SUPPLY & DEMAND SIDE INHIBITORS IN THE DEVELOPMENT OF AN ACTIVE MUNICIPAL BOND MARKET IN INDIA

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Abstract

In the coming decades,rapid urbanization will become an opportunity as well as a challenge to the country's effort to sustain expeditious inclusive growth of any economy.Growing urbanization demands better quality of infrastructure services to urban populations. The urban infrastructure sector is playing an important role in the structural transformation of the economic system, including social development, India is not an exception. The adequate and timely supply of infrastructure finance needed to meet increasing demand for infrastructure services. Since Urban Local Bodies (ULBs) are found insufficient resources for the growing need of infrastructure investment, ULBs have to look for alternative sources for financing the infrastructure needs. Municipal bond has emerged as viable alternatives for accessing capital markets for ULBs to finance urban infrastructure. The municipal bond market in India is merely alive; however, due to several constraints that has not shown much progress in the past few years. In this context, the study seeks to examine the municipal bond market and investigates supply and demand inhibitors, which holds municipal bond financing wave in India till date.

Keywords: Municipal Bonds, Infrastructure Development, Supply & Demand Inhibitors

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Introduction

In the current phase of Globalization, the growth of industrialization has led demand for rapid urbanization whereas unplanned urbanization creates constraints during this process ofgrowth led development ladder.As per the 74th constitution amendment the urban local bodies have undertaken taken the task to facilitate urban infrastructure services and thereby to finance infrastructure projects. The major source of revenue comes through tax, whereas other sources include government grants, subsidies and development assistance. The grant funding delivered by local and central governments provides some backing in addressing the prominence projects. Though, it is not sufficient to place a major impression in this rising problem of huge requirement of infrastructure finance.For financing investment, particularly in building urban infrastructure to the tune of US$ 800 billion (GOI, 2011), fiscal transfers from the higher levels of government to ULBs will not be sufficient; hence, the role of alternative ways of finance is expected to increase. Since the municipalities are finding insufficient public funding for infrastructure investment, need to explore private as well as alternative funding options through the advent of capital market expansion. In this sense, the introduction of municipal bonds is one of the emerging financing instruments introduced by GOI as a leading initiative to finance infrastructure. The present study investigatessupply and demand inhibitors, which holds municipal bond financing wave in India till date with compelling insights into underdevelopment of the municipal bond market in India and suggests viable and practical solutions toward progress.The present study based on the secondary data, collected from the various sources include Ministry of Urban Development, Asian Development Bank and majority of literature support collected from the existing growth theories, policy analysis, high power committee reports, empirical studies. Although having limitations, both in methodology and literature, conclusion derivable from this research provide policy recommendation for the municipal bond market in India.

Municipal Bond market in India

In the theory and practice of finance, municipal bonds (municipal securities) represent a promise by local governmental authorities or other issues related to these institutions to repay to lenders (investors) the amount of borrowed money (called the principal) along with interest according to a fixed schedule (Galiński, 2013). The Government of India, recognizing an infrastructure's key role in the process of economic development, set up the expert group on the commercialization of Infrastructure, known as the Rakesh Mohan Committee, in 1994. The Committee suggested private sector contribution in the urban infrastructure growth and improving the capital markets through supplying municipal bonds.As part of the Jawaharlal Nehru National Urban Renewal Mission (JNNURM), GOI has made some efforts to enable ULBs to access the bond market. Since 1994, the Indo-US Financial Institution Reform and Expansion (FIRE-D) project is working with national, state and local governments to develop a market-based municipal bond market (Vaidya et.al., 2008).

There has been little attention paid in the municipal sector to issue these bonds in India. This absence of interest can be credited to the fact that many municipalities are opposing to debt and in several conditions are legislated not to function in a shortfall position. Several ULBs and utility organizations have issued municipal bonds that so far have mobilized over Rs.12, 884 million through taxable bonds, tax-free bonds and pooled financing. Bangalore Mahanagar Palika was the first ULB to raise resources through private placement of municipal bonds in 1997 and the Ahmadabad Municipal Corporation was the first to make a public offering in January, 1998(Khan, 2013). It issued Rs.1, 000 million in bonds to partially finance a Rs.4, 390 million water supply and sewerage project (Chakrabarti, 2014). This was a remarkable achievement since it was the first municipal bond issued without a state guarantee and represented the initial step toward a fully market-based system of local government finance (Vaidya et.al., 2008). Since 1998, other cities that have opened in the capital markets through municipal bonds without state government guarantee include Nashik, Nagpur, Ludhiana, and Madurai. In greatest cases, bond proceeds have been recycled to fund water and sewerage schemes or road developments. Till now only 28 municipal bond issues have taken place in India, which have included taxable and tax-free bonds and pooled financing issues (Chakrabarti, 2014). Most of these have been private placements rather than public offers. A look at the trend in the value of municipal bond issues since 1997 suggests that the value of municipal bond issuances that were on a rise till 2005 has seen a sharp fall since then and there has been very few issuances since 2007 and practically no issue after 2010 (Khan, 2013).

Constraints and Challenges for the Development of Municipal Bonds

There several characteristics that make the municipal bonddesirable for investors such as Municipal bonds have advantages in terms of the size of borrowing and the maturity period, up to 30 years. Both these features are considered ideal for urban infrastructure financing. Additionally, if appropriately structured, municipal bonds can be issued at interest costs that are lower than the risk-return profile of individual ULBs. There is selected tax exemption status on interest income. Municipal bonds are might be popular among the investors due to additional benefits, driving yields to record lows and hoping for a safe hiding place at a time when taxes are almost certain to rise.Municipal Bonds are considered as safe investment instruments in the US. Bond insurance has played an important role in the development of the US Municipal Bond markets by providing credit enhancement for Municipal Bonds. In US special institutions created called as ‘bond banks’ to support capital market borrowing by smaller municipalities, for which, otherwise, difficult to access the capital markets. A bond bank is an intermediary between capital markets and small municipalities or local bodies.

On the contrary, the municipal bond market may not be sufficiently liquid (liquidity risk). As a consequence, the investor will not be able to convert the investment into cash. Thirdly, there is a market value, risk related to the changes of prices of the securities on the financial market and potential losses. Hence, these risks affect the development of this market. So, the crucial role belongs to rating agencies which evaluate both the risk of the issuer and the securities. Their functioning might attract new investors into a certain municipal bond market. As a result, the functioning of the municipal bond market is strictly connected with the existence of the functional capital market, institutional mechanisms for evaluating the credit rating or a proper autonomy and credibility of local public sector. The organizational structure in India for municipal governance and urban service delivery mainly composed of the Constitutional provisions, State, Municipal Laws, State Finance Commission (SFC) and central Finance Commission (CFC), and status of ULBs. The municipal bond is regulated by legislation of concern government, which gives directives for issuance of municipal bond and related issues. In Indian scenario Article 293 of the Constitution makes certain provisions as to borrowing by the Centre government and the States government. It’s necessary for every state government to take permission from the central government before borrowing money from the market, which may be in the form of municipal bonds. While the initial transaction costs of accessing this market are highsince a ULB needs to invest in meeting the pre-requisites of its first bond issue as the issue size and frequency increase over time, competencies develop, thereby reducing the transaction costs.

In the past, local authorities have had very little freedom with regard to investments and, therefore, have not undertaken long term capital investment planning. This makes it difficult to project and assess debt mobilization needs against debt service capacities. The recent experiences of bond issuance by municipal authorities have shown that projects have not been ready to absorb funds mobilized. Existing accounting and auditing practices also place major constraints on municipal systems. The Structure of issuing bonds for infrastructure developmentsrequires several steps and procedures. For this assistance, municipal bodies need specialized support or advisory at different stages, such as project feasibility study, capital planning process, preparing legal documents, strategy of issuing bonds, credit enhancement, credit rating, formation of bond parties like underwriter, trustee, preparation of information memorandum, audit committee approval, approval from the Government agencies and listing of the bond in exchange, allocation of funds in the project, and monitoring and follow-up for repayment etc.

In developing the municipal bond market, there are some operational problems slowing pace of development. Hence there is an urgent need of improvisation in system for accelerating municipal bond financing. The requirements of municipal bonds are two sides of the same coin, i.e. demand and supply of municipal bonds. On the one side, there is demand for capital for urban local bodies; on the other side, there is a supply of capital from the investor group but, this both sides facing some constraints. Broadly, the constraints in the municipal bond market in India can be classified as those on the supply and those on the demand side. The constraints on the supply side inhibit ULBs from issuing bonds and those on the demand side limit investors (individual and institutional) from participating in the municipal bond market.

Supply Side Constraints

The revenues and expenditure of Municipal Corporations (MCs)revealthat most MCs are generating revenue surplus and overall resourcegaps are not very large. At the same time, it could be observed thatspending by all the municipal bodies is lower than that required forproviding a minimum level of civic amenities (Mohanty et al., 2007). The constraints have a strong effecton the bond market development in India relate to controlling restrictions levied on banks and insurance companies, which has led to a preference for debt paper in the high investment grades. This is intensified bylack of exit opportunities for investors are due to illiquid securities at market. In the case of municipal bonds, fiscal incentives provided are not beneficial to institutional investors such as banks since the impact of the tax break on the investments in municipal bonds is insignificant in relation to the yield offered by alternate investments.

Thetax-free bonds would have to adhere to the Government of India Guidelines For issue of Tax Free Municipal Bonds and the bonds will have to be notified by the Ministry of Finance as notified tax free municipal bonds under Section 10 (15) (vii) of the Income Tax Act before they are issued. Therefore, the tax break serves a limited purpose in attracting banks as investors in such instruments. The unpredictable nature of the flow of grants from the state government has also inhibited project management efficiency, and hence the suitability of bond finance. (Mohanty et al., 2007) found that out of the 18 functions to be performed by municipal bodies in India, less than half of them had a corresponding financing source, which would heavily burden the ability of ULBs to deliver. Additionally, revenues are also restricted as state governments continue to decide crucial parameters such as user charges and property tax coverage (Chattopadhyay, 2006).

Investments in tax-free municipal bonds are not beneficial to other institutional investors such as insurance companies and provident funds because the returns earned by these investors are not taxed. However, it needs to be noted that the entire quantum of municipal lending is very small to draw a significant conclusion.

Demand Side Constraints

The demand for municipal bonds has turned into muted over the previous few years. Availability of Grantcontribution from many municipal governments has not proceeded with borrowing programs to provide for their share of capital costs. This is slow due to pace of project implementation, leading to delays in grant utilization.

Indian financial market conditions are possibly diverting potential investors away from municipal bonds and restricting diversification of their funds. The borrowing market in India is characterized by the existence of bipolarity due to which, on the one hand, long-term funds, including pension funds, funds of the Life Insurance Corporation (LIC) and provident funds of the Employees State Insurance Corporation (ESIC), and funds from the Reserve Bank of India(RBI) and commercial banks are routed towards buying central government securities (Wells, &Schou-Zibell., 2008).In short, the confidence that investors have in the municipal bond market is reduced due to the absence of a specific regulator and clear regulations.

In May 2009, the Securities and Exchange Board of India (SEBI) has notified the Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008. To help channelize a new investment avenue, market regulator SEBI will soon come out with a new set of norms to enable the issuance and listing of municipal bonds with a popular financial product in developed countries like the US (PTI, 2014). Historically, local entities have faced difficulty in meeting some of the statutory listing requirements such as filing of latest audited statements. In addition, both side constraints, linked to the overall development of the bond markets in the country, have implications on municipal bond market development.

Conclusion

A fresh look needs to be taken at the aims and efficiency of some phases that have previously been taken. Established sources of finance for municipal bonds are required to ensure that local public finances are carried on properly. In order to fulfill challenges generated by rising urbanization, Municipal Corporations in India need to incur immense expenditure to support urban infrastructure in the coming decades. Continuousattempts therefore need to be prepared to make municipal bonds more attractive to investors. And issue terms need to be in line with secondary market conditions. Therefore, greater consideration should be given to alternative such as issuing municipal bonds, whose features can be matched to investor needs; funding debt servicing from the revenue from public works and projects (rather than from general sources) by issuing revenue bonds similar to those in the USA and making greater use of private finance.

The municipal bond market in India, however had, a favorable start in its first phase, came almost to a creaking break in the mid of the last decade. Only large Urban Local Bodies (ULBs) such as Ahmedabad, Indore, Pune, Kolkata, Hyderabad etc. had been capable to use this dais along with a few smaller ULBs which resorted to ‘pooled financing’ (like in Chennai and Bangalore). Additionally, not only fresh issues are having problems but, municipalities with previous successful track records also discover it tougher to raise funds via placement of bonds. The municipal bond market in India is merely alive, however, due to several constraints has not shown much progress in the past few years. In this context, ULBs looking for raising capital investment in urban infrastructure must not only prioritize the new market infrastructure. It’s also important for ULBs to design appropriate strategies to examine the municipal bond market and investigates supply and demand inhibitors, which holds municipal bond financing wave in India till date.

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