

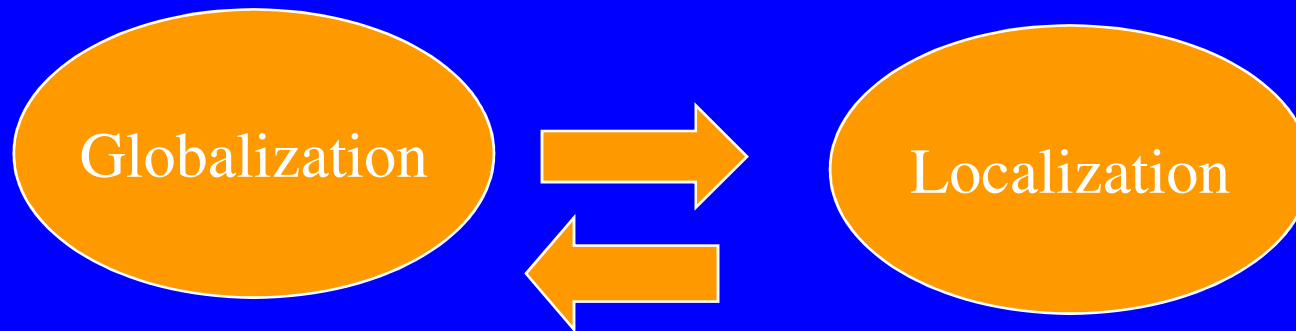
# **The Inter-American Development Bank and Sub-Sovereign Governments Development**

**Multilateral Financial Institution (MFI) Support for Private Infrastructure,  
London, June 14-15, 1999  
4th Meeting**

**Pietro Masci, Division Chief Infrastructure and Financial Markets**

For further information, visit the website at <http://www.iadb.org/sds/ifm>

# Background



- **How to Reconcile them?**
- **What's the road to credit worthiness for Local Authorities?**
- **What's the Role of the Bank in Building Capacity at Local Level?**

**There is an unprecedented political and fiscal decentralization in LA: Sub-sovereign Governments become responsible for delivering services involving the private sector.**

**We will present a framework to assess creditworthiness of Sub-sovereign Governments and to identify:**

- a) the appropriate credit enhancement to achieve creditworthiness at the project level; and**
- b) the effective technical assistance support programs to allow Sub-sovereign Governments to reduce institutional and financial gaps.**

**We will also elaborate on the role of credit enhancements and technical assistance to help Sub-sovereign Governments in the road to creditworthiness and financial independence and to provide services more effectively.**

# Coverage of the Presentation

- **Experience of the Bank: Quantitative and Qualitative Aspects**
- **Framework to build Credit Worthiness.**
  - **Hard Credit Culture**
- **Application of the Framework for Risk Assessment of Sub-sovereign Governments**
- **Application of the Framework at the Project level:**
  - **Credit Enhancement and Private Sector Participation**
- **Application of the Framework for Technical Assistance Programs**
- **Conclusions**
  - **Lessons Learned**
  - **Validation of the Framework**
  - **Competitive Advantage of the Bank. Elements for a Bank Strategy**

# Experience of the Bank Quantitative and Qualitative Aspects

- Total operational lending 1994-1999  
(in US\$ millions) \$36,674.2
- Total lending for Municipal/Urban Development 1994-1999  
(in US\$ millions) \$3,439.2

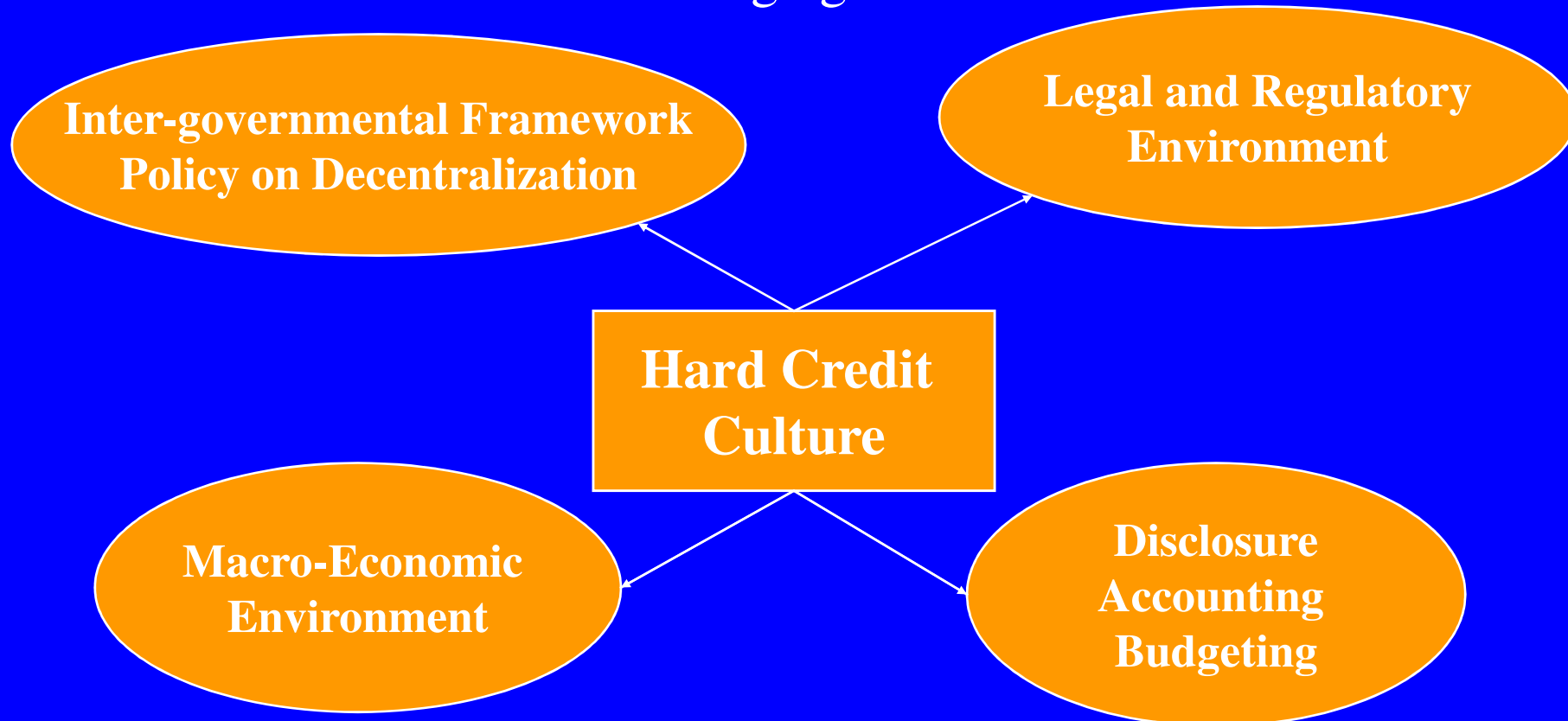
## IDB SUPPORT TO MUNICIPAL DEVELOPMENT

Areas of Intervention	Countries A/B	Countries C/D
Local Government Structure	<ul style="list-style-type: none"> <li>● Decentralization (devolving expenditure; responsibilities)</li> <li>● Institutional strengthening</li> </ul>	<ul style="list-style-type: none"> <li>● Decentralization</li> <li>● Institutional strengthening</li> <li>● Legal/regulatory framework for oversight of service provision at the local level, e.g. DR-0127, ES-0018, HO-0115</li> <li>● Institutional arrangements for better governance (metropolitan councils, special purpose districts, etc.), e.g. ES-0018</li> </ul>
Project Finance	<ul style="list-style-type: none"> <li>● Basic infrastructure projects</li> <li>● Development of concessions for private sector participation, e.g. BR-0169</li> <li>● Guarantees</li> <li>● Strengthening second tier development banks or special municipal development funds (for on-lending to municipalities), e.g. BR-0212, ME-0051</li> <li>● Development of local capital markets, e.g. AR-0250</li> </ul>	<ul style="list-style-type: none"> <li>● Basic infrastructure projects, especially water and sewerage</li> <li>● Strengthening of second tier development banks (for on-lending to municipalities), e.g. EC-0139</li> </ul>
Budgetary/Fiscal	<ul style="list-style-type: none"> <li>● Administrative and fiscal reform/ modernization (changes in legal/tax codes), e.g. AR-0151, ME-0208</li> <li>● Improvements in transfer payments systems, cost recovery, tax collection, rationalization of expenditures, resource allocation, e.g. BR-0212, ME-0208</li> <li>● Standardize procedures for planning and appropriations, e.g. BR-0286</li> </ul>	<ul style="list-style-type: none"> <li>● Fiscal reform/modernization (changes in legal/tax codes), e.g. SU-0019</li> <li>● Improvements in cost recovery and tax collection, e.g. DR-0127</li> <li>● Improvements in investment planning, e.g. EC-0139</li> <li>● Implementation of accounting standards, e.g. ES-0118</li> <li>● Improvements in intergovernmental transfers, e.g. HA-0040</li> </ul>
Debt Management	<ul style="list-style-type: none"> <li>● Improve the quality and administration of investments (selection of "good projects"), e.g. CH-0004</li> </ul>	

# Framework to Build Creditworthiness

# The Road to Creditworthiness

Hard Credit Culture: Introduce a set of values to break the constraint of sub-sovereign governments



Framework to assess creditworthiness and sub-sovereign risk



# Framework to build Creditworthiness

## Willingness to pay

- Legal and regulatory environment
- Legal obligation to repay debt
- Political commitment including receiving taxes
- Financial performance

## Ability to pay

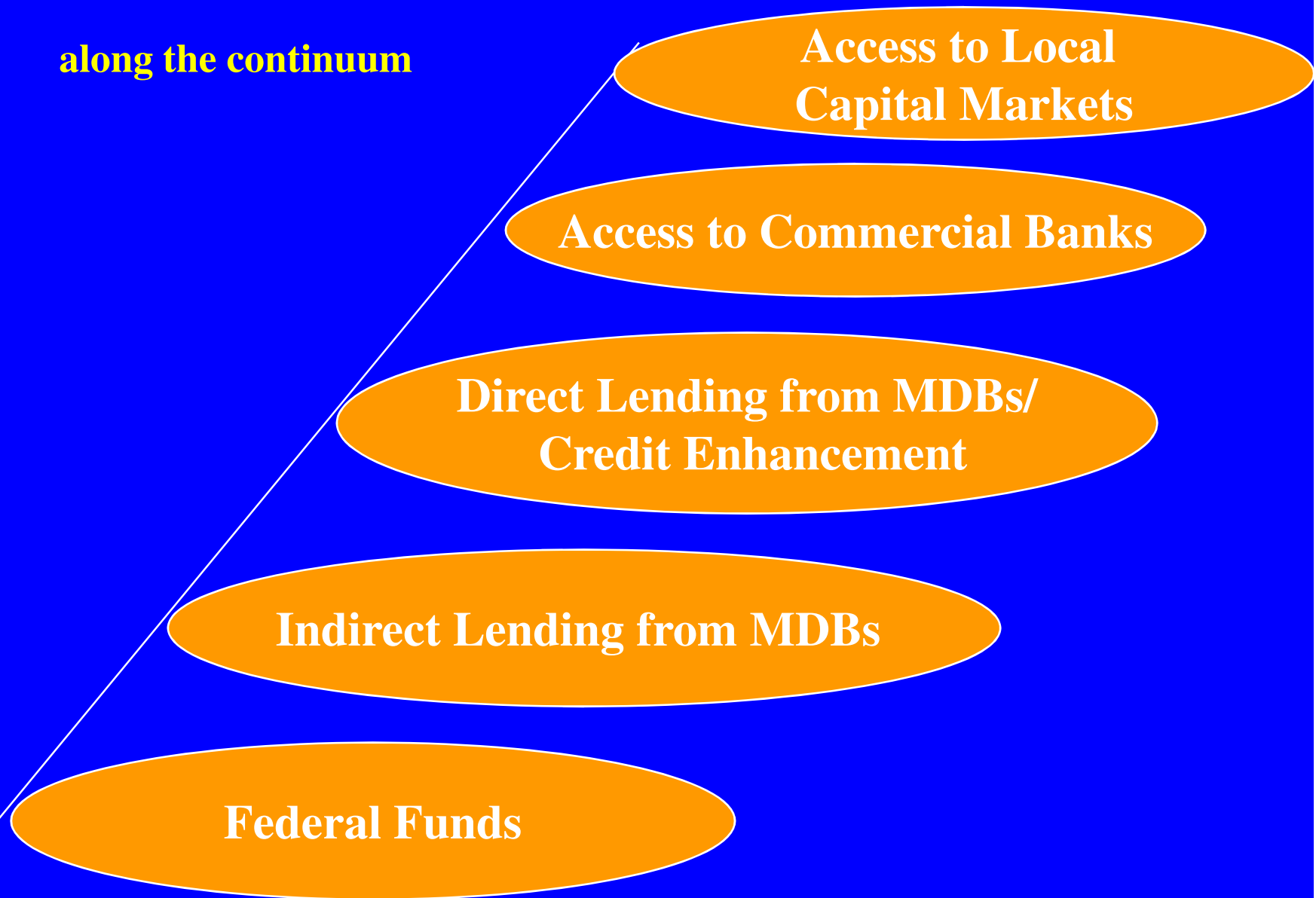
- Social and economic base
- Ability to levy and collect taxes
- Ability to apply collected revenues to debt service
- Management capability
- Projected revenues

## Priorities on specific assets

- Association of assets with public concerns e.g., health, safety, policy, public utilities

# The Road to Financial Independence Progression

along the continuum

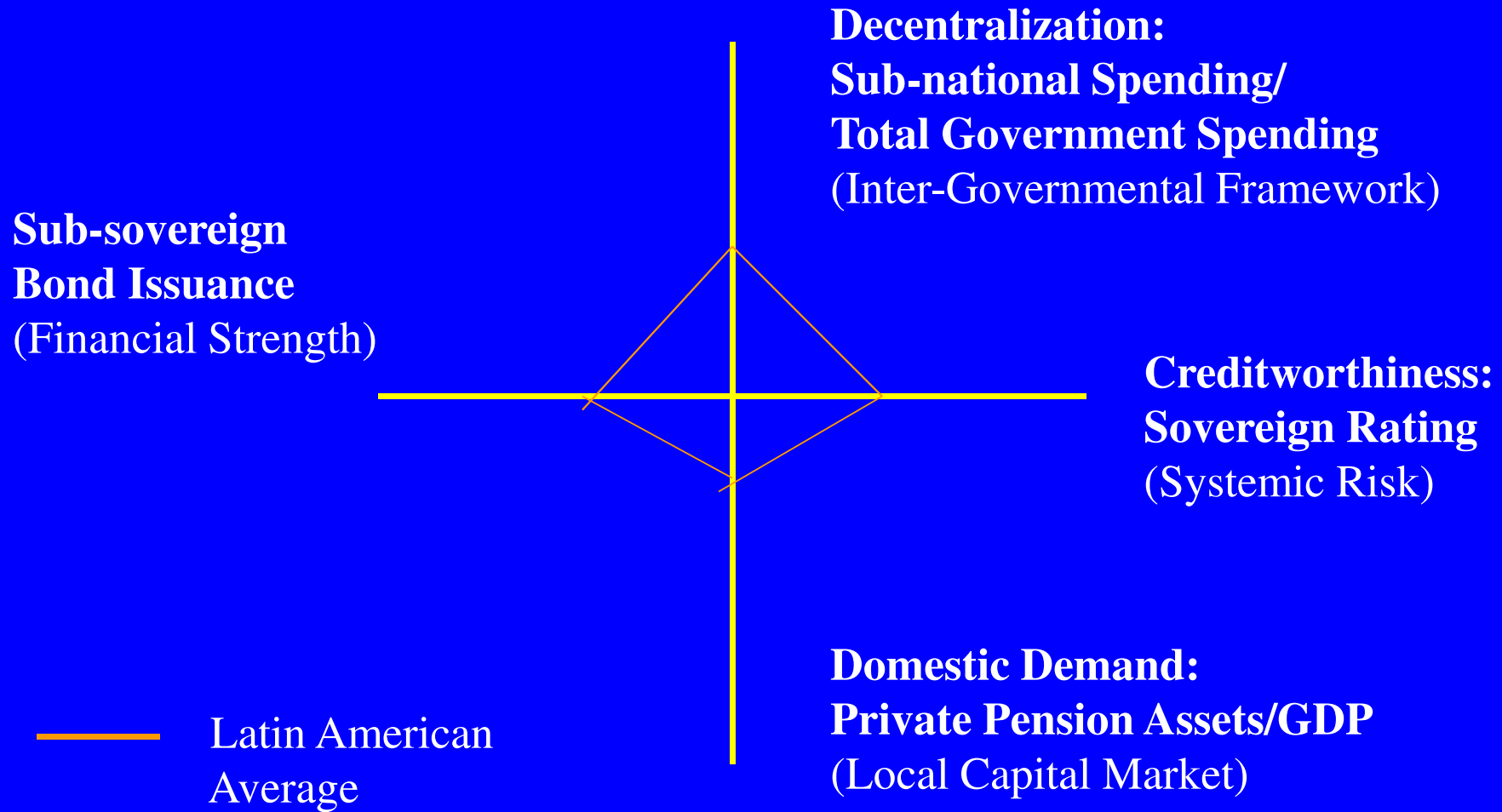


# **Application of the Framework for Risk Assessment of Sub-sovereign Governments in Latin America**

# Assessment of Latin American Sub-sovereign Governments - Main Factors -

Systemic Risk	Inter- governmental Framework	Financial Strength	Local Capital Markets
Creditworthiness (Sovereign Rating)	Decentralization	Sub-sovereign bond issues	Pension Funds (Private Pension Assets)
Macro- Economic	Constitutional	Banking Sector Rating	Yield Curve
Political  MDBs Programs	Fiscal Regime	Sub-national Lending Institutions	

# Framework



# Development of Risk Assessment of Latin American Sub-sovereign market: Argentina

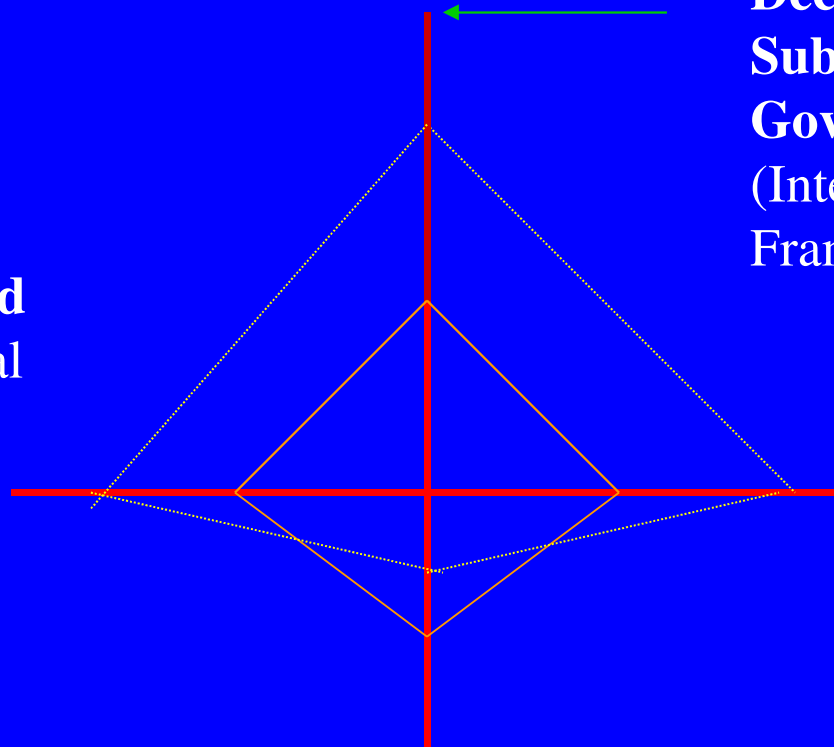
**Sub-national Bond Issuance (Financial Strength)**

**Decentralization: Sub-national Spending/ Government Spending (Inter-Governmental Framework)**

**Creditworthiness: Sovereign Rating (Systemic Risk)**

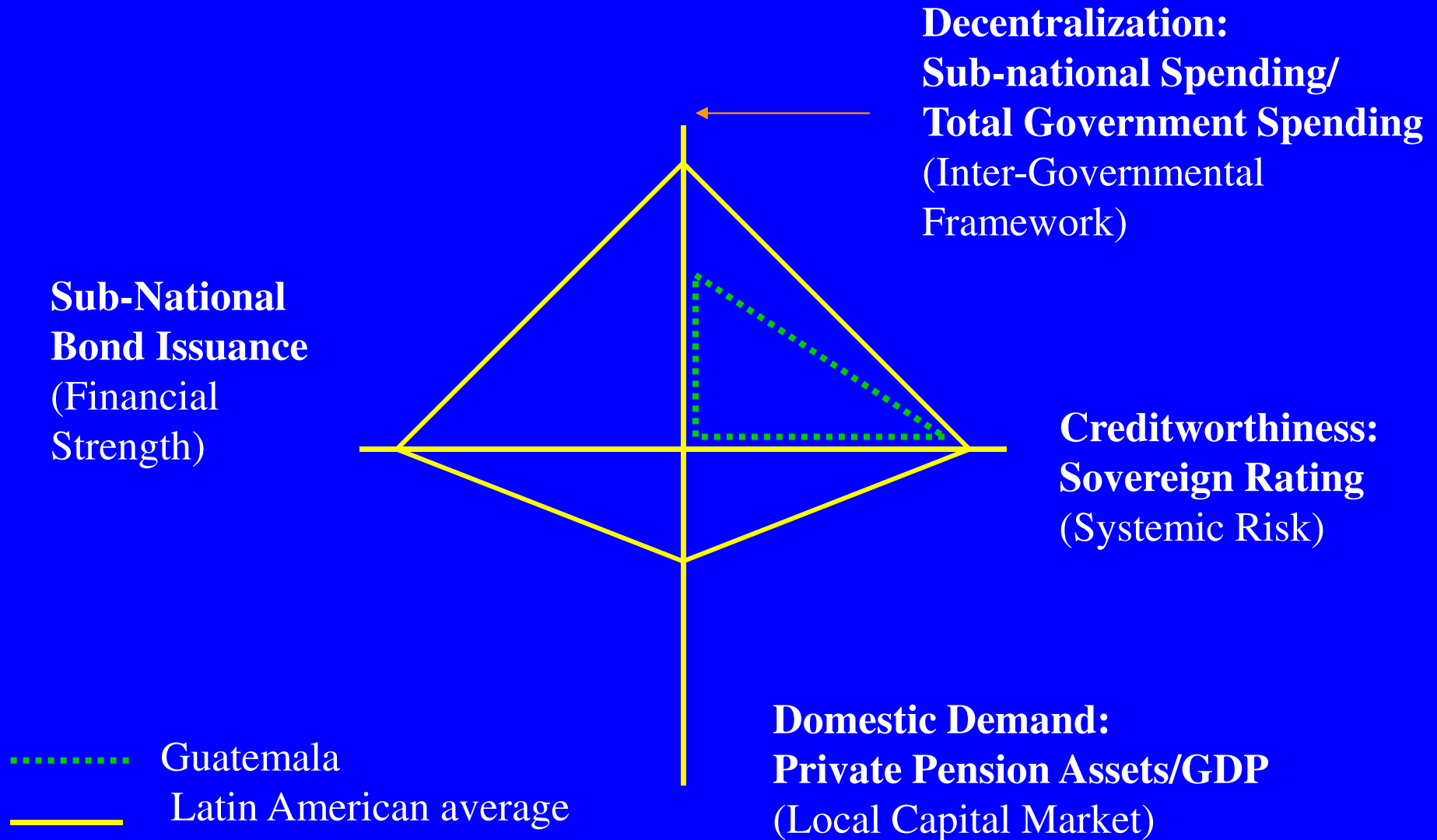
**Domestic Demand : Private Pension Assets/GDP (Local Capital Market)**

— Latin America Average  
..... Argentina



**Argentina has perhaps the most decentralized municipal system in Latin America. The challenge is to improve sub-national creditworthiness to reduce the dependency currently placed on using federal transfer and tax revenue to repay debt.**

# GUATEMALA



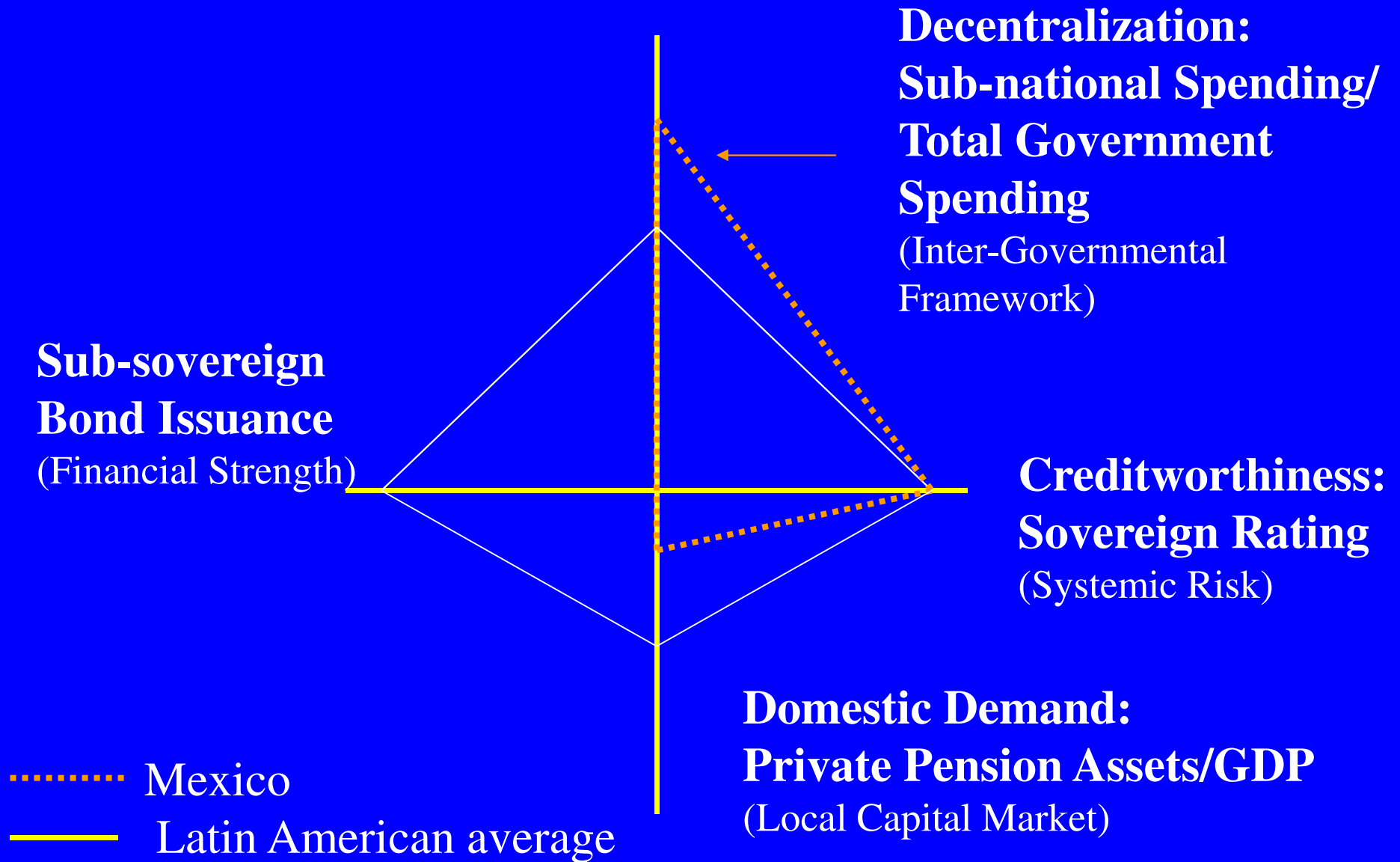


**Guatemala has a history of centralized Government and limited capacity at the local level.**

**The funds of local Governments are provided by the Central Government.**

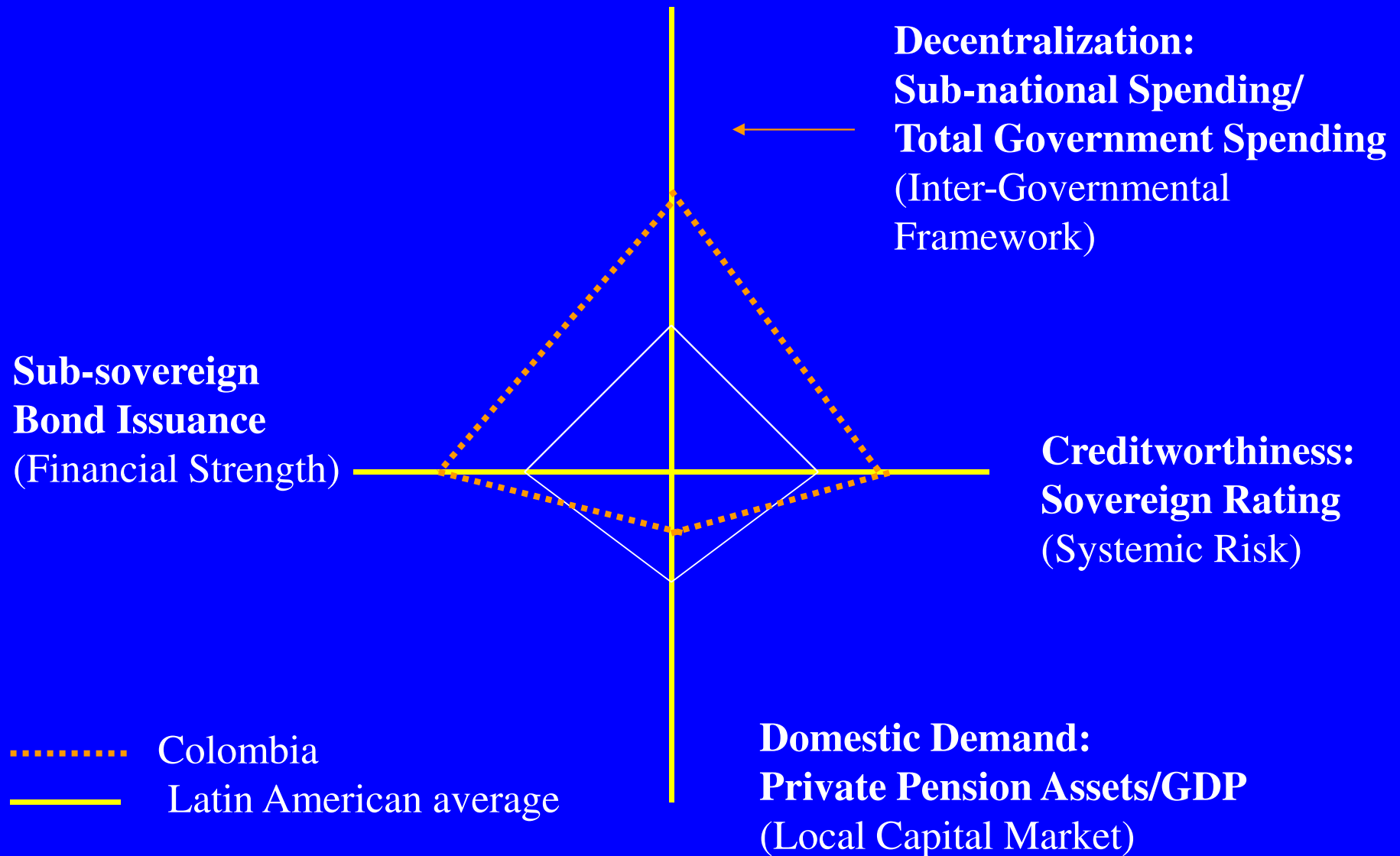
**Positive signs of decentralization are the initiation of revenue sharing and commercial bank interest in municipal lending.**

# Mexico



**The solicitation of ratings by some states indicates a growing understanding of the value of creditworthiness among sub-national governments. However, financial management, accounting and disclosure at the state and local level generally still fall well below the levels required to access financial markets.**

# Colombia



**Colombia has made a concerted effort to devolve both resources and responsibilities to lower levels of government. This has resulted in a nascent domestic bond market.**

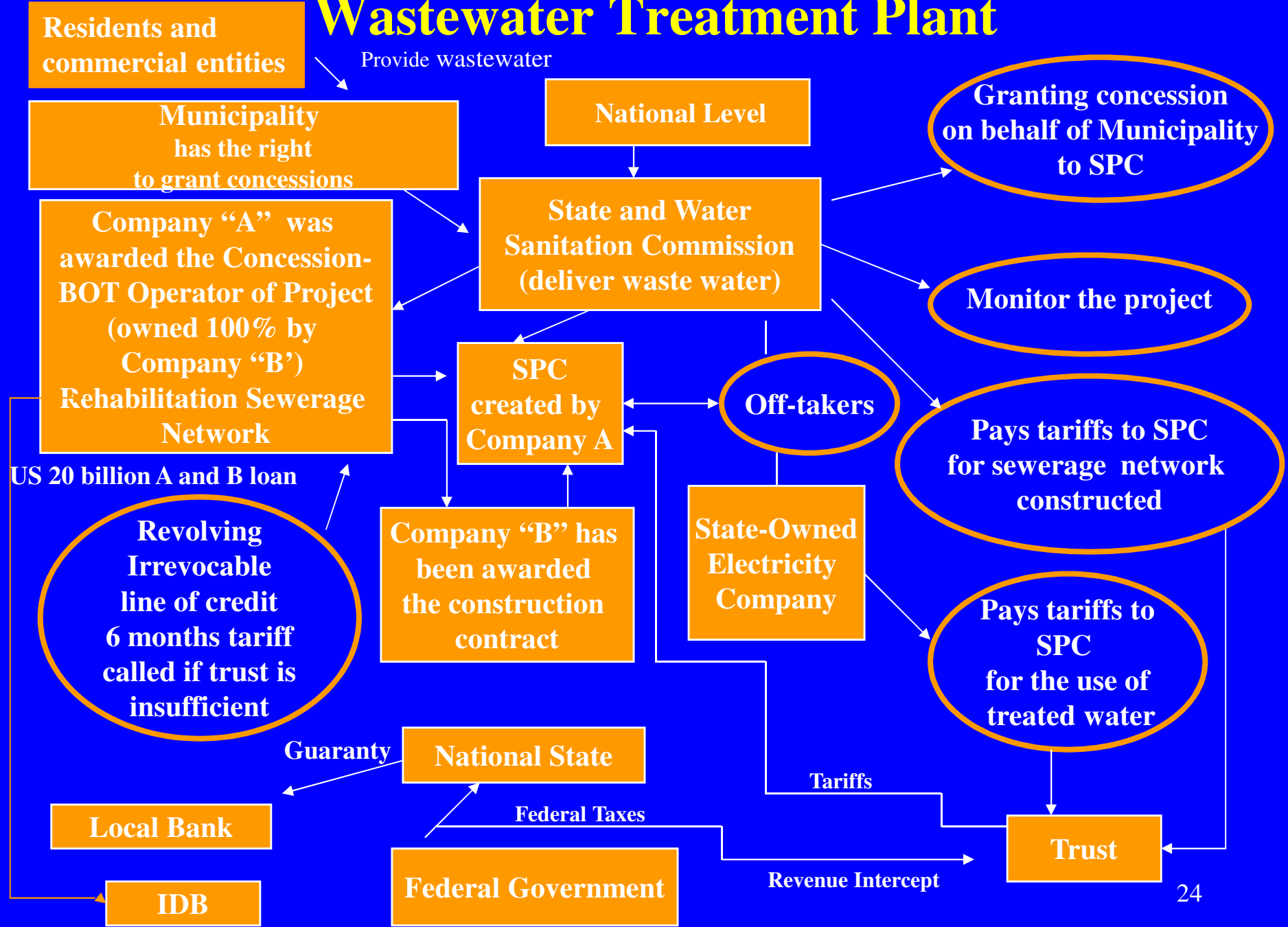
# **Application of the Framework at the Project Level**

## **Examples of Specific Projects with Sub-sovereign Entities**

# **Project Focus: Credit Enhancement**

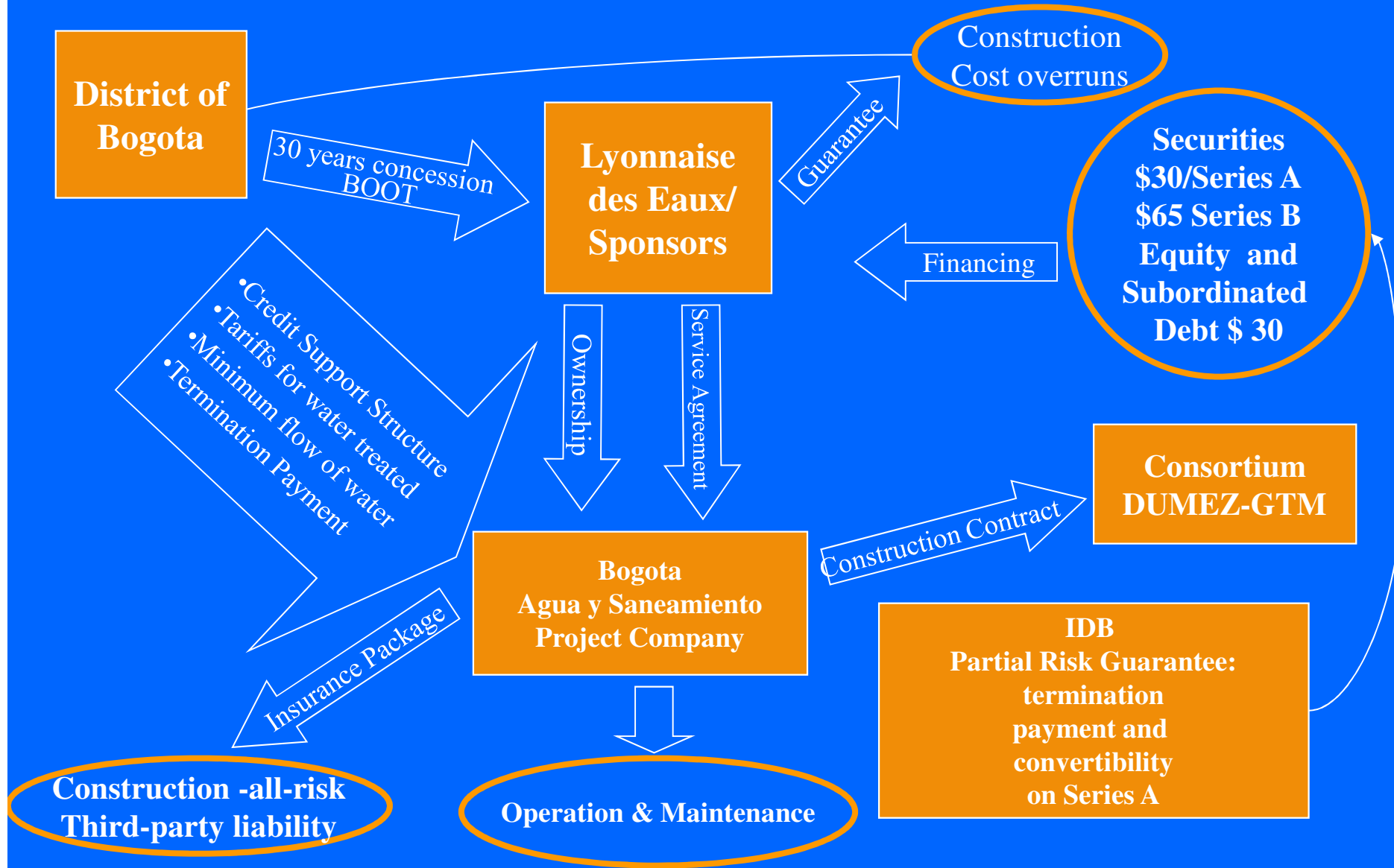
- **Credit enhancement is an instrument to develop creditworthiness**
- **Policy reform versus specific deal**
- **Credit enhancement mechanisms applicable in Latin America:**
  - **Revenue intercept**
  - **Over collateralization**
  - **Guarantee**
  - **Letter of credit**
  - **Debt service account**
  - **Pooling risk mechanisms**
  - **Bond insurance**

# Wastewater Treatment Plant





# Rio Bogota Waste Water Treatment Plant



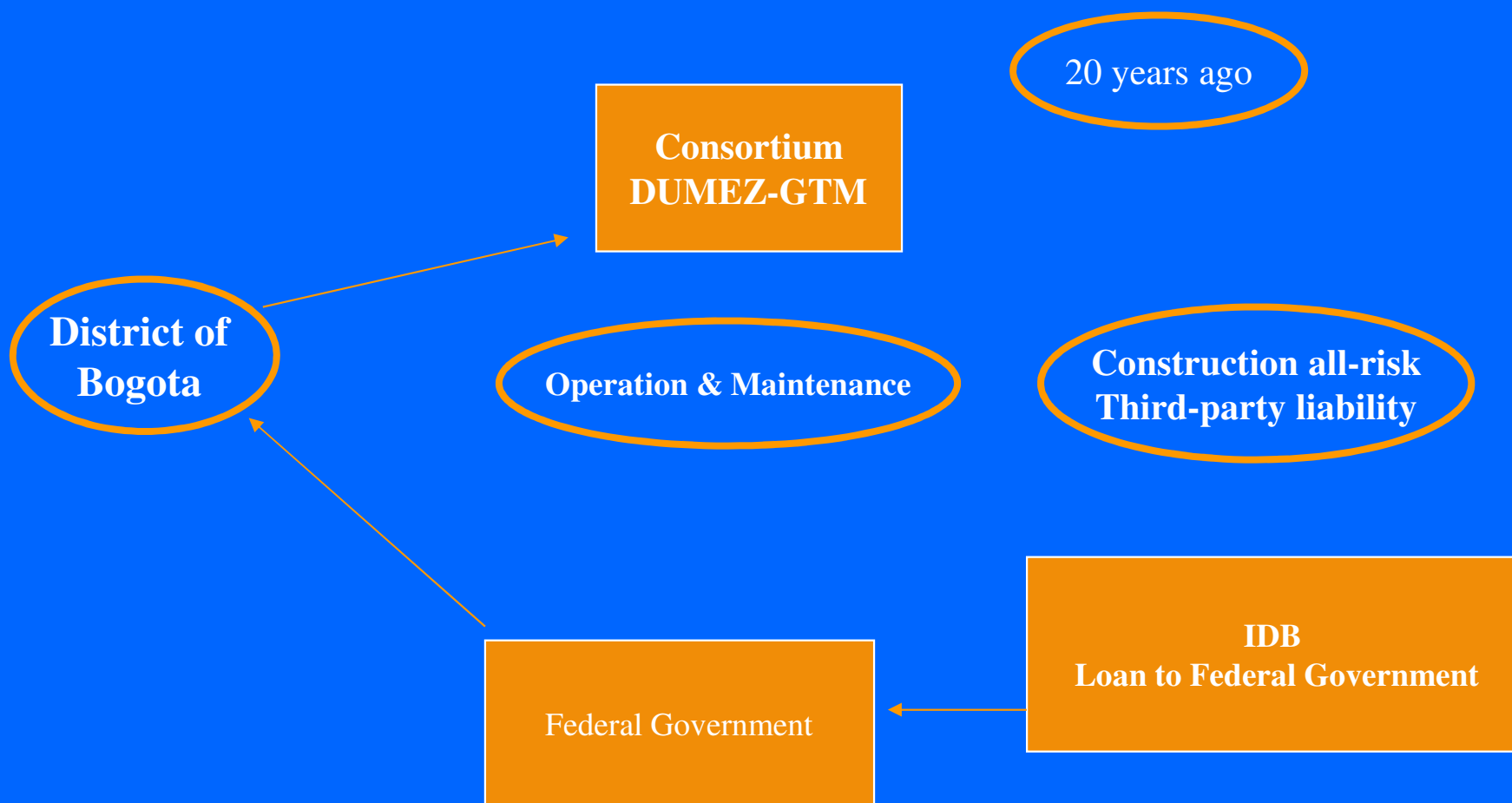
# Wastewater Treatment Plan: Main Issues

- **The objective of the project is good**
- **Construction Risk not resolved: risk borne by contractors gives limited protection to lenders: full recourse to the sponsors is needed**
- **Limited Financial Strength of Sponsors**
- **Risks (e.g., off-taker risk) and Public Utility Policy**
- **Very complex project which increase risks and costs**
- **Decentralization process incomplete**
- **No previous Borrowing on Capital Markets**
- **No local Capital Markets**
- **Role of the Bank: crucial and very significant**

# Rio Bogota: Main Issues

- **First Bank Guarantee for Private Placement without Government Counter-guarantee**
- **Does the Bank partial guarantee have any impact on the non-guaranteed tranche privately placed? Market price of non-guaranteed portion - Price of IDB guaranteed portion = Value of IDB guarantee?**
- **Creditworthiness of project company highly leveraged**
- **Municipality willingness and ability to pay: decentralization process advanced/ previous borrowing/Limited debt/Good Management**
- **Contract awarded in 1994, operation completed in 1998**
- **Bank support limited**

# Rio Bogota Waste Water Treatment Plant



# Project Focus

Rating	Decentralization	Financial Strength	Local Capital Markets
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## A) Project Focus: How the Framework Works

<b>Colombia</b>	<b>Good</b>	<b>Good</b>	<b>Good</b>	<b>Not Available</b>
<b>Country</b>	<b>Limited</b>	<b>Limited</b>	<b>Limited</b>	<b>Not Available</b>

## B) What is needed to finance the Project

<b>Colombia</b>	<b>IDB Partial Risk Guarantee</b>	<b>Limited Federal involvement</b>	<b>IDB Partial Risk Guarantee for bonds</b>	<b>International Bond Market/ Private Placement</b>
<b>Country</b>	<b>IDB/A-B Loan</b>	<b>Federal + Local Mechanisms</b>	<b>IDB/A-B loan</b>	<b>IDB/A-B loan</b>

# **Application of the Framework to Technical Assistance Programs**

# Guatemala Municipal Development

Activities	Decentralization	Creditworthiness	Domestic Demand Local Capital Market	Domestic Supply
Create Co-financing Group, Technical Studies and Environmental Units. Integrate PDM II executing unit activities into INFOM's structure	Units created, workplans developed; and agreed with IDB. Instituto de Fomento (INFOM) Structure	Expected to improve due to strengthened decentralization	Strengthen Local Financial Intermediary (INFOM)	Satisfied by INFOM
Develop financial policies for allocating loans, subsidies and setting interest rates. Design credit evaluation system for municipalities	Policies and procedures implemented. Long-term financing strategy for INFOM	Expected to improve due to strengthened decentralization		
Develop performance indicators and monitoring and evaluation systems for municipal activities, National Training Plan and program components	Performance indicators designed and agreed; work plans developed; contract for implementation awarded; monitoring	Expected to improve due to strengthened decentralization		
Develop standards for municipal organization and service provision, and environmental review procedures	Standards developed and agreed with IDB; new environmental review procedures implemented; implementation	Expected to improve due to strengthened decentralization		
Design and implement program based budget and project cost accounting systems	Action plans developed; contract for implementation awarded			

# Argentina Municipal Reform and Developments Programs

## Objective: to achieve self-sustaining Municipal Development

Activities	Decentralization	Creditworthiness	Domestic Demand Local Capital Market	Domestic Supply
<b>1. Internal Management</b> <b>2. Financial Management</b> <b>3. Tax Administration</b>	Expected to improve in relation to the activities 1,2 and 3	Expected to improve in relation to the activities 1, 2 and 3		
<b>4. Investment to address priority municipal needs (roads, parks, waste collection and disposal, etc.)</b>	Expected to improve			Expected to increase
<b>5. Municipal borrowing (studies, pilot projects, seminars)</b>		Expected to e enhanced	Expected to develop	



# Technical Assistance Focus

Rating	Decentralization	Bond Issuance	Local Capital Markets
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## (1) What the Framework Tells Us

<b>Guatemala</b>	<b>Fair</b>	<b>Poor</b>	<b>Not available</b>	<b>Not available</b>
<b>Argentina</b>	<b>Good</b>	<b>Good</b>	<b>Initial stages</b>	<b>Under development</b>

## (2) How the TA Program is shaped

<b>Guatemala</b>	<b>Indirect Impact</b>	<b>Very focused</b>	<b>NO</b>	<b>Local Financial Intermediary</b>
<b>Argentina</b>	<b>Strengthened</b>	<b>Strengthened</b>	<b>YES</b>	<b>Local bonds (partially)</b>

# Conclusions

# Lessons Learned

- **Complexity of project proportional to risk (comparison with the “non-project” finance of 20 years ago)**
- **Cost of the project, i.e., preparation, negotiation**
- **Outcome is untested**
- **Revenue bonds vs. general purpose bonds**
- **Creative financing structures**
- **Deal vs. policy reform/Maximization of PSP**
- **Role of Technical Assistance**
- **Need of a strategy/Role of the Bank along the continuum**

# Validation of the Framework

- **Less Decentralization implies more complicated structures at the project level**
- **Limited Creditworthiness: requires credit enhancement**
- **Lack of Local Capital Market: recourse to international market which implies more support and credit enhancement**
- **Lack of Legal Framework between Federal and Sub-sovereign: creditworthiness is not achieved**
- **Sub-sovereign bond issues: Importance of presence in the markets**
- **Role of Lending and Technical Assistance Programs shaped according to the stage of the development of the four factors of sub-sovereign development**

# **The Competitive Advantage of the Bank in the Local Development**

- **Special relationship with LAC countries (ownership)**
- **Knowledge of Countries**
- **Vast experience in dealing with Sub-sovereign Governments**
- **Independence and Continuity**
- **Leverage related to mix of lending and TA capabilities.**
- **Experience and expertise, “best practices”, technical analysis**
- **Financial support for poor countries in the region**

# **Elements for a Strategy to Improve Creditworthiness of Local Authorities**

- **Credit enhancement only part of larger package of IDB programs aimed at increasing creditworthiness and self-sustainability of municipalities**
- **Employ a graduation strategy**
  - **policy mix: TA and lending**
  - **credit enhancement and direct lending**
  - **Private Sector participation in projects and infrastructure**
- **Private Sector Financial Intermediaries**
- **Credit Enhancement Program**

# **IDB Strategy For Sub-Sovereign Entities**

**Placing the institutional and governance aspects of the decentralization process as the central focus of Bank operations, to increase private sector participation in local services and infrastructure**

For further information, visit the Infrastructure and Financial Markets Division website at <http://www.iadb.org/sds/ifm>