

Indo-US  
Financial Institutions  
Reform and Expansion Project -  
Debt Market Component  
FIRE(D)

# Project Notes

## Emerging Issues in India's Municipal Bond System: *The Need for Regulatory Control*

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*In January, 1998 the Ahmedabad Municipal Corporation successfully issued the country's first municipal bonds without a state guaranty, marking an important milestone in the development of a debt market for urban environmental infrastructure in India. Today, this market now promises to grow rapidly, for over twenty cities and urban authorities have received credit ratings for their own proposed municipal bond issues. For the last three years, the FIRE(D) Project has played a key supporting role in this process, working at national, state and local levels, and with the country's leading financial institutions and credit rating agencies, to facilitate the development of a municipal bond system. As this system has evolved, new issues have emerged relative to the regulation of local borrowing. This Project Note outlines these issues and recommends a framework for a regulatory system.*

### India's Emerging Municipal Bond System

One of the key developments of India's emerging debt market has been the development of a municipal bond system. National discussion of a municipal bond system was initiated in December, 1995 at a national seminar sponsored by the FIRE(D) Project and has continued at the local, state and national policy levels. Such a system was later recommended by the Rakesh Mohan Committee on the Commercialization of Infrastructure in India. Municipal corporations have also begun to realize the importance of developing a capacity for such direct market borrowing.

Twenty cities and urban authorities have now requested and received credit ratings for proposed municipal bond issues. Among some of the first are: a AA(SO) rating for a Rs. 1 billion issue by the Ahmedabad Municipal Corporation, a AA rating for a Rs. 2 billion issue by the Pune Municipal Corporation, and an A(SO) rating for a Rs. 1.25 billion issue by the Bangalore Municipal Corporation (BMC). Earlier this year, two of these cities, Ahmedabad and Banga-

lore, issued South Asia's first municipal bonds — the Ahmedabad bonds, most notably, were offered through a partially public issue and *without* a guaranty by the state government.

These new developments present promising opportunities for accessing capital markets for urban infrastructure. However, based on worldwide experience of increasing public debt and concerns with high fiscal deficits, it is also important that local government debt be carefully controlled and regulated. Unregulated local borrowing may lead to an undue rise in public debt.<sup>1</sup> More importantly, the strong contagion effect of default on other local bodies, and even state borrowers, is also a major concern.

There is now a need for greater clarity in the placement of institutional responsibility for regulation of these securities. Based on a series of seminars and studies by the FIRE(D) Project, this *Project Note* identifies a regulatory system which, while maintaining prudential norms, will support the continued development of a viable and vibrant municipal bond system in India.

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### The Current System of Controls on Local Debt in India

Internationally, the concern with controls on subnational borrowing is an outcome of both the rising levels of public debt in many countries as well as the “environment of growing decentralization of expenditures and revenue-raising responsibilities.”<sup>2</sup> Based on a survey of twelve countries including India, Ter-Minassian identifies four main approaches to controls on subnational borrowing, namely: a) reliance on market discipline, b) cooperation by different levels of government in the design and implementation of debt controls, c) rules based controls such as a ceiling on total debt and d) administrative controls such as setting of annual limits on the overall debt of individual subnational jurisdictions.<sup>3</sup>

In India, controls on all local borrowing are largely administrative or rule based, as laid down in municipal legislation at the state level. The administrative controls relate to the purpose for which municipal authorities may borrow, and in most cases, the borrowed money is to be used only for permanent works. Further, for any local borrowing, state government authorization is mandatory. The legislation also envisages monitoring by state governments.

Rule based controls are in the form of detailed requirements for the creation of sinking funds and controls on the purpose of investment. Further, some municipal legislation also puts a cap on total borrowing as a multiple of the total ratable value of the properties in that city, which relates to potential, rather than actual, budget performance. In the case of Mumbai, the potential of other sources of revenue such as octroi and user charges for water are not taken into account at all. Further, the ceilings for Mumbai and Chennai, for example, vary greatly — just 12.5% of annual ratable value (ARV) for Chennai compared to almost eight times the ARV for Mumbai — with separate limits for different budgets. Equally important is the lack of clarity as to whether these limits are followed in practice; for example, estimates for Chennai suggest that the total outstanding borrowing has been more than that permitted by the Act. Thus, municipal legislation in India either does not incorporate ceilings on local borrowing or when these do exist, they are not followed rigorously.<sup>4</sup>

Problems with these controls also relate to undue interference by state governments in local decision-making on capital investment. Under current provisions in

most municipal legislation, state authorization of local borrowing is mandatory. However, studies in three states — Maharashtra, Andhra Pradesh and Tamil Nadu — suggest that state government authorization is not given within any explicit framework or guidelines. It is thus necessary to evolve a rule based system which can be more effective.

### Current Constraints on Municipal Systems

Any proposal for a new system of controls on local authority borrowing must be developed within the context of constraints on existing municipal systems. 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. Local capacity is also inadequate for project management, and cost and time overruns are common. This is crucial, because local borrowers will need to be ready to utilize the bond proceeds. Recent experiences of bond issuance by municipal authorities have shown that projects have not been ready to absorb funds mobilized. This may also lead to negative arbitrage.

Existing accounting and auditing practices also place major constraints on municipal systems. The cash based, single entry accounting systems followed by most municipalities make it difficult to arrive at accurate financial information. Existing municipal legislation does not require adherence to Indian accounting standards set by the Institute of Chartered Accountants of India, as does the Companies Act for the private sector. Most municipal legislation also does not provide for mandatory external auditing, which is also required under the Companies Act. These anomalies must be addressed, and the design of a regulatory system will require changes in legislation to ensure improved accounting practices and compliance with proper accounting standards. In this regard, the recent efforts of the Government of Tamil Nadu to introduce improved accounting and auditing practices, as well as computerization, should be replicated.

### The Components of a Regulatory System

The municipal bond system in India must be set within a proper regulatory system. As highlighted by Ter-Minassian, the system of controls to be adopted in a given country depends on “the balance of power among the different levels of government, macro-economic and fiscal conditions, and the state of development of fi-

### A Proposed Regulatory Framework

A simple system of three rules is suggested to provide market discipline while ensuring adequate administrative controls. These provisions would have to be included in municipal legislation through appropriate amendments.

**1. The Purpose of Borrowing, Capital Investment Planning and Project Development:** The first set of rules would limit the purpose of market borrowing to specific investments for infrastructure which must be provided to meet the municipal obligatory functions, and to other commercial investments which directly support these. Any design of controls must explicitly require the local authorities to undertake multi-year investment planning for local needs such as water, sewerage, roads and other facilities. The experience of the Tamil Nadu Urban Development Fund, which requires local authorities to prepare a five year investment plan before availing finance, is very encouraging in this regard. The capital investment plan should be locally approved, audited and certified by independent consultants. In addition, appropriate project development to ensure timely utilization of bond proceeds from specific investments will have to be ensured.

**2. A Statutory Ceiling on Debt:** There should be a specific cap on municipal borrowing which is set in relation to the projected debt service coverage ratios for total municipal borrowing. This would include outstanding debt and all projected debt as reflected in the approved five year capital investment plan. Based on international experience, such ceilings would help to imitate market discipline by linking local borrowing to budget performance. Other norms, such as a debt equity ratio based on current and past performance, may also be used once a commercial accounting system is in place.

**3. Compulsory Credit Rating and Disclosure Requirements:** Disclosure requirements for municipal bonds will need to be more stringent than for other issuers, due to the limitations in local accounting and auditing practices. It is thus suggested that an investment-grade credit rating for any municipal bond issue, as well as adequate and detailed disclosure requirements, are made mandatory by the regulatory agency regardless of the tenure and mode of issuance (private placement or public offer). Credit ratings of municipal bond issues without any state government guaranty will help to reduce the perception of a bail out; this will also ensure compliance with the legal framework suggested above. At the same time, disclosure requirements will help to gradually induce accounting and auditing reforms.

financial markets.”<sup>5</sup> In India, the recent concern with high fiscal deficits would suggest that local borrowing should be limited to clearly identified investment requirements, especially for the provision of infrastructure to meet obligatory functions. And investments which are clearly linked to enhanced revenues should be preferred. Further, local borrowing should be outside the purview of any state or central government guaranties which create contingent liabilities for these levels of government.

While a number of controls exist on major investment institutions, deregulation and reform in India are underway. Interest rates on government borrowing have been deregulated and are now largely market determined. Development of the debt market is also showing signs of progress, especially with attempts to resolve operational impediments. It can be suggested, then, that a system of mixed controls be developed for local borrowing. Such a system would incorporate rules which mimic market discipline and would also attend to the problems of fiscal deficit through appropriate

amendments to municipal legislation. Compliance with rules for market borrowing may be ensured through a market-related agency, whereas the state government could ensure administrative controls through performance monitoring in general.

One key question in developing and implementing the regulatory framework will be the designation of agency responsibility. In the past, there has been excessive dependence by municipal authorities on state governments, and this may make it difficult to delink local borrowing from a perception of assured bail-outs by state governments. Thus, the regulatory system must clearly create independence on the part of the local authority from the state government for any market borrowing. It would be useful to put the actual regulatory role outside the purview of the state government, vesting it with a market-linked agency such as the Securities and Exchange Board of India (SEBI). This would help to reduce the possibility of a perceived bail out, because the state government would not be directly involved in granting permission to the local government

for market borrowing. Because there is no bankruptcy legislation for municipal governments in India, this is essential.

The role of the state government, however, would still remain important in monitoring compliance with the legislative provisions related to purpose, investment planning, debt cap and credit rating as suggested below. The state government can provide comparative information on these parameters which will help to improve market awareness about local issuers. Such monitoring by state governments would also help to provide warning signals if debt limits are likely to be exceeded.

### Conclusion

Such stringent requirements may place some burden on the development of a municipal bond system. However, it must be recognized that without such a framework, the municipal bond system will not develop effectively. Its development will also depend on state and central government support, through measures related to local capacity building, necessary legislative changes and conditional fiscal incentives. Other indirect support measures such as sustainable credit enhancement options, rationalization of state-local fiscal relationships and financial empowerment of local governments are also essential. The role of higher levels of government will thus be critical in developing a viable and vibrant municipal bond system in India and striking the right balance between regulation and support.

<sup>1</sup> There is also a lack of clarity regarding inclusion of municipal bonds in public debt. Though in theory all government debt has to be included in measuring public debt, under current practice local government debt is not included. Some public finance analysts believe that unguaranteed local debt need not be included in the total estimate of public debt.

<sup>2</sup> Teresa Ter-Minassian, "Borrowing by Subnational Governments," *IMF Policy Analysis and Assessment Paper*, Washington, DC, April 1996, p. 2.

<sup>3</sup> Ibid.

<sup>4</sup> Refer to Indo-US FIRE(D) Project Technical Report *Legal Issues in Market Access for Urban Infrastructure in India*, Kirloskar Consultants, Chennai, October 1997.

<sup>5</sup> Teresa Ter-Minassian, "Borrowing by Subnational Governments," *IMF Policy Analysis and Assessment Paper*, Washington, DC, April 1996, p. 15.

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*This Project Note was written by Dr. Meera Mehta, Senior Urban Finance Advisor with the Indo-US FIRE(D) Project.*

## Indo-US Financial Institutions Reform and Expansion Project - Debt Market Component FIRE(D)

The objective of the Indo-US Financial Institutions Reform and Expansion (FIRE) Project, funded by the U.S. Agency for International Development (USAID), is to support the Government of India in its efforts to strengthen domestic capital markets to enable them to serve as efficient source of development finance. The Debt Market/Infrastructure Component (FIRE-D) pursues this goal through the development and financing of commercially viable urban environmental infrastructure projects; by channeling USAID Housing Guaranty funds to selected demonstration cities and states; and through policy advocacy, management support, technical assistance, training and research.

The FIRE (D) Project Office  
E-3/4, Vasant Vihar  
New Delhi 110 057, India  
Tel: (91-11) 614-3551 or 614-9836  
Fax: (91-11) 614-1420 or 614-4480

Regional Urban Development Office  
USAID/New Delhi  
B-28 Institutional Area  
New Mehrauli Road, Near Qutab Hotel  
New Delhi 110-016, India

Community Consulting International  
1012 N Street, NW  
Washington DC 20001-4297 USA

*in association with*  
Technical Support Services  
1012 N Street, NW  
Washington DC 20001-4297 USA

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