Turkey Urbanization Review

Financing Sustainable Cities

Municipal Credit-worthiness:
The Road to Financial Sustainability

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Outline

- The principles of municipal credit-worthiness
- Shadow credit rating and what it can do for municipalities
- Pilot shadow credit rating: Steps and lessons from practice
- Financial Sustainability Action Plan: Medium term vision to improve credit-worthiness

The Principles of Municipal Credit-worthiness

What is credit-worthiness and how it is indicated?

- It is an opinion by third parties whether debt service payments will be made on time and in full
- Credit rating is a scale based symbol indicating relative credit-worthiness of potential borrowers
- Rating is a formal opinion by a specialised agency on the ability and willingness to repay financial debt

Why do credit ratings matter?

- Widely used by the financial sector as a measure of credit risk
- Monitoring tool for institutional investors seeking to diversify their portfolio risks
- Credit rating ultimately reflects probability of default of rated entity

Interpretation of credit ratings

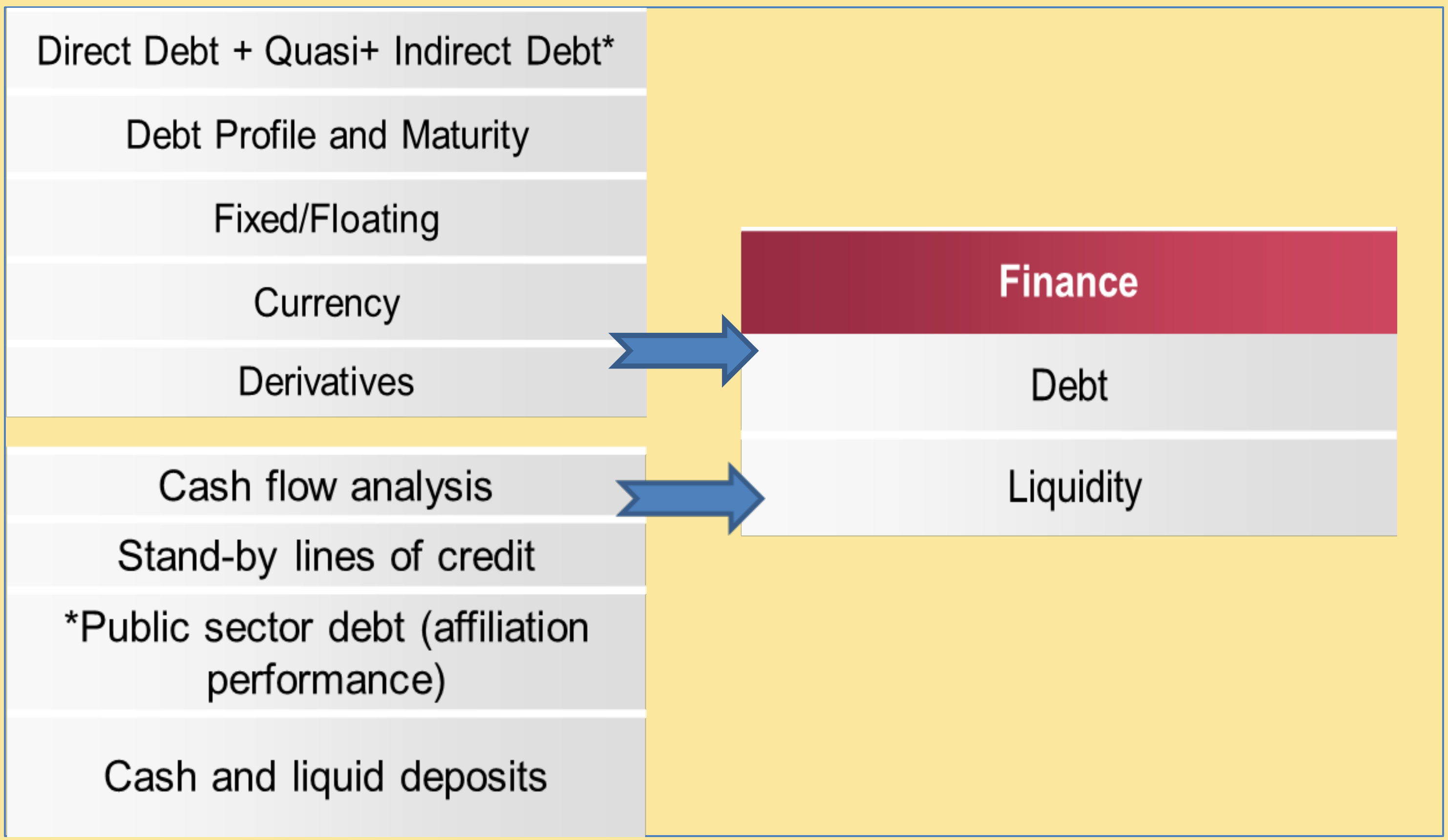
Rating categories		**Description**
Investment Grade	**AAA**	Highest credit quality, risk factors negligible
	AA+ **AA** **AA-**	Very high credit quality, protection against potential risk factors are very strong
	A+ **A** **A-**	High credit quality, protection still strong against risks factors that nonetheless might be more variable and greater
	BBB+ **BBB** **BBB-**	Adequate protection factors considered sufficient for prudent investment. Risk factors might have greater varibility in times of stress
Sub-Investment Grade	**BB+** **BB** **BB-**	Below investment grade thershold although protection for timely debt repayment still exist.
	B+ **B** **B-**	Risk that obligationswill not be met when due. Protection factors will fluctuate according to cycles
Speculative Grade	**CCC** **CC** **C**	Considerable uncertainty for timely payment of principal and interest.
	D	Defaulted

Importance of Municipal Credit-worthiness

- Enhancing the view that debt service payments will be made on time and in full from a lender perspective
- Access to market based municipal funding
- Helping to create a dedicated municipal debt market by increasing the visibility and quality of financial information
- Key to acquiring financial means to support social and economic goals of local citizens and create good quality of life
- Credit rating: interphase between enhancing credit-worthiness and financial sustainability

Principles of Municipal Credit-worthiness

- Investment profile as required by socio-economic profile and regional importance determining municipal service and infrastructure needs
- Debt burden also featuring overall risk exposure arising possibly from contingent liabilities and local public sector



What is a Shadow Credit Rating and What It Can Help Municipalities to Achieve

Shadow Credit Rating – Advantages

- A shadow credit rating is a confidential rating solely to inform decision makers at a municipality of their prospects for attracting market finance and their current creditworthiness
- Ease concerns over possible poor outcome of a public rating
- Shadow ratings can be used a learning process as to which areas of financial profile require further attention
- May allow lenders/donors to structure discourage/avoid supporting poor financial policies

Shadow Credit Ratings-Advantages

- Preparatory step for a public rating simulating all of its steps except the public rating action commentary
- The existence of a credit rating analysis may facilitate formulating preventive and corrective intervention by regulators/national authorities
- Policy formulation and action plans (with performance targets) may be assisted drawing upon credit rating reports
- Information available from rating process may increase negotiating power of municipality for borrowing arrangements

Shadow Credit Ratings-Potential

- Access to bilateral funding from a wider net of sources in addition to national municipal finance agency/vehicle (domestic/foreign, with/without guarantee)
- Ability to tap the market (if available) for wholesale funding for bonds and fixed-income instruments
- Opening of alternative funding sources for funding infrastructure through PPPs and project finance tools
- Facilitate financing of investment goods and fixations (i.e. working with Export Credit Agencies)

Pilot Shadow Credit Rating for Metropolitan Municipality Gaziantep (MMG)

Shadow Rating Steps-1

- Shadow credit ratings used by the World Bank to help municipalities understand their current credit and risk profile with a view to improve creditworthiness
- Review of financial management, planning – systems and practices, including an assessment of compatibility of budget performance
- To arrive at an opininon on:

  - political context and socio-economic profile,
  - fiscal and budgetary performance,
  - reporting and disclosure, financial management,
  - debt, liquidity and contingent liabilities
  - management and governance

Shadow Rating Steps-2

- Main areas of analysis are exhibited as below:

Building Blocks of Analysis	Institutional Framework	Local Economy	Finances	Debt and Liabilities	Management
	Oversight from upper tiers of government	Economic activity	Revenue structure	Debt stock and debt service	Decision making process
	Tax revenue equalization	Taxpayers strength and concentration	Expenditure breakdown	Capital investment plan and borrowing appetite	Governance
	Prudential debt regulations	Demographic trends	Budgetary performance	Public sector debt and contingent liabilities	Financial management
	Transfers	Employment	Capital expenditure financing	Liquidity	Planning and Budgeting
	Accounting and budgeting	Socio-economic development level	Reserve management		Reporting and Disclosure

Shadow Rating Steps-3

- A standardized spreadsheet used to arrive at a common budgetary and financial reporting format reflecting combination of quantitative factors
- The ratios produced divided into five core sections consisting of

  - budgetary performance

  - revenues

  - expenditures

  - debt

  - capital expenditure

Shadow Rating Steps-4

- The scope of required data and information:

  - Past years' Annual Reports
  - Current year Performance and Strategic plan
  - Additional information and data gathered during onsite visit
  - List of information and data requested with a *'Questionnaire'* -not an exhaustive list, may also be seen as the agenda of discussion areas and specific points related to those.

Shadow Rating Steps-5

- Milestones of completing the process comprise:

  - Drafting of credit analysis (rating report)
  - Sharing the findings with the municipality
  - Receiving feedback on factual data and comments
  - Finalization of shadow credit report.

Shadow Rating: Lessons Learned

- Once structured in a standard way the process is straight forward to implement
- Availability of ready to use information and data speed up the process:

  - At a basic level the process could be useful for municipality to learn preparing credit relevant financial data/information

- Commitment of executive and participation from management key

  - Two-way information flow and sharing required

- Medium term vision as to what to achieve

  - Short to medium term targets to achieve for the next 4/5 years investment cycle

Financial Sustainability Action Plan (FSAP) as A Tool to Improve Credit-worthiness

From Shadow Rating to FSAP

- Mapping of strength and deficiencies of Municipality from a financial sustainability perspective
- Evaluation of following focus activity areas to be prioritised with determination of FSAP targets in each, activity steps and timeline
- Assessment of benchmark indicators for financial sustainability and Municiaplity’s relative standing vis-à-vis peers along with their links to FSAP target actions.
- Conclusion with an assessment of the technical support and training required, with a suggested program tied to the overall timeline.

FSAP Process for GMM

- The shadow rating exercise with the full participation of GMM financial management team revealed:

- Strong revenue underpinned by a buoyant economy generating healthy metropolitan taxes, fees and other operating revenue

- Dynamic economic activity base reflected in a strong production and foreign trade potential. This is accompanied by population pressure on the metropolitan area due to already strong migratory flows of domestic jobseekers and of foreign refugees

- Significant investment profile as required by dynamic socio-economic profile and regional economic importance placing municipal service and infrastructure under the need to constant upgrade and improvements.

- Limited direct debt but ***substantial overall risk exposure reflected in hefty financial obligations related mainly to poor debt record of water entity*** giving rise to quasi debt to National Treasury and public institutions. These result in severe deductions in metropolitan municipality’s central government tax revenue shares.

FSAP Steps

- Departing from strengths and deficiencies number of focus areas determined with the issues in each focus areas, target actions and timeline for implementation
- For MMG these were

    - Organizational structure
    - Financial Planning
    - Capital Investment Planning*
    - Debt Management

*Showcase for FSAP

Benchmark of FSAP Indicators

- Assessment of benchmark indicators for financial sustainability is done through comparatively looking at key ratio indicators to reflect relative standing vis-à-vis peers.
- Under- performance as measured by these indicators are linked to FSAP target actions.
- Going forward the progress in the financial planning and debt management focus areas can be measured by monitoring these financial performance ratios.

Benchmark of FSAP Indicators: Ratios

- **Operating margin:** Operating balance/Operating revenue >35%: This ratio gives an indication on the type of responsibilities of an entity (higher margins would tend to indicate more investment driven responsibilities) and the entity's ability to fund capital expenditure through own savings.
- **Budget result:** Overall results/Total revenue (%) (Positive at >5%): A high positive ratio would indicate that the municipality is increasing its reserves and a negative ratio would be the opposite. A consistent depletion of reserves which would bring liquidity to dangerous levels would be a concern.
- **Debt service ratio:** Direct Debt servicing/Current revenue (%)<30%: Is a measure of the debt burden but care has to be taken in interpreting this ratio as entities with large bullet debt repayments may show a low ratio in some years and an abnormal high ones in others, when the debt has to be refinanced. Take into account contractual debt servicing here and not early repayment of debt. Also short-term debt rollover is excluded.
- **Risk payback ratios:** Direct Risk/Current Balance or Direct Debt/Current Balance

  <5 years: This is a key indicator and looks at the real total risk (direct debt+quasi debt)/ debt paying capacity of the entity. It measures how long it would take the entity to pay back its debt if it did not make any capital expenditure that year. The longer the payback ratio the weaker the credit, however, if the current balance is volatile then this ratio would also be very volatile.

Benchmark of FSAP Indicators: Ratios

- Illustrative ratios

	Metropolitan Municipality of X (BB)		Mean		Metropolitan Municipality of Y (BB+)		Metropolitan Municipality of Z (BBB-)	
	2012	2013	2012	2013	2012	2013	2012	2013
Fiscal Performance								
Operating balance/operating revenue (%)	30.51	37.23	43.41	46.37	48.15	41.82	56.32	60.06
Overall results/Total revenue (%)	-3.12	-14.16	3.91	-4.09	5.02	1.32	9.84	0.56
Debt								
Direct Debt servicing/Current revenue (%)	40.43	36.30	27.67	20.49	24.16	18.27	18.42	6.91
Direct risk/Current balance (x years)	2.80	5.34	2.27	3.55	3.2	4.5	0.7	0.8
Direct debt/current balance (x years)	2.11	2.38	2.00	2.56	3.2	4.5	0.7	0.8

FSAP Implementation: Going forward

- **Periodic credit ratings** can be used to supplement internal assessments of the progress of the municipality on the FSAP.
- **Year on year progress on FSAP** should enhance municipality's creditworthiness sufficiently to expect that reasonably affordable debt financing can be obtained for infrastructure investment.