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Credit Risk Management – With Special Reference to Bahrain

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Abstract

The article seeks to answer questions concerning the definition of concepts, their rationale and interaction, rather than providing quantitative and qualitative rating criteria of a country. It deals with the key rating drivers like Political Environment, State of the Economy, The Banking Sector and other Key Economic Sectors like Oil etc. and their relative structural strength. Factors triggering rating actions include the security situation including genuine political reforms leading to concrete steps towards a political revolution, debt stabilization etc.

The rating factors include macro-economic indicators, public finances, external finances and structural issues.

Keywords : *Sovereign Ratings, Government Bond Ratings, Foreign Currency ceilings for bonds and notes, Local currency bank deposit ceilings, Country ceilings, Rating factors – Macro-economic, Public Finances, External Finances and Structural issues and Bahrain's political crisis.*

Introduction

Sovereign credit ratings give investors insight into the level of risk associated with investing in a particular country and also include political risks. At the request of the country, a credit rating agency evaluates the country's economic and political environment to determine a representative credit rating. Obtaining a good sovereign credit rating is usually essential for developing countries in order to access funding in international bond markets.

Another reason for obtaining sovereign credit ratings, other than issuing bonds in external debt markets, is to attract foreign direct investment. To raise investors' confidence in investing in their country, many countries seek ratings from credit rating agencies like Standard and Poor's, Moody's, and Fitch to provide financial transparency and demonstrate their credit standing.

A sovereign entity exercises total authority within its territory. What makes sovereign credits distinctive is precisely that governments have the capacity to alter the "internal" rules that apply to private agents within their jurisdiction (risk of interference) and cannot be compelled to respect "outside" rules unless they have

specifically agreed to do so (risk of indifference).

There are two types of sovereign ratings:

- Government Bond Rating: Aims at measuring the risk of default of any government on its own obligations in either local or foreign currency obligations. It takes into account both the ability and willingness of a government to repay its debts as and when these fall due for payment.
- Ceilings and guidelines: Aim at assessing possible governmental interference on the capacity of other economic agents to repay debt. Foreign currency country ceilings assess transfer risk - the risk that foreign currency debt payments and deposits may be restricted by the government. The local currency deposit ceiling reflects the risk of a disruption or shutdown of the domestic payments system as well as the ability of monetary authorities to support banks during possible banking crises. The local currency guideline indicates - on the basis of economic, financial and structural criteria - the highest rating for an issuer domiciled within a given country. These ceilings cap, under certain conditions, the ratings of specific securities and/or issuers.

Bond ratings are nothing but opinions about creditworthiness. When applied to a given government, they reflect the credit risk facing an investor who holds debt securities issued by that government.

Expected credit loss (EL) is an estimate of the probability of default (PD) and a hypothesis concerning the loss given-default (LGD). Sovereign bond ratings process takes into consideration a number of economic, financial, social and political parameters that may affect a government's creditworthiness. The resultant rating is strictly construed as assessing credit risk. Therefore, one cannot directly infer general assessment about a country's economic prosperity, dynamism, competitiveness or governance from any estimate of government bond ratings. On the other hand, the local currency guideline addresses more directly issues pertaining to general level country risk.

The meaning of default

Default is generally defined as any missed or delayed payment of interest and/or principal. Defaults also include distressed exchanges in which: (1) the issuer offers bondholders or depositors a new security or package of securities that amount to a diminished financial obligation (debt with a lower coupon or paramount, or a less liquid deposit either because of a change in maturity or currency of denomination or required credit maintenance facilities); and, (2) the exchange has the apparent purpose of helping the borrower avoid default.

A default event may also include those situations in which an issuer delays payment for credit reasons even when payment is ultimately made within the grace period provided for in an indenture or deposit agreement.

The probability of default for a government depends on both the ability and willingness to repay. In contrast to non-governmental economic agents that are

forced to default because they no longer have the resources to repay debt, governments, by the distinctive nature of possessing sovereignty can make the deliberate choice not to repay the debt. A government may decide that the economic, social and political cost of repaying the debt is higher than the economic, social and political cost of not repaying it according to the terms of the original contract.

Government default risk should not be confused with generic economic, political or financial risks, although they are often related. For instance, large exchange rate depreciation may precipitate the default of one country (justifying an outright rating change), erode the shock-absorption capacity of another (justifying some downward rating pressure) or have no impact on still another government's credit metrics.

Local Currency & Foreign Currency Sovereign Bond Ratings

As has been discussed earlier, local currency government bond ratings reflect only an opinion of a rating agency about the ability and willingness of a government to raise resources in its own currency to repay its debt to bond holders on a timely basis. The key question is the extent to which a government is able and willing to alter - if and when necessary - domestic income distribution in order to generate enough resources to repay its debt on time.

Two implications can be drawn from this: assessing default risk first relies on a cost-benefit analysis to repay the debt, and, second, requires an evaluation of the government's resources (solvency risk), as well as its ability to mobilize resources in a timely fashion (liquidity risk). To determine whether a government will punctually face debt payment streams, it is necessary to assess the possibility and associated costs of (1) raising additional taxes or cutting spending, which both expose the sovereign to the risk of dampening growth and fuelling social discontent; (2) liquidating assets, risking depletion of productive national resources; or (3) obtaining monetary financing from the central bank, with the risk of undermining the monetary authority's credibility and fuelling inflation.

Foreign currency sovereign bond ratings reflect the capacity of a government to mobilize foreign currency to repay its debt on a timely basis.

There is one important analytical difference between local and foreign currency government bond ratings. While local currency creditworthiness depends exclusively on the government's capacity and willingness to raise finance in its own currency to repay its debt, a government's default in foreign currency can also be precipitated by strains in the capacity of a non-sovereign to service its foreign currency debts.

Until the late 1980's, emerging market governments were very often the main or exclusive borrowers of foreign currencies. This created a direct link between a balance of payment crisis - triggered by a current account deficit difficult to finance - and a government's default in foreign currency. This link has weakened with financial liberalization and the move towards currency convertibility.

In a country in which a high current account deficit would be associated with a high level of private sector foreign debt, a confidence crisis - fuelling further capital outflows - might well lead to a currency crisis. A currency crisis would impact the government's creditworthiness in two possible ways: the government's own foreign currency denominated debt burden will mechanically increase, and the foreign currency resources it could mobilize - for instance the foreign exchange reserves - may have already been depleted.

It follows that in the assessment of a government's foreign currency credit risk, the strength of the whole country's external position must be taken into account.

Rating Gap

Should government foreign currency bond ratings be lower than, identical to, or higher than local currency bond ratings for any given country? Two arguments may justify local currency bond ratings being higher than foreign currency bond ratings. First, one could argue that it is easier for a government to raise finance in local currency rather than mobilize foreign currency resources. Second, it would seem prima facie that governments should be more wary of defaulting on their local currency debt rather than on their foreign currency debt - presumably held by foreigners.

However, it has appeared over time that these two arguments were not always compelling in practice, and this for three principal reasons.

First, financial liberalization - and especially currency convertibility - has opened the possibility that domestically generated confidence crises spill over to foreign currency debt through capital outflows and exchange rate crises. This powerful factor pleads for aligning the foreign currency and the local currency ratings in financially open countries with similar levels of local currency and foreign currency debts.

Second, some countries have accumulated massive foreign reserve cushions as compared to their external debt levels. Naturally, experience shows that foreign reserves can be rapidly lost in times of crises. However, there may be a point in terms of foreign currency accumulation beyond which the "external" creditworthiness becomes materially stronger than the ability and willingness to service domestic currency debt. Third, as to the alleged relative reluctance to impose a burden on local currency creditors, history suggests a more nuanced view. Local currency defaults do happen, sometimes independently of foreign currency bond defaults. This may be related to the fact that a government may believe that nationals will not see a default in local currency bonds as significantly different as an additional tax - i.e. just another manifestation of sovereignty.

FOREIGN CURRENCY COUNTRY CEILINGS FOR BONDS AND NOTES

The "country ceiling" generally indicates the highest ratings that can be assigned to the foreign-currency issuer rating of an entity subject to the monetary sovereignty of that country or area. This is a critical parameter for assigning foreign currency ratings to securities in a particular country. It reflects the degree of interference that

sovereign action can impose on the capacity of a non-sovereign to meet contractual obligations. The lower the ceiling, the larger the potential gap between a company's local currency rating - which reflects its intrinsic economic and financial strength - and its foreign currency issuer rating. The higher the ceiling, the lower its potential influence on private sector foreign currency securities' ratings, with the extreme case of an Aaa ceiling effectively indicating there is no ceiling.

The nature of foreign currency ceiling has changed over time, reflecting changes in the world economy and the structure of financial markets. The analytic rationale for the existence of a ceiling was that all domestic issuers are potentially subject to foreign currency "transfer" risk - i.e., the inability to convert local currency into foreign currency in order to meet external payment obligations in a timely manner. In other words, the ceiling accounts for the fact that a government confronted by an external payments crisis has the power to limit foreign currency outflows, including debt payments, of all issuers domiciled within a country, be they public sector or private sector.

However, the broadening and deepening of international capital markets since the 1990s and the avoidance of a generalized moratorium by most governments facing external payments difficulties in recent years have led us to be more flexible in the application of country ceilings. Since June 2001, we have looked at each situation individually to determine if certain securities are eligible to pierce the country ceiling.

The ceiling is now defined by the probability that a government would resort to a moratorium should it default. To determine the foreign currency country ceiling, we, therefore, multiply the implied default risk associated with existing foreign-currency government bond ratings by the risk that a moratorium would be used as a public policy tool for each country.

Although issuer ratings cannot pierce the ceiling, bonds sold under foreign law may be rated higher than the risk of a general moratorium. The likelihood that an obligation may pierce the country ceiling depends on two factors: the fundamental credit strength of the issuer (as indicated by its local currency bond rating), and the risk of sovereign interference in times of stress.

The risk of sovereign interference is characterized as a function of three parameters:

1) The government's probability of default in foreign currency (i.e. its foreign currency bond rating);
2) The probability that, confronted with a crisis, the government will impose a moratorium; and,
3) the probability that, given a moratorium, an issuer's foreign currency debt service may be included in such a moratorium.

Note that the combination of (1) and (2) provides the foreign currency ceiling.

FOREIGN CURRENCY CEILING ON BANK DEPOSITS

The foreign currency ceiling on bank deposits specifies the highest rating that can be

assigned to foreign-currency denominated deposit obligations of (1) domestic and foreign branches of banks headquartered in that domicile (even if subsidiaries of foreign banks), and (2) domestic branches of foreign banks.

Foreign currency bank deposit ceilings are distinct from foreign currency country ceilings for bonds and notes. While foreign currency deposit ceilings reflect the same kind of governmental interference as the Foreign Currency Ceiling for Bonds and Notes - i.e. foreign currency risk transfer - for emerging market countries, these two ceilings have been typically placed at different levels on the rating spectrum.

The reason is that our experience since 1998, the year we saw our first rated foreign currency bond default, shows that when sovereigns have defaulted on any of their foreign currency obligations, in nearly 40% of the cases, there was a simultaneous default on foreign currency bank deposits (three out of eight rated defaults). At the same time, there are two instances where foreign currency bank deposits have been frozen or where there was a forced exchange without a government default. Since slightly less than half the time FC deposit defaults were cotemporaneous with a government default, and in some cases, such deposit defaults occurred even without a government default, it is clear that FC deposit ceilings are either nearly as risky or perhaps even riskier than a FC government bond. On the other hand, out of 8 rated government bond defaults, in only one instance, Argentina, did we see an across-the-board FC payments moratorium. Therefore, it may be concluded that, in general, the risk of a payments moratorium on non-sovereign FC bonds is significantly less than the risk of a government bond default. In addition, unlike FC bank deposits, we have no examples of a payments moratorium on bonds absent a government default.

In about two-thirds of rated countries, the FC bank deposit ceiling is at least equal to the FC government bond rating. In about one-third of the countries, the FC deposit ceiling is one notch lower than the government bond rating. This notching practice attempts to take into account the fact that it is often legally, logistically and politically easier for governments to impose FC bank deposit restrictions than it is for those same government to default on their own foreign currency debt. Although there are numerous exceptions, these factors have been given greater weight for countries where the government is rated Baa3 or lower, where the risk of a sovereign credit event is by definition higher. This is because, in an external payments crisis, foreign currency bank deposits are the most likely instruments to be affected by a payments freeze (or "voluntary" rescheduling or forced exchange) foreign currency deposits cannot pierce the deposit ceiling.

LOCAL CURRENCY DEPOSIT CEILING

Local currency deposit ceiling is the highest rating that can be assigned to the local currency deposits of a bank domiciled within the rated jurisdiction. It reflects the risk that an important bank would be allowed to default upon local currency deposits either due to limited local currency resources or to the imposition of a domestic deposit freeze.

As such, it reflects: (1) the degree to which the authorities' ability to support an

important bank may be limited due to a monetary regime that does not permit the creation of unlimited quantity of local currency; and (2) the risk of a local currency deposit freeze.

The rationale is that in countries where the central bank can issue emergency liquidity – i.e. fiat currency countries – the deposits in local currency at systemically important banks will be assigned the highest possible rating, which is determined by the local currency guideline. Indeed, cases of too important to fail banks that have defaulted on local currency deposits are exceedingly rare. In countries whose central bank, for institutional or, more rarely, operational reasons, may not be able to extend emergency liquidity assistance on time – this is in particular the case of currency boards – the local currency deposit ceiling will be placed below the local currency guideline.

LOCAL CURRENCY GUIDELINES

The local currency guideline summarizes the general country-level risk (excluding foreign-currency transfer risk) that should be taken into account in assigning local currency ratings to locally-domiciled obligors or locally-originated structured transactions. It indicates the rating level that will generally be assigned to the financially strongest obligations in the country with the proviso that obligations benefiting from support mechanisms based outside the country (or area) may on occasion be rated higher.

As a result, local currency guidelines are typically high, and sometimes much higher than the government's local currency bond rating. For instance, as indicated above, local currency deposits at a bank deemed too big to fail by monetary and financial authorities in a country may be less risky than claims on the government itself. The reason is that if the central bank is not prevented in practice or by statute (currency board), to offer emergency liquidity, it may well be easier for it to help a bank honour its obligations in local currency vis-à-vis depositors than for the government to mobilize the resources it needs to remain current on its own debt.

In establishing this type of "country risk guideline", both quantifiable and non-quantifiable criteria are relevant:

(1) Is there a substantial risk of political regime change that could lead to a general repudiation of debt?

(2) Does the country have a well-established system of contract law, which allows for successful suits for collection of unpaid debts, seizure of collateral etc.?

(3) Does the country have a deep financial system which is effective in making payments and avoiding technical breakdowns?

(4) Is the regulatory/legal environment malleable, corrupt, or unpredictable?

(5) Is there a tendency towards hyperinflation?

RATING FACTORS ANALYSIS

Rating of a country depends on the factors like micro economic performance and

policies , public finances, external finances and structural issues.

Let us review the position of Bahrain from all these aspects.

Macro-Economic Scenario

Bahrain's macro-economic position is strong and the trend is travel as seen from the following analysis

Strengths

- At USD 43,000 per year (market exchange rates) Bahrain's GDP per capita is more in line with 'A" median credits and significantly higher than the 'BBB' median of USD 19,000
- Bahrain is a net creditor at about 70% of GDP, higher than any sovereign in the 'BBB' category, owing to its large oil receipts. The current account has been in surplus for almost a decade and compares to a median deficit position for the 'BBB' category.
- With a ten-year average GDP growth rate of almost 6%, Bahrain has outpaced peers in the 'BBB' category, and its economy has proved to be less volatile than peers and neighbours. Bahrain also enjoys a 20 year track record of low inflation, reflecting the credibility of its long-standing currency peg to the US dollar.
- Bahrain's relatively high World Bank Ease of Doing Business ranking reflects one of its key strengths as a business friendly destination in the Gulf.

Weaknesses

- The political unrest that peaked in the first half of 2011 reflected contentious socio-political issues including demands for more access to housing and land distribution and control of corruption. These upheavals have placed Bahrain in a stalemate.
- With over 85% of fiscal revenue and external receipts coming from oil, dependence on commodity-based revenue is high. The planned expansion of the oil and gas sector suggests that budgetary reliance on oil is likely to increase in the medium term.
- According to Fitch projections, public debt will rise above the 'BBB' median by 2014; limiting Bahrain's financing flexibility and rendering public finance more vulnerable to external shocks such as a prolonged period of low prices.
- As a financial centre, Bahrain is vulnerable to fluctuation in the industry.
- Although the 5x GDP in gross external liabilities is backed by assets of the wholesale banks, around 80% of them are in the form of deposits that raise interest payments and depress Bahrain's liquidity ration relative to peers.

Local Currency Rating

Bahrain's Local-Currency Long-Term IDR is BBB+, which is one notch above its

Foreign-Currency Long-Term IDR. The difference reflects the depth and maturity of Bahrain's domestic capital markets, its track record of low inflation and high credibility of its currency peg.

Country Ceiling

Bahrain's Country Ceiling is also one notch above its Foreign-Currency Long-Term IDR at 'BBB+'. This reflects Bahrain's commitment to a free and open capital account, like the rest of the GCC. Furthermore, the size and importance of its financial sector also renders Bahrain unlikely to impose capital controls.

OUTLOOK AND KEY ISSUES

The political unrest has quietened down since its peak in February and March 2011. While the government has taken a number of measures to appease the opposition, these upheavals have placed Bahrain in a stalemate that is likely to continue for the foreseeable future, marked by protests and clashes between various stakeholders.

Some changes, including the lifting of the state of emergency in June 2011, the setting up of an independent commission (BICI) to investigate allegations of human rights abuses, some, albeit imperfect, efforts to pursue dialogue and a number of measures including changes to Bahrain's constitution are steps in the right direction towards addressing opposition grievances.

While the authorities have taken some measures in response, many key recommendations are yet to be implemented. The government has the ability and willingness to reach a political solution through dialogue and reform. Meanwhile, there are more protests and violent clashes between authorities and the opposition, although more isolated than during the peak months in February and March 2011.

Barring a resurgence of serious violence resulting in severe disruption to economic life, Bahrain's political situation is unlikely to affect the rating further. The fiscal and economic pressure from the hardening social attitudes was adequately reflected in rating actions taken in March 2011, resulting in a three-notch downgrade in Bahrain's rating from 'A' to its current level of "BBB'.

However, a re-escalation of violence, potentially following the quiet summer months would put renewed downward pressure on the rating. In the medium term, the lack of a political solution may fuel radicalization within Bahrain's different factions, raising the likelihood of political unrest and imposing additional economic and fiscal costs on the sovereign. Continual allegations of detentions, and mistreatment of those involved in the uprising would further damage Bahrain's image as a business friendly investment destination.

The political crisis has materially increased Bahrain's economic and political dependence on Saudi Arabia. Fitch believes that financial support from Saudi Arabia will enable key developmental initiatives to proceed and reduce Bahrain's financing requirements. Its increased involvement is likely to lead the opposition to engage in dialogue that could eventually lead to a solution to Bahrain's political crisis.

CONCLUSION

Standard & Poor's Ratings Services affirmed its long-term foreign and local currency sovereign credit ratings on the Kingdom of Bahrain at 'BBB'.

They also raised the short-term foreign and local currency sovereign credit ratings to 'A-2' from 'A-3'. The outlook remains negative.

At the same time, they affirmed the long-term ratings on the Central Bank of Bahrain and raised the short-term ratings to 'A-2' from 'A-3'.

The transfer and convertibility (T&C) assessment on Bahrain is 'BBB'.

The ratings on Bahrain are supported by the country's net external and fiscal asset positions, which are underpinned by the renewed development of hydrocarbon resources. The ratings are constrained by our view of severe domestic political tensions, high geopolitical risks, stagnating real GDP per capita, and the fiscal dependency on sustained high oil prices.

More than a year after major unrest in Bahrain, stability has not returned. The authorities have made efforts to defuse tensions, such as the November 2011 report of the Bahrain Independent Commission of Inquiry (BICI) on the events of March 2011.

Aside from tourism, most sectors are showing moderate rates of growth, albeit posting lower-than-historical averages. The outflow from Bahrain's international financial sector also appears to be stabilizing, at least for banks. Increased hydrocarbon production, as well as public spending, generated real GDP growth of 2.2% in 2011 and we expect growth to rise to 3.2% in 2012.

Given Bahrain's high population growth, however, we estimate GDP per capita would drop by 1.7% in 2011 and foresee average income stagnating in the medium term, exacerbating political tensions.

The unrest has weakened Bahrain's fiscal position, with the budget-balancing oil price rising to $120/barrel. Given an average oil price of $111/barrel in 2011 and increased oil output, the central government deficit amounted only to 0.4% of GDP in 2011, with a significantly wider deficit of 4.6% of GDP forecast for 2012.

Oil- and gas-related revenues account for 88% of total revenues, making the budget precariously sensitive to declines in price or volume. The hydrocarbon-related increase in government revenues masks the full extent of Bahrain's expansionary fiscal policy, where general government expenditures have climbed to 37.1% of GDP in 2012 from 34.5% in 2010.

Moreover, spending has mainly been in the form of transfers and subsidies that have buffeted temporary consumption. As such, we view the structural features of the budget as having deteriorated. However, this will be offset in part by Gulf Cooperation Council (GCC) development funds, which we expect to begin flowing before the end of the year.

We estimate that general government debt will rise to 42% of GDP in 2012, from 24%

in 2009, reducing the government's net asset position to 6.9% of GDP in 2012 from 25% in 2009. Despite a relatively large financial sector, we consider sovereign contingent liabilities to be limited.

The financial system appears relatively well regulated, with manageable asset quality risks from the real estate overhang. Dollarization and the currency peg to the U.S. limit monetary flexibility, but persistent current account surpluses have maintained a net external asset position.

The political unrest has raised cross-border funding costs for domestic institutions, but there is no sign of any systemic stress. That said, we believe Bahrain's competitive advantage lies largely in its being a gateway to Saudi Arabia.

The change in the short-term foreign and local currency ratings to 'A-2' from 'A-3' reflects the revision of our criteria regarding the link between long-term and short-term sovereign credit ratings.

According to these criteria, the short-term rating on a sovereign government is derived directly and solely from the long-term rating. As a result, the change in the foreign and local currency short-term ratings does not reflect our view of an improvement in Bahrain's short-term creditworthiness.

The negative outlook reflects our opinion that we could lower the ratings if political turmoil further weakens economic prospects and threatens external and fiscal performance. We could also lower the ratings if oil prices remain below $100/barrel for a sustained period, if difficulties arise in securing GCC development funds, or if other government expenditures arise that worsen the fiscal profile.

The ratings could stabilize at the current level if a credible political process emerges and a renewed social contract appears likely. In addition, if the boost in public investment improves Bahrain's growth prospects, this would also support the current ratings. Lastly, fiscal reforms that would improve the structural deficit could lead us to revise the outlook to stable.

Acknoledgements

The article is primarily based on the rating reports of the following international rating agencies.

- Standard and Poor's Rating Services
- Moody's Investors Service – Global Credit Research
- Fitch Ratings – Sovereigns
    - Sovereign Review and Outlook (June 2012)
- http://www.investopedia.com/terms/s/sovereign-credit-rating.asp#ixzz299psftSH

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