

Strengthening Local Infrastructure Finance: Municipal Development Funds

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John Petersen, August, 2006

What is an MDF?

- ◆ “municipal” development fund (MDF) is a credit (loan) program that aims at financing infrastructure at the subnational level
- ◆ Multiple recipients of loans -- public, NGO, private -- are possible
- ◆ Major beneficiaries are intended to be local residents and activities

Background to MDFs

- ◆ An evolution of the MDF approach
- ◆ Possible sources of MDF funding
- ◆ Role of Credit / Capital Markets in MDFs (leveraging with private capital)
- ◆ Decentralized Credit Financing for local Infrastructure: Promoted in developing countries
- ◆ MDF Funds and on-lending criteria

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Municipal Development Funds

- ◆ Decentralized Decisionmaking ...
Building grassroots accountability for capital projects
- ◆ MDFs typically operate under Central / Provincial Governments
- ◆ On-lending / Subsidiary Lending Mechanisms using donor funds

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Three Main Goals of MDFs

- ◆ Promote Local Financial and Economic Development via infrastructure
- ◆ Promote use of Credit / Borrowing mechanism for capital improvements
- ◆ Developing Local Government Self-Sustaining Financial/Managerial Capacity
- ◆ *But, these goals do not always mesh*

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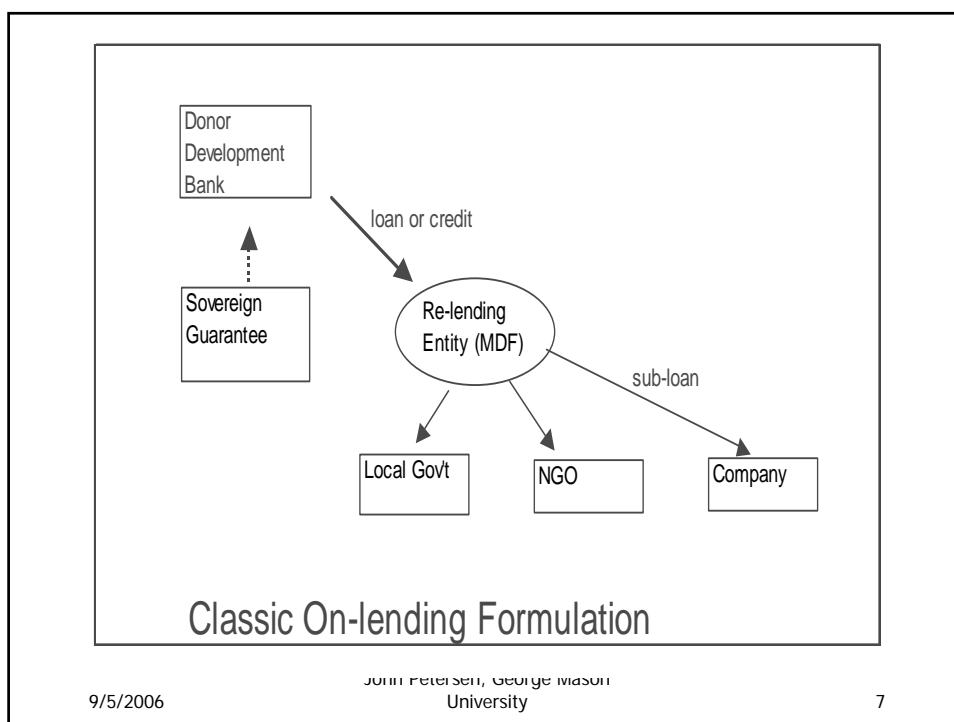
MDF Basic Mechanics

- ◆ MDF can act as loan originator/servicer
- ◆ It can be second-tier "Bank" that supports bank lending
- ◆ It can be financial intermediary that borrows in domestic market and re-lends to local borrowers
- ◆ It can provide "credit enhancements"
- ◆ Critical need: Dependable revenue streams to pay debt ("Credit Culture")

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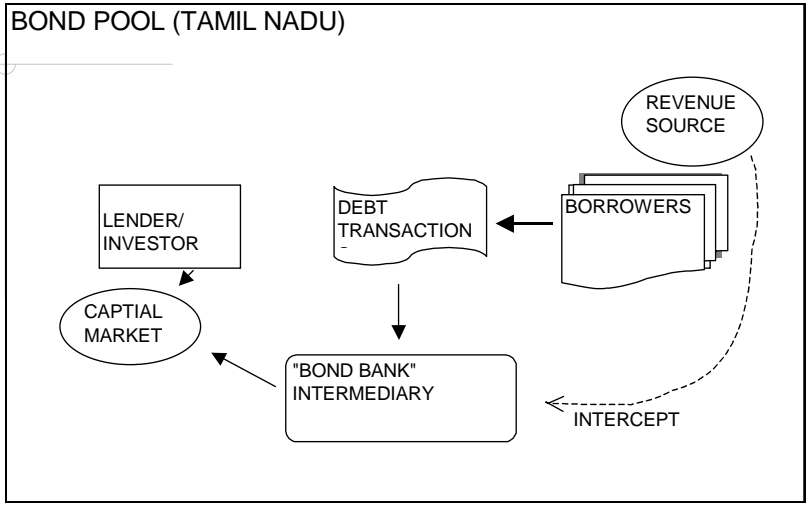
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Alternative Credit Assistance Structures

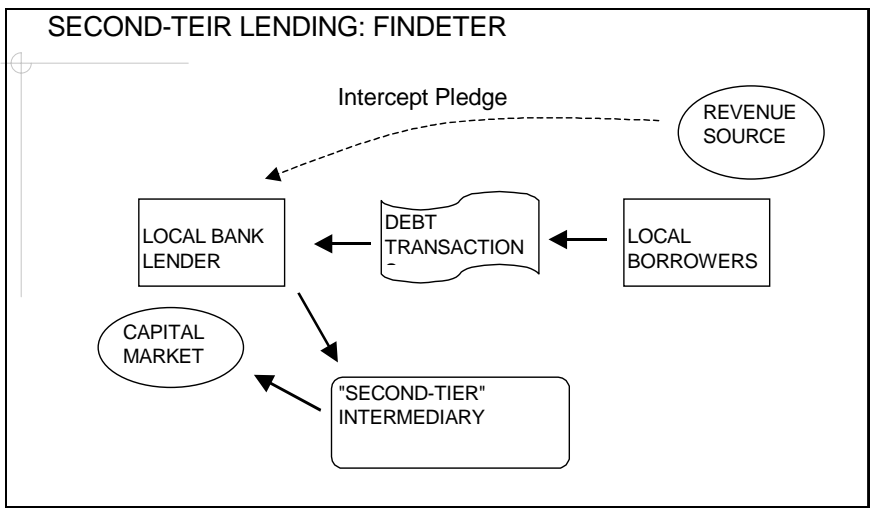
- ◆ Initially, MDFs did only direct loans
- ◆ Alternative ways to assist, using the domestic financial markets
- ◆ Techniques include bond pooling (Tamil Nadu), second-tier lending (FINDETER) and commercial loan guarantees (LGUGC)
- ◆ Security is supplied by an intercept provision in almost all cases.



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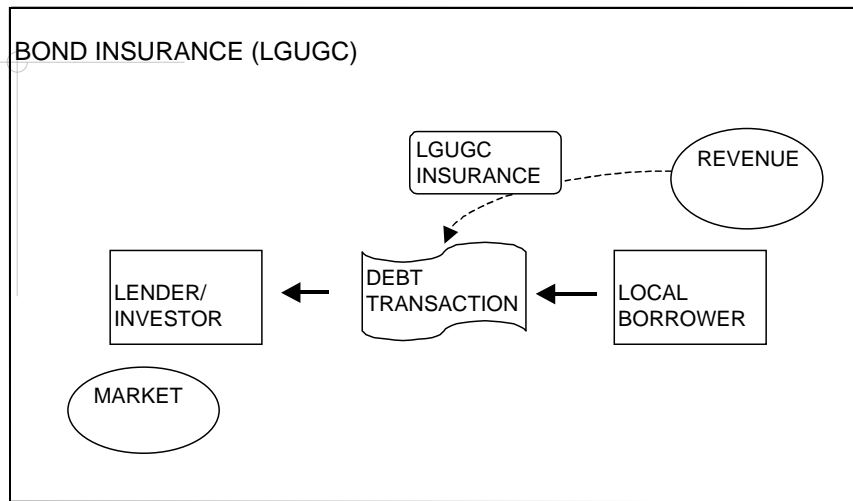
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Alternative MDF Ownership/ Organizational Structures

- ◆ Most MDFs are government owned or guaranteed. Some MDFs are at the subnational level (states, provinces).
- ◆ Efforts to decentralize and to tap growing local credit/capital markets have led to mixed ownership models.
- ◆ Majority "Non-governmental" ownership is rare (INCA in South Africa)

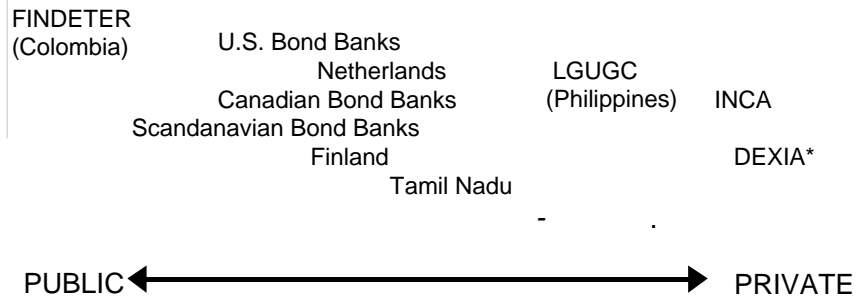
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Organizational Forms of MDFs

Arrayed by Nature of Ownership:



* / has minority government stock ownership

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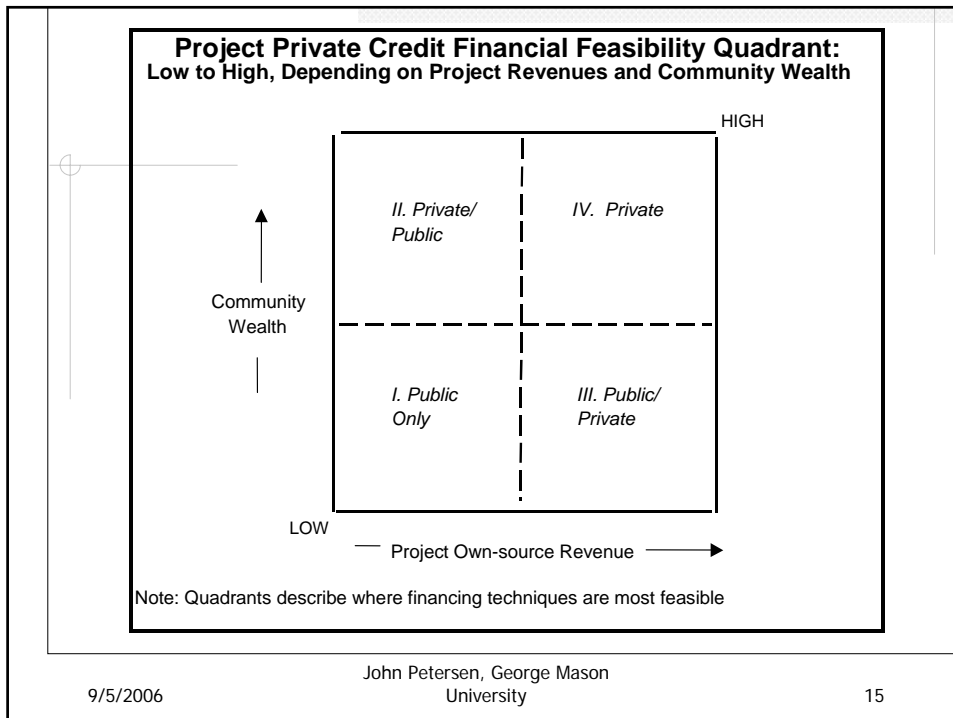
Understanding the MDF's Loan "Market"

- ◆ If the MDF is an intermediary credit provider or enhancer, its role must be to both local borrowers *and* the domestic credit market
- ◆ Triage of borrowers and projects, from those that are not creditworthy to those that do not need help
- ◆ Focus on assisting those that can "graduate" to the private market

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Basic Questions About MDFs

Question Set One:

- ◆ Who are Ultimate Borrowers / Beneficiaries ?
- ◆ What is the creditworthiness of borrowers?
Are projects "self-sustaining"?
- ◆ Management of Investment Projects and subsequent operation?
- ◆ Effects on Local Government Revenue and Management System ?

Question Set Two:

- ◆ Tapping Private Savings: MDF Bonds or Bank Loans to attract private capital ?
- ◆ Loans / Grants ? Are they Integrated?
- ◆ Borrowing Criteria for Borrowers? Role of Creditworthiness ? Credit Ratings?
- ◆ Forms of Security for Loans ? Interception of intergovernmental funds?

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Question Set Three:

- ◆ MDF Loan Performance has been a Concern ... avoiding past failures?
- ◆ Relationship of MDF rates to domestic interest rates?
- ◆ Risk-sharing with private sector?
- ◆ Cost of MDF operations: Loan Loses/ Administrative Costs?

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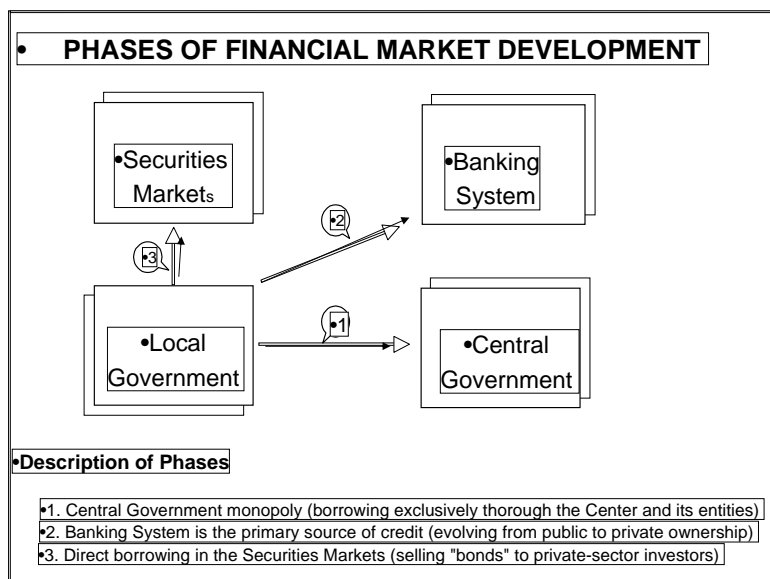
Role of MDF is Changing

- ◆ As domestic capital markets develop, opportunity to use them more.
- ◆ Need is for a creditworthy entity to access the credit markets.
- ◆ MDF can move to the role of a financial intermediary.
- ◆ Provides services other than direct loans.

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Measures of Success For MDFs

- ◆ Growth of Private Sector Municipal Credit Market: Building “bankable” credits
- ◆ Rate of “Graduation” of Borrowing Entities
- ◆ Self-Sustainability of MDFs
- ◆ Reflection of Domestic Interest Rates
- ◆ Identification of Subsidy Elements
- ◆ Integration of Loans & Grants