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Reform and Expansion Project -
Debt Market Component
FIRE(D)

Project Notes

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The Ahmedabad Municipal Bond Issue

India's First without a Guaranty

In January, 1998, the Ahmedabad Municipal Corporation issued India's first municipal bonds not backed by a state guaranty. For Indian cities that face an increasing demand for services and, at the same time, a decline in transfers from state and central governments, such bonds are a promising means of tapping capital markets to finance urban infrastructure. As with any innovation, however, time and effort are needed for the necessary support systems to evolve. This Project Note describes the Ahmedabad municipal bond issue, the evolving municipal bond system in India and issues which must be addressed to facilitate the issuance of such bonds in the future.

In January, 1998, the Ahmedabad Municipal Corporation (AMC) opened a Rs. 1 billion ($25 million)[1] issue of municipal bonds, the first to be issued in India without a state guaranty. The issue was designed to support the water supply and sewerage components of a Rs. 5.89 billion ($147 million) infrastructure investment program that also includes roads, bridges and solid waste management. A 75% private, 25% public issue, its success gave momentum to a growing national consensus that municipal bonds provide a promising alternative for financing urban infrastructure. As interest in this new approach to financing of municipal infrastructure evolves, however, it is important that necessary support and provisions of a municipal bond system develop.

Why Municipal Bonds?

India is facing severe shortfalls in the capital required to finance growing urban infrastructure needs. Estimates indicate that as much as Rs. 300 billion ($7.5 billion) may be needed annually to provide for India's cities, while Rs. 30 billion ($750 million), at most, is flowing to this sector annually. As a result of recent liberalization and financial sector reforms, there has been a decline in mandatory investment through the directed credit system. Clearly, new sources of financial resources are needed, and India's nascent capital markets present one opportunity.

Municipal bonds represent an approach to capital market borrowing by municipal and utility authorities, that presents a number of benefits over more traditional financing approaches. Most importantly, borrowing through capital markets imposes market rigor, which requires project development based on commercial principles, that is, project structures that provide for an adequate return on investment, give attention to risk mitigation and allocation and offer secure institutional structures. In essence, development of a municipal bond market represents a step in the direction of developing a market-based infrastructure finance system.

Scrutiny by the market also focuses attention on municipal performance which, in turn, provides incentives for improved management of municipal finances and services. Municipal bonds also allow for greater flexibility in the timing of investments, because municipalities are not constrained by annual budget cycles and grant decisions made at other levels of government. In light of these advantages, interest in tapping Indian capital markets for urban environmental infrastructure has been mounting.

The Evolving Policy Consensus

Currently, there is an international trend away from financial intermediation, reflecting global recognition of the need for more market-oriented approaches. In India, there has been a growing consensus among policymakers that municipal bonds represent a promising alternative. In 1995, discussion of a municipal bond system was initiated at a national workshop in Bangalore, sponsored by the FIRE(D) Project, on the potential and relevance of a municipal bond system for India.

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In the following year, The Rakesh Mohan Committee on Commercialization of Infrastructure Projects, established by the Ministry of Finance, issued recommendations for capital market development which included the development of a municipal bond system in India. The task force set up to assist State Finance Commissions (SFC) also recognized the need to promote municipal bonds, and many SFCs have included promotion of market borrowing through municipal bonds in their recommendations.

The Ninth Plan Approach Paper produced by the Planning Commission in 1997 recommended the issue and trading of municipal bonds, and the Working Group for Urban Water Supply and Sanitation Sector for the Ninth Five Year Plan recommended direct market access for local bodies through a municipal bond system.

The First Step: A Municipal Credit Rating

A credit rating is a key element of the pre-sale stage of a municipal bond issue, for it provides an indication of the risk level associated with an issuer's ability to repay debt. The rating exercise focuses on four major areas relative to the municipality's profile, its existing operations; its financial and managerial performance; and the specific project for which it intends to borrow funds. In this way, it has also come to be regarded as a solid indicator of a city's performance and competitiveness.

The city of Ahmedabad took the first step toward issuance of municipal bonds when it requested and received a municipal credit rating in February, 1996. India's first municipal credit rating, the city received an A+ for a general obligation of Rs. 1 billion ($25 million), which indicated adequate assurance that investors would be repaid.

Ahmedabad's positive rating reflected a financial revival that began in 1994. Though the city had accumulated significant losses up to that point, it achieved a revenue surplus of Rs. 380 million ($9.5 million) by the end of March 1995 through strong, committed leadership and improved revenue collection and property tax administration. This revenue surplus has been substantial in subsequent years and is expected to continue.

The rating was conducted by Credit Rating and Information Services of India, Ltd (CRISIL) based on a methodology it developed with assistance from the FIRE(D) Project. Since then, all three Indian rating agencies – CARE, ICRA and CRISIL – have become involved in the rating process. The cities of Mumbai, Pune, Vijayawada and Bangalore have been rated and 34 other cities and utility boards have been or are in the process of being rated.

Financing the Ahmedabad Water Supply and Sewerage Project

The city developed a capital investment plan of approximately Rs. 5.89 billion ($147 million) in water supply, sewerage, roads, bridges and solid waste management. At the same time, it initiated a Rs. 1 billion ($25 million) project to provide sewerage treatment and slum upgradation with private sector participation. The city elected to develop the water supply and sewerage project, worth about Rs. 4.89 billion ($122.25 million), in a commercially viable format. The financing plan was designed based on opportunities in the capital markets as well as constraints on institutional finance for urban infrastructure projects.

This component of the Ahmedabad capital investment program then became eligible for financing through USAID's Housing Guaranty (HG) Program under the FIRE(D) Project. The AMC appointed Infrastructure Leasing & Financial Services (IL&FS) as its merchant bankers, and an initial financing plan was developed that included municipal bonds. These two institutions, together with the Housing and Urban Development Corporation (HUDCO), CRISIL and USAID went forward to develop and issue the city's bonds.

Initial AMC Financing Plan

Municipal Bonds	Rs. 1 billion ($25m)
Loan from IL&FS *(USAID HG Loan through the FIRE(D) Project)*	Rs. .9 billion ($22.5m)
Institutional Finance *(HUDCO and Life Insurance Corporation of India)*	Rs. 1.52 billion ($38m)
Internal AMC Resources	Rs. 1.47 billion ($36.75m)
Total	Rs. 4.89 billion ($122.25m)

Introducing a Structured Debt Obligation

One important step was to re-examine the project financial structure and to introduce credit enhancement. IL&FS, in association with the FIRE(D) Project, worked with the AMC to shift from a general obligation bond to a structured debt obligation (SDO). The SDO provided greater security for investors in several ways. Revenues from ten octroi collection centers were earmarked to service the bonds, and an escrow account was created which would be independently monitored by a trustee.

Further credit enhancement was achieved through over-collateralization with a minimum debt service ratio of 1.5 and provisions giving investors recourse to the general revenues of the corporation. Assets were mortgaged with a 1.25 asset coverage ratio, and a sinking fund was created for principal repayment. The AMC then returned to CRISIL with this SDO and receive a improved rating of AA-(so). This improved rating strengthened the perceptions of potential investors, a critical element in the success of a bond issue.

Bonds Are Issued

A determination was made to apportion the issue as 75% private placement, that is, sale of the bonds through prenegotiated agreements with specific institutional investors. The private placement was organized by IL&FS with co-lead managers Kotak Mahindra, SBI Caps and ANZ Grindlays.

The remaining 25% were publicly placed, that is, a scheduled release for sale through the open market. Even though public issue was expensive in term of mobilization, the AMC took this step to create a market image and to help further the agenda for creating a municipal credit system.

The draft prospectus for the public issue was approved by the Securities Exchange Board of India, and in December, 1997, applications were filed with the National Stock Exchange (NSE) and the Ahmedabad Stock Exchange (ASE).

In the following month, the issue opened. The face value of the bonds was Rs. 5,000 ($125) in multiples of Rs. 1,000 ($25) thereafter, with a coupon rate of 14%, tenor of seven years and principal repayment during the final three years.

The private placement was allotted to a dozen Indian financial institutions, including the State Bank of India, the Unit Trust of India, Housing Development Finance Corporation, Ltd, and with commercial banks and mutual funds.

Advertisement of the public issue was handled by Mudra Communications, in newspapers, on buses, hoardings, city cable television and kites. Press conferences were also held in Ahmedabad as well as in Mumbai and Delhi. Brokers conferences were held in those three cities as well as Baroda, Rajkot, Surat and Bhavnagar. Greater than 95% of subscribers were individuals, and the issue was oversubscribed by more than 10%.

Since that time, some trading of the bonds has taken place at the NSE and the ASE. Though trading has been in small amounts, this represents the beginning of a secondary market.

The Way Forward

Based on this experience, as well as research conducted by the FIRE(D) Project, it is possible to identify three main areas that require attention if municipal bonds are to become a more common, reliable method of financing urban environmental infrastructure.

System Development

- *Develop a regulatory framework for permission to issue bonds and disclosure norms*: A structured, streamlined system for state-level support and regulation in the areas of borrowing purpose, capital investment planning, project development and carefully monitored ceilings on debt would be essential. In addition, it is also necessary to develop disclosure norms in consonance with market-based corporate debt instruments prescribed by market regulators in India.

- *Develop the long term debt market*: Currently the tenor of debt instruments is in the range of five to seven years, but several measures are being put in place to develop the long term debt market during the medium term. Pending this development, measures to enhance the tenor of municipal bonds through guarantees for later maturities of principal repayments and interest payments are needed.

- *Liberalize investment guidelines for long-term funds and other resources*: Long-term lending is one approach to providing cheaper financing, and access to sources such as pension and insurance funds should be explored. At present, investment by provident and insurance funds is controlled by central government regulations in favor of government securities. Investment guidelines for long-term funds are expected to be released as a part of financial sector reforms. With this, it will be possible for municipal authorities to access long-term funds.

- *Develop bankruptcy legislation for local bodies and other issuers*: Investor confidence can be strengthened, to some degree, by legal structures which provide recourse for bonds that do not perform as expected.

- *Provide tax and fiscal incentives for the issue of bonds*: The Ministry of Finance (MOF) and Ministry of Urban Affairs and Employment are developing guidelines for the issuance of tax free bonds, and the MOF has sanctioned the issue of Rs. 2 billion of tax-free municipal bonds. This will serve as an impetus for the development of a municipal bond market.

Capacity-Building for Issuers and Advisors

- *Build capacity for project development and management to ensure timely and efficient utilization of bond proceeds*: Accessing capital market funds requires projects developed in commercially viable formats with adequate attention given to project management and implementation. One of the most important aspects relates to identification and management of risks associated with project development and operations. Any risk management strategy will need to both mitigate risks and allocate them to the most appropriate actor, within the contractual framework of the project. This requires considerable initial investment in project development.

- *Enact local reforms in accounting and financial management to meet rigorous disclosure norms:* Reliable information is the foundation of a credit rating and an essential factor in generating investor confidence. For this reason, the FIRE(D) Project has worked to support reforms in financial accounting, reporting and management at central, state and local levels.

- *Reform tariff structure to improve financial viability:* The development of commercially viable infrastructure projects requires the introduction of (at least gradual) tariff reforms and a move toward cost recovery or an efficient pricing regime.

- *Share information and experiences among rating agencies, lenders, investment bankers and financial advisors*: Dialogue among these institutions can only improve and hasten the development of a healthy municipal bond system in India.

Support for Instrument Development

- *Support credit enhancements through sustainable and commercially viable mechanisms*: One of the keys is to develop alternatives to the blanket state government guarantees which have been routinely used for financing urban infrastructure projects. In this context, alternatives need to be explored, such as escrow arrangement with necessary reserve funds; bond insurance structured on market principles, as found in the United States and European nations; financial guarantees; and performance guarantees such as for raw water quantity and quality.

- *Compile comparative information on the performance of potential issuers to develop industry norms and benchmarks*: A Comparative Performance Indicator System, which has been developed with FIRE(D) Project support and applied in the state of Tamil Nadu by Kirloskar Consultants, Ltd, is an example of such a system. By assembling and analyzing information across cities and over time, it becomes possible to compare performance and to analyze trends and relative strengths and weaknesses of urban local bodies

- *Develop new structured financing arrangements within Urban Finance Frameworks*: Unlike the traditional Project Finance Framework, which is limited in scope and focuses only on finances related to a specific project, an Urban Finance Framework takes in account the totality of municipal finances and provides developers and potential investors with a more comprehensive picture of the financial setting within which a project exists.

- *Develop pooling arrangements for small issuers*: Though the limited financial and physical resources of most Indian municipalities makes market borrowing prohibitive on their own, by pooling together it is possible that scale can be reached, that enables development of a commercially viable project and financing through municipal bonds.

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[1] Conversion is based on Rs. 40 = US$ 1.

This *Project Note* is based on a presentation by Meera Mehta and V. Satyanarayana entitled "*Emerging Innovations in Urban Infrastructure Finance: A Case of the Ahmedabad Municipal Corporation*."

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The mission of the Indo-US FIRE(D) Project is to institutionalize the delivery of commercially viable urban environmental infrastructure and services at the local, state and national levels. Since 1994, the Project has been working to support the development of such demonstration projects and the development of a sustainable urban infrastructure finance system. Now, the Project is pursuing this mission through:

- Expansion of the roles of the private sector, NGOs and CBOs in the development, delivery, operation and maintenance of urban environmental infrastructure;
- Increased efficiency in the operation and maintenance of existing water supply and sewerage systems;
- Strengthened financial management systems at the local level;
- Development of legal and regulatory frameworks at the state level;
- Continued implementation of the 74th Constitutional Amendment; and
- Capacity-building through the development of an Urban Management Training Network.

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