Sovereigns and Transfer Risk

Rating in sovereign states and transfer risk assessment

Overview

The LB-Rating module Sovereigns and Transfer Risk is designed for assessing sovereign states for credit and transfer risk. For credit ratings a distinction is made between domestic and foreign currency debt. Transfer risk is the risk that a government restricts foreign currency transfers to the extent that even financially sound companies can no longer meet their payment obligations in foreign currency.

The rating system is based on a scorecard which combines quantitative and qualitative criteria. A differentiated modelling approach reflects the structural differences between various groups of countries. The system provides estimates of the sovereign ‘s one-year probability of default (PD) for domestic and foreign currency debt and of the probability that a transfer event will occur within the next year.

Annual reviews of Sovereigns and Transfer Risk started in 2005; the module was approved for the IRB Approach in early 2007.

Scope of Application

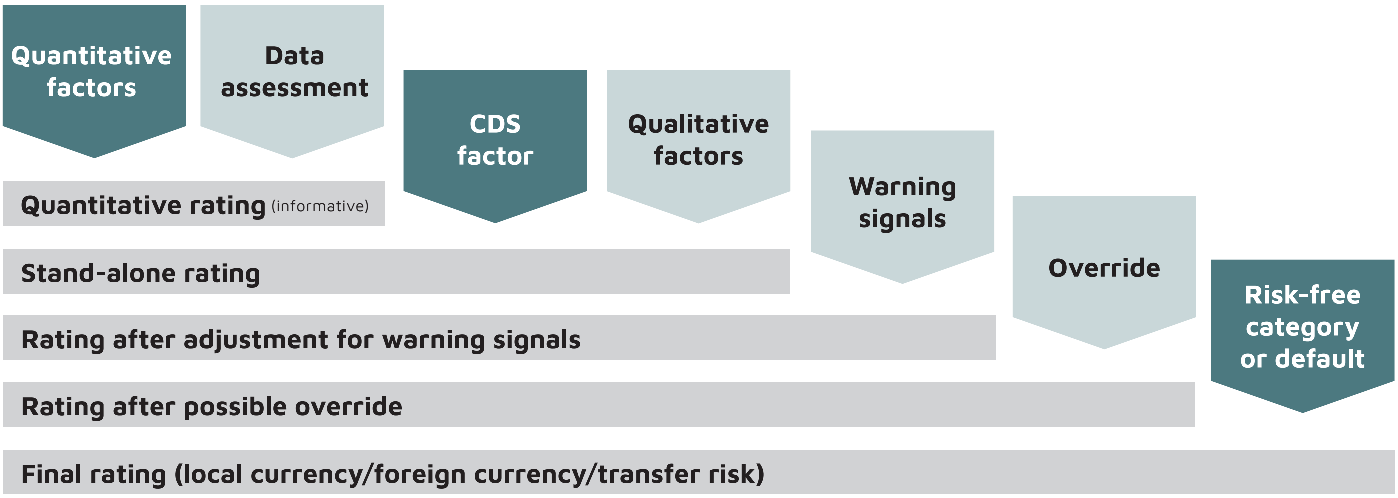
The Sovereigns and Transfer Risk module can be used to rate any sovereign state. Specifics of certain groups of countries are taken into account, for instance the particular characteristics of euro area countries, oil producing countries, state-directed economies or offshore countries.

Limitations

The module may also be suitable for rating certain non-sovereign entities (e.g. Greenland, Jersey), states that are not officially recognised (e.g. Northern Cyprus) or states that are closely linked to a ”parent country“ (e.g. San Marino). Such cases need to be examined individually as they may also fall within the scope of the International Regions and Municipalities module. That module must be used in any case for rating administrative units below central government level.

RSU RATING

Rating Process


Quantitative factors

Data assessment

CDS factor

Qualitative factors

Warning signals

Override

Risk-free category or default

Quantitative rating (informative)

Stand-alone rating

Rating after adjustment for warning signals

Rating after possible override

Final rating (local currency/foreign currency/transfer risk)

■ Dark arrow: mainly data-based

□ Bright arrow: mainly human judgement

Model Components and Factors

The Sovereigns and Transfer Risk rating system consists of three model components (quantitative, CDS factor, qualitative). The quantitative rating criteria are based on macroeconomic and financial metrics. Analysts need to specify how up-to-date and pertinent these metrics are in the case at hand. The CDS factor is provided by an external system. The qualitative factors are checked with analysts in standardised form. The combination of quantitative and qualitative factors and the weights assigned to them are determined by the classification of a country and by the distinction between domestic and foreign currency debt.

Warning Signals

There are many events, both political and economic, that are relevant to the rating of a Sovereign but cannot be appropriately covered by a scorecard. Political unrest or armed conflict may occur abruptly. Such developments can be taken into account as warning signals. A warning signal will result in a direct downgrade by at least one level.

Override and Assignment to Risk-Free Category

If there are exceptional circumstances that have not been sufficiently taken into account otherwise, analysts can override a rating and change it manually. Under very specific circumstances it is even possible to assign a country to the risk-free category.