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Evaluating Country Risk

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. Country risk is evaluated and factored into all A.M. Best ratings. As part of evaluating country risk, 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 the insurance industry, financial system risk is further divided into two sections: insurance risk and non-insurance financial system risk.

A.M. Best's evaluation of country risk is not directly comparable to a sovereign debt rating, which evaluates the ability and willingness of a government to service its debt obligations. Though country risk analysis does consider the finances and policies of a sovereign government, the final determination is not guided by this sole purpose. Additionally, A.M. Best's country risk evaluation does not impose a ceiling on ratings in a given domicile.

A.M. Best's approach to country risk analysis employs a data-driven assessment that scores the level of risk present in a given country, plus a qualitative determination of country-specific conditions that affect the operating environment for an insurer. Countries are placed into one of five tiers, ranging from "CRT-1" (Country Risk Tier 1), denoting a stable environment with the least amount of risk, to "CRT-5" (Country Risk Tier 5) for countries that pose the most risk and, therefore, the greatest challenge to an insurer's financial stability, strength and performance. The conceptual relationship between the relative level of country risk and the rating of an insurer is depicted in **Exhibit 1** below.

In short, as country risk increases (measured by a higher assigned tier), the distribution of ratings migrates down the rating scale. This same relationship effectively applies to any significant category of risk an insurer faces, i.e. higher risk exposure pressures financial stability.

Key elements of country risk can be managed or mitigated, effectively reducing the impact on an insurer's rating. As a result, it is possible for an insurer in any country to achieve A.M. Best's highest Financial Strength Rating (FSR). Country risk is not a ceiling or cap on insurer ratings; it is one of many rating factors.

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

Exhibit 1
Relationship Between Ratings and CRTs

Average Rating

CRT-1	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-
CRT-2	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-
CRT-3	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-
CRT-4	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-
CRT-5	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-

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Exhibit 2
Components of Country Risk Analysis

Economic Risk	Macroeconomy
	Prospects
	International Transactions
	Government Finance
Political Risk	Economic Policy
	Business Environment
	Government Stability
	Social Stability
	International Diplomacy
	Legal System
Financial System Risk	**Non-Insurance Financial System Risk:**
	Banking System
	Vulnerability
	Reporting Standards & Regulations
	Sovereign Debt
	Insurance Financial System Risk:
	Government & Legislation
	Supervisory authority
	Insurer Accountability

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.

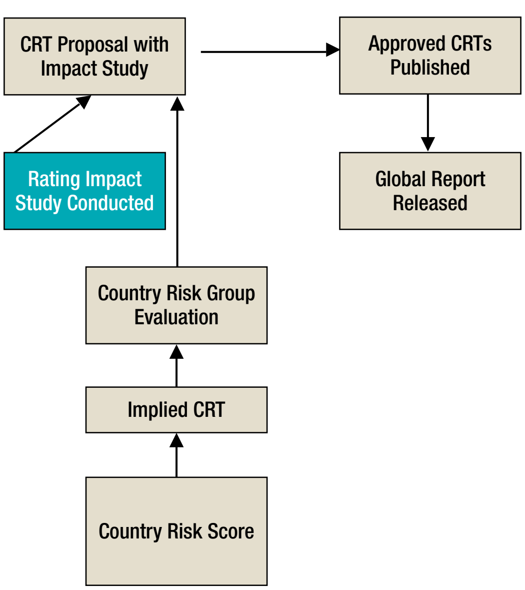
Elements of Country Risk

The three risk categories in A.M. Best's country risk analysis – economic risk, political risk and financial system risk – will be defined below, and some of the key variables used will be discussed (see **Exhibit 2**).

Economic risk is the likelihood that fundamental weaknesses in a country's economy will cause adverse developments for an insurer. A.M. Best's determination of economic risk evaluates the state of the domestic economy, government finances and international transactions, as well as prospects for growth and stability.

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.

Exhibit 3
Country Risk Evaluation Process



Financial system risk (non-insurance) is the risk that financial volatility may erupt due to 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. Basel II, World Bank Insolvency Principles and International Accounting Standards all are referenced in the analysis, as are the performances of banks, equity indices and fixed-income securities.

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. Insurance risk, which A.M. Best considers as a distinct subsection of financial system risk, is addressed separately because of the importance of and A.M. Best's specific focus on the industry. The determination is based heavily on the Insurance Core Principles (ICP) of the International Association of Insurance Supervisors (IAIS). A.M. Best employs a sizable subset of the 28 ICPs by organizing them 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.

Calculating Country Risk

The country risk determination begins assessing a "score." The score is a weighted average of the three risk categories. The score then is squared, representing the nonlinear relationship between the score and the actual country risk present in the country. The main equation for calculating the Country Risk Score is as follows:

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

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, such as where a given domicile has a particularly strong relationship with another – such as Guernsey with the United Kingdom – an additional calculation is added that integrates the larger domicile's influence on the stability of the smaller.

The country risk score provides a baseline of evaluation for each country. A country with a higher country risk score indicates a more risky environment as compared with a country that has a lower country risk score. After the score is determined, the Country Risk Group evaluates additional qualitative factors that would influence the overall score, or one particular category of risk.

Country Risk Tiers

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

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.

Countries with characteristics of a stable insurance industry environment are highly correlated with those countries that are economically large, stable, diverse and efficiently regulated, with stable political regimes supported by a strong and credible legal system.

Annual and Event-Driven Reviews

Each country that is assigned a Country Risk Tier is reviewed annually. This review includes the country risk score, the qualitative analysis, a rating impact study and the committee process each year. During the interim period, the Country Risk Group continually monitors world events and developments and assesses their potential impact on tier assignments. This process is facilitated through the maintenance of a watch list that identifies countries that are experiencing a significantly increased level of volatility that has the potential to impact the CRT.

Exhibit 4
Incorporating Country Risk

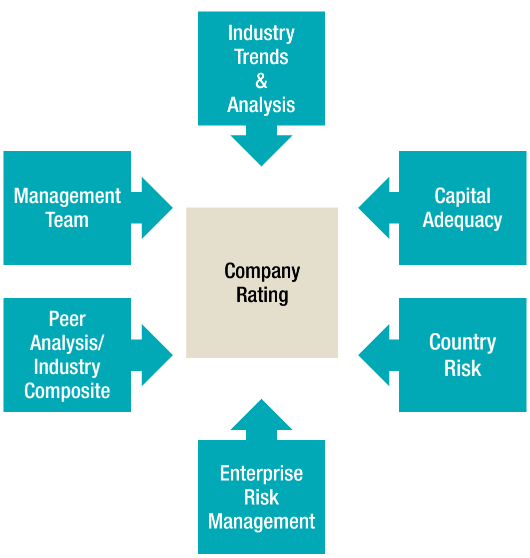


Exhibit 5
Rating Translation
Financial Strength Ratings (FSR) and Issuer Credit Ratings (ICR)

FSR	ICR	FSR	ICR
A++	aaa aa+	B	bb+ bb
A+	aa aa-	B-	bb-
A	a+ a	C++	b+ b
A-	a-	C+	b-
B++	bbb+ bbb	C	ccc+ ccc
B+	bbb-	C-	ccc- cc

It is unusual for a country to be moved up or down the scale outside of the annual review cycle, as the CRTs are designed to remain stable through the business cycle and are not subject to frequent upgrades or downgrades. Therefore, while recent developments are factored into the analysis of country risk, they often are not significant enough to warrant an off-cycle change in the tier assignment. In the event of a change in CRT, the ratings of the companies domiciled in that country will be subject to review.

Applying Country Risk to Ratings

A.M. Best's ratings are independent opinions based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. Country risk is one of many factors considered in evaluating a company according to these three characteristics. The level of consideration given to country risk (i.e. the potential impact on the determination of a rating for a company) is determined on a case-by-case basis for each insurer, based on its financial strength, position in the market and ability to mitigate or manage its exposure to country risk.

A.M. Best's Country Risk analysis seeks to identify those aspects of a country that may create a difficult or unpredictable environment for an insurer. For example, a poorly regulated banking system, poorly executed monetary policy or illiquid equity market could leave a financial system more prone to collapse. On average, most companies in CRT-1 or CRT-2 countries would not be impacted adversely by their operating environments (i.e. country risk). In CRT-3, CRT-4 and CRT-5, there is an increasing probability that environmental factors will affect a company's ability to fulfill policyholder obligations.

A.M. Best employs neither a notching process nor a ceiling in applying country risk to ratings. Country risk is one of many factors that are integrated into a Best's Rating. The integration of country risk into a rating outcome is comparable to the integration of other components of the rating analysis such as enterprise risk management (ERM); senior management discipline and track record; capital management; and competitive market position, among others (see **Exhibit 4**). Analysts are able to ascertain during the rating process whether an insurer is subject to country risk issues. To aid analysts in this process, the Country Risk Group offers internal briefings and mapping guides that serve as benchmarks when comparing insurers across countries and regions.

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METHODOLOGY

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