Emerging Market Countries' Local and Regional Governments' Specific Securities Rating Criteria

Sector-Specific Criteria

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This report updates and replaces *Emerging Market Countries' Local and Regional Governments' Specific Securities Rating Criteria*, dated 25 September 2020.

Related Criteria

International Local and Regional Governments Rating Criteria (September 2020)

National Scale Rating Criteria (June 2020)

Government- Related Entities Rating Criteria (September 2020)

Public-Sector Counterparty Obligations in PPP Transactions Rating Criteria (July 2020)

Public Sector Revenue-Supported Entities Rating Criteria (March 2020)

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Scope

This criteria report describes the main factors Fitch Ratings considers when assigning national-scale ratings to securities or counterparty obligations in a public-private partnership (PPP) transaction issued by a local and regional government (LRG, subnational) or by a policy-driven government-related entity (GRE) in an emerging market country and supported by pledged revenues of that issuer (either GRE or LRG).

Revenues used to secure and prioritize debt service payments typically include federal or other specific central government transfers, as well as cash flows derived from property taxes, payroll taxes, vehicle matriculation taxes, or other taxes and revenues where the subnational entity continues to own and control the revenue. In its analysis of subnational issuers, Fitch will consider the debt instruments or PPP covered by the criteria as on-balance-sheet financial obligations.

While sources of revenue flows and the structures designed to capture these flows may vary from country to country, these criteria outline the principles necessary to notching up or notching down from the national-scale long-term rating of the issuer (issuer rating) to the debt or PPP instruments they may issue.

To date, these criteria have been applied to transactions in Latin America, primarily Mexico. To apply these criteria elsewhere presumes Fitch will be satisfied that the principles outlined herein can be applied within legal and regulatory frameworks in the corresponding countries.

These criteria apply to ratings in national scale only, for new and existing transactions and either short- or long-term ratings. Fitch will assess the key rating factor attributes described in this report and apply a rating within the relevant national scale (for more information, see Fitch's *National Scale Ratings Criteria*). This methodology report must be consulted together with the criteria listed in *Related Criteria*.

Key Rating Drivers

Issuer Rating and Bottom-Up Notching: Fitch's starting point is assessing the credit profile of the subnational issuer. Subsequently, the degree of uplift the security rating may receive above the issuer rating — the rating assigned to its general unsecured obligations — of the subnational will depend on the legal and financial strengths of the debt structure.

The uplift is normally capped at seven notches on the national scale. The degree of potential uplift depends on the structure strengths, enhancements and how those enable revenues to flow uninterrupted to debt service upon default, insolvency or financial distress of the subnational issuer.

Security Rating and Upper-Tier Government: The upper-tier government may commit funds to segregated accounts that can be altered only with its own consent and control, and may earmark them solely for that purpose. In such a case, the reference point for a security's rating will be that of the upper-tier entity. If most of the rating factors are assessed as 'Stronger', the security can be equalized to the National Long-Term Rating (NLTR) of upper-tier government (top down minus zero).

Asset Pledge Analysis: Historical behavior and growth rates of revenues derived from the assets used to back up the debt are analyzed, as well as the components and factors that drive revenue performance. Fitch uses assumptions and stress scenarios while projecting the stressed revenue.

Structure, Financial and Legal Strengths: Fitch will evaluate the custodial arrangement that segregates revenue flows for debt service of rated debt instruments. Rating uplift, if any, for specific debt instruments depends on the relative capacity of those custodial arrangements to isolate segregated revenue flows away from the subnational.

Coverage Analysis and Credit Enhancements: Fitch evaluates expected debt service coverage and performance using base and adverse projection scenarios, with respect to asset behavior, debt service estimates, credit enhancements and main macroeconomic variables, such as market interest rates and inflation rates. Minimum debt service coverage ratios (DSCR) are calculated and compared with peers.

Rating Approach

The national scale issuer ratings assigned by Fitch evaluate the willingness and capacity of an entity to make timely payments on its financial obligations, without considering any specific guarantee, enhancements or subordination. When a specific security is being rated, the rating will reflect the nature of the security, considering its legal and financial strengths, its linkage to the general credit quality of the underlying issuer and any credit enhancements.

In general, this approach applies to securities backed with specific revenues Fitch classifies as operating revenues, whether these are directly collected by the subnational, or collected by the national government and subsequently transferred to the subnational. The analysis may vary if the revenue used as a source of payment is earmarked for a specific purpose.

In the criteria that follow, "the issuer" generally refers to the rated subnational, either government or GRE. A distinguish feature of subnational securities is that the issuer originates or owns the pledged revenue and this is setting apart from issuers operations, through a special purpose vehicle or a separate legal entity. This feature contrasts to a "true sale" transaction, where the originator "de-links" an underlying pool of assets to a structured transaction, intended to ensure that the transaction's main credit risk relates to that of the pool of assets, rather than the idiosyncratic credit risk of the originator. For the latter, Fitch will rely on the master criteria *Global Structured Finance Rating Criteria*.

Subnationals can also engage on PPP agreements, also supported by pledged revenues and PPP´'s payment operation is similar to the payment mechanism of issuer's securities. Hence, the key rating factors explained herein can also be applied to rate PPP agreements (for more information on PPP definition and rateability, see Fitch's *Public-Sector Counterparty Obligations in PPP Transactions Rating Criteria* report).

There can be PPPs where the grantor includes enhancements to secure its payment to the private party. The Enhancements are captured by the hereby criteria and not assessed by the PPP criteria. Therefore, the first step is to apply the securities criteria, then in a second stage, assess the counterparty obligation according to PPP criteria

Rating Factors

To determine the rating of the specific security, Fitch considers the following factors:

- Impact of the proposed additional secured debt on the issuer rating, if any;
- Analysis of the revenue pledged as a source of payment;
- Structure of the financing, and the protection it provides for holders of the security;
- DSCRs and any credit enhancements; and
- Legal protection for creditors.

In Fitch's rating process, the characteristics, strengths and weaknesses of each factor are analyzed, and no specific weighting of such factors is made to reach a particular rating or enhancement above the issuer rating. Even though some of these factors are interdependent, if one of them poses a significant weakness, it may cause the security rating to be equivalent to the national issuer rating, despite strengths shown in other aspects.

Credit Profile and Issuer Rating

The rating analysis of a specific security starts with the issuer rating as determined by the *Rating Criteria for International Local and Regional Governments* or, for a GRE, the *Government-Related Entities Rating Criteria*, and then evaluates if any increased leverage due to the new debt will have an impact on the credit profile of the issuer. The main indicators Fitch observed are leverage and debt service sustainability ratios relative to current revenues and operating/current balance. Such indicators are analyzed based on both historical and projected revenues.

The issuer rating is the starting point for determining the rating of the enhanced security. While evaluating two financial securities of different issuers with similar strengths and characteristics in their legal and financial structures, the securities' ratings may be different, depending on the overall credit profile of the issuer. In this sense, the issuer rating captures the credit fundamentals of the subnational entity and its payment capacity, while the security rating captures the structural features that help protect and isolate the funds to repay the debt, and therefore build upon the default risk of the issuer.

Other factors that support linking both ratings are the additional obligations of the issuer under the securities, especially those related to the issuer complying with fiscal performance metrics and limiting debt levels. The structures Fitch analyzes usually incorporate preventive or acceleration events linked to the credit profile of the subnational and its willingness to pay.

Evaluating Pledged Flows

Fitch requests at least five years of monthly historical information regarding tax collections or related revenues being pledged. Growth rates in nominal and real terms for different periods are evaluated, and projections are made considering scenarios described in the Coverage and Credit Enhancement section. In addition to revenues being analyzed, their components, structures and collection systems are analyzed. Fitch assesses political risks related to possible changes in the revenue base and mitigating factors established in the structure documents, such as funding additional reserves, asset replacement and even covenants requiring early redemption of the outstanding debt balance. These political risks tie the ratings of securities issued by subnationals to the issuer ratings.

In its analysis, Fitch evaluates the history of the pledged revenues and the variables that affect its growth, such as taxpayer registers, tariffs, collection sources, predictability and legal base of transfers. The reliability of historical information is also very important. Most issuers validate information through services offered by well-known external accounting firms, which is also the case for revenue projections provided by the issuer. Fitch reviews issuer projections during the analysis, but such information does not replace internal stress scenarios developed and applied by Fitch.

Subnationals in emerging markets use revenues such as taxes, fees and income typically collected centrally and then transferred from upper levels of government to support the debt service of their debt securities. Fitch closely analyzes the structure and pledge of revenues to these securities because the subnational has an exclusive right to collect or receive funds such as fees and taxes. The pledge of revenues must ensure appropriate separation from issuer operations because implementing a subnational's true sale transactions is typically not possible. Subnational governments create a security pledge and some form of custodial arrangement to prevent interruption or redirection of cash flows from security repayment. Fitch evaluates the political risks of interruption, delay or redirection. Demonstration of irrevocability features and notifications of such pledges may favorably affect the rating of a security.

If there is an interruption of the revenue source or any kind of unexpected operational problem with the trust or other form of custodial mechanism, structures establish an obligation for the subnational to cover revenue shortfalls with other resources. Creditors may also retain legal recourse to the subnational issuers. Therefore, transactions have dual recourse to the pledged revenues throughout the trust and to the subnational responsible for debt service if pledged revenues prove insufficient.

When analyzing the rating of such a security, if Fitch expects other subnational resources would be necessary to avoid a default or complete a debt service installment in the Fitch base case scenario due to volatility in the pledged flows or the amount of leverage in the rated debt structure, the security would be rated at the same level as the underlying subnational.

The pledged resources covered under these criteria are generally collected centrally and then distributed by the national government prior to the segregation under the custodial arrangement. They are usually considered unrestricted revenues of the subnational because their use has not been required or earmarked for another purpose.

Top-Down Approach

In contrast, a higher tier of government may earmark a specific revenue stream for a defined purpose, such as debt service on debt used to fund the subnational government's capital projects. The upper-tier government may commit such funds to segregated accounts that can be altered only with the consent and control of the upper-tier government, and may earmark them solely for that purpose. In such a case, the reference point for a security's rating will be that of the higher tier entity.

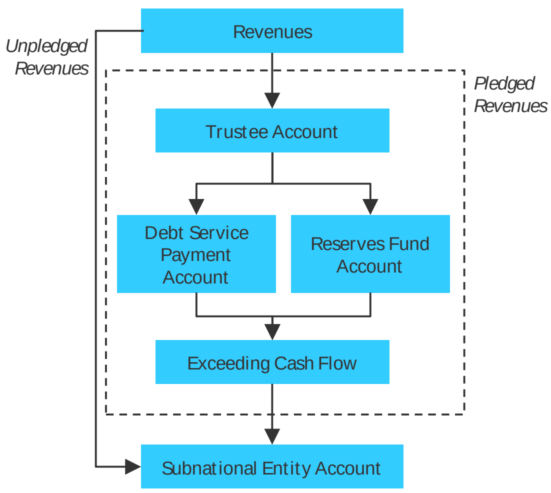
Under a top-down approach, if most of the rating factors are assessed as 'Stronger', the security can be equalized to the NLTR of upper-tier government (top down minus zero). A majority of midrange rating factors would lead to top-down approach minus one notch. Lastly, the presence of a weaker rating factor may lead to a bottom-up approach, thus departing for the NLTR of the subnational, which implies that the security may eventually need extra revenues from the issuer.

Financing Structure

Fitch reviews the characteristics and type of debt the entity intends to incur (e.g. the seniority to other financial commitments, subordination, etc.), debt denomination (local currency, inflation/index linked), interest rate (fixed or variable), use of an interest rate cap or derivatives, and the amortization profile.

The examination of the trust or other custodial mechanism used to back up and/or directly pay debt service is an essential element in Fitch's analysis from an operational and financial perspective. Fitch reviews the waterfall structure of the trust, any segregation into sub-accounts, funding and maintenance of reserve funds, covenants or triggers established, responsibilities and obligations of the trustee, and all factors in general that provide greater financial certainty to creditors and/or investors.

Pledged Revenue Flow



Source: Fitch Ratings

The Pledged Revenue Flow chart shows the typical trust scheme. Pledged revenues are transferred to the trustee account, then segregation is made to each account of interest, capital and reserves funds to complete debt service payment. Finally, if excess cash flow remains, funds are transferred to the issuer.

For covenants established in the trust and financing documents, Fitch places special emphasis on covenants that limit future borrowing and scrutinizes the subnational's budgetary performance. In addition to the usual trigger to maintain a DSCR higher than a required minimum, there are other covenants that could potentially affect the subnational's issuer rating. They may include establishing maximum caps in leverage and debt service for total or current revenues, among other covenants. Fitch evaluates the historical and projected performance of financial metrics relative to the trigger limits established at the security contract/agreement. Finally, the analysis of the security also includes an assessment of the application of the borrowed resources, which in most cases is funding public infrastructure. Fitch also takes into consideration the detail and application of such resources, as law may require dedication to specific purposes.

Fitch assesses the effects of a subnational covenant violation on its credit structure and security rating, along with the possible impact on its credit profile and rating, particularly if there are cross-default provisions. Some clauses give creditors the right to accelerate the security triggered by conditions that are not related to the government's financial and operating performance. Fitch assumes that most investors would not choose to accelerate debt if the security's financial profile is not otherwise impaired. However, where a breach of a covenant is recurrent and material, then the Legal Foundation attribute can be negatively assessed, therefore affecting the notching. Even though the structure supporting the security is strengthened by having additional reserve funds, the restriction of cash flow that would otherwise flow to the subnational could result in pressure on its own ratings, as the subnational may seek to refinance or restructure its debt. That pressure could reduce the subnational's issuer rating, which would also reduce the rating of the specific security linked to it.

Coverage and Credit Enhancements

Fitch's debt service coverage analysis consists of the application of several possible projection scenarios, including asset performance; security debt service, considering its contractual characteristics; and main macroeconomic variables, such as interest and inflation rates. The development and use of scenarios are dynamic and depend on the economic and financial perspectives in each country.

Base Case, Rating Case, and Additional Sensitivity

Fitch will evaluate a DSCR scenario that serves as the agency's expected case in the current macroeconomic environment. This case serves as a base case and starting point of sensitivity analysis. Macro assumptions used in the base case are primarily derived from Fitch's economic data (notably *Global Economic Outlook*) and Fitch's sovereign reports; in the absence of such data, Fitch would use other reputable research and economic institutions. The rating case will consist of a through-the-cycle scenario that incorporates a combination of revenue pledged and debt service stresses, as described below. These stresses are typically formed by referring to historical events, peer analysis and Fitch's future expectations. They may incorporate a particular scenario of events in which the asset pledged and security are particularly vulnerable, such as a downturn in economic activity or inflation effects on the performance of revenues pledged, or currency and interest rate volatility.

The rating case will reveal levels and shifts in DSCR and use of reserves, contrasted with the base case, that are consistent with a stable rating through that stress. As an additional sensitivity, analysts may also use the input variables to test a break-even scenario that determines the maximum level of stress that can be applied to a variable without a default on a rated instrument.

When analyzing debt securities in structures demonstrating strong coverage metrics, Fitch usually limits uplift for the debt instrument to up to four notches above the issuer rating (see the Appendix). Strong coverage means Fitch generally expects revenues pledged to be enough to cover debt service payments under the Fitch rating case scenario without using reserve funds. Equalizing the instrument rating to the issuer rating could be possible if the DSCR is very low — less than 1.0x — in a base case scenario, which indicates the issuer will need to add its own support to the security.

Generally, a security judged to have a majority of stronger attribute assessment, as per the Appendix, may be assigned a rating three-four notches above the issuer rating. A mix of a stronger and midrange attribute assessment would support a rating two-three notches above the issuer rating, and having some attributes judged as weak would suggest a rating one-two notches above the issuer rating.

Fitch should limit the notching in case it perceives a risk of timely delivery of the asset pledged to the trust. This situation can happen under municipal bank loans where an upper–tier government receives the pledged asset from the national government and then transfers it to the trust. The Upper-tier government may delay the flow delivery to the trust therefore affecting the timely payment of the security.

Fitch does not consider in its stress scenarios other cash flows a subnational could provide from other resources to which it has access. The availability of other revenues is constrained by an entity's issuer rating and cannot provide a basis for any uplift. Under higher than expected stressed situations, it is likely an issuer will simply seek to restructure/refinance the specific securities rather than give creditors access to the subnational's additional current revenues. Most structures Fitch analyzes are pass-through structures, where any surplus cash after servicing debt is transferred by the trustee to the subnational issuer and usually used by the subnational for operational purposes. In a high-stress scenario, such cash flows would not exist and there would be little incentive to reallocate scarce additional resources in Fitch's view.

Fitch also evaluates additional credit enhancements debt securities may have, which could extend the security rating uplift to above four notches. Examples of such securities or structures include the use of partial timely payment guarantees (PTPG) provided by third parties, additional resources and the inclusion of extra liquidity reserves, among others. For additional resources, Fitch analyses the performance and quality of the asset, the credit risk of the originator and projected DSCRs of the additional asset equal or greater than 1.0x. When these enhancements are incorporated, the additional notching of the security ranges from one to three notches, depending on the strength of the enhancements and months of debt service timely payment the enhancements provide, assuming the security's first line of defence (assessed in the Appendix) is depleted or interrupted.

The nature and terms of a PTPG can vary, but Fitch assesses the presence of the following key elements to provide additional uplift to a security rating:

- Repayment of any draws on a PTPG must be subordinated to debt service payments on the securities;
- The PTPG must have a term at least equal to the term of the securities benefited by the PTPG;
- Reimbursement of the PTPG can be made from future excess over debt service on the security; if the reimbursement does not replenish the drawable balance of the PTPG, the remaining balance will be used to determine notching uplift;
- Timeliness of payment under the PTPG will be evaluated to assure draws can occur before default on the benefited securities;
- If provided by a third party, such as a financial institution, the provider must have a rating at least at the level of the benefited security.

The uplift provided by a PTPG or additional liquidity reserve will be based upon the amount of additional debt service capacity provided by such enhancements:

- Up to 18 months of additional debt service capacity will draw a one-notch additional uplift;
- From 18 months to 30 months of additional debt service capacity will draw a two-notch additional uplift;
- More than 30 months of additional debt service capacity will draw a three-notch additional uplift.

Legal Considerations

The information Fitch analyzes from a legal perspective includes laws and regulations applicable in public debt; decrees and/or agreements of authorization to incur debt, legal authorization to pledge resources for debt repayment and constitute custodial mechanisms to hold the revenues that support debt service; loan agreements and/or issuance offering memos; trust agreements; irrevocable instructions to pledge resources, derivatives or interest rate cap agreements, among others documents particular to a transaction.

From a legal point of view, the custodial mechanism is an example of a structure that provides legal security to creditors and investors, which, upon default or insolvency of an issuing subnational, separates the revenues pledged from other creditors and from the subnational operating management. This establishes clear and transparent procedures to receive, maintain and distribute resources used to prioritize and cover debt service in a timely manner, without further action from the subnational. From Fitch's point of view, the revenue pledging structure can provide uplift from the subnationals' default risk.

The irrevocability features of the structures and actions taken by the subnational to legally pledge revenues to the debt securities, and the legal language of the documents that protect investors and loanholders from actions that may affect the assets' performance, are the essential factors assessed in Fitch's review to effectively apply the uplift approach for rating the security. Fitch considers that such irrevocability features are an important protection against political risks, such as changing political agendas or government administration changes, and some financial risks, such as short-term liquidity pressures.

To evaluate the legal strength of subnational debt securities, Fitch relies on the services of well-known, recognized legal firms that in each country where the criteria are applied. The external legal review and opinion, performed for every transaction, consist of an examination of all documentation related to the structure, security and subnational debt borrowing framework to assess compliance with regulation, enforceability of the agreed-to terms and the irrevocability features. Fitch views the legal analysis as key during the initial rating process and in subsequent monitoring of the rating.

Political Risk

Political risk is a possible contingency subnational financing structures face. This type of risk may be seen in subnational entities with weak budgetary performance and weak management policies or governance concerns. Factors that may lead to questioning of the revenue pledging by future government administrations or the custodial arrangements to segregate pledged revenue include the complexity of the legal framework, rule of law compliance and a significant length of time to resolve legal disputes. These risks are nevertheless incorporated into the risk profile of the government, a key step to assign an IDR according to Fitch's LRG master criteria.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Data Sources

Fitch's criteria assumptions, analysis and rating decisions are based on relevant information available to its analysts. The sources are the issuer and/or the obligor, public domain and the financial advisor if a financial advisor is engaged. This includes relevant publicly available information on the issuer, such as financial statements and regulatory filings. Fitch also uses forecasts from its Global Economic Outlook and Fitch Sovereign forecasts to build macroeconomic assumptions and scenarios. The rating process can incorporate information provided by other third-party sources. If this information is material to the rating, the specific rating action will disclose the relevant source.

The key rating assumptions and information used for the development of these criteria include the analysis of transaction documents and legal opinions from several transactions executed, primarily in Mexico, and from discussions with issuers, financial arrangers, investors, bankers and national authorities.

Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions and available at https://www.fitchratings.com/.

Rating Assumption Sensitivity

Securities ratings are linked to the issuer ratings. Any movement in the issuer rating could change the security rating in the same direction.

Any additional robust enhancement pursued to lower the securities' likelihood of default could upgrade the security rating.

Any covenant violation established in the transaction documents that could increase the likelihood of default or affect the credit profile of the subnational could result in a downgrade of the security rating. The restriction of cash flows derived from a covenant violation that would otherwise flow to the subnational could result in pressure on its own ratings, as the subnational may seek to refinance or restructure its debt. That pressure could reduce the subnational's issuer rating, which would also reduce the rating of the specific security linked to it.

Appendix 1

Notching Guideline for Specific Securities of Subnationals

	Asset pledge analysis	Structure, financial and legal strengths				Coverage analysis
	Asset performance	**Legal foundation**	**Special purpose vehicle**	**Interest rate risk**	**Reserve fund**	**Debt Service Coverage Ratio (DSCR)**
Stronger Attributes (Widest Notch Uplift, 3-4)	Stability in asset performance (i.e. defined allocation formulas), resilient behavior under downturn economic cycles. Historical positive growth rates.	Robust legal foundation. External legal opinion concludes transaction full compliance with local regulations, enforceability of terms agreed, and irrevocability features.	Pledged revenues are set apart in a trust or other custodial arrangement to ensure full and timely debt service payments. Trustee with best practices in the market.	Fixed interest rate obligation, either explicit or through the use of derivatives (interest rate caps or swaps), from counterparties whose ratings should be commensurate with the rating of the respective securities.	Robust reserve funds that reduce liquidity risks and low probability to use them. (Reserve Fund > 2.0 monthly payments; or Reserve fund >1.0 periodic payment for securities with periodic payments longer than one month).	High DSCR in the rating case scenario (DSCR>2.0x).
Midrange Attributes (Modest Notch Uplift, 2-3)	Asset performance closely linked to economic cycles.	Sound legal foundation. External legal opinion may show some flags or contingencies.	Pledged revenues are set apart in a trust or other custodial arrangement.	Exposure to variable interest rates. Use of derivatives, from counterparties whose ratings are not commensurate with the rating of the respective securities.	Moderate reserve funds that reduce liquidity risks and low probability to use them (1.0 monthly payments> Reserve fund < 2.0 monthly payments).	Moderate DSCRs in the rating case scenario (1.0x>DSCR<2.0x)
Weaker Attributes (Narrowest Notch Uplift, 0-2)	Uncertain asset performance under adverse economic scenarios. Frequent negative growth rates	Weak legal foundation, financial documents might present inconsistencies. Issuer administration experiencing high political risk.	Pledged revenues are set apart in a weaker custodial arrangement. Trustee with historical precedents of operational risk.		Null reserve funds, or insufficient funds to cover the periodic debt service.	Low DSCRs in the rating case scenario (DSCR<1.0x)

Note: While maximum uplift over an issuer's rating will typically not exceed four notches on a national rating scale, wider notching may be applied if the issuer enters into a technical default which, in Fitch's opinion, will be temporary, and will not affect the revenues used to secure the debt instrument.
Source: Fitch Ratings