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Credit FAQ:
When Would A "Reprofiling" Of Sovereign Debt Constitute A Default?

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Policy discussions aimed at resolving the debt crises of certain countries on the periphery of the eurozone have been taking place for some time now. However, these discussions have taken a new turn in recent weeks as some European politicians have begun speaking more openly about solutions that might include a "soft" restructuring, rescheduling, or "reprofiling" of bonded eurozone government debt. While these terms are sometimes used loosely or even interchangeably, we've seen a sharp rise in market participants' interest in understanding whether, under Standard & Poor's published criteria, such a restructuring could amount to a default, with the consequence that Standard & Poor's might lower the relevant sovereign's issuer credit rating to "selective default" (SD).

A Standard & Poor's sovereign credit rating does not speak to the advisability from a policy perspective of sovereign debt restructuring. Rather, a Standard & Poor's sovereign credit rating provides a forward-looking opinion on the likelihood of default. In arriving at our credit opinion we analyze historical default data to the extent we believe it informs our forward-looking analysis of a sovereign's creditworthiness.

Below, we address some of the questions that we've received about the potential rating implications of various publicly discussed options. Readers are referred to our previously published criteria on the subject listed in "Related Criteria And Research" below.

Frequently Asked Questions

How does S&P define a sovereign default?

We generally define a sovereign default as the failure to meet interest or principal payments on the due date, or within the specified grace period, contained in the original terms of the rated obligation when issued. This definition generally includes exchange offers of new debt with less favorable terms than those of the original issue without what we view to be adequate offsetting compensation. "Less favorable terms" may include, for example, reduced principal amount, extended maturities, lower coupon, different currency of payment, or effective subordination. Under Standard & Poor's criteria, a discrepancy between the terms of a sovereign's exchange offer and the original terms of the rated obligation--even if not necessarily significant--may be viewed as a de facto restructuring. In such circumstances, we may lower the rating on the obligation to 'D' (default), even if only a portion of the rated bonds is subject to the exchange offer. We would furthermore lower the sovereign's issuer credit rating to 'SD' (selective default) in such cases, indicating that the sovereign is proposing to pay less than what it had originally undertaken. Rated obligations on which the sovereign is still making full and prompt payment are generally not affected by an exchange offer for another issuance, although we might lower the rating on the still-performing obligations if we concluded that the likelihood of a default had also increased for securities not (yet) restructured. However, under our criteria if an exchange offer so closely resembles to us the terms of the original obligation that it is hard to discern any shortfall, we would likely not characterize such an offer as a default.

Would a "reprofiling" also constitute a default?

The term "reprofiling" has no clearly defined meaning but in the context of sovereigns we understand it generally to mean an extension of maturities in order to allay concerns regarding the encumbered short-term liquidity situation

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of the issuer. Such a lengthening of maturities would constitute a default under our criteria because the sovereign debtor will pay less than under the original terms of the obligation.

Would a "voluntary exchange" of securities constitute a default?

Many sovereigns engage frequently in regular, voluntary, and market-based exchanges or buybacks of their own debt obligations. These voluntary exchanges are usually conducted in the context of conventional treasury management to provide liquidity in certain secondary market segments. These opportunistic transactions usually involve relatively small portions of the outstanding debt obligation. To the extent the terms of the exchanged obligations are honored, these voluntary exchanges do not constitute defaults under our criteria.

In contrast, we would likely analyze in a different light an exchange offer that we view as having the objective of materially changing the size and/or profile of the debt burden of a sovereign in financial distress. In situations where investors consider a default to be possible and where the rating has fallen, it becomes more difficult to conclude that investors are exchanging securities voluntarily. For example, while an exchange offer for longer-dated bonds may appear to be "voluntary", we may conclude that investors have been pressured into accepting because they fear more-adverse consequences were they to decline the exchange offer. In such a "distressed" exchange, holders accept less than the original promise because of the risk that the issuer will otherwise fail to meet its original obligations.

In establishing whether to view an exchange offer as "distressed", Standard & Poor's will evaluate whether, apart from the offer, we believe there is a realistic possibility of a conventional default (that is, of a payment default) on the obligation subject to the exchange, over the near to medium term. The existing issuer credit ratings, as well as rating outlooks or CreditWatch listings, can serve as proxies for that assessment. For example, we consider the following guidelines, in addition to other information, which are set out in our "General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009:

- If the issuer credit rating is 'B-' or lower, we would ordinarily view the exchange as distressed and, hence, as a de facto restructuring.
- If the issuer credit rating is 'BB-' or higher, we would ordinarily not characterize the exchange as a de facto restructuring.
- If the issuer credit rating is 'B+' or 'B', we would analyze market prices and other cues in determining whether an exchange is distressed.

In our view, trading prices of the securities under offer and/or the offering prices can also provide insight about the nature of the exchange offer. For example, prior to the exchange offer, an investor could have sold the to-be-exchanged, soon-maturing security in the secondary market and purchased a longer-maturity obligation similar to the new security offered in the context of the exchange offer. Had the investor been able, relatively close to the exchange date, to purchase more long-dated paper in the market-based transaction than he would receive in the exchange offer, we would, other things being equal, likely consider the exchange as "distressed".

What is the difference between a distressed and a "coerced" debt exchange?

Under our criteria, an exchange offer may be treated as "coercive" if, for example, the issuer employs tactics that pit holders of one series against holders of another series, or hints--directly, or through proxies--that holdouts might have to face more detrimental exchange offers at a later stage. From a credit perspective, however, the coercive aspect of an offer is largely irrelevant. While the coercive aspect may reflect on the government's management style and policy orientation, incorporating coercive tactics into an offer does not, under our criteria, necessarily amount to a de facto restructuring, just as the absence of such tactics would not preclude an exchange offer with what we consider to be the relevant characteristics from being portrayed as a distressed offer.

Regardless of whether coercive tactics are involved, exchange offers are entirely voluntary: investors elect whether to participate. However, the voluntary acceptance of an offer at a distressed value implies a perception of a significant risk that the original obligation may not be fulfilled. Generally, the existence of the issuer's offer acknowledges this reality.

Investors may be satisfied with an exchange offer that is above market prices, especially if they account for the investment on a mark-to-market basis. In fact, investors often are the ones to initiate such transactions. But such considerations do not detract from the credit perspective: the obligation is not being fulfilled as originally promised.

Would S&P still consider an exchange a default if the net present value of the new security is higher than that of the obligation retired in the debt exchange?

An exchange offer may include modifications to more than one characteristic of the original debt obligation. For example, the exchange offer may propose lengthened maturities while at the same time raising the future coupon rate relative to that of the original obligation. One could apply a net present value calculation to assess whether an investor is likely to be financially better or worse off than before the exchange. However, this analysis is highly sensitive to the discount rate chosen. Accordingly, our criteria does not utilize the concept of net present value. Instead, we consider case by case whether the modifications amount to what we view as a de facto default.

Can S&P's definition of default be different from that in CDS contracts?

Yes. We follow the definition of default described above and in our criteria, irrespective of whether an event of default has (or has not) occurred under a credit default swap.

Do you expect a debt restructuring in Greece and what kind of haircut would you anticipate? What about other EMU peripheral sovereigns?

We've rated Greece (Hellenic Republic, B/Watch Neg/C) as noninvestment grade since April 2010. According to historical experience between 1975 and 2010, 8% of sovereigns rated 'B' defaulted within three years and 33% within 10 years. The corresponding data for corporate issuers, drawing on a much larger sample size, are 6% and 24%, respectively. Although the likelihood of a default has, in our view, increased since 2004 when we lowered Greece's rating to 'A', and especially in the past 12 months, a default by Greece is far from certain. If Greece were to default and subsequently restructure its debt, however, Standard & Poor's '4' recovery rating assigned to Greece's debt anticipates an average recovery of between 30% and 50% (see "Standard & Poor's Noninvestment Grade Sovereign Debt Recovery Ratings: 2011 Update," published March 29, 2011, on RatingsDirect). In cases of defaulted rated sovereign debt, such defaults have historically been followed by restructuring negotiations culminating in the exchange of newly issued debt for the old debt. Our recovery estimates reflect our current projections regarding the approximate percentage of the original principal and interest that the sovereign will likely pay if a restructuring is concluded. In the case of Greece, the recovery rating reflects the position of the large (and growing) share of Greece's preferred creditors--mostly the International Monetary Fund and, from 2013, loans from the planned European Stability Mechanism. The preferred creditors effectively subordinate Greece's commercial creditors, implying a significant reduction in commercial creditors' recovery rate in order to reduce the total government debt stock.

Standard & Poor's has currently assigned investment-grade ratings to all other sovereign members of the eurozone. Accordingly, we consider the likelihood of default of other EMU members to be remote at this point.

How does a sovereign emerge from default?

Under our criteria, if there is no resolution of the sovereign default by agreement of the sovereign and other parties involved, Standard & Poor's will typically withdraw the sovereign's default ratings based on the diminished prospects for resolution and the lack of relevance of the default ratings. (For more information on emergence from default when a significant amount of debt has not been restructured, see "Argentina Emerges From Default, Although Some Debt Issues Are Still Rated 'D'," published on RatingsDirect on June 1, 2005.)

Related Criteria And Research

- Criteria | Governments | Sovereigns: Sovereign Credit Ratings: A Primer (May 29, 2008)
- General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update (May 12, 2009)
- Standard & Poor's Noninvestment Grade Sovereign Debt Recovery Ratings: 2011 Update, March 29, 2011
- Argentina Emerges From Default, Although Some Debt Issues Are Still Rated 'D' June 1, 2005
- Sovereign Defaults And Rating Transition Data, 2010 Update, (Feb. 23, 2011)

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