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Clockwise from top left: Agence France-Presse/Getty Images; Bloomberg News; Reuters; Agence France-Presse/Getty Images; Reuters

BUSY DAY: Clockwise from top left: French President Nicolas Sarkozy, with Greek Prime Minister George Papandreou and German Chancellor Angela Merkel; Irish Prime Minister Enda Kenny; Spain's Prime Minister José Luis Rodríguez Zapatero; European Commission President José Manuel Barroso; Italian Prime Minister Silvio Berlusconi

What Constitutes a Greek Default? And Who Decides?

The euro-zone crisis is bringing ratings agencies once again into sharp focus, with euro-zone governments eager to avoid anything that could be considered a default as they try to restructure Greece's debt. After several failed attempts, euro-zone officials are now saying the plan could be to allow a default.

But how do the credit ratings agencies decide whether a Greek restructuring plan constitutes a default? Who are the decision makers? And what criteria do they use to make such a decision?

While there are a multitude of ratings companies, market participants tend to look to the opinions of the three largest: Moody's Investors Service Inc., Standard & Poor's Corp., and Fitch Ratings Inc. These companies are paid to issue ratings on different types of bonds, including those issued by companies and banks. (Moody's is a unit of Moody's Corp., while S&P is owned by McGraw-Hill Cos. and Fitch is a majority-owned subsidiary of Fimalac SA.)

> Moody's said ratings require an assessment of both quantitative and qualitative factors.

In many cases, sovereign-debt ratings aren't paid for by the country. For instance, in February S&P converted its ratings on Belgium, France, Germany, Italy, the Netherlands, Switzerland, the U.K. and the European Central Bank to "unsolicited," saying it has enough reliable public information on the countries and that there is significant interest in their ratings. It wasn't immediately possible to confirm whether Greece pays for its rating.

A rating on a company is based on factors including its financial strength, its past performance and the environment in which it operates. However, sovereign ratings assess a much more complex web of factors.

In its most recent sovereign methodology report, Moody's said sovereign ratings require an assessment of both quantitative and qualitative factors, "whose interaction is often difficult to predict."

"A mechanistic approach based on quantitative factors alone is unable to capture the complexity of the interaction between political, economic, financial and social factors that define the degree of danger, for creditors, of a sovereign credit," Moody's said.

So just who decides on the part this complex interaction plays?

At Moody's, a committee decides. The committee is made up of ratings analysts, including the analyst responsible for the country on which the committee is deliberating.

However, it may also include analysts who might normally look at other entities such as companies or banks.

The committee deliberates and then votes. The lead analyst on the country gets the same single vote as other committee members. However, the most junior analyst on the committee votes first, going through to the most senior person last in an attempt to avoid any top-down influence.

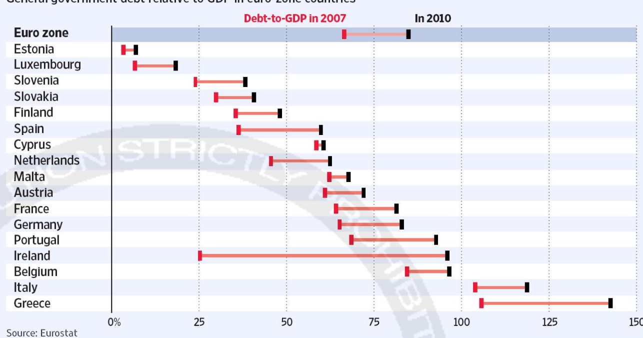
Crucially, part of the decision on a sovereign-rating change is based not just on the ability but also the willingness of a government to pay.

"Sovereign risk analysis is a synthesis of quantitative and qualitative judgments that capture the willingness as well as the capacity to pay," according to Fitch Ratings' sovereign methodology report.

Moody's and S&P are based in New York, while Fitch has dual headquarters in New York and London.

Overextended

General government debt relative to GDP in euro-zone countries



Source: Eurostat

Euro Zone in New Deal on Greece

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ments to help them boost the capital of their banks, and to help them buy back bonds from other countries.

The draft suggested how the governments might cope with a possible default of Greek sovereign debt: "Credit enhancement will be provided to underpin the quality of collateral so as to ensure access to Eurosystem liquidity operations for Greek banks," it says.

Such "credit enhancements" can guarantee some payments to investors.

Euro-zone officials said Thursday that a default might result from their plans to get Greece's private-sector creditors to help finance the country's debt.

That might lead the European Central Bank to reject Greek bonds as collateral for lending, threatening a crucial source of liquidity to Greek banks.

Officials have said that one idea under discussion would be to give Greek banks triple-A-rated bonds that could be bundled with defaulted Greek bonds and used as collateral for lending from the ECB.

Although the ECB Thursday appeared to be coming around to the idea of a temporary default after months of opposition, some senior European Union officials said it is seeking compensation in return for any losses it suffers from the plan. "The ECB wants to be compensated by the EFSF from any losses it suffers so as to continue accepting Greek bonds as collateral," one of these officials said.

This demand, which had been a sticking point in the talks, appeared to have been met.

The official said the ECB governing council is expected to consider the plan in the next few days, and with no last-minute hitches, was expected to agree to continue accepting Greek bonds as collateral for its loans to banks.

One possibility under discussion has been for the EFSF to protect the ECB from losses by buying at cost price the almost €50 billion of Greek bonds it is estimated to hold.

The ECB has expressed concern that a Greek default could hurt other countries by encouraging investors to believe a similar approach is likely for Portugal and Ireland.

A rating agency may assign a selective default rating if a borrower misses a payment on a specific bond or loan, but continues to service its other debts.

The euro climbed against the dollar Thursday as details of a potential deal started trickling in, but later fell back.

Investors have been wary of the common currency in recent weeks, as fears of contagion risks and uncertainty about a financing package for Greece have dominated peripheral countries' bond markets.

Talks were also under way in Brussels between euro-zone officials and top bankers, led by Josef Ackermann, chief executive of Deutsche Bank, about the options.

According to officials, there had been no discussion about expanding the capacity of the EFSF to lend more than €440 billion it can at present. Such a decision may be necessary in future, they said.

—Nathalie Boschat, Matthew Dalton, Maarten van Tartwijk, Geraldine Amiel, Marcus Walker and Laurence Norman contributed to this article.

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