Sub-sovereigns Rating Methodology

Sovereign and Public Sector

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Call for comments

Scope welcomes market participants' comments on its proposed update to the methodology.
Please send your comments by 17 September 2022 to consultation@scoperatings.com

Table of Contents

Summary

This rating methodology explains Scope's approach to assigning sub-sovereign credit ratings. The methodology continues to apply a 'framework-driven approach', focusing on intergovernmental relationships between sub-sovereign and sovereign entities as well as the resulting country-specific budget structures, spending and investment responsibilities, debt management procedures, and liquidity practices. The proposed update enhances the transparency and analytical rigour of our approach for assigning credit ratings to sub-sovereigns and introduces new analytical components relating to environmental and social considerations.

Specifically, we are proposing to:

i. Expand the granularity and refine the analytical focus of the key components of the institutional framework

ii. Integrate the quantitative and qualitative assessments of the individual credit profile (ICP), into our model

iii. Introduce a systematic and explicit approach to environmental and social considerations

iv. Implement a mapping table which gives an indicative notching rather than a maximum indicative notching

v. Change qualitative scorecard structures and assessments and introduce qualitative assessment guidance tables to enhance analytical rigour and strengthen transparency

vi. Adopt additional editorial changes to improve clarity

The proposed changes are not expected to affect existing sub-sovereign ratings or any other ratings assigned by Scope.

1. Introduction

This document presents our methodology for assigning short-term and long-term issuer credit ratings to sub-sovereigns and to their debt obligations[1]. The criteria in this methodology are applicable to higher-tier governments (regional governments, states or communities) and lower-tier governments (cities, districts and municipalities). We believe that a 'framework-driven approach' is best suited for the assignment of sub-sovereign ratings. This approach reflects the importance of the varying frameworks and intergovernmental relationships between sub-sovereign and sovereign entities as well as the resulting country-specific budget structures, spending and investment responsibilities, debt management procedures, and liquidity practices. Our methodology predominately covers sub-sovereigns in Europe, but it can be applied globally provided reliability of information is adequate and institutional characteristics can be appropriately captured via our framework-driven approach[2].

Our sub-sovereign methodology has the following characteristics:

- **Framework-driven approach**

Our analysis acknowledges the importance of the relationship between sub-sovereign and sovereign government tiers. We therefore determine the degree of intergovernmental integration across government tiers by analysing the institutional framework, which results in an indicative downward rating range from the sovereign (or higher-tier government) rating. This approach allows us to explicitly consider the interdependence between institutional frameworks and individual credit profiles.

- **Use of transparent scorecards and guidance tables**

We provide a transparent and detailed presentation of our analytical framework, including a rationale for each key rating factor. Our methodology uses scorecards to enhance rating transparency and comparability, underpinned by consistent assessments of: i) the institutional framework across countries per government tier; and ii) the individual credit profile of an issuer. Our assessment of a sub-sovereign's individual credit profile (ICP) is underpinned by explicit quantitative metrics.

- **Emphasis on quantitative metrics and exclusion of mechanistic thresholds**

Our ICP assessment determines the indicative rating within the rating range generated by our framework assessment. Our assessments are underpinned by quantitative peer comparisons. This approach acknowledges that sub-sovereign budgetary and debt data: i) need to be viewed in the context of the respective framework; and ii) are susceptible to distortion due to differing accounting policies. Therefore, our approach ensures that the selected ratios are meaningful and interpretable.

- **Extended balance sheet and liquidity assessment**

Our approach is underpinned by new research on sub-sovereign risk that emerged during the Global Financial Crisis. Liquidity pressures and the accumulation of high off-balance-sheet risks can be a major source of fiscal deterioration for a sub-sovereign, as observed during recent crises. Our ICP analysis emphasises a sub-sovereign's liquidity practices and its ability to service debt in cases of interrupted access to capital markets and external liquidity. We also focus on risks from off-balance-sheet financing, including contractual contingent liabilities, implicit contingent liabilities and policy commitments.

- **Incorporation of environmental, social and governance aspects**

Our approach includes a systematic and explicit assessment of environmental (E), social (S) and governance (G) risks. Governance considerations are examined as part of the institutional framework analysis (Chapter 2) and the ICP (Chapter 3). Environmental and social risks are also important for sub-sovereign credit quality given rising long-term environmental and social challenges as well as the increasingly pivotal role sub-sovereigns play in supporting sustainability objectives. We recognise these environmental and social factors explicitly and systematically through adjustments to the ICP.

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[1] In case of debt obligations issued jointly, for example pro-rata obligations with equal rights as documented in a global note and issued by several sub-sovereigns, we would assign an issue rating according to a blended rating of all entities that are liable for payment obligations under the issuance. The blended rating is typically a weighted average rating of issuer ratings of all participating entities, according to the entities' share of liability for payment obligations, subject to transaction details.
[2] For instance, our methodology does not apply to sub-sovereigns in the United States.

1.1 Definitions

- **Sub-sovereign**

We define a sub-sovereign as a regional or local government tasked with providing certain public services along with the sources of revenue to fund these mandates. We do not consider public or private companies (such as hospitals, schools or universities) that undertake some of the sub-sovereign government's responsibilities as being part of that government, but we do assess the links between them. Such public or private companies are rated under Scope's Government-Related Entities Rating Methodology.

- **Sub-sovereign default**

We consider the following events to be a default:

- missed coupon or principal repayment on debt issued by the sub-sovereign
- missed coupon or principal repayment on debt benefitting from an irrevocable and unconditional guarantee issued by the sub-sovereign;
- failure to service debt other than loans or bonds owed to private creditors by the sub-sovereign; and
- any debt exchange or distressed debt restructuring that includes, for example, an extension of maturities, a reduced principal amount, lower coupon or interest rates, a change in the currency payment[3] or effective subordination.

However, the following event is not considered to be a default:

- missed coupon or principal repayment on debt owed by the sub-sovereign to a higher-tier government of the same jurisdiction or other official creditors such as multilateral development banks.

- **Rating anchor**

Throughout this methodology, we refer to the 'rating anchor' as the sovereign or a higher-tier sub-sovereign government whose rating is used as a starting point to define the rating range for a sub-sovereign rating. The rating anchor is often the sovereign, given that it is usually responsible for defining the institutional framework characteristics, ensuring oversight of sub-sovereign finances, and providing ordinary and exceptional budgetary and funding support. However, in some systems, such as highly decentralised federal systems, those responsibilities can lie with a higher-tier sub-sovereign government. In such instances, we may use the state or regional government rating as the rating anchor level for lower-tier governments.

- **Intergovernmental integration**

Throughout this methodology, we refer to 'intergovernmental integration' as the relationship between government tiers, emphasising the degree of mutual reliance, burden sharing, support mechanisms and coherent policymaking between sub-sovereigns and the sovereign or higher-tier governments. Our institutional framework assessment focuses on the degree of intergovernmental integration between the sub-sovereign tier and the rating anchor rather than the general strength or supportiveness of the framework. In our view, a framework with high integration, characterised, for instance, by extensive, legally anchored exceptional and ordinary support, robust fiscal rules and oversight mechanisms, and shared decision-making between a sub-sovereign and its rating anchor, entails close ties between their respective credit quality and mitigates differentials in sub-sovereigns' individual credit profiles. Conversely a framework with high autonomy and weak ties among government tiers can widen differences in credit quality and underscore the importance of the sub-sovereign's strengths and weaknesses for its credit quality. As such, our analysis of intergovernmental integration measures the ordinary support provided by the rating anchor and its willingness to provide exceptional support if needed to sub-sovereigns in a given government tier.

1.2 Summary of Scope's sub-sovereign rating approach

Our approach to rating sub-sovereigns is split into four steps. In the first step, we determine the intergovernmental integration between the rating anchor and a sub-sovereign entity based on our assessment of the institutional framework under which a sub-sovereign operates. This determines a rating range vis-à-vis the rating anchor whereby, the higher (lower) the integration, the narrower (wider) the rating range. The framework assessment generally applies to all sub-sovereigns of the same government tier in a country. The second step relates to the sub-sovereign's ICP, which includes qualitative assessments underpinned by quantitative metrics to position the sub-sovereign rating within the range defined by the framework assessment per our mapping

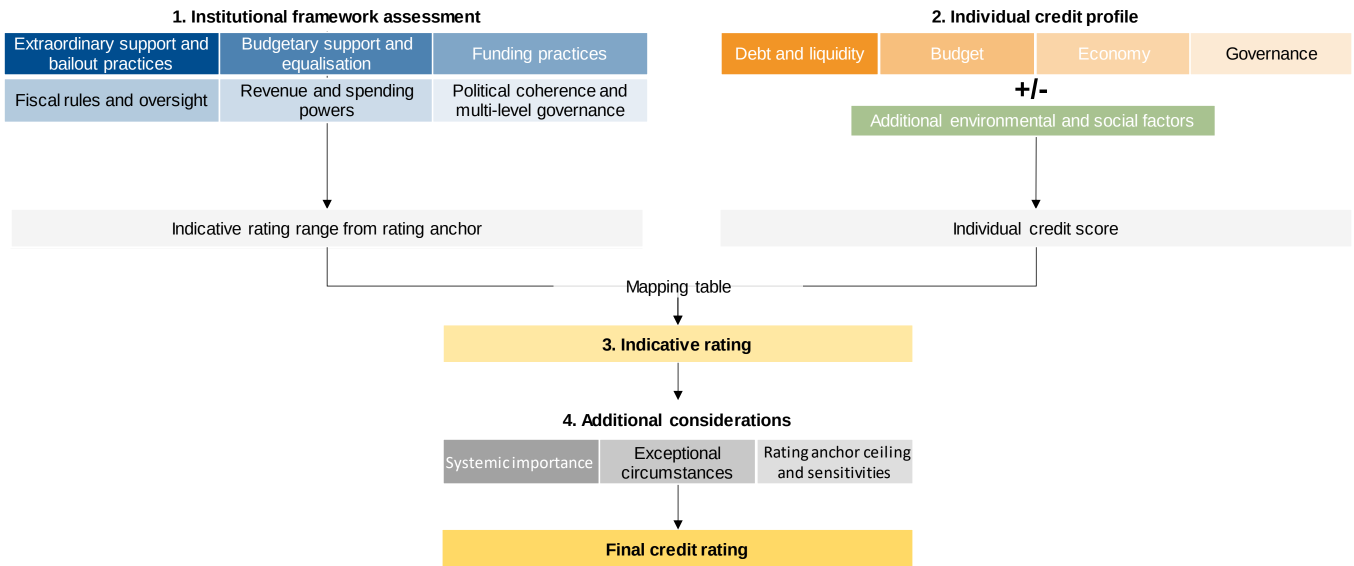
[3] In the case of a currency redenomination that leads to a change in the payment terms of a debt obligation enacted by the sub-sovereign that results in a financial loss (or significant inconvenience to receive payment in full and on time) to investors.

table (which is the third step). The fourth step considers additional factors that could result in the credit rating being adjusted lower or higher and the conditions under which a sub-sovereign could be rated above the rating anchor.

Under our approach, an integrated institutional framework is enough to rate a sub-sovereign close to the rating anchor, whereas a strong individual credit profile would be needed to rate a sub-sovereign close to the rating anchor if intergovernmental integration is low. This view is for three reasons:

1. In cases of financial distress, a sub-sovereign's ultimate recourse to honour its obligations is not its own balance sheet but rather the willingness and ability of the sovereign or higher-tier government to provide additional resources.
2. A sub-sovereign's ability to honour debt obligations depends on the functioning of the relevant national legal systems, regulations and/or policy frameworks as these entities are usually not shielded from the jurisdictions of national courts. The Global Financial Crisis confirmed that sub-sovereigns' (even those whose autonomy is enshrined in the national constitution) access to capital market funding may be strongly impaired if the sovereign faces financial distress. Consequently, a sub-sovereign rating pierces the rating anchor level only in rare and exceptional circumstances, justified on a case-by-case basis.
3. Different institutional frameworks have varying effects on a sub-sovereign's ICP, specifically, its budgetary structure, spending and investment responsibilities, debt management and liquidity practices. By starting our analysis with the institutional framework and complementing it with a peer comparison per national government tier or among entities operating under similar frameworks, we acknowledge these interdependencies and can evaluate the differences between the strongest and weakest entities within each framework.

Figure 1: Overview of Scope's sub-sovereign rating approach



Source: Scope Ratings.

Step 1: Institutional framework assessment

In this part of the assessment, we determine the intergovernmental integration between a sub-sovereign and its rating anchor by assessing the institutional framework under which the sub-sovereign operates. This step is based on six analytical factors. The outcome of this assessment determines the indicative downward rating range from the rating anchor. It generally applies to all sub-sovereigns within a government tier in a country. The rating range can extend from 0 to 10 notches, whereby higher (lower) intergovernmental integration results in a narrower (wider) range from the rating anchor. Details are provided in Chapter 2.

Step 2: Individual credit profile or ICP

Having established the indicative rating range, we assess a sub-sovereign's ICP based on 10 assessments across four risk pillars: i) *debt and liquidity*; ii) *budget*; iii) *economy*; and iv) *governance*. This risk assessment results in a score from 0 to 100; a high (low) score is associated with a strong (weak) credit profile. We also incorporate additional *environmental and social factors* which can adjust the ICP score by up to +/- 10 points. Details are provided in Chapter 3.

Step 3: Indicative sub-sovereign rating

We derive the indicative sub-sovereign rating by mapping the rating range from the sovereign (or higher-tier government) rating, as determined by the institutional framework assessment, to the ICP score. Details are provided in Chapter 4.

Step 4: Additional considerations

Based on this indicative sub-sovereign rating, we incorporate additional rating factors such as: i) the systemic importance of the sub-sovereign; ii) the sensitivity of the sub-sovereign's rating to changes in the rating anchor level and the appropriateness of the implied rating anchor ceiling; and iii) other exceptional circumstances. Details are provided in Chapter 5.

2. Institutional framework assessment

2.1 Overview

In our view, the degree of ordinary and extraordinary support provided by the sovereign or higher-tier government as well as the degree to which the framework entails intergovernmental oversight and common decision-making are key determinants of a sub-sovereign's creditworthiness. The rating anchor's ability to provide support is assessed by the sovereign's or the higher-tier government's issuer rating, while the degree of ordinary support being provided and the willingness to provide exceptional support depend on the level of intergovernmental integration between the government tiers.

The framework assessment is identical across sub-sovereigns of the same government layer within a country except in rare cases where the sub-sovereign operates under significantly different legal frameworks and its characteristics cannot be fully captured by the ICP assessment. In these cases, assessments under the institutional framework may differ across sub-sovereigns of the same government tier within a country.

2.2 Intergovernmental integration – Qualitative Scorecard 1 (QS1)

Our Qualitative Scorecard 1 (QS1) structures our analysis of intergovernmental integration across government tiers around six components: i) *extraordinary support and bailout practices*; ii) *ordinary budgetary support and fiscal equalisation*; iii) *funding practices*; iv) *fiscal rules and oversight*; v) *revenue and spending powers*; and vi) *political coherence and multi-level governance*.

For each analytical component, assessments are made on a five-point scale. We use a scoring system assigning 0 to 'low integration', 25 to 'some integration', 50 to 'medium integration', 75 to 'strong integration, and 100 to 'full integration' for each component. The institutional framework score, ranging from 0 to 100, is calculated as a simple average of these assessments. The score is then used to determine a rating range from the rating anchor level, within which the sub-sovereign's rating can be positioned.

The rationales underpinning each assessment are detailed in the qualitative assessment guidance tables for every analytical component presented in the following sections. Details on mapping the score to the rating range from the rating anchor are provided in Chapter 2.3.

Figure 2. The institutional framework scorecard (QS1)

Analytical components	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Extraordinary support and bailout practices	○	○	○	○	○
Ordinary budgetary support and fiscal equalisation	○	○	○	○	○
Funding practices	○	○	○	○	○
Fiscal rules and oversight	○	○	○	○	○
Revenue and spending powers	○	○	○	○	○
Political coherence and multi-level governance	○	○	○	○	○

Integration score	-
Downward rating range	**-**

Source: Scope Ratings

- **Extraordinary support and bailout practices**

This component examines the formal and informal extraordinary support and bailout practices of the rating anchor for lower-tier governments. In cases of system-wide stress or a sub-sovereign's individual financial distress, the rating anchor generally acts as the ultimate recourse of a sub-sovereign to honour its financial obligations. We consider the degree to which i) extraordinary support mechanisms are embedded in legislation; ii) are part of a formal, rules-based procedure; or iii) are provided on an *ad-hoc* basis, in contrast with systems with a credible history of no-bailouts. Extraordinary support can include exceptional budgetary transfers, liquidity assistance, concessional lending, bond buybacks, and comparable schemes. Our assessment pays attention to the rating anchor's record of providing extraordinary support in cases of system-wide shocks and individual financial distress. When analysing the exceptional support record of any *ad-hoc* support, we consider whether it is reasonable to assume that such support will be extended to other sub-sovereigns[4].

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Strong legal framework entailing very predictable bailout responsibilities for the rating anchor; and/or consistent record of forceful extraordinary support to shield sub-sovereigns' finances from cases of system-wide or individual financial distress	Formal and predictable bailout processes; and/or a stable record of extraordinary support to mitigate the impact of system-wide shocks or individual financial distress, or our expectation thereof	Mostly informal bailout processes; and/or inconsistent record of extraordinary support to mitigate the impact of system-wide shocks and/or individual financial distress	Credible preference for no-bailout; and/or extraordinary support granted only in selected instances of system-wide shocks and/or individual financial distress	Past instances and/or credible expectation of no bailouts

Source: Scope Ratings

[4] For instance, if extraordinary support were provided to a systemic sub-sovereign entity (such as a capital city) but is unlikely to be extended to other sub-sovereigns, we would consider this instance to have a limited bearing on our assessment of system-wide support.

➢ Ordinary budgetary support and fiscal equalisation

This component examines the degree to which sub-sovereigns benefit from ordinary budgetary support from their rating anchor. This can include regular transfers as well as fiscal equalisation schemes. When making this assessment, we consider whether budgetary transfers and equalisation flows allow sub-sovereigns to adequately cover mandated responsibilities and compensate for diverging fiscal capacities. We also consider the predictability and transparency of these budgetary support mechanisms.

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Comprehensive and highly predictable transfer and fiscal equalisation schemes; and/or disparities in sub-sovereign fiscal capacities mostly eliminated	Sizeable and predictable transfer and fiscal equalisation schemes; and/or disparities in sub-sovereign fiscal capacities significantly reduced	Transfer or fiscal equalisation schemes in place; and/or disparities in sub-sovereign fiscal capacities somewhat reduced	Lack of institutionalised transfer or fiscal equalisation schemes; and/or disparities in sub-sovereign fiscal capacities somewhat reduced via *ad-hoc*, less predictable transfers	Lack of consistent transfer or fiscal equalisation schemes; and/or sub-sovereigns relying solely on own fiscal capacities, resulting in potentially high disparities

Source: Scope Ratings

➢ Funding practices

In assessing this component, we consider whether sub-sovereigns' funding profiles are mostly reflective of their standalone credit fundamentals or closely tied to the rating anchor's credit and funding profile. We examine the degree to which sub-sovereigns benefit from ordinary funding support from their rating anchor. This can include on-lending, access to central credit or liquidity lines, common debt issuance and other funding schemes.

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Very strong funding support eliminates own exposure to financial markets; and/or borrowing can be fully covered through available sovereign on-lending or via common debt issuance	Strong funding support greatly reduces own exposure to financial markets; and/or a large portion of borrowing can be covered through on-lending or via common debt issuance	Funding support is occasionally provided and reduces own exposure to financial markets; and/or access to centralised credit or liquidity lines exists	Funding is mostly autonomous; and/or access to centralised credit or liquidity lines is possible on a case-by-case basis	Funding is fully autonomous and reflects idiosyncratic strengths and weaknesses; and/or the sovereign does not provide any tangible funding support

Source: Scope Ratings

➢ Fiscal rules and oversight

This component examines the institutional arrangements that govern sub-sovereign financial management and borrowing practices. We consider the scope, stringency and credibility of sub-sovereign fiscal rules. Our analysis focuses on aspects such as the rating anchor's ability to oversee sub-sovereign financial management and impose borrowing restrictions (e.g. permitting borrowing only to finance investments, with pre-authorisation required). Stringent fiscal rules with robust monitoring mechanisms by higher-tier government authorities typically reflect strong integration.

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Stringent and credible fiscal rules that ensure fiscal discipline and strictly constrain borrowing with very robust oversight by the rating anchor	Stringent and credible fiscal rules that strengthen fiscal discipline and impose borrowing restrictions; and/or robust oversight by the rating anchor	Fiscal rules exist and support fiscal discipline although borrowing is only moderately constrained; and/or the rating anchor performs regular oversight	Fiscal rules are largely self-imposed with some coordination over fiscal policy with central or lower-tier governments; and/or the rating anchor imposes little to no restriction on borrowing	No oversight by or coordination with other government tiers over financial management; and/or sub-sovereigns have full discretion over budgetary targets and borrowing

Source: Scope Ratings

➢ **Revenue and spending powers**

This component examines the distribution of taxation and spending powers across government tiers and the degree of coordination required. We consider the rules that govern tax-sharing and rate-setting as well as those defining spending mandates across government tiers, including the degree to which sub-sovereigns have a say on national revenue and spending arrangements. Systems in which sub-sovereigns share control on resources, decide on spending responsibilities jointly with the rating anchor and can influence national revenue and spending powers are more integrated. Conversely, siloed systems where sub-sovereigns decide independently on spending responsibilities and have autonomy over their own revenues indicate low integration. We also look at systems where the rating anchor exerts unilateral control over major fiscal resources and/or spending responsibilities. A limited taxing capacity could lead to budgetary and political pressures if a sub-sovereign's resources cannot fully fund the services for which it is responsible.

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Control over fiscal arrangements is fully shared across government tiers with joint decision-making on tax sharing, tax base and rate-setting as well as spending responsibilities at national and sub-sovereign levels	Control over fiscal arrangements is largely shared across government tiers with strong coordination on tax-sharing, tax base and/or rate-setting as well as spending responsibilities at the national level	Fiscal arrangements are dominated by the rating anchor, which has control over main decisions regarding tax sharing, tax base and rate-setting and/or spending responsibilities	Fiscal arrangements are largely controlled by the sub-sovereign, which has control over main decisions regarding tax base and rate-setting as well as spending responsibilities; and/or coordination across government tiers is common but there is no joint decision-making on national fiscal arrangements	Sub-sovereigns have autonomy over their fiscal arrangements and decide independently on tax base and rate-setting as well as spending responsibilities with no joint decision-making on national fiscal arrangements

Source: Scope Ratings

➢ **Political coherence and multi-level governance**

This component examines the degree of system-wide political integration between the sub-sovereign government tier and the rating anchor. We assess the degree of policy coordination between different government tiers and the extent to which sub-sovereign legislative powers influence national policymaking and thus contribute to predictable, balanced developments in their institutional frameworks. In addition, we consider whether governance systems are prone to conflict or can minimise conflict between local/regional entities and the central government. For example, strong integration is reflected in multi-level governance frameworks that favour effective policy coordination between different government tiers and/or improve the predictability of changes to the framework that are relevant for sub-sovereigns.

Assessment	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Rationale	Policymaking benefits from robust coordination; sub-sovereigns have a strong and consistent impact on national policymaking; the framework is mature, very transparent, and highly predictable; and/or multi-level governance is mostly conflict-free	Policymaking benefits from robust coordination; sub-sovereigns have a material impact on national policymaking; the framework is stable, transparent and predictable; and/or multi-level governance is generally conflict-free	Policymaking is coordinated; sub-sovereigns have a say on national policymaking; the framework is broadly stable and predictable; and/or interjurisdictional conflicts are effectively managed by multi-level governance	Political coherence is moderate; coordination in policymaking is limited with a negligible sub-sovereign impact on national policymaking; and/or multi-level governance is conflict-prone	Political coherence is low with little to no coordination in policymaking; sub-sovereigns have no tangible say on decision-making at national level; and/or ineffective multi-level governance often results in conflict

Source: Scope Ratings

2.3 Indicative rating range

The degree of intergovernmental integration between the rating anchor and the sub-sovereign's government tier determines the indicative maximum deviation of the sub-sovereign's rating from that of its rating anchor. This methodology defines low intergovernmental integration with a maximum indicative distance of negative 10 notches. A history of rare default events given usually strong economic and institutional ties between government tiers justifies the maximum 10-notch indicative range. Conversely, we usually consider the rating anchor level as an indicative upper ceiling for sub-sovereigns unless conditions for rating above the rating anchor level apply as defined in Chapter 5.1. We set the lower indicative range of between zero notches and negative one notch to reflect that even sub-sovereigns in highly integrated systems are: i) separate legal entities; and ii) still rely to some extent on their credit strength.

To derive the indicative rating range, we map the score from the institutional framework scorecard (QS1) to the table as presented below. A high (low) integration score thus results in a narrow (wide) deviation from the rating anchor level.

Figure 3. Mapping the institutional framework scores to indicative rating ranges

Institutional framework score	100 > x≥ 90	90 > x≥ 80	80 > x≥ 70	70 > x≥ 60	60 > x≥ 50	50 > x≥ 40	40 > x≥ 30	30 > x≥ 20	20 > x≥ 10	10 > x≥ 0
Indicative rating range	0-1	0-2	0-3	0-4	0-5	0-6	0-7	0-8	0-9	0-10

Source: Scope Ratings
NB. Notches are indicative downward adjustments from the rating anchor level.

3. Individual credit profile or ICP

3.1 Overview

In this second stage of the analysis, we derive the ICP score of a sub-sovereign via 10 assessments structured around four risk pillars. The components presented in the following sections are generally underpinned by quantitative metrics that inform our assessments.

For our quantitative metrics, we focus on peer benchmarking with other sub-sovereign entities operating under the same or similar institutional frameworks[5]. In doing so, we acknowledge that analysing the financial performance of a sub-sovereign must be in view of the differing budget structures, spending and investment responsibilities, and debt and liquidity management practices. For instance, framework-induced differences in financial ratios that limit comparability can include: i) sub-sovereigns can have important investments responsibilities, which require wider operating margins to fulfil than sub-sovereigns with little to no investment responsibilities; ii) a large share of sub-sovereigns' operating revenue can be earmarked for specific spending responsibilities which can lead to apparently stronger debt metrics despite the fact that those revenues are not available to the sub-sovereigns to service debt; or iii) there can be regulatory requirements that disincentivise cash holdings such as the obligation to place cash in centralised Treasury accounts at zero interest, impacting liquidity metrics. In addition, differing methods of accounting and reporting can distort financial metrics, limiting international comparability. Typically, we rely on multi-year averages to smooth out volatility and reflect more structural credit fundamentals.

Our assessments also incorporate qualitative and forward-looking factors that require analyst judgment and can be underpinned by additional quantitative metrics, which are relevant on a framework- and country-specific basis. These qualitative factors are outlined in the guidance tables provided in the following section.

3.2 Individual credit profile: Qualitative Scorecard 2

To assess the ICP, we apply a Qualitative Scorecard 2 (QS2) centred around 10 components underpinned by peer benchmarking. This analysis is structured around four risk pillars: i) *debt and liquidity* (four components); ii) *budget* (three components); iii) *economy* (two components); and iv) *governance* (one component). We assess each analytical component on a three-point scale by benchmarking a sub-sovereign's performance and risk exposures to that of peers. Scores are 0 for 'weaker', 50 for 'neutral', and 100 for 'stronger' for each component. The individual credit profile score, ranging from 0 to 100, is calculated as a simple average of these assessments.

In addition, we make two additional assessments for *environmental factors and resilience* and *social factors and resilience*, which can lead to adjustments of the ICP score by up to +/- 10 points. We adjust the ICP by +5 points for components with a 'positive impact', 0 points for 'no impact', and -5 points for 'negative impact'.

We provide guidance for the classification of qualitative assessments in the guidance tables provided in the following sections. For the analytical components that are also underpinned by quantitative metrics, we make our assessments as follows:

[5] Should we deem that there are not enough comparable peers operating under the same institutional framework, we will also include international peers that operate under similar institutional frameworks with comparable budget structures, investment, and spending responsibilities.

- **Preliminary quantitatively driven assessments**

Our preliminary assessments are based on the quantitative metrics outlined per component and are mapped to the three-point scale. Financial ratios are benchmarked against that of peers whereby we analyse the distribution of the metrics and identify the sub-sovereigns that substantially deviated from the average/median as the 'Stronger' or 'Weaker' entities. In instances where an analytical component is underpinned by two quantitative metrics that indicate two different assessments, we would derive the preliminary assessment as follows: 'Stronger' and 'Neutral' = 'Stronger'; Stronger' and 'Weaker' = 'Neutral'; 'Weaker' and 'Neutral' = 'Weaker'.

- **Qualitative adjustments**

The preliminary assessments can thereafter be adjusted based on qualitative factors which cannot be assessed purely on a quantitative basis and incorporate forward-looking views. Based on these qualitative factors, we can adjust the assessment by one category maximum on the three-point scale.

Figure 4. The 'individual credit profile' scorecard (QS2)

Risk pillar		Analytical components	Stronger (100)	Neutral (50)	Weaker (0)
Debt and liquidity	40%	Debt burden and trajectory	○	○	○
		Debt profile and affordability	○	○	○
		Contingent liabilities	○	○	○
		Liquidity position and funding flexibility	○	○	○
Budget	30%	Budgetary performance and outlook	○	○	○
		Revenue flexibility	○	○	○
		Expenditure flexibility	○	○	○
Economy	20%	Wealth levels and economic resilience	○	○	○
		Economic sustainability	○	○	○
Governance	10%	Governance and financial management quality	○	○	○

Additional environmental and social factors	Positive impact (+5)	No impact (0)	Negative impact (-5)
Environmental factors and resilience	○	○	○
Social factors and resilience	○	○	○

Individual credit profile score	-
Indicative notching	**-**

Source: Scope Ratings

3.2.1 Debt and liquidity (40%)

We assign the highest weight to this category to reflect our view that (contingent) debt and liquidity risks are central to a sub-sovereign's debt servicing capacity. Our analysis places strong emphasis on a sub-sovereign's financing ability as reflected in its interest payments, financing and debt position. The liquidity profile is an important factor in the ability to service debt payments on time, particularly when access to capital markets is interrupted. The combination of risk-taking strategies and a high recourse to debt to finance investments realised via guarantees of conventional debt issued by government-related entities was a key trigger for financial distress, and even led to sub-sovereign defaults as a result of eroded own reserves or the circumvention of tight budget or direct debt policy limitations. Consequently, we use an 'extended-balance sheet approach' to assess the crystallisation risk of explicit and implicit contingent liabilities.

- **Debt burden and trajectory**

This component assesses the sub-sovereign's debt burden. The quantitative assessment considers the sub-sovereign's gross direct debt[6] relative to its operating revenue. However, high and rigid operating expenditure can constrain a sub-sovereign's ability to service debt with operating revenue. We thus complement our quantitative assessment with the payback ratio (gross debt/operating balance). We also inform our assessment with a forward-looking analysis of the debt trajectory over a multi-year horizon, in view of expected budgetary performance and investment needs.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	Low debt burden relative to peers	Moderate debt burden relative to peers	Elevated debt burden relative to peers
Qualitative adjustment	Debt is on a firm downward trajectory	Debt is broadly stable	Debt is on a firm upward trajectory

Source: Scope Ratings

- **Debt profile and affordability**

This component assesses the affordability of a sub-sovereign's debt as well as its exposure to interest rate and foreign currency risks and changing financial conditions. Our quantitative assessment is underpinned by the sub-sovereign's interest payment burden relative to its operating revenue and its implicit interest rate, which are critical for assessing debt affordability. We also supplement our analysis with a view on structural interest burden trends and the sub-sovereign's debt structure.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	Low interest payment burden relative to peers	Moderate interest payment burden relative to peers	Elevated interest payment burden relative to peers
Qualitative adjustment	Structurally improving interest burden; and/or favourable debt profile with limited interest rate or foreign exchange risks and high share of long-term debt with a favourable maturity/repayment structure	Stable interest burden and/or balanced debt profile with manageable interest rate or foreign exchange risks and a balanced maturity/repayment structure	Structurally deteriorating interest burden; and/or weak debt profile with material interest rate or foreign exchange risks and an unfavourable maturity/repayment structure

Source: Scope Ratings

- **Contingent liabilities**

This component assesses the size and materialisation risk of explicit and implicit contingent liabilities that have the potential to damage the sub-sovereign's balance sheet. Importantly, we analyse not only the size of contingent liabilities but also the likelihood of those liabilities crystallising onto the sub-sovereign's balance sheet. We consider the degree of oversight of related public sector entities, their debt burden and financial resilience, financial guarantees granted by the sub-sovereign, and implicit liabilities such as pension liabilities, legal and more public-private-partnership commitments and other policy commitments.

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[6] We refer to direct debt as the total gross consolidated debt in currency and deposits, debt securities and loans that are owed by the sub-sovereign. We do not include off balance sheet debt which is accounted for under *contingent liabilities*.

	Stronger (100)	Neutral (50)	Weaker (0)
Qualitative assessment	Limited share of contingent explicit and implicit liabilities relative to sub-sovereign's revenue base; and/or very low risk of crystallisation on the sub-sovereign balance sheet	Sizeable but manageable contingent liabilities relative to sub-sovereign's revenue base with a moderate risk of crystallisation on the sub-sovereign balance sheet	Large contingent liabilities relative to sub-sovereign's revenue base and/or elevated risks of crystallisation on the sub-sovereign balance sheet

Source: Scope Ratings

- **Liquidity position and funding flexibility**

This component assesses the strength of the sub-sovereign's liquidity position. We consider both internal sources of liquidity, including budgetary resources and cash holdings, as well as external sources including access to capital market funding and private or public credit liquidity lines such as credit facilities and short-term commercial paper programmes. Our assessment also accounts for the diversification and reliability of the creditor base. We assess the strength of the liquidity position based on the sub-sovereign's short-term debt liabilities by measuring the extent to which available liquidity covers debt service.

	Stronger (100)	Neutral (50)	Weaker (0)
Qualitative assessment	Access to external liquidity is strong with a diversified and reliable creditor base; and/or own liquidity sources can cover the next 12 months of debt service with significant buffers	Internal and external liquidity is adequate; and/or own liquidity sources can comfortably cover next 12 months of debt service	Internal liquidity buffers do not fully cover the next 12 months of debt service; and/or the sub-sovereign is overly reliant on short-term, external liquidity lines with a concentrated creditor base

Source: Scope Ratings

3.2.2 Budget (30%)

The assessment of a sub-sovereign's revenue adequacy and ability to adjust resources to cover interest expenses and debt repayments is critical. This is because persistent fiscal imbalances increase the probability of a sub-sovereign default, particularly under adverse economic and market conditions. Our evaluation of budgetary performance and risks focuses on a sub-sovereign's ability to maintain balanced budgets and its available budgetary buffers to cover investment expenditure, interest expenditure and debt repayments. We also assess the predictability of revenue and expenditure flows from operations and investment activities which can be used to service debt.

- **Budgetary performance and outlook**

This component examines the sub-sovereign's budgetary performance. We consider the degree to which the sub-sovereign can generate sufficient budgetary margins to cover its debt obligations and investment programme without overly relying on debt. Our quantitative assessment is underpinned by a historical review of the operating balance relative to operating revenue and balance before debt movement relative to total revenue. We complement this with a forward-looking assessment of budgetary performance in view of the sub-sovereign's investment plans.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	Strong budgetary performance relative to peers	Average budgetary performance relative to peers	Weak budgetary performance relative to peers
Qualitative adjustment	Strong fiscal outlook; and/or ample operating margins to cover investments with limited recourse to debt in coming years	Moderate fiscal outlook with broadly stable operating margins; and/or operating margins providing limited room to increase investments without recourse to debt in coming years	Weak fiscal outlook with deteriorating operating margins; and/or operating margins that are insufficient to fund investments or signal long-term fiscal imbalances in coming years

Source: Scope Ratings

- **Revenue flexibility**

This component assesses the sub-sovereign's ability to increase its revenues through higher tax rates, an expansion of the tax base or asset sales. Our quantitative assessment is underpinned by the share of intergovernmental transfers in operating revenue. In addition, we estimate the adjustable share of tax revenue, consider the tax rates applied nationally and examine any political commitments that may constrain the government's ability to increase revenue.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	Low reliance on intergovernmental transfers relative to peers	Average reliance on intergovernmental transfers relative to peers	High reliance on intergovernmental transfers relative to peers
Qualitative adjustment	Ample room to increase revenue if needed with little to no political impediment	Limited share of adjustable revenue with some room to increase revenue if needed	Little to no room to increase revenue; and/or political commitments that constrain ability to raise tax rates

Source: Scope Ratings

- **Expenditure flexibility**

This component examines the sub-sovereign's ability to manage or reduce expenditure. Our quantitative assessment is underpinned by the share of personnel expenditure in operating expenditure and the share of capital expenditure in total expenditure. In addition, we assess essential expenditure items mandated by the national (or higher-tier) government as well as the spending needed to maintain public services as intended. We also analyse the sub-sovereign's record in reducing expenditure, which indicates its ability and willingness to consolidate finances when needed. In this context, we identify the potential for investment backlogs, which would reveal threats to sustainable growth, and/or consider whether, if needed, investments can be postponed without major repercussions on the local economy. We also examine whether any legal or political constraints have the potential to materially limit the sub-sovereign's ability to reduce expenditure if needed.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	Good expenditure flexibility relative to peers	Average expenditure flexibility relative to peers	Low expenditure flexibility relative to peers
Qualitative adjustment	Ample room and willingness to lower operating expenditure, good record of lowering operating expenditure under stressed scenarios; and/or sizeable capital expenditure can be postponed easily	Some room and willingness to lower operating expenditure; and/or capital expenditure provides an additional buffer if needed	Constrained ability and/or willingness to lower operating and capital expenditure leading to high budgetary vulnerability to shocks

Source: Scope Ratings

3.2.3 Economy (20%)[7]

Under this risk category we review the reliability of the revenue base against future spending needs, as both ultimately affect a sub-sovereign's ability to service debt in the medium to long term. The relatively low weight of this risk pillar reflects our view that in many countries, material transfer-dependency may weaken the link between the individual credit profile and the economic performance in the country in which a sub-sovereign is located. In addition, starting the assessment with the sovereign rating already captures critical elements related to the overall macro-economic environment.

- **Wealth levels and economic resilience**

This component assesses the resilience of the sub-sovereign's economic and tax base by focusing on its wealth levels and economic diversification. The sub-sovereign's ability to generate sufficient and sustainable own revenue depends, in part, on its wealth levels. Regional disparities in wealth can imply differing fiscal capacities. Our quantitative assessment is thus underpinned by local or regional GDP per capita levels. We also analyse the resilience of a sub-sovereign's economic base in view of its economic size and diversification and exposure to local, regional and/or global shocks. Usually, a narrow economic base with high reliance on a specific industrial sector increases the volatility of a sub-sovereign's economic performance, and thus its tax revenue, weighing on budgetary performance.

[7] For ratings at the local level, we can use economic data for the surrounding region if local level economic data is not available.

	Stronger (100)	Neutral (50)	Weaker (0)
Quantitative assessment	High wealth levels: GDP per capita exceeds 120% of national GDP per capita	Moderate wealth levels: GDP per capita is between 120% and 80% of national GDP per capita	Low wealth levels: GDP per capita is below 80% of national GDP per capita
Qualitative adjustment	Diversified economic base that underpins strong resilience to shocks and stability of the tax base	Moderate economic diversification that is somewhat resilient to shocks	Narrow or highly concentrated economic base, leading to high vulnerability to shocks

Source: Scope Ratings

- **Economic sustainability**

This component analyses the growth prospects of a sub-sovereign's local and regional economy. We consider the growth potential of the region, demographic trends, long-term business dynamism and structural labour market dynamics. We also take into account the competitive advantages of the respective region, such as its strategic location, transport infrastructure, industrial strength and natural resources.

	Stronger (100)	Neutral (50)	Weaker (0)
Qualitative assessment	Robust economic growth and employment prospects; favourable demographics; and/or strong business dynamism	Moderate economic growth and employment prospects; adequate demographic dynamics; and/or average business dynamism	Weak economic growth and employment prospects; unfavourable demographic dynamics; and/or sluggish business dynamism

Source: Scope Ratings

3.2.4 Governance (10%)

Our analysis of a sub-sovereign's governance focuses on political and institutional strengths, mostly as pertains the quality of its financial management and broad policy outlook. The weighting of this key category for the ICP is justified by our framework-driven assessment, which already captures key credit-relevant governance elements at the sub-sovereign level. At the same time, severe policy and political risks that may trigger a default are captured under 'additional considerations' (Chapter 5).

- **Governance and financial management**

This component examines the quality of a sub-sovereign's governance and financial management. We consider the sub-sovereign's political and institutional strengths, including as regards transparency, accountability, policy predictability and decision-making capacity. This includes a review of recent political events that may influence a sub-sovereign's policy as well as the frequency of changes in governing and management bodies. We regard instances of or tangible concerns related to corruption to be a strong indication of weak governance. We also review the sub-sovereign's record of designing and implementing financial plans and delivering on fiscal and financial targets as well as the quality of its internal and external controls.

	Stronger (100)	Neutral (50)	Weaker (0)
Qualitative assessment	Strong governance quality; transparent, effective and consistent policymaking; very stable and predictable political environment; robust financial management with prudent long-term financial planning and conservative debt management; and/or good internal and external controls and disclosure of key risks	Medium governance quality; transparent policymaking; broadly stable political environment; good financial management with manageable risk appetite; and/or adequate internal controls	Weak governance quality; long-term policymaking lacking a clear strategy or showing inefficiencies; unstable political environment leads to limited policy predictability; lax financial management with weak record of delivering on fiscal targets; lack of effective and credible controls with limited disclosure; and/or tangible corruption concerns

Source: Scope Ratings

3.2.5 Additional environmental and social considerations

Environmental (E) and social (S) factors are credit-relevant and captured through several analytical components. First, our assessment of a sovereign's credit quality, a key input for our sub-sovereign ratings, incorporates ESG risks (20% weight) as detailed in our Sovereign Rating Methodology. In addition, E and S factors are reflected in a sub-sovereign's *debt and liquidity* profile (for instance, to capture debt issued with E and S purposes in mind) and *budget* profile (for instance, to reflect the budgetary implications of E and S spending). However, additional E and S factors can be material for sub-sovereign creditworthiness beyond what is already captured in other sections of the methodology or reflected in historical and forecasted financial and economic data. Our analysis of additional E and S factors looks at sub-sovereigns' exposure to E and S risks as well as the degree to which they are delivering on their E and S policy objectives in view of their mandated responsibilities.

Additional adjustments can be warranted if there are wide regional disparities in terms of E and S exposures. This may require a positive or negative credit-relevant adjustment to reflect instances where the associated risks and/or benefits deviate significantly from country-wide averages and long-term trends. E risks can include high (low) transition risks due to a large (small) exposure to fossil-fuel dependent industries and above-national-average (below-national average) physical risks due to climate change. Social risks can include high (low) poverty rates, strong (weak) employment prospects and adverse (favourable) demographic trends that would not be fully captured under our assessment of 'economic sustainability'.

In addition, we assess E and S factors in terms of a sub-sovereign's related policies and their effectiveness in view of its framework-defined spending responsibilities. Sub-sovereigns that outperform (underperform) on their E and S policy objectives are likely to face lower (higher) spending pressures or investment needs in the long term, with associated benefits (risks) for their credit profiles. To identify whether a sub-sovereign has a material responsibility for specific E and S policy interventions, we analyse the sub-sovereign's budget structure and identify competencies that entail clear spending responsibilities in line with E/S-related UN Sustainable Development Goals. We consider E and S spending responsibilities to be credit-relevant if spending on a policy issue represents at least 5%-10% of expenditure for that government tier.

We adjust a sub-sovereign's ICP based on its strength or weakness against peers on relevant E and S criteria (as it entails medium- to long-term implications for its budgetary planning and performance, investment needs, debt burden or economic base) by up to +/-5 points per component as follows:

	Positive impact (+5)	No impact (0)	Negative impact (-5)
Qualitative assessment	Low exposure to E/S risks relative to peers; and/or the sub-sovereign is outperforming on its E/S policy objectives	Average exposure to E/S risks relative to peers; and/or the sub-sovereign is delivering on its E/S policy objectives	High exposure to E/S risks relative to peers; and/or the sub-sovereign is underperforming on its E/S policy objectives

Source: Scope Ratings

4. Indicative sub-sovereign rating

We derive the indicative sub-sovereign rating by mapping the result of the institutional framework assessment (i.e. the indicative rating range) to the ICP score, as depicted in **Figure 5** below. Based on our approach, a strong ICP score is enough for a high rating, regardless of the framework, while a strong framework supports the ratings of sub-sovereigns with weak ICP scores. When the mapping table provides two indicative notching possibilities, we consider the historical position of the sub-sovereign, its expected future performance and peer comparisons.

Figure 5. Deriving the indicative sub-sovereign rating

Institutional framework assessment		Individual credit profile score							
Score	Downward rating range	100 > x ≥ 80	80 > x ≥ 70	70 > x ≥ 60	60 > x ≥ 50	50 > x ≥ 40	40 > x ≥ 30	30 > x ≥ 20	20 > x ≥ 0
100 > x ≥ 90	0-1	0	0	0	0	0	0	-1	-1
90 > x ≥ 80	0-2	0	0	-1	-1	-1	-1	-2	-2
80 > x ≥ 70	0-3	0	-1	-1	-1	-2	-2	-3	-3
70 > x ≥ 60	0-4	0	-1	-1	-2	-2	-3	-3	-4
60 > x ≥ 50	0-5	0	-1	-1	-2	-2	-3	-4	-5
50 > x ≥ 40	0-6	0	-1	-1/-2	-2/-3	-2/-3	-3/-4	-4/-5	-6
40 > x ≥ 30	0-7	0	-1/-2	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-7
30 > x ≥ 20	0-8	0	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-6/-7	-8
20 > x ≥ 10	0-9	0	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-7/-8	-9
10 > x ≥ 0	0-10	0	-1/-2	-2/-3	-3/-4	-5/-6	-7/-8	-9/-10	-10

Source: Scope Ratings

5. Additional considerations

The combination of the rating anchor level, the institutional framework assessment and the ICP score provides an indicative sub-sovereign rating. Given the idiosyncratic nature of the sub-sovereign universe, however, we include additional considerations when determining the final rating. These include: i) potential adjustments to reflect a sub-sovereign's systemic importance; ii) a review of whether the sub-sovereign can be rated above the rating anchor level and its sensitivity to changes in rating anchor levels; and

iii) a review of exceptional circumstances that could lead to additional adjustments. Although these adjustments have no defined limit, each assessment that causes deviation from the indicative rating will be explicitly communicated and justified.

5.1 Systemic importance

While the institutional framework assessment described in Chapter 2 gives a comprehensive view of the degree to which a sub-sovereign's credit quality is tied to that of the rating anchor, some entities may have intrinsic qualities that make the rating anchor more willing to provide support in cases of financial distress. For example, a systemically important entity is more likely to benefit from extraordinary support than typical entities of the same government tier. Alternatively, entities with less systemic importance, whose default would entail little to no spill-over risk to other public entities, are less likely to receive extraordinary support. In both cases, an additional adjustment to the indicative ratings may be appropriate.

We make this judgment by considering the relevance of the sub-sovereign's economy, debt, expenditure and population relative to other sub-sovereigns within the same government tier, as well as its clout as a public sector issuer, for instance, underpinned by a capital city status. The *systemic importance* assessment can lead to an upwards or downwards indicative rating adjustment from the indicative sub-sovereign rating resulting from the mapping table by typically up to two notches.

5.2 Rating anchor ceiling and rating sensitivity

In this part of the analysis, we assess whether i) the sub-sovereign can be rated above the rating anchor; and ii) the sensitivity of the sub-sovereign's ratings to changes in the rating anchor level, that is, the degree of automaticity between the rating anchor and sub-sovereign rating changes.

5.2.1 Criteria to be rated above the rating anchor

Under our approach, a sub-sovereign rating is indicatively capped by the rating anchor level. Exceptions can exist but are unlikely. The indicative cap reflects our view that there is a minimum degree of default interdependence between sub-sovereigns and rating anchors, even among highly autonomous entities. In a non-US context, sub-sovereigns are typically not shielded from the jurisdictions of national courts and consequently their ability to honour debt obligations depends on the functioning of their particular national legal system, regulation and/or policy framework. The recent Global Financial Crisis confirmed that a sub-sovereign's (even those whose autonomy is enshrined in the national constitution) ability to gain capital market funding will be strongly impaired if the rating anchor faces financial distress. Consequently, we would only pierce the rating anchor level in exceptional circumstances, justified on a case-by-case basis.

A sub-sovereign rating above the rating anchor can be justified based on two conditions: i) the extent to which a special legal status or fiscal autonomy shields the sub-sovereign from central government intervention regarding its tax revenues, expenditures and treasury accounts; and ii) an exceptionally strong ICP score among peers.

The two factors in combination must ensure exceptional liquidity and financing profiles as well as budgetary flexibility and resilience. We define these factors as: i) autonomous access to liquidity with a very strong debt profile, typically reflected by very low financing needs, comfortable cash buffers covering stressed cash outflows over the next 12-18 months, and exceptionally high autonomy to incur debt without rating anchor interference, i.e. sub-sovereign finances are fully protected from political interference by constitution or public law; ii) extraordinary budget flexibility, reflected by robust revenues through economic cycles, very low transfer-dependency and a sub-sovereign's control over the tax payment system with no obligation to forward tax receipts to other government tiers or to redistribute them, enabling it to withstand long periods of macro-economic and financial stress; and iii) exceptional revenue resilience to external shocks and a high potential to outperform, also in cases of rating anchor stress/default.

A positive assessment of these factors indicates a sub-sovereign that can consistently service debt obligations, even if the rating anchor defaults (itself a very unlikely scenario) and can thus result in a sub-sovereign rating above the rating anchor level.

5.2.2 Sensitivity to rating anchor level changes

To assess the sensitivity of a sub-sovereign's rating to a change in the rating anchor level, we analyse on a case-by-case basis: i) the drivers of the rating action on the rating anchor, specifically, their effect to the rating anchor's ability to provide support; ii) any possible implications for the institutional framework; and iii) the expected impact on a sub-sovereign's ICP score relative to peers.

In general, sub-sovereigns operating in less aligned institutional frameworks, coupled with a strong ICP score, are less affected by a change in the rating anchor level. Conversely, sub-sovereigns that are institutionally highly integrated with the rating anchor and/or have a weak ICP score are usually more affected by a change in the rating anchor level. This reflects our view that institutional frameworks with low intergovernmental integration typically dampen the direct impact of a change in the rating anchor level. A change in the rating anchor level does not automatically trickle down to all entities equally and will depend on their individual credit strengths.

5.3 Review of exceptional circumstances

Our rating approach indicatively limits the maximum distance to the sovereign rating, or alternatively to the higher-tier government level, as established by our framework assessment. The indicative rating range reflects that there is always some degree of intergovernmental integration between the sub-sovereign and the rating anchor, also in very decentralised frameworks. However, in exceptional circumstances that cannot be captured by the quantitative and qualitative scorecards, we may adjust the indicative sub-sovereign rating further downwards, that is, below the indicative rating range.

Certain additional factors that might not be fully captured by our scorecards can carry important rating considerations for sub-sovereigns. In exceptional circumstances, we may thus adjust the indicative sub-sovereign rating further downwards, even below the indicative rating range. Additional factors can lead to a one-notch adjustment to the rating, but extreme circumstances may warrant multiple notches. Additional factors can include the following (non-exclusive) considerations:

- Excessive debt (downward adjustment)
- Sizeable, growing and very risky contingent liabilities (downward)
- Excessive budget deficits after capital accounts (downward)
- Very weak and deteriorating liquidity, limited to no market access, or access to alternative liquidity sources and substantial re-financing needs (downward)
- Very weak financial management, consistent weaknesses in fiscal practices, debt management and transparency (downward)
- Highly concentrated and narrow economic base with weak economic fundamentals (downward)
- High political risk and/or acute political interference undermining the ability and/or willingness to service debt (downward)
- High political conflict with higher-tier government increasing the uncertainty around the latter's willingness to provide timely support (downward)
- Event risk, such as wars, natural disasters or a global financial crisis, undermining the ability to service debt (downward)
- Recent history of default or debt restructuring (downward)
- Significant cash buffers (upward)

6. Long-term and short-term issuer ratings

Our Rating Definitions apply to sub-sovereign issuers and their long-term and short-term debt obligations.

See our Rating Definitions for more information on long-term and short-term rating scales. The long-term issuer rating is a measure of a sub-sovereign's fundamental credit quality, which also includes the consideration of short-term risks related to the liquidity position and funding flexibility. Short-term ratings are correlated with the long-term ratings but also emphasise risks and considerations related to liquidity aspects, including an assessment of available cash, liquid assets, access to external short-term liquidity and flexibility in borrowing.

Our evaluation of short-term credit quality is typically highly correlated with our assessment of a sub-sovereign's liquidity position (see Chapter 3.2.1). When two short-term ratings can be derived from the long-term rating, the higher of the two short-term ratings will be assigned when our assessment of the sub-sovereign's *liquidity position and funding flexibility* is either 'stronger' or 'neutral'. Conversely, when liquidity position is assessed as 'weaker', we assign the lower of the two short-term ratings.

7. Sources of information

Our analysis is based on the sub-sovereign's respective statutes and governing documents, annual reports, financial/economic statements/figures and investor relations presentations. In addition, we rely on financial data provided by national authorities as well as economic data from national and international sources. The institutional framework assessment is underpinned by national legislative and regulatory texts, policy documents, academic research and other related materials.

8. Case study: Stylised sub-sovereign rating

In this section, we provide a stylised example of a sub-sovereign rating, detailing each analytical step and rating drivers. This example refers to a hypothetical sub-sovereign entity at the local government level.

- **Rating anchor**

In this example, we assume that the rating anchor for the sub-sovereign's government tier is the sovereign, hypothetically rated at AA. However, if we deem that, due to a highly decentralised federal system, the higher-tier regional government is in charge of defining the institutional framework characteristics, independently conducting oversight of local finances, setting revenue and spending powers, and thus is ultimately responsible for the finances of its local authorities, we are likely to adopt that regional government as the rating anchor.

- **Step 1: Institutional framework assessment**

Figure 6. Application of QS1

Analytical components	Full integration (100)	Strong integration (75)	Medium integration (50)	Some integration (25)	Low integration (0)
Extraordinary support and bailout practices	○	◉	○	○	○
Ordinary budgetary support and fiscal equalisation	○	◉	○	○	○
Funding practices	○	○	◉	○	○
Fiscal rules and oversight	○	◉	○	○	○
Revenue and spending powers	○	○	○	◉	○
Political coherence and multi-level governance	○	◉	○	○	○

Integration score	*63*
Downward rating range	***0-4***

Institutional framework score	100 > x≥ 90	90 > x≥ 80	80 > x≥ 70	70 > x≥ 60	60 > x≥ 50	50 > x≥ 40	40 > x≥ 30	30 > x≥ 20	20 > x≥ 10	10 > x≥ 0
Indicative rating range	0-1	0-2	0-3	0-4	0-5	0-6	0-7	0-8	0-9	0-10

Source: Scope Ratings

As a first step, we assess the intergovernmental integration between the rated sub-sovereign's government tier and its rating anchor, typically the sovereign, based on the relevant institutional framework, as detailed in Chapter 2. The outcome of this assessment is the indicative rating range from the rating anchor level, within which the sub-sovereigns operating under that framework can be positioned. An integration score of 63 indicates a sub-sovereign rating range of between zero notches and negative four notches from the sovereign rating, namely between AA (the sovereign rating) and A- (four notches downward).

- **Step 2: Individual credit profile or ICP**

Figure 7. Application of QS2

Risk pillar		Analytical components	Stronger (100)	Neutral (50)	Weaker (0)
Debt & liquidity	40%	Debt burden & trajectory	○	○	◉
		Debt profile & affordability	◉	○	○
		Contingent liabilities	○	◉	○
		Liquidity position & funding flexibility	○	◉	○
Budget	30%	Budgetary performance & prospects	○	◉	○
		Revenue flexibility	○	◉	○
		Expenditure flexibility	◉	○	○
Economy	20%	Wealth levels & economic resilience	○	○	◉
		Economic sustainability	○	◉	○
Governance	10%	Governance & financial management quality	◉	○	○

Additional environmental and social factors	Positive impact (+5)	No impact (0)	Negative impact (-5)
Environmental factors & resilience	○	◉	○
Social factors & resilience	○	○	◉

ICP score	*50*

Source: Scope Ratings

We then assess the rated entity's standalone credit fundamentals, to position its rating within the range determined by the framework assessment. This analysis follows the guidance tables as detailed in Chapter 3. We start with preliminary assessments based on the quantitative metrics linked to the assessments (as per the guidance tables). For financial ratios, we benchmark based on peers operating under the same (or a similar) framework. We then complement preliminary assessments incorporating additional qualitative, quantitative and forward-looking factors that require analyst judgment, as outlined in the guidance tables. We also evaluate the materiality of additional environmental and social considerations, as detailed in Chapter 3.2.5.

In this example, the rated sub-sovereign has an ICP score of 50 out of 100.

➢ **Step 3: Mapping and indicative rating**

Figure 8. Mapping of rating range and ICP score

Institutional framework assessment		Individual credit profile score							
Score	Downward rating range	100 > x ≥ 80	80 > x ≥ 70	70 > x ≥ 60	60 > x ≥ 50	50 > x ≥ 40	40 > x ≥ 30	30 > x ≥ 20	20 > x ≥ 0
100 > x ≥ 90	0-1	0	0	0	0	0	0	-1	-1
90 > x ≥ 80	0-2	0	0	-1	-1	-1	-1	-2	-2
80 > x ≥ 70	0-3	0	-1	-1	-1	-2	-2	-3	-3
70 > x ≥ 60	0-4	0	-1	-1	-2	-2	-3	-3	-4
60 > x ≥ 50	0-5	0	-1	-1	-2	-2	-3	-4	-5
50 > x ≥ 40	0-6	0	-1	-1/-2	-2/-3	-2/-3	-3/-4	-4/-5	-6
40 > x ≥ 30	0-7	0	-1/-2	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-7
30 > x ≥ 20	0-8	0	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-6/-7	-8
20 > x ≥ 10	0-9	0	-1/-2	-2/-3	-3/-4	-4/-5	-5/-6	-7/-8	-9
10 > x ≥ 0	0-10	0	-1/-2	-2/-3	-3/-4	-5/-6	-7/-8	-9/-10	-10

Source: Scope Ratings

We map the results of Step 1 and Step 2 according to the table above to derive the sub-sovereign's indicative rating. In this example, an ICP score of 50 in a downward rating range of 0-4 notches results in an indicative rating for the sub-sovereign of two notches below the rating anchor. In this example, the sub-sovereign indicative rating is thus A+, two notches below the sovereign rating of AA.

➢ **Step 4: Additional considerations**

As a final step, we capture any additional considerations as outlined in Chapter 5. In this example, we assume that no such considerations apply to this entity and make no additional adjustments. As such the final rating for this hypothetical sub-sovereign corresponds to its indicative rating of A+.

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