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Related Reports

Criteria:

Assessing Country Risk

A.M. Best's Ratings & the Treatment of Debt

Rating Analysts

Andrea Keenan, Managing Senior Financial Analyst

+1 (908) 439-2200 Ext. 5084

Andrea.Keenan@ambest.com

James Gillard, Senior Financial Analyst

+1 (908) 439-2200 Ext. 5818

James.Gillard@ambest.com

This criteria report was updated as part of the annual review process. No substantive changes were made to the prior edition.

This criteria report can be found at www.ambest.com/ratings/methodology

Measuring Transfer And Convertibility Risk

A.M. Best defines transfer and convertibility risk (T&C risk) as the risk that capital and exchange controls may be imposed by government authorities that would prevent or materially impede the private sector's ability to convert local currency into foreign currency and/or transfer funds to nonresident creditors.

A.M. Best assesses the T&C risk present in each of the countries in which ratings are assigned. The final result of this analysis is a T&C ceiling on the credit rating scale. Nevertheless, a T&C risk assessment is not a rating; rather, it is a factor applied to all holding company and debt ratings.

T&C risk assessments are separate and distinct from the application of country risk in the rating process. A.M. Best incorporates country risk into all of its ratings. A.M. Best's definition of country risk and its approach to country risk analysis are summarized briefly on page 3. More information on the country risk methodology, *Assessing Country Risk*, is available at www.ambest.com/ratings/methodology.

A.M. Best's approach to measuring T&C risk evaluates the likelihood that a sovereign would disrupt the ability to convert local currency into foreign currency and/or transfer funds to nonresident creditors. The base assumption is that restrictive controls would be undertaken only in the event that the sovereign was facing default. Therefore, the sovereign rating acts as a starting point for the assessment of the country's T&C risk. All other things being equal, a country with a lower sovereign rating (higher probability of default) will have higher T&C risk. However, the likelihood of a country implementing these controls in a default scenario differs, depending on the disposition of the government and the political situation.

A.M. Best employs a two-step process to calculate the T&C ceiling. The process starts with a sovereign rating and then estimates the likelihood of a government implementing currency restrictions given default. Thus, T&C ceilings are always equal to or higher than a country's sovereign rating.

Assigning a Sovereign Rating

The first step in estimating T&C risk is measuring the creditworthiness of a sovereign. A.M. Best does not assign public credit ratings to sovereign entities. However, for purposes of developing T&C ceilings, A.M. Best performs a credit assessment of the sovereign using publicly available information, including third-party assessments.

If the country's sovereign debt is rated by the other major credit rating agencies, A.M. Best assigns a composite of these sovereign ratings to the country. Each rating that is assigned publicly by each of these agencies is given equal weighting, and an average is applied. If only one agency has a rating, that is the sovereign rating used.



If the other major credit rating agencies do not rate the country's sovereign debt, A.M. Best estimates the country's creditworthiness and develops an internal sovereign assessment. That estimation is possible through use of portions of A.M. Best's Country Risk Assessment. As A.M. Best already evaluates the economic, political and financial system risk of a country, additional analysis evaluates a government's financial position. This involves, among other things, a more detailed look at the country's debt and deficit positions.

If there is inadequate information available to develop a sovereign assessment, A.M. Best is not able to assign a T&C risk assessment and therefore will not assign a rating to a holding company or debt issuance in that country.

Determining the Number of Notch Increase

Once the sovereign rating is established, a determination is made on the likelihood of a country implementing currency controls

given default. To estimate this risk, A.M. Best applies a quantitative model to provide a baseline assessment of the T&C risk and then layers on a qualitative process to determine the final T&C risk assessment.

The final result is a number of notch increase from the sovereign rating between 0 notches and 3 notches.

- A 0-notch increase implies a very high likelihood that, given default, a sovereign will implement restrictive controls.
- A 1-notch increase implies a high likelihood that, given default, a sovereign will implement restrictive controls.
- A 2-notch increase implies a moderate likelihood that, given default, a sovereign will implement restrictive controls.
- A 3-notch increase implies the least likelihood that, given default, a sovereign will implement restrictive controls.

The quantitative model is a weighted average of four components that impact the level of T&C risk in a country. The four components of the model are described below.

Degree of Capital and Trade Controls

The first category measures the degree to which the government currently uses capital, exchange and/or trade controls in the economy. This is an important measure in that it shows the government's proclivity to intervene in the economy. If a country already uses capital controls, it becomes more likely that, faced with a default, it would use increasingly restrictive controls. The indicators used in this section include the freedom to invest in financial assets, short- and long-term financial transaction risk, and the extent of trade barriers and exchange controls.

Integration in World Economy

The second category measures the degree to which the country is integrated into the global economy. A sovereign more integrated within the global economy, including but not limited to memberships in international organizations and reliance on trade, would experience higher costs of implementing these controls. The

Exhibit 1 Estimating Transfer and Convertibility Risk

The quantitative model used to estimate the probability of a country implementing these controls is described by the following equation.

$$\sqrt{((\omega_1(\text{CONT}^2))+(\omega_2(\text{GLOB}^2))+(\omega_3(\text{RL}^2))+(\omega_4(\text{INF}^2)))}$$

Where:

CONT = Degree of capital and trade controls

GLOB = Integration in world economy

RL = Rule of law

INF = Price controls and stability

ω = Weight applied to each component

Methodology

ANALYTICAL COMMUNICATIONS

Carole Ann King, Managing Senior Business Analyst

Brendan Noonan, Managing Senior Business Analyst

Carol Demyanovich, Senior Business Analyst

Joe Niedzielski, Senior Business Analyst

Laura McArdle, Business Analyst

Christopher Sharkey, Business Analyst

Thomas Dawson IV, Associate Editor

PRODUCTION SERVICES

Bette Schedin, Sr. Desktop Publishing Specialist

Country Risk

A.M. Best defines country risk as the risk that country-specific factors could adversely affect an insurer's claims-paying ability. Country risk is evaluated and factored into all A.M. Best ratings. As part of the country risk evaluation process, A.M. Best identifies the various factors within a country that may directly or indirectly affect an insurance company. In doing so, A.M. Best separates the risks into three main categories: economic risk, political risk and financial system risk. Given A.M. Best's particular focus on and expertise in the insurance industry, financial system risk is further divided into two sections: insurance risk and non-insurance financial system risk.

A.M. Best's approach to country risk analysis employs a data-driven model that scores the level of risk present in a given country, plus a qualitative assessment of country-specific conditions that affect the operating environment for an insurer. Countries are placed into one of five tiers, ranging from countries with a "CRT-1" [Country Risk Tier 1], denoting a stable environment with the least amount of risk, to "CRT-5" [Country Risk Tier 5] countries that exhibit the most risk and, therefore, offer the greatest challenge to an insurer's financial stability, strength and performance.

More complete definitions of each of the Country Risk Tiers are as follows.

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 non-transparent 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.

increased cost of these policies, all else being equal, reduces the probability that the government would use these controls. The indicators used in this section include number of memberships in world organizations; a government's attitude toward globalization; and the relative importance of import markets.

Rule of Law

The third category measures the strength and soundness of the rule of law in a country. This measure is used because fundamental respect for property rights and investor rights lessens the likelihood that a sovereign would not allow its currency to be transferred or converted. Indicators used in this section include protection of investors' rights, property rights and the degree of corruption.

Price Controls and Stability

The fourth category measures the degree to which a sovereign uses price controls and how susceptible a country is to bouts of high inflation. Price controls and high inflationary periods indicate the govern-

ment's willingness to use the price level to generate desired political outcomes. Indicators used in this section include historical perspective on high degrees of consumer price inflation and the degree to which the sovereign uses price controls.

Each category of risk is scored, squared and summed using a weighted average (see **Exhibit 1**). The result of this calculation is a score between 1 and 5. A score of 5 denotes the highest likelihood that given default, a country would institute these restrictive capital controls.

This score provides a baseline assessment. After the quantitative model is run, the results are evaluated and a final assessment is made.

Special Cases

Certain countries do not lend themselves to this standard analysis. These countries are considered special cases and analyzed separately. Below two types of special cases are described: (1) countries in monetary unions and (2) countries

that exclusively adopt another sovereign's currency.

Monetary Unions

All countries in a monetary union are grouped and analyzed collectively and assigned the same T&C ceiling. This T&C assessment is based on an analysis of the strength and stability of the monetary union and the associated currency. An example of this type of monetary union is the euro zone. While the sovereign ratings and country risk may differ among the member countries, the T&C ceiling would be the same.

Using Another Sovereign's Currency

A second type of special case is a country that uses another sovereign's currency as legal tender in lieu of using its own. A country that uses another sovereign's currency is not subject to T&C risk in the traditional sense. However, there remains the risk of a disruption to this currency system, and this risk will be reflected in the country's T&C ceiling. These countries are evaluated individually, and depending on the results of the assessment, the number of notches up from the sovereign rating may exceed the standard maximum of 3.

Results

The T&C risk assessments are monitored on a regular basis. Changes in the sovereign rating could impact the ceiling assigned, and changes in the political and economic situation could change the number of notches. These changes, under normal conditions, will be relatively slow moving. However, in a period of stress, the changes could happen quickly.

Applying T&C Ceilings

The final issue to be addressed is how the T&C risk ceilings are incorporated into A.M. Best's rating process. This section will discuss how T&C ceilings are handled for operating companies, holding

companies and debt, and then conclude with two practical examples of the application of the T&C ceiling.

Insurance Operating Companies

A.M. Best does not apply T&C ceilings to its insurer Financial Strength Ratings (FSR). The rationale for this is that an FSR is an assessment of an insurance company's ability to satisfy its policyholder claims. Typically, the majority of an insurance company's policyholder claims are denominated in the country's local currency, and therefore a T&C ceiling would not be appropriate, since there is no transfer or convertibility risk.

Also, T&C ceilings are not applied to an insurance operating company's Issuer Credit Rating (ICR). An ICR is an opinion as to the ability of the rated entity to meet its senior-most obligations. Assuming that policyholders are the senior-most creditors for insurance operating companies, the ICR for that entity would remain an assessment of the insurer's ability to pay local currency obligations. Therefore, it would not be appropriate to use a T&C ceiling on an operating company's ICR. The T&C ceiling does not affect the translation between an insurance operating company's ICR and FSR.

Holding Companies

T&C ceilings are applied to A.M. Best's Issuer Credit Ratings (ICR) on holding companies. For more information on A.M. Best's rating process for holding companies, please see *Best's Credit Rating Methodology – Global Life & Non-Life Insurance Edition* and *A.M. Best's Ratings & the Treatment of Debt*.

Debt Ratings

T&C ceilings are applied to A.M. Best's ratings of debt. For more information on A.M. Best's rating process for debt, please see *A.M. Best's Ratings & the Treatment of Debt*.

Ratings Application of T&C Risk: Hypothetical Case Studies

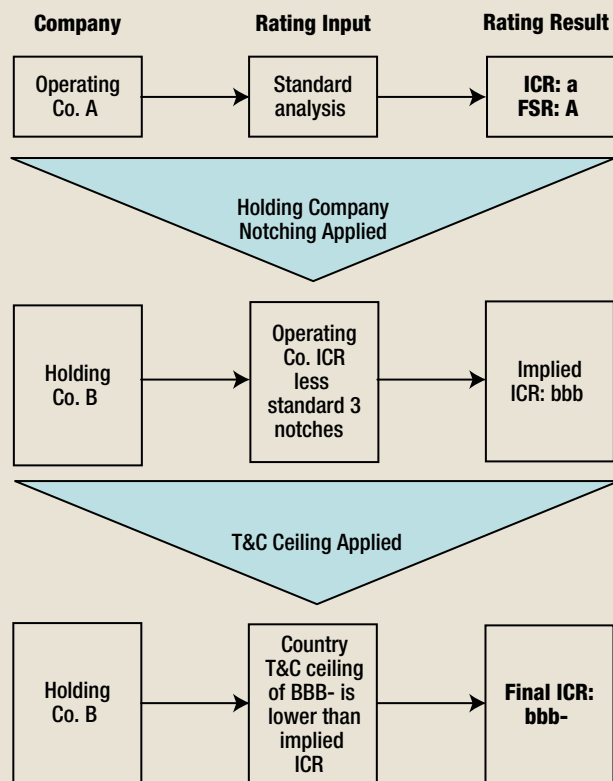
Case 1: Country with a T & C Ceiling of BBB-

Operating Company A operates in a country with a T&C ceiling of BBB-

- Operating Company A receives an “a” ICR and an “A” FSR rating
- Both of these ratings incorporated country risk, however, neither was impacted by the T&C ceiling.
- Operating Company A is owned by Holding Company B
- Typical notching from the operating company to the holding company is 3 notches, implying an ICR of “bbb”
- At this point the T&C ceiling is applied to the rating of Holding Company B and the rating is reduced to “bbb-”, which is the highest possible holding company rating in this country due to the T&C ceiling

The final ratings are:

- Operating Company A FSR = “A”
- Operating Company A ICR = “a”
- Holding Company B ICR = “bbb-”



Case 2: Country with a T & C Ceiling of BB+

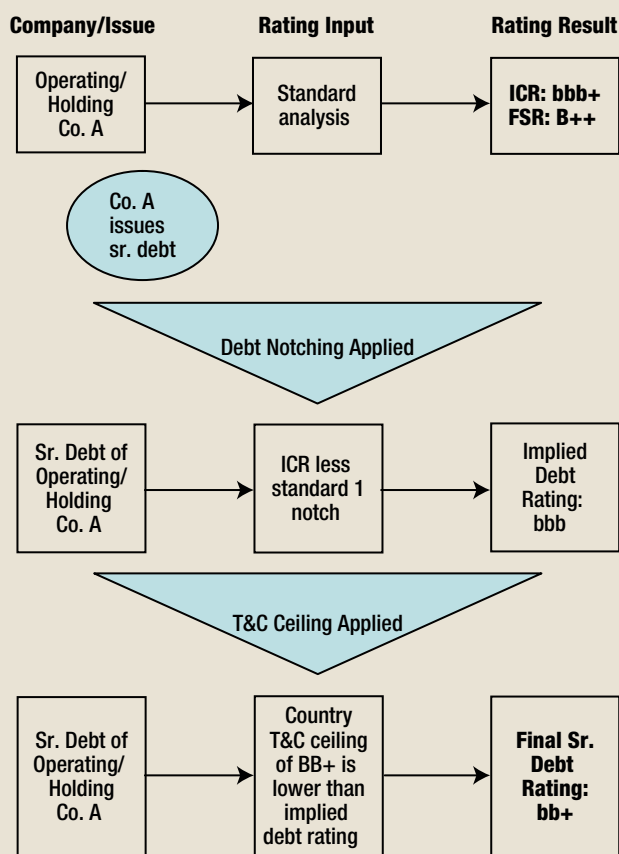
Operating/Holding Company¹ A operates in a country with a T&C ceiling of BB+

- Operating/Holding Company A receives a “bbb+” ICR and a “B++” FSR rating
- Operating/Holding Company A issues senior debt and receives standard 1 notch to senior debt implying a senior debt rating of “bbb”
- At this point the T&C ceiling is applied to the rating of the debt and the rating is moved to “bb+”

The final ratings are:

- Operating/Holding Company A FSR = “B++”
- Operating/Holding Company A ICR = “bbb+”
- Operating/Holding Company A’s senior debt rating = “bb+”

¹ In some regions, Europe for example, some groups are structured with an ultimate parent that is both a holding company and insurance operating company.



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Methodology

CHAIRMAN & PRESIDENT **Arthur Snyder III**

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A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, N.J. 08858
Phone: +1 (908) 439-2200

NEWS BUREAU
830 National Press Building
529 14th Street N.W., Washington, D.C. 20045
Phone: +1 (202) 347-3090

A.M. BEST EUROPE LTD.
12 Arthur Street, 6th Floor, London, UK EC4R9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400



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

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