Rating Cantons and Municipalities

Overview of the methodical credit rating assignment
to local and regional authorities

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Introduction

Rating assignments to cantons and municipalities differ fundamentally from credit assessments in private and corporate client banking business. Requirements for architecture and conception of a sound credit rating model for public debtors are complex. Probably the greatest challenge is to systematically consider and consistently assess the financial and legal interdependencies in a federal state structure and the very diverse institutional framework conditions relevant to creditworthiness. This takes due account of the fact that a substantial part of the credit risk of local authorities at lower levels of government cannot be directly influenced by local executive officials, but is the responsibility of parliaments at higher levels of government.

The federalist state structures in Switzerland differ from those in Germany and Austria primarily in the extensive tax collection powers of the cantons and municipalities (financial autonomy) and the pronounced right of voters to have a say (referendum). Furthermore, public accounting in Switzerland has been based on double-entry bookkeeping with a balance sheet, income statement, and investment statement for over 30 years. The federalist state structures designed along the Swiss model are undoubtedly capable of generating strong fiscal discipline with effective incentives for the efficient provision of public goods and a comparatively low waste of tax revenues. In principle, federalism offers attractive opportunities to promote healthy public finances at all levels of government. In light of this, a profound reform of federalism is being debated in many European countries. In Germany and Austria, important reform steps are already underway in the area of public accounting with the transition from single-entry (Kameralistik) to double-entry bookkeeping (Doppik).

Status Quo

Institutional investors' perception of risk vis-à-vis local authorities in Switzerland has changed fundamentally even before the recent financial crisis. One of the first triggers for the rethink among investors was the financial disaster of the municipality of Leukerbad, which became public in October 1998. The first default of a Swiss municipality in over fifty years caused a huge stir among broad sections of the public. The hope initially expressed in financial circles for an "implicit" state guarantee, whereby the federal government and/or the cantons would be liable in some form for the liabilities of their municipalities, has been dashed. In a landmark decision on June 4, 2003, the Swiss Federal Supreme Court de facto ruled out state liability arising from a canton's failure to supervise its municipalities.

Financial autonomy

In Switzerland, the 1990s in particular were marked by concerns about the growth of public sector liabilities. Since 1990, liabilities have roughly tripled at the federal level,

nearly doubled at the cantonal level, and increased by about half at the municipal level. Despite the overall moderate increase in liabilities at the lowest level of government, individual differences between municipalities are considerable. As elsewhere, Swiss municipalities are gradually reaching the natural limits of their capacity to perform and act. In particular, municipalities as the lowest level of government suffer noticeably from the trend towards decentralization of government tasks. This often involves particularly cost-intensive tasks in the areas of "social security" and "health". In general, however, the tasks to be performed have become much more demanding and complex compared to the past, while the expectations of the electorate regarding municipal public goods and services are constantly growing.

Credit Risk

Since the failure of the municipality of Leukerbad, a number of municipalities from various Swiss cantons have experienced financial difficulties. The risk of loss for institutional investors in this market segment can be considerable. In the case of Leukerbad, affected investors had to wipe a large part of the original claims of around CHF 350 million off their books. In addition, investors occasionally consciously accept financial losses in connection with the restructuring of their debt claims as a prerequisite for the long-term restructuring of a municipal financial budget. The changed perception of risk has triggered efforts to professionalize their credit risk management with regard to the selection, pricing, and valuation of receivables from public-sector debtors, particularly among institutional investors with a long-term perspective. At the same time, the differentiated compensation of creditworthiness risks in Swiss municipal financing has brought the potential for reform in the case of inefficient institutional frameworks back into the consciousness of political players. Over the past decade, numerous cantons have implemented continuous reform steps in various areas of legislation, which among other things help to reduce existing disincentives in the provision of public services by cantons and their municipalities. At the same time, after decades of stagnation, a veritable wave of communal mergers has now begun, with a streamlining of small-scale communal structures. These merger projects are often initiated by the municipalities themselves, but in the case of municipalities with serious financial problems, they are also "promoted" by the cantons on a case-by-case basis with gentle pressure and generous merger contributions.

Credit Rating Concept

The credit rating model for local and regional authorities developed by fedafin is designed as an expert system and takes account of the fact that creditworthiness of local and regional authorities is determined both externally (exogenously) and internally (endogenously) by a modular structure. In a first step, the exogenous credit rating factors are systematically analyzed, identified and evaluated. In a second step, the endogenous creditworthiness factors are systematically assessed on the basis of a system of indicators.

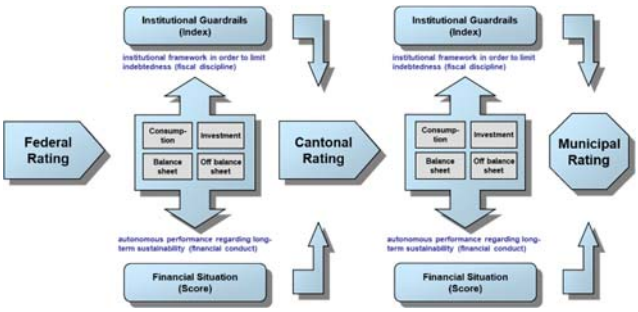
The central cause of financial imbalance of a local or regional authority lies in the failure to politically control the production, distribution, and financing of public goods and services. In Switzerland, all these state activities require an explicit legal basis due to the principle of legality. Depending on the design of such regulations, they can effectively and permanently restrict the scope for debt or create information problems in the form of moral hazard situations, which in turn generate problematic incentives for new borrowing.

Credit Rating Architecture

Due to its sovereign powers, the creditworthiness of the Swiss Confederation basically has an anchor function for the cantonal ratings. The assessment of the Confederation's creditworthiness is based on results of the international credit rating agencies S&P, Moody's, and Fitch (see the information on the use of external credit ratings in the disclosure document on fedafin's front page). In terms of creditworthiness, the Confederation is rated as an excellent debtor with the highest credit rating of Aaa. There is a broad consensus among credit rating agencies on this result. A change in the federal credit rating would affect the cantonal credit ratings in line with the anchor function. With regard to the relationship between the Confederation and the cantons, the financial and legal interdependencies are reduced to a minimum. The Federal Constitution explicitly regulates the

distribution of revenue and expenditure powers in the same way for all cantons. The Confederation has no actual supervisory duties over the cantonal financial budgets. Due to the principle of subsidiarity in Swiss constitutional law, there is probably no other level of government at the international level that has such a high degree of autonomy as the Swiss cantons.

Cantonal credit ratings have a similar anchor function for assessing the creditworthiness of municipalities, as the active influence a canton can exert on its municipalities from a financial and legal perspective is usually considerable. A change in cantonal ratings would affect municipal ratings in line with the anchor function. Experience shows that it is particularly the financially well-off municipalities of a canton that are disproportionately affected by restructuring measures at cantonal level. The credit rating for a first-class municipality will therefore be increasingly restrictive as the canton's creditworthiness declines. This will ensure that the credit rating factors relevant to the cantonal rating also influence the municipal ratings within the canton in an adequate direction. The credit rating model allows explicit consideration of this financial-legal interdependence between the individual levels of government, which is typical of federalist state structures (see Figure 1).



1 Rating architecture for assessing the creditworthiness of local and regional authorities

One of the central problems in assessing the credit risks of Swiss municipalities, on the other hand, is that the institutional framework conditions differ, sometimes massively, between the various cantons and the municipalities in their territory. The impact of such legal norms on the creditworthiness of municipalities varies widely, ranging from a very tightly woven to a coarsely woven safety net for the long-term financial stability of local authorities. As a result, the lower rating range for municipalities necessarily differs from canton to canton. Ultimately, this is the only way to determine consistent and directly comparable municipal credit ratings nationwide.

Credit Rating Methodology

Rating assignments' methodological foundation is an asymmetrically extended Logit function, which realistically reflects the dynamics of credit risks. In particular, it permits consistent consideration of the financial and legal interdependencies between the various levels of government using various parameters and indices. The methodical system allows a risk-adequate and objectively directly comparable assessment of creditworthiness of local and regional authorities.

Rating Criteria

As with any sound credit assessment, both quantitative and qualitative elements are being considered when assigning a cantonal or municipal credit rating. Quantitatively, the credit risk is identified, analyzed, and evaluated on the basis of specific key figures from balance sheets and income statements of past years (ex-post situation). This provides an objective picture of autonomous financial management in comparison with other local authorities. Qualitatively, the credit assessment is supplemented by various risk and success factors that exert a systematic influence on the future development of the credit risk (ex-ante trend). These primarily include institutional conditions in which cantons and municipalities fulfil their service mandate.

Qualitative Rating Criteria

The systematic identification and evaluation of creditworthiness-relevant conditions of the canton for the municipalities is carried out in the form of an index. This index fulfils an important forecasting function with regard to the future creditworthiness of municipalities. We basically differentiate between four circumstances relevant to creditworthiness in the institutional framework:

Financial-legal interdependencies between higher and lower levels of government

- Distribution of duties and competencies
- Financial guarantees of the upper levels of government
- Supervisory duties, liability, and practice
- Effect of the cantonal fiscal equalization system

Rules on debt limitation at the administrative account level

- Distribution of competences in the budgeting process
- Rules for budget balancing
- Distinction between consumption and investment calculation
- Amortization of administrative assets

Rules on debt limitation at balance sheet level

- Distribution of competence for financial investments
- Rules for the valuation of financial assets
- Rules for consolidation

Rules on debt limitation at off-balance sheet level

- Distribution of competence for off-balance sheet liabilities
- Rules for liability and deficit guarantees
- Rules for financial commitments

The effectiveness of regulations to limit the leeway for liabilities depends largely on the complete fulfilment of three requirements. These include a clearly and bindingly formulated target criterion, an equally clearly and bindingly formulated sanction mechanism in the event of non-compliance, and effective monitoring by an independent third party.

Quantitative Rating Criteria

For a final rating assignment, credit-relevant matters are examined which, within the legally prescribed guidelines, lie primarily within the autonomy of the municipalities themselves. Some cantons, and especially municipalities, are relatively small economic entities - comparable to small and medium-sized enterprises. As a result of this situation, many financially relevant variables fluctuate considerably from year to year. However, due to the specific tasks and functions of the public sector, such short-term fluctuations do not necessarily lead to a significant change in the solvency of a municipal budget. Examples of this are considerable fluctuations in the degree of self-financing. The purpose of a credit assessment is not to evaluate a patient's runny nose, but its general state of health. The financial sustainability of municipal service provision is therefore examined on the basis of a specially developed system of key figures. Each ratio meets a number of strict requirements with regard to creditworthiness relevance, ranking, comparability, resistance to manipulation, and robustness.

Systematic identification and evaluation of the actual financial situation of a municipality is carried out in form of a score. This fulfils an important information function regarding the current risk capacity of the municipal finances. We basically distinguish between three situations relevant to creditworthiness in the primary area of autonomy and influence of municipalities:

Assessment of capital structure and indebtedness

- Debt burden and coverage
- Net interest charges
- Debt financing potential

Assessment of profitability and cash flow

- Redemption rates
- Depreciation rates
- Operating cash flow
- Free cash flow

Assessment of financial potential

- Steering power and location attractiveness
- Structural and special risks (administrative accounting)
- Cluster and valuation risks (balance sheet)
- Contingency and liability risks (off-balance sheet)

Credit Rating Outlook

For cantons, an outlook can be assigned to the rating. The outlook (“positive”, “stable”, “negative”) reflects fedafin's assessment of the medium-term rating development.

The rating outlook does not represent a specific probability of rating change, but provides an indication on the likely direction of a potential rating change. The outlook covers a period of 12 to 18 months following the rating outlook assignment.

Outlook

Switzerland continues to face intense competition in terms of location and taxation for legal entities, but also for high income individuals. In many places there now seems to be little scope for further tax cuts. On the contrary, dark clouds are appearing on the horizon of many local and regional authorities in view of tight finances.

While financial resources are already exhausted in some places, future tax shortfalls are likely due to political concessions made by Switzerland in the face of international pressure on tax evasion and tax avoidance. At the same time, the above-average level of immigration to Switzerland in recent years is pushing many areas of public infrastructure and basic services to their capacity limits or even beyond. The initiative against mass immigration adopted by the Swiss people on 9 February 2014 will probably not fundamentally change this situation. If the implementation of this initiative does not succeed in maintaining the substance of market access to the European Union, additional difficulties for large parts of the Swiss export industry cannot be ruled out.

It can therefore be assumed that numerous cantons, cities, and municipalities in Switzerland will continue to face substantial financial challenges in the future. ■

Contact

fedafin AG
Galerieweg 8
9443 Widnau
Switzerland

Phone: +41 71 552 32 00
Email: info@fedafin.ch
Website: www.fedafin.ch

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