Article Title: General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments Data: (EDITOR'S NOTE: —On Dec. 13, 2022, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Criteria Methodology This article describes S&P; Global Ratings' methodology for determining transfer and convertibility (T&C;) assessments. A country T&C; assessment reflects S&P; Global Ratings' view of the likelihood of a sovereign restricting nonsovereign access to foreign exchange needed to satisfy the nonsovereign's debt service obligations. S&P; Global Ratings determines T&C; assessments in two ways. The first approach applies to countries in monetary or currency unions and sovereigns using the currency of another sovereign. The T&C; assessments of monetary or currency unions are a function of the policies--including the histories, current positions, and objectives and flexibility--of these unions' monetary authorities. In these cases, the sovereign has ceded monetary and exchange rate policy authority to a central bank over which it exerts little, if any, influence. This is why all members of a monetary or currency union are assigned the same T&C; assessment, which is the T&C; of that monetary union. All members of the European Economic and Monetary Union (EMU) currently have T&C; assessments of 'AAA'. S&P; Global Ratings is of the opinion that entities domiciled within the EMU have access to foreign exchange needed for debt service that is commensurate with 'AAA' risk. All members of the Central African Economic and Monetary Community (CAEMC), the West African Economic and Monetary Union (WAEMU), and the Eastern Caribbean Currency Union (ECCU) currently have T&C; assessments of 'BBB-'. Countries that use the currency of a second country (with little risk that they will change this arrangement) have T&C; assessments equal to that of the second country. For example, Panama has used the U.S. dollar as its local currency for decades (in addition to the locally issued balboa coins); Panama's T&C; assessment currently is 'AAA', the same as that of the U.S. The second approach applies to the majority of countries and specifically to those with sovereigns controlling their own currencies. Thus, this second approach applies to countries not part of any monetary or currency union or which have no long-term commitment to using the currency of a second country. In these cases, S&P; Global Ratings bases its view of the country's T&C; risk on a review of the sovereign's foreign exchange regime, economic policy orientation and external policy flexibility. The analysis focuses solely on potential restrictions on access to foreign exchange needed for debt service, and not a broad array of foreign exchange controls (see table 1). In our view, the likelihood that a distressed sovereign will try to use foreign exchange controls to stem capital flight, constrain imports, and otherwise reduce the pressure on the currency are in most instances higher than the likelihood that the sovereign will interfere with external debt service. Table 1 Definitions FOREIGN EXCHANGE CONTROLS MEASURES THAT THE SOVEREIGN (OR ITS CENTRAL BANK) TAKE TO RESTRICT SOME OR ALL TRANSFERS OF FOREIGN CURRENCIES AND GOLD BY ITS RESIDENTS. T&C; risk The likelihood that a sovereign will limit the ability of a nonsovereign to exchange local currency for another currency or gold and to remit it to any resident or nonresident in order to meet the nonsovereign's debt service obligations. Sovereigns (and agents thereof) Central governments or entities closely aligned with central governments (including many development banks, export-financing institutions, and deposit insurance providers). The foreign currency ratings of these closely aligned entities rarely exceed the sovereign foreign currency rating, with sovereign-related creditworthiness linked more to potential changes in sovereign policies and support than to T&C; risk. Nonsovereigns Private and public sector entities operating largely in a commercial or independent fashion whose remittances are subject to sovereign intervention. If a sovereign facing stress were to intervene in a manner forcing default, it likely would be through T&C; restrictions. The foreign currency rating of nonsovereigns is usually the lower of the T&C; assessment and the local currency rating of the entity. T&C; assessments for countries in which the currency is controlled by the sovereign usually range from zero to three notches above the sovereign foreign currency rating. (The criteria are summarized in table 2.) S&P; Global Ratings makes a three-notch distinction where it views the likelihood of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being significantly lower than the likelihood of the sovereign defaulting on its 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 typically 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, S&P; Global Ratings views their 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 any outward-oriented economic policies adopted by these sovereigns including free-trade agreements. Foreign investment is encouraged, and current account receipts tend to be viewed as an engine of growth. For countries with a two-notch distinction between the sovereign foreign currency rating and the T&C; assessment, S&P; Global Ratings views the likelihood of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being moderately less than the likelihood 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 a history of more restrictive foreign exchange controls, such as India, external liquidity tends to be better than most peers. S&P; Global Ratings' 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 appears 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 countries with a one-notch distinction between the sovereign foreign currency rating and the T&C; assessment, S&P; Global Ratings views the likelihood of the sovereign restricting access to foreign exchange needed for nonsovereign debt service as being only slightly less than the likelihood 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, in our view, 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. Countries in this category tend to have outward-oriented economic policies, with both FDI and inward portfolio investment playing important roles in economic development. Table 2 Criteria Summary SOVEREIGN T&C; ASSESSMENT EMU members AAA CAEMC, WAEMU, and ECCU members BBB- Sovereign using the currency of another sovereign (expected to be on a permanent basis) T&C; assessment of sovereign controlling currency Sovereign with open foreign exchange regime and outward-oriented economic policies Three notches above sovereign foreign currency rating Sovereign with fairly open foreign exchange regime, outward-oriented economic policies but higher import dependency, and more nonsovereign external debt Two notches above sovereign foreign currency rating Sovereign that is interventionist but the foreign exchange regime is opening One notch above sovereign foreign currency rating Sovereign is interventionist and may have recent history of T&C; restrictions Sovereign foreign currency rating CAEMC--Central African Economic and Monetary Community. WAEMU--West African Economic and Monetary Union. ECCU--Eastern Caribbean Currency Union. Where the likelihood of sovereign default is indistinguishable from the likelihood of T&C; restrictions For some countries, S&P; Global Ratings views the likelihood of the sovereign restricting nonsovereign access to foreign exchange needed to service debt as similar to the likelihood 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. In these countries, the sovereign tends to be highly 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, a rated corporate default resulted from Venezuela's imposition of foreign exchange controls in 2003. There could have been more defaults if more debt service payments had fallen due during this period. Where the likelihood of sovereign default is lower than the likelihood of T&C; restrictions S&P; Global Ratings may assign a T&C; assessment below the sovereign foreign currency rating if it views the restrictions on nonsovereign access to foreign exchange needed for debt service as pervasive. One of the key challenges in producing T&C; assessments is that restrictions can be a matter of practice more than formal policy. Thus, even if we learn of a handful of cases where T&C; restrictions may have contributed to a nonsovereign default, it may be difficult to be sure of the causes and whether there are extenuating circumstances. In situations where there is virtually no nonsovereign access to foreign exchange needed for debt service, the T&C; assessment could fall as low as 'CC,' but not 'SD' or 'D' as the controls themselves may not cause defaults. 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, S&P; Global Ratings does not move a rating to 'D' or 'SD' unless there actually is a payment default (usually evidenced by 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 for similar reasons, 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 country risk. Recent Nonsovereign Default Experience During Periods Of Sovereign Stress In recent decades, nonsovereign defaults during or related to sovereign stress scenarios have, in our experience, been more closely associated with the economic environment and entity-specific operational and financial 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 2002-2003 appear to be the result of 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 the administrative restrictions relating to Argentina's foreign exchange controls did not prevent nonsovereign debt service. The T&C; assessment criteria reflect S&P; Global Ratings' 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 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, price controls including restrictions on raising utility rates, hikes in taxes and government fees amidst cutbacks in services, and delayed/partial government payments. In our view, 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, or sell products for which 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 always 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. Revisions And Updates This article was originally published on May 18, 2009. The criteria became effective upon publication. Changes introduced after original publication: Following our periodic review completed on Aug. 8, 2017, we updated the "Related Criteria And Research" section and removed obsolete sections. We deleted the sections "Ratings Above The Sovereign's" and "Ratings Above The T&C; Assessment" because they were superseded by the articles titled "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, and "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published Aug. 8, 2016. Following our periodic review completed on Aug. 3, 2018, we updated the contact information. On Sept. 25, 2019, we republished this article to make nonmaterial changes. Specifically, we updated the contact information and the "Related Criteria" section. On Sept. 22, 2020, we republished this article to make nonmaterial changes. Specifically, we removed a non-criteria comment on the frequency of application of a provision in the section "Where the likelihood of sovereign default is lower than the likelihood of T&C; restrictions," updated wording at the beginning of the section "Recent Nonsovereign Default Experience During Periods Of Sovereign Stress," and updated the "Related Criteria" section. On Dec. 13, 2022, we republished this article to make nonmaterial changes. Specifically, we clarified the interaction between the T&C; of the monetary or currency unions and that of their members in the first paragraph of the article. Related Criteria And Research Related Criteria Incorporating Sovereign Risk In Rating Structured Finance Securities: Methodology And Assumptions, Jan. 30, 2019 Sovereign Rating Methodology, Dec. 18, 2017 Ratings Above the Sovereign—Corporate And Government Ratings: Methodology and Assumptions, Nov. 19, 2013 Principles Of Credit Ratings, Feb. 16, 2011 Related Research Corporate And Government Ratings That Exceed The Sovereign Rating, updated monthly Sovereign Ratings List, updated monthly