Sovereign Rating Methodology Overview

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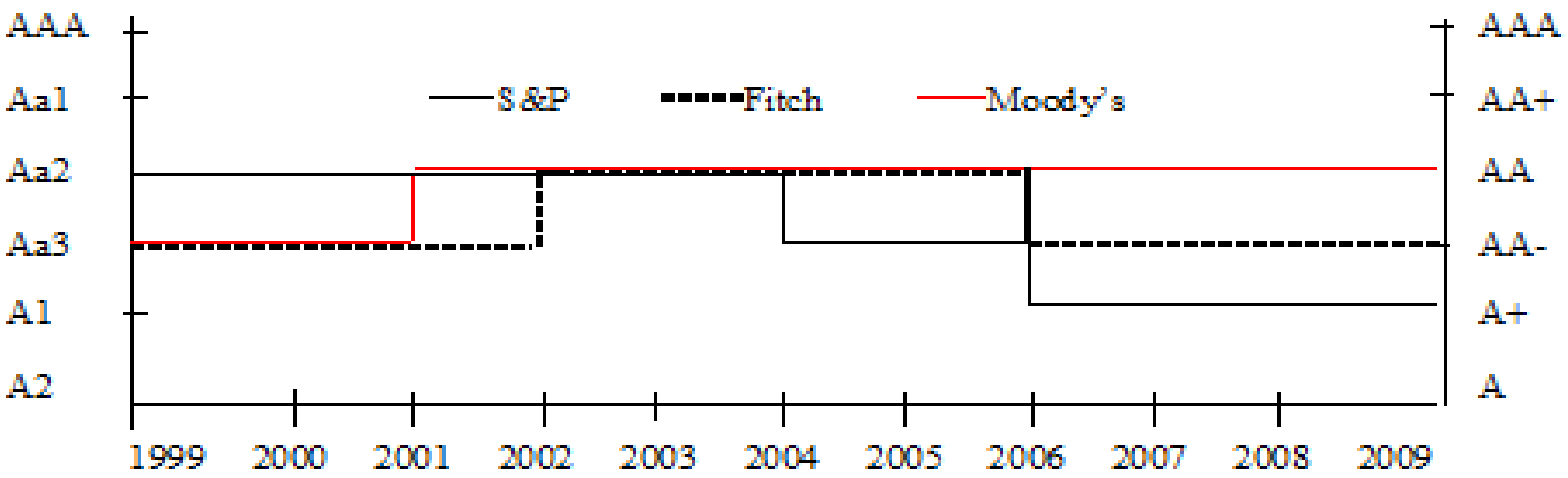
Republic of Italy Credit ratings

Republic of Italy's ratings are split amid the three main Agencies, thus representing a meaningful case study of different approaches to the sovereign evaluation

Moody's	Aa2 rating reaffirmed 3 November 2009 with outlook stable
S&P	A+ rating reaffirmed 13 January 2009 with outlook stable
Fitch	AA- rating reaffirmed 21 September 2009 with outlook stable



How Moody's rates Sovereigns: key criteria

Factor 1: Economic strength (related to the economic structure)

- GDP per capita
- Diversification
- Size
- LT trends

Factor 2: Institutional strength (connected with institution robustness and policies predictability conducive to the respect of contracts)

- the quality of a country's institutional framework and governance – such as the respect of property right, transparency, the efficiency and predictability of government action
- the degree of consensus on the key goals of political action

Factor 3: Financial strength (debt burden compared with the government's resource mobilization capacity)

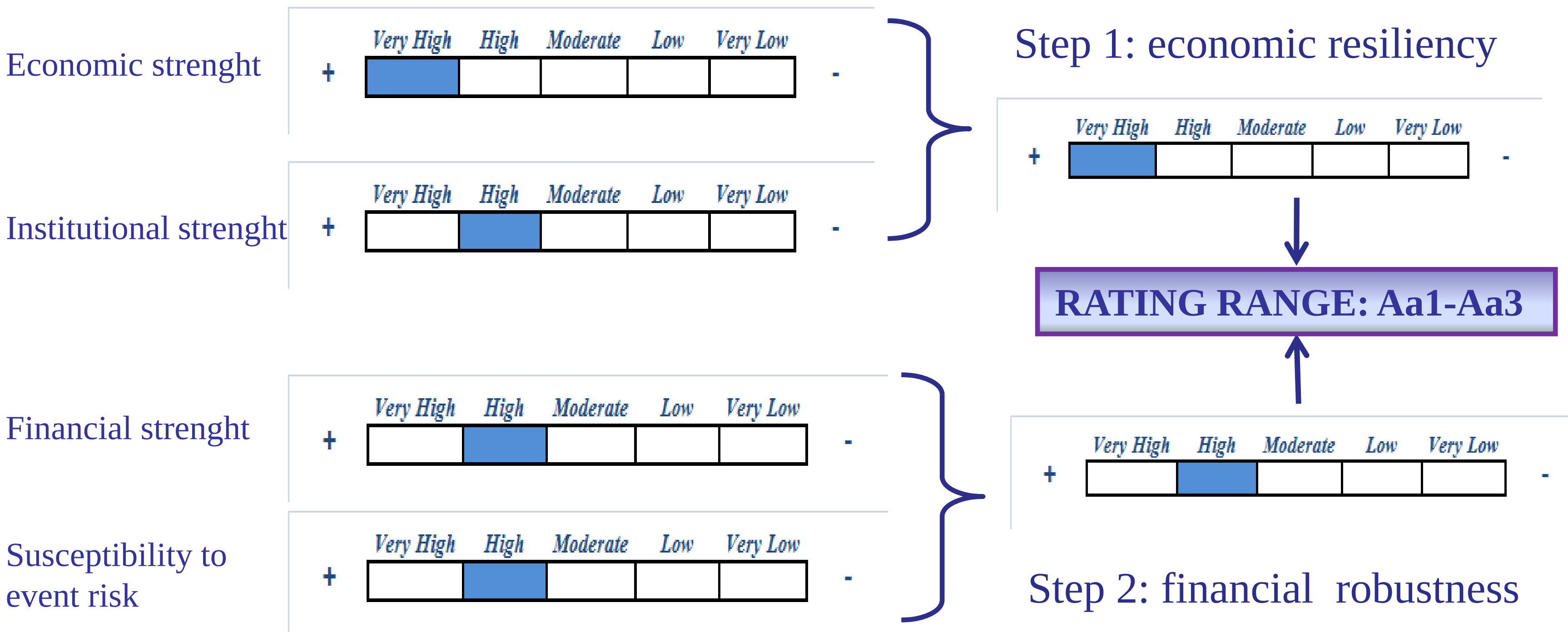
- To what degree government policy choices are constrained by its debt repayment obligations, (balance sheet perspective)
- Ability to generate the money necessary to repay de debt, whether through refinancing, asset mobilization or fiscal adjustment (particular focus on balance of payments)

Factor 4: Risk Susceptibility (risk of a direct and sudden threat to debt repayment)

- Financial
- Economic
- Political (e.g. wars, political chaos, deliberate decisions to hurt creditors)

How Moody’s rates Sovereigns: a three stage process

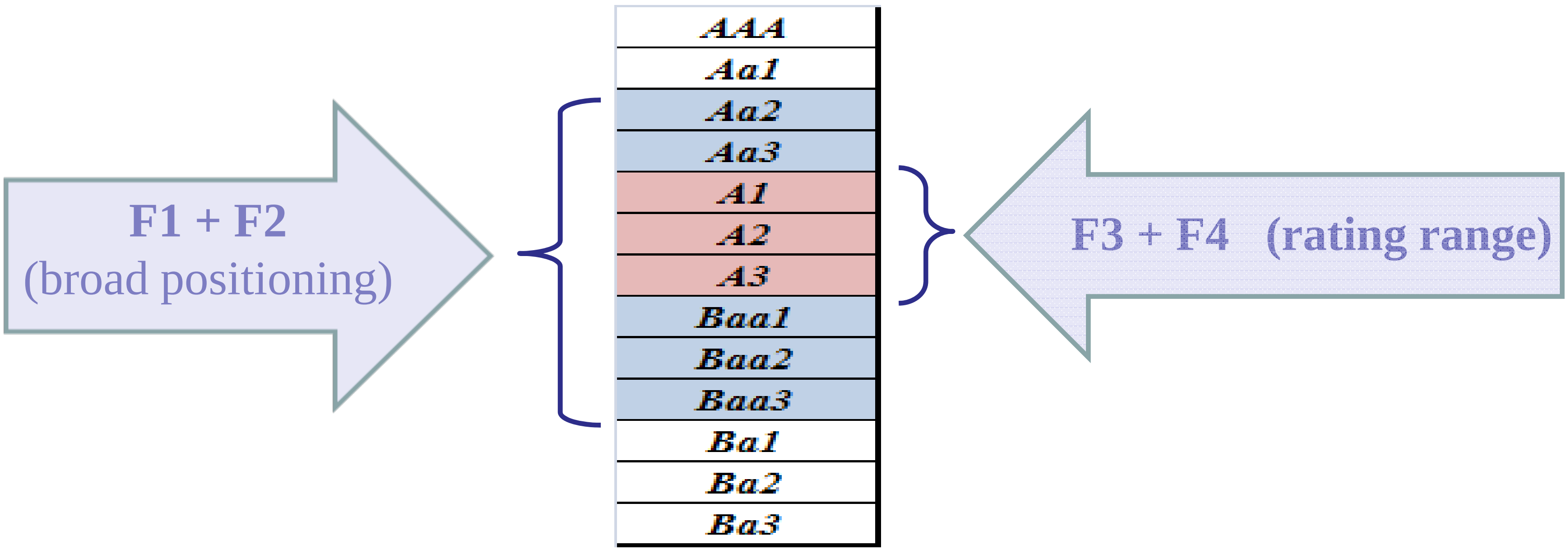
Each factor is measured according to a scale in five different degrees: very high, high, moderate, low and very low. They are combined in couple (step 1 and 2) in order to achieve a rating range into which the final rating is decided (step 3).



Source: Moody’s

Moody's sovereign rating mechanics

Both economic resiliency (step 1) and financial robustness (step 2), namely, the combination of four factors set before, contribute to define the rating range according to the following scale:



Step 3: A rating committee determines the exact rating on the basis of a peer comparison and weighting additional factors that may not have been adequately captured earlier.

Moody's analytical framework: focus on debt

In a long term sustainability perspective, the three main questions underpin public debt analysis:

Debt affordability: to what extent the service of debt compete with the provision of key public services

INTEREST PAYMENT / GOVERNMENT REVENUE

Debt finance-ability: raise funds without a large increase in cost of funding

DEPTH OF DOMESTIC CAPITAL MARKETS AND INTERNATIONAL ROLE OF THE CURRENCY

Debt reversibility: ability to generate resources to restore affordability

ABILITY TO RAISE TAXES, CUT EXPENDITURE AND ABILITY TO GROW OUT OF THE DEBT (ECONOMIC ADJUSTMENT CAPACITY)

Standard & Poor’s sovereigns’ credit ratings

S&P divides the analytical framework for sovereigns into nine categories.

Differently from Moody’s methodology, there is no formula for combining scores to determinate ratings.

The analytical variables are interrelated and weights are not fixed, either across sovereigns or over time.

In most cases, the committee evaluates each category depending on other categories and trends, as much as upon the absolute level of many measures (for example a certain GDP growth ratio may be differently scored for two different countries, given their different stage of development).

Standard & Poor's rating methodology profiles (I)

Political Risk

- ✓ Stability and legitimacy of policy institutions
- ✓ Popular participation in political processes
- ✓ Transparency in economic policy decisions and objectives
- ✓ Public security
- ✓ Geopolitical risks

Economic Structure

- ✓ Per capita GDP
- ✓ Financial system and degree of income disparities
- ✓ Efficiency in public sector
- ✓ Labour flexibility
- ✓ Protectionism and other non market influences
- ✓ Degree of market orientation of the economy

Standard & Poor's rating methodology profiles (II)

Economic Growth Prospects

- ✓Size and composition of savings and investments
- ✓Rate and pattern of economic growth
- ✓Historical economic trends and forecasts

Fiscal flexibility

Economic impact of the fiscal policy stance

- ✓Surplus/deficit trends
- ✓General government revenue and expenditure flexibility
- ✓Effectiveness of expenditures programs
- ✓Appropriateness of the policy mix
- ✓Pension obligations

Standard & Poor's rating methodology profiles (III)

General government debt burden

- ✓General government debt/GDP ratio trends
- ✓Domestic capital market characteristics
- ✓Debt characteristics (maturities, currencies)

Adjusted for noncash items, debt forgiveness/restructuring, privatization proceeds, used cash balances, the increase in the stock of debt should approximate the deficit

Offshore and contingent liabilities

- ✓Off budget and contingent liabilities
- ✓Size and health of non financial public sector enterprises
- ✓Robustness of financial sector

External liquidity

External debt burden:

Impact of micro and macroeconomic policies on the external sector and on its structural characteristics

Standard & Poor's rating methodology profiles: a particular focus on monetary flexibility

Monetary flexibility

EURO ZONE

The European Central Bank's strong monetary flexibility score reflects Europe's low inflation with monetary flexibility bolstered by transparent and well developed capital markets

NON EURO ZONE

- ✓Price behaviour over economic cycles and relative to trading partners.
- ✓Market orientation of monetary policy tools, degree of transparency, development and regulation of financial sector and debt market.
- ✓Role of indexation (wages or other economic factors) and dollarization (foreign currency share of loan, deposits or currency in circulation) in limiting the reach of money tools.
- ✓Institutional factors, such as the resources and operational independence of the central bank.
- ✓Compatibility of the fiscal stance and the exchange-rate regime with monetary policy goals

Fitch Ratings: Sovereign Credit Ratings /1

Because the sovereign is the highest authority and has the power to enforce its will in the jurisdiction it governs, the analysis of a sovereign credit risk must take into account the **willingness** to pay, as well as **financial capacity**.

The **sovereign Issuer Default Ratings** (IDRs) are a forward-looking assessment of a sovereign's capacity and willingness to honour its existing and future obligations in full and on time; they only **relate to the probability of default on debt owed to private creditors** and, in particular, debt securities issued in public markets.

Fitch Ratings: Sovereign Credit Ratings /2

LT IDRs

- Fitch assigns Foreign- and Local-Currency Long Term IDRs to sovereigns and ratings to specific debt instruments issued by sovereigns.
- Reflecting market convention, short-term local-currency-denominated debt, such as Treasury bills, are assigned the Local-Currency Long Term IDR.

ST IDRs

A Short Term IDR is also assigned and is relevant for foreign currency denominated debt with a contractual maturity of 13 months or less.

Fitch Ratings: Sovereign Credit Ratings /3

Local vs. Foreign

Typically the Local-Currency Rating lies above the Foreign-Currency Rating reflecting the sovereign's greater access to local currency. For members of currency unions (notably the euro area) and fully dollarized economies the Foreign- and Local-Currency Ratings are the same.

Country Ceiling

The Country Ceiling is Fitch's assessment of "transfer & convertibility risk" which is related but distinct from sovereign creditworthiness and broader "country risk". It captures the risk that a sovereign may impose restrictions that prevent the convertibility of local into foreign currency and transfer abroad to meet external debt obligations.

Fitch Ratings: Sovereign Rating Methodology /1

Fitch's sovereign credit and rating analysis is a synthesis of **quantitative and qualitative judgements** and focuses on the following factors:

•**macroeconomic performance and prospects;**

•**structural features of the economy** that render it more or less vulnerable to "shocks", including the risks to macroeconomic stability and public finance posed by the financial sector, as well as "political risk" and governance factors;

•**public finances**, including the structure and sustainability of public debt as well as fiscal financing; and

•**external finances,** with a particular focus on the sustainability of international trade balances, current account funding and capital flows, as well as the level and structure of external debt (public and private).

Sovereign ratings must be consistent through time as well as across countries. Rigorous peer analysis is fundamental.

Fitch Ratings: Sovereign Rating Methodology /2

Sovereign Rating Model

Fitch has a proprietary model that generates a score calibrated to the Foreign-Currency Long-Term IDR and promotes consistency of ratings across regions and time. However no model can fully capture all the relevant influences on sovereign creditworthiness and the actual rating determined by the committee can differ from that implied by the model.

Surveillance

All rated sovereigns are subject to surveillance by the primary and back-up analysts, supported in many instances by on-going dialogue with the sovereign authorities.

Limitations

Fitch relies on the accuracy and reliability of information published by national and international agencies as well as provided directly by representatives of the sovereigns.

Fitch Ratings: Sovereign Rating principal focus /1

MACROECONOMIC POLICIES AND PERFORMANCE

- ✓ Track record of macroeconomic stability
- ✓ Credible policy framework
- ✓ Inflation

STRUCTURAL FEATURES

- ✓ High-income and savings
- ✓ Openness to international trade and finance
- ✓ Positive “business environment”
- ✓ Political will and ability to mobilise resources necessary to honour their financial obligations (political risk)
- ✓ Banking and financial system

Fitch Ratings: Sovereign Rating principal focus /2

PUBLIC FINANCE

- ✓Fiscal policies
- ✓**Structure as well as overall level of public debt**
- ✓Degree of budgetary flexibility

EXTERNAL FINANCES

- ✓ Composition and stock of foreign assets and liabilities
- ✓ Capacity of the economy to generate foreign exchange
- ✓ Current accounts of the balance of payments
- ✓ External balance sheet and debt
- ✓ International liquidity if governments rely heavily on borrowing from international capital markets
- ✓ Ability to borrow abroad in local currency and vulnerability to exchange rate shocks

Financial Stability Board stance on Credit Rating Agencies

Recently FSB has agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential in orienting market participants' choices.

National authorities will enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and assuring the **transparency** and **quality** of the rating process. In particular, Credit Rating Agencies should differentiate ratings for structured products and provide full disclosure of their ratings track record and the information and assumptions that underpin the ratings process.

As the rating is still a key issue for investors in government bonds, it would be worthless to extend those requirements also to sovereigns rating process, in order to render at least comparable weighs used in their methodologies.