中誠信(亞太)
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June 2017

# Rating Methodology for Regional and Local Governments

## Summary


This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") applies to regional and local governments in a global context. Local governments are the public administration of geographic areas such as towns, cities, counties and states, mainly responsible for the public services and infrastructure.

The credit rating of regional and local governments is mainly determined by two factors. The first factor is the Baseline Credit Assessment (BCA) of the rated local government, which measures local government's individual standalone credit strength within its operating environment. The second factor is the likelihood of support from higher-tier government when the rated local government is facing repayment pressure. The sovereign rating of the country is set as the rating cap of local governments.[1]

Based on the risk characteristics of regional and local governments, this rating methodology introduces the key determinants for rating local governments. CCXAP assigns credit ratings to them using its rating scale.


## Introduction of Rating Methodology

The key rating determinants are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summarized guidance for the important factors used in assigning ratings, but it does not include every aspects of rating consideration. As a result, the mapped rating may not match the final rating of each company.

In this rating methodology, CCXAP specifies five key rating factors comprising 12 secondary factors in a range of score distribution to evaluate the overall rating score. The final rating is decided through analyzing the special differentiation between the factors by the credit rating committee. All the detailed factors are presented in the following table.

| Rating Factors | Secondary Factors | Tertiary Factors |
|---|---|---|
| **Economic Strength** | Economic Scale and Economic Growth | GDP<br>GDP growth |

[1] In exceptional cases, the credit rating of local government may be higher than its sovereign rating, e.g. if the local government is in the situation of high degree of autonomy.

| Rating Factors | Secondary Factors | Tertiary Factors |
|---|---|---|
| | Income Level<br>Economic Structure | GDP per capita<br>Economic Diversification |
| **Institutional Environment** | Institutional Framework | Stability and Predictability |
| **Financial Performance** | Fiscal Revenue and Revenue Growth<br>Fiscal Stability<br>Fiscal Balance | Government Revenue<br>Government Revenue Growth<br>Taxes/Operating Revenue<br>Operating Revenue/Operating Expenditure |
| **Debt-servicing Capability** | Debt Burden<br><br>Interest Burden | Debt/GDP<br>Debt/Operating Revenue<br>Interest Payment/Operating Revenue |
| **Adjustment Factors** | Development Prospects<br>Debt and Liquidity<br>Governance and Management | |

## Key Rating Determinants

### 1. Determining the BCA of the local governments

BCA measures the local government's ability and willingness of debt servicing. Economic strength, institutional environment, financial performance and debt profile of the rated local government as well as some adjustment factors are considered in the process of BCA evaluation.

(1) Economic strength

The local economy is one of the most important factors to evaluate the credit level of the local governments. This factor indicates the level of economic development and its potential influence. The economic strength of local governments is mainly reflected in the following aspects: economic scale and economic growth, economic structure and income level.

(a) Economic scale and economic growth

The economic strength of local governments depends on its economic foundation. The factor of economic scale and economic growth is measured by the gross domestic product (GDP) and GDP growth of the region where the local government is located, which are two important indicators to evaluate the overall level of economic development and growth rate.

(b) Economic structure

The industrial structure of regional economy indicates whether the economy is well diversified and the degree of concentration in major sectors. The factor of economic structure is evaluated by the economic diversification in the region. The top three industries or service sector as a percentage of regional GDP can be taken into consideration in a quantitative approach.

(c) Income level

The income level generally reflects the development strength of regional economy and the wealth level of regional residents. The factor of income level mainly assesses the living standard of regional residents by using GDP per capita.

(2) Institutional environment

CCXAP mainly considers the institutional environment of the local governments in a qualitative approach during the credit rating procedure, namely the institutional framework factor. This factor combines both internal and external governance and management.

(a) Institutional framework

Institutional framework mainly evaluates that whether the local governments apply clear law and regulation and retain stable power and responsibility, whether the policy change is approved in a prudent and transparent approach. The stability and predictability of institutional framework for the local governments has an influential impact on its management level, which is important to predict the income prospect and expenditure responsibility in the future.

(3) Financial performance

Financial performance is the basic measurement of local government's credit level. CCXAP takes into account fiscal revenue and fiscal revenue growth, fiscal stability and fiscal balance for evaluating the factor of financial performance.

(a) Fiscal revenue and revenue growth

CCXAP considers the financial performance by focusing on all fiscal income of the local governments, including the relatively stable sources of revenue and other forms of revenue. Fiscal revenue is mainly assessed by government revenue and government revenue growth.

(b) Fiscal stability

The factor of fiscal stability of the local governments assesses the statutory revenue and its sustainability, which is measured by the ratio taxes over operating revenue.

(c) Fiscal balance

The factor of financial balance mainly considers the coverage of fiscal expenditure by fiscal revenue, which is the ratio of operating revenue over operating expenditure.

(4) Debt-servicing capability

The ability of debt repayment reflects the financial performance and operating efficiency. The debt level and debt structure directly determines the credit risk of local government. We take into account debt burden and interest burden.

(a) Debt burden

We evaluate the debt burden of the local governments by taking into account two ratios, which are the debt-to-GDP ratio and debt–to-operating revenue ratio.

(b) Interest burden

The factor of interest burden measures the flexibility and capability of debt servicing by the local governments. We use the ratio of interest payment over operating revenue. When the interest burden is lower, the risk of default will be lower.

(5) Adjustment factors

In assessing the BCA of the local governments, there are qualitative adjustment for consideration including the elements of development prospects, debt and liquidity, governance and management.

(a) Development prospects

The development prospects of the local governments are evaluated by the prospects of major economic drivers, sustainability of resources and development of financial markets.

(b) Debt and liquidity

The debt and liquidity of the local governments are measured by the debt structure and maturity profile, indirect debt and contingent liabilities, cash and liquidity management. Debt structure measures the percentage of short-term debt by total debt, and maturity profile measures any concentration of debt repayment in the future. Contingent liabilities of local governments might affect credit quality if the local governments consider providing various types of support to other entities. We also evaluate cash and liquidity management practice of the local governments.

(c) Governance and management

The governance and management is an important factor to affect the credit worthiness of local governments. High degree of transparency and efficiency could not only facilitate the development of regional economic and the improvement of financial performance, but also lower the default risk of local governments. Governance and management are considered from three aspects including policies and practices, internal control and planning, information transparency and accountability.

**2. Considering the support from higher-tier government**

The next step after confirming the BCA of local government is to consider the support from higher-tier government, which could help improve the credit level and lower the default rate of the rated local governments. Support from higher-tier government means that when a local government is facing severe pressure of debt servicing, its higher-tier government may provide support to serve debt or take actions to avoid default. In assessing the support from higher-tier government, we consider the following factors such as the economic and political importance of the rated local government, the legal requirements and degree of oversight from higher-tier government, and the support and bailout histories.

(1) Economic and political importance

The supporting performance from high-tier government is largely affected by the economic and political importance of a local government. The measurement of economic importance is the regional GDP as a percentage of the GDP of higher-tier government. The assessment of political importance is the government policy stance of higher-tier government.

(2) Legal requirements and degree of oversight

Legal requirements mainly consider whether the legal environment requires or restricts the higher-tier government to support the lower-tier government. The degree of oversight from higher-tier government shows its attention to the financial and debt stability of lower-tier government.

(3) Support strength and support willingness

The factor of support strength mainly assesses the credit rating of the higher-tier government. Higher the credit rating of the higher-tier government, stronger is the debt-servicing capability, and greater support can be provided to lower-tier government. The factor of support willingness reflects that whether the higher-tier government has responded in historical near-default events by either providing bailouts or allowing defaults.

**3. Setting the sovereign rating as cap**

Due to the close relationship between the local governments and its sovereign country, the macroeconomic conditions of the country will affect the credit profiles of its domestic issuers, and the financial relevance will also influence the credit risk of both sovereign country and local governments. Therefore, the credit ratings of local governments are generally equal to or lower than the sovereign rating.

**Important Information**



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