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Country Risk at AM Best

Definition of Country Risk

AM Best defines country risk as the risks specific to a country that could adversely affect the ability of an insurer operating in that country to meet its financial obligations. To evaluate and incorporate country risk into its insurance credit ratings, AM Best identifies the various factors in a country that could directly or indirectly affect an insurance company. In doing so, AM Best separates the risks into three categories: economic risk, political risk, and financial system risk which includes insurance specific risk.

Economic Risk

Economic risk captures the likelihood that fundamental weaknesses in a country's economy will cause adverse developments for an insurer. AM 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

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.

Financial System Risk

Financial system risk (which includes both insurance and non-insurance financial system risk) is the risk that financial volatility may erupt because of inadequate reporting standards, a weak banking system or asset markets, or poor regulatory structure. It also takes into account the risk that the level of the insurance industry's development and public awareness, transparent and effective regulation and reporting standards, and a sophisticated regulatory body will contribute to volatile financial system and compromise an insurer's ability to pay claims.

Country Risk Analysis

AM Best's approach to country risk analysis employs a quantitative data-driven analysis that scores the levels of risk in a given country, plus a qualitative determination of country-specific conditions that affect the insurer's operating environment. Countries are assigned a country risk score (**Exhibit 1**) consisting of the weighted average for the three risk categories. Factors incorporated in the analysis of the three risk categories include government effectiveness, property rights, judicial effectiveness, labor markets/freedom, ease of doing business, corruption, economic freedom, political stability, rule of law, voice and accountability, regulator quality, global competitiveness and capital market classifications in addition to traditional economic measures such as growth, inflation, wealth, employment, debt levels, etc. Scores are derived from a quantitative global scoring matrix that encompasses variables from sources including the World Bank, the International Monetary Fund, Freedom House, Global Competitive Index, PRS, Index of Economic Freedom, OECD, Transparency International, the United Nations and IHS Markit.

Exhibit 1: AM Best 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

Country Risk Tiers

In conducting its country risk analysis, AM Best places countries into one of five tiers, ranging from Country Risk Tier 1 (CRT-1), denoting a stable environment with the least amount of risk, to Country Risk Tier 5 (CRT-5) for countries that pose the most risk and, therefore, the greatest challenge to an insurer's financial stability, strength and performance. With five tiers and over 140 countries, the range of countries within a specific tier can be broad. 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 nontransparent 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.

Country Risk Reports

AM Best publishes annual country risk reports on over 140 countries. The reports are designed to provide a very brief high-level factual overview of each country. The risk dials—which categorize a country's economic, political, and financial system risk as very low to very high—are derived from AM Best's country risk score (**Exhibit 1**). The write-up within the reports is not intended to justify the risk dials. Instead, the write-up focuses on presenting snapshots of the economy, the government's structure, the state of the financial system and insurance-related regulations. The reports provide only official data from verified sources that often include government statistics, the International Monetary Fund, and the World Bank.

Country Risk Versus Sovereign Risk

Sovereign risk is a measure of a country's ability to service its debts. A sovereign debt rating, which entails an evaluation of the ability and willingness of a government to service its debt obligations, 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 it represents only a portion of the final determination of the country risk evaluation. Sovereign ratings evaluate the credit worthiness of a country, not the level of country risk for an insurer operating in that domicile.

AM Best does not determine the sovereign credit worthiness of a country, but the country risk inherent to an insurance company operating in that country. Therefore, AM Best employs different weightings to various inputs than the weightings that are used for sovereign credit analysis.

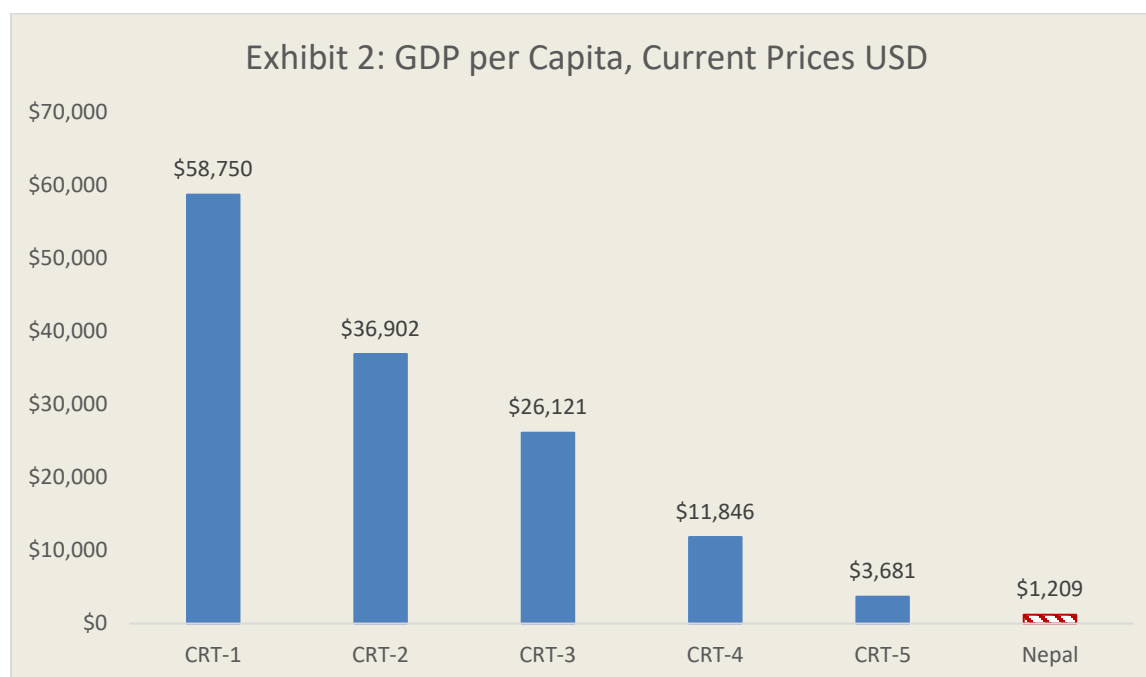
Nepal-specific Considerations in AM Best's Evaluation

The following peer comparison tables illustrate some of the factors that contribute to Nepal's characterization as a CRT-5 country. The factors are organized by the three risk categories—economic risk, political risk, and financial system risk—of AM Best's country risk analysis.

Gross Domestic Product per Capita

The IMF's October 2022 World Economic Outlook (WEO) report estimates Nepal's 2021 GDP per capita in current prices USD to be USD 1,209. **Exhibit 2** illustrates the average GDP per capita for each country risk tier. Nepal's GDP per capita is well below an average CRT-5 country.

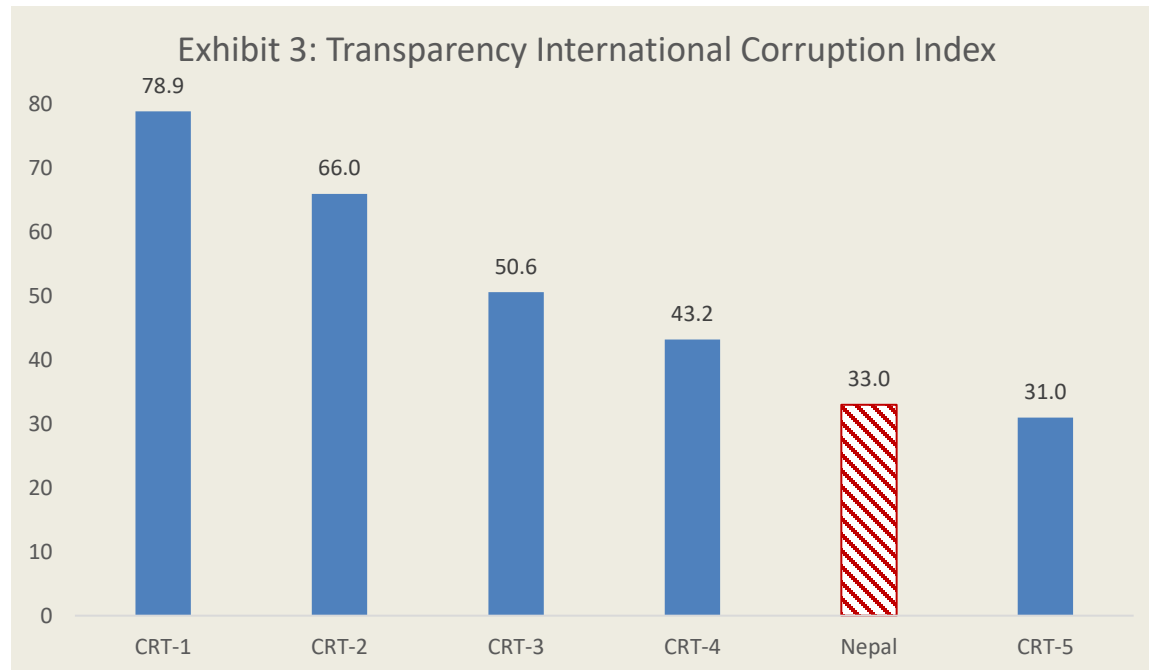
Exhibit 2: Average GDP Per Capita, By Country Risk Tier



Transparency International Corruption Index

One factor AM Best considers in its assessment of a country's legal system is Transparency International's Corruption Perception Index. Nepal's 2021 score was 33, slightly above the CRT-5 average, but ten-points below the average for CRT-4. **Exhibit 3**

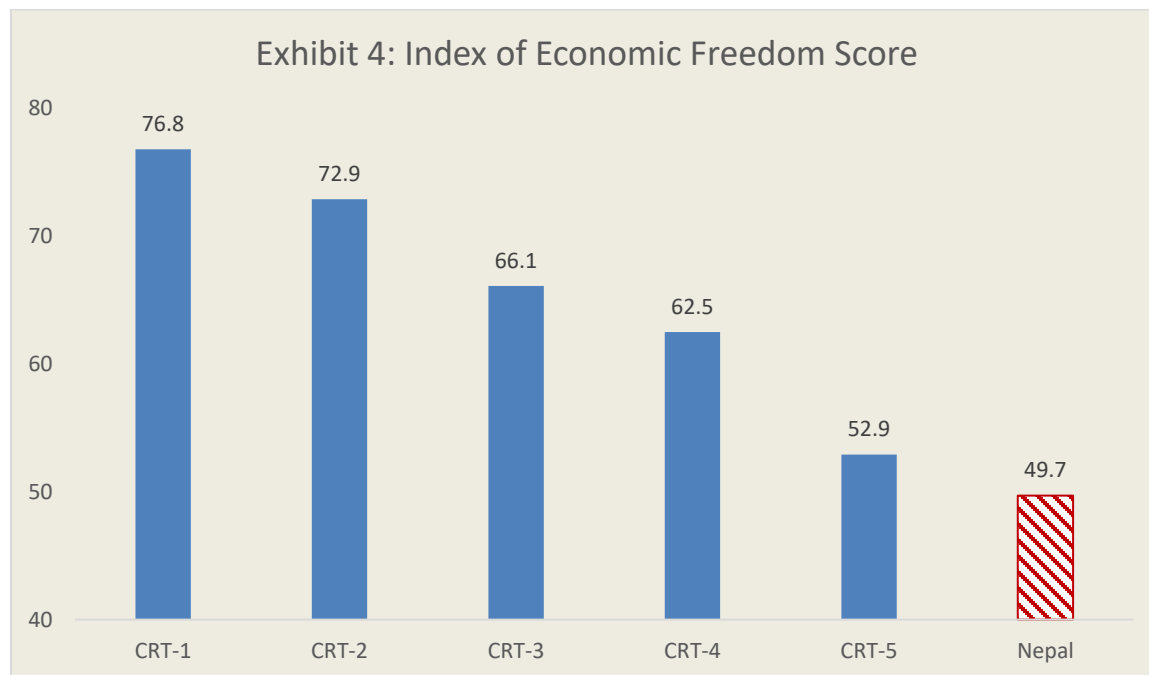
Exhibit 3: Average Transparency International Corruption Index, By Country Risk Tier



Index of Economic Freedom

Along with multiple other metrics, AM Best reviews the WSJ's/Heritage Foundation's Index of Economic Freedom total freedom score. Nepal's most recent score was 49.7, which places it below the average of a CRT-5 country **Exhibit 4**

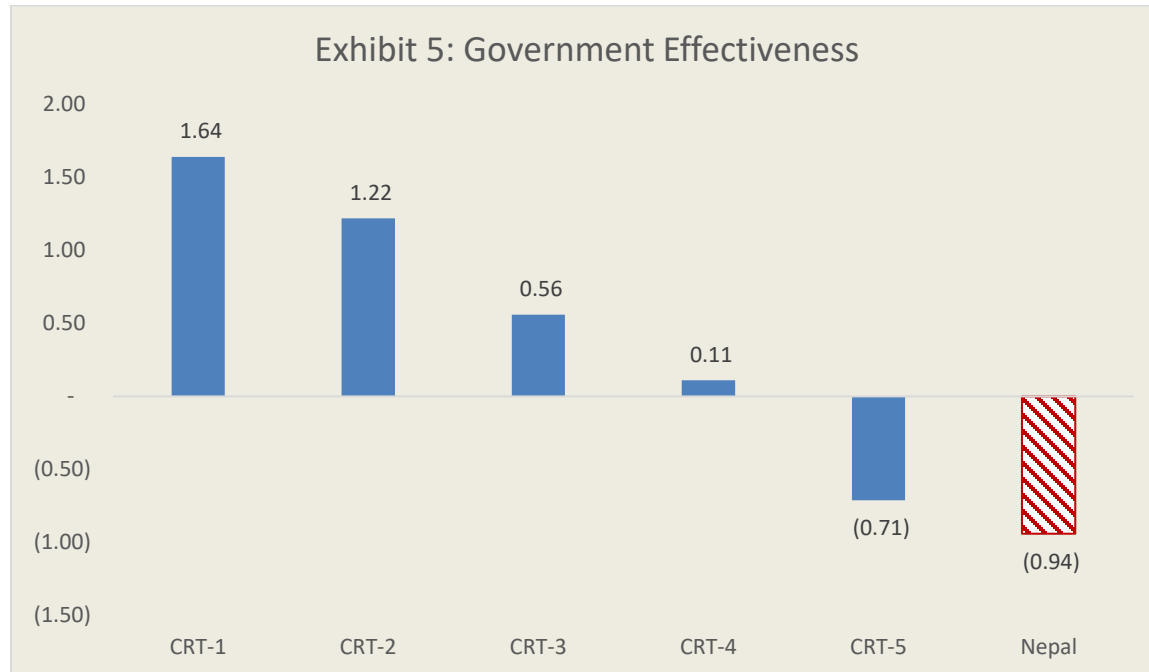
Exhibit 4: Average Total Freedom Score by Country Risk Tier



World Governance Indicators

AM Best also considers the World Bank's various World Governance Indicators (WGIs). The most recent assessment from the World Bank has Nepal at -0.94 for "Government Effectiveness", scoring below an average CRT-5 **Exhibit 5**

Exhibit 5: Average Political Stability and Absence of Violence Score by Country Risk Tier



With regards to the other WGI indicators, Nepal's scores below the CRT-4 average for the other five metrics: "Regulatory Quality", "Political Stability and the Absence of Violence", "Rule of Law", "Voice and Accountability" and "Control of Corruption".

Conclusion

AM Best considers a host of factors when arriving at its assessments of country risk. With a unique focus on the insurance industry, AM Best's country risk assessment is not equivalent to a sovereign debt rating. Instead, AM Best focuses on various economic, political, and financial system elements specific to a country that have the potential to disrupt insurance operations. AM Best covers over 140 countries, segregating them into 5 tiers. Thus, the range of countries within a tier may be broad and countries may appear better (or worse) than peers within their tier depending on the chosen metric.

The preceding Nepal-specific examples are intended to demonstrate a few of the factors that AM Best considers in its tier assignment. While Nepal may appear somewhat better than the average CRT-5 country for some metrics, it also appears to be much worse than the average for others. AM Best finds its classification of CRT-5 to be appropriate for Nepal, given current metrics.