

Box 5 Sovereign Credit Ratings

1. Credit Ratings

Credit ratings are a relative measure of the credit risk an investment has and provide investors with an idea of how safe investing in a particular asset or issuer would be. Thus, the purpose for these ratings, which are issued by entities known as rating agencies, is to show the probability that the issuer will comply with its debt obligations.

The three most prominent rating agencies that rate sovereign issuers are Standard & Poor's (S&P), Moody's and Fitch Ratings (Fitch). On the scale used by these entities, the highest long-term rating is AAA, which is assigned to issuers that have a strong ability and willingness to pay. The lowest rating is D, which corresponds to issuers that have defaulted on their payments. The notation used for each one of these three agencies can be seen in Table B5.1.

The sovereign debt ratings assigned to Colombia can be seen in Table B5.2.¹

The rating assigned to Colombia by the three agencies is within the investment grade range, i.e., issuers that have a BBB- rating or above. The difference in investment grade rating is highly significant since it implies that the issuers in this group are highly likely to honor their debt payments. Many investment policies and regulation criteria are linked to that difference. It must be noted that a reduction in the rating on the part of S&P that lowers it one level would take Colombia to a speculative grade rating. Furthermore, Moody's negative outlook indicates that they could revise the rating downwards in the medium term while the stable outlook of the other two rating agencies indicates that no changes in the rating on their part are to be expected in the medium term.

Table B5.1
Credit Ratings

| Clasificación | Moody's | S&P | Fitch Rating |
|-------------------------|------------------|-----------------|-----------------|
| | Aaa | AAA | AAA |
| Investment grade rating | Aa1, Aa2, Aa3 | AA+, AA, AA- | AA+, AA, AA- |
| | A1, A2, A3 | A+, A, A- | A+, A, A- |
| | Baa1, Baa2, Baa3 | BBB+, BBB, BBB- | BBB+, BBB, BBB- |
| speculative grade | Ba1, Ba2, Ba3 | BB+, BB, BB- | BB+, BB, BB- |
| | B1, B2, B3 | B+, B, B- | B+, B, B- |
| | Caa1, Caa2, Caa3 | CCC, CC, C | CCC, CC, C |
| | Caa | D | D |

Sources: Moody's, S&P and Fitch.

Table B5.2
Colombia's Credit Ratings

| Category | Moody's | S&P | Fitch |
|--------------------------------------|----------|--------|--------|
| Long-term rating in local currency | Baa2 | BBB | BBB |
| Long-term rating in foreign currency | Baa2 | BBB- | BBB |
| Outlook | Negative | Stable | Stable |

Sources: Moody's, S&P y Fitch.

2. Methodology Used by the Main International Rating Agencies²

To determine the credit rating of a sovereign nation, the agencies have methodologies that incorporate different quantitative and qualitative factors. They use different sources of information to evaluate said factors including national statistics or those from entities such as the BIS, the IMF, and the World Bank. Generally speaking, the factors considered can be grouped into the following categories:

- **Macroeconomic performance:** for the rating agencies, the economic growth and prosperity of a country has a significant influence on their creditworthiness. In this category, the agencies assess the resilience, level of wealth, and the size and diversification of the economy including variables such as the nominal GDP, the GDP per capita, average growth, and the volatility of the real GDP. The agencies also do a qualitative analysis of the quality of the macroeconomic data that are produced in the country.

1 Ratings of Colombia's sovereign debt as of February 26, 2018.

2 This section is based on the analysis done by these publications: *Sovereign Rating Methodology* (S&P Global Ratings), *Sovereign Bond Ratings* (Moody's Investors Service) and *Sovereign Rating Criteria* (Fitch Ratings).

- **Institutional strength:** in this category, mainly the effectiveness, stability, and predictability of the institutions and their decision-making process is analyzed. For the rating agencies, institutional strength has an influence on a government's ability to undertake policies that encourage economic growth and prosperity. The S&P agency, for example, does an assessment that is primarily qualitative of factors such as the level of concentration of power, the transparency of the institutions, the quality of budget management, respect for contractual and property rights, the historical handling of political, economic, and financial crises, the history of internal conflict, the level of corruption, any history of defaults on the part of the country, and the potential for geopolitical risks. Moody's and Fitch agencies use mainly the governance indices of the World Bank to measure this category.
- **Public finances:** in this category, the agencies seek to evaluate the general state of public finances using indicators of fiscal sustainability, indebtedness, and debt servicing. Among the quantitative factors considered, the debt level, the cost of the debt, the change in the level of debt, the fiscal balance, and the level of the government's liquid assets are found. They also take into account qualitative factors such as fiscal flexibility, the long-term fiscal tendencies and vulnerabilities, the structure and sustainability of public debt, the depth of the capital market and the risk of contingent liabilities materializing.
- **External Finances:** in this category, the agencies seek to evaluate the economy's transactions, assets, and liabilities with the rest of the world in order to determine the country's ability to obtain the resources that will enable it to meet its obligations in foreign currency. The importance the country's currency in foreign

Table B5.3
S&P Methodology

| Category | S&P |
|--------------------------------|--|
| Macroeconomic performance | <ul style="list-style-type: none"> * GDP per capita * Average growth of the real GDP per capita * Level of exposure to cyclical industries (percentage of GDP) * Exposure to natural disasters or adverse climatic conditions * Quality of macroeconomic data |
| Institutional strength | <ul style="list-style-type: none"> * Historical handling of political, economic, and financial crises * Opportunity to implement reforms * Predictability in policy formulation * History of internal political conflicts * Civil society and social cohesion * Existence of controls in the institutions * Level of corruption * Respect for contractual obligations and property rights * Independence of the media * Quality of national statistics * Geopolitical risks * History of defaults by the country |
| Public finances | <ul style="list-style-type: none"> * Average change in the government's net debt (percent of the GDP) * Government's net debt (percentage of the GDP) * Interest payments (percentage of income) * Level of liquid financial assets * Volatility of government revenue * Fiscal flexibility * Access to funding sources * Debt structure * Contingent liabilities |
| Foreign Finances | <ul style="list-style-type: none"> * Status of the currency * Country's foreign liquidity * Foreign indebtedness * Volatility of the terms of trade |
| Credibility of monetary policy | <ul style="list-style-type: none"> * Foreign currency exchange system * Central Bank's operational, legal, and administrative independence * Availability of monetary policy instruments * Price stability * Central Bank is the lender of last resort * Development and depth of the financial system and the capital market |

Source: S&P.

investment portfolios and international transactions, external liquidity, the level and structure of debt abroad, the level of international reserves, and the volatility of the terms of trade are included among the factors evaluated by the different rating agencies along with other indicators that are specific to each agency.

- *Credibility of monetary policy*: this category seeks to measure both the ability of the monetary authorities of a country to comply with their mandate and their credibility. Although this is a characteristic that cannot be measured objectively, some factors such as, the exchange rate regime, the operational independence of the central bank, the ample availability of monetary policy instruments, the development and depth of the financial system and capital market, the ability of the central bank to act as a lender of last resort, and a history of price stability and low inflation, have an influence on the credibility of a country's monetary policy. In general, some or all of these factors are taken into account by the three credit rating agencies.

Tables B5.3, B5.4, and B5.5 show the factors that are the most important for the methodology of each one of the agencies. The names of some of the categories and the classification of the factors differ between one agency and another. However, for a better understanding of the methodologies, the factors used in each agency's evaluation have been grouped under the categories described.

Table B5.4
Moody's Methodology

| Category | Moody's |
|--------------------------------|---|
| Macroeconomic performance | <ul style="list-style-type: none"> * GDP per capita * Nominal GDP * Average growth of the Real GDP * Volatility of real GDP growth * Global Competitiveness Index of the World Economic Forum |
| Institutional strength | <p>Indices of the World Bank governance:</p> <ul style="list-style-type: none"> * Government effectiveness * Rule of law * Control of corruption * Right to speak and accountability <p>Other indicators:</p> <ul style="list-style-type: none"> * History of defaults by the country * Geopolitical risks |
| Public finances | <ul style="list-style-type: none"> * Government's gross debt (percentage of the GDP) * Government debt (percentage of income) * Interest payments (percentage of income) * Interest payments (percentage of the GDP) * Average change in the government debt (percentage of the GDP) * Debt structure * Level of liquid financial assets * Contingent liabilities |
| Foreign Finances | <ul style="list-style-type: none"> * Current account balance + foreign direct investment (percentage of the GDP) * Indicator of foreign vulnerability * Net international investment position |
| Credibility of monetary policy | <ul style="list-style-type: none"> * Level of inflation * Volatility of inflation |

Source: Moody's.

Table B5.5
Fitch's Methodology

| Category | Fitch |
|--------------------------------|--|
| Macroeconomic performance | <ul style="list-style-type: none"> * GDP per capita * Volatility of real GDP growth * Average growth of the real GDP * Outlook for GDP growth * Employment level and trends * Participation of the various economic sectors * Share of the country in the global GDP |
| Institutional strength | <p>Indices of the World Bank governance:</p> <ul style="list-style-type: none"> * Rule of law * Control of corruption * Government effectiveness * Right to speak and accountability * Regulatory quality * Political stability and absence of violence <p>Other indicators:</p> <ul style="list-style-type: none"> * History of defaults by the country * Geopolitical risks * Index of the World Bank's ease of doing business * UN Index of Human Development |
| Public finances | <ul style="list-style-type: none"> * Government's gross debt (percentage of the GDP) * Interest payments (percentage of income) * Fiscal Balance (percentage of the GDP) * Debt in foreign currency (percentage of total debt) * Fiscal flexibility * History of market access in situations of stress * Ability to issue long-term debt at sustainable rates * Level of liquid assets * Forecast of the debt trajectory * Contingent liabilities * Level of income concentration |
| Foreign Finances | <ul style="list-style-type: none"> * Status of the currency * Net foreign assets of the government (percentage of the GDP) * Dependence on commodities * Level of international reserves (months of imports) * Foreign debt servicing (percentage of income of the current account) * Current account balance + foreign direct investment (percentage of the GDP) * Access to sources of foreign financing * Foreign liquidity * Sustainability and structure of foreign debt |
| Credibility of monetary policy | <ul style="list-style-type: none"> * Average inflation * Consistency of the country's monetary and fiscal policies |

Source: Fitch.