Article Title: ARCHIVE | General Criteria: Understanding National Rating Scales Data: (EDITOR'S NOTE: — We originally published this criteria article on April 14, 2005. We're republishing this article following our periodic review completed on Nov. 14, 2013. This article has been fully superseded by "National And Regional Scale Credit Ratings," published Sept. 22, 2014.) The rapid expansion of Standard & Poor's Ratings Services rating activities in the domestic financial markets of developing and transition economies has led Standard & Poor's to operate an increasing number of national rating scales in parallel with its global rating scale. Standard & Poor's national scale ratings provide an opinion of the relative creditworthiness of entities and specific financial obligations in a particular country. With the benefit of a link with Standard & Poor's global scale local currency ratings, national scale ratings help participants of domestic financial markets measure credit risk objectively, facilitating the pricing of financial obligations and the efficient allocation of capital. National scale ratings typically provide a finer demarcation of credit risk among local obligors than is possible with Standard & Poor's global scale, as the latter spans the full range of global credit quality and incorporates international comparative risk factors, including direct and indirect sovereign risk considerations. In turn, Standard & Poor's national scale ratings are not directly comparable to Standard & Poor's global scale ratings, and national scale ratings of different countries are not comparable to each other. Therefore, rating definitions may vary from scale to scale, and unique symbols are used to highlight each rating scale. Long And Diverse Experience Compared with other local or international rating services, Standard & Poor's has the longest and most varied experience in developing and managing national rating scales. In addition, Standard & Poor's has developed a unique and rigorous methodology for managing national rating scales built upon: An assessment of credit risks in the market served by the national scale, Adjustable correlation guidelines between each national scale and Standard & Poor's global scale local currency ratings, and Extensive coordination and integration of the analytical process for assigning and reviewing ratings on the two scales. In addition to its extensive experience in managing national rating scales in more mature financial markets such as Canada, France and Sweden, Standard & Poor's currently provides national rating scales in eight emerging market economies: Argentina, Brazil, Kazakhstan, Mexico, Russia, Taiwan, Uruguay, and now, Ukraine. Operating procedures, policies, and criteria that have been developed and tested around the world are tailored to serve the needs of borrowers and lenders in each national market. Standard & Poor's is also working with existing and prospective affiliates that operate or are developing national scale rating services in Chile (Feller Rate), India (CRISIL), Indonesia (PEFINDO), Israel (Maalot), and several other emerging markets. As warranted by the development of local financial markets, Standard & Poor's will offer a growing number of national scale rating services to issuers, investors and intermediaries in emerging market economies. This article addresses the key methodological and communications issues posed by national rating scales: Under what circumstances are national scale ratings most valuable? What is the relationship between Standard & Poor's national rating scales and its global scale in terms of the consistency of criteria, the ranking of credit risk, and the degree of default risk? How does Standard & Poor's ensure the quality and consistency of ratings on multiple scales? How are the differences between global and national scale ratings clearly communicated to users of Standard & Poor's credit rating services? National Scale Credit Ratings Defined Standard & Poor's national scale credit ratings provide a current opinion of an obligor's creditworthiness (that is, issuer, corporate, or counterparty credit ratings) or overall capacity to meet specific financial obligations (that is, issue credit ratings), relative to that of other entities and specific obligations in a given country. In contrast to Standard & Poor's global scale ratings, national scale rating opinions are based on a comparative credit risk analysis of active obligors, including the sovereign government, within one country, and exclude direct sovereign risks of a general or systemic nature. Each Standard & Poor's national scale is tailored to the market it serves based on a dynamic perspective on local credit risk conditions. Although national scale ratings emphasize relative credit risk in a domestic context, the scale is not designed to achieve a forced distribution of ratings. Instead, the distribution of national scale ratings can evolve over time with significant shifts in local economic conditions, reflecting a dynamic scale that encompasses the full range of potential creditworthiness of active local obligors. On the other hand, under particularly unfavorable domestic conditions, even the strongest entities in the country may not receive the highest rating classification on the national scale. However, should business and economic circumstances improve, the strongest entities in the country, including the sovereign, may aspire over time to the highest possible rating on the national scale. Given the focus on credit quality within a single country, national scale ratings are not comparable between countries. In most instances, national scale credit ratings only take the form of local currency credit risk opinions. However, foreign currency credit opinions are provided on a national scale basis in highly dollarized economies, and, in such cases, foreign and local currency national scale credit ratings are identical. National scale ratings are conveyed by symbols that distinguish them from Standard & Poor's global scale ratings, including the addition of a two-letter country prefix to Standard & Poor's well-known letter-grade symbols, for example, 'uaAAA', 'uaAA+', 'uaAA', 'uaAA-', 'uaA+', 'uaA', 'uaA-', 'uaBBB+', and so on, for long-term national scale ratings in Ukraine. Benefits Of National Rating Scales National rating scales are of the most value where sovereign and other credit risks skew global scale ratings to low levels in the country and where local issuers and investors are predominant players on the domestic markets. Such a compression of ratings at lower levels is fairly common among the emerging market economies. Added differentiation of credit risk Whether or not regulations dictate the use of national scale ratings, sovereign and country risk factors are important determinants of the market demand for a national rating scale. Sovereign risks (for example, direct constraints such as potential exchange controls) and country risks (for example, indirect effects from government policies affecting exchange rates, interest rates, taxation, regulations, infrastructure and labor markets) may compress the range of global scale ratings assigned to obligors in the country, reducing or even obscuring differences in credit standing that would otherwise be evident in the absence of these sovereign and country risks. For example, sovereign and country risk factors in Mexico result in a narrow range of global scale ratings, with many of global scale ratings compressed in the 'BB' and 'BBB' rating categories. While the potential impact of sovereign risk is a critical consideration for cross-border financing, direct sovereign risks of a general or systemic nature, which affect most national obligors to a similar degree, are of less importance to local participants in the national financial markets who find that national scale ratings are useful in providing the most precise ranking of relative credit risk available for obligors within their country. In addition to sovereign and country risk factors, the frequency distribution of credit risk (as measured by the number of observed global local currency ratings per each rating level for active obligors in the country) may be strongly influenced by other factors. Credit risk attributes that are common to many obligors in a given emerging economy such as limited size, lack of diversity, rapid expansion, or an unstable financial environment may limit the scope for higher ratings on the global scale, even in the absence of direct sovereign risk constraints. Such would be the case in Taiwan, where some two-thirds of rated obligors carry a 'BBB' category or lower global scale rating in spite of a sovereign local currency rating of 'AA+'. As a result, national rating scales offer enhanced differentiation of credit quality where the typical credit attributes of most of the active obligors tend to concentrate global scale ratings in the medium- to low-grade categories. Even though national scale ratings are meant to confer an opinion of relative credit risk within a domestic context, that is not to say that they are fully isolated from sovereign risk considerations and other international comparative risk factors. However, it is important to note that credit risk standards vary among national scales and these standards may change over time for a given national scale, if and when the country experiences a material change in sovereign risk and/or the frequency distribution of credit risk among debt issuers active on the local market. Helps develop local financial markets Demand for national scale ratings, whether initially fostered by regulation, sovereign risk, or other factors, typically endures over a long period. While national regulations often do initially play the role of catalyst in the demand for national scale ratings, market forces eventually lead to an increasing focus on the quality of the credit opinions rendered, recognizing the intrinsic value of national scale ratings. Combining Standard & Poor's internationally established analytical processes with a national focus, Standard & Poor's national scale ratings: Help create more meaningful interest rate differences among obligations, Allow local and foreign investors to better allocate funds according to their risk-return preferences, and Help intermediaries more efficiently price and place debt instruments. Key Characteristics Of National Rating Scales Standard & Poor's national scale credit ratings have the following major attributes: The underlying methodology (for example, for corporates, financial institutions, local governments, and so on) employed is identical to the one used for global scale ratings. National rating scales exclude certain direct sovereign risks of a general or systemic nature, including the potential risk of foreign exchange controls. As a result, obligors and obligations with global scale ratings constrained by systemic, direct sovereign risk may have national scale ratings that are higher than the sovereign's rating on that scale, though such cases would necessarily be limited to countries where the sovereign's national scale (ns) rating is less than 'nsAAA'. National and global rating scales are broadly consistent in terms of the rank order (from highest to lowest credit quality) of ratings. National scale ratings are an expression of the relative creditworthiness of obligors and obligations in a particular country, and are based on a comparative analysis of that country's active obligors (this is in contrast to the all-encompassing international comparative context of global scale ratings). National rating scales are not static yardsticks of relative creditworthiness at a given point in time. Rather, they are meant to provide dynamic opinions of relative credit risk that encompass the full range of potential levels of creditworthiness of local obligors over the medium term. Given the focus on relative creditworthiness, the strongest entities in the country, including the sovereign, often receive the highest possible rating on the national scale, provided the country is not experiencing an acute and widespread financial crisis that imperils the debt service capacity of even the strongest local debt issuers. While no obligors may be rated in the top classification of the national rating scale during periods of severe, nationwide financial stress or the early stages of economic development or transition, the dynamic quality of the national scale provides sufficient scope for potential upgrades and the use of the full rating spectrum--if warranted by improved business and economic circumstances. While Standard & Poor's national scales are relative measures of credit risk within a given country, they do not seek to achieve any kind of a forced distribution of that country's obligors among the scale's rating classifications. Instead, as is the case with the global scale, the distribution of ratings on the national scale fluctuates with credit risk trends and the universe of active obligors. If economic and financial trends are favorable over an extended period, the percentage of ratings in higher categories may rise. Conversely, if unfavorable trends are experienced for a prolonged time, the proportion of ratings in lower categories may increase, as was the experience with Standard & Poor's Argentine national scale during the crisis beginning in 2001. However, changing economic fortunes may also expand or contract the number of issuers with access to the market, potentially offsetting the influence of upgrades and downgrades on the frequency distribution of credit ratings in the local market. For example, during an extended period of economic prosperity and monetary stability, more marginal debt issuers of limited size and credit standing may more readily tap domestic fixed-income markets, while market access may be restricted to only the largest and strongest local obligors during prolonged and severe economic downturns. Underlying default risk differs from that of global ratings The global scale and national rating scales usually imply substantial variations in the default probabilities associated with any particular rating category on the global and national scales. For example, the implicit default risk associated with a Standard & Poor's global scale rating of 'AA' is significantly lower than the risk inherent to a Taiwan national scale rating of 'twAA' by Standard & Poor's affiliate, Taiwan Ratings Corp., which, in turn, is lower than the default risk implied by an 'ruAA' rating on Standard & Poor's Russia national scale. The difference in implicit default risk between Standard & Poor's global scale and any given national scale is a function of the degree of sovereign and country risks in the economy and, to a lesser extent, the distribution of credit risks among active obligors in the country. In order for the national scale to provide adequate differentiation in credit risks for obligors active in the local market, it follows that the higher the sovereign and country risks associated with the national economy, the higher the default risk that is embedded in the national scale. The same naturally holds true when the distribution of global scale ratings is concentrated among the lower rating categories. For example, a national scale serving an economy with medium sovereign risk and a predominance of low-grade, global scale ratings for active obligors (for example, Russia) would have lower global scale, local currency ratings corresponding to each category on the national scale than would be the case for a national scale serving an economy with low sovereign risk and a predominance of intermediate grade, global scale ratings for active obligors (for example, Taiwan). Examples of the relationship between global and national scale ratings are provided in the accompanying table. Linking Each National Scale To The Global Scale Standard & Poor's approach to national scales has emphasized the development of an operating framework linking each national scale with its global scale. The operating framework involves several key principles: Development of broad correlation guidelines between the rating categories of each national scale and the rating categories of Standard & Poor's global scale, Adjustment of correlation guidelines to any material change in sovereign risk or the frequency distribution of global local currency ratings to ensure that the national scale continues to provide adequate differentiation of credit risk among local obligors, and Coordinated analytical teams and rating committees that assign and review ratings on the two scales in each country. The operating framework and, in particular, the internal correlation guidelines have three major objectives: To ensure broad ranking consistency between the ratings on the two scales, while allowing the national scale the scope to provide meaningful differentiation of credit risk among obligors active in the local financial markets; To anchor the national scale to Standard & Poor's global scale measure of default risk, so as to ensure prudent ratings and provide adequate forewarning of default risk; and To allow Standard & Poor's analysts assigning national scale ratings to benefit from the broader comparative perspective embodied in Standard & Poor's global scale. Selected Comparisons Of National And Global Scale Credit Ratings ISSUER GLOBAL LONG-TERM LOCAL CURRENCY RATING NATIONAL SCALE RATING RUSSIA Russian Federation BBB ruAAA Russian Railways BB+ ruAA+ Lukoil BB ruAA MMK BB- ruAA- RAO UES B+ ruA+ MGTS BB- ruAA- VolgaTelecom B ruA- Irkutskenergo B ruBBB+ Rosbank B- ruBBB- Central Telecommunications CCC+ ruBB+ OAO OMZ CCC+ ruBB International Bank of Saint-Petersburg CCC ruB+ Yukos D ruD MEXICO Grupo Bimbo S.A. de C.V. BBB+ mxAAA United Mexican States A mxAAA Grupo Imsa S.A. de C.V. BBB mxAA+ Grupo Petrotemex S.A. de C.V. BBB- mxAA Corporacion GEO BB mxA Xignux S.A. de C.V. BB- mxBBB+ Vitro S.A. B mxBBB Empresas Ica B- mxBB+ It is important to note that the methodology underlying Standard & Poor's national rating scales results in a nonlinear relationship between the global scale rating grade and its corresponding national scale rating grade(s) as one moves down the credit risk spectrum from high to low credit quality. That is, one cannot simply add a certain number of rating levels to a global scale local currency rating to determine the corresponding national scale rating. Rather, the degree of difference between the two rating scales in terms of the assigned letter-grade opinion generally increases as one moves up the rating scale towards the strongest credit rating assigned in the country. For example, an entity carrying a global scale local currency rating of 'BBB' in a medium-risk sovereign nation may well be rated as high as 'nsAA' or even 'nsAAA' on that country's national scale, underlining not only the higher degree of default risk embedded in the national scale but, most important, the inherent quality of national scales to provide greater differentiation in credit standing, particularly at the upper end of the rating spectrum. On the other hand, the rating gap is smaller, if it exists at all, at the bottom end of the rating spectrum, pointing to the ability of national scales to provide an adequate warning of the risk of default. Reflecting the increased scope for differentiation of credit risk, national scale ratings are more sensitive to changes in credit risk and, in turn, are likely to change more frequently and to a larger degree than global scale ratings. That is, a given change in the business or financial profile may affect an issuer's national scale rating but not its global scale rating, or alternatively may translate into a revision of both ratings but one that is more pronounced on the national scale. However, the impact of changes in sovereign risk on national scale ratings is mitigated by corresponding adjustments to the correlation guidelines designed to safeguard the ability of the national scale to provide meaningful credit rating distinctions among local obligors. Symbols And Definitions Highlight Differences For many national rating agencies, the true nature of national rating scales is not fully understood or acknowledged, creating the potential for confusion among users of such credit rating services. Areas of misunderstanding chiefly bear upon the comparative frame of reference and the related issue of the degree of default risk implied by each rating classification. Within the Standard & Poor's network itself, the use of multiple national scales alongside the long-standing global rating scale requires clear and consistent means of communicating credit risk opinions on the two scales, as the same obligation or obligor may be rated on both the global scale and national scale. For example, a company's issue of local currency bonds may be assigned a global scale local currency rating and a separate and quite different national scale rating. Effective means of distinguishing such national scale ratings from global scale ratings are of critical importance due to the potentially large difference in implicit default risk between the two scales. Standard & Poor's has chosen to distinguish national and global scales from one another by means of a mixture of symbols, rating definitions and, on occasion, brand names. In more mature markets, Standard & Poor's has used unique symbols and brand names to convey national scale ratings, as in the case of the Nordic and ADEF scales used in Sweden and France, respectively. In contrast, in emerging markets Standard & Poor's uses its universally recognized letter-grade symbols with a country prefix, as is done in Mexico ('mx'), Argentina ('ra' for Republica de Argentina), Taiwan ('tw'), Brazil ('br'), Russia ('ru'), Kazakhstan ('kz') and now, Ukraine ('ua'). To reinforce the symbolic distinctions between the scales, Standard & Poor's has published rating definitions for each national scale. In the case of the national scales employed in emerging markets (for example, Mexico or Argentina), the rating definitions highlight the market served and the relative risk nature of the scale. In addition, the definitions emphasize that the rating opinions do not address certain direct sovereign risks, and in particular the potential risk of foreign exchange controls. Finally, for a number of national scales, Standard & Poor's retained or developed separate brand names associated with the national scale (for example, CaVal in Mexico, ADEF in France, and Nordic in Sweden). National Scale ratings are updated each month in Standard & Poor's online RatingsDirect service and can be confirmed on Standard & Poor's global Web site at www.standardandpoors.com and its national Web sites and pages. In addition, certain national ratings offered by Standard & Poor's and affiliates are available from local offices and affiliates or in local publications: Standard & Poor's Argentina, Buenos Aires Office, Calificaciones y Fundamentos Mexico, Mexico City Office, Calificaciones y Commentarios Russia, Standard & Poor's Credit Russia and sandp.ru Taiwan, Taiwan Ratings Corp. Affiliates: Chile, Feller Rate, Vision de Riesgo India, CRISIL, RatingScan Indonesia, PEFINDO, Credit Insight Israel, Maalot