Covid-19: Rising credit risks, to various degrees, for European sub-sovereigns

Scope expects the impact of the Covid-19 crisis on most European sub-sovereigns to pose mostly a medium-term risk. Supportive factors include mature institutional frameworks, a revenue base which is less sensitive to economic activity, higher expenditure flexibility, and limited liquidity risks. However, the magnitude of the impact of the crisis will depend on the length and severity of the economic disruption. Rising fiscal pressures and increasing budgetary constraints in some countries worst hit by the crisis are likely to emerge coming from sovereign pressures during 2020.

We expect European sub-sovereigns to be overall less affected by the Covid-19 crisis than sovereigns, though the impact will vary across countries and levels of government.

Supportive factors include (i) mature institutional frameworks under which sub-sovereigns operate, cushioning them from economic shocks (ii) revenue structures which are typically less exposed to economic activity and less likely to be directly affected by the first-round economic impact of the crisis (iii) the ability to postpone large shares of their capital expenditure (iv) accommodative financing conditions.

In addition, the policy response to the crisis across the EU has been rapid and forceful with national governments interposing their balance sheets by adopting deficit spending policies, although to different degrees. Such interventions will primarily lead to a deterioration in public finances and rising debt at the central government level whose credit quality typically anchors Scope's sub-sovereign ratings. At the same time, EU sub-sovereigns in some countries worst hit by the crisis, such as Italy and Spain, face rising fiscal pressure from lower tax income and higher spending, primarily on health and social care.

Most European sub-sovereigns, whose finances overall are less vulnerable to the crisis than sovereigns, remain vulnerable to prolonged economic disruption particularly if their respective sovereigns experience a substantial deterioration in creditworthiness in 2020 and beyond.

Covid-19 impact	EU Sovereigns	EU Sub-sovereigns
Deep recession	High impact on public finances	Lower cyclical impact on budgets
Policy responses	Deficit spending policies	Limited capacity
Public Finances	Rapidly increasing debt	Moderately increasing debt
Funding	Good market access	Affordable risk premia

Scope's sub- sovereign rating approach: focus on institutional factors

Our objective is to present rigorous, transparent and forward-looking sub-sovereign credit research and credit assessments from a distinct European perspective. We aim to balance timeliness and rating stability through the cycle while minimising the risk of surprises to issuers, investors and policymakers even during times of significant uncertainty.

To achieve these goals, our approach on sub-sovereign credit ratings

- places greater emphasis on the institutional frameworks including support arrangements and anchors the sub-sovereign's credit quality at the central government level, which allows us to explicitly consider the interdependence between the sovereign's creditworthiness, institutional frameworks and sub-sovereigns' individual credit profiles;
- detects positive and negative outliers per government tier via a 'portfolio view' with which we establish individual strengths and weaknesses by benchmarking core variables and qualitative factors against national peers; and
- assesses whether the damage inflicted by the current crisis on a sub-sovereign's balance sheet is material and unlikely to be reversed in the near-term.

Analyst

Jakob Suwalski
+49 69 6677389 45
j.suwalski@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389 22
g.barisone@scoperatings.com

Related Research

Q2 2020 Sovereign Update – 02 April 2020

France's residency tax reform poses fiscal risks at the local and national level – 13 June 2019

Italian regions' autonomy plans weigh on predictability of the country's fiscal framework – 29 April 2019

Spain's evolving fiscal framework: implications for the sovereign and its regions – 17 January 2018

Rating Methodology: Sub-Sovereigns

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 3890

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Covid-19 crisis - key credit considerations

Our baseline economic outlook assumes that the Covid-19 pandemic pushes the European economy into recession this year with a gradual recovery from Q3 2020, though there are remaining downside risks (see our Sovereign Update). The magnitude of the crisis will depend on the length and severity of the economic disruption and we expect sub-sovereign's revenues and budgetary performance to be more heavily impacted in more exposed countries such as Italy in Spain in 2020 and probably even more severely in 2021, due to the lag between economic performance and revenue recognition in lower levels of government.

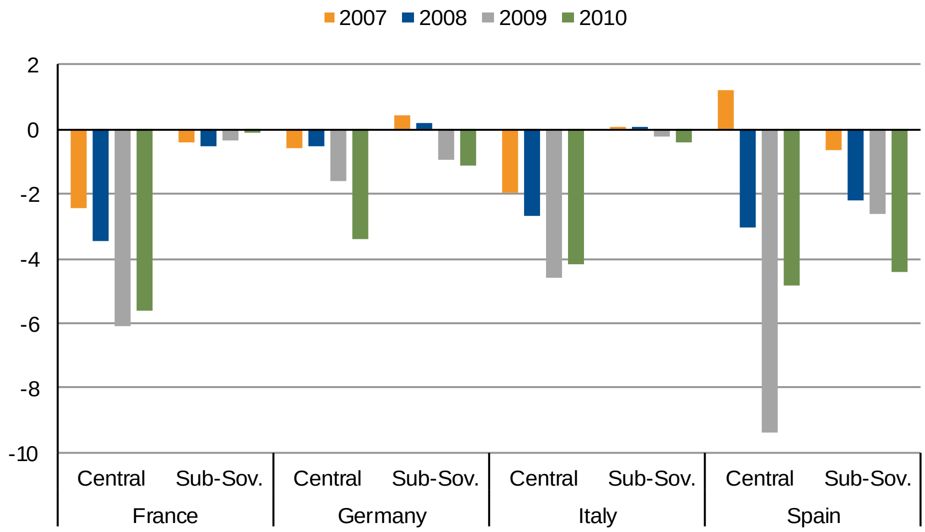
1. Economic impact on European sub-sovereign budgets

The Covid-19 crisis will have less immediate effects on sub-sovereigns than sovereigns

We expect sub-sovereigns to be less affected by the Covid-19 crisis than sovereigns, with varying degrees across countries and levels of government:

- Sovereigns have tended to assume the role of natural stabiliser in the Covid-19 crisis by resorting to deficit spending policies to absorb the costs of higher unemployment and support economic output. This is an echo of government policies in the global financial crisis (see **Figure 1**), which led to extensive reforms of the institutional frameworks in the countries which were hit worst from the crisis, including the Spanish regional framework.

Figure 1: Budget deficits of different layers of government, % of GDP



Source: Eurostat, Scope Rating GmbH

- Most institutional frameworks, under which sub-sovereigns operate, cushion immediate economic effects. In many countries, material transfer-dependency and mature equalisation systems weaken the link between sub-sovereign budgets and the performance of the economy in which a sub-sovereign is located. German Länder mainly receive 'shared' taxes (largely personal income taxes, VAT and corporate taxes). These revenues are initially collected by the local tax offices but are later redistributed at national level in accordance with revenue-sharing agreements and additional transfer mechanisms. This weakens the link between the Länder's tax revenues and their economic performance. In general, we anticipate that countries with well-established institutional frameworks with a proven track record of institutional support from the national government such as for example Germany are likely to be in a stronger position to tackle the economic challenges from the Covid-19 crisis.

- Sub-sovereigns' own revenues are typically less exposed to fluctuations in economic activity and rather dependent on non-market-sensitive revenues. For example, a large share of local government revenues in France and Italy comes from residency and property taxes, which rely on cadastral rental values that are broadly stable through the cycle.
- A material proportion of capital expenditure can typically be rescheduled or resized, implying greater expenditure flexibility. Regional government tiers with more intense health care responsibilities in countries like Germany, Italy and Spain tend to have a rather rigid operating expenditure structure and a lower share of capital expenditure than those mainly responsible for the local infrastructure.

Immediate risks relate to crystallisation of contingent liabilities

Immediate economic risks relate to the crystallisation of contingent liabilities of the wider sub-sovereign's balance sheet, including the indebtedness of government-owned and government-related entities (GRE) which may burden the sub-sovereigns' balance sheet. If such entities were to face severe financial distress due to the economic fallout of the Covid-19 crisis, some debt may be taken over by the sub-sovereign as a first step, thus increasing its direct debt in times of crisis. However, as a positive general trend, we note significant consolidation of the local and regional GRE-sectors in Europe which were worst hit during the last financial crisis, together with a steady reduction of outstanding guarantees.

Key risks relate to the capacities of the frameworks to cope with crises

Key economic risks relate to long-term financial vulnerabilities (sustainability risks) which are affecting all frameworks in Europe to some extent. These risks have re-emerged from crisis to crisis:

- *'Bottom-up accumulated' contingent liabilities* gradually burden the sovereign's balance sheet. Typically, contingent liabilities shocks have been absorbed from crisis to crisis by the sub-sovereigns or transferred over time, following the dissolution of some entities, to the central government's balance sheet.
- *Substantial delays of local and regional public investment.* Usually, real investment is postponed in times of crisis, reducing the quality of existing social and transport infrastructure, and lowering potential proceeds from and economic benefits of new projects if their implementation is delayed.

2. Policy response to the crisis

Policy responses of governments vary

Policy responses of national and sub-sovereign governments vary. Spain's decision to impose a state of emergency and lockdown, thereby centralising command of health care (a core responsibility of Spanish autonomous communities) with the national government, received widespread political backing. Similarly, while Italian sub-sovereigns are responsible for health care, key decisions to respond to the crisis are taken at the central level.

In Germany, the federal government passed legislation which defines basic rules and possible protective measures, but it remains the Länder's responsibility to implement the law. This staggered approach allows Länder with a dominant political party or parties to reach agreement and take action to combat the pandemic faster than in those Länder with more fragmented political power where reaching consensus has proved more difficult.

Conversely, health care in France is centralised and financed through the social security system. French local and regional authorities are mobilising financial resources to support certain companies, purchase medical supplies such as masks, and provide exceptional support to local communities. Most sovereigns in turn have relaxed fiscal rules to allow for more budgetary flexibility.

Central government pressures could potentially weigh on political coherence

A major uncertainty is the capacity of sub-sovereigns to achieve their policy goals in a context where national policies may change quickly and possibly alter permanently the institutional frameworks amid the crisis. To achieve policy objectives and maintain financial performance can be a challenging task for many sub-sovereigns in countries with more rigid frameworks and weigh on political coherence of the system. To cope with the legacy of the pandemic, sovereign and sub-sovereign governments will have to balance fiscal stimulus during the crisis and fiscal prudence thereafter.

We expect potentially additional counter-cyclical measures to support Europe's economic recovery, all leading to greater direct public debt or rising contingent liabilities primarily at the sovereign level but also the sub-sovereign including:

- policies aimed at protecting jobs, such as by subsidising wages or measures to supplement household income, such as higher unemployment benefits;
- the provision of financial relief for households and corporates through credit holidays and tax holidays which can also present risks to sub-sovereigns which rely on those affected taxes; or
- financial rescues of government-owned enterprises or other entities which have become commercially non-viable.

3. Higher borrowing requirements, favourable financing conditions

Sub-sovereigns benefit from accommodative financing conditions

European sub-sovereign issuers face limited liquidity risks. They retain good access to major banks and have not had any major problems in terms of market access, benefitting from accommodative financing conditions. Forceful monetary policy responses including the activation of several crisis response instruments to date should help mitigate the severe economic disruption and support the ground for the anticipated gradual recovery in H2 2020. Scope does not expect the cost of funding for sub-sovereigns to adversely impact their budgetary performance.

We expect rising borrowing requirements of sub-sovereigns this year, primarily from regional government tiers with health care responsibilities which tend to have a low share of capital expenditure, weighing on their budgetary flexibility. This includes Spanish and Italian regions which face higher funding requirements to fund health related operating expenditures and German Länder, which also have announced own debt-financed economic packages of up to EUR 65bn. In view of the likely delayed public investment for his year, we expect more capital market activity in 2021, also regarding the postponed investment share required to maintain the existing social and transport infrastructure or to fund new projects.

4. Scope's approach for rating actions

Main transmission channel is via sovereign rating actions and changes to the framework

The main transmission channel to sub-sovereign ratings will be via potential sovereign rating actions or changes to the institutional framework rather than the direct impact of the unprecedented Covid-19 crisis. Under our approach, we will closely monitor the evolution of countries' macroeconomic conditions, institutional responses and sovereign ratings and the subsequent impact on a sub-sovereign's creditworthiness. The quality of the policy response of sub-sovereigns, including their 'stand-alone' ability to successfully adjust spending in a timely way and to balance fiscal stimulus during the crisis and implement fiscal consolidation thereafter, is another determining factor.

Under our approach, a sub-sovereign rating is indicatively capped by the sovereign rating, which reflects our view that there is a minimum degree of default interdependence between sub-sovereigns and sovereigns. Moreover, sub-sovereign finances are typically not shielded from central government intervention regarding their revenues, expenditures and funding. Therefore, we would pierce the sovereign rating only in exceptional circumstances.

Scope expects downward rating pressures for those sub-sovereigns affected by a downgrade of their respective sovereign. Not all will be affected to the same extent with some stronger issuers benefitting, for example from a favourable individual liquidity and debt profile proving more resilient to the economic disruption.

We could consider taking rating actions on a case-by-case basis, if we observed that:

- the policy responses of the sub-sovereign and the sovereign are insufficient to prevent a permanent damage of the sub-sovereign’s balance sheet and its ability to repay its debt in full and on time;
- co-operation on the policy response among the sub sovereign and the sovereign breaks down, resulting in additional policy uncertainty and/or an ineffective crisis response;
- a given issuer has suffered a permanent damage and deterioration in its individual credit profile considerably more significant than that experienced by its peers;
- an issuer is unable to access capital markets or other liquidity facilities at reasonable financing rates to repay its debt; or
- downside economic risks to our revised baseline economic growth scenario were to materialise absent a commensurate policy response.

Annex: Summary of Scope's 'framework-driven' approach

Step 1 - Framework assessment: integration with the sovereign - country/government layer specific

Category	Weight	Sub-weight		Integration	Score	Weighted score
Institutionalised support	50%	25%	Transfer & bailout regime	Full	100	25
		15%	Borrowing limits	Full	100	15
		10%	Funding support	Full	100	10
Fiscal interlinkage	35%	20%	Tax authority	Full	100	20
		15%	Fiscal equalisation	Full	100	15
Political coherence	15%	10%	Distribution of powers	Full	100	10
		5%	Common policy making	Full	100	5
			Integration with the sovereign		Σ	*100*

Integration	Indicative range
0-10	0-10
10-20	0-9
20-30	0-8
30-40	0-7
40-50	0-6
50-60	0-5
60-70	0-4
70-80	0-3
80-90	0-2
90-100	0-1

Step 2 - Individual credit profile - issuer specific

Category	Weight	QS	Risk	Score	CVS	Score	Weight	Total (QS-CVS avg)
Debt burden and liquidity profile	40%	Debt profile	Low	100	Interest, % op.rev.	43	50%	79
		Contingent liabilities	Low	100	Debt, % op.rev	51	25%	
		Funding and liquidity mgmnt	Low	100	Balance before debt, % op.rev.	94	25%	
		Debt QS score	Σ	100	*Debt CVS score*	Σ	58	
Budget performance and flexibility	30%				Operating balance, % op.rev.	100	40%	72
		Budget management	Low	100	SD operating balance	90	15%	
		Expenditure flexibility	Medium	50	Personnel exp., % op.exp.	66	15%	
		Revenue flexibility	Medium	50	Capex, % tot exp.	70	15%	
					Transfers, % op.rev.	24	15%	
		Budget QS score	Σ	67	*Budget CVS score*	Σ	78	
Economy and social profile	20%				GDP per capita	15	40%	40
		Growth & diversification	Medium	50	Unemployment rate	51	20%	
		Labour market & demographics	Medium	50	GDP volatility	62	20%	
					Old-age dependency ratio	7	20%	
		Economy QS score	Σ	50	*Economy CVS score*	Σ	30	
Quality of governance	10%	Recent events & policy risk	Low	100	Quality	66	33%	73
		Transparency & accountability	Low	100	Impartiality	36	33%	
					Corruption	34	33%	
		Governance QS score	Σ	100	*Governance CVS score*	Σ	46	
							Individual credit profile Σ	*68*

Step 3 - Indicative rating: notch adjustment - *downwards* - from sovereign rating

Indicative sub-sovereign rating			Individual credit profile: *68*						
			Strong		Medium		Weak		
			≥ 75	≥ 65	≥ 55	≥ 45	≥ 35	≥ 25	< 25
			Indicative maximum notch adjustment from sovereign rating:						
100	Full	0 - 1	0	0	0	-1	-1	-1	-1
Institutional framework: integration with sovereign		0 - 2	-1	-1	-1	-1	-1	-2	-2
		0 - 3	-1	-1	-1	-2	-2	-2	-3
		0 - 4	-1	-1	-2	-2	-3	-3	-4
	Medium	0 - 5	-1	-2	-2	-3	-3	-4	-5
		0 - 6	-2	-2	-3	-3	-4	-5	-6
		0 - 7	-2	-2	-3	-4	-5	-5	-7
		0 - 8	-2	-3	-4	-4	-5	-6	-8
	Low	0 - 9	-2	-3	-4	-5	-6	-7	-9
		0 - 10	-3	-4	-5	-6	-7	-8	-10

Issuer
Sub-Sovereign A
Country
Country of A
Sovereign rating
AAA
Indicative rating adjustment
0
Additional considerations
-
Final rating
AAA

Our approach to rating sub-sovereigns is split into three fundamental steps:

(1) We determine the degree of intergovernmental integration between the sovereign and sub-sovereign entity per government tier by assessing the supportiveness of the institutional framework. We determine an indicative rating range vis-à-vis the sovereign rating whereby, the higher (lower) the level of integration, the narrower (wider) the range.

(2) Having established the indicative rating range from the sovereign within which the ratings of the respective sub-sovereigns can fall, we assess the individual credit profile by benchmarking core variables and qualitative factors against national peers.

(3) We determine the indicative sub-sovereign rating by mapping the indicative maximum rating distance from the sovereign rating, as determined by the institutional framework assessment, to the individual credit profile.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com