Article Title: ARCHIVE | Credit FAQ: Rating Criteria For Government-Related Entities Data: (Editor's Note: This article is no longer current. Please see "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published on June 29, 2009.) Standard & Poor's Ratings Services updated on June 14, 2006, its rating criteria for public sector entities and those private sector entities that could be affected by extraordinary government intervention in an economic or financial stress scenario, in an article called "Rating Government-Related Entities: A Primer," published on RatingsDirect. No rating changes are anticipated as a result of this criteria update. This Credit FAQ summarizes the evolution of the criteria and addresses questions received on the subject. It explains why Standard & Poor's does not use joint support analysis for government-related entities (GREs) and discusses the potential impact of European Union (EU) competition laws on government support. We also discuss the implications of privatization of rated GREs. More than 400 GREs are rated according to these criteria around the world, in Europe, Asia-Pacific, and the Americas. GREs include both public sector entities, such as economic development agencies, social housing institutions, and public transportation companies, and private sector entities, such as post offices and some systemically important financial institutions in interventionist countries. Frequently Asked Questions Has Standard & Poor's changed its criteria on government-related entities (GREs)? The GRE primer ("Rating Government-Related Entities: A Primer") does not change fundamentally Standard & Poor's view on GREs, but the methodology for rating these entities has been modified in two aspects: 1. The rating approach has been streamlined in order to reflect better the trends that have affected these entities over the past decade. In particular, Standard & Poor's now classifies the GREs in two broad categories: Public-policy-based institutions, which play a central role in meeting political and economic objectives, and which are mostly rated up to two rating categories (i.e., six notches) below the government's rating; and Commercial enterprises, which play a smaller or no public policy role, and which are usually rated up to two rating categories (i.e., six notches) above their stand-alone rating. Previously, Standard & Poor's had identified three categories, including a first category for entities highly integrated with the related government and usually rated the same as that government. The number of these entities has declined in most countries, as policymakers have increasingly exposed government-owned institutions to market discipline. These entities continue to be rated at the same level as the related government, but have now been included in the wider group of public-policy based institutions. Details of the rating approach for commercial enterprises can be found in the GRE primer mentioned above. These entities were previously captured under the third category called "other enterprises," and include corporate or financial institutions that are likely to receive extraordinary government assistance. 2. Standard & Poor's has increased its flexibility regarding the number of notches that can be added to a stand-alone rating to reflect potential extraordinary government support. We expect that, in most cases, the uplift for extraordinary government support will be not more than three notches, but there are instances where a particularly strong likelihood of government intervention may justify even more uplift, up to six notches. This flexibility has been added in order to avoid a dramatic rating change in cases when credits acquire riskier credit characteristics, and, as a result, Standard & Poor's needs to switch from a top-down to a bottom-up approach. This is the case especially where the sovereign is highly rated and an entity with weak stand-alone credit quality gradually moves from a policy-based activity to a commercial one. Does Standard & Poor's use joint support criteria to rate debt issued by GREs? Based on Standard & Poor's criteria for rating jointly supported obligations, the rating on an obligation may be higher than the rating on the stronger obligor (supporter), in cases where each obligor is fully responsible for the entire obligation and there is limited expected default correlation between the two entities. This is because the risk that both obligors will default is lower than the risk that either one will. Common examples of the application of this criteria include letter of credit (LOC)-backed issues. For more information, see "Criteria Update: Joint Support Criteria Refined," published on RatingsDirect on Feb. 3, 2006. Standard & Poor's does not expect to apply such a probabilistic approach to rating obligations of a GRE, however, as we believe that the correlation between the GRE and its government supporter is usually too high. Under the joint support criteria, the highest correlation category assumes a default correlation of 25%, which applies to entities sharing two of the following: same industry, same region, and a speculative grade rating. In a case where the government would be considered as fully responsible for the GRE's entire obligations, it is most likely that the GRE and its government benefactor would have strong ongoing interactions. For instance, the GRE might fulfill a public policy role, receive ongoing financial contributions, be closely supervised by the government, and/or involve the government in the definition of its strategy. As a result, the correlation between the two entities would be well above the maximum of 25% used in the joint support probabilistic approach. The more likely default scenarios in this case are that both entities will default at about the same time, or that the GRE will default but the government will not. There are rare cases when a GRE may be rated above its government owner, but this is based on the GRE's strong stand-alone credit quality, as well as a low dependence on, or arms-length relationship with, the government, and not on a probabilistic approach. For more details of such cases see the GRE primer. How does Standard & Poor's evaluate the impact of EU competition laws on potential government support? The ability of governments in the EU to support a company operating in the commercial sector is constrained in many instances by laws that regulate anticompetitive behavior of businesses and governments. In the context of governments, the general rule is that state aid granted by a member "state" that distorts competition and affects trade between member states is not allowed. The "state" in this context is interpreted widely and includes member state governments, local and regional authorities, government controlled banks, and other public sector entities. The "aid" in question is also interpreted widely. Examples are: state grants, debt forgiveness, lower interest rates, comfort letters, loans, equity injections, and guarantees. A good litmus test for determining whether state aid is of the prohibited kind is to ask: has the state given something that is not on market terms? Or, to put it another way, has the state paid or received the market price? There are, of course, exceptions to every rule and certain state aid is allowable even if the aid is not on market terms, such as state funding to discharge public service obligations (if public procurement rules are respected, pricing is at the right levels, and the service is a real public service). The state aid rules require member states to notify the EU Commission of any plans to grant state aid that falls within the aid described in Article 87(1) of the EC Treaty and not to implement it until EU Commission approval has been given. If the aid is granted without that approval there are likely to be material consequences because not only is it considered unlawful, but the provider will be required to recover or abolish the aid granted. As a result, when evaluating the likelihood of government support for GREs operating in a competitive sector within the EU, Standard & Poor's will generally consider what constraints there are on the ability of a government to provide support under the EU regulation. These issues have been the subject of considerable scrutiny for the energy and utility industries, as well as for financial institutions. In these cases, government aid can still lawfully be given to an entity, but only if the government has acted or is presumed to act in the same way as any private shareholder. The criteria to evaluate government support would not then differ from that applying to a parent/subsidiary relationship in the private sector (see p. 85 of "Corporate Ratings Criteria 2006," and p. 81 of "Financial Institutions Criteria - September 2005," on RatingsDirect). For more information, see "European Infrastructure Projects and the Legal Risks Arising From Competition, State Aid, and Related EU Laws," published June 2, 2004, on RatingsDirect. What weight does Standard & Poor's give to government guarantees when evaluating a GRE? GREs can benefit from different types of guarantees from the government. On the few occasions when a GRE benefits from a timely, unconditional, and irrevocable guarantee on all its financial obligations, Standard & Poor's would most likely equalize the GRE's rating with that of the government. However, these guarantees are liable to disappear, as governments increasingly tend to expose GREs to market discipline. More common forms of government guarantees include: A timely and unconditional guarantee from the government, but only on a portion of the GRE's obligations, typically for historical reasons (old obligations outstanding from a time when the government was guaranteeing all the debt issued); A guarantee on specific risks or liabilities that would derive from the GRE's present or past public mission, such as pension liabilities for civil servants or environmental risk in the case of nuclear activities; An ultimate guarantee, often based on the GRE's status, that generally requires the guarantor to meet all of the entity's obligations in full, but only after the resources of the guaranteed entity are exhausted; and A guarantee to maintain a pre-defined level of financial balance or capital structure, through operating or capital contributions when required. Although these forms of guarantees are ultimate rather than timely, they all attest a more or less strong form of government support. The last two forms of guarantees generally apply to entities in the policy-based institutions category of GREs and demonstrate a strong form of government support. The first two types of guarantees tend to be seen more in the case of entities that had public policy roles in the past and that now operate more in the commercial sector. In all these instances, Standard & Poor's will evaluate the incentives and capabilities of the government to support the GRE on a timely basis (and not only ultimately) using the approach described in our GRE primer. Even in cases of apparently timely guarantees, Standard & Poor's would analyze carefully the willingness and commitment of a government to honor its guaranteed obligations on a timely basis. This is particularly applicable in the case of guarantees provided by local and regional governments in emerging countries, where Standard & Poor's experience shows that the term "guarantee" is increasingly used loosely to encompass promises and sureties that fall short of unconditional timely binding guarantees, and where governments tend to display varying degrees of willingness to service these obligations on a timely basis. For more information, see "How Much Is a Guarantee Worth in the Public Sector?" published July 29, 2004, on RatingsDirect. When and how does Standard & Poor's start reflecting privatization prospects in a GRE's rating? Privatizations can affect the willingness and ability of a government to provide extraordinary support to an entity. The privatization process is often surrounded by a high degree of uncertainty, however, and the time between the first political discussions and the actual privatization can often be counted in years. The overall implication of a privatization process on the GRE rating depends on several factors, such as the GRE's stand-alone credit quality, the weight of government ownership in the current rating, and the timing and conditions of the privatization. As a first step when privatization is entering the political debate, and well in advance of actual political decisions being taken, Standard & Poor's analyzes the nature, likelihood, and the timing of the privatization process, and evaluates if it is adequately reflected in the current rating approach. As part of this analysis, we look, for instance, at what is happening to similar entities in other countries. If the analyzed entity is classified as a policy-based institution, a privatization process would most likely lead Standard & Poor's to view the profile of the entity as shifting to that of a commercial enterprise. As a result, the rating approach could change from a notching down from the government's rating to a notching up from the entity's stand-alone rating. This process might lead to a rating or outlook change, depending on the existing weight of government ownership and the GRE's stand-alone rating. Once the privatization process and conditions become clearer, Standard & Poor's can further adjust the rating level toward what is likely to be the GRE's postprivatization creditworthiness. The conditions under which the entity might be privatized play a significant role in the potential evolution of the rating. The government may choose to enrich itself through an extra dividend before the entity is sold, or, on the contrary, it may decide to directly take on part of the entity's "legacy" liabilities (such as pension liabilities) in order to make the GRE more attractive to the market. Although a privatization process would often result in a downgrade of the GRE, there are cases where the rating could be maintained if the government demonstrates strong forms of support to the entity and/or if the GRE's stand-alone credit quality is sufficiently robust. There could even be some instances where the privatization process leads to an upgrade of the GRE rating, if the privatization results in a merger with a highly rated entity. Does the probability of extraordinary support from the government increase as the GRE comes closer to default? Standard & Poor's reflects in a GRE's rating its opinion on the likelihood that the government will provide extraordinary support in case of financial distress, including the probability that this support will be granted in a time period sufficient to reduce the probability of default of the entity. This support is reflected in a GRE's rating at any time, even if its current financial profile is strong. In practice, it is sometimes more difficult to obtain evidence of potential extraordinary government support for entities in the high investment-grade category, as the exercise may be highly theoretical. The track record of government support is often limited or nonexistent for entities with a strong stand-alone profile, as such support is unnecessary. (At the same time, past support does not systematically imply that similar support would be granted in the future.) In addition, the supervision of the management or involvement of the government in setting such an entity's strategy is usually less important. Lastly, the government might not state clearly its willingness to give support, as it might have difficulties conceiving of, or communicating on, a situation of financial distress. In contrast, for an entity with a weak or weakening stand-alone financial profile, the government, being faced with an actual support issue to consider, tends to communicate its intentions more clearly through its statements and actions. We also typically try to understand why a government, if expected to be supportive, has allowed the GRE's stand-alone credit quality to deteriorate markedly or to remain in a weak state, as a guide to both its ability and willingness to support. For these reasons, as a GRE's stand-alone situation deteriorates, governments might more clearly demonstrate their willingness to step in and Standard & Poor's might consequently increasingly reflect government support in the GRE's rating, if appropriate, thereby slowing or eliminating the downward rating trend. Does Standard & Poor's apply the same criteria in the case of financial institutions? The framework used to evaluate extraordinary support for financial institutions is the same as for other GREs. Extraordinary support factors for a financial institution encompass the likelihood that the government will intervene when a bank is failing, either because of government ownership or guarantees, or because the bank is systemically important. Sovereigns tend to provide extraordinary support to distressed banks because of the crucial role that banks play in the national economy: safeguarding and allocating national savings, intermediating financial exchanges, implementing monetary policy, and promoting economic growth. Some governments are more disposed to intervention and support than others. Since 2005, we have upgraded financial institutions in several countries that we consider interventionist with respect to the banking sector. This is because we now give greater weighting than previously to interventionist governments' potential extraordinary assistance to systemically important private sector banks in the event of distress. The GRE analytical framework does not, however, directly take into account several macroeconomic and systemic factors that are essential in assessing bank credit ratings. These ongoing system-wide factors rather are reflected in Standard & Poor's banking industry country risk assessments (see "Banking Industry Country Risk: These Are The Good Old Days," published June 6, 2006, on RatingsDirect). Examples include central bank liquidity facilities, prudent and proactive banking regulation, and a legal system that specifies the rights of creditors and debtors and allows smooth resolution of bankruptcies. The banking industry country risk assessments establish a comparative benchmark for the overall creditworthiness of a banking system and individual banks in a country. Does Standard & Poor's evaluate differently support from a sovereign and from a municipal or regional government? The criteria applied are generally the same for entities supported by a sovereign and those supported by a municipality or a regional government. Entities that benefit from local government support are mostly municipality-owned companies in the public transportation, housing, and energy sectors. While a sovereign might have greater latitude to support an entity, given its unique resources, it might also have a greater ability to weaken an entity's stand-alone credit profile. In addition, there are special foreign currency considerations for sovereigns, as described toward the end of the GRE primer. How does Standard & Poor's define a stand-alone rating? A stand-alone rating is Standard & Poor's assessment of an entity's intrinsic creditworthiness, before factoring in extraordinary support from relevant entities such as a government or parent company. As such, for a GRE, it reflects the entity's operating and financial situation and prospects, including any ongoing interaction with the government in the normal course of business, but excluding any potential extraordinary government assistance (such as liquidity injection or a recapitalization) that might be expected in the event of a crisis. Ongoing interaction between a GRE and a government encompasses, for instance, recurrent operating or capital subsidies, access to preferential funding, a monopoly position, favorable contracts, and sympathetic regulatory regimes. These are difficult-to-measure forms of support that enhance both operational and financial performance. On the negative side, price ceilings, risky investment project mandates, and directives to provide loss-generating goods and services represent forms of ongoing government intervention that constrain operational and financial performance.