# Rating Securitizations Above the Sovereign Ceiling

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## Summary

A sovereign's rating normally caps all other ratings from that country. However, there are several exceptions to the general rule. This report explains different methods used in international structured finance to rate issues higher than the country's rating. Fitch IBCA outlines general guidelines, complemented by details of specific mechanisms and deals. Rating above the sovereign ceiling is a rapidly evolving area of analysis, and the methodology may be expanded over time as more information is gathered.

## What is the sovereign ceiling?

Traditionally, a sovereign's rating on its foreign currency obligations has been regarded as the ceiling on ratings for all issuers domiciled in the country. The assumption is that a sovereign default will force all domestic issuers to default. Circumstances leading to a national debt crisis, which include economic and political upheavals, balance of payments crises, trade shocks, and high inflation, directly affect the debt servicing capacity of private borrowers. More important, governments facing default may force private sector defaults by imposing exchange controls and other restrictive measures that impede access by issuers to the foreign currency necessary to service their obligations. This cap on ratings is known as the sovereign ceiling.

## Is the sovereign rating the same as the sovereign ceiling?

Sovereign rating and sovereign ceiling are two related, yet distinct, concepts. The sovereign rating only addresses the government's likelihood of repaying its debt, while the sovereign ceiling indicates the likelihood of the government interfering with private sector debt service. Based mainly on historical evidence, the sovereign rating is the best proxy for the sovereign ceiling.

The sovereign rating is not always the sovereign ceiling. In some cases, Fitch IBCA considers the likelihood of forced defaults as lower than governmental default. In those cases, the expectation is that even if the government defaults, it will not automatically force private sector defaults. Examples of this are Panama and member countries of the European single currency. In both these cases, exchange controls are difficult, if not impossible, to implement. Panama has long adopted the U.S. dollar as its currency and, therefore, exchange controls are meaningless. Also, European countries joining the single currency, in effect, relinquish monetary and foreign exchange policy to the European Central Bank. Access to euros by entities within the single currency zone cannot be affected by individual governmental action. Fitch IBCA looks at all countries on a case-by-case basis to assess the appropriate sovereign ceiling.

## Does the sovereign ceiling apply to both local and foreign currency obligations?

A country's local currency rating does not act as a ceiling owing to the limited interest by part of the government in restricting access to its own currency. Foreign currency is a very valuable commodity in a default crisis, as opposed to local currency whose value is usually ravaged by high inflation in those circumstances. Fitch IBCA will rate any company or transaction above the country's local currency rating without any special mitigating circumstances, but always limited to the stand-alone rating. The stand-alone rating excludes any direct consideration of the sovereign rating or of actions that the government could take to limit access to foreign currency. It represents what the company or deal rating would be if the sovereign ceiling were not an issue. (*For more information, see Fitch IBCA Research on "Understanding Global*

### *Argentina: The Bonex Clause*

Created in the 1970s, Bonex bonds are dollar-denominated bonds issued by the Argentine government. One of the main reasons for their issuance was to facilitate the return of Argentine capital from abroad. For this reason, Bonex bonds have always been exempt from all types of controls, were never subject to default, and were always tradable in Argentina and abroad.

The convertibility of the Bonex bonds led to the Bonex clause appearing in many contracts during the 1970s and 1980s in Argentina. It stipulated that if access to dollars through traditional channels is limited, there is an obligation to obtain dollars through Bonex bonds. This is achieved by buying Bonex bonds in Argentina for local currency and then selling the bonds abroad for dollars. At the time, many banks offered this service, buying and selling internationally through their branches in Uruguay. As long as an open and free market for Bonex bonds in Argentina and abroad existed, this trade continued.

Use of the Bonex clause was widespread during the 1980s. Multinationals used it to repatriate profits and dividends. It was also called the American Express clause because American Express Co. used it to bill Argentines who used its credit card abroad. It was even used by the state-owned airline to quote prices on international flights. Many companies in Argentina continue to use the Bonex clause in their bond indentures. Fitch IBCA believes that in the event of new exchange controls in Argentina, Bonex or other dollar-denominated internationally traded bonds would continue to be available to issuers, helping them to meet their debt obligations.

*Ratings," dated Nov. 2, 1998, available on Fitch IBCA's web site at www.fitchibca.com.)*

### Does the sovereign rating capture all the country risk?

Country risk includes many factors, some of which may be a bigger threat to private borrowers than to the government. Many of these factors can greatly affect the rating of a deal but are less relevant in determining the sovereign rating. They include (but are not limited to) the following:

- Devaluation — A sudden or sustained change in the value of the currency can dramatically increase the debt burden in deals without appropriate swaps or hedges. Fitch IBCA stresses devaluation risk in all deals where debt service and cash flow are in different currencies. The severity of the stress scenarios depends on the rating desired.
- Legal Risk — Changes in the relevant regulations and legislation can severely affect the performance of any deal. The stability and predictability of a country's legal system may have a direct bearing on the rating of structured deals. Whether laws regulating bankruptcy and foreclosure are more beneficial to creditors or debtors will determine what value can be given to collateral. All these questions, crucial to a structured finance transaction, are of less concern when rating a sovereign.
- Economic Environment — A highly volatile economic environment may increase needed credit enhancements to cover expected losses.

### Is it possible to rate above the sovereign ceiling?

Since sovereign foreign currency ratings do not always act as a ceiling, a higher rating is possible. Fitch IBCA has rated a number of structured deals (PDVSA Finance Ltd. in Venezuela, Sino Commercial Properties Funding Ltd. in Hong Kong, and BHN III Mortgage Trust in Argentina) and project financing (Cerro Negro Finance, Ltd. and Fertilizantes Nitrogenados de Venezuela in Venezuela) higher than the respective country's ratings.

### What is necessary to rate above the sovereign rating?

There are several ways to rate a deal above the sovereign rating. In all cases, the crucial point is to ensure access to foreign currency even in the midst of a sovereign default. In some cases, like Panama or some European nations, the country has a sovereign ceiling higher than its sovereign rating. Issuers from these countries, whose ratings are the same or lower than the sovereign ceiling, do not need a special structure. For all others, mechanisms must be in place to ensure access to foreign currency in spite of any exchange controls or other measures.

If exchange controls or other restrictive measures are imposed, they are unlikely to last forever. Depending on the country in question and the rating desired, Fitch IBCA will estimate the likely length of exchange controls and determine the needed coverage. For example, deals looking for an investment-grade rating in Brazil (whose foreign currency debt is currently rated 'B+' by Fitch IBCA) must be able to survive controls lasting between 18 months and two years.

#### Outlasting Exchange Controls

The first set of mechanisms to overcome the sovereign ceiling aims to outlast potential exchange controls. These mechanisms are designed to provide access to foreign currency for the expected duration of exchange controls.

***Offshore Reserve Accounts:*** This method is the simplest of all. Enough foreign

## *Ensuring Access to Foreign Currency*

***Outlasting Exchange Controls***

- Offshore reserve accounts.
- Lag period.

***Bypassing Exchange Controls***

- Future flow deals.
- Currency swaps and guarantees.
- Alternative mechanisms.

***Exemption from Exchange Controls***

- Multilaterals.
- Special cases.

currency to cover debt service is deposited in an offshore account, which is used to make payments if controls are imposed.

***Lag Between Final and Expected Maturity:*** This mechanism provides protection against exchange controls by extending the maturity of the bond if foreign currency is not available. Under normal circumstances, the issuer pays as defined in the term sheet. However, if a convertibility event occurs, the issuer has extra time, equivalent to the expected length of controls, to fully pay the bond. This implies a change in the rating definition, as it only covers ultimate payment of interest and principal during exchange controls.

During the period of exchange controls, all money is captured in local interest-bearing accounts. Any potential shortfall, due to the difference between interest rates and devaluation, is stressed and taken into account. Once exchange controls are lifted, the local currency accumulated is used to buy the necessary foreign currency to service the debt.

In this case, the complexity of the rating increases the chances of misunderstanding by investors as to what is being rated. Because of this, Fitch IBCA will require ample disclosure to investors and that the investors ideally be major institutional buyers sophisticated enough to understand the product clearly.

## Bypassing Exchange Controls

The second set of mechanisms seeks to bypass exchange controls and other measures altogether. The structure of the deal is such that the cash flow is completely unaffected by any governmental measures limiting access to foreign currency.

***Future Flow Deals:*** This type of deal is one of the most common structures utilized in emerging markets. An issuer, typically an exporter, instructs its foreign clients to deposit payments in an offshore account administrated by a trust. The trust then pays bondholders, remitting the excess cash back to the issuer. Under this structure, the only way a government can affect the deal is to force the company to find new clients, a costly and unproductive proposition. Fitch IBCA has used this methodology to rate an oil future flow deal in Venezuela 'A', seven notches higher than the country's foreign currency rating *(see Fitch IBCA Research on "Rating Securities Backed By Future Export Receivables," dated Nov. 6, 1997, and "PDVSA Finance Ltd.," dated May 14, 1998 and May 5, 1998, all available on Fitch IBCA's web site at www.fitchibca.com).*

Although this has been used mostly for export receivables, the same methodology can apply to any other cash flow captured abroad. Examples include workers' remittances, international telephone payments, and credit card receipts, among others. As long as the cash flow is safely captured offshore, the rating can breach the sovereign's but will be limited to the capacity to continue to generate the needed receivables.

Future flow deals can also be further enhanced by the use of supply bonds. In this case, an insurance company will insure against supply risk by paying the trust if the issuer fails to deliver its products. Depending on what conditions, if any, limit the payment, the supply bond may be used to increase the stand-alone rating as well as mitigate convertibility risk.

***Currency Swaps and Guarantees:*** A deal can be rated above the sovereign ceiling if a third party insures or guarantees payment in the event of a forced default or lack of access to foreign currency.

Currency swaps are used to reduce devaluation as well as transfer and convertibility risk. A currency swap promising to pay foreign currency abroad if sufficient local currency is paid domestically will allow the cash flow to bypass governmental controls. However, two conditions must be met. The swap must not have any opt-out clauses in case of a convertibility event, and the swap provider must be rated similarly (but not necessarily as high) as the issue. This methodology has been used in several deals in Asia and Australia *(see Fitch IBCA Research on "Sino Commercial Properties Funding Ltd.," dated April 2, 1997, and "German Hong Kong Residential Mortgage Funding 1998-1 Ltd.," dated June 12, 1998, available on Fitch IBCA's web site at www.fitchibca.com).*

Governmental organizations may also insure against convertibility risk. The Overseas Private Investment Corp. (OPIC), a U.S. government agency that promotes private foreign investment, can guarantee, under certain circumstances, debt payments against the risk of inconvertibility. Because OPIC is a U.S. agency, it less likely that a foreign government will impede residents from paying its debt. However, if that happens, OPIC will pay. It should be noted that although OPIC is an 'AAA' rated entity, the rating on any deal to which it provides convertibility insurance is limited to the stand-alone rating of the deal, since local currency must be paid domestically for OPIC to pay abroad. If the company or deal goes bankrupt, OPIC is under no obligation to pay.

***Alternative Mechanisms:*** In some countries, alternative mechanisms to access dollars during currency crises may exist. A special mechanism is the use of Bonex bonds in Argentina to buy dollars *(see box, page 2)*. Fitch IBCA gave credit to this mechanism when rating the mortgage-backed securities issued by Argentina's state-owned mortgage bank, Banco Hipotecario Nacional. In that case, Fitch IBCA used a probability analysis approach whereby several factors, including the Bonex bonds, were taken into consideration. This approach allows Fitch IBCA to incorporate many factors into a rating, each of which, when considered separately, may not provide sufficient rationale for a rating higher than the sovereign ceiling but do so when taken together. *(For more details, see Fitch IBCA Research on "BHN III Mortgage Trust," dated Nov. 3, 1997, available on Fitch IBCA's web site at www.fitchibca.com.)*

## Exemption from Exchange Controls

Finally, there are cases where no formal mechanisms are used to bypass or outlast controls. Rather, the deal relies on incentives for the government not to impose controls or on historical evidence that would indicate that the exchange controls would not apply to a particular deal or company. Because of the lack of a formal mechanism to access foreign exchange, Fitch IBCA is more conservative in rating these structured deals.

***Multilaterals:*** Many multilateral and bilateral organizations, such as the World Bank or the Inter American Development Bank, benefit from preferred creditor status in countries to which they lend. Payments to these institutions are usually a priority for governments. More important, since the historical record of these organizations is strong, they are exempt from exchange controls and the government will enforce rescheduling of any moneys owed to them. Fitch IBCA will rate above the sovereign ceiling debt that is owed, or that is pari passu with debt that is owed, to multilaterals. No formal ceiling limits how much higher than the country the issue can be rated, but it will be constrained by the stand-alone rating of the deal. Also, Fitch IBCA will take into consideration the history of repayments to the specific multilateral bank.

In some cases, the role of multilaterals is much more direct, such as when they guarantee debt payments. The World Bank provides partial guarantees for private sector projects, which can improve the rating due to both the support of that institution and the likely exemption from controls derived from its participation. (Note that these are different from the convertibility guarantees previously mentioned.)

***Special Cases:*** Historical evidence shows that, in many countries, some sectors of the economy may be exempt from controls due to their strategic importance. In particular, exporters representing a large portion of a country's foreign currency earnings have been allowed to maintain normal commercial and financial relations with the outside world even when the country is in default.

Fitch IBCA has rated the unsecured debt of PDVSA, Venezuela's national oil company, four notches higher than the sovereign's rating. Several factors led to that decision, but crucial considerations were PDVSA's prior access to foreign exchange and a long history of exemption from any measures that would impede foreign debt service. Another example is the oil sector of several African countries. In some cases, even civil war and governmental default did not impede timely debt service. Fitch IBCA will look at other sectors on a case-by-case basis.


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