Article Title: ARCHIVE | Criteria | Governments | Sovereigns: Why National Development Banks And Export Credit Agencies Are Rarely Rated Above The Sovereign Data: (Editor's note: This article is superseded by "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published June 29, 2009, on RatingsDirect.) Standard & Poor's rates 15 national development banks (NDBs) and 14 export credit agencies (ECAs). Most are rated at the sovereign level, a few slightly below. In the wake of a growing number of questions as to why the potential for rating NDBs and ECAs above the sovereign in the country of domicile is quite limited, Standard & Poor's is providing this Credit FAQ to expand upon its recently updated government-related entity (GRE) criteria. (See "Rating Government-Related Entities: A Primer," June 14, 2006.) GREs, including NDBs and ECAs, are enterprises that may be affected by extraordinary government intervention in an economic or financial stress scenario. The potential intervention is in the form of support in most cases, and the GRE rating is enhanced by the government relationship. Conversely, government intervention may redirect GRE resources to the government and weaken GRE credit quality. When Standard & Poor's rates an issuer or a specific obligation above a sovereign, Standard & Poor's is expressing its view that the GRE's willingness and ability to service debt is superior to that of the sovereign and, ultimately, that if there is a sovereign default, there is a measurable probability that the issuer or issue will not default. Sovereign stress/default often creates very difficult political and economic situations, and rating an entity above the sovereign requires consideration of these stress scenarios. Among GREs, commercially-oriented entities with strong operating and financial characteristics, geographically diversified business, modest holdings of government debt, and few government links are the best candidates—particularly where the sovereign itself tends not to be very interventionist. NDBs and ECAs do not typically fall into this category. Also, the evidence from the credit default swap market indicates that the default risk of NDBs and ECAs tends to be slightly higher than that of the sovereign. Frequently Asked Questions Under what circumstances might a government-related entity (GRE) be rated above the sovereign? A GRE may be rated above the sovereign if its stress-tested, stand-alone rating exceeds the sovereign's rating, and if the government is not expected to take actions in a stress scenario that impair the GRE's credit standing. Thus, the GRE should not rely on government contracts, a favorable regulatory regime, liquidity held in government securities, or any other government connection. The best candidates will benefit from nongovernment shareholder support, solid governance standards, financial resilience to interference, and/or a track record of a "hands-off" approach by the government Why are no NDBs and ECAs rated above the sovereign at present? NDBs and ECAs most often do not have stand-alone credit quality exceeding that of the sovereign. Thus, for their ratings to exceed the sovereign's, Standard & Poor's must feel comfortable that the sovereign will provide support even as it fails to meet its own obligations. While there may be a few examples of governments providing such support, there are more examples of sovereign stress extending to NDBs and ECAs. Belize just concluded a rescheduling program comprising Development Finance Corporation (DFC) debt, which the government assumed in recent years as DFC's financials deteriorated. Other examples are from a decade or more ago, with recent sovereign defaults generally recorded by sovereigns without an active NDB or ECA or where its debt is very low. Even where a NDB or an ECA has stand-alone credit quality exceeding that of the sovereign, the NDB or ECA rating is usually constrained by the tendency for sovereigns to ask GREs to provide additional services or pay higher taxes or dividends in a deteriorating economic environment. Does market information support these rating relativities? Yes. As shown in table 1, the credit default swap (CDS) spreads for NDBs and ECAs tend to be slightly wider than the spread for the sovereign in the country of domicile. Banco Nacional de Desenvolvimento Economico e Social (BNDES) in Brazil is an exception, probably related to its relatively small external debt, particularly in relation to its structured obligations, which creates somewhat unusual market factors, including the need to hedge. Table 1 Sovereign CDS Spreads Versus NDB/ECA Spreads COUNTRY SOVEREIGN CDS SPREAD (BASIS POINTS) NDB OR ECA NDB OR ECA CDS SPREAD NDB OR ECA SPREAD MINUS SOVEREIGN SPREAD Brazil (Federative Republic of) 94 69 (25) United Mexican States 40 47 7 Korea (Republic of) 19 16 (3) 17 (2) China (People's Republic of) 10 13 3 14 4 Czech Republic 5 11 6 Japan 3 7 4 Germany (Federal Republic of) 2 2 0 CDS-Credit default swap. NDB-National development bank. ECA-Export credit agency.Source: Markit Partners. All data as of Feb. 2, 2007. Spreads refer to five-year CDS contracts. Why do NDBs and ECAs tend not to have stand-alone credit quality exceeding that of the sovereign? NDBs and ECAs are public-policy-based GREs in that they typically play a central role in meeting the government's political and economic objectives. They often have relatively poor financials because of the uneconomic tasks they are asked to fulfill and the weak capital base the government has provided. When political and economic conditions deteriorate, these institutions may be called upon both to expand unprofitable public-policy-related activities and to contribute more to government coffers. Rather than rating GREs based on their stand-alone credit quality and the risk of sovereign intervention, why does Standard & Poor's not rely upon its joint support criteria? Standard & Poor's criteria for rating jointly supported obligations allows a higher rating than assigned to either the sovereign or the stand-alone GRE, but only where the expected default correlation between the sovereign and the GRE is below 25%. While this may be true in some cases, the circumstances under which sovereigns create or acquire GREs, particularly NDBs and ECAs, suggest a fairly high default correlation. If central banks (aside from those for monetary union members) typically control the monetary arm of economic policy and manage the supply of local currency, why is there any limit on their willingness and ability to extend support to GREs? Printing money above what is needed to meet specific economic policy objectives has costs, which, in the extreme, are hyperinflation and social upheaval. While the ability to print local currency gives the sovereign—and the sovereign alone—tremendous flexibility, the consequences of monetizing debt can be more unpalatable than the consequences of its rescheduling. In such instances, sovereigns may opt to reschedule their local currency obligations, and the likelihood of support going to GREs is no greater than the probability of sovereign default. Is it more likely that a GRE in a monetary union may be rated above a sovereign? A sovereign stress scenario may be considerably less grim for a monetary union member in that depreciation is likely to be less harsh and inflation less severe, suggesting greater scope for rating above the sovereign. However, this would likely apply only to GREs with fairly strong stand-alone credit quality because the ability of the sovereign to provide support would be strained.