



## Underlying Principles

### **WHAT IS A RATING?**

In general terms, ratings are opinions that reflect the creditworthiness of an issuer, a security, or an obligation. They are opinions based on forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend, or distributions) with respect to the terms of an obligation. Ratings for structured finance vehicles reflect an opinion of the ability of the pooled assets to fund repayment to investors according to each security's stated payment obligation.

Ratings are opinions based on the quantitative and qualitative analysis of information sourced and received by DBRS, which information is not audited or verified by DBRS. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security. Ratings may be upgraded, downgraded, placed under review, confirmed and discontinued.

The following outline three important base principles underlying DBRS Corporate ratings:

### **(1) STABLE RATING PHILOSOPHY**

The economic environment will impact the performance of most issuers which DBRS rates and since the growth rate of the economy is continually changing, so too is its impact on issuers. DBRS approaches the reality of a cyclical economic environment by employing a rating philosophy which emphasizes stability ("Stable Rating Philosophy").

The Stable Rating Philosophy considers that increased volatility means increased risk. Hence, a company which is heavily impacted by a cyclical environment will generally be assigned a lower rating to reflect this factor, all else being equal. While the future will likely look good during an upturn and bleak during a downturn, the rating effectively captures this volatility.

While there may be instances when a period of protracted economic growth or contraction impacts the fortunes of an entity and a rating change required, DBRS seeks to minimize rating changes which are due primarily to global economic changes. The goal of each rating is to provide a forward looking assessment of the credit quality of the issuer. Consequently, DBRS takes a longer-term "through the cycle" view of the issuer and as such, rating changes are not based solely on normal cycles in the economy. Rating revisions do occur when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the future.

The most difficult period of assessment for a rating agency is the latter stages of a long/deep recession, particularly if it was much worse than originally expected. The recession may cause structural changes in industrial sectors; the financial strength of governments, business, and individuals; and the attitudes of tax payers or residents. It is at this stage that some ratings may appear to "lag" the economic cycle and further rating actions may occur.



In summary, DBRS believes that there is more value to the investor when a rating does not fluctuate purely with the fortunes of the economy. Therefore, DBRS strives to look through the cycles when considering the impact of economic cyclicality. In short, DBRS emphasizes the differences between structural versus cyclical changes.

## **(2) HIERARCHY PRINCIPLE**

In rating long-term debt, DBRS considers the ranking of the debt relative to issuer obligations noting that the starting point for such ranking is the most senior level of debt.

When issuers have classes of debt that do not rank equally, in most cases, lower ranking classes would receive a lower DBRS rating.

In the investment grade sector, the difference between a debt class and the immediate junior ranking obligation is typically no more than one rating notch. For non-investment grade ratings, it is not uncommon for the rating differential to be more than one rating notch, due largely to the increased importance of recovery expectations. Additional information regarding non investment grade ratings is included in the methodology “DBRS Rating Methodology for Leveraged Finance.”

In general, lower ranking debt will receive a lower rating than prior ranking debt. The following sets out some exceptions to this general guideline:

1. Where there is very little debt outstanding in one category and DBRS has a degree of comfort that the issuer will not be increasing the debt in this category in the future, DBRS may assign the same rating to the debt in the next subordinated ranking category.
2. DBRS may consider different levels of ranking debt to have similar default risk and thus assign the same rating to each.

Generally, DBRS takes off one rating notch for each level of subordination. DBRS may consider increasing the gap between levels of debt by more than one-rating level. The most common considerations for this action would include:

1. Where the senior debt is a non-investment grade rating, it may be appropriate to increase the relative gap as the chances of the issuer being involved in a default situation are higher relative to better rated issuers.
2. Where there is a large amount of lower ranking subordinated debt, the holders of this debt may be taking on significantly more risk than would be the case with senior debt holders.
3. Major benefits or detractions from a covenant standpoint.



### **(3) QUALITATIVE AND QUANTITATIVE CONSIDERATIONS**

A rating is a forward looking opinion and as such requires that judgements be made about the future. Accordingly, a rating must balance both qualitative and quantitative considerations, essentially using past performance as a relative, rather than absolute, guide. The current state of affairs is a very important consideration; however, a DBRS rating is not based solely on a statistical analysis of the present situation. A rating considers many intangibles and, therefore, while future quantitative projections are analyzed and considered, many subjective factors are also recognized and considered.

This third principle also applies to DBRS Structured Finance ratings.