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FACTORS DETERMINING RATING BASIS OF LOCAL GOVERNMENT UNITS

Summary

The need to obtain information regarding credit rating of entities, both public and private was the reason for rating agencies development. A worldwide rating market is characterised by a dominance of the largest international agencies, including: Standard & Poor's, Moody's and Fitch. Rating is one of the tools increasing the competitiveness of a local government unit. The purpose of this study is to present the nature of rating as well as rating criteria of local government units employed by rating agencies.

Key words: rating, rating agency, local government units

JEL Classification: G24, H74

Introduction

The scope of tasks imposed on local government units as well as limited financial resources of entities, resulted in the necessity to seek external financing. So-acquired capital is most often allocated to investments financing, primarily the long-term ones. Information regarding a local government unit condition enabling use of the tools are ratings – assessments made by rating agencies.

The basic task of rating agencies is to collect, analyse and evaluate information concerning credit rating, thus solvency. A rating agency is an investment consulting company, defined as legal entity, whose main area

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of activity refers to issuing credit ratings, that is creditworthiness of an investigated entity.¹ The purpose of agency development was to enhance transparency in a market and facilitate investors an access to an independent evaluation.

A credit rating system is employed in different sectors of the economy due to versatility and various types of methodology including the specific nature of entities or issue of securities. Rating may be applied to²:

- countries,
- local government units,
- insurance companies,
- financial institutions (e.g. banks and investment funds),
- industries,
- enterprises,
- mortgage bonds,
- bonds, including income bonds.

A research literature defines rating as an assessment and investment risk classification system³. Other definition refers to rating as comprehensive creditworthiness of an issuer or an assessment of the issuing, considering specificity and accuracy of an issuer in compliance with past commitments as well as a projection of future financial standing, and an analysis of all types of risk connected with the investment⁴. Simplifying the second definition, it may be stated that rating refers to an opinion concerning a possibility of debt repayment by a particular entity. The essence of rating relates to the fact that a study includes historical data, however rating itself refers to debt service made by an issuer, or a lender in future, thus it is targeted at future events⁵.

¹ Regulation (EC) No 1060/2009 of the European Parliament And of the Council of 16 September 2009 on credit rating agencies. OJ.EU L 302 from 17.11.2009.

² <https://www.fitchpolska.com.pl/>

³ D. Dziawgo, *Credit rating na międzynarodowym rynku finansowym*, PWE, Warszawa 2010, p. 69.

⁴ D. Dziawgo, *Credit – rating – ryzyko i obligacje na rynku międzynarodowym*, PWN, Warszawa 1998, p. 113.

⁵ <https://www.fitchpolska.com.pl/pl/regulatory/ratings-definitions.html> (05.05.2016).

1. Rating agencies and applicable rating scales

Rating background dates back to the first half of the nineteenth century, with the introduction of rating in 1909, when John Moody published the first bond rating using a proprietary method of issuers credit rating in a form of the universal letter code, which has become a global standard over the years. Such way of a synthetic view presentation was positively accepted by market participants, since it was based on the assumptions that a quality and accuracy of the analyses are the result of high competence level of entities (specialists) involved in analyses preparation as well as their independence and objectivity.

A worldwide rating market is characterised by a clear dominance of the largest international agencies⁶, including:

- Standard & Poor's Rating Services (Standard & Poor's or S&P)⁷,
- Moody's Investors Service Inc. (Moody's)⁸,
- Fitch Ratings Ltd. (Fitch)⁹.

It is estimated that the three largest agencies so called 'the Big Three' hold over 90% of a global market regarding the service: S&P – 40%, likewise Moody's and Fitch about 15%.¹⁰ Total revenues of all the above agencies approached USD 6 000 billion in 2014 (Figure 1 illustrates global market share of rating agencies in 2015).

Polish rating agencies hold a short history, CERA S.A. (the Centre of Analyses and Rating) was established as first in Poland and Central and Eastern Europe in 1996 acting on the Polish Bank Association initiative. The Agency was responsible for businesses, local government units, and financial institutions assessments. However, the demand for services performed by a local agency appeared to be lower than it was expected at

⁶ Rating agencies operating on an international market include, inter alia: A.M. Best Company Inc., Japan Credit Rating Agency Ltd., Dominion Bond Rating Service Ltd. of Canada, Rating and Investment Information Inc. of Japan, Egan-Jones Ratings Company, LACE Financial Corp., Realpoint LLC.

⁷ The company Standard & Poor's started activity in 1860 with a publication of financial statistics - currently it belongs to McGraw Hill Companies.

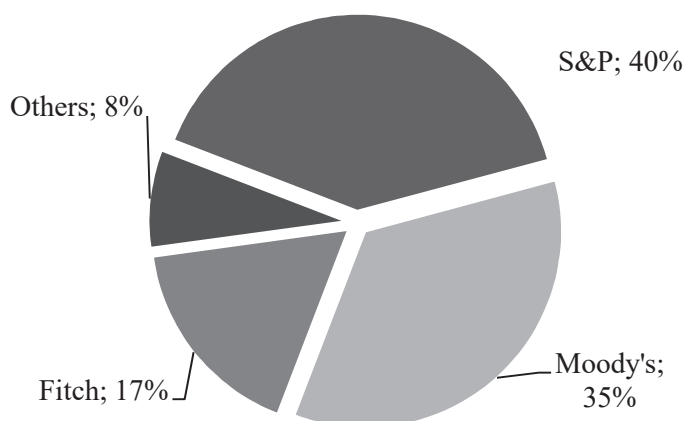
⁸ Moody's Investors Service was created in 1900 as John Moody & Company - currently it is a part of Moody's Corporation.

⁹ Fitch Ratings was founded in 1913 as Fitch Publishing Company - currently it is a part of Fitch Group Company.

¹⁰ I. Bobrek, *Działalność agencji ratingowych na przykładzie sektora publicznego w Polsce*, Scientific Journal ZPSB Firma i Rynek 2016/1, p. 44.

the moment of establishing; within five years of activity the agency published 15 ratings. In 1998 an American agency Thomson Financial BankWatch (TFBW) became the company's strategic investor, which in 2000 was taken over by Fitch Ratings Ltd. In 2001, due to global market takeovers, CERA SA. lost its sole local nature and became a part of an international concern Fitch Ratings Ltd.¹¹ Whereas since 2007 the EuroRating¹², Rating Agency has worked, responsible for enterprises and financial institutions credit ratings, including banks operating in the area of Central and Eastern Europe.

Figure 1. A share in a rating market of selected agencies in 2015



Source: own work based on: *Jak wielka trójka agencji ratingowych decyduje o wiarygodności i wpływa na rynki*, <http://biznes.gazetaprawna.pl/artykuly/941796,wielka-trojka-agencji-ratingowych-rynki-finansowe.html>, J. Żabińska, *Rola i miejsce agencji ratingowych na rynkach finansowych Unii Europejskiej*, Departmental Scientific Journal of Katowice University of Economics. *Innovations in Banking and Finance*. vol. 2; 174, Katowice University of Economics Publishing House, Katowice 2014, p. 30.

Credit rating issued by rating agencies - is regarded as a primary cause of their success. Categories prepared by agencies provide fast information concerning a condition of a given enterprise or country, thus

¹¹ J. Brylak, *Agencje ratingowe na rynku inwestycji. Prawne aspekty instytucji*, Scientific Journal PTE no 11/2011, p. 313.

¹² The Agency does not deal with credit rating of local government units, but publishes credit rating of entities subsidiary, leading a guarantee activity. <http://www.eurorating.com/>

saving investors time it would have to be spent for in-depth analysis of International Monetary Fund. reports. A rating scale employed by most of agencies relies on letters (where A refers to the highest grade, and D respectively to the lowest)¹³. Additionally, a grade is completed by modifiers – numbers (1,2,3 e.g. Mood's) or signs (+) and (-) (e.g.. Fitch and Standard & Poor's) - to further fine-tune the rating. Moreover, a forecast of changes for upcoming years is presented. A favourable rating outlook indicates the possibility of rating upgrading, negative rating – rating downgrading, whereas stable – upgrading or downgrading.

While rating, securities symbols are diversified. In bonds rating system there are two levels: investment and speculative, however four groups of rating are used, from AAA to D (it was necessary to extend rating scale due to a financial market development). In both classifications, of Moody's Investors Service, and Standard & Poor's, a definition of 'high grade' means lower credit risk, thus a high probability of obligation repayment. The first four levels: AAA, AA, A and BBB are regarded as investment securities, where debts, interest and additional benefits are to be regulated on time. Securities classified as BB are regarded as speculative; a C category is perceived as income bonds, however payment of interest depends on a possible corporation profit. Bonds verified as D are extremely risky, and reclaiming of the capital invested may be possible in case of an enterprise liquidation¹⁴. A rating system used by leading rating agencies has been presented in Table 1.

Initially, it was presumed that rating agencies would act as independent, objective guardians of investors' money, but over time and due to outbreaks of further crises and bankruptcy¹⁵ resulting from

¹³ A. Sarnik-Sawicka, *Wpływ działalności międzynarodowych agencji ratingowych na stabilność systemu finansowego* [in:] *Rola międzynarodowej współpracy finansowej w tworzeniu norm i regulacji ostrożnościowych zabezpieczających stabilność systemu finansowego*, J. Żabińska (ed.), AE, Katowice 2010, p. 79.

¹⁴ C. A. Frost, *Credit rating agencies in capital markets: a review of research evidence on selected criticisms of the agencies*, State University of New York at Buffalo, June 2006. p. 25.

¹⁵ An interest in rating agencies activity and ratings issued particularly intensified after the financial crisis outbreak in 2008. Findings after the crisis cause analyses were used to implement new law regulations both in EU, as well as outside EU. In 2011 EU established an organisation European Securities and Markets Authority (ESMA), which since July 2015 has directly supervised registered rating agencies.

creative accountancy and weaknesses of legal solutions, serious doubts have been raised concerning the functioning of rating agencies.¹⁶

Table 1. Rating system and characteristics of rating by selected rating agencies

Level	RATING AGENCIES			Characteristics
	Fitch	Mood's	Standard & Poor's	
Investment	AAA	Aaa	AAA	<ul style="list-style-type: none"> • prime bonds rating, • zero default risk,
	AA	Aa	AA	<ul style="list-style-type: none"> • prime bonds rating, • obligor's capacity to meet financial commitments, instalments and interests is extremely strong,
	A	A	A	<ul style="list-style-type: none"> • high repayment credibility, • risk of lowering beneficial features of investment,
	BBB	Baa	BBB	<ul style="list-style-type: none"> • medium bonds rating, • deficient grade of some issuance components,
Speculative	BB	Ba	BB	<ul style="list-style-type: none"> • medium debt protection,
	B	B	B	<ul style="list-style-type: none"> • insufficient guarantee of financial commitments, instalments and interests,
	CCC	Caa	CCC	<ul style="list-style-type: none"> • low issuance grade,
	C	Ca	C	<ul style="list-style-type: none"> • extremely speculative issuance, • substantial repayment risk
	DDD	C	DDD	<ul style="list-style-type: none"> • extremely risky bonds (junk bonds)
	DD		DD	<ul style="list-style-type: none"> • default imminent
	D		D	<ul style="list-style-type: none"> • default imminent

Source: own work based on: D. Dziawgo, *Ryzyko i obligacje na międzynarodowym rynku finansowym*, PWE, Warszawa 2010, p. 109-110; and own description based on : www.fitchpolska.com.pl, www.standardandpoors.com, www.moodys.com

¹⁶ More: J. Żabińska, *Rola i miejsce agencji ratingowych na rynkach finansowych Unii Europejskiej*, Departmental Scientific Journal of Katowice University of Economics, Economic Studies; *Innovation in Banking and Finance* Vol. 2; 174, Katowice University of Economics Publishing House, Katowice 2014.

2. Rating of local government units and rating characteristics

Local governments' entrance to a capital market was possible due to records enclosed inter alia in the European Charter of Local Self-Government¹⁷. Two basic elements determine a rating issuance of local government units. Firstly, a lack of possibility of bankruptcy by local government bodies - a special character of tasks provided by the organs requires a guarantee of constant and uninterrupted activity within a field of public utility; entities operate regardless of their financial condition and a potential insolvency of the entities may not result in their liquidation.¹⁸ Secondly, there is a rule stating that a financial credibility of a unit cannot be higher than credibility granted to a country thus country rating influences a unit rating. However, there are possible exceptions from the rule – for example the Fitch agency allows a situation when a local government unit of high legal and fiscal autonomy, may receive higher rating than national one. Though regarding Poland, the agency definitely emphasises that a decentralisation process causes a frequent changes of tasks performed by local governments, which results in unfavourable influence on their budgets, as usually resources transferred to fund new tasks are insufficient. A fast growth of payroll expenses, primarily due to government decisions concerning the increase of salaries in education without proper funding results in a pressure on local government budgets and an increase in fixed expenditures in their budgets.¹⁹

The first rating for a local government unit was issued in 1997 by Standard & Poor's agency – it was granted to Łódź, and in the same year to Kraków. In 1998 Wrocław and Szczecin were rated, in 2000: Gdańsk and Bydgoszcz. The first ratings obtained by large towns reached

¹⁷ Article 9, paragraph 8 constitutes that: 'For the purpose borrowing of capital investment, local authorities shall have access to the national capital market within the limits of the law'. The European Charter of Local Self-Government formulated in Strasbourg on 15 October 1985, Journal of Laws from 1994, No. 124, item 607 (rectification of the document title – earlier The European Charter of Regional Self-Government – The Minister of Foreign Affairs Notice of 22 August 2006 on the rectification of the error, Journal of Laws from 2006, No. 154, item 1107).

¹⁸ Article 6, subparagraph 2 of the Act of 28 February 2003. The Bankruptcy and Reorganizational Law (Journal of Laws, No 175, item 1361 as amended). More: M. Langer, *Problem niewypłacalności jednostek samorządu terytorialnego*, Prawo Budżetowe Państwa i Samorządu, 3[2]/2014, p. 83-99.

¹⁹ *Otoczenie prawne samorządów w Polsce*, Special Report, www.fitchratings.com

investment grade, meaning the ability to regulate long-term commitments, however a negative outlook indicated a possibility of rating downgrading due to economic or political changes.

For almost ten years, Poland ratings have been maintained at a relatively constant or increasing level. However, in January 2016 rating downgrading took place by Standard&Poor's agency, from a previous 'A-' 'BBB+'²⁰. Consequently, in case of Kraków a creditworthiness dropped from 'A-' to 'BBB+' (Standard & Poor's), additionally the outlook was changed to negative.²¹ Table 2 presents rating for selected towns in 2016.

Table 2. Rating for selected towns in Poland in 2016 (for long-term obligations in foreign currency)

Town	Grade	Rating outlook	Rating agency	Date of rating confirmation
Bydgoszcz	BBB+	stable	Fitch	09.09.2016
Chorzów	BB+	stable	Fitch	30.07.2016
Gdańsk	A-	stable	Fitch	16.09.2016
Katowice	A-	stable	Fitch	22.07.2016
Kraków	BBB+	negative	Standard&Poor's	21.01.2016
Łódź	BBB+	negative	Standard&Poor's	22.01.2016
Szczecin	BBB+	stable	Fitch	15.07.2016
Warszawa	A2	negative	Moody's	17.05.2016

Source: own description based on: www.fitchpolska.com.pl, www.standardandpoors.com, www.moodys.com

In a presented ranking, Warszawa, Katowice and Gdańsk have the best rating. Warszawa, like Katowice, owe favourable financial results to companies that pay income tax where there is the main headquarter. CIT (Corporate Income Tax) constitutes a very large part of local governments income in big towns. Due to this fact, Warszawa possesses a relatively low debt, moreover Warszawa's authorities rationally

²⁰ http://www.spratings.com/en_US/topic/-/render/topic-detail/global-sovereigns (access 20.01.2017).

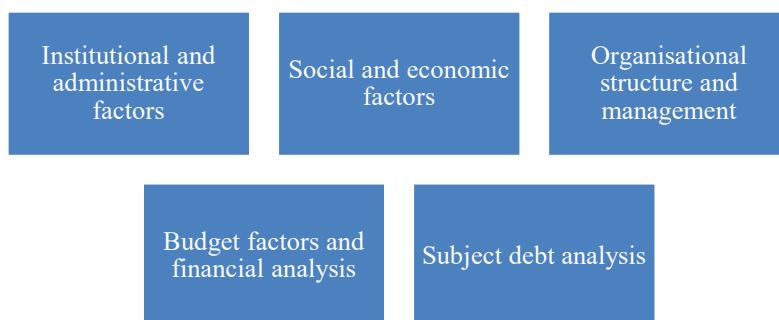
²¹ S&P downgrades rating for Krakow and Łódź, 22.01.2016, <http://www.money.pl/gospodarka/wiadomosci/artykul/sp-obniza-rating-tym-razem-dla-krakowa-i,128,0,2003584.html>

determine the investment tasks.²² In case of Gdańsk, high rating was guaranteed by positive operating results and strong operation and debt repayment ratios in the medium term. Gdańsk rating also illustrates proper strategic and financial management, together with right operation results ensure a town a high ability to fund investments of own resources.²³

3. Rating criteria of local government units employed by rating agencies

Local government rating is formed as a result of detailed analysis, based on extensive sets of micro- and macroeconomic information. While evaluating the economic condition of an examined subject, rating agencies primarily analyse five basic factors which constitute a basis for credit rating of local government unit. The following elements are examined (Chart 2): institutional, administrative, social, economic and budget factors, an organisational structure and management, as well as a financial analysis and subject debt are executed.

Chart 2. Basic rating areas of local government units



Source: own description

²² Warszawa with a negative rating outlook . It was first time rated so low by Moody's, 17.05.2016, <http://businessinsider.com.pl/finanse/rynek/moodys-obnizyl-perspektywe-ratingowa-dla-warszawy-i-poznania/1znyc8p>

²³Fitch confirmed Gdańsk rating 'A'- 'a stable outlook', 18.09.2016 <http://www.gdansk.pl/urząd-miejski/Fitch-potwierdził-Rating-Gdanska-A-perspektywa-stabilna,a,61431>

An analysis of presented areas requires a detailed study which includes inter alia elements listed in Table 3.

Table 3. A detailed analysis of rating areas of local government units

<p>Institutional and administrative factors (Standard & Poor's)</p> <ul style="list-style-type: none">• a presentation of main objectives of state and local policy,• a development of employee relations in a public sector, a number of employees, personnel costs,• an influence of public administration reforms on a town, particularly relations with the remaining levels of state and local government• a state budget influence on a town budget, particularly an amount of state subsidies• a state government policy relative to a local government policy
<p>Social and economic factors (Standard & Poor's)</p> <ul style="list-style-type: none">• all economic aspects including comparison to other big towns in Poland• value added, investments and an employment by economic sectors• restructuring and privatisation of local economic activity• listing of the biggest employers in a town, including average salaries• infrastructure projects (local transport, schools, hospitals, public nursing homes, sewage treatment plants, etc)• external trade relations• EU accession influence on local economy• GDP in the last 3 years, and the future prospects, GDP per capita• economic growth including sectors• unemployment rate and future developments
<p>Organisational structure and management:</p> <ul style="list-style-type: none">• Town organisational structure and distribution of competences• employment structure• changes in the composition of the City Council over the last 2 years including political parties• the main disputable issues between the present authorities and the opposition• relations with central authorities and other levels of government and local authority (political environment description)• a division of authority amongst political and administrative parties

Budget factors and financial analysis:

- a budget implementation, revenues and expenses analysis in the last years
- budget objectives for the next year and current budget execution
- income flexibility: tax policy, state subsidies
- the main expenses areas: education, health, social care, investments, the influence of new financing of health care system on town financial condition
- major investment projects and opportunities to obtain funding
- changes in the Accountancy principles and their impact on a budget and financial situation
- expenses flexibility over the short- and long- term

Subject debt analysis:

- management of budget provisions
- liquidity policy and funds management
- an analysis of a current and future credit and loans demand
- a current level of gross debt and future plans
- present and future debt structure (credits, loans, bonds,)
- debt service (interest rate and depreciation)
- urban companies debt
- an analysis of changes in shareholding and entity debt
- General measures of credit risk (Fitch):
- the main amount of debt compared to local GDP of an entity
- the main amount of debt per capita
- the main amount of debt compared to market value of the assets , subject to taxation
- the percentage share of debt service costs concerning current income and annual operational expenditure
- the percentage share of pension liabilities in current operational expenditure
- debt ratio to fixed assets

Source: own description based on: www.fitchpolska.com.pl, www.standardandpoors.com, www.moody.com

While conducting a detailed analysis concerning institutional and administrative factors, the importance in relations: state- self- governance assigned by rating agencies can be observed. Investigation of such issues as an influence of public administration reforms on a town, or the Government policy relative to Self- Government, indicates that Self- Government is perceived as an element of a whole system of public institutions. Consequently, following the idea that a rating of a subordinate institution cannot be higher than the one of a superior's institution – in this case Poland.

Analysing social and economic aspects, the qualitative factors influencing the income level (a list of the major employers, investments and employment, external trade relations) and costs (infrastructural needs, unemployment rate) are investigated among other things. Comparison of these factors with data concerning other Polish towns is also essential as it illustrates changes and indicates a development direction.

A significant element of an assessment is the organisational structure of the rated entity as well as its management, at this point relations State-Self- Governance, political surroundings, changes in the composition of the City Council, including political parties, or disputes taking place between the present authorities and the opposition are analysed among other things. A local government undertakes tasks of an important social significance, designed to meet expectations and needs of a local community. The activity should be reasonable and logical because the local government has the best understanding of the needs and expectations of the local community.

Another rating area refers to budget factors and financial analysis - the study includes an analysis of variables such as:

- budget results,
- self- financing capacity of assets expenditures,
- operational results.

The data obtained are a starting point for the most crucial part of a research, that is an analysis of an entity debt. A debt management concerning a local government unit can be defined as all of the activities connected with an acquisition, service and repayment of debt. The main objectives of a debt management are²⁴:

- tasks funding, which lack of financial resources within a local government unit income,
- minimisation of financial risk ,
- minimisation of costs connected with debt use by a local government,
- minimisation of liquidity risk and a local government unit insolvency.

A long- term investment programme and a long- term financial planning are instruments to facilitate the management of assets. Guidelines enclosed in the programmes should be a result of a strategy employed by a local government unit - a long- term action plan. A weight

²⁴ J. Osiatyński, *Finanse publiczne. Ekonomia i polityka*, PWN 2006, p. 208-210.

of rating debt analysis is significant as far as a local government financial management is concerned, because development prospects are far more essential than a properly designed annual budget.

Issuing of reliable rating requires a detailed analysis of the following: institutional and administrative aspects, social and economic factors, budget, debt structure and dynamics. The above factors - supplemented by analysis of an institutional and administrative surroundings - are mutually interactive thus rating considerably is far beyond the ranks of traditional financial analysis. The most essential rating element is debt analysis – it is due to the fact that debt ratios have definitely the largest impact on determining the development prospects and unit capacity to repay the financial obligations on due dates.

Conclusions

While preparing rating, rating agencies analyse qualitative and quantitative results, thus try to examine and evaluate future development of a given entity. Rating criteria employed by rating agencies are commonly well known and differ only slightly. However, rating agencies do not reveal accepted weight of particular factors, therefore the clarity of rating is clearly limited. Obtaining rating gives measurable benefits, however is not without disadvantage. The following elements are regarded as beneficial due to credit rating:

- an effective and objective comparative instrument,
- a clarity of rating grade due to standardised scale,
- an assessment and projection of financial situation,
- a risk management tool and risk communication functions,
- building an image and the investment credibility,
- a factor motivating local government bodies,
- an incentive for potential investors – increased interest in local governances,
- a possibility to obtain a competitive advantage,
- an instrument to improve a negotiation situation of a local government unit with a credit institution (bank) – an opportunity to obtain a capital at lower costs,
- an objective evaluation of entity's capacity to meet obligations.
- In turn, the disadvantages include:
 - a high price,
 - a complexity and time-consuming of a rating process,

- a lack of guarantee for investors concerning refund of contribution and obtaining expected profit,
- ex post analysis,
- a schematic evaluation, not taking into account local governments characteristics.

Despite numerous advantages, rating of local government units in Poland loses its meaning. In 2011 31²⁵ towns held it, and in 2014 just 19²⁶, it means that in practice rating is neither commonly regarded as a method to success nor a way to introduce local governments into area of international standards of finance management. External rating is taken into account by banks issuing credits (e.g. the European Investment Bank), or dealing with organisation of municipal bonds issuance. Rating assesses a capacity of a given local government unit to meet obligations, such as loans, or bonds, therefore high rating grade also enables negotiating for more favourable interest rates. It should be noticed that if a local government is a subject to external, independent rating, it proves its credibility, and clarity of financial situation, thus increases potential customers' trust.

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²⁵ <https://www.obserwatorfinansowy.pl/forma/rotator/rating-miasto-kryteria-samorzad-kryteria-koszty/>

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