Municipal Bonds Market in India—Perspectives from investor viewpoint

August 2018
History of Muni Bond issuances in India - Low issuance base

Status of Municipal Bonds Issued

Source: Brookings Report, Building Smart Cities in India (Allahabad, Ajmer, and Visakhapatnam)
† Huge scale of infrastructure development and upgradation required to meet the growth aims at various levels (State/ Centre)
† Requirement of funding will increase given the pace of reforms being witnessed in the country and the objective of creating new smart cities
† Large scale urban migration exerts pressure to create new urban infrastructure while also maintaining/upgrading the existing facilities
† Current sources of revenues in the form of Tax & Non-tax and Grants from state/ central government proves to be insufficient
ULB market access hindered by challenges:

- Financial challenges
  - Limited revenue base
  - Dependence on grants

- Institutional Challenges
  - Financial management systems/MIS
  - Project design and execution

- Governance related issues
  - Management stability
  - Multi level co ordination requirement

Source: DEA, MoF report
<table>
<thead>
<tr>
<th>Issues Faced by Investors</th>
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<tr>
<td>Availability of updated financial information</td>
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<td>Limited credit enhancement for municipal bonds</td>
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<td>Pricing. Lack of frequent and sizeable issuances that can build liquidity</td>
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<td>Consistency of management-frequent changes</td>
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<td>Disclosure and access</td>
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<td>Conservative approach of insurance, pension and mutual funds to invest</td>
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<tr>
<td>Few municipals with high credit quality</td>
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<td>less incentives for municipal bodies to tap debt market-low issuance-lower market appetite – low liquidity</td>
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Way Ahead

Incentivizing investors:
† Bonds issued by Municipals can be made tax-free, at least for retail investors
† Banks could be mandated to lend to ULBs as a part of the ‘priority sector’
† Alternatively, Bank holdings of Municipal Bonds can also be given space in the SLR requirements provided they are of certain specified category
† Long term investors such as Insurance and PF’s can be asked to invest some minimum percentage of their investment book in muni bonds

Incentivizing Municipal Corporations:
† Motivate municipal corporations to get a credit rating from a recognized CRAs and create an incentive structure based upon the credit rating by way of Additional Grants from the Centre/State governments
† The borrowings of the Municipal Corporations from Financial Institutions such as HUDCO etc. can be linked to the bond market

Safeguard Principles:
† PFI’s may look at providing guarantee/credit enhancement to the bonds issued by Municipal Corporations
† Shortfall undertaking from state governments
† Debenture Redemption Reserve
Alternative Fund Raising Options

ULB Direct borrowings:
† Backed by escrow / Debenture Redemption Reserves/ DSRA accounts and strong covenants

Borrowing through Corporate Municipal Entity:
† May be able to ringfence from ULB related governance issues
† Independent Boards
† Investors still need to have detailed credit comfort on underlying ULB

Borrowing through a state or central level specified entity:
† Registered as NBFC under RBI
† Specialised agency to lend funds to ULB’s
† Agency can determine financial eligibility for ULB to access funds from it at a spread
† Develop expertise in ULB funding, monitoring and develop best practices
† Exemption / relaxation from SEBI for NBFC MF limits
† State/central backing may reduce spreads

Borrowing through Pooled Bonds
† Investors still need to take ULB credit view
Municipal Bond Market in U.S.: Takeaways from a success story

**Municipal Market by the Numbers**

- $3.9 trillion capital market
- Approximately 1 million outstanding municipal securities
- Around 39,000 daily trades in municipal securities
- Approximately $11 billion in par traded every day

**Financing State and Local Infrastructure**

- Nearly 2/3 of municipal securities held by individual investors either directly or through mutual funds
- Default rates for investment-grade municipal bonds were 0.18% compared to 1.74% for investment-grade corporate bonds
- 2/3 of infrastructure projects in the United States are financed by municipal bonds
- More than 50,000 different state and local governments and other issuing authorities
- An average of nearly $442 billion in new municipal securities were issued each year in the last decade

Source: Municipal Securities Rulemaking Board