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Specialized Financial Intermediaries for Local Governments
A Market-based Tool for Local Infrastructure Finance

Samir El Daher

INTRODUCTION

1. In developing and transition economies, the combined effect of decentralization and urbanization has increased demand on local governments to provide and finance public services. Against this background, tight fiscal policies have constrained budgetary transfers from central to local governments. Competing claims for scarce budgetary resources have resulted in large funding gaps for local infrastructure investments. Private capital will be required if local services are to be brought to minimum standards that support growing urban demand. Local capability to shoulder the expanded responsibilities and, in particular, mobilize the required resources is contingent upon the existence of an adequate regulatory and fiscal framework for decentralization which requires, most importantly, that: (i) responsibilities for service delivery be clearly assigned among government tiers; (ii) capacity for own-source revenue generation (local taxes and user charges) be enhanced; and (iii) net flows (tax sharing and transfers) from central to local governments be rationalized and made predictable.

2. Local governments seek to cover operating and capital expenditures through own-source revenues and, as available, central government transfers. Where these resources are insufficient to fund capital investments, the financing gap has to be filled through borrowings. (Local borrowing should not be a means to finance current expenditures.) As they assume expanded responsibilities in service delivery, the need of local governments to mobilize private debt to fund capital investments is likely to increase. The ability to access credit markets is a function of creditworthiness, which is assessed by prospective creditors inter-alia on the basis of the: (i) overall quality and efficiency of local (real and financial) asset management; (ii) institutional vehicles and operational mechanisms for local service delivery (which might involve entities distinct from existing political divisions); (iii) selection criteria for local public investments, especially the benefits these would yield at the local level; (iv) pricing policies that contribute to the sustainability of service provision; and (v) laws and regulations regarding such credit-related issues as local asset pledge, bankruptcy and default remedies.

3. In the USA, municipal bond markets have been a primary source for local infrastructure finance through "general obligation" bonds supported by local taxing powers, and "revenue" bonds secured by the earnings of such projects as water supply and mass transit. Other industrialized countries have relied more on specialized financial intermediaries to provide long-term credit for local governments. In many developing countries it would not yet be feasible for a majority of small and medium-sized local government entities (and even some large ones) to have direct access to long-term credit markets. Considerable efforts are required to develop the financial infrastructure necessary to bring these entities to market. One way to foster market access and help increase the flows of private funding for local governments could be through specialized commercially viable, well capitalized financial intermediaries that could independently mobilize long-term debt on private markets for on-lending for priority local infrastructure investments.

COUNTRY EXPERIENCES WITH SPECIALIZED LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES

4. Many developing countries have established municipal development banks as a channel for municipal credit. Some have been administered pools of loans from government sources. Others have sought to serve as a bridge to private credit markets in borrowing on domestic or foreign markets (though mostly with central government guarantees) and on-lending to local governments, directly or through domestic banks.

Industrialized countries have also established specialized financial institutions to foster local economic development. Examples include: local government financial intermediaries in Belgium, Finland, France, Spain and Sweden; municipal finance corporations in Canada (mostly provincial agencies operating at the provincial level); and municipal bond banks in the USA (state instrumentalities operating at the state level). A "State Revolving Fund" is an example of bond bank with an element of public support where lending is mostly accomplished in leveraging central and state capital grants through bond issuance.

5. There is no clearly defined pattern of ownership among European intermediaries specialized in municipal finance. Some are privately owned (France, Spain) and others are publicly owned (Belgium, Netherlands). The public sector can be present at the central and/or local government levels. Thus, Finland's Municipal Finance Plc. is owned by the association of local governments. It is involved in debt pooling for specific and identifiable projects, as is the case for US bond banks. The Swedish local government funding agency "Kommuninvest" is owned by the association of local governments but is privately managed. Holland's "Bank Nederlandse Gemeenten" is jointly owned by the central and local governments; its loans are subject to the joint and several liability of the cooperative of local government borrowers/shareholders. Spain's "Banco de Credito Local" is privately owned by Argentaria and Dexia. A world leader in financial intermediation to local governments – with equity participation in a number of European funds – Dexia is the holding structure for Credit Communal de Belgique (CCB) and Credit Local de France (CLF). CCB is a local government owned cooperative; CLF, originally government owned, has been privatized. CLF's resources are raised through bond issues, whereas deposits represent the main resources of CCB, which is a major depository institution – unlike most specialized financial intermediaries for local governments.

6. In several countries, the World Bank has supported local governments through municipal development funds (MDFs). A comprehensive assessment of World Bank experience in MDF operations has yet to be conducted. However a number of reviews did address specific aspects of MDF operations – Davey (1988), Van Pulley (1992), Dillinger (1993), Ferguson (1995), Peterson (1997) and Kyu Sik Lee (1999). The reviews suggest that the investment components have been largely successful, meeting physical targets, adding to the capacity of municipal infrastructure and helping local governments build a credit record. The institutional development components, focused on local administration and technical capacity building, seem to have had limited success. In terms of resource mobilization beyond official multi/bi-lateral sources, achievements have, with few exceptions, generally fallen short of goals. The reviews suggest that, despite some successes, MDFs have been, to an extent, alternative vehicles for central transfers to local governments, often associated with government subsidies or guarantees, directed or inefficient allocation of credit, and sometimes political patronage. Future MDF operations should aim at encouraging transition to market-based municipal credit systems, including self-sustaining financial intermediaries for local government investments. To this end, it would be necessary to define the requisite policy conditions for local government borrowing, and the steps by which existing MDFs could be transformed into market-based operations. These are issues currently debated in a number of developing countries. (A World Bank database provides information on some thirty specialized local government financial intermediaries worldwide. The information covers, inter-alia, ownership and capital structure, legal and organizational aspects, objectives, products, and lending terms and criteria.)

EVOLVING ROLE OF SPECIALIZED LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES

7. The role, operating strategy and financial structure of specialized financial intermediaries for local governments can evolve through different stages in focusing successively on: (i) funding streams of local government investments; (ii) assisting in local institutional development and helping build a local credit culture/record; and (iii) mobilizing private long-term resources for local infrastructure projects.

8. *(a) First stage*. Municipal development funds would act as a conduit of budgetary and other resources to local governments along specific criteria applicable to loans or grants. The comparison of the two scenarii – "with" and "without" MDF – shows that, in rationalizing the ad-hoc, arbitrary and sometimes politically guided process of resource transfers from central to local governments, the criteria-based MDF funding (relying on strong technical capabilities within the MDF) can strengthen local capacity, improve the selection of investment priorities, and markedly enhance the quality of local project finance.

9. *(b) Second stage*. Specialized financial intermediaries would further develop their capacity in local project finance. Local governments that draw on the intermediary's resources must service their loans out of the economic benefits directly or indirectly generated by the investments funded by such loans. This would help rationalize borrowing practices at the local level and

improve the quality of local investment programs. At this stage, the specialized financial intermediary's resources could consist of budgetary as well as bi/multi-lateral official funding. The intermediary's institutional objectives would be inter-alia to help local governments strengthen creditworthiness in enforcing improved budgeting, auditing and disclosure standards; this would provide prospective lenders with credible and transparent information, and establish a reliable credit track for future borrowings.

10. *(c) Third stage*. Within a maturing financial sector, specialized financial intermediaries would provide the pooling mechanism through which local governments could mobilize additional private financial resources for their investment programs. "Market-based" financial intermediaries for local government entities would operate along commercial principles and issue long-term debt (with no government guarantee) for on-lending mainly to viable, revenue-generating infrastructure investments. Part of the lending may also be directed to investments in public goods – street paving, lighting, security,… – if lenders can establish, and shoulder the risk, that local borrowing entities are able to generate the resources needed to service debt. The range of borrowers would be expanded beyond local governments per se to cover utility corporations serving local constituencies. These corporate entities would be eligible borrowers whether they are public, private or operating under concession arrangements.

OBJECTIVES AND FEATURES OF MARKET-BASED LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES

11. Market-based financial intermediaries for local governments are institutions able to raise long-term resources on private credit markets and operate in a financially sustainable manner. They support local government operations through a range of financial instruments and products adapted to local needs. Market-based local government financial intermediaries (MLGFIs) may operate in primary or secondary credit markets. They involve pool financing arrangements for local infrastructure investments, and provide smaller local government borrowers the possibility to access long-term debt markets. Lending would be mostly accomplished in leveraging the intermediary's equity funds through bond issuance. Non lending products including fee-based financial advisory services may also be offered to local governments, mainly the larger ones. The intermediary's portfolio, diversified amongst a large number of local government borrowers, would provide a good security for, and strengthen the credit quality of its debt issues.

12. In an open and competitive financial system, the comparative advantage of MLGFIs among other financial institutions would mainly rest in the knowledge of the local government sector. The specific focus on local government business allows specialized intermediaries to build a competitive edge over other lending institutions that have a broader client base, and act as a preferred lender for local governments. To achieve financial viability, MLGFIs need a regulatory environment conducive to enhancing local government creditworthiness. They must engage in efficient financial transactions within a business framework well defined in terms of: (i) strategic and institutional objectives; (ii) eligibility criteria and operational features including specific guidelines for portfolio diversification amongst sectors and borrowers; (iii) range of lending and non-lending products (loans, equity participation, guarantees, underwriting, advisory services,..); (iv) financial policies related to funding, lending and capital adequacy; (v) product pricing for balance as well as off-balance sheet transactions; and (vi) market, credit and currency risk management policies. Where relevant, the steps needed to transform existing intermediaries into sustainable market-based operations would have to be considered.

MARKET-BASED LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES AND MUNICIPAL BOND MARKETS

13. Market-based local government financial intermediaries and municipal bond markets are not mutually exclusive approaches to local government access to credit. They play complementary roles and serve different, albeit overlapping, market segments in meeting local government demand for long-term credit. This dual source provides local governments with different options to fund capital investments. Therefore the establishment of MLGFIs is no alternative to building efficient municipal bond markets able to meet part of the credit demand of the larger local governments (which, in aggregate, might be significant). The availability of such alternative source of funding may somewhat reduce the claims by the larger local governments on scarce budgetary resources. This might in turn release additional fiscal space for smaller local governments with no capability to access private credit. Moreover, domestic bond markets would be a source of long-term funding for MLGFIs and thus, indirectly, local governments.

14. Local governments differ markedly in terms of resource base and economic size. These differences bear on funding strategies and choices of financial instruments for capital investments. Thus, while larger, better endowed local governments with good financial records may be able to tap the domestic municipal bond markets – and the international markets, in the case of a

selected few local governments – smaller local governments often need to rely on the pooling capabilities of financial institutions to mobilize long-term credit. (Some small local governments may not be able to access credit in any form.) Moreover, in deciding whether to borrow from a specialized financial institution or to issue debt obligations on the bond market, local governments need to assess and compare the cash-flow implications of both alternatives. Indeed, whereas credit lines from financial institutions allow a drawdown of funds in accordance with borrower expenditure requirements, bond issues would result in relatively large, lump sum, cash inflows. For local governments usually unacquainted with good liquidity management practices, loans from financial institutions allow for more manageable cash profiles and a better control of the "cost-of-carry".

ROLE OF MARKET-BASED FINANCIAL INTERMEDIARIES IN LOCAL GOVERNMENT ACCESS TO CREDIT

15. Market-based local government financial intermediaries mobilize long-term institutional savings for local infrastructure finance in pooling the credit demand of local government borrowers. In acting as a bridge between local government demand for, and capital market supply of debt securities, the intermediaries fill a void where there is little potential for direct local government access to credit. Indeed where institutional investors are in no position to assess individual local government risk, they may be willing to assume a diversified local government exposure through the financial intermediary. As such, the capital markets remain, indirectly through the financial intermediary, the ultimate funding source for local infrastructure investments. In leveraging their equity funds through debt issuance, the intermediaries can deepen and expand the market-based funding pool for local governments and contribute to the upstream development of domestic long-term credit markets. (Regardless of intermediation-specific issues, the development of domestic credit markets requires regulations and guidelines, inter-alia on disclosure, credit rating and benchmarks for pricing local government debt securities.)

16. Market-based local government financial intermediaries must develop appropriate policies and mechanisms for lending to viable, revenue-generating investments (project finance), as well as to priority, public good investments (public finance) that enhance the fiscal revenues of local government borrowers and generate the tax resources needed for debt service. As their expertise grows, financial intermediaries – the repository of knowledge, data and indicators on local government operations and finance – could expand the range of their activities in offering additional products to local governments. Lending products could include for instance short-term credit to improve cash-flow profiles and seasonal expenditure/revenue mismatches. Non-lending, fee-based services could include advisory and technical assistance to local governments as well as underwriting of local government securities, especially in the case of private placements requiring no retail infrastructure.

MARKET-BASED LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES AND MANAGEMENT OF RISKS

17. As all financial institutions seeking to maintain financial viability (and achieve growth and profitability), MLGFIs must effectively manage the main risks inherent in their lending business. Foremost among these are the market, credit and foreign exchange risks. Specific issues (strengths as well as weaknesses) associated with the financing of local governments need to be duly factored in the intermediary's risk management policies. On the one hand local governments, unlike corporate borrowers, are subject to constrains and regulations likely to hinder their debt service capacity – inflexible staffing structure and costs, obligation to maintain minimum levels and standards of services even during economic downturns, special jurisdiction that may shield them from creditor claims, etc.…. On the other hand, local government borrowers which have taxing authority, may increase revenues to meet debt service obligations in calling, within limits, on additional sales, business or property taxes.

18. *(a) Interest rate and off-balance sheet risks.* Market-based local government financial intermediaries, which are in the business of funding long dated assets through long-term loans, need matching long-term resources which they raise on capital markets. As they are not depository institutions, MLGFIs are unlikely to engage in "maturity transformation" in any significant way. Nonetheless, maturity mismatches may arise between the financial intermediary's resources and applications. Any resulting interest rate or duration risk would need to be adequately managed. Moreover, MLGFIs need to develop the capability of managing their contingent liabilities (off-balance sheet exposure including guarantees and other capital sensitive non-lending products). In particular, the pricing of such transactions should reflect the cost of capital tied up therein.

19. *(b) Credit risk*. The ability of a MLGFI to mobilize long-term debt on private markets is conditional upon its creditworthiness. In turn creditworthiness is function of the credit quality of assets, i.e. the portfolio of

local government loans. For MLGFIs, the in-built portfolio diversification resulting from the variety of sub-sectors and borrowers translates into improved portfolio quality. Such a diversified asset base: (i) provides good security to creditors as it strengthens the credit quality of debt issued by the intermediary; and (ii) allows the use of credit enhancement structures that require a diversified, expanded pool of debt. Thus, MLGFI can use guarantees and derivatives that effectively increase market acceptance or lower the cost of debt issues. Securitization of the intermediary's loan portfolio can further strengthen the credit quality of its debt obligations.

20. *(c) Foreign exchange risk*. Market-based local government financial intermediaries may have difficulty hedging any foreign currency exposure that is not passed on to borrowers. Yet, local governments which generate no foreign currency resources – tax and fee income mostly accrue in local currency – may not be able, in the absence of efficient currency swap markets, to bear such foreign exchange risk (hence the importance of fostering the development of domestic markets as a source of long-term, local currency finance). Should the national authorities decide, when foreign currency is involved, to assume the foreign exchange risk – on the grounds that they control monetary policies and foreign exchange reserves and would therefore be prepared better to hedge and manage the risk – a fee duly priced would need to be levied from the intermediary or the ultimate beneficiaries to cover government's exposure.

OWNERSHIP OF LOCAL GOVERNMENT FINANCIAL INTERMEDIARIES AND ELEMENTS OF PUBLIC SUPPORT

21. Ownership structure is an issue often raised in connection with MLGFIs. While private ownership would be the preferred option, public or joint private/public ownership can also be considered as long as the MLGFI: (i) has no monopoly in local government finance; and (ii) operates under the same rules and regulations than other private financial institutions involved in the local government sector. In the case of public ownership (where public equity funds are leveraged in private credit markets) any guarantee that the government, central or local, may provide to back the intermediary's debt issues should be duly priced and structured in a way as to reduce the likelihood, and alleviate the incidence on the guarantor, of its being called upon. Budgetary transfers/grants, if any, from central to local governments may be handled by the intermediary against a fee on a managed, off-balance sheet basis (a case would be where the government may channel, through the MLGFI, clearly targeted and transparent grants for projects involving more exacting national environment standards and for which there would be demonstrated externalities).

CONCLUSION

22. Specialized financial intermediaries for local governments can serve a useful purpose in allowing, through an evolving process, local government access to long-term credit markets. In the initial stages, the institutional and operational focus of the intermediary would be mainly on the asset side – portfolio quality and the economic sustainability of local projects. The ultimate objective would be to move towards establishing "market-based" approaches involving commercially viable, well capitalized financial intermediaries that could independently mobilize long-term debt on private markets for on-lending to priority local investments. The evolving role of the intermediary would require a parallel development at the financial and infrastructure sector levels, including structural and regulatory changes to remove barriers to private sector entry into local infrastructure provision and to private financial institutions' participation in local project finance. While private ownership of MLGFIs is preferable, public or joint private/public ownership can be considered as long as there are no restrictions/penalties on other private financial institutions involved in the local government sector. MLGFIs and municipal bond markets play complementary roles in meeting local demand for term credit. They offer alternative options in financing local governments, the needs and capabilities of which vary in line with their economic size and resource base. Municipal bond markets may be more suited for the larger, better-endowed borrowers. Yet, where local governments lack the scale for direct market access, market-based local government financial intermediaries can fill the void in pooling credit demand and mobilizing long-term resources on local government behalf.