Importance of a National Scale Credit Ratings for Sub-National Authorities that Borrow Long term

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The Cost of Borrowing

Long term financing for infrastructure projects can be costly for sub-national authorities. However, some authorities obtain better terms for their financing than others from financial institutions. Since every authority would like to lower its cost of borrowing, it is important to understand why some pay less than others.

The cost of long term financing for infrastructure development depends on the level of confidence that financial institutions have that a sub-national authority will repay its debts. The term creditworthiness is actually a way of describing that level of confidence. It is a relative term since some authorities are more creditworthy than others. The more creditworthy authorities obtain financing for their projects at less cost than the less creditworthy. So, what can a sub-national authority do to minimize its cost of financing? Ultimately, it is the institutionalization of good financial management practices that enables a local authority to achieve the highest feasible level of creditworthiness. However, it is also essential that financial institutions recognize and understand the quality of an authority’s finances so that their level of confidence increases and they offer the best possible terms for the borrowing.

Demonstrating Creditworthiness to Lenders

In many countries, financial institutions have little experience lending to sub-national authorities. As a result, most have not developed the capacity to assess an authority’s creditworthiness. Since the creditworthiness of this class of potential borrowers is not well understood, financial institutions often choose not to provide long term financing for their infrastructure projects. Even when lenders want to offer infrastructure financing, they may have difficulty differentiating between more creditworthy and less creditworthy borrowers and therefore have no basis for establishing lending terms that balance risk and return. Under such conditions, lenders impose costly lending terms to protect themselves against unknown risks.

Sub-National Public Finance Credit Ratings

Fortunately, in most countries, internationally respected credit rating agencies can provide financial institutions with a substitute or supplement to their own creditworthiness assessment capacity. It comes in the form of a sub-national public finance credit rating. The agencies’ credit ratings are based on an objective external analysis of a sub-national authority in terms of carefully selected risk factors affecting its ability and willingness to repay its debts.

Because the agencies’ principal business is assessing risk, they have a depth of analytic expertise that most financial institutions cannot match. For this reason,
A simplified example

Let’s imagine that a sub-national authority wants to borrow local currency (LC) to finance an LC 100 million infrastructure project. In this example, the credit rating agency gives the authority a national scale rating of A+(ns) which is investment grade, but below the national government’s bond rating of AAA(ns). Further imagine that research by the authority’s public finance advisor shows that national government bonds with a 15 year term carry an interest rate of 5%, but meetings with potential lenders and investors reveal that a 15 year borrowing by an authority rated A+(ns) has to pay 10% interest to attract financial institutions into lending LC 100 million.

Now imagine the following scenario...

- The infrastructure project is expected to generate user fees of LC 20 million annually with a total operating & maintenance cost of LC 8.5 million per year.

- The credit rating agency reviews the project and determines that, due to a variety of project risks, a borrowing based solely on repayment from user fees would be rated BBB(ns) and would have to offer 15% interest to raise LC 100 million, and this would increase annual debt service to LC 17.1 million. This would make the project financially unviable.

- At the authority’s direction, the public finance advisor designs a structured obligation based on a 50% partial risk guarantee purchased from a guarantor that has a AAA rating.
  
  - The structure makes 50% of the borrowing “risk free” and equivalent to AAA(ns) while the other 50% of the borrowing remains an A+(ns) risk.
  
  - The partial risk guarantee requires the authority to pay the guarantor an annual fee of 0.5% on the outstanding balance of the borrowing.
  
  - The guarantor pledges to reimburse the authority’s lenders/investors 50% of any principal lost in the event that the authority defaults on its debt.

- The credit rating agency reviews the partial risk guarantee structure and determines that it reduces the risk of default enough to qualify the total borrowing for a AA+(ns) rating which would enable the authority to borrow at an interest rate of 7%.

- The authority successfully borrows LC 100 million for a 15 year term at an interest rate of 7% and pays another 0.5% per year for the partial risk guaranty. As a result, the annual cost of the borrowing to the authority is LC 11.3 million but this is expected to be covered from the LC 11.5 million annual net revenue available from the project.

Obtaining a public finance credit rating is an excellent way for sub-national authorities to convincingly demonstrate their level of creditworthiness to financial institutions.

Each credit rating agency has its own methodology for assessing the risk that a sub-national authority will default on its debt. However, the essential factors analyzed by these methodologies are virtually the same. The agencies analyze and assess:

1. **The institutional framework surrounding the sub-national authority** including: centralized/decentralized governance; degree of fiscal autonomy; formal responsibilities of the authority; legally mandated annual expenditures; and the characteristics of any funding provided from the national government.

2. **The economic outlook for the sub-national authority** including trends in: the economic base; the local revenue based; employment conditions; local income and wealth; demographics; and the per capita tax/fee burden compared to other similar sub-national authorities and the national average.

3. **The sub-national authority’s debts and other liabilities** including: current debt (long or short term, fixed or variable interest rate, to be paid in local currency or foreign currency); the debt service burden; the needs for future debt financing; other liabilities and contingent liabilities and how they are funded.
4. **The sub-national authority’s finances** including trends in: total revenues (their volatility, their diversity, their predictability); total expenditure; the balance (surplus or deficit) between recurrent operating revenues and recurrent operating expenditures; reserves; and liquidity.

5. **The management and administration of the sub-national authority** including: institutionalized financial policies and procedures; management of the budget; accounting and financial reporting; independent external audits; the affects of politics, labor issues, or citizen initiatives; and the degree of revenue and expenditure flexibility.

Credit rating agencies assign a rating to a sub-national authority based on detailed information about that authority, and analysis of the factors above to predict the likelihood the authority will fail to repay its debts. Although each credit rating agency has its own system of letter grades, generally the ratings range from AAA (highest credit quality) through BBB (credit quality good enough to be considered “investment grade”) to C (exceptionally high levels of credit risk) on a scale that progresses: AAA, AA, A, BBB, BB, B, CCC, CC, C with “+” and “-” to signal degrees of risk between the letter ratings. The Rating Report that accompanies the letter grade also provides the data and analysis that financial institutions need in order to understand the finances of their potential borrower.

**International Scale Ratings and National Scale Ratings**

A sub-national public finance credit rating can be either an international scale rating or a national scale rating. The national scale rating includes a country designator in parentheses, e.g. (mx) for Mexico. The difference between them is their basis for comparison of the risk of default. An international scale rating compares the sub-national authority to the best credit risks in the world: AAA sovereign governments such as Germany, the United Kingdom, and the United States. The purpose is to provide international investors with a way to measure the risk of lending to the authority compared to investing in risk free national government bonds. On any national scale, bonds issued to local investors by the national government are always rated AAA(ns).

To avoid foreign exchange risk, sub-national authorities borrow in local currency from investors that are local financial institutions. Therefore, the authority’s national scale rating is the one that is most useful for demonstrating their creditworthiness to lenders. The difference between a sub-national authority’s rating on international and national scale is typically very substantial. For example, one metropolitan government in an emerging market country has been rated BB+ on the international scale (i.e. not investment grade for international investors), but the same rating agency rates the authority AA+(ns) on the national scale (i.e. a very good credit risk for local investors).

Sub-national authorities which achieve an “investment grade” rating of BBB– (ns) or better on their national scale are considered by most financial institutions to be creditworthy. Those with lower ratings are generally seen as not creditworthy and may be unable to access long term financing. In addition, national scale credit ratings differentiate among the creditworthy authorities in a country by identifying where they stand on a scale that runs from more creditworthy to less creditworthy. This provides financial institutions with a solid analytic basis to differentiate their lending terms among borrowers in a way that balances risk and return. Lower rated authorities pay more for long term financing because they are riskier than higher rated authorities.

**National Scale Ratings and Infrastructure Bonds**

Long term financing for infrastructure can take the form of bank loans or long term bonds sold to investors. Loans are drawn up by a bank that holds the entire loan in its investment portfolio until it is fully repaid. On the other hand, bonds are securities that are issued by a sub-national authority and sold to a variety of investors in a form that can be either held in
Other Advantages of Obtaining a Rating

In addition to providing the means for sub-national authorities to demonstrate their creditworthiness to financial institutions, credit ratings offer other advantages. The Rating Report that accompanies the letter grade spells out the financial strengths and weaknesses of the authority in some detail, and can be used to guide an authority’s financial management improvement efforts. Since ratings are made public, they are a simple and transparently means of communicating an authority’s financial condition to key stakeholders and the community at large. They can also be used by national governments to monitor the financial health of sub-nationals with complete objectivity.

Because of the multiple advantages of having sub-national authorities rated on a national scale, some governments have made ratings a regulatory requirement in certain circumstances. In Mexico, it is a requirement for sub-national authorities to be rated by at least two rating agencies in order to undertake any kind of long term borrowing. In India, the national government requires sub-nationals that participate in a particular incentive grant program to be rated as a means of measuring the impact of financial reform efforts linked to the grants.

The Sub-National Technical Assistance (SNTA) Program

As more and more countries decentralize, the provision of infrastructure is increasingly becoming the responsibility of sub-national authorities (local governments and public utilities). These authorities are finding it necessary to seek long term private financing for their infrastructure projects. Using annual budget allocations to build infrastructure is difficult to manage because the funds required vary greatly from year to year. Long term debt financing allows sub-national authorities to smooth out the annual funding requirement by borrowing a large amount of capital at one time and then repaying the debt in predictable annual increments small enough to make the project affordable to the people served. The Public Private Infrastructure Advisory Facility (PPIAF) works with sub-national authorities to enable access to private financing on the best possible terms, and shares the lessons learned from its global experience.