Article Title: ARCHIVE | General Criteria: Behind The Ratings...Understanding Domestic Rating Scales Data: Editor's Note: This criteria is no longer current. It has been superseded by the article titled, "Understanding National Rating Scales," published April 14, 2005. The rapid expansion of Standard & Poor's rating activities in the domestic financial markets of middle- and low-income economies is leading Standard & Poor's to apply an increasing number of domestic rating scales in tandem with its global rating scale. Standard & Poor's domestic scale ratings provide an opinion of the relative credit standing of entities and specific financial obligations within a particular country (see sidebar).With the benefit of a consistent link with Standard & Poor's global scale ratings, domestic scale ratings help national financial markets objectively measure credit risk and price financial obligations accordingly, thereby facilitating efficient allocation of capital. Domestic Scale Credit Ratings Defined Standard&Poor;'s domestic scale credit ratings provide an opinion of the relative credit standing of entities and specific obligations in a given country. More specifically, domestic credit ratings are current opinions of an obligor's creditworthiness with respect to a specific obligation (issue credit rating) or its overall capacity to meet its financial obligations (issuer, corporate, or counterparty credit rating), relative to the credit standing of other obligors in the same country. Domestic scale credit ratings differ from Standard&Poor;'s global scale ratings in two important respects: (1) domestic scale credit risk opinions are based on comparative credit risk analysis of obligors in one country, instead of on the broad international comparisons embodied in global scale ratings; and (2) unlike global scale credit risk opinions, domestic scale ratings do not address direct sovereign risks, such as the imposition of foreign exchange controls, and only address country risk factors to the extent that they differ among sectors and obligors within the country. Reflecting the focus on relative creditworthiness and the exclusion of certain sovereign risks, the strongest entities in the country, including the sovereign government, will in most cases receive the highest rating on a Standard&Poor;'s domestic scale. For the same reasons, domestic scale ratings are not comparable between countries. In most instances, domestic scale credit ratings only take the form of local currency credit risk opinions. However, foreign currency credit opinions are provided on a domestic scale basis in highly dollarized economies, and, in such cases, the foreign currency credit opinion is identical to the domestic scale local currency credit opinion. Domestic 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 (e.g. 'mxAAA' for domestic scale ratings in Mexico). Domestic scale ratings are measures of relative credit risk tailored to the needs of specific national financial markets. As a result, they typically provide a finer tiering of credit risk among local obligors than would be possible using Standard & Poor's global scale that fully incorporates international comparative risk factors, including direct and indirect sovereign risk considerations. In turn, Standard & Poor's domestic scale ratings cannot be compared with one another, nor are they directly comparable with the local and foreign currency credit ratings provided on Standard & Poor's global scale. To highlight the differences among rating scales, Standard & Poor's modifies its rating symbols and definitions for each domestic rating scale. Standard & Poor's long and varied experience in domestic rating scales has resulted in the development of a unique and rigorous methodology for managing domestic rating scales that includes: Extensive benchmarking of global credit risk in the market served by the domestic scale; Creation of correlation guidelines between each domestic scale and the global scale, and; Extensive coordination and integration of the analytical process for assigning and reviewing ratings on the two scales. In addition to its long-standing experience in managing domestic scales in more mature financial markets, such as France and Sweden, Standard & Poor's also operates domestic rating scales in three emerging market economies: Argentina, Mexico, and Taiwan. For all branch offices and joint ventures in which Standard & Poor's controls the analytical process, operating procedures and policies have been instituted to ensure broad consistency of the criteria and the ranking of credit risk between the domestic and global scale ratings. Standard & Poor's is also working with existing and prospective affiliates that operate or are developing domestic scale rating services in Brazil (Fundacao Getulio Vargas), Chile (Feller Rate), India (CRISIL), Indonesia (PEFINDO), South Africa (CA-Ratings) and several other emerging markets. In all cases, Standard & Poor's objective is to work with affiliates to develop and maintain analytical practices similar to those utilized by branch offices that offer domestic scale ratings. In the future, Standard & Poor's plans to offer domestic scale rating services to issuers, investors, and intermediaries in all major emerging markets. This article addresses the key methodological and communications issues posed by domestic rating scales including: Under what circumstances are domestic scale ratings most valuable? What is the relationship between Standard & Poor's domestic 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 domestic scale ratings clearly communicated to users of Standard & Poor's credit rating services? RATIONALE FOR DOMESTIC RATING SCALES Domestic rating scales have the greatest value and are most prevalent in markets where credit ratings are required by national regulations, or where sovereign and other credit risks skew global scale ratings to low levels in the country. A predominance of local issuers and investors in the domestic market also heightens the demand for domestic scale ratings. At present, local regulation compels the use of domestic scale ratings in over 10 major emerging markets, and the scope of such regulatory requirements seems likely to expand considerably over the next few years. Whether or not regulations dictate the use of domestic scales, sovereign and country risk factors are important determinants of market demand for a domestic rating scale. High sovereign (direct constraints such as exchange controls) and country (indirect effects from government policies affecting the exchange rate, interest rates, taxation, regulation, infrastructure, and labor markets) risks 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, important sovereign and country risks in Argentina result in a narrow range of global scale ratings, with over half the ratings at the 'BBB-' level--the local currency rating of the sovereign. While the potential impact of sovereign risk is a critical consideration for cross-border financing, such sovereign risk issues--which affect most national obligors to a similar degree--are of less importance to local participants in the national financial markets, who find domestic 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 a global scale, even in the absence of direct sovereign risk constraints. Examples are provided by India and Indonesia, where most global scale issuer credit ratings of active issuers are concentrated in the 'BB' and 'B' categories in spite of higher sovereign local currency ratings of 'BBB+' and 'A+', respectively. As a result, domestic scales offer enhanced differentiation of credit quality, where the typical credit attributes of most active obligors tend to concentrate global scale ratings in the medium- to low-grade categories. Another factor influencing the usefulness of domestic rating scales is the degree of openness of domestic financial markets. When national financial markets are dominated by domestic issuers and investors, the relevance of global scale ratings is diminished and, in turn, the attractiveness of a domestic scale for assessing the relative credit risk of local players is enhanced. Even so, demand for domestic scale ratings is also beginning to stem from international market participants, who look upon the credible opinions of relative credit risk provided by domestic scale ratings--unconstrained by sovereign and other international comparative risk issues--as useful complements to global scale ratings. Demand for domestic scale ratings, whether initially fostered by regulation, sovereign risk, or other factors, typically endures over a long-lasting period. While domestic regulations initially play the role of catalyst in the demand for domestic scale ratings, market forces eventually lead to an increasing focus on the quality of the credit opinions rendered, and recognize the intrinsic value of domestic scale ratings. With the benefit of a consistent link with global scale ratings, Standard & Poor's domestic scale ratings can help national markets to: Create more meaningful interest rate differences among obligations; Allow local and foreign investors to better allocate funds; and Help intermediaries more efficiently price and place debt instruments. KEY CHARACTERISTICS OF DOMESTIC RATING SCALES Standard & Poor's domestic scale credit ratings have the following major attributes: The methodology focuses on the relative creditworthiness of obligors and obligations in a particular country, but does not strive for an even or normal distribution of obligors among the scale's grading classifications; The opinions are based on a comparative analysis of obligors in a single country, instead of the broad international comparative context of global scale ratings; and The methodology excludes certain direct and indirect sovereign risks incorporated in Standard & Poor's global scale ratings. Domestic rating scales--as compared to the global rating scale--are based on a much narrower, and potentially, skewed sample of the obligors active in the national market, in contrast to the ratings on Standard & Poor's global scale that incorporate all relevant risks from an international perspective. As a result, the most creditworthy obligors in the country are likely to receive the highest credit rating on the domestic scale but could receive a medium-grade rating on the global scale. With regard to the treatment of sovereign risk, Standard & Poor's global scale ratings incorporate all relevant direct and indirect sovereign risks, which can vary depending on whether the rated obligations are denominated in foreign or local currency. Accordingly, global local currency ratings may differ from foreign currency ratings because the former exclude the risk of direct sovereign intervention that may constrain access to the foreign exchange needed to meet foreign currency obligations. By contrast, Standard & Poor's domestic scale ratings do not address any of the direct sovereign risks that may have a bearing on the ability of obligors in a given country to service their foreign or local currency debt on a timely basis. Indeed, domestic scales assume that sovereign default risk is very low, leading in most instances, to the implicit or explicit assignment of the scale's highest rating classification ('AAA') to the sovereign government. UNDERLYING DEFAULT RISK DIFFERS FROM GLOBAL RATINGS The methodological differences between the global scale and a domestic scale usually imply substantial variations in the default probabilities associated with a particular rating category of the two 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 with a Standard & Poor's Argentine domestic scale rating of 'raAA'. The difference in implicit default risk between Standard & Poor's global scale and a specific domestic 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 domestic scale to provide adequate differentiation in credit risk for obligors active in the national 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 domestic scale; and the same naturally holds true the more the distribution of global scale ratings is concentrated among the lower rating categories. For example, a domestic scale serving an economy with high sovereign risk and a predominance of low grade global scale ratings for active obligors (Argentina and India) would have lower global scale local currency ratings corresponding to each category on the domestic scale than would be the case for a domestic scale serving an economy with medium or low sovereign risk and a predominance of intermediate grade, global scale ratings for active obligors (Taiwan and Chile). Examples of the relationship between global and domestic scale ratings are provided in the table. Selected Comparisons Of Domestic And Global Scale Credit Ratings ISSUER GLOBAL RATING DOMESTIC RATING Argentina* Republic of Argentina BBB- raAAA¶ Perez Companc BBB- raAAA Edesur BBB- raAA+ Multicanal BB raAA- Acindar B+ raBBB Mexico§ Grupo Industrial Bimbo A- mxAAA United Mexican States BBB+ mxAAA¶ Industria Penoles BBB mxAA+ Seguros Monterrey Aetna BBB mxAA Copamex Industrias BB mxA Altos Hornos BB mxBBB+ *Both global and domestic scale ratings in Argentina are for foreign currency obligations, reflecting the dollarization of the economy. ¶Domestic scale sovereign ratings are implicit. §Both global and domestic scale ratings in Mexico are for local currency obligations. LINKING EACH DOMESTIC SCALE TO THE GLOBAL SCALE Standard & Poor's approach to domestic scales has emphasized the development of an operating framework linking each domestic scale with its global scale. The operating framework involves three key principles: Establishing global scale credit risk benchmarks for existing and prospective domestic scale ratings; Coordinating the analytical teams and rating committees that assign and review ratings on the two scales in each country, and; Developing broad correlation guidelines between each domestic scale and Standard & Poor's global scale. 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 still allowing the domestic scale the scope to provide meaningful differentiation of credit risk among obligors active in the local financial markets; To anchor the domestic scale to Standard & Poor's global scale measure of default risk; and To allow analysts assigning domestic scale ratings to benefit from the broader comparative perspective embodied in Standard & Poor's global scale. An example may be useful in explaining Standard & Poor's objective of ensuring a consistent rank ordering of domestic and global scale ratings by means of internal correlation guidelines. If company X is rated higher than company Y on Standard & Poor's global scale, the correlation guidelines are designed to ensure that company Y cannot be rated higher than company X on the domestic scale. Without contravening the ranking consistency objective, the guidelines do allow for a rating distinction between two obligations or obligors on one scale and no distinction between the two obligations or obligors on the other scale. For example, companies X and Y may be rated the same on the global scale, but X may be rated higher than Y on the domestic scale because the latter scale offers finer rating distinctions. The table provides examples of how the correlation guidelines work in practice. It is important to note that the methodology underlying Standard & Poor's domestic rating scales results in a nonlinear relationship between the global scale rating grade and its corresponding domestic scale rating grades 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 rating to determine the corresponding domestic 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 toward the strongest credit rating assigned in the country. For example, an entity carrying a global rating of 'BBB' in a medium-risk sovereign nation may well be rated as high as 'AA' or even 'AAA' on that country's domestic scale, implying not only the higher degree of default risk embedded in the domestic scale but, most important, the inherent quality of domestic 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 not nonexistent, at the bottom end of the rating spectrum, underlying the ability of domestic scales to provide an adequate warning of default risk. Among the entities rated by Standard & Poor's on its CaVal domestic scale in Mexico, for example, the two entities that defaulted following the peso crisis had both been assigned below-average ratings well in advance of the actual default. SYMBOLS AND DEFINITIONS HIGHLIGHT DIFFERENCES For many national rating agencies, the true nature of the domestic scale is not fully understood or acknowledged, creating the potential for considerable confusion among users of such credit rating services. The potential for misunderstanding the nature of the domestic scale can greatly mislead users concerning the comparative frame of reference and the degree of default risk implied by each rating classification. Within Standard & Poor's network itself, the use of multiple domestic 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 domestic scale. An Argentine company's issue of U.S. dollar bonds, for example, may be assigned a global scale foreign currency rating and a separate, and quite different, Argentine domestic scale rating. Effective means of distinguishing such domestic scale ratings from global scale ratings are of critical importance because of the potentially large difference in implicit default risk between the two scales. Standard & Poor's has chosen to distinguish domestic and global scales from one another by means of a mixture of symbology, rating definitions, and, on occasion, brand names. In more mature markets, Standard & Poor's has used unique symbols and brand names to convey domestic scale ratings, as in the case of the Nordic and ADEF scales used in Sweden and France, respectively. By contrast, in emerging markets, Standard & Poor's utilizes its universally recognized letter-grade symbols with a country prefix, as is done with the CaVal scale in Mexico ('mx' for Mexico), the former Risk Analysis scale in Argentina ('ra' for Republica de Argentina and Risk Annalysis), and the new joint venture in Taiwan ('tw' for Taiwan). To reinforce the symbolic distinctions between scales, Standard & Poor's created unique rating definitions for each domestic scale. In the case of the domestic scales employed in emerging markets (Mexico and 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 direct sovereign and comparative country risks (see sidebar). Finally, for a number of domestic scales, Standard & Poor's retained or developed separate brand names associated with the domestic scale (CaVal in Mexico, ADEF in France, and Nordic in Sweden). Domestic Scale ratings are listed in Standard & Poor's monthly Global Ratings Handbook and the Bank Rating Service, as ratings are fully integrated into Standard & Poor's family of rating services. In addition, domestic ratings provided by Standard & Poor's offices and affiliates, are available in the following local publications: Argentina, Buenos Aires Office, Calificaciones y Fundamentos; Chile, Feller Rate, Vision de Riesgo; India, CRISIL, RatingScan; Indonesia, PEFINDO, Credit Insight; and Mexico, Mexico City Office, Calificaciones y Commentarios.