RATING METHODOLOGY – URBAN LOCAL BODIES

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in December 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating the Urban Local Bodies (ULBs) remains materially similar.

Overview

The 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 has 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 further rise 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, the traditional sources of funding[1] have been inadequate. As a result, the ULBs have been increasingly resorting to fund-raising from the capital market and banking system 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.

1 Capital grants and loans from the State Government and long-term loans from specialised lenders such as Life Insurance Corporation of India (LIC) and Housing and Urban Development Corporation Limited (HUDCO).

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. The overall credit quality determinants are:

Inter-Governmental Fiscal Relationships

- Dependence on the state government
- Rule-based transfers from the state government

Economic Strength

- Importance of the city to the state government
- Population profile

Operational Efficiency of the ULB

- Property tax coverage
- Water supply coverage, availability, and metering
- Coverage, treatment capacity, and collection efficiency of municipal solid waste (MSW)
- Surfaced road network
- Street light coverage
- Drainage coverage

Financial Strength of the ULB

- Revenue size including own income generation
- Establishment expenditure
- Revenue balance
- Collection efficiency – Property tax
- Collection efficiency – Water supply /sewerage user charges
- Liquidity
- Debt-servicing ability

Project Pipeline and Execution Track Record

- Capacity to execute projects within budgeted cost and time
- Project viability

Quality of Reporting, Monitoring and Reform Efforts

- Ability to revise property tax and tariff for water supply and sewerage
- E-governance
- Accounting and disclosures
- Institutional capacity

State Government's Credit Quality

Credit Enhancement Features

Assessment of Environmental, Social and Governance (ESG) Risks

Inter-Governmental Fiscal Relationships

ICRA's ratings for the ULBs 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 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 Subsidiarity[2].

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.

Grants: The ULBs obtain scheme-specific grants as well as grants-in-aid from the state government to bridge the assessed revenue shortfalls. In addition, they also obtain Central grants-in-aid, in accordance with the recommendations of the Central Finance Commission (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 possible 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.

Dependence on the state government

Strongly positioned

0-10%

[Revenue grants, devolution and assignments from the state government to the ULB/total revenue receipts of the ULB]

Weakly positioned

>70%

[Revenue grants, devolution and assignments from the state government to the ULB/total revenue receipts of the ULB]

2 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.

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 tier[3], 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. 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.

Rule-based transfers from the state government

Strongly positioned

100-91%

[Rule-based transfers by the state/ total transfers by the state]

Weakly positioned

<30%%

[Rule-based transfers by the state/ total transfers by the state]

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 and the span of sectors that constitute the economy of the region. A diversified economic base is a credit positive, whereas dependence on a few industrial units increases concentration risk.

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

Importance of the city to the state government

Strongly positioned

Very High (State capital, largest city in the state, very large economic base and industrial hub, major tourist destination)

Weakly positioned

Very Low (very small size city in the state)

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.

Population profile

Strongly positioned

Very Good (majority population involved in - IT, Manufacturing, Engineering, major services, etc.; less than 20% population living in slums)

Weakly positioned

Very Poor (majority population involved in - agriculture; more than 50% population living in slums)

ICRA favourably views a steadily growing population base in the employable age bracket with reasonable levels of literacy as it demonstrates the ability of the population to pay taxes and user charges.

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 the range of municipal functions and services it offers. 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) supplied; 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). A service level that is positioned significantly lower than the typical service levels within the state is usually viewed unfavourably. 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 a credit negative relative to 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 favourably when it enables leveraging private sector efficiencies.

Operational Efficiency	Key Performance Indicators	Strongest	Weakest
Property tax coverage	Coverage of properties under tax net - no. of properties under tax net/total estimated no. of properties	100-91%	<30%
Water supply coverage	Percentage of households covered by direct tap connection of water supply	100-91%	<30%
Water supply availability	Water supply in litre per capita per day (gross)	>135	<70
Water supply metering	Percentage of metered water service connections	100-91%	<30%
Sewerage coverage	Percentage of households covered by direct connection of sewerage	100-91%	<30%
Treatment capacity of sewerage	Percentage of sewage being treated against total generation	100-91%	<30%
Collection efficiency of municipal solid waste (MSW)	MSW collected/generated	100-96%	<30%
Treatment capacity for MSW	MSW treated/collected	100-91%	<30%
Surfaced road network	Length of surfaced roads/total road length	100-96%	<30%
Streetlights coverage	Number of street lights (poles)/total road length (km)	>30	<15
Drainage coverage	Percentage of city covered with storm water drains	100-91%	<30%

Financial Strength

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 the gross annual rent of land and building at which they might reasonably be expected to let it out. 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.

Revenue Size

Strongly positioned	Weakly positioned
>1000 *[Total revenue receipts (In Rs. crore)]*	<50 *[Total revenue receipts (In Rs. crore)]*

Own income generation (per capita)

Strongly positioned	Weakly positioned
>5000 *[Total own revenue receipts (excluding grants and transfers from state/central government)/population]*	<200 *[Total own revenue receipts (excluding grants and transfers from state/central government)/population]*

A large revenue base demonstrates the economic size of the service area, the ability to utilise the available sources of tax and non-tax revenues, as laid down in the corresponding Municipal Act as well as the extent of support from the state governments in the form of grants and transfers (which generally contribute primarily to the total revenue base of a ULB).

Collection Efficiency:

a. **Property tax:** Several 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 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.

b. **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. 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. It also reviews the efforts made by the ULBs in administering the user charges (for water supply and sewerage), their track record in revising the charges, and their collection efficiency.

Collection Efficiency	Criteria	Strongest	Weakest
Collection efficiency - property tax	Current collection/current demand	100-91%	<45%
Collection efficiency - water supply and sewerage	Current collection/current demand	100-91%	<45%

Expenditure Structure

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.

Establishment Expenditure

Strongly positioned

<40%
[Establishment expenditure/total revenue]

Weakly positioned

>80%
[Establishment expenditure/total revenue]

Evaluating the quality of spending is analytically more challenging in comparison with evaluating the extent of spending. ICRA analyses the past trends in key expenditure items such as establishment (staff) and operation and maintenance as a high share of spending on establishment and curtailing spending on capital expenditure. 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 a ULB.

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.

Revenue Balance

The revenue balance is an indicator of the operating efficiency of the entity. 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 the service levels are not satisfactory. In cases where service levels are found to be satisfactory, a consistent revenue surplus is usually viewed positively, since this implies capital expenditure can be partly met out of such a surplus, with limited dependence on borrowings. A deficit 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.

Strongly positioned

>30%
[(revenue income – revenue expenditure)/revenue income]

Weakly positioned

<5%
[(revenue income – revenue expenditure)/revenue income]

Liquidity and Debt Profile

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 based on the basis of best available information.

Liquidity and Debt Profile	Criteria	Strongest	Weakest
Liquidity	[Estimated net cash inflows + own cash and bank balance (excluding balance on account of unspent funds from various projects/schemes funded by the state/central governments)]/[(debt servicing obligation over one year + project commitments over one year]	>1.5x	<1x
Debt Servicing Ability	(Revenue Balance + Interest payments) / (Interest payments + Debt Repayment)	>3x	<1x
Debt Size	Outstanding debt/revenue balance	<1x	>3x

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 its liquidity position. On the other hand, if such balance has been accumulated from a ULB's own cash flows without compromising on its expenditure requirements, it imparts a high degree of financial flexibility to the ULB and is considered a credit positive.

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

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, besides engendering other positive externalities. ICRA analyses the capital expenditure requirements under expected levels of growth and service obligations. 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.

Capacity to execute projects within budgeted cost and time

Strongly positioned	Weakly positioned
Very Good (a number of large/complex projects executed)	Very Poor (a few small projects executed)

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 the future.

Project viability

Strongly positioned	Weakly positioned
Very Strong (revenue from some projects adequate to cover debt servicing (if any), maintenance cost, etc. and gereates surplus)	Very Weak (no revenue from any project)

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 the sufficiency of staff at key positions and adequate capacity of the staff in critical functions as 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 disclosures) are, thus, considered positives.

ICRA also evaluates the ULBs track record of introducing e-governance initiatives such as online payment system for tax and user charges, introduction of online building permission applications, etc, which helps in improving the overall efficiency.

Operational Efficiency	Criteria	Strongest	Weakest
Ability to revise tariff for water supply/sewerage	Track record of upwards revision during the last five years as per the provisions of the Act	Very Good (upwards revision adequate to cover the growing costs of operations and support healthy surpluses)	Very Poor (no upwards revision)
Property tax	Implementation stage of Geographical Information System, Unit Area Method, Self-Assessment System	Complete	No Plan
Ability to revise property tax	Track record of upwards revision during the last five years as per the provisions of the Act	Very Good (upwards revision adequate to cover the growing costs of operations and support healthy surpluses)	Very Poor (no upwards revision)
E-governance	Implementation e-governance for bill collection, grievance redressal, property tax, building permission, etc.	Complete	No Plan
Accounting	Preparation of accrual based financial statements, regular audit of accounts	Complete	No Plan
Disclosure	Regular disclosure of financial statements and operational indicators	Complete	No Plan
Capacity	Adequacy/sufficiency of staff at critical positions	Very Good	Very Poor

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 performance[4]. Such improvements could also provide support to the ULBs to improve their credit quality, enabling greater access to the capital markets.

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'[5]. 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.

4 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.

5 Refer to ICRA's Rating Methodology for State Governments available on ICRA's website www.icra.in

Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of a rated ULB with the focus on aspects that can have a material impact on its credit quality. The impact of the E&S risks on a ULB's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the ratings, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of ULBs, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated ULB/ debt instrument. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly, if not precisely. Further, it is not always feasible to fully or precisely disaggregate the sub - components of E&S risks in credit analysis since these considerations often tend to overlap. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the ULB. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future and, hence, these considerations do not necessarily weigh on the rating today — with the expectation that when these risks manifest in the distant future, the rated ULB by then would possibly be able to adapt. While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that a ULB faces and how it already is or is intending to mitigate the impact of such risks on its credit profile.

Environmental considerations

Rapid urbanisation is the main cause for water/sanitation problems and addressing it could require the ULBs to make significant infrastructure investments, though in many cases this is backed by financial support from the Central and the state governments. Man-made and natural disasters such as hurricanes, flooding and earthquakes have always represented significant risks for some ULBs. However, to the extent that the state and Central Government assistance programmes/schemes exist, costs are often shared with, or even completely assumed by, the Central and state governments.

Social considerations

Access to basic services and the economic base of a city determine the degree of exposure to social risks for the ULBs as it impacts the willingness and ability of the residents to pay taxes/user charges or accept any increase. Their ability to increase the tax/user charges or levy new ones is an important factor as the state governments are reluctant in approving such increases or levies. Most of the ULBs have significant unaddressed infrastructure needs that require a step-up in social spending, though the Central and state governments share some of the burden.

Governance Risks

A sound governance and administrative structure attempts to make clear the distinction of power and responsibilities between the council and the administration. The ULB's in implementing e-governance practices to improve the service delivery standards is an important factor considered while accessing its governance. ICRA seeks to gain a qualitative understanding of a ULB's commitment to following transparent and credible practices by the way its financial statements are reported, its level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. The ULB's financial linkages with the respective state government and instances of supporting other government entities at the expense of debt holders are also assessed as the state government may force a ULB to participate in projects beyond its scope.

Credit Enhancement Features

ICRA also analyses various credit enhancement features such as cash flow escrow mechanism, guarantee, cash collateral and debt service reserve account (DSRA), which are available for servicing of bank loans or debt instruments. Some of these features are also stipulated under the Securities and Exchange Board of India (Issue and Listing of Municipal Debt Securities) Regulations 2015. The strength and comfort of these features is analysed as per 'ICRA's Approach - Structural features (Non-securitised transactions)'[6].

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 opinion on the relative credit risk associated with the ULB being rated. ICRA's rating of a ULB involves an 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.

6 Refer to ICRA's Approach - Structural features (Non-securitised transactions) available on ICRA's website www.icra.in

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for an urban local body

		Strong			Comfortable			Adequate			Moderate			Weak		
Linkages with the State Government and the ULB's Importance	Inter-Governmental Fiscal Relationships															
	Economic Strength															
Operations	Operational Efficiency of the ULB															
Financial Performance	Revenue size and Own Income Generation															
	Establishment Expenditure															
	Revenue Balance															
	Collection Efficiency															
	Liquidity and Debt Profile															
Other parameters	Project Pipeline and Execution Track Record															
	Quality of Reporting, Monitoring and Reform Efforts															
State Government	Rating of State Government	AAA	AA+	AA+	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category	
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/ C category**	

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations. The final rating could be further notched up on the basis of various structural features/ credit enhancement features associated with the rated instrument.

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For more information, visit www.icra.in and www.icraresearch.in

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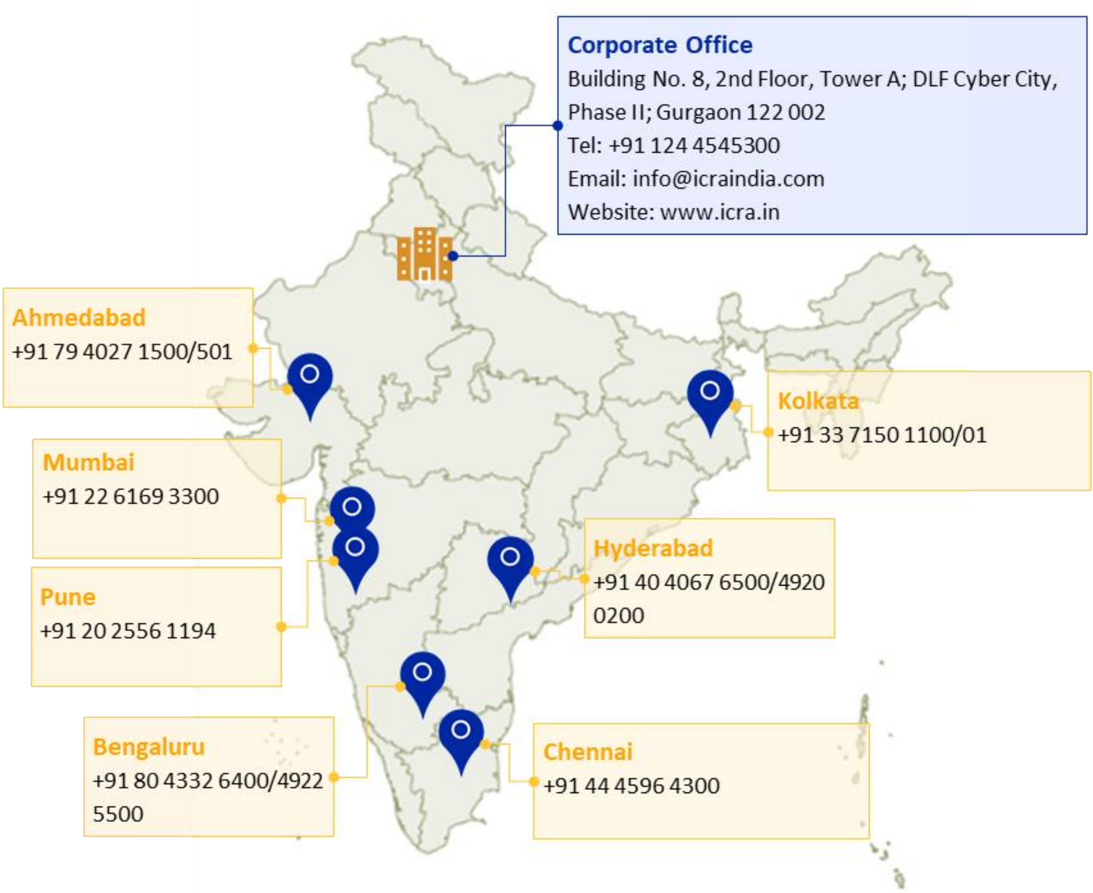

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