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The rise of sovereign credit rating downgrades

What is a sovereign credit rating and why is it important?

A sovereign credit rating is a country's credit rating as determined by credit rating agencies at the request of that particular country. Credit rating agencies consider a number of factors when determining a country's credit rating, including such country's economic and political environment and any associated risks.

From an investor's perspective, sovereign credit ratings are important as they give investors an insight into the economic and political risks associated with investing in a particular country. From a country's perspective, particularly developing countries, it is often critical to obtain a good sovereign credit rating in order to attract foreign direct investment and funding in external debt markets.

Recent sovereign credit rating downgrades

2016 has been a record year for sovereign downgrades. So far in 2016, Fitch Ratings has downgraded 16 countries, S&P has downgraded 21 countries and Moody's a total of 25. Countries downgraded by some or all major credit rating agencies so far this year include Kazakhstan, Mozambique and the United Kingdom. Although different events and circumstances impact on different countries, the three major rating agencies have attributed recent downgrades largely to lower commodity prices (in particular falling oil prices), a stronger US dollar and, for some countries, the decision of the United Kingdom in June this year to withdraw from the European Union.

Impact of a sovereign downgrade on project financing

It is difficult to identify or predict the precise impact of a sovereign credit rating downgrade on projects in a particular country given that a ratings downgrade often is tied with one or more geo-political events which may themselves have a direct or indirect impact on a project. The impact of a downgrade on the appetite of lenders to invest in a country also will be highly dependent on the credit rating that a particular country held to start with and the level of perceived fiscal distress that may be behind the downgrade; *i.e.*, whether investors perceive that the country is running into an unsustainable debt situation or is facing a more transient issue, or whether an actual sovereign default has occurred. A downgrade from AAA/Aaa to AA+/Aa1, for example, is likely to have a less dramatic impact on a country's ability to raise debt (or the associated cost) than a downgrade from BBB-/Baa3 to BB+/Ba1, which would push a country into the non-investment grade or "junk" category.

However, generally speaking, sponsors or developers seeking financing for a project in a country that has recently faced a credit rating downgrade should consider the key issues below.

Commercial bank, Export Credit Agency (ECA) and Multilateral Agency appetite

Project financings are sometimes dependent on raising a significant amount of debt from commercial banks and ECAs or multilateral agencies. Sovereign credit ratings convey information to the market about a country's (and companies residing in that country) ability to repay its debt. A downgrade of a country may negatively affect the appetite of these debt providers to lend to a project located in such a country.

Commercial banks typically are willing to take a degree of commercial risk in a project financing (*i.e.*, the risk that the borrower cannot service its debt due to underperformance of the project or bankruptcy of a key project party) but have a more limited appetite for more political or macro-economic risk. A downgrade of a country in which a project is located likely will negatively impact the willingness of commercial banks to finance that project, particularly if the ratings downgrade is linked to a perceived degree of political instability in that country. In some cases a downgrade may prohibit a commercial bank from lending into a country altogether, at least on an 'uncovered' basis without ECA support.

Given that ECAs are typically a form of governmental or quasi-governmental entity and their purpose generally is to promote exports from their own country, ECAs often provide financial assistance to projects which are perceived to be a higher risk and therefore less attractive to other potential financiers. ECAs may provide financing to a project directly or provide guarantee or insurance cover to commercial banks that fund loans to a project. Given the nature and purpose of ECAs, the downgrade of a country in which a project is located may not necessarily reduce ECA appetite, however this will be highly dependent on the reason for the downgrade and the particular mandate and objectives of a specific ECA. ECAs may be more influenced by the country risk classification that is provided by the Organisation for Economic Co-operation and Development (OECD) consensus, which reflects the OECD's views on transfer and convertibility risk within a particular country, and which are produced solely for the purpose of setting minimum premium rates for transactions supported according to the OECD arrangement.

Multilateral and bilateral agencies with a development agenda also may be more willing to lend to a project notwithstanding a sovereign downgrade of the host country, since they (like ECAs) may be less motivated by credit concerns when assessing whether they can provide support to a project in a particular country. Indeed, agencies such as MIGA (which provides insurance against transfer and convertibility risk, for example) may provide support to a project to enable commercial banks to continue lending despite a sovereign downgrade.

Country exposure limits

Lending entities commonly establish internal lending limits in order to limit their exposure, in particular, to country risk. These limits will set the maximum amount that a particular institution is prepared to lend to borrowers in a particular jurisdiction (including sovereign borrowers and corporate borrowers) and are usually determined on an annual or semi-annual basis. Each lending institution will have its own specific considerations when setting country limits, however, a country's credit rating ranking is likely to be a very significant determinant in this process and a downgrade may therefore directly impact on a lender's ability to lend to a project.

Capital markets appetite

Sovereign credit ratings can affect a country's access to the bond and commercial paper markets as rating levels determine whether some institutional investors are permitted to invest in a particular country's securities. Some investors have mandates that stipulate that they can only own debt with a certain grade, which may narrow the potential pool of investment available to any country or any project located in a country that falls below the required level.

Pricing and terms

A sovereign credit rating downgrade may not necessarily always result in higher borrowing costs for the country itself or projects located therein; however, in general terms, the cost to a country or a project within that country of raising debt is likely to increase as the credit rating of such country decreases.

The risk profile of a project financing and the associated impact on available pricing and terms of course is primarily related to the nature of the project itself, with a basic infrastructure project with a fixed price construction contract and guaranteed revenue streams generally being considered a more attractive investment than a multi – phased, multiple - EPC project which is reliant on spot market revenues. However, setting aside the risk profile of a project generally, a borrower raising financing for a project based in a country that has recently experienced a ratings downgrade or that has a historically low credit rating may face demands from potential lenders and investors for a more restrictive covenant package, enhanced security, strict hedging requirements, sponsor guarantees, political risk and other types of insurance or other types of structural protections.