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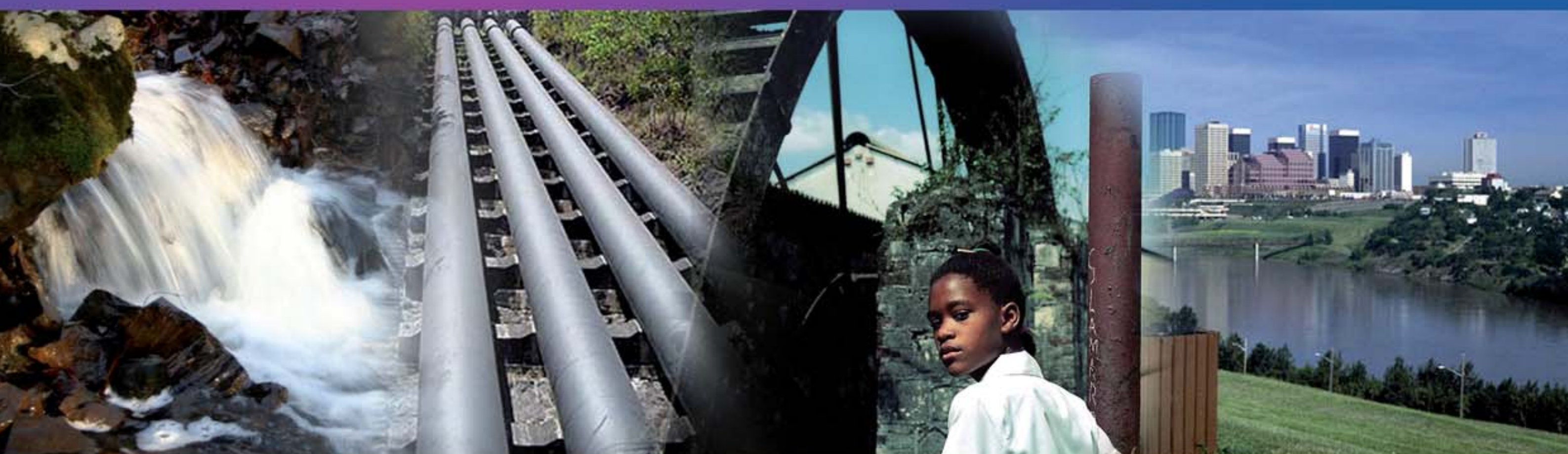

CLGF RESEARCH SERIES

Obtaining a Municipal Credit Rating

a brief overview

by Barry M Jackson

Durban, KZN South Africa

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The Commonwealth Local Government Forum (CLGF) works to promote and strengthen effective democratic local government throughout the Commonwealth and to encourage the exchange of good practice in local government structures and services.

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- Exchange experience among local government practitioners
- Strengthen local government capacity, and
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Obtaining a Municipal Credit Rating:
a brief overview

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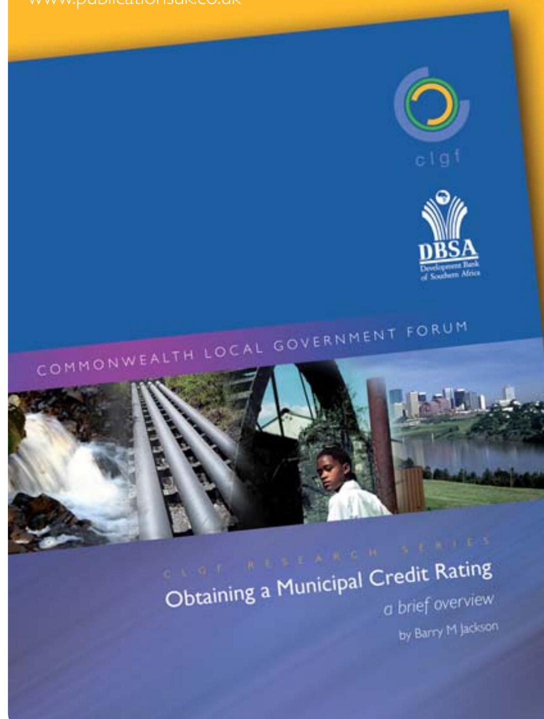

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preface

by CLGF Secretary-General, Carl Wright

Local government throughout the Commonwealth is facing many challenges. Financing the responses to those challenges is always problematic. The Commonwealth Local Government Forum recognises this and is pleased to publish this occasional paper on meeting the financing challenges. *(See www.clgf.org.uk/publications for other papers.)*

This booklet aims to introduce the idea of municipal (or local government) credit ratings to practitioners in the field – local government, central government and local government associations. We hope that this will help you discuss the issue with your colleagues and see the ways in which it may benefit your local authority or indeed your country.

"The rapid urbanisation that is taking place in many countries places particular demands on infrastructure development, expansion and renewal"

The rapid urbanisation that is taking place in many countries places particular demands on infrastructure development, expansion and renewal. All infrastructure work requires substantial capital expenditures. There are limited means of financing these. What this booklet aims to do is to show you how to access finance from the private sector capital market in a way which is most beneficial to your local government.

At the macro-economic level, it is often argued that local government cannot be permitted to have the powers to borrow. However, well regulated local government borrowing can make a substantial contribution to developing domestic financial markets, and this publication provides some case studies of good practice.

CLGF has been very pleased to work with two key partners in the preparation and publication of this booklet: the Development Bank of Southern Africa which kindly released Barry Jackson to write the booklet and meet with CLGF staff in London to develop its focus; and Publications UK who made the production and publication of the booklet possible. To both we are very grateful and we hope our collaborations will continue into the future.

Carl Wright
Secretary-General
Commonwealth Local Government Forum

foreword

by Paul Baloyi, DBSA

The Development Bank of Southern Africa (DBSA) is proud to be asociated with this publication. Effective municipal financing is more critical than ever as decentralisation programmes are implemented across the Commonwealth.

The DBSA is dedicated to supporting development "by mobilising and providing finance and expertise and by establishing partnerships to develop infrastructure to improve the quality of life of the people of Africa." Through providing the expertise to write this booklet, we have been working in partnership with the Commonwealth Local Government Forum. We hope this booklet will enable local government in Africa and throughout the Commonwealth to engage with the issue of credit ratings, which are of political as well as financial value to local and central governments. Numerous examples are cited in this report.

"with effective regulation, their use of the domestic financial markets can have a beneficial ripple effect across the sector"

Many governments have not empowered local government to borrow on the open market. However, with effective regulation, their use of the domestic financial markets can have a beneficial ripple effect across the sector. Central government needs to consider carefully how it can enable local government to make use of this instrument.

Whilst many in local government are averse to borrowing or raising funds on the financial markets, there are also many in banking and the financial markets who are wary of local government. This is why the need for and value of credit ratings is explained in the following pages. If local government across the Commonwealth is to deliver on the Millennium Development Goals in areas such as school building, clinics, sanitation and provision of water, substantial capital is required. This booklet does not argue that bank debt or raising bonds is THE solution, it simply provides a guide on how to do so in a way that is most favorable to local government. I hope you will find it useful.

It has been a pleasure working with the Commonwealth Local Government Forum on this guide, and I look forward to continuing our collaboration in the future.

Paul Baloyi
Chief Executive Officer and Managing Director
Development Bank of Southern Africa

introduction

Calcutta's financial state given highest grade in country

Little in Calcutta can be claimed to be A class… but the civic body is one of them. In fact, A+ Credit Rating Information Services India Ltd (Crisil), which assesses credit-worthiness, has given the Calcutta Municipal Corporation the A+ rating that no other civic body in the country possesses. "If the CMC were a company with its shares listed on stock exchanges, the A+ rating, I feel tempted to say, would have boosted the price of the scrip," said P. Ramesh, Mumbai-based head of Crisil's infrastructure rating. Crisil's current A+ rating is based solely on the civic body's internal finances, excluding government grants. "We are going to tell the people about this," said Mayor Mukherjee, making it clear that his party would go into the civic elections with this achievement on its lips. "They (CMC) are the only civic body in India today whose financial strengths are well defined and in the public domain," said Ramesh. This means if the CMC were to now raise money, the lender would treat it as more than an adequately safe borrower.

Source: The *Telegraph*, Calcutta, India, 18 Jan 2005

This booklet aims to inform practitioners in local government of the value and uses of municipal credit ratings, noting some of the national issues to be taken into account and the general procedure that has to be followed to obtain one.

The author points out how, through borrowing, local governments have the option of paying for major infrastructure development by spreading the costs to the tax payers more evenly over a longer period by borrowing and repaying that loan over a reasonable period. Furthermore, by enabling the local government sector to access the domestic financial markets, governments are assisting the development of these markets. However, with borrowing comes risk and only local governments that manage risks effectively will be able to make the most of this approach to financing their projects. But robust financial management brings much wider rewards than simply cheaper loans.

The booklet describes what a credit rating is in straightforward language, and the financial uses of it. It also touches upon the political value of obtaining a credit rating, drawing on a number of case studies. It notes ways in which central government can promote credit ratings as a tool for improvement in local government – not least through enabling legislation – and reasons why they should give this serious consideration.

It considers two of the key options open to local government – bank debt and municipal bonds, highlighting a couple of the variations within these. Examples are drawn from Africa, India and the USA.

The booklet covers the credit rating process and what local governments can expect to go through in order to receive an independent rating. This covers the materials that will have to be provided and also the political and executive staff buy-in that will be required to ensure a smooth process, and improve the chances of a successful outcome.

Finally, should this be of interest to your local government, local government association or ministry, there are some suggestions on how to take the first steps in making use of credit ratings.

the changing municipal landscape

Nelson Mandela Metropolitan Municipality excellent credit rating

"Our municipality was applauded for its remarkable economic growth, which is higher than the national average. This clearly indicates the good financial status our institution enjoys, and the respect we command on a national level," said Mayor Nondumiso Maphazi to applause from the chamber. She also mentioned the recently announced "excellent" credit rating for the municipality, which is A1 for short-term rating and A for long-term. The same ratings were received last year. "We must therefore set our sights on achieving A+ ratings," she said.

Source: The *Herald*, Port Elizabeth, 12 Sept 2006.

There is a growing appreciation of the benefits of municipalities being able to raise their own capital funds by borrowing in the market place. Municipalities are under immense pressure to extend municipal services to rapidly growing populations. The scale of finance immediately required for these services, especially those needing expensive new infrastructure, means that "business as usual" is not enough. Grants from central government are not forthcoming in the volumes required and large surpluses from municipal taxes are a thing of the past.

More and more municipalities are recognising that they need to borrow funds from the private sector in order to meet today's needs as soon as possible. Whether borrowing is medium or long term, bank debt or bonds, it is prudent to aim for the best possible interest rate in order to keep down the cost of borrowing. The key to this is to work for and obtain the best possible credit rating, and to continuously strive to improve it.

This booklet aims to demystify the technical concepts around borrowing and credit ratings. It should prove useful to at least three sets of interested persons:

- municipal councillors and officials (including managers of municipal-owned utilities)
- central government ministers and officials (these could also include managers of parastatal utility companies), and
- national local government associations

Training institutions are also encouraged to make use of it bearing in mind that there are more sophisticated teaching materials available.

In the **municipal sphere** of government, councillors and officials may be considering market-based borrowing but are uncertain about how to get the best deal. This booklet explains many of the issues potential borrowers face and, in particular, the role of credit ratings: what they are, why they are useful, what they "measure" and how to go about obtaining one.

Likewise, those in **central government** may be deliberating over the desirability and implications of decentralised service delivery together with the policy and regulatory framework for municipal borrowing in their country. This booklet briefly describes the benefits and certain features of a well functioning market for municipal finance and the role of credit ratings within it. The following discussion also provides a few pointers for ensuring that the market continues to function well.

There is a third set of actors – those that represent various **local government associations**. Most countries have some form of association that seeks to represent local government concerns, which include those related to management and finances. These organisations vary greatly in strength and capacity, and the issues they focus on will depend on the state of evolution of local government in each country. Now that municipal finance is such a central theme, most will need to be well-informed on the topic. They need to prepare to play an advocacy role to ensure that the policy environment supports the development of a properly functioning financial market, and that members are empowered to access it. Achieving a respectable level of creditworthiness, as expressed in a strong credit rating, is critical to gaining that access. Throughout the developing world, many local governments have seen the benefits of achieving a good credit rating. This booklet quotes several success stories and expressions of pride on the subject from around the globe.

A framework of rules for subnational borrowing

Thus the analytical framework for this study rests on the principle that a subnational government securities market is desirable and that subnational borrowing will be dictated largely by the operation of the market, working within a framework of rules necessary to keep it a free and efficient allocator among competing uses. Many conditions need to be met, but four are key:

- Subnational governments borrow of their own volition and rely on their own resources for security and repayment of debt.
- Capital markets are free of excessive restrictions — with an arm's length relationship between government and markets and banks – and allocate resources on the basis of risk and reward.
- The market has full access to the information required to assess the financial condition of borrowers and to determine risk and reward.
- Subnational borrowing is subject to appropriate oversight by the central government before it is made available. The central government plays a supportive role, intervening only when well-established rules of borrowing are flouted or subnational government mismanagement threatens fiscal crisis.

Source: *Subnational Capital Markets in Developing Countries: from theory to practice*, Editors Mila Freire and John Petersen

why borrow?

Municipal borrowing supports domestic capital market development

Subnational borrowing appears to have clear positive effects on credit markets. While accessing credit markets imposes burdens and risks, exposure of subnational governments to the market's appraisal of transactions, demands for information, and requirements for budgetary discipline is beneficial and is an important component of responsible self-governance. While not all political and economic systems are capable of supporting a market for subnational debt, emulating the required behavior and laying the foundations for a market flowering when conditions permit are worthwhile activities. Instability in international financial markets renders them an unreliable, fair-weather source of funds, at least in the near term. Thus building viable domestic financial markets is an immediate task–one to which subnational governments may contribute if they are fiscally stable.

Source: *Subnational Capital Markets in Developing Countries: from theory to practice*, Editors Mila Freire and John Petersen

Many national and local governments in the developing world are looking closely at the benefits of using borrowed money to build the infrastructure needed for more and better municipal services. There are several good reasons for this. Firstly, there is recognition that the capital expenditure requirements are enormous and the flow of government grants or donor funds will not be sufficient to meet those needs in the foreseeable future. For most municipalities in developing countries a rapid increase in spending on infrastructure projects is needed as soon as possible, not only to build new infrastructure but to refurbish existing infrastructure. Borrowing for capital expenditure can make this possible. Spending on large items of infrastructure tends to be "lumpy"; borrowing can provide large capital sums for immediate use, and the resulting longer term debt can be serviced from a regular stream of municipal income, whether directly from revenues resulting from the investment or indirectly through increased tax revenues.

Secondly, there is a growing trend toward the decentralisation of service delivery, where locally elected councils decide on capital expenditure priorities and are expected to raise some or all of the funds to meet them. Thirdly, borrowing funds for infrastructure, and repaying them over a number of years, introduces an element of "intergenerational equity". Since the life of an infrastructure asset could be thirty years or more, why should today's taxpayers meet the full cost and later generations reap the benefit? Repaying a long term debt means that those who benefit from the asset will also contribute to its cost.

There is also the value of exposing a city's development plans to public and expert scrutiny and the "discipline of the market". Municipal taxpayers and national government officials can take some comfort from the knowledge that a municipality's proposed infrastructure capital expenditure programmes will be subject to review by financial and technical experts before they are financed. These experts check that the proposed capital expenditures are appropriate and affordable for the municipality. They assess whether they are willing to invest in that municipality and determine what level of return they would require for their investment.

From a national government and macro-economic perspective there is also the value in mobilising local (also known as domestic or national) savings and thereby developing the domestic financial market. In most countries people save through contractual savings for life insurance and pensions. Pension fund administrators need long term secure investments for the funds entrusted to them, but those in developing countries often have very limited options open to them. They are often limited to investing in national government bonds and bank savings deposits or having to invest offshore in order to diversify their investments. Investing in municipal infrastructure enlarges their options and can stimulate the domestic capital market through the demand for good quality long term debt.

On a cautionary note: there are always risks in encouraging local government entities to borrow. There may be the temptation to borrow excessively. There may be over-ambitious or unrealistic revenue projections that do not happen as predicted. Municipalities may inadvertently or dishonestly pledge the same collateral as security for a loan to more than one lender. National governments need to be aware of such risks and regulate appropriately. This should not result in heavy regulation with government pre-approval of every municipal loan. It could be as light as a requirement for regular disclosure of the extent of indebtedness, some prudential ratios to limit total debt, and reasonable limits on pledging inter-governmental transfers. Thereafter it should allow the discipline of the market (including credit ratings) to play its part.

The need for domestic credit markets.

Asian cities cannot finance the infrastructure investments they need without accessing private domestic savings. Urban growth has multiplied demand for investment in water systems, wastewater collection and treatment, roads, and other facilities. At the same time, decentralization strategies have shifted much of the responsibility for this investment to local governments. Private financing can be attracted to urban infrastructure in different ways – including direct private investment in income-earning facilities–but perhaps the most critical avenue will be the local credit market. In a world of decentralized governance, domestic credit markets must be capable of generating long-term financing for cities and their infrastructure agencies.

Banks or Bonds? Building a Municipal Credit Market; **George E. Peterson, Senior Fellow, The Urban Institute, Washington, DC**

what is a credit rating?

In its simplest sense, a credit rating is an opinion by an independent specialist on the chances that a borrower will repay a loan as promised – on time, in full.

It is an opinion based on an assessment of a borrower's creditworthiness, which is the likelihood of making repayment, or conversely the risk of default, on a loan. The credit opinion, summarized in the form of a rating, is prepared by someone who understands the business of the borrower – a suitably qualified rating agency that investors will trust. It enables potential investors to decide whether to invest in the borrower's business, based on the level of risk they are willing to take and the likely reward associated with that risk. At the same time, the rating indicates to an organisation considering borrowing the rate of return they would need to offer to an investor, in the light of the level of risk assessed by the rating agency.

There is a range of ratings – from very secure through to very risky – and the higher the rating the lower the interest rate a borrower would need to pay to attract an investment. Ratings can have many gradations, but rating scales typically have a break-point above which the ratings are classed as "investment grade". This is for the benefit of those who only want relatively risk-free investments, such as pension fund administrators. However, some investors are interested in borrowers below investment grade (normally known as "speculative"), since they may wish to include a higher return (but higher risk) investment within their portfolio (that is, their collection of investments with a spread or mix of risk/return opportunities). An important feature of ratings is that they help investors maintain a diverse portfolio without in-depth knowledge of each of their holdings because the rating agency maintains surveillance over individual borrowers. Thus, the rating agency helps "pool" market knowledge, which makes tracking of a large number of investments much easier and less expensive.

"There is a range of ratings – from very secure through to very risky – and the higher the rating the lower the interest rate a borrower would need to pay to attract an investment"

Each credit rating agency has its own way of displaying its rating scale. The scales used by the three largest international rating agencies, for long-term debt, are placed alongside each other in the table. Many countries also have domestic rating companies that rate only securities issued in their own country and use their own domestic rating scales. Often these companies are affiliated with the international rating companies and receive technical help from them. Appendix A gives an example of a national rating scale used by a domestic rating agency, CA Ratings, in South Africa.

In addition to the formal rating issued for publication, some rating agencies offer other less expensive products for internal use by the municipality. These might take names such as "indicative rating", "rating range", "credit evaluation" or "credit assessment". They are useful tools to inform council and management of progress, or lack of it, and to identify issues to be addressed (see below).

Long-term debt symbols

Moody's	*Standard & Poor's*	*Fitch IBCA*	*Duff & Phelps*	*Interpretation*
Aaa	AAA	AAA	AAA	Highest quality
Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-	AA+, AA, AA-	High Quality
A1, A2, A3	A+, A, A-	A+, A, A-	A+, A, A-	Strong payment capacity
Baa1, Baa2, Baa3	BBB+, BBB, BBB-	BBB+, BBB, BBB-	BBB+, BBB, BBB-	Adequate payment capacity
Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-	BB+, BB, BB-	Likely to fulfil obligations; ongoing uncertainty
B1, B2, B3	B+, B, B-	B+, B, B-	B+, B, B-	High-risk obligations
Caa, Ca	CCC+, CCC, CCC-	CCC, CC, C	CCC	Current vulnerability to default
D	D	DDD, DD, D	DD, DP	

Source: Interpretation from Richard Cantor and Fred Packer. Federal Reserve Bank of New York. Readers should note that individual credit agencies may not agree with this interpretation. Rating agencies do not design their rating scales to conform with each other or with easy summaries.
Note: in 2000 Fitch IBCA acquired Duff & Phelps. [Source: Credit Rating and Bond Issuing at the Subnational Level, a Training Manual, The World Bank 1999]

why obtain a municipal credit rating?

The primary and most obvious reason for obtaining a credit rating is to lower the cost of borrowing. Banks and other investors do not like uncertainty and will charge higher interest rates when they are less certain about the reliability of the person, business or municipality to whom they are lending. In particular, investors rarely have the specialist skills to investigate the financial health and management competence of a municipal borrower, so they tend to rely on experts to do this for them – this is the role of credit rating agencies. A diligent and trustworthy assessment of the likelihood that a municipality will repay loans in full and on time (as revealed by a credit rating) lowers the cost of borrowing in the financial market. Sometimes, a borrower's creditworthiness and credit rating can be raised by using "credit enhancement" measures, as described later in this overview.

Some municipalities might be unable to obtain loan finance without an independent assessment of their finances, plans, management etc., so a credit rating could pave the way toward raising capital in the market. Commissioning a credit rating can be a good way to obtain an independent view of a municipality's readiness to approach the financial market and for determining if anything important needs to be addressed before this can happen.

Obtaining a full credit rating can be expensive and may require considerable effort on behalf of the municipality to prepare for it. Where municipal borrowing is likely to take place soon, the cost of obtaining a rating would need to be compared with the possible savings in interest payments. Where this is the first attempt at assessing a municipality's creditworthiness then the municipality may prefer to start with a less expensive intermediate credit assessment product offered by some rating agencies. Preparing for a rating can be hard work but it does pay off in the longer term.

Other reasons

Many municipalities have found a credit rating to be useful as a management tool. Typically a rating agency will compare key features of the accounts, budget etc. with benchmarks derived from assessing similar municipal operations in the country or internationally. In this way, the rating process helps the council or its executives to identify areas that need improvement. The rating report typically comments on factors that support or constrain the rating. The analysis report of these factors can assist council in the formulation of action plans to address shortcomings in areas such as revenue management, investment planning, management succession planning and political involvement in operations etc.

Improvements in financial management will enable municipalities to better understand the true costs of service provision and may stimulate the need for other approaches such as private sector participation in service delivery, including PPPs (private-public partnerships). If such a decision is to be made, then an accurate knowledge of costs will be essential for planning, procuring and negotiating an effective PPP deal. A credit rating is therefore useful for investors to assess the long-term performance and stability of a municipality when they are considering partnerships in infrastructure development programmes.

> **"Obtaining a full credit rating can be expensive and may require considerable effort on behalf of the municipality to prepare for it"**

Similarly, a good credit rating supports a municipality with everyday commercial activities with third parties: to secure favourable credit terms and when negotiating long-term leases and outsourcing contracts.

A credit rating may enable a municipality to manage its borrowing costs by potentially diversifying the municipality's funding base, since it is healthy for both banks and municipalities to avoid high exposures to only one financing partner. Obtaining a rating increases the marketability of the borrower and its debt obligations (e.g. tradeable bonds – see next section). Thus, it opens up more financing options and enhances the municipality's ability to choose the most efficient and cost effective source of funding at any given point in time.

Credit ratings can play a part in raising or maintaining a municipality's image. Sometimes it might look like service delivery shortcomings have been blown out of proportion by the local press, which can be bad for relations with the electorate and for staff morale. At such times the council could remind ratepayers of its credit rating and the

Chapel Hill's excellent credit rating is good news for citizens

Because a town's credit rating helps investors and creditors measure a municipality's ability to meet its financial obligations. Chapel Hill's excellent credit rating means that it is less expensive for the town to borrow money. Chapel Hill's lower costs for capital improvements can be passed on to you as a property taxpayer and a stakeholder. Municipal credit ratings are based on a number of factors, including fiscal management, debt levels, reserve fund balances, capital funding requirements, long-range planning and economic outlook -- all, beginning with the Town Budget.

"The Town Budget" September 2005; published by the Town Council, Chapel Hill, North Carolina, USA

Cape Town set for even greater achievements

If ever residents of Cape Town needed confirmation that the city's finances are in good hands, the credit rating the city has just received does that, Executive Mayor Nomaindia Mfeketo told today's City Council meeting. The city has been given a top financial viability rating by the company CA Ratings, an independent credit ratings agency, using international criteria and methods. She said the city had been given an A+ rating for the long-term, indicating a strong capacity to repay long-term liabilities, and an A1 short-term rating which indicates an even stronger capacity to repay short-term debt. It is an honour for the city, establishes the city's financial sustainability, and will assist in securing external resources for development programmes. The rating is also a vindication for the major financial institutions which have been doing business with the city and confirms to national and international investors that the City of Cape Town is open for business.

Source: Directorate: Communication and Marketing, City of Cape Town, South Africa

independent professional opinion on how well the administration is run. Comparing ratings can also be a source of friendly rivalry between cities, as has been reported in India and South Africa.

> "...a good credit rating supports a municipality with everyday commercial activities with third parties..."

Central government would do well to encourage the widespread use of municipal credit ratings and could consider sponsoring some to popularise the concept. As mentioned above, ratings help municipalities prepare for standing alone in raising capital expenditure finance and they identify system weaknesses that municipalities need to address. The credit rating process can identify weaknesses in the general environment within which municipalities must operate – which the central government needs to address in order to create a more enabling environment. Typical issues might include changes to the legislative framework or how it is applied, devolving more responsibility to municipal level and constraining the temptation for central government to get too involved in local matters.

Buffalo City finances given clean bill of health

A recent credit rating report on Buffalo City's finances has confirmed that the city has a strong capacity to repay long-term liabilities and short-term debt. According to the report, compiled by a Johannesburg rating agency that looks at risk analysis CA-Ratings, the city's healthy finances are the result of strong economic growth in the automotive industry, the largest contributor to the city's gross domestic product. The textile, clothing and leather industries have also played a leading role in the city's economy, as has the Port of East London, one of the country's major vehicle import and export facilities. Brian Shepherd, Buffalo City's chief financial officer, said the report would have a positive effect on the city's ability to generate external funding. "The credit rating report is an essential document to external funding providers, like banking institutions, governments and donors, to measure the financial health and strength of Buffalo City Municipality." Shepherd said the city's healthy financial status would give funders the confidence to provide grants and loans to the municipality as they now knew the city was able to repay the cash and manage the money correctly.

Source: www.buffalocity.gov.za South Africa, April 7, 2005

bank debts or bonds?

Bank debt

Most municipalities will have borrowed money from their regular bank at some stage, if only for working capital to iron out fluctuations in income. Many have approached banks for larger sums for capital investment only to be told that loans can only be for short term, say five years, which is hardly adequate for large infrastructure projects. Some may have had exposure to development banks or municipal development funds, either with direct loans or through an on-lending programme (funded by an international donor institution via central government). As a rule these tend to be fairly straightforward loans, typically for longer periods than those available from commercial banks. Such on-lent loans might include concessional provisions such as a below-market interest rate, a grace period before repayments start, and a loan life similar to the life of the asset constructed. Often, repayments of on-lent funds are based on a mortgage type system with a regular periodic payment for the duration of the loan. As with house mortgages, payments in early years are mostly interest and those in later years are mostly paying off the capital.

It is common that development banks take a more optimistic and generous view of the prospects of repayment than commercial banks. This will vary greatly, and may be supported by a more-informed appraisal of the financial health of the municipality by specialists, or because of some form of credit enhancement such as a guarantee from another level of government. However, such loans should always be on the basis of a thorough appraisal and some degree of commercial thinking concerning risks. In this way municipalities can be encouraged to adjust to the discipline of the market in preparation for the time that they may need to approach the private sector for finance.

Many municipalities interested in borrowing complain that commercial banks are not interested in long-term finance. This is not uncommon because banking regulations normally limit banks' ability to make long-term loans since their liabilities (deposits) are short-term and volatile and their assets (loans) should prudently match this configuration. Furthermore, commercial banks may lack the expertise to understand the municipal financial environment and so tend to refuse to consider lending, or propose a very high interest rate, or require significant amounts of collateral in view of their perception of the risk involved. As a result, for many local governments borrowing from the private sector is still a long way off. However, at a recent workshop of water utilities in Africa, managers were encouraged to urge their banks to reconsider this, in the light of the business that the utility provides to the bank. Municipalities could also use their business to leverage borrowing opportunities as much as possible within their bank's prudential limits.

Nevertheless managers of utilities and municipalities would do well to ask if their operations could realistically demand consideration of a long term loan by a commercial bank. One presenter reminded municipal and utility managers that they must ask themselves the question: "Would you be happy if the bank invested your personal savings (or your pension funds) in your utility?" Assuming that question, and many others asked during a bank appraisal of a loan, produces positive responses, then the potential borrower can start negotiating loan terms: interest rate (fixed or variable), repayment period, security to be provided etc. Clearly, a good credit rating makes this process easier for the borrower. Potential borrowers should look at ways to start small, on projects with quick returns such as reducing losses (e.g. on water or electricity supplies) or increasing revenues, and agree with the bank that good performance would entitle them to better terms next time.

"managers of utilities and municipalities would do well to ask if their operations could realistically demand consideration of a long term loan by a commercial bank"

Municipal bonds

Most municipal managers will have heard about municipal bonds: how dominant and popular they are in the United States, how they are ideally suited for competitively priced long term finance, how they are gaining popularity in India and Mexico, and how many US-based consultants have advised on their potential throughout the developing world (especially former communist states). They appear to have a future in developing countries, but in most countries they will take considerable time to become established. Issuing bonds will require a capital market, underwriters, interested investors and the prospect of a secondary debt market, usually demonstrated by trading in national treasury bonds.

A major feature of their popularity in the US is the tax-free status of interest payments and the large market provided by wealthy individual investors. Tax exemption is also important in India, where a municipal bond market is developing. However, there are some policy arguments against adoption of tax exemption; one reason being the potential benefits of maintaining a "level playing field" between governmental and private providers of infrastructure (the latter through some form of investment-linked PPP) who would not have tax exemption on their borrowings.

At its simplest, a bond is a debt obligation issued by a borrower in which the borrower promises: (1) to repay the bond debt (the principal) either in full at a fixed date in the future or a number of partial payments at fixed dates, and (2) to make regular interest

Loan period for a bond

The final maturity of a bond is based primarily on the financial condition of the issuer, market conditions, and the type of project being financed. If an issue is used to finance an infrastructure project, the final maturity of the debt should be tailored to the expected life of the completed project… For most Emerging Market issuers, however, it is usually not possible to issue a bond for the expected life of the asset. International and domestic capital markets for emerging market issuers are too volatile and underdeveloped to allow for bond tenors to match the life of the assets being financed. Nevertheless, as these markets develop and demand from pension funds for longer-term bond tenors grows, issuers may be able to increasingly offer longer-term bonds for their infrastructure projects.

Credit Rating and Bond Issuing at the Subnational Level, a Training Manual, The World Bank 1999.

payments to lenders on the debt principal not yet repaid. Since municipal bonds have been common in the US for over 150 years they have evolved with a great many variants using much ingenious "financial engineering".

This publication will not attempt to cover the full range of types of bonds. However, it is important to draw attention to the major differences in "security," check based on the sources of funds that are pledged to the payment of the principal and interest. The two most common major categories of security are: GO (General Obligation) Bonds, and Revenue Bonds. GO Bonds are serviced from the general taxes and other revenues of the municipality (sometimes referred to as "full faith and credit" of the municipality). They are commonly used for infrastructure investment projects that are not self-liquidating (i.e. projects that are non-revenue producing). Revenue Bonds tend to be used for investments in utility services and are serviced by revenues from that service; sometimes multiple revenue sources are pledged. Typically, revenue bonds are "limited obligations" and do not have recourse to a municipality's general revenues (hence the terms "limited recourse" or "non-recourse" finance are sometimes used).

Municipal bonds, especially in emerging markets, tend to be expensive to set up and are therefore limited to very large loan issues (very large is not easily defined across several countries). Bond set up costs include: financial advisers, technical consultants, bond counsel (lawyers), rating agencies, underwriters, preparation of a prospectus, and publicity (sometimes referred to as "road-shows"). If the bonds are to be listed on a securities exchange, there will also be the costs of registration and of conforming to the securities laws. Individual bond issues require extensive preparation and disclosure of key financial data and information on the legal and institutional environment of the issuer.

There are few short cuts in time or money when preparing a bond issue, especially in a newly developing financial market, so early issues in a new market will be limited to the biggest or boldest of municipal borrowers. However, if the basic case for a bond issue is a sound one there will probably be one or two international agencies that would be willing to assist with a pioneer bond issue in a country. This would lead the way through procedures and legal precedents that would make subsequent issues less daunting. As a market develops, and investors gain familiarity with the municipal business, there will be economies, as procedures become standardised and competition increases. Also, there may be opportunities for bond pooling. Where several municipalities wish to raise amounts that are too small to issue as single bonds, they may be pooled through some form of trustee or governmental sponsor arrangement. In such cases, municipalities should have similar, if not identical, ratings and the total amount should be sufficient to justify the costs.

"if the basic case for a bond issue is a sound one there will probably be one or two international agencies that would be willing to assist with a pioneer bond issue in a country"

In addition to a credit rating for the issuing municipality (or each of the pooled municipalities) each bond issue will have its own credit rating. This may well be different from that of the issuing municipality for a number of reasons. The trustee or sponsor of a pooled bond might underwrite or guarantee the bond issue, in which case the guarantor's credit rating would apply. The same could happen if another government entity issued a partial or full guarantee for one municipality's bond. Another form of guarantee is a letter of credit from a commercial bank that has high credit standing. The bank commits to make up any shortfall of cash to service the debt.

The rating of a bond issue could also be improved by the use of credit enhancement measures such as the guarantees mentioned above. Other credit enhancements include setting up a debt service or sinking fund to accumulate capital for eventual repayment of the principle, and the pledging of certain revenues that are channeled through an escrow account. (For example, sometimes intergovernmental payments may be pledged and "intercepted" to make up any deficiencies in debt service payments.) An escrow account is managed by a trustee or some other secure arrangement (e.g. an independent bank) to ensure that pledged funds are available for debt payments. (This is sometimes called a "lock-box".) Revenues are paid into such an account and then

City of Johannesburg bond benefits from credit enhancement

The one billion SA Rand bond (US$153 million equivalent) matures in 2016 (12 years). It amortises over the last three years (principal is repaid in three installments). The IFC and DBSA assisted in structuring the transaction and they provided a partial credit guarantee for up to 40 percent of the principal outstanding, which was shared equally with DBSA. It can be used to repay up to the full amount of principal and interest falling due and payable to bondholders on any given payment date (or any modified dates if the repayment schedule is accelerated by the city), subject to guarantee limits. The enhanced bonds were rated AA-.zaf by FitchRatings. The issue was oversubscribed 2.3 times, reflecting a strong endorsement by the market of the issue and the credit-enhanced structure. The national scale rating achieved was three rating levels above the City of Johannesburg's stand-alone rating.

Source: The Municipal Fund: Global Financing for Local Needs, International Finance Corporation

released first to the lenders to meet debt obligations. Extra funds may revert to the borrower from time to time.

In some markets there is the possibility of bond insurance. Such insurance is set up at a cost to the bond issuer and normally means that the rating of the bond is the same as that of the insurer. The insurer clearly needs a good reputation and sound financial health. The insurer will perform its own "due diligence" on the proposed bond issue and will maintain close supervision of the performance of the borrower and the bond for the life of the bond.

Finally, a note on the trading of bonds. In a developed market, municipal bonds are tradeable financial instruments. Trade in bonds is known as a secondary market. This will take some time to develop in emerging markets but governments should look carefully at the regulatory environment to ensure that this is not inhibited. Indeed, governments would do well to check that a bond market is not constrained by current regulatory practice. This can contribute to the development of the domestic financial market, for both commercial and public sector borrowers.

> "governments would do well to check that a bond market is not constrained by current regulatory practice"

Most investors, even those who seek long-term investments, prefer to know that they can sell a bond in the market if they need to. The more "liquid" the bond market the more favourably investors will view bond issues. Furthermore, when bonds are traded the purchase price will normally indicate how the investment community values the underlying asset. If the financial health of the bond issuer is beginning to look uncertain then bonds may be off-loaded in the market at a discount, i.e. below face value. This would send a strong signal to the issuer that any further issues would be expected to offer much higher interest to compensate for higher risk.

Banks or bonds?

There is no need to choose a single instrument as the "right" way to handle local government credit. Many countries simultaneously use bank lending to municipalities and local bond issuance. The policy rationale, however, justifies emphasizing development of local bond markets. The public monitoring and public disclosure required for efficient bond market operation are consistent with greater transparency for all public financial transactions. Financial sector deregulation has eliminated the possibility of having quasi-monopoly municipal banks draw on especially protected government allocations of low-cost, long-term savings to finance local infrastructure. In a competitive world, bonds have more ways to tap institutional and household long-term savings. Even when the ultimate credit extended to a local government continues to be a loan from a bank or other financial institution, the financial intermediary will increasingly raise its own capital for on-lending from bond issues. That is the direction of change for the most successful intermediation vehicles. Even Credit Local de France, the original municipal bank, now raises the bulk of its financing on the bond market.

***Banks or Bonds? Building a Municipal Credit Market*; George E. Peterson, Senior Fellow, The Urban Institute, Washington, DC**

Jargon-busting in the financial market place

There is much "jargon" used in the private sector finance business.

Jargon (noun)

1. specialist language

language that is used by a particular group, profession, or culture, especially when the words and phrases are not understood or used by other people

2. unintelligible language

pretentious or meaningless language (disapproving)

Jargon is a form of short-hand used to streamline communication within a group, but may alienate those outside the group. Users of financial jargon may be trying to impress others with the complexity of their job, but more likely they forget how unintelligible they have become to outsiders. Here are a few tips to bust the jargon. (This small selection will not make you fluent but might enable you to carry on a conversation with some understanding.)

Amortization – Paying the principal amount of a debt obligation through periodic payments either directly to bondholders or to a sinking fund for later payment to bondholders.

Basis point – 1/100 of 1 per cent. If the interest rate on a loan or bond increases from 8.00% to 8.25%, the difference is referred to as a 25 basis-point increase.

Basis points above LIBOR – quoting an interest rate by linking it to another, in this case the London Inter-bank Offered Rate, the rate at which major London-based banks offer to lend funds to other banks.

Balloon payment – A disproportionately large payment at the end of a bond's maturity or term.

Bullet – An issue of bonds with no amortization features, so that the entire principal is paid on the maturity date.

Callable or redeemable bond – A bond that permits the issuer to redeem it before maturity according to the terms and price (the call price) stipulated in the bond agreement.

Coupon – (1) The term is most commonly used to refer to a bond's interest rate. (2) Historically this referred to a physical coupon, i.e. a detachable part of a bond that evidences interest due. Coupons were redeemed by detaching them from bonds and presenting them to the issuer's paying agent for payment. Today this is usually done electronically.

Debt Service Coverage Ratio – amount of cash flow available to meet annual interest and principal repayments on debt, including sinking fund payments, expressed as a ratio of net operating income (after all other expenses) over total debt service payments. This should always be more than one.

Debt Service Reserve Fund – A fund established by an issuer from which debt service payments can be made if other revenues are insufficient to satisfy the debt service requirements. Typically the amount should be equal to one year's debt service requirement. (Sometimes known as a Sinking Fund.)

Letter of Credit (LOC) – a commitment, usually made by a commercial bank, to honour demands for payment of a debt upon compliance with conditions and/or the occurrence of certain events specified under the terms of the commitment. In municipal financings, bank letters of credit are sometimes used as additional sources of security with the bank issuing the letter of credit committing to met payments if the issuer is unable to do so.

Put option – an option to sell a bond at specified times during its life.

Sub-national borrowers – government entities that are not central government, e.g. state, province, region, municipality, state or municipal-owned utility company etc.

Underwriter – A dealer (e.g. bank, stockbroker) which purchases an entire amount of a new issue of bonds for resale. The underwriter may acquire the securities either by negotiation with the issuer or by award on the basis of competitive bidding.

Yield – annual rate of return on an investment, security etc. Yields on bonds are calculated in various ways and these are not always obvious.

Example of jargon in need of translation: "The maturity of the bond will also have to be determined from the deemed date of allotment, the call rate, the rate of redemption and the level of interest payable annually." This appears to be saying that the date of final payment to settle the debt will be a function of when the bond is issued, together with an assessment of what repayment schedule and interest payments the borrower can afford to service during the life of the loan. In other words, if the periodic repayments are likely to be too demanding for the municipality, it should arrange for a longer term for the bond.

the credit rating process

During the credit rating process, the health of the municipality will be under scrutiny from a number of angles. Before a municipality embarks on the process there should be some form of in-house assessment of its readiness. This assessment could be initiated by either the council or the management. If this is a totally new event then it should quickly become a jointly-owned exercise, preferably driven by two champions: one in the council and one of the officials.

Next, a credit rating agency should be selected. Clearly, the agency needs to be one with experience in municipal matters because these tend to have very different systems from those of ordinary commercial organisations, with different approaches to management and accountability systems, budgeting and accounting etc. Ideally, the agency should have a permanent presence in and knowledge of the country, even if the resident staff are not municipal experts. In any event, it will be important to look around and see what is available. Credit rating agencies may vary considerably in their experience in developing countries, in their approach, and in their charges – especially if all personnel are located offshore. Using offshore staff could also affect the likely time frame of the activity.

Seeking and identifying a suitable agency may expose the lack of suitable local firms and the need to employ an offshore firm (or local firm with offshore affiliates or with expertise located offshore) with inevitable cost implications. At this point, the municipal sponsors may become discouraged. However, among the multilateral banks and the donor community there is much support for increasing the role of municipal credit ratings and it may be unexpectedly easy to raise the necessary financial support. This would be even more likely if a number of municipalities were to approach a donor together. This might best be done by the national local government association. A joint approach could produce economies of scale in the international competitive procurement of a rating agency, and possible savings if the same team investigates more than one municipality while it is in the country, and only needs to carry out one review of the regulatory environment. For example, the World Bank is preparing to sponsor a contract to undertake twelve municipal ratings in Ethiopia as a contribution to stimulating the domestic financial market.

"among the multilateral banks and the donor community there is much support for increasing the role of municipal credit ratings"

The selected rating agency provides the prospective municipality with a formal proposal to perform a rating. When accepted by the municipality, a mandate or engagement letter is signed to formalise the relationship between the two parties.

Once the rating agency has been engaged, the council and senior officials should all be informed of the purpose of the exercise and the value of prompt attention to requests for information. Much damage could be done by uninformed or reluctant people being less than helpful toward rating agency personnel at the data gathering and verifying stages. The municipality should nominate key personnel from whom the rating agency can obtain the data and reports that they will need.

Sample of important ratios and parameters

Current financial position

- Tax receipts/Total revenue
- Non-tax receipts/Total revenue
- Grants from state government/Total revenues
- Revenue surplus/Revenue receipts
- Capital expenditure/Total expenditure
- Overall surplus/Deficit
- Collection efficiency of property tax
- Collection efficiency of water tariff
- Debt service coverage ratio

Operations of the municipal body

- Expenditure on core services/Total expenditure
- Expenditure on wages and salaries/Total expenditure

Source: Rating criteria for municipal and urban local bodies, CRISIL

Data requirements will include:

- annual reports and audited financial statements for several years
- recent budget documents
- long range investment plans
- description of accountability arrangements (council committees etc.)
- management structure (organisation charts for departments and senior officials), and
- information on unfilled positions.

Depending on the domestic experience of the rating agency, there may also be requests for latest information on the regulatory regime within which local government functions. Issues such as the potential for unilateral central government actions will be of concern to future lenders.

The exact sequence of events may vary with local requirements and the ease or difficulty of travel, but the following would be fairly typical. A rating team may make an initial visit to the municipality, or it may arrange by phone to have data sent to the agency. After receiving and studying the documents the rating team will arrange to visit the municipality and interview senior councilors and officials. During this visit the team may wish to gather the very latest financial data and to verify any unclear items.

The visiting team will also be observing how things actually run within the municipality: were the interviewees aware of the exercise? Are they totally familiar with their areas of responsibility? Are there

good working relationships between council and officials? Are there succession plans to replace senior staff if they depart? What are seen as the major challenges for that particular municipality? These interviews can add considerably to the raw data included in reports. One municipality in South Africa submitted excellent financial data portraying an organisation that has been well-run for many years. Subsequent interviews, however, revealed serious uncertainty over the continuation of contracts for several pivotal senior people, and found the city treasurer unable to quote a number of key ratios considered essential for monitoring the financial health of the municipality. It is probable that the overall rating was adversely affected by these observations.

Following data verification and interviews, the rating team would discuss its findings with the agency's internal rating committee, which ultimately decides on the rating to be assigned. The team would then prepare a draft report for discussion with the municipality. Presentation of the report would entail an in-depth discussion of the agency's findings on the strengths and weaknesses of the municipality. This may be painful, but it is always useful. It is also an opportunity for the municipality to produce more information, to challenge any item that may be misreported or a conclusion that may not be sufficiently well-informed. The draft is then reviewed and finalised. It is normally a concise document summarising the agency's reasons for assigning the particular rating, together with a comment on the likely prospects for the rating in the future.

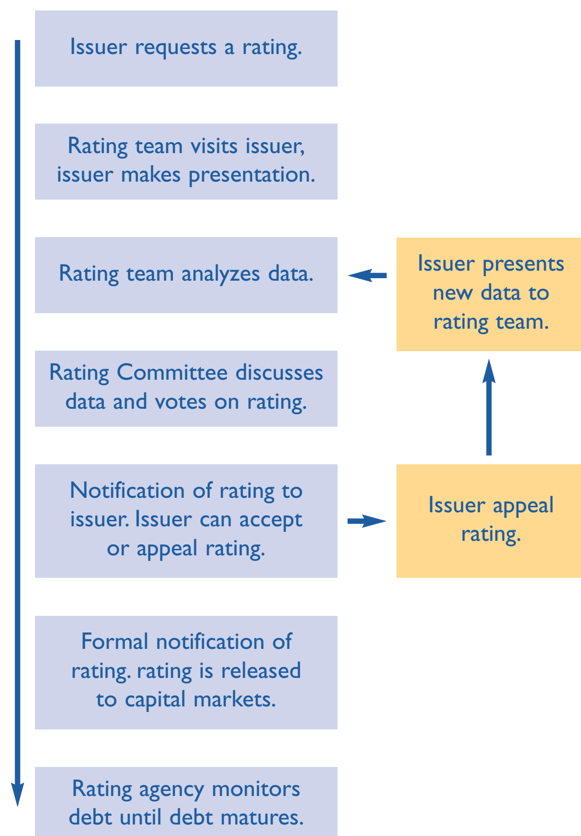
Up to this point the rating exercise has been a confidential activity. The municipality now needs to decide on its publicity strategy: no release (e.g. wait until the next one shows improvement), selected release (e.g. national government and the council's management advisors), or full release in newspapers etc. Rating agencies may assist with publishing the rating in appropriate journals since this is also in their interests to obtain such publicity. In the case of a decision not to publish, rating agencies will generally respect a municipality's desire for confidentiality, but there have been cases where the agency felt obliged to issue a rating publicly even against the municipality's wishes in order to protect the market and investors from what appears to be "rating shopping" by going to different agencies until it gets the rating it wants.

If the rating is published, the rating agency moves into surveillance mode in which it will monitor the performance of the municipality and it will expect to be informed of any material changes in the outlook for the municipality. The rating agency reserves the right to upgrade or downgrade the rating based on new credit-related developments (interpreted broadly). Typically, rating agencies expect to make annual reviews in order to keep the rating current and up to date. Borrowers typically pay for this ongoing surveillance.

The above process has referred to getting overall ratings of the municipal borrower and its general credit standing. Obtaining a rating for an individual bond issue can be somewhat different. This process tends to focus on the bond itself, the security provided, and any forms of credit enhancement that may be included. However, there will always be significant weight given to the operating performance and economic and financial prospects of the municipality as an organisation, so a close scrutiny and frank appraisal cannot be avoided. Furthermore, if the financial advisers suspect that a poor underlying rating of the municipality is making the bond too expensive, they may recommend delaying the bond issue until certain items are addressed.

The above description applies to the process of obtaining a full rating for publication and for use in negotiating loan terms. If the rating service is not intended to produce a published rating then some steps may be simplified or omitted.

The Credit Rating Process



Source: *Credit Rating and Bond Issuing at the Sub-national Level, a Training Manual*, The World Bank 1999.

special features of a rating agency approach

It is worth pointing out that there are certain unique features in the role of rating agencies. Firstly, the independence of their opinions is essential. This may be manifest in a number of ways. For example, some agencies insist on being paid before work starts, to ensure that the client cannot be suspected of withholding payment until a good rating is obtained. Some will separate the business and marketing activities from the rating activities to lessen the potential for conflicts of interest. Nevertheless, there is always a possibility of rating agencies being tempted to be more than generous with their ratings in order to increase their market share. Ideally, in a well-functioning market, potential lenders might become aware of this and discount the rating (treat it as lower than face value), but in small emerging markets this might be difficult to spot. Central government may need to watch for any such tendency and the relevant department could consider occasionally bringing in another firm to carry out a rating, paid by government, as a quality control measure, or comparator.

Secondly, rating agencies seek to maintain a good reputation for quality work and may resist bidding for the provision of a rating unless the extent of the work is totally clear. This also is a delicate subject. Firms that have been encouraged to cut prices to obtain a job may be tempted to cut corners on quality, with a resultant risk for the general reputation of the rating business. On the other hand, fixed prices might represent cartel behaviour within a closed shop, keeping prices high and posing a barrier to new entrants in the market. Any competitive procurement process must be clear on outputs, must not be on price alone, and must include an appraisal of the skills, experience and reputation of the firm and personnel involved.

As a result of their somewhat unique status in the financial and "consulting" arena, rating agencies may use some unexpected language in their letter of appointment, which is sometimes referred to as a "mandate" to prepare an opinion. There will probably be clauses requiring co-operation in the provision of information, e.g. "The undersigned will promptly furnish to [the agency] pertinent financial reports and other information..." and availability for interview, e.g. "The parties record that the mandator will do everything in its power to ensure that the management and other personnel of the ratee with whom the agency seeks to confer in order to perform the rating, shall co-operate with the investigation team at reasonable times and within a reasonable and agreed period."

There will always be a clause reserving the right to modify or withdraw a rating, e.g. "a rating, if assigned, will be subject to revision or withdrawal by [the agency] at any time, without notice, if any information (or lack of information) warrants such action, in the sole opinion of [the agency]."

Lastly, credit rating agencies are not consultants. Their advisory function is strictly limited. When they present their opinion and report on their findings in the rating report, they will draw attention to areas of weakness that would need attention if the rating is to be improved. If they were invited and paid to provide further advice, this could then compromise their independence. On the one hand, they may be tempted to be more critical than necessary, in the hope of landing a bigger consulting contract. On the other hand if they had been involved in advising on improvements could they be relied upon for an objective rating next time? However, there are cases of rating agencies being a subsidiary of a larger company that does offer management advisory services. In which case, there must be very strict separation of the rating and advisory functions. Central government may need to make occasional reviews of how well such restrictions are enforced.

Ahmedabad: importance of systems improvement before a bond issue

In January 1998, the Ahmedabad Municipal Corporation (AMC) issued Rs.1,000 million (US$25 million) in bonds to partially finance a water supply and sewerage project. This was the first municipal bond issued in India without a state guarantee and represented the first step toward a fully market-based system of local government finance. The AMC had previously instituted significant fiscal and management reforms, with technical assistance from USAID's FIRE project, including improved tax collection, computerising the accounting system, strengthening AMC's work force and financial management, and developing a comprehensive capital improvement program. These reforms laid the necessary groundwork for AMC's bond issue and successful implementation of the infrastructure project. During a deteriorating financial situation in 1994, AMC launched a major effort to improve revenue collection with a focus on octroi (tax on consumable items entering the city) and property taxes. Due to these measures, AMC was able to turn around its financial position and achieve a closing cash surplus of Rs. 2,142 million (US$54 million) in March 1999. In addition, management innovations introduced by the municipal commissioner and supported by staff and elected officials helped AMC to change its image among the local citizenry.

Source: Lessons Learned from the Ahmedabad Municipal Bond, Indo-US Financial Institutions Reform and Expansion Project – Debt Market Component FIRE(D) Project Note No. 25 April 2001

what do ratings agencies look at?

Foreign currency ratings and the sovereign ceiling

The sovereign ceiling is a concept that applies only to foreign currency debt. It generally represents the upper limit for ratings of any issuer, including sub-sovereign issues in a given country, as sub-sovereign foreign currency debt will not be rated higher than the sovereign's own foreign currency debt. Why can't a sub-sovereign rating be higher than the sovereign rating? The sovereign ceiling exists because the sovereign government controls monetary policy and access to foreign exchange. The country rating reflects the risk that in an economic or foreign exchange crisis, the sovereign government may choose to restrict foreign currency payments by its sub-national entities. Even if a financially stable sub-national borrower has the resources to pay its foreign currency debt, under such circumstances, it could not do so by law.

This booklet will not include a vast amount of detail here, except to illustrate some points. Each rating agency has a list of issues that must be reviewed when developing its opinion. Each list is slightly different but there are clear similarities since all agencies need to look at similar items in order to arrive at defendable conclusions. What follows is the brief overview of the major groups of issues for GO Debt. The overview is derived from a toolkit prepared by John Petersen and John B. Crihfield for the World Bank.

While the major agencies have different ways of weighting the factors, they do agree on the major analytical ingredients they consider in judging the creditworthiness of sub-sovereign (e.g. municipal) borrowers. Opinions on credit quality are not static and the relative importance of factors can change over time. National policies having to do with items other than local debt per se can change the mix and weighting of credit factors. For example, laws governing purchasing policies, public employee retirement benefits or wages, or the reassignment of functions and revenue sources can all shift the focus of analysts.

The major analytical ingredients can be summarised as follows, with some indications as to how various factors help or hurt a credit rating.

Sovereign rating ceiling

The rating of the national government usually sets the top limit on the rating that a sub-sovereign (sub-national) unit can enjoy. National governments set monetary and fiscal policy and usually have first claim on foreign exchange and can change the rules of the game for subsidiary units of government. Exceptions to this rule can be found if the debt is secured by offshore assets or revenue streams.

Economy

Fiscal health (ability to generate reliable tax revenues) is usually closely linked to the health of the local economy, and diversification of economic activity (which often comes with size) helps balance the economy's performance. Demographics are important. A high dependency population (the very young and very old) and too rapid growth in population are negatives. Higher-income and more educated population is a plus, as is an acceptable distribution and rate of growth in income.

Structure and management

An assignment of functional spending responsibilities consistent with revenue resources is a plus. Intergovernmental transfers are looked at for their size and predictability. The willingness and ability of the national government to detect and deal with financial emergencies is a positive. The rigour of budgetary and financial laws are examined and can be either a plus or negative depending on the flexibility they provide localities. Past performance in achieving budgetary balance is important. Timely and comprehensive financial reporting and following consistent standards are a plus.

Fiscal performance

Revenue composition and trends are considered; and the ability to set rates at the local level is seen as a plus. Tax burdens should be acceptable in comparison to neighbouring regions. Effective use of charges and fees are viewed favourably; large transfers of general funds to local enterprises are not. Composition and trends in expenditure are analysed. Capital spending and maintenance spending are a plus; a disproportionately large wage bill is a negative. The ability to budget and to accurately achieve budgeted expenditure is a plus. Positive balances (surpluses) in the current operating budget is a strong positive. Capital budget planning and paying for large amounts with current revenues is a plus.

Financial position

Liquid assets (money in the bank etc which is easily accessed) and marketable real assets (items that can be sold to meet financial emergencies) are favorable factors, as are healthy reserves in relation to annual expenditures. Outstanding debt is considered. Short term

Local currency ratings

Several governments and rating agencies have encouraged the development of a local currency or domestic rating scale. Such ratings are then issued with a prefix or suffix indicating the country and the fact that it is a domestic rating. If only international ratings were used, all sub-sovereign borrowers would be gathered (and maybe "squeezed") below the international rating of the sovereign, and there may be little scope to differentiate between them. With a domestic scale the sovereign is assigned the highest rating and sub-sovereigns are distributed in a bigger "space" below it.

debt is a concern if not periodically retired (e.g. removing overdrafts, and ideally not carried over from one financial year to the next). Long-term debt and contingent debt (e.g. where there are guarantees to others such as municipal utility companies) are generally a negative unless used in support of productive (self-supporting) activities. Short maturity debt with principal due at the term (bullet maturity) is a negative because of continuing pressure to refinance and the potential burden on current revenues.

Legal framework

The lack of clear laws, legal precedent or effective judicial system are major impediments, especially where there are restrictions on revenue- or enterprise-based pledges. A national history of debt repudiations or insolvencies is a large negative. Approval of borrowings by senior units (e.g. state or national government) and other restrictions on local borrowing may be a positive if efficient and nonpolitical, but can be a negative if complex, difficult and subject to political manipulation.

Accounting and financial reporting

The quality of financial records is examined, and prompt, consistent reports are a plus. Timely independent and regular audits are a positive. Cash flow information or cash basis accounting that provides reliable information on cash available to pay debt service is a positive. Evaluation of liquid assets and accounts receivable can be issues in that required investments in government bonds can be risky and accounts may be in arrears.

From the notes above, it is clear that a municipal credit rating will be greatly affected by external factors such as the national and local economy, the national regulatory framework and the fiscal relationships between different spheres of government. However, there are many items that are directly within the control of the municipality and these are the ones on which a municipality should concentrate. These items are mainly the financial operations (especially key ratios & industry benchmarks), the quality of budgets, books of accounts and capital investment plans. Needless to say, if central government maintains the practice of approving municipal budgets and retains the right to change budgets and plans unilaterally, this would be of concern to lenders. In which case municipalities may wish to initiate a dialogue with government with a view to removing this practice.

The primary evidence of sound financial operations will be the outcome of regular independent audits (not internal audits or spot audits) and any corrective actions recommended by the auditors in their management letter. Has the municipality a clean bill of financial health for the last three years? How has it dealt with any issues raised in management letters? Is it working hard to collect the revenues (tariffs, taxes etc.) to which it is due (including those due from central government departments)? These are the kind of key indicators that a rating agency would start on.

In addition to the financials there are technical and policy issues that the municipality should address. Is the development plan up to date? Have the capital expenditure requirements been properly estimated and are they affordable? Are utility functions run efficiently with a minimum of losses? Are there policies for utility tariffs, investments etc.?

What are the special concerns that rating agencies face in rating emerging market sub-sovereign debt?

Of special interest to those who are exploring this subject for the first time, rating agencies have acknowledged particular concerns and challenges in rating Emerging Market sub-sovereign debt. These challenges, which arise from the political, economic, and social pressures to which Emerging Markets are subject, include:

- Unpredictable legal and regulatory frameworks
- Risky debt profiles
- Financial data that is not independently audited
- Burdens imposed by publicly owned companies
- Shifting intergovernmental political and fiscal relationships
- Incomplete demographic data
- Inflation effects
- Enormous infrastructure needs and
- Uncollected taxes and user fees.

Source: *Credit Rating and Bond Issuing at the Sub-national Level, a Training Manual*, The World Bank 1999

Apply the rating criteria to improve the creditworthiness of your municipality

1. ECONOMIC STRUCTURE AND GROWTH PROSPECTS
- Identify economic driving forces and growth trends
- Determine the demographic characteristics i.e. growth, age, skills
- Understand employers' needs and investment plans
- Acquire reliable statistics i.e. economic, employment, income levels

2. STRATEGIC OBJECTIVES
- Prioritise needs of inhabitants, business and industry
- Determine infrastructure requirements
- Identify the facilitation role of municipality in local economy
- Allocate financial resources to stimulate economic growth

3. CORPORATE GOVERNANCE
- Determine role and effectiveness of councillors
- Establish division of responsibility between elected councillors and employed officials
- Ensure compliance with the governing laws and regulations
- Monitor implementation of strategy and policies
- Ensure independence of internal audit, compliance and risk management departments
- Ensure disciplined financial management and regular reporting
- Ensure transparent disclosure of financial and strategic matters

4. BUDGETARY PROCESS AND FINANCIAL POLICIES
- Determine financial success factors
- Link key strategic objectives with financial success factors
- Implement zero-based operating budget process
- Determine long-term growth trends of tax and service revenue

5. REVENUE AND EXPENDITURE MATCH
- Clearly identify major service responsibilities, distinguish between mandatory and discretionary
- Correlate strategic objectives and service responsibilities
- Maximise own source revenue, grants and subsidies
- Match the cost of service responsibilities with appropriate revenue sources

6. LIQUIDITY
- Determine short-term operating capital requirements
- Develop and implement rigorous credit policies
- Ensure disciplined cash flow and expenditure management
- Invest treasury surpluses only with high quality counterparties

7. DEBT BURDEN
- Match capital investment programme with long-term finance sources
- Match capital spending with infrastructure needs that support economic growth
- Keep debt servicing manageable in relation to operational revenue
- Keep long-term liabilities in relation to the tax base

Source: CA Ratings, South Africa

way forward

It is hoped that this booklet has been a useful introduction with sufficient information to enable the reader to understand and appreciate the potential for using municipal credit ratings in various situations. Municipal mayors and councillors might wish to obtain an independent view on how well they are doing as a local authority. Chief financial officers may be contemplating long term debt but are concerned at the likely borrowing costs. Central government officials may be wondering how to open up local capital markets and encourage municipalities to rise to the discipline of the market. These various concerns are all inter-related. Arranging for a credit rating can be one step, but a significant one, toward opening up a whole new way of doing business for municipalities.

What needs to happen next?

Those in **municipalities** (and utilities) should consider their first steps:

- Identify champions in both council and management
- Set up a small team to undertake an in-house assessment
- Consult the municipality's auditors for an opinion on the accounting systems
- Look at the status of a number of key municipal activities – budget system, revenue performance etc.(see final paragraphs of "What do rating agencies look at?)
- Consider options on type of rating – full, or non-published indicative rating
- Talk to the local government association about co-operation on procuring a rating agency.

Those in **local government associations** could begin to gear up to play a role:

- Check the level of interest among those municipalities most likely to start or extend municipal borrowing
- Offer to facilitate a group of interested parties (to study issues, to assist procurement etc.)
- Begin an in-house study of the state of readiness of the national regulatory framework for municipal borrowing
- Identify aid agencies that might be interested in supporting a rating exercise and any necessary changes to the regulatory environment

Those in **central government** may wish to find ways of supporting this:

- Examine the state of evolution of municipal borrowing; can municipalities borrow?
- Commission a study of possible changes needed to the policy and regulatory framework; are the present rules too restrictive?
- Assist the local government association with international contacts if required
- Be prepared to initiate change.

Each stakeholder has a part to play in opening up the flow of private sector finance for investment in municipal infrastructure services. The needs are enormous, and in most countries there are funds available, but we need ways of linking them together. Central government and national associations can contribute to creating an enabling environment for municipal borrowing, and municipalities need to rise to the challenge of becoming creditworthy borrowers as demonstrated by healthy credit ratings.

Preparatory steps required to obtain an investment-grade domestic and international credit rating:

The consultant is expected to identify the preparatory activities that the city needs to undertake in order to obtain an investment-grade domestic credit rating on the basis of its operational and financial strength. Such activities will include but not be limited to financial restructuring, improvements in financial management, accounting standards and disclosure, corporate and financial governance, and related activities.

The Consultant shall also assist the city in preparing an information package that would facilitate the ratings process. This information would typically include details on the city organisation, management and corporate governance; its strategic vision and goals; its operating environment; its financial information along with pro-forma projections; and supporting documents such as annual reports, and analyst reports.

The Consultant shall specifically delineate short term financial strengthening measures that the city can undertake immediately to improve its financial performance in anticipation of the credit rating process, while also covering steps that will improve its financial condition over the medium to long term.

The Consultant shall also identify training and capacity enhancement needs for the city, in basic corporate financial activities such as maintaining appropriate financial accounts and MIS, carrying out internal audits and supporting external audits, structuring financing plans, identifying financing sources, accessing financial markets, risk identification and mitigation, pricing, and supporting an annual credit review and ratings exercise.

Source: PPIAF, Extract from Terms Of Reference for Capital Investment Strategy for Pontianak, Indonesia, 2005

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appendix A: example of national ratings

Example of national ratings

A credit rating is an opinion with a future focus on the ability and willingness of a debt issuer (a borrower) to repay its obligations in full and on time – in short: it is an opinion on creditworthiness. The opinion is expressed through rating symbols and each symbol has its own definition. The rating symbols used by CA-Ratings are similar to those used by international rating agencies and are well known in South Africa. They are briefly:

za**AAA**	Extremely strong
za**AA**	Very strong
za**A**	Strong
za**BBB**	Adequate
za**BB**	Very low degree of speculation
za**B**	Low degree of speculation
za**CCC**	Moderate degree of speculation
za**CC**	High degree of speculation
za**C**	Capital payment is impaired
za**D**	Default

The symbols from za**AAA** to za**BBB-** are known as **investment grade** categories and the rest as **speculative grade** categories. The ratings "zaAA", "zaA", "zaBBB", "zaBB" and "zaB" may be modified by the addition of plus (+) or minus (-) signs to indicate relative standing within categories. The "za" prefix indicates that the rating is on the South African national scale. CA Ratings' definition of default includes not only payment default, but also other forms of default, such as a forced restructuring of a loan.

Source: *The role of credit rating agencies in financial market development,* August 2006, Leon Claassen, CA-Ratings

Live, work and invest in Durban, South Africa

dipa Durban Investment Promotion Agency

ETHEKWINI MUNICIPALITY

Durban is a dynamic and growing City managed by a forward thinking municipality. Good partnerships between public and private partnerships have provided the basis for an integrated, growing economy. As South Africa's principal port City with Africa's busiest port, Durban is the Southern Hemisphere gateway to business and travel in Africa.

A focused City strategy to accelerate economic growth and job creation has positioned Durban as Africa's preferred new business destination.

"Think local, act global" encompasses the City's brand philosophy. Development of small, medium and micro businesses is a cornerstone of economic strategy, ensuring that local knowledge is integrated with international expertise to develop new ideas and technological approaches in meeting global standards. The retention and expansion of Durban's broad base of medium to larger businesses, through local and foreign direct investments, is key to future sustainability.

Important oil and sugar refineries, a sustainable and growing manufacturing sector with a busy automotive cluster, are part of Durban's thriving industry.

ASSEGAI & JAVELIN / NQOBILE 610704

Durban in the news

Recent developments that have marked Durban as a vibrant, growing City are:

- A calendar of sporting events cementing the City's reputation as the sporting and leisure capital of Africa, leading to **FIFA World Cup 2010** and beyond;
- The phenomenal success of uShaka Marine World with its world-class aquariums and research facilities;
- Africa's leading convention centre, Durban's International Convention Centre, is nearing completion of a R400m expansion, doubling its capacity;
- The recent hosting of the A1 Grand Prix saw the world applaud a colourful, African-style race on closed public roads, set against the background of the Indian Ocean;
- The creation of KZNonSOURCE, a call-centre and business process outsourcing promotion initiative, resultingin new job opportunities;
- The Durban Film Office, promoting and facilitating motion picture production in a city with 320 days of sunshine each year and a spectacular array of filming environments;
- The successful establishment of SmartXchange, an incubator hub to retain and develop ICT&E skills in the City.

Durban is targeting investment that drives confidence in the local markets, thereby creating jobs and developing skills.

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