

**Highlights of the
Presentation of the Credit Rating Model for Water Districts to the
PWRF Steering Committee, EO 279 Oversight Committee and Key Stakeholders
Chateau 1771, El Pueblo, Ortigas Center
May 15, 2008**

Participants:

1. Mr. Daniel Moore, USAID Philippines
2. Ms. Joy Jochico, USAID Philippines
3. Mr. Josefino Gamboa, BAP
4. Mr. Joel Victor Soto, BSP
5. Ms. Teodora San Pedro, BSP
6. Mr. Paul Lazaro, DBP
7. Mr. Francis Perez, DBP
8. Mr. Popo Diloy, DBP
9. Ms. Elizabeth Castro, DILG
10. Ms. Olga Arceo, DOF
11. Ms. Flerida Chan, JBIC
12. Ms. Lydia Oriol, LGUGC
13. Ms. Len Castro, LGUGC
14. Ms. Thelma Sansales, LGUGC
15. Mr. Mario Quitarano, LWUA
16. Ms. Noemi Tan, LWUA
17. Ms. Clyde Esguerra, MDFO
18. Mr. Ramon Alikpala, NWRB
19. Mr. Artemio Baylosis, PAWD
20. Ms. Angelica Villoria, Philratings
21. Ms. Lourdes Tabarina, Philratings
22. Ms. Alma Porciuncula, PWRF Support Program
23. Ms Doreen Erfe, PWRF Support Program
24. Mr. Audi Pantillano, PWRF Support Program
25. Mr. Ferdinand Asuncion, PWRF Support Program
26. Ms. Adora Navarro, PWRF Support Program
27. Ms. Aida Mendoza, PWRF Support Program
28. Ms. Liza Cruz, PWRF Support Program

1. Agenda

The main agenda of the meeting were the presentation of the Credit Rating Model for Water Districts developed for the LGUGC through a technical assistance from the USAID; and a presentation of international experiences and best practices on the use of credit rating as a tool for developing the financial market.



2. Preliminaries

Ms. Alma Porciuncula, Chief of Party (COP) of the PWRF-SP, welcomed the participants and provided a brief background of the meeting's agenda. Mr. Daniel Moore, Chief of the Office of Energy and Environment of the USAID, gave opening remarks, and cited in particular the importance of the credit rating system in developing the domestic credit market. Ms.



Lydia Oriol, President of the LGUGC, gave an overview of the technical assistance. She said the system focuses on credit rating of water districts (WDs) to determine viable borrowers; and to have a sharper basis for segmenting the loan market for WDs. The system will be for LGUGC's internal use. Water districts seeking LGUGC guarantee will be rated for free, others may also seek rating for a fee that will be break-even cost-based. She expressed appreciation to the USAID, PWRF-SP, LWUA and the WDs which all contributed to the development of the credit rating system.

3. Presentations

Mr. Akash Deep Jyoti, a consultant from the PWRF Support Program's sub-contractor CRISIL¹, presented the Credit Rating System. He explained the benefits of having a credit rating system for WDs. Credit rating provides an independent & unbiased evaluation of the creditworthiness of water districts and adequate basis for benchmarking. The model he presented was based on a weighted assessment of credit risk factors and parameters for each of these factors. He also provided some international experiences on how credit rating played a key role in deepening credit markets and protecting investors' interests.



Mr. David Painter, PWRF Support Program's International Finance Advisor, also expounded on international experiences on credit rating and their relevance to the Philippines. He noted demand and supply problems that constrain the development of a credit rating system. Mr. Painter then recommended several approaches to institutionalize credit rating, including mandating it as was done in Mexico, issuing financing policies that will motivate credit rating, introducing funding programs to lessen start up costs for raters, and training LGUs and WDs to prepare for and obtain ratings.



¹ CRISIL is an Indian-based credit rating agency, which is a subsidiary of Standard and Poors.

4. Open Forum

The following were the issues and concerns and clarifications made on the presentations:

Issue/Concern	Clarification/Comments
1. What is the composition of the Rating Committee? (PhilRating, USAID)	The manual stipulates the membership. LGUGC or any rating agency can convene the committee.
2. Is the credit rating applicable to other sectors? (DOF)	Yes, but the indicators need to be adjusted to that certain sector.
3. How much does it cost for a water district to be rated and the succeeding ratings therefrom? What was the experience with the rating exercise? (USAID)	It is the prerogative of LGUGC to determine the fees. It can be on cost basis or cost-plus basis. On the rating exercise, out of 20 water districts initially covered, 16 responded. Still, the information submitted was 50 percent incomplete. Credit rating is actually a function of data availability and willingness to be rated by a water district. Many water districts have insufficient data and poor management system. The two pilot water districts (Silang and Laguna) that were rated, were selected on the basis of available data and agreement of the management for the WDs to be rated.
4. If an entity has AAA rating, does it automatically mean it gets a lower interest rate for its loan (DOF)? If an entity is rated AAA, will it be in a position to bargain for the most preferential rates (BAP)?	There is a strong correlation between the rating and the interest rate, but it is the market that determines the actual rate. Credit rating can help lenders decide on loan approvals, especially in the light of BASEL II requirements. BASEL II now considers risk weights as a factor for the banks capital adequacy requirements (i.e., high credit rating = low provisioning requirement)
5. How were the risk factors and weights determined and how much of the weights were based locally? How was the sample determined? Do you also rate the bank or guarantee company? (PhilRating)	The model was based on criticality of factors (based on international experience) and availability of data gathered from local entities. Parameters for two risk factors, operational and financial, were particularly derived locally. The sample water districts were randomly selected. Yes, banks and guaranteeing institutions are also rated.
6. Will all water districts be rated or only those dealing with LGUGC? Who will shoulder the cost of rating?(PAWD)	LGUGC will rate water districts that apply for guarantee from them. LGUGC will shoulder the cost of rating for these borrowers. For water districts not guaranteed by LGUGC, it can rate them for a fee (breakeven cost). The fee will be shouldered by the water district (borrower) or the lender, who requires their borrowers to be rated.
7. How do you factor in non-quantifiable risks not covered by the model? (JBIC)	There are indicators that are not quantifiable therefore the need for qualitative analysis and discretion among raters. The model takes care of the technical factors but the committee can handle the qualitative ratings.

Issue/Concern	Clarification/Comments
8. Other comments from the participants	To stimulate demand for credit rating, LGUGC enjoined concerned government institutions such as LWUA, BSP and DOF to make credit rating a requirement for borrowings of LGUs and water districts.
	BSP in principle supports credit rating. It recognizes the risk rating system under the BASEL II accord and those adopted by the three rating agencies (PhilRating, S&P and Fitch) for determining bank capital adequacy requirements. However, they cannot impose on banks to require credit rating of their borrowers. They can only prescribe risk ratings on loans, which can motivate banks to require credit rating.
	LWUA pointed out that water districts are currently constrained to expand because they are prone to public and political pressures. Credit ratings can help them ward off political pressure. Adoption of the Mexican policy (mandating credit rating as a pre-requisite for borrowing), may help address governance problems with water districts and promote transparency in lending. This option can be discussed with the EO 279 Oversight Committee. Credit rating can be used as an objective tool to gauge the progression of water districts toward creditworthiness. It may help to mitigate the moral hazard of the EO 279 financing policy.
	LWUA also noted the need to improve the management information and reporting system of water districts. Relatedly, LGUGC said it has a data base for about 500 LGUs, which has allowed them to do credit screening. LGUGC can help with the screening of WDs if the information is available. LWUA agreed that a sampling of 50 water districts would be sufficient for LGUGC to run or validate the credit rating system. If the system is found acceptable after the pilot test, then LGUGC and LWUA can agree on the cost of rating.
	DOF indicated the need to harmonize the credit rating system with initiatives undertaken by LWUA under EO 279.
	DBP also see the credit rating system as a welcome initiative. However, at present, the bank has its own loan appraisal criteria.

5. Closing

Ms. Porciuncula adjourned the meeting by thanking the participants. She indicated that this presentation is part of a continuing advocacy to promote and establish credit rating to help develop the Philippine domestic capital market. The meeting ended at 1:00 pm.

Credit Rating Framework for Water Districts in the Philippines

Akash Deep Jyoti
PWRP Support Program

Key Messages

- ❑ What is credit rating?
- ❑ Credit rating provides credit risk assessment of the issuer: the benefits extend beyond pricing of risks.
- ❑ Credit rating approach provides the guiding framework for assigning the ratings. Credit rating process is exhaustive, independent and objective
- ❑ Credit rating is assigned by a committee on an 18-point scale, which provides adequate breadth for benchmarking water districts. The rating has an outlook, is reviewed periodically and can be put on watch.
- ❑ Credit rating model is the useful tool for assigning the credit ratings. It is based upon the weighted assessment of credit risk factors, and requires data on various credit risk parameters
- ❑ International experience shows that regulators play a key role in deepening credit markets and protecting investors' interests

What is credit rating?

- ☑ **Current opinion** on the credit quality of the debt in terms of borrower's **ability** and **inclination** to meet debt obligations in a timely manner
- ☑ Independent & unbiased evaluation of creditworthiness of the water district
- ☑ Relative position of borrower vis-à-vis the peers and other corporate borrowers

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What a credit rating is not?

- ☒ General purpose evaluation of borrower
- ☒ Audit of the borrower
- ☒ One time assessment of credit worthiness of the borrower valid over the future life of the loan
- ☒ A recommendation to extend or not extend loan

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How is the credit rating of a water district useful?

- ▲ Helps in evaluation and pricing of credit risks
- ▲ Helps in credit history formation
- ▲ Improved visibility & bankability with development institutions
- ▲ Will facilitate flow of capital
- ▲ Indicative of improved governance and transparency in WD sector
- ▲ Helps in benchmarking among WDs and with corporate entities
- ▲ Facilitates independent monitoring of overall debt level & financial risks
- ▲ Will facilitate accessibility to funds from the bonds market in the long-term

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Credit rating framework



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Credit Rating framework

Regulatory risk	Powers-tariffs, borrowings, functions
Economic risk	Demographics, economic growth, per capita income
Operating risk	Efficiency, e-governance
Financial risk	Debt protection, liquidity, indebtedness, surplus
Management risk	Collection mechanisms, political interference, reforms

Rating Committee

- Minimum 5 members, with representatives from professional fields
- Composition has been specified to ensure high degree of competence and objectivity
- Conduct of meetings should ensure active participation of members
- Quorum for assigning the ratings is fixed
- Rating is kept under continuous surveillance; possible outcomes can be 'change in rating', 'outlook change' or 'credit watch'.

18-point credit rating scale facilitates wide-benchmarking

Categories AA to B have modifiers '+' and '-' suffixed

Credit rating outlook

- Indicates the direction in which a rating may move over a medium-term horizon of one to two years.
 - Positive outlook means that a rating may be raised.
 - Negative outlook means that a rating may be lowered.
 - Stable outlook means that a rating is not likely to change.
- Can be assigned by the Rating Committee for ratings from 'AAA' to 'B' at the time of initial rating and is reviewed whenever the credit rating is reviewed. The default credit rating outlook will always be 'Stable'.
- A 'positive' or 'negative' rating outlook is not necessarily a precursor of a rating change, however it provides investors an early indication of possible direction of rating change.

Credit rating watch

- The credit rating can be put on watch by the Rating Committee in case there are events or circumstances (such as mergers and acquisitions, shareholding change, regulatory actions), the impact of which on outstanding rating needs to be evaluated with further information.
- The credit rating watch should be typically resolved within a 3 to 6 months timeframe.

Credit Rating Model

- Based on fundamentally important risk factors, with weights
- Relies upon measurable and available sub-parameters
- Weights are based on the importance of a parameter as well as availability and reliability of data
 - Study of 20 water districts was undertaken
- Management risk is the single most important risk factor, which can impact the credit rating significantly

Risk Factors
Regulatory risk
Economic risk
Operating risk
Management risk
Financial risk

Credit Risk Factors - Regulatory risk

Objective: To assess the degree of operational and financial autonomy conferred on the entity by the regulatory framework.

Key parameters to be examined:

- Debt raising flexibility
- Tariff raising flexibility
- Functions
- Restrictions

Credit Risk Factors - Economic risk

Objective: To ascertain the revenue generating potential of the entity's service area and its infrastructure requirements. The economic base indicates the potential of the population to pay the user charges

Key parameters to be examined:

- Per capita income
- Literacy levels
- Slum population
- Telephone density

Credit Risk Factors – Operating risk

Objective: To assess the ability of the entity to leverage on the economic base of its service area to improve its resource base, service arrangements & delivery.

Key parameters to be examined:

- EBITDA/ Operating Income
- Non revenue water
- Collection efficiency
- Collection ratio

Credit Risk Factors – Management risk

Objective: To assess the competence and the integrity of the management

Key parameters to be examined:

- Water district management
 - Delay in LWUA loans
 - Percentage of Professionally qualified members
 - Capitalization of reserve fund/ sinking fund
 - Relationship with stakeholders
 - Board Meetings
- Project management
 - Operating risks
 - Time over runs
 - Cost over runs
 - Financial risks
 - Debt funding of the projects

Credit Risk Factors – *Financial risk*



Objective: To assess the degree of protection provided by the financials to the entity's debt service commitments going forward. This takes into account the expenditure requirements, economic base, and operational efficiency

Key parameters to be examined:

- Debt service coverage ratio
- Gearing
- Net cash accruals to total Debt
- Net worth
- Net profit margin

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International experience with regulation



- **Argentina**
 - Pension/ insurance funds are not allowed to invest in assets rated below BBB by domestic credit rating agencies and below B by international agencies.
- **India**
 - Limit on banks' investments in unrated instruments
 - Minimum investment grade rating for commercial paper issuance
 - Rating from at least 2 credit rating agencies for public debt issues in excess of US\$ 20 million
 - Investments in corporate bond by insurance funds permitted only for instruments rated above A+
- **Thailand**
 - Unsecured debt issues must be rated

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International experience with regulation



- **USA**
 - Department of Transportation can only extend credit assistance to projects with an investment grade rating BBB
 - Restricts the ability of national banks below 'A' rating to establish financial subsidiaries
- **Switzerland**
 - Investment fund managers are restricted on with whom they may conclude certain derivative transactions, dependent on the counterparty's credit rating.
- **Basel II**

Risk weight to be used by banks for calculating the capital requirements		
Rating	Basel I	Basel II
AAA	100%	20%
AA	100%	30%
A	100%	50%
BBB	100%	100%
BB and below	100%	150%
Unrated	100%	150%

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International experience with municipal securities



- Municipal securities have a significant position among US securities
 - Fresh bond issuances \$459 billion (2005)
 - Outstanding bonds \$2.23 trillion (9% of total debt)
- Households are the largest category (38%) of investors in municipal bonds, followed by mutual funds (37%).
- Diversified investor base helps the financial markets to grow.



CREDIT RATINGS: INTERNATIONAL EXPERIENCE AND ITS RELEVANCE TO THE PHILIPPINES



Philippine Water Revolving Fund Support Program

Why have public finance ratings NOT developed spontaneously?



Demand problems

- Volume of transactions needing ratings
- Cost/Benefit to rated entity
- Investor perceptions

Supply problems

- High cost of starting up
- Information unreliable and/or difficult to get
- Default data unavailable to correlate to model

What can be done to develop public finance ratings?



Demand side approaches

- Encourage more transactions
- The “Mexico” policy and variants requiring ratings
- Demand-side subsidies for ratings
- Require investors to disclose the ratings of their holdings

What can be done to develop public finance ratings?



Supply side approaches

- Government or external funding for raters to overcome start up cost
- Assistance to LGUs and WDs to introduce improvements to accounting, financial reporting, and operational reporting
- Involve international rating agencies with models that have long histories of performance

Next Steps



- Analyze the importance of ...
 - Demand factors
 - Supply factors
 - Potential impact of interventions
- Introduce regulatory changes such as ...
 - LGU and WD ratings requirement for all borrowing
 - Investment portfolio standards for key institutions
 - Rating requirement for all capital market listings
- Introduce funding programs such as ...
 - Reducing start up costs for raters
 - Assisting LGUs and WDs to prepare for and obtain ratings

A final thought...



You have to start somewhere.
Sooner is better.