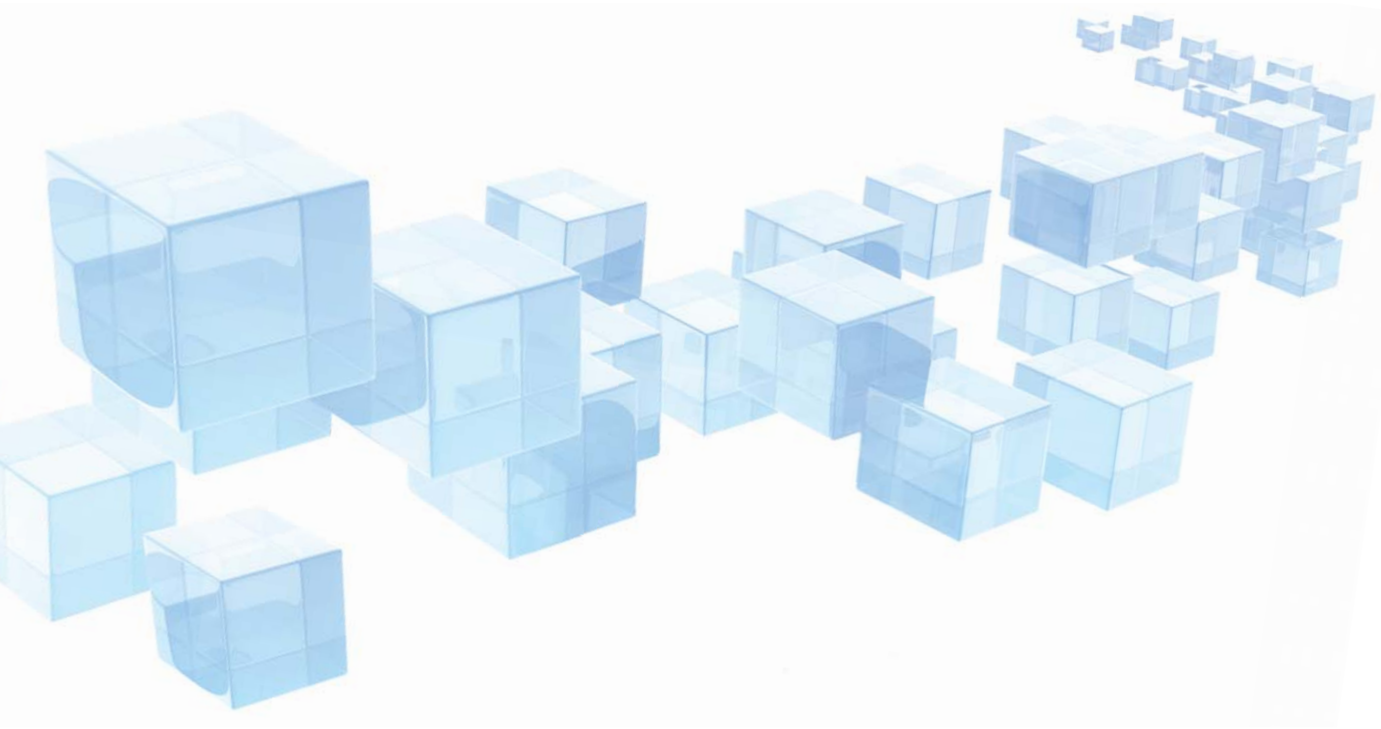
Best's Methodology and Criteria

Evaluating Country Risk

October 13, 2017



Meg Mulry: 908 439 2200 Ext. 5446
Meg.Mulry@ambest.com

Carlos Wong-Fupuy: +44 20 7 397 0287
Carlos.Wong-Fupuy@ambest.com

Stephen Irwin: 908 439 2200 Ext. 5454
Stephen.Irwin@ambest.com

Evaluating Country Risk

Outline

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of A.M. Best Rating Services' rating process.

A. Market Description

Country risk is the risk that factors specific to a country could adversely affect the ability of an insurer operating in that country to meet its financial obligations. A.M. Best evaluates and incorporates country risk into all of its insurance credit ratings, which entails identifying the various risks in a country that could directly or indirectly affect an insurance company. These risks are divided into three main categories: economic risk, political risk, and financial system risk; financial system risk is further divided into insurance risk and non-insurance financial system risk.

An evaluation of country risk is not directly comparable to a sovereign debt rating, which entails an evaluation of the ability and willingness of a government to service its debt obligations and is generally interpreted as a ceiling or cap on insurance ratings. Country risk analysis does consider the finances and policies of a sovereign government, but the final determination is not guided solely by these factors; thus, country risk evaluation is not tied to a sovereign debt rating.

A.M. Best's country risk evaluation entails both a data-driven assessment to score the level of risk in a given country and a qualitative determination of country-specific conditions affecting an insurer's operating environment. Countries are placed into one of five tiers, ranging from Country Risk Tier 1 (CRT-1), for countries with a stable environment that poses the least amount of risk, to Country Risk Tier 5 (CRT-5) for those that pose the most risk and, therefore, the greatest challenge to an insurer's financial stability, strength, and performance.

As country risk increases (as measured by a higher Country Risk Tier), the distribution of ratings generally migrates down the rating scale. This same relationship effectively applies to any significant category of risk an insurer faces, i.e., greater risk exposure will pressure financial stability. This relationship is reflected explicitly in the overall balance sheet strength assessment, as described in Best's Credit Rating Methodology.

Country Risk Tier (CRT) assignments are reviewed annually, though significant events and developments are tracked continuously and may cause an interim change to a country's tier assignment. CRTs are evaluations of the current conditions in a country, but they are designed to remain stable through the business cycle. Therefore, political and industry outlooks, as well as economic forecasts, are integrated into the analysis.

B. Elements of Country Risk

The three risk categories in A.M. Best's country risk analysis are economic risk, political risk and financial system risk. Economic risk is the risk that fundamental weaknesses in a country's economy will adversely affect an insurer. A.M. Best's assessment of economic risk takes into account the state of the domestic economy, government finances, and international transactions, as well as prospects for growth and stability.

Political risk is the risk that governmental or bureaucratic inefficiencies, societal tensions, an inadequate legal system, or international tensions will adversely affect an insurer. Political risk take into account indicators of 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.

Financial (non-insurance) system risk the risk that financial volatility may be present due to inadequate reporting standards, weak banking systems or asset markets, or poor regulatory structure which can adversely affect an insurer. This type of risk encompasses a country's banking system, accounting standards, financial market development, and government finances, as well as the financial system's vulnerability to external or internal volatility. A.M. Best's analysis references to compliance indicators with Basel II & III regimes, World Bank Insolvency Principles, and international accounting standards, as well as the performance of banks, equity indices, and fixed-income securities.

Insurance risk, a distinct subsection of financial system risk, is the risk that the level of development of a country's insurance industry, as well as public awareness, transparency and effectiveness of regulation, reporting standards, and regulatory sophistication could contribute to financial volatility and compromise an insurer's ability to pay claims. A.M. Best's assessment of insurance risk is based heavily on indicators of compliance with the Insurance Core Principles (ICP) of the International Association of Insurance Supervisors (IAIS), using a sizable subset of the 28 ICPs divided into three categories: (1) government commitment to an open and well-regulated insurance industry; (2) adequacy of supervisory authority and its supporting infrastructure; and (3) insurer accountability.

C. Calculation of Country Risk

The country risk determination begins with running a Country Risk Assessment to generate a score consisting of the weighted average for the three risk categories. The score is then squared, to represent the non-linear relationship between the score and the actual country risk in the country. **Exhibit C.1** shows how the Country Risk Score is calculated.

Exhibit C.1: Calculation of the Country Risk Score

$$CR\ Score = [\omega_E I_E + \omega_P I_P + \omega_{FS}(I_{FSi} + I_{FSni})]^2$$

Where: I_E = Economic risk
I_P = Political risk
I_{FSi} = Financial system risk (insurance component)
I_{FSni} = Financial system risk (non-insurance component)
ω = Weight applied to each category of risk

In special circumstances—for instance, for a domicile with a particularly strong relationship with another (such as Guernsey and the United Kingdom)—the Country Risk score incorporates the influence of the larger domicile.

The country risk score provides a baseline assessment. A higher country risk score indicates a riskier environment, and a lower country risk score, a less risky environment. However, the Country Risk Group also evaluates additional qualitative factors that could influence the overall score or one particular category of risk.

D. Country Risk Tiers

The assignment of CRTs to score ranges is based on the concept that a country's risk can be categorized loosely to provide a basis of comparison, provided that differences among countries are acknowledged. Therefore, CRTs can be classified, in a typical scenario, by the following:

CRT-1: The country is characterized by a predictable and transparent political environment, legal system and business infrastructure, a sophisticated financial system regulation with deep capital markets, and a mature insurance industry.

CRT-2: The country is characterized by a predictable and transparent political environment, legal system and business infrastructure, sufficient financial system regulation, and a mature insurance industry.

CRT-3: The country is characterized by a developing political environment, legal system, business infrastructure, capital market, and insurance regulatory structure.

CRT-4: The country is characterized by a relatively unpredictable and political, legal, and business environment, with an underdeveloped capital market, and a partially to fully inadequate insurance regulatory structure.

CRT-5: The country is characterized by an unpredictable and opaque political, legal, and business environment, with weak rule of law, lower human development and social instability, a limited, illiquid, or nonexistent capital market, and a nascent insurance industry.

Exhibit D.1: Components of Country Risk

E. Annual and Event-Driven Reviews

Each CRT is reviewed annually, although the Country Risk Group continually monitors world events and developments and assesses their potential impact on tier assignments. This process is facilitated by a country watch list, which identifies nations experiencing a significant increase in economic, political, or financial volatility that have the potential to impact a country's CRT.

Moving up or down the scale outside the annual review cycle is unusual, as the CRTs are designed to remain stable through the business cycle. Recent developments are factored into the analysis of country risk, but they are seldom significant enough to warrant an off-cycle change in the tier assignment. CRT changes are thus infrequent. However, in the event of a change in the CRT, ratings on the companies domiciled in that country will be subject to review.

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

METHODOLOGY

A.M. Best Rating Services, Inc.
Oldwick, NJ
CHAIRMAN & PRESIDENT **Larry G. Mayewski**
EXECUTIVE VICE PRESIDENT **Matthew C. Mosher**
SENIOR MANAGING DIRECTORS **Douglas A. Collett, Edward H. Easop, Stefan W. Holzberger, James F. Snee**

WORLD HEADQUARTERS
1 Ambest Road,
Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
Paseo de la Reforma 412,
Piso 23,
Mexico City, Mexico
Phone: +52 55 1102 2720

LONDON
12 Arthur Street, 6th Floor,
London, UK EC4R 9AB
Phone: +44 20 7626 6264

DUBAI*
Office 102, Tower 2,
Currency House, DIFC
P.O. Box 506617,
Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Representative Office

HONG KONG
Unit 4004 Central Plaza,
18 Harbour Road,
Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
6 Battery Road,
#40-02B,
Singapore
Phone: +65 6589 8400

Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance and business profile or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services Inc., (AMBRS) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AMBRS.

Version 020116