



ICRA Rating Feature

Rating Methodology for Urban Local Bodies

This note updates and supersedes ICRA's earlier methodology note for rating urban local bodies (ULBs). While this revised version incorporates a few modifications, ICRA's overall approach towards rating the ULBs remains materially similar.

Overview

The urban local bodies (ULBs) play a critical role in the delivery of social, economic and infrastructure services including public health, sanitation, primary education, water supply, and maintenance of road networks. The rapid pace of urbanisation in India over the past few decades has led to an increasing pressure on the ULBs to ensure adequacy of services for a burgeoning population. According to the 2011 Census, India's urban population stood at around 31% of the country's total population and is estimated to grow substantially in future. However, the coverage and standard of basic services provided by the ULBs in urban areas have not improved in tandem with the swift growth in the urban population base.

Considering the current level of urban infrastructure in India and estimates of a sharp increase in urban population, the need for strengthening and augmenting urban infrastructure becomes critical, requiring a large amount of investment in such infrastructure creation. Thus, with a growing population to be served, increasing pressure for better service delivery, and curtailed access to traditional sources of funding, the ULBs need to increasingly resort to fund-raising from the capital market to meet funding requirements. The objective of this note is to help investors, issuers and other market participants understand how ICRA analyses the creditworthiness of the ULBs.

ICRA's Credit Risk Analysis Framework for ULBs

ICRA's credit rating framework primarily evaluates the ULB's operational and financial strength along with the fiscal relationship between the ULB and the respective state government. Given the role of the state governments in determining the operational and financial autonomy of a ULB, ICRA's methodology assesses the linkage between the credit quality of the ULB and the state to which it belongs to. The overall credit quality determinants are:

- » Inter-Governmental Fiscal Relationships
- » Economic Strength
- » Operational Efficiency of the ULB
- » Financial Strength of the ULB
- » Project Pipeline and Execution Track Record
- » Quality of Reporting, Monitoring and Reform Efforts
- » State Government's Credit Quality

While the above parameters do not represent an exhaustive list of rating drivers for ULBs, these are usually the most important and should serve as a reference guide for investors, lenders and market participants to understand ICRA's approach towards assessing the credit quality of the ULBs.

Key Rating Criteria

1. Inter-Governmental Fiscal Relationships

ICRA's ULB ratings factor in the stability of inter-governmental fiscal relationships in terms of clarity of expenditure responsibilities, and revenue-raising powers as laid down in the relevant and respective Municipal Act. While the legislative framework defines the context, ICRA also considers the empirical evidence available with respect to the actual expenditure track record of a ULB, its revenue generation avenues and the funding mix. ICRA favourably considers allocation of expenditure responsibility to the ULBs based on the Principle of Subsidiarity¹.

ICRA looks for a clear, stable and predictable fiscal relationship between a ULB and the respective state government. While higher share of rule-based transfers is a credit positive, a high dependence on the state government for discretionary (and sometimes inconsistent) transfers is a credit negative. Evidence of the state passing on expenditure responsibility to the ULB without corresponding revenue sources being earmarked, arbitrarily withdrawing tax sources, while retaining expenditure commitments, or lack of a demonstrated track record in providing timely support through the mechanism of devolution of taxes and grants are clear credit negatives. While the stability of an inter-governmental fiscal relationship is an important criterion in ICRA's ULB ratings, the same is not viewed in isolation. ICRA also considers the standalone performance of the ULB in terms of its operations, finances, track record and future capex plans. These are discussed in subsequent sections.

ICRA considers a ULB's ability to meet its expenditure commitments primarily from its own revenues and without any significant support from the state government, a strong credit positive. Moreover, if such independence is demonstrated not only in fiscal relationships but also in operational and managerial affairs over a sufficiently long-time, the ULB's credit rating may not be constrained by that of the respective state government.

ICRA also places emphasis on the consistency of policies and principles governing the relationship between the state and the ULB. A number of Indian states have set up the State Finance Commissions (SFCs), which recommend the principles for the sharing of taxes and user charges, and also recommend the grants-in-aid to be given to the ULBs. Although the SFCs are constitutionally mandated, ICRA notes that the history of decentralisation, up to the third tier², is just over 25 years old in India, as against more than 60 years of the operational duration of successive Central Finance Commissions (CFCs). Also, different states had started constituting SFCs at different points in time because of which the system of inter-governmental fiscal relationships between the state and the ULBs remain at varying stages of evolution across the country and is likely to evolve further in the future years.

Table 1: Inter Government Fiscal Relationship

RATING FACTOR - Extent of financial support from the State Government	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Share of total revenue transferred by the state » Share of rule-based transfers by the state 	<ul style="list-style-type: none"> » Revenue grants and assignments from the state government to the ULB/total revenue receipts of the ULB » Rule-based transfers by the state/ total transfers by the state » Revenue grants and assignments from the state government/total revenue expenditure of the ULB

¹ Subsidiarity Principle: Government services should be provided at the lowest level of government that is capable of efficiently providing the goods or services. According to this principle, the area where the benefits of a government service are felt would coincide with the government boundaries at each level of government.

² As per the Constitution of India, governance is provided by three tiers – Central Government, State Governments and Local Governments (urban and rural bodies)

2. Economic Strength

The revenue sources of a ULB are dependent primarily on the level of economic activity within its jurisdiction. The economic base—its growth potential and diversity—is, therefore, one of the critical determinants of the revenue potential of a ULB. ICRA considers both the scale as well as the stability of a ULB's revenue streams as important metrics to evaluate its ability to remain self-sufficient in meeting its expenditure and other obligations including debt-servicing. An important consideration here is the depth and diversity of the economic base, the sectors that dominate the economy of the region, and their growth trend. A diversified industrial base is a credit positive, whereas dependence on a few industrial units increases concentration risk.

In addition to the level of economic activity, the demographic profile of the area is an important consideration for the evaluation of the future revenue potential, as well as the level of demand on the ULB for provision of such services. ICRA evaluates the size of the population served and its growth rate to determine the existing demand for public services, and the level of acceleration likely in future. The age profile, per capita income, literacy levels of the population and share of population living in slums are analysed to estimate the size of the employable population and its ability to pay taxes and user charges. A rapidly growing population could raise pressures on demand for services to a level that could be difficult for the ULB to scale up to, in the short term, and may require investment towards creation of an urban infrastructure. On the other hand, a stagnant population, or one that is skewed towards children and the elderly or where a high share of population lives in slums, would restrict an area's revenue potential (such population groups are considered to have limited ability/willingness to afford/pay), thereby limiting the ULB's ability to grow its revenues.

Overall, ICRA believes that a steadily growing population base in the employable age bracket with reasonable levels of literacy is a preferable demographic profile and a positive rating factor.

Table 2: Economy of the Municipal Area

RATING FACTOR - Socio-Economic base of the city/town	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Demographic trends » Industrial base » Economic diversity and growth 	<ul style="list-style-type: none"> » Size and growth of the city population » Trends in age-profile, income levels, literacy levels, employment rates etc. » Percentage of population living in slums » Employment pattern » Type of industries, number of units, industrial growth rate

3. Operational Efficiency

ICRA's rating methodology recognises the fact that although there could be differences in the scope of services offered across the ULBs, most are obliged to provide largely similar basic urban services. Such services include, among others, maintenance of roads and layouts, water supply, sewage disposal, solid waste management (SWM), and street lighting.

ICRA evaluates the ULB's organisation structure and manpower adequacy vis-à-vis its range of municipal functions and services. Judging performance or operating efficiency based on output measures, such as service delivery levels, inevitably poses a problem, given the inadequacy of standardised and comparable data across the ULBs. Nevertheless, a ULB's performance is assessed on certain service parameters—such as the percentage of population covered by piped water supply and sewerage network (where water supply/sewerage are within its domain of services); volume and frequency of water supply; percentage of non-revenue water (NRW); extent of metering in water supply connections; collection efficiency of municipal solid waste (MSW) and extent of its scientific treatment; coverage of sewerage and extent of treatment and safe disposal; coverage of road network and extent of surfaced road network; and coverage of street lights and storm water drains (SWDs). These key service standards of a ULB are generally compared against the benchmarks set by the Government for assessing mean service levels, and not as absolute indicators on a

standalone basis. A service level that is positioned significantly lower than the mean is usually viewed with concern. ICRA believes that citizens are more likely to accept a fresh tax/user charge or an increase in an existing tax/user charge if service standards of the ULB are satisfactory and vice-versa. ICRA recognises that a ULB may be compelled to impose a new tax/user charge or hike an existing tax/user charge with the objective of improving the quality of services offered such as incurring fresh capex for setting up sewage infrastructure, that was hitherto non-existent. While a fresh capex plan may expose a ULB to funding and execution risks, it need not be as big a credit negative as in case of a ULB that provides below average services and is oriented to maintain status quo.

A rapidly expanding population is likely to put greater stress on the ULB's physical infrastructure and ability to provide its services. In such a scenario, the ULB's track record in outsourcing a part of its activities, while retaining sufficient operational control over service levels, is judged. A ULB's ability to effectively partner with private agencies in the form of public private partnerships (PPPs), to create infrastructure and provide urban services, is viewed positively when it merges public services with private sector efficiencies.

Table 3: Operational Efficiency

RATING FACTOR - Service Standards	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Coverage of key municipal services » Existing service levels 	<ul style="list-style-type: none"> » Percentage of households covered with water supply and sewerage service connections » Per capita per day quantum of water supplied » Non-revenue water/total water supplied » Percentage of metered water service connections » Extent of treatment of sewerage » Percentage of households covered with door-to-door collection of MSW » MSW collected/generated » MSW treated/collected » Road length/city area » Percentage of roads covered with storm water drains » Percentage of road length covered with street lights » Street lights per unit road length

4. Financial Strength

4.1. Revenue Structure

ICRA analyses the tax and non-tax revenue generation options available to a ULB under the relevant Municipal Act and estimates the effort made by it to leverage such options. ICRA also analyses the nature and extent of other revenue sources such as grants and transfers from the state government, which contribute majorly to the total revenue base of a ULB.

4.1.1. Own Tax Revenues

A well-administered and stable source of own tax revenues is a credit positive, as is the demonstrated ability to utilise the available sources of tax, as laid down in the corresponding Municipal Act.

Subsequent to the abolishment of octroi by all the states in India, property tax has become a dominant own source of tax revenue. Across most of the ULBs, the annual rental value (ARV) is the rate based on which property tax is charged. In ICRA's view, the very definition of this rate constrains the revenue-generating potential of property tax for the ULBs. Most Municipal Acts define the ARV as gross annual rent of land and building at which they might reasonably be expected to let. Since "reasonable" expectation is subjective (and in some cases capped by fair rent, according to the prevailing Rent Control Act of the respective state), the

base rate of property tax, as well as its potential, remain depressed. In addition, irregular assessment and lack of periodic revision often leads to wide gaps between the potential and the assessed revenue. Also, a weak administrative system may result in low collection efficiency of property tax. Moreover, many of the newly-formed ULBs, owing to inadequate information systems, have not assessed the entire range of properties available in their jurisdictions. As a result of all these factors, while property prices might demonstrate buoyancy, depending on the dynamics of demand and supply in the local real estate market, property taxes have not shown similar growth trends over the years.

Nevertheless, a number of ULBs have been able to initiate reforms in the method of computation (unit area-based computation), assessment (self-assessment system), coverage (use of geographical information system or GIS for 100% mapping of properties), and collection mechanisms (online payment of taxes), which have resulted in growth in property tax revenues. Considering the critical importance of property tax as a source of own revenues, ICRA reviews the efforts made by the ULBs in administering this tax, their track record in revising property tax rates, and their collection efficiency to estimate the ULB's ability and willingness to grow own revenues, thereby reducing dependence on external sources like discretionary grants from the state government.

4.1.2. State Devolution

ICRA studies the recommendations made by the SFC concerned and the extent of adherence to it in the existing devolution mechanism. Of the total pool of SFC devolution (usually a percentage of the state government's Own Revenue Receipts), the manner in which allocation among the ULBs is decided is evaluated. ICRA also evaluates the periodicity and the timeliness of transfers from the state since that has a critical impact on the ULB's liquidity profile. A rule-based allocation mechanism, which provides a clear framework for fund transfers, is considered a positive rating factor.

4.1.3. Non-Tax Revenues

For the ULBs in India, the non-tax revenue stream is typically the weakest due to inadequate user charges (most of the ULBs are unable to recover the operation and maintenance cost of water supply and sewerage services), poor collection of rent on own properties, and administrative inefficiencies, with the result that available non-tax revenue sources are generally under-exploited. While evaluating user charges, ICRA looks at the quality of services offered by the ULB and then assesses the level of user charges. A track record of poor service and high user charges, that are regularly revised upwards, make for an unsustainable revenue model, which is a credit negative. On the other hand, a combination of satisfactory service levels along with strong revenue potential and successful track record of periodically revising service charges is a credit positive. ICRA also looks at the extent of cost recovery and the adequacy of user charges related to specific civic services and considers a high degree of cost recovery a distinct credit strength.

4.1.4. Grants

The ULBs obtain scheme-specific grants as well as grants-in-aid from the state government to bridge assessed revenue shortfalls. In addition, they also obtain Central grants-in-aid, in accordance with the recommendations of the CFC, which are meant to address specific needs of the ULBs and are routed through the state.

ICRA evaluates the nature of support, the modality of administering various schemes (for scheme-specific grants) and the commitment of the state government towards such schemes. In general, ICRA views grants positively, provided they lead to capacity build-up within the ULB, and their utilisation is adequately monitored, both by the ULB and the state government. Grants without end-use stipulations, have limited utility in general and, if inadequately monitored, could end up being used to meet routine revenue expenditures, which is viewed by ICRA with caution. In ICRA's view, such grants increase a ULB's dependence on the state government and their sustainability is usually not very high, given that they are not linked to any policy initiative. Moreover, considering the typical tendency of the states to delay passing on Central grants to the ULBs, ICRA views the uncertainty in the timeliness of release of such grants unfavourably from a credit perspective.

Table 4: Revenue Structure

RATING FACTOR - Extent of self reliance	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Share of own revenues in total receipts » Collection efficiency of key own revenues » Ability to levy or revise key tax rates, tariffs and charges » Extent of rule-based transfers from the state government 	<ul style="list-style-type: none"> » Own revenue receipts/population » Own revenue receipts/total revenue receipts » Own revenue receipts/revenue expenditure » Non-tax revenues/total revenue receipts » Property tax collection efficiency » User charges collection efficiency » Past trend of key tax rates, tariffs and charges » Rule-based revenue receipts/total revenue receipts » Rule-based revenue receipts/total external revenue receipts

4.2. Expenditure Structure

One of the most critical aspects of ICRA's evaluation of municipal expenditure focuses on municipal functions of a ULB and the expenses incurred on the same. Municipal functions should be covered by adequate allocation of funds on an ongoing basis (by provisioning for the same in the annual budget estimates), and a stable level of expenditure on each of these functions is a positive.

Evaluating the quality of spending is analytically more challenging in comparison with evaluating the extent of spending. ICRA relies on peer comparisons and benchmarks to evaluate the quality of municipal service provisions in areas such as water supply and sanitation, primary education, health, road maintenance and solid waste collection and disposal. A poor track record of service provision, despite expenses, is an indicator of administrative flaws and considered a credit negative. Given the cash-based accounting system followed by most ULBs (although many ULBs have also implemented accrual-based accounting systems), the extent of under-reporting or deferment of expenditure is difficult to evaluate. ICRA tries to capture this by looking at per capita benchmarks, growth trends in expense levels, and unusual movements, if any, in expense heads. In this regard, any sharp inflection is analysed to understand the underlying cause.

ICRA also analyses the past trends in key expenditure items such as establishment (staff) and operation and maintenance. Also, key developments such as revision of pay scales of the ULB staff and additional expenditure towards operation and maintenance are taken into consideration while estimating the future cash flows of an ULB.

Table 5: Expenditure Structure

RATING FACTOR - Cost efficiency	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Expenditure analysis » Cost recovery of key services 	<ul style="list-style-type: none"> » Establishment expenditure/total revenue expenditure » Operation and maintenance expenditure/total revenue expenditure » Cost recovery of services – user charges collected/cost of services (water supply/sewerage/SWM) » Per capita expenditure (revenue and capital)

4.3. Revenue Balance

ICRA evaluates the surplus/deficit on revenue accounts against the backdrop of the quality of services provided by an ULB. A high revenue surplus is not necessarily a credit positive, especially if adequate service levels have not been maintained. In cases where service levels are found to be acceptable, a consistent revenue surplus is usually viewed positively, since this implies capital expenditure can be partly met out of such a surplus, with limiting dependence on borrowings.

ICRA also looks at a ULB's own revenue balance (total revenue receipts less state grants less revenue expenditure) to evaluate the strength of its own revenues (including rule-based transfers from the state that the ULBs are entitled to) in relation to its expense levels. The operating ratio (revenue expense/revenue receipts) is an indicator of the operating efficiency of the entity. An operating ratio above unity, while indicating operational weakness, may be viewed with less concern if ICRA's assessment suggests that the ULB is committed to taking adequate steps for building up own revenue streams.

Table 6: Revenue Balance

RATING FACTOR - Adequacy of revenues	SOME ANALYTICAL INDICATORS
» Extent of surplus generated from regular operations	<ul style="list-style-type: none"> » Revenue expenditure/revenue receipts » Revenue balance (revenue income – revenue expenditure)/revenue receipts » Own revenue balance/revenue receipts

4.4. Liquidity and Debt Profile

In the absence of bank-supported lines of credit, a ULB's liquidity is a function of its cash management, investment policies, flexibility in deferring certain expenditure and the strength of its budgetary planning and control functions. The timeliness of fund transfers from the state assumes critical importance in the evaluation of this aspect. ICRA, therefore, analyses the manner in which the state government concerned undertakes revenue sharing with the ULBs and transfers grants (including central grants, where the state is a pass-through channel) in terms of the extent of support as well as the schedule of inflows. This evaluation is conducted over a period of time to study monthly patterns. The ULB's total debt including revenue-backed debt (debt servicing linked to specific revenues such as property tax or water supply user charges) is analysed in terms of its tenure, repayment pattern and interest rate sensitivity, as it directly impacts the overall liquidity position of the ULB. Additionally, non-debt liabilities such as pending dues towards staff salary, power and water bills, contractor payments, etc. are also analysed to assess the the liquidity position of the ULB.

ICRA also looks at the cash and bank balances of the ULBs to evaluate their liquidity profile. Many ULBs maintain a large cash and bank balance, which typically includes unspent grants received from the Central/state governments towards various projects. Such amounts however cannot be utilised by the ULBs for discretionary purposes and therefore do not provide any major comfort to the ULB's liquidity position. On the other hand, if such balance has been accumulated from a ULB's own cashflows without compromising on its expenditure requirements, it imparts a high degree of financial flexibility to the ULB and is considered a credit positive.

Table 7: Liquidity and Debt Profile

RATING FACTOR - Debt servicing ability	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Track record of debt servicing capacity » Assessed ability to service outstanding debt 	<ul style="list-style-type: none"> » $(\text{Revenue balance} + \text{interest}) / (\text{interest} + \text{debt repayment})$ » $(\text{Own revenue balance} + \text{interest}) / (\text{interest} + \text{debt repayment})$ » Outstanding liabilities/revenue receipts

ICRA looks at debt service coverage through a ULB's own revenues $[(\text{own revenue balance} + \text{interest}) / (\text{principal} + \text{interest obligation})]$. Entities with low or negative own revenue balances, which incur capex and avail debt on the strength of discretionary grants, are usually viewed negatively, as the long-term sustainability of such grants may be an issue of concern.

A ULB that could service its debt obligations out of own revenues after meeting obligatory expenses is generally viewed more favourably from a credit perspective.

5. Project Pipeline and Execution Track Record

ICRA also evaluates the project pipeline, not only from the point of view of its impact on the financials of the ULB, but also in terms of qualitative improvements it may bring to the citizens serviced by the ULB. ICRA analyses the capital expenditure requirements under expected levels of growth and service obligations. Adequacy of revenue surpluses and/or capital receipts to fund this level of expenditure is evaluated too. The ULB's demonstrated track record in planning for growth and effectively executing projects within the budgeted time and cost are a distinct credit positive.

Table 9: Project Pipeline and Execution Track Record

RATING FACTOR – Project Pipeline	SOME ANALYTICAL INDICATORS
<ul style="list-style-type: none"> » Capital expenditure required » Project viability » Capacity to execute projects within budgeted cost and time 	<ul style="list-style-type: none"> » Debt funding/capex » Revenue surplus/capex » Revenue balance from the project » Interest + principal repayment of the project debt/project revenue or ULB's revenue balance

ICRA evaluates the dependence of a ULB on the state and the Central Government to fund its capital expenditure. Historically, large projects have been funded by grants from the state and the Central Governments under various schemes and missions as well as by debt extended by the state and/or specialised lenders. Besides the funding pattern of projects and the ULB's ability to execute, ICRA also evaluates the financial viability of projects and adequacy of future revenue from project assets in relation to operation and maintenance expenditure, and debt service requirement. ICRA looks at a ULB's capacity to fund and execute projects over a period of time, critical for the successful implementation of projects in future.

6. Quality of Reporting, Monitoring and Reform Efforts

ICRA's analysis of this aspect covers four key factors—(i) management capability, (ii) adequacy of existing structures, systems and controls, (iii) extent of transparency in operations, and (iv) reform orientation. ICRA recognises the fact that several aspects relating to the functional domains of the ULBs are still evolving. These include the relationship between the ULB and the state, the manner in which the ULBs manage their affairs, the accounting policies that they follow, and the information system on which they rely for their functioning.

Given these issues, the ULB management's ability to provide effective leadership, demonstrate its ability to plan and implement programmes, partner appropriately with the private sector, maintain links with citizens, and function effectively within the political system of the state concerned, is analysed. ICRA considers that the continuity of staff at key positions and adequate capacity of the staff in critical functions are strong positives. Institutionalised systems and control mechanisms that lower reliance on individuals are a clear positive in assessing an entity's management depth.

ICRA also evaluates the timeliness and accuracy of a ULB's financial reporting, operating statements and budget documents. Key stakeholders for a ULB are the citizens it serves. ICRA's evaluation, therefore, takes a close look at the level of transparency and disclosure norms followed by the entity concerned. Quick and easy dissemination of progress/status reports on projects and regular updates of its financial position, provided through various modes (including website postings) are, thus, considered positive.

ICRA evaluates the progress of ongoing/proposed reforms being/to be undertaken by a ULB, which are critical for the improvement of its operational and financial performance³. Such improvements could also provide support to the ULBs to improve their credit quality, enabling greater access to capital markets.

³ Example: some of the critical areas where reforms were to be implemented under the previous as well as current schemes and missions are property tax, accounting quality, cost recovery, e-governance, and capability build up.

7. State Government's Credit Quality

ICRA also evaluates the credit quality of the state government concerned while assigning credit rating to a ULB. The credit quality of the state government is assessed based on 'ICRA's Rating Methodology for State Governments'⁴. Apart from the legislative and administrative relationship between the two, a ULB regularly receives various transfers from the state government, the extent and frequency of which is directly linked to the financial position of the state government. Considering the strong operational and financial linkages between the ULB and the state government, the credit quality of the latter becomes one of the important criteria in influencing ICRA's ratings for the ULBs.

Summing Up

This methodology broadly highlights the quantitative and qualitative risk factors that are likely to influence the rating outcomes of the ULBs. It should not be treated as an exhaustive discussion of all the factors considered while assigning a credit rating, but a broad framework to help stakeholders understand ICRA's approach to the same. ICRA's credit ratings are a symbolic representation of its current opinion on the relative credit risk associated with the ULB being rated. ICRA's rating of a ULB involves a detailed assessment of factors such as the ULB's operational efficiency, financial position as reflected by the trend and size of its revenue balance, project pipeline and debt obligations. These factors apart, an evaluation is also made of the reforms that the ULBs take/propose for the overall improvement in the operational performance and financial position.

⁴ Refer ICRA's Rating Methodology for State Governments (October 2017) available on ICRA's website www.icra.in



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