Financing investment in towns in developing countries

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

Contents

Introduction

This document is a summary of the work and thinking of the Working Group on the financing of investment in 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 Party 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 authorities in industrialised and developing countries.

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 - it does not give an overall view of the eminently broader issue of the financing, or indebtedness, of local authorities in southern countries. It is a summary of the thoughts of professionals from northern countries 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 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 French overseas *departéments* and territories. This experience covers all areas of local investment - infrastructures, public amenities, social housing. In developing countries, AFD has for a long time also been active in urban development and in financing local authorities in support of the 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 notable 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 authorities as players in economic and urban development. This evolution is expressed notably by 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 the local investment projects (mobilisation of financial counterparties, stimulation of community credit, demands 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; (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 activity 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 underline 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 which ran the exercise and are in no way attributable to the members of the Group.

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See list of rules used in Appendix 4.

Summary of the main findings and lessons

1. Working procedure

The Working Group was active over a period of one year and this was organised around four theme-based meetings[1]

- 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 10 case studies[2];
- 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, 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 financing conditions. The areas of competences of the local authorities, the appointment of contracting authorities, the hierarchies to be established between investments based 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 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 based on a debate on: (i) the conditions which determine whether the loan will bring about the initiation of a virtuous circle or conversely a depressive spiral for the municipal authorities; (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:

- the first is of a demographic nature: the process of urbanisation caused by migration from the rural world and the natural growth in populations in towns are behind the explosion in 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 10 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 essential services and

[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.

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, which until now was mainly allocated to the State (sovereign finance), to finance allocated to districts directly (sub-sovereign finance) or through specialised institutions. The challenge is also to provide municipal authorities with easier access to the financial market by the introduction of specific systems.

Slightly later than in Latin America, at the beginning of the 1990s the African continent and some countries in Southeast Asia developed credit mechanisms for districts which 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 (least developed countries, intermediate-income countries)[3] and by the administrative tradition of these countries (French-speaking, English speaking, with or without decentralisation). These mechanisms therefore extend from investment funds, which are fully subsidised, to local authority banks, which operate under market-like conditions, and also include financing bodies that mix subsidy with credit, the latter often being offered under concessional terms. Promoted by donors and States to provide resources to local authorities, the role of these mechanisms was often also to support local authorities in their gradual transition towards autonomy and efficiency.

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

More recently, local authorities have made direct use of the bond market with the support of institutional donors in the form of guarantees or credit raising. In parallel, donors offer loans to specialised financing institutions (see 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 financing local investments and project financing is bubbling with excitement and some observers constantly point out the contradictions that can appear in the practices employed by donors or even between different units within the same institution.

The Working Group took the view that one of the difficulties of advancing the thinking into the financing of local authorities was to do with (i) the number and diversity of the parameters to be taken into account in each transaction and (ii) the difficultly of reproducing the same scenario from one country to the next. This difficulty comes from the institutional characteristics of the States and the contradictory approaches of governments, which over and above the discussions on decentralisation, sometimes have little inclination to provide their local authorities, particularly big towns, with real autonomy. It also comes from the rigid nature of the organisational structure of the donors which still have little experience of the institutional complexity of the urban sector. Lastly – it stems from the ability of the local authorities themselves to increase their resources, improve their management and think about modernising.

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

3. Main findings and lessons

The main findings and lessons learned 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* whose main parameters reflect a variety of economic situations but also the political, legal and administrative traditions of the governments. Other data plays a decisive factor in the architecture of the financing systems. For example, whether or not the districts are responsible for water and/or electricity bears a strong influence on the volume of the finance market of the local authorities. In addition, with an equal weighting of a national population, the varying degree of balance of the urban network, the size of the towns, the disparities between the biggest and smallest, the richest and poorest, define very different market characteristics.

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 the needs, numerous examples show that accessing resource is not the major difficulty. In many least developed countries, financing resources exceed the absorption capacities due to the weakness of the operators, insufficiencies in 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 abundance of the offer of concessional finance therefore often dissuades operators from making use of the financial market on which they would only obtain loans at higher interest rates and over a shorter term.

Lesson 3. *Borrowing means anticipating income.* The old adage about the professional environment is still as relevant as ever. The loan is an integral part of a funding plan, comparing the operational costs generated and the offsetting income, whether direct or indirect. Local investment contributes to increasing the assets of the community in order to produce services that generate tariff or fiscal income which will contribute to covering future charges relating to the loan. In this sense reference is often made to the “the educational virtue of the loan”, the act of borrowing presupposing in effect an ability on the part of the administrator to project itself in the future.

If these conditions are not fulfilled, the authority is at risk in the same way as households without any money end up with excessive debts and personal bankruptcy as a result of consumer credit.

Lesson 4. A certain number of projects in the municipal sector count on the educational virtue of borrowing and are trying to move the districts into a virtuous circle. Supporting measures and incentives gradually improve the management capacity and therefore income. An initial dosage of a loan finances investments that themselves generate income and so on. The sudden access to borrowing for authorities that do not have sufficient expertise and responsibility runs the risk of pushing them in the opposite direction into a downward spiral. Operational expenses caused 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 continuous development of lending to districts in developing countries is largely based on the adoption of the concept of *financing local authorities* unlike *project financing.* The concept of financing local authorities presupposes extrication from one-off initiatives relating to the decision to finance a specific project to go towards financing mechanisms meeting the medium and long-term financial needs based on the model 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. The recourse to specialised financial institutions (SFI) in order to address the financing needs of local authorities is now the dominant model in intermediate-income countries and lest developed countries in Africa, North Africa/Middle East and South America. These SFI generally combine: (i) credit activities and (ii) missions to support local authorities in programming investment, and more broadly, institutional reinforcement. It is still considered that this route is the best approach to address the needs of the local sector at these stages of development[4] (see virtuous circle concept mentioned above).

These SFI are now experiencing difficulties resulting from the insufficient nature of the local authorities market. This insufficiency often stems more from the curbs on the decentralisation process than from the lack of solvency amongst the districts. This creates stagnation of the SFI's activity. This finding may have brought about the emergence of the idea of a regional specialised institution in order to expand its market. But this type of institution, which 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), seems to have been ruled out. The SFI lastly often suffer from a certain amount of difficulty 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 process and prevent them from diversifying their resources.

***Lesson 7**.* The insufficient size of the local authorities market is often due to the fact that the main part of the infrastructures and services remain 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. Systems such as *town contracts, conurbation contracts or* at another level, *public-private partnerships,* provide, if not alternatives to the legislative and regulations process of decentralisation, at the very least the opportunity to test the ability of the local authorities to assume growing responsibilities.

These systems can therefore effectively support the process of decentralisation and the development of the local authorities market.

Lesson 8. The conceivable developments for the SFI are the subject of debate. In the most-advanced countries where the competence of the districts is extensive, the future of a specialised financial institution will depend on its ability to access a sufficient market

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

(local services concession holders, semi-public companies etc). The alternative for these SFI lies in making their activities commonplace, that is their gradual integration into banks. A specialised establishment finds its justification during the period of formation of the local authorities market. As soon as this market exists, it may become commonplace. Many non-specialised banks join forces in Europe on the local authorities market, particularly since they have the benefit of less costly resources than the SFI due to their deposit-taking activities. In the countries where local authorities account for a marginal portion of public investment, the beneficial purpose of the SFI lies mainly in its capacity to support districts in such a way as to set in motion the virtuous circle process. The difficulty for a number of these institutions in gaining access to a sufficient autonomy to the State, an autonomy which is vital to sound management for a financial institution, may have made certain experts doubtful about the relevance of continuing to support this type of instrument. One of the substitution options is to put in place specific lines of credit at existing commercial banks. The support and advisory duties link in with the banking management of these lines of credit. These duties are preferably outsourced and conducted by bodies entrusted with these tasks[5].

Lesson 9. *Use of the disintermediated bond markets* for local authorities is still a limited phenomenon. These development prospects are naturally slowed down by the needs of the required arrangements (rating, number of contributors, agreement from supervisory authority, guarantees) and by their cost (to be assessed through the profile of the funding – the rate and terms – but also the cost of the disintermediation). This type of finance does, however, provoke a lot of interest, as banks and other financial establishments (particularly insurance companies) often have excess liquidity in developing countries. In this configuration, the activity of the providers of international funds concentrates on introducing guarantee or credit raising funds. 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[6]. The reference points are still the experiences of local authorities in intermediate-income countries such as India, the Philippines, Mexico supported by the World Bank and USAID. Other South African metropolises have been rated by the rating agencies but have not as yet issued any bonds. The recent issue by the Cameroon city of Douala[7] needs to be put in its specific context. The bond is pledged against 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 finance provided by donors, and most importantly, are much shorter in duration and deferral terms, and are 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 to recommend a financing method that would exclude others, and that bond issues and traditional bank finance could usefully cohabit if the conditions were in place.

[5] In some cases (e.g. INCA in South Africa) these duties are still carried out by the credit institution without jeopardising its financial equilibrium.
[6] Johannesburg, rated A-, made the first municipal issue in April 2004 since the end of apartheid. This issue was made in two tranches of 1 billion rand each. In 2004, the city made a third issue of 700 million rand.
[7] Bond issue of 7 billion FCFA at the end of 2004 on the national a market with the following terms – 5 years, redemption on maturity at a rate of 8.25%. Annualised percentage rate of including cots and commission is between 9.5% and 10.5% depending on the source.

As regards the issues, one direction that could be given preference is to make use of group bond issues (launched by specialised and unspecialised credit institutions) so as to address the needs of a set of local authorities not limited to capital cities[8]. More generally, emphasis was placed on the correlation between the abilities of the local authorities and the availability of finance. The increase in the size of the market provokes the diversification of mechanisms of finance and the arrival of new sources. In this sense the strengthening of local authorities - with regard to national economic and institutional contexts - are indeed an essential aspect of the increasing importance of sub-sovereign finance.

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

[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.

1. Simplified typology of systems of finance

Can we think in a uniform manner about the financing of local authorities in developing countries? Do the instruments in place result directly from the given level of economic development, from a specific political-administrative tradition, from a more or less voluntarist decentralisation process?

During its first meeting, the Working Group made an inventory of the systems in existence on the African continent. A simplified typology was proposed, stressing the link between the existence of a structured system for financing investment in local authorities, the level of development of the beneficiary countries and the interest paid to 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 approaches in the three countries.

- *Sub Sahara African countries which have set up an investment fund:* 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 gradually granting districts 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 the donors.
- *Lastly, countries which do not have any specific instrument to finance community authority investment and where the donors and activity are in the form of "project finance",* generally via the State (hand over in the context of urban projects or municipal development projects or specific projects targeted on 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 in the investment fund or lending bank category remain closely dependent on the financing 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 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 authorities to make use of borrowing to finance public investment sector etc.

Table 1

Simplified typology of systems of finance

Class of country	Characteristics	Country	Financing institutions	AFD finance	Resources of the financing system
1	Community sector totally solvent and Active mechanism for community credit	South Africa	DBSA/INCA	Yes	Non-sovereign loans, guarantee and credit raising. Access to market. Own resources and other international donors
		Tunisia	CPSCL (1906, then 1992)	Yes	Sovereign loans retroceded (AFD, BIRD, EIB). Use of financial markets Own resources
		Morocco*	FEC (1959, then 1996)	No	Sovereign loans retroceded (BIRD, EIB, KfW). Use of financial markets (via State) Own resources
2	Communities with a low level of solvency and specialised financial institution type institutions	Senegal	ADM (1997)	Yes but parallel action in favour of communities via the State (donation retroceded)	AFD donation via State (retrocessions) IDA loan % FECL Own resources
		Ivory Coast	FPCL (1992, no longer operational)	No AFD only makes donations to districts (retrocession)	IDA loan retroceded and linkage sought with FIAU and FRAR
		Cameroon	FEICOM (1994)	No Indirect AFD loans to	Levy against community resources

				districts (retrocession)	(CAC) (mutual fund)

Table 1 (continued)

Simplified typology of systems of finance

Class of country	**Characteristics**	**Country**	**Financing institutions**	**AFD finance**	**Resources of the financing system**
2	Communities with a low level solvency and "investment fund" type institutions	Cameroon	CFC (1992, no longer operates)	No Indirect AFD loans to communities (recession)	BIRD credit line with Crédit Foncier de Cameroun. Target: community commercial infrastructure
		Kenya	LGLA	No Indirect AFD loans to communities (recession)	State resources and donors and own resources
		Niger	CPCT (1960, close to 2003)	No Indirect AFD loans to communities (recession)	Deducted from housing receipts and from electricity tax (mutual fund)
		Mali	ANICT (2000)	Yes	External donations including AFD (around 10 donors)
		Burkina Faso	FICOM/FODECOM/ SAGEDECOM (1992)	No Direct or indirect AFD donations to districts	Foreign donations retroceded (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 endowments to existing investments such as the FCCL in Tunisia or the FECL in Senegal.

Additional momentum to the system consists of providing further resources (external contributions) and of introducing, generally in a highly concessionary form, a credit portion to the district.

The risk, which has occurred on several occasions, is that the donors change direction and at the same time challenge the continuity of these mechanisms.

These initiatives mainly date from the beginning of the 1990s at the time when the first transformation of urban projects into MDP or municipal development projects was first examined.

Box 1
Some points of reference

Without rewriting the history of urban projects and the development of the sector over the past 30 years, we would point out that over the 30-year-period there have been several phases.

- **The 1970s**: this decade follows the decade of independence and was the period during which the States were formed. In this context urban projects were focused on housing the largest number of people and on urban poverty ("sites and services" and neighbourhood renovation projects)[9]. The message was simple and clear and can be summarised in these terms: (1) the public power 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) the spontaneous or under-equipped neighbourhoods are no longer to be destroyed but improved and rehabilitated; (3) costs need to be recovered to ensure the "replicability" of the activities.

- **The 1980s:** this was the decade of structural adjustment and institutional, economic and financial reforms. The poverty agenda really does not have a place. Urban projects diversify their activities (finance of housing, municipal development and amenities of towns etc). The focal points of the strategy are less clear than previously at a time when the urban population is becoming the majority in a growing number of countries.

- **The 1990s**: the general context is against a background of economic crisis. The FCFA is devalued. Africa opens up to the multiple party system and decentralisation. We see the emergence of districts as players in urban development but this emergence often occurs without the appropriate resources at the risk of appearing as the sign of a withdrawal of the States. Urban projects diversify even more under the effect of lobbies (defence of the environment, gender, community participation etc)

[9] Cf. preparation of urban development projects– Lucien Godin, July 1987

making it quite difficult to understand the objectives and anticipated results. The intervention of the AGETIP from the 1990s is to play a part in this confusion by prioritising the theme of usage rather than amenities in towns. The role of these agencies in the institutional emergence of districts is however to be of vital importance even though it has become perverted over time.

The Working Group also stressed that the mechanisms of finance 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) tried out solely by the city of Johannesburg and recently, under completely individual terms, by the city of Douala.

These SFI, although tending towards a "common model" do, however, vary considerably in their objects, the resources that they bring in and the conditions under which they carry out their activities amongst the client base. These premises are largely guided: (i) by a more or less favourable economic and monetary context in terms of resources and usage and (ii) by a more or less strong wish by the State to control the financing systems in place (objects and procedures).

The mixing of lending/subsidies and subsidised loans are a major condition for the development of municipal credit in the region, including North Africa and South Africa, and emphasises the essential role of the State in this development. The mixing can extend to being managed by body: CPSCL in Tunisia, ADM in Senegal for example. Subsidised lending does in fact offer more leverage in fact than mixing because it makes it possible to distribute more loans under more favourable terms.

The various initiatives have 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) in order to develop mechanisms to finance local investment which would be demarcated from pure subsidy.

2. Borrowing capacity and decentralisation

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 SFI face in North Africa and South Africa?

The Working Group mainly debated the constraints connected with the weakness of the local authorities market despite an almost general decentralisation movement which started almost 15 years ago. This finding applies to sub-Saharan Africa but illustrations can also be found in Tunisia, Morocco and South Africa.

Three types of constraints were identified: (1) constraints connected with the often still too narrow framework of competence allocated to the districts; (2) the constraints connected with the absorption capacity of the districts; (3) the constraints of implementing the APD by the donors.

1. An often narrow framework of competence

From an institutional point of view, the Working Group found that the competences awarded to districts were still limited in relation to the prospects of finance for development priorities in towns. The decentralisation movement, which started at the beginning of the 1990s in most of the countries examined has still not settled the issue of the actual sharing of the competence between the State, the districts and, where applicable, the other echelons of decentralisation.

Education and health are often the competences transferred within the framework of decentralisation laws. The shortcomings relate more to the competences in terms of refuse or land management but also the distribution of drinking water and energy (electricity). The insufficiencies in defining the community assets such as the street infrastructure or the property status of urban peripheries force the new municipal authorities into a state of powerlessness. So in numerous countries districts are still restricted by the laws for collecting household waste and the maintenance of works (tasks, which it is true to say, they often find it difficult to carry out).

This situation may result from the curb to the decentralisation process or more simply from a practical difficulty in determining the limits of the prerogatives of the central level and local echelons. In sub-Saharan Africa, two factors come into play. Firstly, the technical ministries are concerned about safeguarding their prerogatives in terms of investment and at the same time their special relations with the donors and, secondly it is difficult to change some forms of legislation such as land legislation.

Therefore we are often confronted with a weakness in the investment competences left up to the districts and hence the limitation of the prospects for financing local authorities.

This situation is particularly regrettable in intermediate-income countries where communities have an absorption capacity, both in financial and technical terms, which should allow them to accept more services[10].

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

On this subject the Working Group also identified the difference which exists between countries which have given their local authorities responsibility for water and electricity and others. The services are managed by a community-based body mainly in English-speaking countries. They contribute to creating a significant increase in communities' budgets and their direct investment needs.

2. The community authority's insufficient capacity to absorb

Beyond the limits created by law, the main obstacles to increasing usage is still the low capacity the districts have to absorb, in particular in order to implement projects.
The urban growth and reforms undertaken in the sphere of institutional decentralisation has led most of these countries to strengthen the finances of the districts and to develop the capacity to carry out and finance local investments at community authority level. This has sometimes resulted in a significant progression in local budgets.

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 a system of resources which is often random (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 level of operating costs).

The financial situation of the districts is often a reflection of that of the State, accentuated by the absence of the facilities which the State has in order to subsidise its needs, in particular through borrowing.

The Working Group also emphasised the deterioration of the position of local finances in countries such as Tunisia (over half of the districts are over-indebted after 10 years of voluntarist activity by the CPSCL) or like in South Africa where DBSA and INCA concentrate their activities on the metropolises neglecting other communities due to the risks they represent.

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

Box 2

Extrapolation of districts' ability to finance themselves

By extrapolation, the local (community-based) sector in the main countries in Agence Française de Developpément's priority solidarity zone - Morocco, Tunisia, South Africa and 11 sub-Sahara African countries - have a total volume of resources of €6.5 billion of which:

- 7 billion euros for South Africa (82%)
- 1 billion euros for Morocco and Tunisia (12%)
- and €400 million for the main countries where it operates in sub-Saharan Africa (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** of which:

- 1.4 billion for South African districts (85%)
- €120 million for Morocco communities (8%)
- €30 million for Tunisian communities (2%)
- and €50 million for the main countries of activity in sub-Saharan Africa (5%).

Starting with the assumption that the communities could devote a maximum of 50% of this self-financing capacity (operating surplus) to repaying debt (annuity)[11], the global volume of municipal credit that can be undertaken annually in the region is therefore estimated at €4.5 billion[12] including 3% in sub-Saharan Africa (approximately 100 billion FCFA), 82% in South Africa and the remaining 15% in Morocco and Tunisia.

In addition, the areas in which the districts operate rarely produce a return on investment. Major trading services such as water and energy are most often the responsibility of national concessionaries in French-speaking Africa. Some incidences of credit to districts were able during the 1990s to rely on the prospects offered by the financing of commercial infrastructure (for example, CFC in Cameroon and CCC in Senegal) without any 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 the ability of the districts to schedule and carry out the investments. Very large-scale efforts still need to be carried out in this area. They are slowed down by the attractiveness of the posts in the local authority.

Table 2
Cost structures in 2001 (as a percentage of production)

Country (2000)	Population of community in millions	Total receipts in billions of FCFA	Operating surplus	Cost of maximum debt (in % of receipts)	Cost of debt	Operating surplus (in %)	Volume of annual loans
Sub-Saharan Africa							
Benin	6.2	8.555	0.856	5	0.428	50	3.368
Burkina Faso	2.2	7782	0.778	5	0.389	50	3064
Cameroon	8.0	33.689	3387	5	1693	50	13.334
Democratic Republic of Congo	16.4	69556	6956	5	3478	50	27.384
Ivory Coast	9.2	62534	6253	5	3127	50	24.619

[11] The percentage for Morocco and Tunisian communities 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.

Gabon	1.1	7275	0.728	5	0.364	50	2.864
Mali	4.2	6525	0.653	5	0.326	50	2.569
Niger	1.6	7827	0.783	5	0.391	50	3.082
Senegal	4.4	24033	2403		1.202	50	9.462
Chad	1.6	7754	0.775	5	0.388	50	3.053
Togo	1.4	3778	0.378	5	0.189	50	1.487
TOTAL (billions of FCFA)	56.3	239488	23949		11.974		94.287
In millions of euros		365.097	36.510		18.255		143.739
South Africa (in millions of euros)		7,129	712	10	712	100	3,700
Morocco (in millions of euros)		800	120	10	80	67	570
Tunisia (in millions of euros)		200	300	10	20	6	100
TOTAL (in euros)			899		831		4,513

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, Ivory Coast) can be estimated at between 20 and 25 billion FCFA 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 which gives 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 to 350 million in the three main conurbations.

- Morocco: the districts 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 dedicated to investment to be €120 million.

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

The difficulty experienced by the State itself in the deconcentration of its urban planning and infrastructure services accentuate the weakness of the resources existing locally to undertake and carry out the project. This quite general situation has made numerous countries increase the number of implementation agencies. These agencies are either financed by the State or by donors. Depending on their method of operation, they may contribute either to destructuring the institutional landscape or to gradually creating new synergies with the districts. In particular, it can be supposed that without the Agetip, the projects would mainly have continued to be performed by a central contracting authority.

Box 3
Absorption and decentralisation capacity

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

Absorption capacity

		Weak	Average	Strong
Decentralisation	Weak	Chad	Cameroon	Tunisia
	Average	Burkina Faso	Ivory Coast	Morocco
	Strong	Mali	Senegal	South Africa

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

- ten years after the relaunch of the credit mechanism for districts (CPSCL), Tunisia suffers from the weakness of decentralised competences;
- amongst the countries in sub-Saharan Africa whose districts have an acceptable level of absorption, we see Cameroon and the Ivory Coast (before the crisis) where donors have not really tried to develop community credit or have done so in a very reserved manner.

3. Changes in the way donors contribute

The main advantage of an organised mechanism to finance local investments is that it allows external aid to be channelled more easily in the direction of local authorities. The importance recently awarded 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 the assessment of the investments financed. These instruments therefore represent potential supports for new forms of intervention in 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 could have reduced the impact of the investments financed, priority being given to small initiatives within the range of local authorities.

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

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

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

- planning initiatives - the production of service land or even of housing needs an institutional environment (operators, procedures) which is rarely created (the examples or negative examples of the Agence de Cession Immobilière in Mali);
- in the field of the environment due to the demand of environmental standards encompassing 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 the field of the urban programming and feasibility studies. Community investment funds have often given preference to long lists of investments selected quickly by the town halls and priority performance agencies without conducting an urban survey beforehand.

One of the policies discussed by the Working Group was the development of the State-district contractual procedure which has already been initiated in several countries whose principal advantage is to favour the support of joint initiatives by several players over the territory of towns [see experience in Ivory Coast (European Union funding) or in Senegal (funding by the World Bank and AFD via the PAC)]. This represents a major event in terms of actual decentralisation (transformation of the State/local authority relationship) and prefigures a new approach on how to conduct urban development initiatives: (i) accountability of town halls in the choice of their investments (ii) coordination effort with the State (iii) management of crossed finance (iv) articulation between the 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 of France has now deteriorated: the margins for manoeuvre in terms of resources are low (receipts granted) whereas in parallel running costs are high; the savings capacity is structurally weak and there is little flexibility with investment expenditure. The recovery strategy adopted therefore consists of 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 arbitrate 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 the 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 community semi-public companies with its limits but which provides useful experience; concessions; restructuring of building work; looking into public-private partnerships, notably for schools).

3 The various systems of finance

Which method is best-suited to finance towns through borrowing in developing countries? What financial resources will the financing body have? What legal form will it be in? 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?

These questions were debated by the Working Group on the basis of a matrix of the various 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 use in countries where local authorities make use of borrowing. Each column corresponds to a characteristic aspect of the systems in use and lists from top to bottom the options by rising order of “usualness”. 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 a rising usualness so there is no static reference model.

Table 3
Analysis of financial systems

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 authorities (“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	Financial markets		Ordinary market			No privilege

(markets and deposits)	without intermediaries		rates			

Source: MDP preparation manual, World Bank – Group 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 (which 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 between 5-7 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 (like 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.
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 introducing a more or less strong distortion in competition. One of the main options is whether or not the specialised financial institution exists to finance local authorities, and on a subsidiary basis, the competition position in relation to other lenders.

SFI is virtually indispensable when the lending system is very controlled by the State and specific to local authorities. This option is therefore generally taken at the beginning when usage of borrowing to finance local investment is still rare but is expanding under the impulse of the State as part of an itinerant process of decentralisation. This in particular is the choice made by Tunisia and Morocco but also by 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 which make it possible to lend at non-market conditions and therefore discourage competition.

The benefits of the existence of a specialised financial institution for local authorities on the contrary create doubts about the appropriateness of this specialisation in a context where all the authorities that may invest would be of a size and a level of prosperity sufficient to support competition with the other economic agents in order to access credit. The SFI would find it difficult to be competitive in such a context. 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 based to a large extent on the critical size of the market which is not to be found anywhere else. American local authorities directly raise funds on the public markets without banking intermediaries. The system operates (i) there is a sufficient number of potential investors on the domestic market (ii) because the competitiveness of the local authorities' issues on this market is raised by the tax-exempt status granted to the largest proportion of the revenues drawn by the lenders from their investments. The size of the market also allows several ratings agencies to intervene and provide a certain degree of transparency from the assessment of the quality of the issuers. Lastly, the generalisation of 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 sharing of risk.

The analysis matrix also mentions the case where the institution holds the accounts of the local authorities and operates as a mutual body (local authorities are shareholders in the financing body). Generally the institution must on a statutory basis keep the accounts of the local authorities, receive into these accounts the proceeds of the State subsidies and is authorised to deduct directly from these accounts the sums which 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[13].

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

The discussions confirmed a trend recorded a long time ago, that of the underlying movement towards generalisation. This finding currently applies to bodies of the same type as CPSCL in Tunisia, FEC in Morocco and DBSA or INCA in South Africa. These bodies are confronted each in their measure to the narrowness of their traditional market of action:

- either because the solvency of the client communities is compromised by the insufficient nature of the reforms;
- or because the areas of competence of these local authorities is still too narrow and would necessitate diversification of the activities of the financing body;

[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.

- also because local authorities themselves prefer to make use of other forms of finance which is considered to be more advantageous, such as direct bond issues.

3. Making use of corrective mechanisms

It seems appropriate to list the specifications given during the work of the Working Group on various mechanisms that enable local authorities to access resources more easily:

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

Credit raising

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

Box 5
Credit raising

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 a credit raising 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 which are generally oriented towards the private sector (example of SFI or ARIZ to AFD).

We can, however, quote 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 infrastructures;
- 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 affected by 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 the development of guarantee mechanisms of this type to facilitate the finance of municipal infrastructures 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 financial backer.

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 SFI 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 – 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 Ivory Coast).

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, doubled by the mixing of finance, that is the linkage of the loan with an allocation of a subsidy, the whole thing representing a more or less integrated package (comparison of FEC in Morocco and CPSCL 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[14] due to the constraints which are particular to the mobilisation of the 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 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 of swapping the loans contracted in foreign currency into local currency. The usage of these instruments makes it possible to ward against a future fluctuation of the exchange parity which would be unfavourable to the borrower.

[14] It should be noted that subsidised lending was used on a large-scale 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).

4 The dominant model - the specialised financial institution

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

The countries which have developed credit mechanisms to districts have mostly orientated themselves towards setting up specialised financial institutions. This option is most often selected at the beginning when usage of borrowing to finance local investment is still rare but is still growing under the impetus of the State as part of a itinerant 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, reticence of local managers to borrow at market conditions, 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 their 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 which grant loans which are often subsidised (and in some cases highly subsidised) to local authorities and loans to other institutions investing in urban infrastructures.

Long since 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[15] for around 20 years these institutions have been transposed into the context of the developing countries with the fervent support of donors who consider them to be a comfortable receptacle for APD.

They take several forms with varying degrees of institutionalisation and varying degrees of 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 the communities are primarily perceived as dismemberments of the State. The effect in terms of the financing of community investments is reflected by mechanisms with greater administrative content, as opposed to the systems encountered in English-speaking countries, generally having recourse to State guarantee;

[15] See for example DEXIA history described in Appendix 2

- The 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% (Ivory Coast, Cameroon, Senegal);

Box 6

3. Specialised financial institution scenarios

Scenario 1: investment fund that includes a marginal portion of community credit and therefore no or a very modest level of revolving credit; financed by the State and public development aid mainly from the World Bank, AFD and KfW. Examples: AFD (Senegal), FPCL (Ivory Coast), FEICOM (Cameroon), FICOM (Burkina Faso).

Scenario 2: the specialised financial institution financed by the State and public development aid (mainly the World Bank, AFD and KFW). Mostly practice a medium and long-term credit policy to communities 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 degree of desire by the State to control the financing systems put in place (statutes and procedures);
- a time in the life cycle of the institution: each institution finds itself at a well-defined stage of its development process, intimately linked to the degree of autonomy of the municipalities and their management capacities.

In the less developed systems, where the major problem concerns customer solvency, we mainly come across funds which are sometimes called equipment funds or investment funds[16] which grant subsidies or a mixture of subsidy and lending, with a marginal proportion of credit, so no or a very modest level of revolving credit. They appeared in French-speaking Africa towards the end of the 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; (ii) the loan gives visibility over the medium and long-term financing of the 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).

[16] FEICOM in Cameroon, FPCL in the Ivory Coast, FICOM in Burkina Faso, ADM in Senegal

Box 7

Agence de Développement Municipal - Senegal

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).

The ADM is considerably different from the CCC: (1) it addresses all districts in Senegal; (2) on the basis of a "complete service": the community is supported in the programming of its investments and benefits from automatic finance from ATM 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 needs of 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 community signs a Town Contract with the State to which is attached an ADM community financing agreement, and most importantly, programmed for strengthening capacities, 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 communities FECL - to ATM 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 the insufficient quality of usage (local authorities are considered to be potential borrowers but the solvency of the communities is not, however guaranteed), we come across lending institutions[17] which really start 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 although in a very contained way. It is a question of contributing to improving the solvency of the local authorities which at the same time would expand the market. In order to do this, the specialised financial institution mostly employs a policy of medium and long-term credit to communities under subsidised terms (mixed with subsidies, State guarantee).

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

In fact this generic model presents highly variable characteristics in particular in two areas - the autonomy of the institution in relation to the State and the origin of its resources. These points are developed below.

Volume of activity

[17] CPSCL (Tunisia), FEC in Morocco, DBSA (South Africa and SADC)

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 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 existing 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 per capita in South Africa, 8 Tunisia and 4 in Morocco and around 2 in Senegal, that is 25% of the investments of Southern African communities, 65% of investments in Tunisian communities and over 80% of investments in Senegalese communities.

Table 4
Activities of the specialised financial institutions

Country	SFI	Period	Amount	in millions of euros	per annum	%	Urban population	Investments 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	2	26	4
Morocco	FEC	1998-2003	4 bn dh	389	65	1	17	4
Tunisia	CPSCL	1998-2000	450 m. dt	298	50	13	6	8
Senegal	ADM	1997-2003	100 m. USD	80	11	3	5	2
Total					393	10	81	5

Resources

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

ADM or CPSCL, for example, derive a significant portion of funding from the State (approximately 50% of the finance and granted by CPSCL and 10% - 20% for ADM) which are then allocated to communities in the form of subsidies. In parallel these two institutions access external loans contracted with donors, mainly the World Bank and AFD. CPSCL, unlike ADM, finances one third of the loans granted to communities 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 guarantee from of the State from 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, since 1997 it has been directly active on the futures debt instrument market and the interbank market. Because the State no longer covers the exchange risks, the FEC makes growing use of the Moroccan bond and monetary market.

The situation is different again in South Africa where DBSA and INCA obtain finance essentially on the financial markets; DBSA has an AAA rating, 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, ADB, KfW). As we see, as is the case with South African institutions, and when the context allows it, municipal authorities attempt to raise funds on the capital markets.

This is a favourable development which makes it possible to capture household savings.

This being so, there are very few municipal authorities which inspire the confidence amongst private investors. The majority of them are not considered to be solvent (low level of own resources and limited management ability). We should add that it has happened that specialised financial institutions that have the possibility of obtaining resources on the market, are offered lines of credit 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 way beyond offering credit. They aim to improve the management of local finances and to ensure that a certain number of projects will be carried out, including 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 the assistance is all more crucial since the local authorities are at an early stage of development.

Repayment rate

Generally speaking, the repayment rate is far below the rates which would be viable from commercial point of view[18]. Far from being abnormal, this effect is accompanied by the local authorities' process of learning. Nevertheless, this process of learning is not always optimum.

It does happen that municipal authorities which are unable to repay their loans are not penalised and, are even able to borrow again (repayment becomes particularly problematic when the local authorities have the feeling that they were not involved in the decision to invest) which means that some authors say that this system does not always strengthen the credibility of local authorities, does not prepare the field for lending by the market. But it would be difficult for it to be otherwise - the municipal authorities know that the central government will not abandon them. Therefore the challenge of a support program consists of strengthening the encouragement of local authorities to make repayments (maximum borrowing levels defined on the basis of future capacities to mobilise resources etc). It is interesting to see that two institutions which have excellent repayment rates (MUFIS in the Czech Republic and FINDENTER in Columbia) are

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

institutions which lend to municipalities through private commercial banks. The commercial bank assumes the risk. But this system can only work if 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 put in place with, in the background, control of the decentralisation process and community activity. It also depends on the depths of the market. When the specialised financial institutions act on a deep market, as is the case in South Africa, they can 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, making the granting of finance to local authorities part of the process of strengthening their management and absorption capacity.

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

However the major question that remains is that of the positioning of the specialised financial institution and its gradual transformation into "something else" as soon as its purpose is no longer known, 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 the competition with the 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 so it is appropriate to prepare for this.

In this respect various problems can be mentioned relating to the risks of the non-virtuous development of the specialised financial institution, which would lead to a blockage in the development of local authorities. Firstly, the specialised financial institution could by means of the preferential conditions that it offers (partly thanks to the subsidies it receives) find itself systematically in a monopolistic situation, dissuading commercial banks from entering the market for financing local authorities. A sub-optimal credit market for local authorities would result. Credit to local authorities there 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.

Also this situation would not be effective enough in terms of the allocation of local resources because the local savings available from the often over-liquid commercial banks would be underused - not made available to the local authorities which need it. Naturally the specialised financial institution can mobilise such resources through bond issues. Also it needs to have the capacity to manage growing volumes of loans.

To summarise, the pre-eminence of the specialised financial institutions could lead to the rationing of the resources of local authorities and go against the challenge of collecting local savings and directing it towards the local authorities market over longer periods than the traditional banking sector does.

We should add that intermediate-income countries are facing an additional difficulty: the donors, the funds or the specialised financial institutions that they receive, lend in foreign currencies. However, municipal authorities find it expensive to guarantee against foreign exchange risk. In effect hedging against foreign exchange risk implies entering into a contract with an intermediary bank which, in addition to the cost of the financial product itself, will charge for the counterparty risk. In terms of the product, the most suitable is undoubtedly a currency swap which makes it possible to transform a loan in currency A into currency B[19] 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 specialised financial institution once it has become autonomous and no longer benefits from subsidised resources, on a market where it is in competition with commercial banks. The specialised financial institution is not deposit-taking bank. It therefore has access to more expensive resources. Its positioning then becomes uncertain and its future can be compromised. Its strong points are risk assessment, knowledge of the market, the technical nature and particularly the subsidies of the donors or the State. But how does this system develop once the comparative advantage of the specialised financial institution becomes less obvious compared with other types of lenders because the municipal authorities become less of a risk? The specialised financial institution 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. But this is rare.

Specialised financial institutions which specialise in lending to communities are required to develop gradually. This challenge arose and continues to arise for Dexia. Appendix 1 illustrates the trajectory of this institution in five stages: as a public institution, it firstly responded to the reconstruction needs in France after the war under the supervision of a highly-centralised State, amongst still weak local authorities (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 financed and advised increasingly mature local authorities and developed in order to retain a competitive advantage, benefiting from the reform of the capital markets. It was privatised whilst retaining its specific features and comparative advantage in the financing of local authorities. It then reformed in order to follow the development of modern finance whilst the same time strengthening its role amongst local authorities.

The issue of virtuous development of institutions such as CPSCL 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 good knowledge of the range of the local authorities. And this need for closeness is incompatible with the idea

[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.

of a "regional mission". The other possibility would be to merge the CPSCL into the system for generalist banks in the market.

5. Using bond issues to fund municipal investments

Should we move towards a diversification of systems for funding investments, incorporating the use of bond issues for districts? Do the resources mobilised in this way work out less expensive? Does such a system makes 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 authorities. These experiences are concentrated primarily in Asia: India and the Philippines[20]. Bond resources offer more flexible characteristics. They can be accessed with intermediation (commercial bank or SFI) or without (direct bond issue). In both cases, the issuing organisation (local authorities or financing body) must have been rated beforehand.

In addition, there is a threshold effect. The bond issue must reach a minimum amount justifying the expenses incurred: rating, use of an arranger, advertising, reinsurance. Set against a backdrop of districts 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 securitization and credit raising. They are intended to meet two goals, namely to reduce the cost of resources and to enable local authorities to take the plunge in relation to direct or indirect access to the market.

Local authorities have used the market to fund projects rather than district-level investments. The projects often involve greater transparency, a higher level of profitability and therefore more guarantees. In this way, Tunisia (State) is planning to conduct a bond issue on the market for its national programme to build 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 in relation to 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,

[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.

• Legal fees,
• Listing fees,
• Rating or raising costs.

In total, the yield to maturity, net of tax, comes out at around 4 to 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 for guarantees and the services not being billed for.

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).

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

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

Inset 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 Asian Development Bank. It has a capital of 25 billion rupees (500 million euros). The amount of outstanding debt stands at 3 billion euros[21].

HUDCO has 1,121 employees and 41 agencies located throughout the country. Its activities include the construction of housing 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.

Inset 9.

The Development Credit Authority (USAID)

Through this instrument, the 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.

• A 100 million dollar loan (80% of the project) granted by the Urban Development Corporation (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 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

[21] 40 Rs = USD 1 = EUR 0.8.

relatively healthy financial position. It was rated A+ in 1996, then AA in connection with the first bond issue.

Inset 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 districts, 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 forecastability 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) the 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, in the same way as 34 other towns and municipal water services.

The main concern at present relates to securing repayments to investors or subscribers. Within this framework, the USAID is drawing on the example of the city of Ahmedabad in order to put in place automatic allocation systems for certain resources in order 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 subscriptions up 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 authorities factoring in the major transfers of skills from the State over to districts. These transfers were accompanied by the creation of an allocation system (split taxation), designed to contribute to increasing and securing district resources.

Five years later (1996), new legislation came into force: (i) making it possible for districts 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 general objective is to facilitate district access to a wider range of financial resources in order to fund their investments, given that their situation is considered to have become healthier in part and that efforts are being made through the various projects to strengthen their services.

At the time these provisions were adopted in 1996, districts 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 districts short-term loans as well as overdraft facilities and long-term credit lines, with some 270 million dollars in loans outstanding with districts.

• The Municipal Development Fund (MDF), created in 1984 and supplied with credit lines from the World Bank, ADB 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 districts.

The two options looked into 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 as follows: (i) the BOT put in place as of 1990 by the city of Manila for work to rebuild the Mandaluyong market following a fire and its transformation into a modern shopping centre, (ii) the 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 infrastructures and housing projects for the poor, there are still a number of major constraints: (i) no tax-exemption facilities for interest, (ii) obligation for the government to use certain banks for depositing its funds, (iii) difficulties faced by districts in identifying projects on which the coverage of costs is sufficiently guaranteed to enable this type of financing. In addition, there is no secondary market: bonds are subscribed for by institutional investors (banks, insurance companies), which limits the prospects for the development of this type of funding. Lastly, the government obliges districts to use of the national bank services for issue transactions.

Inset 11.

Bond financing conditions in the Philippines

Legal framework

• The 1991 local authorities code formally gives districts the possibility to carry out bond issues,

• The use of bond issues is only authorised for financing certain clearly identified projects; these projects must be based on a recovery of costs or housing projects for the poor, carried out by private operators,

• Projects must be included in the district's development plan, which in turn must be consistent with the nationwide investment plan,

• The district must record the annual cost of debt generated through these bond issues in its budget.

Taxation

The government has implemented a certain number of promotional measures:

• 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 for,

• 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 charge has become too much and the State has partially withdrawn from this, only guaranteeing interest up to 8.5%. In addition, the contribution of 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 withdrawn in full. The use of bond issues is therefore limited only to the main towns, when these are able to prove their solvency. This situation led the Philippine Banking Association in conjunction with the Philippine Development Bank and 54 commercial banks to put in place a privatised guarantee mechanism in 1998: the Local Government Units Guarantee Corporation.
This fund only guarantees projects with a high possibility of recovering costs and districts with a minimum rating. The fund has signed an agreement with the USAID, which reinsures 30% of the portfolio. The cost of the guarantee comes out at 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 district 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 someway behind the use of commercial banks, but is starting to find its niche.

Johannesburg, 2005

Johannesburg, rated A-, conducted its first municipal bond issue since the end of apartheid in April 2004. This issue was carried out in two tranches:
• 1st tranche: 1 billion rands maturing in 6 years at a rate of 2.3% over the government rate (April 6, 2004),
• 2nd tranche: 1 billion rands 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 (June 25, 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 notably aimed to contribute to financing the “road, railway and water network maintenance” section of the Douala Infrastructure Programme (PID) funded by the IDA. The issue has been secured based on the signature of a crossed debt agreement in favour of the CUD 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 then the city contract that is under negotiation.
The operation is set to be 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 for districts,
• The issuing district 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

• Districts must be formally authorised to conduct bond issues (laws, regulations, etc.),
• In general, the use of bond issues is restricted by the texts or provisions in force to certain types of project or operation, accompanied by a certain number of guarantees (recovery of costs, balanced operation),
• The district 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 districts and districts with lower ratings,
• These mechanisms may be supported by donor agencies.

Appendix 1.
Presentations given at meetings

October 15, 2003

• Presentation of the approach and inventory of experiences (Groupe Huit).

• Relative contribution to an "innovative operation by Dexia for the city of Tlalnepantla in Mexico" (Marie-Alice Lallemant).

• "The financing of urban public services and local authorities in Tunisia", by M. Hammami, head of local finances and MDP (communicated by Niels Devernois).

February 2, 2004

• Presentation of the resources issue (Groupe Huit).

• Presentation of the "INCA activity (SAR) and securitization 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 interventions" (Philippe Lecrinier, AFD).

• Presentation on "the transformation of short-term resources into long-term loans" (Jean-Yves Gourvez, CNCE).

• Presentation of the "municipal bond guarantee mechanism put in place in the Philippines" (Groupe Huit).

• Presentation of the "experience with launching a bond issue by the city of Ahmedabad in India" (Groupe Huit).

April 5, 2004

• Presentation of the employment issue (Groupe Huit).

• Presentation of the "implication 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 on the "AFD's support for the Fort de France district" (Mathieu Discour, AFD).

Appendix 2.
Three basic references for local authority financing systems

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

• The case of France, which has inspired many SFIs,

• The case of Belgium, which represents a reference for mutualist SFIs funded by local authorities,

• The case of the US, the yardstick for the generalised system of financing through municipal bonds.

Appendix 2. three basic references: the case of France

1. The case of France

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

The system in place stems from a number of changes that, without going too far back in time, are marked by a number of key dates:

1966: creation of the Caisse d'Aide à l'Equipement 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, trivialisation of credit;

1987: creation of Crédit Local de France, which replaces the CAECL, but remains a public company;

1993: privatisation of Crédit Local de France;

1996: creation of the DEXIA group through the economic merger of Crédit Local de France and Crédit Communal de Belgique.

This development represents above all a gradual and unscheduled adaptation in light of changes in the environment, heavily marked by the context of the in-depth changes seen on economic structures over the last 30 years. In this respect, it cannot serve as an example for future developments in another country. However, it may provide a few indications in order to mark out, through a transposition, what is actually possible.

CAECL (1966-1986): organisation and activities

The CAECL was created in 1966 to meet two requirements:

• 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 fuelled by the strong growth that was characteristic of the period;

• In addition, these subsidised loans were linked to the financing of operations that had to be subsidised by the State, therefore meeting criteria defined by the State. And yet, a growing number of local authorities wanted to be able to free themselves up in part from this supervision and fund other facilities than those meeting the objectives set by the State.

Created with a status as a public administrative institution, the CAECL remains under the strict control of the Caisse des Dépôts et Consignation, which handles its management, serves as its only 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 local elected representatives and civil servants, with its legal status and financial independence allowing it to build up recognition in the financial world.

Above all else, the existence of a dedicated organisation for the funding of 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 as of this time 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 borrowing among local authorities rose from 2.4 billion to 14 billion.

Lastly, the CAECL is not required to comply with the obligation for local authorities to deposit their free funds with the Treasury: since half of the funds waiting to be used come from loans taken out by local authorities with the Caisse des Dépôts and Caisses d'Epargne are 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 embarking on 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 are primarily made up of two legally different bond products:

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

• The bonds issued by "cities in France" are grouped together on behalf of local authorities, which are directly debited for them, with however the CAECL's guarantee.

These issues are to a great extent free from the constraints associated with direct issues; they are carried out every three months with tranches from 500 million to 1 billion francs at the time.

The reasons behind this 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: the percentage of market-rate CAECL loans began to stagnate.

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

• The decentralisation laws and,

• The "trivialisation" of credit further to the 1984 banking law.

Without entering into all the consequences (which are numerous) of the decentralisation laws, these had two main effects on financing conditions:

• Stimulation of demand for loans, primarily for large local authorities (regions and departments) as a result of the transfer of competences from the State over to these local authorities (the transfer of secondary schools to regions represents a key example of this);

• Generalisation of globalised financing for the investment budget no longer referring, as before, to the subsidies obtained or the balance for each operation looked at independently.

Indeed, local authorities were given total independence in relation to their budgetary choices, in principle free from any opportunity controls.

The trivialisation of credit, which moreover represented a genuine revolution for France's economy, had a wide range of consequences for local authorities:

• Phasing out of preferential-rate loans, with the rather stagnant resources linked to tax-exempt savings now reserved for the funding of local authority housing;

• Expansion of the loan offering to all credit institutions, with the possibility to play on the competition;

• Diversification of loan products that had until now been limited to a narrow range of fixed-rate loans;
• 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 – “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 public 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 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 first lender to local authorities with 45% of new loan flows, whereas local authorities' long-term debt had increased by 40% in current francs since 1982. To a great extent, this change was not only down to circumstances, but also 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, thereby prefiguring a capacity to cope with a fully competitive situation.
The CAECL was rich, having built up management surpluses all the more easily since the services that it received from the Caisse des Dépôts were not billed at their actual cost. Its reserves totalled 9 billion francs, a fortune arousing the State' interest and discontent among local authorities, which believed that this wealth had been amassed at their expense. Within this context, a change in the parliamentary majority occurred, facilitating the rapid culmination of the project (which could no longer be ignored) to denationalise the CAECL.
Further to intense lobbying and various trials and tribulations linked notably 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), Crédit Local de France (CLF), with a capital split between the State (47.5%), the Caisse des Dépôts (25%) and the Caisses d’Epargne (7%), with the remainder held by a certain number of institutional investors, including first-rate foreign financial institutions such as Crédit Communal de Belgique (CCB).
The personnel remained part of the Caisse des Dépôts, notably made available in the 22 regional divisions making up the CLF commercial network.

Trivialisation 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, concerns 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 the predominance of a liberal economic model for over 10 years, the credit sector in France regularly goes back 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 on specific collections (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 - Crédit Local de France – that has managed, good year or bad, to keep a market share of between 40% and 50%, without any preferential rights at all, with the exception of the image advantage mentioned above;

• This specialised body is therefore 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 as a result of the predominance of a long-term or even very long-term loan activity (up to 50 years at present), which means that it is obliged to adapt its process for collecting resources to factor in this specific feature, notably 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-employment match

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

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, unlike organisations that are able to use the diversity of their resources and the partial, if not marginal, nature of their long-term credit activity compared with their total activities as shock absorbers. More specifically, during a period of rising rates, the CLF struggles to remain competitive.

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

The volume issue 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, it is vital, on account of the importance of local investments in France, as soon as the rest of the economy (households, businesses) expresses stronger demand with regard to the traditional lender offering.

CLF: "benchmark banker"?

Another aspect of the CLF's function concerns its role as a benchmark banker. During the first few 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 on account of its pricing policy;

• Above all, an undisputed specialist in risk analysis for “local authorities” - 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 required to develop an equivalent level of expertise;

• Lastly, the CLF’s main value added has from the outset been its ongoing commitment to innovating in order to create financing products enabling local authorities to benefit from market opportunities as effectively as possible, 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, as outlined above, from the effects of heightened competition on pricing. The financial analysis expertise of local authorities remains a strong point, but is no longer a monopoly. Nevertheless, it represents the basis for a highly diversified range of services that is greatly appreciated by the customers of the CLF, effectively contributing to maintaining its market share. Lastly, the innovation effort on financing products is being pursued, on the whole maintaining the CLF’s genuine technological lead, although most of its creations are very quickly copied by its rivals, which have themselves managed to pull ahead on certain niches.

Its long-term viability is still under constant threat by the laws of the market. The undeniable financial success of Crédit local de France must not hide the fact that its survival has only been safeguarded at a 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 European group with diversified activities.

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 since the state, both directly and through the CDC, still has a slim majority, but it is no longer a public company.

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 is still made up of civil servants from the CDC, now on secondments) and sets up its own network of regional divisions. In addition, its bylaws are amended. Previously a company with a management and supervisory board, the CLF 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 economic 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, correspond to the same economic content.
The CCB brings new businesses to the group: retail banking in Belgium, private banking and asset management through its Banque Internationale (BIL) subsidiary in Luxembourg. Above all, the doubling of its solvency in terms of shareholders 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. The Case of Belgium

Indeed, it is important to describe the experience here of the CCB, which still has a market share of around 90% on loans for local authorities in Belgium.

Historical perspective

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 an public company 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”.
Up until 1996, the CCB’s capital was held by local authorities. Since the creation of the DEXIA holding structure with Crédit Local de France, the districts 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 with the help of resources based on loans placed in the public sector through 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 with a mandate to negotiate with clients (franchise). In 1967-1970, the CCB introduced demand accounts for retail customers and diversified its activities and services intended for both public and private customers (loans, diversified range of banking services). It offered all the same services as a commercial bank.

Current status and purpose

The law of April 16, 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 logic 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, which intends to remain the privileged partner of public authorities.
Its share capital is held in full by the 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 December 31, 1998, it accounts for 15% of Belgian savings and 90% of financing for public authorities (representing 45% of its assets). 65% of local authority financing is based on direct credits, with 35% on subscriptions for securities issued.
In addition the CCB is developing financing techniques blending the short and medium-term through the management of current accounts for districts and the processing of their financial transactions. In this way, it is able to offer them access to the monetary and financial markets, thanks to its dealing 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 Banque Internationale Luxembourgeoise, in which it is the majority shareholder, and Crédit Local de France, and on account of its excellent rating, 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 December 31, 1998:
- 602 billion Belgian francs in deposits and savings
- 947 billion Belgian francs in bank certificates
- 333 billion Belgian francs in undertaking 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 conditions 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 districts.

Loans are granted for anywhere from five to 20 years. They are repaid through annuities or in only one instalment: this is the case of bridge loans on income that the district 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 anyway assess the opportunity associated with the project,
• The guarantee, based on the delegation on ordinary income centralised in the account of the borrowing district, authorises the CCB to allocate income to repaying the loan.
Interest rates are set based on 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 district'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.

2. The case of the US
Whereas in Europe, local authority 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 authorities.
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 down 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 infrastructures in the US, include: (i) general obligation bonds, which are guaranteed by the taxation power of the States and local authorities; 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.

Appendix 2.

Three basic references: the case of the United States

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 for 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-70s and Orange County at the beginning of the 90s. 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 (privilege 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 infrastructures, 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.

Appendix 3.
Glossary

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.

Floor/cap

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

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.

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.

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.

EURIBOR (Euro Interbank Offered Rate)

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

UDP, MDP

Urban development project, municipal development project.

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.

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.

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 gravity and independence are recognised by the financial markets.

Refinancing

New issue of debt securities by a company of 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.

Credit raising

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).

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 faced with the entire sector.

Scoring

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

Underwriter

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

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).

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).

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.

MSBR

Monthly state borrowing rate.

BMR

Bond market rate.

Appendix 4.
List of abbreviations

ADM: Agence de Développement Municipal (Senegal)
AFD: Agence Française de Développement
AFD ARIZ: dedicated AFD guarantee fund for banks and institutions
AFD CEFEB: AFD banking, economic and financial research centre
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 infrastructures department
ANICT: Agence nationale d'Investissement des Collectivités Territoriales (Mali)
ADB: African Development Bank
BALO: France's official gazette
EIB: European Investment Bank
BHS: Banque de l'Habitat du Sénégal
IBRD: World Bank (International Bank for Reconstruction and Development)
WB: World Bank
BOT: Build Operate Transfer
CAC: Centimes Additionnels Communaux (Cameroon)
CACEM: Communauté d'Agglomération de la Martinique
CAECL: Caisse d'Aide à l'Equipement 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
LA: local authorities
CLF: Crédit Local de France
CODEVI: Compte pour le Développement Industriel
CPCT: Caisse des Prêts aux Collectivités Territoriales (Niger)
CPSCL: 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)
DCA: Development Credit Authority (India)
DGCID MAE: Direction Générale de la Coopération Internationale et du Développement - French Ministry for Foreign Affairs (France)
BFR: Belgian franc
FCCL: Fonds Commun des Collectivités Locales (Tunisia)
FEC: Fonds d'Equipement Communal (Morocco)
FECL: Fonds d'Equipement des Collectivités Locales (Senegal)
FEICOM: Fonds d'Equipement et d'Intervention Communal (Cameroon)
FGIC: Financial Guaranty Insurance Company
FIAU: Fonds d'Investissement et d'Aménagement Urbain (Ivory Coast)
FICOM: Fonds d'Investissement Communal (Burkina Faso)
FINDENTER: Financiera de Desarollo Territorial (Colombia)

FODECOM: Fonds de Démarrage des Communes (Burkina Faso)
FPCL: Fonds de Prêts aux Collectivités Locales (Ivory Coast)
FRAR: Fonds Régional d'Aménagement Rural (Ivory Coast)
FSA: Financial Services Authority
HDFC: Housing and Urban Finance Corporation (India)
HGC: Housing Guarantee Corporation
HUDCO: Housing and Urban Development Company (India)
IDA: International Development Agency
SFI: specialised financial institution
INCA: Infrastructure Finance Corporation (South Africa)
IRD: Institut de Recherche pour le Développement
ISTED: Institut des Sciences et des Techniques de l'Equipement et de l'Environnement pour le Développement
JBIC: Japan Bank for International Cooperation
KfW: Kreditanstalt für Wiederaufbau. (Germany)
LGLA: Local Government Loans Authority (Kenya)
LGUGC: Local Government Units Guarantee Corporation
MDF: Municipal Development Fund
MUFIS: Municipal Infrastructure Finance Program (Czech Republic)
PAC: Programme d'Appui aux Communes (Senegal)
PDCC: Projet de Développement des Communes Côtières (Ivory Coast)
MDP: municipal development project (Tunisia)
MDP: municipal development programme (Benin)
UDP: Urban development project
DC: developing country
PID: Programme d'Infrastructures de Douala (Cameroon)
LDC: least developed countries
SMI: small and medium-sized industries
UNDP: United Nations Development Programme
PPP: public-private partnership
IIC: intermediate-income country
PROPARCO: Promotion et Participation pour la Coopération économique (AFD)
PSDAT: Programme de Soutien à la Décentralisation et à l'Aménagement du Territoire (Ivory Coast)
SAR: South African Republic
SADC: Southern Africa Development Community
SAGEDECOM: Services d'Appui à la Gestion et au Développement Communal (Burkina Faso)
ME: mixed enterprise
SFI: Société Financière Internationale
AMR: annual monetary rate
MSBR: monthly state borrowing rate
BMR: Bond market rate
UDIC: Shanghai municipality investment agency
EU: European Union
UNCHS: United Nations centre for human settlements: UN Habitat
USAID: United States Agency for International Development
USD: US dollar
PSZ: priority solidarity zone

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