Overview of municipal pooled financing practices

prepared for the participants of the European Study Tour

written and compiled
by Lars M Andersson,
October 2015

Document realized in conjunction with a study Tour organized by IFC and FMDV to Agence France Locale in Lyon, France, and Kommunekredit in Copenhagen, Denmark

IFC International Finance Corporation WORLD BANK GROUP
FMDV Supporting local authorities to access funding
PPIAF Enabling Infrastructure Investment

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Local Government Finance Glossary

PFM
Pooled Financing Mechanisms, different ways of cooperation between local authorities with the aim of achieving cost-efficient financing for local infrastructure projects.

LGFA
Local Government Funding Agency, a type of pooled financing vehicle that is common in Europe, but also used in New Zealand. Typically, majority-owned by local authorities.

Municipal Bond Bank
A pooled financing vehicle used predominantly in the USA. Typically, owned by the state.

Club deal
A one-off bond issue in which a number of local authorities participate. Each local authority is responsible for their part of the bond issue.

SPV
Special Purpose Vehicle, an entity created for a special reason, for example for pooled financing.

Joint and several guarantee
A guarantee where the guarantors are both severally and jointly liable for any claims under the guarantee (all for one, one for all). Used by, for example, Kommunekredit (Denmark) and Kommuninvest (Sweden).

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...and more papers and articles written by Lars M Andersson:

Additional key questions and more

Article in Local Government Chronicle 2013

Article in Municipal Journal 2013

Article in Municipal Journal 2015

Finance Cooperation Between Local Authorities in Developing Countries

Local Government Finance in Europe - Trends to Create Local Government Funding Agencies

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Background and Options

“Everything we know about economic growth says that a well-educated population and high-quality infrastructure are crucial.”

Paul Krugman, Nobel Prize winner,
“America goes dark, New York times, Aug. 8, 2010”

Challenges of today and tomorrow

Government on all levels around the world are striving to support growth in the aftermath of the recent financial crises. Some are doing well, others less so. In developed countries, as well as in emerging markets and developing countries, growth is required if we are to successfully deal with the challenges of our time.

And there are challenges! We are in the position to have very good knowledge of at least two major trends that will greatly affect the cities of today and tomorrow.

Urbanisation moves at a rapid pace all over the world. In 2007, for the first time in history, the urban population of the world outnumbered the rural. Two thirds of the world’s population is projected to live in cities by 2050. According to the World Urbanization Prospects (UN 2014) “Africa and Asia are urbanizing faster than the other regions and are projected to become 56 and 64 per cent urban, respectively, by 2050”.

This produces a set of difficult questions that need to be addressed:

- a rapidly increased need for public services and infrastructure investment in big cities. Infrastructure is essential in order for society to function. There is often an urgent need to upgrade systems for transportation of goods and people (commuters). New education facilities are needed, and so on. This produces a pressure to increase investment plans and the necessity to have access to financing.
- the necessity to provide local services in rural local authorities with less income (from taxes or fees). To be able to, for example, provide for the elderly who do not move to cities to the same extent as young people. Furthermore, rural authorities have the challenge of keeping the workforce for the production of the needed public services.

Another global challenge is climate change. The United Nations’ Intergovernmental Panel on Climate Change (IPCC) presented a part of its fifth Assessment Report in September 2013. The research assessed by IPCC indicates that climate change is, with a probability of 95 percent, caused by mankind. If nothing is done, temperatures will rise and so will the sea level. According to the IPCC, the only chance to limit the rise in temperature to 2°C is to radically reduce emissions.

Whatever the reasons behind global warming, it will deeply involve every part of society. For local authorities, climate change will call for investments and adjustments of the production of public services.

Even though these challenges must be addressed at the national level, their nature also points to an important role for local governments. It is the local politicians of the cities who will be at the forefront dealing with expanding cities and sustainable local development. This ordeal arrives at a time when local authorities in the developed countries are in a weak position due to cuts in state grants and rising social cost. In many emerging and developing countries institutional and financial relations with the national level remain unclear, although efforts to decentralise are part of a global trend.

Investment and growth

The communiqué from the meeting of the finance ministers and central bank governors of the G20 in February 2014 stated that higher infrastructure investment "is crucial for the global economy's transition to stronger growth". It is now a recognized fact that infrastructure investment is the most important mean to get the wheels of global economy moving again. In the World Economic Outlook (IMF October 2014), it is argued that there is a huge need for public investments and that now is the time to move to action. But the problem reaches further than low investment levels in new infrastructure. The quality of existing public asset is deteriorating. The challenge extends to maintaining old investments alongside pursuing new ones.

In the report from IMF, the authors establish the fact that "public capital has declined significantly as a share of output over the past three decades in both advanced and developing countries". The conclusion drawn from this is that public infrastructure investments give such a boost to GDP that "the public-debt-to-GDP ratio does not rise. In other words, public infrastructure investments would pay for itself, if done correctly".

Within the OECD countries, local authorities are responsible for two thirds of all public investments. With the challenges that the world is facing, it is fair to say that local authorities will have to bear much of the burden of local infrastructure investments also in countries outside of the OECD. This means that possibilities for local authorities to work efficiently are key to overall growth. There are two aspects that are specifically important: the prioritisation of investment projects and their financing.

Financing local infrastructure investment

Local government infrastructure investments can be financed through:

- Own revenues (local taxes and/or fees and charges)
- Transfers from central government
- Borrowing from banks or issuing debt in the capital market
- Private financing; Public Private Partnership (PPP), etc.

It is a fact that local authorities' powers to impose taxes, rates, charges and/or fees are in many cases limited in both developed and developing countries. This is in spite of the frequently present rhetoric of decentralisation. Real decentralisation does not happen if the control of local finance remains in the hand of the central government. A change is required if cities and other local authorities are to successfully meet future challenges. For developing countries, the problem extends beyond the lack of powers to introduce and maintain own-source revenues. The system for collecting local taxes and charges are in many countries inefficient and in need of improvement. When it comes to transfers from central government to local authorities, there is a call for long-term predictability and stability. Otherwise, long-term planning becomes extremely difficult. Reforms are necessary in a number of countries also for these reasons. To summarise: the deciding factor concerning the possibilities to employ own revenues and/or transfers for the financing of local investment is the level of decentralisation in the respective countries.

The nature of local infrastructure investment makes it very difficult to use just one of the sources

listed above. The use of debt is almost unavoidable as one of the means of financing. Debt is also an efficient tool to distribute the cost of an investment over the generations that will use it. This requires that cities must be given legal and other conditions to finance investments through borrowing.

However, in order not to become over-indebted a part of the financing should come from own sources or from central government. Again, central government should clear the way for more efficient use of local taxation and employ long-term and stable systems for transfers to the local level. This is also a central consideration when using the debt instrument, which would presuppose a certain level of creditworthiness or, in other words, the ability to repay loans in a timely fashion.

One particular question in loan financing is the duration of the loans. In principle, the lifetime of the investment should be a point of reference. This is the case in many countries where we see loans with duration of 20 to 40 years. In other countries, such as Sweden, local authorities have taken advantages of the lower interest rates at the shorter end of the yield curve. This produces a considerable refinancing risk, both in term of being able to refinance the actual loan but also risking substantially higher interest rates. This happened during the financial crises and has caused great difficulties for the local authorities. It is recommended to have a well-diversified loan portfolio with duration closer to the life of the investment, for the reason that the production of local public services requires a stable and foreseeable economy.

A number of financial instruments could be connected to the borrowing. In many countries, there is a debate over which of these instruments should be allowed for the local authorities to use. In France, some of the local authorities have used the so-called toxic instruments, which have caused losses. In the UK, the use of derivatives has been ruled ultra vires in the famous example of Hammersmith & Fulham.

The following conditions is needed to efficiently use debt as a mean of financing:

- Legal capacity
- Institutional capacity
- Knowledge and skills
- A developed market for loans and/or bond issues

Even if this is fulfilled (which globally still is quite rare), there is one additional problem for cities and other local authorities: They are often relatively small and do not have sufficient funding needs to attract the attention of creditors.

A large part of the local authorities borrowing have been provided by banks, both commercial and development banks. This situation is now likely to change. The cause for this is twofold:

- As a result of the financial crisis from 2008, banks have seen their credit rating falling. Not one single commercial bank can show a AAA-rating and very few a AA-rating. The result is, of course, higher refinancing costs and a need to raise margins.

- The Basel III accord, planned to be implemented gradually until 2018, includes higher capital requirements and a new demand for liquidity. This will limit the scoop of bank lending and will give priority to lenders that will accept high margins. Banks are already adjusting to these new rules, with the result that lending to local authorities has decreased substantially. The Basel III regulations will be implemented in many countries around the world. In most developed countries the implementation of these regulation will be a gradual process from now until 2018. Many emerging and developing countries will also implement these rules, but the timing may differ from one country to the other.

One alternative to bank loans is bond issues in the domestic or international capital markets. The fact that most local authorities are small with limited borrowing needs make it difficult to use bonds for financing. Even big cities are struggling to have a frequent participation. And, without frequency in bond issuance the whole procedure becomes inefficient and expensive. The financial markets require not only liquid issues but also high creditworthiness. Transaction costs are also attached to individual bond issues, such as marketing (road shows), credit rating and legal assistance.

On the other hand, the use of bonds can be very cost-efficient for a frequent issuer with a good reputation in the capital markets.

Let’s have a closer look at financial instruments that could be available:

General obligation bonds

This means that the bonds are backed by the general creditworthiness of the issuer.

Asset backed bonds

This is a bond issue that is guaranteed by the asset it is financing. You can say that this is the same as a mortgage and it means that investments that generate a big positive cash-flow will get good conditions in the bond market.

Revenue bonds

This is a bond issue guaranteed by an income stream. It could be the fees paid by users of, for example, the water produced at the facility. Both asset backed bonds and revenue bonds means that the local authority puts aside either an asset or an income stream as collateral for a loan. This could lead to a situation where the creditworthiness of the local authority becomes like a Swiss cheese. In other words, it risks to erode the general creditworthiness of the local authority.

Retail bonds

This is a bond issue targeted to individuals. In other words, it is a bond with small denominations suitable for investing your own savings. The advantage is that, if successfully placed in the market, retail bonds are very stable over time (many investors – stable secondary market). The disadvantage is that a great deal of marketing is needed to reach private investors and to build confidence. Retail bonds are sometimes thought of as a local bond issue where the residents of a local authority can invest their saving into bonds issue by the same local authority. This gives a further incentive to buy these bonds, if you think that it is directed to a good cause and you still get a fairly good interest. But, on the other hand, if many investors at some point in time react adversely to the measures taken by the local politicians, there could be a massive sell-out of the bonds.

Sale and lease back

This means that you sell an asset, in most cases real estate, and then lease it back. The companies involved in this business have in the vast majority more expensive financing costs than a local authority. The only situation where this could lead to lower costs for the local authority is when there is a tax incentive. So why are these solutions marketed to local authorities? The marketing often involves the argument that it improves the balance sheet. This argument is, in this case, irrelevant to a local authority, if it does not lead to lower costs.

Public Private Partnerships

A Public Private Partnership (PPP) is a form for the procurement of public investments and the management of these. The model was widely introduced during the Thatcher-era in Great Britain and became there subsequently known there under the name of Public Finance Initiative (PFI).

The general definition of PPP is that the public sector enters into an agreement with private companies, usually a consortium, to build, operate and finance a public investment in, for example, roads, schools, hospitals etc. The private companies form a Special Purpose Vehicle (SPV) for the investment in question. In some instances the public sector could also be part owners of this SPV, but this is rare. PPP agreements tend to be long; 30 – 40 years.

Two types of PPP could be seen:

- The current expenditure related to the investments, operations and financing is covered by the public sector in the form of a yearly fee. This applies to, for example, schools and hospitals.
- The current expenditure related to the investments, operations and financing is covered by user fees. This applies to building and maintenance of roads and bridges.

The perceived advantages with PPP that are commonly mentioned are

- Encouraging the allocation of risks to those most able to manage them, achieving overall cost efficiency and greater certainty of success.
- Delivery to time and price. The private sector is not paid until the asset has been delivered which encourages timely delivery. PFI construction contracts are fixed price contracts with financial consequences for contractors if delivered late.
- Encouraging ongoing maintenance by constructing assets with more efficient and transparent whole-life costs. Many conventionally funded projects fail to consider whole-life costs.

- Encouraging innovation and good design through the use of output specifications in design and construction, and increased productivity and quality in delivery.

This model has been more and more criticised over the last 5 - 8 years. This criticism can be summarised in the following points:

Financing; the cost of financing is always higher for the private sector compared with the public sector. Recently the cost of borrowing for private companies has further risen as an effect of the financial crises and stricter banking rules.

- Cost efficiency; in a number of evaluations there are no proofs of lower total costs than if the project was done in a conventional way. Of course, this depends partly on the higher financing costs when the PPP model is used.

- Transfer of risks; it is not clear to what extent risks are being transferred to the public sector. The Treasury Committee of the UK House of Commons writes in a report in 2011 that *risk can be fully transferred only if the procuring authority could abandon a failing PFI concession, which is unlikely ever to be the case.*[1]

- Procurement; PPP-projects are often very complicated and it requires the companies competing for these deals to spend quite a lot of time and money in the process of constructing the offer. This has led to a situation were competition for PPP-contracts has diminished over time.

- Secondary market; many PPP-projects have been resold by the private owners with huge profits, which goes to show inefficiencies of the original pricing.

1 House of Commons, Treasury Committee, Private Finance Initiative, 2011, page 21.

A way forward

As noted above, the use of bonds can be very cost-efficient for a frequent issuer with a good reputation in the capital markets. The good news is that this can be achieved trough cooperation between local authorities and, since they have more or less the same tasks within a country, they are particularly well suited for cooperation. This type of cooperation is often called Pooled Financing Mechanisms (PFM).

The PFM concept has mainly been applied in the developing world, but a few examples can be found in developing countries and there is nothing that intrinsically forecloses a future in which it becomes a much more common strategy around the world. PFMs can develop to be crucial facilitator of the financing of local infrastructure investments in emerging market and developing countries. It is also a process that supports capacity building in local authorities. Financing infrastructure and building independent capacity in local authorities are crucial concerns in the OECD economies, but even more so in places that are less economically developed. As always, great care has to be put into the adjustment to local contexts when these kinds of mechanism are implemented, and it is important that the stakeholders have a local background. The PFM concept is founded on that it is malleable and that it varies in composition considering the economic situation, local government structure and other factors on the ground. It is not a one-fits-all scheme, but a project that needs to grow from the bottom up to service particular contexts.

What is Pooled Financing Mechanisms (PFM) for local authorities?

Definition and purpose

The wide definition of pooled financing is the co-operation between local authorities with a focus on financing local infrastructure investments through external debt sources.

Applying PFM has several *potential* advantages:

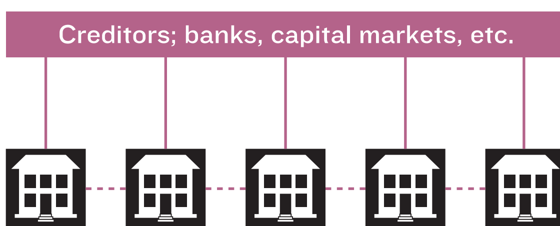
- It gives small and medium size local authorities access to capital markets
- It reduces the cost of borrowing
- It reduces the processing costs
- It reduces risk through diversification, even for big cities
- It reduces risk by providing financial expertise
- It gives incentives to improve creditworthiness
- It is a conduit for the transfer of knowledge
- It increases transparency

PFM does not remove the decision making power of the individual local authority and should be used in open competition with other sources of funding. PFM should be viewed as a complement to other sources of funding.

Levels of PFM

PFM can be constructed in many different ways. A basic level is a group of local authorities working closely together on financial issues without actually borrowing together. They can coordinate their borrowing activities and exchange best practises such as, for example, risk policies. This can include using similar procurement processes in relation to banks and other creditors. There are cases when neighbouring local authorities have agreed on a joint head of finance to further coordinate the financial questions, while the decision making power still resides with the council of each local authority.

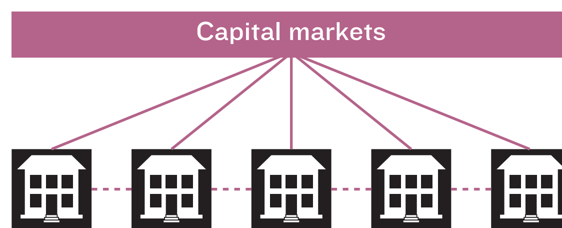
Basic level



The medium level is a so-called "club deal". This is a bond issue in which two or more cities participate and it is done without a special purpose vehicle. Each participating city is responsible for its part of the payment of interests and capital. The main advantages of club deals are that they give small and medium size local authorities access to the capital markets and that they are flexible in the sense that the group of issuers (local authorities) could be differently compounded for each club deal (bond issue). The disadvantage is that they are structurally and legally complicated, which produces costs that to some degree could offset a good pricing of the bonds.

The medium level is suitable for countries with institutional and legal restrains to develop PFM to the advanced level (see below). It could also be a step towards the advanced level, while it gives involved local authorities experience of the capital markets and tests the spirit of cooperation between these authorities. In order to be able to successfully replicate a club-deal, an organised platform is required.

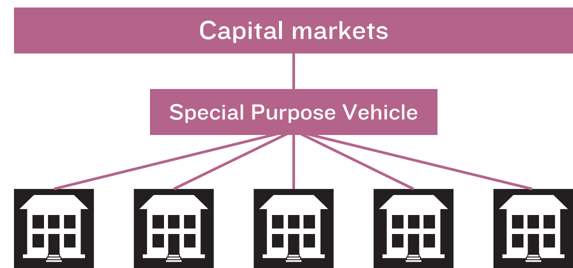
Medium level



A third step is to create a special purpose vehicle (SPV) to act as an intermediary between the cities and the capital markets. The big advantage with a SPV is that it can reach sufficient volumes in its borrowing to diversify its funding operations and achieve cost-efficient pricing in the capital mar-

kets. Diversification also means reduction of risk in the manner that the SPV is not reliant solely on one source of funding or even on one market. The fact that a SPV can employ financial experts to run the operations also reduces the risk. This kind of entity has to have economic strength to be credible to investors. Economic strength, which in this case is the same as creditworthiness, can be gained through sufficient capitalisation and reinforced by guarantees. The guarantors can either be the participating cities, central government, a third party (e.g. public sector pension funds) or a mix of them. The advantage of having a guarantee from the participating cities is that it reinforces the local responsibility for the SPV.

ADVANCED LEVEL



One type of PFM SPV, which can mainly be found in Europe, is Local Government Funding Agencies (LGFA). A LFGA is a cooperation project where local authorities jointly own the agency, sometimes together with a minor ownership of the state.

Arguments for PFM

The rationale behind establishing cooperation in the form of PFM can be divided into the following points:

- Local authorities are by matter of definition small entities. Small borrowers – like small and medium sized municipalities – get less attention from banks and capital markets than big borrowers. This means that a large part of the financial markets are closed to small borrowers, whether they are public or private entities.
- Capital markets require volume. A bond issue has to be of considerable size in order to attract investors.
- Processing costs for pooled financing are considerably lower than if the local entities borrow on their own.
- Financial expertise is often scarce in local authorities since their primary focus is on providing appropriate basic services to the public. Cooperation provides opportunity to employ financial experts. This reduces risks.
- PFM can also be structured in a way that it reduces risk both for investors and the local authority.
- PFM gives incentives to improve the local governments' creditworthiness with the aim of amplifying the cooperating group's joint creditworthiness.
- In all of the known cases, the use of PFM has led to cost reductions for the local authorities in their financial management.

Professionalism, transparency and local democracy

A fully developed PFM with a SPV is a public tool for local development and growth. The construction of such an entity is a project for fiscal decentralisation. Real decentralisation can only happen when local authorities have power over their finances and the access to funding sources for local infrastructure investments. Such powers and possibilities also increase the local accountability for questions concerning local development.

In a situation where central government transfers

and bank financing are not enough to cope with the growing need for local investment, PFM has the potential to give access to capital markets. This is a route to cost-efficient financing, which has been proven by all of the existing PFM agencies.

A PFM agency has to apply a high degree of transparency for a number of reasons. Firstly, the capital markets will require full disclosure of financial information of the agency and participating authorities. Secondly, the most important asset of a PFM agency is its creditworthiness. The latter, in turn, is built upon the creditworthiness of the participating cities, which is why the financial status of these has to be monitored on an on-going basis. It is also essential that the agency is transparent and that it issues comprehensive reports of its activities for the benefit of the involved cities and other stakeholders. Financial information, thus, has to be freely supplied by the cities in the PFM. A large part of this information will be public, which means that it will enhance public understanding of the authorities' activities and thus support local democracy.

A fully developed PFM agency also has the potential to reduce risk through:

1 Prudent asset-liability management and liquidity policies. This means, among other things, using structured financial products only for hedging purposes in their funding and to totally refrain from so called "toxic loans" in the lending. Matching of the duration of assets and liabilities is important, especially in the first phase of activities of an agency.

2 Diversification of borrowing with the use of different markets, different instruments and by targeting a number of different investor groups. An agency has a far better possibility to diversify its funding than a single local authority, because of the size of its operations. Diversification can be achieved by using a number of loan products, loan programmes and markets. The diversification that a PFM makes possible, not only for small local authorities but also larger cities to join this type of cooperation.

When, for example, one market is not functioning well, there are others that will be targeted. The diversification of funding was one of the major reasons why the existing PFM agencies were not hit by the recent financial crises.

3 Professionalism, where the political decisions are separated from the professional. In a PFM agency the political level should be dealing with questions related to overall strategy; questions related to the participating local authorities (capital, guarantees, supervision etc.); and with the follow-up of the professional level. The duties of the professional level, on the other hand, are to prepare the questions for the political level and to handle all financial activities. This not only secures low-risk activities, but also prevents undue influences in the lending activities.

4 Supervision of the cities and local authorities involved as shareholders/members in the PFM. This gives incentives to improve local creditworthiness through peer pressure, which has often proven to be the most efficient way of improving local performance.

Furthermore, PFM schemes can transfer knowledge to the participating local authorities. The existing PFM agencies regularly organise conferences, workshops and consultations.

It should also be stressed that PFM agencies are strongly recommended to work in open competition with other suppliers of loans to cities and other local authorities. The PFM will in that way constantly have to prove itself and its usefulness. Furthermore, this will invigorate competition. There are many examples where the absence of financial cooperation between local authorities has led to a situation of oligopoly, where a few players can steer the market for municipal loans.

Experiences of PFM

Overview

PFM exist in many countries and have many different forms. In Europe, the Local Government Funding Agencies (LGFA) dominate. The oldest is the Danish agency, Kommunekredit, created in 1898 and a recent addition is the French agency, Agence France Locale, which saw the light of the day in October 2013. A LGFA is a special purpose agency owned by local authorities and, in some occasions, with minority shares held by central government or other public stakeholders. It issues bonds in the capital markets, domestically and internationally, and on-lends the proceeds to local authorities that are members/shareholders of the agency.

The US Municipal Bond Banks have a slightly different set-up. They are usually closely related to the various state administrations. The oldest Municipal Bond Banks are to be found in the states of New England, but the concept has also spread to other parts of the USA. In Canada, there are provincial entities for financing local authorities in a number of provinces, for example in British Columbia and Alberta.

The state owned Japan Finance Corporation for Municipal Enterprises was in 2008 converted into Japan Finance Organization for Municipalities (JFM), owned by Japanese local governments.

The New Zealand LGFA was created in 2011 and, recently, the Australian state of Victoria has formed its Local Government Funding Vehicle.

Also in emerging and developing countries, pooled financing has been developed. Two examples are the Indian Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL) and Bond Banks in Mexico. TNUIFSL is a Public Private Partnership with a wider scope of activities than, for example, the European LGFAs, since members of its staff also act as consultants and investment advisors. Mexican Bond Bank-type entities exist in the states of Hidalgo and Quintana Roo.

European Local Government Funding Agencies (LGFAs)

LGFAs have a long and successful history in northern Europe. During the last few years, new additions to the list below are the French Agence France Locale and the UK Municipal Bond Agency.

In Denmark, a LGFA was created as early as 1898. Kommunekredit is a cooperative society and all Danish local authorities have voluntarily joined. The agency is now dominating the market of local government credits in Denmark. Kommunekredit issues bonds in various capital markets, with the support of a joint and several guarantee signed by the members, and then on-lends the proceeds to the local authorities. The guarantee has been in force since the creation of Kommunekredit, but has never been used.

The Norwegian agency has a different background and set-up. Kommunalbanken was established in 1926 by the Norwegian State, at a

LGFA	Country	Creation year
Kommunekredit	Denmark	1898
Bank Nederlandse Gemeenten (BNG)	The Netherlands	1914
Kommunalbanken (NKB)	Norway	1926
Nederlandse Waterschapsbank (NWB)	The Netherlands	1954
Kommuninvest	Sweden	1986
Munifin	Finland	1990
Agence France Locale (AFL)	France	2013
UK Municipal Bond Agency	UK	2014

time when the local authorities were under great pressure. During its history, the agency has had some changes in the ownership structure, but it is now back in the hands of the central government of Norway.

Kommuninvest in Sweden was created in 1986. At that time, the Swedish local authorities were heavily reliant on bank loans for their investments. The competition among the banks were not optimal and they showed signs of oligopoly. Local authorities were charged with interest rates that in no way reflected their creditworthiness. This made a group of local authorities in a region in central Sweden to take the initiative to create Kommuninvest. Over the years more and more local authorities have joined the cooperative society of Kommuninvest and now over 90 percent of all regional and local authorities in Sweden are members. The Swedish agency has radically changed the market for loans to local authorities. Kommuninvest operates, in the financial markets, with a joint and several guarantee from its members. This guarantee, as in the case of Denmark, has never been used.

The Finnish agency Municipality Finance (Munifin) was created in 1990. Munifin is a joint-stock company in which municipalities, municipal federations and companies, owned by municipalities, hold the majority of the ownership. Additional shareholders are the Local Government Pensions Institution and the Republic of Finland. Munifin is guaranteed by the Municipal Guarantee Board (MGB), which is a public law body.

In the Netherlands, the Bank Nederlandse Gemeenten (BNG) was established in 1914 as a specialised financial institution for the public sector. BNG is a statutory two-tier company under Dutch law (*structuurvennootschap*) and is owned by the Dutch State, 11 provinces and 406 municipalities. BNG has a market share of around 60 percent of the Dutch municipal sector.

Also in the Netherlands, Nederlandse Waterschapsbank (NWB) was established in 1954 as a specialised lending institution to provide Dutch local governments and water boards with funding at cost-efficient levels. All of the bank's funding was government-guaranteed until July 1989. The explicit support was subsequently withdrawn as part of a wider government policy of reducing public participation and guarantees.

Business model

All the European LGFAs have more or less the same business model. The agencies issue bonds in domestic and international capital markets and on-lend the proceeds to local authorities and to related entities (for example municipal owned companies). When bond issues are made in foreign currencies, they are transformed into domestic currency by the agencies with the use of swaps. All lending to local authorities is made in domestic currency. The agencies deploy strict risk management routines, including tight matching of borrowing to lending. For this, the mature agencies use a portfolio view, while new agencies often deploy back-to-back matching.

The agency is created for the good of the local authorities and does not seek a priori to make profits. Surplus in the accounts of the agency is reinvested in its activities, with the aim of better serving the local authorities. LGFAs work solely (with lending) within the borders of their respective countries.

Guarantees

Guarantees are widely used by the existing agencies to transport the creditworthiness of the local authorities to the agencies, and to emphasise the local authorities' responsibility for the agency. The Danish Kommunekredit and the Swedish Kommuninvest are, for example, backed by joint and several guarantees signed by their members. In the 116-year history of Kommunekredit and the soon 30-year history of Kommuninvest these guarantees have never been called. These types of guarantee systems require close and ongoing scrutiny of the creditworthiness of the agency's members. This supervision of the financial situation in the local authorities is also an integral part in the work to strengthen local creditworthiness.

Munifin is guaranteed by the Municipal Guarantee Board (MGB), which is a public law body established by the 487/1996 Act on the Municipal Guarantee Board. The membership of the MGB consists of 303 (as of 1 January 2013) Finnish municipalities, representing 99.95 % of the population of Finland.

Members/shareholders

Kommunekredit and Kommuninvest are organised as cooperative societies where only local au-

thorities can be members. Agence France Locale has a set-up with a limited company, where only local and regional authorities can be shareholders. In conclusion, local authorities own 100 percent of these agencies.

The other agencies are owned as follows:

Bank Nederlandse Gemeenten (BNG)
Dutch State 50 %
Provinces 3,6 %
Municipalities 46,4 %

Kommunalbanken (NKB)
Norweigan State 100%

Nederlandse Waterschapsbank (NWB)
Water boards 81%
Dutch State 17%
Provinces 2% (Ownership restricted to the Dutch State and "other legal entities governed by public law")

Munifin
Local authorities 53%
Local Government Pensions Institution 31%
Finnish State 16%

Capital

The agencies' capital is supplied by their members/shareholders. Two examples: Kommuninvest has basically a system where the members' (local authorities) contribution is calculated with reference to their population. The basic model for Agence France Locale is to calculate the contribution with reference to the balance sheet of the local authority. The leverage ratio (capital vs. total assets) varies from 1 to 3.5 percent.

Accessibility and the supervision of creditworthiness

In principle, a LGFA is open for all regional and local authorities under the condition that they meet the financial standards set by the members/shareholders of the agency. It is very important that the prerequisites for entering into the LGFA be strict and transparent. Many of the agencies have the power to refuse membership to local authorities with poor creditworthiness and also to exclude members with rising financial problems.

The creditworthiness of the members of the LGFA is assessed by many of the agencies at least once a year. In Sweden's Kommuninvest the areas of monitoring are: Financial results, Liquidity, Capacity, Commitments and Internal and External influences.

Legal status

All European LGFAs, except Kommunkredit and the UK Municipal Bond Agency, are considered to be financial institutions under domestic and EU law. Kommunekredit is explicitly exempt from being a financial institution by the EU Directive. The UK Municipal Bond Agency is not considered by UK law to be a financial institution.

It should be noted that most PFM agencies in other parts of the world are more often public entities and not subject to financial regulations.

Credit rating, borrowing and lending

Kommunkredit, Kommuninvest and Kommunalbanken have the credit ratings of AAA/Aaa from S&P and Moody's respectively, while Munifin, BNG and NWB are assigned the ratings of AA+/Aaa. During 2014, the Scandinavian and Dutch agencies issued bonds in various capital markets for a total amount of close to €70 billion. These bonds are now, in the eyes of the investors, a specific asset class that is very much in demand.

Earlier this year (2015), as an example, the Swedish Kommuninvest did a 1.25bn US-dollar bond issue of which nearly 80 percent was bought by central banks and international organisations. Re-offer spread to US treasuries was 24.4bp. The cost of Kommuninvest's borrowing is more than 30bp less compared to local authority borrowing from other sources. Kommuninvest has a total lending portfolio of SEK 223bn (€ 24bn) and the administrative costs that are required to run the agency are equal to 8bp. The equivalent for the other mature European agencies is between 7 – 15bp.

In Denmark, Kommunekredit has virtually 100 percent of the market for loans to local authorities. The agency applies a margin of 25bp on loans.

It should be noted that it is very difficult to perform an evaluation of real savings when the local authorities, under a longer period, have worked through a LGFA. The reason is that these agencies are now market leaders, which means that other lenders have had to make price adjustments.

When Kommuninvest began its activities in 1986 the savings were more than 200bp. What happened then was that banks and other lenders had to decrease their margins in order to stay in the market. This means that these agencies also stimulate competition and lead to a better functioning market for loans to local authorities.

New Agencies are created in Europe

Agence France Locale (AFL)

The creation of AFL

A possible French agency started to be discussed as early as at the turn of the century. During 2004 – 2008 a number of so-called “club- deals” were successfully carried through. This was organised by the Association des communautés urbaines de France (ACUF), one of the local government associations in France. The first club-deal was issued in 2004 with 11 participating local authorities and the sixth was issued a year before the creation of AFL with 44 local authorities. These exercises showed the need for an agency, since “club-deals” are in practise very cumbersome to coordinate. Furthermore an agency can produce better interest rates than a group of local authorities using “club-deals”.

In 2010 three of the local authorities’ organisations, Association de Maires de France (AMF), Association de communautés urbaines de France (ACUF) and Association des Maires des grandes villes de France (AMGVF), formed an association: Association d’étude pour l’agence de financement des collectivités locales (AEAFCL). This association’s role was to coordinate the work needed to create a local government funding agency. Apart from the founding associations, around 50 local authorities joined the AEAFCL from the beginning. Over the following year another 30 local authorities joined together with six other local authority organisations: Fédération des villes moyennes (now Villes de France), Assemblée des communautés de France, Association des Maires Ruraux de France, Assemblée des départements de France, Association des régions de France, Association des petites villes de France. Among the local authorities that are members of the AEAFCL, one can find the cities of Lyon, Lille, Bordeaux, Grenoble and Strasbourg. The membership fees were differentiated by type of local authority and size:

Cities with less then 20 000 inhabitants	€ 3 000
Cities with 20 000 – 100 000 inhabitants	€ 5 000
Cities with 100 000 – 500 000 inhabitants	€ 10 000
Cities with more than 500 000 inhabitants	€ 15 000
Départements with less then 500 000 inhabitants	€ 10 000
Départements with more than 500 000 inhabitants	€ 15 000
Regions	€ 15 000

The AEAFCL appointed a working group mainly with financial directors from of its member municipalities. A group of advisors was also procured, with the role to assist the working group in outlining a comprehensive report, containing all major elements that are needed in order to create an agency. The group of advisors that were commissioned consisted of Natixis (Yves Millardet), AB Mårten Andersson Productions (Lars M Andersson), HSBC, Willkie Farr & Gallagher (law firm) and Ernst & Young.

The work was organised in four modules, with separate meetings (working group + advisors) for each of them:

- Module 1: legal form
- Module 2: capital and governance
- Module 3: creditworthiness and supervision of members
- Module 4: financial model, accounting and organisation

The advising group made preparations for each module and then the subject was discussed with the working group. On the basis of these discussions, the advisors produced a final report (FR) submitted to the AEAFCL in July 2011. The FR was approved by the general assembly of the AEAFCL September 20, 2011. From this date the lobbying towards central government and other entities was intensified. The advisors did additional work, as for example drafting the articles of association, in 2012.

The president of France, François Hollande, gave a green light for the creation of the agency during the mayors' early conference in November 2012. During the spring 2013 the law that was required for the creation of the agency, successfully passed the Senate and the National Assembly. Agence France Locale was created October 22, 2013.

The costs of the preparation phase

The total cost for commissioned work (the advising group) could be estimated to around €600 000. This did not take into account the cost of the personnel of the local government associations and local authorities that worked on the project.

Legal status

AFL is considered to be a financial institution and has a licence to act as such by the Autorité de contrôle prudentiel et de résolution (ACPR).

Business model

AFL has applied the same business model as the other European LGFAs. That is, borrowing on the capital markets and on-lending the proceeds to the local authorities that are shareholders/members of the agency. Local authorities are scrutinised before they are accepted as shareholders/members and then annually to secure that sufficient creditworthiness. AFL has the possibility to decline a loan to a member whose creditworthiness has deteriorated.

Lending is only made in Euros and is free from any so called "toxic" financial instruments. The agency has applied strict risk and asset/liability management rules.

Shareholders/members

AFL has already over a hundred members, including the region of Pays de la Loire, cities like Lyon, Bordeaux, Lille, Strasbourg, but also a number of small communes.

Guarantees

AFL creditors benefit from a dual-guarantee mechanism:

1 A several guarantee
Each member local authority acts as a guarantor up to the amount of its total outstanding borrowings (principal, interests and incidentals) with AFL.

2 A joint system
Members called by creditors in case of AFL's default enjoy immediate recourse to the other members so as to ensure a joint liability guarantee system.

Ratings, borrowing and lending

AFL is assigned a credit rating of Aa2 by Moody's, which is one notch below the French State. The rating was assigned before the first bond issue and could be expected to improve once the agency has proved its business model.

Recently, the agency launched its first bond issue. The issue of €750m was within hours oversubscribed up to €1.3bn and ended up with a margin of only 22bp over the French State. Among the investors were central banks, international organisations, pension funds, asset managers and others. In other words, the bond issue was a huge success that is ensuring French local authorities cost-efficient borrowing for investment purposes.

UK Municipal Bond Agency (MBA)

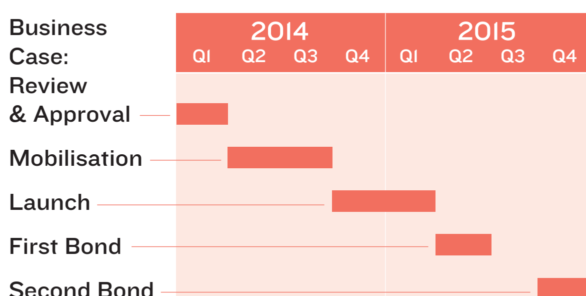
The creation of MBA

The central government entity Public Works Loan Board (PWLB) has been the dominating lender to local authorities in the UK, with a market share of 75 percent. In October 2010 the PWLB raised their margin over Gilts to 100 bp. This margin was lowered to 80 bp, in November 2012, for the local authorities that could supply details of

funding requirements in advance. In November 2013, the rates were lowered to 60bp, but only for infrastructure projects nominated by a Local Enterprise Partnership.

The English Local Government Association (LGA), together with the Welsh Local Government Association (WLGA), started to explore the possibilities of creating a Municipal Bond Agency in 2011. This project was carried out in cooperation with Local Partnerships, an entity jointly owned by the LGA and the Treasury (50/50). In January 2012 an outline business case was presented. This action probably triggered the PWLB to lower their rate the same year, which in turn was one of the reasons why the Municipal Bond Agency project did not gain momentum at that time.

The question of creating a Municipal Bond Agency was raised again by the LGA in 2013, which commissioned three advisors to review the Outline Business Case of 2012 and to suggest a way forward. Aidan Brady (ex. Deutsche bank) was the lead advisor with Francis Breedon (Professor of Economics and Finance at Queen Mary University of London) and Lars M Andersson as strategic advisors. Their report was delivered in March 2014, presenting evidence for why a Municipal Bond Agency should be created. The report was approved by the LGA and this is now being followed by talks with local governments. By November 2013, already around twenty local authorities had agreed to work with the LGA on creating the agency. Among those local authorities one can find Birmingham City Council, Cambridgeshire County Council, City of London Corporation and Newcastle City Council. The report delivered by the advisors envisages the following timeline for the continuation of the project:



The agency was formally created, according to plan, during the 3rd quarter of 2014. The launch of the first bond issue has been slightly delayed, but is now planned for September/October 2015.

Mobilisation costs

In the report of March 2014, the mobilisation costs, up until an operational agency, are estimated at approximately £800 000.

Financial projections for the agency

The agency is expected to reach break-even during 2017 and to have covered the initial losses by 2019/2020.

Business model

The business model is similar to the other European LGFAs.

Legal status

Under UK law the agency is not considered to be a financial institution and is hence not subject to financial regulations.

Shareholders/members

Local authorities hold a majority of the shares with a minority shareholding of the Local Government Association. The number of shareholding local authorities is likely to increase to 56 in the near future.

Guarantees

The advisors have proposed that a joint and several guarantee from local authorities involved in the activities of the agency back the UK Municipal Bond Agency. Before the first bond issue, this guarantee will be underwritten by the members/shareholders.

Borrowing and lending

The UK agency is planning to launch the first bond issue later this year. It is estimated that the margin would be somewhere in the region of 45 – 55bp over Gilts (British Central Government Bonds). This should be compared with the PWLB margin of 80bp.

US and Canadian Agencies

Introduction

Finance Authorities and Bond Banks were created in Canada and USA from 1956, although the decade that saw most establishments was the 1970s. These institutions have overall remained small and exist in most cases as agents of the provincial governments or the state administrations, organized as independent authorities with their own commissioners or board of directors.

Many of these entities have been successful, but on the other hand, their activities have not grown in any substantial way. To some extent this is the result of that many of them exist in small provinces (Canada) and states (USA), though this is not always the case. Both Ontario (population 13,6) and California (population 38,8) have institutions, but also these are small.

The only institution that has lived up to its potential, i.e. grown in a manner one can expect for the size of the population, is the Municipal Finance Authority of British Columbia (MFABC). It is also the only agency that resembles European LGFAs in that it is owned by the local authorities and is thus independent from state and province. It also has a joint and several guarantee. It is thus a singular case in North America, with the exception of having inspired the First Nations Finance Authority (also based in BC) that is run along the same principles. In general, however, the agencies in North America are small, underdeveloped and vehicles of provinces and states rather than local authorities.

Canada

There are seven Canadian municipal finance authorities and corporations. One, the First Nations Finance Authority (FNFA), lends to communities under first nation governments across Canada. The other six each operate in one of the nation's ten provinces. This leaves four provinces (and the three territories) without municipal finance authorities. The majority of these authorities are owned by the provinces and their debt is also guaranteed by the Crown.

The Canadian agencies were established in a period from 1956 to 2006. The oldest, and also in terms of liabilities largest, is Alberta Capital Finance Authority (ACFA). The youngest is FNFA, given legal status in 2006 and commencing lending in 2012. It is also on of the smallest, and is unlikely to ever become very large as less than half a million of Canadian Indians live under first nation government. ACFA is almost double the size of MFABC, even though the populations of Alberta and British Columbia are roughly similar (Alberta four million and BC four and a half). ACFA had liabilities of $13,500 million CAD in 2013, to be compared to Kommuninvest that in the same year had the equivalent of $30,138 million CAD.

There are only two independent authorities more along the lines of the European LGFAs. The first one of these is Municipal Finance Authority of BC (MFABC), and the second one is FNFA that has its seat in BC and was set up with MFABC as its expressed model. These two agencies work with a joint and several guarantee and are owned by the participating borrowing members who select the board.

The status of ACFA in Alberta is somewhat more hybrid than most of the province owned and operated authorities. The province owns a majority of the shares and appoints a majority of the board. But there are also share owners and board members representing four groups: 1) municipal authorities, regional authorities and health authorities, 2) cities, 3) towns and villages, 4) educational authorities. Its judicial form is a "non-profit Corporation" and "provincial authority [acting] only as an agent of the Alberta crown".

Entities and dates of creation:

Entity	Year
Alberta Capital Finance Authority (ACFA)	1956
Newfoundland and Labrador Municipal Financing Corporation (NMFC)	1964
Municipal Financing Corporation of Saskatchewan (MFC)	1969

Municipal Finance Authority of BC (MFABC)	1970
Nova Scotia Municipal Finance Corporation (NSMFC)	1979
New Brunswick Municipal Finance Corporation	1982
Ontario Infrastructure and Lands Corporation	2005
First Nations Finance Authority (FNFA)	2006

USA

There are around fifteen US Bond Banks in as many states. The oldest one, Vermont Municipal Bond Bank was created in 1969 and the youngest one, Michigan Finance Authority, was the result of mergers of various public finance authorities in the state in 2010. The most intense period of creation of bond banks was in the 1970s and 1980s with only four bond banks created in the period 1990-2015. The bond banks are generally small and under the ownership and direct control of the state governments. They are also directly or indirectly guaranteed by the states. The banks are predominantly to be found in smaller states.

The largest bond bank in terms of its liabilities is the recently amalgamated Michigan Finance Authority. This entity has a broad scope, lending not only to municipalities, but also to schools (public and private), healthcare providers, private colleges and universities, as well as dealing with student loans in the state. The second largest bond bank, Virginia Resources Authority, has a more "normal" set of customers and raises funds mainly for local infrastructure. Overall, the size of the activities of US bond banks is limited. In fact, the total added liabilities of all fifteen-bond banks (including Michigan) do not reach the number of Kommuninvest. The Swedish LGFA thus lends more money than all US bond banks combined.

Most bond banks appear to administer state-wide revolving funds from which loans are supplied to local authorities for specific purposes, often clean-water projects.

The state governors usually appoint the boards of the bond banks and the banks are for the most part administered as part of the state government under either minister of finance or revenue or treasury (or the governor's development bank in Puerto Rico). One of the few exceptions from this top-down model is the Sunshine State Governmental Financing Commission in Florida that began as a joint venture between two governmental units: the cities of Tallahassee and Orlando. The members are presently 13 cities and 2 counties in Florida, and these elect the board.

A number of US bond banks also lend to private interests, such as businesses or non-profit corporations in those states in which they are active.

Entities and dates of creation:

Vermont Municipal Bond Bank (VMBB)	1969
Maine Municipal Bond Bank (MMBB)	1971
Puerto Rico Municipal Finance Agency (MFA)	1972
State of New York Municipal Bond Bank Agency (MBBA)	1972
Alaska Municipal Bond Bank Authority (AMBBA)	1975
North Dakota Public Finance Authority	1975
New Hampshire Municipal Bond Bank (NHMBB)	1977
Illinois Finance Authority (IFA)	1984
Virginia Resources Authority	1984
Indiana Bond Bank	1984
Sunshine State Governmental Financing Commission	1985
New Mexico Finance Authority (NMFM)	1992
Idaho Bond Bank Authority (IBBA)	2001
California Municipal Finance Authority	2004
Michigan Finance Authority	2010

Agencies in Japan, New Zealand and Australia

Japan Finance Organization for Municipalities (JFM)

Japan Finance Corporation for Municipal Enterprises (the former JFM) was originally created as central government institution in 1957. In 2008 this company was transformed into Japan Finance organization for Municipalities (JFM). The whole capital contributed by all local governments (prefectures, cities, towns, villages, and special wards of Tokyo) as a joint fund-raising organization for local governments. JFM began operations October 2008, succeeding to the assets and liabilities of the former JFM. The governing law of the present JFM is Japan Finance Organization for Municipalities Law - Law No. 64 of May 30, 2007.

The objectives of today's JFM are to

- Provide long-term funding at low interest rates to local governments
- Support fund-raising of local governments in the capital markets

JFM has the following credit rating:
S&PA A-
Moody's A1
The ratings of JFM are identical to those of the Japanese Government.

JFM's lending to local authorities have a maximum maturity of 30 years, while the JFM bond issues often have 10 year maturity. This constitutes a risk deriving from the maturity gap between lending and borrowing. To manage this risk JFM have allocated sufficient reserves.

The management philosophy of JFM are summarised in three objectives:

- *Securing Corporate Governance Befitting a Joint Organization of Local Governments*. To secure a system under which local governments assume the responsibility for autonomous and independent management. Furthermore, to ensure corporate governance through appropriate risk management and monitoring operations by the Supervisory Committee and external auditors.

- *Responding Positively to Financial Needs of Local Governments*. To closely follow up financial needs of local governments and changes in their fund-raising environment, and to develop appropriate services accordingly. It will achieve our primary objective: the stable supply of long-term and low-interest funds to local governments.

- *Obtaining the Solid Confidence of Capital Markets*. To obtain confidence from the markets, JFM conducts appropriate risk management, maintains sound financial foundation, and discloses information properly. It will enable us to raise funds in a stable and efficient manner, and to contribute to the sound development of capital markets.

New Zealand Local Government Funding Agency

New Zealand Local Government Funding Agency (NZLGFA) has the objective to provide more efficient funding costs and diversified funding sources for local authorities in New Zealand. Legally, the agency is a Council-Controlled Organisation (CCO) operating under the Local Government Act 2002.

NZLGFA was created in December 2011, after three years of preparations. One of the reasons behind this process was the "infrastructure deficit" in New Zealand. As the agency itself put it: "It was clearly recognised by both central and local government that infrastructure spending would need to increase significantly over the next decade to maintain New Zealand's international competitiveness. To balance this cost between current and future generations, it was inevitable that local government borrowing was set to rise considerably. Having a more efficient funding vehicle on hand would minimise the cost of this additional borrowing."

The process with the aim to create the agency was led by a group of nine councils. Representatives from these nine councils and from the Local Government Association of New Zealand (Local Government New Zealand) formed a steering group. In early 2011 an Establishment Board

was formed, where the central government also were represented. The whole process resulted in “a proposed structure for LGFA that shared some features with peer local government funding agencies in Scandinavia, but with a uniquely kiwi element”.

NZLGFA was incorporated as a limited liability company under the Companies Act 1993 on 1 December 2011, following the enactment of the Local Government Borrowing Act 2011.

NZLGFA is owned 80 percent by local authorities and 20 percent by the central government. There are 31 shareholding local authorities; among these are Auckland Council, Christchurch City Council and Wellington City Council.

A joint and several guarantee by the participating local authorities supports the agency’s borrowing. It is also supported by an initial $500 million liquidity facility from the New Zealand Debt Management Office (NZDMO). Furthermore, NZLGFA has an outsourced services agreement with NZDMO.

NZLGFA’s bond issues are rated AA+ (domestic long term) by Standard and Poor’s and Fitch Ratings.

A new funding vehicle in Australia

In 2014, the Municipal Association of Victoria (MAV) took the initiative to create a funding vehicle for the local authorities within the state of Victoria. The new entity has been given the name Local Government Funding Vehicle (LGFV). The Board of LGFV consists of independents, council representatives and MAV representatives. Day-to day activities are outsourced to subsidiaries of National Bank of Australia-

Moody’s has assigned a Aa2 rating to LGFV. This rating has been given despite the fact that the participating councils are not liable to one another, but will instead severally guarantee their debt obligations. According to Moody’s “The very high credit quality of the participating councils and the mature and supportive institutional framework under which they operate support the ratings”. It continues: “In addition, councils in the State of Victoria enjoy significant revenue flexibility with full discretion on the setting of property taxes, fees and charges, which together account for almost 70% of their total revenues”. The rating is also underpinned by the fact that there has been no historical default by a Victorian Council.

30 councils in Victoria, out of 79, will participate in the inaugural bond issuance. In order to keep the rating for later bond issues, LGFV will apply a council eligibility criteria, “i.e. a new council must not have a negative impact on the rating of new or existing bonds”.

According to an article in the Australian Kanganews, “the potential attraction for councils is clear. Reports released by a number of councils refer to analysis conducted by Ernst & Young suggesting the LGFV will improve councils’ cost of funds by around 100 basis points”. Kanganews also writes that “a number of other states are exploring ways for local authorities to move at least some of their debt funding out of the bank sector”.

Pooled financing in emerging and developing countries

India

Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL) is a Public Limited Company incorporated on 7th November 1996, under the Indian Companies Act, 1956, with a paid-up share capital of Rs.10 Million. TNUIFSL is a Public-Private Partnership in the urban sector, between the Government of Tamilnadu (49 percent) and three all India-Financial-Institutions namely, ICICI Bank Limited, Housing Development Finance Corporation Limited (HDFC), as well as Infrastructure Leasing and Financial Services Limited (IL&FS). The establishment of TNUIFSL was supported by the World Bank with a line of credit. Management of the entity is outsourced to ICICI Bank Ltd.

TNUIFSL can only finance capital expenditure and is authorised to lend to local authorities as well as private corporates if the proceed are to be used, for example, for water supply, sanitation, solid waste management, roads/bridges, transportation.

The services provided by TNUIFSL include

- Project preparation and development (including preparation of Feasibility Study, Detailed Project, Project, City Development Plan, Traffic and Transportation Plan etc);
- Project and financial structuring, appraisals and project management;
- Procurement and Contract Management (for works and consultancy);
- Loan Management and Fund Management;
- Treasury Management;
- Financial and Investment Advisory Services;
- Project and Policy Advisory Services;
- Resource Mobilization Services;
- Capital Market Access to local authorities;
- Transaction Advisory Services (including PPPs);
- Management and other consultancy services

Mexico

A Latin American country that has experiences in the field of PFM is Mexico. In the State of Hidalgo a State Bond Bank was created and did its first pooled financing in 2007. This was followed by a second deal in 2010, where 60 of the state's 84 municipalities participated. A third pooled borrowing was carried out in 2012 with the participation of 20 municipalities. In the State of Quintana Roo the State's water and sewer utilities company, CAPA, accessed financing through a pooled financing transaction in 2007. A couple of years later the SNTA supported the State of Quintana Roo with the structuring of a pooled transaction.

Key questions

Value-base

As noted previously, PFM could be applied in different ways. Two main alternatives are so-called "Club deals" or building an agency for joint bond issuing. In both cases, the question of value-base is central. The value-base that is defined is of great importance and will be a guide in the work to fit together the building blocks of the agency. Many of the European agencies are built on a value-base that could be summarised as follows:

Equality; all local authorities should be treated **equally**. All exceptions should be **logical** and **fair**.

Transparency; the process should be as **open** as possible with free-flowing **information** between the local authorities and the organisers of the PFM project

Involvement; the local authorities should be made to feel that this is **their project**, for which every local authority has a **responsibility**.

Creditworthiness

The single most important question when approaching the capital market is creditworthiness. In the centre of the credit quality of a local authority is the stability and predictability of income, be its own revenues or state transfers. But of course, a number of other facts are important to determine the creditworthiness. Among those are the institutional framework and national legislation, cost structure, debt and local governance.

The credit quality of a bond issue can of course be underpinned by guarantees and/or other support mechanisms, but for the long-term success the internal credit quality of the local authorities needs to be in focus.

When structuring a PFM loan or a PFM agency, it is very important to include build-in incentives to improve the creditworthiness of the participating local authorities. One of the first steps is to decide on a credit quality "floor", meaning minimum requirements for participating. Within a PFM project focus should be on raising this "floor" and to help those below the floor to improve and finally join the activities.

The creditworthiness of many PFM agencies is supported by a joint and several guarantee signed by the participating local authorities. The reasons are generally the following:

1 A joint and several guarantee transport the creditworthiness and the risk weighting of the group of regional and local authorities that have signed the guarantee, to the agency.

2 A joint and several guarantee will focus on the creditworthiness of the strongest guarantors, as opposed to a pro rata guarantee that will focus on the creditworthiness of the weakest guarantor.

3 A joint and several guarantee creates a strong link to the public sector and will make the guarantors responsible and loyal to the agency.

4 A joint and several guarantee will provide an internal pressure to improve creditworthiness among all guarantors.

The need for an organisational base for PFM

The object of introducing PFM, whether through club deals or by creating an agency, should be to obtain a long-term and stable solution, to create a tool for repeated bond issues and reliable lending to local authorities. This requires an organisational set-up with clearly defined governance. If the first aim is to issue club deals, it is recommended to, as a minimum, form a steering group that

would have a mandate that would stretch over several bond issues. It could also be considered to create a more formal association for participating local authorities. If the goal of the process is to create an agency, there are several questions that need to be resolved. Some of the key questions of such a process are discussed below.

Key question for a Local Government Funding Agency (LGFA)

Legal structure

The question about the legal status of the entity is very important. The legal form will vary from one country to the other, but here are some general guidelines that could be given:

1 It has to be a legal status that would not prohibit any activities in which you can foresee that the agency will be involved for, say, the next 10 years (if that is possible). The reason is of course that changing the legal status is very burdensome and that the process of changing may weaken the agencies' position in the markets.

2 It is not a disadvantage to be under the supervision of the financial supervisory authority, for the reason that otherwise opponents can attack the project and claim that it is a risky business that none of the local authorities should be involved in. The only reason to try and stay out of such supervision is if that will limit the activities too much or if the supervision will cause costs for the agency. An alternative would be that another impartial body would carry out the supervision.

3 A legal status that is linked to the public sector is preferred (if such a form exists), for the reason that it will emphasize the public nature of the activities. Furthermore it will make the marketing to investors easier.

4 If possible, one should stay away from the legal status of a bank because banks are likely to be under a lot of rules and restrains for the years to come. Furthermore a banking status will lead the investors' impression of the LGFA in the wrong direction.

Ownership

A LGFA is by definition a local government project and should be governed by the same entities. The reason for this is that it creates a direct responsibility for the LGFA and for the individual authorities' ability to work within this framework. When entering into such a cooperation, the question of creditworthiness is no longer a question only for the individual authority, but for the whole group of authorities working together. If, for example, central government would be the sole owner of a LGFA it is a risk that the local authorities' responsibility would be diluted and that a dependence of state intervention in cases of financial difficulties, would be developed. On the other hand, it could be wise to invite central government to take a minority share of the agency, given that this reinforces the common interest of central and local government to develop local infrastructure.

Other minority owners could be local government pension funds, local government associations etc. If private interests were to be invited as owners, it would raise a number of questions that are not to the benefit of the LGFA, for instance questions of creditworthiness of the LGFA and of public nature of the operations.

Voting rights/governance

The principle of equality leads to a recommendation of one member, one vote. Since, in every country, regional and local authorities are quite different in size (population) it is important not to make any type of authority dominant in the LGFA. If, for example, voting rights would be given according to population, the LGFA would be likely to be seen as the agency of the big cities or big regions. This will inevitable lessen the involvement of the smaller authorities, and hence cause a feeling of lesser responsibility.

The governance questions are, of course, very

important for a LGFA, simply because secure and responsible operations and democratic values are the key to success.

The principles of governance are expressed in a number of documents, for example:

The General Assembly can, for example, establish the following documents:

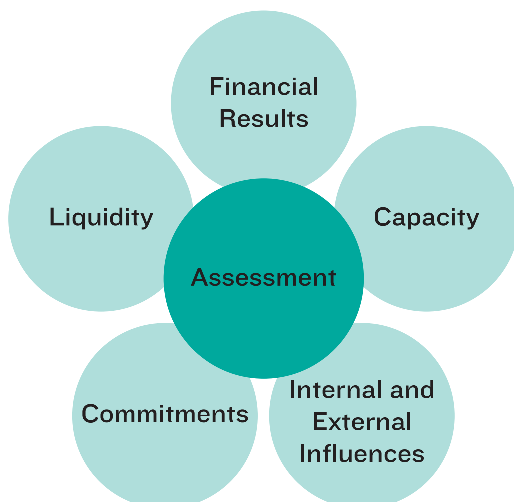
- Articles of Association
- Government Policy
- Code of Conduct
- Instruction for the Board
- Instruction for the Nomination Committee
- Criteria for new members/shareholders
- Owner's Directive (in case of a daughter company, like Kommuninvest and AFL)

The required documents of the above mentioned depends on how extensive the Articles of Association are, if the Government Policy also contains codes of conduct, if the Owner's Directive replaces the Government Policy etc.

The Board of Directors should establish instructions for the CEO and the management group, containing a model for reporting and a risk policy.

Accessibility and supervision

A LGFA should be open for all sub-national public entities, such as regional and local authorities, under the condition that they meet the financial standards set by the members of the agency. It is very important that the prerequisites for entering into the LGFA be strict and transparent. The LGFA should always have the possibilities to refuse membership to local authorities with poor creditworthiness and also to exclude members with rising financial problems.



The creditworthiness of the members of the LGFA should at least be assessed once a year. In Sweden's Kommuninvest the areas of monitoring are described by the this illustration:

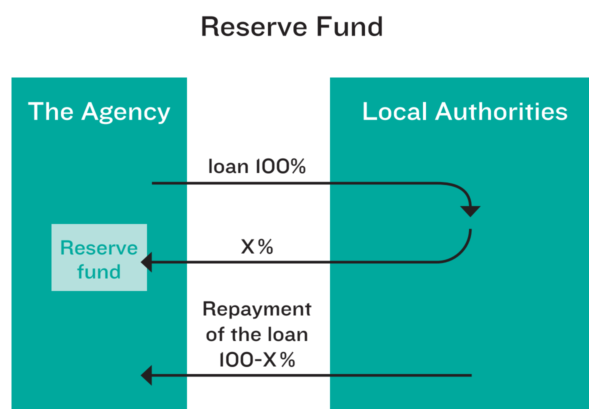
A strict and transparent system for monitoring the creditworthiness of those applying for membership, as well as for the existing members, constitutes an incentive to improvement for each local authority.

Capital

The agency should be supplied with sufficient capital. It is crucial that the agency be perceived as stable in its own rights. The size of capital should be largely depending on whether the agency is guaranteed or if the agency benefits from other support mechanisms. This means that it should reflect the risks within the operations, which are further composed by the creditworthiness of its clients and prudential treasury regulations. And as with every business, you would need a capital in the company that could absorb start up cost and possible negative results before the activities are in full swing.

Above, when discussing the value base, it is recommended that "the local authorities should be made to feel that this is their project, for which every local authority has a responsibility". In order to achieve this, the participating local authorities need to supply at least a part of the capital of the agency, in the form of share capital or participation capital.

In addition to share/participation capital, reserve funds can be implemented, either through external support or within the activities of the agency. An example of the latter is illustrated here:



Experiences of PFM-implementation

Prerequisites and conditions for success

In order to be able to introduce PFM structures the following basic conditions should be in place:

- A legal system that allows local authorities to borrow, even though it could be within limits set by the central government or other central authorities.
- A legal system that allows local authorities to cooperate and to jointly assume commitments.
- A domestic capital market that has reached a certain degree of maturity with investors that could potentially be interested in local government bonds.
- A number of local authorities (at least 10) with sufficient creditworthiness.

These are the basic conditions, but above all there must be a need, obvious to local authorities, for new financing solutions. These local authorities must also be convinced that pooled financing *could* be a way forward. Once the investigation of applicability of pooled financing reaches the conclusion that this is a desirable solution for local government, the next step is to show the merits of such a scheme in order to get the support from central government.

The work to create a PFM agency should be properly organized. A local government association could host the project and supply administrative support. It is important to remember that it is the local authorities that should drive the project. In order to give voice to individual local authorities, the following groups could be appointed:

- A steering group consisting of local politicians. It is very important to have representation from more than one political party to achieve long-term stability.
- A working group consisting of City Managers and CFOs.

A question that is key in this type of processes is the recruitment of leaders, both political and professional. The need for entrepreneurial skills can't be underestimated. It is a question of breaking new ground and it requires hard work and creativity combined with diplomacy.

A process to create PFM cooperation

Each process has to be adjusted to the circumstances in each country, but a basic outline is the following:

1 **Start a process**; a core group of municipalities should take a lead in identifying an appropriate PFM structure, such as club-deals or a PFM agency.

2 **Organise the process**; appoint a steering group with local politicians, preferably from more than one political party, and a working group with city managers and CFOs from the involved municipalities.

3 **Procure experts**; appoint internationally experienced experts, alongside with experts with extensive knowledge of the legal system in the country in question.

4 **Produce a roadmap for the process**; this includes detailed organisation, budget, workload, deliverables and time-line.

5 **Conduct a creditworthiness study**; the aim is to answer the question about the level of creditworthiness that would be sufficient for applying PFM and to assess the extent to which the involved municipalities are able to reach this level. The study should also recommend a plan to improve municipal creditworthiness.

6 **Conduct a legal study**; this includes the legal framework for municipalities as well as the regulation of the capital markets. The study should answer if it is legally possible to introduce PFMs in the targeted country and what legal set-up is required for such a platform.

7 **Conduct a market review**; this includes studies of the domestic capital markets, determining which investors are present and how to attract their maximum interest for PFM bonds.

8 **Conduct a benchmark study**; this includes the study of PFM business models that are applied in other countries and an assessment of what elements could be used in the local context.

9 **Structure a first club-deal**; the primary aim of which is to gain real experience of cities working together and of how the capital market receives a PFM bond issue.

10 **Build a stable platform for future club-deals**; using the experience of the first club deal, a stable platform should be built taking into consideration questions related to governance, creditworthiness, credit enhancement, etc.

11 **If deemed desirable, take the last steps to create a LGFA.**

Going further to create a PFM agency

If the process is giving strong reasons to create a pooled finance agency the following should be taken into account:

A The identification and comparative analysis of all legal forms that the agency could take (bank, specialized financial institution, public institution, cooperative society, etc.) establishing, for each of them:

- any legal prerequisites (laws or other regulations) to be met before its creation,
- administrative authorisations and support (including financial) resources,
- as well as, in general, the advantages, disadvantages and operational and financial limitations of each possible solution

B Reflections on major structural and operational options of the agency, in relation to

- Ownership / stakeholders
- Capital structure – participation capital / share capital
- Strategic and operational governance
- Creditworthiness – supervision of the local authorities – credit rating
- Credit enhancement techniques – guarantees
- Rating
- Lending policy
- Borrowing policy
- Asset liability management / risk management
- IT applications
- HR – organisational models
- Products and services

C Accounting and tax treatment applicable to the agency and multi-year financial projections (balance sheets and statements of income return on capital). These projections will be made through an economic model with the flexibility required for the introduction of various alternatives in terms of:

- Level of activity,
- Cost of funds and operating margin,
- Direct and indirect operating expenses,
- Taxation,
- Amount of capital to meet.

Which are the main challenges?

Administrative challenges; the central government has in many countries shown an initial hesitation to support a local government initiative to introduce PFM. This has not primarily been out of a political interest, but was often initiated by officials within the appropriate ministries and this could lead to extensive regulatory demands on the PFM entity. It is crucial that the central government is led to discover the merit of the project in relation to the development of the country and hence to economic growth. It should also made clear that a PFM entity's activities will be ring-fenced by strict internal risk management regulations and the fact that the entity will perform an ongoing strict supervision of the local governments' creditworthiness.

Market challenges; if there is one or a group of dominating lenders to local authorities, they are likely to feel challenged and are also likely to in various ways try to find weaknesses linked to the project to introduce PFMs. For this reason, it is important to try to find ways of cooperating with the existing lenders.

The other market challenge is to raise the interest among investors for bonds issued by a PFM entity. Contacts with investors should be taken at an early stage to investigate how investors' interests could be accommodated within the project and to give the investors time to be prepared for the first bond issue. This might mean amending their internal investment regulations etc. Well before the first bond issue, an extensive program of so-called "road shows" must be executed.

Cooperation challenges; in many countries, local authorities are not accustomed to cooperate with each other. Clear governance rules have to be put in place. Another fact that could complicate the cooperation is the supervision of the creditworthiness of the participating local authorities. It is crucial that every member/shareholder fully accepts the fact that everyone needs to be scrutinized continuously and that membership/shareholding does not secure an unconditional right to borrow from the agency.

For agencies in emerging and developing countries a further challenge is to build a system for secure repayment of the loans. This might mean that the agency and its members build a fund to secure future payment of the borrowing activities and/or acquire a third party guarantee, which could be underwritten by other domestic stakeholders (central government, developing banks etc.) or by DFIs. It should be stressed that external guarantees will have to be structured in a way that it does not remove the responsibility of the local authorities that have created the agency.

The value of the process

All use of financial markets for borrowing purposes is built upon good creditworthiness. The situation for local authorities varies a lot between different countries. For some developing countries an LGFA is perfectly feasible, while other countries' local authorities lack steady income streams and a solid regulatory framework. Nevertheless, all countries and their local authorities could make substantial gains from the process towards a LGFA.

A project that aims to put in place a financial cooperation between cities in a developing country, addresses almost all the questions that are vital for well functioning local authorities, i.e.:

- Relationship between local authorities and central government, both legal and financial.
- Flow of income: stability, predictability, diversification, trends (especially of tax-bases), system for collection, collection rates and the possibilities to tap new local taxes.
- Cost-structure: steering and control.
- Debt: size, interest payments, maturities, payment record and central government restrictions.

- Institutional factors: organisation, accounting system, audit, level of knowledge and skills.

All the above constitutes a well functioning local authority with high creditworthiness.

Putting these questions in connection with a project that aim to solve a major problem, such as financing infrastructure investment, can be very efficient. You would be able to put the needed reforms in the context of a vision for the future. A project would be organised in a way that it can see the inter-relations between different steps towards a stronger city. The fact that this kind of project encompasses a group of cities the demands on the central government could be stronger and more stringent. The negotiating power that such a project would gather is great, because it strives to resolve an undisputable need for financing for local infrastructure and it would be formed by a group of strong local authorities with a comparably high creditworthiness

Final remarks

The quest for low-cost, low-risk financing has led more and more countries to explore the possibilities of setting up Local Government Funding Agencies. The existing agencies work in a self-controlling way: in order for the agency to be successful in the capital markets, the local authorities (members or shareholders in the agency) must have good creditworthiness. The agencies have controls in place to supervise their members and take action as soon as any deterioration is detected in one of the member's financial situation. These routines are crucial for the agency's rating and, hence, for its success in the capital markets. This is also an efficient brake mechanism against excessive borrowing on the side of the local authorities. Actually, a Local Government Funding Agency relieves central government from many aspects of the monitoring of local government.

Finally, a market-based approach, with the checks and controls of an agency, tends to be more efficient than a system where central government controls local financing through borrowing restrictions. In order for local authorities to be able to contribute to growth, they should be in control of the financing of their own investments.

International Finance Corporation - Initiation and concept of the study tour

IFC, a member of the World Bank Group, is the largest global development institution focused on the private sector in developing countries. Through its sub-national finance program IFC also engages directly with local governments to support municipal infrastructure development. We utilize and leverage our products and services—as well as products and services of other institutions in the World Bank Group—to provide development solutions customized to meet clients' needs. We apply our financial resources, technical expertise, global experience, and innovative thinking to help our partners overcome financial, operational, and political challenges. Clients view IFC as a provider and mobilizer of scarce capital, knowledge, and long-term partnerships that can help address critical constraints in areas such as finance, infrastructure, employee skills, and the regulatory environment. IFC is also a leading mobilizer of third-party resources for its projects. Our willingness to engage in difficult environments and our leadership in crowding-in private finance enable us to extend our footprint and have a development impact well beyond our direct resources.

FMDV – Mobilization of participants and organizational support

FMDV is the international Alliance of Local and Regional Governments dedicated to finance. Acting as a match-maker, it provides solutions and expertise to create and implement the enabling environment, appropriate conditions and mechanisms allowing local and regional governments' access to the necessary resources to fund their urban development strategies, especially through long-term and hybridized financing.

FMDV promotes a holistic approach on urban economy and urban development financing, both in terms of their traditional tools (local taxation optimization, bank loan, bond emission, public-private or public-public partnerships) and in their endogenous variation (local socio-economic revitalization, urban productivity and attractiveness, responsible green economy, local resources valorisation and mobilization, and social and solidarity economy).

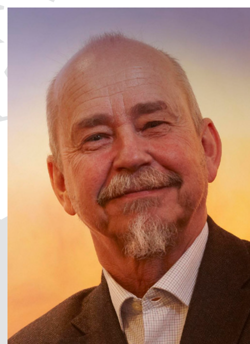
FMDV also leads the debate between multi-scale urban stakeholders via the publication of reference works on the topic, thematic case studies and the organization of dedicated seminars.

www.fmdv.net

PPIAF/SNTA – Grant financing of the study tour

The Public-Private Infrastructure Advisory Facility (PPIAF) is a multi-donor technical assistance facility aimed at helping developing country governments improve the quality of their infrastructure through private sector involvement (www.ppiaf.org).

Through its Sub-National Technical Assistance (SNTA) Program, PPIAF supports sub-national entities develop their capacity to access market based financing without sovereign guarantees in order to improve infrastructure services. The Program aims at improving financial and operational management, and corporate governance of sub-national entities. It also supports technical assistance to strengthen institutional capacity and support local-level reforms, to improve investment planning, and to advise specific transactions and prepare projects for financial support (http://www.ppiaf.org/page/sub-national-technical-assistance).



Lars Andersonn Design of the program and information materials

Lars M Andersson is an advisor in the field of local government finance. During the last twenty years, he has worked with a number of projects around the world, for example, in projects to create Municipal Bond Agencies in France and the UK. Furthermore, he has recently studied the possibilities to introduce pooled financing for local authorities in Romania and South Africa.

Mr Andersson initiated the creation of Kommuninvest, the Swedish Local Government Funding Agency in 1986, and was the agency's first CEO. He developed its operations until 2001. He is now a member of the Supervisory Board of Agence France Locale and chairman of the Strategy Committee within the agency's board and member of the Board of Fonds mundial pour le développement des villes (FMDV).