INFORMATION NOTE

Ratings of Hong Kong by International Credit Ratings Agencies

1.   Introduction

1.1   The Panel on Financial Affairs (the Panel) at its meeting on 4 November 2002 requested the Research and Library Services Division (RLSD) to conduct a research on ratings of Hong Kong by international credit ratings agencies.   As agreed by the Panel, the research addresses the following three issues:

> (a)   rating rationale of international credit ratings agencies;
>
> (b)   ratings definitions of international credit ratings agencies; and
>
> (c)   credit ratings of Hong Kong in the last five years.

1.2   In this study, Standard & Poor's Ratings Services (Standard & Poor's) and Moody's Investors Service (Moody's) are selected because they are the leading global credit ratings agencies.

2.   Rating rationale

Standard & Poor's

2.1   Standard & Poor's credit ratings of a jurisdiction are an assessment of each government's ability and willingness to service its debt in full and on time.   A rating is a forward-looking estimate of default probability.   The appraisal of each government's overall creditworthiness is both quantitative and qualitative.   The quantitative aspects of the analysis incorporate a number of measures of economic and financial performance and contingent liabilities (i.e. the exact amount of liability is dependent upon some future events or circumstances).   The analysis also involves qualitative aspects of political and policy developments due to their importance in affecting future debt service capacity.

2.2   Standard & Poor's divides the analytical framework for jurisdictions into 10 categories.   To assign credit ratings, each jurisdiction is ranked on a scale of one (the best) to six (the worst) for each of the 10 analytical categories.   There is no exact formula for combining the scores to determine ratings.   The analytical variables are interrelated and the weights are not fixed, either across jurisdictions or over time.   Most categories incorporate both economic and political risks which are the key determinants of credit risk.   Economic risk addresses the government's ability to repay its obligations on time and is a function of both quantitative and qualitative factors.   Political risk addresses the jurisdiction's willingness to repay debt.

2.3   The 10 analytical categories are as follows:

(a) Political risk —

    (i)   stability and legitimacy of political institutions;
    (ii)   popular participation in political processes;
    (iii) orderliness of leadership succession;
    (iv) transparency in economic policy decisions and objectives;
    (v)   public security; and
    (vi) geopolitical risk.

(b) Income and economic structure —

    (i)   prosperity, diversity, and degree to which economy is market-oriented;
    (ii)   income disparities;
    (iii) effectiveness of financial sector in intermediating funds, and availability of credit;
    (iv) competitiveness and profitability of non-financial private sector;
    (v)   efficiency of public sector;
    (vi) protectionism and other non-market influences; and
    (vii) labour flexibility.

(c) Economic growth prospects —

    (i)   size and composition of savings and investment; and
    (ii)   rate and pattern of economic growth.

(d) Fiscal flexibility —

    (i)   general government revenue, expenditure, and surplus/deficit trends;
    (ii)   revenue-raising flexibility and efficiency;
    (iii) expenditure effectiveness and pressures;
    (iv) timeliness, coverage and transparency in reporting; and
    (v)   pension obligations.

(e) General government debt burden —

    (i)   general government gross and net (of assets) debt as a percentage of gross domestic product (GDP);
    (ii)   share of revenue devoted to interest;
    (iii) currency composition and maturity profile; and
    (iv) depth and breadth of local capital markets.

(f)   Offshore and contingent liabilities —

    (i)   size and health of non-financial public sector enterprises; and
    (ii) robustness of financial sector.

(g)   Monetary stability —

    (i)   price behaviour in economic cycles;
    (ii)   money and credit expansion;
    (iii) compatibility of exchange rate regime and monetary goals;
    (iv)   institutional factors such as central bank independence; and
    (v)   range and efficiency of policy tools.

(h)   External liquidity —

    (i)   impact of fiscal and monetary policies on external accounts;
    (ii)   structure of the current account;
    (iii) composition of capital flows; and
    (iv)   reserve adequacy.

(i)   Public sector external debt burden —

    (i)   gross and net public sector external debt;
    (ii)   maturity profile, currency composition, and sensitivity to interest rate changes;
    (iii) access to concessional funding; and
    (iv)   debt service burden.

(j)   Private sector external debt burden —

    (i)   gross and net financial sector external debt,
    (ii)   gross and net non-financial private sector external debt;
    (iii) maturity profile, currency composition, and sensitivity to interest rate changes;
    (iv)   access to concessional funding; and
    (v)   debt service burden.

Moody's

2.4   Moody's also provides credit ratings of jurisdictions. According to Moody's, credit rating involves a look into the future, it is therefore by nature subjective. It states that, since long-term credit judgements involve many factors unique to a particular economy, any attempt to reduce rating to a formulaic methodology will be misleading and will lead to serious mistakes. As a result, Moody's uses a multidisciplinary approach to risk analysis, which aims to bring an understanding of all relevant risk factors and viewpoints to the rating analysis. Moody's weighs these factors under various plausible scenarios and comes to a conclusion on what the rating should be.

2.5   In assigning credit ratings of jurisdictions, Moody's considers both quantifiable and qualitative criteria, which include:

> (a) Is there a substantial risk of changes in political regime which could lead to a general repudiation of debts?
>
> (b) Does the jurisdiction have a deep financial system which is effective in making payments and avoiding technical breakdowns?
>
> (c) Is the regulatory/legal environment malleable, corrupt, unpredictable, etc.?
>
> (d) Is there any possibility that the jurisdiction might impose controls on the domestic payments system (e.g. a deposit freeze) which could jeopardize many obligors' ability to repay debts on a timely basis?
>
> (e) Is there any change in the economic environment? If so, will the credit quality be affected?
>
> (f) Are there any changes in monetary and fiscal policies?

2.6   Standard & Poor's and Moody's apply its own rating rationale to assign appropriate long-term and short-term ratings for jurisdictions concerned. In addition, both Standard & Poor's and Moody's publish local currency and foreign currency ratings to reflect different risks, such as the fluctuations of local currency against foreign currencies, the availability of foreign exchange for repaying debt and the risk of imposing foreign exchange controls. As a result, the local and foreign currency ratings of a jurisdiction may not be the same.

3.   Ratings definitions

Standard & Poor's

3.1   Standard & Poor's long-term credit ratings and their definitions are presented in Table 1.   The long-term credit ratings range from the highest categories, 'AAA', to the lowest, 'D'.

Table 1 — Standard & Poor's long-term credit ratings and their definitions

Long-term credit ratings	Definitions
AAA	Highest rating. Extremely strong capacity to meet its financial commitments.
AA	Very strong capacity to meet its financial commitments.
A	Strong capacity to meet its financial commitments, but is somewhat susceptible to the adverse effects of changes in circumstances and economic conditions.
BBB	Adequate capacity to meet its financial commitments, but adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
BB	Less vulnerable in the near term than lower-rated obligors, but it faces major ongoing uncertainties or exposures to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitments.
B	More vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
CCC	Currently vulnerable, and is dependent upon favourable business, financial, and economic conditions to meet its financial commitments.
CC	Currently highly vulnerable to nonpayment.
D	Payment default on its financial commitments. The obligor will fail to pay all or substantially all of its obligations as they come due.

Notes:
[1.]   Ratings in the 'AAA', 'AA', 'A', and 'BBB' categories are regarded as investment grade, while ratings in the 'BB', 'B', 'CCC', and 'CC' categories are regarded as having significant speculative characteristics.
[2.]   The ratings from 'AA' to 'CCC' may be modified by addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

3.2   Table 2 shows Standard & Poor's short-term credit ratings and their definitions.   A short-term credit rating is an assessment of the likelihood of timely repayment of obligations considered short-term in relevant markets.   Generally speaking, short-term means that debt with original maturity of one year or less.

3.3   Short-term ratings are graded into several categories, ranging from 'A-1' for the highest quality obligations to 'D' for the lowest.   The 'A-1' rating may also be modified by a plus sign (+) to indicate that the obligor's capacity to meet its financial commitments is extremely strong.

Table 2 — Standard & Poor's short-term credit ratings and their definitions

Short-term credit ratings	Definitions
A-1	Strong capacity to meet its financial commitments.
A-2	Satisfactory capacity to meet its financial commitments.
A-3	Adequate capacity to meet its financial commitments, but adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
B	Has significant speculative characteristics. The obligor currently has the capacity to meet its financial commitments, but it faces major ongoing uncertainties which could lead to the obligor's inadequate capacity to meet its financial commitments.
C	Currently vulnerable to nonpayment and is dependent upon favourable business, financial, and economic conditions to meet its financial commitments.
D	Payment default on financial commitments. The obligor will fail to pay all or substantially all of its obligations as they come due.

Note:
[1.]   Ratings in the 'A-1', 'A-2' and 'A-3' categories are regarded as investment grade, while 'B' and 'C' ratings are regarded as speculative grade.

3.4   Standard & Poor's provides standard correlations of long-term ratings with short-term ratings (see Table 3 below).   Some long-term ratings may correlate with the same short-term rating.   For example, a long-term rating of 'A+' may correlate with short-term ratings of 'A-1+' or 'A-1', which depends on the situation of each case.

Table 3 — Standard & Poor's standard correlations of long-term ratings with short-term ratings

Long-term ratings	Short-term ratings
rankings between AAA and A+	A-1+
rankings between A+ and A-	A-1
rankings between A- and BBB	A-2
rankings of BBB and BBB-	A-3
rankings between BB+ and BB-	B

3.5   Standard & Poor's credit ratings are designed to remain stable over the course of normal business cycles.   Nevertheless, Standard & Poor's also recognizes that future events may diverge from current expectations.   Accordingly, CreditWatch listings and rating outlooks are vehicles that Standard & Poor's employs to calibrate uncertainty and address potential changes in creditworthiness.

3.6   When circumstances warrant — such as unforeseen changes in business position, finances or economic conditions — Standard & Poor's will place a government on CreditWatch, a signal to the market that the rating is subject to possible change within the near term.   A rating will be removed from CreditWatch once a decision is made to upgrade, downgrade, or affirm it.

3.7   Standard & Poor's rating outlooks (positive, negative, or stable) are assigned to all long-term credit ratings.   Outlooks are different from CreditWatch listings in terms of their longer time frame — one to three years — and their accounting for trends or risks with less impact on credit quality.

Moody's

3.8   Moody's long-term credit ratings and their definitions are shown in Table 4. The long-term credit ratings range from the highest categories, 'Aaa', to the lowest, 'C'.

Table 4 — Moody's long-term credit ratings and their definitions

Long-term credit ratings	Definitions
Aaa	Highest rating. Exceptional credit quality and has the smallest degree of risk. While the various protective elements are likely to change, such changes which may be visualized are most unlikely to materially impair the fundamentally strong position of such issues.
Aa	Excellent credit quality, but there may be elements present which make the long-term risks appear somewhat greater.
A	Good credit quality, but elements may be present which suggest a susceptibility to impairment over the long-term.
Baa	Adequate credit quality, but certain protective elements may be lacking or characteristically unreliable over any great length of time.
Ba	Questionable credit quality. The ability to meet punctually financial obligations may be uncertain and therefore not well safeguarded in the future.
B	Poor credit quality. Assurance of punctual payment of financial obligations over any long period of term is small.
Caa	Extremely poor credit quality. Such obligors may be in default, or elements of danger with respect to financial capacity may be present.
Ca	Usually in default on their financial obligations.
C	Lowest rating. Usually in default on their financial obligations, and potential recovery values are low.

Notes:

[1.]   Ratings in the 'Aaa', 'Aa', 'A', and 'Baa' categories are regarded as investment grade, while ratings in the 'Ba', 'B', 'Caa', 'Ca' and 'C' categories are regarded as speculative grade.

[2.]   Moody's applies numerical modifiers 1, 2, and 3 in each generic rating classification from 'Aa' to 'Caa'.   The modifier 1 indicates that the obligor ranks in the higher end of its letter-rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates that the obligor is in the lower end of its letter-rating category.

3.9   Moody's short-term credit ratings and their definitions are presented in Table 5.   According to Moody's, short-term means that the financial obligation with original maturity of one year or less.   Among short-term credit ratings, the highest rating category is 'Prime-1' whereas the lowest is 'Not Prime'.

Table 5 — Moody's short-term credit ratings and their definitions

Short-term credit ratings	Definitions
Prime-1	Superior credit quality and a very strong capacity for timely payment of short-term financial obligations.
Prime-2	Strong credit quality and a strong capacity for timely payment of short-term financial obligations.
Prime-3	Acceptable credit quality and an adequate capacity for timely payment of short-term financial obligations.
Not Prime	Questionable to poor credit quality and an uncertain capacity for timely payment of short-term financial obligations.

Note:

[1.]   Ratings in the 'Prime-1', 'Prime-2' and 'Prime-3' categories are regarded as investment grade, while rating in the 'Not Prime' category is regarded as speculative grade.

3.10   Similar to Standard & Poor's, Moody's provides the relationship between long-term and short-term ratings (see Table 6 below).   The same long-term rating may correlate with different short-term ratings.   For example, 'A1' of long-term rating may correlate with short-term ratings of 'Prime-1' or 'Prime-2', depending on the situation of each case.

Table 6 — Moody's standard correlations of long-term ratings with short-term ratings

Long-term ratings	Short-term ratings
rankings between Aaa and A3	Prime-1
rankings between A1 and Baa2	Prime-2
rankings of Baa2 and Baa3	Prime-3
rankings between Ba1 and C	Not Prime

4.   Credit ratings of Hong Kong in the last five years

Standard & Poor's

4.1   Standard & Poor's credit ratings of Hong Kong in the last five years are shown in Table 7 below.   In October 2002, Standard & Poor's released its latest credit ratings on Hong Kong, with the outlook on the long-term foreign currency ratings of 'A+' remaining 'stable'.   However, it revised its outlook on the long-term local currency rating on Hong Kong from 'stable' to 'negative'.   According to Standard & Poor's, the outlook revision reflects persistent fiscal pressures caused by ongoing economic changes in Hong Kong.

Table 7 — Standard & Poor's credit ratings of Hong Kong in the last five years

Local currency ratings				
Date	**Long-term**	**Rating outlook**	**Short-term**	**Rating action**
October 2002	AA-	Negative	A-1+	Revise rating outlook from 'stable' to 'negative'.
February 2001	AA-	Stable	A-1+	Raise both long-term and short-term ratings.
December 1999	A+	Stable	A-1	Revise rating outlook from 'negative' to 'stable'.
August 1998	A+	Negative	A-1	Lower both long-term and short-term ratings and revise rating outlook from 'watch negative' to 'negative'.
June 1998	AA-	Watch Negative	A-1+	Revise rating outlook from 'stable' to 'watch negative'.
May 1997	AA-	Stable	A-1+	Raise both long-term and short-term ratings and revise rating outlook from 'positive' to 'stable'.
Foreign currency ratings				
Date	**Long-term**	**Rating outlook**	**Short-term**	**Rating action**
October 2002	A+	Stable	A-1	Both long-term and short-term ratings, as well as rating outlook remain unchanged.
February 2001	A+	Stable	A-1	Raise long-term rating.
December 1999	A	Stable	A-1	Revise rating outlook from 'negative' to 'stable'.
August 1998	A	Negative	A-1	Lower both long-term and short-term ratings, and revise rating outlook from 'watch negative' to 'negative'.
June 1998	A+	Watch Negative	A-1+	Revise rating outlook from 'stable' to 'watch negative'.
May 1997	A+	Stable	A-1+	Raise both long-term and short-term ratings, and revise rating outlook from 'positive' to 'stable'.

Moody's

4.2   Moody's credit ratings of Hong Kong in the last five years are shown in Table 8 below.   Moody's upgraded the long-term local currency ratings from 'A1' to 'Aa3' in October 2000.   Since then, this rating has not been changed.   In regard to the long-term foreign currency ratings, an 'A3' rating has been assigned since February 1998.

Table 8 — Moody's credit ratings of Hong Kong in the last five years

Local currency ratings		
Date	**Long-term**	**Rating Action**
October 2000	Aa3	Raise long-term rating.
October 1998	A1	Assign long-term rating.
Foreign currency ratings			
Date	**Long-term**	**Short-term**	**Rating Action**
October 2000	A3	Prime-1	Raise short-term rating.
October 1998	A3	Prime-2	Both long-term and short-term ratings remain unchanged.
February 1998	A3	Prime-2	Lower short-term rating.

Note:
1.   Moody's has not assigned the short-term local currency ratings of Hong Kong.

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