



Methodology
Sovereign Ratings

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Insight beyond the rating.

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Sovereign Ratings

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Overview

Credit ratings reflect the probability of default or the likelihood that an obligor's debt will be repaid in a timely manner. They are not a performance guarantee, a statement of fact or a recommendation to buy, sell or hold securities. Rather, a credit rating is an opinion regarding the creditworthiness of an issuer, a security, or an obligation.

In assigning a credit rating, DBRS incorporates all meaningful factors that could impact the risk of maintaining timely payments of interest and principal in the future. In the case of a sovereign rating, which exclusively applies to the creditworthiness of a central government's debt to private creditors, DBRS's rating methodology looks at a broad array of economic, fiscal, financial, and political factors in order to assess the government's ability and willingness to service its debt obligations. Given the government's pervasive authority the sovereign rating will often match or exceed ratings assigned to other obligors within the country, but may in certain circumstances be lower.

DBRS's sovereign rating methodology groups risk factors into six categories, each of which contains a set of quantitative and qualitative considerations:

- (1) Economic structure and performance
- (2) Political environment
- (3) Government management and policy
- (4) Debt and liquidity

- (5) Monetary policy and financial stability
- (6) Balance of payments

Together these categories form the basic framework for all DBRS sovereign credit ratings, which reflect the combined influence of all risk factors on a government's credit. The relative importance of risk factors can vary across countries or in response to major shifts in the global economy and financial markets. In some cases, major strengths in some areas will offset weakness in others, or a critical weakness will override a country's strengths.

DBRS's sovereign rating methodology is underpinned by a stable rating philosophy which means DBRS takes a longer-term "through the cycle" view of an issuer to prevent rating changes that are based solely on normal cycles in the economy. Consequently, DBRS will generally be more responsive to structural changes in the credit fundamentals of a debt issuer rather than to changes due to cyclical economic conditions, unless these conditions are unforeseeably large and persistent. Such practice highlights the forward-looking nature of DBRS's credit ratings. An equally important facet of DBRS's analysis is broad peer coverage, which is essential to understand the major differences and nuances of each issuer and maintain consistency across sovereign credit ratings.

Local and Foreign Currency Ratings

DBRS's sovereign rating methodology applies to both local and foreign currency government debt to the private sector. The foreign currency rating applies to debt that is denominated and payable in a currency other than the country's own domestic currency. Sovereign default on either foreign currency or local currency debt generally reflects the outcome of a severe fiscal, economic or political crisis, and default on both types of debt is often strongly correlated. Given this underlying link, DBRS's rating considerations for both foreign currency and local currency sovereign obligations cover the same broad risk categories, although emphasis on certain factors may

vary. In particular, DBRS foreign currency sovereign ratings emphasize factors that most directly affect foreign currency-denominated debt servicing, such as the size and composition of current and capital account balances, foreign exchange rate stability, and international reserves liquidity. Local currency ratings put relatively more emphasis on the depth of the local government debt market and a government's propensity to finance deficits through unorthodox means, such as monetary expansion and inflation, forced financing by banks or other institutions, or arrears to domestic creditors. Nevertheless, foreign currency and local currency sovereign ratings seldom differ widely.

Economic Structure and Performance

A country's economic structure, track record and prospects are fundamental considerations for DBRS's sovereign credit analysis, as the strength of the economy constitutes the primary determinant of a government's capacity to generate revenue and carry its debt. This is also a major foundation of the country's economic and political stability. Analysis in this risk category focuses on factors that point towards the economy's robustness, flexibility and propensity for growth, as well as any structural impediments that could either increase the country's susceptibility to shocks, unduly pressure the fiscal position of government, or inhibit its commitment to service its debts. The following list outlines the primary considerations when assessing the contribution of an economy's structure and performance to a sovereign credit profile.

HISTORICAL GROWTH AND PROSPECTS

A sound record of generating sustained economic growth is a prime indicator of a country's ability to generate wealth for its population and fiscal resources for its government. DBRS looks at the level and trend of key summary indicators, such as per-capita GDP and income, and seeks to understand the growth potential of a country's economy, as defined by an array of variables, including employment growth and labour productivity, economic composition, and private sector investment and savings rates. Structural distortions within the economy, such as an outmoded financial system or a poorly designed tax system, are also considered in the analysis.

INFLATION

High levels of inflation often indicate underlying stresses and distortions that correlate directly with sovereign risk. Like economic volatility, inflation that recurs frequently or persists for extended periods deepens these stresses, and requires increasingly stringent macroeconomic adjustments to stabilize the economy. The pervasive effects of inflation increase social inequality, distort financial statements, deter investment, and erode confidence in government authorities – all of which may undermine a government's capacity and willingness to service debt. As such, analysts examine

historical inflation and GDP volatility, as well as monetary policies, objectives, and institutions.

INTERNATIONAL ECONOMIC INTEGRATION

An economy's degree of openness to international trade and capital flows may affect a country's creditworthiness in several ways. Economic openness tends to enhance economic diversification while fostering a higher degree of innovation, as businesses must continually improve productivity and efficiency to remain competitive. Businesses in open economies also have a greater stake in retaining access to international markets and capital. Key indicators include traded goods/GDP; trade sector employment/total employment; membership in regional trade associations and adherence to World Trade Organization (WTO) and International Monetary Fund (IMF) standards.

DEMOGRAPHICS AND SOCIAL STRUCTURE

Demographics and social structure issues are important considerations, as they can have a considerable impact on political and social stability as well as a government's fiscal position and debt servicing capacity, by affecting the labour force, income distribution, and demand for social services within a country. Countries with a rapidly growing population frequently benefit from an expanding labour force and tax base, but also face greater popular pressure to build appropriate social and economic infrastructure and foster the level of economic activity necessary to avoid rising levels of unemployment. In contrast, wealthy industrial countries generally have passed these infrastructure obstacles, but are confronting low birth rates and aging populations, which often translate into rising pension and health care expenditures and a shrinking tax-paying workforce. As a result, factors like birth rates, demographics, immigration trends, school achievement, as well as income and wealth distributions, are carefully assessed.

Political Environment

Political analysis focuses on the bedrock issue for sovereign credit assessment: How strong and stable is the government's commitment to maintain its creditworthiness, even if meeting debt servicing obligations requires a large and sustained squeeze in domestic consumption and prolonged economic downturn? This category concentrates on the legitimacy, appropriateness, and robustness of political institutions and their capability to resolve issues in an orderly and timely fashion without damaging the country's commitment to service its debt. Important considerations include the government's openness and accountability, the strength of democratic institutions, and the inclusion of minority interests in the political structure. The

degree of consensus on major social and economic issues is important, particularly by parties that at some point may control the government. The political system's responsiveness to social divisions along lines of income distribution, race, religion, and region is also taken into consideration, as well as potential pressures from rival countries or geopolitical threats.

As part of its review of the political environment, DBRS also evaluates the legal structure of the country, including enforceability of contracts, strength of property rights, and the independence and integrity of judicial processes.

Government Management and Policy

DBRS analyzes the government fiscal track record and prospects, looking at revenue generation, expenditure planning and control as well as the coherence and appropriateness of the strategies, policies and processes governing the management of public resources. Particular attention is allocated to the fiscal management framework in place, the adequacy of revenues to cover program and interest expenditures, and the level of fiscal flexibility afforded by the system, that is, the degree to which expenditures can be contained and revenues increased in order to protect or restore fiscal soundness. A government's effect on aggregate demand and macroeconomic stability also draws considerable attention, looking at consolidated government (central and sub-national governments) balances and expenditures as a share of GDP.

EXPENDITURES

The methodology distinguishes among three major expenditure areas: programs, capital investments, and debt service, with an emphasis on identifying major trends, actual and potential areas of pressures, and sources of rigidities in government spending.

With regard to program expenditures, DBRS seeks to understand the government's structure and

role in the economy. The relationship between key expenditure items and major factors such as demographics, economic conditions, or political tensions is analyzed in order to identify sources of pressure or flexibility. Analysts review key government programs, focusing on the coherence and sustainability of each program, the systems in place to monitor and control spending, multi-year cost projections and financing methods, and potential stress case outcomes. Reported figures are reviewed to determine the treatment of material special items, such as current costs of off-balance sheet expenditures or imputed costs for below-market interest rate bonds issued to bail out banks, state enterprises, or provincial governments.

Debt servicing is the most rigid spending item and can constitute a substantial portion of a government's budget. As a result, the stability and trend of government interest and debt payments are an especially important risk consideration. In analyzing debt servicing requirements, DBRS pays careful attention to a government's debt management strategy and capability, incorporating findings from the debt and liquidity profile analysis, which is described in the "Debt and Liquidity" section on page 8.

While capital requirements can be reduced more easily than program expenditures to weather short-term financial hardship, they generally show considerable rigidity over the longer term. Eventually, making up for delayed capital expenditures can add a significant burden to government budgets. Analysts examine current and future requirements and financing methods for infrastructure and other capital spending. Analysts focus on the adequacy and state of good repair of a country's major public infrastructure, as well as the estimated future costs of maintaining existing assets, addressing deferred maintenance (if any), and meeting growth-related requirements. Analysts also examine government accounting for capital spending to determine if accrued costs are recorded appropriately.

REVENUES

Revenue analysis covers the major components of a government's revenue base, focusing on diversification, volatility and ability to grow key revenue sources, as well as tax effort and avoidance, reliance on one-time revenues, and transfer payments between jurisdictions. Key sources analyzed include direct and indirect taxes, tariffs and royalties, as well as earnings from government enterprises. Special emphasis is put on resilience of major revenue sources, and the consistency and prudence of budgetary projections, looking at projections based on both a moderately conservative outlook and alternative stress cases.

Any structural defects in the tax and revenue system warrant scrutiny. An inefficient, burdensome tax system not only limits government budget flexibility, but also creates structural economic problems by exacerbating tax evasion and corruption, distorting business decision-making, and discouraging investment and saving. Correcting these distortions can be difficult, as many interest groups may benefit from the existing structure and government may find little support for change.

FISCAL BALANCE

A government's fiscal performance provides a reliable indicator of management proficiency and commitment to fiscal soundness. While the analysis focuses on the fiscal balance of the central government, it also incorporates the performance of sub-national governments, given the generally

strong relationship between levels of government and the fact that those governments are often competing for the same limited fiscal resources. Analysts look at the government's primary balance (the difference between revenue and non-debt expenditures) as the primary indicator of fiscal flexibility and sustainability, while the overall fiscal balance (including interest charges) better reflects the potential financing requirements in a given year.

Analysts examine historical results as well as projections over the medium term, incorporating possible stress scenarios to assess the cyclicity and sensitivity of the government's budget and financing requirements to various developments. In higher-risk countries, fiscal deficits frequently widen during economic upswings and narrow during contractions, thereby exacerbating economic volatility. This pro cyclical fiscal behaviour can result from factors such as a shallow debt market with diminishing access to credit during downturns, or government's inability to resist spending pressures during economic upturns. In contrast, lower-risk countries generally exhibit greater fiscal stability and a more accommodative fiscal approach. While repeated budgetary shortfalls are perceived negatively by DBRS, the impact of a shortfall on a sovereign rating will generally be discounted if it is believed to be the result of economic cyclicity, as opposed to a structural imbalance about which a government is showing little initiative.

BUDGET PLANNING AND CONTROL

This part of the analysis covers the effectiveness of the budgetary process, including the timing, transparency and comprehensiveness of budget planning, reporting and monitoring systems for government expenditures and revenues, and the ability of the fiscal authorities to control expenditures and adjust the budget as needed. Additional considerations include the allocation of responsibility and control between the legislature and executive branches, adherence to external budget constraints (e.g., IMF targets or the EMU's Maastricht principles), and budget relationships between the central and sub-national governments, such as whether expenditure responsibilities at each level of government appropriately match revenue-generating powers.

In assessing the quality of the fiscal planning and management framework, DBRS compares recent years' fiscal results against original budget estimates, putting emphasis on the frequency and extent of major budget deviations. DBRS also reviews accounting consolidation practices in order to understand the composition of the reporting entity and ensure that all tax-supported activities are appropriately captured.

GOVERNMENT POLICY MANAGEMENT

The set of institutions and procedures by which a government manages major economic and fiscal policy initiatives is subject to a detailed review. Particular attention is allocated to the policy development and implementation framework within

the executive branch and the coordination process with the legislature, sub-national governments, and other interest groups. Analysts examine the coherence and long-term implications of policies aimed at social and structural economic issues, with frequent changes in strategic goals or inability to pass legislation needed to implement government strategies generally perceived as weakness in the policy framework. The review also incorporates any other policy-related issues that may have important adverse implications for a country or its government, such as strategies aimed at regional disparities in income and employment, an inadequate public education system or a severely undercapitalized banking system, along with potential resistance to needed changes.

Debt and Liquidity

The sustainability of a government's debt is a central consideration in sovereign credit risk analysis. DBRS carefully examines the size and structure of government debt and analyzes the full range of factors that affect the debt burden and the government's debt servicing requirements. Analysts focus on three major segments: first, total public sector debt, including both domestic and external obligations of the central government, regional governments and any government guaranteed or tax-supported public agencies; second, debt servicing requirements and the government's debt management capability; and third, the government's access to liquidity.

Analysts examine the composition of outstanding debt and quasi-debt obligations (e.g., unfunded pension liabilities), as well as the debt maturity structure and sensitivity to volatility in inflation, exchange rates, or interest rates, and to widening credit risk spreads. The primary focus in this section is on tax-supported debt, i.e., debt that taxpayers are directly accountable for. Self-supporting government enterprise debt is examined separately and may be given less weight in the analysis, depending on the self sufficiency of the organization and the likelihood that it may require direct government support. Considerable emphasis is put on the medium-term outlook for

government debt and debt servicing obligations, in keeping with the forward-looking approach of DBRS ratings. Government liquidity is analyzed in relation to scheduled debt payments, as well as potential pressure to repay outstanding short-term debt. Liquidity coverage for external debt requirements is given particular attention, with emphasis on international reserves, market depth and access to alternative private financing sources, and contingent liquidity support available from the IMF or other official sources.

DBRS principally focuses on the direct financial obligations of governments, but also considers any indirect or private sector obligations that may have implications for the sovereign credit profile. Indirect liabilities attracting particular attention from DBRS include guarantees and material contingent liabilities, including non-guaranteed debts of public sector organizations and the financial sector, which can constitute a significant drag on government fiscal resources if a bail-out is required. External debts of the private sector are profiled alongside the government's external debt, since both represent claims on the economy's ability to acquire foreign currency. During a crisis, moreover, governments may assume responsibility for certain private sector external debt.

Monetary Policy and Financial Stability

The sustainability of monetary policy and stability of the financial system are intertwined elements of sovereign credit risk analysis. Inconsistent monetary policies invariably increase the risk of inflation, exchange rate volatility, and financial market shocks. A weak financial system can constrain monetary authorities' policy options and worsen the damage from internal or external shocks.

MONETARY POLICY

The analysis focuses on the sustainability and effectiveness of the monetary policy system, that is, whether monetary policy goals, implementation structure, and institutions are consistent with restraining inflation and minimizing risks of an exchange rate or banking crisis. Analysts must also consider whether other conflicting policy goals may take precedence over inflation control, including economic growth, exchange rate stability or government deficit finance.

The monetary regime (i.e., the structure of operational targets and tools used to implement monetary policy) is a particularly important consideration, as it can have major economic and financial implications. Monetary regimes can range from full-fledged inflation targeting (e.g., New Zealand), through an implicit price stability anchor with wide discretionary flexibility (e.g., the U.S.), to exchange rate targeting (e.g., China). Exchange rate target-

ing raises particular sustainability issues, as efforts to confine exchange rates within a narrow range inevitably will be tested by exchange rate speculation. Monetary authorities may then have to tighten policy severely to protect the exchange rate, with a heavy cost for economic growth.

FINANCIAL SYSTEM STABILITY

A weak, unstable financial system is both more vulnerable to shocks and less able to recover promptly, compounding the economic damage from adverse domestic or global events. Moreover, monetary authorities may be reluctant to tighten policy to counter inflationary pressures out of concern that higher interest rates would further worsen bank balance sheets. Conversely, as Japan's experience shows, a chronically weak banking system may be reluctant to make loans even in an environment of significant excess liquidity, hampering the effectiveness of monetary policy to counter an economic downturn.

DBRS sovereign analysts closely review the structure and strength of the financial system, drawing on the expertise of DBRS's financial institutions group. The financial system review includes government efforts to strengthen banks and capital markets through improved transparency, application of global best practice standards, and more rigorous governance requirements.

Balance of Payments

Balance of payments accounts contain significant information on a number of risk considerations, including export, import, and current account trends and volatility; the size, composition, and stability of a country's net financing requirements from international sources; and the potential need for a major exchange rate depreciation or economic contraction to close a balance of payments financing gap. At times, a government may be unable to take sufficiently severe measures to close a large payments gap, resulting in a full-fledged balance of payments crisis. In the extreme

case, a crisis can culminate in a halt in government external debt payments and sovereign debt default.

CURRENT ACCOUNT

Current account deficits are not necessarily a sign of higher credit risk, as well-managed emerging market countries routinely attract net capital inflows and run current account deficits. Moreover, a current account deficit may temporarily widen (or surplus narrow) when a country's cyclical expansion is out of phase with global economic demand, or when investment returns rise due to a sharp



increase in productivity. In certain cases, however, a widening current account deficit may reflect severe domestic demand imbalances, major shocks to export revenues or import costs, or other factors that can raise credit risk concerns. DBRS analysts seek to determine whether a country's current account behaviour falls outside normal patterns and, importantly, whether the country has the capacity to narrow its current account deficits when financing conditions turn adverse.

The volatility of export revenues and import costs are important risk considerations. Deteriorating terms-of-trade or other current account shocks affect sovereign credit risk through both a domestic channel, as economic output declines and fiscal balances deteriorate, and an external channel, if the higher demand for current account financing is met with increased reluctance by

external creditors. The diversity of export goods and markets; import compressibility, dependence on energy imports; and reliance on trade barriers, tariffs and subsidies are often good indicators of a country's exposure to current account volatility.

CAPITAL ACCOUNT

The capital account analysis addresses the size and structure of a country's international capital flows. Particular attention is given to the volatility of financing flows, reliance on short-term financing, and the importance of foreign direct investment. Analysts also pay attention to commercial bank financing flows, which generally have short maturity and may be withdrawn rapidly when banks perceive increased risks. Also, large net outflows in the accounts for domestic residents' assets or errors and omissions may signal an underlying financial instability.

Appendix A: Glossary of Sovereign Credit Risk Indicators

This glossary describes the principal quantitative and qualitative indicators DBRS draws on for sovereign credit analysis. Underlying data generally are from publicly available national and multinational sources. Data definitions and reliability for

some countries are not fully consistent with international norms. DBRS notes these differences and in certain cases adjusts the reported data in order to enhance cross-country comparability.

Economic Structure and Performance

Gross Domestic Product growth

Per-capita GDP

Economic diversity

Inflation

Labour productivity

Employment growth

Unemployment rate

Private sector investment and savings rates

Consumer spending pattern

Demographics:

- Population growth

- Age distribution

- Education levels

Income distribution and poverty

Political Environment

Government stability

Government legitimacy and popular support

Judicial integrity and independence

Political consensus on major economic issues

Contract enforceability and bankruptcy laws

Democratic accountability

Corruption

Ethnic and religious tensions

Military involvement in politics

External threats and tension

Government Management and Policy

Allocation of responsibilities

Budget management process

Expenditures:

- Breakdown, rigidity, and outlook

- Total expenditures share of GDP

- Interest and debt payments/total expenditures

Revenue diversity, stability, and outlook

Tax efficiency and fairness

Fiscal balances' share of GDP:

- Central government

- Public sector

- Primary balance (excluding debt servicing)

Debt and Liquidity

Public sector debt (domestic and external):

- Central government

- Sub-national governments

- Government enterprises

- Off-balance sheet (e.g., public pension)

Government debt structure:

- Maturity

- Currency

- Interest rate – fixed or floating

- Indexed debt

- Public sector debt/GDP

- Government debt service/revenues

External debt:

- Borrower (public and private sector)

- Source (bond, bank, official, other)

- Maturity structure (short-term, average duration)

- External debt/GDP

- External debt service/exports

Liquidity:

- International reserves

- Contingency funds (IMF, commercial bank, other)

- External debt service and short-term/Reserves



Monetary Policy and Financial Stability

Monetary regime (inflation targeting, exchange rate, etc.)

Central bank independence

Interest rates:

- Short-term policy rate
- Long-term targets

Monetary aggregates (growth and share of GDP)

Domestic credit to private sector

Non-performing loans/total banking sector assets

Real effective exchange rate

Broad money/international reserves

Balance of Payments

Exports and imports:

- Growth
- Diversity
- Prices and terms of trade
- Share of GDP

Capital account structure:

- Foreign direct investment
- Bonds and other long-term liabilities
- Commercial bank and short-term
- Domestic residents net external assets

Current account balance/GDP

Foreign direct investment/GDP

Current account receipts/current account balance

Short-term capital flows/current account receipts

Appendix B: DBRS Long-Term Rating Scale

DBRS long-term sovereign debt ratings provide a relative indication of risk. They reflect the relative capacity of a borrower to fulfil its long-term debt obligations in a timely manner. DBRS ratings do not take factors such as pricing or market risk into consideration and, therefore, comprise only part of an investor's investment decision-making process. Every DBRS rating is based on quantitative and qualitative considerations. All DBRS rating categories (except AAA) use "high", "middle", or "low" as subset grades to designate the relative standing of the credit within a particular rating category.

The rating categories include:

AAA

Long-term debt rated AAA is of the highest credit quality, with exceptionally strong protection for the timely repayment of principal and interest. The degree of protection afforded principal and interest is of the highest order. Debt is relatively low and overall liquidity is unquestioned. Revenues and cash flows are relatively balanced and predictable, and expenditures are under control. The political environment is stable and the financial system is fundamentally sound. Monetary and fiscal policies are on a sustainable track and the government is able to respond to event shocks such as volatility in interest rates, exchange rates, or international capital flows. The economic base is diverse and overall economic performance remains relatively strong. There are few qualifying factors that could detract from the performance of the entity.

AA

Long-term debt rated AA is of superior credit quality, and protection of interest and principal is considered high. The economy is well-diversified and dynamic, while the political environment is sound. Expenditures remain under reasonable control and are growing at a level consistent with revenues, with a high likelihood of maintaining the fiscal position in long-term structural balance. Overall, the profile differs from AAA in only a small degree.

A

Long-term debt rated "A" is of satisfactory credit quality. Protection of interest and principal is

reasonable, but the degree of strength is less than AA-rated entities due, for example, to a less diversified, more volatile government revenue base or recurring fiscal shortfalls. Overall financial flexibility remains good and long-term economic growth prospects remain reasonable although the economic base may be somewhat smaller or somewhat less diverse.

BBB

Long-term debt rated BBB is of adequate credit quality. Protection of principal and interest is considered adequate. Although financial performance remains reasonable, the revenue and economic base may be smaller, less diverse, or somewhat susceptible to the adverse effects of business cycle changes. Other adversities that reduce the strength of these bonds relative to higher rated securities may be present, such as relatively high levels of government debt, dependence on external government funding, or a relatively short track record of sound government policies and economic stability.

BB

Bonds are defined to be speculative and non-investment grade. The degree of protection afforded interest and principal is lower. The size of the entity and the scope of the entity's revenue base may be relatively small while expenditures may be high and under pressure. The economic base may be somewhat concentrated in relatively few industries and economic growth may be sluggish or fairly volatile.

B

Long-term debt rated B is defined as highly speculative, where the degree of protection afforded interest and principal is uncertain, particularly during periods of economic recession. High and rapidly growing expenditures combined with an inadequate revenue base have contributed to consistent operating deficits. The political environment is somewhat volatile and government capacity to deal with fiscal difficulties is uncertain.

CCC/CC/C

Long-term debt rated in any of these categories is very highly speculative and is in danger of default



of interest and principal. The degree of adverse elements present is more severe than long-term debt rated B. Long-term debt rated below B often has features which, if not remedied, may lead to default. In practice, there is little difference between these three categories, with CC and C normally used for lower ranking debt of issuers for which the senior debt is rated in the CCC to B range.

D

A security rated D implies the issuer has either not met a scheduled payment of interest or principal, or that the issuer has made it clear that it will miss such a payment in the near future. In some cases, DBRS may not assign a D rating under a bankruptcy announcement scenario, as allowances for grace periods may exist in the underlying legal documentation. Once assigned, the D rating will continue as long as the missed payment continues to be in arrears, and until such time as the rating is suspended, discontinued, or reinstated by DBRS.

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