

Connecting Markets and Cities: The Case of Tamil Nadu Urban Development Fund(India)

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Background

The passing of the 74th Amendment of the Constitution (known as the Decentralization Act) by the Indian Parliament in 1992, which along with privatization and economic liberalization measures, has devolved considerable authority to the local governments in India. The local governments in India are required to gradually assume a crucial role in the delivery of social and economic services (public health, education, housing, urban development, etc), and in poverty eradication programs. As of now few local governments have taken the leads in strengthening their financial position and operational efficiency in order that they take on the unfolding developmental role thrown open by the 1992 Constitutional Amendment.

The Tamil Nadu Urban Development Fund (TNUDF) is a municipal development fund, operating in the southern Indian state of Tamil Nadu since 1996. The Fund has uniquely positioned itself as a strategic intermediary linking capital markets with development projects and capacity augmentation in the urban areas. The Fund has been widely held as a success, in connecting the hitherto inaccessible financial markets and institutions to local development projects and poverty eradication. It has brought to the fore an exemplary kind of network among various stakeholders of lenders and borrowers, that included the multilateral donors, domestic financial institutions, local governments as well as beneficiaries in development financing.

TNUDF case is unique that needs to be replicated, in the urban and semi-urban areas of developing countries needing investment in social and economic infrastructure. The Fund has the potential to revolutionize the concept of development financing and empowering local communities, and could serve well as an effective tool towards the fulfillment of **Millennium Development Goals**. The multilateral donors, who seek to target and empower poor communities to

improve participation and local service delivery would prefer such development fund concept in their objectives to support decentralization drives.

The case drawn from an Indian state would have lessons for other developing countries that are following the path of decentralization and municipal reform, but lacking revenue generation at the local level to undertake expanding expenditure assignments and poverty reduction.

Case Context:

Municipal Development Funds or Social Funds usually have two important objectives: enhance the viability of local development projects through facilitating financial arrangements and project implementations, and increase the sustained access of the poor to local services and infrastructure through user participation. Operating in socio-political environment where government agencies fail to improve the living standards of the poor, these funds create suitable mechanisms for channeling resources from capital markets directly to local investments, and at the same time, empowering the local communities through their participation in the project selection, implementation and operation. The funds are often created in collaboration with an international counterpart and a local counterpart, along with the local government as equity participant. These funds provide the necessary credibility to attract private capital flows into development projects

The Tamil Nadu Urban Development Fund had its origin in the Municipal Urban Development Fund (MUDF), created in 1988 by the World Bank to fund urban infrastructure needs in the Indian state of Tamil Nadu. The successful track record of MUDF encouraged the Tamil Nadu Government to broaden its scope, and in 1996 the Tamil Nadu Urban Development Fund(TNUDF) was established. The Fund was created with equity participations from the Government of Tamil Nadu, Indian financial institutions such ICICI, HDFC, and IL&FS, and a line of credit from the World Bank. A private asset management company, called the

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Tamil Nadu Urban Infrastructure Financial Services Ltd. (TNUIFSL), has been managing the Fund since inception.

Since inception the Fund has made several innovations that were unknown in Indian local development such as fostering private-public partnerships in the creation of social and environmental infrastructure, investments through the creation special purpose vehicles (SPVs), designing credit enhancement and government guarantee in financial arrangement, raising of municipal bonds, structuring securitization for projects, channeling inter-governmental transfers as well as creating an environment for community participation.

Over 500 projects covering water supply and sanitation, roads, bridges, streetlights, solid waste plants, bus stations, and shopping complexes in 90 out of 110 municipalities in the state of Tamil Nadu have been financed by the fund. It provides grants to ULBs to (i) subsidize the capital cost of projects, (ii) provide training and technical equipment, (iii) support project preparation and implementation, and (iv) support privatization and other innovative schemes. The fund supports capacity-building activities such as computerization of accounts and training development of municipal administration to improve ULBs' management performance.

The resources of the Fund come mainly from bond issuances, and loans and grants from state and central governments, loans from the World Bank, and loans from domestic financial institutions. The Fund also augments the capacity of local projects through various forms of credit enhancements and guarantees. In 1999, the World Bank provided a \$105-million loan based on London interbank offered rate with a 20-years maturity and a 5-year grace period to the central Government to finance urban development projects in Tamil Nadu. The balance of the \$205-million project came from ULBs (\$50 million), TNUDF (\$25 million), and financial institutions (\$25 million). TNUDF mobilized about Rs1,100 millions

through bond issuance during 2001 and another Rs400 millions under the pooled financing scheme during 2002.

Municipalities, statutory boards, and state level enterprises as well as local entities are eligible borrowers from the Fund. Special recovery mechanisms such as creation of escrow accounts of property tax collection, water charges, and hypothecation of movables are generally used. Loans are blended with grants to reduce the interest cost for the smaller municipalities and for financing poverty alleviation projects for specific low-income populations.

Pooled Financing

One of the recent innovations of the TNUDF has been the “pooled financing” arrangement for financing smaller urban areas and providing guarantees to lengthen the maturity of borrowing and improve the pricing factor. Financing pools are of two types: (i) a “blind pool,” where a bond bank raises sufficient funds based on its own credit rating and then on-lends to local governments; and (ii) a project-specific pool, where several projects are pooled and lumped together in a bond issuance, thereby significantly reducing transaction costs and improving pricing.

Tamil Nadu Fund uses the second type, with several small municipalities pooled in the bond offers to finance municipal environmental infrastructure projects for smaller and less creditworthy borrowers. Under the arrangement, 14 ULBs of the state pooled some water and sanitation projects under a special purpose vehicle (SPVs) called the Water and Sanitation Pooled Fund (WSPF), and raised about Rs 300 million from the bond market at an interest of 9.2 per cent in the year 2002.

The concept very much is similar to that of state-level bond banks in the United States, where a state-sponsored financial intermediary raises finances by issuing

bonds and then on-lending to ULBs by buying their bonds. In the TNUDF structure the USAID provided a partial credit guarantee to lengthen bond maturity from 7 to 15 years (thus providing the necessary investor confidence), with possible put/call options after 7 years or, an annuity repayment mechanism. TNUIFSL, which is the asset management company for TNUDF, purchased municipal bonds and fund them by issuing its own bonds, with regular credit enhancement structures

The Indian national budget of 2002 proposed the creation of a pooled finance development scheme to help small ULBs access capital markets by issuing bonds with the credit enhancement facilities. Typically, TNUDF or the proposed pooled financing mechanisms are not just debt funds that run on commercial principles, but also bundle grants as well as loans. The funds also provide TA to build ULBs' capacity in project preparation and financial management. This experience reveals the great potential for financing numerous local governments.

Recent Projects Financed by TNUDF: Some of the recent projects undertaken by the TNUDF are as follows.

Karur Municipality Bridge:

TNUDF had facilitated the construction of the first Build, Operate, Transfer (BOT)/Toll bridge, at an estimated cost of Rs.16 crores.. TNUDF has already approved a Rupee loan of Rs.100 lacs to meet a part of



the cost of the project. The construction of the bridge would substantially reduced vehicle operation costs and time. Cash flows to the operator collected by way of tolls which were fairly large to pay for the repayment installments of loans. The provisions of the Tamil Nadu State Toll Act had to be amended allowing the

locality authority to enter into BOT projects and thereby offering investors a stable and transparent regulatory framework. The East Coast Constructions and Industries Private Limited (ECCI) received the concession on the basis of competitive bid.

Madurai Bypass: TNUDF funded the first 27 KM toll road in the state of Tamil Nadu at an estimated project cost of Rs.47 crores. The TNUDF provided the necessary finance to the Madurai Municipal Corporation for the construction of the road. The Corporation issued a 15 year bond issue at 12.25% payable semi-



annually to supplement the resources. The toll road project allowed for a major transportation facility where project benefits flow directly to Madurai Corporation, without recourse to the Corporation's cash flows. The second and third phases of the by-pass are being developed on a BOT basis, with a pledge of the revenues from phase I, making the security more favorable for private participation.

Alandur Sewage Project: The Alandur project was constructed with private sector equity (for the BOT segment of the contract) and with an up-front household participation in the financing of the project. The tariff rates were to cover the operations and maintenance (O&M) expenses, debt servicing and



sinking fund allocations. Deposits to the extent of Rs 5,000 and Rs. 10,000 have been raised from households and from commercial and industrial customers respectively and a cross-subsidy scheme in the ratio of 1:3:5 has been arrived at

for fixation of tariffs for household, commercial and industrial users, respectively. Construction of the sewerage treatment plant (STP) was done through the BOT format backed by user charges and O&M at fixed annual fees over a five year period.

Lessons Learned

TNUDF provides a unique episode financing development linking capital markets with development projects and capacity augmentation in India. TNUDF's success should encourage other state governments to design and implement the municipal financing program through special-purpose funds. We summarize the main lessons of the Tamil Nadu experience as follows:

- (i) The financing and development of local infrastructure, which were the responsibility of local governments hitherto met through budgetary allocations, have now to be met by market based funding techniques with beneficiary participation (loans and grants are blended for the poorer municipalities). This is was evident from the TNUDF experience.
- (ii) TNUDF has the distinction of bringing to one platform a number of stakeholders: governments at the levels of central, state and municipality, multilateral donor, domestic financial institutions, and private investors;
- (iii) The Fund It has been able attract private financing in the form of municipal bonds to the urban sector with innovations such as asset management company, securitization of project revenues, guarantees and debt service reserve fund.

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- (iv) The Fund has recently conducted a pooled financing arrangement whereby projects of smaller and less creditworthy municipalities are being bundled together under a special purpose vehicle and raised resources from the bond markets.
- (v) It has brought about urban sector reforms in the state such as the Tamil Nadu Urban Local Bodies Bill (which was approved by the State Legislative Assembly in November 1998) promoting greater financial and functional devolution to the municipalities.
- (vi) The Central government had announced in the Union Budget 2002 to set up a Pooled Finance Development Fund(PFDF), in line with the TNUDF, to help small and medium-sized local bodies accessing the capital market in the country.
- (vii) It has very successfully reversed the climate of vicious circle in the targeted municipalities that were due to discretionary central-state devolution systems, weak financial accountability and transparency, inappropriate user charge levels, and inefficient collection systems.
- (viii) The Fund has built significant capacity by improving the financial, managerial, administrative, and technical performance of the municipalities, and has the potential of ultimately turning them into creditworthy and well functioning entities.
- (ix) Its projects have resulted in direct and positive environmental benefits in the urban areas through solid waste and sanitation facilities, storm drainage and water supply facilities.
- (x) The Fund has established significant participatory governance, whereby City Development Strategies are undertaken through a

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consultative process involving elected officials, municipal officers, community and professional groups, business and industry representatives and government agencies.
