Article Title: ARCHIVE | General Criteria: Rating Sovereign-Guaranteed Debt Data: (Editor's Note: This article has been superseded by "Rating Sovereign-Guaranteed Debt," published on April 6, 2009.) In light of the current pressures in the credit markets, a number of governments have introduced guarantee programs through which financial institutions can obtain sovereign guarantees for some or all of their debt obligations. The terms and conditions of the guarantees vary, sometimes with regard to factors crucial from a rating perspective, such as timeliness. A guarantee is a form of credit enhancement whereby the evaluation of the creditworthiness of the primary obligor is shifted to an evaluation of the creditworthiness of the guarantor and the terms of the guarantee. Standard & Poor's Ratings Services' guarantee criteria identify the circumstances under which a guarantor would be excused from making a payment necessary for servicing the obligations of the guaranteed securities and take those circumstances into account in the rating. In addition, timely payment is a key component of a guarantee. Standard & Poor's considers obligations to be in default if not paid when due under the terms of the issuance. Debt supported by a sovereign guarantee that does not, in Standard & Poor's view, adequately address timeliness is unlikely to receive the same rating as the sovereign. Standard & Poor's normally will rate an obligation based on the creditworthiness of the sovereign guarantor if the following apply: The guarantee is one of payment and not of collection. The guarantee documentation makes clear that the creditor is able to call on the guarantor for payment upon a default by the primary obligor, without the need for the creditor first to commence legal action against the primary obligor for payment. The sovereign guarantor agrees to pay the guaranteed obligations on the date due. With regard to a sovereign guarantee, "timely" pertains to payment during the grace period or within five business days of the due date. The documentation lists few, if any, conditions that need to be satisfied—or steps that need to be taken—before the creditor is permitted to draw on the guarantee, other than a failure of the primary obligor to make its required payment. Any such conditions will be evaluated on a case-by-case basis. The guarantor's right to terminate or amend the guarantee is appropriately restricted and, in particular, cannot be triggered by the primary obligor failing to pay the guarantee fee. The guarantee is unconditional, irrespective of value, genuineness, validity, or enforceability of the guaranteed obligations. The guarantor waives any other circumstance or condition that might normally release a guarantor from its obligations. The guarantor waives the right of set-off and counterclaim. Where the guarantor retains certain defenses or rights of set-off, Standard & Poor's will evaluate the effect of such retention. Standard & Poor's criteria anticipate that these provisions will be addressed either by statutory instrument (a law, regulation, order, or some combination thereof) or issuance documentation as opposed to verbal representations. Frequently Asked Questions How does the application of the guarantee criteria to a sovereign guarantee differ from the application of the criteria to a nonsovereign guarantee? There are two key differences, and they are related to sovereign intent in extending a guarantee and potential lack of effective legal redress against a sovereign. First, certain elements of the guarantee criteria focus on limiting the circumstances in which the guarantor may be released from its guarantee obligations. In contrast, when a sovereign extends a guarantee, it is usually doing so to further some public policy purpose. With regard to the current financial-sector guarantees, the sovereign guarantors are providing these guarantees to boost confidence in domestic financial systems. Accordingly, we believe the sovereign governments are not likely to try to avoid meeting guarantee claims, as such avoidance could weaken confidence, just as confidence could be weakened if they were to try to alter the terms of their own direct debt obligations. The provision of guarantees is not a business that sovereigns undertake to generate income, as often could be the case for arms-length guarantors. Rather, it is a method for supporting entities of strategic importance and promoting the orderly operations of debt markets considered crucial to the economy. Second, because suing or enforcing a claim against a sovereign could be difficult, analysis of sovereign creditworthiness—either directly or as a guarantor—relies less on legal characteristics and more on willingness issues than is the case for nonsovereign issuers (see "Sovereign Credit Ratings: A Primer," published on RatingsDirect on May 29, 2008). Sovereigns make laws and can change laws. However, as noted above, because the intent of the current waive of sovereign guarantees is to support public policy goals, we believe that a sovereign would view reduction or elimination of its guarantee obligations as counterproductive. For information on Standard & Poor's guarantee criteria, please see "Legal Criteria For U.S. Structured Finance Transactions," published on Nov. 25, 2006, on

RatingsDirect. What type of information will Standard & Poor's request from the sovereign providing the guarantee to evaluate whether the guarantee can be used for the rating? Standard & Poor's evaluates the guarantee framework within its analysis of the sovereign commitment. Our analysis focuses on: Do the guarantees create sovereign contingent liabilities that, if exercised, are tantamount to sovereign debt? If, under some circumstances, we view the sovereign liabilities created by exercising the guarantees as lower priority, it's unlikely that we will assign the obligations the same rating as the sovereign. Are the guarantees unconditional and irrevocable? Any circumstances (such as fraud or some other sort of criminal activity) under which the government might not have to service an exercised guarantee would affect our analysis. Similarly, any appreciable likelihood that a future government might take steps to alter material provisions of the guarantees would be a negative rating factor. How long will it take for the government to service an exercised guarantee, and under what circumstances might this time frame vary? Is there a formal grace period in the issue? If so, how was it determined? How often has the government serviced an explicit guarantee obligation in any industry over the last decade, and what was the method? How were the government obligations triggered, and how much time elapsed before the government paid? Was interest paid over this time period? How is the guarantee under consideration similar, and how is it different? Might the government restrict payments in the event that the debt holder has tax arrears or owes the government funds for any reason? If the entity benefiting from the guarantee is paying a guarantee fee and stops paying the fee sometime in the future, is the government's guarantee obligation affected? Are there any guarantee terms or provisions that vary depending on whether the primary obligor has domestic or foreign ownership, and are there any guarantee terms or provisions that vary depending on whether the primary obligor's business is largely domestic or with nonresidents? Any difference in treatment could result in the sovereign rating not being assigned to the guaranteed obligation. What if the sovereign guarantee does not provide for timely payment? Debt supported by guarantees that fall short of the timeliness provisions in Standard & Poor's guarantee criteria will be rated based on our recovery criteria, not our guarantee criteria. Ratings will not be aligned with those of the government providing the guarantee unless our guarantee criteria are met. Instead, we will apply our recovery rating methodology to rate the issue above the primary obligor's credit rating and assign a recovery rating. With regard to the financial sector guarantee programs of highly rated sovereigns that suggest full payment is highly likely, despite it not being timely, our highest recovery rating (1+) could be assigned. Generally, recovery methodology has been applied to speculative-grade debt, but we have used it for U.S. utility first mortgage bonds in the investment-grade range. Assuming that a '1+' recovery rating is assigned, the issue rating will receive an uplift from the primary obligor's rating according to the following schedule: If the rating on the institution is BB+ or lower, three notches. If the rating is in the 'BBB' category, two notches. If the rating is in the 'A' category, one notch. Ratings in the 'AA' category will receive no uplift. However, in no instances will the guaranteed obligation be rated the same as the sovereign if the guarantee does not fulfill the timeliness and other provisions of the sovereign guarantee criteria. Thus, the enhancement from recovery considerations can bring the guaranteed rating to at most one notch below the sovereign rating. Will short-term issuance be handled in the same manner? No. Short-term obligations—such as commercial paper, where a strict notion of timeliness is critical to investors—would not receive any ratings benefit from recovery analysis if the guarantee does not adequately address the timeliness of payment. What if the guarantee is extended for only a limited period of time? Neither the guarantee criteria nor recovery analysis will be applied to any issue maturing beyond the term of the guarantee; the rating assigned to the issuance will be based on that of the primary obligor. Does the assignment of recovery ratings to some sovereign-guaranteed investment-grade obligations mean that Standard & Poor's will now assign recovery ratings to a wider variety of investment-grade obligations? No, the application of recovery criteria to sovereign-guaranteed obligations is based on the strategic importance of the public policy initiatives that led to the establishment of the guarantees and our views regarding the very high likelihood that the sovereign will pay within the timeframe suggested by our recovery analytics. Do we expect the financial institution guarantees to have a ratings impact on the sovereign governments? In and of themselves, the guarantees have not led to any sovereign rating changes and are unlikely to do so. A sovereign rating incorporates the contingent liability stemming from the financial sector through estimates of potential problematic assets in a stress scenario. As our forecast of potential problematic assets rises, the contingent liability grows, and the likelihood of a negative sovereign rating or outlook change increases. From the standpoint of the guarantees, this would correlate with expectations of a rising number of guarantees being exercised but not with the extension of the guarantees. The financial sector has long been considered a sovereign contingent liability because solvency and—to a lesser extent—liquidity problems that lead to sovereign support can impair a sovereign's credit standing. The impetus to assist banks is strong when there is a systemic crisis because banking system soundness is essential to macroeconomic stability, effective demand management, and sustained economic growth. The Sovereign Group's analysis of the current market turmoil is focusing on probable financial sector recapitalization costs and likely economic impacts, particularly the costs of fiscal stimulus packages.