



GOVERNMENT SUPPORTED ENTITIES

Rating Methodology

Understanding the influence of corporate relationships is integral to complete credit analysis. As business dynamics continuously reconfigure corporate families, its implications for the investor should be outlined. Different corporate structures give rise to diverse support mechanisms, and the degree of credit enhancement implied by any support agreement varies accordingly. Where support agreements are entirely enforceable and completely dependable, ratings of the supported entity may even be at par with the supporting entity, implying maximum possible credit enhancement.

The credibility of the supporting entity is the key variable in the equation. Where the organization being rated is a member of a large corporate family, the influence on this entity may work both ways, i.e. both the stress and support arising from its position within the family, determines its credit standing.

A rating agency analyzes factors that strengthen or weaken the standalone viability of an entity. The interplay of these factors results in a continuum of support

levels, that in turn determines the appropriate degree of credit enhancement.

Support levels may be distinguished by relative strength of supporting entities. Traditionally, the strongest providers of support have been the governments. Factors influencing the analysis of support agreements are similar for both government and non-government relationships. This paper attempts to distil some of the key features common to most Government Supported Entities (GSEs) and addresses their impact on ratings assigned by JCR-VIS.

GSEs are a universal feature, prevalent in all economies, and mostly function as organizations of national importance. Their role often assumes greater significance in a developing economy, where market mechanisms have not matured and the involvement of the state is perceived as being vital to balanced economic growth.

The prevalence of GSEs in Pakistan is a similar phenomenon. Whereas some entities were ac-

Factors influencing the analysis of support agreements are similar for both government and non-government relationships

quired as inheritance to the newly emerged state, others were instituted in key areas, mostly during the first 30 years of independence. These entities were set up for state regulated provision of fundamental amenities. In addition to this, several financial institutions were established, each with its own special mandate for promoting the various sectors of the economy. In certain fields like banking, private sector institutions were also operative alongside government institutions. With nationalization in 1971, the number of GSEs grew further, giving rise to some degree of overlap in mandates of GSEs.

The last decade has witnessed growing confidence in the ability of the private sector to effectively manage corporations, resulting in considerable deregulation and an emphasis on privatization. As such, many of the parameters, relevant in the analysis of a government supported entity have now become fluid.

JCR-VIS Credit Rating Company Limited currently rates the large majority of the rated, local GSE universe.

GSEs exhibit a large degree of diversity in terms of their form, financial viability and significance of their role in the national economy, all of which have a distinct effect on the level, commitment and continuity of support for the entity.

Fundamental Analysis

The approach towards analysis of standalone strength and risk profile of a GSE is no different

from the general rating approach towards non-GSEs. To arrive at a basic rating, the institution's inherent strengths and financial risks are analyzed in conjunction with its future strategy. The rationale of the exercise is the evaluation of an entity's ability to withstand stress in case government support is not forthcoming.

The nature of support available to a GSE is then layered into the rating assessment to arrive at an appropriate credit rating. It is worth emphasizing that ignoring external support factors completely, is neither realistic nor use ful for an investor, or

ignoring external support factors completely, is neither realistic nor use ful for an investor, as support features substantially affect the likelihood of repayment

any other user of credit rating, as support features substantially affect the likelihood of repayment, particularly in times of stress. The significance of external support available to a GSE can also be understood in terms of 'risk diversification'. As the supporting entity is external to the supported entity and not necessarily affected by the internal credit risks of the entity being rated, its support can be viewed as protection against any eventuality within the GSE itself.

Categories of Support

Support available to all GSEs can be distinguished as being either

- 1) Explicit support or
- 2) Implicit support.

Explicit Support

In Pakistan, many of the public sector entities carry government guaranteed debt. In case of explicit guarantees, it is important to discriminate a 'full faith and timely payment guarantee' vis-à-vis an 'ultimate repayment guarantee'. Our earlier publications have highlighted the importance of timely payment and the mechanism in place to ensure against payment interruption in case the GSE in question comes under stress. Where explicit guarantees for timely support exist, GSEs are typically assigned the same rating as the government. In case of a local currency rating assigned on a national scale, federal governments are typically rated 'AAA' and therefore debt obligations that are explicitly guaranteed by the federal government, are rated as equivalents. However, entities as a whole may not enjoy the same rating as the sovereign, if only a portion of total obligations is so guaranteed. JCR-VIS minimizes the rating differential between GSEs and the government, de-

JCR-VIS minimizes the rating differential between GSEs and the government, depending on the proportion of explicitly guaranteed debt to total financial obligations

pending on the proportion of explicitly guaranteed debt to total financial obligations. Further, where the guarantee does not ensure timely payment, the rating will be lower than that of the guarantor.

Implicit Support

Where support is implied, rather than explicit, determining the extent of external credit enhancement, appropriate for the GSE being rated, warrants further deliberation. Having arrived at an assessment of the standalone rating, we assess the extent of support to be expected, and enhance the rating by an appropriate number of rating notches. In case of implied support, standalone ratings are enhanced by a maximum of three notches. We have highlighted below, some of the key points taken into consideration by JCR-VIS, while assessing external support.

Degree of integration/Significance of the GSE's Mandate:

The degree of integration of an entity into the government itself is one indicator for assessing a GSE's significance. Entities that have a constitutionally determined place in the government, or which undertake business that can not be undertaken on a commercial basis or significant regulatory barriers exist to enter or exit the concerned business, are usually assigned ratings equivalent to the government.

In Pakistan's context, certain special industries like armament industries or nuclear facilities, may be considered suitable examples. What needs to be determined, is the incentive a government may have, to extend timely support. In other words, an estimation is required of the cost that the economy may have to bear, in the event of GSE failure vis-à-vis the cost of preventing a default

through timely support. This would require an assessment of how a GSE fits into the state machinery and the extent to which it fulfills the government's key policy objectives.

Mandates as signed to GSEs may not be long-term in nature. These GSEs may exist only as interim solutions to the requirements of a developing economy. Over time the government's interest in such an entity is bound to diminish. Therefore, possible erosion of the GSE's value to the state must be factored into the assigned rating.

Government Ownership/Control:

The extent of ownership of the government and its involvement in the entity's business affairs may be an indication of the interest exhibited towards the GSE under evaluation. Appointment of board members and/or top management speaks the government's stake in the company's well being.

Availability of Financial Resources/ Track Record:

The financial strength of the Government and its continued access to financial markets is a primary concern, which is assessed together with expected strain on these resources due to a large number of GSEs that may be financially distressed. In this respect the total quantum of the government's contingent liabilities should be evaluated to arrive at a measure of expected support to a particular GSE. Form and level of assistance extended in the past may be a relevant indicator in this respect.

In many instances, the government may have extended loans or grants to a GSE. The terms of such credits and/or the size of grants provided help assess the degree of support available.

Social & Political Costs:

Allowing a GSE to fail may be accompanied by varying degrees of social cost. Failure of entities that carry public debt or are listed on the stock exchanges may result in severe public reprimand. As such the government may offer different levels of support to these GSEs, depending on its assessment of expected public reaction.

Credit Standing of Supporting Governments:

Government supported entities may not necessarily be directly related to the federal government. Entities supported by a sub-sovereign i.e. provincial governments, or other forms of local government, e.g. municipalities, often feature similar forms of support. The various factors taken into account while evaluating sovereign supported entities are directly applicable to entities owned or controlled by a sub-sovereign. The only point of difference being the relative credit standing of the sub-sovereign vis-à-vis the federal government.

An interesting form of government supported entities are those set up as joint ventures. In case of a joint venture between two sovereigns, where the GSE is incorpo-

Entities supported by a sub-sovereign i.e. provincial governments, or other forms of local government, e.g. municipalities, often feature similar forms of support

rated in one of the sovereigns, a local currency rating of the GSE would also take into account, the international credit standing of the foreign government, and the local currency rating of the country of incorporation. Moreover, the rating considers whether support is available jointly or severally. If the international credit rating of the foreign government is superior to that of the sovereign where the GSE is incorporated, with liabilities denominated in the GSE's local currency, the ratings are appropriately enhanced. In such cases, the standalone rating of the GSE may be enhanced by more than three notches.

Privatization

Privatization of GSEs has significant implications in this regard. While assigning credit ratings, the possibility of privatization over the

While assigning credit ratings, the possibility of privatization over the near term - whether partial or complete - is to be considered

near term - whether partial or complete - is to be

considered. Though a GSE may continue to assist the government in policy implementation even after privatization, its role in the workings of the public sector would be substantially reduced, thereby reducing or even eliminating the possibility of state support. As such the financial viability of the GSE, in the absence of government support, requires thorough consideration.

The credit standing of the buyer will be a critical factor in the post privatization scenario, that can not be evaluated prior to sell off. However, a standalone rating

based on intrinsic financial strength, does provide investors with a reliable estimate of the entity's risks, for entities where the government is expected to offload its holding, either through partial sell off or complete privatization. To ease the transition of credit ratings into an entity's post privatization credit standing, JCR-VIS, publicly discloses these standalone ratings.

Government Supported Entities - Rating Methodology



Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copy righted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.



Saheen Saleem
Assistant Vice President

Saheen Saleem currently leads ratings of commercial banks and insurance companies. She is also actively involved in ratings of the Leasing and the DFI sector. Prior to joining JCR-VIS, she worked on several projects with local financial consultants.

She holds a Masters degree in Business Administration from the Institute of Business Administration.

Government Supported Entities - Rating Methodology

In formation herein was obtained from sources believed to be accurate and reliable; however, JCR-VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities. Copyright 2002 JCR-VIS Credit Rating Company Limited. All rights reserved. Contents may be used by news media with credit to JCR-VIS.

JCR-VIS Credit Rating Company Limited

Affiliate of Japan Credit Rating Agency, Ltd.

First Floor, PIDC House
M.T. Khan Road, Karachi - Pakistan
Tel: (92-21) 5680766, 5680996, 5671822, 5671833
Fax: (92-21) 5681105, 5671600
E-mail: vispk@cyber.net.pk
Website: www.jcrvis.com.pk