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Financial Strength Ratings and Sovereign Credit Risk FAQ

Sovereign creditworthiness has deteriorated significantly during the most recent economic cycle, as governments have used fiscal policy extensively to stimulate their respective economies. This fiscal stimulus has predictably led to higher deficits, larger government debts and in turn higher sovereign credit risk. This document addresses frequently asked questions about A.M. Best Co.'s handling of sovereign credit issues.

Does A.M. Best rate government debt (i.e. sovereign ratings)?
No. A.M. Best specializes in insurance ratings and does not issue a ratings opinion on the creditworthiness of sovereign governments.

Does A.M. Best place a sovereign ceiling on its insurer Financial Strength Ratings (FSRs)?
No. A.M. Best does not place a cap on its FSRs based on the sovereign credit rating of the country in which the rated entity is domiciled. Not placing a ceiling on the FSR of a company is based on two concepts. Firstly, A.M. Best believes it is possible that a company can be more financially secure than the government of the country in which it is domiciled. Secondly, A.M. Best believes that a sovereign default in a given country, while clearly creating a more difficult operating environment, would not necessarily lead to an insurance company in the domicile failing to meet its policyholder obligations.

Does A.M. Best factor sovereign credit risk in its rating process?
Yes. A.M Best does incorporate sovereign credit risk in its rating process. Firstly, since insurers tend to hold a high proportion of domestic sovereign bonds, the investment position of the insurer is evaluated carefully. Risk charging of assets based on, among other things, the credit quality of the asset is included in the analytical process. In addition, the concentration of an investment portfolio is assessed to determine how exposed the insurer is to any one entity, including the sovereign.

Secondly, A.M. Best incorporates country risk into all of its ratings. A.M. Best's country risk analysis incorporates the degree of economic, political and financial system (both insurance and non-insurance) risk. The creditworthiness of a government is factored into the evaluation of country risk in a given domicile. (For more information on A.M. Best's country risk analysis, please see the methodology *Assessing Country Risk* at *http://www.ambest.com/ratings/countryrisk.html*.)

Does a change (upgrade/downgrade) in a government's sovereign credit rating change its Country Risk Tier?
Not necessarily. A.M. Best categorizes countries into one of five Country Risk Tiers (CRTs). Given that A.M. Best's view of country risk is less stratified than the standard credit market scale, it would not be possible for there to be a one-to-one correspondence between movements in CRTs and movements in sovereign credit ratings.

Sovereign credit risk is one input into the Country Risk Model. The CRT incorporates political, economic and financial system (both insurance and non-insurance) risk; and while the government's creditworthiness is factored into the model, it is only one of many indicators. In addition to the change in sovereign credit quality, the cause of the improvement/deterioration is examined, be it rising debt, a slowing economy or political upheaval. These underlying factors, which are often the basis for a decline in sovereign credit quality, are captured in the analysis and more directly influence the tier assignment.

Does a government's sovereign credit rating downgrade impact an insurer's Financial Strength Rating?
It depends. Sovereign ratings on their own are not a driver of an insurer's financial strength rating. However, as issues arise with sovereign debt, analysts identify those companies impacted by the issues, including the credit risk of the sovereign government considering any rating downgrades, potential liquidity concerns and any potential change in the operating environment of the country. Additionally, as the credit quality of sovereign debt changes, it is incorporated in the evaluation of the domicile's country risk. Beyond the worsening sovereign credit quality, the cause of the deterioration is examined be it rising debt, a slowing economy or political upheaval. The different impacts of specific company issues and overarching country risk are incorporated into the ratings process on a company-by-company basis.

Therefore, it is possible that a sovereign credit rating downgrade could lead to the downgrade of an insurer's FSR, regardless of whether it is currently rated above or below the sovereign. While a downgrade of sovereign debt does increase country risk and could impact a company's rating, most downgrades of a company rating are triggered by an increase in company-specific risks.

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