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From grants to markets: How *Urban Challenge Fund* will reshape urban finance in India

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Urban challenge fund: rating infrastructure and the municipal finance gap

1

The strategic pivot: from grants to debt

India requires INR 80 trillionn in urban infrastructure by 2037. Currently, Urban Local Bodies (ULBs) only utilize ~5% of total funding from debt market. The Urban Challenge Fund (UCF) marks a shift from grant-driven schemes to reform-linked, leverage-based market financing, ULBs must secure ≥50% of project costs via commercial financing.

2

Credit ratings as a structural prerequisite

The 50% market financing condition can be met via bank loans without a formal rating — but institutional lending keeps ULBs dependent on state guarantees and a single funding channel. Bond markets offer scale and diversification across a broader investor base, but require a SEBI-mandated investment-grade rating to access. For most Tier II and III cities, improving creditworthiness is the gateway to a more resilient financing architecture.

3

BWR's positioning

105 ULBs rated: Dominant portfolios in Jharkhand (33) and Uttar Pradesh (24). Experience providing issuer, bank loan and municipal bond rating across the full spectrum—Municipal Corporations to Nagar Panchayats.

4

Strategic risks & analytical discipline

Credit profiles of the ULBs are hypersensitive to milestone compliance and timely reforms. Timeline overruns may delay funding from different levels of government. Data quality risks during National Municipal Accounts Manual (NMAM) transition also makes it difficult to assign ratings for such ULBs.

Source: Asian Development Bank Technical Assistance Report 2025.

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Why UCF and why now

The policy and financial imperative driving India's urban reform agenda

The World Bank (2022) estimates:

70%

Urban areas' contribution to India's GDP by 2036

INR 80 trillion

Urban infrastructure investment needed by 2037

~5%

Share of commercial debt in total ULB municipal receipts

ULB finance gap: UCF leverages a 51% own-source revenue base to pivot cities from grant-dependency (31%) toward the capital markets, where debt penetration is currently a negligible 5%.

Structural barriers: Limited creditworthiness, lack of taxing authority, and slow financial reforms hinder large-scale debt issuance. Poor local governance worsens waste management, water, and wastewater services.

UCF design logic: "Reform-linked" and "leverage-based"—cities only receive central money when they can attract private capital. Market borrowing is mandatory, not optional.

Financing routes: Municipal bonds, pooled funds, scheduled commercial bank lending (e.g. SBI), HUDCO/LIC, infrastructure DFIs (IIFCL, IDFC), and state-level municipal development funds (TNUDF, KUIDFC, MUIF).

Current lenders & rates: HUDCO and IIFCL dominate institutional ULB lending at ~6.8–7.3%; SBI and commercial banks follow. Municipal bonds price at 7.5–8.5% (Vadodara, March 2024: 7.9%) — a narrow cost difference, but with fundamentally different structural consequences.

Why bonds are the modern route: Bond markets force credit discipline, mandate public disclosure, and — following the Ministry of Finance's October 2025 notification making munis repo-eligible — now offer banks a genuinely liquid instrument for the first time.

Source: The World Bank Group 2022; National Urban Policy Framework, MoHUA; Mint 2025; CWAS-CRDF-CEPT University 2024.

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Key features of the Urban Challenge Fund

Fund structure, financing mandate, and disbursement conditionality

INR 1 trillion

Total UCF corpus– allocates INR 900 billion for infrastructure projects and INR 50 billion each for capacity building & credit repayment guarantees

INR 4 trillion

Target total investment leveraged– for every rupee the Central Government puts in, it expects cities to bring in three rupees from other sources.

FY26–FY31

Operational window (extendable to FY34). “Transformation decade" for cities to transition from being grant-dependent to being financially independent entities

Stakeholder	Funding Share	Role in Roadmap
Central Government	25%	First 30% released project approval committees (state and central); remaining tranches of 50% & 20% tied to physical progress milestones.
Market Sources (Bonds/Loans/PPPs)	≥50%	Mandated before full fund release—primary financing driver.
State / ULB Contribution	≤25%	Remaining balance from local budgets or additional market finance.

"No reform, no funding"

Disbursements are strictly conditional on measurable governance, financial, and planning reforms. Non-compliance halts central assistance.

25% central assistance role

Acts as a credit enhancer and first-loss buffer, not the primary funder. Commercial market financing must be demonstrated upfront.

≥50% commercial financing mandate

ULBs must raise at least half of project costs through bonds, loans, or PPPs before accessing UCF grants—making credit ratings non-negotiable.

Source: UCF Guidelines, MOHUA; Press Information Bureau of India.

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Coverage scope and reform-linked funding framework

Theme based project selection

- Creative Redevelopment (CBDs, heritage cores).
- Cities as Growth Hubs (economic anchors, connectivity).
- Water and Sanitation (circularity, waste remediation)

Reform-Linked Funding

- Governance and digital reforms
- Market and financial reforms to strengthen creditworthiness
- Operational reforms—service delivery and utility efficiency
- Urban planning and spatial reforms (ex: green infrastructure)
- Project-specific KPIs with third-party verification
- CRGSS reforms — fostering responsible borrowing in smaller/hilly ULBs

Improved DSCRs

Reforms improve Debt Service Coverage Ratios and reduce project-level risk, strengthening credit profiles over time.

Investor Confidence

Enhanced bankability for long-tenor assets makes them more attractive to institutional investors and DFIs.

Rating drivers

Progressive reform compliance directly strengthens ULBs' institutional credit profiles, enabling rating upgrades.

Source: UCF Guidelines, MOHUA; Press Information Bureau of India.

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Eligibility tiers, lighthouse cities, and qualification criteria

1. Defined eligibility tiers

- **Universal coverage:** All Urban Local Bodies (ULBs) across all States and UTs are eligible to participate in the fund (~9,500 entities)
- **Primary focus areas:** Targeted strengthening of Tier II and Tier III cities, including those with a population of ≥1 million, State/UT capitals, and major industrial cities with ≥100,000 population.
- **Special geographies:** Dedicated coverage for all ULBs in Hilly and Northeastern States, as well as all ULBs with populations below 100,000 in other States/UTs.

2. Designated lighthouse & candidate cities

- **Priority pipeline**: Bhubaneswar and Nagpur (per ADB Technical Assistance Report; not named in official UCF Guidelines) reportedly preparing initial UCF project pipelines
- **WSS saturation target**: 100 selected cities for water supply and sanitation
- **Finance readiness**: Surat, Indore, Visakhapatnam, and Coimbatore targeted for municipal finance support

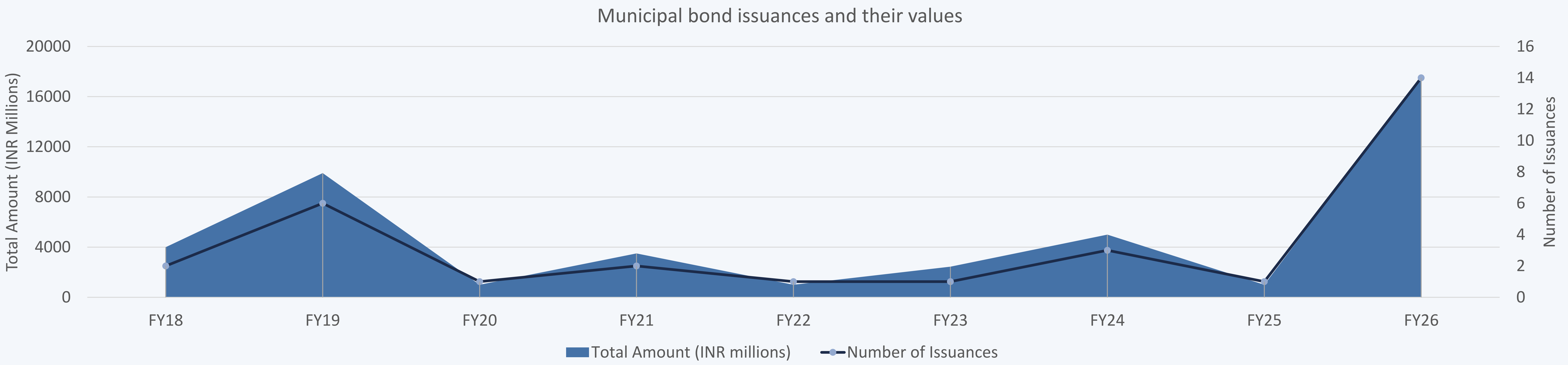
3. Mandatory qualification criteria

- **Reform gate**: Cities must adopt mandatory governance, digital, financial, and spatial reforms, and submit a clear reform roadmap within three months of project approval.
- **Market mobilization**: Projects must demonstrate financial sustainability by raising at least 50% of the project cost through market sources (loans, municipal bonds, or PPPs) to unlock the central grant.
- **Small ULB support**: De-risks market entry for smaller/hilly ULBs by providing a 70% guarantee for first-time loans (up to INR 70 million) and a 50% guarantee for second-time loans (up to INR 70 million).

Source: Press Information Bureau of India; Asian Development Bank Technical Assistance Report.

Indian municipal bond market – rise and rating landscape (1/2)

From dormancy to gradual revival: issuance trends, rating distribution, and the UCF opportunity ahead



Era 1: Dormancy (FY97-FY17)

Between 1997-2010, 10 cities issued 20 municipal bonds worth INR 11.25 billion. During the time period between 2011 and 2016, there was no municipal bond issuance.

Era 2: AMRUT-Led revival (FY18–FY25)

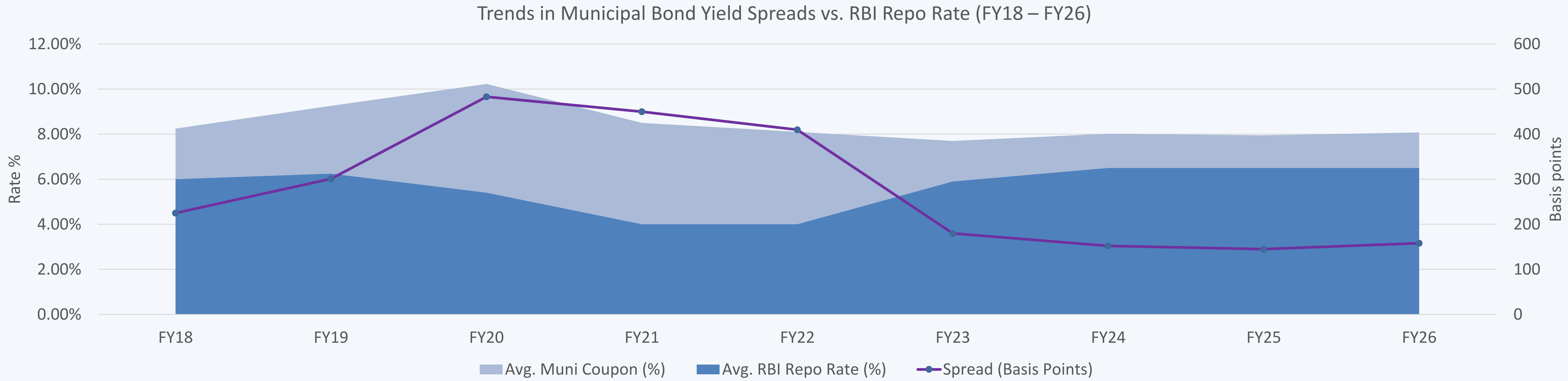
GoI's INR 130 million incentive per INR 1 billion bond (AMRUT) triggered 17 issuances. Escrow mechanisms ensured all bonds rated AA/AA+ despite weaker underlying ULB credit.

Era 3: UCF inflection (FY26 onwards)

UCF mandates ≥50% market financing—making ratings non-negotiable. Budget FY26 adds INR 1 billion incentive for bonds >INR 10 billion, targeting large cities.

Source: ICRA Indian Municipal Bond Market Report, March 2025 (icra.in); RBI Report on Municipal Finances, November 2024 (rbi.org.in); SEBI, Municipal Bonds Statistics.

Indian municipal bond market – rise and rating landscape (2/2)



INR 45.40 billion

31 municipal bonds (excluding pooled bonds) have been issued by 17 cities since FY18.

4.4x issuance surge

From 3 issuances in FY24 to 14 in FY26, debt financing is now a mainstream tool for urban local bodies.

325 bps spread compression

Yield spread dropped from ~480 bps (FY20) to ~155 bps (FY26). Investor confidence has strengthened, drastically narrowing the "risk premium" cities pay over the RBI benchmark.

Source: ICRA Indian Municipal Bond Market Report, March 2025 (icra.in); RBI Report on Municipal Finances, November 2024 (rbi.org.in); SEBI, Municipal Bonds Statistics.

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BWR experience with urban local bodies (1/2)

105 unique rated entities across 11 states — spanning Municipal Corporations, Councils, and Nagar Panchayats

Historical issuer ratings portfolio (pre-2019)

BWR contributed significantly to the initial phase of credit assessments for Indian municipalities, largely driven by the AMRUT scheme framework. This exercise aimed to establish baseline credit profiles for broad geographic regions.

State context	No. Of ULBs rated	Rating modality	Current validity
Jharkhand	33	Issuer Rating	Expired (1-Yr Term)
Uttar Pradesh	24	Issuer Rating	Expired (1-Yr Term)
Punjab	16	Issuer Rating	Expired (1-Yr Term)
Tamil Nadu	6	Issuer Rating	Expired (1-Yr Term)
Other States	26	Issuer Rating	Expired (1-Yr Term)
Total Assessed	**105**		

Note: *The 105 issuer ratings conducted prior to 2019 were assigned strictly for a validity period of one year. These ratings are currently inactive and are presented to demonstrate BWR's historical data pool and foundational exposure to municipal accounting standards.*

Current strategic mandates (active debt ratings)

Following the initial capacity-building phase of ULBs, the market has transitioned toward specific debt issuances. BWR's current portfolio focuses on providing ongoing surveillance for active municipal bonds (NCDs) and bank loan facilities, indicating a shift from broad assessment to targeted, investment-grade debt ratings.

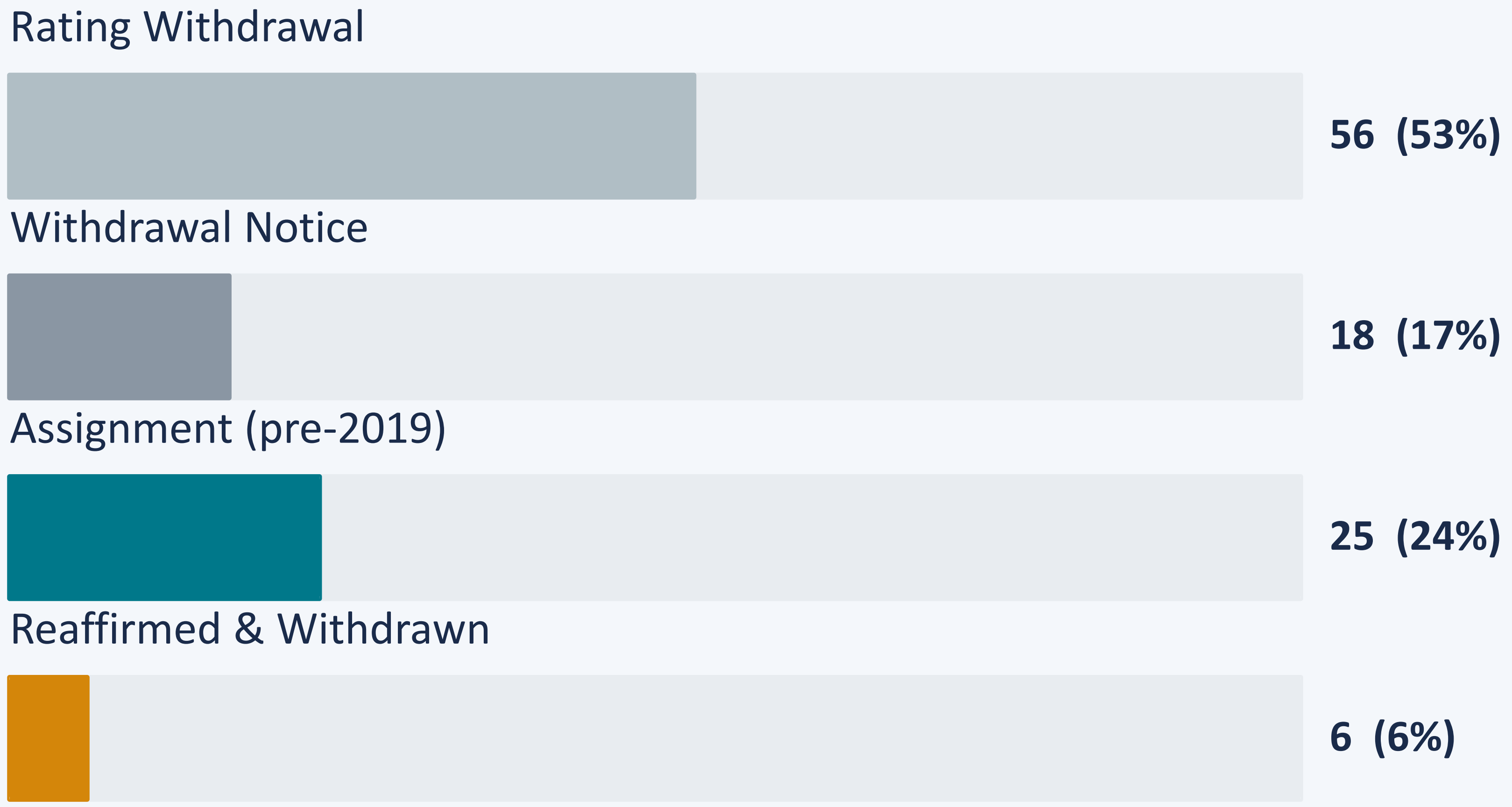
Municipal corporation	Instrument type	Assigned rating	Status
Ghaziabad Nagar Nigam	NCD	BWR AA / Stable	**Active / Surveillance**
Bhopal Municipal Corporation	NCD	BWR AA / Stable	**Active / Surveillance**
Lucknow Municipal Corporation	NCD	BWR AA / Stable	**Active / Surveillance**
Indore Municipal Corporation	NCD / BLR	BWR BB- / Stable	**Active / Surveillance**
Kochi Municipal Corporation	Bank Loan Rating	BWR B+ / Stable	**Active / Surveillance**

Source: BWR Research internal ratings database.

BWR experience with urban local bodies (2/2)

From broad capacity-building to capital market mandates — how BWR's ULB portfolio evolved

What happened to the 105 rated ULBs?



6 ULBs graduated to active bond issuers

Lucknow MC, Ghaziabad NN, Bhopal MC
→ upgraded to BWR AA (investment grade)
Indore MC → downgraded to BWR BB– post-INC

Best-rated ULB per state

State	Top ULB	Rating
Tamil Nadu	Greater Chennai Corp	BWR A
Uttar Pradesh	Lucknow MC (NCD)	BWR AA
Jharkhand	Dhanbad MC	BWR BB
Punjab	Ludhiana MC	BWR BBB+
Madhya Pradesh	Bhopal MC (NCD)	BWR AA
Kerala	Thiruvananthapuram MC	BWR BBB
Maharashtra	Bhiwandi Nizampur MC	BWR BBB
Odisha	Cuttack MC	BWR BBB–
Himachal Pradesh	Shimla MC	BWR BBB
Chhattisgarh	Korba MC	BWR BBB–

AA / A   BBB range   BB range

Source: BWR Research internal ratings database.

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The "untapped market" – small ULBs and hilly states

4,223 small ULBs and cities targeted; ~80% have never accessed market debt

The coverage gap

While large metros have dominated municipal finance, UCF expands support to 4,223 cities—specifically targeting the 80% of urban centres that have never accessed market debt.

The "countermagnet" strategy

Special focus on Hilly and North-Eastern states to develop satellite urban hubs designed to decongest existing capitals and promote regional economic balance.

CRGSS: INR 50 billion Credit Repayment Guarantee Scheme — Provides up to 70% guarantee (max INR 70 million) for first-time ULB loans in smaller/hilly geographies

- **Surge in first-time issuers:** most of 4,223 UCF-covered cities are currently unrated. A credit rating is a mandatory prerequisite for "challenge mode" eligibility and market borrowing.
- **Standardised data & recurring fees:** mandatory digitization reforms standardize the data pool—increasing rating efficiency and securing annual surveillance fee revenue.
- **Guarantee as rating floor:** the CRGSS acts as a massive credit enhancer, allowing CRAs to assign investment-grade ratings to previously "unrateable" segments.
- **Strategic advisory role:** MOHUA's e-directory and support initiatives position CRAs as strategic knowledge partners helping cities build long-term creditworthiness.

Source: : UCF Guidelines, MOHUA; City Finance, MOHUA

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Reform-linked credit uplift

How mandatory UCF reforms translate directly into improved ULB credit profiles

Mandatory governance reforms

Property tax reform, land value capture, audited financials, and digital tools form the non-negotiable entry criteria—improving institutional transparency and investor confidence.

Financial reforms

Improving property tax collection rates and overall creditworthiness enables ULBs to borrow their 50% commercial share from the market. Directly strengthens debt service capacity.

Operational reforms

Setting cost-reflective tariffs for water and electricity and improving utility efficiency ensures project viability post-construction—preventing operational cash flow deficits.

Urban planning reforms

Adoption of transit-oriented development (TOD) and green infrastructure standards expands the long-term revenue base of ULBs, supporting ratings for long-tenor instruments.

BWR role: BWR can provide rating advisory services to help ULBs navigate the "Challenge Mode" selection process. Over time, reform compliance translates into strengthened institutional credit profiles, enabling rating upgrades and lower borrowing costs.

Source: Press Information Bureau of India; MOHUA.

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UCF project lifecycle – from proposal to debt issuance

Phase	ULB / State action	Central Govt (MoHUA) role	Credit / rating considerations
Phase 1 **Initiation** *Challenge-Mode Entry*	Submit project proposal aligned to UCF verticals (Cities as Growth Hubs, Creative Redevelopment, Water & Sanitation). Demonstrate transformative scale and reform commitment.	Initial screening by MoHUA on impact, readiness, and reform commitment. State-level shortlisting of viable proposals.	Preliminary creditworthiness signals assessed: revenue base, debt service capacity, and reform track record.
Phase 2 **Preparation** *Bankability Structuring*	Develop DPRs, financial models, and market-finance plans. Identify revenue streams and escrow structures.	INR 50 billion Project Preparation & Capacity Building Fund (PPCBF) supports DPRs, transaction advisory, and institutional capacity building.	Pre-rating evaluation of project cash flows and revenue model robustness. Bankability of the financing plan assessed.
Phase 3 **Approval** *Final Selection*	Secure in-principle FI commitment for ≥50% market finance. Commit to mandatory governance and financial reforms.	National Apex Committee (NAC), chaired by MoHUA Secretary, evaluates and approves projects after state SHPSC approval and FI commitment.	Formal credit rating finalised if bond route chosen (SEBI mandates investment-grade minimum). Issuer vs. instrument rating distinction applies.
Phase 4 **Credit linkage** *Credit Enhancement*	Finalise 25% State/ULB contribution. Identify and engage market lenders (banks, bond investors, multilaterals).	25% CA released as catalytic gap funding in tranches (30/50/20). CRGSS (separate INR 50 billion n sub-scheme) provides credit guarantees for small, NE, and hilly ULBs only.	Rating uplift methodology applied where CRGSS guarantee enhances instrument rating above issuer's standalone profile.
Phase 5 **Market launch** *Debt Issuance / PPP*	Float municipal bonds, debentures, or sign PPP agreements for ≥50% of project cost. Activate escrow mechanism.	CRGSS activated for eligible small/hilly ULBs. Milestone-linked CA tranches released on geo-tagged physical progress verification.	Ongoing SEBI ILMDS surveillance obligations for bond issuers: disclosure, covenant monitoring, and periodic rating reviews.

Source: UCF guidelines, MOHUA; Amrut, MOHUA.

Risk landscape and mitigation considerations

HIGH	**1. Data integrity & accounting standards** **Risk:** many ULBs are transitioning to NMAM and digitised registers. Ratings based on un-audited or legacy data pose significant accuracy and reputational risk. **Mitigation:** require audited financials as a precondition; apply additional analytical adjustments for NMAM-transitioning entities.
HIGH	**2. Reform compliance dependency** **Risk:** UCF's 25% Central Assistance is strictly contingent on reform milestones. ULB failure to comply may trigger liquidity crises and default on the 50% commercial debt that has been rated. **Mitigation:** Build reform-milestone triggers into monitoring frameworks; seek clarity on how GOI is going to track these reforms.
MEDIUM	**3. Political & regulatory sensitivity** **Risk:** Key revenue streams (property tax hikes, water tariffs) are politically sensitive. Future reversals can abruptly diminish cash flows required for debt servicing. **Mitigation:** Apply sensitivity analysis on tariff reversal scenarios; flag political risk in rating rationale and disclosures.
MEDIUM	**4. Capacity & implementation gaps** **Risk:** Many ULBs lack technical expertise to manage complex PPP structures or large-scale Growth Hub projects. Cost overruns can jeopardise initial rating assumptions. **Mitigation:** Conduct detailed project execution risk review at the rating stage; monitor milestone-based cost and timeline disclosures.
MEDIUM	**5. Guarantee invocation challenges** **Risk:** CRGSS mechanisms remain largely untested. Legal ambiguity in guarantee payout could trigger rating downgrades of the enhanced instrument. **Mitigation:** Seek legal opinions on invocation timelines; apply a haircut to guarantee value in credit uplift calculations until precedent is established.

Source: UCF Guidelines, MOHUA; Press Information Bureau of India.

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ABOUT BRICKWORK RATINGS

Brickwork Ratings (BWR) is a registered credit rating agency by Securities and Exchange Board of India (SEBI) and a recognized External Credit Assessment Agency (ECAI) by the Reserve Bank of India (RBI) to carry out credit ratings in India. Established in 2007, BWR provides rating services for bank loan, NCD, commercial paper, bonds, securitized paper etc. It also provides investors and lenders timely and in-depth research across the structured finance, public finance, financial institutions, project finance and corporate sectors. BWR has Canara Bank, a leading public sector bank, as its promoter and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence with representatives in 150+ locations.

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