

**USING MUNICIPAL DEVELOPMENT
FUNDS TO BUILD
MUNICIPAL CREDIT MARKETS**

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INTRODUCTION

Municipal development funds are financial intermediaries that provide credit to local governments and to other institutions investing in local infrastructure. Around the world, more than 60 countries have established financial intermediaries of this kind. In larger, federal nations such as Brazil and India, individual states often have established their own municipal development funds. Both the World Bank and the Asian Development Bank have announced that they intend to rely more heavily on municipal development funds as a key part of their strategy to help finance local investment needs in Asia.

The development of municipal credit systems has assumed special importance because these systems stand at the crossroads of three of the most fundamental development trends in the region. Rapid rates of *urbanization* have escalated the scale of infrastructure investment requirements. It has been estimated that an annual average of US\$280 billion will have to be invested in Asian urban infrastructure over the next 25 years, and that somewhere between 29,000 crore and 44,000 crore will be needed in India alone over the next five years.¹ At the same time that investment needs are mounting, *decentralization initiatives* are transferring greater responsibility for investment choices and investment financing from central government to local and state governments. *Fiscal adjustments* are impelling all levels of government to try to reduce their budget deficits; one of the favorite instruments of deficit reduction has been to replace government subsidies with market-rate lending in the financing of infrastructure projects.

All of these factors have raised the stakes involved in finding effective ways to provide local authorities with loans to finance capital investment. The goal is not merely to give municipalities access to credit, but to do so in a manner that increases the efficiency of local investment and reinforces financial

¹ These estimates are from Asian Development Bank, Urban Infrastructure Finance, A New Vision: Devolution and Market-Based Mechanisms (April 1996) for Asia, and the Zakaria Committee and Planning Commission for India. See Lalita D. Gupta, Financing Urban Infrastructure: the Issues (February 1996, IDF-Infrastructure Services Review).

sector reforms in the rest of the economy. Municipal development funds are typically envisioned as transitional instruments in this effort. They are intended to prepare the way for self-sustaining municipal credit systems that can tap domestic and international capital markets for financing. Meanwhile, they are administratively convenient institutions for donor agencies and central governments to channel funds through. They tend to replicate on a domestic scale the operations of multi-lateral development banks. MDFs allocate loan capital to local government investment projects following procedures very similar to those that the World Bank and regional development banks employ in international lending, while reaching far more local authorities and smaller investment projects than it would be efficient for international institutions to try to finance directly.

Unfortunately, however, few developing-country MDFs have either evolved into market-oriented suppliers of credit capable of mobilizing private sector savings, or have smoothed the way for private sector participation in the municipal credit market. Most have remained specialized and isolated channels for international donor or Government funding. Parastatal institutions that draw only on public sector funds cannot finance the magnitude of urban investment needs that have been identified. Moreover, they run against the policy trend of liberalizing financial markets. In effect, they substitute government loans for government grants. This stretches the public sector budget, but leaves largely unchanged the process of mobilizing and allocating capital.

As India prepares to deepen its use of municipal development funds, it may be helpful to take stock of international experience with these institutions, and to assess why some have succeeded but many have failed in preparing the way for broader, market-oriented municipal credit systems.

II. INTERNATIONAL EXPERIENCE WITH MUNICIPAL DEVELOPMENT FUNDS: THE KEY ISSUES

Municipal development funds display a great deal of variation in their institutional structure. However, all must perform certain functions. They must:

- * Raise capital
- * On-lend capital to municipalities or other institutions investing in local infrastructure projects
- * Collect debt service payments

The way in which an MDF performs these functions will determine whether it helps or hinders the development of an overall municipal credit system.

This section reviews international experience with MDFs, emphasizing the fundamental functions described above. It is based upon examination of 25 separate developing-country MDFs, as well as the systems that support credit financing of local investment projects in Western Europe, Japan, and the United States. The MDFs from developing countries and the restructuring nations of Eastern Europe that were examined are listed in Annex A. To avoid excessively complex tables, 10 of the MDFs have been selected for summary descriptions in the text tables. These MDFs are representative of the geographical and financial distribution of the entire sample.

In analyzing issues of MDF design, it is convenient to start with the loan repayment process and work backward to the raising of capital. Borrower creditworthiness lies at the heart of all credit systems. Unless there is a high probability that municipal loans will be repaid, private savings institutions will not voluntarily commit capital to the municipal sector.

Loan Repayments and Municipal Creditworthiness

Table 1 summarizes the loan repayment experience of a representative group of developing-country MDFs. Repayment rates can be seen to vary greatly across funds.² On balance, however, municipal lending by MDFs carries a good deal of financial risk. Most of the municipal development funds enjoying high repayment rates benefit from special types of loan guarantees. Loans backed only by municipalities' "full faith and credit" pledge to repay debt from local revenues have proved risky. Non-performance rates run well above levels that would be commercially viable, unless lenders were compensated by steep risk premiums added on to interest rates.

² An attempt has been made in Table 1 to standardize the measurement of non-performing loans, by counting as non-performing the total principal and past-due interest amounts on all loans that are 60 days or more behind originally scheduled payment. However, reporting on loan delinquencies varies greatly across countries and across funds. Moreover, non-performing loan trends, as reported, can fluctuate significantly, both in response to actual payment experience and as the result of forgiveness of outstanding loans or rescheduling of payment dates.

Indeed, MDFs often introduce new, political risks into the municipal credit system, making it more difficult for market-based lending to begin. In some of the MDF systems, non-payment of debt service carries no significant penalty. Municipalities in default can continue to receive grants from central government and frequently continue to receive new loans from the MDF, even though outstanding loans are not being repaid. Municipalities faced with tight budgets may fall into the habit of negotiating with central authorities over debt-service waivers or debt rescheduling. A new local administration may argue that a previous administration, controlled by a different party, undertook the original borrowing, and that the current administration should not be obliged to repay debt incurred for a project it did not favor. Repayment becomes particularly problematic on projects where local authorities feel they were not involved in the investment decision. Central authorities may have designed and built a project, after minimal consultation with local government, then financed the project as a “loan” to the local authority through the municipal development fund, rather than as a capital contribution to the local infrastructure base.³

³ An illustration of the use of MDFs to substitute loan finance for grant finance can be found in Indonesia’s Regional Development Authority. The RDA is operated by the Ministry of Finance. Its primary function now is to finance investment in local water supply and distribution projects. Formerly, these projects were developed and constructed by the central Ministry of Public Works, using Government funds. Then, it was decided that the projects should be put on a financially self-sustaining basis, with capital costs covered by Government loans made through the RDA, which were to be repaid from tariff income. Although the Government of Indonesia has made strides in increasing local participation in project design, initially water projects continued to be designed, built, and paid for by central authorities. However, the cost was entered as a loan to be repaid by the local water authority.

Table 1
Loan Repayment Experience
Selected Municipal Development Funds

Country and MDF	Loan Non-Performance Rate	Automatic Intercept Guarantee	Remarks
Brazil PrAM/PIMES	2%	Yes	Loans are collateralized by value-added transfers from state to local government. The state bank deducts debt service payments directly from municipalities' accounts.
Colombia FINDETER	2%	Voluntary in loan contract	Municipalities open special account to deposit inter-governmental tax-sharing transfers. Bank has right to access account. Municipal loans are made and payments collected by private commercial banks.
Czech Republic MUFIS	0	No	Municipal property commonly used as collateral. Loans are made and payments collected by private commercial banks.
Ecuador BEDE	2%	Yes	Local government loans are collateralized by local government accounts at central bank. These receive all government transfers as well as all local government own-source revenues. Repayment of BEDE loans has first claim.
Honduras BANMA	50%+	No	No collateralization. BANMA does have the right to intervene in local tax collections if loans are delinquent. It can establish a local office and use incremental tax receipts to repay its loans. BANMA continued to make loans to local authorities in arrears. Performance now improving.
Indonesia RDA	30%	No	No collateralization
Jordan CVDB	30%	Yes	Collateralized by government transfers. However, bad loans joined with a falling economy that reduced transfers produced a situation where delinquent loan payments for many municipalities exceeded central government transfers and the quarter system broke down. Performance now improving.
Kenya LGLA	80%+	No	LGLA continues to make new loans to municipalities in arrears. Forms part of an interlocking bad-debt situation, where state also fails to pay amounts legally due to municipalities.
Morocco FEC	20%	No	Local budgets must provide for loan repayments before they will be approved by central government. Central government implicitly guarantees commune loans through official approval of municipal budgets and control of transfers. Municipal enterprises (<i>regies</i>) have not participated in central government budget review and implicit guarantee. Rising aerugos led to requirements that <i>regie</i> loans be guaranteed by local municipality.
Philippines MDF	20%	No	MDF has the legal right to impose intercepts, but has not exercised this right.

The resulting controversies throw local debt servicing into the political realm. The fact that MDFs typically are owned and operated by governmental institutions makes it almost impossible for them to deal with municipalities in a commercial manner. Most MDFs have control over discretionary subsidy funds that they can use to match municipalities' market-rate borrowing or to write down interest rates. Their combined control over subsidies and credit invites borrowers to try to obtain a larger subsidy mix, either before the fact by negotiating more favorable financing terms or after the fact by pleading poverty and not making full loan repayment. The political risks that emerge tend to discourage other entities from entering the municipal credit market. In Honduras and the Philippines, as well as in some other countries, commercial banks reported that they historically had lent small amounts of funds to local governments or to neighborhood associations for water installation or other neighborhood improvement projects, with good repayment results, but that they had withdrawn from such lending because of the increasingly erratic repayment record of municipalities to the MDF and the high-profile controversies that had erupted over municipal debt servicing.

Two of the MDFs with the best repayment records--MUFIS of the Czech Republic and FINDETER of Colombia--are second-tier financing institutions which lend to municipalities through private commercial banks. The private banks assess municipal creditworthiness, assume all credit risk, and collect loan payments using standard commercial methods. (See Section IV for further discussion of these institutions.) These practices have produced very good loan repayment records. However, private-sector banks' willingness to lend to the municipal sector at their own risk requires that several pre-conditions be met. Municipalities must have stable sources of revenue. Financial sector liberalization must have proceeded to the point where private lenders can make their own decisions about credit allocation, based upon their analysis of risks and returns, without government steering of capital. Inflation must have moderated to the point that intermediate-term lending is feasible. If these conditions have not been met, a country cannot "jump ahead" to private-sector municipal lending, merely by establishing an MDF that supplies banks with a sectoral line of credit.

Attempts to Reduce Credit Risk: Loan Ceilings

The poor repayment record of municipal development funds has led governments and external donors to look for structural features that can enhance the creditworthiness of municipal lending.

One common approach has been to establish numerical guidelines that would automatically identify prudent borrowing ceilings, based on a municipality's capacity for debt repayment. The guidelines are often transferred from municipal credit analysis standards applied in developed countries. For example, several municipal development funds in Latin America, including the Urban Development Fund of the State of Rio Grande do Sul, Brazil, and the Municipal Development Program administered by the Ecuadorian Development Bank, limit total debt service (including debt service on MDF loans) to 15 percent of a municipality's revenues, usually defined to exclude one-time or discretionary grants from the State. The 15 percent threshold for debt service traditionally has been a basic guideline for determining prudent levels of municipal indebtedness in the U.S. municipal bond market. The Cities and Villages Development Bank (CVDB) of Jordan and the Communal Infrastructure Fund of Morocco (FEC) have adopted the basic credit assessment procedures used in France. These project a municipality's budget surplus from existing operations, or its "management surplus," then limit new municipal debt to levels that can be serviced within this surplus.⁴ In Colombia, fear of excessive local borrowing led the Central Bank during part of 1995 and 1996 to impose a three-tier municipal borrowing ceiling, based on the ratio of local debt to total municipal income and the ratio of debt service to "free" or uncommitted municipal revenues.

⁴ For example, Jordan's Cities and Villages Development Bank calculates the capacity to service additional debt by projecting a municipality's current revenues from transfers, taxes and fees, then subtracting projected expenditures on recurrent operating costs, service on existing debt and capital investment financed from recurrent revenues. The difference is the management surplus. Local authorities are permitted to borrow up to the point that would absorb 75% of this management surplus.

Numerical ceilings on borrowing can help MDFs resist municipal entreaties for unrealistically large loans. However, ceilings of this kind have been only moderately effective in improving overall debt payment. The rules of thumb that make sense in assessing municipal borrowing capacity in developed country markets often have less relevance in assessing credit risk in developing countries. Local governments in developing nations typically have far less control over the revenue side of their budgets than is true in the United States. Most of their revenue consists of revenue sharing and grants from central or state government. At the same time, tax-sharing arrangements between central government and local authorities tend to be less stable and less predictable than in Western Europe, where intergovernmental flows also figure very importantly in local budgets. For example, in 1992 centrally collected personal income taxes in Hungary and Slovakia were allocated 100 percent to local governments. By 1995, central government, confronted with its own budget deficits, had slashed the share of personal income tax receipts allocated to local governments to 30 and 25 percent, respectively. Comparably abrupt changes in intergovernmental financing can be found in other regions. In this environment, traditional debt ratios are not very reliable indicators of local governments' future capacity to service debt obligations.

Eagerness to disburse loan funds, especially in projects financed by international donor agencies, can further erode the utility of credit limits or advance credit analysis. Jordan's CVDB, for example, adopted credit limits based on future, projected income, after a World Bank report found that the previous system of establishing credit ceilings resulted in slow disbursement of donor funds. However, CVDB's projections of municipalities' future revenue growth and income from new municipal investment projects were highly optimistic, leading to overstated projections of future operating revenues and hence overstatements of municipal capacity to service debt. The CVDB eventually had to waive debt service payments for two years for all municipalities and restructure most of its outstanding loans.

Guarantees

The inability to fully protect debt repayment through borrowing ceilings or advance credit analysis has prompted lenders, including municipal development fund lenders, to look for guarantees that would protect their loans.

The first preference of lenders is a central government guarantee. Occasionally, an explicit, open-ended government guarantee has been provided. The first municipal bonds issued in Hungary after the collapse of the Communist government, for example, were supported by an explicit national government guarantee. More often, the government guarantee is implicit. Under the French municipal finance system in effect until the mid-1980s, the central government reviewed and approved municipal budgets, including plans for municipal borrowing. It was thought that this system carried with it a government commitment to guarantee municipal debt repayments, through special funding assistance and management intervention in the event of threatened default, as had been the practice for many years. However, with the fiscal decentralization of the 1980s, the central government guarantee disappeared. A large volume of outstanding municipal loans had to be restructured when municipalities encountered difficulty in repayment. This experience has raised questions in some North African countries, whose MDFs are modeled after the original version of the French municipal credit system, as to whether the implicit state guarantee for municipal borrowing, based on similar state review and approval of local budgets, will survive decentralization initiatives.

Perhaps the most effective form of municipal loan guarantee has been the intercept provision. These give the lender first claim on intergovernmental transfers otherwise due to the municipality. Intercepts of this kind can be found in a number of Western countries. The majority of states in the United States now have intercept laws, which allow distressed central city governments or distressed school districts to assign to lenders first claim on state aid to the borrowing jurisdiction, if the municipality or school district is not current in its debt payments. This form of guarantee has opened the credit market to jurisdictions that would not otherwise have access to it, and has lowered their interest costs. In the Netherlands, municipal

borrowing through the Municipal Bank of the Netherlands is secured by the common Municipal Fund, through which central government aid is distributed to local authorities. The Municipal Fund in effect guarantees each municipality's debt repayment, reducing the amount of funding available for distribution to all municipalities as grant assistance in the event that a loan guarantee has to be utilized.

In developing countries, intercept provisions have been generally successful in reducing municipal arrears. Table 1 shows that most of the countries with intercept arrangements have arrearage rates of 2 percent or less. Loan repayment rates remain high even when lenders, as in Colombia, cannot access central grant funds directly, but must enter into voluntary contractual arrangements with municipal borrowers to have grant transfers deposited into a special local account which can be drawn upon by the lender in the event that debt service payments are not made in full and on schedule. The importance of intercepts in securing loan repayment has led several MDFs to incorporate coverage requirements into their loan authorization procedures. The state MDFs in Brazil, for example, where municipal loans are secured by intercepts of state-collected VAT revenues, contain provisions requiring that a municipality must have sufficient VAT transfer entitlements to collateralize all debt service.

Although intercepts have been effective in reducing municipal loan arrears, they are not without problems. An intercept arrangement does not overcome the risk that a state or central government will drastically reduce the intergovernmental transfer that serves as loan guarantee. The loans made by Jordan's CVDB were secured by intercept authority. However, when the economy turned down and intergovernmental transfers were cut, these proved insufficient to fully cover debt service obligations. The risk that central authorities will reduce local tax-sharing receipts or grant transfers can be protected against only by other types of measures, such as a constitutional provision stipulating local transfer entitlements,⁵ or a track record of stable transfer policy.

⁵ In Brazil and Colombia, as well as several other Latin American countries, local entitlements to specific shares of national tax collections are now spelled out in the Constitution.

A more fundamental shortcoming of intercept provisions is that they frequently fly in the face of decentralization initiatives intended to place more responsibility for budget choices on local governments. Intercept arrangements can become mere book transfers at the central level. This is especially true when, as often is the case, the same Municipal Development Fund that makes loans to local authorities is responsible for allocating grants and handling local authorities' financial accounts, or is linked to these agencies. In these cases, the MDF may merely credit itself with the loan payment due, subtract the amount from the revenue sharing or grant payment to a municipality, and send the municipality a check for the difference. Local authorities may not even be aware that this process has taken place. Bookkeeping arrangements of this kind, though effective in preserving the MDF's financial position, defeat the purpose of making local governments aware of the costs of investment and having them take into account these costs in deciding the magnitude and type of investment they will finance.

Other kinds of guarantees have been offered to protect municipal loans. In Central and Eastern Europe, it is customary to collateralize municipal loans with real property owned by the municipal government. This practice reflects both the extent of commercial property holdings by local governments and the reliance on real property as collateral throughout the banking system. Lenders in the Central and Eastern Europe region as well as elsewhere recently have moved toward more liquid forms of collateral. Lenders may require that municipal borrowers maintain their ordinary business accounts with the lending authority and grant the agency the right to automatically debit any loan payments due. These practices most commonly are found among commercial banks or municipal development funds that operate through commercial banks. Liquid collateral of this kind has proved extremely effective in reducing loan defaults and is consistent with the principle of fiscal decentralization, since it requires a deliberate choice on the part of a municipality to assign to a lender the right to debit its current account. The "price" of loan repayments is immediately visible in the municipal balance.

MDF Lending: Intermediation and Development Bank Functions

In the theory of financial intermediation, banks perform the role of “delegated monitoring.”⁶ Municipalities and other borrowers could, in principle, tap the capital market directly by issuing bonds or by structuring individual loans with large financial institutions such as pension funds and insurance companies. However, unless the loan at stake is large, it is inefficient for each saver to try to monitor the financial condition of each borrower. A bank performs this intermediation and monitoring function. It gathers savings from numerous sources, assembles specialized professionals capable of loan oversight, and monitors thousands of different loans. Because the financial and risk characteristics of municipalities differ from those of other borrowers, one or more banks that specialize in municipal lending may fill a market need.

The role of intermediation becomes more complex and more ambitious in the case of a development bank. Most MDFs are either literally development banks or are institutions charged with similar functions. Their goals extend beyond credit supply to increasing the efficiency of local investment, promoting the development of service pricing and cost recovery in local investment projects, upgrading municipal financial management generally, and ensuring that critical investment projects get built even when full financial cost recovery is not feasible. MDFs for the most part have addressed this range of goals by trying to bring a host of different developmental functions under their own roofs. Table 2 shows that the typical MDF, in addition to lending funds to local authorities, performs project appraisal from both a financial and economic perspective, blends loan funds with capital grants or subsidies for high-priority projects, oversees local project preparation and construction, provides technical assistance in financial management, and collects loan repayments, among many other responsibilities.

The rationale for bundling together these different functions is straightforward. In principle, it allows an MDF to coordinate all of the activities critical to the success of an investment project. Without

⁶ See, for example, Douglas W. Diamond, "Financial Intermediation and Delegated Monitoring," Review of Economic Studies (1984), LI, 393-414; Diamond, "Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt," Journal of Political Economy (1991), vol. 99, no. 41, 689-721.

coordination, local authorities may never make use of loan funds because they are hoping to become eligible for a capital grant instead, or a project may get financed but never be completed because of inadequate local implementation capacity or poor technical design. As the pre-eminent institution dealing with local government investment, an MDF can assemble the critical mass of technical expertise necessary both to improve local investment practices and serve as a comprehensive counterpart for international funding.

Nonetheless, there are dangers in internalizing all of the functions associated with local government investment financing in a single institution. One danger is bureaucratic delay. In performing the various roles assigned to it, an MDF may become a cumbersome bottleneck that slows down the investment process.

In the early 1990s, for example, the average elapsed time between initial project identification and municipal loan approval at the Ecuadorian municipal development fund was more than 32 months. FINDETER in Colombia has been able to reduce the period between initial loan application and loan approval to a little more than eight months, but municipalities nonetheless have been shifting loan demand to commercial banks, citing the delay in FINDETER project review as the principal shortcoming of its lending process.

A second danger is that a development bank empowered to perform the full range of functions illustrated in Table 2 will act as a monopolist, squeezing out competition and retarding development both of a private credit market and of local governments' capacity to plan and execute projects on their own. If the municipal development bank, for example, has the ability to blend subsidy funds with its loans, it will tend to underprice pure commercial lenders, forcing them out of the market. If municipal authorities must utilize MDF loans in order to gain access to technical assistance, other institutions will find it difficult to compete for loan business. A strong MDF can likewise stand in the way of decentralization initiatives. MDFs often have proved reluctant to let local governments prepare investment projects on their own or set their own priorities for capital spending.

Table 2
Functions Performed by MDFs

Country and MDF	Economic & Financial Appraisal of Projects	Construction Oversight	Financial Technical Assistance	Capital Subsidy Allocation	Credit Assessment & Payment Collections	Post-Project Monitoring
Brazil PrAM/PIMES	No, for small projects	Little	Yes	Yes	Yes	No
Colombia FINDETER	Yes	Yes	Yes	No currently. Yes, in past.	No	No
Czech Republic MUFIS	No	No	No	No	No	No
Ecuador BEDE	Yes	Yes	Yes	Yes	Yes	No
Honduras BANMA	Yes	Yes	Some	Loan Forgiveness	Yes	No
Indonesia RDA	Yes	No	Yes	Some	Yes	No
Jordan CVDB	Yes	Yes	Yes	Yes	Yes	No
Kenya LGLA	Yes	Yes	Yes	Yes	Yes	No
Morocco FEC	Yes	Yes	Yes	Yes	Yes	No
Philippines MDF	Yes	Yes	Yes	Yes	Yes	No

Unbundling Options

The development functions that an MDF performs are critical to improving the quality and cost-efficiency of local investment. Whether these functions should be centralized in a single institution, however, is an open question. An alternative path is to unbundle the functions as much as possible, so that some of them can be assumed by the private sector, once it becomes equipped to do so, and others can be performed by municipalities themselves. This strategy introduces competition into local investment design and financing, while keeping the MDF in a pivotal coordinating role.

Assigning Responsibility for Credit Analysis, Credit Risk, and Payment Collections to Commercial Banks or Other Specialized Private-Sector Firms. Commercial banks and other commercial lending institutions routinely conduct credit analysis and perform loan operations. In countries where private-sector banks already are functioning, such responsibilities may be more efficiently carried out by commercial banks than by the MDF directly. Not only is commercial bank participation likely to boost municipal loan repayment rates and reduce MDF risk exposure, as in the Czech Republic and Colombia, but commercial banks' participation in municipal lending as an MDF partner can hasten their independent entry into the market and clear the way for other private-sector institutions to lend to the municipal sector.

Commercial lenders will be willing to assume municipal credit risk only if the risks can be well defined and limited. The same array of guarantees that have been effective in reducing MDF payment problems should be available to the commercial sector. At present, intercept provisions often are available only to state lending institutions. In Brazil, the Philippines and other countries, the law does not permit private lenders to intercept state tax-sharing payments, even if a borrowing municipality voluntarily seeks to enter into such an agreement. Limitations of this kind impede the spread of municipal lending beyond a state-sponsored MDF. One of the principal reasons for the success of FINDETER in spreading its municipal lending model into the commercial sector has been the ability of banks and municipalities to enter into exactly the same type of voluntary intercept agreements that have been included in FINDETER loan contracts.

In a number of countries with active capital markets, including India, independent credit rating firms also exist. These firms can be introduced to the municipal credit market by MDFs. Experience reveals that credit assessment is a function that MDFs generally perform poorly. They do not have highly trained technical staffs and often are restricted by political factors in awarding loans. MDF reliance on independent credit rating of municipal loan risk can both improve repayment experience and introduce to the municipal credit market firms that will play a crucial role in allocating credit in a fully developed, private market.

Separating subsidies from loans. Linking state capital subsidies exclusively to MDF loans is one of the surest ways to deter expansion of the credit market. Unbundling these functions need not reduce the magnitude of subsidies. Rather, the subsidy decision can be made by a different government agency or agencies, based on the characteristics of the project (e.g., its external benefits or importance to national priorities) or the characteristics of the local government seeking financial assistance (e.g., its revenue-raising capacity). In an unbundled system, the subsidy decision is made independently of how a municipality chooses to finance the unsubsidized portion of project costs. Subsidies are not tied exclusively to MDF loans.

A contrast between Poland and the Czech Republic in the financing of local environmental projects is instructive in this regard. In Poland, most municipal environmental projects have been financed in their entirety through the Environmental Bank at highly subsidized interest rates. This policy delayed the introduction of a commercial credit market. Municipalities preferred to queue for subsidized loans from the Environmental Bank, rather than borrow at market rates from private lenders. In the Czech Republic, municipal environmental investments also have been heavily subsidized, initially through grants and later through zero-cost loans. However, the subsidized funding covered only part of a project's costs. Local authorities were obligated to finance the rest of a project's costs through own-source savings or by borrowing on the commercial market. A large number of municipal environmental projects have been co-financed by the Environmental Fund and commercial banks, leading to very rapid growth in the private

municipal credit market, as banks became quickly exposed to the special characteristics of municipal lending.

In most countries, the share of subsidy funds in overall MDF financing has fallen in recent years. However, MDFs' exclusive ability to match capital subsidies with MDF loans continues to impair market entry by other lenders.⁷

Decentralizing responsibility for small-scale project preparation. Small-scale projects can be a proving ground for decentralized project preparation by local governments. The technical benefits gained by having MDF staff review and approve small-scale individual projects like neighborhood water distribution projects or road surfacing are likely to be outweighed by the time savings gained from allowing local authorities to move ahead on their own. The experience of taking full responsibility for project preparation is an important ingredient of local capacity building. It also furthers the conditions for a competitive credit market. Municipalities that have prepared their own project specifications can “shop around” for the best financing terms. If the project design must be prepared, or reviewed and approved, by a professional team associated with the MDF, it becomes difficult to seek financing from any source but the MDF, reinforcing its monopoly role in the field. At some project size, of course, centralized review becomes critical, at least until local authorities have compiled a track record of efficient project preparation.

⁷ In Western Europe and the United States there is experience both with unbundled subsidies and with bundled systems that tie together subsidies and loan financing. Many of the Western European MDFs, until the 1980s, raised capital non-competitively and supplied it at below-market rates to municipalities. The Environmental Revolving Loan Funds operated by states in the United States blend market-rate capital with subsidies to on-lend at below-market interest rates. These funds generally do not have the other developmental responsibility of developing-country MDFs, however.

Monitoring. Even if some of the developmental functions are unbundled and performed by others, the MDF will remain responsible for a wide range of activities. One of the ironies of the multiplicity of roles performed by MDFs is that the critical banking role of monitoring outstanding loans has been neglected. Few MDFs perform post-construction monitoring to determine if tariff covenants are being implemented, or even assess the ongoing capacity (and willingness) of the municipality to service its debt obligations. World Bank follow-up studies have found that local water distribution projects, for example, rarely generate the revenues forecast at the time of project appraisal; although this situation jeopardizes loan repayment capacity, it is rarely monitored by the MDF financing the project.⁸ Other post-construction conditions that would provide early warning signals of a municipality's difficulty in repaying debt are also ignored.

Raising Capital

Tables 3 and 4 summarize how developing-country MDFs have raised loan funds. As can be seen, MDF experience in tapping the overall capital market is quite limited. This contrasts with the experience of MDFs in Western Europe (see Section IV) and of Environmental Revolving Loan Funds in the United States, both of which have become efficient vehicles for mobilizing funds from the private capital market for urban and local environmental investment.

⁸ World Bank, Review of Urban Sector Investment Program (1988); Michael Garn, "Comparison of Projected and Actual Performance of Local Water Distribution Investment Projects," World Bank, 1988.

Table 3
MDF Access to Capital Markets:
Sources of Funds

Country and MDF	Government and/or Donor Funds	Municipal Deposits	Public or Regulated Institutional Savings	Competitive Capital Market	Supports Parallel Private Municipal Credit Market
Brazil PrAM/PIMES	Yes	No	No	No	No
Colombia FINDETER	Yes	No	Yes	Yes (small)	Yes
Czech Republic MUFIS	Yes	No	No	No	Yes
Ecuador BEDE	Yes	Yes		No	No
Honduras BANMA	Yes	Yes	Yes	No	No
Indonesia RDA	Yes	No	No	No	No
Jordan CVDB	Yes	Yes	Yes	Partial (see text)	No
Kenya LGLA	Yes	Yes	No	No	No
Morocco FEC	Yes	Yes	Yes	Partial (see text)	No
Philippines MDF	Yes	Yes	No	No	No

All developing-country MDFs reviewed for this report received funds from government budgetary contributions and multi-lateral development bank loans. Some developing-country MDFs also function as a type of municipal credit union. Municipalities maintain deposits at the MDF at below-market interest rates; these deposits are then used to finance below-market loans to other municipalities. Such arrangements generally are successful only in financing short-term loans, and are subject to the same kind of pressures as other credit unions. Better-off municipalities may prefer to invest their savings elsewhere, rather than subsidize the borrowing costs of poorer municipalities. To restrain the withdrawal of richer municipalities from the system the law may make it mandatory for municipalities to maintain all of their savings in the MDF. This type of closed-circuit financing can survive as part of a regulated capital market, but once savings deposits are opened to competition, it is difficult to sustain.

Developing-country MDFs' efforts to tap the broader capital market almost always have involved public savings or savings subject to public regulation. Experience with this kind of resource mobilization has been mixed, but includes some prominent failures. The National Housing Fund of Brazil, which at one point financed a large part of the infrastructure investment associated with housing construction in Brazil, borrowed heavily from the state pension fund, then went bankrupt when it was unable to collect on its loans. At the time, this was the largest bankruptcy of a public financial institution in the developing world. BANMA of Honduras sold bonds to the national teachers' public pension fund, which purchased them at government instruction. It became delinquent in repayment. BANOBRAS, the local public works financing institution of Mexico, sold its bonds to state banks, which purchased them at government instruction. In Colombia, the MDF sold a special class of bonds to banks (largely public banks) that participated in its municipal on-lending program; the bonds were preferentially treated by the Central Bank, which allowed them to count against reserve requirements. All of these precedents involve government steering funds into municipal credit intermediaries.

Of the institutions examined in this report, few have sought to raise funds in the competitive capital market, and then only under special conditions. FINDETER attempted to sell \$50 million of bonds in the competitive market--a very small share of its loan funds. However, it succeeded in placing only \$10 million,

or 20 percent, of the issue. The commercial banks to which the bonds were marketed saw FINDETER as a competition in the municipal credit market, and preferred to lend directly to local governments rather than finance a parastatal intermediary. The Country and Villages Development Bank of Jordan competes with other financial institutions for savings deposits from liquid governmental institutions, like the Social Security Institute. FEC of Morocco follows the pre-reform model of local government financing in France. It belongs to the government-owned Caisse de Dépôts et Gestion, which now raises a substantial part of its funds through market-rate bond issues, which are shared with FEC at the cost of capital.

Table 4 provides additional detail on the sources of loan funds for selected MDFs.

Table 4
Sources of Funds: Selected MDFs

Country and MDF	
Brazil: PRAM (1991)	World Bank Loan: 48% State of Paraná Capital Contribution: 52% Initially, State funds were used for complementary matching grants, not loan financing. Later, the State contribution was used to help capitalize the loan fund.
Colombia: FINDETER (1994)	Donor Loans and Grants: 37% Domestic Loans and Bonds: 8% Government Capital Contribution: 49% Retained Earnings: 5%
Ecuador: BEDE (projected 1993)	World Bank & Inter-American Development Bank loans: 73% Government of Ecuador: 27% Municipalities: 0.2% Government funds used for complementary grants
Honduras: BANMA (1991)	Municipal equity: 14% Municipal deposits: 17% Donor loans: 55% Government capital contribution: 12% Other: 2%
Jordan: CVDB (1991)	Local government deposits: 20% Central bank advances: 21% Retained earnings: 15% Government capital contribution: 13% Donor loans: 12% Time deposits, govt. institutions: 11% Other: 8%
Kenya LGLA (1990)	Donor grants and loans: 78% Retained earnings: 17% Other, including local deposits: 5%
Morocco: FEC	Up to 1988, capital came primarily from concessional lending from the state-owned Caisse de Dépôts et de Gestion (CDG) and Central Bank rediscounting of FEC loans. Later, CDG issued market-rate bonds and on-lent funds to FEC at its cost of capital.

Obstacles to Capital Raising

Why has it proved difficult for MDFs to mobilize private sector funds?

Where municipal repayment histories are poor, the underlying income stream is too weak to allow MDFs to raise capital on their own. They lack a stable, predictable income stream to collateralize their borrowing. A government guarantee is then needed to make MDF borrowing creditworthy. Governments willing to provide such guarantees on behalf of an MDF have found it more convenient to borrow from the multi-lateral development banks or through donor agency programs than to go directly to the capital market.

In cases where the municipal repayment record is stronger, another problem has arisen. MDFs as institutions generally are thinly capitalized and not designed structurally to attract outside financing. Financial intermediaries that are able to raise private-sector funds for municipal on-lending normally combine three characteristics:⁹

- They have significant equity (in the form of a government capital contribution, for example) which can be used to augment municipal loan repayments, if necessary, to ensure that the MDF's external debt servicing obligations are met.

- They have a Debt Service Reserve Fund, or its equivalent, whose size is dictated by the anticipated payments of future debt service. In the United States, a Debt Service Reserve Fund equal to two years' debt service obligations is common.

- There is a moral obligations pledge on the part of the state to replenish the Debt Service Reserve Fund from its own revenues, if the Fund is drawn down to meet debt servicing obligations. This

⁹ Standard & Poor's, "Criteria for Rating State Revolving Funds," Credit Week (January 1991).

pledge can take a variety of legal forms, but its purpose is to assure the market that the state will use its budget as a last layer of security in meeting MDF debt obligations.

Funds structured in this way enjoy excellent access to domestic and international credit markets. Credit Local de France and the Municipal Bank of the Netherlands, for example, enjoy AAA bond ratings and are among the most active issuers of bonds on worldwide capital markets. Most states in the United States sponsor bond banks or Environmental Revolving Loan Funds, or both, which operate on similar principles and are very active borrowers in the U.S. capital market.

None of the developing-country MDFs examined in this study has been designed with access to the private capital market in mind. They rarely have more than nominal reserve funds or more than ad hoc guarantees from government. Surprisingly, multi-lateral lenders seem not to have placed a high priority on having MDFs develop into self-sustaining financial institutions, and therefore have not urged the structural changes that would facilitate capital market access.

A final phenomenon has stood in the way of MDFs' raising capital for their on-lending activities. Domestic private capital markets in many developing countries are dominated by commercial banks. MDF bonds, if sold on the private market, would have to be sold largely to banks. However, once municipal debt repayments become a sufficiently predictable and low-risk income stream to collateralize MDF bond issues, commercial banks are likely to want to lend directly to municipalities. In Colombia, commercial banks declined to buy FINDETER bonds largely because they preferred to place the same funds directly with municipal borrowers, without the development bank's intermediation.

Raising funds for MDF on-lending is only one (indirect) way to mobilize capital for local investment. Commercial banks, pension funds and insurance companies can lend funds directly to local governments, or can lend to private firms that invest in basic urban facilities like water distribution systems or toll roads subject to municipal regulation. In fact, capital mobilization is likely to be easier and more efficient in a

competitive environment which uses each of these channels to raise capital for local investment rather than in one where a single MDF enjoys quasi-monopolistic control over sectoral funding.

III. INDIA'S EXPERIENCE WITH MUNICIPAL FINANCIAL INTERMEDIARIES

India's experience with MDFs and other types of municipal financial intermediaries fits broadly into the international pattern.

Creditworthiness

The municipal repayment record has improved over time, opening the possibility of accessing the competitive capital market. The third Calcutta Urban Development Project, launched in the early 1980s, was the first World Bank attempt to use a municipal development loan fund to finance local investment projects. The program had some marked successes. It stimulated a remarkable flowering of innovative sub-projects in poor urban areas of the Calcutta metropolitan region. Project choice was effectively delegated to the local level, a significant change in investment procedures at the time.

However, as a loan program the Calcutta Urban Development Fund embodied many of the characteristics that deter private sector participation in urban infrastructure financing. The World Bank estimates that less than 10 percent of municipal debt payments due actually were paid off in any other form than after-the-fact book adjustments. The Government of the State of West Bengal, managers of the Fund, treated it as a small grant program, and did not actively attempt to collect debt service from municipal borrowers.¹⁰

¹⁰ See Bishwapriya Sanyal and Meenu Tewari, Politics and Institutions in Urban Development: the Story of the Calcutta Metropolitan Development Authority, a case study prepared for the Economic Development Institute of the World Bank (March 1990); also conversations with project managers V.S. Joganatham, Brad Menezes, and Evan Rotner.

The Tamil Nadu Urban Development Fund (TNUDF) represents a second generation financial intermediary. Other states, such as Karnataka and Kerala, have also introduced funds to assist in local infrastructure finance. Under the TNUDF, loans to municipalities have been made at rates approximating market rates of interest. Repayment experience has been better. It is estimated that municipalities are current on about 90 percent of their debt servicing obligations.¹¹ The State of Tamil Nadu has proposed to build on this experience by reducing reliance on external funding of the TNUDF and injecting private capital and private management into the Fund.

A careful comparison of loan repayment rates under all of the recent MDF programs would help the Government of India and the states take stock of their options in further developing these institutions. In addition to the formal municipal development funds, HUDCO, the Municipal Corporation of Bombay, and other organizations have experience with municipal lending for infrastructure investment. An impressive array of payers has been prepared assessing these institutions' lending experience and future plans, as the domestic counterpart of the international experts' background papers. However, detailed information on loan repayment rates does not appear to be available. An assessment of the variations in repayment rates, and the structural explanations for these differences, both between municipal borrowers and between different types of lenders, would help in designing the next generation of municipal infrastructure intermediaries.

Development Banking Functions

The MDFs in India bundle together numerous functions. Both the Calcutta Urban Development Fund and the Tamil Nadu Urban Development Fund allocated grants as well as loans. Under the TNUDF, however, the grant portion of financing has declined to roughly 10 percent. The Funds also provide technical assistance in project preparation and technical design, and advise local authorities on service pricing and financial management. The funds in effect are instruments of the state governments responsible

¹¹ K. Allaudin and P. V. Pajaraman, "Urban Infrastructure Financing, India, Tamilnadu New Financial Intermediary: The Evolution," paper prepared for The Times Research Foundation (March 1996).

for implementing state investment policy in collaboration with local authorities. Consistent with this role, the TNUDF has been operated out of the Ministry of Municipal Affairs of the state.

Accessing Capital Markets

To date, capital has been raised mostly from government budgetary contributions and multi-lateral development bank loans. HUDCO has perhaps the most extensive experience in tapping the broader capital market. It has received directed allocations of savings from public financial institutions like the Insurance Company. Following financial sector reform and the reduction in directed credit policy, HUDCO has also begun to try to raise capital on the competitive private market through bond issues. Indeed, HUDCO probably has gone as far as any other developing country financial intermediary in mobilizing resources from the general capital market.

Financial sector liberalization suggests that Indian MDFs in the future will be more fully integrated into the capital market. They will be under pressure to raise funds competitively in the open market and on-lend at rates that reflect their true cost of capital. Other kinds of municipal lending are likely to develop side by side with MDF activity. The transition to a fuller market orientation undoubtedly will place strain on the MDFs and cause some restructuring of the next generation of financial intermediaries. In Section IV, we examine how institutions of this type in other parts of the world have coped with similar strains and made the transition to operating within a competitive market.

IV. THE TRANSITION TO A MARKET BASED SYSTEM OF MUNICIPAL CREDIT

Two types of models have been pursued in expanding municipal development funds into self-sustaining, market-based systems of municipal credit. In one model, the MDF gradually sheds its state-protected status, becoming an instrument for gathering capital competitively on the open market while continuing to on-lend to municipalities. This is the model that has been followed in most of Western Europe. Specialized municipal credit institutions have lost their historical monopolies, but have built on their close relations with local governments to continue to be the dominant suppliers of municipal credit, now within a competitive environment. Today, these intermediaries finance local credit needs by raising capital on worldwide markets.

In the second model, most of the growth in municipal credit supply occurs outside the MDF, through the entry of private sector institutions into the municipal credit market. The MDF may be designed to phase out as the private sector gains capacity to service municipal credit needs. Or the MDF may continue to play an important but limited role, by meeting the credit needs of certain types of local governments (e.g., smaller municipalities) and by serving as a benchmark for private-sector competition with respect to interest rates and municipal loan maturities.

This section illustrates the process of transition to competitive municipal credit supply through the experience of three institutions. Several lessons appear to stand out:

(1) The loss of monopoly status need not shrink the scale of MDF financing activity. In Western Europe, some municipal credit intermediaries have grown faster in a competitive environment than they did as monopolists. State budget reforms have reduced the volume of capital grants for local investment, driving up municipalities' overall demand for credit. MDFs that have compiled strong records of municipal loan repayment have had no difficulty in accessing worldwide capital markets for funds to on-lend to local governments. In 1994, for example, Credit Local de France raised 43.6 billion French francs through 55 international bond issues in 12 currencies, and 7.9 billion francs from domestic bonds and notes.

(2) No municipal development fund can be expected to voluntarily surrender its monopoly status or to surrender the preferential treatment it receives from government. Even those systems that have made the transition to open, competitive municipal credit markets have had to overcome the resistance of traditional intermediaries which sought to preserve their preferential role. The impetus for competition needs to come from a state policy decision that markets should play a greater role in capital allocation throughout the economy. Rules need to be defined that gradually wean parastatal MDFs from their dependence on government capital and their exclusive ability to blend state capital subsidies with loan funds.

Box 1
Municipal Bank of the Netherlands:
The Western European Approach to Municipal Credit Intermediation

Brief History

The Municipal Bank of the Netherlands (BNG) was founded in 1914 at the initiative of the Dutch Association of Municipalities, with the motive of improving individual municipalities' access to the credit market. However, only a few cities subscribed to the new institution. In 1922, the bank was extensively reorganized and the Dutch government became the major shareholder. The bank has grown to the point where it now has more than \$60 billion of assets, about 90% of which consist of loans to municipalities and other kinds of local government units, such as housing authorities. The bank presently is owned 50% by the national government and 50% by municipalities.

Creditworthiness

In recent decades, the bank has experienced negligible problems with loan repayments. In addition to the bank's appraisal of individual loans, municipal credits are secured by the Municipal Fund which disburses state grant assistance to municipalities and is administered by BNG. Special provisions allow Municipal Fund monies to be used to support municipalities in financial difficulty and to guarantee loan repayments. Municipalities drawing on the Fund in this way are subject to limitations on further borrowing and must follow designated steps in restoring fiscal health and prudent financial management. As a result of the excellent loan repayment record, municipal loans in the Netherlands carry no additional risk weighting for reserve purposes (i.e., they are classified as carrying the same risk as central government debt). BNG itself enjoys an AAA rating from all of the international rating agencies, allowing it to raise financing worldwide.

Development Bank Functions

The Dutch system relies on decentralized project preparation. BNG does not participate in local project development. It appraises loan applications primarily from a financial point of view, though part of its mission is to help implement national policy decisions (e.g., in providing credit to help municipalities spin off service functions to independent local authorities, or in financing the recapitalization of the municipally owned housing stock).

The bank does handle a wide array of financial transactions for local governments. It is responsible for 90% of financial transactions between central government and local government units, including the monthly payment of grants and shared taxes. The majority of municipalities maintain their accounts with BNG.

Box 1 (cont.)

Some of the other Western European municipal credit institutions play a more active role in local technical assistance. Credit Local de France, for example, seeks to establish a permanent financial consulting relationship with its municipal clients; this includes advising municipalities on budget preparation and capital planning.

Raising Loan Funds

For a long period BNG, like other municipal credit intermediaries in Western Europe, enjoyed regulated access to special saving deposits as well as substantial government capital contributions. However, in recent years it has moved into the competitive capital market to raise all of its funds. Through the 1980s and into the early 1990s, most of this capital was raised in the form of direct, privately tailored loans from large domestic financial institutions, principally pension funds and insurance companies. These instruments allowed BNG to match its long-term liabilities with long-term assets in the form of municipal loans, while also serving the financial institutions' needs for safe, long-term fixed income investment opportunities. In recent years, however, pension funds and insurance companies have invested increasingly in the equity market and real estate, reducing the volume of funds available for private lending. BNG has turned to international markets for most of its incremental funds. About two-thirds of new funds are now raised through international bond issues. BNG's AAA rating allows it to raise funds at a low cost of capital. Because BNG is exempt from income taxation and earns stable fees on the financial transactions it manages on behalf of government, it is able to on-lend funds to municipalities at modest margins over its cost of capital.

The other municipal financial intermediaries of Western Europe have gone through similar evolutions. The predecessor of Credit Local de France (CLF) historically enjoyed monopoly access to small-saver deposits collected through the postal savings system. These deposits paid low, below-market interest rates, which CLF passed on to municipal borrowers. The financial sector liberalization of the 1980s changed this relationship. Today, CLF raises more than 80% of its funds through international bond issues. Credit Communal Belgique, in contrast, retains its monopoly access to individual savings accounts and savings bonds, although this monopoly position is expected to be eliminated in the future.

Competitive Position and Overall Market Impact

Between 1965 and 1975, BNG enjoyed a formal monopoly in the Dutch municipal credit market. Government policy then removed the monopoly. BNG's cost of funds and historical relationships with municipal borrowers, however, makes it difficult for commercial banks to compete with it. The most substantial competition occurs in the form of direct lending by pension funds and insurance companies to larger municipalities, without passing through the intermediation of BNG, and in the form of other direct access by municipalities to the capital market.

Box 1 (cont.)

Competition has reduced the dominance of some of the traditional MDFs in municipal lending. Credit Local de France, for example, in 1995 accounted for 42% of local authority lending in the French market. CLF itself was privatized in 1993, and now enjoys no tax advantages over other banks. The formerly state-owned Banco de Credito of Spain likewise has been brought under the majority ownership and management of a private financial group. It now raises its capital on the competitive private market, and competes with other municipal lenders. During the transition period, Banco de Credito raised funds for municipal on-lending for a time through government-backed domestic bond issues. In all of these systems, the aggregate supply of funds to the municipal credit market has grown substantially. No creditworthy municipality has difficulty in obtaining credit at market rates.

(3) *The experience of these institutions suggests a gradual strategy for accessing the private capital market for municipal lending.* The first step beyond direct government provision of capital or international donor financing involves government assistance to MDFs in tapping the private savings market. This assistance may take the form of having government partially guarantee MDF bond issues, either on domestic or international markets. Alternatively, in systems which still have regulated savings and capital markets, certain sources of private savings may be steered into the municipal credit market. If this transition period is used to build up a record of reliable municipal debt repayment, graduation to the competitive capital market is relatively easy.

(4) *It is important to introduce the principles of collaboration between MDFs and private credit suppliers at an early stage of municipal credit market development.* Early on, there may be little interest on the part of commercial banks or other private-sector entities to enter the municipal credit market. One or more MDFs serving as specialized lenders to the sector may provide the best opportunity to establish a standard municipal loan system. Nonetheless, even at this early stage, MDFs can cooperate with commercial banks and other private financing institutions. Both FINDETER in Colombia (Box 2) and MUFIS in the Czech Republic (Box 3) use commercial banks to perform credit analyses, assume credit risk, and collect loan repayments. This experience has introduced banks to the municipal credit market and accelerated their independent entry into it.

Box 2
Territorial Financing Institution of Colombia (FINDETER)

Brief History

FINDETER originally was established as a municipal financing window within the National Mortgage Bank of Colombia. In 198-, it was spun off as an independent financial intermediary. From its inception, FINDETER has functioned as a second-tier, refinancing facility for municipal loans made by commercial banks, and as a development institution that supports capital investment in the sub-national sector. In practice, municipalities apply to FINDETER for loans to finance particular capital projects or a local capital investment program. FINDETER then works with the local government to develop the project's technical specifications, oversee the construction process, estimate the tariff structure necessary for project cost recovery, and prepare budget analyses of the impact on local finances of projects that must be paid in part or full from general revenues. Once a project has been defined in terms of technical specifications, costs, and financial feasibility, FINDETER approves the project and assists the municipality in locating a commercial bank that is willing to finance the project through a municipal loan. The commercial bank performs its own credit analysis and assumes all credit risk. FINDETER in turn agrees to refinance up to 85% of the loan through its refinancing facility. Commercial banks participating in the FINDETER program must make loans at a maximum margin of 2.5 percentage points over Colombia's standardized index of the competitive cost of capital.

Creditworthiness

Commercial bank loans under the FINDETER program have had good repayment history. As of the beginning of 1996, non-performing loans represented less than 2% of total loans outstanding. In addition to the banks' credit appraisals for individual loans, loans are secured by voluntary intercept agreements. The lending bank and borrowing municipality enter into a contractual agreement under which intergovernmental tax sharing payments are deposited in a special account, which the bank has the right to access if loan repayments are not made in a full and timely manner. Under the 1992 constitution, local governments' annual entitlements under national tax sharing are spelled out in detail and guaranteed.

Development Bank Functions

FINDETER is heavily involved in all aspects of local project development for the loans it refinances. Because FINDETER performs all of the development functions, commercial banks are free to appraise only the financial aspects of loans. Commercial banks view FINDETER's approval of the loan application and investment project as security that the project is technically and financially feasible and that construction will be completed. FINDETER's regional offices actively oversee construction progress until the project is completed and operational; it also monitors implementation of tariff commitments.

Box 2 (cont.)

At various times in the past, FINDETER has been responsible for administering a large share of government capital grants to municipalities as well as municipal credit. Grants and loans were blended by FINDETER to promote its views of the priority investment needs of sub-national governments. Most recently, however, the grant and loan functions have been unbundled. From FINDETER's perspective, this has made coordination of local investment programs more difficult and has produced some technically inefficient project designs. From the perspective of local and national government, the unbundling of capital subsidies has promoted decentralization of local capital planning and budgeting.

Raising Loan Funds

To date, FINDETER has raised loan funds primarily from government capital contributions and international donor funding. The government has forgiven FINDETER's obligation to repay the international loans used in its financing, creating a substantial capital contribution as past loans are repaid.

This capital contribution is used primarily to pay for FINDETER's development functions, though increasingly FINDETER is attempting to recover the costs by including them in approved loan amounts.

FINDETER has had modest success in tapping the private capital market. For a time, it sold special bonds to banks that participated in the FINDETER system. Because the bonds were allowed by the central bank to count against commercial banks' reserve requirements, there was substantial demand for them. The only attempt to sell bonds directly into the domestic market, however, succeeded in placing just over 20 percent of a small-sized issue. The issue was marketed primarily to banks, which now see FINDETER largely as a competitor. They would prefer to lend directly to municipalities.

Competitive Position and Overall Market Impact

Commercial banks' favorable experience with municipal lending has led them to vigorously develop the municipal credit market. The same intercept provisions developed by FINDETER are used by banks when lending on their own. When dealing with larger municipalities with well defined sources of income, both municipalities and banks often prefer to bypass the intermediary functions of FINDETER. From a municipality's perspective, it can obtain a loan faster and on similar terms from a bank. Although it foregoes the technical assistance and developmental aid

available from FINDETER, this often is judged less critical than the time needed for FINDETER as a public institution to carry out its investigations. An average period of eight months has been required for FINDETER loan review and approval.

The success of commercial bank lending, in turn, has led to development of a municipal bond market, which larger cities use to raise funds directly from the capital market.

Box 2 (cont.)

This process has produced a three-tier credit market which has proved very effective in meeting local credit needs. The largest cities tend to finance their credit requirements primarily from bond issues (Bogota at the end of 1995 issued its eighth series of bond issues). Intermediate-sized cities and departments raise funds primarily through commercial bank loans, without FINDETER participation.

Small cities and towns heavily utilize FINDETER. Together, this system has provided ample credit growth to the sub-national sector at market rates of interest. The whole system is underpinned by municipalities' ability to pledge future tax-sharing entitlements as loan security. However, the biggest cities now have moved to project financing in paying for road and water projects.

The overall growth of Colombia's local and departmental credit market is summarized below. FINDETER's shrinking market share is a concern to the institution, but from a broader perspective it is a measure of FINDETER's success in developing the overall credit market.

**Municipal and Departmental Debt
(Billions of Pesos)**

<u>Source of Credit</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>
FINDETER	115	142	280	278
Commercial Banks	193	231	459	924
Municipal Bonds	36	74	166	247

(5) *In designing municipal credit systems and the MDF structures that support them, it must be kept in mind that the objective is overall growth of municipal credit supply and overall improvement in local investment efficiency. It is tempting, especially in internationally financed projects, to gauge progress in terms of the specific institution that is being financed with donor or government funds. This is too narrow a focus. A parastatal MDF may expand its activities by squeezing out private sector*

competition, or by using stronger doses of government funds to subsidize its lending. An MDF that is stable in size or losing market share may be fully serving its purpose, as long as it is operating side by side with a private sector credit market that is becoming capable of meeting a larger proportion of local credit needs on its own. An MDF always should be judged by its impact on development of the aggregate municipal credit system.

Box 3

The Municipal Finance Company of the Czech Republic (MUFIS)

Brief History

MUFIS was established in 1994. Unlike the other MDFs described in this paper, its development did not precede development of the commercial municipal credit market, but occurred simultaneously with it. MUFIS was designed specifically to accelerate commercial bank lending to municipalities as a regular part of bank business. The company is owned 49% by the Ministry of Finance, 49% by the Czech and Moravian Guaranty and Development Bank (which in turn is jointly owned by the Czech government and private commercial banks), and 2% by the Union of Towns and Cities.

MUFIS borrows long-term funds in the external market, then lends the funds to participating commercial banks for on-lending to municipalities. Commercial banks accept all of the credit risk attached to municipal loans. Nine commercial banks have signed contracts to participate in MUFIS lending (including the four largest banks); four banks have actually made loans under the program.

Creditworthiness

Commercial lending to municipalities in the Czech Republic did not begin until 1991 following its elimination during the Communist era. Since then, more than 1,100 municipal loans have been made, with a non-performance rate of less than 0.5 percent. All loans under the MUFIS program are current.

In addition to individual loan appraisals, commercial banks typically collateralize their loans with municipally-owned property and/or contractual access to municipal deposit accounts. Specific income streams increasingly are being pledged as collateral, even though the Czech law regarding foreclosure on the income-generating activities of municipalities is not completely clear.

Box 3 (cont.)

Development Bank Functions

MUFIS performs no development banking functions, and does not perform its own credit or financial analysis. Municipalities develop projects on their own. Commercial banks conduct credit analyses and assume all repayment risk. MUFIS' function is to support this system with long-term funds. It lends funds at fixed-rate terms for periods of 8 to 15 years. MUFIS' limited functions enable it to act rapidly. The average elapsed time between the signing of a loan contract between municipality and bank and the first drawdown of funds has been 17 days. This period includes MUFIS legal review and approval of the loan, money transfer from MUFIS to the commercial bank, as well as bank payment to the municipality.

Raising Loan Funds

MUFIS to date has raised funds only through long-term, fixed-rate borrowing in the U.S. market, utilizing a Czech government guarantee as well as a U.S. agency guarantee. Foreign exchange risk is covered in part by a loan fee included in the on-lending rate and in part by Ministry of Finance agreement to reimburse MUFIS for larger-than-projected foreign exchange losses. (The Czech Koruna, however, has maintained a stable exchange rate with the dollar.)

Competitive Position and Overall Market Impact

MUFIS occupies a relatively small niche in the Czech Municipal credit market. In 1995, it financed just over 15% of net municipal lending. Its role has been to promote competition in municipal lending and to increase the average maturity of municipal loans through competition. The former state savings bank had dominated the municipal credit market. The MUFIS program in 1995 financed roughly 45% of total lending by all other banks, helping to consolidate their presence in the market. It financed well over half of all municipal loans of eight-year maturity or longer.

The overall development of the Czech municipal credit market can be seen from Tables 5 and 6. A two-tier market has emerged similar to that in Colombia. The largest cities have financed their credit needs primarily through bond issues, including a \$250 million bond issue by the City of Prague in the international market. Intermediate-sized and smaller cities meet their credit needs through commercial bank lending, either directly or with the support of MUFIS for longer-term loans. A third, important element in the municipal credit market is zero interest rate lending for environmentally sensitive municipal projects from the state Environmental Fund. Attempts are being made to use the commercial banks as the lending agents for the Environmental Fund, in order to overcome the potentially corrosive impact on the market of much higher non-performance rates on Environmental Fund loans.

The rapid increase in the average maturity of municipal loans can be seen from Table 6.

Table 5
The Structure of Municipal Outstanding Debt
(Millions of Kc.)

	1993		1994		1995	
	Kc(mill.)	%	Kc(mill.)	%	Kc(mill.)	%
Commercial bank credits	1,983.4	70.5	4,222.4	28.1	7,330.2	32.7
Bonds	28.5	1.0	7,897.8	52.6	8,557.8	38.2
Zero-interest, environmental loans	800.0	28.5	2,900.0	19.3	6,500.0	29.0
Total	2,811.9	100.0	15,020.2	100.0	22,388.0	100.0

Table 6
Volume and Term Structure of Municipal Commercial
Bank Credits Outstanding
(Millions of Kc.)

Type of Credit	December 31, 1993		December 31, 1994		December 31, 1995	
	Kc	%	Kc	%	Kc	%
Short term ^a	632.9	31.8	769.2	18.2	1,802.4	24.6
Medium term ^b	818.7	41.3	1,663.1	39.4	1,916.6	26.1
Long term ^c	532.7	26.9	1,790.1	42.4	3,611.2	49.3
Total	1,983.3	100.0	4,222.4	100.0	7,330.2	100.0

- a. Less than one year.
- b. 1 - 3 years.
- c. 4+ years.

V. POTENTIAL LESSONS FOR INDIA

International experience does not point to a single model as to how municipal development funds "ought" to be designed. It does, however, help identify critical choices that must be made in MDF design and the implications of these choices.

Is the MDF Intended to Support Decentralization or to Retain State Control of Local Investment while Reducing State Budget Costs?

Many MDFs maintain or even strengthen state control of local investment by establishing a powerful new technical and financing authority. The loan function serves to perpetuate the institution by creating a long-term reflow of loan payments, and reduces the cost of local investment to the state, by partially substituting loans for grants in local capital financing. An MDF which coordinates all local investment financing inevitably exerts great control over local investment choices.

This paper has not sought to take sides in the decentralization debate. However, if the Indian 74th Constitutional Amendment is taken at face value, a political choice in favor of decentralization has been made. The task then is to design an MDF which supports decentralization of investment responsibilities to local authorities, while recognizing the current lack of technical skills and financing capacity on the part of many local governments. Such an MDF would:

- Establish clear criteria for when a local government can "graduate" from MDF project review. A number of larger cities and metropolitan regions already have adequate capital planning and priority-setting procedures. Other cities are building that capacity. Once a satisfactory standard is reached, the MDF would relinquish responsibility for technical control of local projects. Local governments that graduate to this level would be responsible for their own investment choices and use the MDF only to obtain financing.

◦ Not rely on automatic state intercepts as the principal form of municipal loan security. Instead, local governments would be encouraged to set up special reserve accounts or voluntary intercept agreements as ways of demonstrating creditworthiness. The modestly higher financial risks to the MDF would be justified by the benefits of having local governments face directly the costs of their borrowing decisions. These voluntary risk-reducing mechanisms also can be transferred more easily to the private sector credit market.

◦ Take financial discipline seriously, by not lending new funds to municipalities that are in arrears on past debt payments and by not awarding political bail-outs to local borrowers. Not all local governments are in position to finance their capital investment through borrowing. Grants and state subsidies should continue to be targeted to localities that require them. Loans should not be made unless it is reasonable to expect local authorities to repay them; assessing local creditworthiness is the key task of credit analysis. Once a loan is made, however, repayment should be demanded. It only perpetuates dependence on higher authorities to continually hold out special arrangements for local governments that profess to be unable to meet their debt obligations.

Is the MDF Intended to Pave the Way for a Self-Sustaining Municipal Credit Market?

This paper has assumed that public authorities want to develop a self-sustaining municipal credit market. If so, it will be efficient to incorporate certain basic characteristics into the MDF design. All of these measures are intended to accelerate private sector entry into the municipal credit market. Ironically, the surest measure of MDF success will be that its presence in the market place is limited. It will not be the sole, or necessarily the principal, source of local capital financing. Rather, standardized financing for creditworthy borrowers will be turned over to the private sector, with the MDF serving specialized segments of the municipal sector not reached by private lenders.

Specific steps that can facilitate private-sector entry into the municipal credit market alongside an MDF include:

- Ensuring that features of MDF municipal lending that successfully reduce credit risk (like voluntary intercept mechanisms) are equally available to all lenders, not available only to the MDF.

- Unbundling government grants and other subsidies for local infrastructure investment from MDF loans. In this way, the credit market becomes open to market-based competition.

- Unbundling other MDF responsibilities to encourage market competition. One opportunity for unbundling involves municipal credit analysis. This is a pronounced weakness of most MDFs worldwide. India can build on the experience of private-sector credit rating firms in other sectors of the economy to both strengthen the technical quality of credit rating and reduce political pressures on lending decisions.

- Requiring that MDF loans be made at market rates of interest, or with a positive spread over the institution's market cost of capital, so as to permit entry by cost-efficient competitors. Subsidies should be delivered in the form of matching grants, not hidden as interest-rate subsidies tied to MDF loans.

- Tolerating, even encouraging, competition in municipal credit supply. For example, private commercial bank lending and municipal bond issuance should be encouraged. The market will sort out which forms of municipal borrowing are most cost efficient under different conditions. The government should not limit borrowing methods by regulation.

- Extending credit financing to private firms building local infrastructure projects under local government contracts on the same terms that credit is available to

municipalities. Credit access should not drive the choice between public and private investment in infrastructure.

◦ Requiring at an early stage that an MDF raise part of its capital in the private market. Initial efforts may not succeed, or succeed only in part. However, the attempt to raise market financing will help both the MDF and potential private sector competitors assess the strengths and weaknesses of municipal lending, and make clear the issues that need to be addressed in order to attract private capital. This kind of continuing "report card" on the state of the municipal credit market is essential in moving toward a self-sustaining municipal credit system. Without injections of private capital, attracted on market terms, an MDF is likely to remain a sheltered, parastatal financing institution that operates outside the rest of the financial sector.

ANNEX A

SAMPLE OF MUNICIPAL DEVELOPMENT FUNDS EXAMINED FOR STUDY

<u>Country</u>	<u>MDF</u>
Brazil--State of Rio Grande do Sul	PIMES
Brazil--State of Paraná	PRAM
Brazil--State of Santa Catarina	Municipal Fund
Colombia	FINDETER
Czech Republic	MUFIS
Czech Republic	State Environmental Fund
Ecuador	BEDE
Guatemala	INFOM
Honduras	BANMA
India--State of West Bengal	Calcutta MDP
India--State of Tamil Nadu	TNUDF
India-- Bombay	Municipal Corp. of Greater
Indonesia	RDA
Jordan	CVDB
Kenya	LGLA
Mexico	BANOBRAS
Morocco	FEC
Nigeria	Infrastructure Development Fund (proposed)
Poland	Environmental Bank
Poland Authority	Metropolitan Development
Romania	Municipal Credit Facility (proposed)
South Africa	MDF
Thailand	Municipal Guaranty Facility (proposed)
Turkey	Iller Bank
Zimbabwe	GDLF