



## 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. Through more effective access to finance and financial markets, these techniques let ULBs obtain funding at a reduced cost.

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.

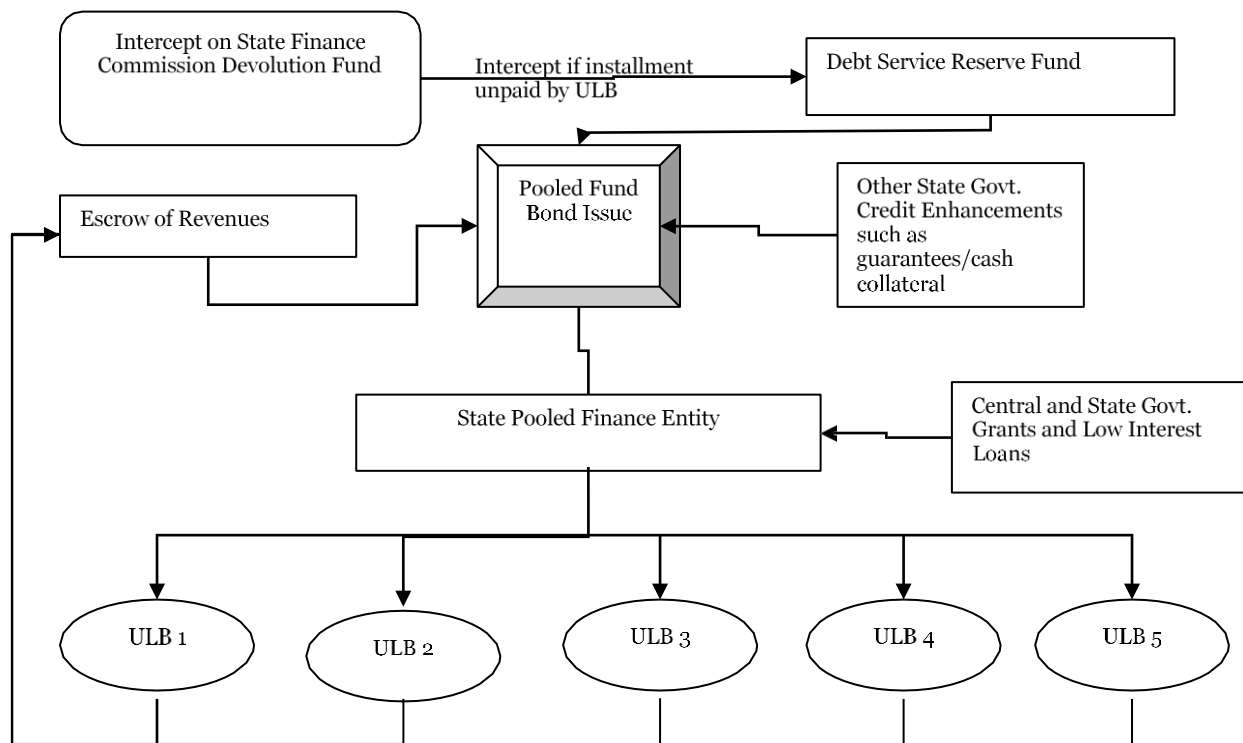
Urban Local Bodies are responsible for ensuring health, sanitation and safety in urban areas in which they operate. As urbanization rapidly increases, the need for decentralized governance and local infrastructure projects has become essential to meet the growing demands of urban populations. The introduction of a third tier to the Indian federal setup aimed to establish a decentralized 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:



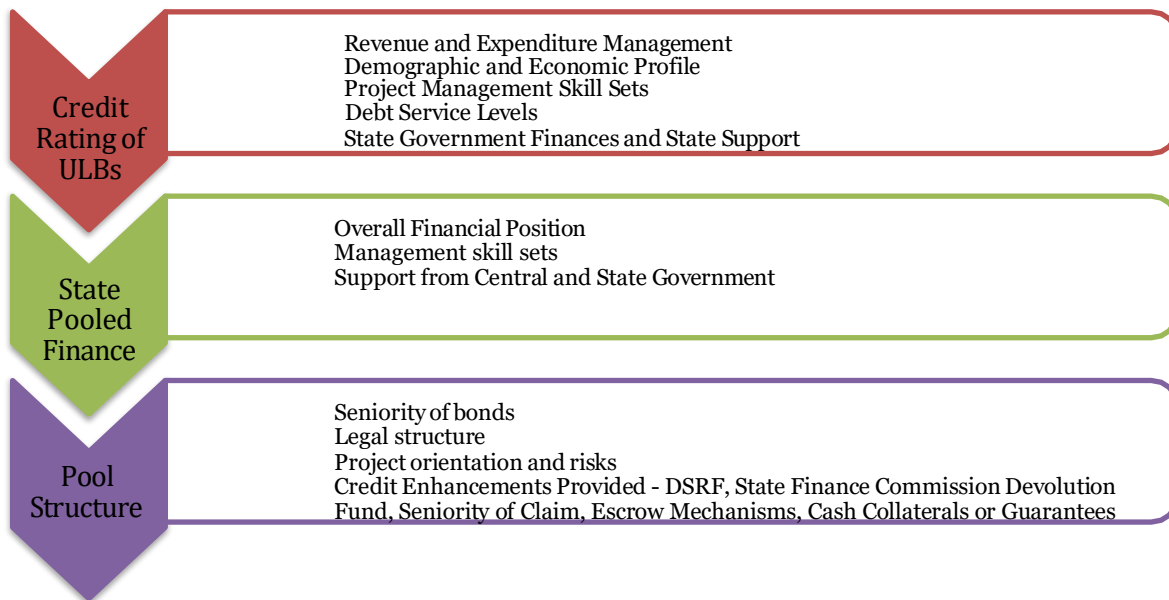
The Debt Service Reserve Fund/ Bond Service Fund (DSRF/BSF) is usually created by the SPFE through the collection of one principal amount from each ULB and maintained as reserve accounts held by the SPFE and the ULB jointly. In cases where there is a payment delay by the ULB, the amount is repaid by 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 assess 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, the structured payment mechanism and credit enhancement which can be used as a 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. The chart below shows the rating criteria for the pooled fund scheme:



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
    - SFCF 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.

## A. Credit Ratings of ULB's

The credit rating of ULB's is based on a comprehensive assessment of various financial, operational, and governance factors. These factors help determine the entity's ability to meet its financial obligations and maintain long-term sustainability. Below are the key sub-pointers that play an essential role in evaluating the creditworthiness of ULBs:

### i) Revenue and Expenditure Management

Urban Local Bodies have tax and non-tax revenues owing to the rapid pace of urbanization 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 analysis of ULBs' revenue streams, including own-non-tax revenue, borrowings, grants-in-aid and other receipts. BWR believes that own-tax and non-tax revenues are the best indicators for assessing 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.

### ii) Demographic and Economic Profile

The demographic characteristics of the area in which a ULB operates are key factors affecting its revenue earning capacity. Both the scale and stability of a ULB's revenues are assessed, as they helps manage its expenditure and debt obligations. Additionally, the economic prospects of the ULB's operating area, the number of industries nearby, and the diversification of economic activities contribute to its 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 to assess the strength, flexibility and potential for expanding the body's revenue base and income generating capacity. Key factors examined include:

- Lucrative Factors:
  - Economic development in the region
  - Strategic importance of the region
- Societal Factors:
  - Population size and growth rate
  - Proportion of the population living in slums

### iii) 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. These factors help assess the ULB's capacity to efficiently plan, execute, and monitor projects, ensuring the successful implementation of infrastructure and development initiatives.

#### **iv) 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.

#### **v) 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 relationship between a ULB and the respective state government is considered 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 analyzes parameters such as the past track record of debt servicing, the stability of revenue stream, and the stability of transfer from the centre to assess the financial stability of the state government. BWR also assesses the extent of a ULB's dependence 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 factor. Indian states have set-up the State Finance Commission (SFC) for sharing taxes and user charges, as well as to recommend the grants-in-aid for ULBs. At times, ULBs receive funds from both 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 viewed as a credit positive.

### **B. Performance of the State Pooled finance entity**

The performance of the State Pooled Finance Entity (SPFE) is influenced by several critical factors, which are outlined below:

#### **i) Overall Financial Position**

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 timeliness and accuracy of a ULB's financial reporting, operating statements and budget documents. This includes reviewing the completeness and transparency of financial disclosures, which are vital for assessing the entity's financial health. In evaluating the overall financial position, BWR considers several key factors, including grants received from central and state government and the performance of debt schemes already launched by the entity. Additionally, BWR also monitor the progress of ongoing and proposed reforms being undertaken by the ULB, as these reforms are critical for enhancing both its operational and financial performance.

#### **ii) Management skill sets**

The effectiveness of the management team is crucial in ensuring the organization's financial success. A dedicated and experienced board plays a central role in setting the direction and making key decisions to improve the company's financial performance. BWR assesses the consistency of performance demonstrated by the management and the quality of Corporate Governance adopted by the entity.

### **iii) Support from state and central government**

Support from state and central governments is vital for the performance of the SPFE. This support includes financial assistance, such as grants or loans, guarantees for bond repayment and favorable policies that create a conducive environment for pooled funding.

## **C. Structure of the Pooled Fund Bond**

The structure of a pooled fund bond for Urban Local Bodies (ULBs) includes several key elements to ensure stability and security for investors. The seniority of the bond determines the order of repayment in case of default, with senior bonds having higher priority over subordinated ones. The legal structure of the pooled fund is critical in determining governance and investor protections, which can influence the fund's stability and risk profile. The project concentration and risks depend on the types of projects financed, with diversified projects offering lower risk compared to concentrated investments in specific sectors or regions. To enhance the bond's creditworthiness, several credit enhancements are provided, such as cash collateral or guarantees to offer additional security, escrow mechanisms to ensure funds are available for debt service, and SFCD intercept availability, where the state government can redirect allocated funds for repayment if a ULB faces financial difficulties. Additionally, other collateral, including excess cash flows or assets held by the SPFE, can be accessed to further secure bondholders in case of payment shortfalls. These elements work together to create a robust structure, improving the bond's reliability and minimizing risk for investors.

## **Operational Efficiency**

BWR assesses the current operations of ULBs by through in-depth research and analysis of the various services rendered and payments collected, comparing both mandatory and discretionary services. BWR conducts thorough research on the core service sectors, evaluating aspects such as population size and per-capita water supply to establish service benchmarks. BWR believes that ULBs focusing on operational improvements have better potential for generating cumulative revenue.

## **Conclusion**

BWR's rating for Pooled Funds is mainly centered around the analysis of the finances of the ULBs and the state government, including the stability of revenues, debt servicing ability, performance of the STFE and the structure of the pooled funds. The parameters mentioned do not constitute the entire framework for the rating process but should instead be considered 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, both in terms of finances and operational ability.

The previous version of this document can be found in <https://www.brickworkratings.com/download/Criteria-PooledFunds-Sep2021.pdf>

**About Brickwork Ratings:** Brickwork Ratings (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by Reserve Bank of India [RBI], offers credit ratings of Bank Loan, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. BWR has rated over 11,400 medium and large corporates and financial institutions' instruments. BWR has also rated NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations. BWR has Canara Bank, a leading public sector bank, as one of the promoters and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence with its offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi along with representatives in 150+ locations.

**Disclaimer:** It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.

Brickwork Ratings India Pvt. Ltd. (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by the Reserve Bank of India [RBI], offers credit ratings of Bank Loan facilities, Non- convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. [hereafter referred to as "Instruments"]. BWR also rates NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations.

BWR wishes to inform all persons who may come across Rating Rationales and Rating Reports provided by BWR that the ratings assigned by BWR are based on information obtained from the issuer of the instrument and other reliable sources, which in BWR's best judgement are considered reliable. The Rating Rationale / Rating Report & other rating communications are intended for the jurisdiction of India only. The reports should not be the sole or primary basis for any investment decision within the meaning of any law or regulation (including the laws and regulations applicable in Europe and also the USA).

BWR also wishes to inform that access or use of the said documents does not create a client relationship between the user and BWR.

The ratings assigned by BWR are only an expression of BWR's opinion on the entity / instrument and should not in

any manner be construed as being a recommendation to either, purchase, hold or sell the instrument.

BWR also wishes to abundantly clarify that these ratings are not to be considered as an investment advice in any jurisdiction nor are they to be used as a basis for or as an alternative to independent financial advice and judgement obtained from the user's financial advisors. BWR shall not be liable to any losses incurred by the users of these Rating Rationales, Rating Reports or its contents. BWR reserves the right to vary, modify, suspend or withdraw the ratings at any time without assigning reasons for the same.

BWR's ratings reflect BWR's opinion on the day the ratings are published and are not reflective of factual circumstances that may have arisen on a later date. BWR is not obliged to update its opinion based on any public notification, in any form or format although BWR may disseminate its opinion and analysis when deemed fit.

Neither BWR nor its affiliates, third party providers, as well as the directors, officers, shareholders, employees or agents (collectively, "**BWR Party**") guarantee the accuracy, completeness or adequacy of the Ratings, and no BWR Party shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of the Rating Rationales or Rating Reports. Each BWR Party disclaims all express or implied warranties, including, but not limited to, any warranties of merchantability, suitability or fitness for a particular purpose or use. In no event shall any BWR Party be liable to any one for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Rating Rationales and/or Rating Reports even if advised of the possibility of such damages. However, BWR or its associates may have other commercial transactions with the company/entity. BWR and its affiliates do not act as a fiduciary.

BWR keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of the respective activity. As a result, certain business units of BWR may have information that is not available to other BWR business units. BWR has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

BWR clarifies that it may have been paid a fee by the issuers or underwriters of the instruments, facilities, securities etc., or from obligors. BWR's public ratings and analysis are made available on its web site, [www.brickworkratings.com](http://www.brickworkratings.com). More detailed information may be provided for a fee. BWR's rating criteria are also generally made available without charge on BWR's website.

This disclaimer forms an integral part of the Ratings Rationales / Rating Reports or other press releases, advisories, communications issued by BWR and circulation of the ratings without this disclaimer is prohibited.

BWR is bound by the Code of Conduct for Credit Rating Agencies issued by the Securities and Exchange Board of India and is governed by the applicable regulations issued by the Securities and Exchange Board of India as amended from time to time.