Learning Module 15: Credit Analysis for Government Issuers

LOS 15a: explain special considerations when evaluating the credit of sovereign and non-sovereign government debt issuers and issues.

Sovereign and non-sovereign entities use debt issuance to finance their operations. In contrast to corporate bonds, these debts are utilized for fiscal projects and to meet budgetary needs. These needs may encompass essential public services such as transportation infrastructure, healthcare facilities, and educational institutions. One example is the issuance of Treasury bonds by the US government.

Sovereign Credit Analysis

Sovereign debt is commonly repaid through various sources of state income, such as taxes, fees, tariffs, and profits generated by state-operated businesses. The primary factor contributing to the relatively low credit risk associated with bonds issued by sovereign entities within a nation is the inherent power of these entities to impose taxes on the private economic activities carried out within their territory. However, it is widely acknowledged that bonds issued by major economies such as the United States or Germany are typically perceived as having minimal default risk. Conversely, bonds from developing economies such as Argentina or Nigeria bear a higher risk of default.

Criteria for Assessing Creditworthiness

The assessment of creditworthiness, whether for corporations or governments, is based on multiple factors. Bond investors evaluate the stability of cash flows, the sufficiency of these flows to meet interest and principal obligations, and the extent to which the issuer relies on debt financing in comparison to alternative sources of funding. Evaluating the creditworthiness of sovereigns or other government borrowers includes a combination of qualitative and quantitative elements unique to the public sector.

Qualitative Factors in Sovereign Creditworthiness

Government Institutions & Policy

Government institutions and policies are vital in maintaining a nation's political and economic stability. These policies cover essential legal aspects such as upholding the rule of law and ensuring transparent financial reporting. Harmonious relations with neighboring countries also gauge political stability. Often, these factors are assessed using a ranking system.

Furthermore, besides a country's ability to repay debts, its commitment to do so is crucial, especially for sovereign issuers. This is due to the principle of sovereign immunity, which prevents bondholders from forcing a sovereign government into bankruptcy. As a result, many investors, in collaboration with entities like the IMF, choose to restructure debts to safeguard their investments.

Fiscal Flexibility

It involves evaluating a government's ability to maintain fiscal discipline across varying economic conditions. Various factors that contribute to the overall economic performance of a nation include the efficiency of tax collection, prudent allocation of budget for public goods, and management of sovereign debt relative to the country's economic activity. Past fiscal behavior and anticipated effects of future fiscal policy changes are considered.

Monetary Effectiveness

Monetary effectiveness pertains to the actions undertaken by a nation's central bank to control the money supply and credit availability. The activities assessed within this domain include determining interest rates, setting reserve requirements, and buying/selling sovereign bonds. The central bank's independence from the government is crucial as it can determine if the country will monetize its debt, which could result in increased inflation and decreased currency value.

Economic Flexibility

Economic flexibility pertains to the assessment of economic activities conducted within the territorial boundaries of a country, intending to utilize them for repaying debts. The size of the economy, per capita income, economic diversification, and growth potential are critical. High-rated sovereigns usually have diversified and growth-oriented economies. Conversely, emerging or frontier economies may depend on a single industry or commodity, making them vulnerable to economic downturns, price changes, or trade disruptions.

External Status

External status refers to how a country's international trade and financial policies affect its ability to manage and service its debt. The credibility of monetary policy and the type of exchange rate regime can influence international capital inflows. Sovereign governments with a widely accepted and traded currency (reserve currency) can more easily access foreign investors with domestic currency debt, reducing the risk of default.

Quantitative Factors in Sovereign Creditworthiness

Quantitative credit analysis estimates how likely a country will meet its debt obligations. Sovereign credit analysts face challenges because they rely on government data that can differ in quality and comparability and may be revised due to political considerations. Consequently, analysts use a macroeconomic approach, emphasizing quantitative factors. Financial ratios help compare sovereign issuers similarly to corporate issuers. Instead of using total sales or assets as in corporations, sovereign ratios use government revenue or GDP to measure economic activity subject to taxation.

Fiscal Strength

Fiscal strength indicates a sovereign’s capability to manage its debt. The factors considered here include the current and future debt burden and reliance on debt vs. other resources. Debt burden indicators resemble corporate leverage metrics, with a higher debt ratio implying lower credit quality. Annual fiscal surpluses/deficits as a percentage of GDP assess fiscal discipline and whether a country's debt burden is improving.

Economic Growth and Stability

Bigger, wealthier economies can better achieve sustainable growth and resist shocks. Important factors considered when measuring economic growth and stability include the economy's size (GDP), per capita income, historical and projected economic growth levels, and variability of these growth levels.

External Stability

This relates to the confidence of foreign investors in holding a country's currency assets. Non-reserve currency countries' ability to meet external debt obligations is assessed by the external liquidity (short-term ability) and external solvency (long-term ability) to generate stable foreign currency inflows to cover external debt and other obligations. Measures of external stability involve comparing external debt to sources of repayment, such as GDP, foreign currency balances, or cash flows. A nation's current account deficits/surpluses, determined by the international trade of goods and services, impact its capital account due to foreign capital inflows/outflows.

Role of External Factors

1. For emerging nations, commodity exports may dominate foreign currency reserves.
2. Demand and prices for these commodities can heavily influence sovereign creditworthiness.
3. Nations with consistent demand, like oil producers, often have large reserves and may establish sovereign wealth funds. However, fluctuations in commodity prices can threaten their financial stability.

Non-Sovereign Credit Risk

Non-sovereign government issuers, such as government agencies or regional governments, issue debt to finance activities. Investors typically face a credit risk similar to sovereign issuers due to either implicit or explicit government backing. Explicit government backing is a government official guarantee or promise to back the obligations (like debts) of a non-sovereign entity. On the other hand, Implicit government backing is an assumed or informal belief that the government will step in to support a non-sovereign entity's obligations if required, even though there's no formal guarantee in place. Debt with implicit backing is perceived as riskier than those with explicit backing since the government has no legal obligation to intervene.

Regional government issuers have their own taxation and income-generating powers but may vary in creditworthiness from the sovereign issuer.

Main Types of Non-Sovereign Government Issuers

Agencies

These are quasi-government entities fulfilling government missions, often authorized to finance their activities using debt. For example, the Airport Authority Hong Kong SAR (AAHK) issued perpetual bonds following a decrease in passenger volume during the COVID-19 pandemic.

Government Sector Banks and Development Financing Institutions

Institutions sponsored by sovereign governments to promote specific objectives. For example, Kreditanstalt für Wiederaufbau (KfW) is Germany's largest national development bank, 80% owned by the government. It receives an explicit and formal guarantee and institutional responsibility from the Federal Republic of Germany.

Supranational Issuers

Entities established by sovereign governments to pursue common objectives. Examples include the World Bank, the Asian Development Bank, and Indonesia Infrastructure Finance (IIF).

Regional Government Issuers

Provincial, state, and local governments issue bonds within a sovereign jurisdiction, known as municipal bonds in the US.

Types of Bonds Issued by Non-Sovereign Governments

General Obligation (GO) Bonds

General Obligation (GO) bonds are debts issued by non-sovereign governments and are not backed by any specific collateral. Instead, they rely on the general revenues and the ability of the issuing entity to levy and collect taxes. The creditworthiness of these bonds is influenced by factors such as the health of the local business environment, the strength of major industries, potential support from the national government, and effective budget management. However, unlike sovereign entities, non-sovereign issuers have limited powers and cannot control major economic institutions. They might also be more susceptible to technological and demographic shifts.

Revenue Bonds

Revenue bonds are riskier than GO bonds as they finance specific projects relying on a single revenue source. Their analysis resembles that of corporate bonds, focusing on the project's viability and financial metrics like the debt service coverage ratio, which measures the available revenue to cover debt costs. A higher ratio indicates better creditworthiness. The stability of cash flows is essential when evaluating these bonds. Besides the usual revenue sources like taxes and fees, other repayment means are crucial, especially for bonds from entities like airport authorities or public utilities. Sometimes, a national government might step in for repayment if revenues are insufficient.

Question

The principle that is *most likely* to prevent bondholders from forcing a sovereign government into bankruptcy is the principle:

A. sovereign priority.
B. sovereign immunity.
C. sovereign obligation.

The correct answer is **B.**

Based on the principle of sovereign immunity, domestic regulations restrict investors from pushing a sovereign government into bankruptcy or selling off its assets to address debt claims, unlike the procedures followed for corporate issuers.

A is incorrect: There is no "principle of sovereign priority."

C is incorrect: While "sovereign obligation" might sound relevant, it's the principle of sovereign immunity that specifically addresses the inability to force a sovereign government into bankruptcy.