Government Related Entities & "Junk" Ratings

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The heightened risk of sovereign ratings downgrades in response to the COVID-19 crisis is likely to have the consequential impact of lowering the ratings of government related entities where there is deemed to be on-going support and extra-ordinary support from government. It may also lower the ratings of financial institutions where there is deemed to be systemic support provided by government and lower the ratings of structured transactions that are underpinned by instruments supported by financial institutions.

Of particular concern are the borderline investment grade rated entities and transactions that have a direct or indirect links to the sovereign rating. If an entity is downgraded to non-investment grade (or "junk") then many investors may be forced to sell if their investment mandates prevent them from holding non-investment grade debt. This will make any future debt requirements increasingly expensive for these new non-investment grade entities.

Pressure on the UK Sovereign Rating

In response to the COVID-19 crisis the UK government announced a support package that includes a commitment to make up 80% of the wages of employees placed on furlough. It will also have to meet the cost of a significant increase in claims for benefits in response to a spike in unemployment. The government has also provided around £330 billion in loan guarantees for businesses. These loan guarantees do not count immediately against government borrowing but they are a significant contingent liability that would crystallise in the event that businesses are unable to repay their loans.

It is not yet clear how much the package of support will ultimately cost the government. Some initial estimates suggest borrowing could increase by over £100 billion, which will be in addition to £55 billion of borrowing the Office for Budget Responsibility (OBR) was already forecasting for 2020/21. In recent years the annual budget deficit has been reducing, but year on year borrowing has been adding to the overall amount of outstanding debt owed by the government.

According to the Office for National Statistics (ONS) at the end of January 2020 the amount owed was approximately £1.8 trillion, which is over 80% of GDP. Depending of the scale of the package of support provided by the government and the impact of the COVID-19 crisis on GDP, the debt to GDP ratio could easily increase to 90% to 100% in the relatively near term and continue to increase to a level significantly higher than 100% in the medium term before debt peak is reached.

Fitch recently downgraded the UK sovereign rating to AA- (from AA). Fitch is forecasting UK public debt to peak at well above 100% of GDP beyond 2025 and announced that UK sovereign rating remains on a negative outlook, which means any further weakening of the UK's fiscal position beyond what is currently expected would lead to further rating downgrades. Such action would move the UK sovereign rating from the AA category into the A category, putting it in the same rating category as those of highly indebted nations such as Japan and Spain. Standard & Poor's and Moody's are yet to take any rating action on the UK sovereign rating. Both agencies have similar ratings for the UK sovereign at AA and Aa2 respectively.

Understanding a Government Related Entity Rating

Government provides on-going and extra-ordinary support

The rating agencies assess a baseline (or stand-alone) credit profile for each government related entity rating. This assessment can then be adjusted for extra-ordinary government support to give a final rating. Changes to the UK sovereign rating can therefore have the effect of changing the rating of a government supported entity, even if the baseline credit profile of the entity remains unchanged.

Different agencies have different approaches for making an adjustment for government support, but they all include similar factors in order to arrive at their final ratings. Standard & Poor's publishes tables of "notching" for **extra-ordinary** government support. The amount of notching adjustment made to the baseline credit profile depends on an assessment of the likelihood of support for the entity, the sovereign rating, and the baseline credit profile rating. The final rating given to a government supported entity can change depending on changes to one or more of these factors.

The likelihood of extra-ordinary support is based on an opinion of the propensity of a government to intervene in a supportive and timely manner. This opinion on can include political and economic considerations and therefore the likelihood of support can change from time to time and this can affect the level of notching. A "high" likelihood of support can result in to up to a three-notch uplift. A "moderate" likelihood of support will only provide up to one notch.

A change in the sovereign rating can also change the level of notching. The higher the final rating of a government supported entity, the more sensitive it is to changes to the sovereign rating. For example, if an entity with a stand-alone credit profile rating of a- (with a "moderate" level of government support) would see its final rating change to A- (from A) if the sovereign rating was changed from AA to AA-. Whereas an entity with a stand-alone credit profile rating of bb+ (with a "moderate" level of government support) would see its final rating remain unchanged at BBB- if the sovereign rating was changed from AA to AA-.

A government supported entity with a stand-alone credit profile rating of bb+ (with a "moderate" level of government support) would only lose its notch for given for extra-ordinary government support if the sovereign rating was downgraded to BBB+.

For most government related entities, the stand-alone credit profile rating has a significant element of on-going government support. This can include regulatory support and provision

of government grants. On-going support is different to the provision extra-ordinary support that is reflected in the notching process described above. A weakening of the sovereign credit position can undermine the stand-alone credit profile and government related entities that are borderline investment grade could find themselves rated as non-investment grade without having any significant deterioration in their operational performance.

Mitigating the Risk of a Rating Downgrade

Increasing requirement to proactively manage ratings

There are various strategies to mitigate the risk of rating downgrade including looking at ways to improve operational margins through reducing costs or seeking additional sources of income. Improving margins, however, needs to be carefully managed to avoid increasing business risk that would offset the credit benefit of the improved margin. Other strategies may include improving the liquidity position through asset sales and new loan facilities and seeking to reduce gearing levels by accessing equity or equity-like sources of finance.

The weakened financial position faced by the UK government is likely to have knock on consequences for the credit standing of government related entities. It will be important not just to have a good understanding of the constituent elements that underpin the headline credit rating of a government related entity, but also to take proactive steps to protect the rating from potential downgrade.

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