



Rating Criteria for Pooled Funds of Urban Local Bodies

Executive Summary

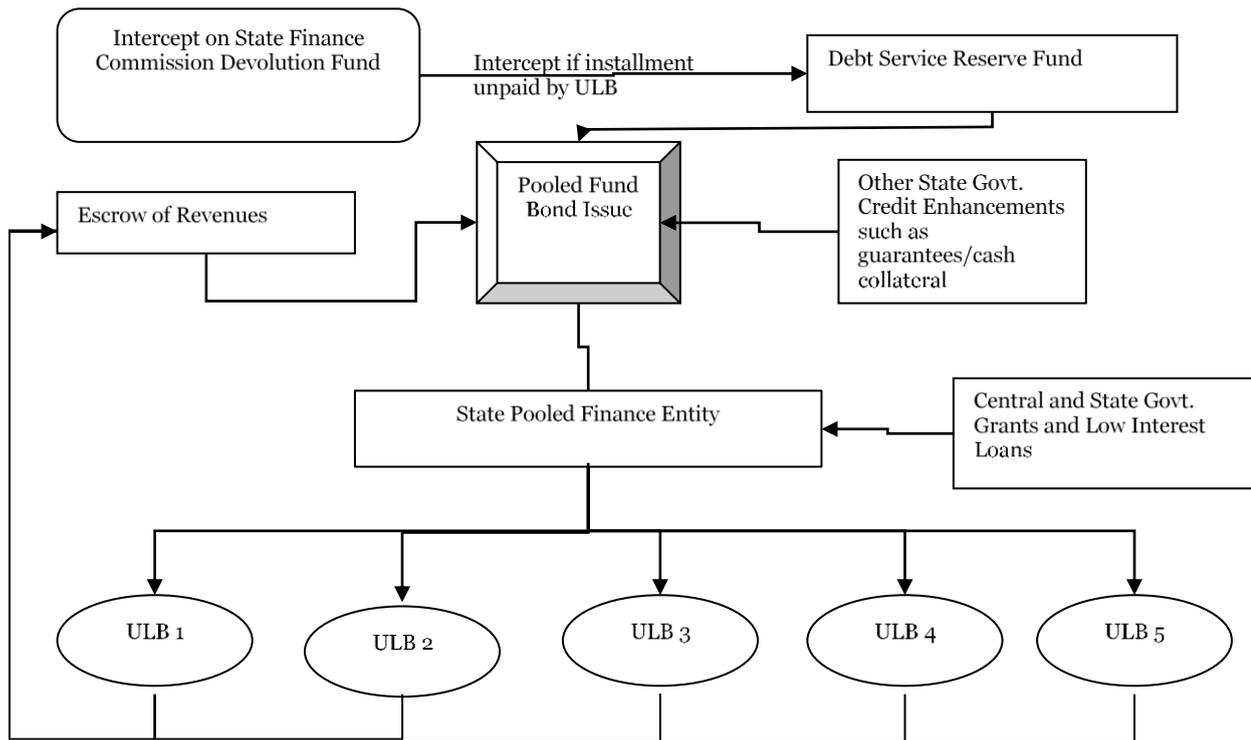
State-Level Pooled Fund Mechanisms under the Pooled Fund Scheme introduced by the Government of India (GoI) were created primarily for facilitating the market borrowings of Urban Local Bodies (ULBs) for implementing infrastructure development projects by enabling them access to capital and financial markets at a lower cost of funds. The State Pooled Finance Entity (SPFE) for each state is responsible for raising funds from markets and distribution of the same among the ULBs in the state based on their project requirements. For the pooled loan of ULBs, the structure and mechanism along with the loan recovery prospects and collection of principal and interest from each ULB, their ability to increase taxes and operational capabilities are assessed for arriving at the rating.

ULBs are local bodies working towards ensuring adequate health, sanitation and safety in the urban areas in which they operate. Due to the rapid pace of urbanisation and complexities in city administration, it became inevitable to have a decentralised system of governance and undertake infrastructural projects at a local level. The purpose of adding a third tier to the Indian federal set-up was to have a decentralised system of governance. The role played by these service agencies can be summarised as under:

1. To function as local units of self-governance
2. To work towards ensuring conditions for healthy living and work
3. To ensure the planned and regulated development of urban areas
4. To mobilise local resources and ensure equitable access of the same

In terms of financial flexibility, ULBs find it difficult to finance developmental work due to a low availability of fund sources. Their main sources of income are the tax and non-tax levies. However, taxes are levied by the central and state governments, and the ones collected by local bodies are not sufficient to cover their ambit of functions to be performed.

The structure of a pooled finance scheme is represented here:



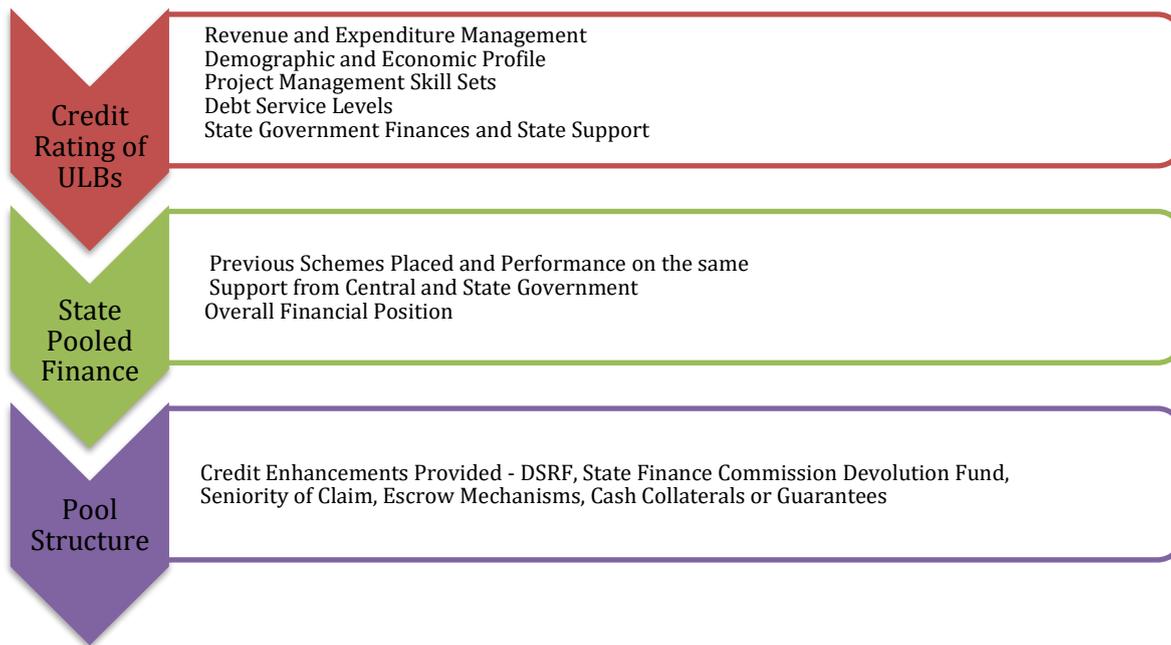
The Debt Service Reserve Fund/ Bond Service Fund (DSRF/BSF) is usually created by the SPFE through the collection of one principal amount from each ULB and maintained as reserve accounts held by the SPFE and the ULB jointly. In cases where there is a payment delay by the ULB, the amount is repaid by drawing down on the DSRF, and the same amount is then topped-up through collection from the ULB. In cases where the amount has not been received from the ULB in question, the repayments are made by interception of the State Finance Commission Devolution out of the amount allocated to the ULB.

Scope of the Criteria:

BWR’s rating criteria for Pooled funds of ULBs assesses the various parameters such as the credit profile of ULBs, SPFE’s financial position, support from central and state governments and payment structure and mechanism of the pooled funds. The overall rating assigned is indicative of the credit quality of ULBs, structured payment mechanism and credit enhancement which can be used as reference for investors, market participants and lenders.

Risk Assessment and Rating Methodology:

BWR factors in the credit worthiness of the ULBs, performance of the SPFE, and structure of the pooled fund. Rating criteria for the pooled fund scheme are represented in the chart below:



The rating process includes an analysis of

- a) Credit worthiness of the ULBs being financed under this scheme:
 - BWR determines the credit worthiness of individual ULBs using the rating criteria as defined in the criteria document for ULBs.
 - BWR also considers the overall performance of the state government as this is expected to influence the financial strength of the ULBs.
- b) Performance of the State Pooled Finance Entity
 - Overall financial position including grants received, performance on debt schemes already launched
 - Management skill sets
 - Support provided by state and central governments
- c) Structure of the Pooled Fund Bond:
 - Seniority of the bond
 - Legal Structure of the Pooled fund
 - Project concentration and risks – Types of projects being financed
 - Credit Enhancements provided
 - Cash Collateral/Guarantees
 - Escrow Mechanisms
 - SFCD Intercept Availability
 - Availability of any other collateral, including access to excess cash flows available with the SPFE
- d) Stress Test: Cash flows for the repayment of loans are stressed under different scenarios to check for possible delays/defaults in the repayment of the loans. Cash flow scenarios generated include a possible draw-down on the credit enhancements provided to arrive at the possible rating. The quantum of shortfall is measured and compared with the availability of other cash flow sources such as the DSRF and cash collateral provided and augmented during the analysis. The stress scenarios are usually done at both the individual ULB levels, as well as the pooled level, while arriving at the overall credit rating that is assigned.

Revenue and Expenditure Management

Urban Local Bodies have tax and non-tax revenues owing to the rapid pace of urbanisation and need for urban infrastructure development, revenue generated by municipalities often falls short of their expenditure requirements. Thus, over and above their own revenue, most local bodies depend significantly on the devolution of resources and grants from state and central governments, and borrowings from financial institutions.

BWR conducts a detailed study on ULBs' revenue streams, including own-non-tax revenue, own-tax revenue, borrowings, grants-in-aid and other receipts. BWR believes own tax and non-tax revenues are the better measures for understanding the inherent strengths of the ULBs.

BWR also evaluates revenue expenditure incurred by performing a detailed analysis of allocations made for primary education, medical, relief, water supply and sewage, public health and safety, solid waste management and public works. The consistency and components of the expenditure of the above-mentioned services is examined by BWR.

Demographic and Economic Profile

The demographic characteristics of the area in which a ULB operates are key factors affecting its revenue earning capacity. Scale, as well as stability, in a ULB's revenues are assessed, as it helps mitigate its expenditure and other debt obligations. Furthermore, the economic prospects of the operating area of the ULBs, number of industries in the vicinity and diversification of economic activities add to their revenue potential. Dependence on a few industries leads to concentration risk because if any one industry goes bankrupt, the finances of the ULB may get affected. A well-diversified portfolio of industries mitigates such a risk.

BWR analyses the monetary and demographic attributes of ULBs with the goal of evaluating the base, flexibility and potential of upgrading the body's revenue base and income producing potential. A portion of the key pointers analysed include the following:

- Lucrative Factors:
 - Economic development in the regions
 - Importance of the region
- Societal Factors:
 - The population base and its development rate, and the extent of slum population

State Government Finances and State Support

Important criteria affecting the rating of ULBs include the credit quality of the state government they are associated with. The relation between a ULB and the respective state government is considered as a positive when it is stable and predictable. Due to strong fiscal relations between ULBs and state governments, the financial position of a state government directly affects the local bodies operating under it. BWR analyses parameters such as the past track record of debt servicing, stability of revenue stream and stability of transfer from the centre to assess the financial stability of the state government.

BWR also assesses the extent of dependence of the ULB on its respective state government for support. A ULB's ability to meet its respective expenses from its own revenues and resources is considered a positive. Indian states have set-up the State Finance Commission (SFC) for sharing taxes and user charges, and also recommend the grants-in-aid for ULBs. Sometimes, ULBs receive funds from the Government of India

and the state government to execute various development works. Timely support from the state government through a structured framework for fund allocation is seen as a credit positive.

Operational Efficiency

BWR assesses the current operations of ULBs by conducting in-depth research and through the analysis of numerous services rendered and payments collected, and by comparing its mandatory and discretionary services. BWR conducts thorough research on the core service sectors. Various aspects such as the population and quantum of per-capita water supply are benchmarked to arrive at various service agreements. BW believes that ULBs focusing on operational improvements have better possibilities in generating cumulative revenue.

Debt Service Levels

BWR assesses a ULB's debt indicators, including maturity, repayment plans, interest rates, repayment obligations, debt composition and proportions of external debt, all valuable markers to characterise debt and repayment capacity. BWR also evaluates the debt-to-service coverage ratio to analyse the ULB's available cash flow to pay current debt obligations. BWR also looks at the ULB's asset management, monetisation of land resources and privatisation avenues, as applicable.

Project Management Skills

Project management skills are a combination of the management quality and operational ability of the ULB. The information systems adopted by the ULB, relation with the state, management of affairs and extent of transparency in operations are indicators of effective project management.

Management, Quality of Reporting

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets and also helps improve the company's financials. BWR assesses the consistency of performance demonstrated by the management and the quality of Corporate Governance adopted by the entity. Additionally, BWR assesses the timeliness and accuracy of a ULB's financial reporting, operating statements and budget documents. BWR evaluates the progress of ongoing/proposed reforms being undertaken by a ULB, which are critical for an improvement in its operational and financial performance.

Conclusion

BWR's rating for Pooled Funds is mainly centred around the analysis of the finances of the ULBs and the state government, its stability of revenues and debt servicing ability, performance of STFE and structure of pooled funds. The parameters mentioned do not constitute the entire framework for the rating process and are instead, to be considered as a basic approach for understanding the credit quality of pooled funds. An important criterion highlighted in the document is the degree of autonomy possessed by the pooled funds of ULBs, in terms of finances, as well as the operational ability.

The previous version of this document can be found in www.brickworkratings.com/download/Criteria-PooledFunds.pdf

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