Rating Methodology: Sub-Sovereigns Feedback Report

Scope Ratings

Scope Ratings would like to thank market participants who provided feedback on its proposed revision of the sub-sovereigns rating methodology which was published on 15 March 2019. This report addresses written comments received during the call for comments period which ended on 3 May 2019.

1. Clarifications and comments: 'Introduction'

1.1. Comment on the applicability of methodology:

- **Comment received No. 1:** Why is the US excluded? There is no explanation: if it is due to the ongoing certification process, mention that. If it is due to unique parameters for the US, mention that. Simply saying that the US is not covered by this otherwise global rating leaves the largest market uncovered for reasons that are not explicitly stated.

Scope´s answer:

The sub-sovereign fiscal framework in the United States has developed in entirely different historical and political contexts compared for example to European sub-sovereigns as reflected in their heterogeneity. US sub-sovereigns have unique characteristics which include a mature US muni bond market with municipalities having the ability to secure their bonds with a "general obligation" pledge, differing levels of tax autonomy and a formal bankruptcy procedure, with the situation differing substantially between US States and local governments. Local governments are treated as legal corporations, which may under some circumstances file for federal bankruptcy protection. This changes for State governments, which possess, in principle, constitutionally unlimited taxing powers, and do not have the legal and constitutional option to file for bankruptcy. Scope (like other agencies) considers this form of institutional set-up as exceptional with the need to define a dedicated rating approach. The explanation is now included in the introductory part of the methodology.

1.2. Comments on the mapping the individual credit profile to the institutional framework assessment

- **Comment received No. 2:** Step 3 – "determine the indicative adjustment from the sovereign rating by mapping the rating adjustment from the sovereign rating …. I find the wording rather confusing. Maybe "indicative sub-sovereign rating" would be a better term then the indicative adjustment from the sovereign rating?
- **Comment received No. 3:** In 2.1.2, referring to above comment – "The outcome of this assessment is then used to determine the indicative distance between the sovereign or higher-tier government and the rating of the sub-sovereign entity". This suggests that you do two assessments, the outcome of which would lead to an additive adjustment, doesn't it?

Scope´s answer: We changed the wording in step 3 from 'indicative adjustment from sovereign rating' to 'indicative sub-sovereign rating'. Similarly, we adopted the following wording in the respective paragraph: "We determine the indicative sub-sovereign rating by mapping the maximum rating distance from the sovereign rating, as determined by the institutional framework assessment, to the individual credit profile".

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Methodology

Rating Methodology: Sub-Sovereigns

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- **Comment received No. 4:** The matrix in Figure 2 raises numerous issues: The credit notches are all positive: I understand that the intent is that the sovereign caps the rating and sub-sovereigns then have differing degrees of notching downwards, this is not explicitly stated. The mapping uses exclusively positive integers, these should all be negative for clarity and to avoid confusion. The matrix is first understandable after reviewing the case study. The 1-10 scale and the 75-25 scale are not explained in the text where the matrix is first shown. This would be useful for understanding at an earlier point and without having to refer to the case study.

Scope´s answer: The mapping table has been updated, with the rating distance from the sovereign ratings expressed by negative notches. The 1-10 – and 75-25 scales are introduced in the above paragraphs “Step 1” and “Step 2”, which also refer to the related chapters including a more detailed description. A reference to the case study was also added.

1.3 Comments on the definition of rating range

- **Comment received No. 5:** It strikes me as odd when a sub-sovereign that is subject to market discipline, do not rely on sovereign transfers and generally acts in a responsible manner (self-financing, prudent spending, low share of debt owed to higher-tier governments, etc.) would then be effectively punished showing wide indicative rating ranges (low assessment of intergovernmental integration if sub-sovereigns retain control over revenues with limited higher-tier influence, low degree of funding support, etc.). This implies that what Scope is rating is less the sub-sovereign’s ability to service its debt burden and more the degree to which they are subservient to and financed by the sovereign. This may also have implications for countries with a significantly weaker institutional structures, effectively downgrading them for sub-sovereigns with greater financial autonomy.

Scope´s answer: Contrary to other approaches, our framework analysis does not result in uplift-notches or downward-adjustments from the (individual) sub-sovereign rating/creditworthiness. The indicative rating range (for a certain government tier within a country) serves as a guidance for the analysis of the individual credit profile.

Under the new methodology, a combination of individual strengths (for example, prudent spending, low debt etc.) with a relatively wide indicative downward rating range from the sovereign rating (low integration) does not prevent those sub-sovereigns from a high rating. However, individual credit strength is a necessary condition for a high rating in less integrated frameworks, while high integration and a weak individual profile could also result in a high rating.

Moreover, a wide indicative range, for example based on low transfer dependency from the sovereign, would allow a sub-sovereign to pierce the sovereign rating, provided the sub-sovereign’s individual credit profile and autonomy is assessed as very resilient against potential shocks, including a sovereign rating downgrade.

The new version of the methodology (following the call for comments) includes a separate chapter (chapter 4 – Ratings above the sovereign and sensitivity to sovereign rating changes) dedicated to the relationship between the sovereign and sub-sovereign to show more transparently under which circumstances Scope

i) rates a sub-sovereign above the sovereign and

ii) adjusts a sub-sovereign rating in the case of a sovereign rating change.

- **Comment received No. 6:** In 2.1.1. the indicative deviation of the sub-sovereign's final rating is given without direction, this should only be a negative deviation under the given circumstances.

Scope's answer: We clarified the wording in the new version. The indicative distance from the sovereign is a maximum downward notch adjustment for a sub-sovereign of the same government-tier in a given country.

- **Comment received No. 7:** page 6, step 1 – should the range for distance to the sovereign not start at zero notches as a sub-sovereign rating can also be equalized with the sovereign due to institutional ties, as we have it in Germany? You might also want to say – (minus) to 10 notches, as the adjustment is only downwards.
- **Comment received No. 8:** 2.1.1 – zero ~~to one~~ notches
- **Comment received No. 9:** In 2.1.1 the rating range distance to the sovereign should start at zero notches as a sub-sovereign rating can also be equalized with the sovereign due to institutional ties. Figure 2 – 1-10 column would have to start at 0 as per above, suggest to also highlight that these are notches.

Scope's answer: The lowest indicative range of the framework is set to a maximum one-notch range, which means indeed that the range is effectively from 0 to 1 from the sovereign rating. This is to reflect the fact that sub-sovereigns in highly integrated political systems are: i) separate legal entities; and ii) rely to a limited extent on their individual credit strength. In the case of a very high intergovernmental integration, a strong importance of the assessment is attributed to the framework under which the sub-sovereign operates. However, we recognize that even in the context of full alignment according to our framework assessment, an exceptionally weak individual profile (as defined in chapter 5.1.1. – review of exceptional circumstances) does not automatically lead to a full alignment of its ratings with the sovereign.

Clarifications and comments: 'Institutional framework assessment'

- **Comment received No. 10:** 2.2: the language 'constitutional transfers' is used, but there is no transfer of constitutions. This should be 'constitutionally permitted transfers'.

Scope's answer: The above-mentioned expression is now replaced by "transfers provided for by the constitution".

- **Comment received No. 11:** Figure 8: again, the indicative notching adjustment is only positive. There is no direction stated, the intended negative adjustments are only implied.

Scope's answer: The figure is now updated by referring explicitly to downward adjustments

- **Comment received No. 12:** Scope may wish to reconsider the relative weights of the three factors for the institutional framework assessment (currently 50%/35%/15%). Under the proposal the highest weight is assigned to the institutionalized support. This is understandable, if the focal point of analysis is a potential default and potential losses stemming from this. However, as Scope rightly points out elsewhere in the paper (p.19), default is rare for sub-sovereigns in Western Europe. A more useful focal point for analysis for assessing German Länder therefore is the identification of potential problems with a sustainable budget performance, short of an actual default. For this, however, the degree of fiscal interlinkage is by far the more relevant factor as compared to institutionalized support.

Scope's answer: Scope appreciates the view that selected weights do not always mirror the institutional framework's relative importance across countries, also reflecting the heterogeneity of institutional set-ups under which sub-sovereigns operate. In general, it is Scope's view that the three factors of the framework assessments are often complementary with the scorecard results providing a comprehensive summary of our assessments. The chosen weights however show Scope's view that institutionalized support is the most explicit form of the willingness to support. While fiscal interlinkage is also important for the framework analysis, a sub-sovereign's budget performance is analysed as part of the individual credit profile.

- **Comment received No. 13:** As regards "funding support" (page 9), Scope proposes that "common issuance" be regarded credit positive. While common issuance can undoubtedly be an indicator of a high level of integration, there are – at least in mature and liquid markets – good reasons why sub sovereign issuers prefer to issue autonomously and where this is in no way an obstacle to an otherwise high level of fiscal integration. Also, please note that there appears to be a incoherence between the text and the table on page 9, as the table defines "full integration" as "highest: autonomous and / or joint issuance with risk weights aligned to the sovereign"

Scope's answer: The framework assesses the degree of integration with the sovereign, which is considered to be high if autonomous funding occurs under equal risk weights or if both levels of government issue together. While autonomous funding is not credit-negative under our framework assessment, it shows a lower degree of integration with the sovereign which results in a potentially wider rating range for a certain government tier as compared to situations where both issue together (high integration) or with one-sided dependence of a sub-sovereign on the sovereign's funding support (medium integration). For the latter situations, we assume a higher probability of sovereign support during situations of fiscal distress as compared to frameworks with complete funding autonomy under separate risk weights. We assess as fully integrated both systems with i) common issuance and with ii) autonomous issuance when the risk weights are identical to the sovereign. On the contrary, we assess autonomous issuance de-linked from the sovereign with separate risk weights to signal low integration, resulting in a potentially wider rating range per government tier.

- **Comment received No. 14:** From the perspective of a German State, we appreciate your acknowledging the importance of the institutional framework. We understand your concept to be based on the rating results of the respective sovereign, with adjustments depending on the level of intergovernmental integration. While this "top-down" approach is certainly appropriate for regional governments which are literally subordinate, it appears less convincing in cases where the regional governments act more independently, like quasi-sovereigns. Regional governments in federal systems in particular enjoy far-reaching legislative powers and may have strong economic weight as well as political clout. A good example are German States, which provide most of domestic public services in the country, not only for themselves, but also on behalf of the federal government. While technically sub-sovereign, German States deal with the Bund at arm's-length and share the administrative tasks (as opposed to acting on the sovereign's orders). For credit rating purposes, such issuers should be treated more like sovereigns rather than subordinates. A "bottom-up-approach", based on a set of regional metrics, with possible uplifts depending on the institutional framework, would be more appropriate than "mapping" the individual profile to the institutional assessment.

Scope's answer: Under our approach, a high integration between the sovereign and a sub-sovereign (or government tier) does not imply one-sided "dependence" of the latter on the sovereign. According to our approach, we assess a framework to be fully integrated if it is characterised by high mutual dependence across government levels. For example, the high co-ordination needs between German Bundesländer and the federal government are visible in the federal legislation ("zustimmungspflichtige Gesetze"), common legislative bodies ("Vermittlungsrat") or more informal institutions (Bund-Länder-Ausschüsse).

We believe that a framework-driven, i.e. Top-down approach is appropriate for the credit analysis of sub-sovereigns for two reasons: i) sub-sovereigns are usually not shielded from the jurisdictions of national courts and consequently their ability to honour debt obligations depends on the functioning of the relevant national legal system, regulation and/or policy framework. The recent financial crisis confirmed that the capital market funding ability of sub-sovereigns can be impaired if the sovereign faces financial distress; ii) we are only aware of very few instances of sub-sovereigns defaults, while at the same time we have identified frequent events of explicit or implicit support between government levels, which prevented fiscal distress or outright default.

We agree that the German Länder provide a high share of general government public services when compared to sub-sovereigns in most jurisdictions. At the same time, we acknowledge the high degree of shared decision-making across government levels. It is our view that the degree of shared decision-making, combined with the history and/or legal framework to provide support in case of distress, constitutes a major determinant for our assessment of credit risk.

Our assessment results would be more similar to that of a bottom-up approach in cases of low framework integration and hence a higher importance of the individual credit profile. However, in cases of high integration we put more emphasis on the fact that the weak individual credit profile of a sub-sovereign can be outweighed by a highly integrated framework.

- **Comment received No. 15:** With regard to the institutional assessment as such, we find that this kind of evaluation does not lend itself easily to the scorecard approach you suggest. Your categories of "institutionalised support", "fiscal interlinkage" and "political coherence" refer to topics which are doubtless relevant in such analyses. However, the numeric approach that you suggest will not easily do justice to the complex correlations between these topics, which are not easily measured in numbers. An integrated evaluation based on a qualitative assessment would be more appropriate, in our view.

Scope's answer: We share the opinion that the assessment of an institutional framework requires a qualitative assessment and we emphasize that the scorecard result is supposed to reflect an integrated qualitative assessment of the institutional framework to ensure international comparability of the framework assessments. At the same time, we have decided to encapsulate the qualitative assessment with weights and three dimensions to select per category. Thereby, the analyst can use a transparent instrument to relate the assessment to an international context, i.e. other government tiers within the same country, other constitutions and/or jurisdictions. Also, the scorecard alone only provides an overview of the assessment, while a qualitative justification for the selection has to be provided, which we believe increases the analytical robustness of the approach and makes it more transparent at the same time.

- **Comment received No. 16:** page 7, 2.1 first para - Would you always start at the sovereign even when assessing a second tier sub-sovereign (e.g. in

Germany a Landkreis) or do you have to rate the upper level first (i.e. here, the state). As the linkage between sovereign and first tier can be different to the linkage between 1st and 2nd tier, would the level of institutional framework assessment not broaden?

Scope's answer: Usually, the sovereign constitutes the starting point of the institutional framework assessment. This holds also for second-tier governments, since usually their intergovernmental legal, fiscal and political relations with the sovereign are more relevant that those with the next-tier government. At the same time, the analysis of a certain layer of government always requires an understanding of the relation between the higher-tier government and its surrounding levels as a starting point of our assessment. Our framework analysis therefore entails an analysis of these relationships irrespective of the rated entity's government level.

- **Comment received No. 17:** 2.3 - could it be that the maths is wrong? If, on the integration scale you use 0 points for low and 1 for high, the sum-product (sum of weighted points) can max be 1, not 100. You are also using points and score interchangeably (I think), maybe better stick to one term.
- **Comment received No. 18 :** 3.2 Scorecard calculations "We use a point system from 1 to 100 for quantitative and qualitative scorecards. In cases where both scorecards are applicable, the two scores result in the individual credit score which we map to our assessment of the institutional framework". Why do you now speak about "credit score" whereas above you only speak about scores?

Scope's answer: The integration scale for the scorecard of the institutional framework has been corrected: 0 points for low and 100 points for full integration, with a sum of weighted points, which can reach a maximum of 100. The inconsistency between the terms "points" and "scores" has been solved.

3. Clarifications and comments: 'Individual credit profile'

- **Comment received No. 19:** With regard to the individual credit profiles, a scorecard approach is certainly a feasible option. However, we find the way you mix qualitative analysis, quantitative analysis and peer review not entirely convincing. The forward-looking assessments point to relevant aspects in the risk categories that you mention. It is not quite clear, however, what the additional quantitative assessments can add to that. The number of indicators appears to be very large, and the rationale for the specific weightings provided to each indicator is not always clear. The overall complexity of the approach could possibly impair the transparency of the analysis and the reasons for a specific rating result.

Scope's answer: Scope´s methodology favours a scorecard approach to enhance transparency and provide guidance for the analysis, by ensuring consistency of the assessments. By combining a qualitative and quantitative analysis we enhance the completeness of the analysis. The quantitative analysis allows us to anchor the analysis to harmonized fiscal data based on the comparison of key quantitative indicators with national peers. The qualitative analysis allows us to fully capture the individual credit characteristics in our assessments, by including a forward-looking assessment of budgetary figures over the financial planning period, for example. We understand that providing a complete structure for the analysis we perform may involve a certain degree of complexity, but we accepted this trade off since the priority pursued by our approach is to enhance transparency, completeness and consistency of the assessment. The selection of the 15 core quantitative ratios is based on empirical economic research, analytical judgement and data availability. We believe the number of indicators is manageable and that a smaller number of indicators would risk not to capture sufficient information to properly implement the comparison among peers. The weights applied to each indicator (showed on page 19) reflect their mutual interdependence, correlation and relative importance for financial distress as observed in history.

- **Comment received No. 20:** 3.1 throughout – you provide weights for the four key categories and also for the 15 CVS parameter, but not for the QS parameter. Why is that? (see that you speak about "arithmetic mean" in 3.2.1. Maybe you want to mention this already earlier.

Scope's answer: All QS variables under the same risk category receive equal weights. We have added clarification in the section 3.1 on page 15. The QS score for each of the four risk categories is then combined with the CVS score of the same category. In general, we expect to apply a 50% weighting to both scorecards. However, in cases of insufficient data availability a different relative weight of the two scorecards (QS and CVS) can be applied, subject to rating committee decision.

- **Comment received No. 21:** In paragraph 3.2 It is stated that the individual credit score results from the result of the two scorecards in case where both are applicable. 1) This means that they do not always both apply? 2) The terminology "credit score" is new, since above only the generic term "scores" is used.

Scope's answer: Please refer to the answer on the comment No. 20 with regards to the weighting of QS and CVS, which depends on data availability. On the terminology: We have clarified the language to be consistent.

4. Clarifications and comments: 'International comparison'

- **Comment received No. 22:** 3.2.2: It is clearly stated that the comparison is with national peers, but the last sentence of the first paragraph implies that a comparative analysis is executed across sub-sovereigns and across time. How is this done? The only comparison is explicitly with national peers. The language used either needs to be made more precise or, if an international analysis is done, what are the mechanisms used? This is tied in with 5.1.1.

Scope's answer: The national comparison applies to the quantitative CVS analysis in order to acknowledge that sub-national fiscal, economic and debt data: i) need to be reviewed in the context of the respective framework; and ii) international comparisons often rely on different national accounting policies. This approach ensures that the ratios selected are more meaningful (as compared to the application of absolute thresholds) and allows us to make a comparative analysis across sub-sovereigns and across time, which is essential to ensure consistency. However, we complement the overall analysis of the individual credit profile with an international comparison. This is especially important for cases with a lack of sufficient data to perform a CVS peer analysis.

- **Comment received No. 23:** 5.1.1: International peer comparison is executed only under specific criteria based on inadequacy of publicly available data or for foreign issuers with public or private ratings. This appears to imply once again that the sub-sovereign rating methodology will only provide national ratings without being comparable internationally. Hence a rating for a sub-sovereign in Italy cannot be properly compared to a sub-sovereign in Spain, reducing the usefulness of the sub-sovereign ratings. Given that there is a indicative sovereign cap and the rating is executed using national peers, are there not problems with international comparisons? While recognizing the technical issues, the lack of international comparability weakens the usability of the ratings significantly, as direct comparability of sub-sovereigns, capped by their sovereign and compared only to the national peer group, lacks a universal background that exists otherwise for ratings.

Scope's answer: In paragraph 5.1.1 we state that we supplement our analysis of the individual credit profile with an international peer comparison. The international comparison is further underpinned by starting the analysis with the sovereign rating and by applying an internationally comparable framework assessment, resulting in an indicative rating range vis-à-vis the sovereign ratings. in cases where data availability allows for the application of the CVS, we will perform the international comparison as a final step of the rating analysis. Conversely, in cases where the lack of data availability for national peers does not allow to perform a CVS, we will make use of more extensive information on international peers to perform the assessment of the individual credit profile.

5. Clarifications and comments: 'ESG risks'

- **Comment received No. 24:** You mention that you also consider ESG factor in your assessment. While we believe that ESG factors can be an important contribution to credit ratings, we feel that a strict test of materiality should apply. Only where a clear and convincing link between ESG performance and the risk of financial default exists can the inclusion of ESG factors improve the quality of a credit rating. The different time horizon should also be kept in mind. Strength or weaknesses with regard to ESG performance will often be material over the long term, but a significant number of investors may want to assess the risk of default over the short or medium term where such factors do not have the same relevance. With regard to the case of stranded assets in particular, this kind of risk will not always be material for issuers from the public sector, given their typical mandate.

Scope's answer: Scope completed the related section with considerations regarding the assessment of timing and materiality in factoring ESG criteria.

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