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Municipal Bond Market in India

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Municipal Bond Market in India

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History of Municipal Bonds

Municipal bonds have played a pivotal role in the development of infrastructure across the globe. This section traces the chronological history of municipal bonds and their growth in different parts of the world.

- The first official municipal bond issue by New York City for a canal dates back to 1812. With increasing urban development, cities in the United States began to issue bonds, proceeds from which would be used to fund municipal infrastructure development requirements and provide free public education. By 1840, the municipal bond market had grown to USD 200 million and to USD 1 billion by 1880.
- The municipal bond market faced difficulties in 1837, when eight states went bankrupt and defaulted on coupon payments to bondholders. State credibility became an issue of paramount importance when people subscribed to municipal bonds. From then on, novel reforms were passed, that necessitated greater cautiousness from states borrowing from its citizens. With an improvement in the economic climate, the municipal bond market touched USD 16 billion by the 1920s.
- Debt issuing bodies, known as "authorities" such as the Port Authority of New York and Triborough Bridge Authority were formed in 1921 and 1933 respectively. The Great Depression hit in 1935 and deterred investors from participating in market activities. However, due to their strong reputation, citizens lent USD 35 million by subscribing to municipal bonds for the construction of the Golden Gate Bridge. These bonds were completely paid back.
- After World War II, several cities undertook a wide array of projects funded by municipal bonds. Projects ranged from housing to healthcare facilities to building public transport. Investor confidence was further enhanced with the advent of municipal bond insurance. This helped the municipalities raise funds for projects in small and remote cities, which would have otherwise been a riskier proposition for investors. Bond insurance also meant that investors did not have to worry about timely coupon payments or the veracity of project due diligence.
- The United States of America and Japan have the world's largest municipal bond markets. According to the US Securities and Exchange Commission's report on the municipal securities market, there are more than one million different municipal bonds

outstanding and the total aggregate principal amount was over USD 3.7 trillion in 2011[1]. In terms of outstanding debt, China has the largest bond market among the emerging economies.[2]

Municipal bonds in India are a relatively nascent concept. In 1996, the Rakesh Mohan Committee on 'Commercialization of Infrastructure Projects' recommended development of the municipal bond market in India. Globally, municipal bonds are classified as revenue bonds or general obligation bonds. However, bonds issued by ULBs in India are structured debt obligations, issued by pledging certain sources of revenue.

o The Bangalore Municipal Corporation had raised INR 125 crore through a private placement in 1997, backed by the state government. Ahmedabad Municipal Corporation issued the first municipal bond without a state government guarantee in 1998. The issue raised INR 100 crore, (25 per cent through public placement and 75 per cent through private placement). Both these bonds were taxable.

o In 2000-01, the Government of India gave tax exemption to interest income from certain municipal bonds. These bonds were to be used for developing infrastructure for the supply of potable water, sewerage or sanitation, drainage, solid waste management, roads, bridges, flyovers, and urban transport.[3] The first tax-free municipal bond was issued in 2002 by the Ahmedabad Municipal Corporation to raise INR 100 crore for water supply and sewerage. This was also India's first municipal bond to be rated. It was assigned an A+ rating (indicating a credit risk profile in the adequate safety category) by CRISIL.

In the last two decades, Indian urban local bodies have been able to raise only INR 1,094.5 crore through municipal bonds.

Evolution of municipal bonds in India

India has a very long history of municipal administration, whose roots can be traced back to the period of Indus Valley Civilization. In the view of N.R. Rao (1986), "The British introduced some kind of municipal management

1 https://www.sec.gov/news/studies/2012/munireport073112.pdf

2 https://www.iimb.ernet.in/research/sites/default/files/WP%20No.%20450.pdf

3 Only if it qualifies as a municipal function under the respective state legislation

much earlier than their consolidation of sovereignty over the country"[4]. As per the World Bank (2011b), "The creation and spread of municipal corporation structure across India is directly related to the taking over of the Indian possessions of the East India Company by the British Crown after the Indian Uprising of 1857"[5].

The Corporation of Chennai is the oldest municipal institution in India and was established on September 29, 1688.[6] Before 1992, India had a two-tier structure, centre and states. The third tier or local bodies came into existence only after the 73rd and the 74th amendments in 1992. The 74th Amendment led to the constitution of the following municipal bodies:

a) Municipal Corporations: operate in larger urban areas

b) Municipal Councils: operate in smaller urban areas

c) Nagar Panchayats: operate in rural areas, which are undergoing transition to develop as urban areas

The 74th Constitution Amendment Act, 1992 brought uniformity in the constitution of municipal bodies and empowered Indian municipal corporations with the power and authority to operate as self-governing entities. While the Constitution of India does provide for the devolution of tax revenue between the centre and states, there is no provision that mandates devolution of tax revenue or confers the power to impose taxes to urban local bodies.

The resource base of urban local bodies (ULBs) typically consists of their own tax and non-tax revenue, state revenue, grants and subsidies from the central and state governments, loans from state governments, loans from banks and other financial institutions and market borrowings. The following table delineates tax and non-tax revenue sources for municipal corporations:

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[4] Rao, N.R. (1986), "Municipal finance in India: Theory and Practice", Inter-India Publications

[5] World Bank (2011b), "Developing a Regulatory Framework for Municipal Borrowing in India", Volume 2

[6] http://egovernments.org/docs/chennai_implementation.pdf

Sources of Tax Revenue in Indian Cities from Municipal Acts	Sources of Non-Tax Revenue in Indian Cities from Municipal Acts
Advertisement tax	Betterment fees
Betterment/development tax	Birth/death registration fees
Cable operator tax	Dangerous and Offensive Trade licence fees
Drainage tax	Duty on transfer of immovable property
Education tax	Fee for building application
Entertainment tax	Fee for fire services
Entry/terminal tax	Fees for registration of animals
Environment tax/land revenue	Fees on dogs
Latrine tax	Market fee
Octroi (local taxes on goods entering the city)	Mutation fees
Passengers and goods tax	Parking fees
Pilgrim tax	Penalty for late tax payment
Profession tax	Receipts from fines
Property tax	Receipts from interest
Sanitation/ conservancy tax	Rent from municipal properties
Scavenging tax	Sanitation/ conservancy charge
Tax/toll on animals	Slaughterhouse fees
Taxes on vehicles	Stamp duty
Timber tax	Surcharge on sales tax
Toll/tax on bridges/vehicles	Water charges

**Source: 74th Amendment, Constitution of India*

The decentralization initiative embodied in the 74th Amendment imposed a lot of responsibilities on municipal corporations due to an ever-increasing demand for urban basic services. However, on account of lack of requisite funds, ULBs, especially the smaller ULBs, found it difficult to provide these services.

Conventional modes of fund generation for municipal corporations comprise grants and subsidies from the state and central governments, and own tax and non-tax revenues. However, these sources fell short in meeting the ever-increasing need for funds. Several infrastructure projects were delayed or stalled due to a fund deficit.

Under such circumstances, the Financial Institutions Reform and Expansion (FIRE) (debt market development component) (FIRE-D), showed an alternate way to raise long-term capital for financing urban infrastructure projects. FIRE-D was launched in India in 1994 as an Indo-USAID[7] collaborative programme. The objective of FIRE-D was to develop urban infrastructure by accessing the domestic capital market, which in turn would help the debt market to evolve.

The Government of India set up the Rakesh Mohan Committee on (1996), to commercialise infrastructure in India. The Committee on Commercialization of Infrastructure Projects endorsed private sector participation and accessing capital markets through municipal bond issues.

In 1997, Bangalore Municipal Corporation became the first municipal body in India to issue INR 125 crore worth of state-guaranteed municipal bonds. Following suit, the Ahmedabad Municipal Corporation (AMC) also issued municipal bonds worth INR 100 crore in 1998. Since the inception of FIRE-D, 10 municipal corporations have issued municipal bonds to finance their infrastructure and civic projects, namely Bangalore, Ahmedabad, Nashik, Madurai, Visakhapatnam, Nagpur, Indore, Chennai, Hyderabad and Ludhiana. All these corporations have issued "structured obligations", which are a special form of general obligation bonds.

Apart from Bangalore and Indore, none of the other municipal bonds is backed by state guarantees. The Nashik Municipal Corporation is the first municipal body whose bonds traded in the secondary market. In 2001, the Ministry of Finance (MoF) amended Section 10 (15) (viii) of the Income Tax Act, to permit municipal corporations to issue tax-exempt municipal bonds under certain specified guidelines. Ahmedabad Municipal Corporation was once again the first municipal corporation to issue tax-free bonds in India.

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7 United States Agency for International Development

The high cost of issuing bonds has restricted access to the capital market to financially robust municipal corporations with high credit-worthiness. In 2003, 14 municipal corporations in Tamil Nadu came together under Tamil Nadu Urban Development Fund (TNUDF) to issue bonds backed by pooled assets. Subsequently, the Karnataka government used pooled financing to finance the Greater Bangalore Water Supply and Sewerage Project (GBWASP), which covered eight municipal towns around Bangalore with a total project cost of INR 600 crore. With this, Government of India initiated the Pooled Finance Development Fund (PFDF) in 2006.

On December 3, 2005, the Ministry of Urban Development (MoUD) conceived an urban-modernisation scheme, Jawaharlal Nehru National Urban Renewal Mission (JNNURM). This scheme aimed to encourage municipal bodies to access the bond market. The last round of municipal bonds was issued in 2010 by the Greater Visakhapatnam Municipal Corporation. Thereafter, Indian municipal bond market has been in a state of stagnation. Only 28 municipal bonds have been issued, including taxable, tax-free and pooled finance, amounting to INR 1,353.1 crore (Chakrabarti, 2014).[8]

In July 2015, the Securities and Exchange Board of India (SEBI) notified a new framework of regulations for the issue and listing of municipal bonds. According to these regulations, a municipal corporation planning to issue debt securities should meet the following prerequisites:[9]

a. It should have had positive net worth in the preceding financial years
b. The bonds should have a minimum investment grade rating of BBB-
c. The issuer should not have defaulted in repayment of debt securities or loans obtained from banks or financial institutions, during the last three hundred and sixty-five days.
d. The corporate municipal entity or the group company/promoters or director(s), should not have been identified as wilful defaulters
    - They should not have defaulted on interest or principal obligation of bonds issued by the entity

8 http://www.worldwidejournals.com/indian-journal-of-applied-research-(IJAR)/file.php?val=March_2014_1393845974_38326_26.pdf

9 http://www.sebi.gov.in/cms/sebi_data/attachdocs/1436964571729.pdf

These new norms were made keeping in mind the central government's smart city programme.

Municipal bonds – An Overview

Definition of Municipal Bonds

Municipal bonds are debt obligations, which are issued by state and local government institutions to finance urban infrastructure and civic projects like construction of schools, dams, roads, railways, etc. Like any other debt instrument, it is also a mode of raising capital from the market by the issuer from investors in exchange for the payment of regular interest and the principal at a pre-determined maturity date. Globally, municipal bonds are broadly classified under two categories:

a. General Obligation Bonds are bonds issued against the credibility and tax revenues of the issuing municipality. These bonds are issued to raise funds for the projects that do not directly generate revenue unlike roads, railways, etc. Payment to bondholders is done by using the tax revenues generated by the municipality.

b. Revenue Bonds are issued to finance revenue-generating projects and the revenue thus generated is used to repay bondholders.

While municipal bonds are perceived as an asset class for risk-averse investors, some of the inherent risks of municipal bonds (similar to other fixed income instruments) include the following.

a. Credit Risk: This risk arises when the issuer fails to make coupon payments and/or principal repayment as per the agreed schedule. Municipal bonds are rated by credit rating agencies to compute the probability of default and measure the associated credit risk relative to other bonds. Investor capital is further preserved by way of bond insurance.

b. Call risk: If a municipal bond is callable, the issuer has the option to repay the principal before its maturity date. An issuer may choose to call the bond if interest rates decline, and then refinance it at a lower rate. This would terminate expected cash flows prematurely.

c. Inflation risk: In an economy plagued by high inflation, interest rates are expected to rise. This would erode value of existing bonds, paying out fixed coupon rates.

d. Interest-Rate Risk: Since municipal bonds pay out fixed coupon rates, investors receive lower than market yield, if interest rates move upwards.

   The same risk may be mirrored for tax free municipal bonds, if investors expect a reduction in tax rates.

e. Liquidity Risk: In the absence of an active market for a particular municipal bond, the investor may be forced to hold the bond or liquidate it at a lower price.

As per the Ministry of Urban Development (MoUD), municipal bonds where the carrying rate of interest is less than or equal to 8 per cent will qualify as tax-free bonds. However, the Corporate Bonds and Securitisation Advisory Committee (CoBoSAC) of SEBI has maintained that the rate of interest on tax free municipal bonds should be floating to make the instrument an attractive proposition for investors.

There are 139 municipal corporations and 3,842 ULBs in India, of which the medium and smaller-sized bodies may not have competency to issue bonds for urban development. To overcome this problem, ULBs pool their projects and issue a single bond backed by the aggregate cash flows from the underlying projects. This not only allows smaller ULBs access to capital markets, it helps develop and deepen the municipal bond market. In 2006, the Central Government approved the Pooled Finance Development Fund (PFDF) Scheme. 5 per cent of PFDF was allocated for project development and 95 per cent would be contributed towards Credit Rating Enhancement Fund (CREF) to improve the credit rating of the Municipal Bonds to investment grade. Bonds issued under PFDF are tax-free. However, interest and dividends received from investment in the CREF corpus are taxable in nature.

Keeping investor protection in mind, SEBI has issued periodic disclosure guidelines and guidelines for issuance of tax-free bonds by municipal bodies. (Please refer to the Annexure for disclosure and issuance guidelines.)

Municipal Bond Rating in India

A municipal bond imposes an obligation on a ULB to repay a fixed principal amount on a certain maturity date along with the interest, based on a stated or formula-based rate (Dirie, 2005). The first municipal bond was issued around 19 years back, in 1997 by Bangalore Mahanagara Palike (BMP).[10] However, even two decades later, the municipal bond market is yet to make its presence felt in the marketplace. One of the reasons for the sluggish growth of the municipal bonds market is reluctant investor participation. ULBs do not typically have a strong track record for timely project completion or service delivery. This weakens projected cash flows and lowers the project IRR. One measure to

[10] http://economictimes.indiatimes.com/view-point/credit-rating-municipal-bond-market/articleshow/3537822.cms

overcome this is credit rating of municipal bonds that helps investors take an informed decision.

Credit rating is an independent opinion by a rating agency on the ability of the borrower to meet its interest and principal obligations in a timely manner. It also facilitates price discovery; the higher the risk associated with a borrower, the higher the coupon rate of that instrument. It is mandatory for all debt instruments with a maturity of more than 18 months to be rated by a SEBI-approved rating agency.

When a municipality is rated, the agency determines its strengths, its weaknesses and its ability to partner with potential lenders (individuals or institutions) and assesses the associated cost of borrowing. The rated municipality is equipped to select a debt instrument that fulfils its needs and to structure debt to finance the project.

In 1997, CRISIL pragmatically adopted the municipal bond rating methodology from Standard and Poor's Rating Services of the USA and conducted a pilot assignment to rate municipal bonds in India. It assessed the Ahmedabad Municipal Corporation (AMC) among others to formulate a framework for credit rating of municipalities and project specific debt issues. AMC was rated A+, indicating adequate safe category.

In due course of time, ICRA and CARE also built their respective frameworks, for evaluating the credit worthiness of municipal corporations in India.

A brief description of the frameworks used by a few rating agencies follows.

CRISIL methodology for municipal bond rating is based on the following:[11]

a. Legal and administrative framework
b. Economic base of the service area
c. Municipal finances
d. Existing operations of the municipal body
e. Managerial assessment
f. Project specific issues
g. Credit enhancement structure

CARE methodology for municipal bond rating takes into account the following:[12]

a. Fiscal profile of the bond issuing municipal body
b. Debt specific factors

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[11] http://www.crisil.com/Ratings/SectorMethodology/MethodologyDocs/CRISIL-Ratings-crieria-municipal-ulbs_2007.pdf

[12] http://www.careratings.com/market-segments/public-urban-local-bodies.aspx

c. Sources and allocation of funds for the project being financed and analysis of major project related revenues and expenditures are assessed.
d. Profile of the project being financed and related risk factors; prioritisation of expenditure across projects.
e. Economic factors
f. Revenue streams for repayment of bonds
g. Organisational structure, management information system, tax billing, collection and enforcementmechanism, ability to implement plans and degree of autonomy given to the local body.
h. Administrative capability of officials at the local government level.
i. Legal set-up within which the local body operates including the power to raise debt, responsibility to repay debt and power to authorize specific issues.
j. Inter-governmental fiscal structure.
k. State of the local economy, local employment characteristics and demographics and development indicators.

The ICRA rating methodology for municipal bond rating is based on[13]

a. Overall profile of the issuer in terms of the area that it services together with its demographic and socio-economic profile.
b. Financial performance of municipalities in terms of the organisation of accounts, past revenue and expenditure profiles, revenue surplus or deficit, past capital expenditure schedule, liquidity position, and debt profile.
c. Trends, composition and expenditure patterns of the key operating departments of municipalities.
d. Appraisal of on-going and proposed projects from the point of improvements in service delivery and funding arrangements.
e. Demographic profile within the municipal limits.
f. Socio-economic indicators in the district in which the municipality is situated.
g. Detailed financial assessment of the past financial performance.

The methodology adopted by Standard and Poor's for municipal bond rating takes into account the following factors.

a. Range of economic system and administrative factors

[13] http://www.icra.in/Files/Articles/Urban%20Local%20Bodies-%20Aug%202016.pdf

b. Parameters affecting the local economy which include economic structure, growth prospects, and demographic profile of population
c. Budgetary performance and flexibility therein, expenditure trends, liquidity, debt burden and off-balance sheet liabilities
d. Assessment of the system structure and management in terms of inter-governmental linkages, stability and supportiveness of higher levels of government, revenue and expenditure balance and management systems and policies
e. Entity's own financial position
f. Evaluates sovereign related factors and credit profile of local governments

Of the 63 JNNURM municipal corporations/councils rated, only 40 per cent have been rated as investment grade.[14] Causes for low rating of the assessed corporations include

a. Lack of operational expertise
b. Absence of skills to participate in the commercial borrowing market
c. Poor cost management
d. Limited decision making powers

Higher rating makes it relatively easier for municipal bodies to raise capital. Thus, it is both commercially and operationally relevant for municipalities to focus on building capabilities and improving service quality. A culture of discipline, disclosure and prudence would germinate in the municipal community, which will eventually lead to better civic services and attract investors from the capital market.

Hurdles to municipal bond market in India

Indian ULBs are among the world's weakest in terms of financial autonomy and in terms of their capacity to raise external capital as per the Report on Indian Urban Infrastructure and Services (2011).[15] The first municipal bond was issued in 1997. Nineteen years later, only 19 municipal bonds have been issued of which[16] 6 were for road construction and 3 were for water and sewerage projects.

In India, only one per cent of the total ULBs' requirement is funded by municipal bonds compared to around 10 per cent in the United States (Khan, 2013). It is observed that no municipal bonds have been issued since 2007.

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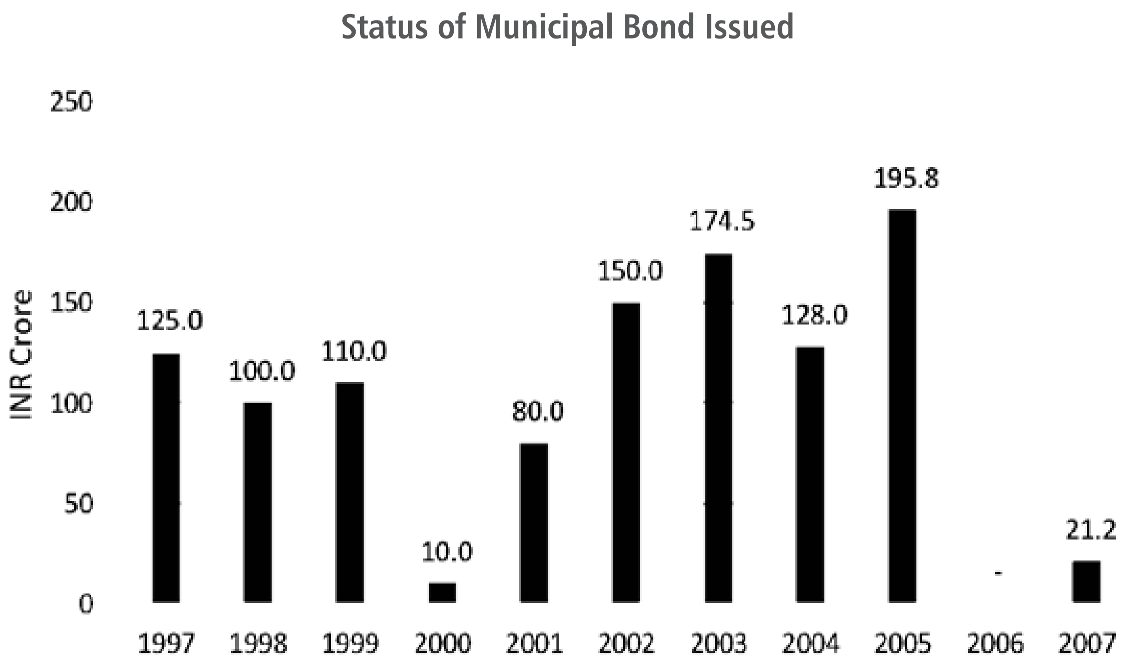
14 http://www.dnaindia.com/money/comment-developing-muni-bonds-market-imperative-for-our-urban-future-1592406

15 http://icrier.org/pdf/FinalReport-hpec.pdf

16 https://www.brookings.edu/wp-content/uploads/2016/08/metro_20160818_indiasmartcitiesreport.pdf



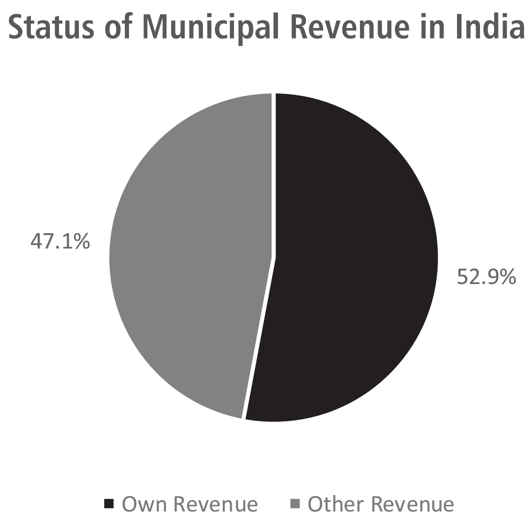
**Source: Brookings Report, Building Smart Cities in India (Allahabad, Ajmer, and Visakhapatnam)*[17]

There are both demand-side and supply-side shortcomings in India's existing municipal bond market.

Increasing dependence on state and central grants

Over the years, ULBs have been dependent on grants and transfers from state governments. The 12th Finance Commission Report reveals that over the years, their dependence on "other source of revenue", which includes grants from central and state governments; transfers from state or central finance commissions, has been increasing. Easy access to grants acts as a disincentive for municipalities to access local credit markets. As per the 13th Finance Commission, 47.1 per cent of total municipal revenue consisted of grants from the state and centre in 2007-08.

[17] https://www.brookings.edu/wp-content/uploads/2016/08/metro_20160818_indiasmartcitiesreport.pdf



**Source: Brookings Report, Building Smart Cities in India (Allahabad, Ajmer, and Visakhapatnam)[18]*

Cost involved in municipal bond issues

Issuing municipal bonds is an expensive affair. A high initial transaction cost is involved with accessing the capital market. The costs can broadly be categorised as management fee, royalty fees, takedown (compensation that is paid to the underwriter for selling the securities), and underwriter's expenses (paid for conducting a new bond issue). Around 1.5 per cent of the issue size goes to meet costs incurred in the due process. Additionally, lack of expertise on the dynamics of the bond market among municipalities is an impediment in exploring the credit market as an option to raise capital.

Poor record keeping

Municipal corporations and ULBs need to adopt investor friendly accounting standards. Lack of transparency and availability of data at the ground level leads to opaque books. While ULBs may disclose the underlying assets, the investor is not aware of ULBs' other revenue streams and debt obligations. This may deter investors from subscribing to bonds issued by municipal bodies that may otherwise have stable cash flows.

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18 https://www.brookings.edu/wp-content/uploads/2016/08/metro_20160818_indiasmartcitiesreport.pdf

Dominance of big municipal corporations in municipal bond market

Currently in India, the municipal bond market is limited to large, financially robust municipal corporations such as Ahmedabad, Bangalore, Nagpur and Nashik, etc. Small and medium municipal corporations with poor financial position are dependent upon the state-owned Housing and Urban Development Corp for their funding needs. To support these municipal corporations in accessing the capital market, Ministry of Urban Development (MoUD) launched a pooled financing scheme called Pooled Finance Development Fund (PFDF). The success of pooled financing model in Tamil Nadu and Karnataka marks the inception of PFDF scheme. However, now the scheme is at a standstill.

Unattractiveness of municipal bonds

Inadequate credit enhancement, restricted reliability of credit information and lack of proper hedging tools for investors make municipal bonds a high-risk, low-return product for many investors. The return on investments made by institutional investors like provident funds and insurance companies in the infrastructure sector are tax-free; therefore, an 8 per cent per annum return on tax-free municipal bonds is not a lucrative deal for them.

Credit Ratings of Municipal Bonds

Corporate bonds are preferred over municipal bonds despite getting investment grade credit ratings. Poor management of finances and the weak financial position of municipal corporations is one reason for this. Barring a few large municipalities, most still lack transparency in their accounting and budgeting systems. This leads to misappropriation of assets and projects a misguiding picture of the income and expenditure of ULBs. Credit ratings slip further with lack of project specific fund monitoring and compliance checks in place.

Illiquid bond market

Another pressing issue in India is that there is virtually no secondary market for municipal bonds, rendering them illiquid. Factors determining liquidity are the volume, time and cost of bonds. Illiquidity of Indian municipal bonds may be linked to low bond issue size and high transaction costs. Inefficiency in clearing and settlement mechanism also makes the municipal bond market illiquid.

Lack of Collateralised Borrowing and Lending Obligations (CBLOs) for Municipal and Corporate Bonds

CBLOs allow an investor to borrow against an underlying listed security in an exchange-traded market. SEBI wants to include corporate and municipal bonds to be brought under CBLOs so that these bonds can be used as collateral. CBLOs are expected to encourage borrowing and increase liquidity in the bond market as a whole. Hence, inclusion of municipal bonds in CBLOs will act as a catalyst for municipal corporations to issue more bonds. Currently in India, only central government securities are allowed to be used to borrow in this market.

What if the ULBs default?

Since the time municipal bonds came into existence, there has never been a single case of default by municipal corporations. However, the probability of such an occurrence cannot be ruled out. Risks arising because of the inability of municipal corporations to tackle issues arising from bankruptcy and default act as a deterrent to potential investors. The Recovery of Debts due to Banks and Financial Institutions Act (RDBF) does not address issues pertaining to possible defaults arising from ULBs. SEBI has asked for a clause for ULB defaults to be included in the Bankruptcy Code Bill.

Paucity of Transparency in Planning and Implementing Infrastructure Projects

The process of planning and implementing infrastructure projects involves numerous stages including designing, financing, monitoring, managing, and supervision to delivery. At each level, a high degree of transparency is required. An improper approach to planning and implementation results in time and cost overruns. Lack of information symmetry among the members of a municipal corporation, inefficient management of finance and corruption can be considered as obstacles in the process of planning and implementing infrastructure projects.

Municipal Bond Market Status in India

India is one of the leading emerging economies in the world and is undergoing rapid urban transformation. As per the McKinsey Report “India’s urban awakening: Building inclusive cities, sustaining economic growth”, 70 per cent of total jobs will be generated in urban India over the period of 2010-2030 and these jobs will be more productive than equivalent jobs in rural India.[19] This will result in a greater influx of people from rural to urban India, leading to the need for better and more efficient urban infrastructure. The ICRIER Report on Indian Urban Infrastructure and Services (2011) states that India will need to invest INR 39,187 billion (at 2009-10 prices) or 46 per cent of its GDP for 2012 between 2012 and 2030 to meet its urban infrastructure requirements.[20] In the same report, it was

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19 http://www.mckinsey.com/global-themes/urbanization/urban-awakening-in-india

20 http://icrier.org/pdf/FinalReport-hpec.pdf

estimated that India's municipal expenditure for the financial year 2012-13 will be equivalent to only 1.53 per cent of GDP, of which less than one-third will be met from own revenue sources. To handle the large fund requirements, the Indian municipal bond market has to evolve from its current nascent stage.

The total amount raised by local bodies includes INR 1,094.5 crore through municipal bonds and INR 258.6 crore through pooled finance. Of the total municipal bonds issued, 40.7 per cent were taxable, and 59.3 per cent were tax-free bonds.[21]

List of municipal bonds issued in India:

Taxable Municipal Bonds in India

Year	City	Amount (INR Crore)	Project Type
1997	Bangalore*	125	Street Drains and City Roads
1998	Ahmedabad	100	Sanitation and Water Supply
1999	Ludhiana	10	Sanitation and Water Supply
1999	Nashik	100	Sanitation and Water Supply
2000	Indore*	10	Upgradation of City Roads
2001	Nagpur	50	Water Supply
2001	Madurai	30	City Roads
2004	Visakhapatnam	20	Water Supply
TOTAL		**445**	

*State Guarantee

Source: Chetan Vaidya & Hitesh Vaidya, 'Creative financing of Urban Infrastructure in India through market-based financing and public private partnership', 2008

21 https://www.brookings.edu/wp-content/uploads/2016/08/metro_20160818_indiasmartcitiesreport.pdf

Tax-Free Bonds in India

Year	Municipal Bodies	Amount (INR Crore)	Project Type
2002	Ahmedabad Municipal Corporation	100	Sewerage and Water Supply
2002	Nashik Municipal Corporation	50	Underground sewerage and storm water drainage
2003	Hyderabad Municipal Corporation	82.5	Widening and Road Construction
2003	Hyderabad Metropolitan Water Supply and Sewerage Board	50	Drinking water
2003	Chennai Metropolitan Water Supply and Sewerage Board	42	Augmentation of Water Supply
2004	Ahmedabad Municipal Corporation	58	Water supply, storm water drainage, roads, bridges and flyovers
2004	Visakhapatnam Municipal Corporation	50	Water Supply
2005	Chennai Metropolitan Water Supply and Sewerage Board	50	Water Supply
2005	Chennai Municipal Corporation	45.8	Road Construction
2005	Ahmedabad Municipal Corporation	100	Water Supply and Road Construction
2007	Nagpur Metropolitan Water Supply and Sewerage Board	21.2	Sewerage and Water Supply
TOTAL		**649.5**	

*State Guarantee

Source: Chetan Vaidya & Hitesh Vaidya, 'Creative financing of Urban Infrastructure in India through market based financing and public private partnership', 2008

With all states running up fiscal deficit[22] and the espoused requirement of funds for infrastructure development, it becomes pertinent to explore alternate sources of funds, along with municipal bonds.

An alternative to infrastructure credit market

Infrastructure investments in India are critically dependent on grants from the central/state government. Alternatively, private players enter the market, resort to funds from banks and deliver build-operate-transfer (BOT) projects. As more and more people migrate to cities, demand for water systems, sewerage, healthcare, roads, and rail will see a steady increase in demand.

Banks, critical to financing of infrastructure projects, have always been shy of these projects, mainly because these projects have long gestation periods, resulting in tenor mismatch. Creating a municipal bond market is obviously a challenging task, especially with only 40 per cent investment grade ULBs. For India, an economy dominated by bank lending, we attempt to look at an alternate way by which both the banking model and municipal bonds can co-exist on a level playing field.

First, the government should aim at increasing its access to the large pool of private capital for financing infrastructure projects. One method of doing so is through co-funding, under which a certain proportion of the total funding requirement is provided by the government as a loan at a low rate of interest. The government's involvement encourages greater private sector participation in financing the projects. This technique has been used by countries like the United States and United Kingdom.

Low investment cap and the statutory requirement of investing only in assets with AA and above rating (while infrastructure assets in India generally range between BBB- to A) are major constraints in exploring the vast resource pool of institutional investors like pension funds and insurance companies. Funds from Public Trading Enterprises (PTEs) such as airport or seaport corporations may also be used to raise capital. PTEs repay through service fee charged from users. Moreover, if a PTE defaults, then the government comes to rescue it.

Municipal banks were formed on three main tenets:

a. **Relationship banking**

Municipal banks forge strong relationships with various ULBs in the municipality. They assist the

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22 https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/0SF201516EB0E8ACC024F4D0BB659A6D1D6E7BB46.PDF

municipality in preparing budgets, projecting cash flows, cost monitoring and other services. These banks also maintain municipal deposits and provide long-term loans and act as intermediaries by managing tax and grant allocations from the central government. They have access to long-term savings, which could be used to fund projects at below the base rate. For example, Credit Local de France, availed of funds accumulated through the postal system's savings plan for small savers.

b. Delegated monitoring

A municipal bank also performs intermediation and monitoring functions. It sources savings from various sources, appraises the projects that require capital, allocates funds and monitors the use of these funds. Due to the indigenous capabilities of the bank, they enjoy higher credibility than the municipalities they support. In the event of a financial crisis, these banks proactively pursue loan restructuring, as opposed to reacting to bad assets.

c. Bundled services and pricing

While municipal banks lend to ULBs after thorough loan appraisal, they do not incorporate risk premium in loan pricing. Consequently, all local projects are financed at the same rate of interest. This prevents local credit markets from being self-sustaining. As a result,these banks are subsidised and repayment becomes a function of intent rather than ability.

India is aggressively chasing the cause of financial inclusion, and municipal banks appear to be a step in that direction. However, this concept has certain limitations. There is a possibility that with increasing financial deregulation, municipal banks may find themselves competing with other financial institutions. This may dilute the competency benchmarks set by municipal banks, exposing municipalities to people who have little expertise in the area of municipal financing.

It may be apt to draw parallels with special infrastructure financing institutions in India that faced competition due to market reforms. They eventually lost their right of exclusivity to long-term savings. One of India's largest commercial banks, Industrial Credit and Investment Corporation of India Ltd. (ICICI), moved from long-term infrastructure financing to retail banking and short-term investments by way of a reverse merger with its retail sister concern. Most of ICICI's loans are less than or equal to 3 years, matching its short-term saving pool.

Certain modifications that could align the concept of municipal bond banks with the Indian financial environment include:

a. Competition: Underwriters of municipal bonds should ensure that there is competition in the market. Bonds should be subscribed to by both retail and institutional participants, as against the crowding out of other investors by private placements.

b. Public Information: All information on projects under consideration should be publicly disseminated by municipal banks. SEBI has already issued detailed guidelines on disclosure requirements, limiting information asymmetry. Credit rating of bonds further enables price discovery and risk premium.

Must for Smart Cities

It is predicted that around 25 to 30 people from rural India migrate to Indian cities every minute, in order to avail better job opportunities and lead a better quality of life. This will result in around 843 million people living in Indian cities by 2050.[23] This colossal urbanisation forecast poses a challenge. It is this that prompted the Government of India to pledge INR 98,000 crore (USD 14.7 billion) over the next five years towards the development of smart cities. It is estimated that investment of around USD 1.2 trillion will be required over the next 20 years to build smart cities.[24] Twenty cities identified in the first round are entitled to INR 200 crore in 2016-17, followed by INR 100 crore each year for the next three years. The Ministry of Urban Development (MoUD) has stated that states and their respective urban bodies will have to manage the balance funding requirement. Three cities from Madhya Pradesh have qualified in the first list of 20 smart cities, namely Bhopal, Indore, and Jabalpur.

- The total estimated cost of Bhopal is INR 3,092.71 crore.
- The total estimated cost of Jabalpur is INR 3,998.5 crore.
- The total estimated cost of Indore is INR 5,099.60 crore.

While investment from the central government is in line with that announced by MoUD, all three proposals assume yearly equity infusion from Government of Madhya Pradesh to the tune of INR 488 crore over the next four years. Considering the Madhya Pradesh state revenue deficit of INR 16,750 crore in 2015-16, the sources of funding these initiatives are unclear.

Traditionally, infrastructure requirements of cities have been met through grants from the central government and states. Every municipal corporation has two limited revenue streams i.e.

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23 https://eu-smartcities.eu/sites/all/files/events/uploads/Smart%20Cities%20India%202015%20Brochure_0.pdf Page 2

24 http://www.makeinindia.com/article/-/v/internet-of-things

a. Revenue from tax and non-tax items in the respective municipality

   For example: property tax, profession tax, cost recovery, user charges, entertainment tax and licence fees

b. Grants from their state government and the central government

One of the early initiatives focussed on making ULBs financially self-sustaining bodies, was when the MoUD solicited World Bank to conduct a study on "Developing a Regulatory Framework for Municipal Borrowing in India". The report observes that there is innate reluctance among ULBs to borrow. Hassle free access to grants from the state and central governments prevents ULBs from exploring borrowing as a viable option for meeting their funding needs. In the absence of any urgency or incentive to maximise revenue to repay lenders, a grant-based capital structure discourages accountability at the local delivery level. Another key reason why ULBs are hesitant to borrow capital is their abysmal track record of project delays and cost overruns, which may result in repayment delays. In the absence of adequate project plans or collateral that would generate lender confidence, lenders are unsure about funding municipal project assets. The report prompted the MoUD to emphasise the need for local bodies to be in a position to finance the funding needs of smart cities. This is mainly to ensure that, while the Central Government extends equal financial assistance to every smart city, each state becomes accountable and financially responsible for urbanisation of its cities.

Recently, SEBI has also begun to take a fresh look at issues that hinder the growth of municipal bond markets in India. To mitigate investor risk, SEBI has urged municipal corporations to adopt investor-friendly accounting norms. To aid infrastructure investments further, SEBI issued fresh listing and trading norms for municipal bonds (Hasmi, 2016). SEBI has also hinted at a possible increase in the 8 per cent interest ceiling, if needed, to attract investors.

According to a CARE Report "Municipal Bond Market in India: The Way Ahead", it is possible to raise around INR 1,000 to INR 1,500 crore per annum, over the next five years through large municipalities by issuing municipal bonds with acceptable investment grades. Municipal bonds in India are not just expected to meet the nation's infrastructure financing requirements, they are also expected to provide expected returns to the Indian investor, who has traditionally preferred fixed deposits, small savings or gold.

Lessons from the International Municipal Bond Market

Most developed and transitioning nations are focussed on developing local credit markets. North America and Europe have a long history of utilising household savings for infrastructure development. North America has heavily relied on municipal bonds, while Europe developed development banks. Developing nations have used either one of these routes or their hybrid, directly or via financial intermediaries.

The United States

The US municipal bond market, whose development was based on the urbanisation boom in the 19th century, is mature in terms of both depth and infrastructure. It provides products to meet the cash flow requirements of long-term urban projects. Revenue bonds are primary sources of funding capital projects; general obligation projects backed by municipal corporations are widely subscribed too. The federal government encouraged the growth of the municipal bond market by making them tax free. This strengthened faith in the federal-state local partnership towards achieving better living standards. Bond banks and state revolving funds were formed to meet the funding requirements of smaller local bodies to issue instruments backed by pooled assets. Municipal bonds are held by individuals, mutual funds, money market funds, insurance companies, and commercial banks. American households hold around three-fourths of the municipal bonds issued, primarily for retirement savings. With negligible instances of default, municipal bonds are safe investments for US citizens and other market participants. As per the US Federal Reserve, total outstanding municipal bonds in 2011 were valued at around USD 3.7 trillion. US municipal bonds have a ground-up approval system. The county legislature approves the project for debt financing as part of its capital budget. It is possible that the legislature solicits constituents for their votes. The strength of the US municipal bond market lies in the active secondary market for sub-national debt, and track record of low failure rates.

The issue or sale of municipal bonds can be done in two ways by the counties: competitive or negotiated.

a. In a competitive sale, underwriters receive a preliminary offering statement on the municipal bonds from the counties, prior to the sale. On the day of sale, all underwriters submit their bids electronically and the underwriter who offers the lowest interest rate for the bond is selected. The selection is done with the help of an automated system.

b. Negotiated sales are most widely used for general obligation bonds but one can also find its use in handling cases of more complex revenue bonds. On the day of sale, the county negotiates the price of the bond with a group of previously selected underwriters. External financial advisors often help counties in such negotiations.

Lesson: Decentralise urban development, not just by making municipalities responsible for their respective cities, but also giving them the power to make decisions related to project financing and investor relations.

Russia

1. The Russian national budget does not support capital infrastructure investments. As in a decentralised model, local and regional bodies are responsible for providing services and infrastructure to their respective localities. Moreover, bonds in Russia are issued at the regional level rather than the local level mainly for the following reasons.

a. Regional bodies are competent to issue bonds

b. The underlying asset is backed at multiple levels, making it less risky

c. Regional governments enjoy tax exemptions

2. The three main types of regional/local instruments issued include:

a. GKO Type Bonds: Short-term zero coupon bonds usually used for meeting operating expenses.

b. Housing Bonds: are used to prepay for housing construction. Since lending to construction companies is a risky proposition and the cost of borrowing from banks is high, the municipalities have addressed this issue by issuing housing bonds.

c. Arbitrage Bonds: were issued to access risk free financing for government projects. These bonds were also expected to build public confidence in the municipal bond market. The government borrowed at a low rate of interest and invested in GKOs. Arbitrage earnings were used for investment in development projects.

The Russian Constitution elaborates on the right of local bodies to independently adopt local budgets, and localise taxes and fees. The City of Moscow leads the development of the municipal bond market in Russia. Two significant uses of proceeds include renovation of city infrastructure and financing projects that were halted on account of lack of finances. Moscow's access to financial expertise gives it an edge over others in drafting its debt prospectus. It proclaimed the proceeds would be used for outstanding debt settlement, before any other allocation, winning investor confidence. As in India, most projects in the past were funded via grants or city budgets. Moscow has witnessed a shift in its approach towards infrastructure financing. The city is working towards a sustainable and sizeable debt pool to meet its requirements.

Lesson: Investor confidence and perception of the issuer is critical to development of a municipal bond market

South Africa

Most infrastructure requirements in South Africa are in rural areas. However, sources of finance are in urban areas, the United States Agency for International Development (USAID) helped bridge this gap through an infrastructure finance framework.

Unique features of the South African Municipal sector include the following.

a. All municipalities rely on their own revenue sources. There is minimal government grant.
b. Significant budgetary requirements are met by imposing service fees
c. Municipal investment is steered towards providing basic amenities to historically marginalised sectors

The following are the hurdles faced by the South Africa municipal bond:

a. Accurately measuring the credit risk of a municipality
b. Reducing risks associated with lending to municipalities including tackling project level risk, providing sovereign guarantee, bond insurance
c. Lack of liquidity because of the absence of an active secondary market

To overcome the problems faced by the municipal bond market, USAID made three major recommendations.

a. Provide steady credit flow to mid-level municipal authorities at low cost of borrowing
b. Innovate structures that forge private-local partnerships in providing basic municipal infrastructure
c. Allow an intermediary municipal credit expert to function, while incentivising the private sector to lend to municipal bodies

Lesson: Private sector partnership in municipal development brings financial responsibility and operational efficiency

Philippines

One of the reasons why Philippines was economically backward compared to other East Asian countries was its underdeveloped bond market. While Manila had an active stock exchange, dominated by participation in listed equities, there was very little activity in local government bonds. Local Government Code (1991) gave Local Government Units (LGU) access to credit and permitted them to issue bonds that would fund self-liquidating, income-producing development or livelihood projects. Unfortunately, the use of bonds to fund urban infrastructure has been limited in size and scope. LGUs are inclined towards financing their funding requirements by way of grants and subsidised credit. Besides, local government bonds are perceived as a measure to fill funding gaps for urban projects. USAID has identified two reasons that have dampened the local government bond market:

a. No tax exemption
b. Difficulties in establishing a mechanism to monitor revenue allocation

Opportunities in financing housing projects using local bonds are being explored to raise low cost funds locally. The Government of the Philippines is working with the World Bank to revamp the Municipal Development Fund. They are studying the urban infrastructure landscape to identify service provisions and arrive at a fine balance between quality and affordability.

Lesson: It is imperative that local government bodies enjoy credibility; investors should be incentivised to lend for local development

Like other countries that have been successful in finding sources of financing within an exhaustive policy framework for urban infrastructure finance, India should also evaluate the role of developer contributions, assessments, system development charges and participation of private sector in financing urban infrastructure. Under such a framework, markets and roles of potential players, get clarified which may result in availability of more capital from all sources. Larger or urban local bodies with high creditworthiness could be oriented more towards maximizing returns to potential investors; on the other hand comparatively smaller ULBs could target concessionary sources of finance.

Recommendations

Incentivise stakeholders in the municipal bond market

The Indian financial markets offer opportunities to both small and large investors, in terms of asset class, tenure, returns etc. However, the asset class lacks the attractiveness associated with its other counterparts like gold and equity.

Urban local bodies: Link additional central or state grants to the ability of the ULB to raise resources through municipal bonds.

Investors: Creating demand for municipal bonds is as much a challenge as supply of municipal bonds. Retail and wholesale investors may be increased by:

a. Exempting municipal bond interest payments from tax
b. Remove the existing interest rate ceiling of 8 per cent on municipal bonds. Allow the market to discover the rate by itself.
c. Include municipal bonds as a part of priority sector lending or count bank subscription to municipal bonds as part of SLR holding

Existing Financial Institutions to Function as State Financial Intermediaries

Many ULBs do not have the foresight or technical competence to explore capital markets as a source of financing their cash flow requirements. The situation is even worse for smaller ULBs which do not have the required asset pool to generate revenue. Enable RBI or existing public/private sector banks to function as state financial intermediaries and provide ULBs with requisite support and advice with respect to using capital markets optimally. When ULBs are small in size, these intermediaries may draw up pooled financing plans, draft an investor friendly prospectus and provide end-to-end support for bond issues. The Tamil Nadu Urban Development Fund (TNUDF) is one such example.

Quality of services

The service quality of ULBs has been poor and failed to meet consumer expectations. ULBs are entrusted with a number of revenue generating responsibilities. However, this has not translated into their balance sheets. Poor service delivery and weak financial position[25] dilutes the credibility of ULBs. ULBs would need to prove their operational capabilities to be able to access private savings.

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[25] Gross fiscal deficit of INR3.33 lakh crore at 2015-16

Pooled Finance Development Fund (PFDF) scheme

The central government's PFDF scheme allows smaller ULBs to pool assets and issue bonds backed by pooled assets. This would enable creation of a bundled asset, which would establish its ability to service debt to potential lenders. PFDF would save on restructuring of existing debts and provide for timely availability of capital to ULBs. Over an extended period of time, PFDF would improve urban infrastructure as ULBs would steer towards self-sufficient systems.

Accounting Discipline

The borrowing capacity of ULBs is low in India on account of several factors including the absence of audit compliance. ULBs have been following cash-based, single entry accounting systems. Investor friendly double entry accounting systems need to be adopted to improve their credit worthiness. There needs to be structural reform in order to provide adequate comfort to lenders willing to participate in the urban credit market. Disclosures and accounting standards need to be in line with capital market expectations for ULBs to improve their credit worthiness.

Setting up a Financing Authority

Every state comprises multiple ULBs. A state level body that would monitor the accounting and budgeting processes of these ULBs would allow uniformity in measuring ULB performance. This body may also study project feasibility, assess corresponding financial requirements and identify suitable sources of financing. Such measures will increase lender confidence and make the municipal bond market competitive.

Municipal Corporations	Ratings
Ajmer	BBB- (FITCH)
Allahabad	B+ (CARE)
Pimpri Chinchwad	AA (CRISIL)
Visakhapatnam	A (CARE)

Annexure[26]

ELIGIBILITY

Eligible municipalities.

No issuer shall be eligible to issue debt securities to public under these regulations, unless the following criteria are complied with:

(a) municipality, whether proposing to issue debt securities itself or through corporate municipal entity, should be eligible to raise funds under its constitution;

(b) accounts of municipality shall be prepared in accordance with National Municipal Accounts Manual or in accordance with similar Municipal Accounts Manual adopted by the respective State Government for at least three immediately preceding financial years;

(c) municipality shall not have negative net worth in any of the three immediately preceding financial years;

(d) municipality shall not have defaulted in repayment of debt securities or loans obtained from Banks or Financial Institutions, during the last three hundred and sixty five days:

Provided that where the issuer is a corporate municipal entity, the requirements at (b), (c) and (d) shall be complied with by the Municipality which is being financed. Explanation - For this purpose, the term default means where interest and/ or principal amount has remained overdue for a period of more than ninety days;

(e) no order or direction of restraint, prohibition or debarment by Board against the corporate municipal entity or its directors is in force;

(f) the corporate municipal entity, its promoter, group company or director(s), should not have been named in the list of the wilful defaulters published by the Reserve Bank of India or should not have defaulted on payment of interest or repayment of principal amount in respect of debt instruments issued by it to the public, if any.

REQUIREMENTS FOR PUBLIC ISSUE

General conditions.

(1) An issuer making public issue of debt securities shall only issue revenue bonds.

(2) No issuer shall make a public issue of revenue bonds unless following conditions are complied with:

[26] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1436964571729.pdf

(a) It has made an application to one or more recognised stock exchanges for listing of such securities therein:

Provided that where the application is made to more than one recognised stock exchanges, the issuer shall choose one of them as the designated stock exchange: Provided further that where any of such stock exchanges have nationwide trading terminals, the issuer shall choose one of them as the designated stock exchange; Explanation- For any subsequent public issue, the issuer may choose a different stock exchange as a designated stock exchange subject to the requirements of this regulation;

(b) it has obtained in-principle approval for listing of its revenue bonds on the recognised stock exchanges where the application for listing has been made;

(c) credit rating has been obtained from at least one credit rating agency registered with the Board and is disclosed in the offer document: Provided that the revenue bonds intended to be issued shall have a minimum investment grade rating: Provided further that where credit ratings are obtained from more than one credit rating agencies, all the ratings, including the unaccepted ratings, shall be disclosed in the offer document;

(d) it has entered into an arrangement with a depository registered with the Board for dematerialization of the revenue bonds that are proposed to be issued to the public, in accordance with the Depositories Act, 1996 and regulations made there under.

(3) The revenue bonds shall have a minimum tenure of three years or such period as specified by the Board from time to time.

(4) The revenue bonds shall have a maximum tenure of thirty years or such period as specified by the Board from time to time.

(5) The issuer shall appoint one or more merchant bankers registered with the Board at least one of whom shall be a lead merchant banker.

(6) The issuer shall create a separate escrow account for servicing of revenue bonds with earmarked revenue.

(7) The issuer shall appoint a monitoring agency such as a public financial institution or a scheduled commercial bank to monitor the earmarked revenue in the escrow account under sub-regulation

Provided that where the issuer is corporate municipal entity, it shall appoint a debenture trustee registered with the Board in accordance with the provisions of the Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993 and Companies Act, 2013.

Deliberations at CoBoSAC regarding the framework for Municipal Bonds

SEBI placed an agenda item on formulation of framework for issuance of municipal bonds and disclosure norms for the same before the "Corporate Bonds and Securitization Advisory Committee" (CoBoSAC) Meeting held in October 2013. It was, inter-alia, decided in the said meeting that a sub-committee may be formed to specify disclosure and other requirements of Municipal Bonds. The sub-committee consisted of stakeholders including representatives of MoUD, MoF and Municipalities. The sub-committee deliberated on the issue and inter-alia, proposed four different structures for municipalities which are as follows:

a) Issuance of securities or Municipal Bonds directly by the ULBs/Municipal Body.

b) Issuance of securities or Bonds through Corporate Municipal Entity (Subsidiary) created by the Municipality.

c) Creating of a statutory body which can borrow from market through issue of bonds for onward lending to Municipal Bodies.

d) Under Pool Finance Development Fund Structure, through issuance of securitized debt instruments by a special purpose distinct entity (Trust) created by one or more municipalities by securitizing the receivables. The four structures proposed are detailed below:

a) Issuance of securities or Municipal Bonds directly by the ULBs/Municipal Body - The Municipal Corporations may issue general bonds or revenue bonds subject to the condition that general bonds shall not be made available for public offering and shall be issued only on private placement basis to institutional investors. It stemmed from the fact that in case of revenue bonds, projects could be identified and the revenue stream can be escrowed, thus providing certain safeguards to the investors. However, in the case of general bonds, the cash flows from the project for which the bonds are issued become part of general revenues of the municipality and thus there are no identifiable resources, which are specifically earmarked to repay such bonds.

b) Issuance of securities or bonds through Corporate Municipal Entity (CME) (Subsidiary) created by the Municipality- Municipalities may consider establishing a "Corporate Municipal Entity" (CME) which would borrow through issue of Bonds and lend it to the concerned Municipality. The objective is to create a conduit entity, which can access the market and which can lend it to the concerned Municipality based on its requirements. The Corporate Municipal entity may not hold or carry out any projects of its own, in which cases it would create implementation, enforcement and hierarchical issues. Further, the transfer of projects of Municipalities to CME in lieu of equity may require legislative amendment. The CME would be a going concern and disclosure would be the same as that prescribed under existing SEBI (Issue and Listing of Debt Securities) Regulations, 2008. In addition, however, it would carry additional information on the Municipal Corporation structure and hierarchies

c) Creation of a statutory body or a 100% Government owned undertaking, which can borrow from market through issue of bonds for onward lending to ULBs or municipal bodies. Government may consider establishing a statutory body or a 100% Government owned undertaking (on the lines of India Infrastructure Finance Company Limited). The objective of such undertaking may be to borrow from the market or from financial institutions for onward lending to Municipal Bodies. Such an undertaking may be capable of assessing/appraising the viability of each of the projects of the Municipality and their Governance level, before meeting their financing requirements. Rather than each investor subscribing to Bonds assessing/appraising the risks and viability of various projects proposed to be undertaken by various Municipal Bodies, if such task could be taken care or assigned to an expert body set-up in this regard, it would yield better assessment and funds may flow to the suitable projects. Further, such an undertaking could be central or state government owned and since the body will be engaged in financial intermediation, may have to be registered with RBI as an NBFC. Such a statutory body can make such borrowings under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008.

d) Issuance of securitized debt instruments by a special purpose distinct entity (Trust) created by one or more municipalities by securitizing the receivables - The guidelines prescribed by the MoUD, under the Pooled Finance Development Scheme (PFDF) Scheme, provides that each State/ Union Territory has to designate either an existing state entity or create a new entity as State Pool Finance Entity (SPFE) for execution of the PFDF Scheme. Such a SPFE could either be a Trust or a Special Purpose Entity.

As per section 2(h) of the SCRA 1956, the term securities include “shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate". Also as per the SEBI Debt Regulations, "debt securities" means non-convertible debt securities which create or acknowledge indebtedness, and include debenture, bonds and such other securities of a body corporate or any statutory body constituted by virtue of a legislation. The committee observed that trusts are pass-through entities and they cannot acknowledge any indebtedness in itself and thus, can issue pass-through certificates (PTCs).

The committee observed that as PTCs are Securitized Debt Instruments and are specifically included under "Securities" under the SCRA and can be issued by Trust and can also be listed. Such a trust or SPFE can make a public issue or private placement of securitized debt instruments which are proposed to be listed, under the extant PFDF scheme by complying with SEBI (Public Offer and Listing of Securitized Debt Instruments) Regulations, 2008. However, the suitability of the existing SDI framework to the SPFE created by the Government needs further examination.

Main recommendations of CoBoSAC[27]

The sub-committee submitted its report to CoBoSAC in October 2014 wherein the committee accepted its recommendation and concluded the following:

I. There should be a separate framework for issuance and listing of debt securities by ULBs or Municipal bodies and SEBI may frame separate regulations in this regard.

II. The framework should provide for issuance of debt securities by ULBs or Municipal bodies to the public as well as privately placed Municipal bonds that are proposed to be listed on the stock exchanges. The committee, inter-alia recommended the following requirements, subject to which municipalities may issue debt securities:

a. The funds raised from issue of Municipal Bonds shall be used only for the projects that are specified under objects in the offer document.

b. The proceeds of the proposed issue shall be clearly earmarked for a defined project or set of projects;

[27] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1419931499189.pdf

c. It will be mandatory for the issuer to obtain rating from a credit rating agency registered with SEBI before the issuance of Municipal Bonds.

d. The Municipal Bonds should have a minimum maturity of 3 years. The issuers will have the option to offer deep discount bonds or other financial innovations especially to enhance the tenor of the bond.

e. The issuers may have the option for buy-back arrangements of the face value of the bonds from an investor.

f. The issuers shall maintain a separate account of the amount raised from the issuance of Municipal Bond, to be utilised only for the project related expenditure;

g. The issuers shall establish a separate Project Implementation Cell and designate a Project Officer who shall monitor the progress of the project(s) and be responsible for ensuring that the funds raised through Municipal Bonds are utilised only for the project(s) for which the Bonds were issued.

h. The funds raised by the issuer are utilised in accordance with the timetable for utilization of bond proceeds and only for the project(s) for which permission has been granted by the Central Government.

i. With respect to audit of accounts of the Municipal bodies, it was suggested that within six months of the close of every financial year, the escrow account and the project account shall be audited by the auditors appointed by the Municipal Corporations, as permissible under their respective constitutions.

However, if it is a statutory corporation, then the accounts shall have to be audited by the statutory auditor. Further, the accounts shall have to be audited in a manner, which is friendly with the investor community and also there should be a single point of contact in each ULB/Municipality, with respect to such accounts, with whom the investors can interact and clarify their doubts, if any.

Considering the aforesaid recommendations of CoBoSAC, SEBI proposes to lay down a framework governing the issuance and listing of debt securities by ULBs/Municipal bodies in India directly or through a CME.

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