

Request for comments

Sovereign methodological cycle - March 2017

Rating-Agentur Expert RA GmbH invites market participants to provide comments on the proposed changes in the Methodology of assigning sovereign government credit ratings and country credit environment ratings (hereinafter – Methodology). During the Methodological Committee Meeting held on the 20th of March 2017 a package of changes in the Methodology was discussed and approved by the independent members of the Advisory board which will lead to the following changes in the short version of the Methodology:

1) **We propose to make the following changes in Section 4.5 “Institutional development of the country” of the short version of the Methodology:**

- replace ***Crime/social instability in the country*** with the ***Rule of law*** measure.

Rationale:

Crime/social instability in the country tends to be a rather outdated and inconsistent measure to measure the level of law enforcement and social stability in a country. After several tests, the Agency believes that the proposed variable - ***Rule of law***, is a more appropriate indicator to measure what this factor is intended to evaluate.

- expand ***Level of information transparency of the government*** to ***Level of information transparency of the government and government policymaking***.

Rationale:

Level of information transparency of the government failed to capture transparency of the government policymaking, which is a substantially important component of the institutional development of a country. The agency believes that the proposed measure of government transparency will be more consistent and will better capture the overall level of transparency of the government.

2) **We propose to make the following change in Section 4.6 “Additional factors for country credit environment rating” of the short version of the Methodology:**

- replace ***Change of the stock index over the last 6 and 3 years*** with ***Weighted change in the main stock index over the last 6 years***.

Rationale:

The current measure of stock index dynamic - ***Change of the stock index over the last 6 and 3 years***, may be subject to extreme levels of volatility when moving from a rating exercise from one year to the next, for instance, when an old observation (three or six years ago) was an outlier and is replaced by a new observation, which is not an outlier. To smooth out such levels of volatility and in order to increase the significance of more recent observations, we are assigning weights to the annual dynamics that are consistently decreasing as we go further into the past. The newly proposed indicator - ***Weighted change in the main stock index over the last 6 years***, incorporates the above, and is therefore a better and more consistent measure of the stock index dynamic.

3) **We propose to add the following indicators to Section 5. “Rating score adjustments” of the short version of the Methodology:**

- *Net foreign assets / GDP*
- *Exports of goods and services / GDP*
- *Total reserves in month of imports*
- *Foreign exchange rate volatility*

Rationale:

The factors currently used for the assessment are not fully capturing the full extent of the currency risk. Therefore, in order to include risks connected to low level of reserves, net foreign asset position, exposures related to the amount of exports of goods and services, as well as very high level of the exchange rate volatility, the above new factors have been introduced.

4) **We propose to make the following changes in Section 5.3.2 “Stress-factors” of the short version of the Methodology:**

- replace the stress-factor *There is evidence of accounting public obligations as corporate obligations* with the new stress-factor *Evidence of large contingent liabilities, such as debt of state-owned enterprises or large pension or other off-budget liabilities or evidence for hiding government debt in off-budget funds or state-owned enterprises.*

Rationale:

The new stress-factor is believed to be able to capture the risks associated with the potential contingencies connected to the debt of state-owned enterprises, large pensions or other off-budgeted liabilities or evidence of hiding government debt in off-budget funds or state-owned enterprises.

- add a new stress-factor for the *Increased level of dollarization*

Rationale:

We have observed that a substantial number of entities from our sovereign rating portfolio exhibit high dollarization levels and are assigned a stress-factor for this. It is usually reflected under *Other* in **Section 5.3.2 “Stress-factors”**. Hence, in order to maintain consistency of our rating process we are introducing a separate Stress-factor - *Increased level of dollarization*.

5) **We propose to make the following changes in Sections 5.3, 5.4 and 5.5:**

- Support and stress-factors are going to have a lower impact on the rating score. Hence, the support and stress-factors will be able to increase (decrease) the rating by 1-3 sublevels.
- Let the support and stress-factors vary among *weak, medium* and *strong*.

Rationale:

While running our internal methodology sensitivity assessments it became apparent to the Agency that the current scoring steps and weights make the final rating score extremely sensitive. Thus, as a result of the statistical models we ran, we decided to recalibrate the steps and weights for the stress and support-factors in order to better reflect the impact these factors should have on the final score.

6) **We propose to change the factor weights for the CCE rating as follows:**

- **I. Condition of the national economy** from 33% to 34%

- **II. Level of development and risks of the country financial system from 24% to 22%**
- **III. Characteristics of government policy from 8% to 9%**
- **IV. Structure and competitiveness of the economy from 8% to 11%**
- **V. Institutional development of the country from 15% to 12%**

Rationale:

Due to new factor introduction and factor substitution underperformed in the current methodological review cycle we are rebalancing the factor-weights for the calculation of the CCE rating score. Our internal tests, including the new factors, show the change in significance and, thus, a reweighting of the factors has been required.

- 7) **We propose to make our Methodology more transparent by including definitions for each of the factors under section 4. “System of indicators” in the Methodology.**

Rationale:

We improve the transparency of our methodology by including a detailed explanation of the meaning and importance of each factor in the rating assessment. In this way, it will be more understandable how the rating assessment was carried out as well as which features of the factors influenced the final rating.

Please submit your comments to: info@raexpert.eu or compliance@raexpert.eu by the 23rd of April 2017. Your response to this consultation will be published unless confidentiality is requested.