Municipal Bonds – The Ideal way to Finance Urban Infrastructure

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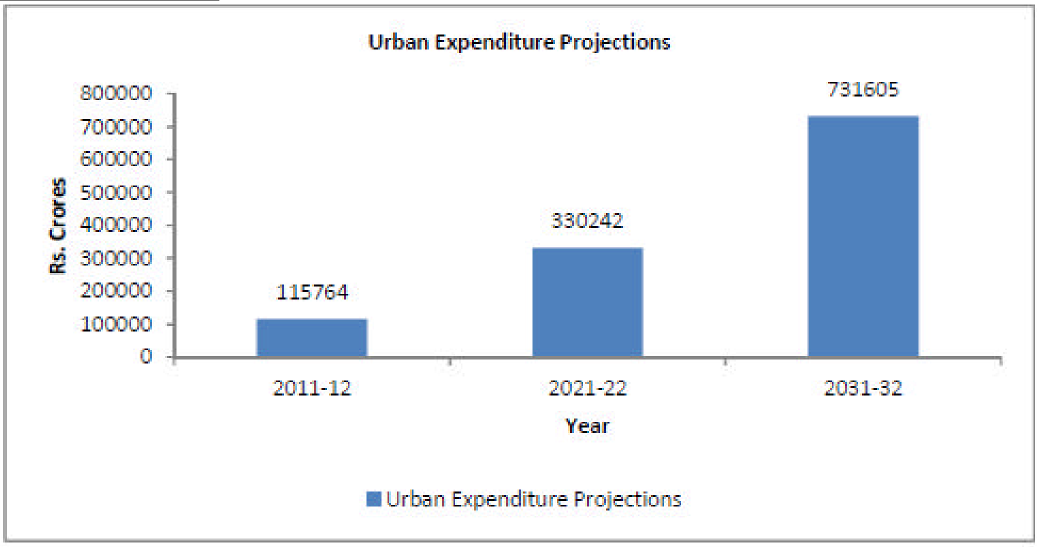
India's urban population is projected to increase to 590 million in 2030. According to the Registrar General & Census Commissioner of India, the urban population in India over the next 25 years is expected to grow 38%. India's population is set to grow to 1.7 billion by 2050 and rapid urbanization will add nearly 900 million people to Indian cities. This increased urbanization of the hitherto primarily agrarian population would lead to a considerable strain on the already strained basic urban infrastructure like water supply, sanitation, sewerage, solid waste management, drains, and infrastructure such as roads, flyovers, highways, and parking lots. If this fast pace of urbanisation is not well managed then the citizens may be deprived of even the basic services. As per the report on Urban Infrastructure and Services the High Powered Expert Committee (HPEC) estimates the requirements for both urban infrastructure services and urban transport are estimated to be as high as Rs. 7,31,605 Crores by 2031-32.

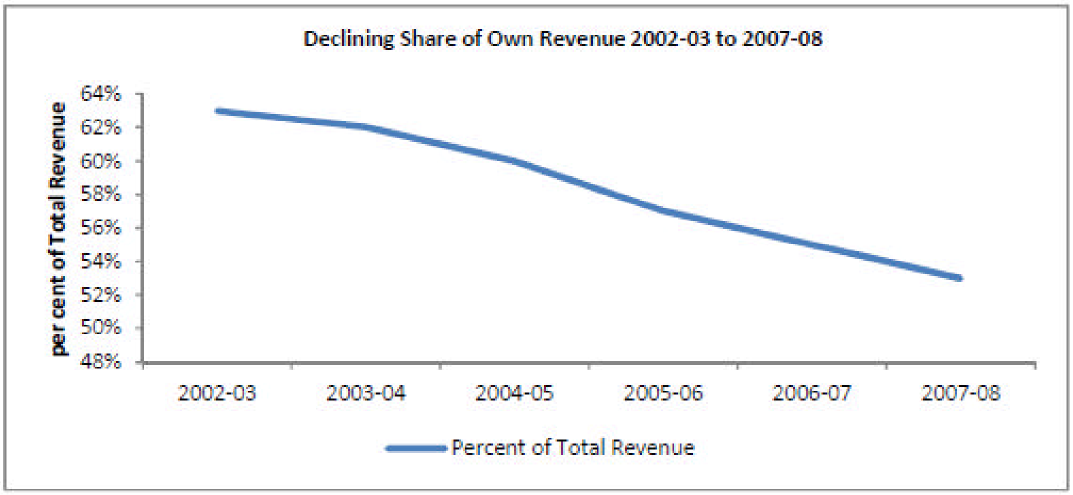


Source: Report on Indian Infrastructure and Services, March 2011

Hitherto, financing urban infrastructure has been done out of internal accruals of the Municipal Corporations or Urban Local Bodies and loans and grants from the State Government in addition to credit from institutions. The present framework for developing infrastructure has inherent weaknesses in its ability to raise resources, legal structure and in respect of project management and implementation.

Typically, a Municipal Corporation is a local government body that administers a city of population 200,000 or more, it is administratively a part of a district in which it is located but interacts directly with the State Government. Some of the large Municipal Corporations are Mumbai, Delhi, Kolkata, Bangalore, etc. It consists of members elected from the wards of the city. The Mayor and Deputy Mayor are elected by the members among themselves. A Municipal Commissioner, who is a government servant, is appointed to head the administrative staff of the Municipal Corporation, implement the decisions of the Corporation and prepare its annual budget.

Majority of the Municipal Corporations are not equipped to deal with the rapid increase in the need for infrastructure and the need for financing the same. Since the sources of revenue are few and enough money is also not generated from taxes and utility payments to fund the expenditure, they have to depend on government funding. This has led to huge amount of fiscal stress due to which they are unable to provide and maintain basic services. The share of own revenue in total revenue has declined from 63% in 2002-03 to 53% in 2007-08.



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Globally, the capital markets have been tapped to fund urban infrastructure requirements. In India however, the raising of resources through the capital markets route has met with a wall for a variety of reasons detailed elsewhere. In the above backdrop, it is only by initiating an aggressive program, that the Municipal Corporations are likely to be able to provide much needed urban infrastructure. One of the sources of raising finance from capital markets has been through the raising of bonds. Whilst larger urban local bodies with more buoyant revenues may find it easier to access such markets, alternative mechanisms would need to be accessed to enable smaller local bodies to raise funds.

Raising of Resources by the Municipal Corporations – Municipal Bonds

All infrastructure projects require extensive capital and have long gestation periods. The cash flow of such projects start flowing only after completion of the project, in such a case it becomes suitable to match the tenor of these projects with the tenor of funding. Financing these through bonds with longer tenor increases the financing capacities and provides an effective way to match assetliability. It was in 1995 that USAID introduced Municipal bonds in a national seminar in India. Later, Municipal bonds were also recommended by the Rakesh Mohan Committee on the Commercialization of Infrastructure Projects in India as an instrument for raising finances from markets.

Municipal bonds are debt obligations issued by states, cities, countries and other governmental entities, which use the money for urban infrastructural development like, building schools, highways, hospitals, sewage systems, and many other projects for the public good[1]. Municipal bonds are a well proven source of funding in the west and it was envisaged that India will attract private capital to the urban infrastructure sector if it follows the same model.

The amount required for the urban infrastructure spending can be partly met through issuing municipal bonds. They are ideal instruments for raising and channelling funds from capital markets to infrastructure development. Through Municipal bonds the Municipal Corporations can fund their projects by mobilising money from investors like pension funds, insurance companies, mutual funds etc. From investor perspective these bonds would be a welcome diversification as currently the bond market in India is dominated by large financial sector issuers.

There can be two types of Municipal bonds:

1. General Obligation Bonds
2. Revenue Bonds

General Obligation Bonds

These bonds are issued where principal and interest are secured by full faith and credit of the Municipal Corporation and with the belief that the municipality will be able to repay its debt obligation through taxation or revenue from projects. These can be used for financing municipal projects where direct cost recovery may not be a viable option, for example projects including roads, street lighting, public health, etc.

Revenue Bonds

Unlike General Obligation Bonds, in Revenue Bonds the repayment of both principal and interest is secured by revenues derived from the projects. The revenue can be user fees or service charge for providing a particular service. The projects may include toll roads, water & sewage treatment facilities etc. Many of these bonds are issued by special authorities created for that particular purpose.

Global Experience

a. United States Bond Market

As of December 31, 2011, there were over one million different municipal bonds outstanding, in the total aggregate principal amount of more than $3.7 trillion as compared to $20 billion of municipal debt outstanding in 1945. Individuals, or “retail” investors, directly or indirectly hold more than 75% of the outstanding principal amount of municipal securities[2]. The municipal securities market in the USA is an extremely diverse market, with close to 44,000 state and local issuers.

This huge municipal bond market is regulated by The Municipal Securities Rulemaking Board which was established in 1975. It develops rules regulating securities firms and those banks involved in underwriting, trading, and selling municipal securities, bonds and notes issued by states, cities, and counties or their agencies to help finance public projects. The Board, composed of members from the municipal securities dealer community and the public, sets standards for all municipal securities dealers. The Board is a self-regulatory organization subject to supervision by the Securities and Exchange Commission (“SEC”).

In respect of those Municipalities which are small and not able to issue bonds on a standalone basis, Municipal Bond Banks (MBB) issue bonds for a pool of municipalities. They first appeared in Canada in 1956 and in the United States in 1970 for the purpose of lowering the cost of debt for municipalities. Municipal bond banks operate as credit enhancing organizations by pooling debt of small municipalities and issuing bonds for the pool.

There are two structures for issuing bonds by bond banks; in one structure, they issue “Revenue Bonds” in the national bond market using their name and purchase the “General Obligation Bonds” (GOBs) of the municipality. In the second operating structure, the MBB ascertains the borrowing needs of the municipal applicants together and issues debt in one large “pool,” taking advantage of the increased size of the issue.

The US State Bond Banks have been particularly active in providing financing for municipal water and sewer projects. They operate as credit enhancement organizations and thus reduce the cost of borrowings for the poorly rated municipalities. The Bond Banks have proven to be highly adaptive for taking on new and evolving roles in meeting state infrastructure financing needs.

b. South Africa

Perhaps one of the oldest proponents of Muni-bonds, The South African Municipal Authorities have been issuing debt securities as early as 1920 (Rand Water Board) and still do so, with maturities extending beyond 25 years. There is however, immense scope of development as a majority of this existing debt was issued under the then Apartheid Government’s “Prescribed Investment Regime” which required institutional investors to hold 54% of their investment portfolios in government or Government backed securities, including municipal bonds. This coerced the institutional investors to hold the Muni-bonds till maturity. In the Post-Apartheid Era, such “Prescribed” investment mandates have been done away with, and Government and Municipal bonds now enjoy far more tradability than before. This also encourages fresh Muni-bond issuances, especially from townships which were earlier suppressed under the apartheid regime.

c. Others

- Some Canadian Provinces viz. Quebec & Ontario have issued Bonds in the past.
- Europe, which features the largest dollar volume of issuances outside of the United States, has about USD 333 Billion in Sub Sovereign Debt. About 82% of this is from German Municipal Bonds (770 issuances between 2000 & 2007). Apart from this, several Eastern European countries such as the Russian Federation, the Slovak Republic, Slovenia, and Romania have entered the municipal bond market to finance large infrastructure projects.
- Latin America too, has dabbled in the Municipal Bond market with Rio de Janerio issuing their first Bond way back in 1996 to refinance their existing debt.

d. Indian Experience

Since 1995 there have been 28 municipal bonds issuance in India adding up to Rs 3083.76 Crores. The last issuance was done by Greater Vishakhapatnam Municipal Corporation for Rs 30 Crores in 2010. The government of India announced JNNRUM and Pooled Finance Development Scheme to encourage investments in infrastructure by financing through capital markets.

In 2005, JNNRUM covering 63 cities was launched with an allocation of Rs 600 Bn to fund urban development. The total capital requirement of these cities exceeded Rs 3,000 Bn. The Ministry of Urban Development till January 2011 had sanctioned projects worth Rs 500 Bn.

Under JNNURM Central Government funding was fixed as 35% share in project costs in case of Category A cities, 50% for Category B cities and so on. For the Urban Infrastructure and Governance Component, the total of State and City share of investment was estimated to be Rs. 142,000 crores, of which State Governments were required to contribute about Rs. 44,000 crores and cities Rs. 98,000 crores.

While many cities came forward and were immensely benefited by the program, only 22 of the total 1517 housing projects were completed as on 31 March 2011. Similarly 231 projects were completed out of 1298 urban infrastructure projects (as observed in the audit report). Against the total allocation of Rs 66084.66 Crore made by Planning Commission, Government of India made an allocation for Rs 37070.15 Crore out of which Rs 32934.59 crore were released up to 31 March 2011[3]. India will soon launch the $40 billion second phase of its urban renewal mission. The Jawaharlal Nehru National Urban Renewal Mission (JnNURM) phase II would be carried out over the next five years as India works to cover its infrastructure deficit throughout the country and manage massive urbanisation programmes as announced by Urban Development Minister Shri. Kamal Nath in Singapore World Cities Summit this year. The Government is considering allocation of 0.25 % of GDP, i.e Rs 175,000 crore for the next phase of JnNURM.

The Government also initiated State Level Pooled Finance Mechanism for implementing the Pooled Finance Development Scheme (PFDF). PFDF was introduced to provide credit enhancement to the projects by providing funds to the Credit Rating Enhancement Fund (CREF). State Pool Finance Entity was expected to make a pool of urban local bodies to hedge risk for the investors. Objectives of the Fund included facilitating Urban Local Bodies (ULB) to access Municipal Bond and Capital Markets, thereby reducing cost of borrowing by ULBs with appropriate credit enhancement and facilitate creation of the Municipal Bond market. The Central Government was responsible for the funding of these State pooled finance entities through the PFDF.

The bonds issued under the pooled finance scheme were envisaged to have a tax- free status under the Ministry's Guidelines for tax - free municipal bonds. The official gazette section 10(15)(vii) of the Income Tax Act was amended under Finance Act, 2007 enacted on 11 May 2007 to make provisions for the tax free status of tax free municipal bonds. For example Tax Free Municipal Bonds issue by Nagpur Municipal Corporation for an amount of Rs.128 crores during the F.Y.2006-07 had the tax on interest exempt under section 10(15)(vii).

Some of the funds which launched issues in past few years are:

1. Greater Bangalore Water & Sewerage Project
2. Tamil Nadu Urban Development Fund (TNUDF)
3. Water and Sanitation Pooled Bond Issue in Tamil Nadu

Issues in Municipal Bonds

a. No governing body and different charters

One of the major issues in the development of the Municipal Bond Market is lack of a single body that governs the municipal bodies. Most municipal bodies are established by a State level Act which is its charter. Each municipal body thus has its own procedures, practices and rules. The objectives and activity of each body thus can be very different. Hence standard procedures cannot be set for activities like borrowing at a national level. The lack of standard practices is a hurdle in speeding up the activities of parties like credit rating agencies and lenders.

Investors and other external agents rely on the good governance practices and management disclosures for ensuring protection of their interest in the company. There are hardly any regulations for public disclosures and transparency norms for municipal bodies. Most municipal bodies disclose records and performance only voluntarily. Also the standard of disclosure is not uniform and audit is sporadic at best.

b. No regulations for municipal bonds

Indian financial markets are adequately regulated with both government and self-regulatory organizations. Among other benefits, such regulations bring investor confidence and protection. There are no such regulatory guidelines for municipal bonds. Such guidelines should establish disclosure standards, performance procedures and grievance redressal.

The Guidelines for Issue of Tax Free Municipal Bonds u/s 10(15)(vii) of the Income Tax Act provides the necessary direction for such bonds. It mentions end use of funds, tenure, coupon, required reforms, monitoring, credit rating and listing among others. A municipal body raising funds within such boundaries will gain investor confidence. Similar directive guidelines are required for taxable municipal bonds.

c. Unclear separate identity

The municipal bodies, usually because of its weak legal structure face trouble in exhibiting a separate identity beyond its officials. Thus the long term contracts face the question of accountability and trust after the officials change. There needs to be surety that the entity and its activities will survive beyond its officials to be able to enter into long term contracts.

d. Lack of Enforceability

The regular investors in Indian Debt Capital Markets are not well acquainted with the legal structure of a municipal body. The lack of clarity toward it being a government or private body makes it difficult to ensure enforceability of contracts. If the investors are not confident of enforcing repayments or covenants, the instrument would not be attractive.

e. No specific investment limits

Many financial instruments like government securities, state development loans, infrastructure bonds, state guaranteed bonds have been allocated specific limits in portfolio of different class of investors. For example, a provident fund has to necessarily invest a minimum of 40% of its portfolio in Central Government securities as per Ministry of Finance guidelines. Such investment limits are not there for municipal bonds. Moreover FIIs and QFIs cannot invest in municipal bonds. This market segment has contributed significantly to the growth of corporate bond markets in India in the last 2 years.

Municipal Bonds: Enabling a Regulatory framework for Municipal Corporation

As discussed above, the legal status of a Municipal Corporation has not been clearly established. There is no direct regulatory authority or entity that sets a standard of practices for the Municipal Corporations. Hence the level of governance at these entities is generally very low. Most of them lack transparency and use single entry systems to keep accounting records. There are no standard audit requirements. Such entities are poor candidates for investment. In order to generate investor interest, governance of the borrowing entity, utilization of funds and the flow of income have to be made clear to the investor. Municipal Corporations should use a well-established regulatory regime that takes care of Corporate Governance of the entities and ensures a fairly acceptable level of disclosures, accounting and auditing practices.

Establishing a regulatory regime for Municipal Corporations as such and ensuring compliance would require substantial time and effort. Furthermore, the education of the various stakeholders as well as for the processes to get established under new machinery would cause considerable amount of delays.

Providing finance to the MB as a whole would require credit assessment and taking risk of the MB, which as already stated may face lack of interest from investors. As such, we may consider carrying out individual projects with limited activities as they would be easier to asses, and can be credit enhanced more effectively so as to garner interest from investors willing to take a selective view.

Besides, the credit assessment of these bonds would be relatively easier than assessing that of the MB. The carved out entity would have separate records and operations. The credit could also be improved at the base level by pooling of multiple such projects and providing diversification benefit. Credit enhancement can be provided to the bonds by way of escrow mechanism to the pool cash flows or cash support from MBs or the state.

Enabling a vibrant Muni-Bond Market

One of the key elements in development of the market for a product is liquidity in the secondary markets. While much has been written and discussed about the Corporate Bonds Market, it has failed to take off mainly on account of lack of liquidity in the secondary markets and therefore aversion to illiquidity risk in the hands of the investors.

One of the major issues which hamper liquidity is the lack of an electronic anonymous trading platform. Experience with the various asset classes like Foreign Exchange, Government Securities etc. has proved that an anonymous trading platform plays a very big role in generation of liquidity. The Exchanges/ Regulators need to take immediate measures to enable building of such platform.

Lack of standardization in the Bonds/NCDs leads to confusion among most participants and therefore arbitrage for the informed players. Standard clauses/ conventions for the Muni Bonds would need to be put into place so as to enable anonymous trading.

In order to be able to provide liquidity, there need to be market makers. The arrangers to the muni bonds would need to be incentivised as well as forced into market making. An effective way would be to restrict the arrangers of the Muni Bonds to only those who would undertake to provide two way market quotes for an all in fee.

Conclusion

Continuing and rapid urbanization poses a challenge in developing economically buoyant and vibrant cities. It would therefore require building of synergies at all levels be it Government private or public. It would do well to enact new laws to change the structure of the ULBs but that would be time consuming and would involve re-educating the stake holders. Attempt therefore should be made, as far as possible, to work within the available framework so as to hasten the process of development of the Urban Infrastructure and the Municipal Bond markets.

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[1] Municipal Bonds and India [THE CHARTERED ACCOUNTANT December 2011]

[2] Report on the Municipal Securities Market, July 31,2012

[3] Performance Audit of Jawaharlal Nehru National Urban Renewal Mission (JNNURM)