Criteria | Governments | International Public Finance:

Methodology For Rating Local And Regional Governments Outside Of The U.S.

July 15, 2019

*(**Editor's Note:** On July 26, 2024, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details. The updated criteria are not applicable in jurisdictions that require local registration until the local registration process has been completed.)*

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OVERVIEW AND SCOPE

1. This article presents S&P Global Ratings' methodology for assigning ratings to local and regional governments (LRGs) outside of the U.S.

2. The methodology applies to global scale, local currency, long-term issuer credit ratings (ICRs) on all LRGs. It also applies to some public-sector entities that are set up as local authorities and are responsible for providing similar services to those an LRG provides. The global scale, foreign currency, long-term ICR is the lower of the related sovereign's transfer and convertibility (T&C) assessment or the LRG local currency ICR. The foreign and local currency ratings incorporate, if relevant, the sovereign stress test, as per our rating above the sovereign methodology (see the Related Criteria section). Also see our T&C assessment methodology, listed in Related Criteria. The local and foreign currency ICRs on an LRG are often the same.

3. Although LRGs' scope of activities may vary, they bear, in our view, the same general responsibilities of delivering public services and funding infrastructure developments. These are supported directly or indirectly by taxes and fees levied on residents or transferred from other levels of government. In our view, LRGs' common task is financing the cost of these services and infrastructure developments with available revenues, as well as with recourse to debt when necessary.

4. We generally do not apply our government-related entity (GRE) methodology (see Related Criteria) to LRGs. However, we can consider within the scope of the GRE methodology public-sector entities set up as local authorities that are government-owned or controlled enterprises. The stand-alone credit profiles (SACPs) of these entities will be based on the application of our methodology for LRGs outside of the U.S. (For further details, please see "Stand-Alone Credit Profiles: One Component Of A Rating," published Oct. 1, 2010.)

5. All references to LRG ratings in this article pertain to an LRG's willingness and ability to service all of its financial obligations on time and in full. However, we do not consider an LRG's nonpayment of intergovernmental debt as a default. We define intergovernmental debt as a type of debt that benefits from either formal or informal forms of ongoing or extraordinary support from another tier of government, most typically the central government (for further details, see Related Research).

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METHODOLOGY

Determining The ICR--Key Steps

6. We determine the rating on an LRG according to the steps depicted in the chart below:

- Assess the institutional framework;
- Establish the individual credit profile based on the equally weighted average of five other factors (economy, financial management, budgetary performance, liquidity, and debt burden);
- Combine the institutional framework and the individual credit profile to establish the anchor as per table 1;
- Adjust the anchor for credit-specific caps, overriding factors (see table 2), and our holistic view of the LRG, when relevant, to establish the SACP; and
- Apply our methodology for rating LRGs above the sovereign, when relevant.

7. The framework for rating LRGs combines quantitative and qualitative factors to establish the ICR. The initial assessments are adjusted by the net effect of qualitative factors, when they apply. Further, we assess factors on a forward-looking basis. In particular, quantitative indicators falling at or near the cut-off points presented in the applicable text and tables can receive a better assessment if trends are improving and a weaker assessment if trends are worsening. Similarly, our view of stable or non-stable (improving or deteriorating) trends in the LRGs' institutional framework are reflected in the ICR, for instance in the matrix selection (see table 1) or the holistic analysis, when relevant.

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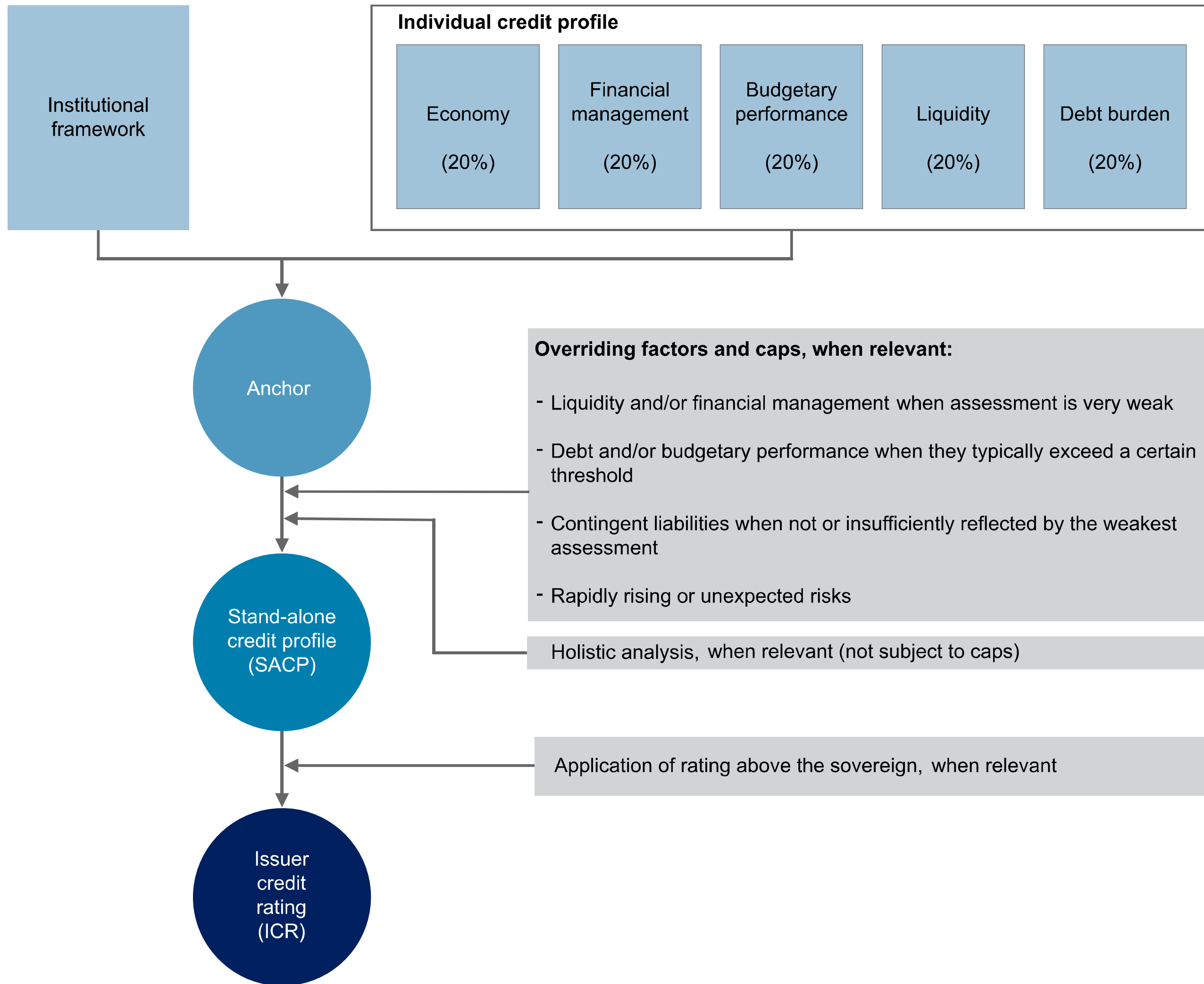

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Table 1

Combining The Institutional Framework Assessment And The Individual Credit Profile

--Institutional framework--		--Individual credit profile--								
Assessment	**Descriptor**	**1**	**1.5**	**2**	**2.5**	**3**	**3.5**	**4**	**4.5**	**5**
1	Extremely predictable and supportive	aaa	aaa	aa+	aa	aa-	a	bbb+	bb+	bb- and below
2	Very predictable and well-balanced	aaa	aa+	aa	aa-	a+	a-	bbb	bb	b+ and below
3	Evolving but balanced	aa+	aa	aa-	a+	a-	bbb	bb+	bb-	b and below
4	Evolving and unbalanced	aa-	a+	a	a-	bbb	bb+	bb-	b	b-
5	Volatile and unbalanced	a	a-	bbb+	bbb	bb+	bb-	b	b-	b-
6	Very volatile and underfunded	bbb+	bbb	bbb-	bb+	bb-	b+	b-	b-	b-

8. If the individual credit profile is not a whole number, the anchor would fall within the range outlined in table 1. For instance, if an LRG is operating in an "evolving but balanced" institutional framework, with an individual credit profile of 2.2, the outcome would be in the 'aa-'/'a+' range. In these cases, we determine the anchor by considering:

- The position within the range (that is, whether the individual credit profile is at the high or low end of the range);
- The expected future performance of one or several of the key credit factors;
- Any credit characteristics that may be under-reflected earlier in the process; and
- A peer comparison.

Table 2

Overriding Factors/Caps

Factors that generally cap the SACP	
A financial management assessment of very weak	Cap at 'bb+'
A liquidity assessment of very weak	Cap at 'bb+'
Financial management and liquidity assessments of very weak	Cap at 'b-'
Factors that generally lower the anchor*	
An excessive debt burden not fully reflected in the debt score§	-1 notch
Excessive deficits after capital accounts§	-1 notch
Risk of materialization of large contingent liabilities not or insufficiently reflected in the debt score	-1 notch
Rapidly rising or unexpected risks	-1 notch or more

*The overriding factors do not lower the SACP below 'b-'. §If an LRG has both very high debt and deficits levels, we would lower the anchor by only one notch if mitigating factors are present. SACP--Stand-alone credit profile.

9. When the application of several overriding factors or caps is warranted, we adjust the SACP by the cumulative effect of those overriding factors and take into account the lowest cap.

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10. A holistic analysis is the final step in determining an LRG's SACP because it helps capture a broader view of stand-alone creditworthiness. The holistic analysis can have a one-notch impact up or down, not limited by any credit-specific caps or overrides. Such an adjustment may be based on stand-alone factors, including our forward-looking view of an issuer's operating framework and financial performance. It may also reflect a comparable ratings analysis, or strengths or weaknesses that are not fully reflected through the application of the methodology because they pertain specifically to the issuer.

11. We derive the ICR on an LRG by applying to the SACP, when relevant, a sovereign-related overriding factor. We generally do not rate an LRG higher than its sovereign. In exceptional cases, when an LRG SACP is higher than the rating on its sovereign, the LRG should be able to meet the conditions and pass the stress tests described in our rating above the sovereign methodology in order to be rated above the sovereign.

12. Finally, when applicable, the LRG rating would be based on "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings."

A. Institutional Framework

13. The institutional framework is the set of formal rules and laws, as well as practices, customs, and precedents, that shape LRGs' institutional arrangements and influence their policies in public finance. Our assessment considers historical track record and future trends that are likely to shape the framework. The institutional framework assessment is mostly qualitative.

14. We assess the institutional framework on a country basis and, when relevant, by level of government. Also, in some instances when regional authorities have an influence on the institutional frameworks that municipal governments operate under, the assessments for the municipalities may vary by region.

15. Factors in our assessment are:

- Predictability;
- Revenue and expenditure balance; and
- Transparency and accountability.

16. We assess each of these factors on a weighted basis: predictability (25%), revenue and expenditure balance (50%), and transparency and accountability (25%). And together these form our overall institutional framework assessment on a five-point scale. The resulting weighted-average assessment is then converted to a six-point scale to determine the institutional framework assessment: '1' (extremely predictable and supportive); '2' (very predictable and well-balanced); '3' (evolving but balanced); '4' (evolving and unbalanced); '5' (volatile and unbalanced); and '6' (very volatile and underfunded).

1. Predictability

17. Our assessment of the predictability of the institutional framework addresses factors such as:

- The frequency and extent of reforms affecting the division of responsibilities and revenues between the levels of governments in a jurisdiction;
- The predictability of the outcomes of reforms when they occur, based on their pace of implementation and impact on both short- and long-term finances; and
- The ability to influence and potentially veto decisions at a higher level, particularly those that

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may adversely affect an LRG's financing system.

2. Revenue and expenditure balance

18. We assess LRGs' ability to maintain fiscal sustainability in the medium and long terms systemwide. Our assessment of revenue and expenditure balance addresses factors such as:

- The overall adequacy of the revenues that an LRG receives or collects to cover its expenditure mandates;
- The strength of a fiscal policy framework imposing prudent limits on an LRG's debt and deficit levels; and
- The availability of exceptional support from a higher government tier.

3. Transparency and accountability

19. Our assessment of transparency and accountability addresses factors such as:

- The national regulation of public-sector accounting systems and standards of financial reporting and planning; and
- The accountability of managers and politicians.

B. Individual Credit Profile

20. After analyzing the institutional framework, we then assess the other five key rating factors that make up an LRG's individual credit profile (see chart).

1. Economy

21. Our economic assessment is driven by wealth and income levels, adjusted when relevant for economic growth prospects, economic concentration and/or volatility, and socioeconomic profile.
22. Our economic analysis starts with determining an initial economic assessment, which is based on national GDP per capita thresholds (see the sector and industry variables in Appendix D of "Sovereign Rating Methodology," Dec. 18, 2017). We then factor in qualitative factors to determine the final economic assessment at the local or regional level.
23. The adjustment for each qualitative factor is generally one assessment category and no more than two assessment categories.
24. The economic assessments are '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

Initial economic assessment

25. We recognize income levels, as measured generally by GDP per capita, are a useful indicator of a country's potential to generate revenues.
26. The initial economic assessment is based on the table on GDP per capita thresholds in Appendix D of the sovereign criteria. The LRG methodology has a scale from '1' to '5' for economic assessment,

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and the sovereign methodology has a scale from '1' to '6'. So, we merge the two lowest categories in that table (corresponding to the scores of '5' and '6' in the sovereign methodology) to form an assessment of '5' under our LRG methodology.

Qualitative adjustments

27. While national GDP per capita is a starting point, we may apply further adjustments to capture additional local nuances. These may include economic growth prospects, economic concentration and/or volatility, and socioeconomic profiles at the LRG level.

28. **Economic growth prospects.** In deciding if this adjustment is applicable, we consider national growth prospects--that is, if they are in line with or well below or above those of sovereigns in the same GDP per capita category (see both the economic section and the sector and industry variables in Appendix D of the sovereign methodology). We also consider the LRG's performance (for example, as measured by real local GDP growth) vis-à-vis the national average.

29. **Economic concentration and/or volatility.** We consider an LRG to be exposed to significant economic concentration and/or volatility if:

- It has exposure to a single cyclical industry, or
- Its economic activity is vulnerable because of growing risks due to a potential asset bubble or a constant risk of natural disasters.

30. **Socioeconomic profiles.** This adjustment applies when the socioeconomic profile of an LRG departs from the national average. In evaluating this divergence, we consider the impact of the LRG's available local socioeconomic indicators on its financial standing, taking into account the revenue-sharing arrangements and set of responsibilities defined by the institutional framework under which the LRG operates.

2. Financial Management

31. We assess how the quality of an LRG's financial management and the political framework in which it operates are likely to affect the LRG's willingness and ability to service debt over time. When it is relevant, we may also extend this analysis to environmental, social, and governance-related risks. The assessment is mostly qualitative.

32. The financial management assessments are '1' (very strong), '2' (strong), '3' (satisfactory), '4' (weak), and '5' (very weak). We cap the financial management assessment at '5' under certain circumstances, as explained below.

Financial management assessment

33. Our assessment of an LRG's financial management relies on the following three key analytical areas:

- Political and managerial strength. We evaluate policymakers' commitment to disciplined fiscal policies and their ability and willingness to make decisions that will ensure LRGs' fiscal sustainability, as well as management's capacity to implement these decisions over several administrations.
- Financial planning and implementation. We consider the quality of the financial planning and

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the processes to implement it over time. We determine whether there is a credible and well-documented medium- to long-term financial plan that supports financial discipline and stability; quality and comprehensiveness of the budgeting process (including the consolidation of the relevant related entities); and the approval process in place to monitor revenues and control expenditures, including pension responsibilities and the implementation of large-scale infrastructure projects.

- Liquidity, debt, and contingent liabilities management. We evaluate management appetite for debt-related risks, such as exposure to market risks, refinancing, and concentration of lenders. We also evaluate the ability to maintain prudent liquidity management practices and manage contingent liabilities, including off-balance-sheet financing of infrastructure projects and liabilities of GREs.

Caps

34. Two factors can lead to capping the assessment at '5': transparency and payment culture.

35. The transparency cap applies when key information on some government activities is missing and/or is communicated with material delays.

36. The payment culture cap applies when an entity's willingness to make full and timely payments on its financial obligations is questioned--for example, if we believe there is at least a moderate likelihood that an entity would not prioritize the timely payment of debt service in a stress scenario.

3. Budgetary Performance

37. The budgetary performance assessment measures the level and the volatility of an LRG's expected cash flows (from operations and investment activities) that are available to service debt. The initial assessment may be complemented by adjustments such as budgetary trends, volatility, budgetary flexibility, and various forms of underspending (for example, pension, off-budget financing, and payables) to form the final budgetary performance assessment.

38. The adjustment impact of each qualitative factor is generally one assessment category and no more than two assessment categories.

39. The budgetary performance assessments are '1' (very strong), '2' (strong), '3' (average), '4' (weak), and '5' (very weak).

Initial budgetary performance assessment

40. Our initial assessment of an LRG's budgetary performance relies on two key ratios: (1) operating balance as a percentage of adjusted operating revenues, and (2) balance after capital accounts as a percentage of total adjusted revenues.

41. We often deal with different public-sector accounting standards across countries. The basis for public-sector accounting varies from pure cash accounting to pure accrual accounting and includes a variety of modified cash and modified accrual accounting standards. The extent of the consolidation of public-sector entities in an LRG's accounts can also differ widely from one LRG to another.

42. We make adjustments to LRGs' reported financial indicators to minimize these inconsistencies. The adjustments aim to align the financial information on the LRGs as much as possible to form a

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modified cash base (when relevant and appropriate in the context of the budgetary performance analysis). We do this by eliminating the noncash items, such as depreciation and provisions, to obtain comparable financial data on LRGs across jurisdictions.

43. We believe that the operating balance (see Glossary), when calculated on a cash or modified cash basis as a percentage of adjusted operating revenues, gives a good proxy for an LRG's cash flows from operations. The ratio reflects the extent to which an LRG can finance its operational costs and public services from recurring revenues--mostly taxes and operating subsidies.

44. The balance after capital accounts (see Glossary) represents a proxy of the overall funding needs or surplus that an LRG derives from its operating and capital activities and would generally correspond to changes in net debt (debt net of cash and liquid assets) in a pure cash-based accounting system. An LRG can finance the balance either by drawing on its cash reserves or by borrowing.

Qualitative adjustments

45. Positive adjustments to the initial assessment may include:

- Expected structural improvement: if our base-case forecasts point to a material structural improvement versus the period average;
- High cash reserves: in particular, when deficits are temporary and can be largely covered by cash reserves; and
- Strong flexibility: if, on top of our base-case assumptions reflected in the initial assessment, we consider that a policy adjustment could lead to material additional revenues or cost savings.

46. Negative adjustments to the initial assessment may include:

- Expected structural deterioration: if our base-case forecasts point to a material structural deterioration from the period average;
- Pronounced volatility in performance: as evidenced by factors such as high inflation, very cyclical revenues, or dependence on volatile state transfers;
- Underestimated spending: as evidenced by factors such as significant underspending on public services or infrastructure, large unpaid debt to suppliers, or off-budget financing through public companies;
- Underspending on pensions; and
- Limited flexibility: if, on top of our base-case assumptions reflected in the initial assessment, we consider that a policy adjustment could lead to very limited additional revenues or to a very limited expenditure cut.

4. Liquidity

47. The liquidity assessment measures the adequacy of internal and external sources of liquidity in the context of debt service needs. The analysis consists of three steps:

- First, determining an initial liquidity assessment based on a debt service coverage ratio (DSCR), adjusted when warranted for qualitative aspects;
- Second, assessing an LRG's access to external funding; and
- Third, combining the first two steps to derive the final liquidity assessment.

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48. The overall liquidity assessments are '1' (exceptional), '2' (strong), '3' (adequate), '4' (less than adequate), and '5' (weak).

Initial liquidity assessment

49. The first step of our initial liquidity assessment is determining the DSCR, which compares the total free cash position in the numerator with debt service in the denominator over the next 12 months.

50. The total free cash position typically sums up:

- Adjusted cash (cash adjusted for any amount that is not fully available for debt service within the next 12 months and for any amount that we expect to fund spending or debt repayment beyond the next 12 months);
- Liquid assets;
- Balance after capital accounts (to which we add back interest);
- Onlending (when relevant); and
- Already contracted short- and long-term funding available to cover spending over the coming 12 months.

51. We assign the strongest DSCR-based assessment of '1' when total free cash minus contracted funding (the strongest form of liquidity) covers more than 100% of the forthcoming debt service. For other scores ('2' to '5'), our initial liquidity assessment also considers forms of short- and long-term funding, but only when they are firmly contracted and, for long-term funding, when they are available to cover all or a portion of expenses--generally the capital expenditure--throughout the period.

52. If applicable, we can further adjust the DSCR-based assessment for various positive and negative qualifiers, each of which generally counts for one category and no more than two categories.

53. Positive adjustments to the initial assessment may include an expected structural improvement in the DSCR over the next two to three years.

54. Negative adjustments to the initial assessment may include:

- An expected structural deterioration in the DSCR over the next two to three years;
- Underfunding--as evidenced by factors such as large amounts of unpaid supplier debt at the LRG level or related public-sector entities; and
- Expected volatility in the liquidity ratio during or beyond the coming 12 months (up to 36 months) due to, for instance, an uneven intra-annual cash position, a lumpy debt amortization profile, or large bullet maturities.

Access to external liquidity

55. As the second pillar of our analysis of an LRG's liquidity position, access to external funding considers:

- An individual LRG's track record (and our opinion on whether this track record will continue) of access to well-established and effectively operating sources of liquidity provided by a central government, upper levels of government, or a central government-related entity;
- The development of the domestic bond market and the diversity of banks willing to lend to the

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LRG sector; and

- An individual LRG's track record (and our opinion as to whether this track record will continue) of market access or links with a diversified pool of banks.

56. Our assessment of an LRG's external access to liquidity includes its capacity to refinance debt and to cover its new borrowing requirements. The assessment is qualitative and mostly considers entity-specific characteristics, although we recognize that the legislative framework under which an LRG operates may affect its access to external liquidity.

5. Debt Burden

57. The debt burden assessment reflects our forward-looking view of an LRG's debt and interest burden relative to its available resources. It includes an initial assessment based on two key measures--tax-supported debt and cost of direct debt--which we can further adjust, when appropriate, based on our analysis of debt structure (including onlent debt) and contingent liabilities, among others. The impact of the various adjustments on the initial debt burden assessment differs.

58. The debt burden assessments are '1' (very low), '2' (low), '3' (moderate), '4' (high), and '5' (very high).

Initial debt assessment

59. We believe that the ratio of tax-supported debt to consolidated operating revenues (see Glossary) is the most appropriate measure for international comparisons. This measure helps to smooth out some of the differences stemming from accounting systems and political frameworks around the world. It is also a good measure, in our view, of all debt that ultimately relies on an LRG's total revenues (tax and other revenues). This is because it notably incorporates the debt of companies that perform a public policy that otherwise would have been directly assumed by the LRG and that rely significantly on the LRG either for operating or for honoring their own financial obligations.

60. The second ratio we analyze is interest payment (see Glossary) to adjusted operating revenues, meaning gross interest on direct debt at the LRG level. This ratio gives us an indication of the sustainability of an LRG's debt by measuring the share of income it uses to cover the cost of debt.

Qualitative adjustments

61. Positive adjustments to the initial assessment may include:

- Exceptionally high operating balance (that is, when direct debt typically represents less than five years of operating margin) typically improves the initial assessment by one category; and

- Debt burden mitigated by large onlent debt. Some LRGs raise debt to onlend it to subsidiaries, GREs, or lower tiers of governments. If we expect these entities to have the capacity and willingness to repay onlent debt and if the share of such onlent debt and interest is a substantial portion of the LRG's total debt and interest, the initial debt burden assessment would improve by up to two categories, depending on the size of the debt and the risk associated with onlent entities.

62. Negative qualifiers to the initial assessment may include:

- Potential significant volatility in the debt burden owing to high exposure to market risks--for

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example, interest risk, currency risk, a short-term maturity profile, and aggressive use of derivative or nonstandard instruments. Such risks could lead to an increase in the cost and level of debt such that they would weaken the initial assessment by one category; and

- Risk of materialization of contingent liabilities that could affect an LRG's financial standing such that it would weaken the initial assessment by up to two categories.

63. **Contingent liabilities.** Contingent liabilities correspond to explicit obligations (such as guarantees not already captured in tax-supported debt) or implicit obligations (such as litigation costs or potential financial support to unguaranteed GREs) that have the potential to affect an LRG's financial profile.

64. Contingent liabilities can generally be grouped into three broad categories:

- Contingent liabilities related to nonfinancial GREs that are not already reflected in tax-supported debt (including the GREs' guaranteed debt) and whose likelihood of support by the LRG is typically not in the lowest categories;
- Contingent liabilities related to financial GREs; and
- Other contingent liabilities--for example, public-private partnerships (PPPs), securitizations, litigation, GREs' payables, guarantees on non-GREs, unless already serviced by an LRG on an ongoing basis, and when relevant contingent liabilities related to environmental, social, and governance risks.

65. Because contingent liabilities and tax-supported debt are closely linked, with potential conversion or shifts from one to the other type of risk, our assessment of contingent liabilities acts as a qualitative adjustment to our debt analysis of an LRG, focusing on the following steps:

- First, we assess an LRG's exposure to the contingent liabilities, mainly through the debt of nonfinancial GREs as well as the estimated recapitalization cost and other potential liquidity support to financial GREs, when relevant. An LRG may incur a contingent risk from companies in which it owns stakes or from other GREs. Due to significant differences in the reporting and consolidation of individual GREs, we focus on the larger GREs.
- We then assess the risk of the materialization of the contingent liabilities.
- The combination of these reflects our view of the magnitude of the effect of the contingent liabilities on an LRG's financial standing.

Issue And Short-Term Ratings

66. The issue rating on an LRG's unguaranteed foreign or local currency long-term debt instrument is usually the same as the respective long-term ICR because subordination is uncommon in this sector. We do not assign recovery ratings to LRGs' obligations. To assign short-term ratings to LRGs, we use our methodology for linking long- and short-term ratings (see Related Criteria).

67. This methodology does not apply to securitized issues, such as tax participation transactions or transactions backed by local taxes (see Related Criteria).

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APPENDIX

68. This appendix provides additional information related to the application of the LRG rating methodology and is intended to be read in conjunction with this methodology.

Overriding Factors And Caps

Debt and budgetary performance overrides

69. We generally make changes to the anchor (see table 1 of the methodology) due to excessive debt or budgetary deficits after capital accounts. Specifically, we lower the anchor by one notch when tax-supported debt is generally more than 450% of consolidated operating revenues, or when the deficit after capital accounts is generally more than 25% of total adjusted revenues. If an LRG has both very high debt and deficit levels, we generally lower the anchor by two notches. In some cases, we lower the anchor by just one notch if mitigating factors are present that indicate a stronger credit profile compared with peers that have similarly weak budgetary performance and debt ratios.

Contingent liabilities override

70. We also lower the anchor by one notch when our expectation of the materialization of contingent risks is insufficiently reflected in the debt burden assessment. In particular, we do so when our debt burden assessment (before contingent liabilities) falls in the weakest category and a two-category adjustment is warranted for contingent liabilities.

Rapidly rising or unexpected risks override

71. We lower the anchor by one or several notches when rapidly rising or unexpected risks are likely to significantly worsen an LRG's creditworthiness. We generally do so in cases of imminent and significant external and domestic political and other environmental (such as natural disasters), social, or governance risks, risks that large guarantees granted to a bank be called upon, and risks stemming from large pension-related costs.

Institutional Framework

72. The following tables display what best describes the strongest, mid, and weakest points corresponding to institutional framework assessments of '1', '3', and '5'. Assessments of '2' and '4' fall in between the respective assessments, but they may also result from a combination of the characteristics listed in the tables.

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Table 3

Assessing The Predictability Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Frequency and extent of reforms affecting the intergovernmental system and predictability of their outcome:		
The system is mature and stable, with a limited number of reforms implemented gradually and with a predictable outcome. It provides very good visibility on the evolution of LRGs' revenue sources and responsibilities for at least the next five to seven years. The system is largely defined in the constitution and codified by law.	The system is evolving with ongoing but no radical reforms, which are likely to affect only moderately LRGs' main revenues and responsibilities. It provides good visibility on the evolution of LRGs' revenue sources and responsibilities for at least the next three years. The system is governed by law but with some overlap and lack of clarity.	The system is very volatile, with ongoing and ill-prepared large-scale transformations, which makes LRGs' main revenues and expenditures highly unpredictable. The visibility on the evolution of LRGs' revenue sources and responsibilities is inferior to one year. The system is not well defined, leading to disputes between governments and changing rules. The system might be subject to high political risks.
Ability of LRGs to influence or oppose reform affecting the intergovernmental system:		
LRGs have strong political power through a dedicated chamber in the national parliament, and they can veto unwanted changes.	LRGs have sufficient political power to soften, but not block, the negative consequences of reforms.	LRGs have weak institutional and political powers, with no power to block or influence unwanted changes.

Table 4

Assessing The Revenue And Expenditure Balance Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Overall adequacy of revenues to cover expenditures needs with state transfers and/or sufficient autonomy:		
The government provides LRGs with adequate resources to cover essential services and infrastructure needs. Transfers are predictable and allocated evenly throughout the financial year. OR LRGs have sufficient autonomy to manage their own revenues and responsibilities efficiently despite possible temporary imbalances during economic downturns.	Operating spending of most LRGs is covered by state transfers or own revenues, but meaningful differences can exist between the strongest and the weakest entities. Capital projects generally require moderate recourse to debt. Central government transfers are relatively predictable and timely.	Central government transfers and LRGs' own revenues are not sufficient to cover essential services and infrastructure needs, resulting in large financing requirements or infrastructure gaps. Transfers are based on political relationships and in-year negotiations and come with delays.
Fiscal policy framework:		
A prudent fiscal policy is defined at the national level, aiming to reduce deficit and debt levels in the LRG sector over the medium to long term. Noncompliance with restrictions is penalized. Prudent restrictions on LRGs' debt and liquidity management limit their exposure to market risks.	A prudent fiscal policy framework is self-imposed at the LRG level. OR Prudent restrictions on LRGs' fiscal policy exist at the national level, but they were introduced recently, or do not prevent fast debt accumulation. Restrictions on LRGs debt and liquidity management are loose.	Restrictions on public deficits and debt are inexistent or inappropriate, leading to excessive debt accumulation, directly or through government-related entities (GREs) or other off-budget financing. Monitoring of LRGs' financials is lax. Restrictions on debt and liquidity management are inexistent or inappropriate.

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Table 4

Assessing The Revenue And Expenditure Balance Of An LRG's Institutional Framework (cont.)

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Exceptional support:		
Strong track record of systemwide, consistent exceptional support that enables LRGs to balance their revenues and expenditures in exceptional situations.	The system provides some exceptional support to the LRG sector in exceptional situations, but there is no established framework and the track record is irregular. No risk of negative intervention.	The system provides limited exceptional support, mostly politically driven, to the LRG sector for major infrastructure projects or natural catastrophes. OR The system is exposed to the risk of negative legal or financial intervention from the sovereign (or a higher level of the government).

Table 5

Assessing The Transparency And Accountability Of An LRG's Institutional Framework

(An LRG would need to exhibit most of the characteristics listed in a given category to achieve that assessment.)

1	3	5
Transparency and institutionalization of budgetary processes:		
Roles and responsibilities, between elected officials setting priorities and managers implementing them, are clearly defined.	The delineation of roles and responsibilities is relatively clear, with elected officials setting priorities implemented by managers.	Delineation in the legislation of the relations between elected officials and managers is not clear, leading to potentially significant imbalances and frequent turnover of the administrative staff after each election.
Disclosure and accounting standards for public finance information:		
Nationally established transparent accounting standards exist, as well as a full accrual accounting system. Best practices and legal requirements are in place regarding public disclosure, comprehensive and timely information on LRGs' budget execution, historical data, and financial planning, including the GRE sector.	Accounting standards are generally transparent but not fully harmonized, leaving room for interpretation. Legal requirements or common practice on financial reports and budgets disclosure are solid but not very detailed, especially regarding the GRE sector.	Accounting standards are weak and inconsistent. Reporting requirements for financial statements and budgets are limited to basic information.
Control levels and reliability of information:		
The timely audit of financial statements, in compliance with national law, by an independent private company or public body is mandatory.	The external audit, in compliance with national law, by a public body is mandatory but is not always very detailed or timely.	The external audit is not mandatory and state agencies' overseeing of legal compliance is limited to basic information.

GRE--Government-related entity.

73. We then apply weights, as described in the institutional framework section of the methodology, to these three key factors (predictability, revenue and expenditure balance, and transparency and accountability). The resulting weighted-average assessment is then converted to a six-point scale (as per table 6) to determine the institutional framework assessment.

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Table 6

Institutional Framework

Weighted average of three factors	Description	Assessment
1-1.5	Extremely predictable and supportive	1
1.75-2.25	Very predictable and well-balanced	2
2.5-3	Evolving but balanced	3
3.25-3.75	Evolving and unbalanced	4
4-4.25	Volatile and unbalanced	5
4.5-5	Very volatile and underfunded	6

Linkages between the institutional framework assessments and sovereign ratings

74. The institutional framework assessments generally have a strong link with the credit quality of the related sovereign, or with the credit quality of a higher level of government that has jurisdiction over the LRG, if this is more relevant. As a result, we expect that LRGs operating in investment-grade-rated sovereigns will generally have associated institutional framework assessments from '1' to '4'. And LRGs operating in speculative-grade-rated sovereigns will generally have associated institutional framework assessments from '5' to '6', and in any case be capped at '4'.

Economy

75. We apply table 7 to assess an LRG's economy.

Table 7

An LRG's Economic Assessment

On a scale from '1' to '5', with '1' being the strongest and '5' the weakest, based on national GDP per capita*

Positive Qualitative Factors	Negative Qualitative Factors
Each of the following factors generally improves the initial economic assessment by one category (and no more than two): - Strong economic growth prospects - More favorable socioeconomic profiles	Each of the following factors generally weakens the initial economic assessment by one category (and no more than two): - Limited economic growth prospects - Very volatile and/or concentrated economy - Less favorable socioeconomic profiles

*See "Sector And Industry Variables: Sovereign Rating Methodology."
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Economic growth prospects

76. In sovereigns where the national growth average is on par with that of sovereign peers in the same GDP-per-capita category, a positive or negative adjustment of typically one assessment category primarily reflects the comparisons with domestic peers.

77. If we consider the national average growth as well above the average of sovereigns in the same GDP-per-capita category, then we may improve the LRG's initial economic assessment by one category when the LRG's real economic growth is more or less in line with the national average. If the LRG significantly outperforms the already strong national average growth, we may adjust the initial economic assessment upward by two categories. However, if the LRG posts weaker growth than the national average, we may either not adjust at all, or adjust by one category down, depending on how significantly local growth departs from national growth.

78. Conversely, if the national average is well below the average of sovereigns in the same GDP-per-capita category, then an LRG performing in line with that national average is likely to receive a one-category downward adjustment. If the LRG significantly underperforms that already weak national average in an international comparison, we may adjust the LRG's initial economic assessment downward by two categories. In the same scenario of national growth well below the average of sovereigns in the same GDP-per-capita category, if the LRG posts stronger growth than the national average, we may either not adjust the initial economic assessment or even improve it by one category, depending on how significantly local growth departs from national growth.

Socioeconomic profiles

79. When an LRG has features that may have a materially negative impact on revenue growth and/or expenditure needs, we generally apply a negative adjustment. These include, among other indicators, lower local GDP per capita, higher unemployment rates, a larger proportion of income support and welfare recipients, and infrastructure gaps compared with the national average. On the other hand, we could apply a positive adjustment if an LRG displays higher local GDP per capita or stronger socioeconomic indicators than the national average, implying lower spending pressure or stronger revenue generation capacity compared with the national average (depending on the availability of relevant information).

Financial Management

80. Table 8 displays what best describes very strong, satisfactory, and very weak financial management assessments. Strong and weak assessments fall in between the respective assessments, but they may also result from a combination of the characteristics listed in the table.

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Table 8

Financial Management Assessment

	Political and managerial strength	Financial planning and implementation	Liquidity, debt, and contingent liability management
1. Very strong	There is broad political consensus on fiscal policies, enabling the government to enact structural reforms, pass budgets, and make unpopular decisions, when necessary. Highly experienced financial team. Management accountability is very strong and there is an implicit agreement among political and managerial teams to respect each respective sphere of influence to achieve fiscal sustainability.	Well- defined, documented, and credible long-term financial plan (generally extending beyond five years) that supports financial discipline and stability. Multiyear track record of accurate budget forecasting, with robust control over revenue and expenditures, formalized budgetary procedures (including consolidation of relevant related entities), an advanced control system in place, and negligible overspending. Solid track record of budgets being approved before the start of the fiscal year. Strict adherence to advanced accounting principles, and comprehensive, reliable, and timely reporting. No related pension risks.	Formal liquidity policy with stipulated minimum and desired levels of cash and equivalents, generally centralized cash management for all government units. Detailed annual cash planning with actual cash flows close to the plan and tight monitoring. Formal debt management policy with long-term debt used for capital expenditure and not operating costs. Comprehensive financial plans for all GREs, linked to the LRG's financial strategy. Detailed assessment and adequate provisioning of other contingent risks including social and environmental risks and off-budget infrastructure funding.
3. Satisfactory	There is generally a consensus to implement needed reforms. Political disagreements may delay important fiscal decisions. Distinction between political and managerial responsibilities may, at times, be unclear. Financial management team has adequate expertise, as well as adequate accountability, which has been maintained throughout changes of administration, ensuring prudent fiscal policies over the years.	Relatively prudent medium-term financial planning, which covers the next two-to-three years but is not as detailed as in stronger managements. Clear budgetary procedures, with moderate budget revisions during the year. Adequate capacity to forecast operating revenues and identify overspending. Some capacity to take corrective actions but less than stronger managements. Budget approval may encounter some delays. Adherence to sound accounting principles and satisfactory standards of financial disclosure and reporting. Mitigated pension risks.	Informal, but prudent liquidity policy, which ensures adequate coverage of cash fluctuations. Adequate, but not detailed cash flow planning. Moderate exposure to foreign-exchange and interest risks. Some assessment, but limited provisioning of other contingent liabilities including social and environmental risks and off-balance-sheet liabilities. Some control over GREs that partly align with LRG policy goals.
5. Very weak	LRG is unable to implement unpopular or needed reforms. Political stability is weak and the government faces challenges to implement policies. Management team is understaffed and lacks relevant skills, qualifications, and experience. There is no distinction between political and managerial responsibilities, and there is no accountability for the public policy decisions likely to put at risk fiscal sustainability in the short to medium term.	There is no medium- and long-term financial planning. May be aggressive budgeting based on unrealistic assumptions and no clear financial targets. Purely incremental budgetary approach and not results-oriented. Substantial budget revisions may occur during the year. Low predictability of revenue collection and unreliable cost-control measures. Very weak accounting and disclosure standards. Unaddressed pension risks.	Numerous and decentralized cash accounts. Debt and liquidity policies are not formal, high reliance on short-term debt, and no cash planning. Assessment and provision for other contingent liabilities (including social, environmental, and off-budget risks) are insufficient. GREs lack a clear rationale, with weak controls for LRGs.

GREs--Government-related entities.

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Budgetary Performance

81. We apply table 9 to assess an LRG's budgetary performance.

Table 9

Assessment Of An LRG's Budgetary Performance

Operating balance as % of adjusted operating revenues*	Balance after capital accounts as % of total adjusted revenues*				
	>0%	0%-(5%)	(5%)-(10%)	(10%)-(15%)	<(15%)
>5%	1	2	3	4	4
0%-5%	2	3	3	4	5
<0%	N/A	4	4	5	5

Positive qualitative adjustments	Negative qualitative adjustments
Each of the following factors generally improves the initial budgetary performance assessment by one category (and no more than two):	**Each of the following factors generally weakens the initial budgetary performance assessment by one category (and no more than two):**
- Expected structural improvement - High cash reserve levels - Strong flexibility	- Expected structural deterioration - Pronounced volatility in performance - Underestimated spending - Underspending on pensions - Limited flexibility

*Based on the average of the past two-year data, the current year, and two years of forecasts. N/A--Not applicable.

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Strong or limited flexibility

82. Strong or limited flexibility is an adjustment to the budgetary performance assessment, when warranted. We compare an LRG with domestic and international peers typically with the same institutional framework assessment (focusing on similar revenue and expenditure balance assessments). The adjustment for flexibility applies when we consider that the entity has relatively strong or limited budgetary headroom through the potential implementation of a combination of policies--on top of what we already reflect in our base-case scenario.

83. Our measure of flexibility takes into account policy mix because we think that a combination of policies that leverages both current and capital revenue and expenditure indicates that an LRG has capacity and willingness to influence its financial leeway. Because capital revenue and expenditure are nonrecurrent items and have a one-time impact, we generally weight them less than operating revenue and expenditure.

84. Typically, an LRG's flexibility depends on its ability to raise taxes, fees, or tariffs, as well as on the political considerations and economic limits that could curb the use of this flexibility.

85. Revenue flexibility also occurs in the form of additional revenue generated by asset sales, provided they can be realistically liquidated and the government is willing to sell or has a track record of selling such assets.

86. When assessing an LRG's expenditure flexibility, we consider its willingness and ability to cut

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expenditures, which mostly depends on its core responsibilities, the type of expenditure, and potential limitations to budget cuts.

Assessment of pensions

87. We consider pension-related risks in our financial management assessment. Also, based on our assessment of how underfunding pensions may pressure an LRG's budgetary stance, we could apply a negative adjustment to the budgetary performance assessment. In extreme situations, we may lower the anchor by one or several notches by using the overriding factor for rapidly rising and unexpected risks.

88. When annual contributions are not sufficient to cover future pension benefits, this can result in the accumulation of significant unfunded liabilities. Unfunded pension plans are frequent occurrences, but we have observed only some instances where LRGs issue debt to cover the gap. Many times, this has sharpened fiscal pressures through accelerated contributions. A historical lack of funding may even turn pension plans into de facto "pay-as-you-go" systems, whereby LRGs pay directly out of their budgeted annual pension-related expenses.

89. We generally consider pay-as-you-go systems as riskier than pension plans. This is because pay-as-you-go systems are characterized by a lack of safety nets (that is, no or very small reserves) that may lead an LRG that is facing acute fiscal pressures to prioritize mandatory pension payments over other expenses, such as debt service. By comparison, long-term reserves established under pension plans--even underfunded--allow an LRG that is facing acute fiscal pressures to temporarily postpone or lower annual pension contributions without putting its debt obligations at risk.

90. Mitigating factors may, however, alleviate risks related to pay-as-you-go systems and, more generally, to underfunding. These factors typically include:

- A lack of materiality (that is, pension-related costs account for a limited proportion of the budget);
- Our assessment that a tight institutional or fiscal framework prevents an LRG from prioritizing pensions over debt obligations; and
- An encompassing policy mix aimed at addressing pension-related risks and prioritizing debt service payments.

91. We consider mitigating factors in both our budgetary performance and financial management assessments.

92. When considering whether underfunding pensions should warrant a negative adjustment to the budgetary performance assessment, we may compare the present value of the projected retirement benefits earned by employees in a given year (that is, the theoretical, annual contribution an LRG should make to the pension plan, as indicated in actuarial statements) with the actual amount spent in the given year as recorded in the budget. When available, we consider the actuarial assessment of the annual contribution (or equivalent if there is no actuarial assessment) as a given because this is the translation of the pension benefits that the LRG has committed to under the pension plan. This is based on and regularly adjusted for evolving assumptions, including revised benefits, mortality tables, discount rate, and amortization method.

93. When relevant for pension plans, our assessment may also take into account annual amortization that is or will be needed to cover unfunded pension liabilities. We do not necessarily consider 100% funding as needed, but rather rely on local or national regulations, or even requirements specific to pension plans that set the expected level of funding.

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Underestimated spending

94. We may apply this adjustment when we assess that there is significant underspending on public services or infrastructure, large unpaid debt to suppliers, or off-budget financing through public companies or leasing schemes. Specifically, off-budget financing may lead to underestimating spending in a sense that if capital expenditure had been carried out in a more conventional way (i.e., on budget), it would have negatively affected the balance after capex. We take into consideration any mitigating factors (such as risk transfer, legal contracts, the jurisdiction's legal framework, delivery methods, etc.) when determining whether this adjustment should apply.

Liquidity

Initial liquidity assessment

95. We apply table 10 to assess an LRG's initial liquidity.

Table 10

Assessment Of An LRG's Initial Liquidity

	Total free cash without contracted funding as a % of next 12 months' debt service	Total free cash as a % of next 12 months' debt service			
	>100%	>120%	80%-120%	40%-80%	<40%
Debt service coverage ratio assessment	1	2	3	4	5

Positive qualitative adjustments	Negative qualitative adjustments
The following factor generally improves the initial liquidity assessment by one category (and by no more than two):	**Each of the following factors generally weakens the initial liquidity assessment by one category (and by no more than two):**
- Expected structural improvement	- Expected structural deterioration - Underfunding - Expected volatility in the liquidity ratio

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96. **DSCR.** The debt service coverage ratio (DSCR) measures how much total free cash (with and without contracted funding) covers the debt service over the next 12 months. We calculate DSCRs at the beginning of the fiscal year. Depending on the review date, the initial liquidity assessment is derived from the DSCRs for the current and the next fiscal year on a pro rata basis.

97. Total free cash typically consists of adjusted cash, liquid assets, balance after capital accounts (to which we add back interest), onlending (when relevant), and already contracted short- and long-term funding.

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98. **Adjusted cash.** Adjusted cash includes reported cash at the beginning of the fiscal year, adjusted for any amount that is not fully available for debt service within the next 12 months and for any amount that we expect to fund spending or debt repayment beyond the next 12 months. For instance, we deduct:

- Borrowings whose proceeds will be used beyond the next 12 months;
- Transfers that are earmarked for capital expenditures and that are to be cashed out beyond the next 12 months; and
- Sinking funds or term deposits earmarked for debt maturing beyond the next 12 months with no possible temporary use.

99. **Liquid assets.** Liquid assets include unrestricted assets that are available to cover debt service over the next 12 months. That is, they exclude sellable assets that have already been taken into account as capital revenues in our forward-looking balance after capital accounts. Specifically, we count highly liquid and immediately sellable assets (usually investment-grade government/agency bonds and short-term liquid assets such as 'A-1+' rated money market instruments, cash, cash equivalents, and bank deposits) and typically apply a 50% discount for other securities, such as speculative-grade nongovernment bonds; non-fixed-income "risk assets," such as listed equities and exchange-traded funds; and unrated bonds. For other types of fixed-income securities, we typically apply an intermediate discount of 25%. These typically include investment-grade nongovernment bonds (e.g., those issued by financial or nonfinancial corporates) and asset-backed securities, as well as speculative-grade government/agency bonds.

100. **Balance after capital accounts.** Balance after capital accounts (to which we add back interest) is taken from the base-case scenario.

101. **Onlending.** When relevant, we also include onlending in the DSCR. In a few countries, onlending (generally coming from upper tiers of government and flowing to lower tiers of government or GREs) may represent important financial flows. Taking them into account in the numerator of the DSCR is a way of giving credit to the onlending entity for annual principal and interest repayments that will eventually flow back and help with the entity's own debt repayment. When onlending is covered by borrowing, we do not account for the outflow as cash is not affected. We only consider cash inflows when we believe that onlent entities have the ability and willingness to timely pay back interest and principal to the onlending entity. When onlending is covered by cash, we add the outflows net of the inflows to the numerator of our DSCR.

102. **Short- and long-term funding.** We include short- and long-term funding--irrespective of whether it comes from capital markets, commercial banks, or multilateral institutions--in the DSCR as long as it is already firmly contracted or already cashed-in after the beginning of the fiscal year. For long-term funding, when it is earmarked for capital expenditures, we include the maximum amount of funding corresponding to the capital expenditures that we account for in the base-case scenario. If we assess that a portion of capital expenditures is not eligible to be paid out of the contracted funding, we deduct the latter accordingly. For short-term funding, we generally do not include commercial paper (CP) programs in the numerator of the DSCR because it typically represents uncommitted funding until effectively placed; however, when the entity draws down on its CP program, upcoming maturities are accounted for in the denominator. Also, we include the average available amount of liquidity lines or short-term debt in the numerator of the DSCR only when we consider that its refinancing is not an issue, which is typically the case when LRGs' access to external funding is satisfactory or above. For entities with access to external financing

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below satisfactory, we generally do not take the liquidity lines or short-term debt into account in the numerator and denominator of the DSCR. Moreover, if no other sources of funding are available (when a lack of access to external funding is not offset by large cash and/or already contracted long-term funding), we typically apply a negative adjustment for underfunding because the drawn liquidity lines are unlikely to be refinanced. Finally, irrespective of our assessment of the LRG's access to external funding, we typically apply a negative adjustment for underfunding when we assess that the entity relies on a very large or increasing amount of credit lines or short-term debt, which denotes a stretched or deteriorating liquidity position.

Access to external liquidity

103. Table 11 describes the five assessments for LRGs' access to external liquidity.

Table 11

Access To External Liquidity Assessment

Access to external liquidity	Typical characteristics
Exceptional*	- Unquestioned historical and forward-looking access to deep and liquid capital markets or to a strong and diversified pool of banks at all times. AND - Unrestricted and unconditional access to well-established and effectively operating sources of liquidity from other levels of government or a central government-related entity (GRE)†.
Strong§	- Proven track record of sufficient access to a deep and liquid capital market or to a strong and diversified pool of banks, including in periods of market dislocation. OR/AND - Access to well-established and effectively operating sources of liquidity from other levels of government or a central GRE†.
Satisfactory	- Some track record of access to sources of liquidity from other levels of government, to the capital markets, or to a strong and diversified pool of banks in normal circumstances (that is, except for periods of severe market dislocation). OR - For entities that have no recent record of access to external funding or have no debt (or close to 0), access to external funding is satisfactory, provided they operate in stable and deep capital markets or have access to a strong and diversified pool of banks.
Limited	- Possible or intermittent legal restrictions on the use of debt instruments for liquidity management. Our assessment also takes into consideration if an entity's liquidity access is potentially limited by covenants or other restrictive terms. OR - Generally good access to the banking system, but a limited number of players in the LRG field or moderate strength of the banking system. OR - Limited development of the domestic capital market for LRGs.
Uncertain	- Legal restrictions banning the use of debt instruments for liquidity management. Our assessment also takes into consideration if an entity's liquidity access is potentially limited by covenants or other restrictive terms. OR - Undeveloped domestic capital markets for LRGs. OR - An extremely limited number of banks that lend to this sector.

*These characteristics can only be found in sovereigns rated 'AA' and higher. §These characteristics can only be found in sovereigns rated 'BBB-' and higher. †By central GRE, we typically mean institutions for which we consider the likelihood of extraordinary support by the central government to be extremely high or almost certain.
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Final liquidity assessment

104. We combine our adjusted initial liquidity assessment (based on table 10) and our assessment of access to external liquidity (based on table 11) to derive the final liquidity assessment per table 12.

Table 12

An LRG Liquidity Assessment

	Access to external liquidity assessment				
Adjusted initial liquidity assessment	Exceptional	Strong*	Satisfactory	Limited	Uncertain
1	1	1	1	1	2
2	1	1	2	3	4
3	1	1 or 2	3	4	5
4	1	2 or 3	4	5	5
5	2	3 or 4	4	5	5

*When two options are possible, we typically choose the better assessment when either the two conditions described in table 11 are met or one of the two is met in an especially strong manner.

Debt Burden

105. We apply table 13 to assess an LRG's debt burden.

Table 13

Assessment Of An LRG's Debt Burden

<table>
<tr><th rowspan="2">Interest payment as a % of adjusted operating revenues§</th><th colspan="5">Tax-supported debt as a % of consolidated operating revenues*</th></tr>
<tr><th><30%</th><th>30%-<60%</th><th>60%-<120%</th><th>120%-<240%</th><th>240% and above</th></tr>
<tr><td><5%</td><td>1</td><td>2</td><td>3</td><td>4</td><td>5</td></tr>
<tr><td>5%-10%</td><td>2</td><td>3</td><td>4</td><td>4</td><td>5</td></tr>
<tr><td>>10%</td><td>3</td><td>4</td><td>5</td><td>5</td><td>5</td></tr>
<tr><td colspan="3">Positive Qualitative Adjustments</td><td colspan="3">Negative Qualitative Adjustments</td></tr>
<tr><td colspan="3">The following factor generally improves the initial debt assessment by one category:</td><td colspan="3">The following factor worsens the initial debt assessment by one category:</td></tr>
<tr><td colspan="3">Exceptionally high operating balance.</td><td colspan="3">Potential significant volatility in the debt burden.</td></tr>
<tr><td colspan="3">The following factor may improve the initial debt assessment by one or two categories:</td><td colspan="3">The following factor may worsen the initial debt assessment by one or two categories:</td></tr>
<tr><td colspan="3">Debt burden mitigated by large on-lent debt.</td><td colspan="3">Risk of materialization of contingent liabilities.</td></tr>
</table>

*Based on the debt level forecasted in two years time (i.e., debt in a year t+2). §Based on the average of actual, if available, or base-case data, for the last year, the current year, and the next year.

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Exceptionally high operating balance

106. We generally apply a positive adjustment for a high operating balance when direct debt typically represents less than five years of operating margin. More specifically, we typically apply the adjustment when average operating surplus is more than about 15% of operating revenue and when five years of operating surplus covers other obligations included in tax-supported debt and contingent liabilities.

Direct debt versus tax-supported debt

107. In rare instances, a government-related entity's (GRE) revenues may be disproportionally large compared with those of the LRG and, therefore, could dilute the debt burden measure on a consolidated level. In this case, we use the government's direct debt as a share of its direct operating revenues to derive the initial assessment. We consider the risk of these GREs in our contingent liabilities assessment.

Composition of direct debt

108. We add financial capitalized lease obligations to direct debt and, when material, capitalized operating lease obligations.

109. We also add the debt obligations of large PPP projects to the sponsoring LRG's direct debt when we assess that the LRG's primary motivation is to achieve off-balance-sheet treatment and when no significant risk transfer to the private sector is apparent, making the PPP payment more akin to debt payment.

110. In our opinion, in the case of availability-based projects, the government is contractually obligated to make regular payments to the private-sector participant and assumes most volume risk. Non-cancelable obligations are a form of long-term, near-debt-like obligations, and therefore we generally add them to the LRG's direct debt measures.

111. In practice, we generally add to a government's balance sheet the net present value of the string of annual capital payments that a government has made to compensate the private partner for building the asset.

112. The approach we use for PPPs also applies to an LRG's securitization of existing credits or future revenues (taxes, fees, or transfers). If an LRG executes a securitization simply to raise debt off balance sheet, we consolidate it in the LRG's direct debt. We treat other securitization deals as contingent liabilities.

113. If a debt sinking fund is not already taken into account in the adjusted cash for the purpose of calculating the DSCR, we may deduct it from the LRG's direct debt under specific circumstances--for instance, for a sinking fund that is strictly dedicated to the LRG's direct debt repayment, is not exposed to adverse economic and financial conditions, and can be relied on in the medium to long term, and for which assets accumulation in the fund does not incur further risks to the financial standing of the entity. We apply haircuts to the fund as per our haircut principles discussed above.

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Composition of tax-supported debt

114. **Nonfinancial GREs.** To assess whether a GRE's debt ultimately relies on an LRG's consolidated operating revenues, and therefore is included in tax-supported debt, we first look at the likelihood that the LRG will support the GRE in case of need. When our assessment is equivalent to a likelihood of support of very high or above, as per our GRE methodology, and when we believe the GRE needs, or we expect it to need, financial support in the foreseeable future, either to operate or to honor its financial obligations, then we generally include the GRE's debt and own-source revenues in the tax-supported debt ratio.

115. **Financial GREs.** Although a bank may benefit from an at least very high likelihood of support from a LRG, we do not include banks' debt in the LRG tax-supported debt because banks are, by their nature, leveraged, which would distort our measure of the LRG's debt. However, we consider the potential recapitalization cost in our contingent liabilities assessment.

Composition of the contingent liabilities

116. **Nonfinancial GREs.** Nonfinancial GREs that are not already reflected in tax-supported debt (including the GREs' guaranteed debt) and whose likelihood of support by the LRG is typically not in the lowest categories are usually reflected in contingent liabilities.

117. **Financial GREs.** When LRGs own, control, or guarantee a financial institution, we seek to assess the maximum risk that the institution could represent for the LRG. When possible, we quantify this risk using our risk-adjusted capital framework model (see Related Criteria). Specifically, we estimate stress-case losses over a three-year period under a substantial, 'A', stress scenario and calculate the ensuing hypothetical recapitalization cost. When such analysis is not possible, we assume a standard recapitalization cost equivalent to 8% of total assets, and other potential liquidity support, when relevant. The 8% standard is based on our observation of cases of bailout of banks by central or local governments in the eurozone after the 2008 financial crisis.

118. **PPPs.** Even though a PPP's legal documentation may state that associated private debt is nonrecourse to the LRG, we have observed that the LRG may, nevertheless, aid a given PPP project for political or economic reasons. Therefore, we view these arrangements as presenting contingent liability risks potentially affecting our view of the LRG's budgetary performance, debt, and liquidity.

119. In addition, even in the case of availability-based projects, we typically treat cancelable PPP obligations as contingent liabilities only during the construction phase. The existence of termination provisions written into a typical PPP agreement potentially gives an LRG the option of walking away from its contractual obligation, subject to the financial compensation of the equity sponsors and bondholders.

120. **Litigation.** LRGs might face a variety of litigation linked, for instance, to expropriations or environmental considerations. We may view such litigation as a contingent liability. This risk is difficult to evaluate because the liability depends on court decisions. As a result, we generally assess litigation risk through discussions with an LRG's senior management and by reviewing the LRG's track record of annual payments relative to total outstanding claims and the LRG's budget size.

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121. **Other common types of contingent liabilities.** If an LRG takes part in a joint-and-several-guarantee mechanism at the benefit of a third-party entity, we generally consider only the LRG's exposure to the third-party entity.

122. Other types of contingent liabilities include extraordinary support to lower levels of government.

Contingent liabilities ratio calculation

123. To assess an LRG's exposure to contingent liabilities, we calculate a contingent liabilities ratio as follows:

- We sum the debt of the nonfinancial GREs that is not consolidated with the other contingent liabilities (such as PPPs, securitizations, guarantees to non-GREs, or litigation) and, if relevant, the expected recapitalization cost or other potential liquidity support expected to be provided to the financial GREs; and
- We compare the aggregated amount to the LRG's consolidated operating revenues.

124. When we believe that the risk would be borne by several entities, we consider only the portion of the obligations that we believe the LRG would likely assume in a case of distress. We generally consider the same portion of the own-source revenues in the LRG's consolidated operating revenues.

125. We then evaluate the impact of the contingent liabilities assessment on the initial debt burden assessment based on table 14. Deciding how much to adjust the initial debt assessment, if at all, reflects our view of the risk that the contingent liabilities will materialize. (For example, our adjustment could be by one or two categories if the contingent liabilities ratio is above 60%.)

Table 14

Contingent Liabilities Exposure As A Percentage Of Consolidated Operating Revenues

Contingent liabilities exposure as a percentage of consolidated operating revenues	<60%	>60%
Adjustment based on risk of materialization	0/1	1/2

126. We assess the risk of the materialization of the contingent liabilities depending on:

- Our view of the likelihood that the contingent liabilities could affect the LRG's budgetary, debt, or liquidity profile at some point; and
- Our view of the LRG's propensity to financially support the related contingent liabilities.

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Glossary

Budgetary performance

127. **Operating revenues.** Recurring revenues that an LRG receives. Operating revenues comprise taxes and nontax revenues, such as grants, operating subsidies, fines, fees for services, tariffs, rents, and other sources from which the LRG derives revenues. They exclude capital revenues, such as capital subsidies and proceeds from asset sales, and any revenues from borrowed funds.

128. **Adjusted operating revenues.** Operating revenues adjusted for material noncash and pass-through items when we deem it relevant.

129. **Consolidated operating revenues.** An LRG's operating revenues and the commercial revenues (comprising fees and sales, among others), when available, generated by nonfinancial GREs (whose debt we include in either the LRG's tax-supported debt or its contingent liabilities). We deduct from the GREs' revenues material sums that come from the LRG itself, such as a subsidy or service contract.

130. **Operating expenditures.** Correspond to the costs of an LRG's operations, its administration, and its provision of services to the population, directly or through other public bodies, as well as interest expenses.

131. **Adjusted operating expenditures.** Operating expenditures adjusted for material noncash (provisions, depreciation) or pass-through items.

132. **Operating balance.** Equals adjusted operating revenues minus adjusted operating expenditures.

133. **Capital expenditures.** Typically cover the repair and replacement of existing infrastructure and the development of new infrastructure.

134. **Capital revenues.** Chiefly comprise proceeds from asset sales and capital grants.

135. **Balance after capital accounts.** Results from the addition of capital revenues to and the subtraction of capital expenditures from the operating balance.

136. **Total adjusted revenues.** The sum of adjusted operating revenues and capital revenues for a given budgetary period.

Liquidity

137. **Total free cash.** The total free cash position sums up adjusted cash, liquid assets, balance after capital accounts, interest spending, onlending (when relevant), and already contracted short- and long-term funding available to cover spending over the coming 12 months.

138. Adjusted cash includes reported cash at the beginning of the fiscal year, adjusted for any amount that is not fully available for debt service within the next 12 months and for any amount that we expect to fund spending or debt repayment beyond the next 12 months.

139. Liquid assets include unrestricted assets that are available to cover debt service over the next 12 months--that is, they exclude sellable assets that have already been taken into account as capital revenues in our forward-looking balance after capital accounts.

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Debt burden and contingent liabilities

140. **Tax-supported debt.** The sum of the following items:

- Direct debt of the LRG;
- Debt of nonfinancial GREs (whether it is guaranteed or not), when: 1) We view the likelihood that the LRG will provide support for the GRE in case of stress as being very high and above; and 2) The GRE needs, or we expect it to need in the foreseeable future, payments or ongoing support either to operate or to honor its financial obligations; and
- Guaranteed debt.

141. **Interest payments.** Correspond to the amount of interest paid within a given budgetary period on direct debt, including the interest component of leases, PPP, and securitizations, when relevant.

142. **Debt service.** Equals interest payments plus the amount of principal repaid during a given budgetary timeframe, including the capital component of leases, PPP, and securitizations, when relevant, as well as short-term debt repaid during the period.

143. **Direct debt.** Comprises long- and short-term financial debt assumed directly by the borrower--loans, bonds, credits, and, when material, capitalized lease obligations. It also comprises debt of PPPs and securitizations when we assess that the primary motivation for the LRG is to achieve off-balance-sheet treatment and when no significant risk transfer to the private sector is apparent, making the PPP payment more akin to debt payment.

144. It excludes guaranteed debt and the debt of GREs. It includes debt serviced via subsidies from other levels of government, unless the legal obligation to service this debt is transferred to the other levels of government.

145. **Guaranteed debt.** Financial debt on which the principal and interest payments are the responsibility of the LRG (as the guarantor), if the borrower that is primarily liable fails to repay the debt. When an LRG is servicing, or we expect it to service, the debt it has guaranteed, then we include the guaranteed amount in the LRG's tax-supported debt, whether it is related to GREs or non-GREs. When not included in tax-supported debt, guaranteed debt is included in contingent liabilities.

SUMMARY OF THE CHANGES AND IMPACT ON OUTSTANDING RATINGS

146. The main changes we have made to our methodology intend to better capture country- and entity-specific situations and ultimately enable greater rating consistency. The goal of this update is also to simplify and provide greater clarity to our LRG analytical framework.

147. We believe that there will only be a limited impact on the ratings within the scope of this methodology. Assuming entities in scope maintain their current characteristics, our testing suggests that less than 10% of our portfolio of public ratings will see a potential impact. Most of those LRGs would be either upgraded or downgraded by one notch. These numbers do not include the potential impact on LRG confidential ratings, on national scale ratings, or on the ratings on LRG-related entities.

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REVISIONS AND UPDATES

This article was originally published on July 15, 2019.

Changes introduced after original publication:

- On June 4, 2020, we republished this criteria article to add "Guidance: Rating Implications Of Exchange Offers And Similar Restructurings, Update" to the "Related Publications" section.
- On Sept. 3, 2020, we republished this criteria article make nonmaterial changes. We updated criteria references in paragraph 12 and the "Related Publications" section and updated the contact information.
- On Dec. 15, 2021, we republished this criteria article to make nonmaterial changes. We updated our contact list as well as references to related criteria and research.
- On May 17, 2022, we republished this criteria article to make nonmaterial changes. We clarified in paragraph 54 that "underfunding" may be in a form other than large amounts of unpaid supplier debt at the LRG level or related public-sector entities.
- On Oct. 18, 2022, we republished this criteria article to make nonmaterial changes. As announced in "Evolution Of The Methodologies Framework: Introducing Sector And Industry Variables Reports," published Oct. 1, 2021, we are phasing out guidance documents over time. As part of that process, we have archived "Guidance: Methodology For Rating Local And Regional Governments Outside Of The U.S.," published July 15, 2019, and moved its contents to the Appendix of the criteria without any substantive changes. As a result, we updated the numbering of the subsequent paragraphs. In addition, we updated various publication references.
- On Oct. 11, 2023, we republished this criteria article to make nonmaterial changes in paragraphs 7, 10 and 13, and to correct a publication error in paragraph 8. All nonmaterial changes clarify that we use "trends" to convey our forward-looking view on institutional frameworks. In paragraph 8, we deleted the word "five" in "The expected future performance of one or several of the five key credit factors," as it is an inaccurate description of our methodology.
- On May 7, 2024, we republished this criteria article to make nonmaterial changes to update references to related criteria and research.
- On July 26, 2024, we republished this criteria article to make nonmaterial changes. Specifically, we deleted references to the public-sector funding agencies criteria in paragraph 121 and in the "Related Criteria" section as a result of the revision of the public-sector funding agencies criteria. Following the conversion of both non-U.S. LRG and sovereign SIVRs, we also deleted the "SIVR And Guidance" section, updated the "Related Criteria" and "Related Research" sections, and added the references to the sovereign sector and industry variables in paragraphs 22, 26, and 28 of this article. Finally, we deleted the "Key Publication Information" box and updated the contact information.

RELATED PUBLICATIONS

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Fully Superseded Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment, Dec. 15, 2008

Related Criteria

- Risk-Adjusted Capital Framework Methodology, April 30, 2024
- Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Sovereign Rating Methodology, Dec. 18, 2017
- Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Methodology And Assumptions For Rating Mexican Tax Participation And Local Revenue Future Flow Transactions, Nov. 6, 2015
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., April 8, 2024
- 2020 Annual International Public Finance Default And Rating Transition Study, Sept. 14, 2021
- How Environmental, Social, And Governance Factors Help Shape The Ratings On Governments, Insurers, And Financial Institutions, Oct. 23, 2018
- What Does S&P Global Ratings Consider A Default For Sovereign And Non-U.S. Local And Regional Governments?, April 13, 2017
- The Time Dimension Of Standard & Poor's Credit Ratings, Sept. 22, 2010
- S&P Global Ratings Definitions, updated from time to time

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