May 2, 2012

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 determines 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 evaluation is not a rating; rather, it is a factor applied to holding company and debt ratings.

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 such restrictive controls would be undertaken only in the event that the sovereign was facing default. Thus, T&C ceilings are always equal to or higher than a country's sovereign rating. With all else being equal, a country with a lower sovereign rating (i.e., a higher probability of default) will have higher T&C risk. However, the likelihood of a country implementing capital and exchange controls in a default scenario depends on the disposition of the government and the political situation.

The application of T&C risk ceilings is separate and distinct from the application of country risk in the rating process, although A.M. Best incorporates country risk and T&C 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.

Evaluating a Sovereign

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

If the country's sovereign debt is rated by the other major credit rating agencies, A.M. Best relies on an equal-weighted average of these ratings. If only one agency rates the country, then that one agency's rating is used.

If the other major credit rating agencies do not rate the country's sovereign debt, A.M. Best evaluates the country's creditworthiness and develops an internal sovereign estimation based on portions of A.M. Best's E*valuating Country Risk* criteria procedure, as well as a more detailed look at the country's debt and deficit positions.

If there is insufficient information available to determine the creditworthiness of a sovereign, then A.M. Best does not make a T&C determination and therefore will not assign a rating to a holding company or debt issuance in that country.

Determining the T&C Score

Once a country's sovereign rating is established, A.M. Best determines the likelihood of the country implementing currency controls given default. To estimate this risk, A.M. Best applies a quantitative assessment to provide a baseline score of the T&C risk and then conducts qualitative analysis to determine the final T&C risk evaluation.

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Criteria:
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Insurance Holding Company and Debt Ratings

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SR-2010-M-141

The quantitative assessment is a weighted average of four components that impact the level of T&C risk in a country. The four components of the calculation 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 measure indicates the government's proclivity to intervene in the economy. If a country already uses capital controls, it is likely that, if faced with a default, it would increasingly apply 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 current 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 into the global economy, including, but not limited to, memberships in international organizations and reliance on trade, would experience higher costs of implementing capital and exchange controls. The increased cost of these policies, all else being equal, reduces the probability that the government would use such 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 in the country's economy.

Rule of Law

The third category measures the strength and soundness of the rule of law in a country. Fundamental respect for property rights and investor rights lessens the likelihood that a sovereign would impede its currency from being 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 government's willingness to use the price level to generate desired political outcomes. Indicators used in this section include historical perspective on periods of high consumer price inflation and the degree to which the sovereign uses price controls.

Determining a Notch Increase

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 view. After the quantitative assessment is run, the results are evaluated, and a final determination is made.

Exhibit 1

Estimating Transfer and Convertibility Risk

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

$$\sqrt{((\omega_1(CONT_2))+(\omega_2(GLOB_2))+(\omega_3(RL_2))+(\omega_4(INF_2)))}$$

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

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 approach that scores the level of risk present in a given country, plus a qualitative analysis 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.

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.

Special Cases

Certain countries, such as those in monetary unions or that exclusively adopt another sovereign's currency, do not lend themselves to this standard analysis. These countries are considered special cases and analyzed separately.

Monetary Unions

All countries in a monetary union are analyzed collectively and assigned the same T&C ceiling. This T&C determination 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 across the group.

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 issuing its own. A country that uses another sovereign's currency is not subject to T&C risk in the traditional sense. However, the risk of a disruption to this currency system remains, which will be reflected in the country's T&C ceiling. These countries are evaluated individually, and depending on the results of the analysis, the number of notches increase from the sovereign rating may exceed the standard maximum of 3.

Monitoring

The T&C risk evaluations are monitored on a regular basis. Changes in a sovereign rating could impact the T&C ceiling assigned, and changes in the political and economic situation could change the number of notch increase. 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

This section will discuss how A.M. Best incorporates T&C ceilings into its rating process 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 (FSRs), which provide an opinion 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 thus there is no transfer or convertibility risk.

Moreover, T&C ceilings are not applied to an insurance operating company's Issuer Credit Rating (ICR), which provides an opinion of the rated entity's ability to meet its senior-most obligations. Assuming that the senior-most creditors for insurance operating companies are policyholders, the ICR for that entity would remain an evaluation 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.

Debt Ratings

T&C ceilings are applied to A.M. Best's ratings of debt.

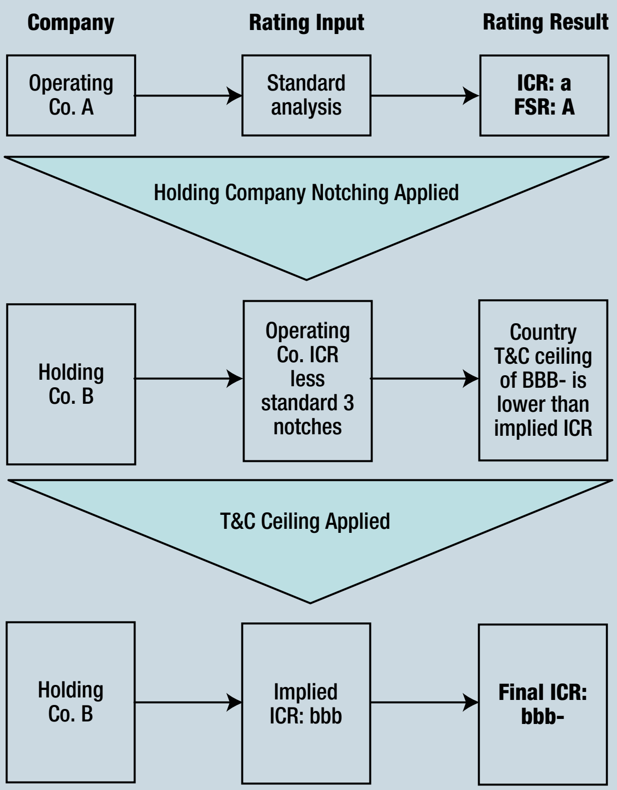
Ratings Application of T&C Risk: Hypothetical Case Studies

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-"



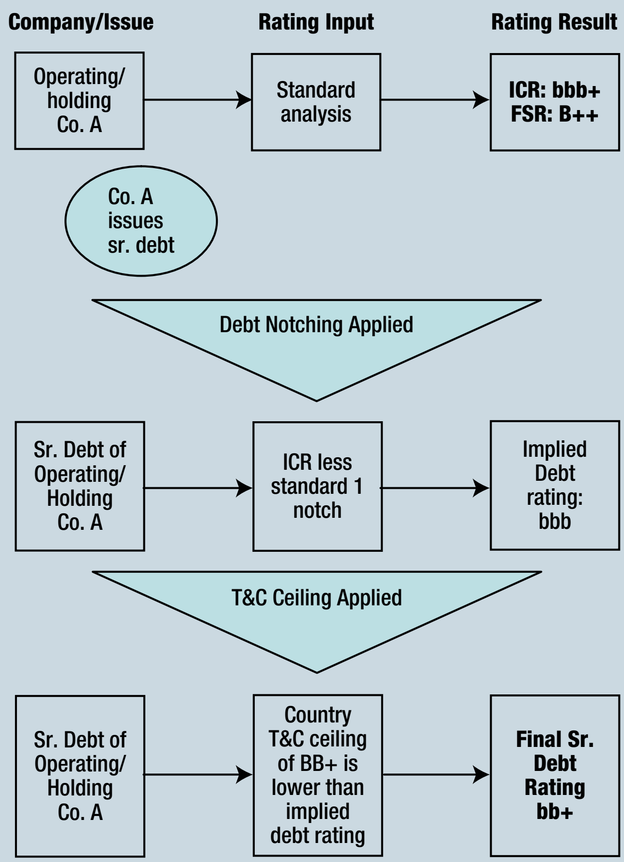
Case 2: Country with a T & C Ceiling of BB+

Operating/Holding Company[1] 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
• Both of these ratings incorporated country risk, however, neither was impacted by the T&C ceiling.
• 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.



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

METHODOLOGY

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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 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).

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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