Article Title: ARCHIVE | General Criteria: Ratings Associated With Risk Of Foreign Exchange Controls Raised In 27 Countries Data: (Editor's note: This criteria article has been superceded by the article titled "Methodology: Criteria For Determining Transfer And Convertibility Assessments," published May 18, 2009.) Based upon evidence that sovereigns under political and economic stress are less often restricting nonsovereign access to foreign exchange needed for debt service, Standard & Poor's has raised its ratings associated with such restrictions from one to three notches above its foreign currency ratings on the sovereigns in the 27 countries listed in table 2. Prior to this change, Standard & Poor's rated nonsovereign issues and issuers above the sovereign on a foreign currency basis in these countries only if there were specific factors moderating cross-border transfer and convertibility risks. Such factors, which include offshore parent support, geographic diversity of operations and assets, and structural features, may support still-higher ratings. This reassessment adds to the list of countries for which Standard & Poor's has long made distinctions between sovereign ratings and the risk of restrictions on access to foreign exchange needed for debt service (see box 1 and table 1). The impact of this reassessment on the nonsovereign sector is fewer split local/foreign currency ratings because the foreign currency rating will be constrained less often by the reduced risk of the sovereign restricting access to foreign exchange needed for debt service. A list of the nonsovereign foreign currency ratings moved to (or closer to) nonsovereign local currency ratings appears in "25 Ratings Raised Based Upon Reduced Risk of FOREX Controls," (RatingsDirect, Nov. 3, 2005). The methodology behind these upgrades is described in "Ratings Above The Sovereign: Foreign Currency Rating Criteria Update," (RatingsDirect, Nov. 3, 2005). Box 1 Table 1 Long-Standing Nonsovereign Foreign Exchange Access Assessments That Exceed The Sovereign Foreign Currency Rating COUNTRY SOVEREIGN LOCAL CURRENCY RATING SOVEREIGN FOREIGN CURRENCY RATING T&C; ASSESSMENT COMMENT AFRICA Benin B+ B+ BBB- CFA franc zone member. Burkina Faso B B BBB- CFA franc zone member. Cameroon CCC CCC BBB- CFA franc zone member. Central African Republic NR NR BBB- CFA franc zone member. Chad NR NR BBB- CFA franc zone member. Congo-Brazzaville NR NR BBB- CFA franc zone member. Cote d'Ivoire NR NR BBB- CFA franc zone member. Equatorial Guinea NR NR BBB- CFA franc zone member. Gabon NR NR BBB- CFA franc zone member. Guinea-Bissau NR NR BBB- CFA franc zone member. Mali B B BBB- CFA franc zone member. Niger NR NR BBB- CFA franc zone member. Senegal B+ B+ BBB- CFA franc zone member. Togo NR NR BBB- CFA franc zone member. AMERICAS El Salvador BB+ BB+ AAA The US dollar serves as the local currency. Panama BB BB AAA The US dollar serves as the local currency. ASIA/PACIFIC Cook Islands BB- BB- AA+ The NZ dollar serves as the local currency. Japan AA- AA- AAA The yen is a widely traded international currency. EUROPE Bulgaria BBB+ BBB A+ EMU accession expected in 2010 or later. Cyprus A A AA EMU accession expected by 2009. Czech Republic A A- A+ EMU accession expected in 2010 or later. Estonia A A AA EMU accession expected by 2008. Greece A A AAA EMU member. Hungary A- A- A+ EMU accession expected in 2010 or later. Italy AA- AA- AAA EMU member. Latvia A- A- AA EMU accession expected by 2009. Lithuania A- A- AA EMU accession expected by 2008. Malta A A AA EMU accession expected by 2009. Poland A- BBB+ A+ EMU accession expected in 2010 or later. Portugal AA AA AAA EMU member. Romania BBB BBB- A- EMU accession expected in 2012 or later. Slovak Republic A- A- AA EMU accession expected by 2009. Slovenia AA AA- AA EMU accession expected by 2008. EMU-European Monetary Union. NR-Not rated. T&C-Transfer; and convertibility. Recent Nonsovereign Default Experience During Periods Of Sovereign Stress Over the last decade, nonsovereign defaults during or related to sovereign stress scenarios have been more closely associated with indirect sovereign risks than with the sovereign directly restricting access to foreign exchange needed for debt service. For example, none of the widespread defaults in Argentina in recent years appear to be the result of its foreign exchange controls. While there were some operational difficulties related to reporting and approval requirements in the early weeks of the foreign exchange controls, which could have resulted in delays, ultimately there were no restrictions on nonsovereign debt service. The criteria adjustment reflects Standard & Poor's view that, for many countries, the risk of the sovereign restricting access to foreign exchange needed for debt service has diminished, at least relative to other risks. This reflects: Globalization and associated pressures to avoid imposing foreign exchange controls; The relatively limited scope of Paris Club-induced sovereign defaults and some sovereign distressed exchanges; The need to restrict capital flight more than legitimate debt service; and The difficult economic environment and deteriorating credit culture that often accompany sovereign stress and lead to higher nonsovereign default rates, which themselves reduce the demand for foreign exchange to service debt. The indirect risks that now play a larger role in determining the possibility of being rated above the sovereign include currency depreciation, liquidity constraints stemming from credit shortages, temporary bank deposit freezes, restrictions on raising utility rates and other price controls, and hikes in taxes and government fees amidst cutbacks in services and delayed/partial government payments. These developments tend to lead to default when nonsovereigns are highly leveraged, have a poor debt structure, maintain unhedged exchange-rate exposure, depend heavily upon increasingly expensive imports, rely on government sales or subsidies, are regulated, and/or sell products for which the demand is highly elastic. While the risk of a sovereign restricting access to foreign exchange needed for debt service remains significant, it is occurring in a decreasing percentage of sovereign default and stress scenarios. Moreover, even when such restrictions are applied, they do not cause defaults for all issuers. The harshness of such restrictions also tends to dissipate over time, and they evolve into administrative procedures that complicate, more than prohibit, access to foreign exchange. For example, export-oriented entities with offshore accounts may have sufficient resources and flexibility to service debt even in the event of restrictions on foreign exchange. However, there is also the danger that relatively well-off issuers and sectors may be the primary targets of special export tariffs, higher repatriation requirements, and other efforts by the government to increase public sector resources. Assessing The Likelihood Of A Sovereign Restricting Access To Foreign Exchange Needed For Debt Service Standard & Poor's bases its estimate of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed for debt service on a review of the sovereign's foreign exchange regime and economic policy orientation, as well as its external management flexibility. It is important to note that the analysis focuses solely on the probability of restricted access to foreign exchange needed for debt service, and not a broad array of foreign exchange controls (see box 2). In most instances, the likelihood that a distressed sovereign will try to use foreign exchange controls to stem capital flight, to constrain imports, and to in other ways reduce the pressure on the currency are higher than the likelihood that the sovereign will interfere with external debt service. Box 2 As shown in table 2, Standard & Poor's views the probability of sovereigns in Chile, Hong Kong, Indonesia, and Mexico restricting access to foreign exchange needed for nonsovereign debt service as being significantly lower than the probability of the sovereigns defaulting on their foreign currency obligations. The rating to which foreign currency ratings of nonsovereigns is limited, absent exceptional circumstances or provisions, is three notches above the sovereign's foreign currency rating. Sovereigns in this three-notch category impose no restrictions on access to foreign exchange needed for current account and most capital account activity. They also impose no repatriation or foreign exchange surrender requirements on export or other current account proceeds. By virtue of these sovereigns' open foreign exchange regimes, Standard & Poor's views the governments and central banks as being less likely than more interventionist sovereigns to resort to such restrictions in a stress scenario. Supporting these views are the outward-oriented economic policies that these sovereigns have adopted, including free-trade agreements. Both foreign direct investment (FDI) and inward portfolio investment are encouraged, and current account receipts tend to be viewed as an engine of growth. Table 2 New Nonsovereign Foreign Exchange Access Assessments COUNTRY SOVEREIGN LOCAL CURRENCY RATING SOVEREIGN FOREIGN CURRENCY RATING T&C; ASSESSMENT AFRICA & MIDDLE EAST Egypt BBB- BB+ BBB- Lebanon B- B- B+ South Africa A+ BBB+ A AMERICAS Argentina B- B- B+ Brazil BB BB- BB+ Chile AA A AA Colombia BBB BB BBB- Costa Rica BB+ BB BBB- Guatemala BB BB- BB+ Mexico A BBB A Peru BB+ BB BBB- ASIA/PACIFIC China A- A- A Hong Kong AA- AA- AAA India BB+ BB+ BBB Indonesia BB B+ BB+ Kazakhstan BBB BBB- BBB Korea A+ A AA- Malaysia A+ A- A+ Mongolia B B BB- Pakistan BB B+ BB Papua New Guinea B+ B BB- Philippines BB+ BB- BB+ Taiwan AA- AA- AA+ Thailand A BBB+ A Vietnam BB BB- BB EUROPE Russia BBB BBB- BBB Turkey BB BB- BB+ T&C-Transfer; and convertibility. For each of the countries shown in table 2 with a two notch distinction between the sovereign foreign currency rating and the T&C; assessment, Standard & Poor's views the probability of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being moderately less than the probability of the sovereign defaulting on its foreign currency obligations. Thus, the rating to which foreign currency ratings of nonsovereign issuers and issues is limited, absent exceptional circumstances or provisions, is two notches above the sovereign's foreign currency rating. Sovereigns in this two-notch category may have some current account repatriation and foreign exchange surrender requirements, but the foreign exchange regime is fairly open. In those countries with more restrictive foreign exchange controls, such as India, external liquidity tends to be quite strong. Standard & Poor's analysis suggests the propensity to restrict access to foreign exchange needed for debt service is low, albeit not as low as in those countries with a three-notch distinction. The countries have outward-oriented economic policies, but perhaps somewhat higher import dependency than in the three-notch group. Both FDI and inward portfolio investment are encouraged. Nonsovereign external debt tends to be proportionately higher than in the three-notch category described above, suggesting servicing of nonsovereign debt will be relatively more burdensome and more likely to be restricted in a stress scenario. In some cases, the two-notch distinction is driven less by openness and more by the fact that a high proportion of external debt is owed to official creditors. In such circumstances, restrictions on access to foreign exchange needed for debt service have limited effectiveness, with the more likely course of action in a stress scenario being Paris Club rescheduling and other appeals for official relief, which are broadly less disruptive. For each of the countries shown in table 2 with a one notch distinction between the sovereign foreign currency rating and the T&C; assessment, Standard & Poor's views the probability of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being only slightly less than the probability of the sovereign defaulting on its foreign currency obligations. Thus, the rating to which foreign currency ratings of nonsovereign issuers and issues is limited, absent exceptional circumstances or provisions, is one notch above the sovereign's foreign currency rating. While these sovereigns are or may recently have been fairly interventionist in their economic policies, including the use of foreign exchange controls, the foreign exchange regime is generally not very restrictive and may be in the process of opening further. There are usually repatriation and foreign exchange surrender requirements on export and other current account proceeds. In many instances, external liquidity is quite strong. Countries in this category tend to have outward-oriented economic policies, with both FDI and inward portfolio investment playing important roles in economic development. Where The Probability Of Sovereign Default Is Indistinguishable From The Probability Of T&C; Controls For countries not listed in either table 1 or table 2, Standard & Poor's views the probability of the sovereign restricting nonsovereign access to foreign exchange needed to service debt as similar to the probability of the sovereign defaulting on its foreign currency obligations. Thus, the rating to which foreign currency ratings of nonsovereigns will be limited, absent exceptional circumstances or provisions, remains the same as the sovereign's foreign currency rating. Over the next few months, Standard & Poor's will be reviewing some of these (aside from those with 'AAA' rated sovereigns, since no additional uplift is possible) for a possible reassessment of the likelihood of foreign exchange controls in line with the criteria described above. However, in a number of cases (e.g., Venezuela), there will be no such distinction in the near term. In these cases, the sovereign tends to be very interventionist and/or has a recent history of using restrictions on access to foreign currency needed for debt service as an economic policy tool. For example, there was one rated corporate default tied to Venezuela's imposition of foreign exchange controls in 2003. There could have been more defaults if more debt service was due during this period. A Wider Ratings Gap When A Sovereign Is In Default When a sovereign is in default or estimated to be close to default, the gap between the sovereign rating and the ratings of nonsovereigns domiciled therein may widen substantially. There are two reasons for this. First, Standard & Poor's does not move a rating to 'D' or 'SD' unless there actually is a default (usually nonpayment or a distressed debt exchange). An issuer or issue rating will not fall to default just because the sovereign's rating has done so. Second (and similarly), a nonsovereign rating typically will not fall to the 'CCC' or 'CC' range unless there is a clear and present danger of default, and will not follow the sovereign into this range if it seems likely that the issuer or issue will be willing and able to continue to meet its debt-service obligations. The gap between the sovereign rating and the T&C; assessment and the gap between this assessment and nonsovereign ratings may widen because there is more clarity around both the specific circumstances of the sovereign distress and the entity's willingness and ability to meet its debt obligations in the face of rising sovereign risk. Characteristics Of Issuers Rated Above A Sovereign Nonsovereign foreign currency ratings are typically the lower of the issuer's local currency rating and Standard & Poor's assessment of the sovereign restricting access to foreign exchange needed for debt service. The local currency rating of a nonsovereign entity reflects Standard & Poor's opinion of that entity's willingness and ability to service its financial obligations, regardless of currency and in the absence of restrictions on the entity's access to foreign exchange needed to service debt. Issuers with a local currency rating above the sovereign's foreign or local currency rating have operational and financial flexibility sufficient to deal with indirect sovereign risk, even as it intensifies in a more difficult environment. In the more-rare case of an issuer having a foreign currency rating above the so-called T&C; assessment, this flexibility is even greater. The specific risks that must be considered in assigning a local currency rating above the sovereign's foreign (or local) currency rating include sharp currency movements, credit shortages, banking problems (including deposit freezes), higher government taxes and fees, late or partial payments from the public sector, a more difficult regulatory environment, economic contraction, and rising inflation and interest rates. When Standard & Poor's rates an issuer or issue above a sovereign, it is not rating to a sovereign default scenario; the nonsovereign rating may fall if sovereign creditworthiness declines. However, in rating above the sovereign, Standard & Poor's is expressing its view that the rated nonsovereign's willingness and ability to service debt is superior to that of the sovereign and that, ultimately, if there is a sovereign default, there is a measurable probability that the issuer or issue will not default. The best candidates for local currency ratings above the sovereign's foreign (or local) currency rating are corporate entities with an existing or potentially large and robust export base (possibly including offshore operations or offshore parent support), with little reliance on the public sector, and with a product or set of products for which demand is relatively inelastic. Standard & Poor's uses increasingly more difficult country-specific stress tests, involving economic downturn, depreciation, and rising interest rates and inflation, as issuer and issue ratings further above the sovereign rating are assigned. The higher-rated nonsovereign issuer or issue has characteristics suggesting it is better equipped to deal with stress than the sovereign and other lower-rated credits. Corporates/transactions with mainly local currency revenue, subject to regulation and/or with a heavy dependence on imports, would not pass the stress tests without heavy overcollateralization or reserves. Cases in which a nonsovereign foreign currency rating is higher than the rating associated with the risk of the sovereign restricting access to foreign exchange typically involve offshore business and accounts. Issue ratings will continue to be boosted on a foreign currency basis by structural enhancements, generally involving the capturing of funds offshore.