

The STAR rating

Background information

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1. The STAR system

STAR stands for Sovereign Transfer and Arbitrary Risk. STAR is Atradius' political risk rating and represents a system for assessing country risk. STAR evaluates a sovereign's willingness and ability to pay. It explicitly measures the impact on public or private entities with cross-border payment obligations. Broadly speaking, the individual default triggers under Atradius' political risk policy are classed as either Sovereign transfer or Arbitrary risk.

- Sovereign transfer risk requires an assessment of the likelihood that a particular country will fail to service or repay its external debts for economic or financial reasons. Its application in this context is predicated on the assumption that sovereign distress is likely to impede both public and private agents in their fulfilment of cross-border obligations.
- Arbitrary action risk refers to the second major component of political risk – that of capricious action by a government. This risk requires an assessment of the likelihood that a sovereign will impose restrictions on private and public entities to fulfil their cross-border payment obligations because it chooses to do so, rather than out of economic necessity. The likelihood of such arbitrary action being taken is assumed to be closely linked to a government's current and past behaviour.
- The STAR rating process consists of two main building blocks: a comparative analysis of external ratings and an internal underwriter and economist assessment. The internal underwriter assessment is obtained through a regular economic survey.

2. The STAR rating scale

The STAR rating runs on a scale from 1 to 10, where 1 represents the lowest risk and 10 the highest risk. The principal features of the STAR rating scale are demonstrated in Table 1.

The 10 rating steps are aggregated into five broad categories to facilitate their interpretation in terms of credit quality. Starting from the most benign part of the quality spectrum, these categories range from 'Low Risk', 'Moderate-Low Risk', 'Moderate Risk', 'Moderate-High Risk' to 'High Risk', with a separate grade reserved for 'Very High Risk'.

The STAR rating scale displays several important structural features. Firstly, each rating category has broad alignment with a specific letter category on the generic sovereign rating scale. Secondly, the 10-point scale is split neatly into two, with the middle category, STAR rating 5, defining the border between what may be labelled 'investment grade' and 'speculative grade' credit quality.

In addition to the 10-point scale, there are rating modifiers associated with each scale step: 'Positive', 'Stable', and 'Negative'. These rating modifiers allow further granularity and differentiate more finely between countries in terms of risk.

Table 1: Rating scale alignments

Grade	STAR	Sovereign scale		
Low Risk	1	AAA		
	2	AA+	AA	AA-
Moderate-Low Risk	3	A+	A	A-
	4	BBB+	BBB	BBB-
Moderate Risk	5	BB+	BB	BB-
Moderate-High Risk	6	B+	B	B-
	7	CCC+	CCC	CCC-
High Risk	8	CC / C		
	9	SD / D		
Very High Risk	10			

Source: Atradius

3. Scale interpretation

In order to assist better understanding of what the rating means in practice, some descriptive criteria are attached to the STAR scale. These stylised rating characteristics are not provided for each rating bucket but rather for the coarse rating grades..

Rating grade 'Low Risk': STAR ratings 1 and 2

Low Risk	1	AAA		
	2	AA+	AA	AA-

Political

Countries in the 'Low Risk' grade are highly stable and well functioning democracies or extremely stable autocratic systems. They are highly developed and stand at the apex of the world political and economic system. The commitment of these countries to this order is not in question. The rule of law and government openness ensure that international transactions are completed entirely unhindered.

Economic

The economic systems that have evolved in these countries are the best there is. They may suffer from bouts of poor cyclical performance but this will be extremely unlikely to affect the quality of economic management.

Transactional

These countries enjoy extremely well functioning financial systems with minimal delay in completing international transactions.

Rating grade 'Moderate-Low Risk': STAR ratings 3 and 4

Moderate-Low Risk	3	A+	A	A-
	4	BBB+	BBB	BBB-

Political

Countries in the 'Moderate-Low Risk' grade may have a variety of political structures in operation, from democratic systems to monarchic autocracies. There may be weaknesses in the political system. In the case of democracies there may be operational issues in the form of government ineffectiveness or fractious state constituents or, in the case of autocracies, interference and heavy state direction may be present. Government interference may periodically result in individual international transactions being at threat but such action is by no means pervasive. These countries are not necessarily free of conflict. Indeed, it is even possible that the conflict that exists is large scale and long lasting. However, there are clear mitigating features which imply that civil society in such countries continue to function effectively despite risk of occasional disruption. The integration of the country into the global political order means that it has the support of major political powers and its civil society continues to function, albeit at some occasional risk. Any threat to the fulfilment of international contracts resulting from the inability of state to function or any reluctance on the part of the government is limited.

Economic

Countries in this segment are unlikely to have the same degree of market orientation as countries in the 'Low Risk' rating grade. Growth on an industry sector basis may be fragile and large imbalances may exist - and actually be growing. State direction may exist as may some structural issues. These issues could have a serious impact on the international position of these countries in

the event of crisis, as vulnerabilities could emerge rapidly. However, for a number of economic reasons – be it strong cyclical growth or deep international links – it would actually take a large adverse event to create such a situation.

Transactional

Weaknesses exist but it would take a large adverse event for these weaknesses to trigger political losses.

Rating grade 'Moderate Risk': STAR rating 5

Moderate Risk	5	BB+	BB	BB-
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The divide between STAR ratings 4 and 5 represents a key structural break in the STAR scale, akin to the divide between investment and speculative grade on the generic rating scale.

Political

Countries in the 'Moderate Risk' grade may have political systems varying from functioning democracies to autocratic regimes. Transparency and accountability of these regimes is often put in question and government interference may be widespread. There may be countries in this category with populist governments and with deteriorating international relations. Such governments may engage in systemic actions that endanger the fulfilment of all international contracts. These countries are unlikely to be deeply integrated into the world political order. Internal and external conflict may be present and, as their coping mechanisms are not strong and/or international support is limited, the countries will typically be vulnerable to an escalation of any such conflict.

Economic

The extent of the market economy is likely to be constrained and the commitment of countries to effect market based reform varies. Cyclical economic performance may however be strong, either as a result of successful reform or simply due to global cycles. While such cyclical performance boosts its international economic position, structural weaknesses imply that it is vulnerable to crisis. At least one major structural

weakness is likely to be present in the economy (e.g., high debt, high inflation, too high credit growth, diminishing reserves, or poor public finances).

Transactional

There are issues with transactional efficiency that may create delays in fulfilment of international contracts.

Rating grade 'Moderate-High Risk': STAR ratings 6 and 7

Moderate-High Risk	6	B+	B	B-
	7	CCC+	CCC	CCC-

Political

Countries in the 'Moderate-High Risk' grade have political systems that are very likely to be fragile. This fragility acts as a significant impediment when it comes to promoting internal stability, economic progress and commitment to fostering international relations. As a result, significant conflict situations, both internal and external, may exist. International relations may have deteriorated to the point where a significant threat of sanctions may exist. States may display serious lack of commitment to the international political and economic order and therefore the risk of politically motivated losses is very high. The investor-unfriendly political climate implies that foreign parties are likely to be very reluctant to enter these markets unless they have a high degree of protection.

Economic

Economic systems are poor. The extent of international economic engagement will vary as will the position of these countries in the international supply chain. They may rely heavily on imports which they are unable to finance in the long run, as their exports are largely low value added items. They may even be closed economies. Industrial structure is weak and countries are likely to be engaged in agricultural commodities and primary processing to a large extent. If a relatively sophisticated industrial country is in this category, then this is as a result of a serious

political or economic crisis, e.g. a country that has only recently defaulted on international obligations or has suffered from a currency or banking crisis (possibly even more than one crisis). Several economic stability and international position indicators are likely to be sending poor signals.

Transactional

There are issues with transactional efficiency that pose a significant risk of creating delays in the fulfilment of international contracts.

Rating grade 'High Risk': STAR ratings 8 and 9

High Risk	8	CC / C
	9	SD / D

Political

Countries in the 'High Risk' grade generally experience extremely adverse political conditions. Large scale conflict is most likely to be present with no clear internal authority. Civil society will have significant difficulties in functioning. The government of the day (if one exists) will have little power and ability, meaning that few foreign parties are willing to engage with such a country. The government is either unable or completely unwilling to engage with the international political and economic order, implying that individual parties will largely stay away from engaging in cross-border transactions with private or public buyers in that country. Some vested interests (e.g. commodity exports, defence, or aid agencies) may, through special conditions, be able to have cross-border contracts fulfilled.

Economic

The economic situation is extremely poor. Even basic subsistence farming will most likely be at threat, making countries extremely vulnerable. The international position is extremely weak. If international debt is outstanding, then it is in default. Every single economic indicator displays high level of vulnerability.

Transactional

The banking sector infrastructure is almost non-existent, implying significant impediments to transfer of funds through the system.

Rating grade 'Very High Risk': STAR rating 10

Very High Risk	10	
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When market conditions are so severe that insurance activities are deemed infeasible, the STAR rating 10 is applied. Atradius has then decided not to provide cover in these countries. This condition may apply to any type of market during extraordinary circumstances (e.g. in the midst of a full-blown economic crisis), when the assessment of both sovereign and individual buyer payment capacity is associated with too high uncertainty.

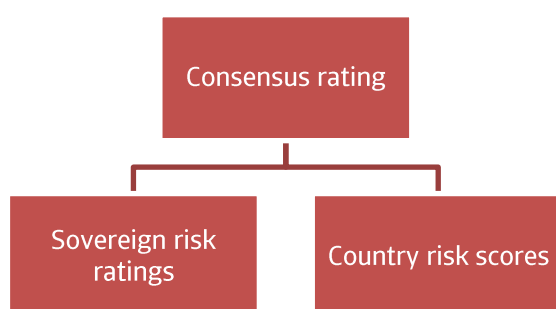
4. STAR rating composition

4.1 External ratings and STAR

To summarise, the STAR rating is composed of two key elements: an underwriter assessment captured through a survey, and a combination of external ratings. A number of different external ratings are combined to give the first part of the STAR rating. These are the sovereign long-term foreign currency ratings supplied by the major rating agencies and a selection of country risk scores. The external rating measures are statistically combined and mapped onto the 10-point STAR rating scale (see section 2 for a discussion of the rating scale). The external ratings selected for benchmarking display a reasonable correspondence with our definition of political risk and have the advantage of being widely known and used in financial market applications.

The combination of external ratings yields a 'consensus rating' that constitutes an anchor position in the STAR rating process. This initial position on the credit quality ladder serves as a benchmark to which the internal assessment is added.

Figure 1: The external 'consensus'



4.2 Internal underwriting opinion and STAR

While combining external ratings serves as a sound basis for creating a market driven rating, Atradius has in-house intelligence that must be allowed to impact on the rating. To facilitate this, the STAR rating system uses a web-based underwriter survey. Answers to this survey are appropriately scored to generate an underwriter rating that is reviewed in parallel with the external consensus rating. The underwriter survey is,

as such, an integral component of the political risk rating framework, with the survey responses contributing directly to the final STAR rating outcome. The survey is scored according to the principle that political risks are additive. We assume strong dependence between risk categories, suggesting the need for adopting this 'maximum principle' in aggregating responses. Risks cannot be discounted against each other without a documented rationale and the worst assessment of all risks governs the risk profile of the country. This essentially means that the worst score, in any category, becomes the overall underwriter country risk score. The principal objectives of the survey are to:

- yield a user-led insight of political risks in the markets that we cover. The underwriter survey uses Atradius' extensive in-house knowledge and supplements the country risk assessments of external agencies;
- reflect in-house expertise and information that is not available in the public domain. The survey systematically taps into and stores unique market knowledge that rarely finds its way into the public domain;
- supplement the country consensus rating and tailor it to Atradius' definition of political risk. Where applicable, it constitutes a clear basis for over-riding the implied rating suggested by the external consensus risk assessments. As such, the STAR rating reflects Atradius' proprietary view of country risk;
- ensure ready justification of rating and business decisions. Survey results are stored systematically offering clear justification for rating movements, both past and present.

Table 2: Survey framework

Political risks	
Sovereign stability	Current environment
	Risk Outlook
Economic stability	Current environment
	Risk Outlook
Transactional efficiency	Current environment
	Risk Outlook
Catastrophe	Current environment
	Risk Outlook

Table 2 provides an overview of the survey framework. Firstly, political risks are considered in the context of 'sovereign stability'. Sovereign stability factors offer an assessment of the overall political and security situation in a country. Secondly, economic risks are considered in the context of 'economic stability'. Economic stability considerations look to assess notions of economic balance and sustainability.

Thirdly, financial risks are considered in the context of 'transactional efficiency'. Transactional efficiency aims to give a broad assessment of the capacity to service debt in full and on time. Catastrophe risk is rarely featured in the structured analysis of country risk but is still a covered cause of loss under Atradius' political risk contract. Therefore we seek a broad assessment of the capacity of the country to withstand the economic and financial impact of a major natural catastrophe. These different assessment categories are scored accordingly and used as the basis for rating adjustments. This part of the survey is essentially what is collated to reflect Atradius' in-house view of country risk.

The STAR ratings are discussed and approved on a country-by-country basis through Country Committee, which is Atradius' country risk forum. The STAR rating represents global coverage and any country is immediately brought up for committee discussion and rating validation as soon as the risk perception changes to a significant extent.

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