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Best's
Methodology and Criteria

Measuring Transfer & Convertibility Risk



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Measuring Transfer and Convertibility Risk

Outline

- A. Transfer and Convertibility Risk
- B. The Evaluation Process
- C. Special Cases
- D. Monitoring
- E. Applying a T&C Ceiling

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 Best's Credit Rating Process.

A. Transfer and Convertibility Risk

AM Best defines Transfer and Convertibility (T&C) risk as the risk that government-imposed capital and exchange controls by a sovereign entity would prevent or materially impede the ability to convert local currency into foreign currency and/or transfer funds to nonresident creditors. A Best's Transfer and Convertibility Ceiling (T&C Ceiling) is always equal to or higher than a country's sovereign rating. 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.

AM Best determines the T&C risk for each country in which an AM Best-rated entity is present. The final result of this risk analysis is a T&C Ceiling on the credit rating scale; this ceiling is applied to holding company ratings and Best's Issue Credit Ratings (e.g., debt ratings). Furthermore, the application of a T&C Ceiling is separate and distinct from the application of country risk in the rating process.

B. The Evaluation Process

Evaluating a Sovereign

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

If a country's sovereign debt is rated by other major credit rating agencies, AM 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.



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If other major credit rating agencies do not rate a country's sovereign debt, AM Best evaluates a country's creditworthiness and develops an internal sovereign rating estimation, that encompasses an in depth look at a country's debt and deficit positions.

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

Components of the T&C Score

Once a country's sovereign rating is established, AM Best evaluates the likelihood of the country implementing currency controls if it were faced with default. To estimate this risk, AM 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.

The quantitative assessment is a weighted average of four factors that comprise the level of T&C risk in a country. **Exhibit B.1** details the quantitative assessment equation used to estimate the probability of a country implementing T&C controls.

Exhibit B.1: T&C Assessment 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

For clarity the ω symbols sum to one

The four components of the calculation in **Exhibit B.1** are described in the following sections.

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 its economy. This measure indicates the government's tendency to intervene in the economy. If a country already uses capital controls, it is likely that if faced with a default, it would increase restrictive controls. The indicators used in this category 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 a country is integrated into the global economy. A sovereign that is more integrated into the global economy—for instance, through membership in

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international organizations and reliance on trade—would experience higher costs in implementing capital and exchange controls. For an integrated sovereign, the increased cost of these policies reduce the probability that the government would use such controls. The indicators used in this category include the number of memberships in world organizations, the 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 abate the likelihood that a sovereign would impede its currency from being transferred or converted. Indicators used in this category include investors' rights, property rights, and the degree of corruption.

Price Controls and Stability

The fourth category measures both 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 a government's willingness to use the price level to generate desired political outcomes. Indicators used in this category include historical perspective on periods of high consumer price inflation and the degree to which the sovereign uses price controls.

Arriving at the Final T&C Score

The final T&C score is determined using the formula shown in **Exhibit B.1**. The result of this calculation is a score between 1 and 5. A score of 5 denotes the highest likelihood that a country would institute these restrictive capital controls in the event of default. At the other end of the spectrum, a score of 1 denotes the least likelihood that a country would institute these controls.

The score of 1 through 5 provides a baseline for the adjustment to the sovereign rating. After running the quantitative assessment, the results are evaluated and a final determination is made. The final result reflects an adjustment to the sovereign rating of between 0 notches and 3 notches.

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

C. Special Cases

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

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and may be analyzed separately. Examples of scenarios where countries might be analyzed separately include but are not limited to the following:

Monetary Unions

All countries in a monetary union are analyzed collectively and assigned the same T&C Ceiling, even if the sovereign ratings and country risk may differ among the member countries. 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 Eurozone.

Using Another Sovereign's Currency

Another 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 and therefore the adjustment from the sovereign rating may exceed the standard maximum increase of 3 notches. However, the risk of a disruption to this currency system remains, which will be reflected in the country's T&C Ceiling.

D. Monitoring

The T&C risk evaluations are monitored on a regular basis. Changes in a sovereign rating could affect the T&C Ceiling assigned, and changes in the political and economic situation could change the number of notches increased. These changes, under normal conditions, are expected to be relatively slow-moving. However, in a period of economic stress, the changes may happen quickly.

E. Applying a T&C Ceiling

Insurance Operating Companies

AM Best does not apply a T&C Ceiling to its Best's Financial Strength Ratings (FSRs), which provide an opinion of an insurance company's ability to meet its ongoing insurance policy and contract obligations. For this, it is assumed that, typically, an insurance company's policyholder claims are denominated in the country's local currency. Thus, there is no transfer or convertibility risk.

A T&C Ceiling is also not applied to an insurance operating company's Best's Issuer Credit Rating (ICR), which provides an opinion of the rated entity's ability to meet its ongoing financial 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.

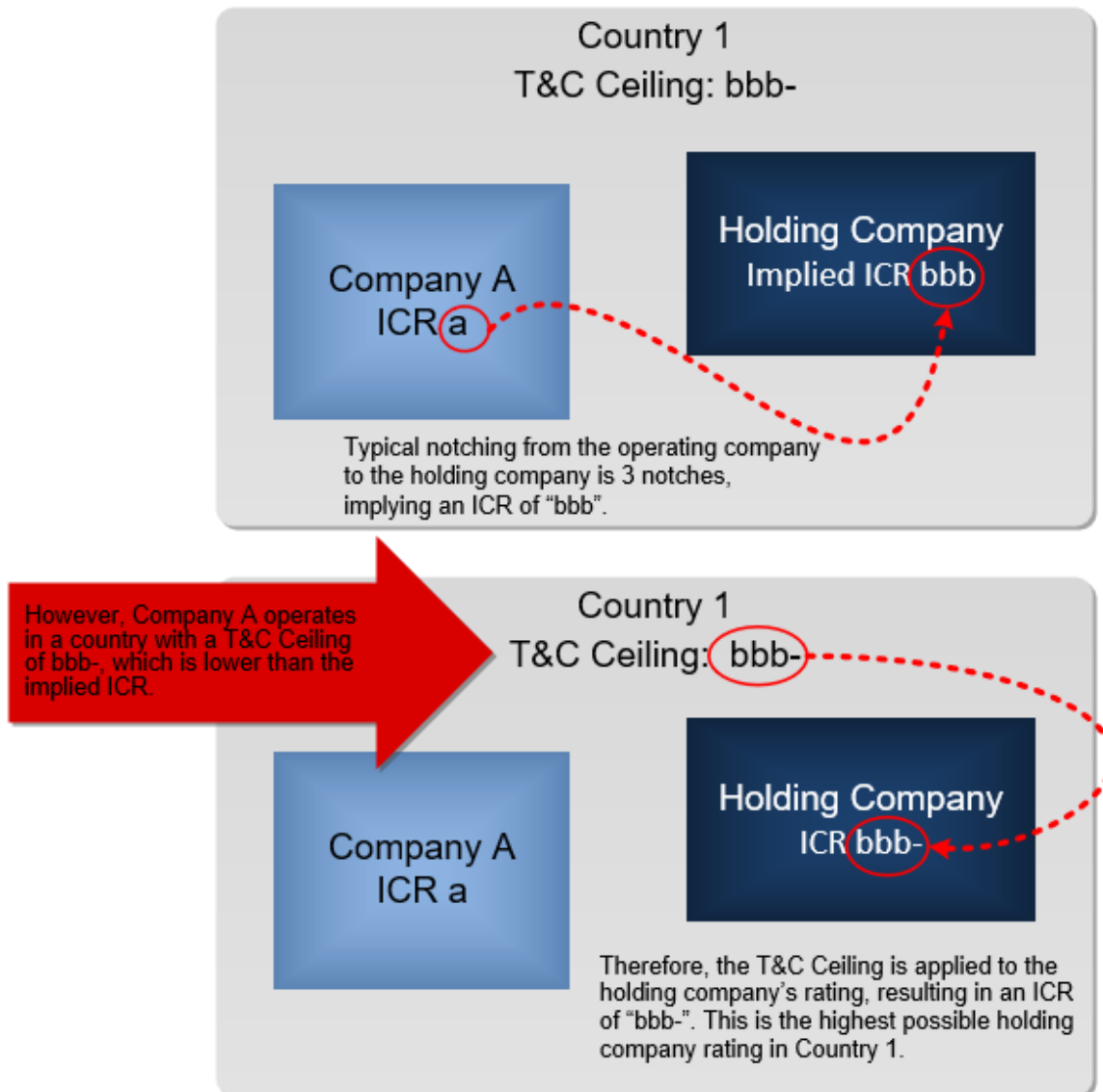
Note: In some regions, groups are structured with an ultimate parent that is both a holding company and insurance operating company. A T&C Ceiling is not applied to the ICRs or FSRs of these operating-holding companies.

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Holding Companies

A T&C Ceiling is applied to ICRs of holding companies. **Exhibit E.1** illustrates the application of a T&C Ceiling for a hypothetical holding company domiciled in a country with a T&C Ceiling of “bbb-”.

Exhibit E.1: Holding Company Rating with a T&C Ceiling

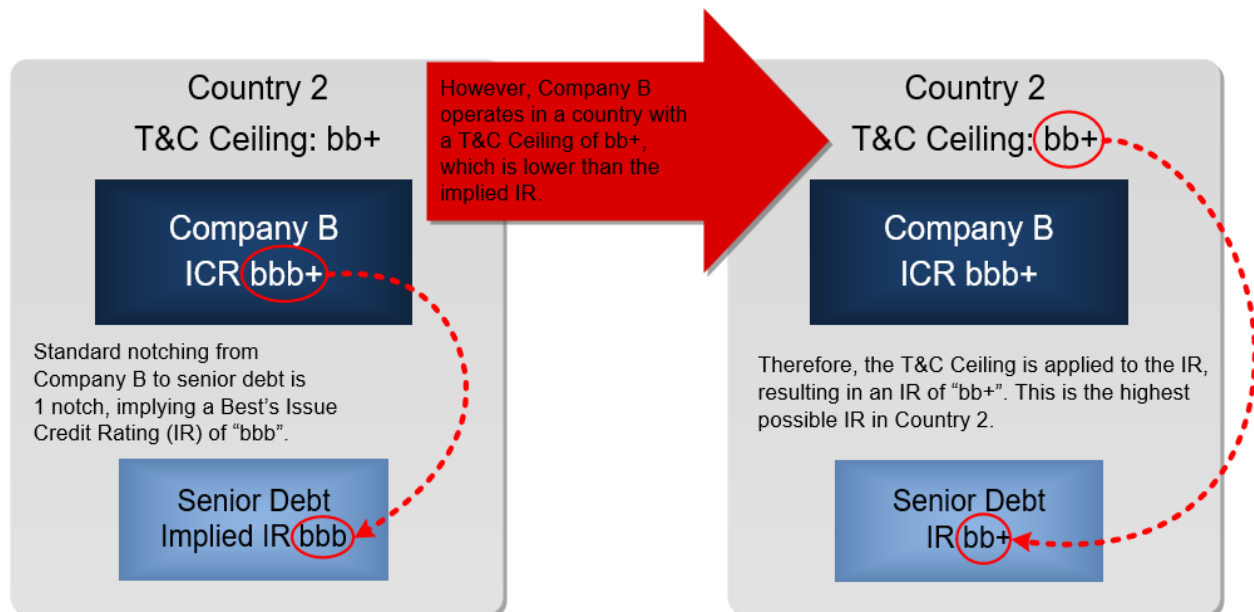


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Best's Issue Credit Ratings

A T&C Ceiling is also applied to rated debt. **Exhibit E.2** contains an example in which a hypothetical T&C Ceiling of “bb+” is applied to the Best's Issue Credit Rating of an operating company's senior debt.

Exhibit E.2: Best's Issue Credit Rating with a T&C Ceiling



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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 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).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

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, business profile, and enterprise risk management 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. (AM Best) 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 AM Best.

