

Evaluating Country Risk

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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 AM Best's 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. AM 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 assessment is not determined solely by these factors; thus, country risk evaluation is not tied to a sovereign debt rating.

AM 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 relationship is reflected explicitly in the overall balance sheet strength assessment, as described in Best's Credit Rating Methodology. A similar relationship effectively applies to any significant category of risk an insurer faces, i.e., greater risk exposure will pressure financial stability.

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



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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 AM 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. AM 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 the international environment will adversely affect an insurer. Political risk takes 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 is the risk that financial volatility may be present due to weak banking systems or asset markets, poor regulatory structure or inadequate reporting standards, 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 shocks. AM Best's assessment also references compliance indicators with Basel 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. AM Best's assessment of insurance risk is based heavily on indicators of compliance with a sizable subset of the Insurance Core Principles (ICP) of the International Association of Insurance Supervisors (IAIS), 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.

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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 evaluation process also considers 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.

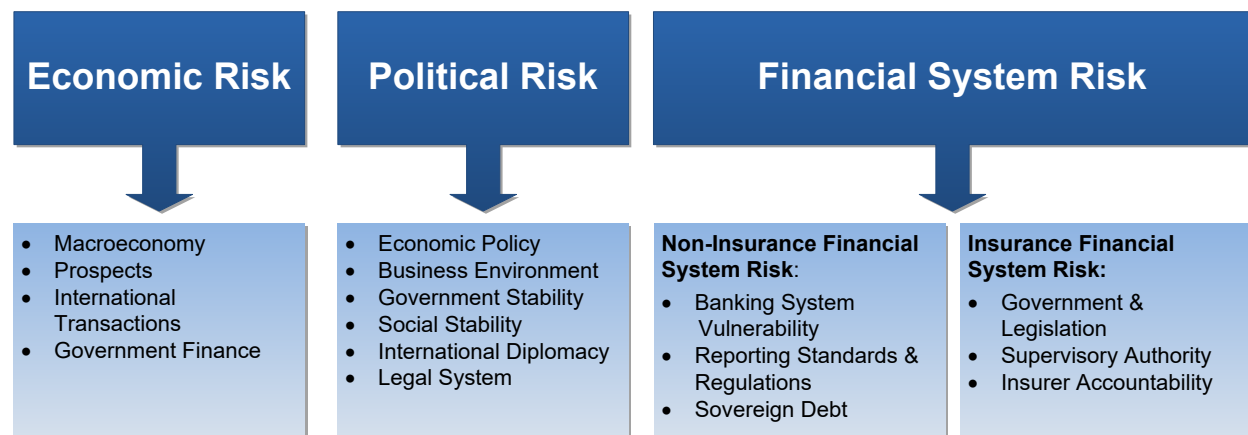
CRT-3: The country is characterized by a developing political environment, legal system, business infrastructure, capital market, and insurance regulatory structure.

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.

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Exhibit D.1: Components of Country Risk



E. Annual and Event-Driven Reviews

Each CRT is reviewed annually, although world events and developments as well as their potential impact on tier assignments are monitored continuously.

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, or that have significant exposure to that country, will be subject to review.

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