

Regional and Local Government Rating Methodology

Fedafin's methodology for rating assignments to regional and local governments

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1. General Remarks

This rating methodology describes general principles and criteria for the credit risk assessment of regional and local government issuers. Included are all regional and local authorities with autonomous tax collection powers, such as cantons, political municipalities, school municipalities, or parishes. The credit rating methodology does not apply to sovereign countries.

The issuer rating is a long-term credit rating reflecting our opinion of the issuer's relative creditworthiness. Specifically, the issuer rating reflects an issuer's ability to fully and timely meet senior unsecured debt obligations. According to our monitoring policy for standard annual rating updates, our rating opinion covers a period of one year. However, when analysing an issuer's creditworthiness, more than one year is considered by the analysts. The issue of stability in rating assignments is addressed by including forward-looking criteria and stability factors as well as by using appropriate analytical methods and valuation approaches. We therefore believe that our regional and local government rating methodology meets the requirements for a through-the-cycle rating as far as possible.

This rating methodology describes several risk factors and criteria that may have an impact on a rating assignment. Nevertheless, individual governments' risk profiles may be very different, and our analyst team may classify certain criteria as not relevant or include other criteria not described in this methodology. The team may also deviate from the standard weighting of individual risk drivers if considered appropriate.

2. Government Rating Architecture

When assigning ratings to regional and local governments, financial and legal interdependencies of the federal state structure need to be considered. A significant part of credit risk of local authorities at the lower levels of government is directly influenced by rules set and decisions made at the higher levels of government. At the same time, we do not assume a general implicit extraordinary support by higher government levels in a crisis situation (see section 2.5).

Figure 1: Government Rating Methodology

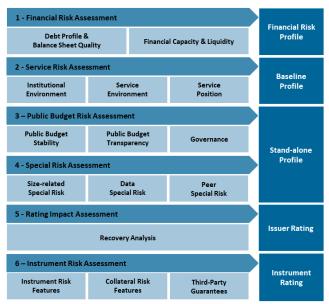


Figure 1 shows the general framework for regional and local government credit ratings. The starting point usually is the financial risk assessment with a focus on debt profile and balance sheet quality as well as financial capacity and liquidity (section 2.1). This is augmented by an analysis of public service risks (section 2.2), public budget risks (section 2.3),



and other entity-specific risks (section 2.4), resulting in the stand-alone profile (SAP).

In certain cases, recovery considerations are necessary to arrive at the issuer rating and thus at an issuer's ability to meet its senior unsecured debt obligations in full and on time (Section 2.6). To derive credit ratings for financing instruments with different seniority levels, normally a notching approach is applied considering those instruments' specific characteristics.

2.1. Financial Risk Assessment

The financial risk assessment mainly focuses on two areas of analysis: (1) debt profile and balance sheet quality; (2) financial capacity and liquidity. The analysis of debt profile and balance sheet quality includes questions on the sustainability of the debt burden and the coverage of debt by financial assets. Interest burden and potential for future debt financing are also assessed. Regarding financial capacity and liquidity, the analysis focuses on whether sufficient funds can be generated to service the debt and to amortize administrative assets. An important indicator in this regard is the resource strength of a local authority.

We apply a logit transformation to several key financial ratios¹ and aggregate the resulting scores to the financial risk profile. In addition, further key figures are systematically included if they fall below or exceed certain predefined values. The financial risk profile is usually averaged over four years to smooth minor annual fluctuations.

The financial analysis is generally based on the regional or local government's annual financial statements. Budgets and forecasts may be considered for plausibility checks but are not included in the financial analysis as standard. However, significant deviations from past performance due to a material change in public policy or the service environment may lead to a review of the current rating or the rating outlook.

2.2. Service Risk Assessment

The financial risk profile should be interpreted in the context of the specific environment in which a government operates. Therefore, in this section, we analyze the extent to which a government's institutional environment, service environment, and service position influence credit risk. Analyzing these qualitative factors leads to a better comparability of governments' financial profiles across government levels and jurisdictions.

The service risk assessment includes the three modules (a) institutional environment, (b) service environment, and (c) service position. In the first two modules a "floor" and a "ceiling" are defined, which serve as lower and upper limits applied to an issuer's financial risk profile. For example, if a government operates in a service environment with particularly high risks, the resulting lower ceiling means that a "Aaa" rating cannot be achieved even with best financial ratios. At the same time, this compression of the curve of achievable logit score values affects the entire rating range. Therefore, with moderate or weak financial ratios, a difficult service environment can lead to additional downgrades, too, albeit these will be less severe. On the other hand, institutional conditions (e.g. very strict fiscal rules, extensive autonomy in raising taxes, or ordinary financing support through a very generous fiscal equalization scheme) can result in an evaluation not falling below a certain threshold (floor) even in case of a very poor current financial risk profile. Moreover, this upward shift in the curve of achievable logit score values can also lead to rating upgrades for issuers with a moderate financial profile, although these upgrades will be smaller. Finally, the assessment of the issuer's service position may lead to a direct up- or down-notching.

2.2.1. Institutional Environment Profile (Floor)

This module focuses on the institutional framework in which a government operates. Analysts assess whether certain regulatory provisions systematically reduce an issuer's credit risk, essentially on the basis of two criteria: (1) fiscal discipline; (2) financial resources.

¹ More information on definitions and details of key financial ratios are provided on <u>e-rating</u>.



A key criterion for assessing fiscal discipline is whether there are effective regulations in place to limit potential debt. The effectiveness of such regulations requires clearly and bindingly formulated target criteria as well as equally clearly and bindingly formulated control and sanction mechanisms. In addition, the analyst team may consider the extent to which a government is free to autonomously levy taxes and/or set necessary tax rates, whether the population can vote on large expenditures, and whether the government has demonstrated strong and consistent budgetary discipline in the past.

The assessment of financial resources focuses on financial equalization systems that an issuer might directly benefit from. The overall potential generosity of such a system is tied to the higher government level's financial capacity. Often, this government funds a substantial share of an equalization system's payments by vertical contributions. In addition, the extent to which it tries to shift tasks and their accompanying expenditures to lower-level governments, thus impacting their cost structure and consequently the effectiveness of vertical contributions in alleviating these costs, is also influenced by its own financial situation. We therefore approximate an equalization system's overall generosity by the credit rating of the relevant superior government.² A second element of the analysis is the extent to which an equalization system reduces financial discrepancies between same-level governments. If they are promised sufficient contributions to attain a fixed minimum level of resources, this improves their financial outlook relative to a situation without equalization system.

The institutional environment profile can be categorized as "excellent", "very strong", "strong", "favorable", or "standard". If the assessment is "standard", the rating is not changed compared to the financial risk profile. However, if the assessment is "favorable" or better, the rating floor may be increased, reflecting that a favorable institutional environment may partially offset a weak financial profile.

This module focuses on the service environment of regional or local governments, with the two main criteria being (1) risks resulting from the federalistic government structure and (2) sector risks. When analyzing federalism-specific risks, we ask how supportive the higher state level government is to an issuer in question. The credit rating of the higher state level has an anchor function, particularly in the assessment of municipalities, as a canton's active influence on its municipalities in financial and legal terms is generally considerable. Financially well-off municipalities of a canton may be disproportionately affected by financial restructuring measures at the cantonal level. A top-rated municipality's credit rating therefore becomes more restricted as the credit rating of the canton in which it is located decreases. This ensures that factors relevant to a canton's creditworthiness also influence the municipal ratings within the canton in an appropriate direction.

The assessment of sectoral risks involves analyzing risks that affect many authorities at the same level of government. Examples include economic fluctuations and political or regulatory changes. Strong economic fluctuations can, for example, lead to high levels of unemployment and low or negative corporate profits, reducing a government's fiscal income both currently and in future. Political decisions like the introduction of substantial new programs that cause high expenditures for specific government levels increase their financial risks, as could changes to rules of international business making.

The evaluation of relevant criteria in this module results in an assessment of "favorable", "moderate", "limited", "weak", or "very weak". If the assessment is "favorable", the rating is not changed compared to the financial risk profile. However, if the assessment is less than "favorable", the rating ceiling may be lowered, reflecting that certain risks in the market environment cannot fully be offset by a strong financial profile.

Moody's and Fitch (see the information on the use of external ratings in the $\frac{\text{disclosure document}}{\text{document}}$ on the fedafin website).

^{2.2.2.} Service Environment Profile (Ceiling)

² The assessment of the Swiss Confederation's creditworthiness is based on the results of the international rating agencies S&P,



2.2.3. Service Position Profile

In this module, we analyze the relative competitive position of an issuer and its resilience to adverse shocks compared to its peers. A particularly strong competitive position can lead to more stability of the issuer over the business cycle, whereas a weak competitive position can make a regional or local government particularly vulnerable in a downturn. We assess the competitive position of a regional or local government based, for example, on its attractiveness as a business location or its socio-economic characteristics such as the prevailing unemployment rate or population growth (or population decline). We also examine factors that increase (or decrease) an issuer's resilience to certain shocks, e.g. due to financial crises, energy crises, or pandemics. Positive or negative resilience factors include, for example, the stability or concentration of a government's revenues. The particular resilience or vulnerability to specific risks such as climate change risks are also considered in this module.

The evaluation of the relevant criteria in this module results in an assessment of "excellent", "strong", "fair", "limited", or "weak", which in turn is reflected in a rating up- or downgrade of up to two notches.

The resulting stage in the rating process after the financial risk assessment and the service risk assessment is called the baseline profile 1. This serves in turn as the input for the public budget risk assessment.

2.3. Public Budget Risk Assessment

The previous qualitative analysis emphasizes the issuer's service environment and its position relative to peers. In the public budget risk assessment, we focus more directly on the issuer and assess government-specific factors that affect credit risk. The three main risk profiles considered are (1) the public budget stability profile, (2) the public budget transparency profile, and (3) the governance profile.

2.3.1. Public Budget Stability Profile

In this module, we assess an issuer's public budget stability based on the appropriateness of specific accounting standards (e.g. valuation, capitalization, consolidation). We also look at concentration in off balance-sheet positions (e.g. granted guarantees) or in specific tangible or intangible balance-sheet assets. Finally, we account for diversification of the financing structure, or a lack thereof.

The resulting assessment as "strong", "fair", "limited", or "weak" translates into a maximum of one upward or up to two downward notches, based on the baseline profile 1 as an anchor rating.

2.3.2. Public Budget Transparency Profile

The public budget transparency profile evaluates whether accounting standards and financial revision are adequate. For over 30 years, public accounting in Switzerland has been based on double-entry bookkeeping with balance sheet, income statement, and investment statement. This provides a certain degree of transparency and comparability. If an issuer does not meet these minimal requirements, this will be accounted for in this module.

The evaluation of the relevant criteria in this module leads to an assessment of "fair", "limited", or "weak". Using the baseline profile 1 as a starting point, the resulting down-notching normally is minus one notch if the resulting assessment is "limited" and minus two notches if the resulting assessment is "weak".

2.3.3. Governance Profile

The core question of the governance profile is whether the issuer's governance is appropriate or whether certain negative aspects may increase an issuer's credit risk. Possible criteria include the composition of the decision-making bodies in terms of independence in decision making, transparency and reporting standards, the government's reputation in terms of compliance flaws, or structural obstacles to independent decision making.

The evaluation of the relevant criteria in this module leads to an assessment of "fair", "limited", or "weak". Using the baseline profile 1 as a starting point, the resulting down-notching



normally is minus one notch if the resulting assessment is "limited" or "weak".

2.4. Special Risk Assessment

The combined assessment of an issuer's financial risk profile, its service environment, and government-specific characteristics is referred to as the baseline profile 2. In rare cases, it may be necessary to add certain special modules to the risk assessment. Specific examples are (a) size-related special risks, (b) data and peer special risks, and (c) benchmarking and adjustment.

2.4.1. Size-related Special Risk Profile

Swiss municipalities vary greatly in size, from over 400,000 inhabitants in Zurich to less than 50 inhabitants in some municipalities in the cantons of Bern, Ticino, Solothurn, and Wallis in 2023. The potentially increased volatility of financial ratios is already systematically accounted for in the financial risk profile. Nevertheless, very small communes may be exposed to additional credit risks. On the one hand, the information content of statistical data (relevant for example in the service position profile) in these municipalities is often limited for data protection reasons. Furthermore, there may be a lack of sufficient know-how in relevant areas. In this module, it is possible to consider these additional risk factors due to limited size.

The evaluation of the relevant criteria in this module leads to an assessment of "fair", "limited", or "weak". Using the baseline profile 2 as a starting point, the resulting down-notching normally is minus one notch if the resulting assessment is "limited" and minus two notches if the resulting assessment is "weak".

2.4.2. Data and Peer Special Risk Profile

This special risk module summarizes potential risks arising from poor data quality and other special risks. Possible

indicators include a limited track record due to newly established or restructured governments, distorted or incorrectly disclosed data and information, or exceptional data fluctuations due to trend breaks or imbalances. In addition, this module may capture increased credit risk due to violations of national laws and regulations or the occurrence of a risk event (e.g. accidents, reputational damage, called guarantees, lost lawsuits) that was not sufficiently captured by the other modules above.

The assessment of the relevant criteria in this module may be "fair", "limited", or "weak". Starting from the baseline profile 2, the resulting down-notching normally is minus one notch if the resulting assessment is "limited" and minus two notches if the resulting assessment is "weak".

2.4.3. Benchmarking and Adjustment

In a final step, analysts compare the resulting stand-alone profile with market benchmarks or the credit risk assessment for relevant peers. Although this only applies in exceptional cases, analysts have the option in this module to raise or lower the stand-alone profile by one notch if necessary.

2.5. Stand-Alone Profile and Issuer Credit Profile

Figure 1 shows that the modules described so far lead to the issuer's stand-alone profile (SAP). The SAP reflects the creditworthiness of a government independent of extraordinary support or guarantees. As described above, any existing relevant financial and legal interdependencies between the issuer and its upper-level government are already included in the stand-alone profile. At the same time, we do not assume a general implicit extraordinary support in case of a crisis situation for regional and local government issuers. Specifically, we do not assume that there is in general a significant probability that a higher-level government would extend direct financial support to an issuer that is not already provided for by law (e.g. as part of an equalization system). Therefore, the SAP usually corresponds to the issuer credit profile

some form for the debts of their municipalities, have been dashed. In its rulings in 2003 (BGer 2C.4/1999), the Swiss Federal Supreme Court practically ruled out state liability arising from a canton's breach of supervisory duties for its municipalities.

³ In October 1998, the severe financial difficulties of the municipality of Leukerbad became public and resulted in the first default of a Swiss municipality in over fifty years. The hopes initially expressed in the financial community of an "implicit" state guarantee, whereby the Confederation and/or cantons would be liable in



which reflects the overall creditworthiness of a local or regional government.

2.6. Issuer Rating

To arrive at a local or regional government's issuer rating, and thereby its ability to meet senior unsecured debt obligations in full and on time, it is necessary to analyze the expected loss for each seniority class in the liability structure in the event of a default. Important components for this analysis are the expected general recovery rate of a regional or local government with the corresponding probability distribution and the expected seniority structure of the liabilities in the event of a default (waterfall). This can be done in a detailed systematic recovery analysis, where analysts estimate the expected loss for each seniority class in the liability structure in a default or similar failure event. In most cases, however, regional and local authorities exhibit standard liability structures (e.g. no subordinated or secured debt). In addition, a very broad range of recovery rates is generally observed among regional and local authorities, which is why we do not normally deviate from the standard case of a recovery rate distribution with an expected value of 50%.4

A detailed recovery analysis is therefore generally not required and the rating for senior unsecured debt instruments usually corresponds to the issuer credit profile. If an issuer exhibits a liability structure deviating from the standard case or if a default is likely and we have clear indications that the overall expected recovery rate deviates from the standard case (e.g. also because administrative assets cannot be sold or pledged), a detailed recovery analysis may be applied and non-standard financial instruments are evaluated based on their specific characteristics as specified in the Corporate Rating Methodology.

3. Rating Outlook

For cantons and large municipalities, an outlook can be assigned to the rating. The outlook ("positive", "stable",

"negative") reflects fedafin's assessment of the mediumterm rating development.

The rating outlook does not represent a specific probability of rating change but provides an indication on the likely direction of a potential rating change. The outlook covers a period of 12 to 18 months following the rating outlook assignment.

4. ESG Factors Material to Credit Rating

Fedafin acknowledges the fundamental importance of ESG criteria for an issuer's activities and financial performance. ESG related variations in individuals' behavior, technologies and regulatory environments as well as considerations regarding good corporate governance already materialize in rating assignments and have done so in the past. The credit rating model outlined above contains several criteria related to ESG. While the characteristics of corporate governance are evaluated in a separate module, environmental and social factors can affect the credit rating in several different modules. For instance, if the tax base of a regional or local government consists to a substantial extent of companies in the fossil industry, political measures to reduce the use of fossil energy on the national level could have a negative impact on company profits and thereby tax revenues for the regional or local government. This effect would therefore directly impact the financial risk assessment of the issuer.

Very direct environmental risks can affect small municipalities in mountain regions. The decreasing stability of permafrost due to global warming can lead to an increase in rockfalls and landslides. This may result in high costs for municipalities to build appropriate infrastructure to protect the population. If residents of these communities move away due to the increasing risks, this leads to an erosion of the issuer's tax base. Both effects may materialize directly in the financial risk profile in the medium term. If this development is anticipated by the analysts, the effect can be reflected in the resilience module of the service position profile.

was 75%. Weighted by debt volume, the median value was 52%. The recoveries fluctuated between 100% and 0%.

⁴ Moody's regularly publishes the recovery rates of municipal issuers in default. For the period 1970-2022 the average issuer-weighted median recovery rate for the municipal rating universe



Within social factors, cyber risk poses a significant challenge. The need for privacy and data security of individuals could be threatened by a cyber-attack. Such an incident may lay open flaws in a government's risk management, which is evaluated within the data & peer special risk module of special risk assessment. These examples emphasize that ESG factors can impact a credit rating in various ways.

As an independent credit rating agency operating at the nexus of investors and capital seekers, we feel an obligation to be transparent about our approach to credit relevant ESG factors, which is why we signed PRI's "Statement on ESG in credit risk and ratings" in August 2018. PRI is an investor initiative in partnership with the United Nations Environment Programme Finance Initiative and the United Nations Global Compact, dedicated to highlight the investment implications of ESG factors and to help investors integrate these factors into their investment decisions. By signing the statement, we share a common vision to improve the systematic and transparent consideration of ESG factors in credit ratings.

Any material influence of ESG factors on the credit risk of an issuer is therefore disclosed in our credit rating reports. In longer reports we include a separate block that lists the relevant ESG factors and states whether their respective impact on the credit rating is positive or negative. However, it is important to understand that in making this influence transparent, we do not issue a moral statement or an ideological endorsement of a specific activity. We merely show how the probability of default of an issuer or the associated expected loss of a financial instrument are affected by ESG factors.



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