

## **Municipal Rating Methodology - Subnational Entity (Province/Regency/City)**

The scope of the analysis will be limited for Indonesia area, meaning that the comparisons made in the report will, to the extent possible, involve only the regional governments in Indonesia. The general analytical framework consists of both quantitative and qualitative analysis. The analysis generally relies on documentation that regional government provides, includes financial statements, budget documents, financial forecasts, as well as policy documents related to treasury management and risk management. In addition, the interview and discussion with regional government's staffs and senior management team is necessary. The final rating on fiscal management assessment will be on the range of *idAAA* (the highest rating) to *idD* (default). The rating may be modified by the addition of a plus (+) or minus (-) sign to show relative strength within the rating category.

Several key factors to be analyzed:

### **A. INSTITUTIONAL FRAMEWORK**

PEFINDO measures predictability, reliability and supportiveness of public finance systems and legislative frameworks which are likely to affect a regional government's ability to service debt in the long term period. Key analytical factors in assessing institutional framework are:

- A.1. Predictability
- A.2. Revenue and expenditure balance
- A.3. Transparency and accountability

### **B. INDIVIDUAL CREDIT PROFILE**

#### **B.1. Economy**

The analysis includes how economic factors are likely to impact a regional government's revenue generation capability and spending needs, and ultimately its ability to service debt in the medium to long term. Key analytical factors include wealth and income levels, diversification of the economic structure, demographic profile, and growth prospects.

#### **B.2. Financial Management**

The assessment includes how the quality of a regional government's financial management and its political context are likely to affect its willingness and ability to service debt over time. The focus is on the assessment on financial management systems, tools, policies and practices of the regional governments.

The final scoring will be based on score from 1 (Very Positive) to 5 (Very Negative). The scoring from 1 to 5 may be modified by the addition of a plus (+) or minus (-) sign to show relative strength within the scoring category. There are 9 factors to be analyzed as follows:

##### B.2.1. Transparency and disclosure

Degree of transparency is examined based on the regional government's ability and willingness to provide access on reliable, accurate, and timeliness information. The most crucial factor is the availability of clear and comprehensive disclosure of its financial reporting including detail of financial position and the use of all its financial resources. The accessibility on detail information of all regional government's activities and policies are also highly considered in rating determination. Other relevant factors such as degree of compliance with accounting standards and regulations, sophisticated and integrated accounting and financial reporting system, audit conclusion, frequency of publication and the existence of effective publication tools are also important factor to be assessed.

### B.2.2. Budgeting

A comprehensive analysis is conducted to assess the regional government's budget performance. The assessment includes the regional government's budgetary system and procedures, the ability to set timelines, reliable and realistic budget assumption and the consistency of the budget to its long-term strategic development plan. Level of variations between budget and realization, particularly in relation with revenues and expenditures as well as the number of budget revisions during the year is also crucial factor to be evaluated.

### B.2.3. Long-term capital and financial planning

The analysis is to determine the ability of regional government to set a clear and comprehensive long-term strategy development plan and its effort to achieve the targets. The analysis is not only conducted in regional government's level but also in each working and supporting units as the goals in each working unit will support the overall long-term plan. The assessment includes the reliability of long-term planning, commitment and political support as well as the track record of regional government to achieve the targets. The actual performance against historic medium-term plan is also highly considered.

### B.2.4. Revenue and expenditure management

The revenue management assessment is to determine the regional government's ability to set a reliable revenue target. The analysis includes the regional government's ability in forecasting and collecting the primary taxes and other source of income, the diversification of its revenue sources, and ability to identify and utilize the potential revenue base is also further considered. The variance of revenue between the actual result and budget is also important to be assessed.

The expenditure management examination is mainly focus on regional government's planning and monitoring during the year to compare with its fiscal target. On operational costs, the regional government's ability to control and monitor costs is crucial point to be analyzed. For capital expenditure, the assessment is conducted to the level of planning, funding, and prioritizing the various projects. The exposure to delays and cost overruns for projects are also critical points to be incorporated.

### B.2.5. Debt management

PEFINDO will review the regional government's policies related with debt such as the debt level in order to view the aggressiveness of the financial policy, the proportion of short term and long term debt to be matched with the usage of the debt, the interest rate of the debt (fixed or floating), the foreign currency exposure and the related hedging activities (if any), and the debt maturity profile. In addition, the concentration of lenders is considered.

### B.2.6. Liquidity management

In this analysis, PEFINDO will review the availability of standard written policies/guidelines on cash flow management and comparing those policies/guidelines with the fact or daily implementation, as well as the availability of realistic cash flow projection. We should also review how well the regional government covers both their short term and long term financial obligations, its investment policy, the risk appetite and its relationships with banks and investors. The regional government's track record in fulfilling its financial obligations is also highly considered.

### B.2.7. The management and financial independency of government-related entities

The general assessment will be held on how well the performances of several major business entities owned by the regional governments. The analysis includes the business prospects and the financial performances of those companies, the managements' reliable financial projections and their capabilities and strategies to achieve the projections. The transparency, reliability and timeliness of the reporting will also be considered. The revenue contribution of the regional government owned companies in term of dividend is also taken into account, as well as the potential capital injection needed to support the strategic companies.

#### **B.2.8. Political and managerial strength**

PEFINDO will analyze the managerial capability of regional government, including the qualifications and experience of management, as well as the degree of political influence on the regional government's policies or decisions. In this analysis, the size and influence of a political majority will be assessed. The track record on passing budgets without amendments is also considered.

#### **B.2.9. External risk management**

The analysis covers the ability of the regional government to know, identify, measure and mitigate the key external risks. The external risks could be related with the country's economic condition, the change in central government policy regarding the grants distributed, the change of system in regional government, or natural catastrophes. The degree of financial flexibility and other actions to show willingness to service their financial obligations during a stress scenario is also incorporated.

#### **B.3. Budgetary Flexibility**

The analysis covers how much a regional government could increase its revenues or reduce its expenditures in case of need, in order to maintain its debt servicing ability. The in-depth analysis is taken on the regional government's operating expenditure flexibility, capital expenditure flexibility and potential pressure sources.

#### **B.4. Budgetary Performance**

PEFINDO measures how the level and the volatility of a regional government's expected cash flows from operations and investment activities, and the ability to service debt within a forward looking perspective. It also aims to gauge the efficiency of the regional government's financial policy.

#### **B.5. Liquidity**

The analysis measures how regional government internal sources of liquidity (such as cash reserves, marketable securities, projected cash inflows and outflows within 1 year-including seasonality and elasticity to economic performance) and external sources of liquidity (such as committed bank lines, access to capital markets) are likely to impact its debt servicing capability in a forward looking perspective.

#### **B.6. Debt Burden**

PEFINDO measures the expectations for the level, structure, and sustainability of a regional government's debt is likely to impact its debt servicing capability in a forward looking perspective. The debt and interest burden of regional government is measured relative to its available resources. Potential volatility on debt in the relation with interest rate risk, currency risk, derivative instruments and debt maturity profile should also be analyzed. The examination is also conducted on any explicit obligations (such as guarantees) or implicit moral obligations. The assessment is also conducted on other long-term liabilities, mostly unfunded pension liabilities.

#### **B.7. Contingent Liabilities**

The assessment measures to what extent the risk of occurrence of some off-balance sheet risks and their relative sizes are likely to impair a regional government's capacity to repay its debt in the medium to long term. Assessment is done mostly qualitative, focusing on the nature of liability, its materiality, the quality of monitoring, and the amount of contingency reserves. The contingent liabilities are considered material if individual entity or transaction represents more than 20% of the regional government's operating revenues, but if the individual liabilities are minor, assess the overall sector risk and the track record of materialization of those risks. For uncontrollable risks such as natural catastrophes and geopolitical risks, the assessment is done qualitatively.

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