Financing Urban Infrastructure in Small and Medium Towns –
Pooled Bonds as an Instrument of Financial Inclusion

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Context

As per the estimates of the Ministry of Urban Development the Urban Local Bodies (ULBs) in India require cumulative capital investments of Rs.39.2 lakh crore over the next 20 years in order to address prevailing urban infrastructure and service gaps[1].

The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) provides assistance to ULBs in the states to the extent of 35-90% of the cost of projects being approved under this mission. However, ULBs face constraints in meeting the remaining part of the cost of such projects in view of their limited financial resources and the absence of a domestic market for long term municipal debt. Grants from the State Government and loans from the State nodal agency are currently being provided to partially bridge this gap. However, with an estimated Rs.1 lakh crore worth of projects having been sanctioned since the inception of the JNNURM, this alternative is also reaching its limits.

The challenge before the Government of India is to find the resources to fund the massive infrastructure requirements of the urban sector. Even if the Government were to somehow mobilize its share of funding, it is inconceivable how ULBs, particularly the small and medium towns, could bring in their contribution under the existing arrangement without taking recourse to a substantial increase in property tax, which is the principal source of ULBs' own revenue, or a manifold increase in tariffs for services, both of which are politically sensitive options.

On the other hand, thanks to a healthy growth rate in the GDP and the high domestic savings rate of our economy, there is enormous opportunity to tap the financial market for meeting ULBs' funding requirements. This has been tried out with some success in the past by states like Tamil Nadu, Karnataka and Gujarat, through the issuance of municipal bonds, which is well documented. However, the total amount of capital raised so far through this route is a paltry Rs.1,200 crore[2], and most

[1] HPEC Report on Indian Urban Infrastructure and Services; March 2011.
[2] Source: IDFC

of the standalone local body bond issues are those of larger cities. Consequently, the market for municipal bonds in India is almost non-existent, unlike in countries such as the US where this is the principal mode of financing urban infrastructure.

Drinking Water State Revolving Fund

Many public water systems find it difficult to obtain affordable financing for infrastructure improvements which would enable systems to comply with national primary drinking water standards and protect public health. Recognizing this fact, US Congress established the Drinking Water State Revolving Fund (DWSRF) as part of the 1996 Safe Drinking Water Act (SDWA) Amendments. The goal of the program is to provide States with a financing mechanism for ensuring safe drinking water to the public. States can use federal capitalization grant money awarded to them to set up an infrastructure funding account from which assistance is made available to public water systems. Loans made under the program can have interest rates between 0 percent and market rate and repayment terms of up to 20 years. Loan repayments to the State will provide a continuing source of infrastructure financing into the next century. The program also places an emphasis on small and disadvantaged communities and on programs that emphasize prevention as a tool for ensuring safe drinking water.

Source: United States Environmental Protection Agency, Office of Water (4606), EPA 816-F-00-028, November 2000

Over two decades ago, the US was also faced with a similar predicament of having to raise resources at the local government level for complying with the environmental standards for air and water. With limited federal dollars on hand, the Government decided to take recourse to leveraging its resources to tap the capital market. The Clean Water Act (1987) and the Safe Drinking Water Act (1996) provided for State level financial intermediaries and thus State Revolving Funds (SRF) were established through statute so as to pool the capital requirements of local governments (read local bodies) to establish critical long gestation infrastructure like water / wastewater treatment and conveyance systems, apart from using the proceeds for short term cash management and debt swap. Retail investors and their proxies, viz. mutual, pension and insurance funds have been the main subscribers to such pooled municipal bonds as they have traditionally looked at long term investments with tax-free returns. The municipal debt market is the 4th largest debt market in the US after mortgages, Government securities and corporate bonds. An estimated 87,500 state and local governments in the US have thus borrowed money from the municipal bond market using the pooling structure of SRFs and created assets worth $2.4 trillion (till 2006).

The basic premise behind the pooled bond structure is that by combining program equity with a pool of loans, the risk of a single borrower loan default causing a bond default is reduced. The more the size and diversification of a pool increases, even with the inclusion of smaller and less creditworthy borrowers, and the more the concentration of the largest participants decreases, the more the default risk is

spread, thereby improving the creditworthiness of the pool and lowering the cost of funds. The structure provides four key benefits:

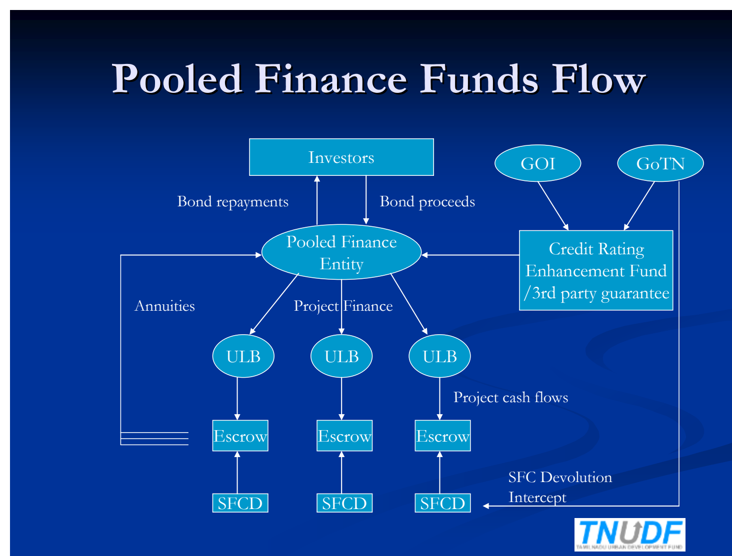
1. Each individual borrower has access to the capital market at a much lower interest rate than it would otherwise get if it borrowed on its own.
2. Transaction costs are spread among participants, providing a further efficiency
3. Resources once used to fund grants can instead be used to make subsidized loans, spreading the resources to a larger group of beneficiaries.
4. Bonds used to finance loans can receive higher ratings than those of the underlying borrowers due to pool diversity and program equity.

India presents a similar opportunity to tap into the growing pension, insurance and provident funds to fund urban infrastructure. To avail of it, however, certain structural issues need to be addressed first. To begin with, it has to be realized that debt financing is a more efficient mode of capital delivery to urban sector projects as it brings an element of discipline. With an obligation to repay, ULBs are compelled to judiciously plan, design and execute projects that can maximize revenues, while minimizing O&M costs in a sustained manner throughout the asset life span. Unbridled grants, on the other hand, tend to encourage profligacy. Thus, the present model of grants driving projects, which unfortunately may have afflicted programmes like the UIDSSMT, has to be modified to ensure that the funding agency continues to have a vested interest in monitoring outcomes over the project lifecycle. The extant guidelines do provide flexibility to the state nodal agency to pass on JNNURM grants as loans to ULBs, but in the absence of any commitment on their part to ensure a rational debt-grant mix according to the project viability and ULB's financial status, most states continue to extend assistance to local bodies of a category on a one-size-fit-all mode.

If JNNURM needs to get more bang out of its buck, it may consider compulsorily leveraging GOI's contribution to raise debt from the capital market to fund urban projects. The states may continue providing matching funds for such projects, which would again have to be leveraged. However, part of the JNNURM corpus may be set apart for providing need based grants, but strictly by way of viability gap

funding, especially for low income ULBs or for projects that demonstrably benefit poor communities.

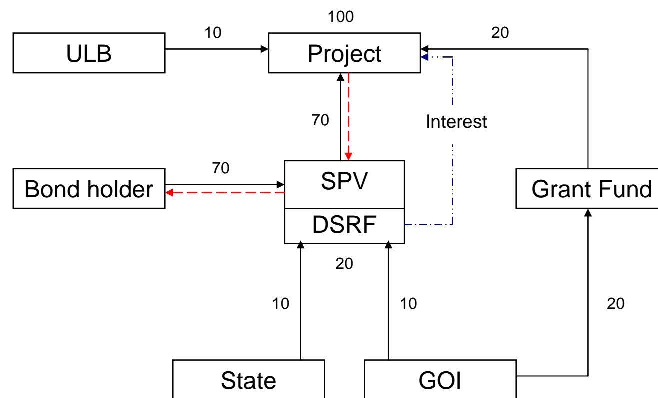
At the same time, GOI needs to proactively develop the municipal bond market. Having identified the principal players who may have an appetite for such instruments, it may engage with them to understand their concerns. The recent experience with tax-free pooled bonds, especially under the Pooled Finance Development Fund (PFDF) Scheme, should be closely studied to address market concerns and the concept modified so as to attract more investors. Recommendations of the Tamil Nadu Urban Development Fund (TNUDF), the State Pooled Finance Entity (SPFE) for the state of Tamil Nadu, after the first and perhaps the only issue of tax-free pooled bonds under the new scheme, merit consideration. A schematic diagram of the pooled bond structure as exists at present is given below:



One of the principal recommendations emanating from this experience is to open the scheme to taxable bonds, without any cap on the coupon rate, in line with market expectations. Others include declaring such bonds as either SLR equivalent paper or qualifying under priority sector norms in order to encourage banks to participate. There are certain other suggestions relating to taxation and interest subvention that also require to be looked into.

In this context, the following alternative supply side financing model is proposed under JNNURM.

Accessing External Financing – A Possible Approach



Leveraging GOI/State funds for external project financing

1. The core idea is to create a Fund structure where GOI and State funds under JNNURM are used as a combination of equity and junior debt to leverage and access funds from the capital market, rather than be deployed as grants into the ULB projects.

2. The focus here is to use GOI/State funds to create a vehicle for raising external resources to meet the financing gaps for ULB projects in a sustainable manner.

3. A key benefit in creating such a vehicle will be to ensure that public resources are more effectively used for creating urban infrastructure within the country, besides the establishment of financial intermediaries that encourage the injection of external capital to finance urban infrastructure.

4. The proposed approach would complement JNNURM by building on the initial experience of the Pooled Finance Development Scheme of MoUD and deepen the Municipal Bond market in India.

5. While, in the past, Municipal Bond schemes have tended to focus on providing a tax-free status, experience in Tamil Nadu and elsewhere shows that it may be useful to instead provide flexibility of raising resources instead through taxable bonds with no cap on coupon rate.
6. However, in order to limit the interest burden on ULBs, it is proposed to reduce the effective cost of financing even with the relatively higher cost of the external financing component, by providing interest subvention.
7. Under the proposed structure, the SPFE (an SPV) would float taxable (or tax-free, as the need may be) pooled bonds to raise the counterpart funding for a pool of ULB projects being found eligible for assistance under JNNURM.
8. Each issue of bonds would be collateralized by a suitable Debt Service Reserve Fund (DSRF) as determined by the rating agency so as to target a minimum rating, say AA. Such DSRF may be provided by the GOI/State as equity to the SPV. The interest earning on the DSRF corpus could be used to provide interest subvention on the ULB loan from the SPV that would be raising external debt at market rate through the bond issue.
9. Since the tenor of the pooled municipal bond would be decided based on marketability, typically in the range of 5-10 years, or with put/call option at suitable interval, whereas loans to ULBs may be necessarily of longer duration, say 7-20 years, asset-liability mismatch would have to be handled by the SPV either through its internal resources, including equity, or through securitization of its assets.
10. For the purpose of building the pooled municipal bond market, the GOI/State could underwrite the initial few bond issues till the SPV establishes itself or the market matures. Alternatively, in the beginning, issues could have a senior debt (bond proceeds) and junior debt (GOI/State contribution), in order to provide greater comfort to investors.
11. Bond issue proceeds would be on-lent to the ULBs participating in the pool at concessional terms, including soft rate of interest (through interest subvention using the earnings of the DSRF) and long tenor. Alternatively, the SPFE could in turn utilize the proceeds to subscribe to bonds issued by such ULBs.

12. Repayments by ULBs would be routed through an escrow account and in case of default, this would trigger an appropriate release from the DSRF to ensure timely payment to bondholders. Erosion of DSRF would be replenished by suitable intercept by the SPFE of the releases of the State Finance Commission devolution grants. In case these credit enhancement measures do not suffice, third party guarantee (such as the USAID partial guarantee for TNUDF's first pooled bond issue), say by the State Government, could be resorted to.
13. The SPV at the state level may be created jointly by GOI, State and select financial institutions such as IIFCL and IDFC that are mandated to invest in urban infrastructure. The SPV would be managed on behalf of the stakeholders by a financial intermediary, which may be in the nature of a PPP with GOI/State holding not more than 49% equity so as to give it a private fund manager status, which would enable it to attract talent from the market. However, for coordination purposes and to ensure greater credibility, it may be ideal if the financial intermediary is headed by an officer of the State Government on deputation for a fixed tenure of not less than, say, 3 years. The detailed modalities of setting up SPFEs at State level are already contained in a toolkit prepared by the MoUD under the PFDF scheme.
14. The SPV could float a dedicated issue for a group of ULBs in a state, pooling together their requirements for identified projects. These could either be developed projects awaiting financial closure or projects already pre-financed by other entities during the construction phase.
15. The SPV can kick start a consistent and a regular stream of issues to raise capital periodically and such issuance can follow appraisal of existing / proposed shelf of projects including an analysis of project viability and debt servicing / financial strength of the sponsoring ULBs. As repayments from earlier bond issues start coming back from ULBs and bond instalments are paid, the equivalent portion of DSRF could be freed up, and go towards strengthening the next bond issue. This would further collateralize the pooled bonds and improve the issue and the SPFE's rating and consequently reduce the cost of borrowing from the market. At some point of time, the SPFE may become sufficiently capitalized so that GOI/State may not need to provide any support, except targeted capital grants for hardship communities.

16. A range of project pooling, structuring and payment security options, such as those suggested above, need to be examined and developed to manage and mitigate risks and meet debt servicing and rating expectations of potential investors for such issuances.
17. Needless to say, this would also require the financial intermediary (SPV) to have project structuring and appraisal skills as well as capabilities in financing and raising funds from capital markets. With its experience of more than a decade of successful non-guaranteed financing, Tamil Nadu Urban Infrastructure Financial Services (TNUIFSL), which has the requisite experience in handling pooled municipal bonds on behalf of TNUDF/WSPF and has been recommended by GOI to the states, is a potential candidate to train SPFEs to adopt this role. Similarly, the Karnataka Urban Infrastructure Development Finance Corporation (KUIDFC) is another resource in this regard. However, in case entities like IIFCL and IDFC are brought in as promoters of SPFEs, they can provide the initial skill-sets to handle sophisticated financial tools.
18. The recommendations made by TNUDF /WSPF after the first and only tax-free pooled bond issue under the PFDF scheme (see Annex) merit consideration by the Government of India.

The above concept builds on the philosophy of the need to access and raise external means of financing for urban projects, preferably in a non-guaranteed mode, and the recent initiative of TNUDF to create a Master Financing Indenture for pooled financing of urban projects with KfW assistance. However, this idea, when combined with the assistance available under JNNURM makes this more practicable. However, pooled financing offers certain challenges, as enumerated below:

- Need for legislative sanction in order to give statutory footing to SPFEs, on the lines of SRFs in the United States would be necessary. Similarly, environmental legislation on the lines of the Clean Water Act and the Safe Drinking Water Act would compel ULBs to hasten the creation of water and sanitation infrastructure, which would provide the right impetus to the pooled bond mechanism by unleashing demand for funds.

- Development of a sound programme structure for the pooled financing mechanism, which would address issues such as whether the SPFE would sub loan to ULBs or subscribe to the latter's bonds; whether the GOI/State contribution would be the equity piece for the DSRF or would constitute junior debt, etc.
- Implementation tools need to be developed, which would include toolkits and standardized documents for bond issues, loan agreements, project covenants, project monitoring and so on.
- Capacity building at National, State and ULB level, so that implementation agencies are equipped to handle the transition to such new forms of market financing. The rich experience of entities in the US, notably the SRFs, bond banks, underwriters and rating agencies, could be tapped in the initial phase.
- Education of all stakeholders, such as investors, underwriters, rating agencies, lawyers, etc. about the pooled financing mechanism as it is a nascent market; this could take the form of conferences, newsletters and publicity material.
- Support, especially at the policy level, for establishing SPFEs in States (something that has not yet materialized, except in a couple States) and rolling out the pooled bond programme.
- Loan tracking system and customer service support will be crucial to the sustenance of the model.
- A separate Grant Fund to be set up to handle hardship grants / viability gap funding and to be administered at the SPFE level on rational principles.
- Project Development is critical to any such programme and for this, investments by the SPFE through a dedicated Fund may be required.
- Innovative instruments like bridge financing (to insulate investors from construction risk) and take out financing (to handle asset liability mismatch) may have to be explored.

Given the massive requirements of capital investment, it is a very opportune moment for the Government of India to pursue this structure and approach to provide scaled-up finances for urban infrastructure development in the country. However, equal importance needs to be given to the demand side of the municipal finance market. ULBs face serious constraints in their ability to absorb and utilize funds in a timely manner. Capacity building at State and ULB level has to go hand in hand with other municipal reforms. A new breed of city managers who are adept at project financing and project management needs to be created, possibly through close involvement of training institutions.

It has been suggested that public private partnerships (PPP) may be an effective medium of addressing this capacity constraint in the ULBs. Unfortunately, not much success on this score has been noticeable in the urban infrastructure sector, except for a few isolated initiatives that could not be replicated elsewhere. One reason for such low penetration of the PPP model could be the absence of laws or policies that promote private sector participation (PSP) in most States. Others include the usual capacity constraints as well as the unwillingness of ULBs / parastatal agencies to share risks with the private sector while structuring PPP contracts. Given the experience of PPP projects in ULBs so far, it is difficult to foresee in the near future any substantial participation by the private entities in ramping up urban infrastructure or delivery of services, except in the nature of the usual EPC contracts.

In this context, urban India may have to, for a long time, live with the scenario of public sector investments in and creation of urban infrastructure, as well as delivery of civic services. Pooled financing, therefore, appears to be the only way out to raise the necessary resources and creation of infrastructure in a sustained manner. However, unless demand side issues are addressed, any amount of supply of capital may not suffice. This is discussed in the next section.

Sustaining Debt – Unlocking Land Value

The most critical but neglected area in the urban finance sector is the debt sustainability of ULBs. Given the limitations in exploiting traditional revenue modes such as taxes, fees and tariffs, if ULBs are to cumulatively absorb on an average Rs.1 lakh crore every year, most of it in the form of debt, and if there are serious

impediments in structuring successful PPPs in infrastructure creation and service delivery (as has been the experience so far), then we need to look at other options to generate revenue, such as by unlocking the value of land.

Since most ULBs have very limited commercially exploitable lands, and since sale of family silver is not a sustainable proposition, a more feasible way of appropriating value resulting from better infrastructure and service delivery is by imposition of betterment levy on lands situated in areas that benefit out of investments in urban infrastructure. This has to be made a pre-condition for accessing GOI assistance and can become part of the mandatory JNNURM reform agenda. Thus, if a town introduces a new sewerage system, for instance, it should be incumbent upon it to assess the impact on land values post implementation and, thereafter, impose a betterment levy on all lands, subject to guidelines, in the benefited area, for which necessary provision may be made in the State municipal laws.

Such betterment levy may ideally be linked to the area guideline value / circle rate and guided by the capital cost of the optimal infrastructure and the economically feasible maximum tax rate. Such levy may be, for obvious reasons, deducted from capital gains calculations. It may be collected as a one-time recoupment by the ULB at the time of seeking planning permission by the owner of the land. Additionally, it may have a recurring component (say 2% of the one-time betterment levy) collectable every year for maintaining the assets created from all occupiers of the lands that benefit from the creation of infrastructure in the area.

The other way of unlocking the intrinsic value of land is to apply the tools of town planning, on the lines of the Gujarat Town Planning Schemes. Typically zonal Detailed Development Plans (DDP) should follow the Master Plan of any city. The DDP is basically a land use zoning plan on a micro level, which also spells out the infrastructure requirements that need to be planned for. Unfortunately the City Development Plans (CDPs) that are currently being prepared by cities, with the help of consultants, as a pre-condition for accessing finance under JNNURM are largely investment plans that do not explore the possibility of raising revenues from land through re-zoning or re-development.

Ideally speaking, the TPS model should be applied to all cities under JNNURM to redevelop areas by pooling and redistributing land after providing for adequate

social infrastructure. Initial finance for funding the hard elements of such infrastructure could come from JNNURM. Subsequent value appreciation of land could be partly expropriated by the ULB to repay the contracted debt, either by reserving commercially exploitable land for itself within the redeveloped area or by the imposition of a suitable levy.

Hence, town planning has to necessarily become an integral part of city development under the JNNURM scheme of things. City managers must, by corollary, also be trained in urban planning. Reform agenda has to obviously move to the next level, viz. empowering city governments with planning functions, which presently vest with either the Town and Country Planning department or the Local Area Development Authority. Of course it has to be a progressive delegation, starting perhaps with the larger agglomerations covering the JNNURM cities and later going to smaller towns.

In this context, it may not be out of place to state that in the next phase, regional planning is essential to cover small and medium towns. Only when city development plans are in sync with the Regional Plan will maximum benefit accrue. Invariably there are synergies in this approach. For example, common sanitary landfill site facilities make sense only if there is an integrated regional solid waste management plan, which should typically flow from the Regional Plan.

Solution Themes

Based on the above discourse, it now seems plausible that a substantial part of the infrastructure financing requirements of small and medium towns can be met by adopting the pooled financing model. The broad contours of the approach are as follows:

A. Government of India, in consultation with State Governments, to prepare a model law that enables States to establish a State Revolving Fund, initially called the State Pooled Finance Entity (SPFE), to raise market resources to fund urban infrastructure creation, principally in the water and sanitation sector.

B. Ministry of Urban Development to take a policy decision that its funds under JNNURM, along with States' counterpart financing, would be hereafter

leveraged to mobilize funds from the capital market through the statutorily established SPFE, which will be the financial intermediary between such market and the ULBs.

C. The PFDF scheme may be recast, based on the recommendations made, and become the main vehicle of investment in the urban sector under the JNNURM. The toolkits developed under the scheme may be put to optimal use.

D. While GOI would aim at a gearing ratio, say of 1:7 through the pooled financing mechanism (which means that for each rupee that GOI contributes to the SPFE as equity, the latter would raise at least seven rupees from investors), it would contribute to separately establishing a Project Grant Fund and a Project Development Fund at the SPFE level.

E. The SPFEs to be PPP entities on the model of TNUDF that need to be professionally staffed and managed with the support of promoters like the IIFCL and IDFC, who may take majority stake in the asset management company, while the GOI/State could be the principal equity holders in the SPV.

F. The SPFE to act as the state nodal agency under JNNURM, perform the role of developing, appraising and structuring projects proposed by ULBs, raise finance on their behalf from the capital market through pooled bond issues, on-lend the bond proceeds to the participant ULBs, monitor the implementation of projects by ULBs and ensure repayment of dues to investors in a timely manner.

G. GOI and States to ensure fulfilment of reforms agenda, including imposition of betterment levies, and full recovery of user charges to cover not just O&M but also debt repayment. However, in cases of hardship or poor communities, suitable grants may be given by GOI, bundled along with the loan, through the SPFE.

H. Town planning functions to be mandatorily given to ULBs so that they can prepare CDPs that suitably appropriate land values through appropriate land use zoning and detailed development planning in accordance with Master

Plans. State Town and Country Acts to be amended to provide for land pooling and reassignment in furtherance of the CDP.

I. Massive exercise to be undertaken by States to substantially upgrade the capacity of ULB officials to handle subjects like town planning, project development and financing, project management and contract management. Till such time, recourse to consultants may be permitted with the assistance of the SPFE.

J. Private sector participation in urban infrastructure and services may be the better option in certain circumstances. Using tools like the Public Sector Comparator, in use in some countries, those sub-sectors or services that are most amenable to PPP may be identified and stipulated for PSP using SPFE finance (including grants). States may be encouraged to pass appropriate law promoting PPP, for which a model draft may be circulated by GOI.

JNNURM had estimated that during 2005-12, on an average, GOI would need to invest around Rs.9000 crore every year in creating urban infrastructure. Given the growth of nearly 9% in the economy, it may not be too difficult for it to double this annual investment over the next 20 years. If 2/3rd of this is set apart for grants and 1/3rd for leveraging market capital, with a gearing of 7, as indicated above, the market for municipal debt has a potential demand of over Rs.40,000 crore per annum. Assuming that such amount can be raised in the debt market, overall around Rs.12 lakh crore, i.e. over half of the estimated requirement for urban infrastructure in small and medium towns could be mobilized from this market for the urban sector. With a sound policy framework for PPP, it is possible to substantially bridge the financing gap by involving the private sector.

To sum up, therefore, sustained investments in urban infrastructure on an unprecedented scale is conceivable, provided GOI/State funds are leveraged to attract market capital; however, to sustain such a magnitude of debt the ULBs will have to take recourse to applying town planning tools to unleash and appropriate land values, apart from carrying out the traditional reforms, including those relating to property tax and user charges. On the demand side, towns need to substantially improve their capacity to deliver on infrastructure and services, for which the

involvement of the private sector is indispensible, calling for better skills in contract management. Ultimately, such local bodies need to be vested with greater powers than what has been achieved so far, so that the level of governance is significantly improved.

ANNEX

RECOMMENDATIONS OF THE STATE LEVEL SANCTIONING AND MONITORING COMMITTEE FOR TAMIL NADU UNDER POOLED FINANCE DEVELOPMENT FUND (PFDF) SCHEME (2008)[3]

1. **Cap on interest rate:** Considering the present market conditions, the cap of 8% on tax-free instruments may be unattractive and this may be removed to allow the market conditions to fix the interest rate.

2. **Priority Sector status / recognize under SLR category for Banks:** The Government of India may, in consultation with Reserve Bank of India, grant "priority sector" status for the investment by banks in Pooled Finance Development Bonds and / or categorize these investments to be eligible under "Statutory Liquidity Reserve". This will be a more stable investment avenue for Banks. Not only that, it will act as an additional incentive for investments in these Bonds.

3. **Social Infrastructure Lending / recognize under Other Approved Securities for Insurance Companies:** The Government of India may categorize these investments under "Social Infrastructure Lending" and / or categorize these investments under "Other Approved Securities" for insurance companies in order to encourage insurance companies to invest in the tax free Pooled Finance Development Bonds.

4. **Limited amendment to Section 14 (A):** The Government of India may exempt investments made in the Tax-free Pooled Finance Development Bonds issued under PFDF Scheme from the preview of Section 14 A of the Income Tax Act, 1961. By doing so, the entire income earned on investment in Tax-free bonds

[3] Courtesy: Tamil Nadu Urban Infrastructure Financial Services, Chennai

will be exempted from Income Tax. This will encourage banks to invest in the tax free Pooled Finance Development Bonds.

5. **Taxable Bonds under PFDF Scheme with higher CREF:** In order to encourage the tax exempted entities like Provident Funds / Pension funds / Exempted Trusts to invest in Pooled Finance Development Bonds, the PFDF Scheme may allow mobilization of resources by issue of Taxable Pooled Finance Development Bonds. In such case, there will not be any revenue loss on account of tax-free status to Government of India. However, the interest rate on taxable bonds is bound to be higher then the tax-free bonds and this will be an additional burden on the ULBs. Hence, in order to compensate the Urban Local Bodies, a portion of the savings accruing to Government of India on account of non-tax free status may be passed to the State Pooled Finance Entities as an additionality to the Credit Rating Enhancement Fund (CREF).

   Considering the above, the Government of India may consider a higher CREF in the case of taxable bonds ie., at-least 20% of the issue size as CREF without any further restriction. The State Government may contribute 10% of the issue size towards CREF. The interest earned on CREF may be used to subsidize the interest rate to be charged by the SPFEs to local bodies.

6. **Capital Gains Municipal Bonds:** In order to enlarge the investor base, the PFDF Scheme may allow mobilization of resources by issue of Capital Gains Pooled Finance Development Bonds.

7. **Interest earned on CREF – Tax exempt:** At present, as per the PFDF Scheme, the interest earned on CREF is taxable and accordingly the SPFE has to pay Income Tax at the applicable rate. The Government of India may exempt the interest earned on CREF investment from income tax. This will facilitate the SPFEs to pass the interest benefit to the participating ULBs.

8. **Capital grant for formation and operationalisation:** One time Capital Grant of at least Rs.5.00 crores may be sanctioned by Government of India to each

State Pooled Finance Entity (SPFE). The interest earned on investment of such capital grant may be used to meet the initial operational expenses.

9. **Streamlining approval Process:** Approval of the PFDF Sanctioning and Monitoring Committee for a tax-free bond issue may be deemed to an approval of the Government of India, for the issuance of notification by the CBDT, which should be done within a period of 15 days. This would allow the SPFE to access the capital market at an appropriate time.

10. **Redefine CREF to address Asset Liability Mismatch (ALM):** The first issue of Tax-free Pooled Finance Development Bonds proved that there is limited market for long term bonds (15 to 20 years), but urban infrastructure requires funds for longer terms.

    Hence the tenure of the bonds has to be fixed at a maximum of 10 years (preferably 5 to 7 years). This will lead to ALM and in order to address this, CREF is to be calculated based the amount required to address this ALM. About 1/3rd of the issue size may be required as additional CREF in order to address the ALM, in addition to the present CREF, as may be ascertained by the rating agencies.