Module Sovereigns and Transfer Risk

Ratings on sovereign states and transfer risk assessment

Overview

Rating sovereign states and assessing transfer risk
The *Sovereigns and Transfer Risk* module has been designed for assessing credit and transfer risk for sovereign states. For credit ratings a distinction is made between debt denominated in domestic currency and debt denominated in foreign currency. 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 both quantitative and qualitative criteria. A differentiated modelling approach reflects the structural differences between various groups of countries. The system provides an estimate of the sovereign's one-year probability of default (PD) for local or foreign currency debt and of the probability that a transfer event will occur within the next year.

The *Sovereigns and Transfer Risk* module has been validated annually since 2005; it was approved for use under the IRB Approach in early 2007.

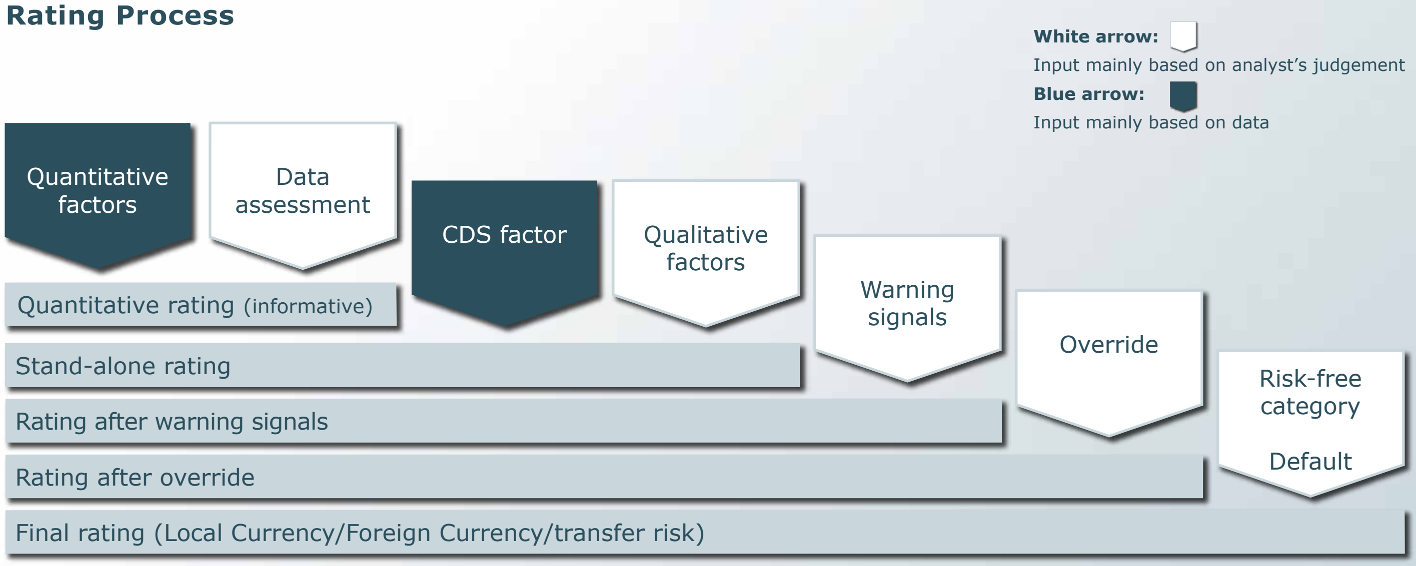
Scope

- 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 eurozone 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 by each institution. They may also fall within the scope of the International Regions and Municipalities module, which must be used in any case for rating administrative units below central government level.

Rating Process



Model components and factors

The Sovereigns and Transfer Risk rating system consists of three model components (quantitative, CDS factor, qualitative). The quantitative factors are determined based on macro-economic and financial metrics. In addition, the analyst needs 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 assessed by the analyst in a systematic and 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 local 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 recorded in the rating system as warning signals. A warning signal will result in a direct downgrade by at least one notch.

Override and assignment to risk-free category

If the analyst believes that any relevant idiosyncratic risk factors have not been sufficiently taken into account at the previous stages, the rating may be adjusted manually (override). Under very specific circumstances it is even possible to assign a country to the risk-free category.

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