Sovereign Rating Methodology

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Criteria for Assessing Country Ceilings

Local and Foreign Currency Ceilings

This is an update to the methodology previously published in May 2019. There are no material changes and as such no rating impact.

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I. INTRODUCTION

A country ceiling caps the highest rating that can be achieved by the financially strongest issuers domiciled in that country, and can differ according to the currency used to denominate the obligations being rated – local currency country ceiling and foreign currency country ceiling. It is ARC's proxy for a country risk rating, capturing all of the attributes reflected in sovereign ratings – institutional robustness, government finances, and the overall health of the economy – and speaks broadly and holistically to overall macro conditions in a country.

This methodology explains ARC's approach to assigning local and foreign currency country ceilings to issuers and / or issues, the difference between a local and a foreign currency country ceiling and the linkage between a sovereign rating and a country ceiling.

ARC is not currently assigning sovereign ratings and consequently also not assigning country ceilings. The approach the agency is taking in this situation is to use as reference for its rating assignments, when necessary, the second best local or foreign currency ceiling, as the case demands, assigned by the set of credit rating agencies considered relevant by the rating panel.

II. LOCAL CURRENCY COUNTRY CEILING

OVERVIEW: WHAT IS A LOCAL CURRENCY CEILING?

ARC Ratings' local currency country ceiling caps the highest rating that can be achieved in local currency by an issuer domiciled in that country. It is ARC's proxy for a country risk rating in local currency. The local currency ceiling (LCC) potentially enables private sector entities to be rated higher than the sovereign in local currency.

The LCC is the purest measure of country risk, stripping out the role of external financial flows into and out of a country. It captures all of the attributes reflected in sovereign ratings – institutional robustness, government finances, and the overall health of the economy – and speaks broadly and holistically to overall macro conditions in a country.

The LCC is relevant only for those instruments denominated in local currency and domiciled in that country. As such, assets issued abroad denominated in the related local currency (for example a World Bank bond denominated in any given local currency) are not capped by the ceiling. The LCC is a ceiling, not an explicit rating. It does not attempt to measure volatility of local currency markets or currencies.

LINK TO LOCAL CURRENCY SOVEREIGN RATING

The local currency ceiling (LCC) has a strong connection to the sovereign credit rating of a country in local currency. Sovereign defaults or debt restructurings almost always coincide with severe economic malaise in a country, and are also accompanied by investor aversion and capital outflows, leading to a significantly impaired financing environment all around for almost all, if not all, issuers in a country. All of these conditions increase the risk of economy-wide payments disruptions, as is reflected in the LCC. Moreover, the sovereign has a unique taxing authority in local currency and the ability to print money, suggesting that in most cases the sovereign rating may well be the highest rating accorded in the country despite the presence of a higher LCC.

Despite the linkages to sovereign risk, it is still not uncommon for economic agents to be rated higher than a government in local currency – hence the rationale for the LCC that sets this cap. Indeed, empirical evidence shows that in many instances of sovereign restructurings, private sector borrowers maintain a higher credit standing than the government whether because of better financial circumstances or because of preferential treatment by a sovereign (for example, exemption from emergency taxes). In addition, policy measures that would deepen economic dislocation in an economy are often counterproductive to government financial health and revenue mobilization. Still, because of these relationships and connections, the sovereign rating is the basis for the LCC.

TABLE 1: CONDUITS OF RISK TRANSMISSION FROM A SOVEREIGN DEBT CRISIS:

- Capital outflows and adverse funding and liquidity situations
- Contracting economic activity; recessionary conditions
- Dominant role of government in the economy means macro conditions are closely linked to sovereign risk
- Sudden government policy shifts to stabilize government finances portend to impair companies' financial prospects
- Falling value of exchange rates makes the cost of doing business higher, and serves to dampen demand
- Accumulation of payments arrears that lead to system wide-payments problems
- Weakening asset quality of banks makes lending more cautious, exacerbating liquidity constraints and long-term investment-led growth prospects

OTHER KEY CONSIDERATIONS IN SETTING LOCAL CURRENCY CEILINGS

In addition to the consideration of the sovereign local currency rating, ARC accords the LCC based on the assessed risks of system-wide default, hyperinflation, widespread government nationalization or regulatory/legal changes, and currency redenomination in an economy. It also assigns LCCs based on the degree of internationalization of an economy, a factor that will reflect how immunized corporates can be from the domestic business cycle or from factors affecting sovereign risk. Most of these factors are imbedded in the analysis of a sovereign rating, but they also determine how much a local currency ceiling can deviate from the sovereign local currency rating.

Hyperinflation risk is highest in countries with central banks that are not independent, especially in situations in which central banks will be used in an irresponsible way as a tool of government policy to finance the government. Stated differently, hyperinflation risk is oftentimes highest in countries with a propensity for large fiscal deficits that rely on monetization because of financing pressures. Oftentimes, in such countries, interest payments consume an outsized proportion of expenditures, and the government's balance sheet is very fragile. These are good warning signals for hyperinflation risk.

Nationalization risk relates to the government's financial situation as well as political priorities.

Regulatory and legal risks that would compromise the enforcement of contracts are other important factors determining the local currency ceiling of a country because they dampen investment, economic activity and create payments problems.

Redenomination risk speaks directly to the impairment of the contract should the new payment medium be materially devalued. Redenomination risk should not be confused with currency fluctuation risk. The ceiling does not incorporate or respond to swings in the value of currencies, except of course, if such changes lead to heightened, sustained solvency or liquidity risks. Fiat currency countries that join currency unions at an exchange rate that does not imply value erosion, and whereby the new currency is fully convertible, are not penalized in terms of redenomination risk, albeit considered on a case-by-case basis.

When these aforementioned risks are especially high, the LCC is constrained to the level of the sovereign; in that environment the sovereign would very likely have the best credit standing in an economy, especially given its access to resources and policy tools. Governments have taxation authority and the ability to force the printing of money, tools private agents do not have at their disposal.

RATINGS OF CURRENCY UNIONS AND THE EUROZONE

LCCs of currency union members are not treated any differently in ARC's criteria from countries with fiat currencies. ARC determines, on a case-by-case basis, the rating of each member country of a currency union depending upon our assessment of the intrinsic credit strengths of the country (including all of the factors cited above), of the currency union underlying institutional framework (including obligation of inter members cross support or debt mutualization mechanisms), and also risks of exiting the currency union (redenomination risk).

The Eurozone currency union uniquely involves a reserve currency, which, like other currency unions, is not differentiated in ARC's criteria. In the Eurozone, the local currency ceiling is the same as the foreign currency ceiling (FCC), given the reserve currency status of the Euro.

Setting Eurozone country LCCs is more complicated than setting other LCCs because the Eurozone LCC is accorded coincidentally with the FCC. Hence factors to be described in the discussion on the FCC, namely transfer & convertibility risks, are also considered.

ARC does not assign a blanket 'AAA' LCC to all Eurozone countries. The reason for this is that the existential risk of an exit from the Eurozone or a collapse of the Eurozone infrastructure is not zero, implying that there is a more than zero risk of currency redenomination. It is ARC's view that this assessment varies country by country in the Eurozone. In other words, some countries are more compatible with Eurozone membership than others. Moreover, related to the identical FCC, the risk of capital controls is not zero in the Eurozone, a consideration for setting the FCC (and feeding into the LCC). The Eurozone's banking system remains deeply fragmented and while institutional capacity to handle shocks in the banking system has improved, valid concerns still exist about the sufficiency of funds to backstop national banks. For these reasons, T&C risk is higher in some Eurozone countries than in others, warranting discrimination in assigning FCCs and LCCs.

STEPS TO DETERMINE A LOCAL CURRENCY CEILING

A local currency ceiling for a country is based on the long-term sovereign credit rating in local currency. Other factors are additive to the analysis.

STEPS TO ARRIVE AT THE LCC

1. ARC determines the sovereign rating of a country in local currency based on ARC's methodology for assigning sovereign ratings.
2. ARC considers what type of monetary arrangement the sovereign maintains and the durability of this arrangement.
   - Reserve currency countries may or may not have negligible risks of hyperinflation, government nationalization, sweeping economic collapse and currency redenomination.
   - The USA and Japan automatically receive the highest possible LCC on ARC's ratings scale, AAA, in ARC's criteria.
   - Eurozone member countries are assigned a LCC on a case-by-case basis, based on Step 3 of the Criteria, and also in consideration of the FCC criteria.
   - Fiat currency countries automatically move to Step 3 of the Criteria.
3. ARC employs an analysis that assesses the risks impacting the extent of acceptable divergence of a local currency ceiling from a local currency sovereign rating.
   a. Regulatory and Legal Risk:

      ARC relies on World Economic Forum's Global Competitiveness Report indicators on property rights, the regulatory environment, the efficiency of the legal framework, and the strength of investor protection. Such indicators speak to the operating environment of corporates and are also generally informative about the stability of the legal framework.

   b. Hyperinflation Risk

      ARC looks at the propensity for hyperinflation including central bank independence, proclivity to monetize government deficits, management of the exchange rate, and inflationary tendencies.

   c. Risk of Economic Collapse

      ARC analyses systemic risks and shocks of all types in terms of their likeliness and potential scale to assess the extent this would cause a full-scale collapse of the payments system and more than just a cyclical erosion of the value of an asset.

   d. Government Expropriation Risk

      ARC assesses government involvement in the economy and the history of intervention to help us predict how tangible this risk is and how much it should weigh down a local currency ceiling.

e. Redenomination Risk

ARC assesses the risk of currency denomination that would contractually impair the value of every local currency contract.

f. Internationalization of the Economy

ARC assesses the extent to which the economy is internationalized and potentially immunized from a sovereign or domestic crisis. Countries with extensively internationalized corporate sectors are delinked – to some extent – from crisis conditions in the home economy, even though corporates may still be subject to emergency measures and general economic malaise.

4. The Rating Committee votes on the LCC based on these factors and steps.
5. Separately, issuer-specific rating committees are assembled to determine the stand-alone rating of an issuer, and to assess if that issuer's rating is capped by the LCC.

LOCAL CURRENCY CEILINGS IN PRACTICE

ARC's LCC sets a guideline for the highest possible local currency debt rating in a given economy. The height of the LCC must be sufficient to accommodate any issuer in the country, save for those which structured debt transactions to specifically reduce or eliminate any of the risks described above.

In practice, at the lowest end of the rating scale, the divergence between the local currency ceiling and local currency sovereign rating is expected to be smaller given the importance of factors a) to f) above in also influencing the sovereign rating.

III. FOREIGN CURRENCY COUNTRY CEILING

OVERVIEW: WHAT IS A FOREIGN CURRENCY CEILING?

ARC accords foreign currency country ceilings (FCC) for every country it rates. The FCC is a ceiling and not a rating. This ceiling serves as a cap for any foreign currency debt issuance in a country. The FCC serves as ARC's proxy for a country risk rating in foreign currency.

The FCC can be higher than the sovereign foreign currency rating depending on our assessment of two key risks: transfer risk and convertibility risk – combined, T&C risk, also known as payments moratorium risk. Foreign currency ratings are accorded for individual issuers based on the FCC as well as any given issuer's own individual credit strengths and weakness, as determined in a separate rating committee.

The FCC is oftentimes set higher than the foreign currency sovereign rating of a country to accommodate any and all issuers with 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, but also must reflect ARC's assessment that the government would not want to or be able to. at least to some extent, interfere with scheduled payments by that issuer. A company could have a higher rating than the government in foreign currency because of the expectation that the sovereign would give that issuer preferential access to foreign exchange even in the event of a general moratorium on payments.

Hence, it is not uncommon for economic agents in an economy to achieve a higher rating in foreign currency than the government despite the government's control over the levers determining the availability of foreign exchange. Whereas in an economy the government is oftentimes 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 FCC.

LINK TO FOREIGN CURRENCY SOVEREIGN RATING

As is the case for the LCC, the FCC is directly linked to the sovereign rating. The many forces at play that constrain a sovereign's payments prospects in foreign currency are likely to affect many corporates and other issuers in that country as well. However, the foreign currency ceiling must also take into account situations whereby individual non-sovereign issuers may indeed have greater resources in foreign currency than a sovereign, even if these are rare occurrences.

A sovereign's special access to foreign currency is owed to its relations with external creditors, and its monopoly over control of the flow of capital into and out of a country. Moreover, sovereigns can levy emergency taxes (in any currency) and execute policies to shore up government finances when under duress which influence repayments prospects economy-wide. Hence the same modes of transmission from a sovereign debt crisis to non-sovereign debt stresses discussed above in Table 1 (p. 3) influence all issuers in an economy, and explain why the starting point for any ceiling is the sovereign debt rating.

TRANSFER AND CONVERTIBILITY RISK DEFINED

Transfer risk is the risk that a government will 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 chief 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 types of risks implicitly limit the unfettered availability of foreign exchange for use by economic agents in an economy, and therefore are critical considerations for the foreign currency ceiling.

Practically, there are many empirical examples of governments restricting foreign currency payments in order to ration resources for their own uses and to prevent sharp currency depreciation. However, there are also empirical instances where interference has been avoided because such measures can often be counterproductive, suffocating an economy and investment prospects, and in turn, the government's financial picture. ARC has also witnessed situations whereby a sovereign has defaulted and capital controls were imposed but certain issuers were exempted from these straightjackets.

These examples provide justification for a selective notching of the FCC against the sovereign rating in foreign currency, based on ARC's assessment of T&C risk.

EUROZONE COUNTRIES ARE NOT UNIVERSALLY ACCORDED AAA CEILINGS

Economies in the Eurozone are not universally accorded a blanket AAA FCC. First, this practice is based on ARC's assessment that there is existential risk of Eurozone exit – a risk that bears on the LCC of those countries – and differing country -by -country. Second, this practice is based on ARC's assessment that T&C risk is not zero – a risk that bears on the FCC - also differing country by country. Hence, both exit risk and T&C risk are factors exerting downward pressure on the LCC/FCC of many Eurozone economies, to differing extents.

ARC considers T&C risk to be greater than zero in the Eurozone for several reasons:

1. Cyprus Example

   The capital controls put in place in Cyprus in 2013 underscore that T&C risk is not zero despite the illegality of such controls according to the European Treaty.[1]

   Cyprus imposed capital controls during the peak of its crisis, limiting deposit withdrawals and money transfers abroad. These controls were not explicitly intended to prevent debt payments being made by debtors. They enabled selective access to funds and unfettered access by the government and the Central Bank. Still, the existence of controls de facto interfered with the payments system.

2. Greece Example

   The Greek government imposed capital controls in the summer of 2015 when risks of a Greek exit from the Eurozone (Grexit) threatened the banking system due to deposits outflows in advance of a domestic referendum on Eurozone membership.

   The capital controls implemented in both Cyprus and Greece provide clear evidence that T&C risk exists in the Eurozone, as it does for all other economies, and is a potent tool to provide temporary stability to an economy.

3. Prospects for Capital Controls to Help Ward Off Systemic and Existential Threats

   The creation of a European Banking Union and Single Supervisory Mechanism raises the risk of capital controls being deployed to safeguard the integrity of the Eurozone.

   If forced to make a choice between Eurozone exit and the imposition of "illegal" capital controls, ARC's opinion is that the European Authorities would choose the latter, and possibly on a more precautionary basis even before the Eurozone's stability is under grave threat.

   Hence, in addition to the risk of countries imposing controls – the examples of Cyprus and Greece – there is the additional risk of top-down controls being imposed by the ECB as regulator of the financial system.

STEPS TO ARRIVE AT THE FCC

1. The foreign currency sovereign rating is determined by a rating panel of analysts. The starting point for the FCC is the foreign currency sovereign rating because the FCC is based on the prospects of government interference,

[1] Article 63 of the Treaty for the Functioning of European Union states, "…all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited."

and explicitly takes into account government default risk.

2. The monetary/exchange rate regime is considered.

   - For reserve currency countries, Japan and the USA, the LCC and FCC alike are set at 'AAA'.
   - For the Eurozone, which also has an identical LCC and FCC, in addition to the risk of exit (redenomination risk) being a key consideration, the rating committee stress tests the prospects for capital controls (T&C risk) – Step 3.
   - For all other countries, ARC performs a T&C risk assessment advancing to Step 3.
   - Countries with multiple exchange rates and black market exchange rates naturally are deemed to have high T&C risk.

3. ARC employs an analysis that assesses the acceptable divergence of a FCC from a foreign currency sovereign rating based on a T&C Assessment. Many of these items are also imbedded in the foreign currency sovereign rating.

   a. History of foreign exchange controls in the country.

      While history does not necessarily predict the future, it does suggest biases and precedence.

   b. Discussion of legal framework governing capital controls.

      The legality of capital controls is considered. In the Eurozone, the legal framework allows for a 'AAA' LCC/FCC for high credit quality countries. While the existence of a legal framework that impedes the imposition of capital controls does not suggest that they will not be imposed, it does provide a barrier, albeit permeable. Separately, membership in WTO implies a commitment to free flows of goods and capital, and is thus another instructive factor about willingness to impose unorthodox controls.

   c. Evaluation of institutional strength of a country.

      Countries with weak institutions are fundamentally less resilient to shocks and more likely to impose emergency measures that interfere with foreign currency payments.

   d. Stress testing of policy responses during hypothetical crisis scenarios on the following themes.

      o Is there a reasonable scenario whereby the government would enable an economic agent to make foreign currency payments when it does not?

      o How responsive is a government to the pull of globalization that would lend it not to interfere with payments in times of crisis?

      o How internationalized is the economy? Countries that are more internationalized generally have companies with greater access to foreign currency, and that can make payments from overseas bank accounts.

        - degree of openness of an economy and its dependence on trade and capital flows. (X+M/GDP; FI/GDP); countries with more diverse export baskets are more open than single-product commodity producers.

- the size of the equity markets as a proxy for economic integration (Market Cap/GDP).

  - How important is the real economy to the government's financial stability and would impairing private actors' access to foreign currency have unreasonable costs over the long-term?
  - Would the sovereign treat certain entities with special consideration, exempting them from extraordinary taxes or restrictions that the sovereign might impose in order to shore up its finances or payments capacity?

e. Proximity to crisis is factored in.

   Generally, at the lower end of the rating scale, notching is circumscribed to a few levels. Countries deep in crisis or in default on foreign currency payments are more likely to use unorthodox means including capital controls to manage the crisis environment.

   Countries rated 'B' or below, or that are in or approaching default on foreign currency debts, cannot have investment grade FCCs (above 'BB+') because of the unpredictability of crisis management policies.

4. The Rating Panel votes on the FCC based on these factors and steps.

Separately, issuer-specific rating committees are assembled to determine the stand-alone rating of an issuer, and to assess if that issuer's rating is constrained by the FCC. The rating committee analyses that issuer's resiliency to a debt crisis in other sectors of the economy, namely the government. Issuers with large international operations, where most of their earnings are from abroad, for example, are more immunized against a crisis in their home country. Also, issuers with internationalized operations are likely to have more diversified funding sources that de facto reduce their susceptibility to T&C risk from the home country. The issuer rating in foreign currency is capped by the FCC.

Ratings can pierce the FCC only when transfer and convertibility risk are reduced beyond the level implied in the ceiling. This can occur if a debt transaction is structured to enhance creditor protection from transfer or convertibility risk (i.e. income streams placed in offshore accounts), or because of security provided by a foreign parent.

BANK RATINGS

The episode of the Cypriot controls provides an example of the rationale for why banks cannot in almost all circumstances be rated higher than the sovereign. Cyprus' crisis involved a massive default on bank deposits and ultimately a restructuring of Cypriot government bonds. In this case the large banking sector and its exposure to Greek restructured debt was the trigger for the sovereign default. The systemic risk posed by banks is an important contributor to the sovereign rating.

Moreover, banks are almost always capped by the sovereign rating of a country, whether in LC or FC because of their exposure to government debt and their linkages to the macro-economy. Financial institutions can, potentially, be rated higher than a sovereign if their holdings of sovereign debts are minimal, they have substantial assets overseas, or in the event of foreign parent support.

Countries with vibrant offshore banking systems oftentimes warrant higher ceilings given the independence of these systems from the local policy environment – a reflection of the wish of those governments to support that sector.

FOREIGN CURRENCY CEILINGS IN PRACTICE

ARC's generally high foreign currency ceilings reflect the increasing globalization of economies. Deepening globalization and economic and financial integration weighs on the cost/benefit calculation of governments. Interfering with the growing international source of income and employment for economies has an increasingly higher cost. Those economies most open in terms of trade and capital flows would suffer most from policy interference.

Countries on the lower end of the sovereign rating scale generally have smaller uplifts in their foreign currency ceilings due to institutional weakness and the increased likelihood that policymakers would be put in the position to make difficult crisis management decisions that could impair the contracts of other economic agents in the country.

In practice, foreign currency ceilings are usually lower than local currency ceilings given the inherently greater risk of availability of capital that is not denominated in local currency.

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