



## Short-Term and Long-Term Rating Relationships

The following policy examines the rationale for DBRS's use of two different scales for rating short- and long-term obligations, the similarities and contrasts involved in the use of the scales, and the resulting relationship that exists. Note that: (i) While short-term debt can encompass a variety of different securities, this policy references the most common, commercial paper (CP), which consists of unsecured promissory notes of less than one year in duration. (ii) When discussing the mapping that exists between short- and long-term ratings for Corporate issuers, the long-term rating is typically the most senior unsecured rating of the entity in question or the issuer rating, such that its legal ranking would be equivalent to CP. (iii) The bulk of the comments made in this policy deal with "corporate" credits. There are nuances in the area of Structured Finance, which are discussed in the last section.

### **RATIONALE FOR TWO RATING SCALES**

While DBRS makes use of several rating scales to cover a variety of situations, the vast majority of DBRS ratings fall under two primary scales:

1. Virtually all long-term credit ratings use the DBRS long-term scale with symbols ranging from AAA (highest credit quality) to C (very highly speculative).
2. The scale for CP ratings ranges from the highest credit quality of R-1 (high) to the highly speculative category of R-5.

All scales also have a "D" classification to signify default as defined by DBRS.

A key starting point is the fact that the rating approach and key considerations used to determine ratings are highly similar for short and long time horizons. This means that there will be a meaningful relationship between short- and long-term ratings.

However, there are some unique aspects in assessing short-term credit risk and DBRS believes that these can be more clearly delineated through the use of an entirely separate short-term rating scale. Specifically, short-term funding exposes issuers and investors to a somewhat different set of risks and considerations than long-term funding. The difference is primarily due to liquidity considerations within the shorter maturity duration. Therefore, when assessing the credit quality and rating of a CP issuer, DBRS places a high reliance on short-term liquidity considerations. Liquidity is a consideration in long-term ratings as well, but its importance is magnified in the case of short-term ratings.



The separate scale used to assign CP ratings also provides an indication that DBRS has considered and is comfortable with the fact that back-up liquidity provides acceptable support for the assigned rating. In the short term, a borrower does not have the flexibility to design and structure new financing options should there be a change in its ability to access the CP market. Therefore, the short-term credit analysis must consider alternative liquidity support for CP programs, as addressed in other DBRS policies.

## **SIMILARITIES AND DIFFERENCES**

There is a strong relationship between short- and long-term ratings because the key rating considerations are almost identical. At first glance, risks such as management succession, extended lawsuits, possible regulatory changes, potential new competition, possible future labour issues and challenges related to technology change would appear to be longer-term issues that should have little bearing on an entity's ability to roll over its short-term maturing CP. In actual fact, however, the emergence or development of any longer-term risk can have an immediate impact on an entity's ability to repay or roll over its CP. Most borrowers, including the most creditworthy, would be hard pressed to repay CP obligations purely from internally generated cash flow. This creates a reliance on continued access to capital markets, with CP being the most sensitive to investor concern, which could arise from market or company-specific issues. As such, CP ratings are by no means simply an evaluation of an entity's internal liquidity metrics that are available to repay short-term maturing debt. All credit factors must be considered when assigning CP ratings.

As noted before, however, DBRS believes that it is appropriate to place a higher reliance on liquidity for CP ratings, creating one meaningful difference in the evaluation of short-term and long-term obligations. Longer-term analysis also considers liquidity, but in the longer term, ratings are determined more by the level and stability of cash flow expected through a full economic cycle. This involves an investigation of all factors that could impact future cash flow of the company in question. The details of the trust indenture are another consideration for longer-term ratings.

As such, while short- and long-term ratings have meaningful similarities because they essentially reflect the same credit considerations, the reality is that some factors are weighted differently in determining short- versus long-term ratings. This creates both a rationale and an added value in utilizing a separate scale for CP ratings.



## RATING MAPPING

The conclusion of the aforementioned points is that while short-term ratings will not be totally explained by the long-term ratings assigned to an entity, there will be a strong relationship between the short- and long-term ratings for any given credit, barring any differences caused by consideration for factors such as covenants or guarantees. In other words, while it is possible for an entity with strong liquidity to achieve a short-term rating that is superior relative to its long-term rating, it is not possible for this “gap” to vary significantly from the longer-term DBRS opinion on the issuer. For example, a company with a long-term rating of A (low), which is defined to be at the lower end of “satisfactory”, would be precluded from achieving a “superior” short-term rating of R-1 (middle).

**DBRS Rating Mapping Table<sup>1</sup>**

Long-Term Ratings <sup>2</sup>	Short-Term Ratings							Long-Term Ratings <sup>2</sup>
AAA	R-1 H							AAA
AA (high)	R-1 H	R-1 M						AA (high)
AA	R-1 H	R-1 M						AA
AA (low)		R-1 M	R-1 L					AA (low)
A (high)		R-1 M	R-1 L					A (high)
A			R-1 L					A
A (low)			R-1 L	R-2 H				A (low)
BBB (high)			R-1 L	R-2 H				BBB (high)
BBB				R-2 H	R-2 M			BBB
BBB (low)					R-2 M	R-2 L	R-3	BBB (low)
BB (high)						R-3	R-4	BB (high)
BB							R-4	BB
BB (low)							R-4	BB (low)
B (high)							R-4	B (high)
B							R-4	B
B (low)							R-5	B (low)
CCC							R-5	CCC
CC							R-5	CC
C							R-5	C
D								D

Standard Mapping  Exception

1. Short-term ratings as noted in this table include proposed changes to lower-end categories as detailed in the September 15, 2006, press release.

2. Long-term ratings would typically relate to the most senior unsecured debt of the issuer, equivalent to an issuer rating.

Note: For the purpose of this table, DBRS has not shown the “high” and “low” categories involved with C to CCC rating categories.

Referencing the above Mapping Table, there is a standard relationship between short- and long-term ratings when exceptional liquidity strength or liquidity concerns are not factors. With respect to the “exceptions” (or “mapping exceptions”) as noted in the Table, the most likely exceptions occur when AA, A (high) and BBB (high) rated entities are able to achieve respective R-1 (high), R-1 (middle) and R-1 (low) CP ratings due to the existence and expected continuation of superior liquidity strength. For example, AA rated banks and governments are candidates for R-1 (high) ratings.



While not noted in the mapping table, there may be unique circumstances that lead to rating mappings that are not covered even with the “exception mappings” as noted. For example, DBRS has had cases where “A” rated entities have achieved R-1 (middle) CP ratings, where BBB rated entities have achieved R-1 (low) ratings, and where an entity with a long term non investment grade rating was able to achieve a short term investment grade rating. However, these and possibly other mappings not noted on the table are very rare correlation exceptions that typically relate to very unique circumstances. While DBRS reserves the right to make these exceptions when deemed to be the correct rating judgement, such occurrences are and will continue to be extremely infrequent.

In the experience of DBRS, mapping exceptions of a positive nature for the short-term rating tend to occur mainly within the following Corporate sector areas:

1. Retail and commercial banks are frequent candidates for mapping exceptions. Banks are, by definition, liquidity providers and it would be very unusual for a bank to be able to obtain a favourable long-term rating while having a meaningful weakness in the key area of liquidity. By their nature, banks have liquidity strength through their ability to attract deposits, a typically broader than average access to an array of capital markets due to their frequent issuer status, almost always have a meaningful level of available liquid assets on the balance sheet, also typically have meaningful portions of their security and loan portfolios that could be repoed or securitized if needed and, in many cases, have access to unique and/or lender of last resort government-related opportunities. The last point regarding government support is an important one. Note that the case for correlation exceptions is not usually as strong for investment banks, bank holding companies or atypical banks, which would not typically enjoy the same benefits from deposit gathering or potential government assistance.
2. The second major grouping that is a candidate for mapping exceptions relates to senior level governments (above local or municipal governments). In countries with well established and liquid capital markets, senior governments may in certain cases exhibit a high level of sophistication with respect to their management and borrowing practices and benefit from several government-specific characteristics which generally provide governments with superior short-term credit stability relative to Corporate credits with similar long-term ratings. The key benefits are (a) stable and predictable revenues and expenditure bases (b) ability to adjust taxes and levies, if needed, and (c) easy access to capital markets due to high investor receptivity. For correlation exception consideration, however, DBRS must be assured that the short-term debt burden is manageable and other short-term rating considerations remain adequate.



Outside of the aforementioned areas, mapping exceptions for other Corporate credits are less frequent than in the banking or government areas, but possible. Where exceptions do occur, the rated entity must be able to demonstrate liquidity strength due to some combination of the following considerations: high and stable cash flow; relatively low debt levels; a relatively low level of dependence on short-term debt; a well dispersed long-term debt maturity schedule; high levels of liquid assets that are expected to be maintained; other assets that have ready ability to be quickly securitized; a conservative management philosophy towards liquidity and debt; the ability to secure funds from a higher-rated parent or affiliate; manageable business risk; and a base long-term rating that is considered to be strong within its rating category. In the case of corporations with stable cash flow, low debt levels and other potential alternative sources of funds, the corporation may have the ability to enjoy a relatively stronger short-term rating, such that a BBB (high) long-term rating may translate into an R-1 (low) rating. However, corporations generally do not have the liquidity characteristics of financial institutions; hence, AA rated corporations will rarely have the ability to achieve an R-1 (high) rating. This also partly reflects the tough definition DBRS has for its highest-rated CP rating category.

It is also possible, although less likely, for liquidity concerns to result in a CP rating that is below the typical long-term rating relationship. For example and as noted in the table, the case of an entity with an A (low) issuer rating that receives a CP rating of R-2 (high). These exceptions would occur if DBRS had meaningful concerns with either the liquidity support or the liquidity strength of an issuer. One example of where such a mapping exception could occur would be the case where an issuer did not meet DBRS standards with respect to having acceptable back-up liquidity for its CP program.

Lastly, as noted in the Mapping Table, it is not impossible for an issuer with an unsecured senior long-term rating in the BB (high) non-investment grade area to achieve a CP rating from DBRS at the lowest end of “adequate”, within the category of R-3. Consistent with other mapping exception situations, the driving rationale for such a situation would be the existence of liquidity strength that provides a buffer for any short-term challenges. For a mapping exception to “cross the investment-grade line” however, there would also be a high focus on ensuring that liquidity strength included an acceptable free cash flow position and that there were no major refinancing risks. In addition, DBRS would need a level of comfort that the issuer in question would have a relatively low level of event risk and despite its non-investment grade long-term status, that the probability of default in the short term would be remote, much lower than any expectation related to the typical level for long-term obligations of credits in the BB (high) rating category.



## **STRUCTURED FINANCE**

Correlation mapping for Structured Finance transactions is similar to Corporate sector credits in the broadest sense, and in virtually all cases, the Mapping Table would hold for Structured Finance. However, there are some differences that should be noted:

1. There are fewer “exceptions” for Structured Finance rating mappings than the breadth allowed for in the Mapping Table. This reflects the fact that ratings are based on “structured” entities, which reduces the level of impact that above-average liquidity strength can have for the short-term rating without being equally considered in the long-term rating. In addition, the short-term ratings outlook for Corporate issuers may include management, business or other factors that are not applicable to Structured Finance issuers. Specifically, this means that:
  - a. If the Mapping Table was done for Structured Finance only, mapping exceptions as noted would be expected to be less frequent in Structured Finance than in the Corporate rating area. It would be especially rare for a newly structured entity to have these rating correlations, but they are possible in the event where established transactions have been reviewed and DBRS has determined that while the short-term rating has not been affected, the long-term rating has. In the latter case, DBRS would maintain the short-term rating until and unless the long-term rating fell out of a potential mapping relationship.
  - b. In all cases, for Structured Finance transactions, a period of time would elapse between the receipt of information suggesting a downgrade would be necessary and, if necessary, the rating change. This time would be used to confirm assumptions, check facts, analyze mitigating factors and determine if credit should be given for other forms of enhancement that provide support for the transactions.
2. As in corporate, it is possible for below-average liquidity strength to cause a CP rating to be lowered to a rating that is lower than the typical relationship with the longer-term rating in the Structured Finance area. A long-term rating reduction that triggered the possible removal of external liquidity support could cause DBRS to have a higher degree of concern for the CP rating than would normally be the case for the relative level of the long-term rating. While viewed as a remote likelihood, such a situation is not impossible.

For Structured Finance, the Mapping Table is not intended to establish criteria for swap, counterparty, liquidity or credit enhancement obligations.