MUNICIPAL FINANCE

1

BACKGROUND SERIES

Linkages Between Local Governments and Financial Markets: A Tool Kit to Developing Sub-Sovereign Credit Markets in Emerging Economies

John Petersen
with John B. Crihfield

APRIL 2000

The World Bank

Linkages Between Local Governments and Financial Markets: A Tool Kit to Developing Subsovereign Credit Markets in Emerging Economies[1]

1. Introduction

Decentralization and devolution of government throughout the world have brought new prerogatives and responsibilities to local governments as service providers to their local constituents. At the same time, and a part of the same movement, has been the desire to use markets as allocators of resources, including the allocation of credit in the private capital markets. This development has gone hand in hand with an increasing disposition towards private ownership and operation of many activities formerly carried out by government, where possible. A third trend has been the increasing globalization of the financial and real markets. Reduction in barriers to the mobility of capital and goods has been a near universal objective. It has also placed increasing constraints on the fiscal and monetary policies of individual national economies.

These three trends are tending to converge in the increased need for local governments to be self-reliant. They are also pressed to be more efficient in their operations, and increasingly to raise revenues from their own resources, and to access domestic and international markets in the process. By the same token, the trends of devolution and international competition are placing limitations on the ability of central governments to provide for the needs of the local governments. Correspondingly, the international lending and donor institutions are both limited in their resources and are often constrained by tradition to dealing only through sovereign units.

An upshot of these movements is an increasing emphasis on the ability of sub-national units to access directly the private capital markets to meet their development and infrastructure needs.[2] The purpose of this toolkit paper is to describe the linkages between local government credit financing needs and the capital markets in the emerging countries. The paper is presented in the form of a framework for decision making about identifying, analyzing, and strengthening these linkages. No two countries are alike. Therefore, it considers a host of connections between the operation of the credit markets at various stages of development and the structure, powers, and practices of local governments. Given the existing environment, of which numerous examples are presented, the paper considers a number of policy options.

---

[1] This paper draws on the authors' experiences in analyzing and implementing capital markets in emerging economies. In particular, we draw from GFG's contributions to M. Glasser, *e. al.* "Formulation of a Regulatory Framework for Municipal Borrowing in South Africa," Research Triangle Institute (November 1998 draft) and various background reports used in conjunction with our work in the Philippines, Poland, the United States, and in international credit analyses in conjunction with projects for USAID, U.S. EPA, and the U.S. Treasury.

[2] We use the terms local, municipal, subnational, and subsovereign often interchangeably throughout this paper, unless we are dealing in a specific context. The terms can also encompass states, provinces, and other subnational governments, depending on the context. Debt, loans, and bonds are used interchangeably, again depending on context.

It is important to note that local governments, whatever may be the desired goals of greater autonomy and capacity at that level, are found in a variety of existing contexts in terms of political power and authority. These structures will shape the desirability and applicability of many of the market-oriented and local empowerment suggestions found in this toolkit. There are generic differences between unitary states, hierarchical federal states, and those systems that recognize separate spheres for each level, including that of local government. These differences are embedded in constitutions and legal systems that, although subject to change, will greatly condition the degree to which subnational governments are free to act on their own.

The toolkit does not attempt to be prescriptive as to the best approach in all cases. But it does start from the premise that local control and decision making are good things that are to be cultivated and encouraged. It also argues for maximizing competition among private-sector financial options at the local government level wherever that is possible and prudent, reflecting the fundamental belief that numerous alternatives are invariably better than a "one way" of doing things.

The potential scope of the subject of subnational governments' access to financial markets is very large. It involves not only the many policy choices and interconnections within the government sector itself, but also a host of options regarding the organization and operation of the financial sectors in each of the respective countries, as well as their respective appetites for borrowing internationally. Aside from only a few exceptional cases, local governments in most countries have traditionally been relatively minor players in the financial markets; but, that situation is and should be subject to change.

The term "credit market" is used broadly in this paper since in many cases of emerging economies the leading provider of credit will be the banking system. For reasons discussed below, this reliance on banks as financiers may either be a substitute for, or a precursor to, a functioning domestic securities market in local government obligations. However, the view adopted here is that the development of a securities market should be as a means of obtaining long-term capital. Such markets, appealing to nonbank institutional investors, were in a phase of rapid development until the recent crises in emerging bond and equities markets.

The view taken in this paper is that the objective is to broaden the scope of the borrowing decision at the subnational level, and that the desired end result will be a private capital securities market representing potential private providers of credit and many governments competing for that credit. Questions of the possible scale of activity and the stage of financial development may mean that domestic securities markets may be limited in their growth potential and may be supplemented or even supplanted by regional or international markets. It may also affect the types of instruments and intermediaries that may make the most sense in rising capital in selected markets.

Several vantage points are possible when surveying the linkages of local governments to the financial markets. One vantage point is that of "global" policy maker

determining how best to fit a municipal securities component into the emerging domestic and existing international credit markets, given a host of other policy constraints and objectives. The second is that of the would-be borrowing local government that is intent on achieving as much flexibility as possible in financing decisions and desiring to secure capital on the best possible terms. The third perspective is that of the lender/investor that needs information to judge relative risk and rewards, remedies in the case of trouble, and assurance that the rules of the game will not be violated or hastily changed. These three views will not be consistent in all respects at all times. But the ultimate objective is assumed to be the same: to improve subnational governments' access to credit in ways that are consistent with the overall fiscal health of governments and the viability of the domestic financial markets.

An organizing principle is needed. In this case, it is assumed that a local government securities market is desired and that subnational borrowing will be dictated largely by the operation of the market, working within a framework of rules necessary to keep it a free and efficient allocator among competing uses. Many conditions need to be fulfilled for markets to operate in an optimal fashion. With respect to subnational governments, for markets that otherwise are operating efficiently, we might restrict ourselves to the following three key conditions:

- Subnational governments are taken to be largely borrowing at their own volition and relying upon their own sources of security.
- The market is free of undue restrictions and makes its allocation decisions on the basis of risk and reward.
- The market has full access to information that allows it to judge the financial condition of the borrower and to judge risk and reward.

The desire and ability of governments and financial markets to achieve the above conditions will rest on a bevy of underlying and intertwining policy and technical issues. Thus, in performing a diagnostic analysis of the options and possibilities, the tool kit will ask the following categories of topical questions:

Credit capacity, borrowing powers, and regulation within the governmental sector:

What are the types of debt security?
What debt instruments are to be used?
What types of subsovereign units are best candidates to borrow?
How is local debt to be authorized?
What limitations should be placed on borrowing?
What is the role of monitoring and oversight?
What are the remedies in case of fiscal problems?

Investor needs, regulation, and the operation of financial markets:

What is the financial market structure?
Who are the potential investors, their investment objectives and constraints?
What is to be the regulatory framework of the marketplace itself?
What is the role of disclosure and how is it to be accomplished?
What is the role of credit analysis and credit ratings?
How might various risks be mitigated by the private sector?
How should credit assistance be provided to comport with the market?

Some might say that the above two series of questions represents a separation between, first, the demand for loanable funds by the public sector and, second, the supply of them as provided by private suppliers of credit. Such a separation is conceptually useful; but, in practice things are more complicated. As will be evidenced in this paper, the linkages between subnational governments and the credit markets, even in countries with only nascent financial markets, are diffuse and complex. Few of the actors are interested only in one financial relationship, and the relationships are often more than only financial. The common thread is that subnational governments are increasingly important economic actors, and the stage on which decisions are made is increasingly a market.

2. Subnational Governmental Entities as Borrowers

Subnational debt may be the obligation of a local, regional, provincial, or state government, or of projects that are sponsored by them, including projects involving the private sector through subsidies, partnerships, and concessions. The legal and financial relationships that subnational governments may enter into, including the type of debt they contract, can differ markedly among countries. In many places these relationships are evolving, and even where they are established, they continue to be dynamic. Thus, the policy maker and the analyst alike must be prepared to look at a variety of factors and risk exposures when dealing with the debt transactions of subnational governments.

Analysis of subnational government debt can have many elements in common with other borrower types such as public utilities and private sector firms. But, there are some special features relating to the powers, structure, and operation of the subnational governments themselves. For example, most local governments deal exclusively in the domestic currency for revenues and expenditures. Thus, except for certain types of facilities (electric power, ports, airports, telecommunications), they will not have much access to foreign currency payments. Also, governments typically have certain powers over the local market for services that approach monopoly status that may be enforced by regulation. On the other hand, governments are site-specific and unable to change the geographic locus of business or the fundamental nature of the services they provide. And, by that same token, they do not go out of business.

A fundamental distinction in classifying debt is whether the obligor is the subnational government itself or is debt to which it is a party. The obligor may be the subnational government itself, relying primarily on its taxing power and other general governmental revenues to form the credit backing of the loan (i.e., general government borrower); or the obligation may be limited to a particular revenue source of an enterprise to which the general governmental credit is <u>not</u> pledged (a limited or non-guarantee obligation). This distinction is reasonably clear in the United States where a revenue-generating project or enterprise that is financed with a limited obligation is referred to as a revenue bond.

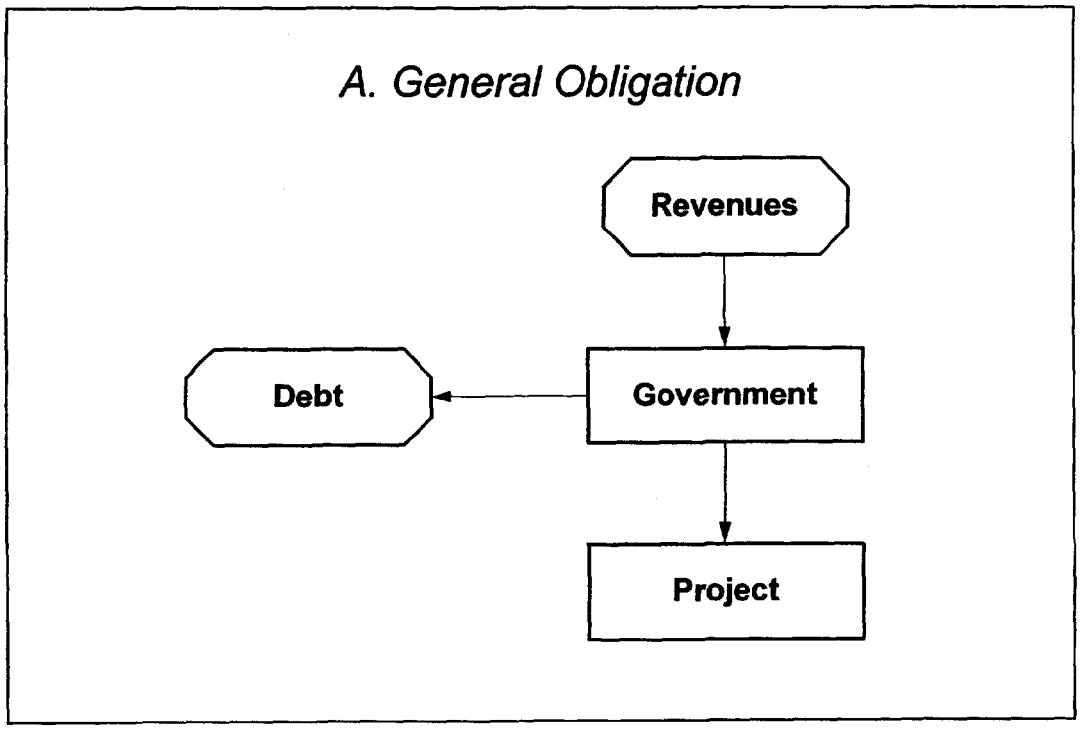
However, the distinctions between general and limited pledges can be blurry. This can be the case in a project financing where there may be mixtures of public and private funds, service and off-take contracts, profit-sharing arrangements, concessions with guarantees of use, etc. This is especially so in those countries where governments formerly carried on a variety of commercial and industrial activities that are now being totally or partially privatized. A major distinction is found in those "project finance" cases where the private sector is a direct investor in a project, is an equity provider and is actively engaged in its operation and management. In these cases, the analysis may become very complex and involve a blend of risk factors involving both the public and private sectors.

2.1 Prototype Credit Structures

The accompanying charts present simplified schematic illustrations of three prototype financing and credit structures involving subnational governments. For ease of exposition, we have assumed that the financing involves a project, which is typically the case. However, the borrowing might be used for other purposes, including relending.

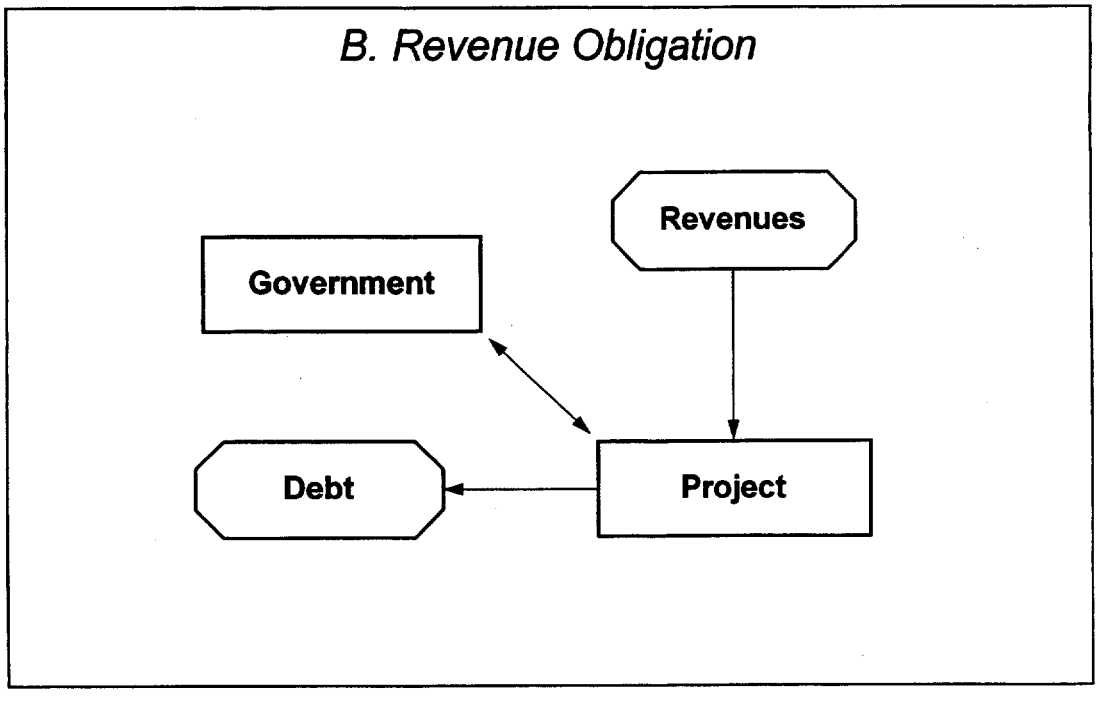
a. General Government Obligation (general revenue supported)

In this case the government uses its general revenues to support the debt service payments and owns and operates the project itself. In most countries, this would be the likely structure for public safety, public education, and health and welfare capital expenditures, which activities themselves are not revenue producing. The government issues the debt in its own name and pledges its general revenues. The proceeds of the borrowing are spent on a project. However, neither the project itself so financed nor earnings from it are specifically tied to the repayment of the debt. An important variation on this theme is where the local government gets intergovernmental assistance, such as shared taxes or grants, which are pledged as part of the security.



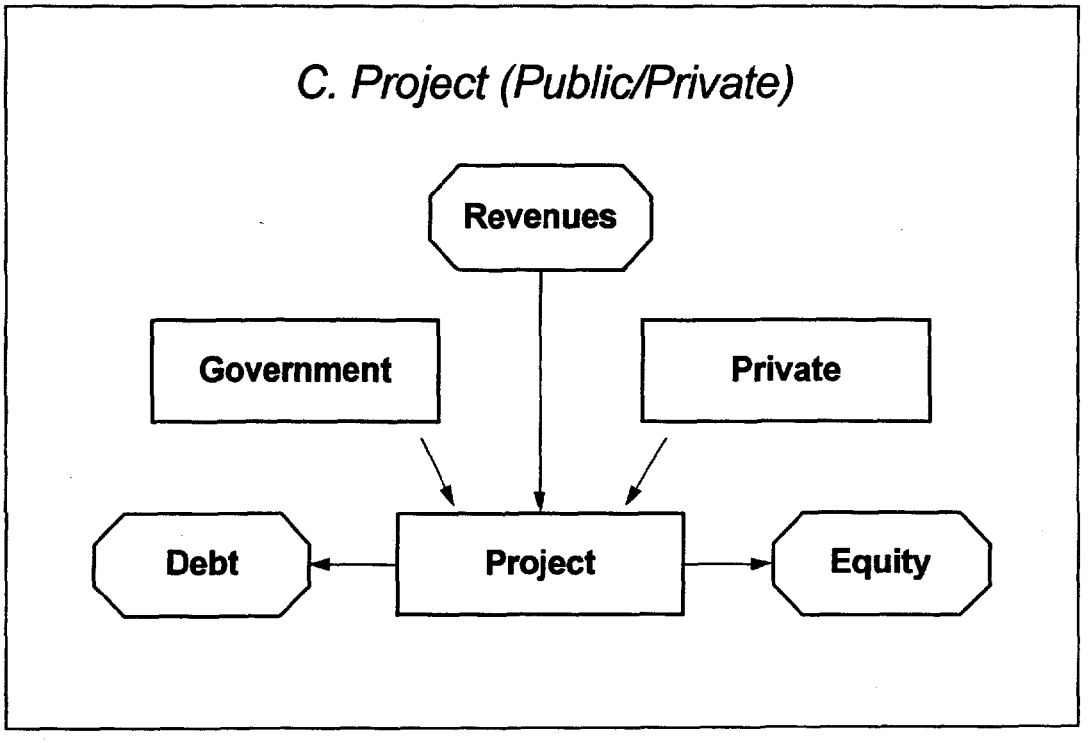
b. Government Limited Obligation (enterprise activity supported)

In this case, the facility is an enterprise that produces revenues through charges and fees that are used to defray much or all of the costs of operation and debt service. The debt is secured primarily or exclusively on the project earnings, general revenues are typically not pledged directly, and there may be a prohibition against their use. Common subnational enterprises are public utilities, such as water and sewer, electric distribution, local toll facilities, public markets, harvest processing facilities, and local ports and terminals, etc. The debt is issued either by the project itself (which may be a limited-purpose special district) or on behalf of the project by the general governmental sponsor.



c. Project Financings (public/private undertakings)

In this third case, which is typically a "utility" type project, the government enters into arrangements with the private sector in the form of concessions or partnership agreements to build, own, and/or operate the project. The government, either national or local or perhaps both, may provide any number of inputs into the financial structure: equity interests, subsidies, and various forms of guarantees related to the demand for outputs or for supplying needed inputs. Likewise, the private sector, or international lending entities, may contribute debt, equity, and various enhancements to the financial mix . The obligations of, and returns to, the respective parties are determined by contract. The debt is typically issued in the name of the project and may be nonrecourse, looking only to project earnings, ownership, and/or assets for security.



2.2 Classifying Potential Subnational Borrowers

Many subnational governments already have access to credit. That may be in the form of access to government sponsored lending programs, bank lending, or sales of bonds in the domestic or international capital markets. However, many more do not have access and the odds and avenues for them gaining it run a gamut of possibilities.

A fundamental consideration has to do with the fiscal capacity and financial acumen of subnational jurisdictions. These two factors, which relate to the ability and willingness to pay, largely govern which units are candidates for debt issuance. They are not always correlated with size, but larger jurisdictions typically are of greater interest to private providers of credit for a number of reasons, including greater sophistication, the ability to draw upon more resources, and the ability to spread the fixed costs of debt transactions over larger volumes of borrowing. In most countries, a familiar triage of possibilities occur. Three groups of jurisdictions can be identified as regards to the likelihood for the issuance of subsovereign debt in private markets[3]. These groups are:

- *Those units that because of size, and financial and managerial resources already have access to capital markets.*

[3] Later, there will be a discussion of concessionary finance and technical assistance. At this stage, the concern is with identifying the likely "potential market" for private-sector capital access and under what conditions.

- *Those that have no or only limited access to capital markets, but can generate revenues sufficient to their responsibilities and are otherwise capable of borrowing private capital.* This group consists of those units that (a) are large and that have sufficient capabilities to attract private interest without direct central government help, and those (b) that are too small or that lack the managerial capability to attract private lending at present, but with assistance could gain access.

- *Those that cannot generate sufficient revenue either to provide the services they require or to build the needed infrastructure.* Jurisdictions in this group, which for all practical purposes are "financial wards" of higher levels of government, do not have access to capital markets and most likely should not.

Jurisdictions in the first two groups have the potential to use private credit resources under a regime where any central government assistance rendered to municipal market development is essentially accommodative and indirect.[4] Those local units in the third group, the small and poor, most likely can not and should not borrow in the private credit markets.

As handy as this triage might appear to be, it is one that will defy the drawing of strict lines of demarcation in practice. The advocate of light-handed intervention and believers in market solutions will say that the market will define, better than government regulation, which jurisdictions fall into which category. Any classification scheme will be dynamic over time and subject to revision. For example, it is conceivable that some governments that are generally too small and too poor to gain access to markets using their general revenue funds may latch on to a project financing that is creditworthy. Or, if they choose to pledge (or can pledge) their intergovernmental payments, even those with otherwise insufficient own-source revenues might qualify for private credit.

Government policies regarding intergovernmental finance and governing technical and credit assistance to small and unsophisticated jurisdictions will affect how the market assesses creditworthiness. As a general rule, countries that have a weakly financed and unsophisticated local government sector will find themselves having to do one of two things. Either they must largely forego the private securities market as a medium for direct borrowing, or they will need to devise active policies to help move local governments up the creditworthiness ladder.

[4] By accommodative and indirect we mean that the assistance is not given to particular jurisdictions in terms of concessionary credit assistance but rather is directed at creating laws and regulations that permit or engender private capital flows to subnational governments in a securities market context.

2.3 Making Distinctions Among Local Jurisdictions

Formulating the triage of local jurisdictions used above on the basis of *existing* creditworthiness is useful for analytic purposes, such as describing potential demand for credit access and the likely size and viability of a local government securities market. But, should such distinctions be codified into law or regulation for purposes of predetermining which units can access the markets and obtain credit? In developed economies, freely operating credit markets effectively classify borrowers on their own, and reflect their credit assessments in the prices charged for borrowing. Nonetheless, even in these mature markets, regulatory classification is sometimes practiced by central or state governments in order to provide certain privileges to some borrowers or to impose restrictions on others. For example, in the United States most state governments differentiate among local governments through various legal classification mechanisms, and these differentiations can include differential borrowing powers. However, the credit market itself further differentiates among governments, based on varying assessments of creditworthiness. These assessments are based on perceived differences of the jurisdictions' economic vitality, managerial efficiencies, financial condition, and the necessity and viability of individual projects.

We believe that detailed regulatory prescriptions are best avoided. But, senior levels of government have a legitimate interest in how their progeny and juniors behave in the financial markets. If a significant amount of questionable subsovereign debt is issued, two harmful things could happen. The severity of each depends on the political makeup of the country. If the sovereign is providing either a *de jure* or *de facto* sovereign guarantee, large amounts of failure can lead to national bailouts that increase the supply of credit and lead to inflationary pressures. Domestically and internationally, in the absence of national government bailouts, widespread defaults could create distrust about such debt generally, and could cause general market instability.

To guard against imprudent behavior, most national governmental credit systems use classifications. These classifications are not meant to prohibit debt for some classes, but to differentiate among jurisdictions in terms of allowable maximum outstanding debt or, more typically, the maximum debt outstanding in relation to some revenue source, such as the property tax. However, in subsovereign financial systems being put into place for the first time, or radically redesigned, there may be a tendency to overuse classifications, which themselves may be poorly designed or not enforceable.

The strongest argument against rigid regulatory classification is that upward mobility between categories of financial strength and managerial maturity should be encouraged. Classifying a jurisdiction in a way that encourages it to be dependent on external assistance and avoid responsible borrowing on its own is exactly the opposite of the effect the government intends to have. Artificially limiting market access runs counter to the basic policy goal of maximizing private sector investment.

2.4 Subnational Borrowers by Governmental Type

Within the local government sector, debt may also be incurred by municipal enterprises and quasi-municipal entities. These types of borrowers can be created by agreement of existing municipalities, or by legislation of the national or regional government. There are at least three kinds of special-purpose arrangements. These are as follows:

a) Separate restricted funds, accounting arrangements, or special purpose entities within a municipality, whose revenues and expenditures are restricted to specific purposes and are separated from the general fund. These entities typically derive their power from the municipalities, although they may be run with a good deal of independence.

b) Entities created by agreement by more than one municipality to accomplish a special purpose (e.g., to provide fire protection efficiently across a broad area). Their revenues and expenditures can be separated from those of the organizing municipalities. Their powers can derive solely from the municipalities ("joint powers"), or though legislation which can limit or extend such combining powers.

c) Quasi-municipal entities created by state or national legislation. These entities might provide municipal services (e.g., water development, disease control, or transport services) where needs do not necessarily relate to municipal boundaries. They have such powers as are described in authorizing legislation.

In theory, these three types of subnational special-purpose governmental entities might issue limited obligation debt based on their own revenue sources and the ability to borrow against them. That is, they do not necessarily have the guarantee of a parent municipality.

As one might expect, there are two sides of the special-purpose, special entity borrowing coin. The argument against such issuers is that they can lead to a proliferation and fragmentation of local government and can cause diffusion of local revenue sources. The argument in favor of such issuers is that they allow services to be delivered by an appropriately crafted entity with targeted taxes, fees, and charges. Since geographic areas of traditional general governments are typically inherited from a political and economic logic that may be long past, the case for promoting special service districts along the lines of economic service areas is often compelling.

The practical implication of the above discussion is that local government borrowing powers should be kept widely available and flexible in the sense that they may be harnessed to addressing not only common but also special infrastructure problems. A special case in point, as we will examine below, is the special taxing and fee district which may permit a general unit of government to gear its taxing and charging powers to

the particular needs of subdivisions. The special taxing district has seen a good deal of use in the United States.

One application of special districts is in the use of business improvement districts. These are special taxing units that levy a tax in addition to the normal taxes and have powers and personnel to address the special needs of downtown areas, especially those that are subject to urban decay and distressed conditions, including extraordinary sanitation and public safety needs. The concept has caught on in parts of Europe and is beginning to spread to developing economies as well.[5]

Definitions and Control of Public Debt

The definition of public debt can be an important policy issue in deciding the boundaries of local government borrowing prerogatives. In the European Union legislation, which is subject to the deficit and debt limits contained in the Maastricht Treaty, there are limits placed on public indebtedness which include the debt on the central, regional, and local governments including social security funds, but excluding public enterprises. The limitation thus is not expressed in terms of the ownership of the facility but rather the activity, the general government sector being defined as the institutional units producing nonmarket services as their main activity. Effectuation of the limitation has led to several concerns about how to coordinate debt incurred at the sovereign level with that at the subsovereign level.

The upshot of the EU definition is that for local units, which are subject to the above limitation, will have an inducement to place as much of their debt as possible on a self-supporting, commercial basis in order to avoid the macro-level curbs on borrowing. Evidently, however, the EU definitions would also include certain contingent obligations that subnational governments might enter into in support of commercial debt, such as obligations to purchase a commodity or service (an off-take guarantee) and pledges to make up project operating deficits or debt service deficiencies from general funds.

The curbs on general obligation tax-supported debt embodied in the EU limits are akin to the individual state-based limitations of tax-supported debt that arose in the United States. In the U.S., the restrictions on general debt hastened the rise of the nonrecourse revenue-bond obligation that is used for enterprise activities and other forms of non-recourse obligations such as the moral obligation bond.[6] These limited obligations, many of which are de facto supported by taxes and fees raised by the general government, once represented only a minor fraction of municipal borrowing. They now typically make up around 60 to 70 percent of all bonds sold in the United States.

5 "Johannesburg's Changing Center," *The Economist* (November 7 - 14, 1998) p.50

6 See J. Petersen and R. Forbes, "Remarkable Rise of the Revenue Bond" in G. Kaufman (ed) _____

3. Types of Debt Security

As noted in the preceding section, types of debt are defined by the kind of security given by the borrower. Security (that is, where the money will come from to repay the debt) typically runs to two questions (1) where the money is *expected to come from* and (2) where it *might have to come from,* which is the ultimate collateral and remedies in case of failure. Before investing, creditors want to know not only where the money is expected to come from, but also what are their remedies or security in the event of default. Unless the remedies and security are deemed adequate, the markets may set risk premiums that make credit unaffordable to many jurisdictions. Knowing the security on debt is important: uncertainty as to remedy and security builds inefficiencies into the market.

The question of what remedies should be available by law to creditors is critical. Any framework for subsovereign borrowing needs to spell out what powers a jurisdiction has to pledge assets, revenue streams, and to exercise its powers to set taxes, tariffs, and other levies. It is also desirable to spell out how such security can be affected in the event of default or other financial emergency.

3.1 General Debt

In most emerging countries, with the exception of the largest units, general purpose subsovereign debt has in the past carried some form of sovereign government backing. Increasingly, national governments are attempting to wean local governments off of such backing and encouraging them to borrow on their own credit. The credit of the subnational unit, without an explicit or implicit guarantee by the national government, is often not clear. Accordingly, expressions such as "general obligation" or "balance sheet" debt often mask an unresolved question of ultimate security: that is, just what remedies are available to an investor in case the unit fails to pay on time and in full. Questions of limited obligations and special security are dealt with below. Here we focus on general obligations, incurred on behalf of a jurisdiction as a whole, to benefit the population at large.

Aside from the good faith of a jurisdiction and the prospect of national assistance if things get difficult, subsovereign general obligations have often been backed by the ability of creditors to seize financial and physical assets. For a number of reasons, this physical collateral system is not a sound approach to securing credits. Local governments with physical assets that are unrelated to their municipal service responsibilities, e.g., a commercial enterprise, might be best advised to divest themselves of the asset so as not to divert scarce city management capacity to managing a potentially private activity. Municipal assets that are used directly or indirectly in the provision of vital services should not be risked as collateral. Although often desired by lenders, physical collateral

can divert the jurisdiction's attention from making sure its general revenues are sound enough to support borrowing.

The terminology and meaning of the general obligation pledge is subject to variation. The term "full faith and credit" originated in the United States and is generally understood to mean more than a general, unsecured promise.[7] Debt not backed by specific revenue flows should be backed by a pledge of all general revenues as a source of debt service payment. The jurisdiction could be specifically obligated to use any and all of its general resources, including the raising of taxes and fees as required, to meet debt service obligations. Stronger and more specific remedies for creditors are likely to strengthen investor confidence in subsovereign debt in emerging economies, a subject we return to in Section 10 of this paper.

3.2 Special Pledges and Limited Obligations

The above discussion considered the forms of security and remedies implicit in a general obligation, promise to pay using general powers of taxation and other general government assets, if needs be. We now consider the kinds of limited security that can be given to secure subsovereign debt. Limited security arrangements include the following:

- Pledging of physical or monetary assets.
- Pledging the right to operate a facility or provide a service.
- Pledging of selected revenues, such as:
  - from tariffs, fares, or rentals.
  - from particular taxes or special levies.
  - from grants or shared taxes (intergovernmental transfers).
- Pledging the power to set specific tax rates, utility tariffs, and other levies.
- Pledging by the executive to budget for and recommend payment of future debt service, without an explicit binding pledge that those appropriations will be made.[8]
- Pledging to assign the payment of future intergovernmental revenue.

---

[7] In the United States the term full faith and power means the application of the general taxing power to the repayment of the debt. That power in its traditional and strongest formulation has meant the imposing of taxes "unlimited as to rate or amount" sufficient to repay the debt. Over the years various limitations and caps entered into the pledged taxing powers, although by and large it remains as the ultimate in taxing power pledges. As a practical matter general obligation defaults are almost unheard of and are promptly cured by a mandamus from a court to levy taxes and the intervention of state governments to make sure that that happens. States in the U.S. are usually very sensitive that they not get a bad reputation by the failure of a local government not to pay its debts for fear of the implications for other local governments. Default by a general government means the loss of local governing powers, sometimes with the appointment of a control board or a receiver to take over operations until the debt in resolved.

[8] This type of security is known in the U.S. as appropriation or moral obligation debt. It recognizes that debt is not a full faith and credit binding obligation but rather is subject to the will of successive legislatures. Its origins are lease rental debt that holds that the obligation only runs from fiscal year to fiscal year and is subject to reconsideration of the legislature each year.

These several types of local government security arrangements, and how they are effectuated, are discussed in the following sections.

3.3 Pledges of Assets, Operating Rights, and Revenue Streams

A very common form of pledge backing debt in developed markets is one which is restricted to a particular revenue stream or enumerated local government assets. Also possible is for the creditor, in case of default, to step in and perform the activity and receive the revenues. But, both the carving out of specific revenues and giving the creditors rights to assets and operational powers raises a host of operational and policy issues.

Local officials may be hesitant to pledge assets because the loss of such assets and their benefits in the event of default would be dramatic. There may be assets or revenue streams that are so vital to maintaining basic governance that they should be protected from a debt service pledge. Examples of such vital assets and operations may include the following:

- Intergovernmental share transfers to provide services to selected segments of the population or earmarked purposes.
- Those physical facilities deemed essential to the public health, safety and welfare, such as water supply, fire equipment, and hospitals.

Another consideration is that a government will have a limited number of pledgable assets, especially non-vital properties. The extent to which they are forced to pledge these assets will reduce their future ability to secure loans, and a loss of future financial flexibility.

As a practical matter, private-sector lenders are of two minds when it comes to asset pledges. They are anxious to achieve as much collateral as possible and to apply leverage to reluctant debtors. However, lenders will be reluctant to take indispensable physical assets as collateral on a loan. They may be willing to take marketable assets, such as vacant land, office buildings, parking lots, or sports facilities, but they are not likely to foreclose on essential service facilities, such as water or wastewater treatment plants, town halls, city streets, or fire stations. If the legal system provides adequate assurance, the lenders are more likely to secure local debts by pledges of actual or potential revenue streams that are sufficient to cover the debt service.

Because of the practical and political problems of tying up essential facilities, a prohibition on pledging properties deemed essential to the public health and safety could be included in authorizing legislation with little impact on a market's development of other useful security devices. If this restriction were included, minimum essential services can be defined by law and then left to the underlying borrowers to decide what

fits the definition. These might include water, sewer, and refuse collection as is necessary for human health and safety. Alternatively, assets relating to these services could be pledged, but the law should require minimum essential services to be continued at all times. These restrictions would not be barriers to borrowing, since lenders are not interested in repossessing pipes in the ground, but rather desire revenue streams.

A pledge of revenues from public utilities is appropriate for financing related to those utilities that benefit from the financed improvements. But, it raises concerns if the pledge of revenue-producing properties is used to secure unrelated financing. Part of the concern is simple economics. When a jurisdiction subsidizes general expenditures at the expense of utility charges, it results in a misallocation of resources. In economic theory, and usually in practice, the service that does the subsidizing is under-allocated, and the service that is subsidized is over-allocated.

Importance of the Rate Setting Pledge

South Africa presents an interesting example of the importance of the rate setting pledge in a revenue bond, and the potential problems when its application is uncertain. Several South African cities are attempting to implement privatization plans that involve what in fact are non-recourse revenue bonds. These are intended to rely exclusively on the water tariffs of the privately operated water treatment plants to pay debt service. As is typically the case, the tariffs will need to be increased over time to meet increased operating costs or to offset unforeseen expenditures. However, legislation in the national congress gives a national minister the discretion to set water tariff rates, in effect over-riding local control and contract. If that happens, then the private concessionaires want the local communities to agree to raise property taxes to the degree needed to make up any shortfall in revenues.

While the latter alternative improves the creditworthiness of the bonds, it has raised other problems. First, the general tax base of the municipality is eroded by the "standby" liability in case water rates are not raised and taxes must be. Second, the water ratepayers and the property taxpayers are not one in the same. The multitude of water users own little if any taxable property and they greatly outnumber the better off property taxpayers. This opens up the potential that local elected officials might not regret, but might indeed welcome the reneging on water rate increases by the national official since it would shift the burden of the debt makeup to the wealthier, but fewer, constituents that pay the property taxes.

3.4 Pledging to Set Tax Rates, Tariffs, and Other Levies.

Local revenue-raising powers may be limited in emerging economies. But, even where the powers of local governments to set rates and make levies do exist, there can be ambiguity as to whether local government can pledge to set tariffs, tax rates, or other charges at a level sufficient to service a debt.[9] There can be issues as to whether such covenants unlawfully bind future administrations and legislators in the exercise of their prerogatives. However, without such a forward-looking and binding-contract ability to pledge, the pledge is much less meaningful to the point of being worthless. Where the tariffs, rates, or charges can be increased or decreased at the discretion of the local authorities, a covenant to set and maintain those tariffs, rates, or charges at adequate levels to meet operating costs and pay debt service is a useful financing tool.

The experience in many emerging market countries is that the primary cause of debt service default and payment arrears is failure to increase rates and charges that were planned to be the source of revenues. Subnational jurisdictions will benefit from clear legal authority to covenant future tariff or tax increases to secure debt. Jurisdictions may choose whether or not to use this mechanism, but they should have the legal authority to covenant, if possible.

3.5 Intergovernmental Revenue Intercepts

In many countries local jurisdictions can assign creditors their interest in specified revenue streams, such as shared taxes and grants, received from the national or other higher-level governments. Revenue intercepts are attractive to a creditor because they promise stable and predictable revenue streams that can be easily accessed to pay debt service. Intercepts can be designed in various ways either to assure adequate funds are available to meet debt service payments prior to their coming due (an ex ante intercept) or to be tapped only in the event of a local government's default (an ex post intercept). Another variant is to have a bank credit facility standing by to advance money in case funds are not on hand to meet debt service payments and then have the loan repaid out of future intercept receipts.

In the case of pre-assignment of revenues to pay debt service, some have argued that it may be tempting for jurisdictions to routinely not budget for or to pay debt service and to force creditors to rely on intercepts. Accordingly, intercepted protected creditors become lazy and do not care either about the underlying worth of the investment being financed by the loan nor about the local government's financial condition or performance. This, it is argued, neither encourages responsible priority-setting at the local budget level nor promotes a rational market allocation of resources. If this "asleep at the switch" problem is thought to be compelling, it can be addressed by assessing a significant penalty or administrative fee to the borrower that routinely uses the intercept to pay its debt service bills. This penalty ensures that the jurisdiction is always better off collecting its own revenues and paying its own bills.

---

[9] Such provisions are known as rate covenants.

There also may be a tendency to use withholding of transfers for all kinds of purposes, not the least of which is ensuring debt repayment. In South Africa, for example, there is a move afoot to use a share of the transfers for financial capacity building and in the Philippines a mandatory 25% share of the internal revenue payments to local governments must be used for developmental investment. Each instance of using leverage over transfers to assure local activities may make sense individually. But, if the mechanism is used for many different purposes, the overall intergovernmental transfer system can become splintered into a set of constraining and competing mandates.

Intergovernmental Transfer Payments As Collateral

Typically, in newly emerging economies, local governments are highly dependent on transfers from the central government. While these can be very volatile and untested for sustained periods of time, they form a major portion of revenues and are attractive for interception to cover debt service payments. Columbia offers an example of the widespread use of intercepts of central government payments to cover debt service through the Findetere program.

As a rule, if intergovernmental payments are used for pledging, there should be a coverage factor so that the historic and/or expected level of transfer covers the debt service payments by some fraction greater than one. In the Philippines, about 50% of all revenues received by cities are through intergovernmental transfers from the national government, and for provinces the average figure is 75%. The smaller and more rural the local government, the higher the proportion of transfers to total revenues. In that country, government owned banks (the de facto required depositories for local governments) have gotten deeds of assignment of transfer payments to cover bank loans. As aid is received, the banks have a right of offset against any loan amounts owed the banks prior to dispersal for other purposes.

Intercepts can have a powerful impact on local borrowers, especially small and remote units. The assignment to bondholders of state payments to local school districts (which typically make up over 50 percent of revenues for the districts) is very common in the United States. It is the basis for the high credit ratings enjoyed by local school districts covered by such programs, the rating of which is usually only one full notch below that on the state's general obligation debt.[10] As a result of this wide-spread appreciation of the impact of state assistance and other small-borrower preferences, local schools are among the lowest cost borrowers in the U.S. municipal bond market.

3.6 Enterprise or "Self-supporting" Financing

[10] One notch means if the state's general obligation is AAA, then the intercept protected debt will be rated AA.

A common use for special pledges of revenues and assets is for a self-supporting "enterprise" that generates its own means of repayment and does not rely on recourse to general revenues.[11] This limited obligation involves the pledge of only specified system or project revenues to repayment. In accounting terms, this implies the creation of a special fund to receive the specified revenues, which are expended to meet costs associated with the enterprise, including the payment of debt. This concept focuses credit concerns on the viability of a particular project or system, rather than on the viability of the jurisdiction. Poor or unsound general purpose jurisdictions can have viable enterprises, and vice versa.

There are several advantages to this type of financing:

- It establishes a relationship between the cost of service and service prices. This promotes more efficient operations. The cost/price relationship need not be absolute and can be modified in practice, but it has the benefit of assembling the costs and making any subsidy paid transparent.

- If the utility has been run at a surplus to subsidize other governmental functions, then the added "tax" burden resulting to utility users becomes evident.

- To the extent that general revenues have subsidized enterprise operations, the use of dedicated revenue structures will free up general revenues to pay other costs.[12]

- Management and operation of revenue-producing facilities tend to be more efficient and the facilities are better kept up since they need to be in shape to produce revenues. This can be encouraged by contractual provisions protecting income and value, paired with creditors' active interest in assets and their operation.

- When there are legitimate reasons to use general revenues as well as specific revenues, it may be better to use general revenues to reduce the amount of debt incurred. For example, this can be done by making a municipal "equity" investment in the asset up front, and borrowing to build or acquire the rest of the asset, pledging only revenues produced by the asset, or even a part of the asset's operations, to meet debt service requirements. This practice is common in Western European countries for many municipal utility operations.

There are also disadvantages to limited obligation, self-supporting financing.

---

11 This is the traditional notion of the enterprise revenue bond. There is a legion of variation on the idea, many of which have been designed in the U.S. to circumvent restrictions on tax-supported debt. This approach allows and encourages allocation of full costs of services to the beneficiaries. Economically, this is desirable because it leads to efficient allocation of scarce resources.

12 In some places, such as in South Africa, the subsidy runs from the utility to the general fund, rather than the other way.

- The expressions "asset stripping" or "security dilution" convey the concern faced by existing creditors of jurisdictions that have relied on a utility to generate subsidies for the general fund, when those revenues are instead pledged to a utility-specific purpose.[13] In other words, where prior lenders have looked to the overall revenues as a source of repayments, a subsequent sequestering or stripping away of revenue streams weakens the credit.

- Limited obligations may hinder redistribution of infrastructure and services among population groups (say, from rich sections to poor ones) by keeping potentially redistributable revenues for the benefit of an already privileged area. If there are to be preferential and redistributive policies, they typically must be financed from the sponsoring unit's general funds.

- Future financing options are restricted. Enterprise financing is a matter of contract between the public-sector sponsor, acting on behalf of the enterprise, and the investors.[14] Investors typically will require restrictions that reduce the options of borrowers in the future. For example, borrowers must meet certain conditions before they are able to issue more debt secured on the enterprise earnings (additional bond test), must conform to certain requirements regarding reserves and insurance, and must abide by a rate covenant, as was discussed above.

In some countries the local governments have been able to use utility surpluses as a means of subsidizing the general budget.[15] But the ideal of transparency implies that utility surpluses used for cross subsidization should not be buried, but should be reflected in a specific tax or surcharge that reflects the added cost of cross-subsidies. Without this transparency, it is not possible to see if the utility is operating at an economic optimum in getting the most delivered service per unit of input. Having reached that optimum, the redistribution becomes a clear added cost for some and benefit for others.

The above discussion focuses on that enterprise financing associated with traditional "natural monopolies," public utilities provided by local governments. However, there are other potentially revenue-producing activities that are "semi-commercial" in character, such as transportation terminals, public markets, abattoirs, farm processing plants, and the like. In addition, industrial estates, tourism facilities (including hotels), toll roads and bridges, and a number of other revenue-producing facilities are candidates for complete or partial financing by the use of "revenue bonds.'

---

13 However, most economists would applaud this elimination of the cross-subsidy on efficiency grounds.

14 For example, there may be requirements that the borrower not pledge the same asset to another lender, except under stated conditions (additional bonds test), that the revenues provide certain coverage of the debt service (rate covenant), and that revenues be retained for use on the facility and to the benefit of bond holders (closed loop). Negotiation of these restrictions and the associated tests is an integral part of the borrowing transaction.

15 Subsidies can be hard to detect. A government may fleet many of its costs off to the utility by allocations of administrative and other costs to the utility or it may receive utility services below cost or for free. Where the utility is part of the government, the allocation of costs can be highly judgmental.

Critical components of such proposals are the reliability and growth of revenues, the technology used, the facilities' adequacy, firm construction dates and costs and future operating costs being either fixed or controllable in the future.

Depending on the nature of the facility, determining the nature of and risks in these technical and economic factors requires engineering studies and market demand studies. The objective of the studies, from the financial perspective, is to obtain objective estimates of what will be the net revenues available after operations to pay debt service on the loans or bonds and, if not, what steps might be taken to ameliorate the situation. Such studies are especially critical in new, free-standing projects where there is no experience yet with operations.

Importance of Feasibility Reports

Projects that are intended to be self-supporting should generate sufficient revenues to pay for their operation and also to meet some or all of their capital costs. In many cases, projects represent monopolies either because of being essential in a technical sense (water and electricity), or are exclusive in location (toll roads and bridges) or because the sponsoring government exercises a high degree of market control by regulation (solid waste and parking facilities). Other projects, however, such as sporting or cultural venues, are not essential, subject to competition and face greater market demand risks. In any case, facilities may be subject to construction and technological risk, such as cost overruns, start-up delays, or failure to produce the expected amounts or quality of output.

Assessing these factors and associated risks is at the heart of the engineering and marketing studies that underlie determining a project's feasibility. Emerging economies are often short-handed of the technical skills needed to put together engineering and market demand studies and the independence needed to provide objectivity in the analysis.

The difficulties of separating project promotion from technical analysis and the unfortunate consequences of not doing so are reflected in the fate of the sports complex built in the municipality of San Pedro Sula, Honduras. The complex was built to host the Central American Games. It was expected to be able largely to pay for itself. Some $15 million in bonds were sold to help offset the anticipated costs of $25 million (which were expected to be offset by a variety of revenues). In fact, the project ended up costing $36 million and net project revenues fell far below expectations. The city made a general obligation pledge in addition to the project revenues and it is now in serious difficulty.[16]

The issuance of the bonds *per se* was not the problem with San Pedro.[17] Rather, it was a lack of analysis that permitted the city to take on large and unfathomed risks. Among the cited problems with feasibility study were:

- no analysis of the market for "special seat" sales, although these were expected to generate nearly 80% of the operating revenues
- no detail of the assumptions that were used in the construction estimates
- no project alternatives were considered, such as upgrading an existing stadium
- no evaluation of using the private sector and more equity in the construction project
- no description of the various risks or possible contingencies if the complex's revenues were not realized.

16 San Pedro attempted to sell the bonds in its limited financial markets with no success (all the bonds went to the contractors). The city was faced with a lack of bank credit, in part due to the weak and oligopolistic nature of the domestic banking system.

17 Giovanni Giovannelli, *Non Performing Municipal Borrowing in Central America - A Case Study* First World Bank Conference on Capital Market Development at the Subnational Level, Santander Spain (October, 1998)

In short, there never was a credible assessment of either the project's economics and prospects nor of the impact on the guaranteeing municipality's finances.

Failure to do engineering and feasibility studies or of having them performed objectively by skilled professionals can lead to severe problems for the sponsoring local government, especially if it pledges its own credit as part of the security. See the box on the feasibility reports.

3.7 Special District Financing

A variant of enterprise financing is special district financing. A special district is created to provide infrastructure and services to a subset of the general population and to a geographic area that demands special types or levels of service. These districts have been used to provide urban services (water, sewer, and roads) to areas that are developing rapidly or that have special needs (such as downtown areas). They may be used to provide infrastructure, services, or both.[18] They are common in Western Europe and the United States, and are beginning to emerge in developing countries.

There are many examples; but the common theme is that if there are special benefits that can be ascribed to a particular area, then the special district provides a mechanism for recovering costs that are associated with the benefits. Special districts can provide a way of transcending political boundaries or uniting jurisdictions into a single financing unit to provide a regional service. Of particular note is where new development or extensive redevelopment is occurring and where property (as opposed to individuals) is the long-term beneficiary of the improvements. For example, new public utilities and transportation, storm drainage, parks, and similar improvements increase the attractiveness of an area and enhance property values. As the area is improved by these expenditures, the amenities themselves and access provided to them increase property values, as well as other indices of economic activity and worth. If the costs of the capital improvements are borne by the public sector, then the public sector should have a way of capturing its investment. Such a value capture mechanism is possible with a special district that gears its taxes or charges to pay for capital improvements, the benefits of which were received by the improved properties.[19]

A successful special tax relies on good and timely measurement of values and an efficient collection system. In the United States, for example, some special taxing districts are administered by private for-profit organizations that undertake the

---

18 A district may be "dependent" and overseen by the governing body of the municipality, or "independent" with an autonomous elected or appointed board. In many areas storeowners or homeowners form associations to manage the district and levy charges. The key is the ability to levy taxes and charges, and to attach (i.e., to seize) properties that do not pay.

19 In its most common form in the United States and a few other places in Europe, the tax district uses property taxes (expressed as a percentage of taxable property value) or assessments (fixed dollar levies). However, the district can use other bases to charge for the benefit or service, including square footage (or meters) or front footage (or meters), number of vehicular trips (for roads), impervious surface (for drainage), lumens of light (for lighting), residential bedrooms (for educational facilities), square footage of space (for parking), and so forth. The key is that there be a logical "nexus" between the improvement and the form of charge that is used.

calculations and do the tax billings, acting as agents for the host governments. The entire revenue-raising mechanism is meant to support obtaining credit and is specified in the loan or bond agreement. This improves the administration of taxes, and the integrity and efficiency of the system becomes, in effect, a matter of contract with bondholders. In Western Europe the special district or special authority covering all or parts of more than one political jurisdiction has facilitated the subsequent privatization of services, such as water utilities in the United Kingdom and France.

4. Debt Structures, Instruments, and Methods of Sale

Debt structure and instruments have to do with the mechanics of how the principal of debt is to be repaid, how long a debt will be outstanding, and how interest due on that debt will be figured and paid. Method of sale has to do with the procedures by which debt is offered to the final investors and debt obligations exchanged for the bond proceeds. As a rule, these matters will largely be determined by the market. That is as it should be, assuming that the market is competitive and that debtor, investor, and banker are all equally well informed. The financial markets are fluid, and what might be attractive one day can be unattractive the next. Inflexibility is costly.

A major concern at the national level is not to create regulation that interferes with the flexibility of lenders and borrowers in structuring debt in ways that best suit both parties. This section examines the case for maintaining flexibility and alternatives in the structuring of local government debts. It describes debt structure and illustrates the range of instruments available to suit the profiles of issuers and investors.

4.1 Maturity or Term of Debt

The maturity of a debt instrument should be no longer than and, better yet, matched to the economic life of the asset it is financing. Ideally, amortizing the liability on one side of the balance sheet is matched by the depreciation of the asset financed. Thus, infrastructure assets, such as water systems, roads, or municipal buildings, which typically have lives of 15 to 30 years, should, in principle, be financed with long-term bonds of similar duration.[20] In many emerging markets this matching is impossible to accomplish as investors are unwilling to extend loans beyond a few years and even then, the rates of interest may be exorbitant because either there is large perceived risk beyond a few years and/or capital can be committed at short maturities at substantial returns.

Even if longer term capital is available, the shape of the yield curve may make borrowers prefer the use of shorter term debt.[21] Typically, the yield curve is upward sloping, i.e., the longer the term of the debt, the higher the interest rate payable. The upward slope is caused because investors want extra compensation for the lack of liquidity of long-term lending. They have increasing uncertainty as to what economic conditions, price levels and interest rates will be in the future. But that is not always the case. Short-term rates may be temporarily driven up by liquidity shortages and efforts to defend the currency. Moreover, if expectations are that the prevailing level of interest rates is unsustainably high, and that rates are expected to fall, then the yield curve may be inverted, with short-term rates higher than long-term rates. In such cases some borrowers

---

20 Matching asset life to debt term is also sound public policy because facilities can be paid for by those who use them.

21 The yield curve is sometimes called the term structure of rates and relates the interest rate to the term of the debt (the years it will be outstanding).

may borrow short, if they believe long-term rates will fall. Others may choose to lock in the relatively lower long-term rates.

There is also a trade-off between the lower rates typical of short-term debt and refinancing risk. If the debt is shorter in maturity than the life of the asset, the issuer is exposed to refinancing risk, i.e., new debt may have to be raised during the life of the asset at a higher rate than the original loan. If the borrower's credit risk has worsened, it may not be possible to refinance. Refinancing can, of course, work in favor of the borrower. That happens where the general level of interest rates declines or where the issuer's credit has improved. In the case of general obligation bonds, the latter situation could happen as a result of improved general creditworthiness of the jurisdiction. In the case of project finance, the construction and initial phases of operation are riskier than later phases in a mature project, and it may be possible to refinance at lower rates. However, financiers are aware of this, and rely on the later phases to provide some compensation for the additional risk taken at the outset, so would probably reserve the right to refinance for themselves. All in all, maintaining an unhedged position is risky, and not advisable with public funds.

4.2 Debt Service or Repayment Structures

The cash flow profile of debt refers to the way in which the borrower pays and the lender receives interest and principal over the life of the liability. Several common profiles are described below. A term bond typically has a fixed rate and term, and pays a semiannual coupon with the principal due at the end. On the other hand, serial bonds have the principal repaid in installments over the term of the debt. These repayments may be variously structured. Principal may be repaid in equal increments, which is called a level principal structure and leads to progressively smaller debt service payments ("front-end loaded"). This is a conservative approach that leads to rapid repayment of debt and frees up future borrowing capacity quickly.

On the other hand, if the debt service payments are level, then the earlier year payments contain proportionately more interest than principal. These are called a level debt service structure. Alternatively, the debt service schedule may be structured to increase over time. Use of the increasing debt service structure ("back-end loaded") in municipal bonds is increasing in the United States and elsewhere in those cases where growing revenues are believed very likely to occur.

Original discount bonds, called "zeros" when they fully discount future interest payments, pay no or reduced interest coupons. The investor realizes interest return by buying the bond substantially below its principal value. Such bonds can be originally issued at discount or created synthetically by investment banks by stripping the coupon off a standard term or serial bond. Zeros are attractive to parties who wish to secure a fixed amount of capital in the future without being exposed to reinvestment risk. When the zero bonds are created synthetically, the coupon stream from a stripped bond can be sold to an investor who is primarily interested in an annuity flow.

Cash flow profiles can be engineered to match the cash flows generated by the activity that is being financed. Liabilities can be index-linked, where the revenue flows are expected to vary with an index, such as inflation or an input cost. In this case, interest payments can go up or down, depending on the movement of the index. As noted, amortizing payments can be structured with an escalating profile, with lower debt service in the early years. This is common in commercial property finance, for example, where there is a "ramp-up" period when rentals are expected to escalate, and can be appropriate for certain municipal assets. Similarly, interest payments for initial periods can be deferred by using bond proceeds to pay interest costs in early periods (capitalized interest).

Bank loans or municipal bonds may be made at either fixed or floating rates of interest, the latter being payment mechanisms where the interest rate is reset from time to time. In emerging markets, the variable rate may be the only interest payment structure available for obligations beyond a short maturity. The relative advantages of fixed versus floating rate debt are similar to those regarding short term versus long term debt. Floating rate debt implies continuous uncertainty about the cost of debt, but it can be appropriate where the matching revenues are expected to vary with changes in interest rates. However, this is not usually the case for municipalities. Financial flexibility and access to liquidity are very important considerations for floating rate borrowers. If there is limited ability to change taxes or rates to respond to rising interest rates, then over-reliance on variable rate debt is worrisome. The rating company Standard and Poors generally recommends that the combined short-term debt and variable rate debt not exceed 20 % of total debt but it depends on the circumstances (degree of flexibility) and matching of revenues versus debt service.[22]

Municipal bonds also may pay interest on a variety of "coupon" dates. Although the semi-annual is the most common, structured loans can have varying coupon profiles (semiannual, quarterly, even monthly) to suit the cash flows requirements of the borrower and the capacities of the issuer.

There are several caveats to make in considering the cash flow of municipal bonds. It is unlikely that the repayment structure of bonds should be regulated aside from confining borrowing to capital expenditures and having maturities not exceed the useful economic life. Most municipal bonds in emerging markets have had short maturities and frequently have had term bond or bullet maturity structures. This, in effect, has meant that the loans to local governments were for the construction and start-up period. Then, implicit in the repayment structure, they have required the borrower to "roll over" the loan into another one at maturity or to come up with alternative means of long-term financing. Such an approach subjects the issuers and lenders to great uncertainty

[22] In the United States, where there is an upward sloping yield curve from short-term to long-term tenor, there has been a reward of between 100 and 200 basis points for using variable rate instead of fixed-rate debt. The structure allows flexibility to restructure debt, since it typically can be called at the reset date to restructure debt.

regarding future debt service requirements and effectively holds borrowers hostage to future changes that may be forced upon them when they again come to market to renew the loan.

A final area of policy regarding the structure of instruments is that of the restrictions that may be placed on interest rates or on the maximum maturity of bonds. Interest rates may be capped by "usury rates" that set an absolute ceiling on the rates the issuer will pay. While this was once common practice in the United States, the restriction has disappeared for all practical purposes over the last twenty years. The effect of limiting interest rates is to ration capital away from governments during periods of high interest rates. Such restrictions continue to be seen, however, as a matter of contract in the case of variable rate instruments, where a cap is either introduced or a borrower may purchase a rate cap contract from a commercial bank that will agree to pay the excess interest for a fee. The other common restriction is on maximum maturity, which is often specified in conjunction with the expected useful life of the improvement being financed. Again, these are seldom effective and the market itself provides the limitation on how far it will extend debt, especially at fixed interest rates.

4.3 Methods of Sale

Municipal securities can be sold to investors in a number of ways, ranging from the competitive auctioning of bonds to the highest bidder to a placement of them with the final investor, much as a direct loan is made from a bank. In most emerging markets, the offering is done through a process called negotiation, in which the borrower procures the services of a financial services firm (such as an investment banking firm) to sell its bonds.[23] The firm either will underwrite the issue, in which it agrees to buy the bonds at a certain price, or act as an agent and make a "best effort" to sell the bonds for which it receives a commission on the bonds sold.

The various methods of sale have their advantages and disadvantages. Generally a competitive sale environment requires there be a very active market with a large number of issuers offering fairly standardized securities and a large number of investors interested in owning them. The large volume of activity results in a number of bankers that follow the market, make bids, and place bonds to investors. It also means there are other professionals that help with the design of the issues, preparing documents, and running the auctions.[24] The competitive auction, with several underwriters bidding on a bond issue, as commonly seen in the United States municipal bond, is a rarity in other markets.

---

[23] For larger bond issues, a combination of firms, called a syndicate, may band together to underwrite and distribute the issue.

[24] Other professionals include financial advisors, legal counsel, auditing firms, and printers to produce the documents. There may also be banks to handle the investment of proceeds and to oversee the payments under the debt contract (trustees and paying agents).

Where bond markets are less homogenous and sales are irregular, issuers typically require that an underwriter be hired to help prepare the issue and to seek out possible investors. This technique is called a negotiated sale in which the underwriter is selected before the sale of the issue to final investors. The negotiations can be made competitive by injecting elements of competition among firms into the underwriting selection process and subsequently by holding underwriters to the projected terms of the issue. To help achieve competition, the issuer may employ the services of a financial advisor that is knowledgeable in the design of transactions and the process of marketing of securities. The advisor can perform a variety of functions but in the negotiated transaction its primary duty is to assure the issuer that it is being dealt with fairly by the underwriter and is holding up its end of the transaction. The advisor usually helps the issuer in the process of selecting the underwriters. See the box on Krakow Selects An Underwriter.

The underwriting process, as opposed to the use of a best effort marketing arrangement, has the advantage of guaranteeing the issuer that sufficient funds will be borrowed. However, the investment banker undertakes the risk of reselling the issue and will demand more remuneration in the process of underwriting than simply acting as a placement agent. To make their profit and to cover expenses, the underwriters buy the bonds at a discount, which means that they buy the issue for less than the value at which it is reoffered to the final investors.

Selecting an Underwriter by Competitive Negotiation

The gmina (city) of Krakow, Poland proposed a bond issue for 15 million Polish zlotys in 1996. The city, assisted by a financial advisor, sent an RFP to a large number of investment banking and commercial banking firms. The solicitation described the project and needed funds, provided information about the city and asked for proposals from interested firms. The RFP and selection process contained several elements designed to make the choice of firms transparent and competitive. The RFP contained a tentative maturity structure for the issue and asked respondents to price the bonds (provide interest rates) and to indicate their gross profit, assuming that the bonds had been sold on a given day. In addition, the respondents were asked to estimate an itemized list of costs and to indicate which costs would be met from their profits and which would be paid by the City.

Respondents were also asked to critique the structure and suggest alternatives of their own. Firms were also asked about their experience and financial capacity. The combination of factors were used in selecting the finalists, but all-in cost of borrowing was the most important. All costs, including future interest payments and fees paid by the city, were made comparable by using an all-in-cost internal rate of return calculation.

After the responses were analyzed by a committee, individual firms were contacted to clear up any questions (all responses were kept confidential). Of the eight firms (and syndicates of firms) that responded, the best three were invited to make presentations and to make their best and final offer. A syndicate made up in part of the

local representative bank was selected. The final offer committed the underwriting syndicate to price the proposed bonds on a par with Polish Treasury bonds of the same maturity, a highly aggressive bid.

Subsequently, Krakow received an investment grade credit rating from Standard & Poors and sold bonds (Deutsche mark denominated) in the Euromarket in late 1997, the first Polish city to do so.

The mechanics of selling of the bonds and the setting of interest rates and other terms differ among the various domestic securities markets. In some countries with relatively small inactive markets, the terms of the bond offering may be set well in advance of the sale date. The bonds may then be sold on a given day with a discount or premium to make returns competitive with prevailing interest rate conditions. The technique of fixing terms before the sale date tends to put the underwriter firms at most risk and issuers pay an interest rate premium in fixing the rates. Another approach is to commit to have the bonds underwritten at a certain mark-up or in relationship to some regularly published interest-rate index, usually that on government bonds. Finally, the terms can be determined by offering the bonds at a proposed structure and then changing the terms to meet the effective demand from investors in what amounts to an "informal" auction. The key point is that the terms and their acceptability to the issuer remain open until the sales contract with the underwriter is signed (the bond purchase agreement).

The bond instruments or other evidence of ownership are delivered (physically or electronically, depending on prevailing market practice) and money is exchanged for them (settlement) from the day of sale or up to two weeks after the sale. Depending on market conventions and the nature of the security, the borrower (or the underwriter) may have selected a paying agent and/or a trustee that receives funds from the issuer and makes the periodic payment of interest and principal. The trustee, if one is used in the transaction, has the additional duty of overseeing the bond contract between the borrower and ultimate buyers and is responsible for looking after the interests of the investors.

The important thing to remember is that beyond the procedures set down by enabling laws at the national level, the specifics of the bond offering are a matter of contract between the underwriter, the ultimate investor, and the issuer. This puts a premium on the issuer getting good legal and financial advice independent from that given by the underwriter and the final investor.

5. Restrictions on the Issuance and Use of Subsovereign Debt

Most countries choose to place restrictions on the use of debt by local governments. Restrictions on local governments involve substituting national policy for local flexibility and the regulating effect of the market on municipal borrowing. Among the restrictions that may be considered from a national perspective are restrictions on the purpose of borrowing, restrictions on the amount of borrowing or debt outstanding, restrictions on the use of proceeds, and restrictions on the type of security given or recourse available to the lender.

A distinction that is commonly subject to regulation is between the use of short-term debt and long-term debt. The difference between the two can be somewhat arbitrary (and some times conflictive). Short-term debt is that which is due one year or less from the date incurred; long-term debt is that which is due more than a year after it is incurred.

5.1 Restrictions on Short-term Debt

Short-term financing can be useful as a part of a local government's normal operations, such as to pay operating expenses before annual tax revenues are received. It can also be used in anticipation of nonrecurring revenue, such as from the sale of assets, receipt of a grant, or issuance of long-term debt. Operating cash needs can be financed from a municipality's working capital, or with the borrowed funds. The former source is usually cheaper and more reliable, but some local governments do not maintain adequate working capital funds. Furthermore, events can happen that either slow the receipt of revenues or cause unexpected surges in spending that lead to cash shortages. Ideally, governments carry reserves of working capital, but such liquid reserves can be a source of political bickering. Many believe that reserves are a target for political criticism or are a temptation to politicians that any idle funds are fair game for their spending plans.

Whatever may be the pros and cons in a particular situation, "snowballing" short term debt as a result of chronic operating deficits has been a leading cause of financial emergencies when banks and other investors lose confidence in a government's ability to run surpluses and repay its short-term debt. An outstanding case is that of New York City in the 1970s, but more recent examples can be found.

As an example, South African municipalities may legally borrow to finance both routine and unusual short-term needs. However, they are required by regulation to settle their short-term debts by the end of the current fiscal year by and within twelve months by the national Constitution. The usual form of borrowing is a bank overdraft, although other kinds of short-term borrowing are also done. These short-term borrowing techniques result in unsecured debt. Historically, the banking community in that country allowed overdrafts as a matter of course. There is now an increase in the use of overdrafts by municipalities, and in some cases, these overdrafts are not being settled as required by law at the end of the fiscal year.

Recently the City of Johannesburg found itself caught out by having accumulated a large amount of outstanding short-term debt for purposes of commencing a capital spending program that was to have been funded by the sale of long-term debt. The domestic markets closed to the City in late 1997, and it was embarrassed for sufficient investor interest in rolling over its short-term debt. Ultimately, the Development Bank for Southern Africa stepped in and made a loan secured on a specific tax source. The local commercial banks, meanwhile, which had refused to roll over the short-term loan, became irate that the DBSA had "peeled off" part of the general revenue base and had done the deal on terms that were only marginally better than they were offering.

A major concern with short-term debt is assurance that recurring expenditures are met from recurring revenues. Deficits that accumulate over time because of a failure to match operating revenues with expenditures can reach levels that compromise a local government's ability to deliver basic services. The objective is to allow reasonable operational flexibility for local governments, while protecting the public against the consequences of allowing operating deficit debt to swell to unreasonable levels. There are major risks in snow-balling short-term debt. First, it can reach unreasonable levels, requiring an unacceptably high proportion of revenues to be devoted to debt service at the expense of public services. Second, if it accumulates over time and becomes a permanent. fixture, the government finds itself at the mercy of the marketplace. Eventually, when creditors perceive that the floating debt has reached excessive levels, they can decide to withhold further credit extensions. Then, the pyramid of accumulated short-term debt can collapse, as happened to New York City in the 1970s.

To protect the public against unreasonable operating debt levels, short-term borrowing could be limited in a number of ways, including the following:

- as a percentage of the municipal operating budget,
- to anticipated cash needs for a certain number of months, or
- to revenues or receipts to be received within a period of time.

To further protect against accumulations of debt, short-term borrowing could be required to be paid off in full at least once a year, with appropriate safeguards against immediate re-borrowing, such as an interval when no short-term borrowing would be permitted. However, it is also likely that either natural or financial emergencies may make this a difficult area to enforce. Thus, a waiver procedure might be needed to permit exceptions. Such waivers might be best viewed as part of a general intervention policy as is discussed below.

5.2 Restrictions on Debt by Purpose

Debt allows local government to acquire or build capital improvements more quickly than can be done on a pay-as-you-go basis. It allows more equitable payment schemes, since users can be made to pay for the capital cost of facilities as these are used

over time. But, the use of long-term debt has costs and risks. It limits a local government's budget flexibility in future years. Unwisely used, it can burden citizens with high tax rates or service tariffs. A rule followed in many countries is that long-term debt may only be used for investment (capital spending) purposes and not to cover operating deficits. Even more restrictive is the rule that bonds may only be used for "self-supporting" revenue generating activities, a requirement in the Philippines. In both cases, the underlying conviction is that governments should only borrow long-term when they use proceeds that will contribute some future capacity to repay.

Long-term debt is clearly appropriate for capital investment when the term of the borrowing is related to the useful life of the capital asset being built or acquired. Should multiyear debt be allowed for other purposes? Such purposes could include work-outs as part of a fiscal recovery package, or extraordinary expenses related to the transition and restructuring underway in a developing country.

At least two alternatives are available with regard to regulating the purpose of long-term debt. First, a permissive general authorization for long-term subnational borrowing would allow local government to borrow for any public purpose authorized to it by law. It would be up to the local jurisdiction to decide what borrowing is wise and appropriate and for the market to accept that purpose.

Alternatively, jurisdictions can be authorized to borrow only for specific public purposes. Candidate purposes might include the following:

- Building or acquiring a capital asset whose anticipated useful life will equal or exceed the term of the borrowing;
- Funding revenue-generating projects that are self-supporting,
- Funding accumulated operating deficits as part of a legal or administrative restructuring;
- Funding extraordinary needs, including but not limited to, government restructuring or retrenchment packages or programs to abate natural or man-made disasters.

There are advantages to each alternative. Two factors favor a more liberal authorization policy. First, local government finance is an evolving art, and there should be room to adopt new forms and techniques of local finance. Second, if national policy favors decentralization (which is the operating premise of this paper), then local managers should be allowed decision flexibility. On the other hand, those arguing for limitations could state, first, that a list of allowable uses provides clarity about what is permissible, which may help reassure young capital markets. Also, there may be a perception that the public needs to be protected from politicians or managers who might otherwise use long-term debt inappropriately for their own short-term gain.

5.3 Restrictions on Amount of Debt

A recent International Monetary Fund publication has argued for a rules-based control of subnational borrowing, with limits on the debt of individual jurisdictions that "mimic market discipline."[25] Such control could be framed in terms of the maximum annual debt service to a conservative projection of revenues that would be available to pay debt service.[26]

Debt Limitations

Subnational debt limitations are very common, although the definitions used can be arcane and open to confusion. Debt limits are typically of three sorts: (1) a limit on the amount of indebtedness issued, usually expressed as a ratio of actual or potential source of revenues, such as taxable property values; (2) a limit on annual debt service as a percentage of not previously committed annual revenue; and (3) special limits on short-term indebtedness (maturity of less than one fiscal period). In terms of annual debt service, a restriction of its not being more than 15% of current recurring revenues is the most common. Limits on total debt issuance is expressed as a percentage of revenues used in order to restrict the amount of total cash revenues attributable to borrowing. Short term borrowing for cash flow purposes is often required to be paid off by the end of the fiscal period, but this requirement is often violated.

Other restrictions commonly found relate to restricting long -term borrowing to capital purposes (physical investments) and prohibitions on borrowing in foreign currencies. Enforcement of restrictions can be uneven and frequently open to differing interpretations. For example, in Poland the requirement that Regional Audit Agencies (RIO) of the voivodships make sure that gmina (cities) have complied with budgeting requirements and borrowing restrictions led to inconsistent interpretations of the restrictions. It also led to political bickering between the gmina and vovoidshiops over the desirability of the projects, although a substantive review by the latter of projects to be financed was not called for in the borrowing laws.

The argument against such control over the amounts of long-term borrowing is that it is an unnecessary interference with the market and that, in particular cases, it may

---

25 Teresa Ter-Minassian, editor, *Fiscal Federalism in Theory and Practice*, Washington DC, International Monetary Fund, 1997, p. 171-172.

26 Although many government's debt ceilings are expressed in terms of the debt principal outstanding in relationship to either a measure of tax base or revenue flows, the best prescriptions are likely to use annual debt service in relationship to available revenues. Actually crafting such a restriction calls for considerable care in definitions. See Charles Smith, "Measuring and Forecasting debt Capacity: The State of Oregon Experience," *Government Finance* Review (December 1998) pp. 52-54. As Smith points out, the legal limit is usually much higher than the effective market limit.

be desirable for local jurisdictions to temporarily exceed any given ratio as it invests for the future or spends down accumulated reserves. The argument favoring such control is that it protects the public from reckless borrowing by officials or elected representatives who may not be sensitive to the long-term risks. However, there appears little in the way of scientific bases for deciding on a particular limit.

A limiting ratio of outstanding debt or debt service to available resources for repayment can probably be set that provides a reasonable degree of protection, and yet is high enough not to interfere with sound management. An escape clause allowing the debt limit to be exceeded either under financial emergency legislation or with special permission from the senior level authorities (or, as in the U.S., by virtue of a local referendum election) would provide for the exceptional case where a higher ratio makes sense. Such prescriptions may be appropriate for general fund debt, but do not make sense when applied to self-financing or enterprise projects. In these cases, if the pledge is clearly limited to project revenues, this limit need not apply.

5.4 Authorizing Debt

There are several ways in which borrowing might be authorized in a local jurisdiction. Loans can be approved by action of the local government executive, by action of the local governing body, or by action of the community at large, such as through a referendum. Local borrowing can also be approved by state or provincial authorities, or by national authorities. Each of these mechanisms can be conditioned by a variety of considerations, including the financial capacity of the borrower to pay debt, the purpose of the borrowing, the form of borrowing, and consistency with national economic policy. Most also act as a curb on the local officials' prerogatives.

Borrowing authorized by the executive seems appropriate for relatively small amounts and short-term borrowing, where the future financial health of the local jurisdiction is not at risk. However, large amounts or long-term borrowing should be based on legislative act. Borrowing involves trading off future flexibility in exchange for investment capital today. For large amounts of debt, the decision about what to borrow for and how much are policy decisions properly made by a local governing body. Experience in other countries suggests that without local council or legislative approval (where elected bodies exist), the probability of future debt repudiation or refusal to enact necessary tax or tariff changes to meet debt service obligations increases dramatically. Also, public debate on debt policies and plans help keep the process open and visible. (See box, Cebu Considers a Deal.)

Borrowing approval can also be made by the community (electorate) at large. Borrowing authorized by referendum depends on the nature of the local political process. It may encourage citizen participation in the decision making process and bind the community for the long haul, notwithstanding changes in the elected council. At the same time, voter approval for borrowing has disadvantages, since it adds to time and expense, and can turn financial decisions into political battles.

Cebu City Considers a Deal

A worry is that unsophisticated local governments are subject to blandishments and may lack the knowledge and processes to fend for themselves as borrowers with expanded opportunities. But that susceptibility has a lot to do with the local political process and the role of the press. In fact, high-flying financial schemes are likely to catch attention and, there are few who believe that when it comes to the private sector there will be something for nothing

The City of Cebu, Philippines provides an example of how the process works . The City and its Mayor have been actively seeking financing for a ring road which is a core to its development plan. In mid-1998, a couple of firms, one based in Hong Kong and another in Austria, proposed that the City enter into $500 million in loans and $75 million in a letter of credit. The proceeds are to be used for a ring road development that is key to the City's development plan. The Mayor of Cebu liked the idea, and the firms, eager to move things along, paid a couple of councilmen from the Mayor's party to go to Europe to see, secretly it turned out, examples of what the firm and its associates had financed. The councilmen were treated in a first class way and, in order not to insult their hosts, signed letters that the City would be entering in other agreement in three months.

Subsequently, things began to get sticky. Political opponents began to wonder if this were a scam. The local representative of the investment firms, was arrested on 32 counts of passing bad checks and after posting bail, skipped town for Hong Kong. Local bank officials indicated that three signatures had been forged on documents shown in the transaction, evidently guaranteeing $150 million in city funds. The Mayor, sensing problems, established a committee of knowledgeable citizens to meet with the proponents; but the financiers refused to meet, saying it would be pointless. By this time the Cebu scam saga was getting daily press coverage in Cebu and Manila.

The Mayor announced in late November that the financing consortium was embarrassed by the episode and would give the City a grant instead a loan, or at least put in a few million Peso in the project for free. But, the next day, the consortia had evidently changed its mind about any "grants instead of loans" and it was clear that the "deal" would collapse.

There are two perspectives one may take on the ill-fated deal. One is that big decisions are beyond the grasp of many local governments and should be kept out of their reach. But, blandishments by over-energetic project proponents that stand to gain (or by con artists that wish to defraud) are facts of life at all levels of governments. The other perspective is that local party politics and news-hungry journalist are ready to shine bright lights on shady deals. Having local banks and bond dealers around either to compete openly for the deal or to help with the diligence is not a bad idea, either.

National or state borrowing approval could be predicated on several conditions. These could include the financial capacity of the borrower to pay debt, as measured by credit analysis, the application of a formula, or a ratio specified by law or regulation. Other relevant considerations include consistency of local borrowing with national economic policy (such as the timing of the borrowing), the purpose of the borrowing, and the form of the borrowing. Such oversight and review might control irresponsible borrowing at the local level. However, reviews introduce delays, require the development of oversight capacity at the national or state level, and inject a point for political rather than economic considerations to enter the decision making process. In general, the marketplace, aided by appropriate disclosure rules and investor reviews (including those of rating agencies if they are present) will do a better job of testing the financial capacity of the borrower to pay debt than will national regulators.

Another question is whether state or national authorities should certify the procedures used in the borrowing process.[27] Such certifications can help build investor confidence and relieves individual investors of some of the "due diligence" that would otherwise be required. However, in most emerging countries there may be little if no capacity at the senior levels of government to undertake this task when it comes to securities offerings. Imposing a review requirement that cannot be done well slows the development of the market more than leaving the due diligence inquiry up to the investor. It also opens a zone for political second-guessing and bickering.

---

[27] In the United Sates, the bond counsel (a legal counsel that specializes in municipal bond transactions) often drafts the needed resolutions and contracts and provides opinions as to the transaction being in conformance with the applicable laws and regulations. Some states in the United States also have procedural checks. Texas local government issuers must obtain approval as to procedures (but not as to use of proceeds or other substantive matters regarding purpose) from the Office of the Attorney General before issuing debt. This office reviews the proposed bond issue's supporting documentation, certifies validity, and issues an opinion. This opinion is needed for the bonds to be legally binding, and relieves individual purchasers of the necessity to inquire into the process by which the bonds were issued. Sometimes softer approaches are used. Oregon requires that localities prepare bond documents following recommended guidelines. Many states require that prospective sales be reported to a central office and placed on an official calendar. The state of North Carolina requires a filing and a *de facto* approval before sale and that requirement has its exceptions and is largely procedural.

6. Financial Market Structure, Regulation and Operations

Any tool kit examining the options for a subsovereign credit system must look at the "supply of funds" side of the equation, and where borrowers and lenders meet, that is the financial marketplace. To what extent does there exist a "market" for subsovereign obligations and how should would-be borrowers attempt to access it? Perhaps more relevant in most emerging economies is the question of where subsovereign securities fit into an overall strategy to develop domestic financial markets. Promotion of private capital markets has been a primary objective or financial market regulators.

The financial market that we have in mind is understood to be one having some level of effective competition in rates and terms and that involves the investment of private capital, although various governmental entities may be suppliers of capital as well. It is also, for our purposes, thought of as primarily "domestic," that is, where the borrowers and lenders (or issuers and investors in the case of bonds) are subject to domestic rules and deal in the local currency. Last, although issuance of equity capital by governments is possible in some cases, the focus is on credit instruments, that is, financial instruments that provide no voting rights or ownership but rather represent interest-bearing obligations that are to be paid in a timely basis.

A key objective of many policy efforts in the past few years has been to create a municipal bond market for subnational securities in their respective domestic markets. At the same time this objective has been embraced, the domestic financial markets have themselves been undergoing great change. Most of the liberalization and subsequent growth of the domestic securities markets has focused in privatization and the desire to promote private-sector equity ownership. It is in this context of reformulating the private and public sectors that subnational borrowers must navigate.

6.1 Financial Market Structure

The focus on the early securities market growth in emerging and transitioning economies has been on equity markets, with debt private markets coming later and hesitantly. Most national debt markets are dominated by central government debt and perhaps that of parastatals. The banking system, either government owned or privately owned, also has tended to dominate investments in government bond markets along with government-controlled investors. Corporate debt has traditionally been financed through the banking system and there are relatively few corporate bond issues in most emerging securities markets.

The topic of financial market structure and development far exceeds the relative narrow scope of this paper, but it is vitally important to judging the various linkages that local governments may forge with the capital markets. Many emerging governments are at the earliest stages of developing securities markets, and those bond markets that do exist likely are dominated by the national governments and the commercial banking system, the latter of which may be very far along in terms of financial maturity.

One can gain a general idea of the relative size of the financial markets by comparing figures that are collected on an international level. For example, the volume of listed securities of exchanges or transactions on the exchanges to the overall GDP of the country is a rough indicator of the relative role of the financial markets in the economy.

More precisely in terms of credit markets, one would look at listed securities in the debt market (such list including any exchange listings, as well as bonds in the OTC market) in relationship to GDP. Relative size of the banking sector can be measured by loans and investments to GDP and the size of securities markets to listed securities and domestically-held debt to GDP. Similar measures of other financial institutions and intermediaries provide indices as to the state of development of the domestic financial markets.

The extent to which the central government is directly involved on the allocation of credit is not always immediately apparent. Government ownership of banking system and other financial institutions (retirement funds, insurance companies, etc.) can be very influential in deciding which borrowers' needs are served and on what terms. Also, governments in laying out prudential rules and reserve requirements for financial institutions, for example, can either mandate or build in large incentives for them to invest in certain classes of obligations. A favorite market support approach has been either to require that reserves contain government bonds (both sovereign and subsovereign) or to make the capital adequacy rules such as to favor investment in these types of securities. Of course, such requirements are not entirely self-serving, since implementation of monetary policy requires there be levers over bank portfolios. In theory, open market operations can be carried on in any security. But, there is the continuing problem of "adverse selection" where securities that have their market directly manipulated by the monetary authorities are being either supported or subverted for reasons unrelated to the subnational issuer.

The recent turmoil in the financial markets, especially that involving the Asian countries, has focused attention on the relationship between the finance industry, especially banking, and other industries. The degrees of interlocking ownership, control of boards, and the extent of self-dealing between financial institutions and their non-bank affiliates have been at issue. Although subsovereign governments have been a relatively minor player in such concerns in Asia, in South America the relationship between municipal and provincial governments and the banking system has come under considerable scrutiny. Financial institutions named banks do not necessarily follow prudential practices, just as regulators do not necessarily regulate nor are laws on the books enforced.

Reserve Requirements and Capital Rules

Prudential regulations can have a major impact on the market for various types of obligations. Many sovereign governments have effectively built in markets for their securities by requiring that financial institutions hold a certain amount of sovereign direct or guaranteed obligations as part of their reserves. In other cases, banks may be required to put up government debt as collateral if they wish to hold government accounts. For example, prior to the availability of deposit insurance for large denomination accounts, the collateral requirement on public deposits was a powerful incentive for banks to hold U.S. municipal bonds.

One source of useful information regarding potential demand (as well as an overall measure of perceived subsovereign risk) are the weights that banks must use to calculate their capital adequacy. Although these have varied internationally, they are increasingly coming into conformance with the BIS (Bank of international Settlement) capital adequacy ratios. The ratio refers to the ratio of bank capital to performing loans (non-performing loans carry special provisions). The BIS minimum is currently at 8%.

Under the BIS regime, loans to the sovereign government of the same country as the bank are assigned a 0.0 sectoral risk weight (i.e., they are assumed to be domestically risk free) and those of private-sector firms are assigned a 1.0. The BIS recognizes that the relationship between the central government and subnational governments vary from country to country and therefore allows the central bank in the respective countries to assign the appropriate risk weight. Thus, the weightings provide the central bank's opinion as to the relative risk of loans to the sub-national governmental sector in comparison to the sovereign and the private sector.[28]

In the U.S., the BIS credit factors range from 0.1 for general obligations to 1.0 for private activity (corporate) bonds. In foreign countries, subnational government obligations that have explicit central government guarantees have BIS ratios of 0.0 (which makes them tantamount to direct sovereign obligations) and those that do not, have ratios that can range up to 1.0 or even higher. Ratios can be changed to recognize overall changes in sectoral credit strength. This recently happened in South Africa, where the ratio was increased from 0.1 to 1.0 for sub-national governmental securities when the national government announced that it would no longer guarantee municipal and provincial debt.

Prudential rules regarding other financial institutions such as insurance companies and pension systems have similar impacts on various types of security. To

[28] Higher capital adequacy ratios require banks to put up more capital per amount of loan, thereby raising the cost of capital and increasing the interest rates demanded of the sector relative to the sovereign.

the degree that subnational securities have been lumped together with sovereign securities, they have often benefited by favorable treatment.

6.2 Market Development and Regulation

Since the 1980s, there has been a move worldwide toward decreasing direct regulation of the financial markets and opening the markets up to greater domestic and international competition. This has involved all aspects of the financial markets, from the privatization of banking systems to feverishly creating stock exchanges to support the privatization of formerly state-owned enterprises in many parts of the world. It has brought with it a greater number of domestic firms in the securities business and more openness to foreign firms doing business in the various domestic markets. The entrance of foreign firms has been important also because they bring experience in financing subsovereign obligations.

Not only have the financial markets become more open and larger, regulation of them has also seen a move toward greater self-regulation by industry participants. The shift has really been from regulation by fiat, with direct involvement by the government in the investment decisions, to a greater reliance on market forces. These developments present something of an enigma. Less regulation by ministerial fiat and less official involvement in individual transactions has given way to more in the way of general rule writing and setting up rules of the road for functioning markets. Thus, the presence of more firms and a greater variety and number of instruments in the market mean that there is need for more regulation. But, the nature of regulation has changed. It is more in the form of general rules of fair dealing, capital adequacy, and more by general rules rather than by specific fiat. This changed regulatory mode depends on the operation of self-regulatory bodies rather than by the central government agencies. This is not without its costs and risks.

Where do subnational governmental borrowers fit into the emerging securities market regulatory scheme? The question is just beginning to be asked in most places since subnational government securities are still a rarity. Emerging markets have also seen a mixed bag of motivations in the creation of regulatory schemes, including proactive requirements to encourage sound business operations. For example, there is the requirement in Chile that public issues of securities be rated by a licensed rating agency. A similar requirement was being implemented by BAPEPAM, the securities regulatory body in Indonesia, which was instrumental in creating a national rating agency, Perfindo.

The fundamental concept of regulation is to define the financial system and establish rules by which it will operate. That is easier said than done. For example, what are securities and what constitutes transactions in them? Different countries have different legal traditions that can influence the nature of a market's operation, as is discussed in the accompanying box on the *Titulor Valor*.

Another issue has to do with the regulation of the banking system and other institutions that provide financial services. Here again countries enter with widely varying traditions. There is the deep seated debate between advocates of the "universal" banking systems and those that advocate the strict separation of the banking system and the securities markets (such as found in the U.S.) Most emerging and transitioning economies come out of a bank-oriented financial system, often with government-owned or favored "universal" banks that have seen virtually every phase of domestic financial commerce as fair game. As the financial markets broaden and mature, there is the need to define the regulatory boundaries between banks, securities markets, and other financial institutions. For example, in addition to the prudential regulation of traditional financial institutions such as banks, insurance companies, and pensions, there are new entities to regulate such as mutual funds, clearing and settlement operations, securities depositories, and the use of new instruments such as derivatives and asset backed securities.

What is a Security?

Establishing the definition of security is important both from the legal point of view as to what the investor can look to in support of the obligation and, more mechanically, from the view of securities regulation in defining just what is the nature of the transaction and the instrument involved. Efforts to regulate securities and to harmonize laws among countries have been hampered by different concepts as to what is a security.

For example, in the Spanish-speaking world (and, similarly, in the civil systems of Eastern and Central Europe) the concept of security has differed from that which evolved under English Common law and subsequently incorporated into securities regulation. A security in Spanish-speaking countries is embodied in the concept of a *titulo valor*, which encompassed only a limited number of specific physical documents that have the right of ownership embodied in the document itself. Thus, the only evidence of ownership for the security investor is the existence and possession of the document itself. (The corollary to this is the "bearer" bond which is physical evidence of indebtedness, but which nonetheless could be registered and immobilized.) The *titulo valor* instrument is like money, since it can be transferred physically without re-registration or even endorsement and is payable upon presentation.

As in the case of the bearer bond (the issuance of which became illegal for most transactions after the early 1980s in the United States) the *titulo valor* proves to be woefully inadequate as a concept for evidencing ownership given the nature of modern transactions. Not only does it pose physical safekeeping and transfer problems, it does not fit the needs of new financial instrument constructs.[29] New instruments necessarily

[29] A major advantage (or disadvantage, depending on one's point of view) of the bearer form is that it presents major problems for tax collecting authorities. In many countries, as a result, a presumptive tax is withheld at the source of instrument payment if the authorities are aware of the debt (another reporting problem).

rely on book-entry and dematerialization, such as variable rate securities, derivatives, and investment contracts. New definitions of security in Latin America now being enacted into law rely on the economic basis of what constitutes the security, rather than the strict definitions of what physical instruments qualify as *titulor valor*.

In emerging markets, financial markets regulation has a variety of roles to play and the end results may not always be in harmony. Among the competing objective are:

- Market development: Regulators are first of all providing incentives to market development, especially as part of the effort to convert formerly government owned institutions into privately owned ones.
- Market integrity: This requires prudential measures to minimize systemic risk and protect the solvency of individual firms. Regulators want to foster lively, creative markets yet protect the integrity of the payment system and avoid excessive risk taking.
- Fairness: Protection of investor and prevention of monopoly power. Regulators are keen to prevent fraud and manipulation. Asymmetry of disclosure information (the issuers control it, the investors need it).
- Efficiency: Markets are to be allocators of capital resources. The theoretical benefits of markets as allocators of capital rests on competition among players and fair price discovery mechanisms. But the participants must be limited to those that have adequate capital and experience and pass standards of behavior.

In most emerging countries, the majority of local governments will approach the markets as largely untested and typically small borrowers. On the other hand, where they have adequate revenue bases, they can often be viewed as potentially strong credits. Even where banks have dominated the direct lending, the development of a securities market benefits banks. It provides the banks themselves with more liquidity as investors, even while promoting more competition with and among them by providing an alternative source of funds to direct bank loans. And, a developing credit system allows them other ways to earn fee incomes, such as acting as trustee.

6.3 The Securities Marketplace

Domestic securities markets are in various stages of development and reflect differing philosophies regarding regulation, intensities of competition and technological development. For example, how much trading occurs on the formal markets (exchanges) versus Over-The-Counter (OTC) transactions. (This is a "telephone" market where there are dealer to dealer trades in securities that are not listed on the exchange or that can be

traded off the exchange as well as on it.) How much of the off-market trading is reported and how are such trades cleared (that is, the ownership of securities exchanged against payments)? How integrated are the markets: is there a single market or are there segmented markets by types of instruments?

There has been a tendency for regulators in emerging markets to force all securities (equity and private debt) to trade on the exchanges in order to develop the exchange. But formal exchange listing requirements, which typically are copied from those in developed countries, and related fees can be burdensome. That burden can be unfair and costly to new companies and to those that are small. One answer has been to create a separate bracket for smaller, higher risk companies. (Japan, for example, has a corner of its exchange set aside for small, higher-risk companies). Another approach is to allow the development of an OTC dealer-to-dealer market or the restriction of certain classes of offerings to sophisticated institutions and individuals. This approach provides trading liquidity to otherwise less liquid shares without exposing the general public to undue risk. New credits can season and then graduate to an exchange listing at a later time.

However, rules that permit the creation of a number of separate markets can be uneconomic and lead to an undesirable diffusion of resources. The most recent moves have been toward fewer organized exchanges and towards a screen-based, fully reported trading as opposed to the open-cry , single-place market.[30] The more integrated and transparent a market's operation, the better defined the market's participants and scope, the more likely that market competition, on the basis of price and quality of service, will discipline the market behavior without direct regulatory involvement.[31] The more these conditions are met, the more securities regulation can rely on self-regulation through self-regulatory bodies as opposed to direct regulation for setting the detailed market rules and enforcement.

---

30 A recent article on the future of the exchanges indicates that the number is likely to decline rapidly and a few large international exchanges will dominate activity. See "Survey: Financial Centers" *The Economist* (May 9th -15th 1998) pp. 54 *et.seq.* The exchanges may be fewer, but their physical location may be less relevant as trading can occur wherever a computer can be plugged in.

31 A major factor in enlarging market competition is permitting the entry of foreign firms into the market.

7. Disclosure and Market Regulation

Complete and timely disclosure of information about issuers is a necessary, if not always sufficient, condition for the effective operation of any securities market. That includes for municipal securities where the subsovereign borrowers themselves will provide the ultimate security. Information--consistent, complete, timely and comparable--is at the heart of judging the risks and rewards of investments. While information will not always answer all the questions (and bad information can give the wrong answers), an absence of information makes even knowing the right questions to ask difficult.

Emerging and transitioning markets face particularly difficult problems with disclosure. Many emerging economy countries are undergoing dramatic changes in their fiscal structure, as are the financial markets structure and regulation themselves rapidly changing. As we have noted, the vague basis for local security or the former direct guarantee by the sovereign is being replaced by more specific pledges of assets and revenues. Some countries, such as South Africa, have been and will continue to be highly reliant for revenues on commercial public utility operations (water and electric) and other emerging countries, for a variety of reasons, may wish to restrict long-term debt to self-supporting commercial operations.

The ability of these governmental operations to generate resources to support themselves, or to generate surplus for general revenue purposes, depends on efficient technical and managerial operations. Even where there is primary reliance on local taxes or on intergovernmental transfer payments, information on trends in these compared to local expenses becomes vital to determining relative credit quality.[32]

Disclosures to the securities market are originated by the underlying borrowers themselves, the local governments. The borrowers may be assisted (or even superseded) by the central government or provincial government authorities in accumulating information, but the idea is that the party financially responsible for timely and full payment of debt service is the party responsible to make disclosures. A closely related concept is that the party that is in control of decisions to honor obligations and that has control over the relevant information is the one responsible for information.[33] Except in the case where the issuer is only a "conduit" borrowing on behalf of another entity that is responsible for the debt, the issuer is the controlling party and obligated to report the information.

---

32 Aside from the immediate needs of the bond market, it would appear that effective democratic government will depend on reporting on a consistent format of the operating results of governments.

33 For example, a guaranty by a third party (such as the national government) has been seen as a reason to require less disclosure on the part of the actual borrower. That concept, however, has been rejected in U.S. practice where a guarantee (or insurance) does not obviate the need for full disclosure by the borrower. In South Africa (as elsewhere) the custom evidently has been to lessen or relax requirements where the national government is the guarantor. As noted above, the change is the fiscal climate will supersede that doctrine.

7.1 Disclosure Requirements and How They are Met

Disclosure can be required by central governmental fiat, by securities market regulation, or as a byproduct of the operation of the market through contract and market practice and convention. Market-dictated disclosure is realized through meeting investor expectations, habitual procedure, and, most importantly, fear of antifraud provisions in the securities law (or similar legal obligations related to fair-dealing and fraud).[34]

In the securities markets, disclosure is aimed at the investor for the purpose of informing the investor so that it can make informed investment decisions. However, an often overlooked but very practical byproduct of securities disclosure is that the performance, condition, and prospects of borrowers are reported. These economic and financial factors are of material interest to those other than investors in the market. Also, the concept of disclosure reaches beyond investor "protection" (avoidance of fraudulent behavior) to supporting the rationale allocation of resources and being able to evaluate cost risk, whatever its level may be.[35]

Generally, formal disclosure requirements are met when the issuer sends published reports to the marketplace. The timing and scope of reporting information are important and technology is changing the process of publishing, as may be seen in the box on the Internet. There often are recipients of the information who in turn "translate" or re-communicate the disclosure and their opinions of it to existing and potential investors. The most important of these are the rating agencies, and the agencies, as will be discussed below, are often seen as a surrogate for disclosure.

The policy objective of securities market development argues that investor protection needs to be counter-balanced with the need to reduce burdens on certain classes of borrowers to accommodate their access to the securities market. Lessened standards often are applied to smaller issuers or those classes of securities that are believed to represent less risk.[36]

As noted, the content of disclosure can be determined in two ways: (1) by a regulator's detailed listing of contents of documents and a sequence of presentation at various times, or (2) by a "flexible" standard that depends in its application on what the issuer and its advisors and agents perceive as information that investors should find useful in reaching an investment decision. In practice there is usually a combination of the two approaches, with a listing of generic types of information, leaving the particulars

---

34 The nature of the securities laws and effectiveness of anti-fraud provisions are critical to effectuating good disclosure through a market-based mechanism.

35 This is not just an academic distinction but goes to the heart of market regulation. If the primary purpose is avoid fraud and investor loss, then the emphasis should be on screening out high-risk securities that regulators feel might cause loss to the investors. This substitutes a bureaucratic decision for that of the market place. The other approach, and the one stressed in the U.S. philosophy, is to require full disclosure, and then to let the market decide on the appropriate rate of return that is required to offset the level of risk, no matter what its magnitude.

36 Traditionally, government securities have belonged to this lower disclosure requirement, although that tradition has been eroded in the United States and elsewhere and the exceptions are less likely.

to those responsible for the deal. Since the scope and detail of meaningful disclosure can vary markedly both among and within markets, issuers and debt issues, the modern trend is to rely on market forces and self-regulatory bodies to specify the details of content. Disclosure documents can also be available from a central source (a depository) using information received on a recurring or event-driven basis.[37]

Disclosure over the Internet

Electronic transmission of information over the Internet has already begun to change the processes of bond sale and disclosing information in the securities markets. Although the capability of electronic transmission of data has been known for few years, it was not until the use of Internet became widespread that issuers were willing to move their bond sales on to the Internet, taking bids real time over the net. An early experimenter with this procedure was the City of Pittsburgh which held its first Internet competitive bond auction in early 1997. That year, several large municipal bond issuers permitted bidders for their bonds to either file bids by sealed envelope as is the conventional practice or over the Internet just prior to the close of auction.

In 1998, municipal issuers began to publish preliminary official statements over the Internet. Again the City of Pittsburgh led the way. Investors that wish hard copy have the right to contact the City for a printed copy of the official statement. Normally the City would print 750 copies of the official statement at a cost of $15,000. However, only 4 requests for hard copy were received. In addition, many issuers are posting their budgets and financial statements on web sites.

The economies of posting bond disclosure over the web are considerable to both bond sales techniques and disclosure information. The access to a large number of investors and underwriters at low cost will promote improved disclosure from a timeliness and cost standpoint. Just as many of the emerging market exchanges are leap-frogging the structure of their forebears in the developed countries, new information technologies will swiftly change the flow of information in the markets.

7.2 Financial Disclosures

Fundamental to continuing disclosure is the timely production of financial statements that follow consistent accounting standards and that are readily available to investors on a timely basis. Uniform accounting standards for local governments are critical to disclosure. In many countries, accounting systems are in transition and under

[37] In the U.S. that role is played in the municipal market by a limited number of officially sanctioned (but privately owned) repositories as well as a central repository operated by an SRO (the Municipal Securities Rulemaking Board, MSRB).

review for improving their timeliness, conceptual consistency and transparency. [38] International bodies are also active in trying to achieve cross-country comparability. Strong accounting practices are central to improved financial management. And in that regards, it should be noted that where the adoption of accounting standards required in order for any borrower to sell bonds or undertake a loan (perhaps with the exception in certain *de minimus* borrowers), then the adoption of the standards would be accelerated.[39]

Accounting standards and their applications vary greatly among countries and between the private sector and public sector. Most governments come from an orientation of controlling expenditures and revenues, stressing the legality of their actions and reporting their conformance with adopted legislation. This has frequently led to the use of cash accounting techniques in the recognition of receipts and outlays and frequently obscured the economic purpose or life of the expenditures. On the other hand, much of credit analysis does indeed focus on cash flows and particularly those that relate to the availability of cash to pay debt service in full and on time.[40]

Another common distinction is where the government borrower is involved in an enterprise activity. In those cases, there may be use of accrual accounting techniques that conform with those used in the private sector. While the use of accrual accounting has sound economic rationale for determining the worth and period income performance of an activity, credit analysis will typically require conversion to a cash basis to assure that the timing and magnitude of cash is available to meet debt service requirements.[41]

The biggest concerns with cash accounting techniques are with its focus on short - term assets and liabilities and the ability of the obligor to change results by accelerating or delaying the timing of payments and receipts.

The frequency and independence of audits are important issues. Most governments rely on audits performed by governmental auditors from senior levels of

---

38 One team of investigators reviewing the Latin American markets stress the problem of financial information: "The first problem is the quality of municipal or subnational management and accounting, which is often poor and incomplete." M. Freire, M. Huertas, B. Darche, *Sub-national Access to the Capital Markets: The Latin American Experience* First World Bank Conference on Capital Markets Development at the Subnational Level (Santander, Spain, October, 1998)

39 International Federation of Accounting (IFAC) *Guideline for Governmental Financial Reporting*. The IFAC is attempting to develop widespread adoption of generally accepted accounting standards.

40 In credit analysis, it is customary for analysts to restate accounting reports to a cash basis to examine the availability of cash to meet debt service payments. Revenue bond contract indentures are expressed in terms of minimums of available current revenues after meeting expenses (cash outlays) in relationship to debt service needs.

41 Asset valuation techniques differ among countries. Those that use a historical basis can greatly understate the replacement value of plant and equipment in periods of high inflation. For example, water utilities with much of their investment in underground piping and reservoirs may have major assets that have expected useful lives of from 40 to 100 years. Utilities that use current market values for assets will appear to be much less leveraged in terms of debt as a proportion of total assets, than those that do not. However, their current depreciation charges will likely be higher, which makes them appear less profitable.

government. Such audits often check for compliance with various program requirements as opposed to reflecting financial condition or assigning costs to activities. In some countries, governmental financial records are not publicly available and bank secrecy laws are an impediment to reporting various portions of the financial statement. Unavailability of financial data for these or other reasons is a disclosure in and of itself, and a warning flag that the one's ability to assess ~~access~~ financial risk is nil and that political and legal risks are particularly important.

In addition to financial statements, and depending on the nature and characteristics of the project being financed and the nature of the security pledged, added information having to do with operations and characteristics of the service provided and market served may be required in order to obtain appropriate disclosure.[42] For example, investors in limited obligation or enterprise security that looked to cash available after operating expenditures to repay debt want to know about the operating characteristics of the enterprise and the market it serves. They need this information in order to judge how efficiently it was being operated and if there were any concerns about future strength of demand, supplies, labor relations, environmental matters, lawsuits and the like. The list of potential items worthy of disclosure can be long and the particulars will be dictated by the nature of the operation and the security pledged.[43] Thus, an important initial disclosure will be the intention or contractual commitment of the issuer to provide information on a recurring basis in the future.

An important caveat, and one that is adjunct to this subject, is where disclosure requirements are made stringent and the regulators of the security markets then choose to promote reliance on private sector advisory and information services to examine disclosures and make informed judgments. An aspect of disclosure requirements is recognition that not every investor is to read every document and understand every nuance of every deal. Rather, a limited number of qualified professionals are doing the examining and forming opinions for which they are paid by investors. These opinions are published and become a "baseline" of assessment and themselves are part of the disclosure process. The leading example of this role being played is the rating agencies that post ratings on issuers and issues and continue to keep them under surveillance while the debt is outstanding.[44] We now turn to the subject in the following section.

---

42 The word "appropriate" is used because once beyond a simple general government balance sheet pledge (and likely even in that case), the information needed to assess risk will be situational to a particular local government. For example, a government that relies heavily on utility operations such as electric and water systems, will find its ability to pay debt heavily influenced by the operations of those utilities. If the cost of raw materials or labor costs are rising rapidly and/or users are not paying their bills, then cash will be short and may lead to inability to make timely debt service payments.

43 The listing of items to consider are found in various trade and professional publications. A good starting point for generic items is continued in the GFOA Disclosure Guidelines for State and local securities (Chicago, 1991).

44 But, nothing is free. Regulators may not be doing the substantive reviews and forming opinions on the adequacy of disclosure itself. They need to institute meaningful safeguards that those who do (such as financial advisors, rating agencies, and other information providers) are professionally qualified, are operating in an ethical fashion and not manipulating the market, and are free of conflicts.

Accounting for Accounting Differences

Accounting and financial record keeping differences can be an impediment to analyzing the performance and condition of governments and their enterprises. Because most subnational governments do not pay taxes and do not have their securities listed on the stock exchanges, the pressure to have prompt reporting and uniform accounting has been lacking.

Disclosure of information is meant to support analysis of the risk and reward relationship. Appraising "economic" risk, that is, that the borrower will be able to pay interest and principal as promised depends on recurring knowledge of its financial performance (operating statement) and condition (balance sheet). Since most problems involving "willingness to pay" are occasioned by fiscal stress, strong financial reporting practices supports assessment of this risk determination, as well.

From a disclosure standpoint, the immediate objectives are to get financial data on a comparable basis; to measure the availability of dependable, recurring revenue streams to make debt service payments; and to measure liquid reserves available to continue meeting debt service requirements in case the recurring revenues are interrupted. With proper reporting, other items, such as the strength and stability of the underling economy, other indebtedness and the mix and costs of various inputs used by the borrower, are also disclosed by or can be calculated from the financial statements and their footnotes.

8. Credit Analysis and Credit Ratings

Credit analysis is an activity found on the "buy" side of the market. It is a process where investors and their advisors examine available information regarding issuers and their obligations and seek to make judgments regarding the relative rewards from a particular investments versus the risks those investments entail. Credit risk is typically taken to mean the economic, legal and political risk inherent in a particular obligation, or more succinctly, the default risk it embodies. That is distinct from the concept of market risk or interest rate risk which usually pertains to how the entire debt market (interest rates and exchange rates, in the case of foreign currency denominated debt) will perform. The preceding section on disclosure discussed the types of information that analysts require of the issuers themselves in judging credit risk; but, information used in credit analysis can be garnered from a variety of sources, such as a governmental statistical agency or even the local newspapers. The important concept is that there are multiple and objective sources of information which is timely and accurate.

Credit analysis demands resources and analytical skills that many investors, especially smaller institutions and individual investors, do not have enough of to justify a commitment to understanding a particular variety of credit. Thus, they prefer to rely on the opinions of experts. The role of the expert opinion is best reflected in the function of the commercial credit rating companies, or rating agencies as they are often called. An independent, objective system of credit ratings of high quality is seen as an essential component to the development of a vibrant, private sector capital market. It is especially important in the case of securities market investments where the investors are both numerous and "passive" and must rely on provision of information from the issuers and others in arriving at investment decisions. If the ratings are respected and used, the rating companies have the clout to demand disclosures and the skills to interpret the data. To the degree they are successful in obtaining data and their use of it reflects legitimate risk indices, then the entire market is aided by the categorization of debt and the monitoring of performance.

8.1 Subsovereign ratings

The appeal of credit ratings is clear: They provide a third-party opinion by experts that inform investors that themselves do not have the skill or resources to carry on their own investigations about the relative creditworthiness of competing investment opportunities. This is particularly so if investors have a diverse portfolio of securities, each of which represents only a small part of the holdings.

The concept of creditworthiness is important in this context. It has to do with the comparative risk of there being "payments difficulties" experienced by the borrower. The rating agencies uniformly do not rate the comparative market values of securities or general market risks *per se*. Each rating agency has its own formulation as to how various factors are to be weighted in arriving at an opine, but they typically look at pretty much the same factors when it comes to subsovereign credits, as is discussed below.

Aside from the United States, ratings of subsovereign governments is very much in its infancy. An increasing number of developed countries now have their subdivisions rated, especially those that have entered in the international bond market. For emerging and transitioning countries, the number of bond ratings by recognized international rating agencies, while growing, is still sparse. Nonetheless, the rating agencies have been staking out the subsovereign government area and many observers believe that progress in the development of subsovereign securities markets will depend on establishing ratings.

8.2 Subsoverign Rating Factors

Each of the rating agencies has its own recipe for figuring the alphabet rating categories they assign to respective credits. Ratings range from AAA for the highest category which is usually only conferred on sovereign credits down to C or D categories which are for those bonds in default, with varying hopes for ultimate or partial repayment. While the major agencies have different ways of weighting the factors, they do agree on the major analytical ingredients they consider in judging the creditworthiness of subsovereign credits. These can be summarized as follows, with some indications as to how various factors help or hurt a credit rating:

- Sovereign Rating Ceiling:

The rating of the national government usually sets the top limit on the rating that a subsovereign unit can enjoy. National governments set monetary and fiscal policy and usually have first claim on foreign exchange and can change the rules of the game for its junior units of government. Exceptions to this rule can be found if the debt is secured by offshore assets or revenue streams.

- Economy:

Fiscal health is usually closely linked to the health of the local economy and the diversification in activity (which often comes with size) helps balance the economy's performance. Demographics are important. A high dependency population (the very young and very old are negatives) and too rapid growth in population are negatives. Higher-income and more educated population is a plus, as is an acceptable distribution and rate of growth in income.

- Structure and Management:

An assignment of functional spending responsibilities consistent with revenue resources is a plus. Intergovernmental transfers are looked at for their size and predictability. The willingness and ability of the national government to detect and stem financial emergencies is a positive. The rigor and timeliness of budgetary and financial laws are examined and can be either a plus or negative depending on the flexibility they provide localities. Past performance in achieving budgetary balance are important. Timeliness and comprehensive of financial reporting and following consistent standards are a plus.

- Fiscal Performance:

Revenue composition and trends are considered with ability to set rates at the local level seen as a plus. Tax burdens should be acceptable in comparison to neighboring regions. Effective use of charges and fees are viewed favorably, large transfers of general funds to local enterprises are not. Composition and trends in expenditure. Capital spending and maintenance spending are a plus; a large wage bill is a negative. The ability to budget and to accurately realize budgets are a plus. Positive balances (surpluses) in current operating budget is a strong positive. Capital budget planning and paying for large amounts with current revenues a plus.

- Financial position:

Liquid assets and marketable real assets are favorable factors, as are healthy reserves in relationship to annual expenditures. Outstanding debt is considered. Short-term debt is a concern if not periodically retired. Long-term debt and contingent debt (where there are guarantees to others) is generally a negative unless used in support of productive (self-supporting) activities. Short maturity debt with principal due at the term (bullet maturity) is a negative because of continuing pressure to refinance and potential burden on current revenues. Overlapping debt of other governments that relies on same economic base is considered.

- Legal framework:

The lack of clear laws, legal precedent or effective judicial system are major impediments, especially where there are restricted revenue or enterprise-based pledges. A history of repudiations or insolvencies is a large negative. Approval of borrowings by senior units and other restrictions on local borrowing may be a positive if efficient and nonpolitical, but can be a negative if complex, difficult and political.

- Accounting and financial reporting:

The basis and quality of financial records is examined, and prompt, consistent reports are a plus. Timely and independent audits are a positive. Cash flow information or cash basis accounting that provide reliable information on cash available to pay debt service is a positive. Evaluation of liquid assets and accounts receivable can be issues in that required investments in government bonds can be risky and accounts may be in arrears.

Opinions on credit quality are not static and the relative importance of factors can change over time. National policies having to do with items other than local debt *per se* can change the mix and weighting of credit factors. Laws governing purchasing policies, public employee retirement benefits or wages, or the reassignment of functions and revenue sources can all shift the focus of analysts.

8.3 Role of the rating agencies

The role of credit ratings is not without controversy. On the one hand, emerging markets have a shortage of trained analytical staff and the existence of the rating agency provides for a pooling of skills that can opine on the quality of a credit on behalf of all investors, using a standard methodology (at least standard to each agency). On the other hand, the concentration of opinion in a few hands using methods that are proprietary and not fully disclosed can lead to a dangerous dependence on a handful of "experts " that influence the markets without an effective check. Another urge, as noted, is to have a regulatory requirement that bonds must have a rating before they can be listed in the exchanges or sold to the investing public. The international rating agencies themselves have considerable difficulty with the regulatory rating indicating that it leads to the "shopping for ratings" to obtain the highest rating or an acceptable one at the lowest cost. Requirements for ratings can also lead to the creation of national agencies that are not technically competent and that can be politically influenced. The major agencies themselves prefer to have the market for their opinions free and for the investors to be the final arbiters as to which agencies' opinions are worthwhile.

The development of credit ratings in emerging markets have followed two tracks that have tended to overlap. The first is for various market participants in the emerging markets to create a domestic rating agency *de novo*, sometimes in alliance with an established international rating agency. The focus of these homegrown agencies has been on domestic credits and to meet regulatory requirements. Generally, their opinions have carried little weight internationally. The second track, which appears to be the prevailing path, has been for the major international rating agencies to open offices or to acquire local firms that fashion ratings.

8.5 Expanding the market for ratings

The international rating agencies have been establishing beachheads in subnational markets, both to cover the changing circumstances of subnational borrowers and in anticipation of a future new issue market. This process is illustrated in South Africa. CA Ratings (now affiliated with Standard and Poor's), Fitch-IBCA, and Duff & Phelps are actively promoting their products, even though the South African local government bond market is now moribund. For the present, the primary market for rating services appears to be tracking the fortunes of approximately five billion Rand in South African municipal bonds that no longer trade. Whatever may be the size and cloudy prospects of the new issue municipal bond market in that country, the agencies continue to show substantial commitment to following municipal debt.

A particular role for the agencies in South Africa is in monitoring outstanding debt for banks, insurance companies and other institutional investors that neither have any analytical capacity of their own, nor much desire to invest in any. What happened was that prior to 1994 South African municipal bonds carried an implicit sovereign guaranty. Once that was revoked by the new regime, investors found themselves suddenly having to distinguish among municipal credits that had been for all purposes homogenous. Furthermore, the transformation into a new government structure presented

new elements of risk. Rating agencies supply the analysis by pooling the credit research for their subscribers, few of which want to devote the resources needed to follow individual credits.

Emerging Market Ratings and Bond Insurance

International credit ratings are a relatively recent thing and started first with the primarily Western European countries and corporations that were active in the Euromarket in the 1980s. There were very few subsovereign credit to rate given the dominance of bank lending to the sector and the propensity of sovereigns to guarantee debt of their juniors.

Subsequently, the rating agencies inched into the emerging markets by way of first rating the sovereigns borrowing in hard currencies and then those public or private operations that gave promise of providing hard currency to pay back international bondholders. The next instrument to come on the scene was the asset backed security (the ABS). These are issues secured by pools of underlying loans, starting off with car loans, credit card accounts, and mortgages (MBS or mortgage backed securities). The higher end of these markets (representing United States and Western European issuers) has became flooded and the margins are very thin. Attention next turned to the emerging markets, especially with the advent of the Brady bonds.

The assets that back the ABS configuration are typically dollar-denominated securities consisting of export receivable, credit cards, and telephone receivable. Using the ABS approach, the borrowers have been able to borrow at much lower rates than in the domestic markets. However, to gain access, these entities have had to gain ratings and in order to get ratings have typically had to obtain credit enhancements. That in turn stimulated the growth of bond insurance.

The secret to this has been to structure the debt through an offshore origination and securing the debt by receivable through a trust. The future receivables are held by an offshore trust and receivable obligors are required to make payment to that trust. Payments never enter the country of the issuer. This avoids problems of convertibility and should mitigate most if not all of the sovereign risk. These obligations are therefore not constrained by the sovereign rating of the borrower's country.

More insurance companies are being formed to handle nontraditional, including emerging market, business. These insurers will handle non-investment grade paper and no longer price under the assumption of zero loss.[45] They require higher reserves and may have less than the highest bond rating. Insurers make money where the perception of risk exceeds the actual risk and where by close monitoring and direct involvement they can alter the actual risk. Risk perceptions may be institutionalized in various prudential restrictions placed on lending institutions and investors. These perceptions and restrictions cause credit spreads among classes of debt that the insurer, by superior access

[45] Investment grade paper is understood to be that which is rated in the fourth tier of ratings (BBB or Baa) or higher. By convention this is paper the value of which can be carried on the books at purchase price by financial institutions. With the emphasis on marking all securities "to market" (current prices) that convention has slipped.

to information, deeper analysis, and ability to diversify risk, can narrow by "renting out" the use of its credit rating charge premiums and enjoy a return on capital.

But there continues to be some pockets of interest in new debt issues. Fitch-IBCA provides ratings for the privately financed South African bond bank, INCA, on its municipal investments and holdings. With the rapid change in the South African local government structure, there is a desire by existing investors to stay current, and there is the continuing prospect that once the governmental structure settles down there will be a flood of new issues. Borrowers, anxious to position themselves are keeping ratings up to date. At least two of the rating agencies have developed rating contracts that provide for continuing rating of the borrower. Each agency has compiled data for a much larger number of municipalities than they have been called upon to rate, and each makes an effort to recast data reported to them into standard formats. At the same time, it appears that not all segments of the investor community are either familiar with, or convinced by, rating resources and opinions. Some investors express fundamental reservations about the value of credit ratings in general. But once the ratings are published, all investors must be aware of them and calculate the effects into their pricing decisions. It seldom pays to bet against the rating of a respected agency.

Rating agencies suffer from inherent difficulties that go with being both financially viable and having a powerful effect on market behavior. First, their methodologies are necessarily proprietary. If everyone could emulate the rating through the use of a known formula, then why pay for a rating? Second, important factors used in ratings can be largely subjective. What is the risk of political instability including either visiting bad times on the nation or even repudiating debt? (Even when the "good guys" as measured by other standards win control in a country, bondholders and creditors can lose if the terms of outstanding debt are unilaterally changed.) Third, in publishing opinions the rating organizations assume that certain conditions and relationships will prevail. In a rapidly changing world, such assumptions may be erroneous.

8.6 Credibility in Ratings

The problem of credibility is borne of a distrust of the rating process in many places, rooted in instances where the rating agencies' response to changes in credit quality have either failed to foresee financial disruptions or have lagged behind rapidly moving events. A present example of the fallibility of ratings is found in the precipitous downgrading of several sovereign credits in Asia during the on-going financial turmoil. The accompanying box shows where the ratings by the credit rating company of Standard & Poors for six Asian credits stood as of the December 1996. Generally, the dividing line between "investment grade" and "noninvestment grade" is drawn between the BBB and BB categories, using the S&P nomenclature.[46] The precipitous declines in the ratings of Indonesia and Korea, and the serious slides of Thailand and Malaysia caused havoc for them in the markets. It is interesting to note that in December of 1996,

[46] The equivalent dividing line for Moody's is between Baa and Ba. Duff & Phelps and Fitch IBCA use the same symbols and demarcations points between investment grade and noninvestment grade as does S&P.

all of the countries were listed as having either stable or positive credit outlooks.[47] Not only were the ratings reduced over the next two years, but the countries also went through a continuing period of "negative outlook" on S&P's Creditwatch, which exacerbated the uncertainty as to how far they would fall.

Credit Rating Volatility in Asia*

	December 1996	September 1997	December 1997	September 1998
India	BB+	BB+	BB+	BB+
Indonesia	BBB	BBB	BB+	CCC
Korea	AA-	AA-	B+	BB+
Malaysia	A+	A+	A-	BBB-
Philippines	BB+	BB+	BB+	BB+
Thailand	A	A-	BBB	BBB-

* Selected Standard and Poor's long-term foreign currency sovereign ratings

Several other emerging market sovereign ratings have been downgraded in the wake of recent events. The drops were especially sharp following the Russian devaluation and default in the summer of 1998, which sent all the emerging markets into a tailspin. (Russia, prior to its currency and credit crash, actually had investment grade sovereign ratings from both Standard & Poors and Moody's on some of its Euromarket obligations.) Governments tried to protect currencies and depleted foreign reserves. Depletions were followed by devaluations, flights of capital, and widespread concerns over domestic firms and banks making payments in foreign currencies and, ultimately, domestic currency as well as credit quality and systems deteriorating.

Subsovereign government credit ratings also were lowered, but selectively. Typically because the sovereign rating, the effective estimate of "macro" creditworthiness and the cap on the subsovereign ratings fell. Again looking at Standard and Poors, in the year between October 1997 and October 1998, out of the 18 ratings on subsovereign governments, 7 were lowered (two in Korea and five in Russia). At that time neither the central Europe or South American subnational government ratings were affected.

Whether changes in credit ratings anticipate, coincided with, or themselves stimulated financial turmoil in the financial markets is an important question and is being asked with increasing frequency. Once rated, issuers run the risk that the agencies may

47 Stable means that there is nothing on the horizon to suggest a downgrading. Positive outlook means that there are indications that the rating may be upgraded, with a negative outlook implying that the rating may be reduced.

change their minds as economic and political conditions change. Relatively well-rated Malaysia was shocked to have its rating dropped from the single A category to that of triple-BBB just days before a large international bond offering, a move sure to cost the country higher interest rates. The nation's Prime Minister called for controls over the market power exerted by the rating companies. Interestingly, the credit ratings for some of the lower-rated Asian borrowers were not changed amid the recent market tumult. Evidently the rating agencies got it right for India and the Philippines in the first place. It is also interesting to note that both of these on-the-fringe of creditworthiness countries had lagged behind the formerly high-rated "tigers" when it came to economic growth and the pace of capital market development.

8.7 Private Bond Insurance

Allied with the development of international credit ratings has been the development of commercial bond insurance. Bond insurance acts as a third party guarantee that debt service will be paid in timely fashion. The attraction is that the insurer carries a high (best of all, the highest) credit rating from the internationally recognized rating agencies. This third-party guarantee of debt with a high credit rating lowers the cost of borrowing more to the borrower than the premium that it pays for the insurance.

Bond insurance had its origins in the United States and has been tremendously successful and pervasive in that country's municipal securities market.[48] For bond insurance to catch on and be successful, two things need to take place: (1) investors find value in the promise of these insurers to meet the debt service payments and (2) investors perceive differences in credit quality among issuers, usually expressed as a difference in rates of interest that they demand. Differences in credit quality are typically encapsulated in the rating symbols that are conferred on the debts. The commercial insurer has a high rating from the recognized rating agencies that carries with it the promise of a lower interest rate for the insured borrower. While these are accepted notions in the highly developed subsovereign markets in the United States, the notions are still novel ideas in emerging markets. Not surprisingly, the idea of bond insurance has been most successfully applied to sales in international currency markets.

In recent years, bond insurers have transformed themselves into taking a much broader approach than was traditional. Much as in the case of credit ratings, commercial bond insurance is a product of the U.S. municipal bond market. It became an international commodity as both the U.S. bond insurers found the original market becoming surfeit and as international markets became larger and more complicated. While all major insurers still have the AAA rating, several smaller insurance firms have emerged that will be of less than prime grade and will cover credits that are less than investment grade.

---

[48] The United States routinely has 50 per cent of the dollar volume of municipal bonds sold carrying bond insurance.

The international bond insurance market was beckoning until 1997. In 1996 Standard and Poors asked chief executives of the international insurance industry what they saw in terms of future international expansion. At that time, international business made up about 2% of the bond insurance companies' "book."[49] They responded that insurance was estimated to grow rapidly to 9% of the outstanding business in 2000 and 17% by 2005. Although most of the early bond insurance was sold in Western Europe, it was clear that the rapid expansion was likely to come in Asia. In 1996, a consortium of firms started up ASIA limited, which was slated to be a nonprime grade competitor for Asia business, in particular. Also, the relatively small-sized insurer Capital Markets Assurance Company (CapMAC) reached heavily into the international markets in hopes of opening up new frontiers of profits. The company's excursion out in front of the majors did not fare well. The Asia turmoil laid both ASIA and CapMAC low, the latter being subsequently absorbed by the bond insurance giant MBIA.

The international financial turmoil of 1997 sent a strong warning to the industry that perhaps the risks of the new emerging market frontier were not adequately understood. On the other hand, it can be argued that the slow entry of the majors was well rewarded since they avoided large capital charges and the downgrading that crippled ASIA. Standard and Poors has opined that future growth in the emerging markets was likely to be more cautious than was contemplated in 1996. The insurance industry had had a bad experience once before by entering the real estate market. While the growth of private insurance can be expected to continue, it will likely be much slower in the emerging market area than was originally thought.

> " [T]he primaries have redefined their strategy as a result of the recent global crisis placing less focus on emerging markets and targeting less risky issuers and transactions that characterized the early years of global expansion."[50]

None of the primary bond insurers were affected adversely by the 1997 and 1998 plunges. The primaries have only 3.1% of their par exposures in foreign based policies. Municipal type-international business is about two and half times as profitable as domestic work and has been largely restricted to superior, investment-grade issuers. With less competition, now that CapMAC has been taken over by MBIA, the possibility of higher premiums has improved.

The crises in the Asian bond markets in 1997, was followed by the broad-scale emerging markets crisis of the summer of 1998, which was caused by the Russian devaluation and default. The major insurers were spared the fallout because they had been slow to add Asia credits to their risk portfolios. However, a new specialty insurer, ASIA, was caught in the down-draft because of its regional orientation and, hence, lack of diversification. Although upon its creation in 1996 it was given a respectable "A" rating

---

49 See Richard Smith " 1997 May Prove to be Pivotal Year, "Standard and Poor's Bond Insurance Book 1998 (Standard & Poors, New York) p.5.

50 D. Veno and R. Smith "Bond Insurers International Exposure; Opportunity Reward and Manageable Risk" Standard & Poor's Credit Week Municipal (September 28, 1998) p.21

by Standard and Poors, the very next year this was lowered to BA as rating downgrades of the policies in its portfolio caused a major erosion in its capital position.[51]

9. Monitoring and Oversight of Local Government Financial Condition

A senior government has a justifiable interest in subsovereign indebtedness and subsovereign finances more generally. The kinds of information required to understand the nature of subsovereign debt and the financial condition of local governments that are debtors are much the same for governments and investors. Whether conditions are improving or deteriorating, and actual or anticipated failure to meet expenditures, including debt service, are vital concerns to the investors and should be to senior level governments, as well. As a result of this common interest, an active securities market is an important way to stimulate continuing interest in local financial condition. Furthermore, what the central government is willing and able to do to avoid and cure financial problems are of fundamental concern to the investor and, by the same token, reflect how active or passive the sovereign will be regarding the financial health and service capabilities of its progeny.

Financial monitoring may focus only on borrowing localities, with specific information needs tied to disclosure as mentioned above. Or, it may be of a more general nature pertaining to all localities and include such things as annual budget and expenditure reviews. As indicated, much of what an emerging country needs for local debt monitoring can be achieved by an active municipal securities market that insists upon continuing disclosure requirements, and by the availability of audited, standardized financial statements. The evolution of the credit market may be the major factor in the evolution of the relationship between the central government and its junior partners. Once market dictated transparency and regularity of reporting is achieved, there should be a lessening need for on-going supervision or regulation of subnational jurisdictions.

The political and financial relationships between sovereigns and subsovereign units are rich and varied. They are evolving along new lines, many of which will be unique to the country's tradition and depending on where it is along the devolutionary scale. Rather than prescribe a single approach to monitoring and oversight of subsovereign conditions, it might be best to review what has been international experience in both developed and emerging countries.

9.1 International Experience

[51] The involvement of the Asian Development Bank and other owners of ASIA Ltd. was hoped to provide a certain degree of insulation because of the "management insights" and one would suppose the political clutch that the owners represented. The Asian Development Bank was a significant owner of ASIA and it was hoped that as a vital source of credit, default on insured obligations would represent a "last option." Be that as it may, the tumble in Asian ratings had terrible consequences for ASIA's insured portfolio. Short of widespread defaults, a massive systemic downgrading of credits is the worst thing that can happen to an emerging market insurer.

The nature of, and justification for, national government oversight and intervention in local government financial affairs varies fundamentally between those nations that are unitary governments with a strong sovereign center versus those that are federal systems where certain prerogatives are left with the affiliating states and their local governments. For example, the United States, Canada, India, and several Latin American countries have the federal system of government with specific powers and prerogatives reserved to each of the layers. Within these federal systems, local governments are typically subordinate to the states or provinces. However, local governments within the states may themselves posses varying degrees of independence for exercising self-governance. Generally speaking, in the federal systems, oversight of the local governments finances will be largely left to the states. In the unitary nations, the oversight will be by the central government from which all powers of the state are derived.

9.2 United States Experience

Oversight and intervention devices vary greatly in the United States. As a general rule, the older states in the Eastern part of the country (the original colonies) have tighter controls and oversight over the local governments. These are called "Dillon Rule" states wherein the local governments are solely progeny of the parent states and have only those powers that are expressly given them in the constitutions and by the legislatures.[52] These states , since the local governments are seen as accountable to the parent, often have strict reporting requirements and if the local governments gets into trouble, the state is typically in a position, if it chooses, to step in and take over the operation of the government, including removing local elected and appointed officials. Because the administration and finances of local governments in the U.S. have been at a high level for many years (since the great depression of the 1930s), there are only a few examples of direct intervention; but, it can be very sweeping when used.

In New York in the mid-1970s, the State of New York stepped in at the time of the New York City crises and established a control board that, by virtue of its required approval powers over all financial decisions taken by the City, effectively dictated city finances. The control board stayed in effect for a period of five years until the City had enjoyed two years of budgetary balance. At the time of the takeover, the State took back the City sales tax and used it to secure indebtedness which was funded out the City's accumulated deficit. A new financing vehicle, the Municipal Assistance Corporation was created to sell bonds backed by the special sales tax and to refund outstanding City notes as they came due. The City had use of the sales tax revenues only to the extent that the debt service was first paid on the refunding bonds. The federal government initially refused to provide special aid, however it did accommodate the workout by providing a liquidity facility to the City. It also sponsored federal legislation that permitted the City's pension system to invest in the City's and Assistance Corporation's securities without

52 Dillon was a state of Kansas judge that in the late 19th century laid out the theory of expressed and implied powers for local governments under the constitution of the states.

violating various federal prudential standards for pension investments. The pension systems actually financed most of the recovery and bought something on the order of $4 billion in Municipal Assistance Corporation bonds.

Another example of strong state intervention occurred in Massachusetts with the City of Chelsea. When the City was on the brink of insolvency (it had little debt outstanding but was defaulting on payroll and vendor payments and there was widespread corruption) the state governor removed all the elected officials from office and appointed a receiver. That person reported only to the governor and ran all aspects of the City, approving all contracts, tax levies and the like. The state also created a special guarantee program to back the city's bonds which were sold to fund several improvements. After a period of three years during which the city charter was rewritten and approved by the state legislature, elections were held and the City was given back to newly-elected elected officials. The legislation provided that the City had to meet certain tests including financial operations or it would again revert to receivership.

The City of Bridgeport, Connecticut provides another example of state involvement in the case of local government financial emergency. Originally, the State of Connecticut attempted to use a limited control board approach that had the board approve the City's budget, but with that body not having the power to oversee or enforce the implementation of the budget. The City overspent its budget and, having various political differences with the state, attempted to go into bankruptcy under the federal bankruptcy code, which has provisions in Chapter Nine for defaults by local governmental units.[53] The State of Connecticut opposed the City's bankruptcy petition and the bankruptcy court held that the City was not technically insolvent[54] The state subsequently stiffened the powers of the control board and provided transitional aid and the City did not default on its debt.

The City of Philadelphia when faced with financial emergency in the 1980s came under the oversight of a New York City style state control board that had oversight over all spending decisions. The Washington DC model is much the same, where there is a body that must approve budgets and approve expenditures and which, in this case, in effect has taken day to day control of the operation of key city services. While elected officials are left in place, they effectively lose control over the spending decisions.

The above cases of municipal intervention in the U.S. relate to states where the state has traditionally taken a strong role in oversight of local government, or in the case of Washington DC, the U.S. Congress has exercised influence over the capital city's

---

53 The municipal bankruptcy chapter was permissive in that a state could forbid a subdivision from filing under the chapter. The state of Connecticut, however, did not legislate such a provision until after the city had filed for protection. Since the city of Bridgeport was found not to be technically bankrupt, the issue of whether or not a state could prohibit filing after the filing had been made was not decided.

54 John E. Petersen testified in the case and pointed out that the city had $400,000 in cash balances and had not demonstrated that it could not get more by simply raising taxes or cutting expenditures. The judge accepted his argument.

operation.[55] There is, however, another salient tradition of much less oversight and non-intervention in the Untied States, which follows from a tradition of "home-rule" whereby the local governments have much more autonomy. This appears to be especially prevalent in states west of the Mississippi River. The most important recent example is that of Orange County California. In this case, the State of California had not specifically denied local governments the use of the federal bankruptcy code. Undeterred, the County when it had insufficient funds to pay debt on time in December 1995, entered into bankruptcy (providing it with immediate protection from its creditors) and defaulted on $200 million in short term debt. The State of California refused to get involved and the County entered into extensive litigation and subsequent settlements on its own without state intervention or oversight.

In a somewhat similar case in the 1980s, the Washington State Power Supply System, which was a large regional utility (a regional authority) owned by a number of local governments (special districts and municipalities) in three states. The Washington Power Supply System (WSPPS) defaulted on revenue bonds. The State of Washington's Supreme Court held that the basic contract on which the borrowing had been secured was invalid and the borrowing itself was thus *ultra vires* (invalid).[56] Because of the limited obligation nature of the pledge, the bondholders were simply out of luck. The new construction on nuclear plants ceased. No action was taken against the underlying jurisdictions (except for securities fraud litigation). None of the respective state governments got involved in attempts to bail out the local utilities.

9.3 Monitoring and Oversight in Other Countries

(a) Canada

In the Canada federal system, the provinces have parental powers over the local governments and effectively control their finances. The Canadian system is highly decentralized when it comes to the national-provinces relationship but highly centralized when it comes to provincial-local relationships. Quebec is a special case and sets its own taxes. Localities are reliant on the property tax (which is set by the province) and transfers from the provinces. Local government capital spending and borrowing are generally subject to provincial approval and most borrowing is done through provincial intermediaries (bond banks) that provided additional security by provincial pledges. Local governments have limited powers and are essentially fiscal wards of the provinces.

---

55 Although the District of Columbia has its own elected officials, the U.S. Congress has what amounts to line item control over the budget and can mandate or set aside other laws in the District.

56 The court reasoned that the utility only had the ability to charge for electricity actually produced and distributed. It did not have the legal ability to levy charges and pay for electricity not produced nor received. This pledge of payment even in the event electricity is not produced or received (a "hell or high water" provision of payment) was necessary to meet debt service in the case of delays in completing construction, which there were because of massive engineering and construction problems and environmental concerns.

(b) South Africa

South Africa represents an important example of an emerging country that reflects the pressure of a changing governmental structure on intergovernmental fiscal relationships. The country has moved from a highly centralized system of government to one that in its constitution now recognizes three spheres of government, national, provincial and local. South Africa has gone through a reorganization that has combined the formerly white municipalities with the less affluent black townships. The rapid amalgamation has led to a variety of problems, including the nonpayment of property taxes and utility bills by the newly absorbed area. Since the public sector financial structure of South Africa has placed and continues to place much of the fiscal responsibility on local units, the nonpayment of taxes and charges has caused widespread fiscal stress. As of now, insolvent local units come under the control of the provincial level. Unfortunately, that level is on even more tenuous grounds than the local governments themselves.

Responding to the fiscal problems at the local level, the national government has instituted "project viability" which requires quarterly reports from municipalities as to their financial position. These positions are subject to monitoring and, if needs be, supervision of the distressed units. The metes and bounds of supervision are yet untested, but the quarterly current financial position monitoring is probably the most continuous and timely found in the world.

(c) Argentina

Argentina is a historically highly decentralized governmental system, with significant powers given to the provincial governments. The provincial governments are the parents of the local governments, much like the U.S. and Canadian systems. The regions vary greatly in income and level of development. Essentially the central government raises taxes, the majority of which are then transferred to and spent at the provincial level in providing services. This financial structure obviously places great importance on the intergovernmental distribution mechanisms. All three levels of government are permitted relatively free reign to borrow, much of which has been done to cover operating deficits. This gave rise to large amounts of unsustainable debt. Another problem was the influence that local governments had over the investors. Most of the financing was done through provincial owned banks that were highly influenced in their investment decisions by the needs of state and provincial governments.

After large increases in debt both domestically and internationally in the 1980s, the central government stepped in to bail provinces and cities out by replacing local debt with national debt. In the 1990s the national government essentially closed the window of the provincial banks to lend to their parent governments. However, provinces have continued to borrow by pledging future intergovernmental revenues and borrowing from private banks. Generally, in Argentina there has been a recurring problem of a lack of discipline where provinces and localities can borrow to cover current deficits. Since the

provinces and municipalities have a high degree of independence, the central government's ability to mandate the former's behavior is limited. The federal government and provinces have entered pacts to try to control provincial spending and borrowing.

(d) Brazil

Like South Africa, Brazil's constitution provides nominally "equal status" to all three levels of government. Throughout the 1990s, the country has embarked on a policy of devolution. As in the case of Argentina, lack of effective control by the central government led to the running up of high levels of indebtedness by the provinces and localities. The provinces and localities experienced widespread defaults in the 1980s. Subsequently, the debts were rescheduled in the 1980s by the central government in order to convert short-term debt into long-term debt. A major problem in Brazil was that the national government had no effective control over the amount of debt incurred by the local government and the provinces. In the final analysis, Brazil was unwilling to allow for massive defaults. As in Argentina, negotiations among the levels of government are ongoing.

(e) Transitioning Economies in Europe

All of the transitioning economies of Eastern and Central Europe emerged from highly centralized systems where the local government subdivisions were service delivery points for the state and highly dependent on the state for fiscal transfers. In addition, local governments might own various enterprises that generate revenues, but that often operated at a deficit. Financial reporting systems were often designed for measuring levels of inputs or for tax purposes.

Economies tended to be on a cash basis with a small and highly centralized banking sector and no functioning capital markets. Major capital spending was financed by grants or soft loans and was directed by the central government or, in the case of smaller routine projects, financed on a pay-as-you go basis by the locality. As a result of the format and purpose, financial reports often gave little insight into the financial condition of the local governments. Since the local governments had no existence beyond the state, there was little consideration of monitoring or interventions aside from the removal of officials by the central government if they failed to perform as wished. There evidently has been little thought given to formally coping with financial emergencies of local governments, although Hungary reportedly does have legislation in place for municipal bankruptcies.

More recently, these transitioning governments have been moving to greater local autonomy and various financial reporting systems have been instituted to provide more useful information about local conditions. These systems tend to follow the European model of full accrual accounting and the balance sheets are often spotty and suspect because of questions of ownership, value of real assets and accounts receivable. Largely,

capital financing has been done through specialized loan funds or commercial banks (themselves often undergoing the process of de-nationalization and carrying suspect balance sheets) that have traditional relationships with the local governments.

9.4 Formulating and Enforcing an Intervention Process

Intervention may be needed when a local government is in fiscal stress. In the credit market context that means that the governmental obligor is threatening or has in fact defaulted on its obligations. There, of course, can be other indices of stress and default may be the last step in a long journey of deteriorating service levels and finances. The question then becomes, what steps do senior level governments (or others) take to protect citizens and creditors and to correct whatever is causing the financial malaise? Available remedies to financial emergency may be of most immediate interest to investors, but how they are enacted and enforced is very much a question of national policy interest since they affect issues of self-governance, the delivery of essential services and the health of the financial markets.

An intervention process can be defined by generic national law, or be a matter of individual contracts between debtors and creditors. A viable municipal borrowing market need not have a detailed statutory intervention process. Rather, the parties can define the intervention and receivership processes contractually, and these processes can be customized for a particular deal. However, there may be constitutional restrictions on the ability of a local government to contract for intervention and practical problems of having courts enforce the contract. Therefore, it is likely best that national policy makers develop an intervention process by law or regulation for reasons both of clarifying creditor's and debtors' rights and of having a clear framework for dealing with subnational financial emergencies more generally.

As we have commented before, the best approach to financial oversight is through market forces that demand the timely provision of information, that, in turn, serve to control access to market, and thereby force financial discipline. But, information demands from rating agencies and the widespread use of uniform accounting and financial reporting standards are essential in this scenario. It may be that where the institutions and market players are in the formative and untested stages, sole reliance on the market may be premature. Nonetheless, it is important not to discourage market initiatives nor to weaken market incentives. Legal requirements that bond market participants must disclose and send information to a central point help the markets work more efficiently and prod governments to assume and fulfill reporting responsibilities.

While individual local jurisdiction should be free to negotiate monitoring and intervention provisions with creditors, a codified national approach helps to demarcate the relationship between subsovereigns and the financial markets. A commonly used law or regulation in this respect lends certainty and avoids the fallout that an individual default might have on other local jurisdictions.

A legislated intervention and default cure process should include the ranking of and remedies for respective creditors. A number of options are available as to the priority of claims. In some countries, local governments are able to put owners of bonded debt at the head of the line. In others, the depository bank or the senior level of government gets first fruits. In still others, domestic creditors come before foreign ones, a position that is likely to discourage foreign lending. In the case of security, the first to take physical possession may have the advantage.

Options are numerous in terms of remedies available to creditors. Creditors could be given the right to intercept funds due to a jurisdiction from other spheres of government. They could also have a right to trigger imposition of an additional tax within the defaulting jurisdiction, or to trigger the appointment of a receiver to control expenditures or the operations of a jurisdiction. At the same time, the citizens need protection for "minimum essential" services, such as water needed for health and safety, sewage operations, and refuse collection. Creditors should have the right to apply to court for execution on their security interests and for judicial intervention. Courts should be empowered to deal with insolvency and the priority of claims among creditors, and to discharge debt where the local jurisdiction could not otherwise be made solvent.

The particulars of an intervention process will reflect the structure of government and varying concerns about preserving local democratic prerogatives and protecting essential services. However, it is essential that it be as clear and comprehensive as possible and that it provide substantive remedies and protections for private investors.

10. Designing and Implementing Credit Assistance

In the initial sections of this paper three groups of subsovereign jurisdictions were identified based on their "readiness" to access private credit markets. Financial condition, managerial skills, and (to a certain extent) size each contribute to the estimation of credit quality and possible private market access. The first group includes those jurisdictions that already have access, but could enjoy more and better options given a supportive policy and regulatory environment. The second group potentially can have access, with various forms of help, including credit assistance that is complementary with the operation of credit markets. And a third group consists of jurisdictions that cannot access the market, even through market-oriented intermediaries (or the effort to do so is likely to be counterproductive from a policy standpoint).[57]

A central question is how to assist jurisdictions that do not now have the resources to be self-financing, possibly because they do not have an adequate tax base. If the central governments chooses to assist these jurisdictions through a predictable and stable system of intergovernmental transfers, even smaller units can have adequate local revenues. Such revenue streams from both local sources and intergovernmental transfers can be used for capital investment (with or without borrowing).

If a community has reliable revenue streams, then it belongs to the second group. Access to borrowed capital should, in principle, be available. Private markets may still not serve these jurisdictions because of the small size of their financing needs, their inability to do analysis and planning, or their inability to deal with the capital markets concepts and practices. For this group, market intermediaries and technical assistance could be made available to help bridge these gaps. This middle group of potential borrowers is the major focus of this section.

National governments can provide an environment to promote marketability of local debt. Macroeconomic and regulatory policies that are right, and in place, are a large part of what needs to be done to help municipalities have access to borrowing. Several questions arise when considering assistance for local jurisdictions in the two groups that do not have access to the market. Should assistance of any kind be rendered to help local jurisdictions gain access to credit? If so, what forms should such assistance take in order to encourage private capital market participation and to minimize "crowding out" of private capital providers? How should developmental resources be allocated? Finally, what administrative and technical assistance should be used to deliver assistance?

---

[57] It is useful to understand why particular jurisdictions cannot access the capital markets. Distinctions in this regard are what differentiate the second and third groups. The second group is made up of jurisdictions that have or could have predictable, stable, and sufficient revenues to meet their service delivery responsibilities, but whose capital requirements are relatively small, or who lack the skills and capacity to develop and pursue borrowing options. The third group includes jurisdictions that do not have, and cannot develop, adequate financial resources to meet their responsibilities. Borrowing will not solve this problem, and could even exacerbate it. One should not create capital borrowing programs for municipalities with inadequate revenue sources.

10.1 Types of Credit Assistance

Assistance in accessing capital markets can take several forms. These range from technical assistance and credit enhancement, to direct lending positions and interest rate subsidies that induce private market participants to join a transaction. At least three basic questions should be asked to judge whether to use a given tool in a given instance:

- Does the assistance technique leverage private sector investment?
- How likely will this tool crowd out private-sector capital?
- Does the tool increase the risk of moral hazard; that is, how likely will it be misinterpreted as a form of state guarantee?

The above questions are considered next in the context of several forms of assistance that might be rendered to promote private capital market development.

10.2 Technical Assistance

Technical assistance that helps familiarize jurisdictions with credit markets practices and helps them become more "creditworthy" will be most likely to leverage private-sector capital. It is least likely to crowd out private capital and the most likely to attract its interest. It also is least likely to raise moral hazard risk. Technical assistance and training provided in accounting and budgeting, identifying and analyzing capital investment projects, operating and managing facilities, and the like, expand managerial skills and encourage more efficient financial practices.

As a practical matter, technical assistance is difficult to do in the abstract and it goes much better with practical applications. Technical assistance and training should maximize the likelihood that a borrower will eventually be able to do some or all of these functions for itself. Wherever possible, the bias should be toward creating local institutional and technical capacity. Technical assistance and training that is most supportive to capital market access are found in capital planning, cash flow projections, and project management. These disciplines allow the municipality to work with budget constraints; to practice matching revenues to expenditures; to consider how much to borrow, for what purposes; and how quickly it can and should pay back loans. In the technical realms of debt finance, there are a variety of choices. As is discussed below, either public or private lending entities can help provide access to markets, especially if standardized documentation and processes are developed. The standardization of the documentation and of the components of the transaction helps to resolve questions of security and keep costs down.[58]

---

[58] The costs of developing pioneer bond issues are considerable since they represent for public and private parties alike a heavy investment in learning skills, developing documentation, and charting new procedures. In the case of the Philippines, these costs for four relatively small bond issues ranged from 4 to 5 per cent of the total issue proceeds. Bond issues are very much subject to economies of scale since the novelty and complexity of a deal may have little to do with the size of the issue.

10.3 Financial Assistance

Financial assistance that is designed to help local jurisdictions gain access to private credit can take several forms. When contemplating linkages to the private credit markets it should be recognized at the outset that direct financial assistance that is insulated from a market test carries significant drawbacks and risks, since it always embodies the problems of adverse selection and moral hazard.[59] And to the degree it is institutionalized, it can foster long-term dependency.

The lure of cheap credit provides an incentive for local governments to be or appear to be needy, rather than to be self-sufficient. Direct assistance also creates hidden subsidies in the form of contingent guarantees and enhancements. It also can crowd out the private sector, which will typically both set higher credit standards and charge more for lending. Finally, direct assistance is usually less efficient at leveraging private sector resources than technical assistance. But concessional finance continues to have a role in most economies, either to encourage sought-after activities or to surmount barriers. And, careful design can reduce the above drawbacks and risks, even if it cannot eliminate them.

In addition to the above problems, concessional financing can distort choices. The burdens in future facility operating costs can be overshadowed by the sudden availability of capital credit. Financial assistance reduces only the cost of capital facilities to the borrower. By helping the unit access debt, the assistance provider is also helping the borrower take on increased facility operating costs. Borrowers with no access to capital from hard credit sources may not have been required to fully investigate these costs nor to build them into their budget planning. There may be little or no capacity to properly operate, maintain, and ultimate replace the facility, which rapidly slips into disuse.

A fundamental principle governing the design of direct financial assistance is that it should always be looking for an exit strategy and a shifting of obligations to the commercial credit markets. This means that the assisting entity might absorb some of the risks that are at present unacceptable to the private credit markets.[60]

10.4 Direct lending

---

59 Adverse selection refers to the phenomenon of having only high-risk and otherwise unmarketable credits use the credit preference and receive the advantages. Moral hazard refers to an incentive for users of the preference to shirk on their obligations (default).

60 This might mean finding a way to eliminate a narrow risk (e.g., environmental risk) through provision of risk insurance. Or, it might mean taking a junior lien in order to comfort potential private lenders. Or, it might mean a guarantee on the "long end" of a debt structure if commercial lenders are able to provide short and medium principal maturities.

Direct lending is an inefficient form of financial assistance, and one that is likely to crowd out private lenders and to invite moral hazard. Unfortunately, many of the direct lending programs aimed at the local level have been directed from the center, often making loans to unwilling and inattentive local units, that ended up treating them as grants. However, there can be constructive direct lending roles. The International Finance Corporation's A/B Loan syndication and certification structures have demonstrated leverage efficiencies can be achieved with such instruments, if they are well designed. In order to increase leverage and reduce crowding out and moral hazard, direct lending should be designed to induce co-financing by commercial lenders. The smallest possible direct lending role required to achieve this objective will minimize the risk of crowding out and maximize the efficiency of the assistance rendered. Thus, for example, if only a five percent junior lien position will induce the private market to join in a co-financing, the provider of this form of assistance must be prepared to forego a larger loan program.

Although past direct lending programs have had a poor record for loan repayment, the tide appears to be turning as of late in some countries (See box on Development Loan Collection Enforcement). Credit discipline, if it is instilled into direct lending programs, can help prepare borrowers for the realities of the private market so long as sufficient economic inducements can be designed to enable borrowers "to graduate" to private market access.

10.5 Debt service subsidies

Debt service (either interest rate or principal payments) subsidies resemble direct lending in that they constitute ongoing payment streams to support local borrowing that can be inefficient. They are more likely to lead to moral hazard than is more indirect or softer forms of financial assistance, such as insurance, partial guarantees or technical assistance. Nonetheless, they can be useful tools, if they are well designed to insure two things: (1) that the smallest subsidy necessary to induce private capital market participation is used, and (2) that they are used only where the assistance provider can be reasonably assured that this is the only tool that will make the borrower creditworthy.

Among the devices used to subsidize interest costs through the private credit system are so-called linked deposits and co-lending programs. In the former case, a commercial bank may receive a deposit from a government intermediary that agrees to a reduced rate of interest if the bank agrees to use the deposited funds to make a loan for a particular purpose to a local government. In other words, the deposit is "linked" to a particular use of loanable funds. Advantages of this approach are that the private institution still takes the credit risk, must do the credit analysis, and administers the loan. A similar approach is where the government intermediary makes a co-loan for a portion of the principal amount and does so at a reduced rate of interest. Here, the borrower gets the advantage of the "blended rate" on its loan. The private lender, however, still has its principal at risk and administers the loan, while having the intermediary as a partner in the transaction.

A well recognized problem has been the moving of local governments from a soft loan environment into a atmosphere of harder credit demands. Development banks have generally had a very poor loan repayment record which has made many observers skeptical about the ability of local governments to make the transition into a securities market atmosphere. However, there are efforts to correct the situation in some countries by calling delinquent borrowers on the carpet. South Africa demonstrates one way of doing this.

In January 1996, the Development Bank of South Africa (DBSA) inherited the development loan portfolio of the Ministry of Finance for local governments. The portfolio, known as the LALF portfolio, consisted of approximately 390 loans representing about 900 million Rand ($50 million) that had been made to local governments primarily under the old regime that existed prior to 1994. At the time of the transfer, most borrowers were timely in their payments. Amid the turmoil of the transition into the new governmental structure in South Africa, many of the local government obligors for whatever reason began to go into default. The DBSA in 1998 undertook a program of enforcing payment of the loans. The DBSA saw its role as that of acting as a bank with commercial incentives and a capital position to protect. Thus, while the original terms of the loans might be concessionary, its role was to keep the payments on schedule and to instill discipline into the borrowers. DBSA is not expected to lose money and erode its capital base; its goal is to make some money and make reasonable returns to capital, while promoting longer-term, socially useful development.

DBSA recoiled at the growing delinquency rate of the loans and moved to deal with the local authorities in a manner to re-institute timely payment of the loans. Loan officers were assigned to the respective regions and given procedures for going after over-due loans. In three provinces, 32 of the 40 loans that were defaulted were put back on a timely basis using technical assistance and the threat of closing off future credit from the bank as means of restoring the credits. In South Africa, both governmental and private lenders have the power to seize assets of the borrower.

10.6 Guarantees and Insurance

Guarantees are a traditional and important form of financial assistance. Due to their contingent nature, their cost is not easy to measure at the time the guarantee is given. They can lead to lax lending practices and hinder the creation of effective private markets. However, guaranteeing specific risks or specific maturities may be worth consideration. The ability of a credit assistance provider to reduce or eliminate specific risks in a transaction (e.g., specified environmental hazards or the repudiation of certain contractual obligations) or to back maturities that the private sector is unwilling to provide can leverage private capital investment. Properly designed and implemented, a

"surgical" use of guarantees can reduce the risks of crowding out and moral hazard. Some of the World Bank's guarantee operations have begun to demonstrate the utility of guaranteeing specific risks or maturities as a means of inducing private capital providers to participate.

One way to reduce the risk that these and other credit enhancements will crowd out commercial lenders is to price them according to the respective degrees of risk presented by different borrowers. Under such a regime, local borrowers and commercial lenders see the relative costs involved in securing guarantees and will treat them as having a cost. The idea of charging needier borrowers more in terms of a premium than those that are better off may be offensive to some observers. But, the incentive must be present to improve financial operations if the governments are ever to stand on their own in the credit markets. Buying down part of the costs with grants but making the issuers borrow at risk adjusted rates on the margin may be one approach to forcing units to pay attention to market interest rates and to scale projects accordingly. Yet another option is to price enhancements with "seasoning" premiums that are in part subject to rebate as borrowers' live up to their obligations and see their circumstances improve.

10.7 Intergovernmental Payment Intercepts

As discussed previously under forms of security, intercepts are a form of financial assistance, and one that need not have any significant cost to the national government.[61] Intercepts can be a powerful credit enhancement. They are more effective, the more dependent the jurisdiction is on transfer payments from other spheres of government.[62] A stream of stable, predictable intergovernmental transfers can be made pledgeable and interceptable, which would enhance creditworthiness. Significant penalties or administrative fees when the intercept is exercised could discourage jurisdictions and creditors from relying on the intercept mechanism, and encourage them both to manage the debt payments in a businesslike fashion. Such a mechanism can leverage private sector funding, rather than crowd it out. In the Philippines, the intercept mechanism is being combined with a guarantee scheme to enhance loans provided by private banks to local governments. See box on the Local Government Unit Loan Guarantee Corporation.

---

61 If the aid is to be provided anyway, making it pledgeable and interceptable does not add to the cost. Any administrative costs could be borne by the borrower.

62 Traditional rating agency analysis has given state aid intercepts only modest credit enhancing power in the United States. However, the power of a state aid intercept can be substantially increased if the state aid flow goes through a trustee-administered "lock box" arrangement in which debt-holders have first access to the revenue as a matter of course.

Local Government Unit Guaranty Corporation

Under the sponsorship of the Philippine Bankers Association, a banking consortium of 22 Philippine and foreign banks has created the Local Government Unit Guaranty Corporation (LGUGC). The LGUGC will provide guarantees (insurance) on loans made by participating financial institutions to local governments (LGUs). Some 230 million Pesos were raised by subscription from the participating banks, deposited into a special account, and are available for backstopping the guarantees of periodic debt service payments.[63]

The premise of the LGUGC program is that the guarantee will stimulate private commercial bank interest in local government credits. For institutional and regulatory reasons, these have been borrowing only from GFI s (Government Financial institutions). The GFIs are being privatized and are sometimes "loaned-up" on LGU credits. In any event, the GFIs and the government are under pressure to open up the LGU market to greater competition and to develop a municipal bond market. The guarantee program gives comfort to the private banks as they start lending to the sector. It is also anticipated that it can serve as an enhancement for bond issues. The guarantee depends in large part on a pre-assignment of the LGU's intergovernmental payments to the corporation which can be tapped in the event of default. The initial program is geared to the largest 120 LGUs at the outset. Once the guarantee system is in place, it can reach down to smaller governmental units.

10.8 Intermediaries for small borrowers

The policy issue is whether a special intermediary should be created for jurisdictions that cannot access credit markets through existing market mechanisms. Special intermediaries should not replace existing commercial lending and underwriting institutions, but should complement them. In some countries, the private sector may be able to provide such intermediation, without the need to create a new agency or function for government, and, in principle, this is desirable. However, a small issue may not attract the market's attention and even if it does, it may not be economical to finance them in the formal securities markets.

Many kinds of intermediary models are possible, including bond banks (see below), bond pools, revolving loan funds, and municipal lending institutions. Such an institution might borrow in its own name and use the proceeds to purchase debt instruments of municipal borrowers (banking), or it might assemble and repackage

63 Technically, the program works like bond insurance programs as opposed to a letter of credit or conventional bank guarantee because there is no acceleration of debt in case of default. Rather the insurer "steps in" and assumes debt service payments and keeps the original term of the loan going. This means that the annual liability is much less for the insurer and it can work at a higher leverage factor.

municipal debt instruments and make them available to the market (pooling). A major attraction of such pooling and banking structures is that they can provide economies of scale in issuance and because of their larger size of issuance have a better chance of attracting a secondary market interest.

But, any intermediary model has costs. These costs may include administrative costs, perhaps subsidized relending rates, credit enhancement costs, or a combination of all three. However, with a properly designed and efficiently run intermediary, the costs will likely be less than those involved in outright capital grants, and will have the virtue of helping local officials understand and practice the trade-offs involved in debt finance.

Special intermediaries can be designed to provide several services to local governments. These include access to capital markets for jurisdictions that otherwise would not have access; savings on the sundry fixed costs of debt issuance; streamlined and standardizing borrowing procedures and documentation; assistance with capital planning and cash-flow projections; and pre-structuring loan packages. The senior government may also decide whether to offer direct financial assistance, such as credit enhancement (e.g., in debt service guarantees or itself procuring commercial enhancements) or by re-lending the intermediaries' funds at subsidized interest rates. The more "passive" the financial assistance and the more it is used in tandem with normal credit channels, the better. As discussed above, there are moral hazard risks associated with direct financial assistance that is insulated from a market test. In our opinion it is better to expose the novice borrower to the actual costs of capital and the discipline of the market, at least on the margin.

If the objective is to promote local self-sufficiency, it is generally advisable to avoid enhancement methods that reward dysfunctional units, that are non-transparent, or that crowd out private investment. If there is a stream of stable, predictable intergovernmental transfers for jurisdictions that themselves at present lack the resources to be self-sufficient, these transfers could be made pledgeable and interceptable. This would enhance creditworthiness and leverage private sector funding at little or no cost to the national government. However, it is a judgment call as to the extent otherwise impecunious units should be encouraged to borrow. For those local units that have little prospect for financial self-sufficiency, it may be simply a way for the senior level that is providing the transfers to pass the buck of indebtedness.

Assisting Small Bond Issuers: Is the U.S. Experience Relevant?

The U.S. is often perceived as having a highly sophisticated financial market, with knowledgeable and skilled investors and issuers. But that is not true with many of the estimated 40,000 subnational governmental issuers in the U.S. bond market. Many are small and unsophisticated. However, the well-established legal and regulatory processes, the availability of skilled advisors, and competition among potential lenders greatly improves the access of smaller units to the markets. A combination of state-backed financial intermediaries such as bond banks, the availability of private bond insurance, and preferential federal tax policy keep competitive pressure on dealers and banks in providing services to small issuers.[64] As a result, the typical U.S. small local government credit has been elevated to being very competitive in the markets.

Encouraging this largely market-driven process, a good deal of attention has been given to upgrading local government financial management practices and reporting, an oversight function that states have long had as regards their progeny but have worked at with increasing vigor during the past few decades. Bond banks, bond insurance and other organized lending and credit enhancing programs have placed requirements that local governments report their financial condition on a regular basis along lines of generally accepted accounting principles. These developments, along with the widespread use of credit ratings and recently adopted securities-related reporting requirements of the U.S. Securities Commission, have also worked to standardize and regularize financial reports.

10.9 Bond Banks

A recent survey of state bond banks in the United States shows that these have a variety of administrative and program structures and financing experience that can be useful to emerging municipal markets.[65] Initially, the mission of the bond banks in that country was to improve access to the financial markets for small, rural governments. Instructively, the approaches used in operating the banks and the scope of their activities have varied, depending on the relative priorities among various of financing needs and their legal and political environment. The earliest bond banks were seen as general extensions of state government creditworthiness to help close the marketing gap for small, isolated general-purpose municipal issuers. As experience was gained, the banks frequently have taken on specialized areas of activity, such as financing environmental activities, local schools, short-term borrowing, and equipment leasing. They have also

64 Tax policies can be very important along these lines. Small issuers (those that issue less than $10 million annually) have a niche market because of special tax provisions regarding the holding of their bonds by banks. The provision cannot be "passed through" the pooled borrowings by bond banks, which encourages the small issues to be sold separately and has made bond banks somewhat less competitive for loans to the smallest issues.

65 John Petersen, *A Primer on State Bond Banks in the United States,* paper at the First Conference on Capital Market Development for Subsovereign Governments, World Bank, Santander Spain (October , 1998)

moved to taking up limited obligations, participation in structured transactions, and providing enhancements.[66]

Because they are competitive with private lenders and dealers and many times can finance at lower costs or on better terms than are otherwise available in the market, the creation of bond banks has been resisted by both commercial banks and securities deal in many states.[67] After early adoptions in several states, the bond bank movement in the U.S. slowed down as opposition from such competing interests and concerns about stretching state credit enhancements too thin began to crystallize. More recently, the interest at the national level in creating revolving funds as a means of replacing recurring capital grants from the central government has re-activated interest in state-based financial intermediaries, including the traditional bond banks.

---

66 Not surprisingly, most U.S. bond banks have been created in largely rural states in which there were not strong regional financial markets. For example, the creation of bond banks in New Hampshire, Vermont, and Maine was to an extent a reaction to those states being in the backwater of the New England regional financial markets that were dominated by large Boston banks.

67 Because they aggregate small issues into a large one, they can provide economies of scale. But that process reduces the amount of business available to regional dealers and banks. On the other hand, large money center dealers may support their creation if they think they will get the underwriting business. The latter, however, have little political influence in the state compared to those investment firms that are located there.

11. Concluding Observations and Policy Guides

The foregoing sections of the paper have covered a number of aspects regarding how subnational governments link into the overall framework of the private credit markets. The linkages are multifaceted, even in relatively immature systems. And, they are dynamic, changing as the structure of governments and the financial markets change. We chose to concentrate in the activities and constraints of borrowing by subnational governments, which served as the focal point for discussing relationships, practices and policies. We commenced by determining which governments are likely to be candidates to borrow, what security they might pledge, how they should or should not be constrained in their decisions, and the various instruments they might choose to use and means by which they would place them in the market.

Linkages are approached from various angles: the potential investor, the organization of the securities market and its regulation, likely investor groups and their regulation, the need for information and its use to analyze credit, and the rating and private insuring of securities. We concluded with an examination of two of the specific policy arenas, credit assistance and financial emergencies. We saw what tools senior governments might choose to wield in developing markets, looking at forms of credit assistance and methods by which senior governments monitor and, when necessary, intervene in the affairs of local governments.

Throughout the toolkit, we have made various suggestions and drawn conclusions regarding how national policy regarding linkages between subnational governments and the private financial markets should be fashioned. These suggestions and recommendations, of course, are constrained by two things:

- own experience with and our reading of others' experiences in several emerging countries, and

- our objective of promoting competitive and sustainable private-sector credit markets that deal in subnational securities and loans.

There is no desire to say here that "one size fits all," nor to minimize different structures of government and levels of credit market development. Nonetheless, we believe that the following observations regarding policies and practices form a point of departure in appraising a country's readiness to promote markets for subnational government securities. They also can stimulate debate over the substance of existing markets and how access to them might be improved and new markets best engendered.

11.1 Policy Guides Regarding Security Pledges, Instruments, and Methods of Sale

- It is better not to make distinctions among local governments as to their powers and the procedures they are to follow with respect to borrowing. Generic laws that contain generally broad formulations and simple parameters based on objective criteria are better.

- The legal status and remedies for various types of obligations of subnational governments should be clear. That is frequently not the case where such obligations have formerly carried explicit or implicit sovereign guarantees. The ultimate security and the process for enforcement of the obligation by creditors should be explicit and easy to effectuate.

- Parties to debt transactions should be empowered to design security provisions to meet circumstantial and specific needs, as well as general requirements. Essential services, for example, can be defined and minimum levels protected in the case of asset and intergovernmental transfer pledges.

- In addition to tax-supported debt, jurisdictions should be able to offer limited obligation security arrangements (e.g., revenue bonds) that do not involve the pledge of general revenues.

- Local governments should be able to enter into tariff-setting and other covenants with respect to limited obligation debt. If senior level governments retain rate-making approval, there should be provision for their giving prior approval to rate adjustments for purposes of debt contracts or otherwise providing indemnification against default for want of the ability to adjust rates.

- Local governments should be able to make assignments of their revenue (i.e., revenue intercepts). An exception can be made for those revenues as are determined to be necessary to provide minimum essential services. This might also be done by a regulation that only up to a specific fraction of transfers may be pledged to debt service payments.[68]

- Local governments should have the ability both to create and to join with others in the creation of special districts to address service needs related to specific areas or activities. They should have revenue powers that allow them to capture value created by their activities and investments within or on behalf of those districts.

- The marketplace should be free to decide on specific types of instruments and associated payment mechanisms to employ so long as those types are generally permitted of borrowers. Unless there are compelling reasons to make restrictions of

[68] This is akin to a minimum coverage requirement often found in limited obligation bonds.

all borrowers, there is no basis to treat subnational units differently so long as there is full disclosure and competitive norms are met.

- Wherever possible, it is best to introduce competition into the marketing of debt. This can be accomplished by formal solicitation and bidding procedures to procure services of underwriters, advisors, banking services, and other professional specialties.

11.2. Policy Guides Regarding Borrowing Powers

- Restrictions on borrowing powers may be appropriate in many emerging market situations where the objective is to balance local self-determination with limited experience and capacity. However, the overall object is to link self-determination with fiscal self-sufficiency and local accountability. This is best accomplished by observing market driven standards and using market-driven incentives.

- Short-term debt should be limited to only providing for cash flow shortfalls in anticipation of realistic income streams to be realized within the fiscal period. Short-term debt should be paid off annually by the close of the fiscal year, and remain paid off for a reasonable interval of time. Exceptions may be in the event of financial emergencies and part of the emergency or intervention plan.

- Long-term debt should be limited to capital investment in property, plant, and equipment. It should not be used to finance operating deficits except as part of a financial emergency recovery plan as defined by statue and regulation.

- Limitations in debt outstanding should be related to either the available tax base or some measure of recurring revenues and where possible, should be expressed in terms of annual or maximum debt service. For example, total debt service (principal and interest) on general obligation long-term debt should be limited to a percentage of projected available annual revenues. The market should determine acceptable ratios of debt service coverage in the case of self-supporting debt, which will vary by the technical and economic aspects of the improvement and the security pledged.

- Approval of borrowing by a jurisdiction's legislative body in most cases is sufficient, so long as the debt outstanding after borrowing falls within certain parameters. Routine approval by senior levels of government diminishes local flexibility and responsibility and opens the door to political manipulation. However, waivers of limitations in unusual cases by cognizant state or national authorities may help flexibility.

11.3 Policy Guides Regarding Financial Market Regulation and Disclosure

- Local governments as borrowers should fit within the overall regulatory framework for banking and securities markets. Balancing the competitive norms of market efficiency and development while preserving the integrity of the payment system and protection of investors is necessary. Generally, subnational governments should enter financial markets on an equal footing to private firms, while recognizing the distinctions that flow from their taxing and governance powers.

- A secondary market for securities is important to investor liquidity. But, formal listing on exchanges should only be required where the potential size of secondary activity justifies the time and expense. Neither local governments nor smaller private firms should face excessive requirements that may accompany listing on security exchanges.

- A secondary market for subnational can be developed among the Over-The-Counter markets, which may prove to be more efficient for smaller issuers, the bonds of which are traded infrequently. Investor protection needs to be balanced with permitting economical access by smaller issuers, which should be a fundamental tenet of disclosure requirements.

- A key concern in market regulation is that of disclosure. Subsovereign securities, as those of other issuers, should be subject to disclosure standards that require both information at the time of the initial offering and subsequent regular reporting to investors. The focus should be on the process and generic needs. The substantive data needs in meeting such standards may best be left to self-regulatory bodies in the market and to participants in individual transactions.

- Financial information needs to be reported in clear, common formats and promptly after the close of the fiscal period. For debt monitoring purposes, reporting on a cash or modified accrual basis are especially useful, as are cash flow statements. Audits should be independent, recurring, and punctual.

- A central repository of financial information regarding governmental borrowers is a useful tool in promoting efficient disclosure. Such a repository should also contain information regarding the security pledged and liens against real and personal property if those are not recorded elsewhere.

11.4 Policy Guides Regarding Credit Analysis, Credit Ratings, and Bond Insurance

- Credit analysis is a product of the credit market's operation and only becomes viable when and where there are a variety of competing investments with differing risk and reward characteristics. Where there are large numbers of passive investors and

transactions are diverse and numerous, individual investors will become reliant on the opinions of specialists.

- Credit ratings are the leading form of institutionalized credit analysis and assist in developing an active securities market by pooling skills to develop opinions. Ratings play an important role in that they focus on credit risk (risk of payment delay or default) which is then used to help judge risk and reward.

- Ratings have a positive side benefit of ranking governments on their perceived ability and willingness to pay. The symbols are easily understood and lend popular appeal to the otherwise lackluster but essential task of improving finances (as a means to upgrading one's rating).

- Credit ratings can tend to centralize and dominate credit analysis and as proprietary operations, the precise basis for ratings is not always clear. Reputations for objectivity and freedom from influence (as well as being correct most of the time) are necessary for credibility. The demand for ratings should derive from the market itself. Ratings companies should compete. In domestic markets, it is not a good idea to demand ratings of issuers as a matter regulation, to have "official rating agencies" nor to set "standards" for ratings. In foreign market borrowings, aside from private placements, international ratings are likely required by the market.

- Private sector bond insurance is of potential interest to subsovereign credits. The insurance companies are somewhat active in emerging economies, although recent events have dulled interest. With the possibility for diversification limited within countries, commercial insurance may be slow to take hold. However, credit assistance programs that have sufficient capital, that are market oriented and that use insurance principles in determining charges may hasten development.

11.5 Policy Guides Regarding Credit Assistance and Financial Interventions

- Credit assistance, where provided, should be provided only to that level necessary to permit a government to access the private credit markets. Governments should be subject, to the extent that they can be, to the costs and demands of private credit at least at the margin. Those that are too poor and too small to borrow in the market should not be encouraged to borrow unless and until their underlying financial situation makes that feasible.

- Direct lending, interest subsidies, guarantees, and insurance and other financial assistance should be designed to provide incentives for governments to access the markets on their own. Such programs should recognize differences in creditworthiness and have those differences reflected in the rates of interest or the amount of loans extended.

- Financial intermediaries that pool smaller loans into larger offerings such as found in bond banks can provide economies of scale and give the opportunity for greater liquidity in the secondary market. Such bond banks or pools can either be public sector or private sector in sponsorship but should be essentially financial institutions and subject to credit market discipline.

- Forms of intervention by senior levels in the case where there is a local government financial emergency should be comprehensive and complete. They should provide for creditor rights, remedies, and workouts, as well as financial recovery (or dissolution) of the debtor unit itself. There should be the added flexibility in terms of making specific pledges of security and remedies a matter of contract. But, it is best to have in place a statutory framework to define rights, essential services, and the procedure for recomposition of debt. Interventions should be rare and not be used as a backdoor for the senior level of government to bail out local governments and their creditors.

The World Bank
Urban Development

1818 H Street, NW
Washington, DC 20433
USA

Internet: www.worldbank.org/urban