected to place a call on the capital of the rated operating company, or expose the rated entity to material risk – even in cases where the parent is assigned no public rating.

Holding companies and their associated capital structures can have a significant impact on an insurance company subsidiary's overall financial strength. Holding companies can provide subsidiaries with a level of financial flexibility, including capital infusions, access to capital markets and, in some cases, additional sources of cash flow from other operations. Likewise, debt and other securities are typically obligations of a holding company. Depending on the magnitude of such obligations, they can reduce the enterprise's financial flexibility, place a strain on future earnings and inhibit surplus growth at a subsidiary.

A.M. Best reviews both an insurer's capital structure and its holding company's capital structure to determine whether they are sound and unencumbered. This review includes an

assessment of the quality of capital with a focus on the amount, composition and amortization schedule of intangible assets, as well as the presence of surplus notes at the operating company. Integral to an insurer's rating assignment is A.M. Best's assessment of a company's ability to meet the debt service and other obligations associated with its parent's capital structure, as well as the risks that a capital structure imposes on a company.

Published by A.M. Best Rating Services, Inc.

METHODOLOGY

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Version 020116