

International Rating Methodology for Regional and Local Governments

Analysts

New York

Gersan R. Zurita
1 212 908-0318
gersan.zurita@fitchratings.com

Barcelona

Fernando Mayorga
34 93 323 8400
fernando.mayorga@fitchratings.com

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Related Research

- “Swedish Local Authorities: Wide Responsibilities; Centralised Revenues,” dated March 2002.
- “Financing of Mexican States, Municipalities, and Agencies: Alternatives and Strategies,” dated January 2002.
- “The Evolution of Local Government in Japan,” dated September 2001.
- “U.S. Local Government General Obligation Rating Guidelines,” dated May 2000.
- “Impact of Management Practices on Municipal Credit,” dated May 2000.

Throughout this report, the terms “regional and local governments,” “subnationals,” “subnational government,” “subnational local authority,” and “local authority” are used interchangeably to refer to municipal and regional, state, or provincial governments.

■ Overview

Fitch Ratings’ analysis of the general obligation (GO) debt of subnational units of government assumes that the entity is in a “stand alone” position and centers on the ability and willingness of the rated entity to pay its financial obligations in a timely manner without the benefits of any credit enhancement or additional support from whatever source. However, a GO rating will reflect the degree of national government support, whether implicit or explicit, or if the form of support is fiscal (e.g. budgetary subsidies) or financial (e.g. debt guaranties or enhancements).

In most cases, both the long-term foreign and local currency ratings (FCR and LCR, respectively) of sovereign debt will limit the ratings of the subnational government. Particularly in countries that remain highly centralised, in which the local authority will depend on transfers from the central government for a substantial portion of the revenues available for debt service payments, the LCR of sovereign debt will also cap the LCR of subnational authority debt.

■ Motivation and Rationale for Ratings

A subnational authority, particularly one that is large and internationally recognised, may wish to access the international capital markets or obtain a Fitch rating for a variety of reasons, including:

- The need for infrastructure projects is increasing while funds from central or national governments are diminishing due to financial constraints.
- Commercial banks are not a natural source of credit due to the long-term nature of the financing required for many capital investments.
- Access to private sector third-party project financing is facilitated when the sponsor assuming the “off-take” risk has an international currency rating. Project finance ratings are frequently limited by sovereign or sponsor ratings.
- Less often, central governments require ratings of local authorities for regulatory purposes (e.g. to regulate the banking system, limit overall public sector exposure to external financing, and safeguard pension fund investments in government securities, among other reasons).
- By their own initiative, local authorities will also often request to be rated even when they do not expect to issue securities in the capital markets, as a rating will be perceived as a credible independent assessment of an entity’s fiscal performance.

Another trend generating strong interest in ratings is decentralisation, the process of transferring power from national governments to cities, provinces, and regions. Many nations are adopting decentralised structures in response to a number of concerns of national interest, or simply as central governments recognise that a decentralised structure may lead to a more efficient and effective delivery of public services and greater local accountability.

Central governments are influencing the demand for ratings for subnationals. Motivated by central bank and other oversight agency regulations, governments have become reluctant to continue closing persistent fiscal gaps generated at the subnational level. In some countries, the drive to greater accountability at the local level is influenced by central governments' need to comply with the fiscal conditions of their agreements with the International Monetary Fund (IMF) or other multilateral lenders and by a gradual shift of political power from the center to the lower tiers of government.

Consequently, new lending limitations and tighter regulations create a gap in funding for subnationals in countries without a well developed municipal bond market. In Europe, subnationals can borrow from a credit institution of their choice or through the bond market. In fact, many subnationals continue to finance their capital projects through large, well capitalised universal banks with whom they have developed long-term relationships. However, a number of Spanish, Italian, and German subnationals have accessed the capital markets for a number of years. Recognising the advantages inherent in bond financings for borrowers, Fitch expects more European subnationals to enter the capital markets in the near future.

In the emerging markets, Russian regions, Argentine provinces, and many Eastern European and Latin American cities have also issued eurobonds. The Asian, Russian, and Brazilian crises of 1997–1999 derailed and temporarily froze the development of the global municipal bond market, but the underlying need for funds remains. With these crises, the need to reorder debt structures and debt amortisation schedules actually intensified.

Ultimately, the ideal scenario for subnationals is to have access primarily to a large domestic capital market, similar to the U.S. municipal bond market or Yankee bond market for Canadian issuers. However, in many countries, the capital (savings pools, pension

funds, money market funds, among other types) available to invest in long-term dated municipal bonds remains insufficient. The domestic markets are also illiquid. Partly for these reasons, subnationals in the emerging markets have borrowed in the global markets in spite of the currency risk.

Entering the international credit markets presents government issuers with many challenges. A rating is the first step in establishing a long-term relationship with international investors. The credibility of that relationship must be maintained over time with good disclosure practices and forthright discussion of an issuer's strengths and weaknesses. Other challenges include the commitment of staff time and expertise to compile the diverse information needs required by international market analysts, the availability of socioeconomic measures and trends, and the availability or development of budgets and audited financial statements.

■ Decentralisation

Decentralisation may be one of the defining issues of the 21st century, as it will influence the distribution of political power and have important implications for development and how it is financed. (Refer to International Bank for Reconstruction and Development/The World Bank, World Development Report 1999/2000, Chapter 5 Decentralisation Rethinking Government.) Greater autonomy may lead to more efficient and responsible government, but there is no guarantee that it will work, as the tension between central government and subnationals can strain to the point of crisis.

Generally, in a decentralised environment, the regional and local economy will influence the issuer's ability to raise revenues available for debt service far more directly than a centralised system. In contrast, management quality, as demonstrated primarily by the fiscal and financial conditions of the issuer, will differentiate the credit quality of the subnationals operating in a highly centralised system.

With regard to how the institutional framework, whether centralised or decentralised, will influence the operating revenue structure of the subnationals, Fitch will need to know the following:

- The size of the transfers and their relative share of the subnational's operating revenues.
- Whether transfers are earmarked for specific purposes or can be used to fund operations and debt service.

- Revenue sources that have been legally delegated to the subnationals.
- Flexibility of the subnational to effectively adjust its tax revenue budget to a changing economic environment.
- Legal and political risks associated with the national revenue-sharing system and the direction of any changes in the system (toward more or less decentralisation). With respect to the legal and political risks, Fitch recognises that federal structures are dynamic over the long term, but the shifts may influence fiscal balances in the near term.

With regard to how the institutional framework will influence the operating expenditure structure of the subnational, Fitch will consider the following:

- The size and type of mandated expenditures (e.g. public health, public education, or public transportation).
- Whether operating expenditures may be funded by user charges, fees and taxes delegated to the unit, or earmarked revenues from another unit of government.
- Whether the subnational can adjust its expenditure budget effectively to a changing economic environment.
- Socioeconomic trends underpinning the demand for public services (e.g. if population growth is straining the supply of public services).

The importance of socioeconomic trends is illustrated by regional governments in Italy providing public health services to local residents. These expenditures represent, by far, the heaviest burden for the regions. An analysis of the factors that lead to greater demand for health services, such as a rapidly ageing population or an increasing share of household income dedicated to health expenditures, will be fundamental to the rating. Similarly, in the Mexican states, public education at the elementary level represents the most significant concern for public officials due to a still rapidly growing population.

■ Rating Factors: Criteria

The rating analysis of subnational entities comprises both quantitative and qualitative factors. Generally, the qualitative factors will bear greater importance and include the characteristics of the institutional framework, political factors associated with intergovernmental relations, socioeconomic profile, and other elements that offer insight into the willingness of the entity to pay its financial obligations.

In terms of the quantitative factors, Fitch generates financial models, primarily to analyse the trends and projections of the public finances and debt levels of the entity. The quantitative analysis affords mainly a prediction of the ability or capacity to pay financial obligations.

Nevertheless, Fitch recognises in its methodology that both the quantitative and qualitative factors can influence, either together or separately, an entity's ability and willingness to pay financial obligations. Most important, the quality of management plays a central role in the rating analysis.

Institutional and Administrative Factors

A study of the institutional framework is a fundamental and necessary beginning to Fitch's rating process. With a clear view of the intergovernmental relations, the process will then shift to other factors, including the socioeconomic profile of the area, public finances, and debt position.

A detailed description of the issuer's organisational structure and types of public services provided by the entity, as well as an understanding of the legal environment, will enable Fitch to assess the degree of autonomy, demand for capital, and other fundamental credit factors. Full autonomy is rare, and cities, provinces, and other local governments are normally subject to constitutional and statutory regulation regarding governmental powers, organisational structure, financial operations, debt issuance, and government service provision. Therefore, in most cases, a sovereign government, by definition, will enjoy greater financial flexibility than its political subdivisions.

Analysis of the framework would reveal whether an entity should be rated equal to the sovereign either because of central government explicit guarantees or other mechanisms of credit substitution. Alternatively, the analysis could indicate that the framework remains in flux, with changing tax powers, still undefined scope of responsibilities, lack of consensus on revenue sharing systems, or even the nature of constitutional charters at the regional and local levels. If so, implications on the ratings would be profound.

Administrative and Legal Information Requirements

- Description of an issuer's government responsibilities (e.g. schools, road maintenance, and health care).
- Organizational chart.
- Electoral procedures for governing body and chief elected officers.
- Appointment process for key administrative and professional employees.
- Professional qualifications of key administrative and professional employees.
- Specific governmental powers and limitations granted by a national constitution, charter, or statute.
- Financial and debt oversight powers by other governments or the central government.
- Relationship of the issuer to other government bodies, particularly in terms of service provision, governmental powers, financial autonomy, and debt issuance.
- National regulatory environment as it affects the issuer, such as recent or planned privatization of government-owned utilities, environmental regulations, or foreign currency or debt restrictions.
- Pending or proposed legislation that impacts revenue sources, issuance of debt, pledged security, operation of utilities, or shifts in service mandates to/from the issuer.
- Summary of bankruptcy and insolvency laws and related court rulings as they affect the issuer.
- Detail on statutory, charter, and constitutional limitations on debt issuance and ability to raise additional taxes.
- Results of recent local elections and the national results.
- Statement of political priorities.

Economic and Social Profile

Fitch assesses the economic base of an issuer to evaluate the long-term potential for stability of its revenue structure during economic cycles, job losses, employment shifts in key industries, and other situations. A diverse economy is a positive credit factor, with no dominant employer or industry and a blend of manufacturing, agricultural, services, government, wholesale and retail trade, mining, and financial services jobs. Any dominant employer or industrial sector would be evaluated by Fitch, as its

Economic Information Requirements

- Employment by sector, multiple year trends.
- Comparative unemployment rates.
- Largest employers (10–20 or more).
- Population trends and demographics.
- Details of significant ethnic, religious, and linguistic minorities.
- Income measures, including per capita income.
- Trend of property values.
- Information on transport, communication, and utility services.
- Infant mortality statistics.
- Health services availability.
- Literacy/education statistics.
- Commercial building occupancy rates.
- Building permit trends/recent new construction.
- Resident housing starts.
- Other economic measures (e.g. tonnage shipped, harvest results, and major agricultural products).
- Gross domestic product (GDP) for the issuer, including a description of how it is measured and by whom.
- Investment and foreign direct investment, analysed by sector and names of major western firms.
- Imports and exports by sector.
- Inflation, price level compared with the national average.
- Description of the communications and transport infrastructure.

performance may potentially jeopardise the creditworthiness of the entity.

Discussion of the issuer's economy in relation to national and regional economies is particularly relevant. A local government may not be diverse itself, but may be part of a larger, more diverse metropolitan area. Employment type can also be significant. For example, government employment related to national capital cities or service sector employment related to major universities can be a stabilising factor. Employment related to ageing industrial plants may be vulnerable to closure or relocation outside the region or country.

An issuer's strategic importance, such as its status as national or provincial capital, regional service or financial center, or benefiting from natural resources of national significance will be viewed favourably by Fitch. Furthermore, the availability of basic economic

infrastructure is relevant to the quality of life (and any social pressures that must be addressed by the local authority). This includes reliable electricity supply, transportation system, health, water and wastewater treatment facilities, and modern telecommunications services.

An entity enjoying an economy based on its own resources and geographic advantages would be stronger than one dependent on national tax incentives or subsidies for existing or future employment growth; that is, the economic viability of the entity is a fundamental strength. As such, the strategic location of a port or transportation center can be vital to the local economy.

In contrast to the U.S. and Germany, where economic and political activity is highly dispersed throughout the national territory, often international municipalities may be assigned centralised political and governmental functions and, consequently, economic activity may be concentrated in one or two major cities. This is seen in Rio de Janeiro, Tokyo, and London, among many others. High concentrations of political and economic life in one district can often be detrimental to the viability of secondary local authorities.

Demographic trends are also a significant component of the rating analysis, especially for entities responsible for elementary and secondary education and public health. In addition, population characteristics can be decisive in terms of the weight of certain liabilities, such as pensions, the debt of hospital systems run by the entity, and new debts to finance substantial capital investments to meet the demands of a growing population.

Budgetary Factors

Fitch evaluates financial operations to measure the degree of flexibility during times of economic stress. The ongoing liquidity of an issuer in meeting current obligations and debt service is a critical credit consideration. Other credit elements include revenue diversity, autonomy to raise taxes, ability to balance financial operations over the economic cycle, willingness to control expenses, cash flow management, and the weight of capital investments on the fiscal performance of the entity. Fitch also considers employee relations and the financial impact of collective bargaining agreements. Consistent financial management and a tradition of conservative budgeting usually indicate a growing local economy

Budgetary and Financial Information Requirements

- Table of revenues and expenditures, history (past five years) and forecasts showing budgets, and the final figures. This analysis should show separately figures for new borrowing, debt repayment, and interest paid and distinguish between capital and current expenditure/revenue.
- Statement of accounting standards.
- Current year budget versus year-to-date financial operations.
- Next year's budget, if available.
- Taxpayer composition for major tax sources.
- Description of each tax and rate-setting powers.
- Level of tax and other revenue arrears.
- Proportion of revenues and expenditures received/paid as barter rather than cash.
- Basis for allocation of transfers to the issuer from the central administration (formula versus negotiation).
- Budget-setting process.
- Description of main expenditure responsibilities and cost drivers (e.g. number of teachers/pupils in the case of education).
- Analysis of protected and unprotected expenditures.
- Detail on nonrecurring revenue sources, asset sales, and privatization.
- Capital improvement plan.
- Investment policy.
- Audits for issuer-owned utilities or businesses.
- Detail on union membership and contract terms.
- Trend of cash balances and statement of invested funds.

and political stability, two important determinants of creditworthiness.

Financial analysis begins with a review of the issuer's financial statements and accounting policies. A balance sheet disclosing cash balances, intragovernment borrowing (among various related entities of the subnational authority), and assets and liabilities would be an ideal starting point. Lack of financial information can limit the credit rating. While Fitch prefers financial statements audited by an independent and reputable accounting firm, it is understood that many governments cannot provide them. Fundamentally, budgetary presentations of

Best Practices with Significant Rating Value for Fitch

- Cash reserve policy/working capital reserves/budgetary cushions.
- Multiyear financial forecasting.
- Monthly or quarterly financial reporting and monitoring.
- Contingency planning policies.
- Policies regarding nonrecurring revenue.
- Depreciation of fixed assets.
- Debt affordability reviews and policies.
- Pay-as-you-go capital funding policies.
- Debt retirement speed.
- Five-year capital improvement plan integrating operating costs.

fiscal performance are inadequate but often the most commonly available form of financial disclosure worldwide. Generally, the greater the quality of the financial disclosure, the better the results of the rating process.

Management

Management has always been viewed as a crucial component of credit analysis at all levels of government. However, Fitch has concluded that management practices are even more important to predicting favorable credit performance than

Worst Practices with Significant Rating Concern for Fitch

- Cash basis accounting.
- Qualified audit opinion for material weakness.
- Deficit financing for two of last five years.
- Debt retirement speed.
- Unfunded accrued pension liability.
- Short-term borrowing growing significantly faster than annual spending.
- Debt reprogramming that defers a small share of current debt service.
- Overreliance on nonrecurring revenue.
- Aggressive investment policy for operating funds.
- Pension contribution deferral in the current budget year.
- Budgetary impasse beyond legal completion date.
- Lack of capital improvement plan.
- Excess borrowing from related entities, with no capacity to repay in near future.

appreciated in the past. Since 2000, Fitch has been placing greater and more specific weight on management practices, both good and bad, that are employed by issuers in running their financial operations (*for a complete discussion of management in Fitch's rating approach, see Fitch Research on "Impact of Management Practices on Municipal Credit," dated 4 May 2000, available on Fitch's web site at www.fitchratings.com*).

As a key to ratings in the 21st century, management analysis, as well as new viewpoints in the examination of local economies and sources of repayment, collateral pledged, or structural enhancements, form the cornerstone to Fitch's revised rating guidelines for subnational debt. These subjects will be discussed fully in upcoming research reports. Additionally, for issuers in developing markets, in particular, Fitch believes that, in the age of the internet and rapidly expanding technology, frequent and complete updates of financial disclosure that may be widely accessible to investors worldwide in both English and the native language, will be vital in differentiating winning borrowers in the international capital markets.

Financial Analysis

Fitch's financial analysis addresses the entity's primary revenue sources, expenditure trends, operating results, and liquidity position. The composition of the revenue stream available for general purpose governmental services will be examined. A diverse, flexible revenue base indicates greater resilience in economic down cycles and less vulnerability to loss of a major employer or industrial weakness.

The analysis focuses on the trends for each major revenue source, preferably spanning a five-year period or for the duration of the last full economic cycle. In addition to recent trends, Fitch will examine forecasts of budgetary performance in light of macroeconomic projections. Helpful to a complete analysis is supporting information that includes statutory authorisation, allocation formulas, property assessment valuations, tax rate history, rate or levy limitations, legal procedures for increasing rates or terminating the tax, history of recent rate increases or decreases, and collection rate frequency. Revenue and expenditure growth relative to local inflation rates will be relevant to entities operating in inflationary environments.

Fitch will also examine the decentralised sector of the entity, focusing on the flows to and from entity-owned enterprises, such as public service utilities, and nonrecurring revenues from asset sales or privatisation proceeds. Intergovernmental revenues, such as national government revenue sharing, are particularly relevant to entities operating in centralist systems or with weak economies.

Actual and projected financial operations should clearly delineate operating or current expenditures, debt service expenditures, and capital expenditures. It is also useful to outline revenues and expenditures that are passed through to other government entities or are highly restricted in use. Fitch will examine potential pressures on an issuer's operating budget, such as collective bargaining agreements, ongoing subsidies for mass transit, or subsidies for issuer-owner banks or utilities. Financial summaries should indicate key assumptions and background information, as applicable, such as actual and projected exchange and inflation rates.

Fitch reviews an issuer's budget and capital plan closely. The budget is analysed for realistic, conservative revenue, expenditure, and economic assumptions. A capital plan should indicate planned capital projects and estimated funding sources, including debt issuance. Capital expenditures can be significant components of the overall financial plan and key to economic development strategies of many developing market issuers. Budget and capital plans are important indicators of an issuer's commitment to long-range planning and financial management.

Debt and Indirect Risk Factors

Debt: Fitch reviews the purpose of the proposed financing. Financings for essential government purposes creating long-term investment in the community, such as schools, mass transit, or water and wastewater service, among other purposes, are a positive credit factor. Financing short-term operating expenses or operating deficits on a long-term basis is a credit weakness.

There is relatively less investor scrutiny of the use of bond proceeds for GO debt than with revenue-secured debt subject to competitive pressures (power plants or telecommunication utilities) or user fees (water and sewer systems, port facilities, or toll roads). Because GO debt is secured by diverse general revenue sources and taxing powers, typically both construction and operating risks are mitigated. However, Fitch would review the project feasibility

Debt Information Requirements

- Debt management policies.
- Itemization of debt by issue, principal outstanding, security, currency, payment frequency and maturity.
- Debt service schedule for proposed issue.
- Debt service schedule for all debt, combined.
- Detail on special pledges, collateral provisions and guarantees, including legal documentation.
- Detail on debt guaranteed by the issuer.
- Analysis of pension liabilities, including pension fund deficit or surplus, annual subsidy, annual current contribution and any actuarial studies and related funding assumptions.
- Detail on off-balance sheet and project debt.
- Date, amount and circumstance of default, if any.
- If relevant, information on overlapping debt burden on the issuer's taxpayers imposed by other government entities.
- Details of assets that could be sold in the event of a financial crisis.
- Use of planned debt issue, prioritisation process, investment project financial appraisal.
- Details of satellite companies (majority owned) i.e. type of company, and the nature of their business, amount of subsidies and transfers received from the entity, turnover and profit (loss), debt levels, degree of control by the issuer.

of GO debt issued on behalf of a revenue-producing project, particularly where the project is expected to contribute all or a portion of net revenue toward debt repayment.

The overall structure of the issuer's debt, including the proposed securities offering, is critical to Fitch's analysis. An ideal debt structure has moderate and predictable debt service with minimal reliance on refinancing and no deferral of principal repayment. Scheduled debt repayment should meet annual budget constraints and not rely on future revenue growth, future economic growth, nonrecurring revenues, increased taxes, or future legislative action. Balloon maturities or a large proportion of short-term debt indicate refinancing risk. A debt structure with substantial foreign currency or variable interest rate exposure can be troublesome in some economic cycles.

Debt structure is frequently a concern with local authorities in developing markets. Fitch examines an issuer's principal payout ratio, considering the sovereign environment, the use of debt proceeds, and the responsibilities of the issuer. A very short ratio, e.g. three to five years, may be a credit weakness because it may indicate significant refinancing risk. A longer ratio, perhaps seven to 10 years or more, would be preferred.

Many local governments also rely on domestic bank loans with short three- to five-year terms for borrowing needs. This local bank debt may carry very high interest rates to compensate for inflation levels in the country or, as in Argentina's latest crisis, country risks (political, financial, economic, and institutional risks). Besides the international credit markets, major sources of inexpensive long-term debt may be multilateral financing or project financing. Countries such as Mexico may develop greater domestic sources of long-term capital over time through growth of privatised pension systems or other large savings pools.

Fitch evaluates the issuer's overall debt burden, including outstanding, proposed, and future indebtedness. The debt structure evaluation includes long-term liabilities such as off balance sheet project financings, lease obligations, debt guarantees, equity interests and liabilities in utilities, businesses, or banks, and securitised obligations issued through a trust. Because long-term pension liabilities can be particularly burdensome, as much information as possible should be provided. A formal statement regarding the issuer's history of timely debt repayment and default is also useful. Fitch considers debt that is self-supporting from an enterprise or utility system a credit strength.

Common debt burden measures are listed below:

- Debt principal relative to local gross product.
- Debt principal per capita.
- Debt principal relative to estimated market value of taxable property (for issuers relying heavily on property taxes to finance operations and debt service).
- Debt service as a percentage of current revenue and annual operating expenses.
- Annual pension liabilities as a percentage of current operating expenses.
- Debt relative to fixed assets.

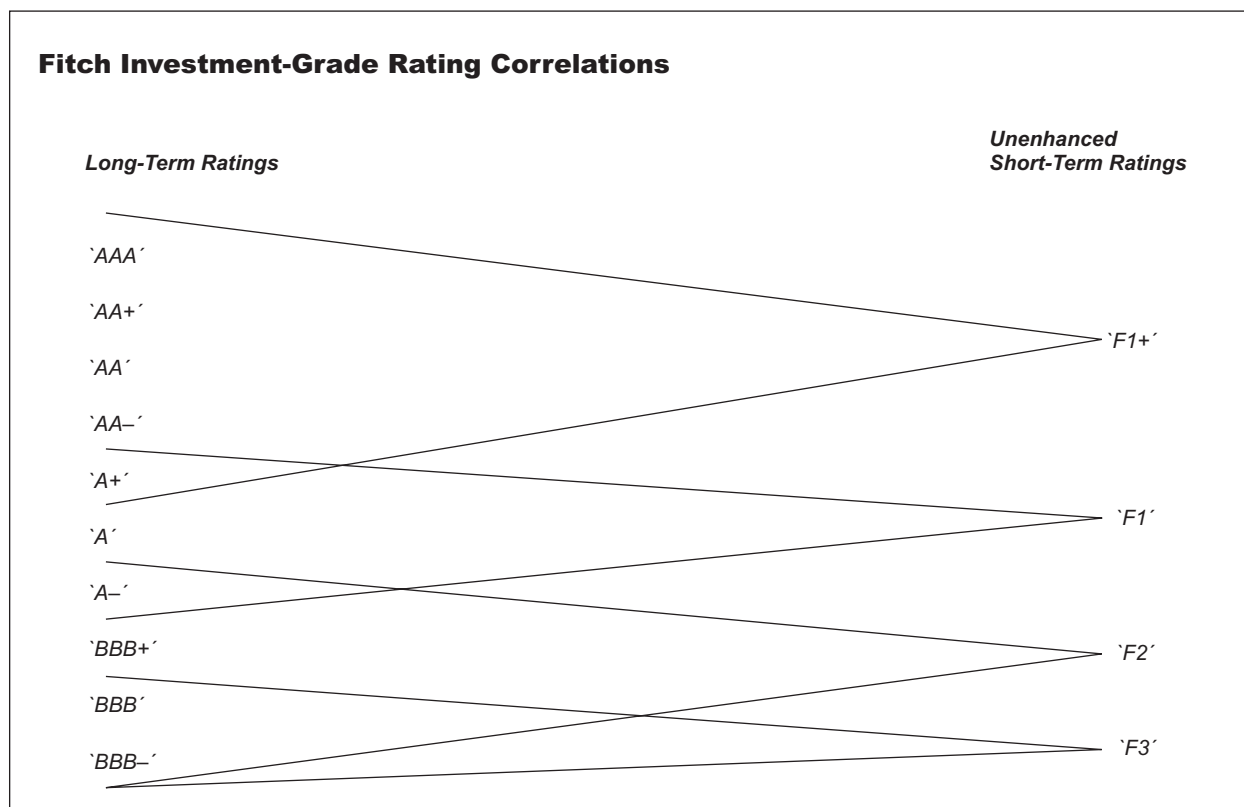
Some measures may be less relevant to an issuer due to the availability or quality of financial information.

Debt relative to fixed assets may be more useful in evaluating debt burden for limited purpose companies such as government-owned utilities.

Indirect Risk: Fitch will measure the indirect risk of the issuer as far as it may affect its credit quality. In some countries, risk has been decentralised through the creation of satellite companies that have taken on debt. These satellites may be funded, to a large extent, through transfers by the issuer. Fitch will evaluate, as far as possible, not just the central administration of the local authority but also its related entities to measure the extent of possible indirect risk. Some satellite companies provide essential public services and, although their indebtedness may not be directly guaranteed, it is probable that the local authority will intervene to bail out these companies if needed either through direct funding or equity capital contributions.

Lack of complete information on indirect risks is considered a negative credit factor by Fitch. To measure the potential exposure of the local authority, Fitch will analyse more closely the transfers to and from the subnational government's central administration accounts, the debt trends, and the nature and viability of the services provided by nonconsolidated entities. In that way, Fitch can assess whether:

- The subnational has had to assume debts in the past from agencies or companies — an indication of financial and liquidity problems of nonconsolidated entities.
- There are large unexpected transfer payments (more than budgeted amounts) to particular agencies and companies, often indicating bailouts.
- There are large transfers from the companies recognised as revenue or dividends by the central administration, which may imply dependency.
- The agencies and companies are fulfilling important functions usually ascribed to the local authorities (e.g. water provision or waste collection, among others) or the company is very important to the local economy in terms of employment; this could indicate moral hazard at the company level, as there would be a strong moral obligation from the central administration to offer assistance in case of crisis regardless of management's role in driving the company to insolvency or bankruptcy.



■ Local Currency vs. Foreign Currency Ratings

In addition to assigning the highly visible FCRs, Fitch will also assign LCRs on the international ratings scale to local governments (issuer ratings). For example, a Russian city or region may have dollar- and ruble-denominated obligations; both would be rated by Fitch for the benefit of international institutions and investors. However, in addition to the debt (issue) ratings, Fitch will also assign an issuer LCR to the entity.

FCRs consider all credit risks faced by an entity, including the risks of transfer and convertibility of currency. Therefore, they are subject to the “sovereign ceiling.” Namely, given a sovereign nation’s ability to obtain priority access to foreign exchange in times of economic stress, FCRs of subnationals are generally limited by the FCR of the nation. Convertibility risks include not only the legal restrictions on obtaining foreign exchange but also the practicality of purchasing foreign currency during times of foreign exchange shortages or economic uncertainty.

Fundamentally, LCRs incorporate all economic and credit risks faced by an issuer, except the risk of converting local currency to foreign currency on a timely basis. The analysis recognises that subnational issuers in emerging markets may operate in more volatile economic and political environments than U.S., Canadian, or western European local governments. LCRs incorporate this volatility, thus providing a measure of an emerging market subnational’s creditworthiness relative to subnational issuers worldwide. Essentially, issuer LCRs summarise Fitch’s opinion of the intrinsic or stand alone credit risks associated with an entity. Particularly in the emerging markets, such ratings will often provide more meaningful information to an investor than the FCR assigned to the debt and more so in cases where the sovereign ceiling lies below the investment-grade threshold.

Although the LCR of the sovereign is typically not viewed as a ceiling, often Fitch will cap the LCR of the subnational authorities to the sovereign’s LCR, especially in countries that remain highly centralised or in which the sovereign determines, among other things, the structure and nature of revenues of the subnationals and limitations on debt taken on their own credit capacity.

To illustrate, Bogotá, Colombia's Fitch LCR is currently 'BBB-', but its FCR, including the issuance of the 9¹/₂% notes due 2006 in November 2001, is 'BB' at the sovereign ceiling (FCR of the Republic of Colombia). Although Bogotá's 'BBB-' issuer rating signifies that the district's capacity and willingness to pay all of its obligations can be characterised as investment grade, the FCR on the issues is limited to the sovereign ceiling, as Colombia could at least theoretically impede Bogotá's access to foreign currency. Stated another way, Fitch would have rated the notes investment grade ('BBB-') were it not for the ceiling imposed by Colombia's long-term foreign currency rating ('BB'). Therefore, Bogotá's long-term local currency rating ('BBB-') provides a more indicative assessment of Fitch's opinion of Bogotá's own credit strength.

■ Short-Term Debt Ratings

In addition to long-term debt ratings, Fitch also assigns short-term debt ratings to subnationals worldwide. Unlike the U.S. and Canada, where the short-term debt municipal markets are highly developed, especially commercial paper, in most countries, subnational governments are not permitted to borrow on less than a one-year duration. Shallow or illiquid markets also impede short-term borrowing. However, local authorities in Western Europe and other regions will issue increasingly debt securities, including commercial paper. The basis for the short-term debt rating analysis is the same as for the long-

term debt rating approach. However, a short-term rating places greater emphasis on the existence of liquidity necessary to meet the issuer's obligations in a timely manner than a long-term rating.

Therefore, Fitch will require additional specific documentation addressing mainly periodic cash flows. The cash flow data should enable Fitch to evaluate seasonal patterns, timing of receipts versus outlays to detect temporary funding gaps, and the relative importance of nonrecurring revenues and expenditures during the year. In addition, the documentation should also address the structure of the debt (maturity and frequency of market access) and relevant structural enhancements, such as liquidity support. Details of the nature and structure of the support, whether a standby bond purchase agreement provided by a third party, internally derived liquidity, or pledges from an associated entity, will be crucial in determining the credit quality of the liquidity support. A subnational's short-term debt ratings (both LCR and FCR) will range between 'D' (default) and 'F1+' (exceptionally strong credit quality) and will tend to correlate with related long-term ratings. However, subnational short-term debt issuance ratings do not correlate as closely with the long-term debt ratings, unlike corporates, due to the differences in the nature of the borrowing and the definition of liquidity and pledged revenues supporting the financing.

Rating Process

Upon engagement, Fitch will assign two or three analysts to the rating. Officials will provide Fitch with regularly published statistical information concerning public finances, together with information about the level, currency composition, and maturity of debt. In addition, data about the structure of the local economy and the buoyancy of the tax base will be examined.

An agenda for discussion on the initial rating visit will be drawn up to discuss the main policy issues and obtain a deeper understanding of the trends detected in the data. The first rating visit will usually last two to three days. Subsequently, a draft of the credit analysis report is submitted to the issuer for comment. The analysis is presented to the Fitch rating committee that assigns the rating(s). The committee's decision is communicated to the issuer and then the rating and report are published.

Following the rating committee, a detailed press release is issued through the media for the benefit of investors and other rating users. Fitch's opinions are also disseminated through various electronic media outlets such as Dow Jones, Reuters, and Bloomberg. In addition, all subnational reports are made available on Fitch's web site at www.fitchratings.com.

For long-term debt ratings, Fitch will formally review credit conditions annually. Speculative credits in the emerging markets might be reviewed more regularly.

Typical Rating Timeline

Week One	Weeks Two–Three	Weeks Four–Six	Ongoing
Meeting scheduling	Management meeting	Rating committee meeting	Surveillance
Pre-meeting preparation	Analyst request for additional information	Rating advised to issuer	
	Rating report draft sent to issuer for comments	Rating disseminated publicly via press release	

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