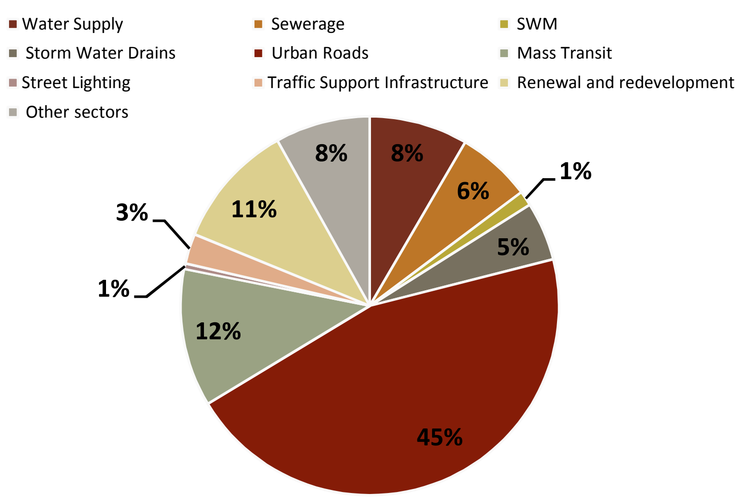
Municipal Bonds in India

With the fast pace of urbanization and rural to urban migration, more than **37.7 crore Indians now live in 7935 towns** in India. The urban population growth at 29.8% from 2001 outpaced the national average growth (17.1%) by a huge margin. The growth of urban amenities and improvement in service delivery levels, however, has lagged behind this massive rate of growth of urban population. In the eleventh five year plan period (2007-2012), the **total outlay for urban development and housing sector was only Rs.68,080 crore** as compared to Rs. 5,50,000 crore for rural development programmes. The High Powered Expert Committee setup by the Government of India (2011) estimated that the urban infrastructure require an investment of at least **Rs. 39.2 lakh Crore over a 20 year period** to cope with the growing urban demand and to close the existing gaps. The committee also stated that over Rs. 19.9 lakh crore will be required for the operation and maintenance costs of urban assets.

Sector-wise Investment Required



Major Scheme Commitments from Governments For Urban Infrastructure		
Smart Cities Mission	**AMRUT**	**Swachh Bharat (U)**
• Rs.48000 Crores over 5 years from Centre's Share • Rs.48000 Crores over 5 years from State's Share	• Rs. 50000 Crores over 5 years from Centre's Share • Minimum Rs.50000 Crores over 5 years from State's Share	• Rs. 14,623 Crore over 5 years from Centre's Share • Minimum of Rs.4874 Crore Crores over 5 years from State's Share

In spite of the renewed focus on urban development through major central schemes like Smart Cities Mission, AMRUT and HRIDAY and commitments by state governments, the requirement can only be partially financed. Urban Local Bodies (ULBs) will **have to explore various external sources for raising the additional funding**. These sources may include land monetization, private partnerships, pooled financing and borrowings. **Municipal bonds can be an efficient way of financing of the urban infrastructure.**

Overview of ULBs and Municipal Finances

The 74th Constitutional Amendment Act was enacted to formalize and broaden the legal status of ULBs and devolve powers to them in core 18 areas. It also provided for a three tier structure of ULBs viz., corporations, municipalities and nagar panchayats. The amendment mandates a five year term for the elected bodies and constitution of state election commissions to conduct regular elections. The amendment enshrined in the constitution the devolution of functional responsibilities and financial powers and formation of a state finance commission every five years to distribute financial resources between states and local bodies on the lines of central finance commission.

- Regulation of land use & buildings
- Roads & bridges
- Water supply
- Public health and Sanitation
- Slum improvement
- Urban poverty alleviation
- Provision of Urban amenities and facilities
- Cattle pounds and Animal rights
- Registration of birth and deaths
- Public convenience
- Regulation of slaughter houses and tanneries
- Urban Planning
- Planning of Economic and Social development
- Fire Services
- Urban forestry & Environment
- Safeguarding interest of weaker sections
- Promotion of culture and education
- Crematoriums

12th Schedule Functions under the Constitution to ULBs

As of 2014, there were 162 municipal corporations, 1482 municipalities and 2349 nagar panchayats in India. According to a study commissioned by the Fourteenth Finance Commission and conducted by the Administrative Staff college of India, Hyderabad, the devolution of powers and finances to the ULB is not complete in all states and has been inconsistent in different states.

Revenue (Own Sources)		Revenue (Non-own Sources)				Expenditure (Revenue)			Expenditure (Capital)
Tax Revenue	Non-tax revenue	Assigned revenues	Grants-in-aid	Borrowings/Loans	Other Receipts	Establishment	Administrative	O&M	Capital
Property tax Advertisement tax Octroi	User charges and fees Hire charge Fees Fines Rent on assets	Entertainment tax Profession tax Motor vehicle tax	Plan grants under various schemes/ projects Non-plan grants Externally aided projects	Borrowing from state and central governments Financial institution Municipal bonds	Miscellaneous receipts Sundry receipts	Employee salaries Allowances Welfare	Rents Office maintenance Transport and communications	Power and fuel Procurement Interest payment on loans	Water supply Sewerage SWM Roads/street lighting Payment of principal on loans

As per the study, total ULB revenues in 2012-13 were Rs.96,640 crore out of which, own source income was only 51.6% (Rs. 49,913 crore) while the remaining (Rs. 46,727 crore) was from other sources including market borrowings. While the total expenditure remained a little short of the income at Rs.94,286 crore, 64% of the total expenditure was revenue expenditure and a revenue deficit of about Rs.4000 crore was incurred.

It is clear that the **ULBs have been dependent on state and central grants to meet their expenditure and revenue deficits**, thus diluting the focus on development of capital infrastructure. The study indicated that the option of market borrowings remained largely untapped, with **only 1.4% of the total revenue coming from market borrowings**. Of the Rs. 920 crore borrowed for ULBs in the 10 states which provided the data in 2012-13, Rs. 854 crore was borrowed by municipal corporations. Of these, municipal corporations in Madhya Pradesh and Maharashtra accounted for about Rs. 548 crore.

The FFC recommended a grant of Rs. 87,143.8 crore to the ULBs for the 2015-2020 period in its recommendations but also observed that **"…the Finance Commission's role is only to supplement the resources of the panchayats and municipalities, not substitute them. It is for the local bodies, particularly the urban local bodies, to take appropriate action, with the support of the State Governments, to augment their own revenue sources and also explore sources of borrowings, including issuance of bonds for meeting huge requirements for provision of basic civic services and creation of urban infrastructure."**

A History of Municipal Bonds in India

Municipal bonds, also known as 'Muni' are instruments of debt obligation. Like corporate bonds, they are an acknowledgement of the money owed by the issuer (a municipal body in this case) to the holder of the bond. The issuer pays **the holder of the bonds an interest at a specified rate periodically**.

The Bangalore Municipal Corporation was the first municipal body to issue bonds with state guarantee in 1997 worth Rs. 125 crore. The **Ahmedabad Municipal Corporation** in 1998 held a highly successful bond issue worth **Rs.100 crore without state guarantee**. In 2001, the Central Government allowed the municipal **bodies to issue tax-free bonds provided the bonds met specified guidelines.** The guidelines mandated that the bonds can be issued only for capital expenditure on urban infrastructure and can be used for the specified project(s) only. The guidelines also mandated that a dedicated revenue stream should be directed to an escrow account to meet the debt servicing obligations (e.g. Property tax from specified zones). **Ministry of Urban Development which was the designated body for approval of tax-free bonds capped the interest rate on the municipal bonds at 8% under notified guidelines.** Some states like Tamil Nadu and Karnataka have also formed corporate entities to raise funds for the municipalities through a pooled funding mechanism. Since then, **municipal bonds of only about Rs. 1353 crore have been** issued as taxable/tax-free bonds or pooled financing.

Current Framework

Based on the World Bank report on Regulatory Framework for Municipal Borrowing in India (2011), the Ministry of Urban Development recommended that SEBI should draft a regulatory framework for issue of municipal bonds based on the 2001 guidelines. **In July 2015, the Securities and Exchanges Board of India (SEBI) notified a new regulatory framework for issuing municipal bonds in India.** The new regulations allowed for municipal bodies or a corporate municipal entity (a body corporate registered under the Companies Act and a subsidiary of the municipality formed for the purpose of raising funds) to issue municipal bonds through private placement or public issue.

Only ULBs with an investment grade rating (rated BBB- or higher) are allowed to do a public issuance, with no default in last 365 days and positive net worth are some conditions for a municipal bond issuance. The municipal body must also comply with the state's municipal account standards or the National Municipal Accounts Manual to be eligible for the issue. All bond issues must be rated by a recognized credit agency. The regulations also provide for a 100% asset cover on the debt and provision of a buy-back option. The regulations also mandate, in case of public issue, a guarantee from State Government or Central Government or a structured payment mechanism where the issuer deposits debt servicing amounts in the designated bank account at least 10 working days before due date of payment.

Public Issue of Municipal Bonds

- Only revenue bonds which earmark a revenue stream from the project to be directed to an escrow account can be issued.
- The issue will have a tenure of minimum 3 years and not more than 30 years
- The issuer will create a separate escrow account for servicing the debt obligations
- The issuer shall meet all disclosure requirements as per the guidelines
- The funds raised will only be used for the projects specified in the offer document
- The issuer munnicipality must contribute atleast 20% of the issue cost thorugh it's own resources
- A public issue municipal bond must be mandatorily listed on an recognized stock exchange

Private Placement and listing of Municipal Bonds

- Revenue bonds or general obligation bonds without earmarked revenue stream may be issued
- The subscription amount will be a minimum of Rs.25 lakh per investor
- The privately placed issue may be listed on an recognized stock exchange

Analysis of Current Situation

Municipal bonds can be a good tool of bridging the gap in the requirement and available resources of the ULBs. However, the past experience shows that the **ULBs have not been very keen to use this financing mechanism** as a source of funding. Out of the 65 cities which were assigned credit ratings and required additional funds, only a couple of cities have tapped the market for funds. Similarly, **the lack of operational efficiency reduces the creditworthiness of the municipal entities and thus makes their bonds less attractive.** As per the Fourteenth Finance Commission, the cost recovery and the collection efficiency of user charges remain far below the service level benchmarks specified. Similarly, while bigger municipal bodies can go for bond issues easily, the **smaller municipalities often find it difficult to access the market due to lack of capacity and scale.** An active pooled financing mechanism at the state level, where the Special Purpose Vehicle borrows from the market on behalf of a group of municipalities will help tap the municipal bond market further. **Similarly, as noted by the Fourteenth Finance Commission, the borrowing restrictions placed on the municipalities and incomplete devolution of powers, constraints the capacity of the municipalities to leverage the municipal bonds market.**

On the demand side, the investor interest in the municipal bond instrument has remained low or has even declined. Even the municipalities which have had successful issues in the past have faced the brunt. **The Nagpur Municipality planned to raise in 2007 Rs. 128 crore but was able to procure only Rs. 21 crore.** Similarly, the retail participation in the bond market has been weak in India leading to a large unrealized potential. **A tax concession on the returns earned on municipal bonds and the liquidity provided by exchange-traded bonds can be a good incentive to encourage broader participation in the municipal bond markets.** If the demand and supply side issues can be addressed, the potential for municipal bonds remains large and will be helpful in filling the large deficit in urban infrastructure financing.

International Experience

Internationally, especially in USA, municipal bonds are one of the principal source of urban financing. The municipal bonds market in the US remains the largest in the world. The largest owners of municipal bonds in the US are individuals, mutual and money market funds, insurance companies and commercial banks. As per the US Federal Reserve, there were approximately $3.7 trillion outstanding in municipal bonds in 2011. In Europe, Germany issued the large majority of sub-sovereign debt with 770 issues from 2004 to 2012 worth over 82% of the total municipal debt issued in Europe. The use of municipal bonds to access debt from markets is also growing in developing countries like Brazil, Malaysia and South Africa.

Conclusion

Municipal bonds, if used effectively, by the municipal bodies can be a huge boost for the massive investment requirement in the urban infrastructure sector. But for the full potential to be achieved, a lot needs to be done by the ULBs and the state governments to bring operational efficiency and financial viability in urban projects.