SOVEREIGN RATINGS AND COUNTRY CEILINGS

APPROACH TO SETTING SOVEREIGN RATINGS AND COUNTRY CEILINGS

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I. INTRODUCTION

This paper explains how ARC sets the Sovereign ratings and Country Ceilings that it uses as analytical reference in its rating assignments.

II. SETTING SOVEREIGN RATINGS AND COUNTRY CEILINGS

ARC does not currently assign sovereign ratings nor country ceilings. The approach used for its rating assignments is that, when necessary, the analytical reference will be the second-highest sovereign rating and country ceiling (or a similar measure of transfer and convertibility risk) assigned and publicly available by a set of reference credit rating agencies (the 'Reference CRAs'). In the event that only one rating from a Reference CRA is available for a specific country, the 'second highest' rule will be waived. The selection of the Reference CRAs will be carried out by a panel of ARC's cross sector senior rating analysts (the 'Senior Panel'), will be reviewed at least on a quarterly basis and will be approved by its Board Criteria Review Committee. The selection of the Reference CRAs and, as a result, the sovereign ratings and country ceilings used by each asset class's, cannot be overruled by a rating panel.

ARC notes that choosing the second highest of sovereign rating and country ceiling from a set of reference credit rating agencies might lead to situations in which the result of the second highest for each factor comes from a different Reference CRA. For example, the second highest sovereign rating comes from CRA 1 and the second highest country ceiling from CRA 2. ARC considers that this outcome guarantees the consistency and independency of its approach. In the event that the highest and second highest ratings and or country ceiling are equivalent, one of these will be selected.

The specific use of the sovereign ratings and country ceilings is described in each asset class' Methodology and Criteria available on ARC's website.

III. SOVEREIGN RATINGS AND COUNTRY CEILINGS

Sovereign ratings are a key reference point in any rating assignment, however, they are not necessarily the highest achievable credit rating for any particular entity domiciled in a certain country.

For financial instruments denominated in local currency, issued by issuers domiciled in a certain country, the factors that might lead to assign a credit rating higher than the sovereign are captured in the specific Criteria, as well as on the specific weaknesses and strengths of the issuer/transaction.

For financial instruments denominated in foreign currency, issued by issuers domiciled in a certain country, the country ceiling is the relevant measure for the highest achievable credit rating. The country ceiling, which itself is linked to the sovereign rating, can be the highest achievable credit rating for the financially strongest issuers domiciled in the specific country. Therefore, ARC uses it as a cap for any foreign currency debt issuance made by an issuer domiciled in that country.

The country ceiling can be higher than the foreign currency sovereign rating depending on two key risks: transfer risk and convertibility risk which, combined, is referred by ARC as 'T&C risk'.

The country ceiling can be higher than the foreign currency sovereign rating of a country to recognise that certain entities or issues can have more robust payments prospects in foreign currency than the sovereign. This situation could exist because the issuer's intrinsic financial situation is healthier than the sovereign in foreign currency, combined with an assessment that the government would not want to, or be able to, interfere with scheduled payments due by that issuer. This could happen despite the government's control over the levers determining the availability of foreign exchange. Whereas in any economy the government is much stronger than other economic agents in its own local currency (due to taxing authority and ability to print money), in foreign currency the government has no direct comparative advantage over the private sector other than its unique relationship with official creditors and its willingness and ability to interfere with foreign currency payments of economic agents domiciled in that country - T&C risk -, which is what fundamentally constrains the country ceiling.

TRANSFER AND CONVERTIBILITY RISK DEFINED

Transfer risk is the risk that a government might interfere with the distribution of foreign currency in order to ration it for its own use, or to prevent downward pressure on its currency. In doing so, it would interfere with payment mechanisms of other economic agents for foreign currency obligations falling due.

Convertibility risk is the risk that a government would interfere with the conversion of local currency into foreign exchange. The main reason for this would be the same as for transfer risk, namely, to hoard foreign exchange for a government's own use and to prevent a currency from sliding.

Both risks implicitly limit the unfettered availability of foreign exchange to be accessible by economic agents in an economy, and therefore are critical considerations for the currency ceiling.

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