Tax-Supported Rating Criteria

Master Criteria

This criteria report updates and replaces the previous version, dated 11 September 2015

Scope and Limitations: This master criteria report identifies rating factors considered by Ind-Ra when assigning ratings to a particular entity or debt instrument within its scope of the master criteria. Not all rating factors in the master criteria may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

Five Key Rating Factors: India Ratings and Research (Ind-Ra) evaluates five major factors (debt, economy, finances, management and liquidity) in determining the credit quality of a tax-supported governmental issuer. The rating process analyses trends in these areas and seeks to identify actual and potential future obligations and exposures.

Debt and Other Long-Term Liabilities: In evaluating debt and other long-term liabilities, Ind-Ra seeks to determine the extent and nature of the issuer's outstanding liabilities and evaluates the outlook for the future with a focus on affordability and flexibility.

Economy: Ind-Ra's economic analysis considers the capacity of the issuer's economic base to support ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Finances: Analysis of finances is focused on the issuer's financial resources and flexibility to support its obligations over the near and long terms.

Management and Administration: Management practices and actions can positively or negatively influence the other major credit factor. Ind-Ra's analysis of management encompasses both elected officials and appointed staff members.

Liquidity: Ind-Ra analyses the ability of the issuer to receive dues and make payments of the debt obligation as per schedule. The liquidity position highlights the ability of an issuer to make resources available to meet revenue requirement when there is a slump in demand or an increase in costs. The available cash position determines the strength of the liquidity profile; a strong-to-moderate cash position ensures minimum liquidity risk.

Interaction of Rating Factors: The major rating factors are interactive. For instance, while an issuer may have a vibrant and wealthy economy, weak fiscal management or stringent tax rate limits may offset the positive credit factors, resulting in a reduced ability to meet obligations. In turn, a weak economy may be offset by other strengths, such as proactive management or a very low debt burden.

Rated Securities: For state governments, Ind-Ra's analysis focuses on specific security structures, and an assessment of the subnational credit quality. When a specific security is being rated, the rating will reflect the nature of the security and its relationship to the general credit quality of the issuer.

Ind-Ra tax-supported ratings consider an obligation's relative vulnerability to default and do not incorporate any measure of recovery given default.

Related Research

Rating of Public Sector Entities Criteria (December 2018)

Revenue-Supported Rating Criteria (December 2018)

Local and State Government Rating Criteria (December 2018)

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Variations from Criteria

Ind-Ra's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on an instrument-by-instrument or issuer-by-issuer basis and full disclosure via rating action commentary (RAC), strengthens Ind-Ra's rating process while assisting market participants in understanding the analysis used in the ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific instrument or entity. Such adjustments are called variations. All variations will be disclosed in the respective RACs, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular instrument or entity.

Rated Security

Rated security analysis applies when In-Ra is rating a specific debt issuance, in addition to the issuer's general credit quality.

Legal Pledge

A security's rating takes into account the strength of the legal pledge. The rating for a special tax security, where payment is derived from a specific tax revenue source, while still informed by the analysis of the issuer's general credit, also reflects structural factors, such as lien status, indenture requirements, and debt service coverage.

Lien Status

In tax-supported ratings, the lien status is generally only a rating consideration for special tax bonds, which normally provide a first lien on the pledged revenue. Rating distinctions between senior and subordinate lien debt generally are based on notably weaker legal protections for subordinate bonds provided by the indenture. Ind-Ra only makes such distinctions in cases where there are no cross-default provisions between the liens and, when made, the distinctions are generally small (one to two notches).

Indenture Requirements and Relevant Statutes

Similar to lien status, indenture requirements are most relevant to special tax bonds. Important indenture provisions include: the issuer's covenants, including the rate covenant (where applicable); the flow of funds; any requirements that enhance or hinder the bondholders' ability to be repaid; and recourse available to bondholders that could prevent a default. For example, the additional bonds test (ABT) is key to special tax bond ratings, while legal and statutory provisions that strengthen the issuer's incentive to appropriate can enhance the rating of appropriation-backed debt. Bondholder protections that are incorporated into statute are particularly strong.

A properly structured debt service reserve fund (DSRF) can provide protection for special tax bondholders by providing a buffer against low tax collection periods. Ind-Ra believes this protection is more important for entities with relatively weak coverage or tax streams with significant volatility and has little impact on the credit quality of bonds whose coverage and ABTs are already strong. A DSRF is also a rating factor in appropriation-backed debt where construction risk is a rating factor.

Debt and Other Long-Term Liabilities

In evaluating debt and other long-term liabilities, Ind-Ra seeks to determine the extent and nature of the issuer's current liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Debt Ratios and Trends

Debt analysis includes a review of trends in the amount of debt issued and outstanding. Ind-Ra analyses the trend in debt in relation to resources. Sustained increases in debt at a rate in excess of economic growth may ultimately overburden a tax base and strain budget resources.

Ind-Ra uses various ratios to measure the burden of debt on the issuer's population and tax base. Calculations include all long-term, fixed obligations of the issuer, excluding unfunded pension and other post-employment benefit (OPEB) liabilities, which are considered separately in the context of an issuer's overall long-term liabilities. In general, a low debt burden is a positive credit factor.

For special tax bonds, debt ratio analysis includes the calculation of historical, current, and projected coverage of debt service by the pledged revenue source.

Future Capital and Debt Needs

Debt factors are considered within the context of the issuer's infrastructure needs and capital plans. Current debt levels may be low; however, future capital projects may significantly increase debt ratios, weakening the issuer's debt profile. Ind-Ra evaluates the impact of expected future debt on the issuer's debt ratios and views favourably a comprehensive and realistic approach to capital planning. The issuer's ability to meet its capital needs where there are restrictions on debt issuance is also a consideration.

Debt Structure

Ind-Ra reviews the types and proportions of debt utilised and the rate at which the debt is repaid. The review of outstanding debt also includes an assessment of the uses of borrowed funds, with uses for non-capital purposes considered a credit weakness.

Another consideration is the percentage of fixed-rate debt in the issuer's debt structure. Ind-Ra views high levels of short-term debt, variable-rate debt, and/or derivatives with concern, as they expose the issuer to the possibility of unexpected and, in extreme cases, unaffordable future financial demands. Ind-Ra evaluates whether the issuer has a clear understanding of the benefits and risks of entering into these types of transactions.

Pension and Other Post-Employment Benefit Funding

Ind-Ra reviews defined benefit pension plan and OPEB funding as part of the analysis of debt and long-term liabilities. Defined contribution plans are not subject to Ind-Ra pension analysis, as they are a predictable annual commitment and considered as part of the issuer's operating budget.

Pension and OPEB liabilities are not directly included in the calculation of an issuer's debt ratios. Pension benefits represent a more variable commitment to future payments than bonded debt to the extent that they can be significantly influenced by a variety of actuarial, accounting, investment, and other policy decisions of the sponsoring government. OPEB is a legally softer obligation than debt or pensions, perhaps more aptly considered a service obligation and, in most cases, are subject to modification by the government.

The analysis of pension obligations focuses on whether there has been stabilisation or progress in the funded ratio over time and a commitment to funding actuarially calculated annual required contributions (ARCs). Key considerations are: the magnitude of the liability; the funded ratio; the size of the resource base from which funding is derived and the liability as a percentage of this base; the amount of the government's budget needed to make pension contributions; and the government's historical commitment (or lack thereof) to system funding, as well as actuarial and other assumptions influencing the burden. For each rated entity, Ind-Ra closely evaluates all significant pension plans in which the government participates.

Ind-Ra views favourably entities that have well-funded pension plans and consistently fund the ARC. In cases where the unfunded liability is sizeable, Ind-Ra views positively actions or plans to reduce it over time. Concerns arise if the liability level is high or increasing or if the actual contribution is consistently below the ARC.

Indirect Risks and Contingent Liabilities

In looking at an issuer's debt obligations, Ind-Ra examines not only liabilities directly incurred and payable by the issuer but also outstanding debt for which the issuer may in the future have an obligation. Examples include moral obligations, where the issuer may support but is not legally obligated to support – the debt upon failure of the primary security, and needs of related governmental entities that may require financial resources of the rated issuer. Such obligations are monitored but typically excluded from direct debt calculations unless the issuer's resources have been relied on to cover the obligation during the past three years.

Economy

Ind-Ra economic analysis considers the capacity of the issuer's economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Major Economic Drivers

The evaluation of the economy begins with a determination of the types of economic activity that dominate the area. For example, some issuers are heavily reliant on an industry like automobile manufacturing or natural resource mining, while others have a more diverse base. A broad, diverse, and stable economy is a credit strength, and undue concentration in one or a small group of industry sectors or taxpayers or a high level of cyclicality may be cause for concern. For issuers dependent on property taxes for a sizable portion of their revenue, Ind-Ra pays particular attention to the level of and trends in the valuation of the total tax base and the largest taxpayers.

Employment

Ind-Ra reviews trends in employment and seeks to understand why a given employer or employment sector has expanded or contracted. Trends in unemployment are reviewed in the context of labour force changes and other factors that might have an impact, such as cyclicality.

Income and Wealth

Income levels are evaluated on both an absolute and a relative basis to regional and national averages. Reviewing trends in the issuer's income and wealth, compared with those of the region and other states, provides an indication of the rate of economic value being created, which has implications for future revenue performance.

Other Demographic Factors

Ind-Ra reviews key demographic metrics, particularly population trends. Although population growth is usually considered a positive factor, population stability can also be a positive rating consideration, particularly for states that do not have a wide range of service demands and spending pressures. Conversely, high-growth areas can pose risks, as capital needs are often great, and providing the appropriate level of infrastructure and services to match, but not exceed, growth needs can be difficult. Ind-Ra considers the reasons a particular area attracts or loses population. Demographic structure and projections are also important for assessing future expenditure pressures, particularly in healthcare and education.

Tax Burden

Comparing the level of taxation, can provide an indication of competitiveness, financial flexibility, and/or tax relief pressures. The level of taxation can either encourage or hinder economic development. If the tax burden is already high, an increase may be difficult to implement and have ill effects. Ind-Ra reviews tax rates in comparison to those of similar entities nationally and other entities in the region.

Event Risks

Where relevant to the sector and material to the rating, Ind-Ra explicitly considers the potential event risks that may adversely affect the issuer's ability to repay the debt. Event risks arising from natural hazards as well as human error or mechanical malfunctions are identified and the management of the relevant risks evaluated. Ind-Ra also evaluates issuers ability to safe guard itself from such unforeseen events. Where it is determined that a credit has vulnerability to event risk, mitigating factors will be evaluated. Some issuers have multiple assets and analysis may consider a single event unlikely to affect all assets to such an extent that it would hurt timely payment of debt. The debt will not be affected so long as there is sufficient liquidity to get through the immediate impact of the event. In these cases where operating characteristics and revenue frameworks provide mitigation of risk, self-insurance may be a common option for an issuer. In some cases, risk mitigation will not be sufficient and the rating may be capped below an investment-grade threshold depending on vulnerability to the uninsured risk.

Finances

The analysis of an issuer's finances is focused on evaluating the issuer's financial resources and flexibility to support its obligations over the near and long term.

Revenue Analysis

Ind-Ra reviews revenue sources for volatility and diversity. In general, a diverse revenue system with a foundation of broad-based taxes is more stable and better able to capture the issuer's economic wealth, resulting in a stronger financial profile. Reliance on economically sensitive revenues, such as real estate transaction taxes, may expose the issuer to financial volatility and lead to a credit concern. An issuer's ability to control its own revenue sources, including the power to adjust tax rates, is an important credit positive. For entities that rely heavily on funding from another unit of government, Ind-Ra evaluates the consistency of the funding and how potential adjustments would affect the rated issuer.

For special tax bonds, the revenue analysis considers the historical performance of the pledged revenue stream, including its average rate of growth and year-to-year volatility.

Expenditure Analysis

Ind-Ra reviews trends in expenditures, the issuer's flexibility to make adjustments in spending (both as part of the annual budget process and during the course of the fiscal year), and the expected stability in each major spending item. The analysis also considers potential funding pressures, including outstanding litigation. The centralised ability, or mandate, to implement timely spending cuts to maintain balance is a credit strength.

Operating Margin Trends

Ind-Ra evaluates recurring revenues, compared with recurring expenditures. Concerns arise when operating expenditures consistently exceed operating revenues, as the use of nonrecurring revenue is unsustainable and usually leads to depletion of reserves and deeper financial imbalances.

Fund Balance and Reserve Levels

Ind-Ra views a satisfactory fund balance as an important cushion against potential revenue and expenditure volatility. The amount Ind-Ra considers satisfactory varies based on such factors as economic or tax base concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features. Fund balances that have been maintained consistently over time also are beneficial. Similarly, segregated funds that are available, or could be made available, for general expenditures can contribute to financial flexibility.

Liquidity

Ind-Ra analyses the ability of the issuer to receive dues and make payments of the debt obligation as per the schedule. The analysis of the issuer's liquidity position takes into the consideration the following factors: the tax collection schedules, the timing of transfers received, the timing of disbursements, the quality and timing of receivables and payables and any committed undrawn bank lines. The liquidity position highlights the ability of an issuer to make resources available to meet revenue requirements when there is a slump in demand or an increase in costs. The available cash position determines the strength of the liquidity profile; a strong-to-moderate cash position ensures minimum liquidity risk.

Management, Administration and Reforms

Management practices and actions can positively or negatively influence the other major credit factors.

Institutionalised Policies

Ind-Ra views positively the implementation of and consistent adherence to sound processes and policies for budgeting, debt, and financial operations. Notable policies include established rainy day reserve funds (particularly those with automatic funding sources and limits on use), multiyear revenue and expenditure forecasts, restricting use of nonrecurring revenue to nonrecurring expenses, sound capital planning, and debt affordability guidelines.

Budgeting Practices

Ind-Ra reviews an issuer's budgeting practices, particularly revenue and expenditure estimations, and compares the key assumptions included in an issuer's budgets to actual revenues and expenditures over time. Ind-Ra views conservative estimates favourably and is concerned if an issuer does not appear to be incorporating fully current economic, political, or financial conditions. Regular intra-year budget reviews, although rare at state and local bodies, can allow an issuer to identify underperforming revenues or overspending in time to make necessary adjustments to eliminate or lessen budget gaps and are also a positive credit factor.

Financial Reporting and Accounting

Where established accounting practices exist, Ind-Ra expects the issuer will be in compliance. Additional financial reporting, such as interim revenue reporting throughout the year, is viewed positively.

Political, Taxpayer, and Labour Environment

Ind-Ra expresses no preference for one form of government over another and does not view any type as better for credit quality. Rather, the key credit element is the efficiency with which an elected government can make service and spending decisions and its ability to adjust and react to changing economic and financial conditions.

Evidence of taxpayer dissatisfaction, with the level of either taxation or service provision, is a credit concern, as it may reduce an issuer's flexibility to address budget shortfalls. A negative taxpayer environment could include voter or legislative attempts to contain the government's legal ability to raise revenues or build reserves. This concern increases in environments with easy access to the voter-initiative process. Similarly, a difficult labour environment can limit budgetary options.

Revenue and Spending Limitations

Establishing and adhering to policy guidelines is considered a credit positive. However, onerous statutory or constitutional operating limitations are potential credit risks. Additionally, Ind-Ra recognises that, in some instances, practical limitations are just as restrictive. An inability to generate sufficient revenue to fund needed services due to political or other practical concerns can have long-term implications for an issuer's financial and economic health.

Figure 1

Attributes: Management, Administration and Reforms

Stronger	• Highly efficient decision-making process, based on financial prudence • Highly efficient delivery mechanism using electronic platform for providing government services/collection of taxes • Institutionalised, prudent financial and debt management policies • Conservative and thorough budgeting process with regular interim reviews, contingency planning, and the ability to make adjustments as needed during the fiscal year • Long-term financial planning process • Good level of transparency and disclosure • Timely financial reporting • Good fiscal marksmanship (actual vis-a-vis budgeted operating revenue, operating expenditure and capital expenditure)
Midrange	• Efficient decision-making process • Efficient delivery mechanism using electronic platform for providing government services/collection of taxesFinancial and debt management policies that may be somewhat less conservative but still reasonable and, if not followed, a process is in place to regain compliance • Realistic budgeting process and some ability to make adjustments during the fiscal year • Good level of transparency but limited public disclosure • Timely financial reporting • Moderate fiscal marksmanship (actual vis-a-vis budgeted operating revenue, operating expenditure and capital expenditure)
Weaker	• Often cumbersome decision-making process; resolution of key issues is problematic • Weak delivery mechanism using electronic platform for providing government services/collection of taxes • Financial and debt management policies not present or not consistently followed, without plans to gain compliance • Optimistic budget assumptions and inflexible budget amendment process that makes midyear adjustments difficult • Weak level of disclosure or reliability of accounts • Financial reporting delayed • Poor fiscal marksmanship (actual vis-a-vis budgeted operating revenue, operating expenditure and capital expenditure)

Source: Ind-Ra

Note on Sources

Ind-Ra's analysis and rating decisions are based on relevant information available to its analysts. The sources of this information include the issuer and/or the obligor, and the public domain. Sources also include relevant publicly available information on the issuer, such as financial statements, regulatory filings, audited reports of Comptroller and Auditor General and different reports tabled in state legislatures and Parliament. The rating process may also incorporate information provided by other third-party sources. If this other third-party information is material to the rating, the specific rating action will disclose the relevant source.

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