Sovereign Ratings Methodology & Debt Management

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Transparency & Reporting on Public Debt: Does It Pay Off?

The World Bank

FABDM Webinar

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STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Agenda

- **Sovereign credit ratings and other definitions**
- **Latin America’s Sovereign Ratings**
- **Sovereign ratings methodology**
- **Role of Debt and Debt Management**

Definitions: Rating Sovereigns, Not Countries

- **Standard & Poor's rates sovereign governments and other public and private sector entities which can issue debt; it does not rate countries.**

- **For example, Standard & Poor's rates the United Mexican States, the Socialist Republic of Vietnam, and the Federal Republic of Germany, but not Mexico, Vietnam, or Germany.**

Definitions: What A Rating Is And Is Not

A Standard & Poor's sovereign rating is:

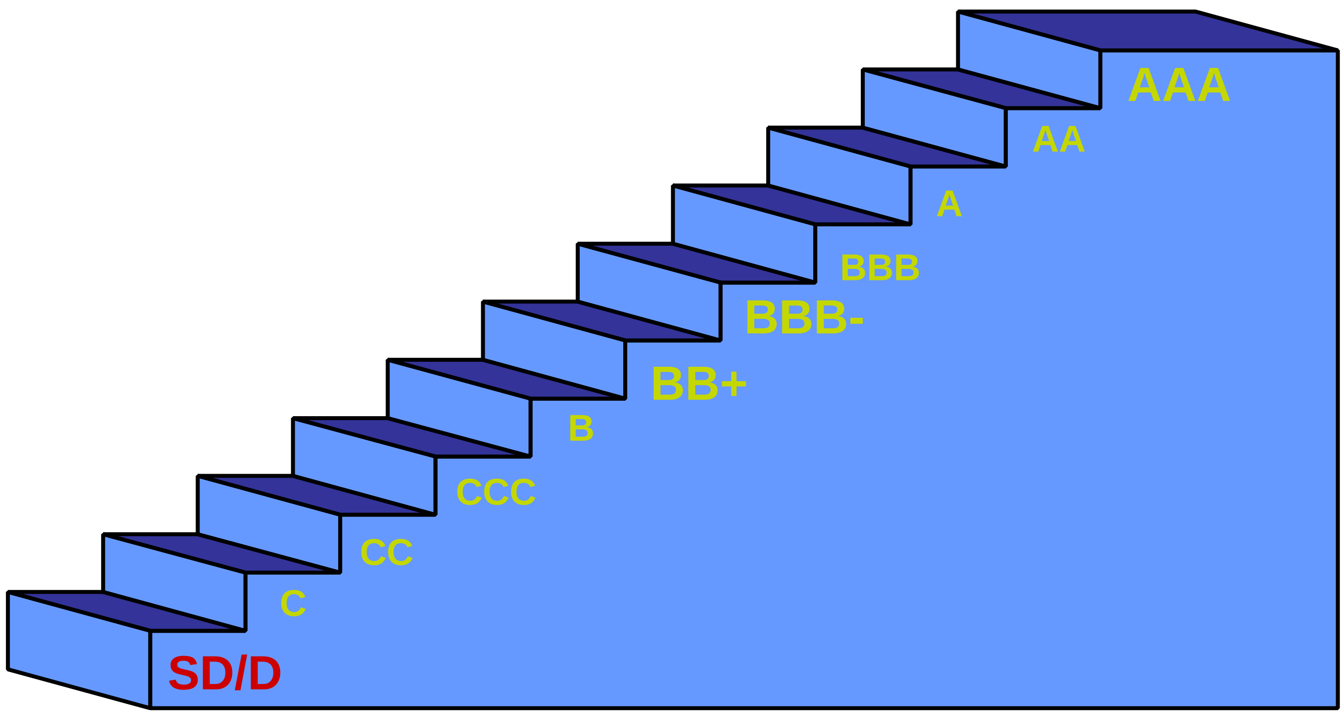
- **A current opinion of the creditworthiness of a sovereign government, where creditworthiness encompasses likelihood of default and credit stability (and in some cases recovery).**
- **A globally comparable, independent, forward-looking opinion.**
- **A reflection of medium-term fundamentals -- through economic and political cycles.**

A Standard & Poor's sovereign rating is <u>not:</u>

- **A country risk rating.**
- **A statement of fact or a recommendation to buy, hold, or sell a particular instrument or make any investment decisions.**
- **A measure of liquidity, volatility, or market value of a financial instrument.**

Standard & Poor's Ratings

- 129 rated sovereigns worldwide
- 26 rated sovereigns in Latin America & the Caribbean



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S&P Sovereign Ratings: Latin America (November 2014)

Chile AA- /AA+

Trinidad and Tobago A/A

Curacao A-/A-

Aruba BBB+/BBB+

Mexico BBB+/A

Peru BBB+/A-

Colombia BBB/BBB+

Panama BBB/BBB

Bahamas BBB/BBB

Brazil BBB-/BBB+

Montserrat BBB-/BBB-

Uruguay BBB-/BBB-

Costa Rica BB/BB

Guatemala BB/BB+

Bolivia BB/BB

Paraguay BB/BB

Suriname BB-/BB-

Barbados BB-/BB-

El Salvador BB-/BB-

Dominican Republic B+/B+

Ecuador B+/B+

Honduras B/B

Jamaica B-/B-

Belize B-/B-

Venezuela CCC+/CCC+

Argentina SD/CCC+

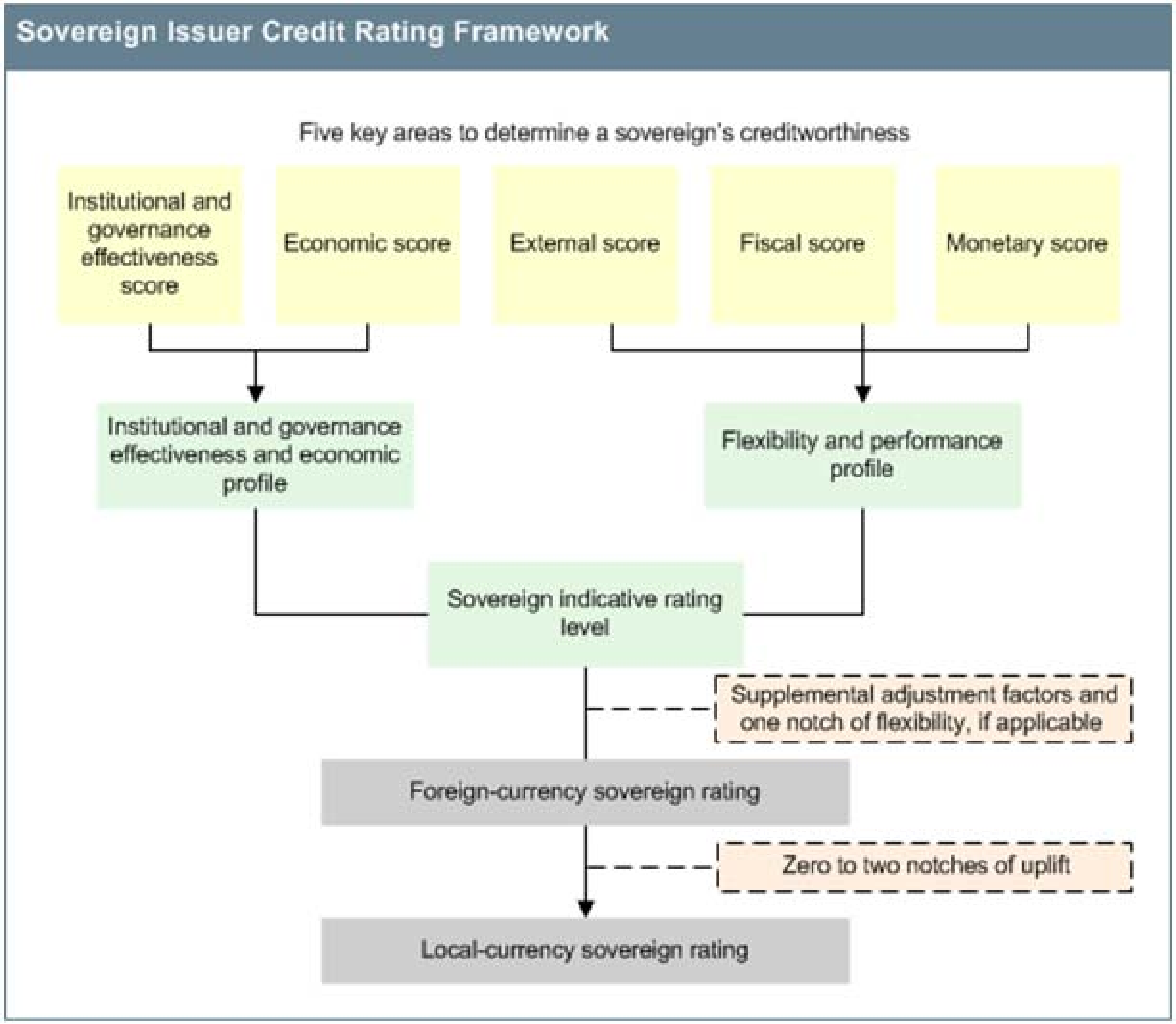
Outlook: Positive, Stable, Negative

Rating: Foreign Currency / Local Currency

Ratings as of November 19, 2014.

Source: Standard & Poor's Ratings Services.

Framework For Sovereign Ratings



Source: Standard & Poor's Ratings Services "Sovereign Government Rating Methodology And Assumptions" as of June 24, 2013 as published on the Global Credit Portal®.

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Determining Indicative Ratings Under Updated Criteria

Table 2
Indicative Rating Levels From The Combination Of (1) The Institutional And Governance Effectiveness And Economic Profile With (2) The Flexibility And Performance Profile

		Institutional and governance effectiveness and economic profile										
Flexibility and performance profile	Category	Superior	Extremely strong	Very strong	Strong	Moderately strong	Intermediate	Moderately weak	Weak	Very weak	Extremely weak	Poor
Category	Score	1	1.5	2	2.5	3	3.5	4	4.5	5	5.5	6
Extremely strong	1 to 1.7	aaa	aaa	aaa	aa+	aa	a+	a	a-	bbb+	N/A	N/A
Very strong	1.8 to 2.2	aaa	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb-
Strong	2.3 to 2.7	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb	b+
Moderately strong	2.8 to 3.2	aa+	aa	aa-	a+	a-	bbb	bbb-	bb+	bb	bb-	b+
Intermediate	3.3 to 3.7	aa	aa-	a+	a	bbb+	bbb-	bb+	bb	bb-	b+	b
Moderately weak	3.8 to 4.2	aa-	a+	a	bbb+	bbb	bb+	bb	bb-	b+	b	b
Weak	4.3 to 4.7	a	a-	bbb+	bbb	bb+	bb	bb-	b+	b	b-	b-
Very weak	4.8 to 5.2	N/A	bbb	bbb-	bb+	bb	bb-	b+	b	b	b-	b-
Extremely weak	5.3 to 6	N/A	bb+	bb	bb-	b+	b	b	b-	b-	ccc/cc*	ccc/cc*

*Assigning 'CCC+', 'CCC', 'CCC-', and 'CC' ratings is based on "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published on Oct. 1, 2012.

Source: Standard & Poor's Ratings Services "Sovereign Government Rating Methodology And Assumptions" as of June 24, 2014 on published on the Global Credit Portal®.

Fiscal Analysis

Our fiscal analysis focuses on:

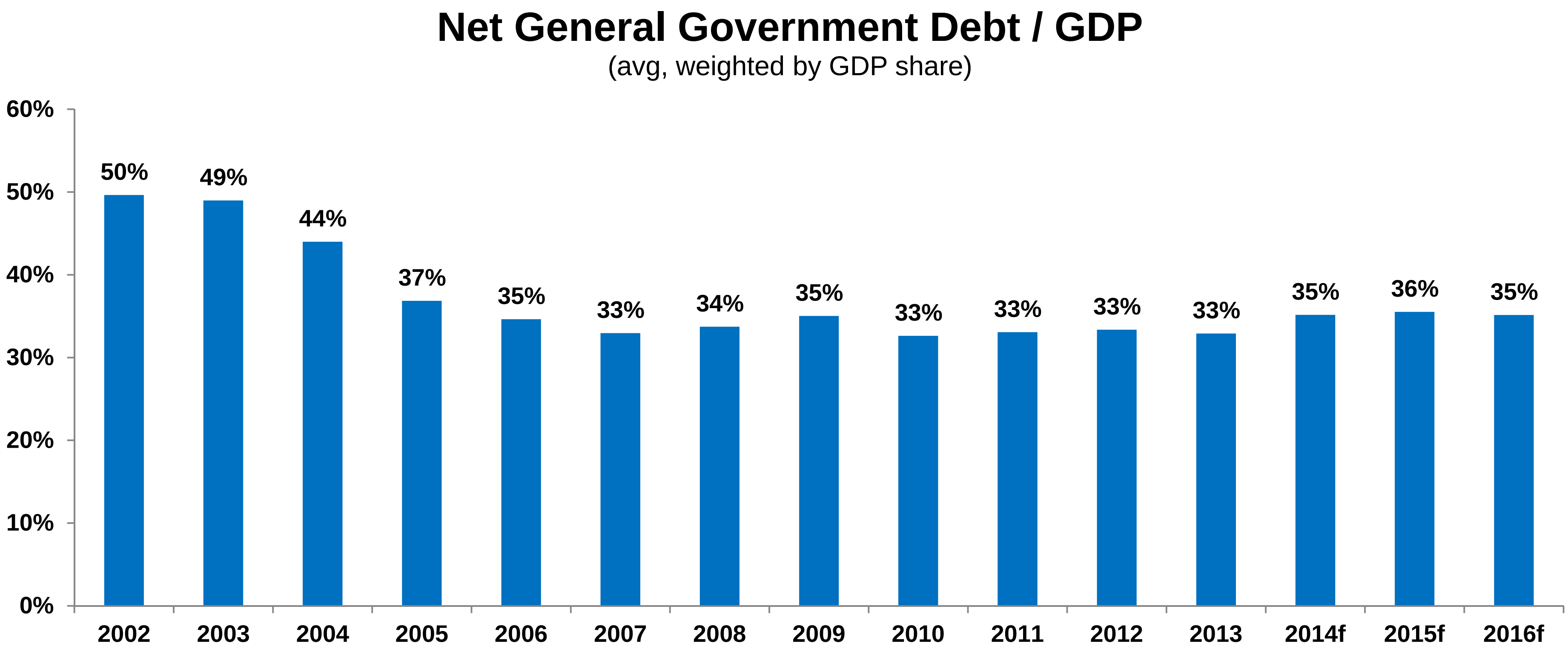
- **Fiscal performance and flexibility.**
- **Fiscal trends and vulnerabilities.**
- **Debt level and cost of debt.**
- **Access to funding and debt structure.**
- **Contingent liabilities.**

Debt Structure and Funding

- **Debt level and cost of debt starting point**
  - Net general government debt as a percentage of GDP
  - General government interest expenditures as a percentage of revenues
- **Worse assessment if**
  - Significant exposure to exchange rate movements and refinancing risk such as if more than 40% of debt is denominated in foreign currency or the average maturity is typically less than three years
  - Non residents hold consistently more than 60% of central government commercial debt
  - Debt service is vulnerable due to amortization profile that varies by more than 5% of GDP from one year to the next or due to possible acceleration from puts or rating triggers
  - More than 20% of the resident banking sector balance sheet is exposed to the government, which limits room for additional lending without crowding out private sector borrowing

Government Debt

Latin America's debt levels have declined, the debt composition has improved, and local debt markets have experienced greater development.



Source: Standard & Poor's Ratings Services.

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Brazil and Mexico rely on local markets

Brazil

- **Facilitate better composition of debt**
  - Increased fixed rate and inflation-linked issuance
  - Reduction in floating rate paper and elimination of dollar linked debt
  - Lengthen maturity; 10-year yield curve; longer-dated inflation-linked paper
  - Annual Borrowing Plan; Tesouro direto

Mexico

- **Track record of predictable and systematic debt management**
  - Local fixed rate issuance of 30 years; and longer inflation-linked paper
  - 100 year global bond
  - Annual Financing Plan, Cetes directo for retail investors; syndicated local issuance for new benchmarks
  - Joined Citibank's WGBI 2010

Example Peru and Colombia local markets

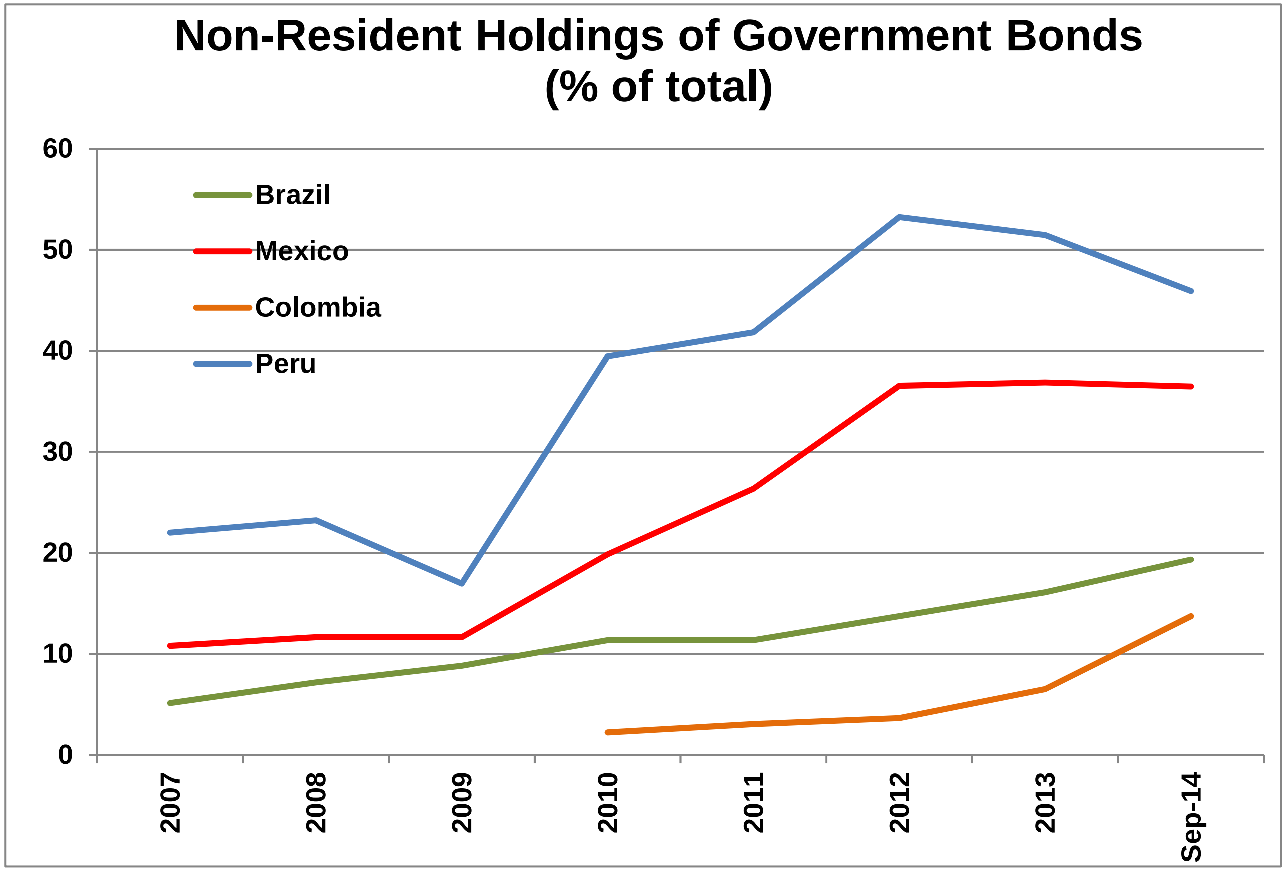
Peru

- **Deepening the development of local currency public debt**
  - New regulations to increase access to primary bond auctions for local entities
  - Minimizing informational asymmetries on local paper between securities firms and credit institutions
  - Offering benchmark bonds for the middle and long parts of the sovereign curve
  - Increased inflation linked issuance

Colombia

- **Improved debt management and local market development**
  - Issuance of TES with fixed rates and long-term maturities
  - Increased liquidity; Primary Dealers Program in secondary markets
  - Lengthen maturity; 15 year yield curve; 20 year inflation-linked paper.
  - Low percentage of floating rate notes
  - Sound information disclosure to increase transparency in pricing

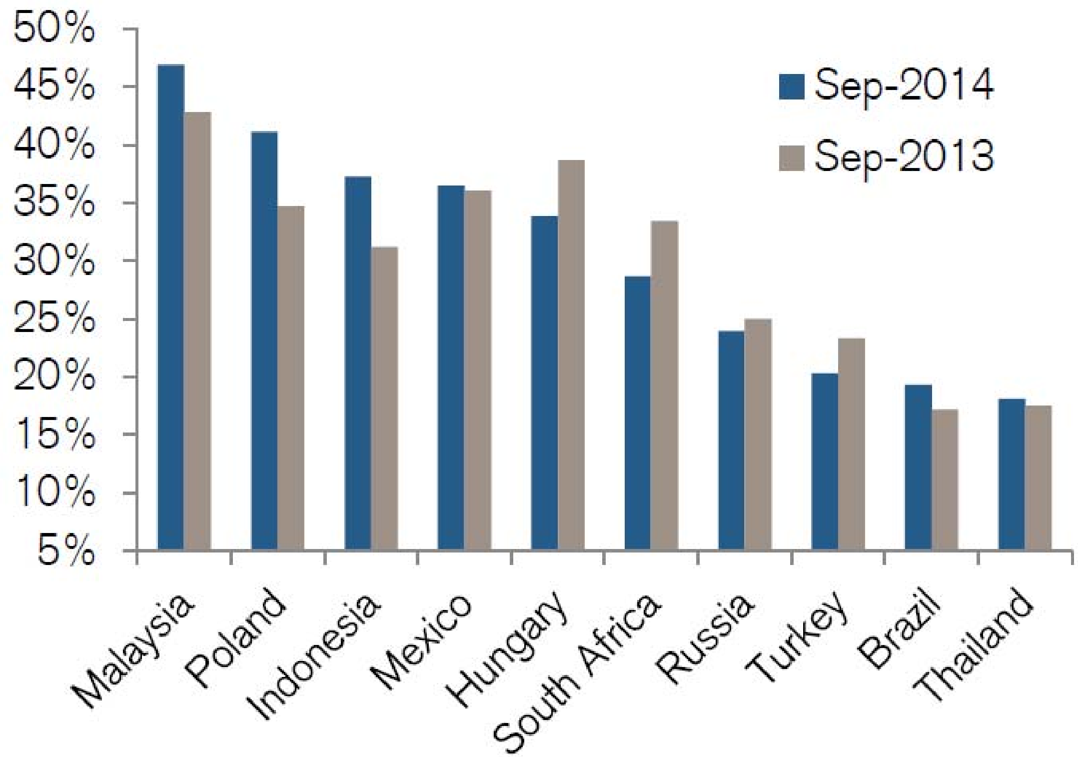
Growth in Latin America's local government bond markets



Source: Brazil Ministry of Finance, Colombia Ministry of Finance, Central Bank of Mexico, and Central Bank of Peru.

Part of a global trend

Non resident holdings in EM-10 local currency government bonds (Percentage of total outstanding)



Source: Credit Suisse. “Emerging Markets: Non residents’ holdings in Local Currency Government Bonds”. 7 November 2014.

Contingent Liabilities

- **Standard & Poor's defines contingent liabilities as any obligations with the potential to become a fiscal burden and impair fiscal flexibility.**
- **The liabilities can be related to the financial sector, to nonfinancial public sector enterprises, or to off-budget activities.**
- **The largest sovereign contingent liability is almost always that posed by the risk of a systemic crisis in the financial system. The impetus to assist banks is strong, since banking system soundness is generally viewed to be essential to macroeconomic stability and sustained economic growth.**
- **NFPEs also pose a risk to a sovereign because they generally are formed to further public policies and can suffer from weak profitability and low (or virtually nonexistent) equity bases, which leave them vulnerable to adverse economic circumstances.**

Interface with debt management office

- **Debt management team often "point person" for rating agencies and investors**
- **Open dialogue and fluid communication**
- **Information on policy agenda, economic developments, data dissemination**
- **Coordinates agenda for management meetings**
- **Informs Standard & Poor's ideally ahead of debt issuance, both global issuance, and increasingly important in local markets**
  - "New Issuance Desk" program

Interface with debt management office

- **Information needs**
  - Political, Economic, Fiscal, External, Monetary
  - Websites, specific requests

- **Management Meetings**
  - Travel in teams in country
  - In our offices NY, Mexico, Sao Paulo, London, etc.
  - Multilateral meetings (IMF/WB, IADB, ASDB)
  - Broadens committee composition

- **Government Related Entities**
  - Policies, procedures, and track record of support or negative intervention
  - Data on level indebtedness

Conclusions

- Reduced fiscal vulnerabilities follow from lower debt levels, but also better composition of debt
- Solid debt profile stems from active debt management
- Clear and transparent communication by debt management offices with investors facilitates building local yield curves

Overall, importance of communication with debt management office with ratings agencies and investors

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