

Municipal Bond Market in India: The Way Ahead

The Securities and Exchange Board of India (SEBI) recently released its paper on the Municipal Bonds market in India. The paper brought to the table fresh focus on the relatively muted municipal bonds market of the country. Given the nature and pace of growth envisaged in India, it would be essential for the Urban Local Bodies (ULBs) and in particular the Municipal Corporations to be an active member in the growth story. The onus is on the ULBs and more so on, the Municipal Corporations to ensure that infrastructure grows in proportion with the requirement of the hour. ***CARE's estimates suggest that a potential of Rs 1,000-1,500 Cr. per annum could be raised through Municipal bonds over the next five years by the larger municipals with investment grade.*** It is assumed that the larger ones with a good credit rating could be the ones to access the market to begin with.

This study aims at bringing to fore certain possible steps which would aid the growth of the Municipal Bond market in the country along with a brief review of the recommendations put forward by the 'Corporate Bonds and Securitization Advisory Committee' (CoBoSAC) in the paper released by SEBI.

The first section details the need for an active municipal bonds market in India, the section after reviews the various problems that have been associated with the municipal bonds market in the country over the years, the third section details certain findings/suggestions which were arrived at in this study and the last section briefly outlines SEBI's recommendations along with CARE's view on the same and a conclusion follows there upon.

1. Municipal Bonds: Bridging the funding gap

Currently Municipal bodies rely majorly on their own revenue sources (tax and non-tax) and the grants they are beneficiary to from the State and Central Governments. However, these two primary sources are not expected to suffice given the scale of infrastructure development and upgradation that is required to meet the growth aims at various levels (i.e. State level and at the Centre). Given the fast pace of reforms being witnessed in the country and the objective of creating smart new cities, the requirement for funding would increase over the next decade or so; for instance, the 'smart cities' programme plans extensive coverage to facilities such as- Water, Sanitation, Waste and Garbage treatment, Sewerage, Urban transport, Street lighting, Roads maintenance etc. Additionally, large scale urban migration also exerts pressure on the ULBs to create new urban infrastructure while also maintaining/upgrading the existing facilities that have been built over the years. The overall funding requirement for these projects is enormous.

For the development of urban infrastructure, estimates start from Rs. 39 lkh Cr. (*Source: Planning Commission*) to Rs. 53 lkh Cr. (*Source: McKinsey*). The Smart City programme introduced by the Centre has envisaged infrastructure spending to the tune of Rs. 7 lkh crore over the next 20 years (i.e. Rs. 35,000 Cr. each year). Secondly, much support cannot be expected from the state governments who remain challenged on their part to adhere to the FRBM norms for following fiscal prudence thereby making it tight for them to lend satisfactorily to ULBs. Lastly, the financial system of its own would also consider it

difficult to lend for these causes given the long nature of such loans. This is where Municipal bonds are expected to enter and bridge the funding gap.

In the context of the need for infrastructure expenditure, and relative paucity of available funds, it becomes more pertinent for the Municipal bodies to take course to the debt market for their infrastructure funding requirements. ***The motivation for SEBI's paper is to form a more enabling environment for the Municipal Corporations to issue bonds.***

2. Issues in the Municipal bonds market

It has been argued at several forums that the Municipal bond market in India faces certain pressing 'demand side and supply side' challenges which have curtailed its growth.

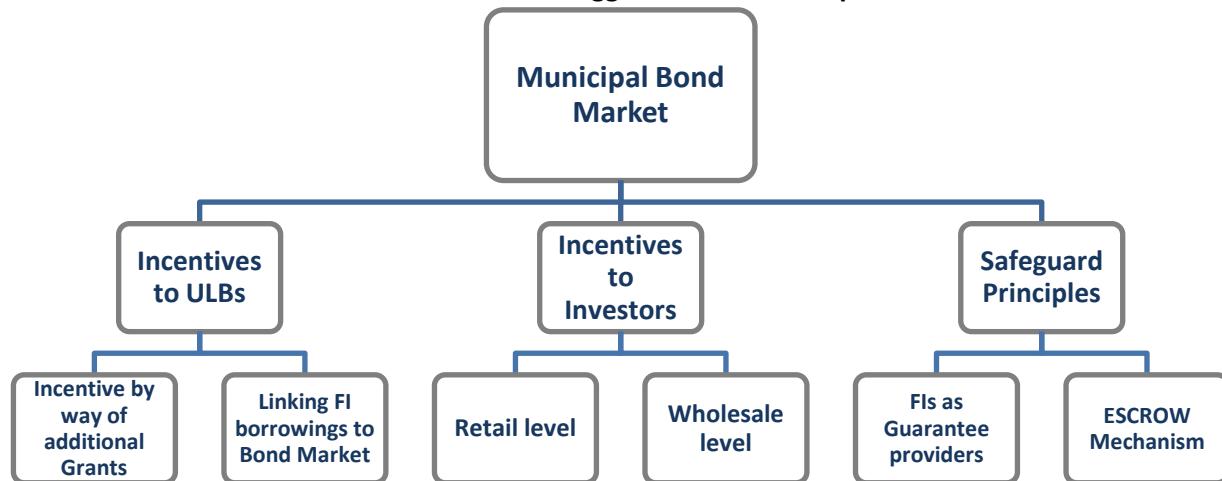
- On the demand side, the conservative approach of insurance and pension firms to invest in Municipal bonds and limited credit enhancements for municipal bonds limit the potential demand for these bonds.
- On the supply side on the other hand, issues such as very few municipal entities with high credit, lack of incentives for municipal bodies to tap debt market, preponderance of institutional finance and lastly absence of any particular requisites to issue bonds serve as major impediments.

In light of the various demand and supply side issues to the Municipal Bond market in the country, this study lays below three broad criteria which would encourage the participation of Municipal Corporations in the bonds market; by incentivizing Municipal Corporations to issue Bonds (*Answering supply side issues*), incentivizing investors to invest in Municipal Bonds (*Answering demand side issues*) and forming certain safeguards to promote the municipal bonds market.

3. CARE's suggestions for the Municipal Bond Market

As CARE estimates indicate that between Rs 1,000 – Rs. 1,500 Cr. could be raised by way of Municipal bonds every year over the next five years by the larger ULBs with investment grade, efforts should be underway to improve this market.

Exhibit 1: Flowchart of CARE's suggestions for Municipal Bond Market



A. Incentivizing Municipal Corporations for bonds issuance

- ***Incentive by way of Additional Grants:*** Given that all municipal bodies who issue a bond would be assigned a credit rating, it would give a fair sense of the credit worthiness of the municipal body. Hence, a clause can be introduced to the effect that municipals which raise debt by way of bond issuances are beneficiary to additional grants from the Centre and State governments that go beyond the allocations as specified by the Finance Commission. This will be a certain and definite incentive to municipals to issue bonds.
- ***The borrowings of the Municipal Corporations from Financial Institutions such as HUDCO etc. can be linked to the bond market:*** For instance, HUDCO can be mandated to lend to municipal bodies close to 80-90% of the financing requirement provided the municipal body raises the balance 10-20% through the debt market.

B. Incentivizing investors to invest in Municipal Bonds

There is a need to spur investments in Municipal bonds by making them attractive both at the retail level and the wholesale level. Creating a demand for these bonds will go a long way in stimulating the supply for the same. Some suggestions on encouraging demand at the retail and wholesale level are elaborated upon below.

At the retail level,

- The minimum tenure of the bond should be increased to 5 years from the current recommendation of the CoBoSAC of 3 years.
- All bonds issued by Municipals should be made tax-free.
- The ceiling of 8% on interest rate should be withdrawn for such bonds.
 - The interest rate can be marked at 50 basis points higher than the 5-yr Government security paper. Such a step would enable municipal bonds to become a second alternative to the safe government bonds and thereby induce investments.

At the wholesale level,

- Banks should be mandated to lending to ULBs as a part of the ‘priority sector’.
- Alternatively, Bank holdings of Municipal Bonds should also be given space in the SLR requirements provided they are of certain specified category.

C. Safeguard principles

In order to ensure that there is no uncertainty relating to the security of these bonds, two safeguard policies are recommended below;

- ***Organizations such as HUDCO etc, can further provide guarantee to the bonds issued by Municipal Corporations,*** i.e. after lending x% to the municipal, they could provide guarantee for the residual amount raised by way of bonds by the Municipal Corporation.
- ***Additionally, an ESCROW mechanism can be created*** wherein the first charge of pre-specified revenue should be kept aside for paying the interest and principle amount to the guarantee provider. The guarantee provider would in turn invest in the safe government bonds and pay the interest to Municipals.

4. CARE's suggestion: Establishing a State Municipal Development Corporation (SMDC)

The Paper by SEBI outlines four broad recommendations which are summarized as under:

1. The bonds are issued by the ULB (Municipal Corporation directly)
2. The bonds are issued through a Corporate Municipal Entity (CME) which would be a subsidiary created by the Municipality.
3. Creation of a statutory body or a 100% Government owed body which would borrow from the market through issue of bonds and lend the same to the ULB or Municipal body.
4. The (securitized) debt instrument would be issued by a special purpose entity (Trust) created by one or more municipalities by securitizing the receivables. (*Pooled Finance mechanism*)

CARE suggests the formation of an organization called the 'State Municipal Development Corporation' (SMDC) which is a state level organization. This entity can perform the same function of being a conduit i.e. it would borrow from the market by issuing bonds for onward lending to the ULB (Municipal Corporation). However, along with this, it would also ensure that operations in the ULB remain glitch free. In an implicit manner, it would serve as a supervisor for the ULBs juxtaposed with being a link to the market. Hence, an SMDC would not only satisfy all the functions outlined by SEBI in its recommendations, but it would also go a step ahead in over viewing the operations and financial health of ULBs.

5. Conclusion

In order to bring about sustained development in infrastructure, a well-developed and diversified bonds market is a pertinent factor. Support for the same can be found in international markets such as the USA and UK. Closer home in China, the government is reported to soon start a full-fledged nationwide market called the 'Muni bonds market' later this year.

Hence, focusing on this and making suitable policy changes on this front are only seen to have positive repercussions on the overall development of the state. ***CARE's estimates of Rs. 1,000- Rs. 1,500 Cr. per annum over the next five years to begin with being raised by way of Municipal bonds is an indication of the expected growth in the market in the years to come.***

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