CRISIL Ratings

Rating criteria for municipal and urban local bodies

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Executive summary

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

The emerging scenario indicates 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. Hence, municipal bodies will need to explore alternatives such as promoting private sector participation in core services, and accessing capital market to fund critical infrastructure projects.

The CRISIL Ratings methodology for rating municipal and urban local bodies (ULBs) has been developed after an in-depth study of such bodies in India and abroad. CRISIL was first in Asia to award a rating to a municipal bond issued by an Indian municipal body in February 1998, and subsequent issuances by municipal bodies using this methodology.

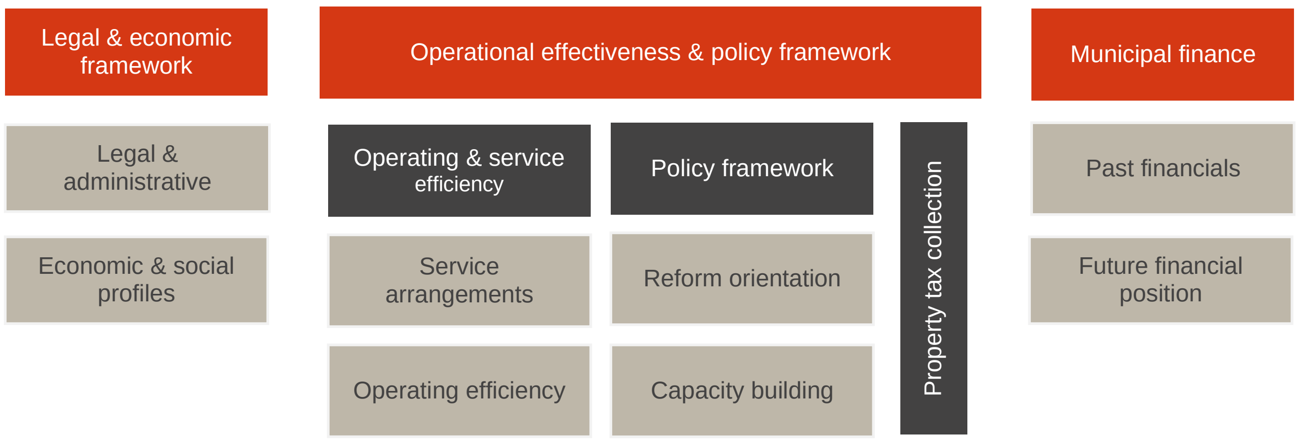
Over the years, it has rated several municipal bodies to fulfil the requirements of AMRUT (Atal Mission for Rejuvenation and Urban Transformation) and National Smart Cities Mission. This has helped CRISIL Ratings to fine-tune its rating methodology to factor in the latest trends in the sector.

Scope of the criteria

This criteria[1] covers rating of instruments issued by municipal bodies and ULBs incorporated in India. The document also covers CRISIL Ratings' approach to financial ratios used for analysing these entities, including adjustments, if any, carried out to the reported metrics in the financial statements.

Methodology

The rating methodology of CRISIL Ratings for municipal bodies entails an assessment of the following key factors:



[1] Link to previous criteria: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/utilities/archive/Criteria-for-Rating-Municipal-and-Urban-Local-Bodies-nov2020.pdf

Legal and economic framework

Legal and administrative framework

The analysis of the legal and administrative framework is based on the relevant Act that defines these elements of a municipal body. The Act also outlines the obligatory and discretionary services to be extended by a municipal body. CRISIL Ratings believes a clear legal and administrative framework − incorporating matters relating to the functional domain, tax and non-tax powers, administrative and fiscal linkages with the state government, and the organisation and audit of accounts and borrowing powers – augurs well for managing the operations and finances of a municipal body. The key features, as defined in the Act and evaluated by CRISIL Ratings, include:

Election of municipal authorities and the decision-making process

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

Municipal functional domain

CRISIL Ratings evaluates the obligatory and discretionary services that have to be extended by a municipal body to determine 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 profiles of the ULB as these services are typically run at commercially unviable user charges.

Tax-levying powers

This is evaluated in relation to the functional domain and tax effort of the municipal body, in terms of deploying all sanctioned tax options. A comparison of the municipality's functional domain versus its revenue-raising powers largely determines the potential fiscal strength of the corporation and its ability to maintain acceptable levels of services. The minimum and maximum tax rates and specific-user charges it levies constitute key inputs in assessing its flexibility and autonomy.

Borrowing powers and administrative requirements for mobilising funds from the capital market, as specified in the Act

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

Funding support from state government

The Act specifies the revenue that a municipal body will receive by way of loans, grants or transfers from the state government. CRISIL Ratings studies the method of such fund transfer 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. 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 profiles

CRISIL Ratings studies the economic base of the service area of a municipal body to assess 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:

- Population base and its growth rate, and the proportion of slum population
- Industrial activity: This covers an assessment of the presence of major industrial estates 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 economic buoyancy in the area

An analysis of the economic base of the service area is particularly relevant with respect to cost recovery in services rendered. CRISIL Ratings 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 increase in taxes and user charges. Furthermore, non-tax revenue from activities such as commercial property development would also depend to a large extent on the economic base. However, the economic base 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 capability building

Key parameters evaluated by CRISIL Ratings 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. The cost recovery from such services is also taken into consideration, measured in terms of the efficiency of tax collection.
- Policy framework - The functioning of the municipal body and its financial health depend on the initiatives taken by the management to improve the internal processes and level of municipal services, and enhance the resource base. The ability to implement necessary reforms as well as organisational capability building is evaluated in detail.
- Property tax collection efficiency - Property tax is the largest own revenue source for most municipal bodies. An efficient collection mechanism for this tax is central to its revenue and has a bearing on the overall financial independence. The frequency of property tax rate revision and undertaking of surveys are also studied in detail.

Service arrangements

In this, CRISIL Ratings attempts to understand the existing operations of the municipal body by studying the range of services it provides and comparing its obligatory and discretionary services as defined in the Act. CRISIL Ratings takes a positive view of municipal bodies that focus on providing mandatory services, against those that focus more on discretionary services.

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

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

CRISIL Ratings evaluates the track record of collecting property and water taxes. The cost of services recovered from collection of charges levied is also studied. The ability of the municipal body to increase revenue collection and recover costs indicates stability in income and hence the financial capability to improve existing services or widen service base.

Reform orientation

CRISIL Ratings analyses the efforts the local body takes to improve its operations and accounting quality. Providing better services gives greater satisfaction to citizens and increases their willingness to pay user charges. This is important as local bodies are striving to improve cost recovery in the services offered. Local bodies that focus on operational reforms have better prospects of improving revenue.

Capacity building

It has been the experience of CRISIL Ratings in municipal bond ratings that a corporation's financial health is, to an extent, linked to the initiatives undertaken by its management to enhance the resource base and improve municipal services. In CRISIL Ratings opinion, it is therefore important to analyse: (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 Ratings 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. It also examines the details of the trend in tax rate revisions, administrative structure and systems and procedures for improving collection, such as GIS mapping or surveys.

Municipal finances

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

Own revenue receipts

CRISIL Ratings analyses own revenue receipts closely as they provide an understanding of the efforts of municipal bodies to generate revenue for the services rendered. Own revenue receipts are broadly classified into tax and non-tax revenue. Tax revenue includes own taxes (collected by the local body within the municipal limits) and shared taxes (may be levied by either the local body or the state government and shared by both). Non-tax revenue comprises user charges and other own sources, such as rent from municipal properties and revenue from town planning. CRISIL Ratings regards greater reliance on own revenue a positive factor as the local body has better control on income. Therefore, this 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 Ratings places emphasis on the property tax assessment and collection mechanisms adopted by a municipal body. Growth in property tax collection is evaluated in the context of the increase in the number of eligible properties and their assessed rental values. CRISIL Ratings also studies the simplicity and ease of applicability of the taxation rules. Finally, the track record of the corporation with respect to the frequency and extent of rate revisions and collection efficiency is analysed. Additionally, there are grants received from the state government that are quite stable, considering the extent of support most municipal bodies receive from state governments. With GST (Goods and Services Tax) subsuming own revenue such as octroi and local body tax, the dependence of municipal bodies on state government grants has increased. While analysing grants from state governments, greater importance is attached to stable and non-conditional grants that do not impose a burden on the corporation in terms of performing additional functions. The likelihood of a reduction in state government grants due to 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 receipts

A corporation's revenue receipt is a reflection of its size. The revenue base of the corporation can be classified into tax revenue, non-tax revenue, shared tax revenue and grants. Larger the revenue receipts of the corporation, higher is its ability to meet the increase in expenditure.

Revenue receipt = tax revenue + non-tax revenue + shared tax revenue + grants

Own revenue/revenue receipts

This indicates the degree of self-reliance in terms of revenue generation that limits dependence of a corporation on state government grants. Most municipal corporations receive financial support in the form of state governments grants to meet current expenses. Own revenue, over which the local body has greater control, is considered a more stable source as it is largely in control of the municipal corporation.

Higher share of grants compared to own revenue sources indicates greater dependency of ULBs on state governments. This is also because key revenue grants such as octroi, which was earlier levied by ULBs, is now abolished and replaced with state government grant as compensation for loss of revenue.

Own revenue/revenue receipt= (tax revenue + non-tax revenue)/total revenue receipt

Revenue expenditure

CRISIL Ratings carries out an activity- and head-wise assessment of the revenue expenditure incurred by a municipal body. The activity-wise analysis focuses on the stability and consistency in expenditure allocations made for providing core services. The service quality is also measured by comparing the per capita expenditure on core services across municipal corporations.

The CRISIL Ratings 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 controls that can be exercised by the municipal body. CRISIL Ratings believes 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 (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 Ratings experience, this parameter is a better indicator since it has a greater control over income and expenditure. Also, the level of operating surplus provides a sense of funds available with the body for debt-servicing and part-funding any infrastructure addition. Mostly, a better operating revenue surplus over the years should improve capacity over and above the capital income-related additions. This would augment revenue base, thereby ensuring sustainability in income.

Operating surplus/revenue receipt

The amount of surplus generated by the corporation is considered critical as it indicates its ability to fund capital expenditure (capex), and its operating efficiency. A high ratio of surplus to revenue receipts is considered favourable as it implies that a large part of the revenue receipts can be directed towards productive capital works.

Operating surplus/revenue receipt = (revenue receipt – revenue expenditure)/total revenue receipt

Capital account

CRISIL Ratings assesses the stability of a municipal body's capital receipts as well as its judicious deployment towards capacity building. It does not look favourably at forced capital surpluses arising from cutbacks in capex to fund revenue deficits. A track record of consistent and rising developmental capex 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

The debt profile of a municipal body is assessed with reference to the source, tenure, interest rates, and repayment arrangements of all its major loans. 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. Interest coverage (operating revenue surplus to interest expense) and debt service coverage (operating revenue surplus to principal and interest repayments) ratios are also assessed.

Interest coverage ratio represents the extent of cushion a corporation has to meet interest obligation from its revenue surplus. This ratio provides an indication of the debt servicing and liquidity stress from the revenue account perspective. This ratio is akin to the interest coverage ratio of manufacturing and services entities, and hence links a corporation's interest and finance charges to its ability to service them from own revenue surplus.

The ratio implies that the corporation should generate adequate operating surplus for it to be able to meet its interest obligation. Corporations with a higher interest coverage ratio can better absorb adversity and are more likely to pay interest on time.

Interest cover = (revenue receipt – revenue expenditure)/interest and finance charges

Debt service coverage ratio (DSCR) measures the availability of cash to meet interest and principal obligations. DSCR measures the ability of the corporation to produce enough cash to cover its debt payment. The ratio captures the internal resource capacity of the corporations to repay debt. A higher DSCR would suggest better debt-servicing capacity.

DSCR = operating surplus/(interest + principal repayment)

With respect to projects undertaken by corporations for which funds are being raised, CRISIL Ratings assesses the existing level of service, improvements envisaged through the project, project cost, means of funding, and the effect of debt-funding on the municipal body's DSCR.

Liquidity

The availability of unencumbered cash balance or liquid investment adds to the financial flexibility of a 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 Ratings.

Conclusion

The CRISIL Ratings criteria for rating municipal and urban local bodies focus on their legal and economic profiles, operational efficiency and capability building, and financial position. It is based on the CRISIL Ratings understanding of, and experience in, rating municipal bodies and on studies conducted of such bodies in other geographies.

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 arrears in collections
- Borrowing powers
- Ability to pledge revenue for servicing debt or creation of sinking fund

Economic and social profiles

1) Demographics and area covered
2) Industrial and commercial activities
3) Population growth rate
4) Importance of the city
5) Per capita property tax or creation of sinking fund

Municipal finances

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

Current and future financial positions

- Own revenue/revenue receipts
- Grants from the state government/total revenue
- Operating surplus/deficit
- Operating surplus/revenue receipt
- Non-debt capital income/capex
- Operating surplus/net debt
- Interest coverage ratio
- DSCR

Project-specific issues

- Proposed projects
- Project tenure and funding pattern
- Servicing of debt contracted 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
- Capex in relation to existing services
- Per capita expenditure on health services
- Collection efficiency of taxes and user charges

Policy framework

- Organisational 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 Ratings Limited (A subsidiary of CRISIL Limited, an S&P Global Company)

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set 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 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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