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Fitch Takes Rating Actions on El Salvador Following Local Law Securities Debt Exchange

Fitch Ratings - New York - 05 May 2023: Fitch Ratings has downgraded El Salvador's Long-Term Foreign Currency Issuer Default Rating (IDR) to 'RD' from 'CC' following the execution of an exchange of domestic pension-related debt. Fitch believes that the recent exchange constituted a default event as outlined in Fitch's "Sovereign Rating Criteria" published April 6, 2023.

Subsequently, reflecting the completion of the debt exchange, Fitch has taken the following actions:

--Upgraded El Salvador's Long-Term Foreign Currency Issuer Default Ratings (IDR) to 'CCC+' from 'RD', and upgraded the country ceiling to 'B' from 'B-'.

--Affirmed the Short-Term Foreign Currency ratings at 'C'.

Fitch typically does not assign Outlooks to sovereigns with a 'CCC+' rating or below.

A full list of rating actions follows at the end of this rating action commentary.

Key Rating Drivers

Pension-Related Debt Exchange: On April 28th, outstanding Certificados de Inversion Previsional (CIP) issued to private pension funds (AFPs) under domestic law were exchanged for Certificados de Financiamiento de Transicion (CFT), as outlined by the pension reformed approved last year (Dec. 20, 2022). The new debt instruments were issued by the newly created Instituto Salvadoreno de Pensiones (ISP), which replaced the Fideicomiso de Obligaciones Previsionales (FOP).

The government offered three series (A, B, C) to the following private pension funds: series A replicates the terms of the restructured CIPs in 2017 (USD6.2 billion outstanding) with a maturity of 24 years and yield of 4.5%; series B coincides with the CIPs issued after 2017 (USD2.2 billion outstanding) with a maturity of 44 years and yielding 6%; series C offers a higher yield of 7% in exchange for an extension of maturity to 50 years and a four-year grace period. The private pension funds chose series C by an overwhelming majority.

Default Event: Fitch deems this operation a Distressed Debt Exchange (DDE), constituting a default under Fitch's criteria. The exchange involved an adverse change in terms via the extension of maturities and the addition of a grace period on the majority of the public securities in question. In Fitch's view, the exchange operation was aimed at reducing the sovereign's financing needs against the backdrop of El Salvador's tight financing constraints and financial distress.

Rating Upgrade: The upgrade of El Salvador's IDR follows the successful completion of the exchange. This reflects Fitch's view that another default event no longer appears probable but remains a real possibility in light of compromised repayment capacity. El Salvador's 'CCC+' rating reflects fiscal and external liquidity positions that have improved relative to Fitch's prior expectations and following the payment of sizeable global bond amortizations earlier in the year, but remain tight, as well as constrained market access and high reliance on short-term debt.

Fiscal Consolidation Efforts: The government's fiscal deficit declined significantly to 2.5% of GDP in 2022, from 5.5% in 2021 and 10.1% in 2020. The ongoing fiscal consolidation has been driven both by robust tax collection and expenditure restraint. Fitch anticipates the fiscal consolidation will continue this year as the debt-exchange has materially diminished pension-related expenditures.

External debt service risks declined as the government bought back a sizeable portion of its sovereign external bonds maturing 2025. The operation reduced the total amount outstanding to USD348 million (1% of 2023 GDP) from USD800 million. Non-financial public sector debt reached 75.9% at year-end 2022 down from 80.4% in 2021 and 88.1% in 2020. Fitch anticipates government debt/GDP will continue to decline over the coming years given an improvement of the primary balance.

Financing Sources Remain Limited: External borrowing costs remain prohibitively high, rendering the government dependent on short-term domestic debt (LETES and CETES). Short-term debt reached 8.4% of GDP at YE 2022 and remains at elevated levels. The banks' appetite and capacity to increase their short-term debt holdings is limited, but they are likely to continue extending these positions. Multilaterals are providing the funding to bridge the financing gap, particularly the Central American Bank for Economic Integration (CABEI), the Development Bank of Latin America (CAF), and the World Bank.

CABEI has provided most of the budgetary funding, but its capacity to significantly increase its lending remains unclear. Adoption of bitcoin as legal tender and broader governance concerns have been obstacles to reaching an agreement for an IMF program, which could open up additional sources of multilateral lending.

Precarious Foreign Reserves Levels: International reserves have declined over the past four years, pressured mostly by a wide current account deficit (CAD) and high external amortizations. International reserves declined by USD900 million to USD2.4 billion in 2022 and have only moderately grown through 1Q23. Around USD2.2 billion of reserves (almost 85%) correspond to the reserve requirements of the banking system, and drawdown of this for external sovereign debt service could imperil financial stability under the dollarization regime.

The CAD reached 6.6% of GDP in 2022 from 4.3% in 2021 as imports outgrew exports. Remittances inflows are a mainstay of the economy and were 24% of GDP in 2022, albeit down from 25.7% in 2021 as remittances lagged nominal GDP growth.

Country Ceiling Upgrade: Fitch upgraded El Salvador's country ceiling to 'B' given the absence of any capital controls which would potentially constrain private sector debt repayment capacity. The government has not imposed or signaled any intent of imposing such controls despite recent periods

of sovereign stress. El Salvador's dollarization regime further reduces incentives for imposing capital control.

ESG - Governance: El Salvador has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBG I) has in Fitch's proprietary Sovereign Rating Model. El Salvador has a medium WBG I percentile ranking of 36.7%, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

ESG - Creditor Rights: El Salvador has an ESG Relevance Score of '4' for Creditor Rights, as willingness to service and repay debt is highly relevant to the rating and is a key rating driver with a high weight.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Public Finances: Intensification of financing strains that weaken willingness and/or capacity to service government debt, as a result of fiscal deterioration that increases financing needs or deterioration in financing sources.

--External Finances: Further decline in external liquidity that heightens risks to financial stability and debt repayment capacity.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Public Finances: Fiscal consolidation efforts than lead to a material reduction in financing needs and/or easing of financing constraints through progress in unlocking additional funding sources.

--External Finances: Improvement of the current account deficit resulting in a sustained improvement of foreign reserves.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns El Salvador a score equivalent to a rating of 'CCC+' on the Long-Term Foreign-Currency IDR scale. However, in accordance with its rating criteria, Fitch's sovereign rating committee has not utilized the SRM and QO to explain the ratings in this instance. Ratings of 'CCC+' and below are instead guided by the rating definitions.}

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

El Salvador has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As El Salvador has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

El Salvador has an ESG Relevance Score of '5' for Rule of Law, Institutional, Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As El Salvador has a percentile rank below 50 for the respective Governance Indicators, this has a negative impact on the credit profile.

El Salvador has an ESG Relevance Score of '4' for Creditor Rights as willingness to service and repay debt is highly relevant to the rating and is a key rating driver for El Salvador given the implementation of buy backs of 2023 and 2025 bonds at below par and the recent implementation of pension debt exchange that Fitch deemed a default.

El Salvador has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As El Salvador has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
El Salvador	LT IDR	RD	Downgrade	CC
	LT IDR	CCC+	Upgrade	RD
	ST IDR	C	Affirmed	C
	Country Ceiling	B	Upgrade	B-
	• senior unsecured LT	CCC+	Upgrade	CC

RATINGS KEY OUTLOOK WATCH

POSITIVE	⊕	◊
NEGATIVE	⊖	◊
EVOLVING	◊	◆
STABLE	○	

Applicable Criteria

[Country Ceilings Criteria \(pub.01 Jul 2020\)](#)

[Sovereign Rating Criteria \(pub.06 Apr 2023\) \(including rating assumption sensitivity\)](#)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.3 [\(1\)](#)

Macro-Prudential Indicator Model, v1.5.0 [\(1\)](#)

Sovereign Rating Model, v3.13.3 [\(1\)](#)

Additional Disclosures

[Solicitation Status](#)

Endorsement Status

El Salvador EU Endorsed, UK Endorsed

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