

# Criteria for rating municipal and urban local bodies

November 2017



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## Executive summary

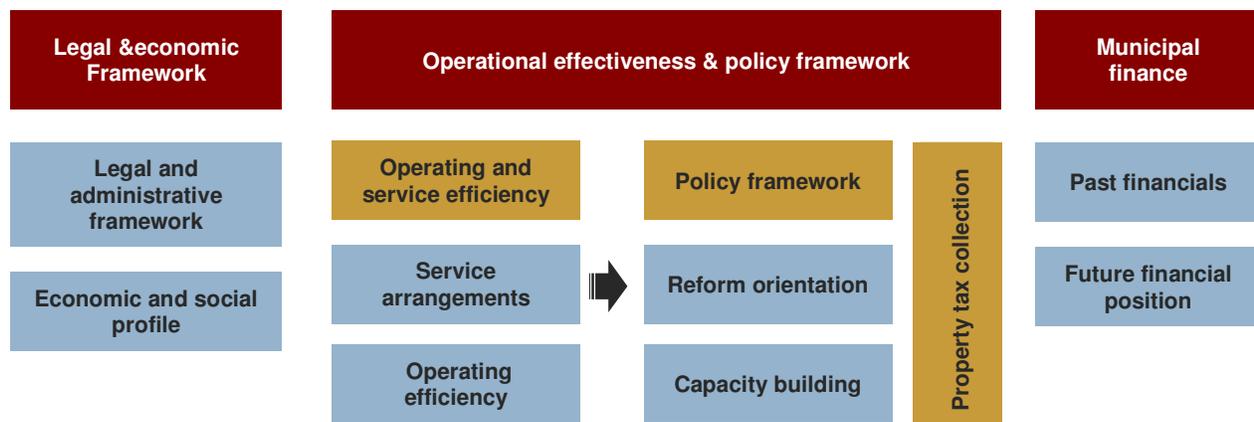
Municipal bodies have traditionally relied on both internal and external sources to fund expenses. While internal sources comprise tax and non-tax revenues, external sources comprise grants and transfers from governments, loans from institutions and concessional finance from multilateral agencies.

The emerging scenario indicates that budgetary resources and recourse to institutional finance may not be adequate to meet the requirements for urban infrastructure, including critical services such as water supply and sewage. In such a scenario, municipal bodies will need to explore alternatives, such as promoting private sector participation in core services and accessing capital markets to fund critical infrastructure projects.

CRISIL has evolved its methodology for rating municipal and urban local bodies<sup>1</sup> (ULBs) after an in-depth study of such bodies in India and abroad. The methodology was used by CRISIL to award a rating to the country's first municipal bond in February 1998 and subsequent issuances by municipal bodies.

During the past two years, CRISIL has rated several municipal bodies due to the AMRUT and Smart City requirements. This has helped in fine-tuning our rating methodology to factor in the latest trends in the sector.

CRISIL's rating methodology for municipal bodies entails an assessment of the following major factors:



<sup>1</sup> CRISIL's Rating Criteria for Municipal and Urban Local Bodies – below is the link for the previous criteria

[https://www.crisil.com/Ratings/SectorMethodology/MethodologyDocs/Criteria-for-Rating-Municipal-and-Urban-Local-Bodies\\_Final.pdf](https://www.crisil.com/Ratings/SectorMethodology/MethodologyDocs/Criteria-for-Rating-Municipal-and-Urban-Local-Bodies_Final.pdf)

## Scope of the article

This article highlights the criteria adopted by CRISIL in rating instruments issued by municipal and ULBs incorporated in India. This opinion piece elucidates CRISIL's rating criteria for assessing the credit quality of municipal and ULBs.

## CRISIL's assessment framework

### LEGAL AND ECONOMIC FRAMEWORK

#### Legal and administrative framework

CRISIL's analysis of the legal and administrative framework is based on the relevant Act that defines the legal, structural and administrative elements of a municipal body. The Act also outlines the obligatory and discretionary services to be extended by a municipal body. CRISIL believes that a clear legal and administrative framework for a municipal body, incorporating matters relating to the functional domain, tax and non-tax powers, administrative and fiscal linkages with the state government, and organisation and audit of accounts and borrowing powers, augurs well for managing the municipal body's operations and finances.

The key features as defined in the Act, evaluated by CRISIL, include:

#### ***Election of municipal authorities and decision-making process***

CRISIL studies the municipal corporation's constitution, elections to the standing and working committees, and terms of office. It also studies the municipal authorities' decision-making process, which provides insights on the time involved in taking important decisions, as also the corporation's transparency and responsiveness to pertinent issues.

#### ***Municipal functional domain***

CRISIL evaluates the obligatory and discretionary services, which have to be extended by a municipal body, to determine the extent of its operational responsibilities and the constraints imposed therein. Specifically, if the Act envisages services such as public transport and hospitals as obligatory, it may negatively affect the credit-risk profile of the ULB, as these services are typically run at commercially unviable user charges.

#### ***Tax-levying powers allocated to the municipal body***

CRISIL evaluates the tax-levying powers allocated to the municipal body in relation to its functional domain and the body's tax effort in terms of deploying all sanctioned tax options.

A comparison of the municipality's functional domain versus the revenue-raising powers allocated to it largely determines the corporation's potential fiscal strength and its ability to maintain an acceptable level of services.

#### ***Minimum and maximum tax rates and specific-user charges, which can be levied by the municipal body***

These constitute a key input in assessing the flexibility and autonomy of the municipal body.

#### ***Borrowing powers and administrative requirements for mobilising funds from capital markets as specified in the Act***

CRISIL assesses the municipal body's flexibility to raise funds for projects. Checks imposed on borrowing by the municipality are a critical consideration. These include ceiling on debt, provisions available for earmarking revenue, maintaining sinking fund and the manner in which such funds are maintained.

### ***State government – municipal body linkage***

The Act specifies the revenues that the municipal body will receive by way of loans, grants or transfers from the state government. CRISIL studies the method of such fund transfer from the state government and analyses the extent to which these are discretionary. Formula-linked transfers are viewed favourably, as they are assumed to constitute a steady future revenue stream for the corporation largely independent of the political dispensation. CRISIL believes that clarity and transparency in the transfer arrangement define the stability of grant receipts. This assumes importance in the light of the large share of state government grants in the revenue profiles of municipal bodies.

### **Economic and social profile**

CRISIL analyses the economic base of the municipal body's service area, with the objective of assessing the tax base, elasticity of tax income, and the possibility of enhancing the body's tax base and revenue-generating potential. Some of the key indicators examined include:

- The population base and its growth rate, and the proportion of slum population.
- Industrial activity: This encompasses an assessment of the presence of industrial estates or major industries, and of indicators such as sanctions and disbursements made by financial institutions, and industrial water connections in the service area.
- Commercial activity: An assessment is made of economic activities being carried out in the service area.
- Importance of the service area within the state, as it will drive industrial and commercial activities in future.
- Connectivity: Proximity to major economic centres.
- Per-capita property tax levels indicate the overall level of economic buoyancy in the area.

The analysis of the service area's economic base is particularly relevant with respect to cost recovery in services rendered. CRISIL anticipates that most municipal entities would gradually get into a regime of full cost recovery. The economic base of the service area would thus be a strong indicator of the citizens' ability to bear increases in taxes and user charges. Further, non-tax revenues from activities such as commercial property development would also depend, to a large extent, on the service area's economic base. The economic base, however, only indicates the potential revenue base and is less critical than the municipal body's efficiency in collecting taxes and controlling expenses.

## **OPERATIONAL EFFECTIVENESS AND POLICY FRAMEWORK**

Key parameters evaluated by CRISIL are:

- Operating efficiency and service arrangements – An understanding of the range of services (both obligatory and discretionary) provided by the municipal body and the level of penetration or adequacy of such services. Also, the cost recovery from such services are taken into consideration, measured in terms of the efficiency of tax / charges collection and the level of cost recovered.
- Policy framework – The functioning of the municipal body and its financial health depends on the initiatives taken by management to improve the internal processes, enhance the resource base and improve the level of municipal services. The ability to implement necessary reforms as well as organisational capability building are evaluated in detail.
- Property tax collection efficiency – Property tax is typically the largest own revenue source for most municipal bodies. An efficient collection mechanism of such taxes are central to the revenues of the body and has a bearing on the overall financial independence. Further, the frequency of property tax rate revision and undertaking of surveys are also studied in detail.

### **Service arrangements**

In this, CRISIL acquires an understanding of the municipal body's existing operations through a study of the range of services provided by the body, and by comparing its obligatory and discretionary services as defined in the Act. CRISIL takes a positive view of municipal bodies that focus on providing mandatory services, compared with bodies that have a large focus on discretionary services.

An in-depth evaluation is conducted of core services, including water, sewage and drainage (area and population coverage, per-capita supply and treatment capacity), primary education and health services (number of school and hospitals). A low level of existing services indicates pressure on the body to spend extensively on infrastructure.

The level of services provided in terms of area or population coverage and quantum of per-capita water supply are carefully benchmarked to arrive at a relative standing of the service arrangements.

### **Operating efficiency**

To assess the municipal body's operating efficiency, CRISIL evaluates the corporation's track record of collection of its major tax sources such as property and water. Additionally, the cost of services recovered from collection of charges levied on various services are also studied.

The ability of the municipal body to increase its revenue collection and recover costs indicates stability in revenue, and hence the financial capability to fund improvement of the existing services or widening the service base.

### **Reform orientation**

CRISIL analyses the local body's efforts towards improving its operations and accounting quality. An improvement in operations leads to higher satisfaction among citizens, and in turn, increases the willingness to pay user charges. This is important, as local bodies are increasingly striving towards improving the cost recovery in the services offered. CRISIL believes that local bodies focusing on operational reforms have better prospects of increasing revenue.

## **Capacity building**

It has been CRISIL's experience in municipal-bond ratings that a corporation's financial health is, to a certain extent, linked to the initiatives undertaken by its management to enhance the resource base and improve municipal services. In CRISIL's opinion, it is therefore important to analyse the municipal body's: (1) organisational structure; (2) administrative systems and procedures; (3) project management skills; (4) the control exercised on expenditure; (5) the ability to manage political forces and resist political interference; and (6) the initiative taken to enhance resources, implement reforms and improve collection mechanisms.

## **Property-tax collection efficiency**

In this, CRISIL evaluates the per-capita property-tax collection, which is a comprehensive indicator of the economic activity in the area and the service level of the corporation. CRISIL also examines the details of the trend in tax-rate revisions, administrative structure, systems and procedures for improving collection, such as GIS mapping or surveys.

## **MUNICIPAL FINANCES**

CRISIL analyses municipal finances in detail in the prevailing framework of revenue and capital accounts.

### ***Own-revenue receipts***

CRISIL analyses the own-revenue receipts closely, as they provide an understanding of the municipal bodies' efforts to generate revenue for the services rendered. Own-revenue receipts are broadly classified into tax and non-tax revenues. Tax revenues include their own taxes (which are collected by the local body, generally within the municipal limits) and shared taxes (which may be levied by either the local body or the state government and shared by both). Non-tax revenues comprise user charges and other own sources, such as rent from municipal properties and revenue from town planning. CRISIL regards a higher degree of reliance on own revenue as a positive factor, as the local body has a greater control on the revenue, and hence is considered to be a more stable revenue source.

The main source of own tax revenue for municipal corporations across the country is property tax. CRISIL places emphasis on the property tax assessment and collection mechanisms adopted by a municipal body. The growth in property tax collections is evaluated in the context of the increase in the number of eligible properties and their assessed rental values. CRISIL also analyses the simplicity and ease of applicability of the taxation rules. Finally, the corporation's track record with respect to the frequency and extent of rate revisions and collection efficiency is analysed.

Additionally, there are grants received from the state government, which are typically quite stable, considering the extent of support most municipal bodies receive from the state governments. With the recent introduction of Goods and Services Tax (GST) subsuming own revenues, such as Octroi and local body tax, the dependence of municipal bodies on state government grants has increased. While analysing grants from the state governments, greater importance is attached to stable and non-conditional grants, which do not impose a burden on the corporation in terms of performing additional functions. The likelihood of a reduction in the grants extended by the state governments, due to the deterioration in financial health, and the stability and transparency of the transfer mechanism are also assessed. The recommendations of relevant state finance commissions, if available, are also evaluated.

### ***Revenue expenditure***

CRISIL carries out an activity- and head-wise assessment of the revenue expenditure incurred by a municipal body. The activity-wise analysis considers the proportionate allocations made for providing core services (water supply and sewage, primary education, public health and medical relief, public safety, public works, and solid waste

management). CRISIL focuses on the stability and consistency in expenditure allocation to these core services. The service quality is also measured by comparing the per-capita expenditure on core services across municipal corporations.

CRISIL's analysis of revenue expenditure considers the allocations made under various functions, such as wages and salaries, operating expenses, repairs and maintenance, and debt servicing. This analysis indicates the causes of any increase in expenditure, and the flexibility and expenditure controls that can be exercised by the municipal body. CRISIL believes that in cases where wages and salaries and debt-servicing components constitute a major proportion of the total cost, the extent of flexibility and the potential for expenditure control are limited.

### ***Operating revenue surplus/deficit***

CRISIL assesses the operating revenue surplus/deficit (revenue receipts less revenue expenditure). The surplus position is examined to see whether it accrues from an increase in revenue or the control exercised over expenditure or a mix of both. In CRISIL's experience, this parameter is typically a better indicator, since it has a greater control over the revenue income and expenditure. Also, the level of operating surplus provides a sense of funds available with the body for debt-servicing and part-funding infrastructure addition. Mostly, a better operating revenue surplus over years should lead to an improvement in the capacity over and above the capital income-related additions. This would improve the revenue base of the corporation, ensuring sustainability in improved revenue.

### ***Capital account***

CRISIL assesses the stability of a municipal body's capital receipts as well as its judicious deployment towards capacity building. CRISIL does not look favourably at forced capital surpluses arising from cutbacks in capital expenditure to fund revenue deficits. A track record of consistent and rising developmental capital expenditure is viewed positively, as this would build the economic infrastructure in the municipal domain, thereby improving the civic services provided in the service area and the overall investment climate of the corporation.

### ***Debt servicing***

CRISIL assesses the municipal body's debt profile with reference to the source, tenure, interest rates, and repayment arrangements of all the major loans raised by the body. The loan repayment schedule and average interest cost are also examined in detail. The operating surplus as a proportion of net debt (total debt – sinking fund) is looked at to understand the operational capability of the municipal body to service debt. In addition, the interest coverage (operating revenue surplus to interest expense) and debt-service coverage (operating revenue surplus to principal and interest repayments) ratios are also assessed. With respect to projects undertaken by corporations, for which funds are being raised, CRISIL assesses the existing level of service, improvements envisaged through the project, the project cost, means of funding, and the effect of debt-funding on the municipal body's debt-service coverage ratio.

### ***Liquidity***

The availability of unencumbered cash balance or liquid investments add to the financial flexibility of the municipal body and provides cushion for meeting operational expenses and debt repayment in case of cash flow mismatches. Hence, a greater quantum of such balances are viewed favourably by CRISIL.

## Rating methodology for municipal and ULBs

### Legal and economic framework

#### *Legal and administrative framework*

- Municipal functional domain
- Taxation powers
- Tax-collection ability and experience in managing the arrears in collections
- Borrowing powers
- Ability to pledge revenue for servicing debt or creation of sinking fund

#### *Economic and social profile*

- Demographics and area covered
- Industrial and commercial activities
- Population growth rate
- Importance of the city
- Per-capita property tax

#### *Municipal finances*

- Accounting quality
- Analysis of surplus/deficits
- Growth in tax and non-tax revenues
- Collection efficiency, debtor analysis
- Dependence on the state governments for discretionary grants and fund transfers
- Expenditure on core services
- Past/projected debt-servicing requirement
- Past/projected debt service coverage
- Liquidity
- Projected revenue/expenditure growth

#### *Current and future financial position*

- Own revenue / revenue receipts
- Grants from the state government/total revenue
- Operating surplus / deficit
- Operating surplus / revenue receipt
- Non-debt capital income / capital expenditure
- Operating surplus / net debt
- Interest cover
- Debt-service coverage ratio

#### *Project-specific issues*

- Proposed projects
- Project tenure and funding pattern

- Debt-servicing requirement due to borrowing for new projects
- Existing services and improvements envisaged

### *Operational effectiveness and policy framework*

#### *Operating and service efficiency*

- Expenditure on core services /total expenditure
- Establishment cost/ revenue expenditure
- Water supplied per capita
- Area and population coverage for each of the core services
- Per-capita expenditure on primary education
- Capital expenditure in relation to existing services
- Per-capita expenditure on health services
- Collection efficiency of taxes and user charges

#### *Policy framework*

- Organisation structure and responsibility division
- Systems and procedures: level of computerisation
- Project management capabilities and track record of execution
- Reform orientation
- Initiatives adopted to enhance resources
- Level of control exercised on expenditure
- Level of disclosures and transparency

#### *Property tax collection*

- Level of tax collection per capita

### **About CRISIL Limited**

CRISIL is an agile and innovative, global analytics company driven by its mission of making markets function better. We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

We are majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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**Last updated: April 2016**