BEST'S COMMENTARY

Our Insight, Your Advantage™

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AM Best's Credit Ratings and Country Risk FAQ – Why We Do Not Impose a Sovereign Ceiling on our Ratings

A company can be more financially secure than the government of the country in which it is domiciled. Placing a sovereign ceiling on an issuer credit rating would ignore a company's ability to manage country risk

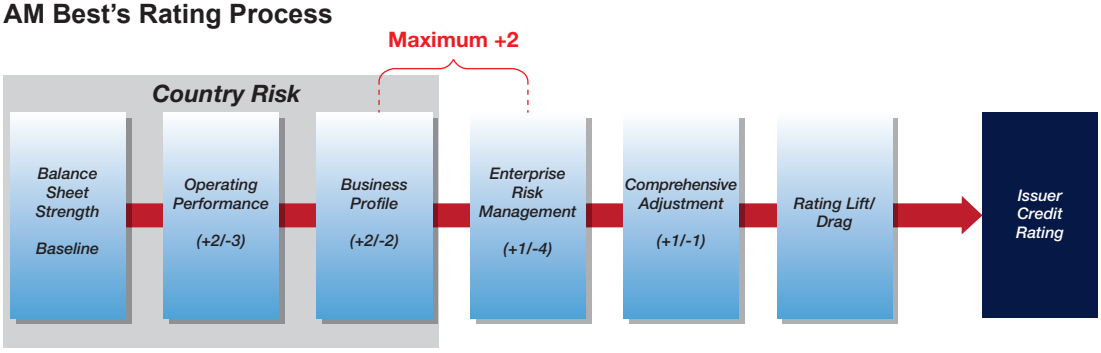
AM Best specializes in insurance ratings and recognizes that because every insurer is unique: the impact of the overall operating environment on companies may differ, as well as the options for mitigating that impact.

AM Best does not apply a sovereign ceiling on the insurance companies it rates. Placing a sovereign ceiling on an insurer issuer credit rating (ICR) would ignore a company's ability to manage country risk by avoiding risk or by hedging, or by accepting what cannot be controlled and using counter measures such as additional capital, strong underwriting performance, or diversification.

Nevertheless, country risk is factored into all of AM Best's ICRs, during the review of balance sheet strength, operating performance, and business profile that forms part of AM Best's rating processs (see **Exhibit 1**).

This document addresses some frequently asked questions about AM Best's handling of sovereign credit issues, the application of country risk, and discusses how country risk is incorporated into its *Best's Credit Rating Methodology (BCRM)*.

Exhibit 1
AM Best's Rating Process



Source: Best's Credit Rating Methodology

Does AM Best factor sovereign credit risk in its rating process?

No. AM Best is a specialist in insurance ratings and does not rate the ability of sovereign governments to service their financial obligations, including debt issues. However, in instances where domestic sovereign bonds comprise a large portion of an insurance company's investment portfolio, the investment position is evaluated carefully. Through Best's Capital Adequacy Ratio (BCAR), AM Best uses country-specific risk charges—based on the origin of the asset and the asset class—to capture the potential for market illiquidity and volatility.

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AM Best also examines an investment portfolio's concentration, to determine the extent of an insurer's exposure to any one entity—including the sovereign.

What's the difference between sovereign credit risk and country risk?

Sovereign credit risk is the measure of a country's overall capacity and willingness to pay its financial obligations on a timely basis. It does not directly address the underlying operating environment in a country. Country risk, as measured by AM Best, considers the overall operating environment of a country in which an insurer operates. Country risk encompasses economic, political, and financial system risks, to create a more accurate picture of an insurance company's operating environment in a specific domicile.

Does AM Best place a sovereign ceiling on its insurer ratings?

No, AM Best does not set ceilings in its ratings process, although movements from one country risk tier (CRT) level to another could affect the overall assessment of balance sheet strength. A company can be more financially secure than the government of the country in which it is domiciled.

Placing a sovereign ceiling on a rating would ignore a company's ability to manage country risk by avoiding risk or by hedging, or by accepting what cannot be controlled and using counter measures such as additional capital, strong underwriting performance, or diversification. AM Best also believes that a sovereign default, while clearly creating a more difficult operating environment, would not necessarily lead to an insurance company in the domicile failing to meet its policyholder obligations.

What are AM Best's Country Risk Tiers?

When analyzing country risk, AM Best incorporates a data-driven, quantitative scoring system that measures the level of risk in a country, as well as a qualitative determination of country-specific conditions that affect an insurer's operating environment.

Countries are placed into one of five tiers, ranging from "CRT-1" (Country Risk Tier 1), which denotes a stable environment with the least amount of risk, to "CRT-5" (Country Risk Tier 5), for countries at the higher end of the risk spectrum and, which therefore pose the greatest challenge to an insurer's financial stability, strength, and performance.

Does a change (upgrade/downgrade) in a government's sovereign credit rating result in a change in the Country Risk Tier?

Not necessarily. Although a government's creditworthiness is factored into the model, it is only one of many indicators. In addition to changes in sovereign credit quality, we carefully scrutinize the cause of any improvement or deterioration—be it rising debt, a slowing economy, or political upheaval. These underlying factors, which are often the basis for a decline in sovereign credit quality, are captured in the analysis and more directly influence the tier assignment.

Countries are placed into one of five Country Risk Tiers. Moreover, the drivers of sovereign credit ratings and country risk tiers are not the same. Sovereign credit risk is considered in country risk as a factor in the overall analysis.

Does a government's sovereign credit rating downgrade impact an insurer's ICR?

It depends on the circumstances. On its own, a sovereign rating is not a driver of an insurer's ICR. However, as issues arise with sovereign debt, analysts identify those companies impacted by the issues (including the credit risk of the sovereign government), taking into account any rating downgrades, liquidity concerns, and potential changes in the country's operating environment.

Sovereign downgrades can have an impact for companies with investment portfolios skewed to domestic government bonds due to its effect on BCAR. Any changes in the credit quality of sovereign debt are also incorporated in the evaluation of the domicile's country risk.

We examine the cause of any deterioration in sovereign credit quality, as well as each insurer's exposure to that deterioration. The different impacts of company-specific issues and country risk are incorporated into the ratings process individually for each company.

A sovereign credit rating downgrade could thus lead to the downgrade of an insurer's ICR, regardless of whether the company is rated higher or lower than the sovereign at the time. A downgrade of sovereign debt increases country risk and could affect a company's rating, but most downgrades are triggered by an increase in company-specific risks.

How often are Country Risk Tiers updated?

Country Risk Tiers are updated at least once annually, but with ongoing surveillance. The country risk quantitative scoring system is usually updated between April and June, as year-end data becomes available. However, AM Best conducts event-driven reviews of countries if the level of country risk is perceived to have become materially higher or lower than what the Country Risk Tier reflects. Country Risk Tiers incorporate the likelihood of short-term fluctuations and therefore are designed to remain stable through a business cycle, so off-cycle adjustments do not occur often. In the event of a change in the Country Risk Tier, any companies domiciled in or exposed to the affected country will be examined for the potential impact on their rating fundamentals.

Is country risk applied to all Issuer Credit Ratings (ICRs)?

Yes. Country risk is factored into all of AM Best's ICRs, during the review of balance sheet strength, operating performance, and business profile, as **Exhibit 1** shows.

What are some of the key metrics used to determine the Country Risk Tier for a given country?

Many metrics are used to determine the Country Risk Tier. To measure the economic, political, and financial system risks in each country, AM Best uses data from numerous sources—such as the International Monetary Fund, the World Bank, the Index of Economic Freedom, the United Nations, the Global Competitive Index, the World Trade Organization, and the Organization for Economic Co-operation and Development (OECD).

Key concepts captured in the assessment of country risk include macro economic factors (growth, price stability, and wealth); currency fluctuations over time; the vulnerability of the financial system; political and social stability; regional stability; the business environment; the level of corruption; the rule of law; the independence of the judiciary; reporting standards and regulation; and the overall strength of the local insurance market (legislation, regulation, and insurer accountability).

How is country risk factored into the rating process?

As discussed in the *BCRM*, country risk is one of many factors considered in evaluating a company. Country risk plays an important role in setting the rating assessment range for a company's baseline assessment. The amount of consideration given to country risk (i.e., the potential impact on the assessments of balance sheet strength, operating performance, and business profile) is determined individually for each rating unit based on its capitalization, market position, and ability to mitigate or manage its exposure to country risk.

Companies that are domiciled, conduct business, or have asset exposures in higher-risk countries are subject to more volatile external conditions. In these countries, a strong initial capital position can erode more quickly; thus, the initial rating assessment range of a well-capitalized insurance rating unit domiciled or operating in a high-risk country will be lower than that of a similarly capitalized insurer in a low-risk country.

What specific factors are considered when assessing the impact of country risk on a company's ICR rating assessment?

A number of factors are considered when evaluating a company's ability to manage the operating environment to which it is exposed, among them the following:

- The amount of excess capital a company holds to offset or withstand deterioration in the operating environment (for example, owing to increased market volatility or asset write-downs)
- The depth and use of local market knowledge to improve underwriting performance
- Special terms or conditions to lessen or limit market exposure
- Diversified assets and insurance portfolios (portfolio asset allocations, business lines or regions, minimal if any concentrations of revenue sources or exposure)
- Risk mitigation measures
- Contingency plans
- Shareholder financial strength and flexibility

AM Best recognizes that every insurer is unique and the impact of the overall operating environment on every company may differ, as well as the options for mitigating that impact. Therefore, during the ratings process, the impact of country risk on a particular insurer is considered case by case.

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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 credit-worthiness 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.

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