

## TAMIL NADU URBAN DEVELOPMENT FUND

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### 1. INTRODUCTION

- 1.1. The Urban Local Bodies in Tamilnadu (a major state in the southern parts of India) comprise of 6 municipal corporations, 102 municipalities and 43 intermediate urban centres recently upgraded as municipalities. There are also roughly 565 rural Panchayats also called Special Village Panchayats, which are in varying degrees of urbanization going by the occupation and civic needs of the settlements in these Panchayats. According to the national census conducted recently, Tamilnadu is above the all India average at 41% compared to 29% in terms of proportion of urban population to total population in the state.
- 1.2. Resources of Urban Local Bodies: The government of Tamilnadu has been contributing to the finances in these urban bodies by way of revenue and capital expenditure grants from the Budget. They were inadequate and did not comprehensively address the infrastructure creation and maintenance issues in the urban local bodies. The Constitution of India was amended (74th amendment) to provide for greater transfer of resources and functions to the urban local bodies in 1996 and the state governments were constitutionally required to allocate specific functions and resources to them by statutory means. Major resources of these urban bodies come from property taxes, profession tax, duty on registration, entertainment tax and monies devolved from taxes collected by the state by means of statutory transfers. A user charge for water supply is in vogue in many urban local bodies.
- 1.3. Expenditure Heads in ULBs: Major expenditure items in the urban local bodies are for operation and maintenance of civic assets and services, payment of salaries and allowances for staff and pensions. Many of them have contracted debt from institutions such as the Housing and Urban Development Corporation of India, Life Insurance Corporation of India etc., as well as from the state government for undertaking major investments in water supply and sanitation and solid waste management. Hence debt service is another major item of expenditure. In practice investment in creation and maintenance of infrastructure such as water supply, roads and transportation assets was quite minimal owing mainly to the paucity of grant funds from the state government and the reluctance of the private and public financing institutions in involving themselves in this line of activity.
- 1.4. Urban Development Projects in Tamilnadu: The government of Tamilnadu has been successful in associating multilateral institutions such as the World Bank in the development of the urban sector in the state and for this purpose has been willing to put in place many reform measures both for service delivery and for attracting investments in the sector. The Tamilnadu Urban Development Project – I was a major effort at addressing this issue in terms of capacity enhancement for project execution in the local bodies, financing packages aimed at cost recovery and creation of revolving fund for further project finance and initiating a financial intermediary for this purpose.

It was a logical step for the government to scale up the experience gained in TUDP-I and organize a much larger intervention in the urban sector through the Tamilnadu Urban Development Project – II which coincided with the national initiative on decentralization and democratization of the urban sector through the Constitutional amendment no 74. The project has two distinct components—an institutional development component which looks at capacity building in the urban local bodies for good governance, financial and technical administration, project execution and project monitoring and professional and transparent accounting and auditing arrangements as per accepted standards on the one hand and on the other hand a financing window for sub projects in these urban local bodies aimed at civic services improvement and ensuring access for the poor to such services. The Tamilnadu Urban Development Fund (TNUDF) is the financing window for the project and is managed by a professional company called the Tamilnadu Urban Infrastructure and Financial Services Limited (TUIFSL)

## 2. THE URBAN SERVICES AND FINANCES IN TAMILNADU

2.1. *The State Finance Commission (SFC)* - The Constitution of India mandates setting up of a statutory Finance Commission every five years once to recommend the revenue sharing principles between the state and the local bodies including the urban local bodies. Two such Commissions had been constituted so far in Tamilnadu in the year 1994 and 1999. Their award period covers the financial years 1997 – 2002 and 2002 – 2007 respectively. The third commission has been constituted with appropriate terms of reference on the 1 Dec 2004.

2.2. *Investment estimation by SFCs* - The finance commissions have not only come up with recommendations on revenue sharing between the government and various tiers of local bodies but also the financial requirements of local bodies to provide civic services based on standards arrived at in consultation with the stakeholders and the scale of finance required for the services. They have come up with likely investment outlays for various tiers of local bodies including the urban local bodies. The first finance commission estimated for Urban Local Bodies, a gross outlay of Rs.30.52 Billions.

### *First State Finance Commission---Investment estimates ( I SFC Report )*

Sl. No	Local Bodies	Requirements towards Civic services							Others	Total
		Water Supply	Sewerage sanitation	Roads	Storm drains	Street lighting	Solid waste			
		Rs.millions	Rs.millions	Rs.millions	Rs.millions	Rs.millions	Rs.millions	Rs.millions	Rs.millions	
1	Chennai Corporation	2633.6	1568.2	1749.9	1020.8	58.7	179.1	~	7210.3	
2	Other Corporation	1528.7	5404.4	542.3	1664.7	150.8	143.9	~	9434.8	
3	Municipalities	1687.8	4147.4	994.3	1572.8	168.2	259.1	~	8829.6	
4	Town panchayats	1333.9	1009.7	1533.4	491.2	199	187.6	~	5054.8	
	<b>TOTAL</b>	<b>7184</b>	<b>12129.7</b>	<b>4819.9</b>	<b>4749.5</b>	<b>576.7</b>	<b>769.7</b>	~	<b>30529.5</b>	

Note: Town Panchayats are intermediate urban local bodies and constitute a substantial number

Source: Report of the First State Finance Commission

**The second state finance commission estimated an outlay of Rs. 81.24 Billions**

SECOND STATE FINANCE COMMISSION									
INVESTMENT REQUIREMENTS (Rs.millions)									
Sl.No	Local bodies	Water	Sewerage	Roads	Storm	Street	Solid waste	Others	Total
		Supply	Sanitation		Drains	Lighting	Managmt		
1	Chennai corp	1756	956.6	1147.2	3124.9		502.2	1430.9	8917.8
2	Other corp	3306	3136.8	1960.9	4354.5	431.9	657.3	1986.8	15834.2
3	Municipalities	6733.8	3912.8	2043.7	11016	435.8	337.5	2310.2	26790.1
4	TownPanchayats	14094.1	416.7	4065.1	6844.7	1253	204.8	2829.1	29707.5
			<b>Total</b>						<b>81249.6</b>

Source: Report of the Second State Finance Commission

The Second State Finance Commission also did an analysis of the sustainable levels of investments that can be made by the ULBs keeping in mind their resource base and their committed expenditure on operation and maintenance as well as staff costs. The Commission estimated that the sustainable levels of investment would be about Rs.24.28 billions. The details are as below:

**SECOND STATE FINANCE COMMISSION  
REQUIREMENT AS PER SUSTAINABLE LEVEL OF FINANCING**

RS.Millions									
SINo	Local bodies	Water	Sewerage	Roads	Storm	Street	Solidwaste	Others	Total
		supply	sanitation		drains	lighting	Mgmt		
1	All corporations	1092.4	1077.6	2981	1749.4	208.8	691.1	1950	9750
2	Municipalities	2100	560	1500	720	390	260	970	6500
3	Town Panchayats	4030	80	800	1600	160	160	1200	8030
				<b>Total</b>					<b>24280</b>

### 2.3 Investment Assessment by TNUDF:

2.3.1 An estimate of the gap in investment outlays for essential civic services in the Urban Local Bodies was made recently as part of the ongoing exercise for a World Bank project, TNUDP III. The result indicates a potential investment outlay of Rs. 69 billions in the short term and an outlay of Rs. 120 billions in the long term. However based on the capacity of the Urban Local Bodies to finance this outlay from out of their revenues, the devolution of fiscal resources from the state government and the user charges at sustainable rates, the actual investment capacity has been estimated at Rs. 27 billions in the short term and at Rs. 70 billions in the long term. This needs to be financed out of long tenor borrowings primarily comprising of loans from government, the financial institutions and the market.

**Summary of Capital Investment Estimate for Core Civic Services - Short-Term (2004-05 to 2008-09)**

*Rs. millions*

Sl. No.	Particulars	Municipal Corporations	Municipalities	Upgraded ULBs (erstwhile TPs)	Total	%
1.	Water Supply	4538.9	7634.4	4213.8	16387.1	23.82
2.	Sewerage and Sanitation	5449.0	3874.2	284.3	9607.5	13.97
3.	Storm Water Drainage	11358.2	12504.1	5413.1	29275.4	42.56
4.	Solid Waste Management	55.0	97.8	38.7	191.5	0.28
5.	Roads and Other Road Infrastructure	2273.7	2011.7	1467.4	5752.7	8.36
6.	Streetlights	393.4	458.0	469.9	1321.4	1.92
7.	Other Services and Infrastructure	2406.8	2658.0	1188.7	6253.6	9.09
	<b>Total</b>	<b>26474.9</b>	<b>29238.3</b>	<b>13075.9</b>	<b>68789.1</b>	<b>100.00</b>
	<b>Percentage</b>	<b>38.49</b>	<b>42.50</b>	<b>19.01</b>	<b>100.00</b>	
<b>Capital Investment Estimate per Capita - Rupees</b>						
1.	Year 2003/04 Population	3130	3350	6410	3578	
2.	Year 2008/09 Population	2944	3204	6219	3402	

Source: TNUDF/TCG-INDIA-2004

**Note:** The norms for various civic services such as water supply and sanitation, storm water drainage, roads and culverts etc., have been arrived at after extensive consultations with all stakeholders. For example, in the case of water supply, the norms vary between 90 liters per capita for municipal areas to 140 liters per capita in the Chennai corporation areas.

**Summary of Capital Investment Estimate for Core Civic Services - Long-Term (2004-05 to 2023-24)**

*Rs. in millions*

Sl. No.	Particulars	Municipal Corporations	Municipalities	Upgraded ULBs (erstwhile TPs)	Total	%
1.	Water Supply	9190.4	14172.5	6612.4	29975.3	24.90
2.	Sewerage and Sanitation	7268.9	13125.1	3222.3	23616.2	19.62
3.	Storm Water Drainage	14575.5	15688.9	7013.7	37278.1	30.97
4.	Solid Waste Management	177.8	180.0	70.3	428.1	0.36
5.	Roads and Other Road Infrastructure	5034.1	6979.9	3450.8	15464.8	12.85
6.	Streetlights	1022.2	936.9	695.7	2654.8	2.21
7.	Other Services and Infrastructure	3726.9	5108.3	2106.5	10941.7	9.09
	<b>Total</b>	<b>40995.7</b>	<b>56191.7</b>	<b>23171.7</b>	<b>120359.1</b>	<b>100.00</b>
	<b>Percentage</b>	<b>34.06</b>	<b>46.69</b>	<b>19.25</b>	<b>100.00</b>	
<b>Capital Investment Estimate per Capita - Rupees</b>						
1.	Year 2003/04 Population	4847	6439	11359	6261	
2.	Year 2023/24 Population	3565	4988	8275	4708	

**Source:** TNUDF/TCG-INDIA-2004

**Note:** The norms for various civic services such as water supply and sanitation, storm water drainage, roads and culverts etc., have been arrived at after extensive consultations with all stakeholders. For example, in the case of water supply, the norms vary between 90 liters per capita for municipal areas to 140 liters per capita in the Chennai corporation areas.

2.3.2 This study has also made an analysis of the sustainable levels of investments that the Urban Local Bodies can make based on their borrowing capacities and the expected levels of devolution of grants from the state governments. The position is presented below as assessed in the study:

**Comparison of Capital Investment Estimate and Sustainable Capital Investment Estimate**

*Rs. in Millions*

Sl. No.	Category of Urban Local Body	Capital Investment Estimate	Sustainable Investment Estimate	Percentage to Capital Investment
<b>A.</b>	<b>Short-Term (2004-05 to 2008-09)</b>			
1.	Municipal Corporations	26474.9	13014.9	42.93
2.	Municipalities	29238.3	9610.4	38.20
3.	43 Upgraded ULBs (erstwhile Town Panchayats)	13075.9	4681.8	45.50
	<b>Total / Average</b>	<b>68789.1</b>	<b>27307.1</b>	<b>42.21</b>
<b>B.</b>	<b>Long-Term (2004-05 to 2023-24)</b>			
1.	Municipal Corporations	40995.7	28394.7	63.22
2.	Municipalities	56191.7	23685.6	45.48
3.	43 Upgraded ULBs (erstwhile Town Panchayats)	23171.7	18021.1	79.96
	<b>Total / Average</b>	<b>120359.1</b>	<b>70101.4</b>	<b>62.88</b>

Source: TNUDF/TCG India - 2004

2.3.3. The clear estimation of investment outlays in the local bodies especially the ULBs and the demand pulls exerted by the civic societies in the urban centres as expressed through successive elections to the councils led to the search for appropriate mechanisms for financing the outlays in different and innovative ways. The Government of Tamilnadu was clearly searching for a mechanism to leverage the revenues of the Urban Local Bodies and attract private capital into financing of municipal infrastructure.

**Apart from initiating a series of reform measures in the ULBs to streamline revenue collection and expenditure, GoTN was looking for an arms length institution that can ensure resource mobilisation with minimal guarantees and provide sustainable finance for civic infrastructure.** It was felt that such an institution should also help closer interaction with financial markets by improving transparency in accounting transactions in the local bodies, introducing e-governance for quality and timely civic service and capacity building for efficient and cost effective execution of infrastructure projects and their operation and maintenance.

### 3. THE TAMILNADU URBAN DEVELOPMENT FUND

#### 3.1. The Municipal Urban Development Fund

From June 1988 until September 1997, the government implemented the Tamilnadu Urban Development Project – I (TUDP-I) that was financed by the World Bank out of IDA credit. This was the largest urban finance project in India at that time and incorporated the contemporary reform measures needed for the urban sector in India. The project had an institutional development component and an on-lending component for municipal sub-projects. The on-lending component was administered through the Municipal Urban Development Fund (MUDF), which was a revolving fund. This was established to address the lack of long term financing capital for urban infrastructure in India and particularly Tamilnadu. The

Project Management Group (PMG) constituted to take forward and implement the TUDP – I project acted as the fund manager for MUDF.

- 3.2.1** Assessment of MUDF: The MUDF financed about 500 sub-projects in Tamilnadu covering various components of urban infrastructure such as storm water drains, roads, bus stations, markets etc. It disbursed about Rs. 1.65 billions. The fund could establish a good track record of lending procedures and well defined rules for disbursements and loan recovery. Though conceived as an experimental operation, it exhibited potential to become a good financial intermediary.
- 3.2.2** The MUDF had to contend with some shortcomings that may seem today as totally understandable compared with contemporary realities in the municipal financing sector in India when it was conceived. Its lending capacity was far too small compared with investment outlays needed in the urban local bodies. It relied heavily on government grants and fund mobilisation was quite restricted. It depended on public financing especially IDA credit and had virtually no private capital component. It was administered by a Project Management Group, which was housed within the government set-up. This had implications in terms of efficiency of operations in view of large turnover of officers and staff, rigid compensation for staff and considerable risks in project selection and funding associated with the political economy.
- 3.3** The track record of Municipal Urban Development Fund (MUDF) encouraged Government of Tamil Nadu to broaden the scope of the Fund with a view to attracting private capital into urban infrastructure and facilitate better performing Urban Local Bodies (ULBs) to access capital markets. In consultation with the World Bank, which was financing the TUDP-I, the government agreed on a restructured format for the Fund, which would attract private capital to leverage the public fund contributions.

#### **4. THE TAMILNADU URBAN DEVELOPMENT FUND (TNUDF)**

- 4.1** Constitution of TNUDF: Tamilnadu Urban Development Fund (TNUDF) was established on November 29, 1996, as a trust under The Indian Trust Act 1882., with contribution from Government of Tamil Nadu along with all India financial institutions viz., ICICI Bank Limited (formerly ICICI Ltd), Housing Development Finance Corporation Limited (HDFC) and Infrastructure Leasing and Financial Services Limited (ILFS). TNUDF is the first public-private partnership providing long-term debt for civic infrastructure on a non-guarantee mode. The management of the TNUDF was sought to be in a different format from the earlier MUDF to attract better talent into the fund management and to relieve the fund of substantial political and regulatory risks. Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL) a company registered under Indian Companies Act, 1956 was established as the Fund Manager of TNUDF. Participation of Government of Tamil Nadu in the equity of TNUIFSL has been kept to the minimum with majority holdings by All Indian Financial Institutions. The TNUDF was established with assets transferred from the MUDF as Government contribution in the Fund. A Grant Fund window was also established to fund technical assistance for sub-project preparation at the local body level and for funding poverty alleviation components of the project.

- 4.2. *Private capital in ULB projects:* Although some private financial institutions in India indicate their willingness in financing ULB projects off and on, none of them are ready to enter this new market in a major way due to some perceptions about sub national government financing. They cite substantial political economy risks associated with municipal governments and governance. They also cite the non-standard and less than credible accounting and financial reporting systems in these local bodies. Moreover, the urban local bodies still depend on financial support of the state governments and this induces uncertainties in revenue projections and realizations in tune with the fiscal ups and downs of the respective state governments. Above all, municipal loan processing is a costly exercise and engages larger resources of the financial institutions. Given these constraints, the FIs however consider the state of Tamilnadu as the best bet for participating in urban sector project financing in view of the commitment of state government to implement reforms at sub-national levels and comparatively better compliance of lending terms by the urban local bodies in the earlier disbursements under MUDF.

## 5. OBJECTIVES OF THE TNUDF

**The objectives for the TNUDF were set keeping in mind the scope for improving the financial, managerial, administrative and technical capacities of the ULBs, the limited supply of long-term finance required for urban infrastructure investment and the lack of financial intermediaries with expertise and experience in municipal financing. Major objectives set for the Fund are as below:**

- Fund Urban Infrastructure projects, which improve the living standards of the urban population.
- Facilitate private sector participation in infrastructure through joint venture and public -private partnership.
- Operate a complementary window, the Grant Fund, to ensure access to urban infrastructure by the poor.
- Improve the technical, managerial and financial management in urban local bodies equipping them for qualitative maintenance of civic infrastructure and to access finance from the markets.

## 6. LENDING POLICIES OF TNUDF

- 6.1. *Policy setting:* It was recognised that the urban local bodies need to draw up large number of sub-projects costing a few millions of rupees and below but need to be technically drawn up and implemented without cost and time escalations. Phasing of projects, providing technical assistance for project management and adopting a well laid out procurement procedure, which would be monitored by the TNUDF, were some of the measures considered expedient for inclusion in the lending policies of the Fund. Lending Policies are approved by the Board of Trustees of the Fund and administered by the fund manager viz. TNUIFSL. Professional expertise and collaborative exercise with urban local bodies in project identification, project development and implementation have been the value addition by the TNUIFSL over the earlier practices of the Department of Municipal Administration of the Government.

**6.2** Major components of the lending policy: Major components of the lending policy approved by the Board of the Fund are as below:

- i. TNUDF's lending policies encourage long tenor, fixed rate market friendly debt financing for eligible civic projects.
- ii. These policies provide for advisory services to urban local bodies to directly access market funds either directly or through a pooling arrangement.
- iii. These policies also incorporate appropriate provisions for Environmental and Social standards and upfront rehabilitation measures for project affected persons in the project design.
- iv. A minimum economic rate of return of 12% for project and appropriate exposure norms for individual project as well as for a ULB as a whole have been prescribed as part of due diligence process.
- v. TNUDF finances the costs of civil works, services, goods and materials. It does not finance the land acquisition costs and working capital.

## **7. PERFORMANCE OF THE TNUDF:**

**7.1.** Size of the Fund: The TNUDF consisted of a World Bank line of credit for US \$ 80 million, mobilisation by the Fund for US \$ 25 million, co-financing by the participating FIs for US \$ 25 millions and contribution by Government of Tamilnadu and the ULBs for US \$ 48 millions amounting to US \$ 173 millions. This is in addition to the unit capital contribution of the participating FIs for US \$ 10 millions. In terms of lendable resources for ULBs in Indian currency, this amounted to approximately Rs. 7 billions. In the course of operations, the co-financing component of the FIs was substituted for ULB contribution to sub-projects either from the general budget or as public equity for the projects.

**7.2.** Project approvals: The Fund has so far approved 179 projects (1997-2002) at a total project cost of INR 6.7 billion (Rs.675.02 crores). The Fund could disburse about Rs.3.5 billions as on date and used the cash resources available with it to prepay costlier MUDF assets to the government of Tamilnadu. The projects appraised by TNUDF primarily include core civic amenities like storm water drains, sewerage, sanitation and solid waste management schemes, water supply, roads etc. as well as revenue generating commercial complexes, wholesale markets, bus stands etc. Performance of the Fund has been good with project loan recoveries close to 100% (99.75%) of the schedule repayments. The Fund returned a surplus distribution of Rs. 0.79 billions to the contributors during the operating period from 1999 to 2003 on a unit capital base of Rs. 1.96 billions.

**7.3** Performance against objectives: Measured against each objective, the Fund and the AMC together have ensured that the experiment has been beneficial to all parties concerned.

- 1) Fund assisted investments in ULB infrastructure for the five-year period 1997-2002 was a sizeable Rs.6.7 billions of which assistance from the Fund was Rs.3.5 billions. In the initial stages, roughly 65% of the loan outstanding accounted for roads and associated works, 25% accounted for water supply, sewerage and sanitation projects, the rest being distributed among remunerative projects like bus stations. However this portfolio changed with prepayment of loans disbursed for road and associated projects by the ULBs

- 2) and with the disbursement of loans for underground sewerage projects under the National River Conservation Project. As on date, roughly 50% of the loan outstanding is accounted by sewerage and sanitation projects.
- 3) The Fund through the AMC assisted the ULBs in concluding fruitful public-private partnerships and BOT projects such as the Alandur STP (BOT - Rs.70 million) the Karur Toll Bridge (BOT - Rs.152 million), Madurai Toll based Ring Road (BOT - Rs.430 million)
- 4) The Fund provided a total grant assistance of Rs. 220 millions providing access to civic infrastructure for the poor during this period.
- 5) The AMC provided project development and implementation assistance (DPRs, PMC etc.) for 32 large underground sewerage projects in ULBs.
- 6) The Fund mobilised counterpart funds to the extent of Rs.1.4 billion. It also provided advisory services for a pooled fund floated by 13 ULBs for Rs.290 million, a tax-free bond issue by a water authority for Rs.420 million, a bank-consortium led financing of bonds worth Rs.290 million for a toll road project.
- 7) The AMC successfully collaborated with all the ULBs in introducing accounting reforms such as introduction of double entry accrual based system of accounting, e-governance systems for effective tax administration, registration for births and deaths, solid waste management, complaint registration and redress etc., Some of the ULBs prepared city corporate plans.

**7.4 The operating results:** The operating results of the TNUDF during the period 1999-2003 (after all contributions from the participants had been received) can be summarized below based on records available and a recently conducted review.

<b>Financial Analysis of Past Performance</b>					
A comprehensive analysis of the Profit and Loss (P&L) statement of the Fund for the past 5 years (1999-2003) has been carried out and details are given below:					
<b>Income and Expenditure (1999-00 to 2003-04)</b>					
	<b>(Rs.Millions)</b>				
<b>(Financial yr. Ended Mar)</b>	<b>1999-00</b>	<b>2000-01</b>	<b>2001-02</b>	<b>2002-03</b>	<b>2003-04</b>
<b>INCOME</b>					
Interest recd on Loans	257.731	481.03	632.283	613.599	184.146
Interest recd from Invest	0.00	6.047	42.145	33.194	67.025
Income from cash balances	170.678	91.453	130.900	133.111	147.792
Profit on sale of investments	0.00	0.400	12.219	9.270	17.474
Other Income	0.00	0.162	0.00	0.736	0.00
Excess provision written back	15.218	0.00	0.223	0.669	5.383
<b>TOTAL INCOME (Rs. Millions)</b>	<b>443.627</b>	<b>579.09</b>	<b>817.77</b>	<b>790.579</b>	<b>421.82</b>
<b>EXPENDITURE</b>					
Interest paid on borrowings	210.899	287.619	467.491	512.340	206.475
GoTN (TNUDF I)	210.899	220.291	235.776	258.873	3.113
GoTN (TNUDF II)	0.000	3.688	111.667	159.501	135.392
NCDs	0.000	63.640	120.048	93.966	67.970
TNUDF III	0.000	0.000	0.000	0.000	0.000
Operating expenses	18.621	43.268	16.680	28.112	25.329
Management & other fees	17.338	39.283	15.867	27.361	25.004
Administration costs	1.283	0.737	0.813	0.751	0.325
Bond issue related expenses	0.000	3.248	0.000	0.000	0.000
Provisions made	0.000	7.806	210.000	134.400	90.000
<b>TOTAL EXPENDITURE (Rs, Millions)</b>	<b>229.520</b>	<b>338.693</b>	<b>694.171</b>	<b>674.852</b>	<b>321.804</b>
<b>SURPLUS (Rs. Millions)</b>	<b>214.107</b>	<b>240.397</b>	<b>123.599</b>	<b>115.727</b>	<b>100.016</b>

Source: Review of TNUDF, TCG-India, 2004

**7.5 Key ratios:** Some of the key financial ratios have also been culled out from the data furnished by the fund and they show some interesting results as can be seen below:

	1999-00	2000-01	2001-02	2002-03	2003-04
Debt - Equity ratio	1.17	2.28	2.18	2.62	1.36
Current Ratio	1.75	1.63	2.51	3.12	4.26
Loans to Assets	0.54	0.66	0.61	0.47	0.15
Investments to Assets	0.41	0.29	0.35	0.45	0.76
DSCR	3.43	1.52	1.32	1.19	0.3

Source: TNUDF/TCG – India: 2004

A striking feature of the financial position is the low gearing of TNUDF. The DER has ranged between 1.17 and 1.36, which is rather low for a financial institution. The loans to assets ratio also reflects the relatively low off-take of funds for project disbursements, which is also reflected in the high investment to assets ratio. The debt service coverage ratio (DSCR), though declining due to reduced profits, has been comfortable, indicating the Fund's ability to meet its debt servicing obligations in time (owing to large prepayment of loan assets and borrowings, the ratio is not representative for 2003-04)

The projected and actual achievements for various items of financial performance such as disbursements profit before taxes, net profit on net worth etc., have also been arrived at based on the audited results available with the Fund. They are tabulated below:

**Rs./Millions**

TNUDF Financial Indicators						
FY		1999-2000	2000-01	2001-02	2002-03	2003-04
Yearly Disbursements	Projected	920.0	890.00	830.00	970.0	950.00
(Rs.Millions)	Actual	560.0	2190.00	200.00	25.0	509.00
Cumulative Disbursements	Projected	1110.0	2000.00	2830.00	3780.0	4630.00
(Rs.Millions)	Actual	760.0	2950.00	3390.00	3415.0	3924.00
Profit before provisions for taxes	Projected	266.0	322.00	302.00	320.0	360.00
(Rs.Millions)	Actual	214.0	240.4	334.00	250.0	190.00
Net Profit/Net Worth (%)	Projected	13.4	14.80	13.00	13.0	13.90
(Return on Equity before taxes)	Actual	15.3	13.40	16.78	12.6	9.39
Net Profit/Average Assets(%)	Projected	5.9	5.60	4.70	4.2	4.20
	Actual	5.7	4.40	6.00	3.7	2.80
<b>Loan Recovery Rate (%)</b>	<b>Projected</b>	<b>84.0</b>	<b>90.00</b>	<b>90.00</b>	<b>95.0</b>	<b>95.00</b>
	<b>Actual</b>	<b>99.0</b>	<b>100.00</b>	<b>99.75</b>	<b>99.9</b>	<b>98.80</b>

Source: TNUDF II, Internal review, World Bank, November, 2004

An interesting observation is that the Return on Equity (ROE) before payment of taxes was healthy in the beginning but substantially got reduced due to various factors outside the control of the Fund.

**7.6 Current Loan Asset Portfolio:** The loan asset portfolio of the Fund reflects the priorities of ULB investments in sanitation and sewerage projects, Water supply, roads and transportation projects. An analysis is presented below as at 30 November 2004. It is seen that the biggest component of the loan asset portfolio is sewerage and sanitation followed by water supply projects.

TNUDF- Loan asset portfolio distribution, 30 November 2004 (Rs. Millions)

Sector	Loan outstanding	Percentage to total
Sewerage & Sanitation	880	50.29
Water Supply	570	32.57
Roads & associated works	70	4.00
All other projects	230	13.14
Total	1750	100.00

Source : Provisional Accounts/Nov. 2004/TNUDF

## 8. ASSESSMENT OF EXTERNAL ENVIRONMENT OF THE TNUDF

**8.1** Broadly, the operating environment for TNUDF can be described in terms of two factors viz. the market and economic factors. The market factors can be broken down to the demand-supply scenario for urban infrastructure, competition from other players, and the ability of borrowers to absorb funds, Government policies and so on. The economic factors influencing TNUDF could be described as interest rates, capital market situation, overall economic conditions etc.

**8.2** *Economic Factors* -Declining interest rates during the period under review have had a major impact on TNUDF's financial performance. Market interest rates have declined both at the short end as well as for long term. This has impacted TNUDF in two ways: one, the lower lending rates offered by competitors has weaned borrowers away from TNUDF, whose lending rates have tended to be higher. TNUDF has pegged its interest rates based on its borrowing terms with the state government. This is a fixed interest long tenor arrangement. It is benchmarked to the average yield on a 10 year Government of India bond. This arrangement does not contemplate prepayment of borrowing and also reset of tenor and interest rate. This is reflected in the sharp decline in loan assets of the Fund from Rs.37.3 billions as at March 2003 to Rs.8.526 billions by March 2004, caused by prepayment of loans by few borrowers who have refinanced their loans with funds from competitors at lower rates of interest.

Secondly, the return on investments and cash surpluses of TNUDF has shown a steady decline, due to the sharp reduction in interest rates, especially at the lower end of the spectrum. The average return on cash and short-term surplus has declined from 10.91% in 1999-2000 to 5.67% in 2003-04. The falling yields on GOI securities/T-Bills, reduction in one-year interest rates has led to a decline in overall yield on short-term surpluses of the fund.

### 8.3. Market Factors, State Government Policies and Developments in the Urban Sector:

**8.3.1** The off-take of project funds by TNUDF's borrowers has been below targets. This can be attributed to several market forces. A primary reason is still the restricted ability of the sector (ULBs) to fully absorb funds. Although the demand-supply gap for urban infrastructure is large and growing, eligible borrowers for TNUDF's funds are limited, given the definitions of loan eligibility and exposure norms. A second factor is the increased competition from other players who were providing funds at much lower interest rates.

**8.3.2** There are multiple agencies engaged in funding urban infrastructure projects, including specialized agencies such as Tamilnadu Urban Finance and

Infrastructure Development Corporation (TUFIDCO), Housing and Urban Development Corporation (HUDCO) etc. that are public sector agencies. All of them being State/Government owned entities, the competitive interplay of the agencies, each of which have differing cost and financing structures has undermined the capability of TNUDF to effectively counter competition, which has mainly been in the form of lending rates. With competing agencies owned by the same entity viz. the State or Federal Government, there is a need for some measure of regulation to ensure that competitive under pricing of loans does not hurt the agencies as well as the State Government. Another reason for the low off-take of disbursements could be attributed to the project selection. Except for the quicker disbursing projects in transport sector (roads), in other sectors such as water supply, sewerage and sanitation, project finalisation and implementation tended to be slow and hence also the disbursements. Along with this, pre-payment of TNUDF loans for about Rs.2 billions, saddled the TNUDF with large cash balances (cash balances, short-term deposits were Rs.4.1 billions as of March 31,2004).

#### **8.4 Concerns of level playing field for TNUDF**

**8.4.1** Competition from other players had an impact on the operations of TNUDF during the period. Two principal agencies in the market for urban infrastructure in Tamilnadu are TUFIDCO and HUDCO. While TUFIDCO is a State owned entity, HUDCO is an all-India financial institution. They seem to enjoy distinct advantages and hence there were concerns of level playing field in the Urban project financing scene in Tamilnadu.

**8.4.2.** Apart from the market borrowings, both these agencies receive/raise fairly large resources at low cost, which enables them to maintain a low cost fund regime. For instance, TUFIDCO received grants from Government of India (GoI) and Government of Tamilnadu (GoTN) for Chennai Mega City program and other schemes, which are in the nature of quasi-equity. Further TUFIDCO is also registered as a Non-Banking Finance Company (NBFC) with RBI, which enables it to raise public deposits. It is also eligible to claim Income Tax exemption under specific sections of the Income Tax Act 1961 for income under infrastructure lending activities. As regards HUDCO, it has a wide resource base, including Statutory Liquidity Reserve (SLR) bonds, tax free bonds, foreign currency borrowings, grants etc. which has enabled it to keep its cost of funds low (the reported weighted average cost of borrowings during 2002-03 was 7.32%). The lower cost of funds enabled these agencies to lend at lower rates to borrowers. For instance, the lending rates of TUFIDCO range from 8.50% to 9.00% for loan tenors ranging from 5 years to 15 years. Similarly, HUDCO also is reported to be lending in a range of 8.5% to 10.50% for loans of tenor from 5 years to 15 years. Both the agencies above to expand their lending portfolio in the ULB sector in view of large investible funds with them.

**8.4.3** Thus, while competitors could lower their lending rates, TNUDF was restricted by its inability to renegotiate lending rates. This was probably due to almost its entire borrowings being dependant on a single source viz. the World Bank funds routed through GOI/State Government; Further the loan being of a long tenor (15 years), there was no rate reset or review options available to TNUDF and its annual cost was determined by GoTN according to a preset pricing formula. Finally, the loan agreement also determined the spreads that could be charged to borrowers over the cost of borrowing. As there was no reset option in its

borrowings, TNUDF could not have an option to reset/review its lending rates. However, TNUDF could lower its lending rates in 2003-04 in view of the fall in yield of 10 year GOI paper which is the benchmark rate for its borrowing terms with Government of Tamil Nadu.

**8.4.4** Concerns of unfavorable tax treatment to TNUDF vis-à-vis other agencies: When the TUDP II project was formulated, it was assumed that the business of TNUDF would not be taxed since the Fund has been designed primarily to finance municipal infrastructure projects. However, this assumption could not be sustained subsequently. The Income Tax Department of the Government of India classified the Fund as an association of persons and gave a ruling that the contributors to the Fund were repatriating dividends out of business income. Even though the Government of Tamil Nadu, which is the major contributor, had consistently reinvested dividends earned, the argument from the Fund side to exempt its income from taxation did not get a positive response. The Fund as on date has gone on appeal to the Income Tax Tribunal for tax exemption and refund of taxes already paid. For the period 1999-2000 to 2003-04 the Fund paid out a sum of Rs.540 millions as taxes. A favorable tax treatment could have created opportunities for the Fund to leverage the sum in various forms such as debt service reserve funds etc. It could have also been utilised to lower its interest rates and be competitive in the market.

## **9. ASSESSMENT OF PRIVATE PARTICIPATION IN FUND AND AMC:**

**9.1.** The design of the Fund ownership accommodated private sector financial institutions such as the ICICI, HDFC, ILFS etc. This was expected to provide the necessary edge for raising counterpart funding for projects by accessing the debt market and in introducing professional outlook in appraisal of projects and ensuring sustainability of the project funding structure. While the Fund kept up this commercial focus on sanctioning project finance, it also introduced certain rigidities in the lending policies.

- The Fund could not arrive at appropriate and sustainable debt tenor and interest rate mechanism for various projects in the context of rapidly falling interest rate regime in the capital markets.
- It could not match the flexibility of other institutions like banks and financing companies in resetting interest rates and tenors for loan assistance and in certain circumstances even allow prepayment of debt.
- Similarly, the Fund's lending policies provided for a rigid margin over and above the interest rates charged regardless of the borrower credentials and the nature of projects.

**9.2.** This forced the ULBs to access other institutions for raising debt and introducing unhealthy competition in the bargain. One would have expected the participating financial institutions to advise the Board of Trustees to be market oriented in extending financial assistance and to periodically review the lending policies consistent with the changes in the financial markets. In the bargain, the Fund lost business and urban local bodies approached other financial institutions for debt swaps and take over financing. This in itself is healthy except that the take-over finance was provided by other public sector institutions primarily.

**9.3.** On the contrary, the participation of the financial institutions in the AMC brought positive outcomes for all the parties concerned.

- It resulted in a professional and self-motivated staff in the AMC.
- Appropriate HR policies incorporating rewards and incentives based on performance was a welcome change in the otherwise staid personnel structure seen in the government departments.
- Preparation of manuals for project appraisal, inclusion of environmental and social impact assessments in the project design and execution, advisory services to ULBs in financial accounting reforms, successful award and management of consultancies for project preparation and implementation by the ULBs brought financial and project discipline to be enforced as a matter of policy.

These are some of the positive results of private sector participation in the AMC.

## **10. POLICY OPTIONS FOR THE FUTURE**

**10.1.** The financial intermediation already introduced has produced positive results.

- It has established an alternative funding mechanism apart from state budget grants for urban projects.
- Concept of self-sustainability in project financing has gained acceptance among all the user agencies.
- Tolls and user charges and upfront user contribution for project equity are some of the concepts popularized by this process.
- This experiment has also enhanced the confidence levels in the urban local bodies to access debt markets on their own or in association with other local bodies as a pool finance arrangement.

**10.2.** However the TNUDF and the state government need to closely debate the following issues for a competitive institution like the TNUDF to consolidate its gains as a financial intermediary in the urban sector and march forward both in terms of larger portfolio of lending and in terms of innovative project financing methods.

- ❖ Taxation of the Income earned by the Fund even though they were ploughed back is an issue that should be taken up with the Federal Government for positive outcomes.
- ❖ Flexibility in product pricing is essential vis-à-vis the borrowing entities as well as the state government which is still the biggest fund provider through multilateral line of credits.
- ❖ The TNUDF should become an active market player by not only mobilizing larger resources at competitive interest and tenor for enhancing its kitty but also actively assist financially sound urban local bodies to access the financial markets directly for their requirements. While the first suggestion can lower the average cost of funds to TNUDF, the second suggestion could enhance the role of the Fund as friendly merchant banker for the ULBs.
- ❖ Conflict of interest issues in associating financial institutions in the Fund need to be resolved and the role of such institutions in enhancing the size

of the Fund as effective means of private finance flows into the urban sector.

Alternative models on the lines of the US bond banks especially for the environment enhancing projects such as water supply and sanitation, wastewater treatment etc., would need to be studied.

**10.3** The constitution of the AMC viz., The Tamilnadu Urban Infrastructure Financial have been well received both by the state government and the local bodies. The existing arrangement may continue and in future the state government may also consider inducting other professional finance and urban sector specialist institutions into the Board of the AMC.

**10.4.** In the second phase of this financial intermediation, the state government would emphasise on further up-gradation of skills of AMC staff and a scaled up interaction with the urban local body managements especially the policy makers among the elected representatives to understand and incorporate in their projects sustainable models of fund application and its recovery from the users through a combination of taxes and user charges, upfront equity and any other form of innovative project finance.

**11.0 Conclusion:** The constitution of the Tamilnadu Urban Development Fund (TNUDF) was a right step by the state government of Tamilnadu to broaden the scope and size available for urban sector project financing in the state. Its management by a professionally competitive entity viz., TNUIFSL ensured that the urban local bodies not only received project assistance but also substantial capacity building for good governance and for accessing the financial markets directly.