Article Title: ARCHIVE | Criteria | Insurance | General: Counterparty Credit Ratings And The Credit Framework Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Insurers: Rating Methodology," published on May 7, 2013.) A Standard & Poor's Ratings Services issue credit rating is a current opinion of an obligor's creditworthiness with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program. It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation as well as the currency in which the obligation is denominated. An insurer financial strength rating is an example of an issue credit rating because it focuses on insurance policy obligations. On a global basis, Standard & Poor's issue credit rating criteria have long identified the added country risk factors that give external debt a higher default probability than domestic obligations. In 1992, Standard & Poor's revised its criteria to define external versus domestic obligations by currency instead of by market of issuance. This led to the adoption of the local currency/foreign currency nomenclatures for issue credit ratings. As rating coverage expands to include a growing range of emerging-market countries, the analysis of political, economic, and monetary risk factors becomes even more important. Counterparty Credit Ratings In response to a need for issuer rating evaluations when no public debt is outstanding, Standard & Poor's provides a counterparty (also called issuer) credit rating—an opinion of the obligor's overall capacity and willingness to meet its financial commitments as they come due. The opinion is not specific to any financial obligation, as it does not take into account the specific nature or provisions of any obligation. Issuer credit ratings do not take into account statutory or regulatory preferences, nor do they take into account the creditworthiness of guarantors, insurers, or other forms of credit enhancement to an obligation. Counterparty credit ratings, corporate credit ratings, and sovereign credit ratings are all forms of issuer credit ratings. Evolution of a distinct set of issuer credit rating definitions recognized the long-standing market practice of using senior debt ratings as shorthand for an issuer's general credit standing. Rapid growth of the interbank and derivatives markets has strongly accelerated such use of counterparty credit ratings. Because a counterparty credit rating provides an overall assessment of a company's creditworthiness, it is used for a variety of financial and commercial purposes, such as negotiating long-term leases or minimizing the need for a letter of credit for vendors. Sovereign Risk Sovereign credit risk is a key consideration in the assessment of the credit standing of financial institutions and corporates. Sovereign risk comes into play because the unique, wide-ranging powers and resources of a national government affect the financial and operating environments of entities under its jurisdiction. Experience has shown time and again that defaults by otherwise creditworthy borrowers can stem directly from a sovereign default or indirectly from the deterioration in the local operating environment or regulatory framework that typically accompanies a sovereign default. In the case of foreign currency debt, the sovereign has first claim on available foreign exchange, and it controls the ability of any resident to obtain funds to repay creditors. To service debt denominated in local currency, the sovereign can exercise its powers to tax, control the domestic financial system, and even issue local currency in potentially unlimited amounts. Given these considerations, the credit ratings on nonsovereign borrowers most often are no higher than the ratings on the relevant sovereign. Although "sovereign ceiling" is an inappropriate term, when determining the creditworthiness of an issuer, Standard & Poor's does always assess the impact of sovereign risk and how it could affect that issuer's ability to fulfill its obligations according to the terms of a particular debt instrument. This is done in a more flexible manner than the term "ceiling" suggests by looking at the issuer's own position and ability to meet its obligations in general as well as the particular features of a specific obligation that might affect its timely payment. For example, borrowers could add features to specific debt issues, such as external guarantees, or they could structure them in particular ways—such as asset-backed transactions—that enhance the likelihood of payment. Nevertheless, for debt issuers in all but the highest-rated countries, the sovereign risk factor remains an extremely important consideration in the assignment of overall creditworthiness. There are two key elements that form the basis for Standard & Poor's evaluation of sovereign risk on the creditworthiness of a particular issuer or debt issue: The economic, business, and social environments that influence both the rating on the sovereign itself and the ratings on the issuers domiciled there. The ways in which a sovereign can directly or indirectly intervene to affect an entity's ability to meet its offshore debt obligations, even if that entity has sufficient funds on hand to meet that obligation. Actions by the sovereign. Sovereign governments in many countries act to constrain an issuer's ability to meet offshore debt obligations in a timely manner. Although higher-rated sovereigns are not expected to interfere with the issuer's ability to use available funds to meet such offshore obligations, the chances of some form of intervention increase significantly for entities domiciled in lower-rated nations. At a time of local economic stress, when foreign exchange is viewed as an increasingly scarce and valuable commodity, the likelihood of direct constraint on, intervention in, or interference with access to foreign exchange can be high. For this reason alone, it is unlikely that most issuers' ability to meet offshore debt obligations in a timely manner can be viewed as more probable than their sovereigns' own likelihood of meeting their offshore debt obligations. Even when the issuer has sufficient funds to meet its offshore debt obligations, the sovereign may absolutely prohibit or otherwise constrain the issuer from meeting those obligations in a timely manner. For example, the Venezuelan government in 1994 and 1995 and the Argentine government in 2001 and 2002 rationed the availability of foreign exchange to private-sector entities to the point that many of these entities defaulted on foreign currency debt obligations—despite some of them having sufficient funds to meet these obligations in a timely manner if access to foreign exchange had been possible. A sovereign government under severe economic or financial pressure that is seeking to retain valued foreign-currency reserves in the country and that might not be able to meet—or already has not met—its timely obligations on offshore debt could impose many constraints on other governmental or private-sector borrowers, including: Setting limits on the absolute availability to foreign exchange. Maintaining dual or multiple exchange rates for different types of transactions. Making it illegal to maintain offshore or foreign-currency bank accounts. Requiring the repatriation of all funds held abroad or the immediate repatriation of proceeds from exports and conversion to local currency. Seizing physical or financial assets if foreign-exchange regulations are breached. Requiring that all exports (of the goods in question) be conducted through a centralized marketing authority or the posting of a significant bond prior to the export of goods to assure immediate repatriation of proceeds. Implementing restrictions on inward and outward capital movements. Refusing to clear a transfer of funds from one entity to another. Revoking permission to use funds to repay debt obligations. Mandating a moratorium on interest and principal payments or required rescheduling or restructuring of debt. Nationalizing the debt of an issuer and making it subject to the same repayment terms or debt restructuring as that of the sovereign. Local currency/foreign currency distinctions. Country risk considerations are a standard part of Standard & Poor's analysis for credit ratings on any issuer or issue. Currency of repayment is a key factor in this analysis. An obligor's capacity to repay foreign currency obligations could be lower than its capacity to repay obligations in its local currency because of the sovereign government's own relatively lower capacity to repay external versus domestic debt. These sovereign risk considerations are incorporated in the debt ratings assigned to specific issues. Foreign currency issuer ratings are also distinguished from local currency issuer ratings to identify instances when sovereign risks make them different for the same issuer. Local currency/foreign currency distinctions are effectively made every time a credit rating is assigned to a debt issue. At the issuer credit rating level, the distinction is conveyed in the assignment of separate local currency issuer credit ratings and foreign currency issuer credit ratings. Once again, these issuer credit ratings reflect the obligor's general capacity to repay financial obligations and do not address the specific terms or risks of any financial transactions. For most of the issuers covered by Standard & Poor's, the local currency and foreign currency issuer credit ratings are identical. Local currency/foreign currency distinctions exist for several highly rated sovereign issuers. In many countries farther down the ratings spectrum, a large number of issuers have foreign currency credit ratings that are lower than their local currency credit ratings because of sovereign risk considerations. Local currency issuer credit ratings in these countries can be very valuable information because they fully identify the stand-alone credit characteristics of each issuer and are often different than foreign currency issuer credit ratings, which could be constrained by external payment risks related to the sovereign. The analytical challenges posed by the rapidly globalizing financial markets are substantial. Ratings on many emerging-market credits are bound to be dynamic, and analytical techniques will have to develop in concert. At this juncture, the frameworks that distinguish issuer versus issue credit ratings and local currency versus foreign currency credit ratings add powerful analytical insights. Factoring sovereign risk into insurer financial strength ratings. Standard & Poor's definition of insurer financial strength ratings explicitly incorporates the potential for direct sovereign risk. The potential for direct government intervention, demonstrated primarily through mandated changes in contractual terms of insurance obligations in response to economic crisis, can result in lower ratings on insurers, including foreign branches and guaranteed subsidiaries, especially for those domiciled in higher-risk environments in which systemic risks or severe economic stress—the predecessors to government intervention—are perceived to be greatest. Although the incidence of direct government intervention in the insurance sector is infrequent, the role of this important sector in facilitating local economic and commercial markets can lead and has lead to government or regulatory interventions. These actions, which could entail government- or regulator-mandated changes in contract terms (such as in Argentina or Brazil), usually reduce systemic risks. However, through their unilateral nature, they can affect all insurers operating in the domicile regardless of their intrinsic financial strength, foreign affiliation, or support. The potential for such risk to impair policyholder or creditor protection is difficult to assess. In judging the potential for the government intervention, Standard & Poor's will consider the systemic risk in the insurance sector, the role and contribution of the sector in underpinning local commercial and financial markets, overall economic environment, and government and regulatory policies toward intervention. Incorporating country risk as a critical input into all ratings within a given domicile has long been Standard & Poor's practice. These sovereign risk considerations are included in the financial strength ratings assigned to insurers and debt ratings assigned to specific issues. The vast majority of insurance companies are rated no higher than the sovereign state exercising jurisdiction over them, reflecting each government's broad legal and regulatory powers, including its control over the domestic financial system and its ability to tax and impose foreign exchange controls. Financial strength ratings also reflect the influence of general country risk factors on the insurer's business franchise and financial standing. Local currency/foreign currency distinctions are effectively made every time a credit rating is assigned. At the issuer credit rating level, the distinction is conveyed in the assignment of separate local currency issuer credit ratings and foreign currency issuer credit ratings. Financial strength ratings (both full, interactive ratings and pi ratings, which are based on public information) are local currency ratings. Financial strength ratings address an insurer's capacity to repay local-currency obligations, which could be stronger than its capacity to repay obligations in foreign currency because of the sovereign government's potential to impose convertibility or exchange controls. In addition to incorporating the risk of direct sovereign intervention, other direct and indirect sovereign risks—such as the impact of macroeconomic volatility, currency devaluation, asset impairment, or investment portfolio deterioration—and other possible controls are factored into the financial strength rating. Sovereign stress has an overwhelming impact on insurer creditworthiness—through both direct and indirect effects. The direct impact of a sovereign local currency default should weigh heavily on companies with direct exposure to sovereign local currency debt, as is often the case for insurers that have a significant liquidity position maintained in government bonds. For this reason, the rating on insurance subsidiaries that are considered core operations of global insurance groups will not be higher than the sovereign local currency rating without explicit support. Similarly, Standard & Poor's will not assign domestic insurers a rating higher than the local currency rating on the sovereign in which they are domiciled, other than in demonstrated cases of extraordinary financial strength and other characteristics that mitigate domestic risk factors. Only in exceptional circumstances would the rating on a company be higher than the local currency rating on its home country without explicit support. Such would be the case if the local insurer can be shown to have the wherewithal to survive a comprehensive set of stress case assumptions consistent with a sovereign default scenario (e.g., government bonds trading at a fraction of their face value, highly depressed equity valuations, or loan and bond assets having migrated to highly speculative levels if not defaulted). Rating insurers higher than the sovereign. Reasonable conclusions from historical precedent—combined with Standard & Poor's current expectations about future sovereign default scenarios—are that there can be insurers that, through a guarantee from a parent, demonstrate that they are partially sheltered from sovereign and country risk. Even when the sovereign has defaulted on its obligations, there have been many instances when insurers have been able to meet their policy obligations. If the parent is financially strong and is domiciled in a country with a strong sovereign rating, Standard & Poor's would not necessarily expect the subsidiary to fail to meet its policy obligations during a sovereign local (and foreign) currency default scenario. Likewise, if the insurer has a branch operation in a sovereign undergoing a local currency default scenario, Standard & Poor's would not necessarily expect the branch to fail to meet its policy obligations. As a general matter of corporate law, a branch has no separate existence from the insurance company. However, it is not always clear whether certain obligations of branches (or obligations of guaranteed subsidiaries) would be serviced in a full and timely manner if the host sovereign government were to restructure the payment of public and private sector local currency obligations or unilaterally alter payment terms and/or conditions that effectively prevented the local branch from paying on that obligation in a timely manner. With explicit support—such as a guarantee or as a branch—the financial strength rating on an insurer would generally be six notches higher than the sovereign local currency rating in domiciles where the sovereign local currency rating is investment grade and four notches higher in domiciles where the sovereign local currency rating is noninvestment grade, limited by the rating on the guarantor. The same degree of support would be applied to the financial strength rating on a branch operation. Ideally, these would be companies or branches to which senior group management has demonstrated a strong commitment—a track record of support in good times as well as bad. Without a guarantee, there are limited, exceptional circumstances that could occur that would result in a company or branch rating above the local currency rating on the sovereign. These include, but are not limited to, insurers domiciled in certain specified financial centers—such as the Cayman Islands or Bermuda—that are viewed as independent of that financial center's sovereign risk or when most assets are located outside of the jurisdiction and a sovereign collapses with no impairment to the financial strength of the insurer. Governing law. The law governing a specific debt issue, as well as other legal factors, could be relevant in evaluating whether a sovereign could affect timely payment of a debt obligation. However, Standard & Poor's exercises caution in placing weight on the legal factor. When sovereign powers are involved, issues such as conflicts of law, waivers, and permission to hold and use funds held outside the country of domicile are confused at best and would likely be tested and resolved by the courts only after, rather than prior to, a default. Special cases. In some instances, an issuer is technically domiciled in a country for tax or other reasons than business undertaken within that country. For example, insurers domiciled in certain specified financial centers, such as Bermuda or the Cayman Islands, are viewed as independent of that financial center's sovereign risk. No substantial business is undertaken within that jurisdiction, no substantive assets are maintained in that jurisdiction, and the issuer could change its location quickly and without risk to the debtholder if the sovereign imposes any form of controls or onerous taxes. Multilateral lending institutions, such as the International Bank for Reconstruction and Development (the World Bank), the International Finance Corp., and the InterAmerican Development Bank enjoy preferred creditor status. By virtue of the borrowing country's membership in the lending organization and as a condition of eligibility to receive loans, the country ensures that it will not impose any currency restriction or other impairment to the repayment of such loans. In some cases, the treaty establishing the organization also specifies such special treatment of loans by member nations. Often, these loans, though made to other nonsovereign entities, are also guaranteed by the borrowing country, and the lending institution has a policy that no further loans will be granted to borrowers in that country if any loans are in default. These factors give the borrowing country strong incentives to maintain timely loan repayment. The result has been an excellent repayment record for such obligations, even while other borrowings from banks or other lenders have fallen into default. One analytical element is assessing the creditworthiness of these loans in the proportion of a country's total external indebtedness made up of this type of obligation. The larger the proportion, the more difficult it might be for the country to meet these in a timely manner and preserve its special status. Frequently Asked Questions What is the difference between issuer credit ratings and issue credit ratings? An issuer credit rating is an opinion of an obligor's overall financial creditworthiness to pay its financial obligations. It does not apply to any specific financial obligation. In addition, it does not take into account the creditworthiness of the guarantors, insurers, or other forms of enhancement on the obligation (although if a guarantor guarantees all obligations, the guaranteed entity may receive the same issuer credit rating as the guarantor). An issue credit rating is an opinion of an obligor's creditworthiness with respect to a specific financial obligation or a specific financial program. Because a financial strength rating is a rating on a specific class of obligations, namely policy obligations, and does not apply to all obligations of the company, it is considered an issue credit rating. What is the difference between an issuer credit rating and a counterparty credit rating? The terms "counterparty credit rating" and "issuer credit rating" are interchangeable—they are different product names for the same rating. "Corporate credit ratings" and "sovereign credit ratings" are also forms of issuer credit ratings. Standard & Poor's insurance ratings group adopted the product name "counterparty credit rating" in 1995. Can an obligor be assigned both long-term and short-term counterparty credit ratings? An obligor may be assigned a counterparty credit rating on the long-term rating scale, the short-term rating scale, or both. Do counterparty credit ratings have both local currency and foreign currency ratings? Country risk considerations are a standard part of Standard & Poor's analysis for credit ratings on any issuer or issue. Currency of repayment is a key factor in this analysis. An obligor's capacity to repay foreign currency obligations might be lower than its capacity to repay obligations in its local currency because of the sovereign government's own relatively lower capacity to repay external versus domestic debt. These sovereign risk considerations are incorporated in the debt ratings assigned to specific issues. Foreign currency issuer ratings are also distinguished from local currency issuer ratings to identify instances when sovereign risks make them different for the same issuer. Both local currency and foreign currency counterparty credit ratings are assigned to all insurance holding companies and all insurance operating companies with a public Standard & Poor's financial strength rating. Are counterparty credit ratings interchangeable with financial strength ratings? The counterparty credit rating refers to an issuer's overall financial capacity to pay its obligations and does not address any specific class of obligations. The financial strength rating is an issue credit rating because it refers only to a specific class of obligations, namely policyholder obligations. Counterparty credit ratings measure an entity's overall default risk, while an issue credit rating refers to the default risk only of a specific instrument or class of obligations. When would an insurer be assigned a counterparty credit rating that is different from the insurer financial strength rating? Because a counterparty credit rating is an opinion of an obligor's overall capacity to pay its financial obligations, including its senior obligations, it would be unusual for a company to be assigned a different financial strength rating from its counterparty credit rating, given that policyholder obligations are typically an insurer's most senior obligations. One example of when this can happen is when policy obligations are judged to be expressly subordinate to other obligations. In that case, the financial strength rating would be lower than the counterparty credit rating. Another example is when the financial strength rating is derived from a guarantee that supports only policy obligations. How is a counterparty credit rating determined for an operating insurance company? Assuming that Standard & Poor's is working with an existing financial strength rating as the starting point and the financial strength rating has not been derived from a guarantee that supports only policy obligations, the procedure for determining a counterparty credit rating is as follows: If in the country of jurisdiction, policyholder claims are the senior-most claims or are pari passu with the senior-most obligations of the company, the counterparty credit rating assigned will be the same as the financial strength rating. This is because the counterparty credit rating should be at the level of the company's senior-most obligations. If in the country of jurisdiction, policyholder claims are subordinate to other obligations, the financial strength rating will most likely be one notch lower than the counterparty credit rating. What is an insurer counterparty credit rating if the financial strength rating is derived from a guarantee that supports only policy obligations? In this case, Standard & Poor's would not assign a counterparty credit rating or the counterparty credit rating would be derived from the stand-alone rating on the insurer. When does Standard & Poor's assign counterparty credit ratings? Every obligor that receives a rating from Standard & Poor's also receives a counterparty credit rating. The exceptions are operating insurance companies that do not have financial strength ratings, structured finance entities, and entities whose only rated obligations are guaranteed. Does every financial strength rating get a counterparty credit rating? Financial strength ratings refer only to policy obligations, while counterparty credit ratings measure an entity's overall default risk; they are not interchangeable. That being said, every insurer that receives a financial strength rating will also be assigned a counterparty credit rating unless the financial strength rating on the insurer is derived from a guarantee that covers only policy obligations. In those instances, Standard & Poor's assigns a counterparty credit rating that is equivalent to the stand-alone rating on the insurer or will not assign a counterparty credit rating if no stand-alone rating has been assigned. As mentioned above, operating insurance companies that do not have financial strength ratings will not receive counterparty credit ratings. Does every counterparty credit rating have an outlook associated with it? By extension, does every financial strength rating have an outlook? Outlooks are assigned to both counterparty credit and financial strength ratings, and every interactive counterparty credit and financial strength rating has an outlook.