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# Financing Investment in Towns in Developing Countries

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Summary of the results of the Working Group  
“Financing the investment of local authorities”  
at the Agence Française de Développement

Agence Française de Développement  
Research Department



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# Introduction

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This document is a summary of the work and thinking of the Working Group on financing the investment of local authorities, “*Groupe de travail sur le financement des investissements des collectivités locales*”, which took place in 2004 at the initiative of *Agence Française de Développement* (AFD). The Working Group included representatives from multilateral and bilateral donors (the World Bank, KfW and USAID), United Nations agencies, the French Ministry of Foreign Affairs, semi-public institutions, private banks or specialist finance organisations such as the *Caisse des Dépôts et Consignations*, Dexia, the *Caisses d'épargne* and *Crédit coopératif*. It also benefited from contributions from experts in urban management, local finance, project finance, financial engineering, as well as specialists in decentralisation and the financing of local government in industrialised and developing countries.

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The purpose of this Working Group was to examine the context in which public or private donors offered financial resources to local authorities in the emerging and developing countries as part of the investment policy in the latter. This publication is not therefore a research document and does not give an overall view of the eminently broader issue of the financing, or indebtedness, of local authorities in countries in the South. It is a summary of the thoughts of professionals from countries in the North, who specialise in local credit and investment finance.

These considerations were supported by a large number of case studies reflecting the diversity of the sector of activity and its rapidly changing nature, both on an institutional level and in terms of the financial instruments available. An in-depth description of the three reference models (Belgium, the United States and France), which largely inspired the systems for financing local authorities in the countries where the *Agence Française de Développement* operates, is given in Appendix 2.

The financing of local authorities through lending is one of the traditional activities of AFD in the French Overseas Territories. This experience covers all areas of local investment: infrastructure, public amenities, social housing. In developing countries, AFD has also long been active in urban development and in financing local authorities to support decentralisation processes. AFD is probably, along with the World Bank and USAID, one of the most active donors to local authorities. The numerous initiatives in the municipal urban sector since the beginning of the 1990s have contributed to the appearance of a specific form of engineering and have encouraged noteworthy innovations in terms of institutional support and financing (investment funds, organisations specialising in lending to districts, delegated contracting authority agencies, State-community contractual policy, etc.).

This type of initiative is now part of a context that is evolving significantly due to the growing importance of decentralisation policies and the increasing contribution of local government as players in economic and urban development. This evolution can be mainly seen in the greater recognition of the contracting authority status granted to municipal authorities and, most often, over a broader area of competence than before.

These transfers of competence and contracting authority are naturally bringing about changes in the financial arrangements for local investment projects (mobilisation of financial counterparties, stimulation of municipal credit, requirements in terms of urban management and maintenance, etc.). As a result of these major trends, donors are

modifying their methods of support by accompanying finance to or via the State (known as sovereign finance) with increased levels of direct intervention in local authorities (known as sub-sovereign finance).

It is in reference to these structural modifications that the Working Group set itself the objectives of: (i) conducting an inventory of existing systems in the countries where AFD acts and in other continents and (ii) putting into perspective the problem of financing the investments of local authorities in such a way as to define the focal points of an operational strategy in this sector for the coming years.

It is not the purpose of this document to transcribe the work of the group in an exhaustive manner but to provide a summary and to highlight the most notable results. For this reason, the preparatory documents produced before each work session and the presentations made during the meetings have not been reproduced in full.

AFD would hereby like to express its thanks to all the participants and its utmost recognition to everybody—some from far away—who has been so involved and devoted time, energy and budgets to this joint project. It goes without saying that any insufficiencies or errors in this summary are the responsibility of the team that ran the exercise and are in no way attributable to the members of the Group.



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See Appendix 4 for the list of acronyms used.



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# Summary of the main findings and lessons

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## 1. Working procedure

The Working Group was active over a period of one year and was organised around four theme-based meetings<sup>1</sup>:

- the first meeting was devoted to introducing the general theme: the financing of investment in towns in emerging and developing countries. After analysing the developments concerning the change in contexts, the meeting drew up a typology of the countries, based on existing funding mechanisms, as well as the typology of the financing systems based on ten case studies<sup>2</sup>;
- the second meeting was devoted to the theme of resources, that is, to the nature of the different types of finance, its origins, volumes, cost and characteristics. Specialised financial institutions (SFIs), recourse to the financial markets, the collection of local savings and, generally speaking, the corresponding financial engineering were examined, again based on case studies;
- the third meeting was on the subject of “usage”, in particular, the suitable balance between the nature of the intended investment and the available

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1. Held on 15 October 2003, 2 February, 5 April and 8 September 2004.

2. South Africa, Belgium, Colombia, the United States, France, Morocco, Mexico, the Philippines, Tunisia, Senegal.

financing conditions. The areas of competencies of the local authorities, the appointment of contracting authorities, the hierarchies to be established between investments depending on their impact on the future receipts of local authorities, the various methods for financing projects, public-private partnerships and the absorption capacity both of companies and implementation “operators” (executing agencies, delegated contracting authorities, project units, semi-public planning or construction companies) were reviewed;

- lastly, the fourth meeting was devoted to drawing up a summary of a debate on: (i) the conditions which determine whether the loan will cause the initiation of a virtuous circle for the municipal authorities or, conversely, a depressive spiral; (ii) an examination of possible changes to the various financial systems based on the institutional environment.

## 2. Context

### **Donors are currently rethinking the way in which they operate in the urban sector in developing countries as a result of two developments:**

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- the first is of a *demographic* nature: the process of urbanisation caused by migration from the rural world and the natural growth of urban populations is behind the explosion of the need for urban infrastructures and public services; these needs are exacerbated by the scale of the accumulated backlogs and by the increase in poverty in urban areas;
- the second is of an *institutional* nature: for over ten years, decentralisation policies have been accompanied by a transfer of responsibilities towards the municipal authorities, which are destined to gradually become major players in the fields of economic development, the provision of basic services and combating poverty when in fact they often have little experience and are ill-prepared for managing the town.

This new configuration is causing donors to change the way they act. This entails in particular a shift from financing thus far mainly allocated to the State (sovereign finance) over to finance allocated to districts either directly (sub-sovereign finance) or through specialised institutions. The challenge is also to provide municipal authorities with easier access to the financial market by bringing in specific mechanisms.

In the early 1990s and slightly later than in Latin America, the African continent and some countries in Southeast Asia developed district-oriented credit mechanisms that have now become the main vehicles for financing municipal investments. These mechanisms take on different forms in different countries and are often dictated by the level of economic development (LDCs and IICs<sup>3</sup>) and by the administrative tradition of these countries (French-speaking, English-speaking, decentralised or not). These mechanisms therefore ranged from fully subsidised investment funds through to local government banks operating under market-like conditions, as well as financing bodies that mix subsidy with credit, the latter often being offered under concessional terms. These mechanisms, promoted by donors and States to provide resources to local authorities, frequently had the additional role of supporting local authorities in their gradual transition towards autonomy and efficiency.

Ten to fifteen years later, the results are mixed. The existing financing mechanisms suffer from the poor state of local finance, competition from other forms of finance or even dysfunctions within the institutions themselves (high levels of committed costs, lack of transparency, inadequate financing profiles, etc.).

More recently, local authorities have made direct use of the bond market with institutional donors providing them with support in the form of guarantees or credit enhancement. In parallel, donors offer loans to specialised financial institutions (see

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3. See Appendix 4 for a list of the abbreviations used in the document.

Section 4) or to semi-public operators under such concessional conditions that it would be absurd to make direct use of the market or public-private partnerships. The sector for local investment financing and project financing is bubbling with excitement, but some observers point out the contradictions that can appear in the practices of donors, or even between different units within the same institution.

The Working Group took the view that one of the obstacles to further developing thinking into local authorities financing was due to (i) the number and diversity of parameters to be taken into account in each operation and (ii) the difficulty of reproducing the same scenario from one country to the next. This stems from the institutional characteristics of States and the contradictory approaches of governments, which over and above the discussions on decentralisation, sometimes are little inclined to give their local authorities, particularly big towns, any real autonomy. It also comes from the rigid nature of the organisational structure of donors, who still have little experience of the institutional complexity of the urban sector. It also results from the capability of the local authorities themselves to increase their resources, improve management and think about modernising.

### 3. Main findings and lessons

The main findings and lessons learnt at the end of the Working Group process are shown below.

**Lesson 1** - The financing of local authorities in developing countries is set against *an extensive and complex client typology*, the main parameters of which reflect a variety of economic situations as well as the political, legal and administrative traditions of governments. Other data play a decisive factor in the architecture of financing systems. For example, whether or not the urban districts are responsible for water and/or

electricity bears heavily on the volume of the market for local authority financing. In addition, with equal weighting of national populations, very different market characteristics emerge depending on the varying balance of the urban network, the size of the towns and the disparities between the biggest and smallest or the richest and poorest.

**Lesson 2.** The issue of local authority investment in developing countries seems to arise at present mainly in terms of *usage*. Although it may seem paradoxical in view of the large scale of their needs, numerous examples show that accessing resources is not the major difficulty. In many least developed countries, financing resources exceed absorption capacities due to the weakness of operators, the insufficiencies of the contracting authority and the fragility of the corporate fabric. In intermediate-income countries, the availability of concessionary finance is actually rarely insufficient for economically profitable and well-constructed projects. The abundant supply of concessional finance, therefore, often dissuades operators from making use of the financial market, on which they would only obtain shorter-term loans at higher interest rates.

**Lesson 3.** *Borrowing means anticipating income.* The old adage about the professional environment is still as relevant as ever. A loan is an integral part of a financing plan that compares the operational costs incurred with the offsetting income, whether direct or indirect. Local investment helps to increase those community assets that will produce services generating tariff or fiscal income. In turn, this income will help to cover future charges relating to the loan. In this sense, reference is often made to the “educational virtue of the loan”, the act of borrowing presupposing in effect that the administrator will be able to project itself in the future.

If these conditions are not fulfilled, the local authority is at risk in the same way that households with no money end up with excessive debts and personal bankruptcy as a result of their consumer credit.

**Lesson 4.** Certain projects in the municipal sector count on the educational value of borrowing and try to move local authorities into a *virtuous circle*. Support measures and incentives bring a gradual improvement in financial management capacity and hence income. An initial dosage of a loan finances investments that themselves generate income and so on. For authorities that lack expertise or responsibility, sudden access to borrowing runs the risk of pushing them in the opposite direction into a *downward spiral*. Operating expenses incurred by implementing the investments are insufficiently covered by new income, the loan costs create a burden on investment capacities, income stagnates and then falls and investment becomes impossible, etc.

**Lesson 5.** The continued development of lending to municipalities in developing countries is largely based on the concept of *local authority financing* rather than *project financing*. This concept presupposes moving away from one-off initiatives based on decisions to finance a specific project and moving towards financing mechanisms that meet medium and long-term financial needs, much on the lines of the activities conducted by specialised financial institutions in North Africa (CPSCL, FEC) and South Africa (DBSA, INCA). The risk assessment is different and places emphasis on borrower risk without, however, underestimating the project risk.

**Lesson 6.** Recourse to *specialised financial institutions* (SFIs) to address local authorities' financing needs is now the dominant model in intermediate-income countries and least developed countries in Africa, North Africa/Middle East and South America. These SFIs generally combine: (i) credit activities and (ii) missions to support local authorities in programming investment and, more broadly, institutional reinforcement. This route is still considered to be the best approach for addressing the needs of the local sector at these stages of development<sup>4</sup> (see virtuous circle concept mentioned above).

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4. CVDB in Jordan was one of the pioneers of this model, which is inspired by Latin American experience of investment funds.

These SFIs are now experiencing difficulties due to *insufficiencies of the local authorities market*. This insufficiency often stems more from the curbs on the decentralisation process than from lack of solvency amongst the local authorities. The result is a stagnation of the SFIs' activity. This observation might have given rise to the idea of a regional specialised institution in order to expand the market. Yet this type of institution would only superimpose itself on those that already exist without the benefit of the vital proximity to the client (knowledge of legal statuses, background, connection with supervisory government authority, guarantee system) and seems to have been ruled out in the present context. Finally, SFIs often find it somewhat difficult to sufficiently extricate themselves from the influence of their supervisory authorities in order to carry out their activities autonomously. This can handicap the way they are managed and their performance, slow down their modernisation and prevent them from diversifying their resources.

**Lesson 7.** The insufficient size of the local authorities market is often due to the fact that infrastructure and services remain largely under the control of central bodies (the national water office, the sanitation agency, the national electricity company, etc.), which are in most cases the leading public investors in towns. Schemes such as *town contracts*, *conurbation contracts* or, at another level, *public-private partnerships* provide, if not alternatives to the legislative and regulatory process of decentralisation, at the very least the opportunity to test the local authorities' ability to assume growing responsibilities. Such schemes can thus effectively support the decentralisation process and help to develop the local authority market.

**Lesson 8.** The conceivable developments for SFIs are the subject of debate. In the most advanced countries, where local authorities have a wide competency, the future of a specialised financial institution will depend on its capacity to access a sufficient market (local services concession holders, semi-public companies, etc.). The alternative for these SFIs lies in *opening up to more general activities* or, in other words, their gradual

integration into banks. A specialised establishment is justified during the period of formation of the local authorities market but once this market exists, it may then offer more extensive services. Many non-specialist banks succeed in Europe on the local authorities market, particularly since they dispose of less costly resources than the SFIs due to their deposit-taking business. In countries where local authorities account for a marginal portion of public investment, the SFIs' interest lies mainly in their capacity to support districts in such a way as to set in motion the virtuous circle process. The difficulty some SFIs experience in gaining access to sufficient autonomy from the State (an autonomy that is vital to sound management for a financial institution) may have made certain experts doubt the relevance of continuing to support this type of instrument. One alternative is to set up specific lines of credit at existing commercial banks. The support and advisory missions link in with the bank's management of these lines of credit. The missions are preferably outsourced to bodies entrusted with these tasks<sup>5</sup>.

**Lesson 9.** *Use of disintermediated bond markets for local authorities* is still a limited phenomenon. The prospects for its development are naturally slowed down by the requirements for setting up this kind of instrument (rating, number of contributors, agreement from supervisory authority, guarantees) and by their cost (to be assessed according to the profile of the financing—the rate and terms—but also the cost of disintermediation). This type of finance does, however, incite considerable interest, as banks and other financial establishments (particularly insurance companies) often have excess liquidity in developing countries. In this configuration, the activity of the international donors focuses on providing guarantee financing or credit enhancement. The city of Johannesburg is still today the only local authority in AFD's area of activity that has raised funds directly on the financial market<sup>6</sup>. The reference points are still the experiences of

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5. In some cases (e.g. INCA in South Africa), the credit institution continues to perform these missions without jeopardising its financial equilibrium.

6. Johannesburg, rated A-, made the first municipal issue since the end of apartheid in April 2004. This issue was made in two tranches of 1 billion rand each. In 2004, the city made a third issue of 700 million rand.

local authorities in intermediate-income countries such as India, the Philippines, Mexico, backed by the World Bank and USAID. Other South African cities have been evaluated by the rating agencies but have not as yet issued any bonds. The recent bond issue by the Cameroon city of Douala<sup>7</sup> needs to be put in its specific context: the bond is secured by a debt of the same amount held by the city against the Government (this debt is recorded in a cross-debt agreement). Many observers say that under the present state of play, the funds obtained directly on the market are still relatively expensive compared with the donor-provided finance and, most importantly, they are much shorter in duration and deferral terms and not therefore suitable for infrastructure projects.

**Lesson 10.** On completion of this overview, the position of the Working Group was that there was no justification for recommending one financing method to the exclusion of others, and that municipal bond issues and traditional bank finance could usefully cohabit under the right conditions.

As regards municipal bond issuance, one direction that could be given preference is to make use of pooled bond issues (launched by specialised or unspecialised credit institutions), which can address the needs of groupings of local authorities not limited to capital cities<sup>8</sup>. More generally, emphasis was placed on the correlation between the capacities of the local authorities and the availability of finance. The increase in market size brings about the diversification of financing mechanisms and the arrival of new funding sources. In this sense, the strengthening of local government—within the national economic and institutional contexts—is certainly essential to increasing the importance of sub-sovereign finance.

7. Bond issue of 7 billion FCFA at the end of 2004 on the national market with the following terms: 5 years, redemption on maturity at a rate of 8.25%. Annualised percentage rate including costs and commission is between 9.5% and 10.5% depending on the source.

8. Cf. activity of USAID's Development Credit Authority in South Africa with DBSI, INCA and INVESTEC Bank, or the Water and Sanitation Pooled Fund in India, and also the Local State Unit Guarantee Corporation in the Philippines.

**The following sections and appendices give a more detailed account of the material produced by the Working Group and which led to the formulation of these different findings or lessons.**

# Simplified typology of financing systems

*Can we think uniformly about the financing of local authorities in developing countries? Are the instruments in place the direct result of a given level of economic development, a specific political-administrative tradition or a varyingly voluntarist decentralisation process?*

During its first meeting, the Working Group listed the systems that exist on the African continent. A *simplified typology* was proposed, stressing the link between the existence of a structured system for financing local authority investments, the level of development of the beneficiary countries and the degree of interest in the decentralisation process. Three types of situation were identified (see Table 1).

- *Intermediate-income countries with specialised financial institutions*: South Africa (and some other SADC countries making use of DBSA and INCA services) and North Africa (mainly Tunisia and Morocco), with notable differences in approach in the three countries.

- *Sub-Saharan African countries that have set up investment funds* which, in some cases, have a credit component. The systems have mostly emerged to address the need for institutional support that can channel external aid towards urban communities regardless of their size. These initiatives illustrate the importance attached by certain countries to a controlled decentralisation process that gradually gives local communities an active role in managing towns. This is notably the case in Senegal, Cameroon, Mali and Burkina Faso. These experiences are still at an embryonic and generally fragile stage due to their close dependency on the policy of donors.
- *Lastly, countries that do not have any specific instrument to finance local community investment and where the donors provide funds in the form of "project finance"*, generally via the State (funds retroceded in the case of urban projects or municipal development projects or specific projects targeting a particular sub-sector).

Table 1 illustrates this typology and lists the existing systems, mentioning very briefly the type of resources mobilised and whether or not AFD is involved.

The Working Group emphasised that most of the financing systems within the investment fund or lending bank category remain closely dependent on the funds and technical support provided by external donors, including in North Africa. The systems have often created the institutional instrument for urban projects financed by the World Bank, AFD or to a lesser extent KfW.

They have made it possible to overcome the institutional, economic or even cultural obstacles encountered through the development of credit: unsuitability of the legal framework (authorisation to borrow, guarantees given) over-cautiousness of banks and ignorance of the way the local sector operates, reticence of heads of local government to make use of borrowing to finance the public investment sector, etc.

Table 1.  
Simplified typology of financing systems

Class of country	Characteristics	Country	Financing institutions	AFD finance	Resources of the financing system
1	Local authority sector generally solvent and active mechanism for municipal credit	South Africa	DBSA/INCA	Yes	Non-sovereign loans, guarantees and credit enhancement. Access to market. Own resources and other international donors
		Tunisia	CPSCL (1906, then 1992)	Yes	Retroceded sovereign loans (AFD, IBRD, EIB). Use of financial markets Own resources
		Morocco*	FEC (1959, then 1996)	No	Retroceded sovereign loans (IBRD, EIB, KfW). Use of financial markets (via State) Own resources
2	Local authorities with a low level of solvency and "investment fund" type institutions	Senegal	ADM (1997)	Yes but parallel action in favour of local authorities via the State (retroceded grant)	AFD grant via State (retrocession) IDA loan % FECL Own resources
		Côte d'Ivoire	FPCL (1992, no longer operational)	No AFD only makes grants to local authorities (retrocession)	IDA loan retroceded and linkage sought with FIAU and FRAR
		Cameroon	FEICOM (1994)	No Indirect AFD loans to local authorities (retrocession)	Levy against community resources (CAC) (mutual fund)

Table 1. (continued)  
Simplified typology of financing systems

Class of country	Characteristics	Country	Financing institutions	AFD finance	Resources of the financing system
2	Local authorities with a low level of solvency and "investment fund" type institutions	Cameroon	CFC (1992, no longer operates)	No Indirect AFD loans to communities (retrocession)	IBRD credit line with Crédit Foncier de Cameroun. Target: community commercial infrastructure
		Kenya	LGLA	No Indirect AFD loans to local authorities (retrocession)	State resources and donors and own resources
		Niger	CPCT (1960, closed in 2003)	No Indirect AFD loans to local authorities (retrocession)	Deducted from housing receipts and from electricity tax (mutual fund)
		Mali	ANICT (2000)	Yes	External grants including AFD (around 10 donors)
		Burkina Faso	FICOM/FODEC OM/SAGEDECOM (1992)	No Direct or indirect AFD grants to local authorities	Retroceded foreign grants (KfW for FICOM) and State resources
3	Underdeveloped municipal sector and no financial instrument	Others		Yes	Intervention in the form of direct subsidy or retroceded via State. Some loans.

The most integrated systems have drawn support from the *existence of a system for making provisions for existing investments* such as the FCCL in Tunisia or the FECL in Senegal. Setting up this type of system or injecting it with new momentum has

meant providing further resources (external contributions) and introducing a share of credit for the local government entities, generally in a highly concessionary form.

The risk, which has arisen on several occasions, is that the donors change their policy lines, which then puts the continuity of these mechanisms into question.

These initiatives mainly date from the early 1990s, at the time when it was first envisaged to transform urban projects into municipal development projects (MDPs).

### Box 1 Some points of reference

Without rewriting the history of urban projects and the development of the sector over the past thirty years, we should recall that this period has gone through several phases.

- **The 1970s:** this decade follows the decade of independence and was the period during which States were being constituted. In this context, urban projects focused on both housing the largest number of people and alleviating urban poverty (“sites and services” schemes and neighbourhood renovation projects)<sup>9</sup>. The message was simple and clear, and can be summarised in the following terms: (1) the government does not have the resources to build housing for each household and will need to devote its resources to land development for self-construction; (2) spontaneous urban settlements or under-equipped neighbourhoods are no longer to be demolished but improved and rehabilitated; (3) costs need to be recovered to ensure the replicability of such activities.
- **The 1980s:** this was the decade of structural adjustment and institutional, economic and financial reform, during which the poverty agenda did not really fit in. Urban projects diversified their activities (financing of housing, municipal development and urban amenities, etc.). The focal points of strategy were less clear than previously, while, at the same time, urban populations were becoming a majority in a growing number of countries.

9. Cf. preparation of urban development projects – Lucien Godin, July 1987, World Bank.

- **The 1990s:** the general backdrop for this decade was one of economic crisis. The FCFA was devalued. Africa opened up to the multiparty system and decentralisation. Sub-national authorities emerged as players in the field of urban development, but their new roles rarely went hand in hand with the necessary resources—which could have been interpreted as a sign of the withdrawal of State responsibility. Urban projects diversified even further under the effect of lobbies (defence of the environment, gender, community participation, etc.), which meant that the objectives and expected outcomes were somewhat difficult to understand. When AGETIP agencies began to play a role in the early 1990s, this only added to the confusion, as they were focused on employment programmes rather than urban amenities. The role of these agencies in the institutional emergence of local authorities, however, was to be of vital importance even though it has become perverted over time.

The Working Group also stressed that the financing mechanisms identified all come under the category of “*specialised financial institution*” in contrast to commonplace or generalist systems (commercial banks) or systems with no intermediation (direct use by local authorities of the financial market). The only municipalities to have tried the latter are the city of Johannesburg and recently, under completely individual terms, by the city of Douala.

Although these SFIs tend towards a “common model”, they do vary considerably in their status, the resources that they bring in and the conditions under which they carry out their activities amongst their client base. These parameters are largely guided by: (i) a more or less favourable economic and monetary context in terms of resources and usage and (ii) a more or less strong wish by the State to control the financing systems in place (status and procedures).

The mixing of lending/subsidies and subsidised loans is a major condition for developing municipal credit in the region (including North Africa and South Africa) and

underlines the essential role of the State in this development. The mix can even be managed by a single entity (for example, CPSCL in Tunisia and ADM in Senegal). Subsidised lending does, in fact, offer more leverage than mixing because it makes it possible to distribute more loans under more favourable terms.

The various initiatives highlighted the fact that the “quality” of the client base (solvency and ability to programme and carry out the investment) was the main condition (curb or stimulant) for developing mechanisms to finance local investment, defined as being different from pure subsidy.



# Borrowing capacity and decentralisation

# 2

*Which factors are delaying the emergence of organised systems to finance local investments in developing countries? Why have investment funds, which are very widespread in Latin America, not been more successful in Africa? What new challenges do the SFIs face in North Africa and South Africa?*

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The Working Group mainly discussed the constraints connected with the *weakness of the local authorities market*. Despite the general shift towards decentralisation that began almost 15 years ago, this weakness persists and can be observed in Sub-Saharan Africa, as well as examples in Tunisia, Morocco and South Africa.

Three types of constraints were identified: (1) constraints linked to the often still too narrow framework of competency assigned to local authorities; (2) constraints connected with the authorities' absorption capacity; (3) constraints for donors in implementing ODA.

### 1. An often narrow framework of competence

From an institutional point of view, the Working Group found that the competencies transferred to local government were still limited in relation to the funding prospects for development priorities in towns. The decentralisation movement, which started in the early 1990s in most of the countries examined, has still not settled the issue of the actual sharing of competencies between the State, the local authorities and, where applicable, the other echelons of decentralisation.

Education and health are often the first competencies to be transferred within the framework of decentralisation laws. The shortcomings that exist involve more the *competencies relating to highway and land management, as well as the distribution of drinking water and electricity supply*. The insufficiencies in defining community assets, such as the road infrastructure or the property status of peri-urban areas, force the municipal authorities into a state of powerlessness. As a result, in a good number of countries, local authorities are still restricted by the laws on household waste collection and public works maintenance (tasks which, it is true to say, they already often have trouble in performing).

This situation may result from curbing the decentralisation process or, more simply, from the practical difficulty in determining the limits of the prerogatives of the central authority and local echelons. In Sub-Saharan Africa, two factors come into play. Firstly, the competent ministries are concerned about safeguarding their prerogatives in terms of investment, as well as their special relations with the donors. Secondly, it is difficult to change some forms of legislation, such as land legislation.

This means that we are often confronted not only with a weakness in the investment competencies assigned to local authorities, but also, with the resulting limited prospects for local authority financing. This situation is particularly regrettable in intermediate-income

countries where urban districts have an absorption capacity, both in financial and technical terms, that should enable them to take on more services<sup>10</sup>.

On this subject, the Working Group also identified the difference that exists between those countries that have made local authorities responsible for water and electricity and those that have not. These services are managed by a community-based body above all in English-speaking countries. They contribute to creating a significant increase in municipal budgets and direct investment needs.

## **2. The community authority's insufficient capacity to absorb**

Beyond the limits posed by law, the main obstacle to increasing usage is still the low absorption capacity of local authorities, particularly in order to implement projects.

Urban growth and the reforms undertaken in the sphere of institutional decentralisation have led most of these countries to strengthen the municipal finances and to develop the capacity to carry out and finance local investments at community authority level. This has sometimes resulted in a significant increase in local budgets.

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However, in most of the countries in the regions where AFD operates, *local finance accounts for less than 5% of the State's tax receipts*. The solvency of local authorities is made more fragile by an often-random system of resources (insufficient mobilisation of taxation potential, dysfunction in the system for making available the funds recovered by the State, etc.) and by managing expenditure in a sometimes debatable way (high operating costs). The financial situation of the local authorities often reflects that of the State; and is even more pronounced, as the former do not have the same facilities as the State for subsidising their needs, in particular through borrowing.

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10. Cf. the strategic study on the future of CPSC (Tunisia), Groupe Huit-IDC-Sides, 2002.

### Box 2.

#### Extrapolation of the municipalities' capacity to finance themselves

By extrapolation, the local (urban-based) sector in the main countries in the *Agence Française de Développement's* priority solidarity zone (PSZ: Morocco, Tunisia, South Africa and 11 Sub-Saharan African countries) would have a total volume of resources of €8.5 billion, of which:

- 7 billion euros for South Africa (82%)
- 1 billion euros for Morocco and Tunisia (12%), and
- 400 million euros for the main Sub-Saharan countries in AFD's PSZ (6%).

The global volume of self-financing capacity is roughly estimated at between 10% and 20% of these resources, making a figure of **1.6 billion euros**, of which:

- 1.4 billion euros for South African municipalities (85%)
- 120 million euros for Moroccan municipalities (8%)
- 30 million euros for Tunisian municipalities (2%), and
- 50 million euros for the main Sub-Saharan countries in AFD's PSZ (5%).

Assuming that the municipalities could devote, at most, 50% of this self-financing capacity (operating surplus) to repaying debt (annuity)<sup>11</sup>, the global volume of municipal credit that can be undertaken annually in the region is thus estimated at 4.5 billion euros<sup>12</sup>, including 3% in Sub-Saharan Africa (approximately FCFA 100 billion), 82% in South Africa and the remaining 15% in Morocco and Tunisia.

The Working Group also emphasised the *deteriorating position of local finances in countries such as Tunisia* (over half of the municipalities are over-indebted after ten years of voluntarist activity by the CPSCL) or *South Africa*, where DBSA and INCA concentrate their activities on large cities and neglect other urban communities due to the risks they represent.

11. The percentage for Moroccan and Tunisian municipalities is higher due to the concentration of the financing mechanism around FEC and CPSCL.

12. Average terms applied to the loans were 5% over 10 years for Sub-Saharan Africa, 15% over 10 years in South Africa, 8% over 10 years for Morocco and Tunisia.

The local sector's capacity to borrow from donors (directly or via the State) is still therefore very limited and can only be apprehended in the form of highly concessional mechanisms.

In addition, the areas in which the municipalities operate rarely produce a return on investment. In French-speaking Africa, the major trading services such as water and electricity supply are most often the responsibility of national concessio-holders. During the 1990s, some incidences of credit to municipalities were underpinned by the prospects offered through financing commercial infrastructure (for example, CFC in Cameroon and CCC in Senegal). However, these met with no real success due firstly to the minimal timeframe for a return on investment, and secondly to the random nature of this return.

Lastly, the Working Group emphasised the importance that needs to be attached to *local authorities' ability to schedule and carry out the investments*. Very large-scale efforts are still required in this area, but are hampered by the low appeal of jobs in local government.

The fact that the State itself has difficulty in devolving its urban planning and infrastructure services only goes to accentuate the weakness of local resources for undertaking and carrying out projects. This relatively widespread situation has led numerous countries to increase the number of executing agencies. These agencies are either financed by the State or by donors. Depending on their method of operation, they may either further destructure the institutional landscape or gradually create new synergies with the local authorities. In particular, it can be supposed that without the AGETIPs, the projects would basically have continued to be carried out by a central contracting authority.

## 2. Borrowing capacity and decentralisation

Table 2.  
Borrowing capacity of municipalities (estimates)

Country (2000)	Urban population in millions	Total receipts in billions of FCFA	Operating surplus	Cost of maximum debt (in % of receipts)	Cost of debt in billions of FCFA	Operating surplus (in %)	Volume of annual loans
<b>Sub-Saharan Africa</b>							
Benin	6.2	8.555	0.856	5	0.428	50	3.368
Burkina Faso	2.2	7.782	0.778	5	0.389	50	3.064
Cameroon	8.0	33.689	3.387	5	1.693	50	13.334
Democratic Republic of Congo	16.4	69.556	6.956	5	3.478	50	27.384
Côte d'Ivoire	9.2	62.534	6.253	5	3.127	50	24.619
Gabon	1.1	7.275	0.728	5	0.364	50	2.864
Mali	4.2	6.525	0.653	5	0.326	50	2.569
Niger	1.6	7.827	0.783	5	0.391	50	3.082
Senegal	4.4	24.033	2.403		1.202	50	9.462
Chad	1.6	7.754	0.775	5	0.388	50	3.053
Togo	1.4	3.778	0.378	5	0.189	50	1.487
TOTAL (billions of FCFA)	56.3	23.9488	23.949		11.974		94.287
In millions of euros		365.097	36.510		18.255		143.739
<b>South Africa (in millions of euros)</b>							
		7,129	712	10	712	100	3,700
<b>Morocco (in millions of euros)</b>							
		800	120	10	80	67	570
<b>Tunisia (in millions of euros)</b>							
		200	300	10	20	67	100
<b>36</b>	<b>TOTAL (in euros)</b>		<b>8,494</b>	<b>899</b>	<b>831</b>		<b>4,513</b>

**Notes:** In Sub-Saharan Africa, investment resources in 11 countries in the priority solidarity zone (Senegal, Benin, Togo, Burkina Faso, Niger, Mali, Chad, Cameroon, Gabon, Democratic Republic of Congo, Côte d'Ivoire) can be estimated at between FCFA 20 and 25 billion per annum, equal to approximately €35 million (based on total receipts of €350 million).

- South Africa: the annual volume of investments of the South African municipal authorities is estimated at between 15 and 20 billion rand per annum, that is €2.5 billion, of which 50% in the three metropolises of Johannesburg, Durban and Cape Town. This investment expenditure should be related to the global volume of their receipts, which amount to 58 billion rand or €7 billion giving an investment ratio of 35%. If we take the view that, on average, these investments are 20% financed from own resources, the amount of these resources is equal to €500 million per annum, of which probably at least €300-350 million in the three main conurbations.

- Morocco: the municipalities and urban communities in Morocco have total receipts of 700 to 800 million euros per annum. By using the ratio of 10% to 15% of self-financing, we estimate their own resources earmarked for investment to be 120 million euros.

- Tunisia: Tunisian municipalities have total receipts of 200 million euros per annum and have an average self-financing capacity of 10% to 15%, which is equal to 20-30 million euros.

## Box 3

**Absorption and decentralisation capacity**

In particular, examination of the performances of the countries in the region, based on the two parameters "scope of competencies" and "absorption capacity", shows several types of situations, as follows:

		<i>Absorption capacity</i>		
		<b>Weak</b>	<b>Average</b>	<b>Strong</b>
<i>Decentralisation</i>	<b>Weak</b>	<b>Chad</b>	<b>Cameroon</b>	<b>Tunisia</b>
	<b>Average</b>	<b>Burkina Faso</b>	<b>Côte d'Ivoire</b>	<b>Morocco</b>
	<b>Strong</b>	<b>Mali</b>	<b>Senegal</b>	<b>South Africa</b>

This approach shows that the decentralisation and absorption capacity of municipalities do not necessarily go hand in hand, and makes it possible to localise both the blockage points and the potential for introducing financing mechanisms for local investments. For example:

- ten years after the relaunch of the credit mechanism for districts (CPSCL), Tunisia is still suffering from a low level of decentralised competencies;
- among those countries in Sub-Saharan Africa whose municipalities have an acceptable level of absorption, we see that, in Cameroon and the Côte d'Ivoire (before the crisis), donors have not really tried to develop local authority credit or have done so in a very reserved manner.

**3. Changes in the way donors contribute**

The main advantage of an organised mechanism for financing local investments is that it allows external aid to be more easily channelled in the direction of local authorities. The importance recently given to budget aid, as opposed to project aid, is likely to strengthen these types of systems: specialised investment funds and financial institutions offer the advantage of creating reliable channels to finance local public players and to

give importance to assessing the investments financed. These instruments therefore represent potential supports for new forms of financing for towns in developing countries.

However, the Working Group stressed that the direction taken in urban and municipal projects over the last ten to fifteen years may have reduced the impact of the investments financed, priority being given to small initiatives within the scope of local authorities.

These projects have effectively resulted in the financing of modest initiatives in towns. These new projects entailed:

- acting in a larger number of municipalities with budgets that were not necessarily bigger than before,
- adjusting operations to the financial capacities of the towns (particularly since it was necessary to mobilise a district counterpart),
- contributing to locally-based initiatives, taking the view that these were better able to improve the living conditions of the population,
- giving priority to labour-intensive work, etc.

The result of this approach is that the financing of more structural and more costly initiatives has stopped, particularly in the area of infrastructure, such as roads, water, sanitation. Certain types of investment projects have been abandoned by the development banks and donors due to the complexity involved in putting them together. This is the case for:

- planning initiatives, as the production of serviced land or even housing requires an institutional environment (operators, procedures) which is rarely present (an example or counter-example is the *Agence de Cession Immobilière* in Mali);
- the environmental field, due to the requirements of environmental standards which cover social issues (resettlement);

- certain specific amenities, such as commercial infrastructure, for reasons relating to the difficulty of involving the beneficiaries.

In addition, the favoured methods of intervention have often led to a loss of expertise in urban programming and feasibility studies. Community investment funds have often given preference to *long lists* of investments rapidly selected by municipalities and executing agencies, with no prior urban survey being conducted.

One of the policies discussed by the Working Group was the *development of the State-district contractual procedure* that has already been initiated in several countries. The main advantage, this procedure is to favour the support of joint initiatives by several players over the territory of towns [see experience in Côte d'Ivoire (European Union funding) or in Senegal (funding by the World Bank and AFD via the PAC)]. This represents a major step forward in terms of actual decentralisation (transformation of the State/local government relationship) and prefigures a new approach on how to conduct urban development initiatives: (i) accountability of municipalities in the choice of their investments, (ii) coordination effort with the State, (iii) management of crossed finance and (iv) linkages between investment initiatives and the strengthening of institutional capacities.

#### Box 4

##### **Support for rationalising usage: the example of Fort de France**

Major urban projects have been carried out in Fort de France in three main areas: the attractiveness of the town centre, working-class districts and prevention of seismic risk. The financial position in Fort de France has now deteriorated: the margins for manoeuvre in terms of resources are low (receipts granted), whereas running costs are at the same time high; savings capacity is structurally weak and there is little flexibility with investment expenditure. The recovery strategy adopted therefore consists in optimising usage:

- accounting controls on expenditure (on personnel, debt restructuring, ancillary budget for cultural service) in such a way as to return to an ability to choose between the forms of usage;
- creation of a conurbation community in 2001 (CACEM) which has additional resources with three positive effects (rationalisation of the link between competences and containment of costs; rationalisation of the link between the fiscal contribution and service provided; improvement of investment capacity);
- strengthening of programming and piloting capacities (Grand Projet Ville, financial recovery plan); strengthening of financial programming tools; and some limits such as sub-management;
- outsourcing of services (use of communal semi-public companies, with its limits, but which provides useful experience; concessions; restructuring of building work; looking into public-private partnerships, notably for schools).

# The various systems of finance

## 3

*Which method is best suited to financing towns through borrowing in developing countries? What financial resources will the financing body have? What legal form will it take? What will be its general activity objectives (risks, method of lending)? What will be its functional relations with other partners in the project and particularly the supervisory ministries? Will the financial balance of the financing body be assured?*

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These questions were debated by the Working Group on the basis of a matrix of the different types of financing bodies active in the sector, *ranging from the most heavily-administered to the most liberal*. Some examples of the main “reference models” were given (see Appendix 2):

- France (CAECL, then CLF, then Dexia): SFI
- Belgium (former CCB): mutual SFI
- The United States: system for municipal bond issues on a large scale.

Table 3 summarises the main options in countries where local authorities make use of borrowing. Each column corresponds to a characteristic aspect of the systems in use and lists the options from top to bottom in order of increasing “generality”. As a general rule the system in use in a given country at a given time is defined by just one box in each column. However, the options change over time, generally in the direction of increasing generality, so there is no static reference model.

Table 3.  
Analysis of financial systems

1	2	3	4	5	6	7
Resources	Suppliers	Risk	Rate	Products	Main shareholders	SFI privileges
State budget loans	Monopolistic specialised institution	Local State-guaranteed loans	Subsidised rates	Special loans exclusively to local authorities	State	Compulsory intermediary for State subsidies
Resources allocated (e.g. tax-exempt savings)	Specialised institutions in competition with the commercial banks	Service of the debt is a compulsory expense	Market rate with a reduced margin	Normal market loans	Local government (“crédit mutuel”)	Monopoly on local authority deposits
Financial markets	Commercial banks	Local authorities may have suspended payments	Tax benefits to lenders	All financial products incl. direct products and derivative products	Private investors	Bond issues guaranteed by the government
All banking resources (markets and deposits)	Financial markets without intermediaries		Ordinary market rates			No privilege

Source: MDP preparation manual, World Bank – Groupe Huit/F. Péchon, 1996.

## 1. Type of resources

The first column of Table 3 corresponds to *the resources used to finance the loans granted to local authorities*. The possible options extend from the specialised budget line within the State budget to the employment of all banking sources via the allocation of a savings section, as was the case in France until 1986, and also the usage of limited bond issues on the domestic market, which are guaranteed by the State (as is the case for the Moroccan FEC).

One of the main characteristics of the local authority banker is to be able to offer a long-term resource of over 15 years, whereas the resources offered by the market are generally loans of 5 or 7 years.

The quest for the least costly and longest-term resources has therefore often led the credit mechanisms for districts to seek access to *household tax-free savings* (such as the *Livret A* and *Caisse d'Epargne* in France).

In most countries, this form of savings is allocated to other sectors considered to be a priority such as housing. It is mainly accessible to specialised bodies.

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In countries where this form of savings is not accessible, it is replaced by State budget lines created with or without the contribution of donors.

## 2. Types of suppliers and privileges

The system of financing local public investment is rarely fully generalised (i.e. the competition between local authorities and other economic agencies in accessing credit is totally free).

Fiscal benefits, State guarantees, legal protection and various forms of privileges are often granted to lenders, thereby distorting competition to a greater or lesser degree. One of the main options concerns whether or not a specialised financial institution exists to finance local authorities and, subsidiarily, what its competitive position is in relation to other lenders.

*The SFI is virtually indispensable when the lending system is highly state-controlled and specific to local government.* This option is therefore generally chosen in the early stages, when borrowing to finance local investment is still rare but is expanding under the impulse of the State as part of an incipient process of decentralisation. This is notably the choice made by Tunisia and Morocco and also South Africa.

Commercial banks are, generally speaking, very cautious about such a market and, consequently, the specialised financial institution most often has a *de facto* if not an automatic monopoly. In addition, this system is frequently accompanied by recourse to preferential resources that make it possible to lend at non-market conditions and therefore discourage competition.

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Although there are benefits to be gained when there is a specialised financial institution for local authorities, doubts may be raised about the appropriateness of such specialisation in a context where all the authorities likely to invest have a sufficient size and level of prosperity to support competition with the other economic agents for access to credit. In this environment, the SFI would find it difficult to be competitive. The same is true in systems where the State would systematically enhance the signature of local authorities, for example by guaranteeing all or part of their borrowing.

*The American system* is very specific and difficult to transpose. It is largely based on a critical market size that is not to be found elsewhere. American local government

directly raises funds on the public markets without banking intermediaries. The system operates successfully because (i) there is a sufficient number of potential investors on the domestic market and (ii) the local authorities' bond issues on this market enjoy an enhanced competitiveness due to the tax-exempt status of most of the revenues the lenders draw from their investments. In addition, the size of the market enables several ratings agencies to intervene and provide a certain degree of transparency regarding the assessment of the issuers' quality. Lastly, generalising the system has generated development of a commercial activity of counter-guaranteeing issues, which raises the quality and therefore reduces the cost thereof to the issuer by a certain degree of risk-sharing.

The analysis matrix also mentions the case where *the institution holds the local authorities' accounts and operates as a mutual body* (local authorities are shareholders in the financing body). Generally, the institution is statutorily required to keep the accounts of the local authorities, receive into these accounts the proceeds of the State subsidies and is authorised to directly deduct from these accounts the sums that are due to it. This was the case with the former *Crédit Communal de Belgique* (now Dexia) and was the plan sketched out in Niger at the beginning of the 1960s (CPCT), then in a more consolidated manner, in Cameroon in the form of the FEICOM in the middle of the 1970s<sup>13</sup>.

Additional aspects of the "reference model" are shown in Appendix 2.

The discussions confirmed a long observed trend, that of *the underlying movement towards generalisation*. This finding currently applies to bodies of the same type as

13. This organisation still exists and its functions have been extended to that of recovery agent and of equalising local taxation ("additional community centimes" and local taxes). It is however in a poor state of financial health and the continuation of its activities on the same basis as those established at the outset is now compromised.

CPSCL in Tunisia, FEC in Morocco and DBSA or INCA in South Africa. These bodies are confronted, each in their own way, with the narrowness of their traditional market of action, because either:

- the solvency of the district clientele is compromised by the insufficient nature of the reforms, or;
- the local authorities' areas of competence are still too narrow, which would require diversifying the activities of the financing body, or;
- the local authorities themselves prefer to make use of other forms of finance considered to be more advantageous, such as direct bond issues.

### **3. Making use of corrective mechanisms**

It seems appropriate to list the precise features provided during the work of the Working Group of various mechanisms that enable local government to access resources more easily:

- credit enhancement,
- guarantee funds,
- lending at subsidised rates,
- acceptance of foreign-exchange risk.

#### ***Credit enhancement***

In a context where districts lack of solvency, local authorities need to have recourse to a set of financial techniques that allow them to gain investor confidence. One of these techniques is credit enhancement. The dual objective of this financial technique is to reduce the cost of the resource and to allow local authorities to cross the threshold of direct access to the market.

**Box 5.**  
**Credit enhancement**

When a local authority is given a rating, sometimes the rating is not sufficiently positive to support a bond issue and attract subscribers. The local authority can then make use of the services of a credit enhancement company rated AAA/Aaa as a structure without debt and with a high level of capitalisation to raise the bond issue. It therefore guarantees the repayment flows of the bond.

These companies—MBIA, FGIC, FSA on the Paris market—only take risks on investment-grade rated organisations with ratings of BBB+/Baa1 and AA/Aa.

Usually the premium is calculated each year as a percentage of the outstanding capital due. It is deducted, which creates a slight actuarial additional cost, and paid flat on the issue. Annual premiums are discounted on the basis of:

- discounting to the rate of the issue (if this is fixed),
- discounting to the rate for a swap secured against the profile of the issue (if the rate is indexed).

### ***The guarantee fund***

An example is given in the presentation of the experience of the Philippines in Section 5. A pool of banks sets up a guarantee fund for municipal bond issues providing remuneration and specific procedures such as the possibility of carrying out a seizure on financial transfers from the State to the issuing district.

The donors also offer guarantee systems that are generally oriented towards the private sector (example of SFI or ARIZ to AFD).

We can, however, cite the Development Credit Authority of USAID, one of its activities being to guarantee the bond issues of municipal authorities (up to an amount

of 50%) and to provide technical assistance. Activities recently undertaken by these funds include:

- (South Africa) the contribution of 20 million rand to INCA-Investec Bank in a debt repurchase programme from certain municipal authorities in difficulty; the debt is restructured by INCA and resold to private investors on the financial market;
- (South Africa) the guarantee of a loan issued by greater Johannesburg contracted over 10 years from a local bank (INCA or DBSA) for the purpose of financing infrastructure;
- (India) the guarantee provided to the Water and Sanitation Pooled Fund set up to collect resources on the market (bond issues) and to redistribute the proceeds thereof in the form of loans to 14 municipal authorities involved in the project;
- (Morocco) the reinsurance mechanism positioned with a guarantee fund created by several Moroccan commercial banks, Dâr ad-Damâne (DAD), which supports small public-private partnerships formed around local public services;
- (Philippines) the contribution to the finance of Local Government Unit Guarantee Corporation set up by local banks to guarantee municipal bond issues under certain conditions.

A recent survey conducted by UNCHS, The Global Shelter Facility, recommends developing guarantee mechanisms of this type to facilitate the financing of municipal infrastructure and social housing initiatives by the financial market.

#### ***Subsidised lending or mixing of finance***

One of the reasons several specialised financial institutions have met with failure, particularly in Sub-Saharan Africa, has been the concerted refusal of the donor and the government to hand over the external finance mobilised by the State under the same (subsidised) conditions as those made to the State by the donor. The justification was “the concern not to create competition on the domestic banking sector”, which could

be potentially mobilised on the local authorities market. This approach has led some SFIs to offer rates of around 12%-15% over a term of 5-7 years. These conditions, even though they represented an initial opportunity for the local authorities in that they could not have borrowed from a commercial bank even under these conditions, offered only little future to the system put in place (example of CCC in Senegal, FFCL in the Côte d'Ivoire).

As a consequence, activities then moved towards a demand for hand-over under more advantageous terms, whilst at the same time remaining above those of the initial loan, accompanied by the mixing of finance—i.e. linking the loan to the allocation of a subsidy—representing overall a more or less integrated package (comparison of FEC in Morocco and CPSC in Tunisia).

Certain donors acting amongst the specialised financial institutions in developing countries show preference for mixing the forms of finance, as opposed to subsidised loans, which are considered to be insufficiently transparent. The allocation of external loans can be verified, as can subsidies provided by the government. However, this approach has its limits: firstly the leverage effect of the subsidised loan on the volume of credit put in circulation is higher; on the other hand, the mixing solution handicaps the specialised financial institution in the management of its cash flow<sup>14</sup> due to the constraints which are particular to the mobilisation of subsidies.

### ***Hedging of foreign-exchange risk***

The specialised financial institutions in developing countries are regularly confronted with foreign-exchange risks connected with the loans they contract directly and

14. It should be noted that subsidised lending was used on a large scale in France until the end of the 1980s by the *Caisse des dépôts et consignations* and the *Caisses d'épargne* (subsidised loans connected with State subsidies).

indirectly with external donors. This foreign-exchange risk sometimes neutralises the often very advantageous conditions offered by the same donors, for example in South Africa and Morocco.

The instruments for hedging foreign-exchange risk generally consist in swapping the loans contracted in foreign currency into local currency. The use of these instruments makes it possible to ward against any future fluctuation of the exchange parity that would be unfavourable to the borrower.

# The dominant model: the specialised financial institution (SFI)

# 4

The generalist commercial banks do not act on the local authorities market in AFD's preferred area of intervention. We simply see in traditionally English-speaking or Portuguese-speaking countries the presence of short-term finance granted by commercial banks to the local authorities whose deposits they manage. This finance (cash advances, overdraft authorisation) is generally granted under very unfavourable conditions and is accompanied, on the part of the bankers, by guarantees taken out with supervisory government authorities (Ministry of Finance).

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The countries that have developed credit mechanisms to districts have mostly orientated themselves towards setting up specialised financial institutions. This option is most often chosen at the beginning when borrowing to finance local investment is still rare but is nonetheless growing under the impetus of the State as part of an incipient decentralisation process: the specific nature of the local authorities market, the need to make use of financial products that are considerably subsidised requiring State intervention, the reticence of local managers to borrow at market conditions and the disinterest of commercial banks in this type of market (see Box 5).

The constraints attached to strengthening the local authorities market do, however, limit the development prospects of these bodies and, after several years, raise the question of their financing and the diversification of their resources.

### **1. Diverse nature of municipal development funds**

These institutions are financial intermediaries directly managed by the State or by intermediaries on behalf of the State, and which grant loans that are often subsidised (and in some cases highly subsidised) to local government and loans to other institutions investing in urban infrastructure.

For a long time, these institutions were the privilege of developed countries, where they aimed to overcome the absence of long-term credit to small municipal authorities on the part of the private capital markets<sup>15</sup>. Yet over the last 20 years or so, they have been transposed into the context of developing countries with the fervent support of donors who consider them to be a comfortable receptacle for ODA.

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They take several forms with varying degrees of institutionalisation and structuring depending on the context, according to:

- *the administrative history of the country*: this considerably influences the development of organised mechanisms for the financing of community investments. The French-speaking system and the public accounting rules which are attached to it have directed practice towards centralised systems where communities are primarily perceived as dismemberments of the State. The effect in terms of the financing of community investments is reflected by

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15. See for example the history of Dexia described in Appendix 2.

mechanisms with greater administrative content, as opposed to the systems encountered in English-speaking countries, generally having recourse to State guarantee;

- *a more or less favourable economic and monetary context* in terms of resources and applications; the level of economic development has quite a direct influence on whether or not there is an organised system for financing community investments, this variable also being correlated to the degree of urbanisation of the country. In fact, the first countries in Sub-Saharan Africa that have introduced organised systems for financing local investments are countries where the current urban population exceeds 50% (Côte d'Ivoire, Cameroon, Senegal);

#### Box 6.

#### Three scenarios of specialised financial institution

**Scenario 1:** the investment fund, which includes a marginal portion of communal credit and therefore no, or only a very modest level of revolving credit; financed by the State and official development assistance mainly from the World Bank, AFD and KfW. Examples: AFD (Senegal), FPCL (Côte d'Ivoire), FEICOM (Cameroon), FICOM (Burkina Faso).

**Scenario 2:** the specialised financial institution financed by the State and official development assistance (mainly the World Bank, AFD and KfW). It mostly practises a medium and long-term credit policy to districts under subsidised terms (mixing with subsidies, State guarantee etc.). Examples: CPSCL (Tunisia), FEC (Morocco).

**Scenario 3:** the specialised financial institution which finds its resources partly on the bond and banking market supported by international donors (in this case the AFD) without making use of State guarantee (non-sovereign loans). Makes short, medium and long-term loans to local authorities under market conditions in accordance with prudential regulations in line with the country's banking legislation. Examples: DBSA and INCA (South Africa and SADC).

- a process of democratisation of varying degrees of advancement, causing a varying level of desire by the State to control the financing systems put in place (statuses and procedures);
- a point in the life cycle of the institution: each institution finds itself at a well-defined stage of its development process, intimately linked to the municipalities' degree of autonomy and their financial management capacities.

In the less developed systems, where the major problem stems from customer solvency, we mainly come across funds that are sometimes called *equipment funds or investment funds*<sup>16</sup>. These grant subsidies or a mixture of subsidy and lending, with a marginal proportion of credit, and therefore no, or a very modest level of revolving credit. They appeared in French-speaking Africa in the late 1980s with the declared objective of "lending to municipal authorities".

This development is also mainly based on two basic principles: (i) development is designed over several generations and consequently necessitates suitable financial instruments and (ii) the loan gives visibility over the medium and long-term financing of investment needs (revolving effect). It is a first step towards less-subsidised methods of finance and entails greater empowerment for the beneficiaries. For example, ATM in Senegal has already begun this process (Box 7).

**Box 7.**  
**Agence de Développement Municipal - Senegal**

The ADM was formed in 1997 at the initiative of the *Programme d'Appui aux Communes* (PAC) (PDU4), as an extension to the *Compte de Crédit Communal* lodged with the *Banque de l'Habitat du Sénégal* (BHS) at the end of the 1980s (PDU2).

16. FEICOM in Cameroon, FPCL in the Côte d'Ivoire, FICOM in Burkina Faso, ADM in Senegal.

The ADM differs considerably from the CCC: (1) it addresses all municipalities in Senegal; (2) on the basis of a “complete service”: the municipality is supported in the programming of its investments and benefits from automatic finance from ADM on the basis of simple criteria (demography and solvency); (3) financing is granted in the form of a subsidy representing on average 70% of the amount of the requirement, the loan of 20% (terms: 4.25% over 12 years, payment in monthly instalments, no deferral) and self-financing of 10%; (4) a delegated contracting agency, AGETIP, takes responsibility for implementing the investments; (5) lastly, the municipality signs a Town Contract with the State, to which is attached an ADM municipal financing agreement and, more importantly, a capacity-building programme, the main objective of which is to improve the community's solvency in such a way as to allow it to gradually borrow more and be less dependent on State subsidies.

The system is co-financed by the State, which has notably transferred a significant portion of its subsidy to the municipalities (FECL) to ADM through IDA and through AFD. *The objective is to increase ADM's activity to allow it to increase its equity capital.*

In more developed contexts where the main problem is the narrowness of the market combined with insufficient quality of usage (local authorities are considered to be potential borrowers, but the municipalities' solvency is not, however, guaranteed), we come across lending institutions<sup>17</sup> that are really starting to play the role of a specialised financial institution, even though the borrowing conditions are far from those of the market and the loans are still often highly subsidised. Unlike in the least developed contexts, lending to local authorities can be considered albeit in a very contained way. It is a question of helping to improve the solvency of the local authorities, which would at the same time expand the market. In order to do this, the specialised financial institution mostly employs a policy of medium and long-term credit to municipalities under subsidised terms (mixed with subsidies, State guarantee).

17. CPSC (Tunisia), FEC (Morocco), DBSA (South Africa and SADC).

The support programme for these specialised financial institutions includes one or more elements to improve the capacities of the communities with respect to their responsibilities (autonomisation process, capacity for management and implementation, etc.).

This generic model does, in fact, present highly variable characteristics in two areas particularly: the institution's autonomy *vis-à-vis* the State and the origin of its resources. These points are developed below.

### **Volume of activity**

In terms of volume the five main institutions operating in AFD's area of activity in Africa have a total annual volume of financing (loans plus subsidies) of around 400 million euros, of which 65% is in South Africa, 30% in Morocco and Tunisia and 5% in Senegal and in the embryos of the specialised financial institutions found in other Sub-Saharan countries. In relation to the urban population in these countries, the amount per capita provided by these bodies would be around 10 euros per capita in South Africa, 8 in Tunisia and 4 in Morocco, and around 2 in Senegal, that is to say, 25% of the investments of South African municipalities, 65% of investments in Tunisian municipalities and over 80% of investments in Senegalese municipalities.

Table 4.  
**Activities of the specialised financial institutions**

Country	SFI	Period	Amount	in millions of euros	per annum	%	Urban population	Invest. per capita
South Africa	DBSA	1996-2000	7 billion rand	832	166	42	26	6
South Africa	INCA	1997-2000	3.4 bn rand	404	101	26	26	4
Morocco	FEC	1998-2003	4 bn Dh	389	65	16	17	4
Tunisia	CPSC	1998-2003	450 m. Dt	298	50	13	6	8
Senegal	ADM	1997-2003	100 m. USD	80	11	3	5	2
<b>Total</b>					<b>393</b>	<b>100</b>	<b>81</b>	<b>5</b>

## **Resources**

Municipal development funds and specialised financial institutions are mostly financed by the public sector (government, ODA). The mixture of lending/subsidies and subsidised lending are the preferred methods for expanding municipal credit in the priority solidarity zone.

ADM and CPSCL, for example, derive a significant portion of funding from the State (approximately 50% of the finance granted by CPSCL and 10%-20% for ADM), which is then allocated to municipalities in the form of subsidies. In parallel, these two institutions access external loans contracted with donors, mainly the World Bank and AFD. Unlike ADM, CPSCL finances one third of the loans granted to municipalities from its equity capital.

The Moroccan FEC has benefited from State support in the form of endowments from the Treasury (80-100 million Dh per annum since 1996) and from the State's guarantee for its commitments and foreign-exchange risks. Accordingly, it has had easy access to international finance from the World Bank, the European Investment Bank, KfW and the Moroccan bond market. Lastly, it has been directly active on the debt instrument futures market and the interbank market since 1997. Because the State no longer covers the exchange risks, the FEC makes growing use of the Moroccan bond and monetary markets.

The situation is different again in South Africa where DBSA and INCA obtain finance essentially on the financial markets; DBSA has been rated AAA, Baa2 and BBB respectively by Fitch, Standard and Poor's and Moody's. It raises most of its resources on the South African financial market. INCA finds 70% of its finance on the South African financial market and 30% from external donors (AFD, AfDB, KfW). Following the example of South African institutions, and when the context allows it, municipal

authorities attempt to raise funds on the capital markets. This is a favourable development that makes it possible to capture household savings.

Be that as it may, there are very few municipal authorities that inspire confidence amongst private investors. The majority of them are not considered solvent (low level of own resources and limited management capability). We should add that, on occasion, specialised financial institutions that have the possibility of obtaining resources on the market are offered credit lines at much better terms by donors.

#### ***Area of activity***

From the point of view of the types of loans and other services offered, the objectives of these institutions or funds go far beyond offering credit. They aim to improve the management of local finances and ensure that some projects will be carried out (even when there is no complete guarantee that the costs will be recovered). As a benchmark institution, the fund or the specialised financial institution can bring together the critical mass of technical assistance needed to improve local practices. Naturally, this assistance is all more crucial as local authorities are at an early stage of development.

#### ***Repayment rate***

Generally speaking, the repayment rate is far below commercially viable rates<sup>18</sup>. Far from being abnormal, this effect is accompanied by the local authorities' process of learning, which however is not always optimal.

It does happen that municipal authorities that are unable to repay their loans are not penalised and are even able to borrow again (repayment becomes particularly

18. For example, the non-repayment rate of CVBD in Jordan is 30% and that of FEC in Morocco is 20%. It is 80% in Kenya (1996).

problematic when the local authorities have the feeling that they were not involved in the decision to invest). This prompts some authors to claim that this system does not always strengthen the credibility of local authorities and does not prepare the field for lending by the market. Yet it would be difficult for it to be otherwise, as the municipal authorities know that the central government will not abandon them. Therefore, the challenge of a support program consists in further encouraging local authorities to honour their repayments (maximum borrowing levels defined on the basis of future capacities to mobilise resources, etc.). It is interesting to note that two institutions that benefit from excellent repayment rates (MUFIS in the Czech Republic and FINDENTER in Columbia) lend to municipalities through private commercial banks, with the latter assuming the risk. This system can only work, however, provided that local authorities have made progress in the way they manage their finances and investments.

### ***Autonomy***

The degree of autonomy of the specialised financial institutions depends on the varying degree of desire of the State to control the financing systems and, secondarily, in decentralisation and municipal activity. It also depends on the depth of the market. When the specialised financial institutions operate on a deep market, as is the case in South Africa, they are able to acquire autonomy from the State.

## **4. Virtuous development of the specialised financial institution**

The specialised financial institution addresses real needs. It represents the dynamic alternative to subsidies and makes local authorities financing an important instrument for strengthening municipalities' financial management and absorption capacity.

Emphasis in this respect should be placed on the educational role of the specialised financial institution through its support of decentralisation.

Yet the major question that remains is how to position the specialised financial institution and gradually transform it into “something else” as soon as its purpose is no longer useful, or worse, as soon as its pre-eminence becomes harmful. This is the case when local authorities have a sufficient size and level of prosperity to bear competition with other economic agents for access to credit. This case still rarely occurs in developing countries but it is beginning to appear in some emerging countries and it is therefore advisable to prepare for this happening.

In this respect, various problems should be mentioned regarding the risks of the non-virtuous development of specialised financial institutions, which would lead to a blockage in the development of local government. Firstly, because of the preferential conditions offered by the specialised financial institution (partly thanks to the subsidies it receives), it could systematically find itself in a monopolistic situation, dissuading commercial banks from entering the local authorities market. A sub-optimal credit market for local authorities would result, as their credit via this market would actually be limited by the exclusion of commercial banks. This situation would be contradictory to the scale of the municipal requirements, which would curb urban development in the most mature local authorities.

Moreover, this situation would not be sufficiently effective in terms of local resource allocation because the local savings available from the often over-liquid commercial banks would be underused and not made available to the local authorities that need them. Naturally, the specialised financial institution can mobilise such resources through bond issues, but it also needs to have the capacity to manage growing volumes of loans.

To summarise, the dominant position of specialised financial institutions could lead to local authority resources being rationed and could undermine the challenge of collecting local savings and directing them towards the local authorities market over longer periods than those offered by the traditional banking sector.

We should add that intermediate-income countries are facing an additional handicap: donors and funds, or the SFIs they support, lend in foreign currencies. However, municipal authorities find it expensive to guarantee against foreign exchange risk. Effectively, hedging against foreign exchange risk implies entering into a contract with an intermediary bank that will charge for the counterparty risk, in addition to the cost of the financial product itself. Product-wise, the most suitable one is undoubtedly a currency swap, which makes it possible to transform a loan in currency A into currency B<sup>19</sup>. For example a five-year loan in euros at a rate of 4% without counterparty risk would be almost equivalent to a loan in rand at 9.4%.

Another important issue is the development of the SFI once it has become autonomous and no longer benefits from subsidised resources, on a market where it is competing with commercial banks. The SFI is not deposit-taking bank. It therefore has access to more expensive resources. Positioning then becomes uncertain and its future can be compromised. The SFI's strong points are risk assessment, knowledge of the market, technical expertise and especially subsidies from donors or the State. Yet how does the system develop once the SFI's comparative advantage becomes less obvious compared with other types of lenders, who will be more open to municipal authorities as they present less of a risk? The SFI may experience difficulties in maintaining itself in such a context. The same also applies to systems where the State systematically enhances the signature of the local authorities, for example by guaranteeing all or part of their borrowings. However, this is a rare occurrence.

Any SFI that specialises in lending to municipalities needs to develop gradually. This challenge arose and continues to arise for Dexia. Appendix 1 illustrates the 5-step

19. A currency swap is an exchange of debts denominated in different currencies. This form of swap is used to benefit from an attractive differential between the domestic market and the foreign market. For example if a French company can obtain a loan at 10% in francs or at 12% in dollars, whilst an American firm has its own currency at 9% and francs at 11%, they will each borrow on their home market and then exchange funds.

evolution of this institution: firstly, as a public institution, it responded to the reconstruction needs of post-war France under the supervision of a highly-centralised State, in a context of still weak local government (subsidies, highly concessionary loans over the long term); it then supported the erosion of the centralised model and adapted itself to growing budget tensions (formation of a “*caisse*” fund to raise funds on financial markets with a State guarantee). It went on to finance and advise increasingly mature local authorities and developed in order to retain a competitive advantage, benefiting from the reform of the capital markets. It was later privatised whilst retaining its specific features and comparative advantage in local authorities financing. Finally, it then reformed in order to keep pace with the development of modern finance, whilst at the same time strengthening its role with local authorities.

The issue of virtuous development of institutions such as CPSCS in Tunisia now arises. The Tunisian market is not sufficiently deep to allow this institution to develop into a private institution of a type such as INCA in South Africa. Only an institution with a regional mission would be viable. However, the comparative advantage of a financial institution specialised in lending to local authorities is precisely its in-depth knowledge of the local authorities. This need for closeness is incompatible with the idea of a “regional mission”. The other possibility would be to merge the CPSCS into the system for generalist banks in the market.

# Using bond issues to fund municipal investments

## 5

*Should we move towards a diversification of systems for financing investments, incorporating the use of municipal bond issues? Do the resources mobilised in this way prove to be less expensive? Does such a system make sense in developing countries, and if so, under what conditions?*

The Working Group has reviewed the few significant experiments carried out by a handful of major local governments. These experiences are concentrated primarily in Asia: India and the Philippines<sup>20</sup>. Bond resources offer more flexible characteristics. They can be accessed with intermediation (commercial bank or SFI) or without intermediation (direct bond issue). In both cases, the issuing organisation (local authority or financing body) must have been rated beforehand.

20. Local authorities in China (including large municipalities) are not authorised to borrow from the banking sector. Neither are they able to conduct bond issues. To ensure their development, they create investment companies in which they generally have a 100% stake, which raise resources on the market on their behalf (either through the banking sector or directly on the market). This is notably the case of UDIC in Shanghai.

In addition, there is a threshold effect. The bond issue needs to reach a minimum amount justifying the expenses incurred: *rating, use of an arranger, advertising, reinsurance*. Set against a backdrop of municipalities with a solvency shortfall, local authorities, as highlighted in Section 3, need to make use of a number of financial techniques to enable them to build up investor confidence. These include *securitisation* and *credit enhancement*, both of which target two goals: first, to reduce the cost of resources and, second, to enable local authorities to take the plunge in relation to direct or indirect access to the market.

Local government has used the market to fund *projects rather than municipal-level investments*. The projects often involve greater transparency, a higher level of profitability and therefore more guarantees. In this way, the Tunisian State is planning to conduct a bond issue on the market for its national programme to build rubbish dumps, with the risk to be borne by the borrower and the investor.

The arguments generally used to justify the benefits of such a bond issue include:

- the availability of high volumes,
- the possibility of more favourable rates than under the conditions offered by banks,
- greater independence *vis-à-vis* traditional lenders,
- a certain recognition for the issuing local authority.

### 1. Definition

There are three types of placement:

- *Public*: underwritten by a group of banks headed by a lead underwriter,
- *General public*: reserved for the general public, e.g. inhabitants,
- *Private*: subscription contract.

As a rule, the issuer is advised by an *arranger*, which negotiates on its behalf with the syndicate of banks, whether this concerns a public or a private placement.

The *cost of the operation* (notably a public issue) includes the costs and commissions incurred, with the main items as follows:

- Management commission,
- Placement commission,
- Commission to guarantee the successful completion of the placement,
- Financial service costs,
- Charge paid to the securities regulator,
- Institutional financial advertising costs,
- Legal fees,
- Listing fees,
- Rating or enhancement costs.

In total, the yield to maturity, net of tax, comes out at around 4-5% in France (excluding rating costs). Lower costs (around 3%) have been obtained in India and the Philippines as a result of the contribution by donor agencies guarantees and unbilled services.

## **2. A few examples**

Four significant examples are presented here: the city of Ahmedabad in India (1999), the Philippines (1996), the city of Johannesburg in South Africa (2005) and the city of Douala in Cameroon (2005).

### Box 8. HUDCO (India)

HUDCO (Housing and Urban Development Company) was set up in 1970 as a public limited company, with a significant percentage of international capital. HUDCO's primary mission is to "improve housing for all social groups, with priority given to poor urban populations".

It works with funding (loans) from the KfW, JBIC (Japan), USAID and the Asian Development Bank. It has capital of 25 billion rupees (500 million euros). The amount of outstanding debt stands at 3 billion euros<sup>21</sup>.

HUDCO has 1,121 employees and 41 agencies throughout the country. Its activities include housing construction and the development of living areas and services.

It works with the HDFC (Housing Development Finance Corporation, Ltd), which was set up in 1977 with the same status, and represents India's leading bank for housing.

### Box 9. The Development Credit Authority (USAID)

Through this instrument, USAID provides guarantees for private borrowers operating in the economic development sector. These guarantees may be used either in the case of loans taken out in the local currency or in the case of bond issues on the local market.

The guarantees provided by DCA normally require the lender to take on at least 50% of the risk.

### ***Ahmedabad, 1999: financing for the Raska Project (125 million dollars)***

Ahmedabad is the first city in India to have launched a direct municipal bond issue. The operation was carried out from 1999 to 2000 in order to supplement the funding of the Raska Project, a major water supply and purification project.

21. 40 Rs = USD 1 = €0.8.

The financing plan was based on:

- a 100 million dollar loan (80% of the project) granted by the Housing and Urban Development Company (HUDCO),
- a 25 million dollar bond issue (20%),
- all covered by a guarantee provided under the USAID Housing Guarantee Program.

In October 2001, the city of Ahmedabad repeated this experience with a second municipal bond issue for the same amount (25 million dollars), although benefiting from a number of tax breaks this time. This issue will supplement the financing plan for a second phase of the Raska Project. For reference, the city of Ahmedabad has 3.2 million inhabitants and a relatively healthy financial position. It was rated A+ in 1996, then AA in connection with the first bond issue.

#### Box 10.

#### India: CRISIL/Standard & Poor's rating systems

In India, CRISIL (Credit Rating Information Service of India Ltd), the country's leading rating agency, launched a local authorities rating service in 1997, based on a rating scale similar to Standard & Poor's.

For municipalities, CRISIL looks at six factors: (1) the legal and regulatory framework, (2) the region's economic base, (3) the current financial situation, (4) the municipality's existing operations, (5) the municipality's managerial capabilities, (6) the project concerned. Particular attention is paid to the availability of a stable and assessable resource for the repayment of debt servicing.

At Standard & Poor's, the criteria are as follows: (1) the support and predictability of the system, (2) the demographic profile, (3) the economic structure and growth prospects, (4) the level of political and administrative stability and sophistication, (5) the performance and schedule for debt and finances, (6) liabilities.

There is also a threshold effect. The bond issue must reach a minimum amount justifying the expenses incurred: rating, use of an arranger, advertising, reinsurance.

Since then, the cities of Mumbai, Pune, Vijayawada and Bangalore have all been rated along with 34 other towns and municipal water services.

The main concern at present relates to securing repayments to investors or subscribers. Within this framework, USAID is drawing on the example of the city of Ahmedabad in order to set up automatic allocation systems for certain resources to service its debt. A sinking fund has been opened by the city for capital repayments. Over the medium term, the objective is to open up subscriptions to new investors other than institutional players (financial institutions, banks, insurance companies, etc.), even if such operations prove to be more costly (advertising, etc.).

### ***Municipal bonds in the Philippines***

In 1991, the Philippine government adopted a new code for local government, factoring in the major transfers of skills from the State over to local authorities. These transfers were accompanied by the creation of an allocation system (split taxation), designed to contribute to increasing and securing local government resources.

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Five years later (1996), new legislation came into force: (i) making it possible for municipalities to access private sector resources, (ii) promoting the development of municipal bonds, (iii) encouraging the use of BOT (build-operate-transfer) contracts and concessions to fund urban services, etc.

The overall objective is to make it easier for local authorities to access a wider range of financial resources in order to fund their investments, given that their situation is considered to have become somewhat healthier and that efforts are being made through the various projects to strengthen their services.

At the time these 1996 provisions were adopted, the local authorities already had several sources of financing for their investments.

- *Local development banks*, with three banks dominating the market, namely the Philippines Land Bank, the Development Bank of the Philippines and the Philippines National Bank. These organisations are State banks, which have since been privatised. They grant municipalities short-term loans as well as overdraft facilities and long-term credit lines, with some 270 million dollars in loans outstanding with such clients.
- *The Municipal Development Fund (MDF)*, created in 1984 and supplied with credit lines from the World Bank, AfDB and Japan Bank for International Cooperation.

The MDF is administered by the Ministry of Finance. Loans are granted over a period from 15 to 25 years under very favourable conditions. In 10 years, the MDF will have granted 272 million dollars in loans to 1,900 sub-national entities.

The two options examined by the government to encourage private sector involvement in core service funding are as follows:

- *Public-private partnerships*: the first experiments appeared with the adoption of provisions relative to BOT in 1990, the most visible of which are: (i) the BOT set up by the city of Manila in 1990 for work to rebuild the Mandaluyong market following a fire and to transform it into a modern shopping centre, (ii) Luzon Province's BOT for a bus station, (iii) *idem* for a drinking water network in Mindanao;
- *Municipal bonds*: a dozen local authorities have carried out bond issues for a combined total of approximately 30 million dollars. While this trend is picking up pace, notably for the funding of municipal infrastructure and housing projects for the poor, there are still a number of major constraints: (i) no tax-exemption facilities for interest, (ii) obligation imposed by the government to use certain banks for depositing funds, (iii) difficulties faced by districts in identifying projects on which the cost recovery is sufficiently guaranteed to enable this type of financing. In

addition, there is no secondary market: bonds are subscribed by institutional investors (banks, insurance companies), which limits the prospects for the development of this type of funding. Lastly, the government obliges municipalities to use the national bank services for bond issue transactions.

### Box 11. Bond financing conditions in the Philippines

#### Legal framework

- the 1991 local government code formally authorises local authorities to carry out bond issues,
- the use of municipal bond issues is only authorised for financing certain clearly identified projects; these projects must be based on recovery of costs or housing projects for the poor, carried out by private operators,
- projects must be included in the local development plan, which in turn must be consistent with the nationwide investment plan,
- the municipality must record the annual cost of debt generated through these bond issues in its budget.

#### Taxation

The government has implemented a certain number of incentives:

- bond revenues are exempt from filing fees with the securities regulator,
- institutional investors taking part in housing operations guaranteed by the Housing Guarantee Corporation (HGC) are exempt from tax on interest on loans, issues and mortgages granted or subscribed,
- bond issues subscribed for social housing projects enjoy additional tax breaks.

Guarantee mechanisms

- the Philippine government has acted as guarantor for most of the bond issues intended to finance social housing operations. However, the expense has become too high and the State has partially withdrawn from this system, only guaranteeing interest up to 8.5%. In addition, the State's guarantee is subject to certain constraints: (i) existence of an inventory of land reserves, (ii) approved land use plan, (iii) assurances that the operation is financially balanced, making it possible to amortise the debt;
- for municipal infrastructure projects, the government has completely withdrawn. The use of municipal bond issues is therefore limited only to the main towns, when these are able to prove their solvency. In 1998, this situation led the Philippine Banking Association, in conjunction with the Philippine Development Bank and 54 commercial banks, to set up a privatised guarantee mechanism: the Local Government Units Guarantee Corporation. This fund only guarantees projects with a high cost recovery and municipalities with a minimum rating. The fund has signed an agreement with USAID, which reinsures 30% of the portfolio. The cost of the guarantee amounts to between 2.5% and 3.5% of the value of the bond issues; a delay of over 30 days in repaying subscribers authorises the use of the guarantee fund. To collect the sums committed under the guarantee system, the LGUGC may intercept transfers from the State to the municipality in question. Since it was set up in March 1998, the LGUGC has provided around 1.4 billion pesos (approximately 30 million dollars) for 10 municipal bond issues in the country. The majority of bonds have a seven-year maturity. The bond market still remains some way behind the use of commercial banks, but is starting to find its niche.

***Johannesburg, 2005***

In April 2004, Johannesburg (rated A-) conducted its first municipal bond issue since the end of apartheid. This issue was carried out in two tranches:

- 1st tranche: 1 billion rand maturing in 6 years at a rate of 2.3% over the government rate (6 April 2004),

- 2nd tranche: 1 billion rand maturing in 12 years with a joint SFI-DBSA guarantee on 40% of the amount at a rate of 1.64% over the government rate (25 June 2004).

In April 2005, the city conducted a new 700 million rand issue, with bonds maturing in 8 years at 1.54% over the government rate. This initiative reflects the rapid change in the perception of municipal risk in South Africa.

### ***Douala, 2005***

The Urban Community of Douala launched its first bond issue in April 2005. This issue totalled 16 billion FCFA and was specifically aimed at helping to finance the “road, railway and water network maintenance” section of the Douala Infrastructure Programme (PID) funded by the IDA. The issue was secured through the signature of a crossed debt agreement in favour of the Urban Community of Douala, representing a total of 10 billion FCFA.

This is in line with the agreements concluded with the State in connection with the December 1999 objectives contract, as well as the city contract that is under negotiation.

The operation was carried out in two tranches:

- 1st tranche: 7 billion FCFA (carried out in April 2005), maturing in 5 years, with 1 year deferred, and a rate of 8.3%,
- 2nd tranche: 9 billion FCFA (to be carried out before the end of 2005).

## **3. Minimum conditions for general use**

In light of the experiences presented, the conditions required for municipal bond issues to develop include:

Healthy local finances

- the fundamental reforms making it possible to guarantee stable resources for municipalities must have been implemented; the same conditions apply for the pricing of services likely to be financed through bond issues,
- there must be one or more rating or scoring systems adapted to local authorities,
- the issuing municipality must be able to manage the debt and cash (*in fine* amortisation of the bond loan requiring specific provisions making it possible to defer repayment).

A minimum regulatory framework

- local authorities must be formally authorised to conduct bond issues (laws, regulations, etc.),
- in general, the laws and regulations in force restrict the use of bond issues to certain types of project or operation, accompanied by a certain number of guarantees (cost recovery, balanced operation),
- the local authority must incorporate the annual charge for debt generated through these bond issues into its budget.

Tax incentives

- as a rule, interest on bond issues is exempt from tax in order to guarantee the best possible subscription rate,
- the tax breaks granted are carefully controlled and may vary according to the nature of the operation being financed.

Insurance and guarantee mechanisms

- the existence of guarantee mechanisms is vital in order to be able to extend the use of bond issues to include smaller local entities and those with lower ratings,
- these mechanisms may be supported by donor agencies.



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# Appendix 1: Presentations given at meetings

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## **15 October 2003**

- Presentation of the approach and inventory of experiences (Groupe Huit).
- Contribution relating to an “innovative operation by Dexia for the city of Tlalhepantla in Mexico” (Marie-Alice Lallemand).
- “The financing of urban public services and local authorities in Tunisia”, by M. Hammami, head of local finances and MDP (communicated by Niels Devernois).

## **2 February 2004**

- Presentation of the resources issue (Groupe Huit).
- Presentation of “INCA’s activity (SAR) and the securitisation mechanism for this institution’s portfolios through AFD-Proparco” (Martha Stein-Sochas, AFD).
- Presentation of the “municipal bond market in South Africa” (Virginie Dago, AFD).
- Comments on the “South African context and AFD operations” (Philippe Lecrinier, AFD).
- Presentation of “the transformation of short-term resources into long-term loans” (Jean-Yves Gourvez, CNCE).

- Presentation of the “municipal bond guarantee mechanism set up in the Philippines” (Groupe Huit).
- Presentation of the “experience of launching a bond issue by the city of Ahmedabad in India” (Groupe Huit).

### ***5 April 2004***

- Presentation of the usage issue (Groupe Huit).
- Presentation of the “involvement of local authorities in managing basic services (and more specifically water)” (Alain Henry, AFD).
- Presentation of the “Tunisian MDP3” financed by the World Bank and the AFD (Françoise Brunet, consultant).
- Presentation of the “AFD’s support for the Fort de France district” (Mathieu Discour, AFD).

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# Appendix 2: Three basic references for local authority financing systems

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Here, it seemed useful to outline three major references on the question of local authorities financing:

- the case of France, which has inspired many SFIs,
- the case of Belgium, which represents a reference for mutualist SFIs funded by local government,
- the case of the United States, the yardstick for the generalised system of financing through municipal bonds.

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## 1. France

Since decentralisation, local authorities in France have undertaken 70% of civil public investments.

The present system is the result of a number of changes that, without our going too far back in time, are marked by a number of key dates:

- 1966: creation of the *Caisse d'Aide à l'Équipement des Collectivités Locales* (CAECL), a public administrative institution managed by the *Caisse des Dépôts et Consignations* (CDC);
- 1982-1986: overhauling of French economic structures: decentralisation laws, generalisation of credit;
- 1987: creation of *Crédit Local de France*, which replaced the CAECL, but remained a public enterprise;
- 1993: privatisation of *Crédit Local de France*;
- 1996: creation of the Dexia group through the financial merger of *Crédit Local de France* and *Crédit Communal de Belgique*.

This development represents above all a gradual and unplanned adaptation to a changing context, heavily marked by the in-depth transformations of economic structures over the last 30 years. In this respect, it cannot serve as an example for future developments in another country. However, with some transpositions, it could well provide a few indications to illustrate what is actually possible.

### **CAECL (1966-1986): organisation and activities**

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The CAECL was created in 1966 to meet two needs:

- *quantitatively, the budget for subsidised loans from the Caisse des Dépôts, backed by the collection of tax-exempt savings, was no longer sufficient to meet the level of demand, which was fuelled by the strong growth typical of the period;*
- furthermore, these subsidised loans were linked to the financing of operations that had to be subsidised by the State and thus complying with State-defined criteria. Yet, a growing number of local authorities wanted to partially liberate themselves from this supervision and to fund facilities other than those in line with objectives fixed by the State.

Created as a *public administrative institution*, the CAECL remained under the strict control of the *Caisse des Dépôts et Consignations*, which handled its management, served as its sole banker and as operator for the collection of resources in the form of bond issues.

Nevertheless, it introduced a number of major innovations: board of directors made up of an equal number of locally elected representatives and civil servants, as well as a legal status and financial independence that enabled it to acquire recognition in the financial world.

Above all else, the existence of an organisation dedicated to funding local authorities, set against a backdrop of strong growth (over 5% per annum on average between 1966 and 1972), enabled local authorities to establish themselves at this early stage as the leading civil public investor (twice as much as central government bodies); in current French francs, the CAECL's loans grew from 382 million in 1966 to 2.9 billion in 1972; at the same time, total local authority borrowing rose from 2.4 billion to 14 billion.

Lastly, the CAECL was not required to comply with the obligation for local authorities to deposit their free funds with the Treasury: of the funds waiting to be used and originating from loans taken out by local authorities with the *Caisse des Dépôts et Caisses d'Épargne*, half was paid into an account opened with the CAECL, bearing interest at a rate of 1%. At a time when cash management had not yet been invented and local authorities were obliged to raise all of their funding before initiating a project, this specific feature made it possible to usefully top up resources collected by the CAECL by making use of public savings.

These resources were primarily made up of two legally different bond products:

- The CAECL's "own" issues, subject to a relatively restrictive system of prior administrative authorisations, and launched twice a year.

- The “*villes de France*” bonds, which were pooled issues for grouped local authorities, and directly debited for them, with however the CAECL’s guarantee.

These issues largely avoided the constraints associated with direct issues; they were carried out every three months with tranches from 500 million to 1 billion current francs.

### ***The reasons behind the shift from the mid-1980s onwards***

The period that followed the first oil crisis put an end to the expansion of the CAECL’s activities. Indeed, local authorities continued to borrow within a context marked by high inflation, as reflected in negative real interest rates for all subsidised loans. It was at this time that the proportion of market-rate CAECL loans began to stagnate.

From 1983, two series of reforms led to wholesale changes in financing conditions for local authorities:

- the decentralisation laws,
- the “generalisation” of credit further to the 1984 banking law.

Without examining all of the (numerous) consequences of the decentralisation laws, this legislation had two main effects on financing conditions:

- it stimulated the demand for loans, primarily for large local authorities (regions and *départements*) as a result of the transfer of competencies from the State to the local authorities (the transfer of secondary schools to the regional authorities is one key example);
- it helped to generalise globalised financing of investment budgets, with no reference necessary, as in the past, to either the subsidies obtained or the balance for each separate operation.

Indeed, local authorities were given total independence for their budgetary choices and *a priori* opportunity controls were no longer imposed.

The generalisation of credit, which moreover represented a genuine revolution for the French economy, had a wide range of consequences for local authorities:

- the phasing out of preferential-rate loans, with the rather stagnant resources linked to tax-exempt savings now being reserved for the funding of local government housing;
- the expansion of the supply of loans to all credit institutions, with the possibility to play on competition;
- the diversification of loan products that had until then been limited to a narrow range of fixed-rate loans;
- the rapid increase in debt set against the backdrop of a slowdown in inflation.

### ***The regional loan committee episode***

The future of an institution created in 1982, the *Comités régionaux des prêts* (regional loan committees), is significant in relation to the rapid changes in financing conditions that characterised this period. Within the context of decentralisation, these regional loan committees were set up in line with the first decentralisation law: they are consultative bodies made up primarily of elected representatives in addition to *ex-officio* members representing government bodies (prefect, regional head of the Treasury) and public lenders (CDC and *Caisses d'Epargne*). They were intended to ensure a balanced distribution in accordance with the regional priorities for preferential-rate loan budgets. This self-regulation by local elected representatives was logically in line with the spirit of decentralisation. However, only three or four years later, the existence of these regional loan committees was no longer justified following the decision to end preferential-rate loans.

### ***The transformation of the CAECL and the creation of the CLF***

In 1986, the CAECL became the leading lender to local authorities, with 45% of new loan flows. The local authorities' long-term debt, on the other hand, had increased by 40% in current francs since 1982. To a great extent, this change was not only due to circumstances, but also to the desire of one man, Pierre Richard, the future Chairman of *Crédit Local de France*, who, in just a few years, managed to modernise the structures, simplify the procedures and adapt the range of products and services available, moving towards a genuine approach to accompany decentralisation and thereby prefiguring a capacity to cope with a fully competitive situation.

The CAECL was wealthy, having built up operating surpluses all the more easily as the services that it received from the *Caisse des Dépôts* were not billed at their actual cost. CAECL reserves totalled 9 billion francs, a fortune that aroused the State's interest and discontent among local authorities, which believed that this wealth had been amassed at their expense. It was in this context that a change in the parliamentary majority occurred and facilitated the rapid adoption of the project (which could no longer be ignored) to denationalise the CAECL.

After intense lobbying and various trials and tribulations mainly related to the stock market crash in October 1987, the CAECL's management team received authorisation at the end of 1987 to transform it from a public institution into a private-law limited company (*société anonyme*). The new structure, called the *Crédit Local de France* (CLF), had a capital split between the State (47.5%), the *Caisse des Dépôts* (25%) and the *Caisse d'Épargne* (7%), with the remainder held by various institutional investors, including first-rate foreign financial institutions such as the *Crédit Communal de Belgique* (CCB).

The personnel remained part of the *Caisse des Dépôts* and was made available to the 22 regional divisions of the CLF commercial network.

### **Generalisation of credit for local authorities**

The main change seen from 1988 onwards, in addition to the very broad diversification of products offered to local authorities, is the almost complete disappearance of preferential-rate loans for the *Caisse des Dépôts*, whose level of funds under management has progressively fallen in the absence of any new flows. However, it is still interesting to observe that, despite a ten-year dominance of the liberal economic model, the credit sector in France regularly returns to the idea that State intervention is needed to correct the market's imperfections. Indeed, there is a certain nostalgia among local authorities for preferential-rate loans, and they have regularly managed to veer from the market-rate principle, in the form of loans backed by specific forms of saving collection (CODEVI loans, urban project loans, etc.). However, this represents only a marginal percentage of their debt today.

### **Impact on the local public investment financing market**

This system can be characterised as follows:

- local authorities freely borrow from all credit institutions and, where relevant, through direct issues on the financial markets;
- however, there is a specialised credit body, the *Crédit Local de France*, that has managed, in both goodyears and bad, to retain a market share of between 40% and 50%, without enjoying any privileges other than that of image, mentioned above;
- this specialised body is thus competing with all other credit organisations operating in France. In addition, unlike banks, it does not have any deposit resources (CAECL's account progressively disappeared in the very first years of CLF's activities): all of its resources are collected on the domestic and, above all, international financial markets;
- it also stands out from most other credit organisations thanks to its substantial activity in long-term or even very long-term loans (up to 50 years at present). This

means that it is obliged to adapt its process for collecting resources to factor in this specific feature, chiefly by looking for backing with as narrow a gap as possible between the characteristics of its assets and its liabilities, at least in terms of rate risks (the very long term is hedged for rate risks, but not necessarily in liquidity).

### ***The resource-usage match***

The CLF represents one of the world's biggest private issuers on the financial markets. Although it has lost its triple A rating (like almost all other private financial institutions), it continues to represent a first-rate signature capable of raising resources in large quantities (over 50 billion francs per annum at present) on very good terms.

Nevertheless, it is obliged to pass all the volatility of market rates—which directly define the prices of the resources it is collecting—on to its loan conditions. This is not the case for organisations that dispose of shock absorbers in the form of diversified resources and the partial, if not marginal, nature of their long-term credit activity compared with their total activities. More specifically, during a period of rising rates, the CLF struggles to remain competitive.

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From a macroeconomic point of view, the CLF's function is to attract, on behalf of local authorities, financing resources that are adapted to their local structure and volume requirements, which is something that the rest of the banking sector does not set out to do and would probably not be capable of doing.

The question of volume is fundamental. During a period of low demand for credit throughout the economy, competition is heightened and the need for the CLF's macroeconomic function becomes less obvious; conversely, on account of the

importance of local investments in France, it becomes vital as soon as the rest of the economy (households, businesses) expresses stronger demand for the traditional lender offering.

**CLF: “a benchmark banker”**

Another aspect of the CLF’s function is its role as a benchmark banker. During its early years, when competition still appeared to be limited, this role had several facets:

- market-maker: the CLF had far-reaching influence on the rates adopted by other lenders largely on account of its pricing policy;
- above all, an undisputed specialist in analysis of “local authorities” risk: expertise inherited from the CDC, but more specifically, widely developed after 1990 further to the suspension of payments for the town of Angoulême; it provided its two rivals with a simple and reliable *de facto* indicator for their commitment policy, saving them the investment cost required to develop an equivalent level of expertise;
- lastly, from the outset, the CLF’s main value-added has been its ongoing commitment to innovations: in order to create financing products that enable local authorities to maximise the benefits of market opportunities, despite the incompatibility of market volatility and the relatively slow decision-making process imposed on local managers by democratic control.

What is the situation today? The CLF has not been a market-maker for a long time now and, on the contrary, is suffering from the effects of heightened competition on pricing (see above). Expertise in local authority financial analysis remains a strong point, but is no longer a monopoly. Nevertheless, it does constitute the basis for a highly diversified range of services that is greatly appreciated by CLF customers, and thus effectively helps to maintain market share. Lastly, the innovation effort on financing products is being pursued and, on the whole, this maintains CLF’s real technological

lead. Certainly, most of its innovations are very quickly copied by rivals, which have themselves managed to pull ahead on other niches.

Nevertheless, *the long-term viability of this French system is still constantly threatened by the laws of the market*. The undeniable financial success of the *Crédit Local de France* should not hide the fact that its survival has only been safeguarded at the cost of successive transformations in order to face up to the fundamental dilemmas of such an institution. For most financial institutions, credit is but one of many activities and does not tend to be the most profitable; the aim is more to consolidate and supplement other higher-earning activities. Maintaining an organisation that is doubly specialised, through its activity (credit) and its market (local public sector), at a competitive level of profitability on a sustainable basis represents a major challenge in many respects. Conversely, diversifying its activity or target would risk removing all its distinguishing features and making it lose its comparative advantage and more concretely its signature quality, which is vital for the performance of its core business.

The CLF's changes since 1987 have to a great extent been transformations seeking to resolve this dilemma thanks to a dual movement: completion of the privatisation process and, concomitantly, the development of an international activity still focused on its core business, but within the framework of a diversified European group.

The key steps have been as follows:

1992: listing on the stock market, leading to a new shareholding structure (French State: 25.5%; CDC: 25%; individuals and investors: 49.5%). The CLF is not yet really privatised, as the State, both directly and through the CDC, still has a slim majority, but it is no longer a public enterprise.

1993: privatisation and separation from the CDC. The breakdown of its capital is as follows: French and foreign investors: 62%; individual shareholders: 18%; CDC: 12%; French State: 8%. The CLF now has its own staff, separate from

the CDC's workforce (although part of this personnel still includes civil servants from the CDC, now on secondment), and has set up its own network of regional divisions. In addition, its bylaws are amended. Previously a company with a management and supervisory board, the CLF now adopts the most frequently used system for companies under French law: a board of directors appointed at the general shareholders meeting, and a chairman and chief executive officer. At the end of 1995, the State sells its remaining interest, leaving the CDC as the only public shareholder with a very minority interest.

1996: creation of the Dexia group through the financial merger of the CLF and CCB. In legal terms, in the absence of a European company law, the operation involved setting up two holding companies, one Belgian and the other French, each with a 50% stake in the operational companies: CLF in France and CCB in Belgium. In this way, the capital of each holding company (Dexia France and Dexia Belgium), listed respectively in Paris and Brussels, corresponds to the same financial content.

The CCB brings new businesses to the group: retail banking in Belgium, private banking and asset management through its *Banque Internationale Luxembourgeoise* (BIL) subsidiary in Luxembourg. Above all, the doubling of its solvency in terms of shareholder equity opens up an opportunity to accelerate the group's international development, which was already well underway at the CLF. This development was reflected in the creation and above all the acquisition of subsidiaries in numerous European countries (UK, Spain, Germany, Austria, Italy, Sweden, etc.) and the United States.

## **2. Belgium**

It is also important to describe here the experience of the CCB, which still has a market share of around 90% on loans to Belgian local authorities.

### ***Historical perspective***

The *Crédit Communal de Belgique* is a longstanding institution. Indeed, it was founded by the government in 1860 as a limited company (*société anonyme*). In 1986, it was transformed into a public enterprise incorporated for an unlimited period (*société anonyme à durée illimitée*). It aims to “facilitate, through appropriate credit operations, the investments and day-to-day running of budgets for provinces, districts, regional organisations and subordinate institutions or similar”.

Until 1996, CCB’s capital was held by local authorities. Since the creation of the Dexia holding structure with *Crédit Local de France*, the local authorities have a 50% (+ 1 share) interest, with the rest having been opened up to the private sector.

### ***Key stages***

From 1861 to 1914, the CCB granted credit to districts through resources based on loans placed in the public sector via banks. In 1912, it issued its first bank certificates. Between the two wars, it carried out public loan issues directly. In 1941, it launched its first continuous issue of bank certificates and, in 1947, it created its own savings accounts.

In the 1960s, under pressure from banking rivals, the CCB increased the number of branches with management entrusted to full-time professional independent employees who were authorised to negotiate with clients (franchise). In 1967-1970,

the CCB introduced demand accounts for retail customers and diversified its activities and services for both public and private customers (loans, diversified range of banking services). It offered the same range of services as a commercial bank.

### ***Current status and purpose***

The law of 16 April 1963 confirmed the CCB's public interest nature in terms of its corporate purpose, which justifies government control over its activity.

Its position on the Belgian banking market and its alliance with *Crédit Local de France* through the creation of Dexia have given it a rationale for a banking business enjoying a privileged position on the public authorities market, without excluding private client markets. In this way, the CCB has become a general bank that intends to remain the privileged partner of public authorities.

Its share capital is held in full by Dexia Belgium Holding, which is listed on the stock market, with 50% (+ 1 share) of the capital remaining in the hands of local authorities. It is operating in a competitive context, in which its knowledge of local authorities and its banking expertise represent its main competitive advantages.

### ***Scope***

Registered with the Banking and Financial Commission, the CCB offers a comprehensive range of financial services and products to all client types. With a balance sheet of 4,252 billion Belgian francs at 31 December 1998, it accounts for 15% of Belgian savings and 90% of public authorities financing (i.e. 45% of its assets). 65% of local government financing is based on direct loans, with 35% on subscriptions for securities issued.

In addition the CCB is developing financing techniques that blend the short and medium terms by managing local authorities' current accounts and by processing their financial transactions. In this way, it is able to offer them access to the monetary and financial markets, thanks to its trading room, as well as cash optimisation solutions, such as cash pooling, making it possible for a given client to merge debit and credit accounts and invest the corresponding cash in intermediary products (e.g. public debt securities).

The CCB, through its network of 1,000 branches and the creation of telephone and telematic-based banking services, guarantees a very strong and close relationship with all of its customers, including local authorities.

With the *Banque Internationale Luxembourgeoise*, in which it is the majority shareholder, and the *Crédit Local de France*, and on account of its excellent rating, the *Crédit Communal de Belgique* is able to offer its customers (notably public authorities) the best techniques and the best conditions on the market.

### **Resources**

The CCB is able to draw on all the resources available to a commercial bank, i.e. at 31 December 1998:

- 602 billion Belgian francs in deposits and savings
- 947 billion Belgian francs in bank certificates
- 333 billion Belgian francs in undertakings for collective investment certificates

In addition to these resources, it has a good level of liquidity, enjoying the best conditions available on the market.

### ***Financing terms offered to districts***

Local authority investments are financed based on the traditional method: own resources, state subsidies, medium-term loans.

Subsidies are paid:

- either in capital, into an account opened with the CCB,
- or through annuities to repay instalments due on loans taken out by local authorities.

Loans are granted for 5 to 20 years. They are repaid through annuities or in a single instalment: this is the case of bridge loans on income that the local authority expects to receive.

The conditions for granting loans are based on a review of various financial criteria, namely:

- the financial balance of the project,
- the capacity of the local authority to repay the loan: the CCB examines the district's financial situation but does not in any way assess the opportunity associated with the project,
- the guarantee, based on the right to ordinary income centralised in the account of the borrowing district, authorises the CCB to allocate income to repaying the loan.

Interest rates are set according to the market and in a competitive environment, since local authorities are required to put their requests for financing up for tender.

Annual cash requirements may also be financed by the CCB, in the form of advances to be deducted against income for the year that has not been received,

provided that they are paid into the local authority's current account opened with the CCB.

***Other financing systems***

They are offered by banking rivals in line with a similar approach and techniques to those adopted by the CCB. As such, local government preference is based on competitiveness criteria. Today, the CCB still has a certain advantage, winning nearly 90% of the tenders issued in 1998. It is reasonable to believe that the competition will become stronger in the future and that, in time, the financing of local public authorities will be less and less the work of only one institution.

### 3. The United States

Whereas in Europe, local government investments are financed to a great extent through loans taken out with specialised financial institutions, in the US, this financing is based on the bond markets. This situation reflects the country's federal structure, the absence of financial institutions specialising in municipality financing and the reticence of the banking system (entirely private) to finance local government.

Over the last two centuries, the municipal bond market has developed very rapidly and has become a key component in the US credit market. The growth of this market is due to the country's decentralised structure and the innovations that have characterised its financial system.

Municipal bonds, which represent the main instruments for financing local infrastructure in the US, include: (i) general obligation bonds, which are guaranteed by the taxation power of the States and local government; and (ii) project revenue bonds, which are based on income from the operations that they are financing.

#### ***General obligation bonds***

These bonds represent the instrument of choice for financing local investment projects; they are based on the capacity of States and municipalities to collect tax, with the main ones including: (i) individual income tax; (ii) property tax; (iii) sales tax. Over the last 15 years, other general obligation bonds have developed in response to the proliferation of districts with special economic missions (Special Purpose Districts), created to provide services that go beyond the borders of a given municipality (water supply system, sewage system, hospitals, fire protection, roads, etc.).

### ***Project revenue bonds***

This second category of municipal bonds is based on licence fees, tariffs for users or specific taxes rather than on the general taxation power of States and local authorities. They are primarily used to finance projects relating to health, higher education, transport (toll roads, public transport, ports, airports, etc.) or public services (water supply, waste water treatment, electricity, etc.). The guarantee for these bonds varies considerably, but is generally linked to a source of income generated directly by the services provided (e.g. income from the sale of electricity guaranteeing bond issues to finance work to build a power station). However, for certain municipal service projects that would not generate enough income to cover the debt, such as convention centres, public parking facilities or street lighting, the guarantee can be reinforced through a specific tax on sales.

Municipalities also issue hybrid bonds combining general obligation and project revenue bonds. These are known as double-barrelled bonds and are guaranteed based on both income generated on the services provided and the general taxation power of the issuing local authorities.

### ***Relative benefits of the two categories of bonds***

General obligation bonds are based on the entire tax base, maintaining their appeal as the financing instrument of choice for States and local authorities. However, the financing of investment projects through licence fees and user tariffs has increased considerably over the last 20 years due to the following factors: (i) the limited legal capacity of local authorities to bear a growing level of debt; and (ii) the continuous innovations seen on the financial markets, facilitating the use of project revenue bond issues. In addition, as reassuring as a bond commitment secured through tax income may be, it does not represent an absolute guarantee of repayment. In fact, many investors believe that a source of income reserved for debt servicing, with the possibility

to increase licence fees or user tariffs, represents a more flexible and more secure guarantee than using tax income as collateral, since this income remains subject to various restrictions, repeal and the goodwill of voters.

### ***Short-term instruments***

Although municipal bond markets tend to be long term in general, various short-term instruments are available, such as commercial paper or municipal bonds, which may be issued for periods from 30 up to 270 days. Many of these instruments may be renewed over several years and are more like long-term debt instruments. For instance, this is the case with revenue anticipation notes (bonds issued by a public authority pending receipt of non-fiscal revenues) or tax anticipation notes (bonds issued pending receipt of fiscal revenues), which are issued in response to differences in timing between incurring expenses for operations and receiving income.

### ***Structured instruments***

For the last 10 years or so, structured financing instruments, which represent conventional financial instruments combined with derivative products such as futures, options and swaps, have become an integral part of municipal debt markets. These derivatives are powerful instruments for hedging risks, protecting a financial position against undesirable changes in prices.

### ***The issue of insolvency risks***

Unlike with federal government securities, municipal bonds are not safe from defaults on payments, with examples including the City of New York in the mid-1970s and Orange County at the beginning of the 1990s. Credit ratings that enable investors to assess the solvency of local authorities issuing bonds and the financial and legal

mechanisms designed to improve the quality of municipal credit (preferential debt, options, guarantees, etc.) have become key factors in investment choices.

***Other financing systems***

Although it is difficult to obtain accurate quantitative data, around 70-80% of local authority financing needs would appear to be met through bond issues, with the remaining 20-30% covered by the private sector, which is very active in the United States in terms of financing local infrastructure, such as water supplies, waste water processing, and solid and hazardous waste management. Most power plants are privately owned. It is important to note that private education is very popular in the United States. In fact, it dominates the school and university systems.

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# Appendix 3: Glossary

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## **AMR**

Annual monetary rate. This represents the yield rates for a monthly placement renewed at the end of each month at the average monthly monetary market rate.

## **Arranger**

Lead underwriter for a bond issue involving a syndicate of banks or financial institutions.

## **BALO**

*Bulletin d'Annonces Légales Obligatoires*, France's official gazette for the publication of institutional financial information.

## **BMR**

Bond market rate.

**Bond**

Debt securities issued by companies, governments and governmental bodies in order to obtain capital, committing the issuer to pay interest throughout its duration at specific dates and to repay the capital upon maturity.

**Credit enhancement**

This technique enables debt issuers to reduce the cost of the operation thanks to an improvement in its rating, obtained thanks to backing by a first-rate insurer (*information required to obtain a rating*: issuing company financial statements and issue transaction structure).

**EURIBOR** (Euro Interbank Offered Rate)

Interbank rate for interest on investments from one to 12 months.

**Floor/cap**

Technique for swapping interest rates with cap or floor-rate guarantees.

**MSBR**

Monthly state borrowing rate.

**Primary market**

Market on which marketable securities are sold when they have just been issued and are being offered to investors for the first time. Users of capital, such as businesses and governments, are able to obtain capital provided by investors on this market.

**Private placement**

In this case, a subscription contract, drawn up between the issuer and subscribers, replaces the firm underwriting contract for a public placement. Subscribers may be individual investors.

**Public placement**

A public issue subject to a firm underwriting, i.e. through to maturity, by institutional investors. They form a “banking syndicate” headed by a lead underwriter.

**Rating**

Financial evaluation procedure for districts that gives rise to a rating (and a report) attesting to the quality of the signature of the local authorities wishing to issue securities.

The operation is carried out by a firm whose seriousness and independence are recognised by the financial markets.

**Refinancing**

New issue of debt securities by a company or government, income from which will be used to repay existing loans in order to reduce the amount of interest to be paid and/or extend the maturity.

**Risk**

A *liquidity risk* arises when a long-term loan is being financed through more short-term resources. This raises the risk of having to refinance for the years left to cover at a higher cost.

A *currency risk* arises when a loan is being financed in a foreign currency.

This raises the risk that the exchange rate might change in such a way that the resource gains value in relation to its use.

An *interest rate risk* arises when there is a difference between the rate of the resource and the rate of the loan, over the repayment period, the index or the means of setting the index.

A *tax risk* arises following a reduction in the percentage of local authorities in sharing resources with the central State.

A *systemic risk* arises following a change in governmental policy with respect to the entire sector.

### **Scoring**

Qualitative evaluation technique for a borrower client (individual or company), focusing primarily on their solvency.

### **Secondary market**

Market on which savers trade with one another. It makes it possible for investors who have bought securities on the primary market to sell them on again in order to obtain liquid assets.

### **Spread**

For variable or floating rate bonds, this represents the difference between the coupon paid and the reference rate. It may be positive or negative, expressed in absolute values or as a percentage (this term generally applies to international issues).

For example, if a loan is launched at a rate of +0.5% over six months, we say that the spread is 0.5%. The term also applies for rates on issues from borrowers other than the State, which must offer a higher interest rate than the equivalent Treasury bond with the same characteristics, referred to as the benchmark.

### **Swap**

Technique for exchanging or swapping fixed interest rates into variable rates or vice-versa, or a technique for swapping securities (or currencies).

***UDP, MDP***

Urban development project, municipal development project.

***Underwriter***

Financial institution serving as an intermediary between a securities issuer and investors.

***Yield to maturity***

Discounting rate that makes the amount of funds borrowed (placed) and the amount of funds repaid (recovered) financially equivalent.

The rate of yield to maturity for a placement is equivalent to the internal rate of return on an investment (same formula).



# Appendix 4.

## List of abbreviations and acronyms

AfDB:	African Development Bank
ADM:	Agence de Développement Municipal (Senegal)
AFD ARIZ:	Dedicated AFD guarantee fund for banks and institutions
AFD CEFEB:	AFD banking, economic and financial research centre
AFD DOO:	Overseas division
AFD EVA:	Evaluation and capitalisation mission
AFD GOA:	Regional department for West Africa
AFD GOD:	Regional department for French overseas departments and territories
AFD RCH:	Research department
AFD TDH:	Human development department
AFD TEN:	Rural, environment and natural resources department
AFD TFP:	Financial systems and private sector development department
AFD TID:	Urban development and infrastructure department
AFD:	Agence Française de Développement
AGETIP:	Agence d'Exécution des Travaux d'Intérêt Public
AMR:	Annual monetary rate
ANICT:	Agence Nationale d'Investissement des Collectivités Territoriales (Mali)
BALO:	France's official gazette
BFR:	Belgian franc
BHS:	Banque de l'Habitat du Sénégal

BMR:	Bond market rate
BOT:	Build Operate Transfer
CAC:	Centimes Additionnels Communaux (Cameroon)
CACEM:	Communauté d'Agglomération de la Martinique
CAECL:	Caisse d'Aide à l'Équipement des Collectivités Locales
CCB:	Crédit Communal de Belgique
CCC:	Compte de Crédit Communal (Senegal)
CDC:	Caisse des Dépôts et Consignations
CFC:	Crédit Foncier du Cameroun
CLF:	Crédit Local de France
CODEVI:	Compte pour le Développement Industriel
CPCT:	Caisse des Prêts aux Collectivités Territoriales (Niger)
CPSSL:	Caisse de Prêts et de Soutien aux Collectivités Locales (Tunisia)
CRISIL:	Credit Rating Information Services of India
CVBD:	Cities and Villages Development Bank (Jordan)
DAD:	Dar ad Damane (Morocco)
DBSA:	Development Bank of Southern Africa (South Africa)
DC:	Developing country
DCA:	Development Credit Authority (India)
DGCID MAE:	Direction Générale de la Coopération Internationale et du Développement - French Ministry for Foreign Affairs (France)
EIB:	European Investment Bank
EU:	European Union
FCCL:	Fonds Commun des Collectivités Locales (Tunisia)
FEC:	Fonds d'Équipement Communal (Morocco)
FECL:	Fonds d'Équipement des Collectivités Locales (Senegal)
FEICOM:	Fonds d'Équipement et d'Intervention Communal (Cameroon)
FGIC:	Financial Guaranty Insurance Company
FAIU:	Fonds d'Investissement et d'Aménagement Urbain (Côte d'Ivoire)

FICOM:	Fonds d'Investissement Communal (Burkina Faso)
FINDENTER:	Financiera de Desarrollo Territorial (Colombia)
FODECOM:	Fonds de Démarrage des Communes (Burkina Faso)
FPCL:	Fonds de Prêts aux Collectivités Locales (Côte d'Ivoire)
FRAR:	Fonds Régional d'Aménagement Rural (Côte d'Ivoire)
FSA:	Financial Services Authority
HDFC:	Housing and Urban Finance Corporation (India)
HGC:	Housing Guarantee Corporation
HUDCO:	Housing and Urban Development Company (India)
IBRD:	World Bank (International Bank for Reconstruction and Development)
IDA:	International Development Agency
IFC:	International Finance Corporation
IIC:	Intermediate-income country
INCA:	Infrastructure Finance Corporation (South Africa)
IRD:	Institut de Recherche pour le Développement
ISTED:	Institut des Sciences et des Techniques de l'Équipement et de l'Environnement pour le Développement
JBIC:	Japan Bank for International Cooperation
KfW:	Kreditanstalt für Wiederaufbau (Germany)
LA:	Local authorities
LDC:	Least developed countries
LGLA:	Local Government Loans Authority (Kenya)
LGUGC:	Local Government Units Guarantee Corporation
MDF:	Municipal Development Fund
MDP:	Municipal Development Programme (Benin)
MDP:	Municipal Development Project (Tunisia)
ME:	Mixed enterprise
MSBR:	Monthly state borrowing rate
MUFIS:	Municipal Infrastructure Finance Program (Czech Republic)

PAC:	Programme d'Appui aux Communes (Senegal)
PDCC:	Projet de Développement des Communes Côtières (Côte d'Ivoire)
PID:	Programme d'Infrastructures de Douala (Cameroon)
PPP:	Public-private partnership
PROPARCO:	Promotion et Participation pour la Coopération Economique (AFD)
PSDAT:	Programme de Soutien à la Décentralisation et à l'Aménagement du Territoire (Côte d'Ivoire)
PSZ:	Priority solidarity zone
SADC:	Southern Africa Development Community
SAGEDECOM:	Services d'Appui à la Gestion et au Développement Communal (Burkina Faso)
SAR:	South African Republic
SFI:	Specialised financial institution
SMI:	Small and medium-sized industries
UDIC:	Shanghai municipality investment agency
UDP:	Urban development project
UNCHS:	United Nations Centre for Human Settlements (UN Habitat)
UNDP:	United Nations Development Programme
USAID:	United States Agency for International Development
USD:	US dollar
WB:	World Bank

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# Publications

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