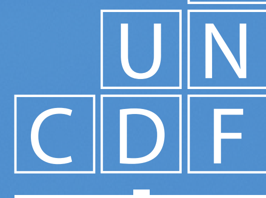


Impact Capital for Development

POLICY BRIEF

Empowering Cities & Local Governments through Guarantee Mechanisms

Empowering Cities & Local Governments through Guarantee Mechanisms

I. Why Are Guarantees for Cities & Local Governments Important?

Guarantees are a financial instrument to unlock public and private funding for local infrastructure by mitigating risks, increasing investor confidence in cities and local governments, and bringing down the cost of capital for municipal borrowing. In particular, concessional or publicly-funded guarantees for subnational governments can significantly accelerate transformative investments at the local level.

The COVID-19 pandemic has presented a new, unprecedented source of investor risk that is depressing business confidence to historic lows. According to the World Bank, global foreign direct investment fell by 42% in 2020, from $1.5 trillion in 2019 to an estimated $859 billion—the lowest level since the 1990s. Against the backdrop of the COVID-19 pandemic and declining investments, it is critical now more than ever to unlock private financing for developing economies by mobilizing a diverse set of instruments, including guarantees.

II. What Are the Typical Bottlenecks?

In developing countries, the current level of local government lending and the associated financial mechanisms is not sufficient to enhance development finance and address critical infrastructure gaps. While there are some guarantors that operate a business model similar to insurance by collecting a premium for a guarantee and providing either a full or partial guarantee to the lender in the event of default, this type of scheme is not conducive to cities and local governments given their weak fiscal positions.

There are some public guarantors, such as the World Bank Group's Multilateral Investment Guarantee Agency (MIGA), but it operates at the sovereign level for priority projects of national governments by mitigating political and other risks for high-value transactions. Such lack of public or private guarantors in the sub-sovereign infrastructure space is due to the limitations of sovereign and private finance, a small market of transactions to guarantee, and the policy and regulatory restrictions on sub-sovereign finance. In order to facilitate credit access for cities and local governments, partial or full guarantees from the central government or international development partners are required.

III. Examples of Effective Guarantees for Cities & Local Governments

At the global level, the **European Fund for Sustainable Development Plus (EFSD+) Guarantee** – Sustainable Cities Window was established to support cities through guarantees for infrastructure investments that address the demographic, climate/environmental, and economic challenges.

The objective is to contribute to the mobilization of additional finance for investment in sustainable urban development, and support the wider strengthening of the ecosystem for subnational finance. In particular, the guarantee mechanism aims to increase the role of the private sector as a technology provider and co-financier in addressing investment needs and maintenance of municipal infrastructure, such as in the areas of water, sanitation and waste water management, solid waste management, air pollution and green urban areas, urban residential rehabilitation, district heating and lighting, affordable and green social housing.

The EFSD+ guarantee will be structured in a way to lower investment risks for long-term financing and create enabling conditions for the delivery of quality municipal services. The EFSD+ will also support capacity building to systematize risk-sharing mechanisms and promote public-private partnerships in subnational finance.

UNCDF has proposed a financial instrument aligned with the Malaga Coalition policy agenda, the Guarantee Facility for Sustainable Cities, which will support transactions that will pilot and test innovative infrastructure financing solutions that can be taken to scale, specifically in Africa and Southeast Asia. UNCDF has received a positive opinion from the EFSD+ Operational Board and the total funding approved for the facility amounts to EUR 154 million, with the formal agreement expected to be entered into force in 2023.

At country level, since many local governments operate in different contexts with different intergovernmental frameworks and have uneven levels of experience in subnational investment, guarantee structures need to be designed in line with the specific characteristics of localities. For example, in the Philippines, the Local Government Unit Guarantee Corporation (LGUGC) was founded as a private financial entity by the Bankers Association and the Development Bank of the Philippines.

It offers financial guarantees for local governments and other public and private entities, such as water districts, electric cooperatives, renewable energy projects, and medium or large enterprises seeking to develop infrastructure with private and public capital. The basic approach of LGUGC is to provide guarantees to partner financial institutions in case of borrower default, and in return, the partner lends to or underwrites bond issuances. Borrowers pay a guarantee fee, depending on the risk assessment, and LGUGC also rates local governments' creditworthiness.

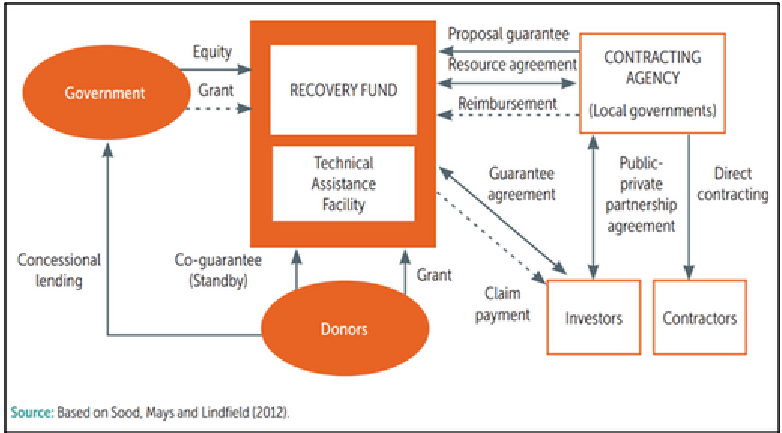
Only local governments with a minimum investment grade rating are eligible for its guarantees. As a result, local governments in the Philippines have borrowed a fair amount through special financial intermediaries with public and private funding that serve different types of local projects.

While the Philippines' guarantees are run by a private financial entity, many countries design and implement a diverse set of financial mechanisms to conduct guarantees.

For example, Cameroon has a public body financed from the national government budget, which provides loans, grants, cash advances, guarantees, and technical assistance to local authorities, and in Nepal, there is an autonomous agency that is primarily financed from loans and grants from international financial institutions and development agencies.

Additionally, guarantees can be combined with other types of financial instruments as a component of blended finance, such as public-private partnerships, direct grants, and concessional lending from international or multilateral organizations, to support local infrastructure or other needs.

A local government revolving recovery fund is an example practice of providing short-term liquidity to local governments for response and recovery. Such funds are usually co-financed by the central government, with the participation of local governments as contracting agencies and supported by donors through a combination of various financial instruments. The following graph showcases a feasible model of such recovery fund:



Source: Based on Sood, Mays and Lindfield (2012).

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This policy brief's content directly comes from the UNCDF's flagship publication – Local Government Finance is Development Finance. For more information about the book, download here or via + QR code

For more information on the work of the Local Transformative Finance Practice, visit https://www.uncdf.org/local-development-finance

The UN Capital Development Fund makes public and private finance work for the poor in the world's 46 least developed countries(LDCs).

UNCDF offers "last mile" finance models that unlock public and private resources, especially at the domestic level, to reduce poverty and support local economic development.

UNCDF's financing models work through three channels: (1) inclusive digital economies, which connects individuals, households, and small businesses with financial eco-systems that catalyze participation in the local economy, and provide tools to climb out of poverty and manage financial lives; (2) local development finance, which capacitates localities through fiscal decentralization, innovative municipal finance, and structured project finance to drive local economic expansion and sustainable development; and (3) investment finance, which provides catalytic financial structuring, de-risking, and capital deployment to drive SDG impact and domestic resource mobilization.

UN Capital Development Fund Two UN Plaza,
26th Floor, New York, NY 10017

www.uncdf.org

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