

DBRS Canada Newsletter

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WHAT KEEPS DBRS ANALYSTS UP AT NIGHT

The next ten years are going to be very tough, in the sense that society will face new challenges that could impact generations for years to come. One of the functions of a credit rating agency is to be the “canary in the coal mine” and to highlight some of those challenges, specifically through our ratings and commentaries on governments, financial institutions and corporations. It isn’t always what people or politicians want to hear, and it’s easy to blame rating agencies in times of crisis. But getting opinions into the market and providing leadership on credit issues is what we strive to do, irrespective of the message. So what keeps our analysts up at night?

Sovereign Credit Migration

We recently published ratings on [Canada](#), the [United Kingdom](#) and the [Republic of Ireland](#) (AAA Stable, AAA Stable, and AA Stable, respectively) but with significant caveats. Developed economies face considerable headwinds including outsized deficits and high public debt, significant household or consumer debt, as well as demographics that will strain even the most robust of economies. The aging baby boomer cohort portends a sobering story in that unfunded pension, health care and old age security benefits will have to be paid out in greater levels over the next several decades. In some countries, many of these obligations remain unfunded meaning that some governments have “kicked the can” down the road for future generations to deal with. This will place significant strains on the fiscal balances of several nations and if not dealt with imminently and in a credible way, could lead to downward credit rating pressure. Greece may be a small country but it may be the canary in the coal mine, and that’s why we should pay attention.

Why Do Sovereign Ratings Matter?

The migration of sovereign ratings matters for several reasons. First, it is rare for any bank, and in most cases corporate ratings, to be higher than the sovereign’s rating, unless these entities have significant operations outside of the home country, and are considered to be able to withstand, in a stress scenario, a loss of operating revenue from the home country. In this regard, sovereign ratings act as a constraint on bank and corporate ratings. The sovereign has full taxing powers and significantly more tools at its disposal to deal with balance sheet or income stresses. DBRS now has investment grade ratings for [Brazil](#), [India](#) and [Mexico](#). This allows those developing economies to have more investment grade bank and corporate ratings, which in turn allows for greater access to capital markets. The opposite is also true, downward pressure on ratings pressures bank and corporate ratings, raising the debt cost of capital for the private sector.

Ratings also matter for the cost of capital for sovereigns. The lower the rating, the greater the potential for higher borrowing costs and/or collateral requirements. Witness Portugal’s recent need to post collateral for swaps, something that sovereigns have rarely needed to do. And sovereigns often need access to global capital markets to fund their expenditures. (It is rare for a sovereign to default, but not as rare as you might think – highly speculative emerging markets are frequent defaulters, and six of the G-20 members have gone that route in the last 40 years.)

What Then Are the Risks for Sovereign Ratings?

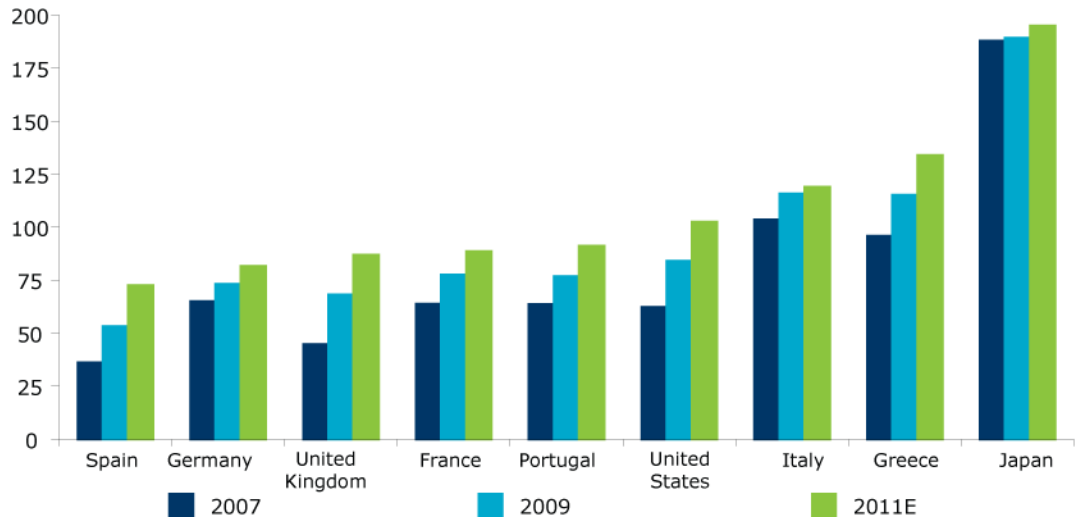
There are many risks and we articulate them in the challenges section on the front page of each of our ratings reports. Those risks vary by country and type however in this report, we will focus on five key risk factors.

High Public Debt

As we have noted in several previous newsletter and commentaries, public debt levels are at elevated levels and increasing at a steady pace in many developed economies due to ongoing deficits. High levels of public debt can be sustained for prolonged periods, especially if largely financed domestically (Japan, Italy) but can lead to significant pressures if mainly or even partly financed externally (Greece, Spain). (Since Greece and Spain are in the Eurozone, they issue in euros, which are bought by domestic and international

investors. Italy, also in the Eurozone, issues in euros, but its bonds are largely purchased by domestic banks. Japanese bonds are largely bought by domestic banks.) How governments deal with their fiscal imbalances and how successful they are will ultimately influence their credit ratings.

General Government Gross Debt (% of GDP)

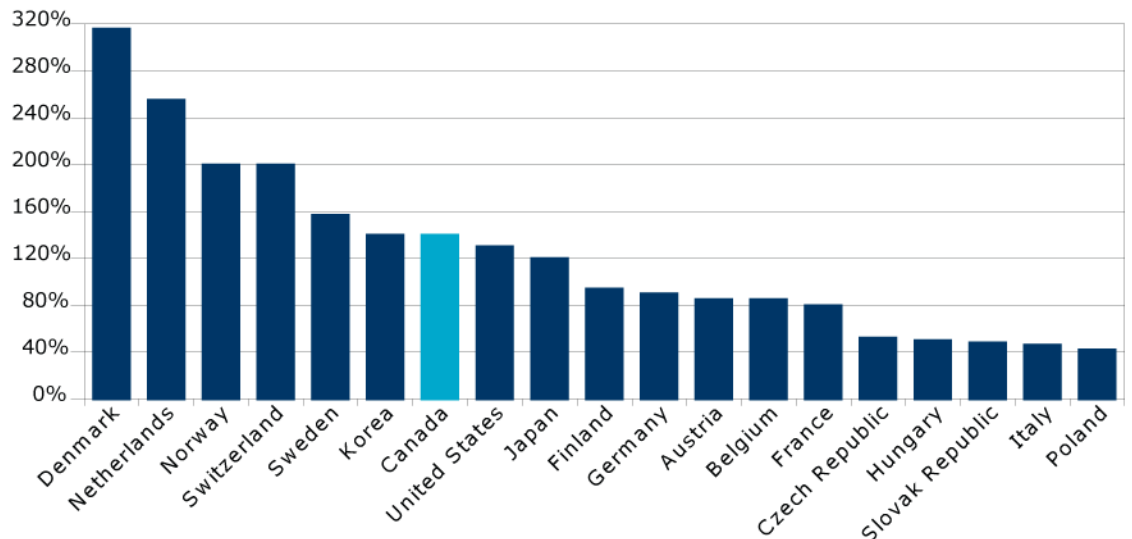


Source: Eurostat and DBRS.

Household Balance Sheets

Find me a levered consumer (particularly to the housing market) and I will show you where the next debt problem will be. We have just witnessed the spectacular consequences of a consumer over-levered to the U.S. housing market. In the chart below, we highlight some of the data for various countries around the world. Chronic or elevated consumer debt levels cannot be sustained in perpetuity and hence the effects of consumer de-leveraging will be felt in incalculable ways for some time to come.

International Comparison of Household Debt-to-Income, 2008

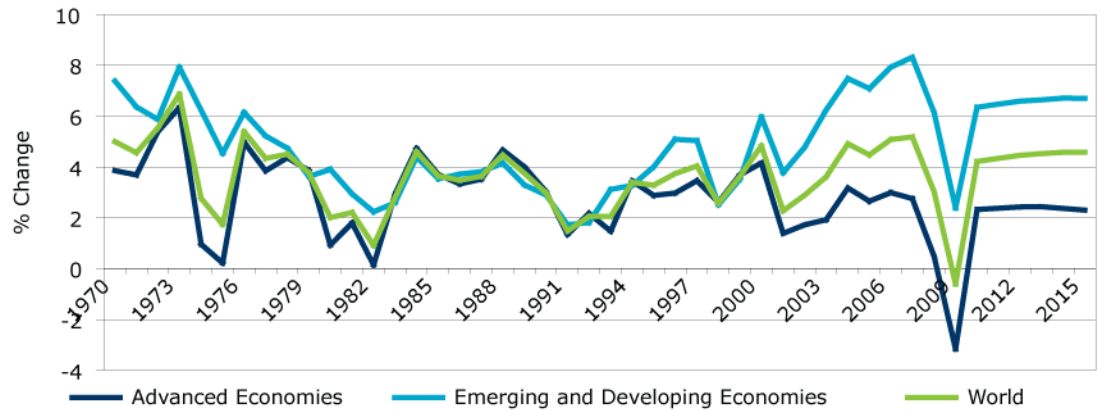


Source: *Where Is the Money Now*, Certified General Accountants Association of Canada, May 2010.

Lower Growth

One of the by-products of consumer de-leveraging, not to mention financial system de-leveraging, is its insidious impact on real GDP growth. Case in point, the IMF projects lower real GDP growth for advanced economies through 2015 than we have seen in previous economic cycles. Robust GDP growth has skated many budget deficits aside but this time may be different.

Real GDP Growth

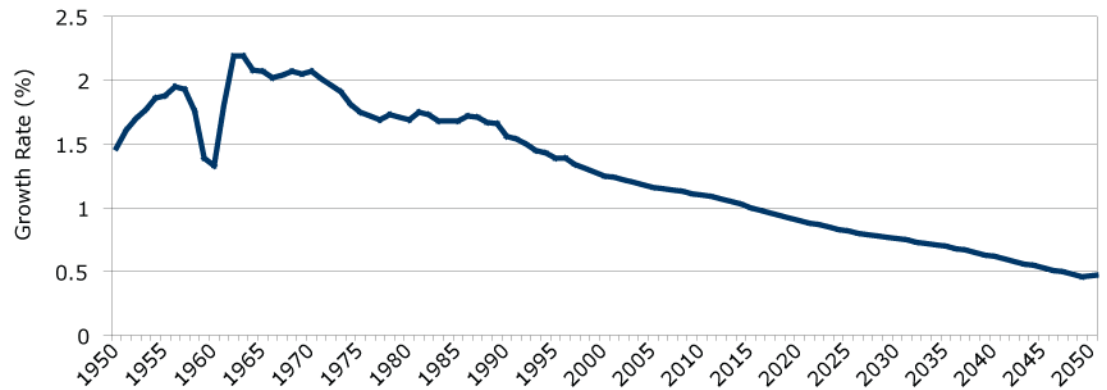


Source: International Monetary Fund: Rebalancing Growth, April 2010.

Ageing Population

The combination of low population growth rates and an aging baby boom cohort is not a good mix. A lower revenue base from the former, and higher health and old age expenses from the latter, will exert fiscal pressure on even the most prudent of nations which will likely require governments to re-think how certain services are funded and delivered, especially health care.

World Population Growth Rates, 1950–2050



Source: U.S. Census Bureau, International Data BAse, July 2007.

Political Risks

The risk of the dissolution of a Parliament, policy error or even policy slippage, where a fiscal plan is not adhered to, can cause a sell-off of a government's bonds. DBRS works to anticipate political events like these by visiting countries and meeting policymakers face-to-face to get a sense of their commitment to economic programs and to gauge the stability of the country's political process.

Conclusion

Many risk factors keep a rating analyst up at night, but perhaps the largest unknown is the future of sovereign credit ratings, and their impact on credit ratings for financial institutions and corporations within their respective countries. Based on recent economic indicators, the "gathering clouds" I referred to in a **recent speech** may be losing momentum but given the wide variety of complex global challenges we have discussed, the clouds have by no means dispersed and the potential for them to turn into a "storm" still exists.

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