International Local and Regional Governments Rating Criteria

Outside the United States

Sector-Specific Criteria Report

This criteria report updates and replaces International Local and Regional Governments Rating Criteria dated 5 March 2012

Sector-Specific Criteria: This criteria report incorporates and expands upon the Master Criteria report *Tax-Supported Rating Criteria,* 14 August 2012 (see *Related Research*), with a focus on international local and regional governments. It identifies rating factors that are considered by Fitch Ratings in assigning ratings to a particular entity or debt instrument within the scope of the Master Criteria and in different jurisdictions.

Application: Not all rating factors in this report may apply to each individual rating or rating action. Each specific Rating Action Commentary or rating report will discuss those factors most relevant to the individual rating action.

Institutional Framework: To determine the rating of an international local or regional government outside the United States (for US-specific criteria see *U.S. State Government Tax-Supported Rating Criteria*, 14 August 2012 and *U.S. Local Government Tax-Supported Rating Criteria*, 14 August 2012), Fitch first evaluates the institutional framework under which the subnational operates (see *Assessment of the Institutional Framework for Subnationals – Key Inputs in the Rating Process*, 23 March 2011).

Additional Rating Factors: Once the institutional framework has been assessed, Fitch then analyses the four major rating factors to establish the general quality of the local or regional government. These include debt and other long-term liabilities, budgetary performance, management and administration, and the local economy.

Trend Analysis: Fitch's rating process involves analysing relevant trends and identifying actual and potential future obligations and exposures. The analysis is carried out in the context of the institutional framework in the jurisdiction in which the rated entity is located and will take into account Fitch's base case scenario.

Interaction of Rating Factors: Although an issuer may have a vibrant and wealthy economy, weak fiscal management or stringent tax rate limits may offset the resulting positive credit factors, resulting in a reduced ability to meet obligations. A weak economy may be offset by other strengths, such as proactive management, higher support by way of transfers from upper tiers of government or low debt.

Debt Securities: When a specific security is rated, the rating will reflect the nature of the security and its relationship to the general credit quality of the issuer.

Related Criteria

Tax-Supported Rating Criteria (August 2012)

Rating Subnationals Above the Sovereign - Outside US (May 2012)

Related Research

Assessment of the Institutional Framework for Subnationals – Key Inputs in the Rating Process (March 2011)

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Institutional Framework

Figure 1
Attributes: Institutional Framework

Stronger	• Effective oversight from upper tiers of government • Strong horizontal and vertical equalization • Realistic prudential ratios with penalties for non adherence • Formula driven and predictable transfers systems • International accounting policies with both accruals and cash based financial data provided
Midrange	• Satisfactory levels of control from upper tiers of government • Formula driven horizontal equalization but limited vertical equalization • Some prudential regulations in place • More limited budgetary and financial information requirement
Weaker	• Constant interference from upper tiers of government, • No predictability in the funding from upper tiers of government • Limited or inadequate controls in place • Constant changes in responsibility • Cash based accounting only

Source: Fitch

A study of the institutional framework in which the subnational authority operates is a fundamental and necessary beginning to Fitch's rating process. Once the agency has a clear view of intergovernmental relations and funding, it assesses the other rating factors.

The institutional framework, whether centralised or decentralised, influences subnationals' operating revenue and expenditure. To assess it, Fitch looks at the revenue structure and flexibility of the subnational and the funding arrangements, if any, from the central government. Any equalisation mechanisms in place that could mitigate a weaker socio-economic profile would be viewed as positive. An assessment of the type of responsibilities of the subnational, whether operating or investment focused, is also important.

A detailed description of the types of public services provided by the entity, and an understanding of the legal and regulatory environment, enables Fitch to assess the degree of autonomy, rigidity of expenditure, demand for capital investment and other constraints. Full autonomy is rare, and cities, provinces, and other local governments are normally subject to constitutional and statutory regulation regarding governmental powers, organisational structure, financial operations, debt issuance, and government service provision. Therefore, in most cases a sovereign government has greater financial flexibility than its political subdivisions.

In analysing the strength of the institutional framework, Fitch gauges, amongst other things, the level of control the central or upper tiers of government have over the subnational. The agency views prudential regulations (eg, debt or debt-servicing limits) favourably if they are not too restrictive. In developed markets where debt-management experience among subnationals is considerable, formal prudential regulations can be replaced by capital market discipline. However, in countries with an evolving regulatory framework or where responsibilities have recently been devolved to the subnational, prudential regulations can act as a control mechanism for responsible debt accumulation and affordability.

In most cases, both the Long-Term Foreign- and Local-Currency ratings of the sovereign limit the ratings of the subnational government. Normally the sovereign local- and foreign-currency Issuer Default Ratings cap those of subnational authorities. Nevertheless, in some jurisdictions, if the subnational has a large degree of fiscal autonomy, there is no history of central government intervention, and the subnational does not heavily rely on state transfers, it may not be capped by the rating of the sovereign if the former's fiscal and financial situation is strong (see *Rating Subnationals Above the Sovereign,* 2 May 2012 under *Related Research*). Fitch does not apply a floor to its ratings of subnationals even though in some instances

sovereign support through extraordinary funding to a troubled subnational has been forthcoming.

Financial Reporting and Accounting

Where established accounting practices and requirements exist, Fitch expects the issuer to be in compliance with them. Additional financial reporting, such as interim revenue reporting throughout the year, is viewed positively.

Fitch considers financial statements audited by an independent and reputable accounting firm to be optimum but it understands that many governments do not provide them as it is not a legal requirement. Budgetary and cash flow presentations are the most commonly available form of financial disclosure for non-US public finance entities.

Debt, Other Long-Term Liabilities and Liquidity

Figure 2
Attributes: Debt and Other Long-Term Liabilities

Stronger	• Low overall debt levels as measured by debt to current revenue (less than 50%) • Low debt service burden (below 5 years of the operating balance) • Modest future capital and debt needs, with comprehensive long-term capital planning; • Predominantly fixed-rate, amortizing debt (less than 15% in unhedged variable-rate or other short-term debt) • Limited indirect risk and strong liquidity • PSE funded largely from third party fees • Professional debt management office, conservative use of derivative instruments • Substantial available liquidity, without requiring external short-term borrowing
Midrange	• Moderate overall debt levels as measured by debt per current revenue (less than 100%) • Affordable debt burden (between 5-10 years of the operating balance) • Manageable future capital and debt needs with identified funding sources; attention to long-term capital planning • Mostly fixed-rate, amortizing debt (15%–25% of unhedged variable-rate or other short-term debt) • Some loss making PSEs • Sound available liquidity; some external short-term borrowing may be required
Weaker	• Above-average to high overall debt levels as measured by debt to current revenue in excess of 100% • High debt burden (more than 10 years of the operating balance • Large future capital and debt needs without identified funding sources; limited attention to long-term capital planning leading to deferred maintenance • Elevated levels of variable or other short-term debt (greater than 50%) • Highly indebted public corporate sector which require on going transfers or capital injections • Low liquidity levels; reliance on external short-term borrowing to meet routine obligations (greater than 15% of general fund receipts)

Source: Fitch

In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature of the issuer's current liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Debt Ratios and Trends

Debt analysis includes a review of trends in the amount of debt issued and outstanding. Fitch analyses the trend in debt in relation to resources. Sustained increases in debt at a rate above economic growth may overburden a tax base and strain budget resources.

Fitch uses various ratios to measure the direct burden of debt on the issuer's population and tax base. Calculations include all long-term, fixed obligations of the issuer, excluding unfunded pension and other post-employment benefit liabilities, which are considered separately in the context of an issuer's overall long-term liabilities. In general, a low debt burden is a positive credit factor.

Future Capital and Debt Needs

Debt factors are considered within the context of the issuer's infrastructure needs and capital plans. Current debt levels may be low; however, future capital projects may significantly increase debt ratios, weakening the issuer's debt profile. Fitch evaluates the impact of expected future debt on the issuer's debt ratios and views favourably a comprehensive and realistic approach to capital planning. The issuer's ability to meet its capital needs where there are restrictions on debt issuance is also a consideration.

Debt Structure

In some developed markets, subnationals are strongly reliant on short-term domestic bank funding. This can result in high refinancing risk. In addition, bank loans may carry high interest rates to compensate for inflation in the country or country risks (political, financial, economic, and institutional risks). Besides the international credit markets, major sources of inexpensive long-term debt may include multilateral or project financing.

Fitch reviews the types and proportions of debt used and the rate at which it is repaid. Slow amortisation rates limit long-term financial flexibility. The review of outstanding debt also includes an assessment of the uses of borrowed funds, with uses for non-capital purposes considered a credit weakness.

Another consideration is the percentage of fixed-rate debt in the issuer's debt structure. Fitch views high levels of variable-rate debt with concern as they can expose the issuer to the possibility of unexpected and, in extreme cases, unaffordable future financial debt burdens. Fitch evaluates whether the issuer has a clear understanding of the benefits and risks of entering into these types of transactions and instruments.

Fitch also views high levels of short-term debt as a concern as it increases re-financing risk. Fitch examines an issuer's average life of debt amortisation, taking into account the national environment, the use of debt proceeds and depth of the capital markets. A short ratio ie, under three years, may be a credit weakness because it may indicate significant refinancing risk. A longer ratio, seven to 10 years or even more, is a credit positive.

Pension and Other Post-Employment Benefit (OPEB) Funding

Fitch reviews pension and OPEB funding as part of the analysis of risk, recognising that pension and retiree health benefits represent a more variable commitment to future payments than debt to the extent that they can be influenced by a variety of actuarial, accounting, investment, or other policy decisions of the sponsoring government.

Fitch's analysis focuses on the size of the liability, the funded ratio, measures of affordability, and actuarial and other assumptions influencing the burden. The agency views favourably entities that have well-funded pension plans and consistently fund the annual required contribution. In cases where the unfunded liability is large, Fitch views positively actions or plans to reduce it over time. Concerns arise if the liability level is high or increasing.

Indirect Risks and Contingent Liabilities

In some countries, a large part of the overall subnational risk has been decentralised through the creation of public sector entities that have taken on debt. These entities may largely be funded by transfers from the issuer. In looking at an issuer's debt obligations, Fitch therefore not only examines liabilities directly incurred and payable by the issuer but also outstanding debt for which the issuer may in future have an obligation. Such obligations are monitored but typically excluded from debt calculations that include the direct debt of the issuer either through bank loans or debt issuance. They are, however, included in Fitch's total tax-supported debt calculations. The latter would include the direct risk of the issuer and the debt of non-self-supporting public sector entities, as well as unfunded pension obligations.

Liquidity

Fitch analyses an issuer's liquidity position, including tax collection schedules, timing of transfers received, the timing of disbursements, and the quality and timing of receivables and payables. Those in the strongest position do not depend on external cash flow borrowing. The liquidity analysis is particularly important in financially strained situations or in those cases where access to the capital or debt markets becomes more difficult.

Fiscal Performance

Figure 3
Attributes: Fiscal Performance

Stronger	• Diverse, stable, and broad-based sources of operating revenue with substantial flexibility to be increased, if needed • Ample ability to adjust spending, either as part of the budget process or during the fiscal year, without undue impact on service provision • Consistently positive operating margins, in excess of 15% • Ability to easily adjust capital expenditure and high proportion of capex funded from internal resources • Consistently sound reserve levels, with automatic funding mechanisms and clear restrictions on their use
Midrange	• Somewhat concentrated operating revenue, but in a relatively broad-based, stable source, with some flexibility to be increased, if needed • Some ability to make spending adjustments, although avenues to make reductions may be limited without affecting services, or less timely. • General trend of positive operating margins, between 5% to 15% • Large proportion of capex funded from the current balance • Satisfactory reserve levels maintained over time, although some year-to-year fluctuation may be present
Weaker	• Severely limited revenue flexibility particularly in a declining revenue environment • Spending levels heavily dictated by long-term contracts or other agreements that make adjustments difficult, if not impossible • Trend of negative operating margins • Consistent budget deficits and capital expenditure funded essentially from borrowing • Low or severely reduced reserve levels, without a clear path to replenishment

Source: Fitch

The analysis of an issuer's finances is focused on evaluating the issuer's financial resources and flexibility to support its financial obligations over the short and long term. The analysis begins with a review of the issuer's financial statements, budgets, budget outcomes and accounting policies. A balance sheet disclosing cash balances, intra-government borrowing (among the various related entities of the subnational authority), and assets and liabilities is an ideal starting point. Adherence to international accounting principles is also positive.

Revenue Analysis

Fitch reviews revenue sources for volatility, diversity and predictability. In general, a diverse revenue system with a foundation of broad-based taxes is more stable and better able to capture the issuer's economic wealth, resulting in a stronger financial profile. Reliance on economically sensitive revenue such as real estate transactions may expose the issuer to financial volatility and lead to a credit concern. An issuer's ability to control its own revenue sources, including the power to adjust tax rates, is an important credit positive. For entities that rely heavily on funding from another tier of government, Fitch evaluates the consistency of the funding and how any adjustments would affect the rated issuer.

Fitch also looks at dedicated transfers, if any, that can only be used for specific expenditure, to assess the revenue available for debt servicing in case of stress.

Expenditure Analysis

Fitch reviews trends in expenditure, the issuer's flexibility to make adjustments in spending, (both as part of the annual budget process and during the course of the fiscal year), and the expected stability of each major spending item. For example, an issuer with a high fixed-cost burden or a highly unionised workforce will generally have less ability to make meaningful spending cuts than one with a low fixed-cost burden or a more flexible labour situation. In addition, in some countries the employment position of civil servants is protected and therefore the issuer is unable to cut the public labour force to reduce operating costs. The analysis also considers potential funding pressures, including outstanding litigation. The centralised ability, or mandate, to implement timely spending cuts to maintain balance is a credit strength.

Operating Revenue and Expenditure Trends

Fitch evaluates recurring revenue compared with recurring expenditure. Concerns arise when operating expenditure consistently exceeds operating revenue, as the use of non-recurring revenue is unsustainable and usually leads to depletion of reserves and deeper financial imbalances.

Fund Balance and Reserve Levels

Fitch views a satisfactory fund balance as an important cushion against potential revenue and expenditure volatility. The amount Fitch considers satisfactory varies depending on such factors as economic or tax base concentration, revenue and/or expenditure volatility, and flexibility to adjust revenue and spending. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features, but fund balances that have been maintained consistently over time are also beneficial. Similarly, segregated funds that are available, or could be made available, for general expenditure can contribute to financial flexibility.

Management and Administration

Management practices and actions can positively or negatively influence the other major credit factors, affording strong ratings to entities with limited economic or financial resources or weaker ratings to more diverse or affluent entities.

Figure 4
Attributes: Management and Administration

Stronger	• Highly efficient decision-making process, based on financial prudence • No governance concerns • Strong evidence of consistent co-operation among officials • Institutionalized, prudent financial and debt management policies that are consistently followed • Conservative and thorough budgeting process with regular interim reviews, contingency planning, and the ability to make adjustments as needed during the fiscal year • Long-term financial planning process • Good level of transparency and disclosure • Timely financial reporting
Midrange	• Efficient decision-making process • Evidence of generally cooperative relationship among officials • Financial and debt management policies that may be somewhat less conservative but still reasonable and, if not followed, a process is in place to regain compliance • Realistic budgeting process and some ability to make adjustments during the fiscal year • Good level of transparency but limited public disclosure • Timely financial reporting
Weaker	• Often cumbersome decision-making process; resolution of key issues is problematic • Difficulty in gaining consensus among officials • Some governance concerns • Financial and debt management policies not present or not consistently followed, without plans to gain compliance • Optimistic budget assumptions and inflexible budget amendment process that makes midyear adjustments difficult • Weak level of disclosure or reliability of accounts • Financial reporting delayed

Source: Fitch

Institutionalised Policies

Fitch views positively implementation and consistent adherence to sound processes and policies for budgeting, debt, and financial operations. Particularly beneficial practices include established rainy-day reserve funds (particularly those with automatic funding sources and limits on use), sinking funds for bullet debt repayments, multiyear revenue and expenditure forecasts, restricting use of non-recurring revenue to non-recurring expenses, sound capital planning, investment policies and practices, and debt affordability guidelines.

Budgeting Practices

Fitch reviews an issuer's budgeting practices, particularly revenue and expenditure estimates, and compares the key assumptions included in an issuer's budgets to actual revenue and expenditure over time. Fitch views conservative estimates favourably and is concerned if an issuer does not appear to be fully incorporating current economic, political, or financial conditions. Regular intra-year budget reviews, which allow an issuer to identify underperforming revenue or overspending in time to make necessary adjustments to eliminate or lessen budget gaps, are also a positive credit factor.

Political, Taxpayer, and Labour Environment

Fitch expresses no preference for one form of government over another and does not view any type as inherently better for credit quality. However, political stability, and confidence in the political system at the central and subnational level are credit positives. The key credit element is the efficiency with which a subnational government can make service and spending decisions and its ability to adjust and react to changing economic and financial conditions. A history of cooperation between the executive and legislative branches gives Fitch comfort that financial challenges will be handled effectively.

Evidence of taxpayer dissatisfaction, with the level either of taxation or of service provision, is a credit concern, as it may reduce an issuer's flexibility to address budget shortfalls. A negative

taxpayer environment could include voter initiatives or legislative attempts to contain the government's legal ability to raise revenue. This concern increases in environments with easy access to the voter initiative process. Similarly, a difficult labour environment can limit budgetary options.

Revenue and Spending Limitations

Establishing and adhering to policy guidelines is considered a credit positive. However, onerous statutory or constitutional operating limitations are potential credit risks. In addition, Fitch recognises that in some instances practical limitations are just as restrictive. An inability to raise revenue or fund programmes to adequate levels due to political or other practical concerns can have long-term implications for an issuer's financial and economic health.

Economy

Figure 5

Attributes: Economy

Stronger	• Broad, diverse, and stable economic base • Lack of taxpayer concentration (less than 3% for the single largest and 10% for the top 10) • Consistent, moderate population and employment growth levels • Stability and diversity among major employers • Robust wealth indicators, including personal income per capita • Moderate tax burden relative to area or other similar communities nationally • Good infrastructure and business environment
Midrange	• Fairly diverse economic base • Moderate taxpayer concentration (3%–5% for the single largest and 10%–15% for the top 10) • Stagnant or rapidly growing population • Moderately diverse employment base, with some dominance of a few industries or employers • Sound wealth indicators, including average to above-average personal income per capita
Weaker	• Small, limited, or concentrated economic base • Taxpayer concentration (above 5% for the single largest and 15% for the top 10) • Declining or extremely rapidly growing population (greater than 10% per year) • Dominance of one or a handful of industries or employers • Unfavourable demographic profile • Below-average wealth indicators

Source: Fitch

Fitch's economic analysis considers the capacity of the issuer's economic base to support balanced operations and repayment of debt, capital expenditure needs and provides insight into potential future financial and debt resources or challenges.

Major Economic Drivers

The evaluation of the economy begins with a determination of the types of economic activity that dominate the area. For example, some issuers are heavily reliant on an industry like automobile manufacturing or natural resource mining, while others have a more diverse base. A broad, diverse, and stable economy is a credit strength, and undue concentration on one or a small group of industry sectors or taxpayers, or a high level of cyclicality may be cause for concern. For issuers that are dependent on property taxes for a large proportion of their revenue, Fitch pays particular attention to the level of and trends in the valuation of the total tax base and the largest taxpayers.

Employment

Fitch reviews trends in employment and seeks an understanding of why a given employer or employment sector has expanded or contracted. Trends in unemployment are reviewed in the context of labour force changes and other factors that might have an impact, such as cyclicality.

Income and Wealth

Income levels are evaluated on both an absolute basis and relative to regional and national averages. Reviewing trends in the issuer's income and wealth compared with those of the region and country provides an indication of the rate at which economic value is being created, which has implications for future revenue performance.

Other Demographic Factors

Fitch reviews key demographic measures, particularly population trends. Although population growth is usually considered a positive factor, population stability can also be a positive rating consideration, particularly for smaller communities that do not have a wide range of service demands and spending pressures. High-growth areas can pose risks, as capital needs are often great, and providing the appropriate level of infrastructure and services to match but not exceed growth needs can be difficult. A population decline could have a negative impact on the tax base and therefore on the revenue of the subnational.

Fitch considers the reasons that a particular area attracts or loses population. Demographic structure and projections are also important for assessing future expenditure pressures, particularly in health care, education and infrastructure.

Tax Burden

Comparing the level of taxation, regionally and nationally, can provide an indication of competitiveness, financial flexibility, and/or tax relief pressures. The level of taxation can either encourage or hinder economic development. If the tax burden is already high, an increase may be difficult to implement and have negative effects. Fitch reviews tax rates in comparison with those of similar entities nationally and other entities in the region.

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