

ANNEX III. SUBNATIONAL GOVERNMENT FINANCING⁹

A3.1. **Local government bodies (LGBs) access to private capital depends critically on significant improvement in their credit-worthiness.** No amount of credit enhancement or financial engineering can substitute for a sound legal, institutional and regulatory framework underpinning and incentivizing sound local body finances. The central issue in setting up mechanisms to channel private savings to local bodies for the financing of infrastructure is the assurance to lenders that they will be repaid. Factors that often reduce creditworthiness of local bodies include an inadequate accounting and risk management framework for asset-liability management, lack of autonomous authority to set realistic tax-rates and tariffs or user charges for the basic services they provide and inflexibility in wage structures and hiring-firing policies. Box III.1 below provides Fitch Ratings best and worst practices with rating value in terms of the financial management of sub-sovereign bodies. This provides a useful checklist of financial management reforms that local governments can pursue.

A3.2. **A major impediment to the development of subnational credit markets is the moral hazard of explicit or implicit guarantees of a federal government bailout of subnational debt.** For this reason, the development of subnational credit markets requires, inter alia, a strict no-bail-out policy for LGBs in trouble. This is easier said than done. Inman (2003) points out that in the US, it took about 70 years of the federation for the principle of hard budget constraints for US states and local governments to be generally accepted. The turning point was the federal government's refusal to bailout eight defaulting states and the Territory of Florida in the 1840s. Mexico and South Africa have both formulated no bailout systems for their LGBs in which national governments do not guarantee sub-sovereign debt. In the case of Mexico, the capital risk weighting of bank loans to LGBs is linked to local credit ratings. South Africa has established a Municipal Financial Emergency Authority for technical assistance, resources and legal remedies to LGBs in distress. (Weist 2002) A related legal issue is the need for orderly bankruptcy/ work-out procedures as well as a time-bound procedure for foreclosure. In 1995, Hungary introduced a US style Chapter-11 type bankruptcy "stand-still" procedure to regulate debt clearance procedures in case of default by local governments. Since the law was introduced, eight small cities went through the procedure, and are now in stable financial condition. (Noel 2000).

A3.3. **Pooling credit risk of small and medium local governments offers great potential for enhanced access to infrastructure finance.** A common method of credit risk pooling is to set up bond banks that sell its own securities and on-lends the proceeds to local governments. A common feature of all bond banks is that they rely on their member municipal governments to repay their issued debt but also provide a number of credit enhancements to lower the overall cost of borrowing. In Denmark (*KommuneKredit*) and Sweden (*Kommuninvest i Sverige Aktiebolag*), the bond bank debt is secured by the "joint and several" obligation of member municipalities to pay the debt, in case an individual member defaults. British Columbia's Municipal Finance Authority has an obligation to levy property taxes on all land and improvements in the province — including the City of Vancouver, the only municipality in the province that issues its own securities to finance capital projects. *Japan Finance Corporation for Municipal Enterprises* and Norway's *Norges Kommunalkbank*, both have sovereign guarantees. The ultimate guarantor of debt issued by Finland's *Municipality Finance Plc* is MGB, a public institution with member

⁹ This section was written by Abhas Jha.

municipalities consisting of 98% of the national population. In New Hampshire, the New Hampshire Municipal Bond Bank issues two types of bonds, one with a guarantee of the state government and the other without such a guarantee. (Moody's 2001)

A3.4. An offshoot of the bond bank model that has worked especially well in the US is the State Revolving Funds. In 1984, as a consequence to the "Federal Clean Water Act", the US Federal Government set up state revolving funds (SRFs) for wastewater and water projects in the US. The federal government makes capital grants to the state government, matched by a contribution from the state (currently at 20%). Several states use these subsidies to create dedicated reserve funds to collateralize pooled bond flotation to support financing needs of local governments in the state. The pooled SRF bonds of New York State are AAA rated even when many participating local governments have lower ratings or are not rated at all. SRFs typically provide a number of credit enhancements like debt service reserve funds and state transfers payment intercept provisions to provide additional comfort to lenders and thereby lowering the cost of borrowing. Another key advantage of the SRF model is the low overheads. The Maine Municipal Bond Bank (which administers the SRF) raises US\$ 100 million/year with a staff of four. Typical savings from pooling range from 250-650 basis points. Small and medium municipalities often are unable to identify and prepare bankable projects. The SRFs provide 3-year interest free loans to local governments for project preparation. This has helped create a strong pipeline of creditworthy projects using SRF resources.

A3.5. There is a lot that policy-makers can do to strengthen municipal primary and secondary bond markets. Close to 50% of total US municipal bond issues (75% of BBB, A, or better) are covered by bond insurance (El Daher 1997). Policy makers could consider setting up a bond insurance facility (either in the private or public sector) to facilitate small issuers, considered less creditworthy, to access the domestic markets for high investment grade debt. Leigland (1997) lists several measures to promote the secondary market in sub-sovereign debt. Among direct measures, countries are exploring ways to facilitate the listing of bonds on domestic stock exchanges and to encourage the development of pre-indication posting or other municipal finance information systems similar to those used in the US to support placement and sales function (e.g. Blue List and Munifax). Amongst indirect measures, removing minimum holding requirements by institutional investors for government securities, including municipal bonds eliminates the bias toward private placement inherent in the system and increases the incentive of institutional investors for trading. This is one of the objectives pursued by the government of South Africa in abandoning its prescribed investment regime for institutional investors. Municipal assets are an often underused and overlooked source for enhancement of municipal bonds. Municipalities in China and Poland have used public land as collateral for raising money and then successfully disposing of the assets at higher prices on completion of the project.

A3.6. The experience with Municipal Development Funds has been decidedly mixed. More than 60 countries have set up specialized financial intermediaries or municipal development funds for raising capital to on-lend to subnational governments. However, as Peterson (1996) points out, very few MDFs have evolved into market-oriented suppliers of credit capable of mobilizing private sector savings. Some common features of many successful MDFs (e.g. MUFIS in the Czech Republic and FINDETER in Colombia) include the transfer of credit risk to the private sector, "unbundling" functions like payment collections and credit analysis to specialized private sector firms, separating subsidies from lending and providing technical assistance and capacity building for project preparation. Standard and Poor's developed ratings criteria for state revolving funds in 1990 and refined them in 1994. These criteria include significant credit enhancements like significant equity,

reserve funds, tax base access, and legislative provisions and are usually seen in institutions like Dexia and the Municipal Bank of Netherlands that have successfully raised private capital.

A3.7. Increasing local currency financing and better mitigation of foreign exchange risk will be important for enhanced access to capital for subnationals. Subnationals often lack capacity to manage and mitigate foreign exchange risk. The macroeconomic fragility and external debt overhang of the 1990s has left federal ministries of finance wary of taking on any additional foreign currency denominated debt even more so the contingent claims of subnational government debt. However local currency debt in Latin America is characterized by short tenors, volatile interest rates and an absence of deep and liquid secondary markets. In such a situation investors have been traditionally unwilling to take on the long tenors typical of infrastructure projects. However, a number of positive developments in the recent past have improved the situation dramatically. The maturation of domestic pension fund industry and other institutional investors has created a sophisticated investor class looking for local currency debt instruments all along the yield curve. Subnationals offer such investors an opportunity to diversify their portfolio. Countries like Mexico have taken tangible steps to improve their legal and regulatory framework for securitization which mitigates interest rate and credit risk-thus opening up demand from investors previously not interested in simple debt offerings from subnationals. Credit enhancements by international financial institutions like local currency partial credit guarantees, monoline wraps will further deepen local currency debt markets.

Box III. 1: Best Practices with Significant Rating Value for Fitch

- Cash reserve policy /working capital reserves /budgetary cushions.
- Multiyear financial forecasting.
- Monthly or quarterly financial reporting and monitoring.
- Contingency planning policies.
- Policies regarding nonrecurring revenue.
- Depreciation of fixed assets.
- Debt affordability reviews and policies.
- Pay-as-you go capital finding policies.
- Debt retirement speed.
- Five-year capital improvement plan integrating operating costs.

Worst Practices with Significant Rating Concern for Fitch

- Cash basis accounting.
- Qualified audit opinion for material weakness.
- Deficit financing for two of last five years.
- Debt retirement speed.
- Unfunded accrued pension liability.
- Short-term borrowing growing significantly faster than annual spending
- Debt reprogramming that defers a small share of current debt service.
- Over reliance on nonrecurring revenue.
- Aggressive investment policy for operating funds.
- Pension contribution deferral in the current budget year.
- Budgetary impasse beyond legal completion date.
- Lack of capital improvement plan.
- Excess borrowing from related entities, with **no capacity to repay in near future.**

Source: Fitch Ratings, “International Rating Methodology for Regional and Local Governments”, April 4, 2002, http://www.fitchratings.com/corporate/reports/report.cfm?rpt_id=141098

Infrastructure Finance Corporation Limited of South Africa

Infrastructure Finance Corporation Limited, trading as INCA, is the only infrastructure debt fund in South Africa that is 100 per cent privately owned and operated. INCA was established in response to the South African government's call for increased private sector involvement in infrastructure funding. As a result of its unique position INCA has become a primary mobiliser of funds for lending to infrastructure providers. The main funding sources it draws on are local and international market funds, raised through a series of INCA bond issues and long-term loans extended to the corporation by international financial institutions. Another source of funding available to INCA is shareholders' capital.

The infrastructure providers to which INCA lends funds include municipalities, water boards and other statutory institutions in South Africa whose main business is the establishment of social and economic infrastructure in South Africa. This funding has mainly been in the form of long-term fixed interest rate loans.

INCA's mandate allows it to fund fixed and movable assets of all entities within the statutory sector. INCA, however, focuses mainly on balance sheet funding to the municipal sector and its appraisal and lending process is tailored to the needs of municipalities, water boards and other utilities. After specifically assessing the management capacity, economic future, current financial position and future prospects, with an emphasis on reliable free cash flows generated by the borrower, INCA provides a shadow rating to a borrower. Based on the shadow rating of the borrower and the pure size of the free cash flows generated by the borrower, INCA approves a long-term and short-term credit facility available to borrowers. These facilities are annually reviewed and adjusted if needed. INCA provides fixed and/or floating rate finance for terms from 1 to 20 years. Transactions are concluded by way of standardized loan agreements.

Source: INCA's website: <http://www.inca.co.za/>

An Example of a Well -run Municipal Development Fund: The Tamil Nadu Urban Development Fund (TNUDF)

(TNUDF) has established itself as one of the best run municipal funds in the world. The Fund which has lent over Rs. 4.93 billion to urban local bodies in Tamil Nadu has achieved repayment rates of over 96% and made a profit of Rs. 848 million in the financial year ending March 31, 2003. The TNUDF is a trust fund established under the Indian Trusts Act, 1882, by GoTN, ICICI, HDFC and IL&FS with a line of credit from the World Bank. GoTN's equity in the venture is restricted to 49%, to allow private sector management in investment decisions. Other shareholders of TNUDF are ICICI (21%), HDFC (15%) and IL&FS (15%). ICICI, the lead institution, has taken up management responsibility, putting in place appraisal systems and key personnel.

TNUDF can lend to urban local bodies (ULBs), statutory boards, public sector undertakings and private corporates for water supply, sanitation, solid waste management, roads / bridges, transportation, sites and services and integrated area development projects. It can only fund capital expenditure, civil works, services and goods / materials. It cannot fund land acquisition costs, O&M expenditure / other revenue expenditure such as salaries etc. For a ULB to be eligible for funding from the Fund, its total expenditure should be less than its total revenue and annuity payments / total revenue should be less than 30%. In case where ULBs fail to meet above criteria, the project specific returns (IRR) should be greater than 18.5% p.a. For private sector borrowers, long term debt to net worth ratio should be less than 1.5, net fixed assets to long term debt should be greater than 1.5 and average debt service coverage ratio (DSCR) should be greater than 1.5.

Various credit enhancement measures such as escrow accounts of property tax, water charges etc. and hypothecation of movables are put in place. In the case of commercial complexes, a default option of conversion of up to 40% of loans outstanding into office space is stipulated.

Source : Jha (2004)

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