Article Title: ARCHIVE | General Criteria: Rating Government-Related Entities: A Primer Data: (Editor's Note: This article has been superseded by "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published on June 29, 2009.) Government-related entities (GREs) are enterprises potentially affected by extraordinary government intervention in an economic or financial stress scenario. In most cases, the intervention is in the form of support, and the GRE rating is enhanced by the government relationship. Conversely, government intervention could redirect GRE resources to the government and weaken GRE credit quality. Most GREs are in the public sector and controlled by a government (or governments) through majority ownership. However, some GREs have little or no government ownership and are GREs because of their monopoly positions or their roles as systemically important financial institutions, as providers of other crucial goods and services, or as critical employers. A government's actions affect all entities domiciled in its jurisdiction, in some cases directly by methods such as regulation and licensing and in other cases more broadly through the impact of fiscal, monetary, and other economic policies. Sovereign and country risks play a role in most ratings because of the power of governments to shape the operational and financial environments in which corporations, financial institutions, and other entities operate. The impact of sovereign and country risk is an important part of the criteria Standard & Poor's Ratings Services uses to rate all issuers as well as specific obligations. In addition, supranationals are affected by government policies—but in a fundamentally different manner that involves several or many sovereigns. The subject of this criteria piece is the narrower set of institutions that are either in the public sector (of one country) or in the private sector but could be affected by special government influence in a stress scenario, usually because of their economic importance. This criteria article replaces "Revised Rating Methodology for Government-Supported Entities," which was published on RatingsDirect on June 5, 2001. The main differences include: The three categories of GREs have been combined into two: public-policy-based institutions and commercial (or potentially commercial) institutions. The notching guidelines have been relaxed so there is greater scope for the rating on the GRE to be further from the stand-alone or government rating, though it continues to be bounded by these two ratings. Specific consideration of systemically important private-sector financial institutions in interventionist countries is included. A new section has been added on rating GREs above the related government and above the sovereign. Foreign currency considerations are explicitly addressed. No rating changes are anticipated as a result of this criteria update. Criteria Evolution And Overview Governments rely on market mechanisms more often now than they did in the past. In numerous countries, privatization is on the agenda, but even where it is not, many policymakers are showing a growing tendency to expose government-owned institutions to market discipline. At the same time, in some instances, important private-sector institutions that face operational and financial difficulties continue to benefit from various forms of extraordinary government support. Standard & Poor's methodology for rating GREs has evolved in line with these trends. Whereas 25 years ago, ratings on public-sector enterprises were most often aligned with the ratings on their owner-governments, Standard & Poor's analytical approach increasingly focuses on the stand-alone credit quality of the GRE and determining the durability of the entity's links with the government. The advantage of this approach is that it is analytically rigorous, forcing consideration not only of the operational and financial aspects of the entity but also the evolution of the relationship with the government. If government support for an entity wanes, signs of government ambiguity emerge, or the government's ability to support diminishes, the rating may be adjusted to rest more heavily on the institution's own debt-servicing capabilities. If the government adopts a privatization program or a more active competition policy (such as recommended by the European Union; EU), a similar adjustment will occur, taking into account the specifics of the affected institutions. Therefore, abrupt changes in ratings are minimized. Standard & Poor's analysis of the likelihood of extraordinary government influence begins by classifying the GRE on the basis of its public-policy role and integration into the government's operations and finances. All GREs are rated on the basis of a combination of stand-alone credit quality, which includes all ongoing government support, and the likelihood of extraordinary support. For institutions most closely tied to the government, the significant probability that the government will extend timely extraordinary support in a stress scenario tends to be the crucial factor, and the rating on the entity is linked to that on the government. A rating on a closely tied institution generally differs from that on the government by no more than two rating categories.

Conversely, all private-sector GREs—as well as public-sector GREs that benefit from supportive government policies and possibly direct assistance but are capable of functioning in a commercial environment—have ratings more closely aligned with their stand-alone credit quality. As with more closely tied institutions, the stand-alone rating includes ongoing government support. The potential for extraordinary assistance in a stress scenario might enhance the rating on such an institution, usually by no more than one or two rating categories. Among the private-sector GREs in this category are systemically important financial institutions in countries where the likelihood of the government providing direct support to a failing institution or facilitating a merger with a stronger institution boosts credit quality. In the case of healthy private-sector banks with no special role in the national economy, the rating enhancement usually does not exceed one notch. Stand-Alone Ratings Incorporate Ongoing Government Influence The first analytical step is the determination of the GRE's stand-alone credit quality. A stand-alone rating reflects the GRE's strategies, performance, and prospects, including whatever government support or intervention the GRE typically receives in the normal course of business. However, it excludes credit for any extraordinary government assistance or influence that might be expected in the event of a crisis. This exercise is done in accordance with the criteria Standard & Poor's has established for the specific type of institution or project being analyzed. The financial institution, utility, oil company, housing project, or other criteria employed are the same as the criteria used for a similar private-sector institution that does not benefit from the potential for extraordinary government support or intervention. Because the stand-alone rating includes any long-standing government involvement in the GRE's operations or finances as well as consideration of how government influence is evolving, the term "stand-alone" has, at times, caused some confusion. The stand-alone rating focuses on the status-quo environment, including material government influence. Crucially, it is forward-looking in including potential changes in that environment. Ongoing government influence included in a stand-alone credit rating embraces, in addition to subsidies and capital injections, access to preferential funding, a monopoly position, favorable contracts, and sympathetic regulatory regimes. These are difficult-to-measure forms of support that enhance both operational and financial performance. On the negative side, price ceilings, risky investment-project mandates, and directives to provide loss-generating goods and services constitute forms of government intervention that adversely affect operational and financial performance. The stand-alone rating provides the clearest view of the contingent liability the GRE poses for the government, aside from economic efficiency considerations. The stand-alone rating identifies the downside, or credit cliff, for the GRE if the potential for extraordinary government support were to dissipate. A key assumption made in determining the stand-alone rating is that the government will not specifically intervene to maintain the solvency or liquidity of the GRE; in other words, the government will not bail out the enterprise in a crisis. Particularly where privatization or reduced government involvement is on the agenda, Standard & Poor's makes assumptions as to what changes in the entity's capital structure and business focus are likely to occur. This results in a stand-alone rating that is forward-looking and necessarily subjective but that is nonetheless useful in managing the issuer's rating transition to a possible eventual privatization. The analytical process also includes comparisons with similar institutions, both locally and globally. Extraordinary Government Influence Could Enhance Or Impair A Rating On A GRE The stand-alone rating on the GRE and the rating on the government form the inclusive bounds between which the rating on the GRE lies. Following the determination of the stand-alone rating, consideration is given to extraordinary government influence. Although in most cases, the likelihood of government support enhances the GRE rating, in some cases, government intervention is a negative, potentially draining resources and keeping financial flexibility below what it would be on a stand-alone basis. In assessing the credit implications of government ownership or the government relationship, Standard & Poor's generally classifies GREs in one of two broad categories: Public-policy-based institutions, which play a central role in meeting political and economic objectives and have credit standings more closely associated with those of their governments. Commercial (or potentially commercial) enterprises, which play a lesser or no public policy role and have credit standings more closely connected to the stand-alone ratings on the GREs. The purpose of this categorization is to clarify Standard & Poor's thinking about the relationship between the government and the entity concerned. It recognizes a range of relationships that imply varying degrees of government intervention, with different degrees of certainty. Standard & Poor's task is to evaluate the potential government influence and factor it into the rating on the GRE in a coherent and consistent manner. The strongest form of government influence usually implies alignment of the ratings on the GRE and the government. In most cases, this will mean that the rating on the entity exceeds the stand-alone rating, but for some well-capitalized and well-run institutions, the rating could be below the stand-alone rating. In the latter case, the GRE rating could be seen as being constrained by the government, but of course the relatively strong operational and financial characteristics are themselves the result of government decisions, at least if the GRE is in the public sector. For policy-based institutions, depending on conclusions about the government's willingness and ability to provide timely support (or take resources), the rating tends to be within two rating categories of the government rating. For more commercial GREs benefiting from a supportive government, the issuer rating would generally be within one or two rating categories of the stand-alone rating on the entity. In the case of healthy private-sector bank GREs with no special role in the national economy, the enhancement over the stand-alone rating usually does not exceed one notch. However, in a situation where the stand-alone rating on the GRE and the rating on the government are far apart or where one of these ratings or the relationship between the GRE and the government is changing, the GRE rating could vary by more than these guidelines. Distinguishing Between Public-Policy-Based And Commercial GREs Distinguishing between public-policy-based and more commercially oriented entities can be quite difficult. Most GREs benefit from supportive government policies and potentially benefit from extraordinary assistance, so they in fact lie on a continuum between these two categorizations. Given the growing tendency of governments to privatize and pursue market-oriented policies, Standard & Poor's tends to put entities on the policy/commercial dividing line in the commercial category. For public-policy-based institutions, government influence tends to be a matter of both policy and law, with the latter expressed, in part, through timely or ultimate guarantees (see section below for discussion of guarantees). Commercially oriented entities generally do not benefit from any guarantee and may be in the private sector. Extraordinary government support is possible but less likely than for policy-based institutions. However, government interest and influence might affect the business risks faced by commercial GREs. Public-policy-based GREs Even when government control is assessed as very strong, support is often less than totally certain, and a rating differential between the government and the GRE might be appropriate. Extraordinary government support is not simply a matter of a positive attitude and supportive disposition. Standard & Poor's must be convinced that the government could and would intervene to avoid default by the enterprise. The degree of likely support could be constrained by the number of GREs and the government's limited capacity to provide support. The degree of notching that is appropriate to consider in individual cases will reflect the stand-alone assessment of the GRE (which, in and of itself, might be indicative of government support), the rating on the government, and Standard & Poor's assessment of the robustness of government support. Rating distinctions of up to two categories are most common. A rating distinction within a single category of that on the government is generally appropriate when the enterprise benefits from an ultimate (non-timely) guarantee, the government is rated in the 'AA' or 'AAA' categories, the government's relationship with the entity is regarded as stable, the GRE has moderately strong stand-alone creditworthiness, or the number of GREs is relatively small. A larger rating distinction addresses situations where there is no statutory guarantee, there are many government-related entities with ambiguous or diminishing public policy roles (which, in aggregate, pose a significant contingent financial risk to the government), or the risk of privatization of the rated entity is deemed to be rising. Among the specific issues Standard & Poor's considers in assessing the degree of notching for potential extraordinary government influence (within the bounds set by the stand-alone rating on the GRE and the rating on the government) are the following: The government's track record of extraordinary support for GREs. If untested, what are the government's policies on support, does it have the means, and what mechanisms are in place for diagnosing and responding to financial distress in a timely fashion? The government's track record of burdening GREs with higher taxes and dividends or other means to boost government resources during a period of increasing political or economic stress. The specific GRE's economic and political importance as well as its ranking in terms of order of importance to the government versus other GREs and its public policy role compared with similar entities in other jurisdictions. The essentiality of the service the specific GRE provides and the likelihood of other (particularly private sector) entities providing the same products or services. The likelihood of access to the debt markets by the government or related entities being compromised in the event of a particular GRE defaulting as well as the importance of continued, unimpeded access to debt markets for the government. The government's policy and track record regarding privatization, including the government's history of assuming liabilities or re-capitalizing companies upon privatization. These issues are not always clear-cut and will be weighed within the context of the direction of government policy and the underlying credit strength of the enterprise itself in reaching a final rating conclusion. For some emerging-market governments, support could be more questionable when the legal system and governance is weak and when there are a number of entities relying on such support. In these instances, the GRE rating might be driven more by the inherent credit attributes of the GRE itself. When the government plays a large role in the economy, its support could be diluted, and the ratings on GREs can rest largely on their stand-alone credit quality, whereby the same GRE in a leaner public sector might benefit from more support. Notwithstanding the current government policy, the ultimate rating decision takes into consideration the time horizon of privatization risk, the likelihood of a reversal in current policy, and the stand-alone rating. Within Europe, the impact of EU competition policy on state ownership and support is a factor that might pressure governments to change policy and pursue privatization—or to at least limit government support. When is a GRE rating aligned with that on the government? The rating on a GRE is generally aligned with that on the owner-government when the entity is a government ministry or when the entity either is the source of substantial budgetary revenue, has a constitutionally or legally mandated place in the machinery of government that is difficult to change, and engages in activities that cannot readily be undertaken on a commercial basis. Alignment does not result solely from the entity's policy role or importance but rather from its place in the processes of government. Among the entities in this category are deposit insurance agencies, strategic petroleum reserves, and a number of development banks and export credit institutions. In some cases, the potential for government intervention limits the rating. A government-owned oil company, for example, might have higher stand-alone credit quality than the final rating indicates because the final rating includes the government's tendency to increase taxes and dividends, to require the GRE to provide subsidies, or to restrict the GRE's flexibility in some other way in a period of fiscal or external stress. Commercial GREs Commercial GREs include an array of government-owned enterprises with lesser or no defined public policy mission as well as private-sector institutions that could be affected by extraordinary government influence. Among private-sector GREs are systemically important financial institutions in countries with interventionist or supportive governments. Commercial GREs are generally rated within one or two categories of their stand-alone ratings. In the case of healthy private-sector bank GREs with no special role in the national economy, the enhancement over the stand-alone rating usually does not exceed one notch. Rating enhancement based on the potential for extraordinary government support reflects situations where government support is possible but is less certain than for a policy-based institution. It also applies to situations where the government could act in an increasingly supportive manner during a crisis and, as such, reduce the business risks faced by the GRE. In some cases, government officials assert support and pledge to assure avoidance of default, but Standard & Poor's may constrain the notching because of doubts about institutional stability, administrative processes, or the ability to diagnose and promptly respond to financial distress. Standard & Poor's might believe that an upcoming possible privatization or an existing partial privatization contradicts the logic of support or erodes the identity of interest between the government and the enterprise. There is also the situation of considerable ambiguity, where the government has a track record of avoiding default by its enterprises, but its official or stated position is one of nonsupport. Ambiguities of this kind generally lead to an analytical approach that puts less weight on the government relationship and more on the enterprise's own credit attributes. With these caveats, Standard & Poor's broadly considers the same issues reviewed in connection with policy-based institutions in considering the degree of notching. The comparators are other commercial GREs. Potential extraordinary government support could rise as the stand-alone assessment falls Standard & Poor's application of criteria guidelines is dynamic, so a given institution could transition between the policy and commercial classifications and in or out of the GRE category altogether. Evidence leading to greater or lesser confidence in extraordinary government support could vary over time. In particular, the evidence for government support might increase as the financial condition of a corporate or a financial institution (or of an entire financial system) deteriorates. Ratings may accordingly incorporate additional support as the stand-alone assessment deteriorates, braking a slide in ratings that would otherwise occur. Where this happens, the GRE rating may deviate from the normal notching guidelines. For example, during the late 1990s and early years of the current decade, the ratings on several troubled private-sector Japanese banks remained in investment grade because of the substantial measures that the Japanese government took to support the sector. Certain banks might have failed without that government intervention. At the depth of the crisis, the ratings uplift exceeded two rating categories for some banking groups. Over the last few years, the stand-alone creditworthiness of Japanese banks has rebounded, and the notching has returned to the norm. Government Guarantees Some GREs have outstanding obligations benefiting from timely, unconditional government guarantees. These guaranteed obligations are most often rated the same as the government. However, the issuer credit rating will not necessarily be the same, despite the level of support indicated by the guarantee. To determine an issuer credit rating (and thus the rating assigned to nonguaranteed financial obligations), the entity is classified as policy-based or commercial, and the appropriate approach indicated above is employed. Ultimate guarantees generally require the guarantor to meet obligations in full—but only after the resources of the guaranteed entity are exhausted. Issuer ratings for GREs enjoying an ultimate, rather than a timely, guarantee are also rated in accordance with the methodology outlined above. As already suggested, these entities are generally placed in the policy-based category of GREs. When a government guarantee carries conditions—or when the guarantee obligation is timely and ranks equally with the government's own obligations, but administrative and other problems hamper timely service—the guaranteed issuer or issue is rated in accordance with the GRE criteria rather than receiving the government rating. A private-sector entity generally cannot discriminate between obligations with the same ranking, but in the public sector, lags in payments on guarantees do occur, and they rarely result in creditors accelerating other obligations or seeking legal redress. Rating A GRE Above The Rating On Its Government A GRE may be rated above its government if the stand-alone rating on the GRE exceeds the rating on the government and the government is not expected in a stress scenario to take actions that impair the GRE's credit standing. Rating a GRE above the government under which it operates is not common. The key considerations are: The GRE should be a commercial enterprise operating in a competitive environment. Government linkages, including contracts and liquidity held in government securities, should be minimal. Government control/ownership, which should be materially less than 100% and unlikely to increase, is viewed in a parent/subsidiary context. If the parent (government) is under severe stress, it could demand increasing amounts of cash from the subsidiary (partly government owned-entity). As a result, the GRE should demonstrate significant ability to mitigate this type of government-owner interference through methods such as nongovernment shareholder support, solid governance standards, financial resilience to interference, and a track record of a hands-off approach by the government. The proposed GRE rating should incorporate standard country risk analysis, which includes a review of the business and financial impact of country risk and subjects the GRE to significant stress tests, particularly for rating above the sovereign foreign currency rating. The entity must have the ability to mitigate relevant country risks. Generally, regulated utilities are judged least likely to have such characteristics, and exporters or entities with off-shore operations are most likely. Rating above the sovereign Expanding on the last bullet point above, aside from a GRE that is essentially an arm of the government, it is highly unlikely that the potential for extraordinary sovereign support can bring a the local currency rating on the GRE above the foreign currency rating on the sovereign. For sovereign support to provide such enhancement, Standard & Poor's must feel comfortable that the sovereign will provide support even as it fails to meet its own foreign currency obligations. More commonly, the rating on the GRE exceeds the sovereign foreign currency rating only if the stress-tested, stand-alone GRE rating exceeds the sovereign foreign currency rating. Stress tests normally involve sharp currency depreciation, higher inflation, economic contraction, and rising real and nominal interest rates as well as reductions in government support, higher required reserves and other taxes, increases in regulatory risk, and nonpayment of government obligations. When Standard & Poor's rates an issuer or specific obligation above a sovereign, it is expressing its view that 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 situations, and rating entities above the sovereign requires consideration of stress scenarios. Among GREs, commercial entities with strong operating and financial characteristics, geographically diversified business, and modest holdings of government debt are the best candidates, particularly where the sovereign itself tends not to be very interventionist. Financial institutions are usually not rated above the sovereign foreign currency rating Financial institutions usually have neither local nor foreign currency ratings above the foreign currency rating on the sovereign because of: The bank's overall credit exposure to the general economy, the performance of which is likely correlated with sovereign creditworthiness. The threats of negative intervention—such as a deposit freeze—in a sovereign stress scenario. However, a sovereign stress scenario could 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. Government-owned banks are least likely to be rated above the sovereign. Banks are typically among the most harshly affected by a sovereign default or distress scenario, and government-owned banks frequently are affected more than private-sector ones. Foreign Currency Considerations The criteria outlined so far focus on the methodology for assigning local currency issuer credit ratings. Foreign currency considerations introduce several dichotomies: If the related government is not a sovereign, the foreign currency rating on the GRE is the lower of its local currency rating and the transfer and convertibility (T&C;) assessment for the country of domicile. The T&C; assessment is the rating associated with the probability of the sovereign restricting nonsovereign access to foreign exchange needed for debt service. If the related government is the sovereign and the GRE is a policy-based institution, the foreign currency rating on the GRE is either the local currency rating on the GRE or the sovereign foreign currency rating, whichever is lower. The latter constraint is not the T&C; assessment because a sovereign can interfere with policy-based entities it owns or supports in a variety of ways without resorting to T&C; restrictions. T&C; restrictions are normally designed for nonsovereigns. A local currency GRE rating that is based on the potential for extraordinary sovereign support and exceeds the foreign currency rating on the sovereign (but never the local currency rating on the sovereign) addresses just the GRE's capacity for meeting local currency debt-servicing requirements. The reason that the sovereign local currency definition applies here is because policy-based institutions are in large part agents of the government. If the related government is the sovereign and the GRE is a commercially oriented institution, the foreign currency rating on the GRE normally is the local currency rating or the T&C; assessment for the country of domicile, whichever is lower. The GRE local currency rating can exceed the sovereign foreign rating only if the GRE's stand-alone assessment exceeds the sovereign foreign currency rating and the potential for negative intervention is viewed as low. The best candidates among GREs are sound oil companies playing no policy role and strong private-sector institutions, where the sovereign is not expected to act in ways that specifically diminish these GREs' flexibility in a time of sovereign stress. Rating definition differences can complicate discussions of sovereign support and intervention. Although a nonsovereign local currency rating speaks to willingness and ability to service financial obligations, regardless of currency and absent restrictions on access to foreign exchange needed to service the obligations, a sovereign local currency rating speaks to willingness and ability to service only local currency financial obligations. Sovereigns (or their central banks) generally control access to foreign exchange, and as a result, the notion of a sovereign restricting its own access is redundant. Restrictions on such access have been the most common way for sovereigns to interfere with nonsovereigns in an external crisis, though the reliance on such measures is diminishing. Sovereign local currency ratings are higher than foreign currency ratings (in many instances) because of the unique power of sovereigns to create local currency and thus meet all local currency obligations. A variety of considerations sometimes prevent sovereigns from doing so, though sovereign local currency defaults are infrequent and rather nuanced. In each of the last 25 years, sovereign foreign currency defaults have exceeded local currency defaults by more than 5x. This is compelling evidence supporting higher sovereign local currency ratings and, by extension, higher local currency ratings for GREs that are essentially arms of the government. Such marked differentials do not exist for nonsovereigns because of their inability in many circumstances to distinguish among equally ranking obligations, aside from the situation where the sovereign restricts access to foreign currency. Summary Broadly categorizing GREs in accordance with the nature and stability of the relationship with the government enhances the predictive power of GRE credit ratings. This approach addresses the variations in the nature of the relationships between governments and GREs while recognizing the ongoing evolution of these relationships. Relationships between GREs and governments are often unclear or seemingly contradictory. Some governments have a clear track record of supporting certain entities, even though the stated policy is one of nonsupport. Some governments treat their enterprises badly, refusing price increases or imposing unprofitable tasks. This sometimes implies acute credit risks, while at other times it reflects and deepens the government's moral obligation to the entity. Governments often deal with GREs arbitrarily, precisely because they are likely recipients of extraordinary government assistance and do not necessarily need strong financial profiles to continue to trade and access financial markets. The task of Standard & Poor's is to evaluate the relationship, while recognizing that extraordinary government support/intervention is not a black-and-white issue.