WORLD BANK GROUP

Pooled Municipal Bond Issuance in Tamil Nadu (India)

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Summary Overview

Location: Tamil Nadu, India, South Asia

Approach to Blended Finance: The Water and Sanitation Pooled Fund (WSPF) in Tamil Nadu issued a pooled bond to facilitate access to long-term domestic capital markets for small and medium Urban Local Bodies (ULBs) to finance water and sanitation services.

This enabled a grouping of 13 ULBs to overcome high transaction costs and mobilize funds through a single bond issuance. Debt was repaid from project cash flows and from general ULB revenues. A multi-layered credit enhancement package was designed in order to extend the maturity of the bond and increase investor confidence. The different credit enhancement mechanisms included a debt service reserve fund capitalized by the state government, creation of individual ULB escrow accounts, a local debt service reserve fund, a State revenue intercept mechanism, and a partial credit guarantee from USAID.

Public Disclosure Authorized

Context

In the 1990s and early 2000s, reforms in India helped create opportunities for financing capital infrastructure for water and sanitation. Reform efforts included facilitation of private sector investment and increased autonomy awarded to municipal governments, known as Urban Local Bodies (ULBs), in India. In parallel, growth in the local debt markets meant that local debt became an attractive tool for reducing the financing gap in the sector, particularly for ULBs.

In 1996, the State of Tamil Nadu, the World Bank, and USAID set up the Tamil Nadu Urban Development Fund (TNUDF). The Fund was established as a public-private partnership for the purpose of attracting private domestic financing for different types of infrastructure investment. However, the TNUDF primarily serviced large ULBs with dependable revenues. Many of the small and medium sized municipalities tended to be excluded from accessing financing via the TNUDF. Bond issuance fees, legal costs, and an inability to get a credit rating prevented small and intermediate local governments from accessing capital markets. In addition, sanitation and water were among the most neglected areas of public infrastructure provision.

To address these shortcomings, the State Government of Tamil Nadu (GoTN) created a pooled entity the Water and Sanitation Pooled Fund (WSPF). The WSPF functions as a special purpose vehicle to specifically help small urban local bodies finance their water and sanitation services by raising capital market resources on a pooled basis.

Financial Structure and Approach to Blended Finance

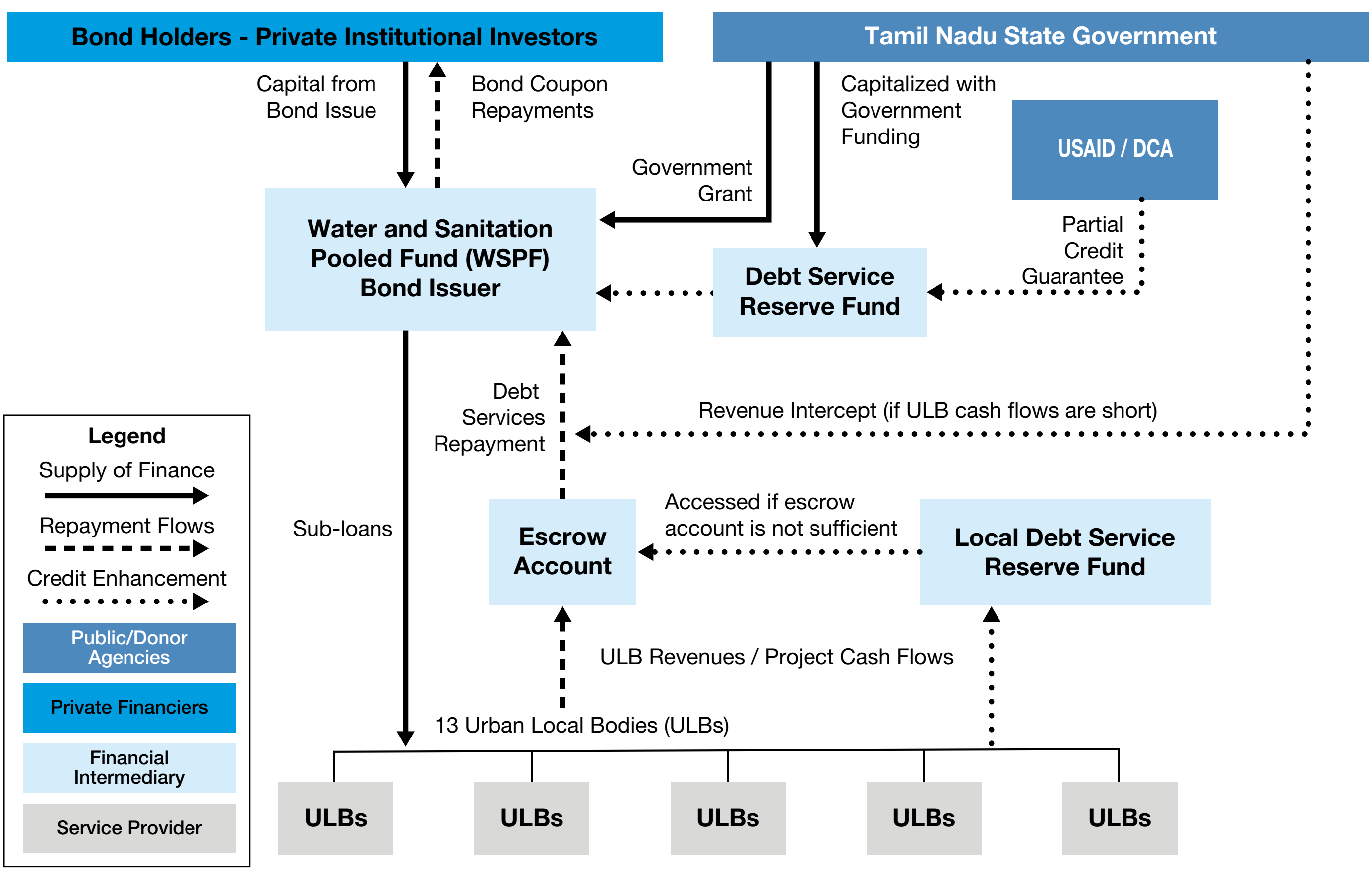
An early WSPF pooled bond issuance took place in 2002, to facilitate access to domestic capital markets for 13 small and medium ULBs. The selected local bodies were mixed in terms of financial strength, but all had in common that they were unable to issue a municipal bond on their own. The bonds were issued by WSPF, and the proceeds were then lent back to the 13 local governments as sub-loans to finance their infrastructure projects.

The pooled bond issuance for the 13 municipalities and town panchayats took the form of a structured debt obligation for Rs. 304.1 (US$6.2 million). The bond was AA rated, and had a coupon of 9.2 percent per annum and a maturity of 15 years, with put and call options after ten years. These options acted as a safeguard for investors by offering them the opportunity to take their money out prior to the end of the bond lifespan. The ULBs paid back their WSPF debt obligations from project and municipal revenues, including water tariffs and from interest earned on the money deposited from connection fees.

WSPF bonds were unsecured, but a multi-layered credit enhancement mechanism was put in place, which was instrumental to the fund's success. Figure 1 shows the blended financial structure with credit enhancements.

The state government of Tamil Nadu capitalized a debt service reserve fund (DSRF) with an amount close to 1.5 times the annual principal and interest payments. Approximately US$1.42 million was assigned to the fund, and helped generate investor confidence through the assurance that the fund could pay creditors if the municipal borrowers were unable to meet scheduled repayments.

FIGURE 1 Pooled Municipal Bond Issuance in Tamil Nadu, India: Financial Structure



A second level of enhancement was created by legally requiring the 13 participating local governments to establish an escrow account and make deposits into it so that their annual debt service obligations to WSPF was paid in early. Municipal revenues from property tax and other tax collections, as well as project revenues, were the source for funds deposited into this account. A third level of enhancement was added with a local debt service reserve fund, which received contributions amounting to 5 percent of the principal amount borrowed by each ULB. That account could be tapped in the event that revenues in the debt service escrow were not sufficient. A fourth layer of enhancement included the ability of the WSPF to intercept State revenue transfer payments.

Finally, a partial credit guarantee was provided by USAID on the WSPF's debt service reserve fund. The guarantee would help re-supply 50 percent of the principal amount of a default paid for by the debt service reserve fund (DSRF). In that case USAID, would be reimbursed for its guarantee payment by the GoTN, while all other funds used from the DSRF would be reimbursed by deducting moneys from the defaulting ULB's individual State revenue transfer payments.

Results

The WSPF helped spread credit risks and pool the ULBs' resources to meet funding requirements for market access, thereby achieving economies of scale in the process. The proceeds from the pooled bond issuance were disbursed to ULBs in 2003, and the majority went to refinance outstanding loans at lower interest rates for previously completed water and sanitation projects. The WSPF issuance for this initial bond set a model for future pooled bond use. It was well structured from a credit perspective and achieved a very high AA rating, which enabled it to be sold.

In Tamil Nadu and Karnataka state, similarly structured bonds have since been issued. In Karnataka, a special purpose entity, the Karnataka Water and Sanitation Pooled Fund Trust (KWSPF), was established in 2003. The KWSPF was intended to facilitate market access for eight local governments. In 2005, it succeeded in issuing a 15-year bond to support the Greater Bangalore Water Supply and Sewerage Project. As was the case for WSPF, a USAID partial credit guarantee for 50 percent of the principal was an important feature of the transaction.

Lessons Learned

The Tamil Nadu pooled fund demonstrated that grouped financing vehicles can play a critical role in attracting repayable finance to small- and medium-sized water and sanitation service providers. However, development of the structural components for setting up such entities is time and resource intensive, which has undoubtedly contributed to the fact that few other such funds have been set up so far.

A supportive environment for municipal finance facilitated the use of effective credit enhancements in the transaction, which lowered the risk for commercial financiers. Participating ULBs were legally required to establish an escrow account and there was a State revenue intercept mechanism.

Credit enhancement mechanisms require explanation, when they are new to a market. The first pooled transaction suffered from insufficient and inadequate marketing. Investors did not fully understand the transaction and the guarantees provided, as the financing mechanism was new to the market. Once properly explained, the bond sold well. Likewise, the revenue intercept mechanism was used once for one of the local borrowers because of a repayment problem. This proved that such a mechanism could work, but it took a long time for WSPF staff to implement, since it was the first time that such a mechanism was used, and it involved multiple governmental agency approvals.

Sustainable issuance is important for longevity of a pooled financing initiative. After the first issue, the WSPF did not issue another bond again for several years. Its CEO was hired by a development bank and the senior staff were heavily recruited to banks and rating agencies, depleting its expertise and momentum. This lack of sustainable issuances created a lack of liquidity for the WSPF bonds, and risked making them more expensive.

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This case study is part of a series prepared by the World Bank’s Water Global Practice to highlight existing blended finance experiences in the water sector.

Blended finance refers to “the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets,” as per the OECD definition (WEF OECD, 2015). Concessional funds can be used in a catalytic manner to open up new opportunities for commercial financing, by providing technical assistance to borrowers and lenders to help them become more familiar with each other, help structure transactions, provide credit enhancement mechanisms, etc.

Private capital flows can help with meeting immediate financing needs for investment in the water sector but ultimately need to be repaid. Repayable financing from private sources to the water sector can come in various forms, including as commercial bank loans, bonds or equity. To obtain such financing, water-sector actors need to be able to repay the borrowed amounts and the associated funding costs, which means that they need to be deemed “creditworthy” by providers of finance.

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