CEE Case Study: How Scope's Qualitative Scorecard informs sovereign ratings

Scope's sovereign methodology is based on two scorecards: i) a data driven-quantitative scorecard (CVS) and ii) a judgement-driven qualitative scorecard (QS). Both are centred on Scope's five key sovereign risk categories: 'Domestic economic risk', 'Public finance risk', 'External economic risk', 'Financial stability risk' and 'Institutional & political risk'. The aim of this report is to provide further transparency on Scope's qualitative risk assessment (QS) through a case study on how the QS informs the final sovereign credit ratings for the Republic of Bulgaria, Hungary, Romania and the Republic of Croatia.

Scope's quantitative scorecard provides an indicative rating range, which, in the case of these four Central and Eastern European (CEE)-sovereigns, is the same level of "bbb" as shown in **Table 1**.

Table 1: Scope's scorecard results

Quantitative scorecard	Average of "BBB" peer group	Peer comparison			
		Bulgaria	Hungary	Romania	Croatia
Domestic economic risk					
Public finance risk					
External economic risk					
Financial stability risk					
Political and institutional risk					
Indicative rating range		bbb	bbb	bbb	bbb
Qualitative adjustment (notches)		0	0	0	-2
Final rating		**BBB/Pos**	**BBB/Pos**	**BBB/Neg**	**BB+/Sta**

AAA	AA	A	BBB	BB	B	CCC	CC	C

Source: Scope Ratings GmbH

In a second step, Scope's qualitative adjustments via the QS reflect idiosyncratic characteristics and relative credit strengths and weaknesses against their peer group (in this case, all against "bbb"-indicative peers). The overlay of the QS assessments on top of the CVS' initial "bbb" quantitative result determines the final rating levels:

- Bulgaria's (BBB/Positive) positive qualitative considerations include its prudent policymaking and currency board arrangement, underscored by strengthened reserve levels and an objective to enter the Exchange Rate Mechanism II (ERM II). The qualitative adjustments also reflect Bulgaria's credit weaknesses due to (1) the economy's susceptibility to external changes in global economic conditions, (2) low political stability and frequent elections, and (3) a lack of monetary policy flexibility.
- Hungary's (BBB/Positive) relative credit strength is its consolidation of public finances accompanied by a marked improvement in public debt structure and funding sources. The qualitative adjustments also reflect Hungary's weaknesses due to (1) a vulnerability to external shocks, including currency depreciations that adversely affect domestic borrowers, and (2) weakening institutional credibility.
- Romania's (BBB/Negative) positive qualitative adjustment is due to its high growth potential driven mainly via productivity growth. The adjustments reflect Romania's weaknesses related to (1) fiscal management, (2) the business environment and political stability, and (3) the economy's high foreign-currency exposure.
- Croatia's (BB+/Stable) negative adjustments are due to (1) weak productivity growth and labour trends, (2) shortcomings in its fiscal policy framework and business environment, and (3) large foreign-currency debt exposing the economy to FX risks.

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Scope's Qualitative Scorecard: CEE case study

Dual scorecard approach

Scope implements a quantitative Core Variable Scorecard as the first step in determining an indicative sovereign rating range. The CVS aggregates the main components of the five rating categories and determines an overall score, which is mapped to the long-term rating scale[1]. Scope complements the CVS with the Qualitative Scorecard to account for analytical components that cannot be captured within the CVS either due to insufficient data availability or the use of additional models that allow for the application of country-specific parameters. The key features of the QS are:

- ✓ Through the QS, the analyst can adjust the CVS indicative rating result by up to three notches, absent extraordinary circumstances, e.g. a country undergoing a crisis or having a recent history of sovereign default.
- ✓ The QS is organised into five complementary sections corresponding to the five analytical categories of the CVS (Domestic economic risk, Public finance risk, External economic risk, Financial stability risk, and Institutional & political risk), each having three available qualitative adjustments.
- ✓ For each assessment, the analysis of the relative strengths and weaknesses is conducted vis-á-vis a peer group based on the country's indicative rating range as determined by the CVS. The assessments are made on a five-point scale: very strong = +2 notches, strong = +1 notch, neutral = 0 notch, weak = -1 notch, or very weak = -2 notches. The "notches" in this context represent relative scoring, and do not reflect direct notches to the country's credit rating. The resulting relative scoring adjustments are then aggregated using the same weights for the five overall analytical categories as in the CVS to determine the overall QS adjustment (which can result in an end-rating adjustment of up to three notches).
- ✓ The qualitative analysis reflects, among other considerations, an assessment of a sovereign's idiosyncratic characteristics, the authorities' policy implementation and a review of the sovereign's debt sustainability under a variety of assumptions (e.g. weaker economic growth, higher interest costs, and/or fiscal loosening) over the medium-term. Scope publishes the overview of its QS adjustments in the rating report of each sovereign, to enhance the rating process transparency and comparability.

In the remainder of the report, Scope provides examples for how individual QS assessments for the five analytical risk categories are evaluated in the case of four CEE economies. While these economies are all under the quantitative model's "bbb"-indicative peer group, the varying QS judgements inform the disparate end-ratings for these sovereigns.

1. Domestic economic risk

Description: Assesses the coherence and credibility of the economic, structural and monetary policy frameworks, a country's medium-to-long-term growth potential, and macro-economic imbalances arising from a lack of diversification, weakening demographics, income inequalities, and exposure to the external markets and credit cycles. The assessment includes social considerations and sustainable growth evaluations consistent with "S" and "E" under an Environment, Social and Governance (ESG) analytical framework.

[1] Please refer to Scope Ratings' 'Rating Methodology Public Finance Sovereign Ratings', 04 May 2018, for the mapping of CVS scores and indicative rating ranges.

Table 2: QS adjustments: Domestic Economic Risk

Domestic economic risk	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy					
Economic policy framework					
Macro-economic stability and sustainability					

Source: Scope Ratings GmbH

1.1. Growth potential of the economy

- Romania – strong: Romania's potential growth is expected to average 4.3% over 2018-19 due to productivity gains and capital accumulation. While this growth outlook is still one of the highest in the EU, IMF research shows that an increase in EU fund absorption over the new programming period could further raise the sovereign's growth potential.
- Croatia – weak: Croatia's weak growth potential of 1.7% over the 2018-19 period reflects adverse demographics and emigration leading to a shrinking pool of workers, and investment substantially below pre-crisis levels. Another reason is the relatively large share of state-owned enterprises, which are less productive than private-sector entities.

1.2. Economic policy framework

- Bulgaria – strong: The pursuit of prudent policymaking underscored by the objective to enter ERM II ensures a degree of pro-growth policies whilst providing fiscal responsibility. Scope has a positive view of the currency board's record of stabilising Bulgaria's economy and expects policymakers to remain committed to the euro peg, but also recognises the significant constraints this policy places on the central bank.
- Romania – weak: While the monetary transmission has improved in recent years[2] and the overall governance at the National Bank of Romania remains robust[3], several factors constrain the effectiveness of Romania's economic policy framework, including the weak enforcement of fiscal rules, a low share of EU-funded investments, inefficient state-owned enterprises, and the weak business environment.

1.3. Macro-economic stability and sustainability

- Croatia – weak: Croatia's high reliance on tourism, at around 20% of GDP, increases the economy's external vulnerability given the high seasonality and potential volatility in tourism flows[4].

2. Public finance risk

Description: Assesses the consistency and appropriateness of budgetary policies, ability of the government to generate revenues and control expenditures, the fiscal position of a sovereign under several scenarios and its resilience under sudden episodes of fiscal stress, as well as a sovereign's debt portfolio structure, depth of domestic capital

[2] European Commission, Country Report Romania 2017
[3] IMF Article IV, Romania May 2017
[4] European Commission, Croatia's Tourism Industry: Beyond the Sun and Sea, Economic Brief 036, March 2018

markets, access to international capital markets and the extent of liquid public-sector assets.

Table 3: QS adjustments: Public Finance Risk

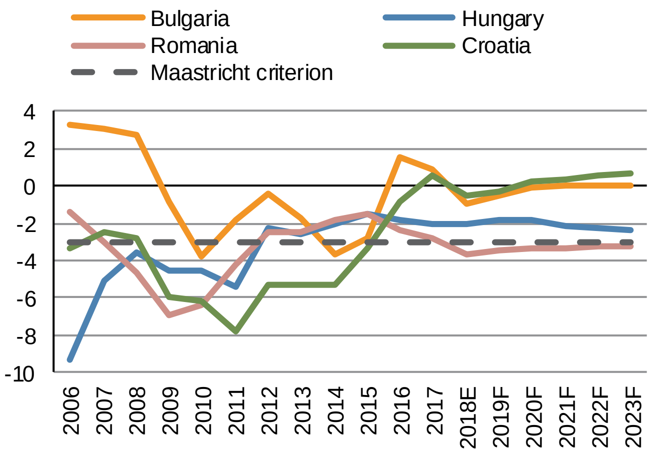
Public finance risk	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Fiscal policy framework					
Debt sustainability					
Market access and funding sources					

Source: Scope Ratings GmbH

2.1. Fiscal policy framework

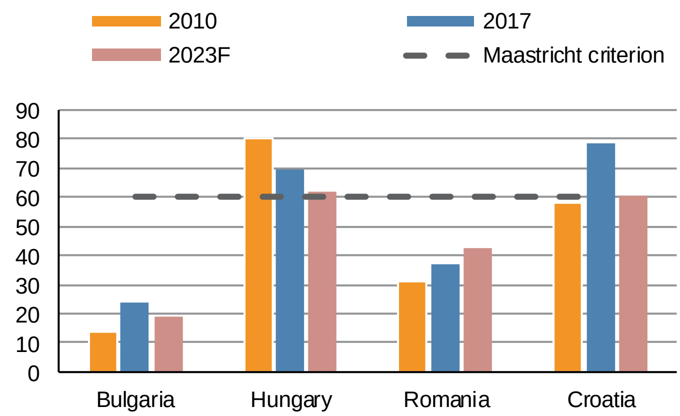
- Croatia – weak: Croatia's fiscal policy framework has weaknesses in several areas. According to the European Commission (EC), the country has made limited progress in strengthening its budgetary planning, multi-annual budgetary framework and the independence of the Fiscal Policy Commission. The adoption of the Fiscal Responsibility Act and Budget Act, aimed at improving fiscal governance, has been postponed. Furthermore, high territorial fragmentation resulting in complex fiscal relations across several levels of government and many pathways to early retirement remain challenges. However, the new fiscal acts are expected to make central and local government budgets more binding, which should reduce the size and frequency of revisions.

Figure 1: Fiscal balances, % of GDP



Source: IMF, Scope Ratings GmbH

Figure 2: Debt levels, % of GDP



Source: IMF, Scope Ratings GmbH

2.2. Debt sustainability

- Croatia – weak: Scope's public-debt sustainability analysis, which includes a stressed scenario incorporating a combined growth, interest-rate, primary-balance and foreign-currency shock to the IMF baseline, points to a high sensitivity to exchange rate developments given Croatia's large share of foreign-currency-denominated debt of 76% of total debt at end-2017, the consequence of the domestic market's limited absorption capacity and high level of euroisation. However, Scope considers the risk to be mitigated by the Croatian National Bank (HNB)'s de-facto peg of the kuna to the euro.

- Hungary – strong: Despite Hungary's relatively high debt levels, the country's debt structure has improved significantly over the past few years, reflecting the debt management office's prudent debt funding strategy aimed at developing the domestic investor base, keeping foreign currency debt within a 15-25% share of total debt range, and mitigating cross-currency exchange rate risks by using euro swaps for all foreign-currency obligations. Scope's public debt sustainability analysis indicates that slower growth remains the key risk to Hungary's debt sustainability.

2.3. Market access and funding sources

- Croatia – weak: Scope notes positively the government's effort to improve debt management, which supports a sustained reduction in debt servicing costs and increasing maturities. However, the share of loans as a government funding instrument, while decreasing, remains high at 31.5% at the end of 2017, exposing the government to the domestic banking sector. In addition, despite the government's new debt-management strategy in 2017, three years after the previous one expired, Croatia has a weak track record on communication with the market.

3. External economic risk

Description: Assesses the financing of the current account, external debt sustainability and development of external imbalances arising from, for example, a non-diversified export base and/or narrow range of export markets and captures the external debt portfolio structure and the ability to continue FX debt servicing if external markets are closed.

Table 4: QS adjustments: External Economic Risk

External economic risk	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Current account resilience					
External debt sustainability					
Resilience to short-term external shocks					

Source: Scope Ratings GmbH

3.1. Current account resilience[5]

- Bulgaria – weak: Bulgaria's current account has been volatile: the current account balance reached lows of -23.9% of GDP in 2007 and -22.0% of GDP in 2008, before rapid consolidation to +0.3% of GDP by 2011. In Scope's view, volatility in the current account makes Bulgaria's surplus subject to change under a scenario of rapid economic growth or changes in regional economic health.

3.2. External debt sustainability

- Croatia – weak: External debt sustainability analysis points to a large impact from a change in exchange rate assumptions on debt: with over 90% of the total external debt stock owed in foreign currency, a sudden depreciation of the domestic currency can have significant negative net wealth and cash flow effects on the Croatian economy.

[5] The name of the QS adjustment has been modified for clarity. In Scope's Rating Methodology, the adjustment is named "Current account vulnerability".

3.3. Resilience to short-term external shocks[6]

- Bulgaria – strong: Bulgaria's macroeconomic performance is buoyed by broad-based support for its currency board arrangement, which pegs the FX at 1.9558 levs to the euro and continues to be a crucial factor anchoring macroeconomic policies. The credibility of the currency board arrangement is supported by the central bank's reserve accumulation, with foreign exchange reserves totalling USD 25.2bn as of July 2018, amounting to 2.8x of short-term external debt. Scope considers this higher reserve coverage ratio to be critical for the maintenance of external sector and FX stability.
- Romania – weak: Romania has a managed floating FX, and since 2009, has had a relatively stable evolution. Scope notes that while pressure on the exchange rate would likely support economic growth via expenditure switching, the depreciation would adversely affect borrowers' balance sheets by raising the value of foreign-currency debt. This would affect banks' balance sheets through their foreign-exchange exposures, which comprise almost 40% of total private non-financial sector credit, or about 10% of GDP.
- Hungary – weak: Hungary is exposed to foreign-currency movements given the high share of forex lending in total lending to non-financial corporations at around 45% in Q2 2018. Foreign-currency reserves have almost halved over the past five years, down to around EUR 24bn in Q2 2018, reflecting the conversion of foreign-currency loans by the banking sector (for which the central bank provided around EUR 9bn) and the repayment of government foreign-currency debt via the self-financing programme. However, the reserves-to-short term-external-debt ratio remains adequate at around 180%, and the exchange rate has been relatively stable since 2014, currently at around 327 forint/euro.
- Croatia – weak: While deleveraging in corporate and household sectors in Croatia has significantly reduced both borrowers' and banks' foreign-currency exposures over the past five years, susceptibility to currency movements remains elevated as around 60% of total bank loans are denominated in foreign currency. In addition, while, according to recent IMF estimates, Croatia's official reserves amounted to around 130% of short-term external debt in 2017 and are expected to increase to 160% in 2019, comfortably above the 100% adequacy benchmark, medium-term gross external financing needs of around 30% of GDP annually are high compared to those of peers.

4. Financial stability risk

Description: Evaluates policy measures that minimise systemic risks and support the banking system, including macro-prudential rules and bank regulation standards that enhance resilience to shocks and contagion, and analyses the implications of financial imbalances, in particular credit-fuelled growth, private sector indebtedness, and asset price bubbles, on the financial soundness of banks.

[6] The name of the QS adjustment has been modified for clarity. In Scope's Rating Methodology, the adjustment is named "Vulnerability to short-term external shocks".

Table 5: QS adjustments: Financial Stability Risk

Financial stability risk	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Financial sector performance					
Financial sector oversight and governance					
Resilience to financial imbalances and fragility					

Source: Scope Ratings GmbH

4.2. Financial sector oversight and governance

- Croatia – weak: The Croatian banking sector remains vulnerable to heavy exposures to government loans and to certain non-financial corporates. Bank loans to the state constituted around 16% of total loans in 2017. In addition, as publicly expressed by the ECB, the HNB's independence could be undermined by the adoption of the Central Bank Act, which would enable the state audit office audit powers, access to confidential information, and a right for parliament to vote on HNB reports. On the positive side, the possible exposure of the Croatian banking sector to European banks is mitigated by the sector's continued substitution of cross-border funding for domestic funding, as well as the European supervisory framework and the framework for recovery and resolution of credit institutions.

4.3. Resilience to financial imbalances and fragility[7]

- Bulgaria – weak: According to the currency board system, the Bulgarian National Bank (BNB)'s ability to act as a lender of last resort to domestic banks is restricted. The BNB can provide liquidity support to the banking system only by the degree that reserves exceed monetary liabilities. In addition, support can only be given under certain conditions and for short periods, against liquid collateral. While the amended Public Finance Act facilitates a legal framework to address the lack of lender of last resort liquidity functions, significant procedural aspects still need to be resolved and compliance with EU state aid rules ensured. Furthermore, Scope considers greater stability in and reforms to Bulgaria's banking sector to be critical, while recognising the legacy of the 2014 crisis and the still-lingering vulnerabilities present within the system.

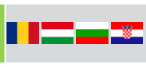
- Croatia – weak: Croatian banks are exposed to currency risk from the large foreign-currency-denominated debt of their corporate and household clients. In addition, currency mismatches between bank assets and liabilities could emerge should clients again save more in euros driven by, for example, an increase in interest rates[8]. Furthermore, according to the HNB, the growing reliance on domestic funding, while being perceived as less risky, has increased the maturity mismatches in bank balance sheets, mostly due to the reduced maturity of deposits. The HNB's proven record of managing the exchange rate, however, partly mitigates currency risks.

[7] The name of the QS adjustment has been modified for clarity. In Scope's Rating Methodology, the adjustment is named "Financial imbalances and financial fragility".
[8] Croatian National Bank, Financial Stability Report No. 19, 2018

5. Institutional and political risk

Description: Assesses government's commitment to preserve its creditworthiness, ability to implement politically challenging structural reforms, policy continuity and political stability, as well as geopolitical and civil security risks that can disrupt economic activity. Institutional and political risk considerations are consistent with "G" in an ESG analytical framework.

Table 6: QS adjustments: Institutional & Political Risk

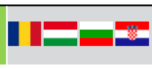
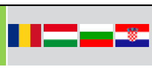
Institutional & political risk	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Perceived willingness to pay					
Recent events and policy decisions					
Geopolitical risk					

Source: Scope Ratings GmbH

5.2. Recent events and policy decisions

- Romania – weak: In Scope's view, the substantial political volatility in Romania over 2017-18 owing to corruption allegations and infighting within the main ruling party, the Social Democratic Party, creates downside risks to political stability despite the coalition government's comfortable majorities in both the Chamber of Deputies and the Senate.
- Hungary – weak: While Hungarian politics have been characterised by stability and policy continuity over recent years, the current government's consolidation of political power has come at the expense of independent institutions, especially affecting the central bank and judiciary, fair democratic processes and a free media. Despite its EU membership, the current government has been in legal conflict with European Union institutions over shortcomings in the government's respect for human rights, democracy and the rule of law.
- Bulgaria – weak: Bulgaria has seen significant turnover in governments in recent years. The unstable governments restrict continuity in reform drives, raise incentives for populism that weighs on the fiscal balance sheet, reduce the capacity for long-term economic planning, and undermine the business environment and investor confidence.
- Croatia – neutral: Scope views positively the successful conclusion of the Agrokor Group debt settlement – which is systemically important for Croatia given the Group's revenues in 2017 accounted for around 11% of GDP – easing the potential for further political instability. However, structural reforms aimed at addressing important institutional shortcomings that resulted in a burdensome business environment and inefficient use of resources will be difficult to implement given the narrow majority of the current government and lack of policy continuity.

Annex I: Qualitative Scorecard results

CVS		QS						
Rating indicator	Category weight		+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Domestic economic risk	**35%**	Growth potential of the economy					
Real GDP growth Real GDP volatility GDP per capita Nominal GDP Inflation rate		Economic policy framework					
Unemployment rate Old-age dependency ratio		Macro-economic stability and sustainability					
Public finance risk	**30%**	Fiscal policy framework					
Primary balance Interest payments		Debt sustainability					
Gross debt Gross financing needs		Market access and funding sources					
External economic risk	**15%**	Current account resilience					
External debt Currency turnover/reserves		External debt sustainability					
Net international investment position (NIIP) Current account balance		Resilience to short-term external shocks					
Financial stability risk	**10%**	Financial sector performance					
Non-performing loans (NPLs) Tier 1 ratio		Financial sector oversight and governance					
Credit to GDP gap (bubble) Credit to GDP gap (imbalance)		Resilience to financial imbalances and fragility					
Institutional and political risk	**10%**	Perceived willingness to pay					
Worldwide Governance Indicators		Recent events and policy decisions					
		Geopolitical risk					

*Implied QS notch adjustment = (QS notch adjustment for DER)*0.35 + (QS notch adjustment for PFR)*0.30 + (QS notch adjustment for EER)*0.15 + (QS notch adjustment for FSR)*0.10 + (QS notch adjustment for IPR)*0.10

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