Article Title: Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign Data: (EDITOR'S NOTE: —On May 19, 2022, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) 1. This article presents S&P; Global Ratings' methodology for rating non-U.S. local and regional governments (LRGs) higher than the sovereign in which the LRG is domiciled. The update aligns this practice-specific methodology with the cross-practice criteria, "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions" (the RAS criteria), published Nov. 19, 2013. This article expands on the concepts presented in the RAS criteria as they relate to rating non-U.S. LRGs above the sovereign. 2. The criteria relate to "Principles Of Credit Ratings," published Feb. 16, 2011. SCOPE OF THE CRITERIA 3. The criteria apply to global scale ratings on non-U.S. LRGs. SUMMARY OF THE CRITERIA 4. These criteria are aligned with the RAS criteria and provide additional details related to the LRGs when we consider rating them above the sovereigns they are domiciled in. In particular, three conditions are all necessary to qualify an LRG for a rating above the sovereign (as per paragraph 39 of the RAS criteria): The ability to maintain stronger credit characteristics than the sovereign in a stress scenario, such as having predominantly locally derived revenue (i.e., a lack of dependence on central government revenues, subsidies, or other government transfers); An institutional framework that is predictable, stable, and limits the risk of negative sovereign intervention, such as revenue and expenditure autonomy supported by both constitutional and statutory provisions; and The ability to mitigate negative intervention from the sovereign through high financial flexibility and independent treasury management. 5. S&P; Global Ratings can rate an LRG above the sovereign when the LRG presents a set of special characteristics that are described in this article and meets further conditions (including the ability to pass the stress test) specified in "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013. 6. These criteria apply when we consider assigning an LRG a local currency rating that is higher than the sovereign foreign currency rating. When we are considering a rating above the sovereign local currency rating, even if the latter equals the foreign currency rating, the entity should be able to pass an appropriately more stressful scenario associated with both a sovereign foreign and local currency default. 7. When assigning an LRG a local currency rating above the sovereign foreign currency rating, S&P; Global Ratings is expressing its view that the rated LRG's willingness and ability to service debt in all currencies, in the absence of transfer and convertibility (T&C;) risk, is superior to that of the sovereign. Ultimately, this means that if the sovereign defaults on its foreign currency debt, there is an appreciable likelihood that the issuer will not default. 8. Therefore, to be rated above the sovereign foreign currency rating, an LRG must exhibit, in addition to other conditions outlined in the RAS criteria, sufficient operational and financial flexibility to deal with the sovereign and country risks, even as they intensify in a very difficult period of stress. The vast majority of non-U.S. LRGs are not rated above the respective sovereigns since their structural and institutional features are not sufficiently resilient to the sovereign stress. Those few non-U.S. LRGs that qualify to be rated above the sovereigns are classified as having "high" sensitivity to country risk, as explained in paragraphs 44 and 46 of the RAS criteria, and can be rated up to two notches above the related sovereign rating. 9. Absent rare, structural factors that mitigate T&C; risk, an LRG foreign currency rating is the lower of the local currency rating on the LRG, or the T&C; assessment. 10. This paragraph has been deleted. 11. This paragraph has been deleted. METHODOLOGY 12. In order to assign an LRG a local currency rating above the foreign or local currency rating on its sovereign, we assess whether there is an appreciable likelihood that the LRG's credit characteristics would remain stronger than those of the sovereign in a scenario of economic or political stress. In other words, S&P; Global Ratings considers whether the structural differences and the institutional features enabling the LRG to be rated above the sovereign are resilient to a major economic or political disruption, and whether the LRG would have sufficient flexibility to mitigate negative intervention from the government. 13. For S&P; Global Ratings to rate an LRG higher than its sovereign, we expect the LRG to exhibit all of the following (also specified in paragraph 39 of the RAS criteria): The ability to maintain stronger credit characteristics than the sovereign in a stress scenario; An institutional framework that is predictable, stable, and limits the risk of negative sovereign intervention; and The ability to mitigate negative intervention from the sovereign thanks to high financial flexibility and independent treasury management. 14. If these three conditions are met, the entity must also pass a hypothetical sovereign foreign currency default stress test to be rated above the sovereign (see more on stress test requirements in paragraphs 34-40 and table 3 of the RAS criteria). If a rating above the sovereign local currency is considered, we apply a more stressful scenario associated with both a sovereign foreign and local currency default. 15. For an LRG located in a sovereign with a foreign currency rating of 'AA-' or higher, the stress test for a sovereign default scenario would generally not be required, given the very low likelihood of a highly rated sovereign defaulting. Nevertheless, we will review, from a qualitative perspective, why an LRG would (or would not) be expected to default at a time when the sovereign is defaulting, based on the LRG's expected resilience to a severe stress scenario and limited direct links to the sovereign. 16. When the sovereign rating is 'B' or lower, the default scenario might be more predictable. If the sovereign rating is 'B' or 'B-', we might develop a country-specific default scenario to determine whether we could rate an LRG above the sovereign. For sovereign ratings of 'CCC+' and below, we expect the current stressed conditions to represent both our base case and the expected default scenario, and we generally will not perform a stress test for LRG ratings up to 'B-' (unless the transfer and convertibility assessment were also 'CCC+' or below). Where the sovereign rating is 'CCC+' or below, we would still perform a stress test for entity ratings that could exceed 'B-'. 17. For sovereigns rated 'B-' and lower, the ratings differential between an LRG and the sovereign can be larger than two notches, but the rating on the LRG is capped at 'B+', as described in table 2 of the RAS criteria. Importantly, for LRGs operating in countries with sovereigns rated at such weak levels, we have partially modified three conditions listed in paragraph 13 (see "Sovereigns With Low-Speculative Grade Ratings" for more details). The Ability To Maintain Stronger Credit Characteristics Than The Sovereign In A Stress Scenario 18. The first condition that we look for when considering rating an LRG above its sovereign is credit characteristics that are stronger than the sovereign's and that are expected to remain stronger, including during periods of stress. In other words, the LRG rating might fall if the sovereign rating declines, but it should remain stronger than that of the sovereign and ultimately avoid default should the sovereign default. 19. To maintain stronger credit characteristics than the sovereign in a stress scenario, an LRG would generally need to have the following characteristics: An economy that is more resilient and wealthy than the national one and is less affected by business cycles; Very strong financial performance, relative to peers in the rating category; Lack of dependence on the sovereign or any less creditworthy government for any appreciable share of its revenues, the collection of taxes or fees, the servicing of debt, or the provision of essential services; A strong credit culture within management, which would likely prevail against political pressures to adopt whatever relief measures the sovereign might adopt; and Sufficiently robust economy and finances to withstand country-specific stresses regarding recession, a weakening currency, a haircut to financial assets, higher interest rates, unemployment, and inflation (see table 3 in the RAS criteria for more information). 20. While we usually observe a fairly high correlation between the evolution of the economic and financial performance of the sovereign and the LRG sector, in some cases particular LRGs have consistently posted stronger performance than their national peers. This is often because the LRG has a more favorable balance between resources and responsibilities than its peers, greater commitment to fiscal discipline, or a more resilient economy. These situations are more typical of decentralized systems where LRGs benefit from significant financial autonomy, which enables them to follow their own financial strategy, and/or countries in which economic wealth and structure vary greatly from one region to another. 21. Since LRGs' economic profiles and growth patterns strongly influence their financial performance, if an LRG has positive structural differences relative to the sovereign, then this suggests to us that the LRG's economy would be more resilient than the national one in an economic downturn. Our analysis typically includes comparing differences in characteristics such as economic structure (including concentration in a particular economic sector), growth dynamics, unemployment, wealth, and competitiveness. An Institutional Framework That Is Predictable, Stable, And Limits The Risk Of Negative Sovereign Intervention 22. To be rated above the sovereign, an LRG must have a stable and predictable institutional framework that is not subject to frequent or radical modifications. This effectively excludes LRGs with institutional frameworks assessed as '5' or '6' according to "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published July 15, 2019. In assessing the institutional framework, we take into account a sovereign's track record of exceptional negative intervention affecting lower layers of governments. We believe that a stable institutional framework that provides an LRG with a fair amount of independence helps to prevent the sovereign from substantially and unilaterally altering an LRG's financial status, as well as supports the LRG's financial and fiscal autonomy. 23. For an institutional framework to be stable and predictable, it should have a strong legal status. This would typically be afforded by constitutional protection and/or the need for the LRG's agreement if fundamental aspects of its financial autonomy were to be altered. Constitutional protection is most relevant in countries where the constitution is determinant and difficult to change, requiring, for instance, a vote of a very large majority at the regional and national parliaments. An LRG's bargaining power can also be relevant, particularly in countries where regional parties play a role in national politics, or where the regions themselves have a say in central government decisions. 24. Other institutional framework features that we believe support its stability and predictability are: Transparent political institutions with broad public backing and a well-established system of intergovernmental relations exist. Changes in intergovernmental relations--including changes in revenue authority, expenditure responsibility, and/or intergovernmental transfers--occur in a clear manner after open discussion. No subset of regional and local governments is singled out for special treatment, except in accordance with objective standards based on the level of development, infrastructure needs, or some other set of criteria. The Ability To Mitigate Negative Intervention From The Sovereign 25. To be able to mitigate negative sovereign intervention, we believe that an LRG must benefit from substantial financial autonomy, both on expenditure and revenue. 26. On the expenditure side, financial flexibility includes the LRG having autonomy in the definition and adjustment of its main costs (for instance, by setting the wages of civil servants). Additionally, LRGs benefiting from better infrastructure than their peers are likely to have more flexibility to defer investments in times of financial hardship. The share of expenditures linked to the national equalization system is also a key aspect. We view LRGs that do not participate in such systems, or participate minimally, as more autonomous. 27. On the revenue side, we assess LRG autonomy as a lack of dependence (or very limited dependence) on transfers or shared taxes coming from the sovereign or other levels of governments. We assess an LRG's capacity to collect and manage its main tax proceeds without sovereign interference, coupled with its capacity to modify the fiscal regime of a large share of its revenues (tax rates, deductions, fiscal benefits altering the tax base, creation of new taxes, etc.). This analysis relates both to the legal and practical capacity of an LRG to alter the main components of its tax base and rates. Practical considerations include the ability, from a political and social standpoint, to raise taxes during a period of economic stress, and the political willingness, assessed by historical track record and stated policy, to deviate from national tax rates. 28. Finally, we also consider whether an LRG has complete control over its liquidity or whether the central government would be able to reduce the LRG's treasury or limit the LRG's access to its treasury. In some countries, LRGs are legally required to place all or part of their liquidity at the central treasury. By contrast, in highly autonomous systems, the LRG and the central government treasuries are totally independent. Our liquidity analysis considers not only normal circumstances, but particularly financial stress scenarios where the central government would have a greater incentive to access an LRG's liquidity (in cases when LRGs need to place all their funds at the central treasury) or reduce or delay the payment of state transfers, for example, to avoid defaulting. 29. Similarly, we assess potential restrictions to debt issuance. Restrictions typically include a system of prior authorizations, and quantitative and qualitative limits. Sovereigns With Low Speculative-Grade Ratings 30. For an LRG domiciled in a country with a sovereign rated 'B-' or lower, we generally apply the same three conditions explained above, but defined with greater specificity because of a greater predictability of the particularities of the potential sovereign default scenario at this rating level. 31. As such, the gap between the LRG and sovereign ratings may widen substantially beyond one notch (with a maximum LRG rating capped at 'B+', as per table 2 of the RAS criteria) because the circumstances of the sovereign distress and the LRG's willingness and ability to meet its debt obligations in the face of rising country risk are clearer than for highly rated governments. 32. The experiences of rated LRGs that defaulted following the sovereign defaults (e.g., in Russia in 1998-1999 and in Argentina in 2001-2002), as well as the experiences of the LRGs that did not default in the same countries, have enabled us to develop a series of specific considerations for the application of the above criteria as sovereign creditworthiness declines. 33. In particular, regarding the ability of an LRG to mitigate negative government intervention, S&P; Global Ratings considers the following points. Limited risk of negative sovereign intervention 34. An LRG having finances that are relatively independent from its sovereign's finances may limit the risk of the sovereign reducing the LRG's revenues or passing down additional expenditure responsibilities to the LRG. In contrast, a track record of sovereign intervention, such as a moratorium on debt payments affecting all or certain types of debt or additional restrictions on capital movement, including T&C; constraints, would likely prevent an LRG from being rated above its sovereign. Revenue generation capacity versus debt coming due 35. An LRG's revenue collection would likely come under severe stress if the sovereign defaulted. In such a scenario, we would assess whether the LRG's current free cash and liquid assets, excluding the portion invested in sovereign bonds, and expected stressed revenue flow are sufficient to cover its future debt service payments and most sensitive expenditures, including salaries and social benefits, over the following 12 months. An absence of short-term debt maturities or spending peaks could ease financing pressure for an LRG under revenue stress. Dependence on domestic and international financial markets 36. Access to deposits and accounts in domestic banks, as well as the liquidity and value of other domestic financial assets (including government bonds) may be limited if the sovereign defaults. We have observed situations where LRGs had made deposits with banks that went bankrupt, resulting in significant liquidity stress. Similarly, reliance on funding or facilities from domestic or some international banks to refinance upcoming debt service exposes the LRG to significant liquidity risk. Strong credit culture 37. Finally, in order to rate an LRG above the sovereign, we expect an LRG to demonstrate its willingness to repay debts on time and in full, and even if the sovereign were to default on its own debt. In assessing this, we look for a strong track record of above-average credit culture and financial management sophistication. We have observed that the most visible and politically important LRGs in a country, such as financial and economic centers, often demonstrate such a credit culture. Ratings in the 'CCC' category and lower 38. Once a sovereign rating is 'CCC+' or below, the capping provisions of the RAS criteria no longer apply (except for a cap of 'B+', as explained in paragraph 17) and unless the T&C; assessment is also in the 'CCC' category. As such, the rating on an LRG located in a sovereign rated 'CCC+ and below will be rated in the 'CCC' category or below only if it meets the conditions of "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC'," published Oct. 1, 2012, or the section on "Distressed Debt Restructuring And Issue Credit Ratings" in "S&P; Global Ratings Definitions," published Nov. 10, 2021, and/or if the T&C; assessment is in the 'CCC' or 'CC' category, in which case, T&C; constraints continue to apply, as per the RAS criteria. While the T&C; assessment directly constrains the foreign currency issuer credit rating, it may indirectly affect the local currency issuer credit rating. That's because we assume in the case of a T&C; event, when transfer and/or convertibility restrictions are imposed, there would be a default on any foreign currency debt instruments where debt service payments come due during the T&C; event, and, furthermore, we assume creditors would accelerate in such cases. We would consider it a default on both the foreign and local currency issuer credit ratings if the LRG did not fully pay accelerated debt, in local currency equivalent. Therefore, the local currency rating on the LRG could only exceed the foreign currency rating if the LRG had sufficient local currency liquidity to cover such potential debt accelerations. For example, this could be the case if an LRG had relatively little foreign currency debt, compared with its liquidity. We also would need to check cross-default provisions in the LRG's local currency debt instruments to determine whether they would be triggered by a T&C; event or a default on or acceleration of foreign currency debt. REVISIONS AND UPDATES This article was originally published on Dec. 15, 2014. Changes introduced after original publication: Following our periodic review completed on Dec. 13, 2016, we removed two paragraphs that were related to the initial publication and no longer relevant. Following our periodic review completed on Dec. 8, 2017, we added the "Revisions And Updates" section. On Jan. 30, 2019, we republished this criteria article to make nonmaterial changes to the contact information. On June 19, 2020, we republished this criteria article to make nonmaterial changes to criteria references. On May 19, 2022, we republished this criteria article to make nonmaterial changes. Specifically, we updated outdated text, as well as references to "Rating Implications Of Exchange Offers And Similar Restructurings, Update," May 12, 2009, which has been superseded by "S&P; Global Ratings Definitions," published Nov. 10, 2021. RELATED CRITERIA AND RESEARCH Related Criteria Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019

Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013 Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC', Oct. 1, 2012 Principles Of Credit Ratings, Feb. 16, 2011 Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009 Related Research S&P; Global Ratings Definitions, Nov. 10, 2021