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Creating the Local Financing Framework
for Sustainable Development Goals:

The Potential Catalytic Role of Subnational Pooled Financing Mechanisms

with the support of

AGENCE FRANÇAISE DE DÉVELOPPEMENT

FMDV

Supporting local authorities
to access funding

Foreword from Geoffrey Makhubo

GEOFFREY MAKHUBO
Member of the Mayoral Committee for Finance, City of Johannesburg,
Vice-President of FMDV

In 2015 and 2016, central governments are negotiating a series of crucial agreements to ensure an effective and efficient implementation of sustainable development policies, involving structural transformation and new forms of multi-stakeholder partnerships for change. In several statements, local and regional authorities have been identified as the first partners of central governments, and considered as key players in the mobilization and catalysis of new financial resources for development, available at the subnational level but still little or poorly exploited.

As such, local and regional governements constitute a focal point for concerted and co-produced financial policies and strategies, for the mobilization and planned orientation of the wealth produced by the agglomeration effects related to the urbanization of the planet.

According to the Report of the Intergovernmental Committee of Experts in preparation for the IIIrd International Conference on Financing for Development, global needs in investments are estimated at 5 to 7 trillion dollars annually, corresponding approximately to twice the amounts currently dedicated. A significant part of those investments will need to be engaged at subnational levels. It is then essential and urgent to organize effective financing instruments, which are arguably the missing link to allow Local Governments to ensure effective services and invest in sustainable infrastructures.

In this context many countries have established or authorized various forms of financial intermediation instruments, enabling local and regional authorities to moblize additive ressources, particularly through the capital markets.

Through an open consultation of different stakeholders including Central and Local governments, donors or private investors, and considering the existing experiences and programs developped by institutionnal partners such as the World Bank, the French Development Agency (AFD) or USAID, FMDV, the International Alliance of Local and Regional Governments dedicated to financial solutions, identified the potential catalytic role of Subnational Pooled Financing Mechanisms (SPFM) as one the most adapted solution to allow local governments from developing and emergent countries to diversify their actual resources.

Several models have been implemented through those specific instruments, in different contexts. The rich experience and financial leverage resulting from such mechanisms need to be better shared to inspire innovative policies that can spur mobilization of additional resources for the future implementation of the new Agenda for Development (FfD Conference and Post 2015) and the New Urban Agenda (Habitat III) in a global framework constrained by climate change (COP21).

This Policy Paper, developped by FMDV with the support of AFD, provides an overview of various Subnational Pooled Financing mechanisms, their benefits and the conditions of success in emerging and developping contexts. It also provides guidance and recommendations adressed to stakeholders in order to create the necessary environnement to allow Local and Regional Governements to leverage the additionnal necessary funds from the capital markets through those innovative mechanisms.

This first document is part of a global program launched by FMDV on Subnational Pooled Financing Mechanisms that will be followed by advocacy and actionable documents, Study Tours, and Country programs to encourage the development of those strategies in emerging and developing contexts, and support the organization of pilot transactions.

We therefore invite you to actively participate to our dynamic, joining our platform and exploring with us the potential of SPFM to allow Local and Regional Governments to ensure appropriate services and infrastructures for their population.

I wish you a pleasant reading and judicious use of this publication, and I hope to welcome you soon during one of our activities.●

Foreword from Philippe Orliange

PHILIPPE ORLIANGE
Director of Partnership,
Strategy and Communication
French Development Agency (AFD)

The expert work, coordinated by the FMDV, into mechanisms for the pooled access of local authorities to bond markets corroborates with three strong convictions of the French Development Agency: first, the idea that the success or failure of the future Agenda for Development and Climate Change will be determined by territorial stakeholders; second, the conviction that local authorities should receive resources which match up to their responsibilities; finally, the certainty that, to create funding at a local level, the widening of the range of available financial tools and the deepening financial innovation are indispensible.

It is an opportune moment to advance new ideas on this topic. Indeed, the post-2015 agenda, as it seems to be shaping up, invites us to do just that; its objectives reflect for the first time the major role accorded to cities in responding to the key issues of our modern world. This development reflects the increased power of local authorities as a result of two things: the urbanisation of the world, on the one hand, which multiplies the needs for investment in infrastructure and equipment; and decentralisation, on the other hand, which makes local authorities increasingly responsible for defining, financing and overseeing the completion of these investments.

The French Development Agency, which has, over the last fifteen years, consistently shown itself capable of innovation in its support of major world cities, notably in creating more than 1 billion euros worth of direct financing to local authorities, without central government guarantees from the respective countries, is happy to support the initiative launched by FMDV, alongside several major world cities. The pooled access of local authorities to private capital markets is an approach which has already been successfully undertaken in certain OECD countries. By inventing shared mechanisms to tap into long-term, competitive resources, these schemes could in the future offer numerous other cities new ways of successfully following through with their policies of sustainable development.

Subnational Pooled Financing Mechanisms Overview

DEFINITION, PROVEN BENEFITS AND MAIN CHALLENGES

This document is aimed at providing a policy framework and recommendations for national governments and their development partners to assess and consider support to Subnational Pooled Financing Mechanisms ("SPFMs").

SPFMs have a documented successful track record in providing long-term cost-effective private finance from both banks and bond issues to fund essential infrastructure and public services provided at the subnational level, in developed, emerging and developing countries' contexts. The key points of the study are based on three expert papers commissioned as part of this effort, as well as other independent research. For access to the three papers and the extensive bibliography, please visit www.fmdv.net.

This document has been developed by FMDV with the support of AFD.

An extensive report will be made available in the second half of 2015.

WHAT ARE SUBNATIONAL POOLED FINANCING MECHANISMS?

Definition

Subnational Pooled Financing Mechanisms (SPFMs) provide joint access to private capital markets (bank finance and bonds), as well as public sector funding at advantageous terms for borrowers (e.g., in that case, local and regional governments), sharing similar missions and credit characteristics, but lacking the financial scope and scale, expertise and credit history to access credit markets on their own.

By providing credit enhanced financial structures, accountable management processes, and lower transaction costs, pooled financing facilities can serve as efficient, creditworthy links between small projects and sources of private capital. They mitigate debt service payment risk, diversify project risk, and provide the technical professional management required to enable sustainability and access to private finance.

The critical success factor is that the composite subnational pooled financing facility is perceived as creditworthy and able to meet the investor requirements for debt service, based on the projected expenses, revenues from projects, and supplementary funds from the public sector. Towards this end, many subnational pooled financing structures include technical assistance and project preparation support.

With regards to the finance of infrastructure and essential public services, subnational pooled financing is a proven means of mobilizing private financing for local infrastructure projects in both developed and developing countries. Pooled financing have been used to finance capital expenditures of local and regional governments related to essential public services, including water & sanitation, energy, transport, telecommunications, education, marketplaces, etc. in countries like India, Mexico, but also in USA, Sweden, Denmark and more recently in France for example.

Modus operandi

All SPFMs, with the exception of club deals and other basic structures, rely on setting up credible separate legal entities ("Special Purpose Vehicles") or other investor-accepted entities that can function under national laws, with transparent governance structures, processes, and accountabilities for contracting debt and making debt service payments.

Owners of the SPFMs are often governments (and related entities), but they can also include the private sector, development partners, NGOs, and combinations thereof. Irrespective of the ownership structure, all SPFMs need to employ the same level of excellent professional experts in their development and ongoing management.

The exact equity and debt structures will necessarily vary, based on the specific country legal framework, the projects being financed, the interest and capacity of the local governments, and political processes. For this reason, governments that are interested in setting up SPFMs will need to invest in an initial assessment of the most appropriate SPFM structure given financial needs and the existing legal, institutional, and legal frameworks and the current state of the domestic financial sector.

A **related critical strategic decision is the focus of the SPFM**. SPFMs can be set up for a specific sector (for example, water and sanitation, renewable energy, education, etc.). It is important to note that SPFMs are increasingly being applied to climate change projects.

The second critical determinant of the structure of the SPFM is the level of perceived creditworthiness of the local governments themselves. In the case of developing countries, it is critical that SPFMs employ several layers of credit enhancements to achieve the quality credit assessments that will enable them to access low-cost long-term private finance.

It is important to note that using credit enhancements is very costly and not feasible to design around each small project. Using a SPFM thereby enables "economies of scale" by utilizing the large inventory of credit enhancements available to projects, including reserve accounts, cash flow over collateralization, intergovernmental financial transfers and intercepts, partial credit guarantees, first loss-facilities, and subsidies (e.g., output-based aid).

MAIN PROVEN BENEFITS OF SPFMS

As reviewed in this study, government-sponsored SPFMs in Europe, the United States, and developing countries have been successful over the last few decades in securing long-term cost-effective finance, and providing an attractive asset class for local investors.

Along these lines, the scaling up of SPFMs can advance this imperative of domestic capital development, helping to implement the required financial framework for the Post-2015 Development Agenda.

SPFMs are proven financial structures that have mobilized during the last 15 years over US$ 1 trillion of private finance in developed countries and close to US$ 3 billion in developing countries to finance a broad spectrum of essential public services, including water & sanitation, energy, transport, telecommunications, education, marketplaces, etc.

Moreover, SFPMs have catalyzed the rise of a local/subnational-development oriented asset class in the domestic capital markets, matching the long-term investment needs of in-country pension funds and other institutional investors with the availability of creditworthy pools of essential infrastructure projects.

The reported benefits of SPFMs are widespread and demonstrated with extensive evidence, as summarized below:

Felipe de Jesús Gutiérrez Gutiérrez

Secretary of Urban Development and Housing, Federal District of Mexico

In a context of urban transformation, coordination between local governments is critical to the livability of cities. Intermunicipal financing dynamics, like subnational pooled financing mechanisms, represent one of the solutions to allow local governments to access long-term financing needed to address urban challenges. These innovative financing mechanisms will be the focus of discussions to be held during the preparatory conference towards Habitat III "Financing Urban Development: the challenge of the millennium" to be held in Mexico City in March 2016.

Elena Bourganskaia

Global Head for Water and Municipal Infrastructure,
International Finance Corporation (IFC)

Exploring pooled financing mechanisms can give us a way to reach smaller municipalities for which it is difficult to provide financing directly even if they are creditworthy. Those municipalities will have to meet the standards and agenda of investors, and have the flexibility to get the funding where it is needed for their projects. Pooled financing seems to be a good instrument for creating an incentive structure for municipalities to build these capacities, improve creditworthiness, and cooperate with other municipalities.

1. OBTAIN FINANCE FOR LOCAL INFRASTRUCTURE AND OTHER ESSENTIAL PUBLIC SERVICES

Local and regional governments often cannot access the funding needed for projects that are essential public services, given the limited national funding available, the lack of access to private markets, limited availability of domestic long-term debt capital for such purposes, and the need for support in developing viable projects.

In addition, since many local projects are small in total cost (less than US$ 5 million) they lack the scale needed to attract and secure funding.

Despite these obstacles, **SPFMs have been successfully used since 1898 in securing finance for both large and small local projects, securing over US $1 US trillion in finance in Europe and US, and over US$ 2.6 billion in developing countries**. For example, in 2014 alone, the Scandinavian and Dutch agencies issued bonds in various capital markets for a total estimated value of € 70 billion. In fact, these bonds constitute a specific asset class that is very much in demand in international markets. As documented by our research, pooled funds have successfully secured finance for over 40,000 local projects in both developing and developed countries.

2. REDUCE FINANCIAL BURDEN ON NATIONAL GOVERNMENTS

Properly constructed and managed, SPFMs provide prudent financial instruments that enable the mobilization of needed finance for local and regional governments, reducing the financial burden on national governments and also the costs of ongoing subnational government monitoring given the built-in periodic financial audits conducted by the technical management of SPFMs and private creditors.

In terms of financial access, SPFMs diversify financial sources for local and regional governments, tapping into private sector finance as well as into underutilized resources at the local level by optimizing user fees for services, tax payments, and other assets such as land. An independent legal structure of the SPFM can also provide for off-balance-sheet financing using proven nonrecourse financing techniques, limiting contingent liabilities for the government other than that specified in the SPFM, meaning any default will not affect the credit of the shareholders or the government (subnational or national).

3. REDUCE COSTS FOR LOCAL INFRASTRUCTURE PROJECTS THROUGH FINANCIAL ENGINEERING AND ECONOMIES OF SCALE IN ALL ASPECTS OF THE PROJECT LIFE CYCLE

Transaction and development costs for local infrastructure projects, especially smaller ones, often undermine their ability to be financed. SPFMs have successfully reduced finance, development, and management costs for local infrastructure projects:

- *Reduced perceived risk*, by creating a consolidated financial asset that improves the creditworthiness and is investible given SPFM structure, use of credit enhancements, diversification (through a collection of many projects, etc.);
- *Reduced finance costs*, given lower risks reducing interest costs and extending the time period of finance and providing access to lower cost finance markets (such as bonds);
- *Reduced develop ment costs for projects* through standardization of project development procedures; and
- *Reduced costs for managing and monitoring projects* by creating standardized processes and economies of scale.

4. ACT AS "MARKET-MAKERS", STIMULATING THE DEVELOPMENT OF DOMESTIC CAPITAL MARKETS

SPFMs have proven to serve as "market-makers," stimulating the development of domestic capital markets in both developed and developing countries. SPFMs provide institutional investors, banks, and other investors with creditworthy investments, in effect a new "asset class." SPFMs introduce new competitive pressures on existing providers of credit to subnational entities, serving to reduce interest rate costs and related fees. As market makers, they can also provide stability in the flow of funds at times when banks are reducing their lending to infrastructure projects, and also reduce uncertainty in the funding of local infrastructure.

5. ENABLE GREATER QUALITY OF PROJECTS AND CREDITWORTHINESS

Local and regional governments usually lack the experienced technical in-house expertise required to develop, finance, and operate projects. SPFMs serve as conduits for transfer of knowledge and provide incentives to improve creditworthiness. They help with capacity building for local governments that do not have needed in-house project development, finance, and management capacity. Moreover, SPFMs often organise conferences, workshops and consultations.

In some cases, the use of SPFM processes can include the standardization of user fees for services provided by SPFM projects, thereby increasing the predictability and quality of revenues, and thereby improving creditworthiness.

6. CATALYZE THE ADOPTION OF STRICT MARKET STANDARDS, ENABLING GREATER RESULTS AND TRANSPARENCY

Local and regional governments through SPFMs need to comply with market standards that require compliance with strict credit standards as well as comprehensive project monitoring, thereby creating incentives and processes for improved results and transparency.

7. CREATE NEW “HARD CREDIT CULTURE” FOR COUNTRY’S LOCAL AND REGIONAL GOVERNMENTS

By adopting SPFMs, the contagious impact of a new “hard credit culture” can be ignited and subsequently spread throughout the country and region. The adoption of new credit principles and techniques can be disseminated through peer-to-peer exchange, emulation and enhanced collaboration.

8. ADVANCE THE SUSTAINABLE DEVELOPMENT GOALS (SDGS) AND NATIONAL DEVELOPMENT GOALS, BY REDUCING COSTS TO END-USERS AND IMPROVING OPERATIONAL EFFICIENCIES IN THE PROVISION OF LOCAL SERVICES

SPFMs have been successful in providing a technical framework securing the public support and private finance and processes required for providing essential public services fundamental to advancing the achievement of the SDGs and national development goals. These public services are the basis for improving living standards, market dynamism and innovation, economic competitiveness, private sector development, income generation, and job creation. SPFMs have therefore enabled greater capacity of local and national government agencies to perform and maintain services for citizens, improving standards of living and MDGs implementation as well as sustainable financial planning and ↺

> « **In South Africa, Pension Funds are clients for municipal bonds.** The investors’ appetite will be led by the quality of the project to finance: if the Pooled Financing mechanism is consistent and gives appropriate risk-adjusted returns on identified projects, Pension Funds may be interested as well. »

ROB SOUTHEY
Alexander Forbes, South Africa

investment capacities at the local and regional government level.
A specific important application is the use of SPFMs to help integrate the growing number of poor underserved secondary cities around large mega cities, helping to include them into an integrated market with essential public services needed for social cohesion and private sector development. Local infrastructure projects as a market (and long term financing needs) are an emerging topic so this needs to be better advocate/made public /create knowledge on this specific class.

9. FACILITATE DEVELOPMENT EFFECTIVENESS

Support from national, regional, and local governments and development partners has been essential to the successful development of SPFMs in developing countries. It is critical to note that the long-term consistent support of development partners has been essential in securing private capital and catalyzing the required changes to country frameworks and processes that enable delivery of infrastructure services and economic development. Specific interventions have been to improve the legal, regulatory, and institutional frameworks for local and regional governmental functions and ability to mobilize private finance. Key areas have been the adaptation of reforms related to the authorities of local governments and the creation of stable, predictable, and adequate intergovernmental financial transfers; and support of related technical capacity building of government entities.

Sean Keogh

Head of Strategic Transactions Group,
Development Credit Authority – USAID

The USAID Development Credit Authority goal is to get real transactions off the ground to provide development impact. We want to be positioned where we are needed the most by financing relevant projects, and deepening the capital market. […] Pooled Financing does open capital market for borrowers who will only be able to access private loans that are more expensive for more restricted terms. This will increase the ability of the borrower access to a more liquid and cheaper market.

MAIN CHALLENGES TO MAKE SPFMS FEASIBLE AND EFFICIENT

While the introduction of SPFMs are reported as relatively simple in developed countries, significant challenges in developing countries have been reported due to the need to develop national and local level frameworks and domestic capital markets, as well as develop the credit enhancements, projects, and technical capacity for their set-up and operation.
A review of the history of SPFMs in developing countries reveals many challenges and risks that need to be avoided. Most significantly, SPFMs have historically required extensive upfront technical assistance to develop and structure them so they can be successful in securing private finance.
However, **once established, SPFMs are reported as being cost-effective in terms of securing long term low cost finance, low operating costs, and having low default rates.**

As noted in the above section, for these very same reasons SPFMs can act as transformative levers of change on both local and national levels, catalyzing domestic capital markets and transforming the enabling national frameworks for sustainable development. Therefore the greater investment and complicated processes for setting up SPFMs in developing countries have delivered significant returns but only after sustained efforts and in the longer term. The public sector therefore needs to recognize that setting up SPFMs is a complicated and high investment process that can catalyze broad development impact and transformative processes, in addition to greater access to private capital.

A summary of the reported challenges and preconditions to avoid risks for SPFMs are as follows:

1. REQUIRED HIGH-LEVEL AND SUSTAINED POLITICAL SUPPORT

For all successful SPFMs in developing and developed countries, national and local governments have been steadfast champions and have contributed major political support and resources to their development. Moreover, the required consistency of approach and focus is more likely if the use of SPFMs is part of the country's larger development plans and associated strategies supported by its development partners, including decentralization and devolution.

2. REFORMS IN INSTITUTIONAL, REGULATORY, AND LEGAL FRAMEWORKS

Depending on the specific circumstances of the country and the structure of the SPFM, there may be a requirement for extensive adaptation in national institutional, regulatory, and legal frameworks to ensure the correct structure and operations of the SPFM.

A critical precondition is fiscal decentralization and devolution that creates the "space" for local and regional governments to set up SPFMs, with the explicit endorsement and support of the national government reinforced by a supportive culture of cooperation, mutual partnership, and local government accountability.

Importantly the financial flows underpinning the creditworthiness of the SPFM need to be clearly evidenced, with core components being own source revenues and predictable, timely, and adequate intergovernmental financial transfers.

3. STAKEHOLDER CONSULTATION AND CONSENSUS, WITH PRIVATE SECTOR "CROWDING IN"

Given the high turnover of political leaders and short-term political and budgetary pressures, it is also critical that consistent support be provided by a large group of stakeholders, including development partners, citizens, NGOs, and the private sector. Moreover, the ↺

Therefore SPFMs are an essential mainstream financial instrument that needs to be scaled up as an integral part of the new financial framework to support the achievement of the SDGS and national development goals, using a « blended finance » approach for government-owned and sponsored projects.

These financial instruments enable local and regional governments to play their part of the implementation of national and international development policies as the « *first partners of national government* **», also creating a « new highway » for the systematic use of a wide range of capital from the private sector as well as potentially from foundations, NGOs, and social impact investors.**

As evidenced in this paper, the wide variety of SPFM structures and processes demonstrate its pivotal usefulness in developing countries and the ability to adapt them to different country objectives and contexts.

The power of the SPFM approach derives from the use of diversification and harnessing new resources for sustainable development through the scaling up of the infrastructure asset class with new financial interlocutors and capabilities embodied within SPFMs.

By upgrading the financial culture within local and regional governments, SPFMs can serve as « market makers », as aptly demonstrated by the European Local Government Funding Agencies.

success of SPFMs in securing private finance requires buy-in from the private sector, including both targeted investors (domestic banks, institutional investors) and rating agencies (if bond issuance). Therefore, the successful development and finance of a SPFM requires investment in developing a new level of "maturity" of stakeholders, through intensive communication, consultation, advocacy and lobbying.

4. HIGH UPFRONT STRUCTURING COSTS & NEED FOR PRUDENT PROFESSIONAL MANAGEMENT

SPFMs are structured financial vehicles that depend on the use of well-crafted financial structures and legal contracts. There has been the reported issue of SPFMs being used in ways that have resulted in over indebtedness of local governments. It is therefore important to ensure careful supervision of the SPFM structure, and to ensure transparency in all liabilities incurred by the subnational and national government. Therefore the creation of a successful SPFM requires significant investment, with the involvement of highly skilled professionals and independent review by public sector finance experts to mitigate risks of financial burdens for the local, regional, or national government.

5. PROFESSIONAL EXPERT MANAGEMENT OF SPFMS

For SPFMs to be creditworthy and access private finance, they need to have credible and experienced management that can meet investor requirements. The operations need to be managed on a technical basis with no political intervention that could result in diverted funds or subversion of the required high credit standards. The SPFM expert management team needs to be recognized by the targeted investors as having credible long-term track records in credit and risk management, so that the investment criteria and due diligence fiduciary requirements are explicitly satisfied. In addition, investors will require independent in-depth expert audits be conducted on a regular basis.●

« **The commercial banks should be actively involved in the consultative process in order to already be aware of this new financial product and risk.** The appetite for secondary and small municipalities already exists but there is no viable tool to facilitate financial transactions. Pooled financing mechanisms seem to be part of the solution. »

REMO MOYO
Divisional Executive Public Sector,
Nedbank, South Africa

Subnational Pooled Financing Mechanisms in detail

RANGE OF SPFM STRUCTURES, TYPES, AND REPLICATION TO DATE

There is a wide spectrum of different SPFMs developed to date in both developed and developing countries, differentiated by the varying degrees of financial engineering required to reduce credit risks and access private finance.

A full spectrum structures has been used around the world, ranging from structures that leverage market perceptions of high creditworthiness of local governments in developed countries, to the heavily structured credit enhanced structures used in developing countries.

Developing countries have relied heavily on funding from development partners in four areas:

- Assessment and processes enabling the needed reforms in legal, regulatory, and institutional frameworks;
- Capacity-building of the relevant government entities;
- Preparation of projects;
- The development of the PFM structure and initial underwriting costs (e.g., financial advisors, legal support, rating agency fees, etc.).

SPFMs have been constructed in many different ways, with varying levels of complexity that have evolved over time, as noted below.

1. 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.

2. THE MEDIUM LEVEL IS A SO-CALLED "CLUB DEAL"

This is a bond issue in which two or more local authorities participate and it is done without a special purpose vehicle (i.e., a separate legal entity set up to manage the pooled fund).

Each participating local authority 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 the low cost pricing of the bonds. The medium level is suitable for countries with institutional and legal restrains to develop SPFMs 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.

3. THE ADVANCED AND MOST USEFUL LEVEL IS TO CREATE A SPECIAL PURPOSE VEHICLE (SPV) TO ACT AS AN INTERMEDIARY BETWEEN SUBNATIONAL ENTITIES AND CAPITAL MARKETS

The significant advantage of using 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 markets. 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 subnational entities, central government, a third party (e.g., public sector pension funds, development partners, local guarantee agencies) 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.

Given the optimal development benefits provided by SPV structures, this paper will only examine SPFMs established through separate legal entities (SPVs) and accountable government entities for the purposes of accessing private finance (bank finance and bond issues), and not other structures such as club deals mentioned above.

FOCUS ON THREE TYPES OF SPFMS:

Three generic broad types of SPFMs using SPVs have evolved over time, with differences between the European and US models, and further variations that have been successfully established in developing countries reflecting the wide range of domestic needs and contexts. The following three broad types of SPFMs are covered in this paper (see table 1):

1. LOCAL GOVERNMENT FUNDING AGENCIES (LGFAS) used as dominant source of finance in Europe:

A specific type of SPFMs has been used for over a century in Europe – Pooled Financing Agencies (PFAs). They serve as the principal conduit for local and regional governments (LRGs) access to credit for many countries. The dominant role of PFAs is illustrated by the Swedish cooperative bank *Kommuninvest* that reported mobilized loans of over € 9 billion in 2014 alone. Despite alternative source of available financing, local and regional governments are setting up new LGFAs in France and the U.K given the perceived unique benefits of these financial mechanisms.

This type of SPFM has deep historical roots, having been expanded in Europe since 1898 after the establishment of the Danish agency, *Kommunekredit*, followed by replication in six European countries: Netherlands (1914), Norway (1926), Sweden (1986), Finland (1990), France (2013), and the U.K. (2014). All the European LGFAs have the same general business model. The agencies issue bonds in domestic and international capital markets and on-lend the proceeds to local authorities and to related entities such as municipal owned companies. When bond issues are denominated in foreign currencies, they are converted into domestic currency by the agencies with the use of foreign currency swaps. All lending to local authorities is made in domestic currency, thereby matching the revenues generated by the projects. The agencies deploy strict risk management routines, including tight matching of borrowing to lending (asset-liability management). Towards this end, the mature agencies use a portfolio view, while new agencies often deploy back-to-back matching. LGFAs are created for the good of the local authorities and their citizens, and do not seek *a priori* to make profits. Surplus in the accounts of the agencies are reinvested in their activities, with the aim of better serving the local authorities. LGFAs lend solely within the borders of their respective countries.

2. MUNICIPAL BOND BANKS used as dominant source of finance on US and also developed in Mexico:

Municipal bond banks and pooled financing facilities first appeared in the United States in 1970 for the purpose of lowering the cost of debt for municipalities. There is no single definition that describes all bond banks, but a broad definition might be an entity that *sells its own securities* and relends bond proceeds to multiple local governments. A “general purpose” state-based lender has grown slowly in the U.S. over the past forty-five years.

Since 1970, U.S. Bond Banks have offered an advantageous mechanism for small communities to finance municipal projects, accounting for over US$157 billion in debt finance, using credit enhancement for local governments that cannot access credit on their own. The US Clean Water State Revolving Fund (CWSRF) reports that over 25 years, it has provided over US$ 100 billion to over 30,000 small projects. The Vermont Municipal Bond Bank, which was created in 1969, is generally credited as the nation’s first general purpose bond bank, and was soon followed by the Maine Municipal Bond Bank, Puerto Rico Municipal Finance Agency, Alaska Municipal Bond Bank Authority, North Dakota Municipal Bond Bank, and the New Hampshire Municipal Bond Bank. Although there

Table 1 : Summary of the three main types of SPFMs and their reported respective advantages and benefits against their disadvantages and challenges

SPFM Type	Legal Status & Operation	Advantages & Benefits	Disadvantages & Challenges
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	- Owned by Local Government Members (may include association of local and regional governments) -Membership based on standard financial criteria related to LG financial status and transparency - Access to credit based on existing market perception of local government creditworthiness - Agency borrows funds that are on-lent to participating LGs - Management usually is by a Management Corporation; in any event LGFAs need to be separate from political interference	**- Improved management of LG finances superior to that of national government control**: Agencies provide tight management control employing prudent asset and liability management (portfolio management or back-to-back matching on specific project basis); Approvals required for use of funds; Joint and several guarantees when used can reinforce the responsibility of local governments for the agency **- Access to low-cost funding available in domestic and international markets**: Also swaps can be used to hedge currency risk if there is a deep foreign exchange market for the home country currency (example: Agency France Locale borrows at 22 bp versus 135 bp from other sources) **- Reduced cost**: Less financial advisory, credit based on local government balance sheet so less cost for project documentation and monitoring, no (or limited) cost for external credit enhancements as core credit enhancement is joint and several guarantees provided by LGs; example: Agence France Locale set up only cost € 600,000 (excluding cost of LG personnel); Low annual administrative costs of mature agencies 7-15 bps **- High transparency** required of sub-national financials (annual audits of member creditworthiness) **- High autonomy** from national government	**- Not applicable to local governments that the LGFA or markets perceive as uncreditworthy** **- Requires extensive collaboration** between participating LGs **- Requires same extensive on-going long-term consultation on bond issuance** with marketplace to ensure development of attractive assets that investors will readily accept; also need to coopt existing lenders so they do not act to undermine the creation and success of the Agency **- Requires extensive development investment** to address above challenges and conduct needed consensus-building processes (with politicians at national and local level, and with expert support) **- Need to ensure properly managed** so undue high debt burdens are not created for participating sub-national entities or national government
2. Bond Banks - US - Mexico	- Owned by Public-Sector Entity - Access to finance depends on the finance structure of the bond bank, its management, and credit enhancements	**- Wider applicability for accessing finance**: Local and regional governments that are not perceived as creditworthy based on their own financial status can access long-term, cost effective finance from bonds and banks **- Improved management of LG finances superior to that of national government control**: Bond banks provide tight management control employing prudent management **- High transparency** required of projects, and incentives LG improvements in creditworthiness	**- Requires significant long-term investment** from local governments, the national government, and development partners to create the national-enabling environment, required frameworks (legal, institutional, and regulatory), revenue enhancement measures, reliable financial fiscal surplus, project implementation capacity - Can create debt crisis for government if not properly managed but no defaults or debt crises to date
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	- Owned by Public-Sector Entity, PPP, or Private Sector Entity - Potential link to municipal development funds (e.g., FINDETER in Colombia) - Access to finance depends on the finance structure of the PFM, its management, and credit enhancements	Same as above - Overall excellent track record of debt service and low default rates (e.g., India pooled funds repayment rates 98% (versus 23% for state-guaranteed parastatal –financed projects) - Ability to reduce contingent liabilities for government if SPFM and national bankruptcy laws protect the local and national government	Same as above - Risk of creating liability for national government; case of Colombia GIF Water and Sanitation failed pooled fund which Ministry of Finance had to bail out

is no comprehensive list of all the state bond banks in the U.S., there are at least 25 of them in operation.

Bond Banks have also been set up successfully in Mexico, mobilizing over US$ 1 billion in domestic private finance to date. It is important to note that nearly all bond banks in the United States and Mexico are owned and operated by state government agencies. This successful track record demonstrates that pooled financing institutions do not need to be privately owned or managed to secure private financing.

3. MODIFIED POOLED FINANCING FUNDS used in some developing countries (India, Philippines, Kenya, South Africa, Colombia, Mexico):

The successful SPFM approaches from developed countries have been successfully adapted to circumstances in developing countries to secure both bank loans and bond finance with greatest replication in Asia (India, Philippines), as well as Latin America (Mexico) and Africa (Kenya, South Africa). USAID has long advocated the use of pooled financing, providing technical assistance and a partial credit guarantee to the landmark pooled finance facility *Tamil Nadu Urban Development Fund* in the 1990s. Due to its success, in 2006 the Government of India established a central government office accountable for scaling up pooled funds across India at the state level, using the Pooled Finance Development Fund Scheme (PFDF) to provide credit enhancement facilities to Urban Local Bodies (ULBs) based on their creditworthiness, enabling them to access market borrowings through the state-level pooled funds.

In Mexico, the Bond Bank of the State of Hidalgo, founded in 2007 with support from the USAID Global Development Alliance program, conducted three bond issues raising a total of US$213 million. Other pooled funds have been successfully utilized to fund small projects in Kenya and the Philippines.

SPFMs have successfully secured finance for over 650 small projects in developing countries: India (279), South Africa (230), Colombia (105), Kenya (35), and Mexico (12). These SPFMs have used targeted official sector interventions to catalyze the use of new institutional and finance processes that enable development effectiveness, delivery of infrastructure services, and economic development.

Specific interventions have been made to improve the legal, regulatory, and institutional frameworks for LG functions and ability to mobilize private finance. However, the scaling up of SPFMs in developing countries has not occurred, given the need for greater support from the public sector. Specific preconditions include enabling local and regional governments to achieve a stable financial status by greater authority over own sources of revenues and providing them with timely, predictable, and adequate intergovernmental financial transfers. In some countries, the specific authority to contract debt may be required.

DETAILED SECTION ON SPFM STRUCTURES & OPERATIONS

This section provides more detailed factual evidence underlying the general points made in the paper's first section, whenever possible using summary charts to provide the differences in the three generic SPFM approaches. The following areas are covered:

- Structures including, use of credit enhancements and types of investors
- Financial benefits
- Participants and costs
- Preconditions
- Key difficulties and limitations
- Starting points for incubation

SPFM Structures: Use of Credit Enhancements, and Types of Investors

1. CREDIT ENHANCEMENTS

The structure of SPFMs and the type of credit enhancements vary based on the specific country, its institutional and legal structure, the types of projects to be financed and their bankability, and political considerations.

Examples of the types of credit enhancements include the following:

- **Reserve accounts**: Many pooled funds place their annual central capital grant in a reserve account which is pledged as collateral to investors in the event any borrower fails to meet debt service obligations. This is referred to as the reserve account model.
- **Cash-flow over-collateralization**: Some pooled funds lend their annual capital grant funds to local governments and pledge the repayment of those loans to investors. In this case, the investors will have as collateral the repayment of loans from the pool of projects they finance plus the repayment of loans made with central government funds. This is referred to as the cash-flow model. An example is State Revolving Funds in which project debt payments are used for debt service with credit enhanced backup from the revenue intercept from the central government.
- **Transfer intercepts from state governments**: Many pooled funds have statutory authority to intercept state transfers to local governments if the latter should default on obligations to repay loans. This intercept mecha-

nism is viewed favorably when the local governments depend on state transfers for a large portion of their revenues and when the state transfers can be redirected from the pooled financing facility to investors. Intercept mechanism have been used extensively in the U.S. and developing countries as a source of security for local government financing.

- **Partial credit guarantees**: Many pooled funds in developing countries have used partial credit guarantees to achieve the needed market confidence. Examples include the use of USAID partial credit guarantees used in the following SPFMs: Tamil Nadu Urban Development Fund (India), K-Rep pooled fund (Kenya), and the Bond Bank of the State of Hidalgo (Mexico).

SPFMs can use a wider set of credit enhancements used in other projects to enable viability and sustainable development, such as first loss tranches and output based aid to subsidize poor users that cannot afford to the full cost of the delivered service.

2. OVERVIEW BY TYPE OF SPFM

A summary of the three main types of SPFMs is presented in the table 2, including variations in the model, national preconditions, terms of issuance, credit enhancements and types of investors.

The key fact for developing SPFMs: the financial benefits

The most important financial benefit is access to markets. The use of SPFMs has meant that local governments that could not access finance for their projects have been able to do so, accessing the long-term finance required for providing services to their citizens. Because of this special function, SPFMs issue large amounts of finance. For example, in 2014 the Scandinavian and Dutch agencies issued bonds in various capital markets for a total amount of nearly €70 billion. One SPFM alone - Swedish Kommuninvest - issued US$1.25 billion bond issue in 2014 of which close to 80 percent was bought by central banks and international organisations.

Therefore SPFMs are confirmed as viable financial instruments creating an attractive asset class for many international investors.

Second, by aggregating small projects into one larger facility, SPFMs can pay lower debt service costs (i.e., reduced interest rates and related fees) and operate cost-effectively, passing on these lower costs to the users in the infrastructure services, resulting in reduced service fees. Because SPFMs can be structured to improve creditworthiness and reduce risks, debt-servicing costs are reduced. Moreover, as noted earlier, SPFMs are reported as creating new competition in markets, reducing the market interest rates. Therefore the use of SPFMs can result in two levels of financial benefits: lower debt service costs and lower overall administrative costs.

1. REDUCED DEBT SERVICE COSTS

When Swedish Kommuninvest began its activities in 1986, the savings between its cost of debt service and that of other sources were more than 200 basis points (bps). To compete, banks and other lenders had to decrease their margins in order to stay in the market. This means that SPFMs can serve to stimulate competition and lead to a better functioning market for loans for local authorities.

More reported examples of debt serving costs are in the table 3 below.

2. REDUCED ADMINISTRATIVE COSTS

Savings are also realized through the reduction in transaction costs associated with the economies of scale in the project development and underwriting process. Ongoing operational costs are also reduced through economies of scale. SPFM staffing levels, generally small, vary greatly depending on volume of loans and the nature and number of programs for which the SPFMs are responsible (see table 3). ↺

« **Pooled financing entities need to focus on financing infrastructure and not other kinds of financial activities.** They should offer a single product to the market and the local authorities: access to capital on preferential terms that participating municipalities would be otherwise unable to get because they do not have the high credit rating that a pooled financing does. »

DAVID PAINTER
Senior Municipal Infrastructure Finance Adviser PPIAF/SNTA, World Bank Group

Table 2 : Summary of Key Components of SPFMs

Type	Model	Terms of Issuance	Credit Enhancements	Types of Investors
All	All SPFM models (the three below)	- Legal under national and state laws and regulatory frameworks, investor-acceptable accountable structure & low perceived political risk from government - Professional and competent management - Demonstrated ability and willingness to service debt per market requirements	Either through leverage of creditworthy local governments and/or external support from national government, development partners, etc.	- Full range private sector: banks and bond market, national and international, equity funds - Support from national, regional, and/or local government - Possible support from related government entities: pension funds, guarantor, municipal banks, etc. - Support from development partners, NGOs, foundations, etc.
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	- Requires Special Purpose Vehicle - Ownership: Local Governments usually jointly own the agency, sometimes with ownership of the state (in the case of the Norwegian LGFA, the central governments owns 100%, in the Netherlands the state owns 50%) - Dependent on LG creditworthiness	- National law enabling LGs to borrow - Issuance: Standard bond issuance	Joint and Several Guarantees	- Domestic institutional investors - International institutional investors - Associations - Pension Funds
2. Bond Banks - US - Mexico	- Requires Special Purpose Vehicle - Owned by local governments (two thirds operate as independent authorities governed by a board or commission appointed by the governor of the state; others operate as lending programs within a state government department (e.g., a state's Finance or Environmental Protection Department - Viability depends on SPFM structuring	- National laws enabling the pledging of state intercepts - Majority operate as independent and self-supporting authorities under state law - Issuance: Standard bond issue, also bank loans	- State intercepts - Partial credit guarantees - Debt Reserve Fund - Partial Credit Guarantee (for Mexican Bond Bank of Hidalgo)	- Domestic Institutional Investors - Local Banks (includes national offices of international banks)
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	- Requires Special Purpose Vehicle - Owned by public sector, private sector, or a combination thereof - Management varies dependent on domestic context	- National laws enabling SPFMs; may require laws that enable LGs to collect own source revenues (taxes, fees, etc.) and set own rates; borrow long-term - Issuance: Standard bond issues, bank loans	- Debt Reserve Fund - Inter-governmental Financial Transfers - Partial Credit Guarantee (for almost all)	- Domestic Institutional Investors (India Water SPFM sold to domestic pension funds) - Local Banks (includes national offices of international banks) - Possible support from related government entities: pension funds, guarantor, municipal banks, etc. - Support from development partners, NGOs, foundations, etc.

Table 3 : Examples of Reduced Debt Service Costs

Type	Examples
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	> The cost of Swedish Kommuninvest's borrowing is more than 30bp less compared to other sources > Danish Kommunekredit provides 100% of the total loan market to local authorities at an interest rate cost of 25bps > Agence France Locale issued a bond of €750 m. oversubscribed up to €1.5 billion with margin of only 22 bps over the French State (compared to 135 bps for loans from banks) > UK Municipal Bond Agency issue is expected to issue a bond this year at 45-55 bps over Gilts (British Central Government Bonds); this is less than the existing dominant source of finance for local governments – 80 bps provided by the Public Works Loan Board (PWLB)
2. Bond Banks - US - Mexico	> Bond banks are generally rated better than the local governments included in the financings, so interest rates are lower > In the U.S., interest earned from municipal bonds is tax free, and there is a large demand from institutional investors for long-term fixed income securities, so interest rates are very low
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	> Tamil Nadu UDF and the Water and Sanitation Pooled Fund (India) issues bonds with a spread of about 70 bps above the state borrowing cost. Each subsequent bond issue has reduced costs due to higher credit ratings. There has been secondary market, albeit small, with bond being purchased by pension funds.

Table 4 : Reduced Administrative Costs

Type	Examples
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	> Annual administrative costs for mature European agencies are between 7 – 15bp of their total debt portfolios > Kommuninvest (Sweden) has a total lending portfolio of SEK 223 billion (€ 24 billion) with annual total administrative costs of 8bp (or € 19.2 million)
2. Bond Banks - US - Mexico	> Maine Municipal Bond Bank estimates the cost to sell a US$1 million bond by a locality at US$31,000 - $38,000, versus the cost to sell it through the bond bank of US$2,000 - $5,000, a savings of $28,550 to $33,300 per issue > Low staffing levels: Maine Municipal Bond Bank raised US$ 100 million/year with a staff of six; Michigan Bond Bank employed ten people; Vermont Bond Bank had one full-time director and a part-time consultant > Mexico Bond Bank operating costs approx. US$350,000- US$500,000 a year including personnel, office space, etc. (paid either by the state government or by the bond bank charging a managing fee from the transactions) > Mexico Bond Banks cost of issuance was approx. 1.5%, including fees of underwriting agent, bond counsel, public finance advisor, Trustee, paying agent, etc.
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	In the case of the Tamil Nadu UDF, the Asset manager started with a staff of 5 and has kept operating costs at less than 1% of the Assets under Management

Participants in SPFM and Cost Contributions

For SPFMs to be successful, there needs to be a true depth and quality of multi-stakeholder participation across the government –- national and local governments -- as well as with the private sector professional experts required to set up the PFM and the targeted provider of finance (or intermediaries such as rating agencies).

In all SPFMs, governments need to specify the objectives of the fund, and professional finance experts are required to develop and maintain the creditworthy structure and operation of the SPFM. The public sector - to varying degrees the local governments, the national government, and development partners - are also required to cover the upfront development costs, such as financial advisory, technical studies, legal fees, rating agency and underwriting costs, as well as meet investor criteria for creditworthiness (for

Table 5 : SPFM Participants & Contribution to Costs

SPFM Type	Participants	Roles	Financial Contributions
Overall Common Characteristics	- Local governments - National government (support) - SPFM professional staff - Rating agencies for all SPFMs issuing bonds (i.e., ratings not required when funding is provided by banks)	- Governments specify objectives - Professional ensure creditworthy structure and operation	- Public sector (local governments, central government, or development partners) cover upfront costs of development and any costs impeding creditworthiness, and provide guarantees and/or debt reserves to meet investor criteria
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	- Local Governments - National Governments (support) - Third parties (e.g., pension funds, municipal guarantee board)	- Ownership: Local Governments usually jointly own the agency, sometimes with ownership of the state (in the case of the Norwegian LGFA, the central government owns 100%; in the Netherlands, the state owns 50%) - Strict standard financial criteria for local government membership set by professional staff and evaluated by staff - Guarantors: Local Governments often provide joint and several guarantees, with or without the central government and/or third parties	Public sector (local governments, central government) cover upfront costs of development and any costs impeding creditworthiness - Local governments, pension funds, and/or municipal guarantee board provide guarantees to meet investor criteria - Examples: Agence France Locale advising group cost € 600,000 (excludes cost of personnel of local government officials working on the project); UK Municipal Bond Agency development costs estimate £800,000
2. Bond Banks - US - Mexico	- State governments - In case of Mexico, development partner USAID and private sector partner	- Integrated into state government - Professional management - For Mexico, technical assistance provided by USAID and its private sector partner	- In Mexico bond banks, USAID and the State split the cost 50/50 for designing and creating each Bond Bank, training personnel and writing the operations manuals (US1 million); preparing the state legislative frameworks in each state so that the state could issue properly structured bonds cost the peso equivalent of approximately $1 million per state, also split 50% - 50% between USAID and each state government
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	- State and local governments - Development Partners	- Separate legal structure for pooled funds (no liability for government) - Technical assistance and partial credit guarantees provided by development partners	Tamil Nadu Pooled Funds start-up costs were approximately 1% of Assets under Management for the first 5 years (amortized)

example, provide debt service reserve, state intercepts, or intergovernmental financial transfers, and/or guarantees).

It is important to note, that as noted in the prior section on structure, in all cases except for club deals the establishment of a Special Purpose Vehicle ("SPV") or an investor-acceptable entity is needed with professional and competent management and a strong source of capital and operations that can be considered bankable for investors. Moreover, in developing countries the support of development partners is an essential component given the challenges with regard to both the country's enabling environment, as well as with the need for financial expertise and significant start-up costs.

The table below summarizes the role of participants overall and by the main three types of SPFMs. ↺

« The institutional context of municipalities have to be considered while reviewing possibilities for developing pooled financing. Moreover, one needs to get a true national consensus on municipalities' broad needs. Indeed, cities are national assets. Urban development is also a national project that aims to promote sustainable growth. Hence there is an absolute necessity to take the debate on pooled financing at the State level. »

SITHOLE MBANGA
Chief Executive Officer,
South African Cities Network (SACN)

Table 6 : SPFM Key Preconditions for Success

SPFM Type	Legal & Regulatory System	Institutional frameworks	Creditworthiness of Local Governments	Domestic Markets
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	- A legal system that allows local authorities to borrow - A legal system that allows local authorities to cooperate and to jointly assume commitments	- Requires that investors are comfortable with municipal creditworthiness and quality/continuity of political leadership	A number of local authorities (at least 10) with sufficient creditworthiness	A domestic capital market that has reached a certain degree of maturity with investors that could potentially be interested in local government bonds
2. Bond Banks - US - Mexico	- Most Bond Banks have required state legislature approval	- Usually requires that investors are comfortable with state creditworthiness and quality/continuity of political leadership	- Not required provided sufficient credit enhancements	Same as above
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	- SPFM can be set up to meet national requirements with no recourse to local, regional, or national governments	- Critical that national, regional, and/or local government can provide solid evidence of required high level of reserves to cover debt service (may be multiple)	- Not required provided sufficient credit enhancements	- Flexible – not dependent on existence of domestic capital market as funding may come from domestic banks as well as other investors (funds, foundations, social impact investors, etc.)

« There is no unique solution to be applied everywhere and the Agence France Locale was the end of a step by step process depending on where you start from, according the cultural as well as political context of the country. »

YVES MILLARDET
Chairman of Management Board,
Agence France Locale

What are the Preconditions for SPFM Success?

- **Effective Political Leadership:** The first precondition for the successful development of SPFMs in any country is the recognition of a number of local and regional governments that they require new financing solutions. Government leaders to exhibit resilient leadership and steadfast commitment to developing an SPFM using best practices based on local needs and have the political will to confront issues related to the country's legal, regulatory, and institutional frameworks.
- **Professional and Competent Management:** Regardless of whether the SFPM is an independent authority or a lending program of the government itself, professional and competent management is critical to its success. Senior managers are typically drawn from the private sector or government agencies with extensive municipal finance experience. For example, given the depth of municipal finance in the U.S., state governors often draw from a deep pool of talent to manage bond bank institutions.
- **Sufficient Long-Term Committed Funds to Cover Significant Technical and Consultation Costs:** As noted in earlier sections, the start-up costs are significant especially in developing countries. Therefore it is critical to have committed support with funds that are multi-year and not subject to change. This may require a change in political processes of both governments and development partners.

The other key preconditions for success by type of SPFM are summarized in the below table.

The main challenges of developing SPFM at country level

There are many levels of challenges in developing and operating a SPFM. Key reported difficulties and limitations include the following:

1. CENTRAL GOVERNMENT CONCERNS

In many countries, the central government has been reluctant to support a local government initiative to introduce SPFM due to concerns of potential debt crises. It should also be made clear that a SPFM entity's activities will be ring fenced by strict internal risk management regulations and the fact that the entity will perform an on-going strict supervision of the local governments' creditworthiness.

2. VESTED INTERESTS

If there is one or a group of dominating lenders to local authorities, they are likely to feel challenged and therefore are likely to try to undermine introduction of an SPFM. For this reason, it is important to try to find ways of cooperating with the existing lenders.

3. DEVELOPING LOCAL MARKET INTEREST

The other market challenge is to raise the interest among investors for bonds issued by a SPFM entity. Contacts with investors should be taken at an early stage to investigate how investors' interests and concerns could be accommodated within the SPFM structure. Moreover, the SPFM might mean amending existing internal portfolio lending and investment allocation processes. Therefore developing market interest and obtaining market input is critical in structuring the SPFM.

4. COOPERATION AND STRICT TECHNICAL FINANCIAL CRITERIA

In many countries, local authorities are not accustomed to cooperate with each other. Clear governance and technical rules have to be put in place and accepted by the participating local governments. It is crucial that every participant in the SPFM fully accepts the fact that every local government and project needs to be scrutinized continuously and that participation does not secure an unconditional right to borrow from the SPFM.

5. ACCOUNTABILITY

A further challenge is to build a system for securing repayment of the loans to all the projects. For local governments that are not creditworthy, the SPFM needs to secure future payment of the borrowing activities often using a third party guarantee, which can be underwritten by other domestic stakeholders (central government, municipal guarantee agencies, etc.) or by development partners. Such credit enhancements need to be structured in a way that it does not remove the responsibility of the local authorities that have created the SPFM.

While daunting, these country-level challenges can be overcome by coordinated and persistent leadership. In effect, the very process of addressing the challenges spurs the integrated development of the required new dynamics and coordination essential to the new global financial framework.

Starting Points for SPFM Incubation

In developed countries, the starting point for establishing SPFMs has been local and regional governments. However, in developing countries, the ignition for starting the process historically has been development partners from those developed countries who have benefited from the use of SPFMs, notably the U.S. and Europe.

A summary of historical champions broken out by SPFM type is below (see table 7).

In summary, SPFMs represent a radical departure from the paradigm of grant based financing and require significant upfront effort from governments, and if needed, from their development partners. **Best practices show the importance of coordinated and sustained development cooperation, and private sector engagement, with SPFMs providing a catalyzing role for transformative change.**●

Table 7 : General Context for SPFM Development

SPFM Type	Initial Champions	Other supporters	Actions
1. LG-Credit Based PFMS Structures - European LG Funding Agencies (LGFAs) - Currently being explored in developing countries	- Local and regional governments and their associations	- Pension Funds - National government - Parliamentarians - Banks - Rating agencies	Advocacy at national government level (Ministries of Finance); contracting of experts for studies; working groups (political and technical)
2. Bond Banks - US - Mexico	- Same, except for Mexico where USAID and their technical partner were pivotal	Same - Includes development partners if in developing country	Create state legislation authorizing Bond Bank, recruitment of expert staff, set up boards with State Governors as chairs
3. Developing Countrries Pooled Facilities - India - Philippines - Kenya	- USAID (India, Philippines, Mexico, Kenya), World Bank (India), JBIC (Philippines) national governments, state and local governments	- Local banks and other entities - Development partners: KfW, JBIC, AFD, IFC, World Bank	Workshops, Technical Studies, Consultations, engagement of local banks, development of toolkits, support of project development, recruitment of expert staff, set up SPVs and management companies

Summary of Policy Recommendations

WHY ENGAGE WITH SPFMS?

The evidence has demonstrated that SPFMs can be employed so that citizens obtain infrastructure services that were previously lacking, thereby serving as **a "new highway" for local and regional governments to play their role as "first partners of national governments" in delivering on the SDGs and national development goals.**

Moreover, the evidence demonstrates that SPFMs have enabled local and regional governments to **deliver higher quality essential infrastructure services at lower costs.** Depending on the structure of the SPFM and legal commitments, there may not be contingent liabilities for the national government other than those committed to within the SPFM funding structure such as equity, intergovernmental financial transfers, and state intercepts.

The reported benefits from using SPFMs cut across **access to finance as well as operational efficiencies and larger developmental impact,** including:

- reduced cost of finance (longer tenors, reduced interest rates, reduced transaction costs);
- ability to leverage central government finance effectively for support of specific projects (for example using central government intergovernmental financial transfers as credit enhancements);
- streamlined standardized process for more effective project development (e.g., standardized project development processes, loan documentation, user fees, etc.);

- lower risk given the pool's diversification;
- ability to collect fees and enable self-sustaining operation;
- wide applicability to many sectors; and transformative impact in catalyzing domestic capital markets, improvements in creditworthiness and transparency, and public sector effectiveness.

The key challenge is how to operationalize the role of SPFMs in more economic and simple implementation processes, so they can be scaled up and deliver on local finance.

WHO CAN ENGAGE AND HOW?

Given the need to develop a virtuous cycle between markets and local governments, the SPFM development process takes significant investment over several years. The process requires behavioral changes in local, regional, and national governments and commensurate changes in the domestic capital markets. Specific actions includes extensive stakeholder consultation, detailed technical assessments, training, project preparation, the structuring of creditworthy financial entities managed by experienced competent professionals, and "roadshows" building local investor demand.

A summary roadmap of the different actions that need to be undertaken by each main actor is provided in the table below.

The actions above can build on the lessons learned in the many SPFMs that have developed to date in developed and developing countries, showing the large spectrum of options that can be adapted to specific country contexts and developed as appropriate over time.

The Addis Ababa Action Plan for the Local Financing Framework

SPFMs can be used to catalyze the new operational framework for building local capital markets in developing countries and build the technical structures and capacity to access finance for local infrastructure and essential services. In effect, SPFMs can serve as local infrastructure development agencies, and provide a prudent financial framework using investment criteria to ensure the prudent use of finance by local and regional governments in local infrastructure and capital expenditures. Within the new global financing framework, there needs to be the recognition of the pivotal role of SPFMs:

1. **SPFMs as a mainstream "blended finance" instrument that needs to be scaled up for accessing greater amounts of finance for infrastructure.**
   In particular, SPFMs can be used as a viable creditworthy financial instrument to "crowd in" the growing spectrum of interested groupings committed to addressing critical social issues, such as foundations, NGOs, and social impact investors.
2. **SPFMs can play a pivotal role in addressing the need for sustainable climate smart approaches, as well as the growing lack of equity (social, gender, etc.) and need to deliver "last mile" services to poor citizens in rural and underserved areas.**
   Using the diversified project approach, projects that are less viable can be offset by more profitable projects in the pool, and also utilize targeted subsidies from the national government and development partners. A specific important application is the use of SPFMs to help integrate the growing number of poor underserved secondary cities around large mega cities, helping to integrate them into an integrated market with essential public services needed for social cohesion and private sector development.
   SPFMs can also help create more cohesion between local and regional governments and their development projects within a specific region concerned with the consistency of the regional planning.

Khalifa Sall
Mayor of Dakar, Senegal,
President of UCLG Africa and Vice-President of FMDV

The pooled financing offers to African Cities and Regions collective and solidarity financial dynamics, yet for local interest projects. This cooperative pooling would reaffirm to the central states the will of local and regional governments to engage together on the mobilization of new resources, and their ability to make it happen.

Table 8 : Timeline for Actions

Who	The Timeline for Actions		
	Catalyzing Interventions	**Create Structure**	**Secure Finance**
National Governments	- Champion initiative working with local governments and their associations and the development of long-term domestic debt markets - Support training, stakeholder consultations and required assessments (technical. legal, market, etc.) - Create enabling environments: (a) Authorize some or all local governments to collect own-source revenues and contract multi-year private debt subject to prudent conditions and monitoring; (b) provide intergovernmental financial transfers that are predictable, timely, and adequate; (c) support the different required technical assessments: legal, market, project, etc. (d) laws enabling pension and insurance sector reform allowing purchase of sub-national public bonds, future flow financing, treatment of public insolvency, etc.	- Establish national support structures and processes that can support local financing and SPFM(s) - Establish regulatory requirements under national laws	- Provide financial support as needed to meet investor requirements (options are equity, intergovernmental financial transfers, etc.) - No guarantees provided
Local & Regional Governments	- Improve sources of revenue - Select projects from capital expenditure budget that generate revenues that can be used to service debt - Undergo training - Contract experienced professionals to support projects	Based on assessments, set up legal structure and governance with market-based investment criteria -Board to be composed of political representatives (no involvement in project selection) -Management company to be staffed by competent professionals who make all lending decisions	- Contract financial advisors to conduct all required steps for negotiation based with full disclosure and transparency
Private Sector	- Input from banks, pension funds, and rating agencies on investor requirements and concerns - Conduct assessments and training	- Provide financial advisory on investment standards, development of solid credit structure with needed risk mitigation, support development of viable projects, provide legal support in development of documentation, provide rating advisory, etc. - Negotiate credit enhancements with providers	- Provide independent financial advisory to negotiate best deal terms - Provide local currency finance through banks/and or bond issuance
Targeted Support from Development Partners	- Support the development of long-term domestic debt markets through policy and regulatory advice to establish an enabling environment including enabling laws (noted above), - Fund technical assistance for assessment and project preparation if needed	- Funding of technical assistance to develop debt instruments (loans and bonds) and develop solutions to inevitable obstacles - Fund bond counsel fees, bond rating fees, trustee fees, paying/transfer fees, etc. - Design the required of risk mitigation and credit enhancement support with the financial experts to meet investor requirements	- Finalize commitments needed to close the “viability gap,” such as partial credit guarantees, mezzanine debt, grants, etc.

ENGAGING COUNTRY ACTIONS

The immediate actions that national governments and their development partners can take are the following:

National governments should proactively explore how to adapt SPFMs to meet the needs of their countries and advance their national development goals and the achievement of the SDGs in consultation with their local and regional governments and local finance providers.

- Need to develop a common reform agenda to enable local and regional governments to borrow, collect own revenues, set tariffs, as well as have permissions on staffing and procurement.
- Need to commission the development of a SPFM roadmap, followed by studies by professional experts on creditworthiness of the subnational entities, legal framework (including local government authorities, bankruptcy laws to ensure no government liability); market assessment of possible investors, opportunities, and constraints.
- Need to secure enabling-information and SPFM technical experts; if funding is not available, request support from development partners.

Development partners should prioritize the use of SPFMs in their development strategies as a mainstream financial instrument, advancing their capacity for development effectiveness by systemically "crowding in" the private sector and other sources of capital.

- Development partners need to provide technical assistance for the development of SPFMs.
- It is critical that multi-year commitments be secured to ensure the success of these instruments.

Development and development partners should ask the leadership of their existing development programs to support the scaling up of SPFMs as financial instruments in their programs as an urgent priority.

- Existing infrastructure programs can use SPFMs to enable access to finance for small projects. Appropriate sectors include water and sanitation, energy, transport, telecommunications, agricultures, educations, health, marketplaces, etc.
- Existing technical assistance programs supporting the development of projects and funds (e.g., project development assistance, financial advisory, etc.) can be used to cover the significant technical support required for designing and implementing SPFMs. If needed, other technical assistance funds should also be provided.
- Existing risk mitigation and capital investment instruments can be used to support SPFM, such as partial credit guarantees, output-based aid, feed-in tariffs, subsidized interest rates (on-lending bank programs), mezzanine debt, equity funds, etc.

ENGAGING GLOBAL ACTIONS

From a dedicated program to the creation of a global platform on Subnational Pooled Financing Mechanisms.

A global set of enabling tools need to be provided as part of the new local financing framework to enable cost-effective replication and scaling commensurate with the urgent imperative of providing local infrastructure worldwide. Towards this end, the following steps need to be taken:

« A pooled financing vehicle could be very interesting for the AFD. We would have to look at our tool kit and how we can use our funding instruments, technical support, guarantees, and apply them in a new way. We are ready to think out of the box. »

MARTHA STEIN-SOCHAS
Regional Director,
AFD South Africa

Development partners should support the development of the Local Financing Framework, by funding the development of simplified SPFM Toolkits and related training to enable the scaling up of SPFMs.

- The Global Local Financing Program needs to include the development of SPFM case studies, lessons learned, challenges and solutions, etc.
- A technical training course needs to be developed and also provided on-line.
- There needs to be demonstration SPFMs with learn-by doing transaction teams aimed at developing a supply of local experts to support SPFM development process and operation.
- Scale can be achieved by developing a SPFM Network that prioritizes peer-to-peer coordination with the many subnational programs, such as World Bank City Creditworthiness Initiative, etc.

An international independent advisory group should be set up to provide expert financial support to governments interested in exploring the establishment of SPFMs.

A training and advocacy platform should be established, in alignment with the new infrastructure platforms being established to scale up the use of blended finance and access to infrastructure (GFX – Convergence, INFRADEV Marketplace, etc.)

- Investors could be provided SPFMs for investment.
- Peer-to-Peer exchange could build momentum and collaboration, sharing of best practices, lessons, learned, etc.
- Build directories with access to need technical experts (e.g., financial advisors, lawyers, etc.)

The OECD tracking of development partners' official development assistance under TOSSD should include appropriate metrics for recording, monitoring, and tracking the use of development partner support for SPFMs and their effectiveness in mobilizing private sector and other finance.

In conclusion, SPFMs are a proven financial instrument that should be scaled up as part of the Post-2015 Financial Framework for mobilizing private financing for small infrastructure and essential public services essential to achieving the Sustainable Development Goals (SDGs) and national development goals. The Financing for Development follow-up should mainstream this financial instrument with the support of governments and development partners. ●

FMDV's Call for Joint Action on SPFMs

FMDV is coordinating with local and regional government associations, development partners, private sector investors, and experts to move forward on these recommendations.

Recognising the potential of Subnational Pooled Financing Mechanisms (SPFM) to finance the investments of local governments; to enhance their solvency and credibility in the eyes of investors, given their role as "market makers"; and more widely their positive influence, on a national level, on the state of local finances, the FMDV launched in 2015 the Subnational Pooled Financing Mechanisms Program.
The program aims, through analysis of existing uses of SPFMs, to study how these examples could be replicated in emerging and developing contexts, by targeting five pilot countries: Colombia, India, Turkey, Mexico and South Africa.
Given the initial positive results and emulation between the stakeholders consulted about this approach, the FMDV calls for the project to go further, by creating the "SPFMs' Platform".

This platform, which gathers together all the stakeholders working across the creation and running of these mechanisms (central and local governments, technical and financial partners, private banks, rating agencies), will aim to:

- **Disseminate information about SPFMs and produce an informed and updated diagnostic assessment of the performance** and diversity of all previous examples of SPFMs.
- **Evaluate the opportunities, issues and conditions for the creation and development** of SPFMs in the context of developing countries.
- **Support the development of the national conditions governing the establishment of this scheme within each country** through organizing a grouping of committed stakeholders.
- **Develop operational advocacy (recommendations)** within the context of international agendas, allowing local authorities and their networks to propose their own innovative, concrete, credible and varied options for financial engineering methods for development.
- **Define a detailed plan of action,** which is in line with the common interests of the stakeholders so as to ensure the possibility of a follow-up to this first exploratory phase.

The platform will invite the different stakeholders to become involved in the development of SPFMs in the following ways:

- **Central states and their existing financing instruments** – to evaluate the opportunities to help local governments in developing SPFMs and identify the necessary conditions for their practicability: the legal reforms, modifications in decentralization.
- **Local governments** – to meet and engage in a dialogue about the opportunities to develop SPFMs in their country and their region, to bring about an innovative discussion about local financing and to incorporate market access conditions into their financial management policies
- **Donors and technical and financial partners** – to put together their support strategies and adapt their existing tools and services to assist central and local governments in creating environments which are favourable to the development of SPFMs, and in preparing pilot initiatives.
- **Rating agencies** – to better understand this new asset class and to put together adequate rating criteria.
- **Private investors** (pension funds, banks, insurance companies etc) – to invest in this asset class which allows a diversification of their invested capital, and to play a fundamental role in the long-term financing of local development. ●

FMDV'S CALL FOR JOINT ACTION
ON SUBNATIONAL POOLED FINANCING MECHANISMS

In mapping the broad range of components of the local and regional governments' sustainable financing value chain, FMDV recognizes the potential of Subnational Pooled Financing Mechanisms (SPFMs) in addressing part of the financial engineering gap identified.

Therefore, FMDV launched in 2015 a dedicated operational program aiming to analyze the existing uses of SPFMs, study the conditions for adaptation and replication in emerging and developing contexts, create momentum for these instruments, cooperation with and appropriation by public and private partners, as well as target five pilot countries: Colombia, India, Turkey, Mexico and South Africa.

Given the initial positive results and emulation between the stakeholders consulted about this approach, FMDV is now launching a call for joint action and support to create a dedicated multi-stakeholder Platform, gathering local and regional governments' associations, central and local governments, technical and financial partners, private and public banks and rating agencies.

This policy paper, carried out with the support of AFD, will help stakeholders to better understand the logics and benefits of SPFMs, identify challenges and, above all, opportunities, and finally advocate for joining the "SPFMs Platform".

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FMDV
Supporting local authorities to access funding