What an ARC Ratings Credit Rating Is All About

LOCAL EXPERTISE, SHARED INSIGHT, BETTER JUDGMENT

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I. Introduction

ARC Ratings, S.A. (ARC Ratings) is an international credit rating agency based in Europe and registered as a Credit Rating Agency (CRA) with the European Securities and Markets Authority (ESMA). ARC Ratings’ mission is to provide an expert credit risk opinion from an independent and multifaceted standpoint, while constantly monitoring the evolution and validity of such assessment through time. ARC Ratings’ opinion is the end-result of a global and local research effort assembling evidence focused on the ability and propensity by the rated entity to honour its commitments. The general principles of such approach are embodied in the present ARC Ratings’ Rating Methodology, which in itself is quite dynamic and constantly evolving. ARC Ratings performs an annual reappraisal of all its methodologies in terms of their practical efficacy and may review them anytime sooner if any significant matter requires such action in order to make sure that the final outcome will always be a clear, precise and forward-looking assessment of every rated entity’s financial strength and about the overall credit quality of any rated obligation.

ARC Ratings is a multicultural and geographically polycentric credit rating agency established under the initiative of five prominent local credit rating agencies from four different continents (but open to new shareholders in the future), whose aim is to consolidate and strengthen a global information and collaboration network for the benefit of more accurate and superior-quality credit risk assessments to investors, without any geo-ethical or idiosyncratic biases. ARC Ratings will focus on all credit rating segments, including those risks stemming from intermediate and medium size non-financial corporations and financial institutions which are usually not covered by incumbent rating agencies.

II. What an ARC Ratings Credit Rating is All About

The purpose of a solicited credit rating is to thoroughly inform investors of ARC Ratings’ opinion concerning the ability and willingness of an entity to honour, on a full and timely basis, the financial commitments (capital and interest) subject to that rating. Such rating may include:

- the full range of senior and unsecured (explicitly so or established by law and/or regulation) short-term financial instruments with an initial maturity period up to one year and/or medium and long-term financial instruments, with initial maturity period exceeding one year;
- certain financial commitments (issuer’s short-term and/or medium and long-term rating).

Typically a strong linkage exists between short and medium and long-term ratings. However, as the rating process is dynamic, this linkage may be broken under certain circumstances, at the discretion of the Rating Panel.

A particular issue may either rank senior or subordinate to other claims, and, consequently, such issue may either receive a higher or lower rating than that of the entity’s own issuer credit rating. An issue may be supported by specific
collateral that may secure a higher credit rating than that of the overall issuer’s credit rating. Additionally, specific clauses in the underlying legal agreements related to a financial commitment, such as collective action clauses or pari passu, may also influence the rating level of specific issues of an entity as may the jurisdiction under which all legal aspects of the rated issue are governed.

ARC Ratings’ final opinion is translated into a letter-grade rating along a rating scale. ARC Ratings’ rating assignments conform to an underlying Stable Rating Principle, which means the clear and uncompromising adoption by its Rating Panel of a long-term perspective for any rating assignment, with an analytical foresight travelling along the whole economic cycle in order to fully assess the ability of the rated entity to honour a claim under every conceivable circumstance. Thus any assigned rating is supposed to remain stable throughout the ups and downs of the economic cycle. The Stable Rating Principle by ARC Ratings is anchored in the classic tradition of analytical reliability, which once was the major pillar of this industry so that investors may make investment decisions as well as expected return calculations.

At the time of ARC Ratings’ rating’s assignment events may be occurring or very likely to happen whose outcomes may have an influence on the assigned rating. The rating outlook is used to indicate the direction of this influence.

The date of an initial public assignment of a credit rating by ARC Ratings will serve as a predictable schedule for its semi-annual (both for short-term and medium and long-term sovereign’s financial commitments and for short-term financial commitments of other entities) or annual (in case of other entities’ medium and long-term financial commitments) review/follow-up, through the regular procedure of a rated claim’s or issuer’s risk monitoring. ARC Ratings will generally only publish any new rating assessment upon such dates. If a previously unforeseen and very significant event does occurs or is about to occur with the potential to disrupt the logic of any standing rating assignment, ARC Ratings’ Rating Panel may decide to upgrade or downgrade an initial rating assignment outside of the periodic review schedule, while issuing an explanation of the underlying rationale for such a rating change.

The Stable Rating Principle, coupled with a periodic review for every rated issue and issuer is designed to reinforce the market stabilization target implicitly embodied in the credit rating technique. Such technique was originally and appropriately conceived to provide investors with a higher degree of assurance about the “true” risk profile of any investment by accurately and, if possible, timely providing the market with an independent and forward-looking assessment thereof. As circumstances evolved to produce less competition among the prevalent rating agencies, such rating reassessments to new and supposedly unforeseen events have become a mere reaction to consummated realities. The informative price-forming value of a reactive rating assignment is null, if not negative, given the chain market reactions that a delayed rating provokes.

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1 The 2008 financial crisis and the quick (and unforeseen) deterioration of credit quality of entities across the full rating spectrum obfuscated the classic definition of a rating. Instead the ratings by the large incumbents have become “benchmark-related” to a rather unclear concept of a “best quality peer”. ARC avoids such confusion by not assigning a “best-in-class” rating just for this mere distinction. In other words, if no issuer or issue among a set of entities (sovereigns, non-financial corporations or financial institutions) will qualify for its highest AAA rating, ARC will not assign it.
ARC Ratings will generally only act upon the discipline of the ratings’ periodic reviews, that is, ARC Ratings will only change a rating following such periodic and scheduled review, except in cases of previously unforeseen and significant events, which have the potential to disrupt the logic of any standing rating assignment. By producing a list of “periodic review schedules” for each and every rating, ARC Ratings’ market surveillance will help fostering an orderly assessment of credit risks worldwide. Enhanced investor assurance is likely to provide the basis for safe credit expansion, thus contributing to a new financial order as well as to a more vigorous and reliable global economic recovery.

III. ARC Ratings’ Rating’s Assignment Process

The main stages to ARC Ratings’ rating process are:

1) Initiation of rating process at the issuer’s request;

2) In depth analysis and evaluation:
   • Analysis and evaluation of credit risks, based on publicly available as well as confidential information;
   • Due diligence meetings with management/leadership.

3) Delivery to the issuer of the Preliminary Report for Discussion by ARC Ratings;

4) Assignment of the rating by an independent, multipolar and multicultural rating panel composed of:
   • ARC Ratings’ Chief Ratings Officer;
   • ARC Ratings’ Head Analyst and team of Analysts that made the analysis;
   • the department head of the member domestic credit rating agency within the jurisdiction or region of the rated entity;
   • one randomly chosen lead analyst of the corresponding department reporting to another network partner.

5) Delivery of the Public Report Proposal and the assigned rating by ARC Ratings to the respective issuer;

6) Issuer’s decision to give permission to ARC Ratings to publish the Report as well as the corresponding rating. If Issuer does not give such permission the Report and its corresponding rating will remain strictly confidential unless applicable laws provide otherwise;

7) Continuous monitoring and formal follow-ups at least every six months both for short-term and for long-term sovereigns’ financial commitments, and at least every year for other entities’ medium and long term financial commitments.

ARC Ratings’ ratings and ratings’ outlooks assigned are opinions based on a thorough, rigorous and systematic, quantitative, qualitative and comparative analysis of a number of factors and are based on information gathered from a wide range of information sources, with emphasis given to the entity whose financial commitments are subject to rating,
including confidential information. By including confidential information of the entity whose commitments are subject to rating, ARC Ratings’ ratings allow a strong reduction of the information asymmetry that typically exists between the issuer and the investors. At the same time, the confidentiality of the issuer’s information is preserved, since this information is weighted in the rating and outlook assigned, but not made public.

The analytical tools employed by ARC Ratings will differ from case to case depending upon the idiosyncrasies of the entity, but it will always include a series of fairly common quantitative and qualitative factors for each rating segment and typically a minimum of five years of historical analysis. The specific adjustments for each particular case are fully disclosed in the report that underpins the notation.

Prior to the assignment or completion of a review (follow-up) of a rating and rating outlook, ARC Ratings provides the entity whose financial commitments are subject to a rating with documentation that supports the rating and rating outlook to be assigned (Preliminary Report for Discussion), giving it the opportunity for factual clarification or correction so that the underlying assumptions for such rating and rating outlook are as accurate and complete as possible. The comments of the entity whose financial commitments are subject to a rating are taken into account by ARC Ratings in assigning the rating.

Ratings and ratings outlooks are assigned by the Rating Panel composed of:
- ARC Ratings’ Chief Ratings Officer;
- ARC Ratings’ Head Analyst and team of Analysts that made the analysis;
- the department head of the member domestic credit rating agency within the jurisdiction or region of the rated entity;
- one randomly chosen lead analyst of the corresponding department reporting to another network partner.

After the rating assignment by the Rating Panel, the entity whose obligations are subject to a rating can decide whether or not to publish the rating. ARC Ratings may not override such decision, unless so provided by law.

The rating publication is always accompanied by a report that supports the rating and rating outlook, encompassing the analytical factors considered most relevant by the Rating Panel for the rating and rating outlook assignments. This report is published on ARC Ratings website (www.arcratings.com) in full and for free, in addition to ratings, outlooks and press releases.

ARC Ratings carries out a constant monitoring of the progress of the entity whose financial commitments are subject to rating over the entire period during which the rating is valid. This monitoring process is accompanied by a formal update (follow-up) at least every six months both for short-term and for medium and long-term sovereigns’ financial commitments, and at least every year for other entities’ medium and long-term financial commitments. Investors will be provided with a schedule of rating reviews, as applicable, and may, therefore, anticipate the timing of the potential rating changes or confirmations, except in cases where, prior to such scheduled review, ARC Ratings considers that a
previously unforeseen and very significant event with the potential to disrupt the logic of any standing rating assignment may occur or has just occurred. Thus, investors are sure to have available updated and fully vetted information on the credit risk of the financial commitments subject to a rating at all times. Prior to the use of the rating by the investor, ARC Ratings recommends that investors confirm such rating by consulting the public ratings list on its website (www.arcratings.com).

ARC Ratings also assigns Indicative Ratings to financial commitments. An Indicative Rating is an assessment of credit risk that is based on the rating methodology, that is strictly for private use and may not be made public either by the issuer or by ARC Ratings (which means it is not a rating as defined in REGULATION (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 September 2009 (Regulation 1060/2009) on credit rating agencies, in REGULATION (EU) No 513/2011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 11 May 2011 and in REGULATION (EU) No 462/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 May 2013).

IV. Conclusion

While a thorough quantitative analysis remains unquestionably important, the qualitative characteristics of ARC Ratings’ analysis cannot be overemphasized. It is critically relevant to look “beyond the numbers” and “beyond the cycle” to evaluate the intangible strengths and weaknesses of an entity. A crucial aspect of ARC Ratings’ analysis is the correct understanding of the entity, as highlighted above. Ultimately, ARC Ratings’ emphasis is on determining how this will affect the institution’s financial safety and soundness.

V. Limitations of Ratings

ARC Ratings’ ratings provide a risk opinion based on public and confidential information. ARC Ratings will cross-reference information and, whenever practicable, seek independent verification. Nevertheless, the rating is subject to the quality of the information it uses, as well as the truthfulness of all information received. The rating process is not an audit.

In addition, ratings are based on information available at a particular point in time and cannot take into account unforeseen events, either external (some changes in legislation, natural disasters, a sudden terrorist attack from abroad, etc.) or internal (unforeseen political instability in case of a sovereign or merger, acquisition etc. in case of non-financial corporations or financial institutions). However, ARC Ratings carries out a constant monitoring of the progress of the entity whose commitments are subject to rating, over the entire period during which the rating is valid. Although all due care is employed in the collection, cross-checking and processing of the information for the purposes of the rating analysis, ARC Ratings cannot be held liable for the truthfulness of such information. However, ARC Ratings only assigns a rating when it perceives that the whole information body holds the minimum required level of quality for its analytical
task.

During the rating process, ARC Ratings adopts methodologies and procedures to ensure transparency, credibility, and independence. In addition, such methodologies and procedures provide that the ratings and ratings outlooks’ assignments are not influenced by conflicts of interest. Exceptions to these principles are provided by ARC Ratings in conjunction with the financial commitment rating and outlook.

ARC Ratings will incorporate systemic shocks in a global systemic risk rating that will indicate whether it is likely, in ARC Ratings’ opinion, that ratings may be subject to growing or diminishing overall systemic risk in an interconnected environment of markets, asset classes, debtors and creditors.

ARC Ratings’ ratings are not recommendations to buy, sell or hold any securities. Instead they are only one of the elements to be considered by investors. These ratings do not consider interest rate risk, exchange rate risk, liquidity risk and other market risks incurred by the investor with the financial commitment subject to rating except insofar as these risks impact the credit risk of the rated financial commitments.
ARC Ratings, S.A. is registered as a Credit Rating Agency (CRA) by the European Securities and Markets Authority (ESMA), within the scope of the REGULATION (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, of 16 September, and recognised as External Credit Assessment Institution (ECAI) for Corporates by the Bank of Portugal.