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MUNICIPAL BOND issuances likely to increase in FY2020

Recent SEBI amendments, Govt incentives major boosters

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The Securities and Exchange Board of India (SEBI) has approved the second round of amendments to the SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015 on August 21, 2019. Briefly, the amendments are as follows:

A. Expansion in the scope of regulations to other entities involved in municipal functions
B. Changes in requirements related to accounting, audit and disclosure of financial statements
C. Modifications in the provisions pertaining to debt-servicing mechanism of the municipal bonds
D. Other changes

The Ministry of Housing and Urban Affairs (MoHUA), the Government of India (GoI) has also extended the incentive scheme in FY2020[1] for the entities, which would raise funds through municipal bonds. As per the scheme, an entity would be eligible for an incentive of Rs. 13 crore for an issuance of at least Rs. 100-crore bond (maximum incentive of Rs. 26 crore for each entity). The scheme would be available to 12 entities on a first come, first serve basis during FY2020 (was available to 10 entities in the previous year).

BACKGROUND

Previous amendments to municipal bond regulations and other regulatory changes

In July 2015, the Securities and Exchange Board of India (Issue and Listing of Debt Securities by Municipalities) Regulation, 2015, ushered in an institutional framework for issuance of debt securities by the urban local bodies (ULBs) and their subsequent listing and trading. Subsequently, the first round of amendments to the SEBI (Issue and Listing of Debt Securities by Municipalities) Regulations, 2015 were notified by the SEBI in February 2017. The key amendment was related to the eligibility criteria for the ULBs, according to which, a ULB must have surplus income as per its income and expenditure statement, in any of the immediately preceding three financial years. Prior to this amendment, the eligibility criteria for the ULBs was a positive net worth in any of the immediately preceding three financial years.

Later in June 2017, the SEBI notified the rules related to the continuous disclosure to be made by the issuers and the compliances to be adhered to.

In April 2019, the Reserve Bank of India (RBI) permitted the Foreign Portfolio Investors (FPIs) to invest in municipal bonds within the limits set for FPI investment in state development loans (SDLs). Consequently, in May 2019, the SEBI also permitted the FPIs to invest in municipal bonds. The regulatory change expands the investor base for municipal bonds and is likely to have a positive impact on the overall development of the municipal bond market in India in the medium to long-term.

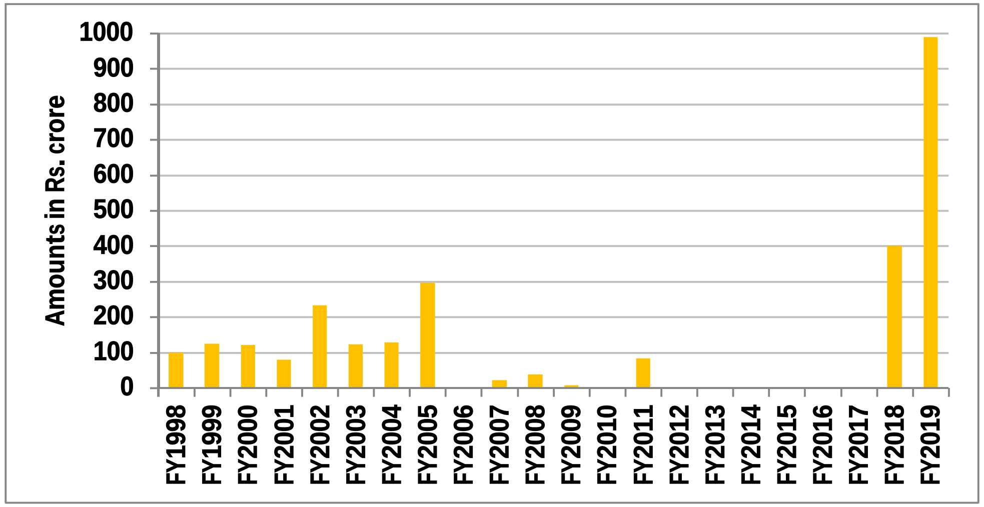
[1] The scheme was originally announced for FY2019 only.

Municipal bond market in India

The urban local bodies (ULBs) in India began their capital market access in FY1998, when the Ahmedabad Municipal Corporation issued the first municipal bond to part finance its water supply and sewerage project. The Indian municipal bond market, however, had remained quite shallow for around two decades, with only a nominal sum of around Rs. 1,353 crore (till FY2017) having been raised by the various ULBs, municipal utilities (water supply boards) and state pooled finance entities from the capital market.

However, a significant improvement has been witnessed in the Indian municipal bond markets in recent years. During FY2018-2019, seven ULBs raised Rs. 1,390 crore through eight municipal bond issuances. The improvement is attributed to the issuance of fresh regulations for municipal bonds by the SEBI in July 2015 and an increased push from the Government of India (GoI) to the ULBs to raise funds from the capital market to fund their urban infrastructure requirements. The GoI's commitment to the same was also reflected by the announcement of an incentive scheme to the ULBs for issuing municipal bonds. While the Andhra Pradesh Capital Region Development Authority (APCRDA) also issued bonds (five issuances) and raised Rs. 2,000 crore in FY2019, the same was not classified as municipal bonds because of APCRDA's ineligibility to be termed an issuer, under the municipal bond regulations. However, APCRDA was successful in getting an incentive from the GoI. Including APCRDA's issuances, the total amount raised through municipal bonds stands at Rs. 3,390 crore during the last two years.

Exhibit 1: Municipal bond issuances in India till date



Source: ICRA research; Excluding APCRDA issuances

KEY AMENDMENTS IN THE MUNICIPAL BOND REGULATIONS

(A) Expansion in scope of regulations to other entities involved in municipal functions

The regulations prior to the amendments applied to a ULB or a corporate municipal entity, which is a subsidiary of a ULB. Post latest amendment, urban development authorities as well as other entities, which are involved in municipal functions listed in the Twelfth Schedule (refer Box 1) of the Constitution of India have become eligible to issue municipal bonds. Additionally, the state pooled finance funds/entities (for financing urban infrastructure) and the SPVs established under the Smart Cities Mission have also been included in the definition of an issuer. The expansion if the definition will increase the number of entities wishing to issue municipal bonds, which is a positive for the size of the municipal market.

Box 1: Twelfth Schedule of the Constitution of India

Twelfth Schedule (Article 243W) of the Constitution of India as per the Constitution (74th amendment) Act, 1992 lists the following functions and duties of an urban local body:

1. Urban planning including town planning
2. Regulation of land use and construction of buildings
3. Planning for economic and social development
4. Roads and bridges
5. Water supply for domestic, industrial and commercial purposes
6. Public health, sanitation conservancy and solid waste management
7. Fire services
8. Urban forestry, protection of the environment and promotion of ecological aspects
9. Safeguarding interests of weaker sections of society, including the handicapped and mentally challenged
10. Slum improvement and upgradation
11. Urban poverty alleviation
12. Provision of urban amenities and facilities such as parks, gardens, playgrounds
13. Promotion of cultural, educational and aesthetic aspects
14. Burials and burial grounds; cremations, cremation grounds and electric crematoriums
15. Cattle pounds; prevention of cruelty to animals
16. Vital statistics including registration of births and deaths
17. Public amenities including street lighting, parking lots, bus stops and public conveniences
18. Regulation of slaughter houses and tanneries

Source: ICRA research

(B) Changes in norms related to accounting, audit and disclosure of financial statements

Accounting Standards:

With the inclusion of other entities in the scope of regulations governing municipal bonds, the accounting standards/policies to be followed by an have also been amended as follows:

- Urban Local Bodies – National Municipal Accounting Manual (NMAM) or State Municipal Accounting Manual (SMAM)
- Corporate Entities – Accounting standards as prescribed in the Companies Act, 2013
- Other Government Entities – Accounting standards/policies, specified in their respective statute of incorporation/establishment

Audit and Disclosure:

Earlier, the regulations required accounts to be audited by an auditor appointed by a ULB as per the respective municipal act. Additionally, the timelines for submission of unaudited half yearly accounts to the stock exchange (SE) and the debenture trustee (DT) was three months from the end of the respective half year. Also, the annual financial results were required to be submitted to the SE and the DT within six months from the end of the financial year.

After the amendments, the revised requirements are as follows:

- Appointment of an auditor by the Comptroller and Auditor General of India (CAG) for the entities that have the CAG as their statutory auditor
- Submission of annual financial results as audited by the CAG-appointed auditor within two months from the end of the financial year
- Submission of CAG-audited annual financial results within nine months from the end of the financial year
- Submission of unaudited financial results for the half year within 45 days from the end of first half year, which is in line with the prescribed timeline for corporate issuers with listed debt securities and/or equity shares

(C) Modifications in provisions related to debt-servicing mechanism of bonds

Before the latest amendments, the regulations required the creation of a separate escrow account for debt servicing, which was to be mandatorily audited by an auditor appointed by the ULB. Now, the regulations require specific escrow accounts to be created and maintained by the issuer and monitored by a debenture trustee. The specific escrow accounts required as per regulations are as follows:

No-Lien Escrow Accounts: All the revenues of the issuer as mentioned and detailed in the offer document/private placement memorandum, should be deposited to this account and must be available for timely servicing of debt obligations.

Interest Payment Account: Throughout the tenure of the debt securities issued, at least an amount equivalent to two interest obligations is to be kept in this account. The equivalent amount is to be transferred from the No-Lien Escrow Account to the Interest Payment Account.

Sinking Fund Accounts: The principal amount, due for repayment, is to be periodically transferred to this account, in proportion to the tenure of debt securities issued. The amount is to be transferred from the No-Lien Escrow Account to the Sinking Fund Account.

General Accounts or Municipal Fund: All funds set aside for general purposes of the issuer and any surplus remaining in the No-Lien Escrow Account is to be transferred to this account.

Project Escrow Funding Account: In case of the issuance of municipal bonds to fund new projects, an issuer must create a separate Project Escrow Funding Account in which the issuer shall deposit at least 20% of the project cost before the commencement of the project.

All the specific accounts to be created by an issuer, except for the General Account or Municipal Fund, must be supervised by a debenture trustee. The issuer will disclose balances in all the specific accounts on a quarterly basis along with the notes pertaining to transfers, on its website. After the necessary transfer of required funds from the No-Lien Account to the specific debt-servicing accounts, the balance in the No-Lien Account may be transferred to the General Account or Municipal Fund, subject to receipt of a certificate from the debenture trustee. Also, the regulations now specifically mention the appointment of a SEBI-regulated debenture trustee for all issuances.

While amending the regulations, the following requirements have been removed by SEBI:

- Appointing an agency to monitor the earmarked revenue in the escrow account in case of revenue bonds
- Obtaining a viability certificate or a detailed project appraisal report (DPAR) before filing the offer document in case of a public issue
- Establishment of a separate project management cell for project monitoring
- Maintenance of 100% asset cover and specification of resources in whose favour charges can be created by the issuer
- Guarantee from the state/Central Government or a structured payment mechanism in case of unsecured debt securities
- Requirement related to the trading lot for privately placed debt securities

(D) Other Changes

Requirement for an in-principle approval of stock exchanges has been mandated for issuance of debt securities on a private placement basis, which are proposed to be listed. Also, a limit of two hundred persons to offer debt securities through a private placement basis in a financial year has been mandated.

IMPACT ANALYSIS

Municipal bond issuances to increase in FY2020

The expansion in the scope of the regulations will increase the number of eligible entities for issuance of municipal bonds. The entities, which would become eligible, are urban development authorities, water supply and sewerage boards, solid waste management entities, slum development boards, etc. Moreover, special purpose vehicles (SPVs) under the Smart Cities Mission (SCM) and state pooled finance entities (SPFEs) will also be eligible to issue municipal bonds. With the increase in coverage of the regulations to a large number of entities other than ULBs as well as the extension of the incentive scheme, the number of issuances during FY2020 is likely to increase as against a total of eight issuances during the last two years. The first municipal bond issuance in FY2020 has been made recently by the Greater Hyderabad Municipal Corporation (GHMC) for Rs. 100-crore. Additionally, three more entities are reportedly in the final stages of issuing municipal bonds worth Rs. 600-crore during FY2020 (Rs. 200-crore by Lucknow Municipal Corporation, Rs. 150-crore by the Ghaziabad Municipal Corporation and Rs. 250-crore by the Pune Metropolitan Region Development Authority).

While the accounting standards for the ULBs were mentioned in the original regulations, the accounting standard requirements for the newly added entities, which are involved in municipal functions, have now been added in the regulations. Additionally, the disclosure timelines of financial statements by the issuers have been largely aligned with those for corporate bonds. A separate process has been prescribed for the entities (mostly ULBs), for which the statutory auditor is the Comptroller and Auditor General of India. In such cases, a CAG-appointed auditor would conduct the first level audit of the issuer's financial statements, followed by a subsequent audit by the CAG. Considering a longer time required for the completion of CAG audit and criticality of audited financial statements to investors, the new process in ICRA's opinion would address the issue and therefore is a positive step from investors' perspective. However, it is unclear if the same regulation would be also applicable for the entities, in which the statutory auditor is the local audit department of the respective state government.

Overall, ICRA believes that the recent measures taken by the SEBI and the GoI would provide a conducive environment for the development of a healthy municipal bond market in India. The expansion in the scope of SEBI regulations to include all entities involved in municipal functions would enable the newly added entities to tap municipal bonds, a new funding source for them, to fund various urban infrastructure projects. Additionally, the recent amendments address a number of other concerns, especially those pertaining to disclosure norms and debt-servicing mechanisms, which can potentially boost the confidence of investors and augment the availability of finance for urban infrastructure through municipal bonds.

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