

PROGRAMME DOCUMENT

LOCAL FINANCE INITIATIVE (LFI)

2014-2017

Geographical Coverage: Global (Initial pilots in Tanzania, Uganda and Bangladesh)

Programme Overall Outcome: Increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

Programme Intermediate Outcomes:

- (1) Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive local development in a number of target developing countries.
- (2) Increased ability and willingness of domestic financial sector to provide financing for small to medium-sized local development infrastructure projects.

□ Programme Duration: 5 years

Anticipated start/end dates: 2014-2017

Funding Management Options: Parallel and Pass-Through

Administrative Agent for Pass-Through: UNDP

□ **Total Estimated Budget *:** US\$ 30,519,000

Out of which:

1. Funded Budget: US\$ 3,150,000

UNCDF \$800,000

SIDA (PFIS) \$1,650,000

ONE UN \$700,000

2. Unfunded budget: US \$ 27,369,000

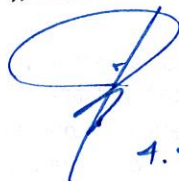
Approved on behalf of United Nations Capital Development Fund

Marc Bichler, Executive Secretary, UNCDF

Signature

Name of Organization

Date & Seal



1.4.2014



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1. Situation Analysis

1.1 The development challenge addressed by the Local Finance Initiative (LFI)

Least developed countries include some of the world's fastest growing economies and also include countries whose growth in real terms is limited. Not all are growing at the rate required to keep pace with population increases. The balance of LDC economies and the growing sectors is unevenly spread across their territories and inequitably distributed through their societies, often producing relative disparities and disequilibria. These structural problems present serious challenges for equitable and sustainable development.

"With the global economy still struggling to return to a strong and sustained growth path, the external environment faced by the LDCs has been less propitious in the past five years than previously. The recent slowdown [in the growth of] of world trade, which is now at a near-standstill, has weakened the demand for LDC imports, most notably in the case of developed countries but also in emerging economies. In addition to weaker demand for their exports, the LDCs have been confronted with a heightened volatility of commodity prices and capital flows.

As a result, economic growth in the LDCs has been weaker by a full two percentage points in the past five years (2009–2013) than during the previous boom period (2002–2008). It has also been below the target rate of 7-per- cent annual growth established in the Istanbul Programme of Action (IPoA) for the Least Developed Countries for the Decade 2011–2020."¹

The same report highlights the differential growth rate within LDCs, with 15 of the 49 countries growing at rates in excess of 6% during the previous five years and 10 countries effectively falling behind with growth of less than 3%.

Yet the key challenge LDCs face over the next 5 years is not only aggregate growth, it is the quality of that growth and its ability to transform the economic and social structure across the whole territory. This can be reflected in two ways: Sustainable and equitable growth on the one hand and resilience to shocks on the other.

The overall picture in LDCs hides significant disparities and risks. Over 2 billion people continue to live on less than a dollar a day and whilst absolute levels of poverty are falling and inequalities are increasing.² Additionally, natural disasters, changing weather patterns and globalized economic relationships threaten the resilience of communities to external shocks. There are still many least developed countries mired in conflict.

The situation is even more polarised within developing countries themselves. Even the fastest growing countries, like Mozambique, report that poverty levels in many rural and peri-urban areas have not significantly changed over the last decade. Lao People's Democratic Republic (PDR) is on course to begin graduation to middle income status yet inequalities are growing and the median Gross National Income (GNI) per capital is still well below the threshold for a middle income country status, despite the increase in the mean figure.

¹ UNCTAD Least Developed Countries report, 2013

² UNCDF, Inclusive Future, 2013

This picture of overall growth, increased inequalities and stubborn pockets of poverty within LDCs reveals **a more uncertain and differentiated world in which many localities are not sharing the benefits of growth.** How can resources be reinvested locally to build resilience and reduce inequalities?

This is the challenge of local economic development and it is a challenge that becomes more and not less important as developing countries experience growth and capital accumulation but lack the means to reinvest that capital to promote sustainable, equitable and inclusive development. The result is localities lacking in infrastructure and capital investment that could support a more sustainable and equitable inclusion into the growing economy. Without this investment there is a tendency for value chains to be extractive and for a reduced scope to develop the clustering, linkages and labour markets that could recycle the proceeds of growth at the local level.

UNCDF's work on local development finance aims at ensuring that people in all regions and locations benefit from growth. This means dealing with the specific local development challenges of, for example, peri-urban areas and remote rural locations. It means re-investing domestic resources back into local economies and services through, for example, fiscal decentralisation on the one hand and the demonstration of innovative forms of private capital mobilisation on the other hand. Together this can improve the effectiveness of public and private investments in fostering local economic development. Both these approaches lead to increases in local revenue (through taxes and fees) for local institutions that again can be reinvested in the local economy.³

The growing differentiation at the local level is accompanied by two broad trends in development finance. Firstly the general decline of Official Development Assistance (ODA) since the 2008 economic crisis and secondly the above mentioned accumulation of significant capital surpluses in LDCs that are not reinvested locally due to perceived risk and a lack of investment opportunities, instead they are often held in unproductive real estate or in overseas accounts. These trends complicate the task of investing in public and private infrastructure for local development in those regions that are lagging behind.

Inclusive and sustainable growth requires resilient local economies that include a varied mix of public sector and private sector investment and that are not over dependent on one activity. Economic activities can contribute to inclusive local growth if they leverage and utilize other local resources, or they can be of an 'enclave' nature where the activity has little impact on the surrounding economy. Therefore not all local economic activity has the same impact on local development. Many local economic development programmes seek to apply both public and private capital in synergy and to use land use zoning, training and other incentives to create clusters of economic activity that link inputs and outputs, therefore adding value within the locality and diversifying the base of the local economy. This issue is explored in detail in Annex 1 that describes trends in local economic development.⁴

What is local development? It is not simply development that happens locally, as all activities happen somewhere. Instead it has been usefully defined as:

³ This process leads to an increase in Local Fiscal Space, one of the impact indicators for local development finance applied by UNCDF. Fiscal space is defined by the IMF as the “room in a government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy” UNCDF applies this concept at a local level, taking into account both public and private finance. See *Finance and Development*, June 2005, Volume 42, Number 2, IMF Washington, and also www.uncdf.org for the set of Local Development Finance indicators.

⁴ Annex 1 is based on a paper by D Jackson on Local Economic Development presented at Duke University, July, 2011.

“ ... development that leverages the comparative and competitive advantages of localities and mobilizes their specific physical, economic, cultural, social and political resources. Said differently, in the expression local development the adjective local does not refer to the where, but to the who and the how of development promotion. It refers to the actors that promote it and the resources they bring to bear on it. Development is local if it is endogenous, open and incremental, that is: if it makes use of locality-specific resources, combines them with national/global resources and brings them to bear on the national development effort as additional benefit in a positive sum game.”⁵

Local Development means ultimately reducing poverty in its various forms by increasing the prosperity and wellbeing of localities and strengthening their resilience to economic and environmental shocks. This requires:

- Leveraging and using local resources;
- Providing benefits, employment and services to local people - In economic terms, promoting forward and backward linkages and positive externalities;
- Strengthening and using local institutions;
- Increasing local environmental resilience and sustainably exploiting environmental resources;

The Local Finance Initiative (LFI) is a global programme for local development finance that will work in harmony with ongoing local development programmes, to test ways of unlocking (preferably domestic) private finance for infrastructure projects as part of local economic development strategies and policies in least developed countries and in doing so will address the challenges outlined above.⁶ The LFI programme does this with the purpose of seeking a demonstration effect and paving the way for further capital investment in local infrastructure, thus realising UNCDF's mandate and comparative advantage in applying seed capital and technical assistance to policy reform and creating enabling environments for further capital flows. This contributes to achieving the targets of the UNCDF's Local Development finance programme, which include applying UNCDF's capital investment mandate to demonstrate how increased local fiscal space and increase rates of local gross fixed capital formation can accelerate local economic and social development, thereby leveraging further public and private resources to the local level.⁷

1.2 The challenge of mobilising private capital for infrastructure investment in the LDCs

There is a recognition of the critical role of the private sector in fostering economic growth, poverty reduction, and the attainment of the Millennium Development Goals (“MDGs”) and other

⁵ L Romeo, The Imperative of Good Local Governance, Chapter 3, 2013

⁶ The reference to local development strategies is about the overall policy environment and objectives of government. It does not necessarily refer to overly prescriptive strategies but to the indicative local economic planning practiced in much of the world.

⁷ In addition to Local Fiscal Space (see footnote 3) Gross Fixed Capital Formation is an impact indicator for local development finance applied by UNCDF. Gross Fixed Capital Formation is measured by the total value of a producer's acquisitions, less disposals, of *fixed assets* [as defined in public finance] during the accounting period plus certain specified expenditure on services that adds to the value of non-produced assets. See UNDESA, System of National Accounts, 2008, Chapter 10 – the capital account. This is a useful measure at local level because it captures both public and private capital assets that contribute to economically productive activity including service delivery, agricultural and industrial activity, processing etc. UNCDF applies an adapted measure of Gross Fixed Capital Formation at the local level.

internationally agreed development goals.

This was again highlighted at the 2008 Financing for Development (FfD) Summit in Doha and the UN 2010 MDG Summit in New York. Despite the consensus on the critical role of the private sector, the basic financial, legal and fiscal infrastructure required for private sector development is still widely lacking in many developing countries, arresting private sector development at local and national levels.

The recent global financial crisis has led to additional challenges, given the decreases in official development assistance and reduced availability of finance and risk capital in developing countries. Therefore the longstanding imperative for mobilizing private sector capital and leveraging limited official sector funds has escalated in importance. The Doha Declaration stresses that “greater efforts are required to support the creation and sustenance of an enabling environment [for mobilizing domestic financial resources for development] through appropriate national and international actions.”

Whereas the engagement of the domestic and private financial sectors in larger industries in developing countries has somewhat improved in recent years, financing of local economic development remains a matter of concern. Despite the fact that in many cases there is untapped domestic and private capital, which could be used to support small and medium-scale infrastructure development at the sub-national level, this capital is not available for LED actors, whether they are local governments or private businesses.

However, private sector capital can be successfully mobilized using financial structures and instruments that mitigate risks. For example, some infrastructure projects in developed countries and developing countries use the financial approach of non-recourse financing, in which the project is a legal entity with “ring-fenced” revenues that are earmarked for paying debt service. Furthermore, many risk mitigation instruments are already available that have proven successful in leveraging limited official sector support, such as the partial guarantees offered by the World Bank,⁸ regional development banks, and many donors such as USAID.⁹ The LFI Programme employs these proven financing techniques to mobilize private financing for relatively small infrastructure projects that are critical for supporting local economic development hand-in-hand with capacity building mechanisms to empower both government officials and the private sector to scale up local development finance, while providing inputs that improve the business-enabling environment. A second potential area is through municipal finance, particularly where the debt is secured on a general obligation basis (that is against the total revenue and assets of the municipality) but the bond itself is issued to finance an infrastructure project designed to increase revenues that will themselves support the servicing of the debt. Revenues can be increased through land taxes, rents, fees. For LDCs these instruments are not yet developed but would increase the scope for innovative public private partnerships that foster local economic development.

Yet there are many obstacles to take into consideration. Even if official bilateral and multilateral financing is available to a country for investment in bankable projects, such financing usually requires

8 See World Bank definition of their partial guarantee products:
http://siteresources.worldbank.org/INTGUARANTEES/Resources/IBRD_PRG.pdf

9 A recent USAID press release states: “As the momentum for partial credit guarantees builds, DCA’s portfolio has increased from \$1.8 billion of local wealth mobilized at the end of 2009 to \$2.3 billion today. The \$2.3 billion in available credit has helped 87,000 enterprises at a cost of only \$82 million to U.S. taxpayers. The \$82 million has been set aside as a provision for defaults.” See http://www.usaid.gov/press/releases/2010/pr101028_1.html Actual losses from the DCA program have so far amounted to only \$7.6 million on \$981 million in loans disbursed.

sovereign guarantees, which are often unavailable due to fiscal constraints at the national level. As mentioned above, one of the most promising of these capital sources are the country's own domestic savings that have been mobilized by domestic banks and institutional investors (primarily pension funds and insurance companies). Nevertheless there is a need to develop sources of local currency financing for local infrastructure projects. Moreover, there is a lack of bankable projects and little funding for developing them and experience from the LFI pilots in Tanzania and Uganda demonstrate that project development costs can be significant.

Analysis has identified three major reasons that restrict the availability of domestic and private capital for LED. These include:

Inadequate national legal and operational frameworks impede engagement of the domestic financial sector in LED. There is a lack of a coherent approach in developing countries to engage the private sector in LED. There is a lack of clear definition of the competencies and respective roles of LED public and private sector actors for channelling private sector investments into infrastructure projects. Business-enabling environments for LED, including the appropriate regulations and laws, remain inadequate in many developing countries, requiring the development of new communication venues between stakeholders that can articulate the needed changes for private sector growth and development.

In other cases, adequate regulations and legal frameworks exist but fail to translate regulations and legal provisions into effective operational guidelines. Local governments may be legally allowed to finance local development but in the absence of relevant regulatory and operational guidelines are not in a position to do so. If borrowing is more appropriate through a private sector project company, governments are not adequately trained to set up such a vehicle. In most of the cases in developing countries, Local Governments (LGs) need to develop their own knowledge of project development requirements and sources of possible ways to finance and support the needed development of business plan, feasibility studies, engineering studies, legal contracts, etc.

Inadequate technical capacity and poor skill sets deter development of bankable development projects. Very often in developing countries there is a lack of technical skills, technological know-how, and tools required to develop bankable projects or address development challenges. A lack of knowledge usually means the inability to make informed decisions; identify, design, develop, finance and manage viable projects; and address any specific problems that may arise during such a process. Project proposals developed locally are often insufficient in fleshing out viable business models and controlling for risks, therefore failing to attract private sector lenders and institutional investors and convince them of project credit-worthiness.

Banks have little interest in financing small and medium-sized infrastructure projects. Private sector lenders and institutional investors in developing countries tend to steer away from investing in small- and medium-sized infrastructure projects because of the high transaction costs, low profit margins in relation to the time required by bank personnel, and the perceived risks and lengthy borrowing period usually associated with such projects. Moreover, the need for long-term investment in infrastructure projects does not usually match with the tendency for commercial banks in developing countries to lend short term. The effect is two-fold: the limited access of LED stakeholders to domestic and private capital and a lack of willingness on the part of these financial sectors to invest in LED.

1.3 The relevance of UNCDF's core approach to local development finance

The UNCDF approach to local development finance in least developed countries recognises the need to unlock existing sources of capital for local development and attract new investment capital to the local level. To this end UNCDF applies its seed capital and technical assistance to develop innovative solutions that leverage or mobilize, allocate, and invest resource flows to the local level for local development, thus meeting the capital funding gap. This means that the key factors are the demonstration effect of the innovation and the additional fund flows unleashed for local development. This requires strengthening the capacity of existing public and private institutions and the procedures they use as well as providing the seed capital itself.

This is illustrated in figure 1 that shows the approach of UNCDF to local development finance. purpose of as poverty reduction through. LDFP programmes mobilise, allocate, invest and account for these increased flows through improved and strengthened local public and private institutions. The circle at the bottom left shows how UNCDF seed capital and technical assistance is applied towards this end. The term “capital” is applied in its wider sense, encompassing its multiple definitions as: a factor of production; an accounting term in public finance (i.e. not a recurrent cost); a large scale fiscal or financial flow; an income generating resource; and finally a valuable and / or expendable resource. LDFP seed capital leverages these flows to the local level, promoting poverty reduction through sustainable, inclusive and equitable local development.

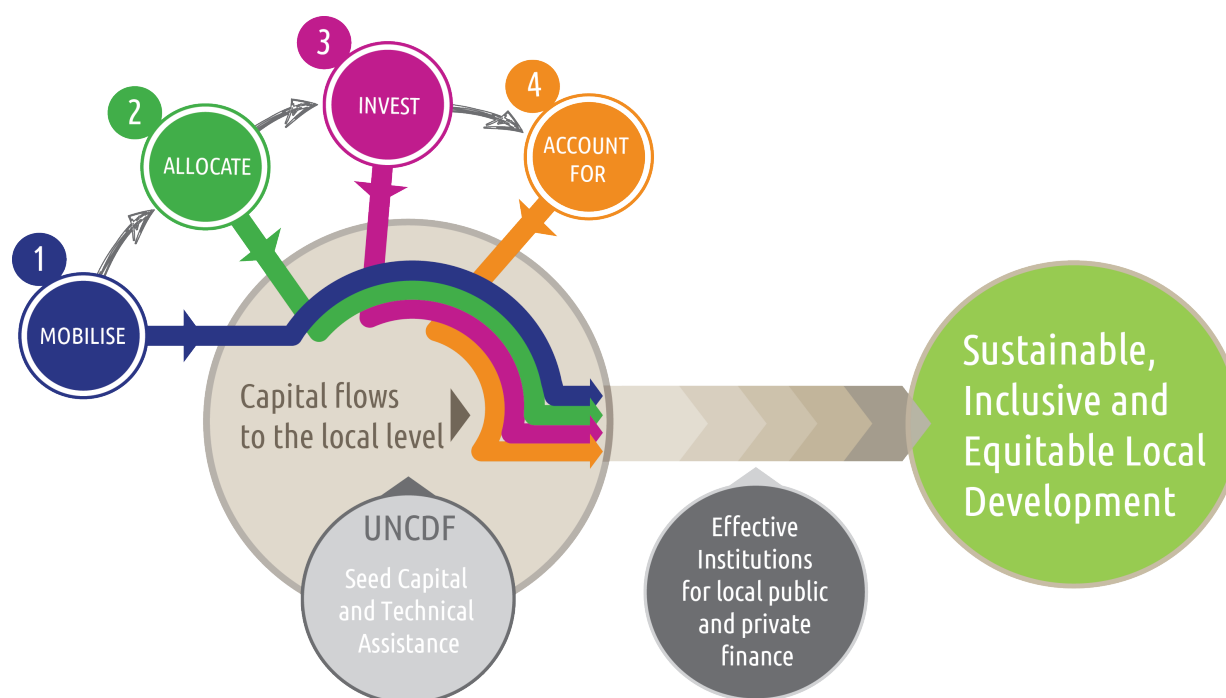


Figure 1.

Least Developed Countries are already working with UNCDF on local development programmes for infrastructure and service delivery, food security, gender, climate resilience and economic development.

UNCDF-LDFP (Local Development Finance Programme area) aims to improve life of people in localities by strengthening financial mechanisms for infrastructures and services and delivering resources through

locally appropriate means. According to its Business Plan 2014 - 2017, LDFFP will intervene both through national and global programs that will be articulated at country level to maximise UNCDF's intervention relevance and impact. LFI is one of the Global programs that will be embedded in countries programs in most of the places where UNCDF intervenes. The Global coverage of this program, as all others UNCDF-LDFFP programs aims to build a south-south thematic cooperation, improve the quality of UNCDF support (especially on the monitoring and evaluation side) and develop a piloting based knowledge.

The LFI global programme will combine expertise in public and private development finance to enable support for those revenue generating infrastructure projects that support national development priorities in the pilot countries. These are relatively new financing modalities for Least Developed Countries and UNCDF is leveraging its two decade experience in developing local public financial management and local public infrastructure in LDC environments to introduce these new methods of financing local development, therefore providing a demonstration effect and building confidence for other actors.

LFI will work in harmony with other ongoing local development programmes, to test ways of unlocking (preferably domestic) private finance for infrastructure projects as part of coordinated actions with the public sector. UNCDF local development finance projects support the efficient and effective use of public and private finance for local economic development. Through fiscal decentralization and the investment of own revenue local governments can have a comparative advantage in the provision of public economic goods such as roads, bridges, market places, irrigation and drainage systems, aqueducts, canals and storage facilities. This extends to a role in stimulating best practice amongst private sector contractors and to capitalizing the local economy through the employment and demand created. The local public sector is a large economic actor in many LDC localities. These ongoing programmes will seek synergies with the LFI global project.

LFI will apply a variety of investment modalities including municipal finance, structured project financing, Small and Medium (SME) finance and public private partnerships. In all cases the objectives are to demonstrate how domestic private capital can work in synergy with public investments and provide targeted interventions in support of infrastructure projects with proven local development impact. UNCDF will provide inputs where appropriate together with technical assistance in the form of feasibility studies, market research, cash flow analysis etc.¹⁰ In the case of municipal debt finance LFI will work with local governments and national entities to create the capacities and regulatory environment to test responsible municipal finance instruments such as the EcoBond being piloted in Bangladesh. UNCDF can be a buyer of first resort to provide confidence to this new market. The program will be initially piloted in Bangladesh, Tanzania and Uganda and extended to five more countries during 2014 – 2017.

¹⁰ UNCDF will seek to provide access to grants and credit enhancements where appropriate, dependent on availability of funding

2. Programme Strategy

2.1 Lessons Learned

There are a number of efforts currently underway to increase funding for infrastructure projects in developing countries. However, most of these focus on large traditional infrastructure projects—major roads and ports, national power production and distribution systems, urban water and sewer systems, and telecommunications. But the relatively small infrastructure projects that local governments have begun to identify through their LED efforts have received much less attention and financial support. This is a problem that UNCDF began to address in its pilot activities in Bangladesh, Uganda and Tanzania. Financial scans in Uganda and Tanzania were performed with the aim of developing solutions to this problem and in Bangladesh UNCDF began to explore alternatives for municipal finance such as bonds. The governments of all three countries subsequently asked UNCDF to develop programmes based on the preliminary assessments and proposed financial approaches and pilot LFI programmes were launched in Uganda and Tanzania and a pilot Bond initiative was launched in Bangladesh. In Uganda this was part of an on-going Local Economic Development Programme¹¹ and pioneered the use of risk mitigation instruments combined with proven non-recourse project finance principles to smaller-scale local infrastructure projects.

Based on the experience of UNCDF's assessments and work to date in Bangladesh, Uganda and Tanzania, in addition to other UNCDF programmes worldwide, some reasons for inadequate domestic financing of local development would appear to be the following:

Local development in general and LED in particular is a complex undertaking requiring time and national and international partnerships. Delivering economic development to a locality or region is complex as it is subject to influences beyond the control of local, regional or national governments. Equally, the time-frame for seeing results is closer to a business cycle (12-15 years) than to the electoral cycle (3-4 years). As a result, local economic development is more likely to succeed if it is treated as a long-term partnership between public, private, and institutional sectors, both at the national and international levels. This is especially true since the private sector is the natural choice from which to launch LED, with greater resources and continuity, ensuring broad-scale development impact and sustainability.

Bankable projects are the starting point for unblocking domestic and private finance. The most critical bottleneck to accessing finance is the lack of bankable and investment ready projects. Finance is not available because requests for finance tend to be just “concepts” or “wish lists,” lacking business plans, feasibility studies, market assessments, engineering and legal inputs, etc. where feasibility studies exist they lack finance fundamentals that enable the sponsors to take them over the last mile. The skills and capital required for developing bankable projects and businesses are lacking in developing countries. Often the large equity investment requirements imposed by commercial lenders and high costs of accessing legal and financial advice to structure projects and business deals make it almost impossible for small investors to develop projects. Targeted donor intervention can be the fulcrum for jumpstarting the development of projects and mitigating the risks that impede their bankability.

11 The UNCDF District Development Programme (DDPIII) in Uganda

Economically viable projects with significant development and transformative impact take time to identify and develop. UNCDF aims at projects that have significant transformative impact at the local level. However, these projects may have relatively low economic returns despite their high social returns. Although such projects may be socially highly desirable, developing countries do not have enough expertise, resources and sometimes political will to develop these projects to a stage where they become bankable and or investment ready.

Risk perception of lenders must be addressed. The perception of risk is another critical bottleneck preventing small-to-medium sized infrastructure projects from accessing private capital from banks and institutional investors, such as pension funds and insurance companies in developing countries. Local financial institutions often have less experience and limited expertise in evaluating the technical and market risks of non-recourse project financings. Coupled with limited experience in risk mitigation measures this produces a distorted perception of risk causing lenders to sometimes deny financing to potentially viable projects. Therefore local banks and institutional investors need to be induced into the development and financing of the local development projects, through targeted credit enhancements supplemented with overall training, so they can assume their inherent role as leaders of the country's local development finance.

2.2 Programme Approach

The overall **outcome of the programme** is to increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

To achieve this goal, the programme will focus on addressing the widely acknowledged problem of blocked domestic and private financial sectors, resulting in a suboptimal allocation of funds to productive uses critical to development. As a result, social resources are used at a suboptimal level, resulting in diminished total social benefits. In essence, the programme strategy consists of bringing the supply and demand to an optimal level by reducing perceived risks and transaction costs of financial services for all local development stakeholders and participants of the finance market. The approach will be systematic and technical in nature, focused on jump-starting the process of mobilizing private sector financial resources in both commercial banks and institutional investors through the selective targeted use of public resources.

The supply side is represented by domestic and private financial institutions, and the demand side is represented by project developers which may include private businesses as well as local governments and the non-government sector. Since LED project developers, particularly those dealing with small and medium-scale infrastructure, are unsure about their ability to formulate financially sound and viable projects, the demand for financial services is relatively low. Since domestic providers of financial services are unconvinced about the ability of borrowers to repay, the costs of providing financial services are high, and supply of such services remains limited.

For the purposes of strategy formulation, the programme distinguishes **five major institutional groups engaged in local development**:

- **Project developers:** Private businesses, local governments, domestic non-government sector. This includes SMEs and farmers suffering from a lack of basic industrial infrastructure such as warehouses and logistic services, processing plants, cold storage facilities, and traditional

infrastructure services as irrigation, water, energy, transport, communications, etc.

- **The financial sector and related services:** Commercial banks, institutional investors such as pension funds and insurance companies, as well as service providers such as public and private credit bureaus, consulting and accounting firms, lawyers and others providers that are needed to building internal capacity for developing and financing infrastructure projects.
- **Local governments:** Local institutions with a mandate to promote the economic and social development of their territorial jurisdictions. These institutions produce social and economic development plans, engage with local chambers of commerce and also have responsibilities to promote an enabling environment for local economic development.
- **Government agencies:** ministries and agencies defining policy development and finance, and regulatory and operational frameworks, such as ministries of local government, finance, investment promotion, investment, trade and commerce, government regulators, and others.
- **International development community:** UN family and Bretton Woods institutions, bilaterals development partners, multilateral development agencies and international non-government organizations which provide invaluable technical assistance at the local level.

The LFI Programme thus aims to improve the ability and willingness of stakeholders to use domestic finance for local development and to create enabling national and international environments for sustained participation of the domestic financial sector in local development. This can be either through investing domestic finance itself or by deploying non-domestic finance in a way that demonstrates effect and creates confidence for the investment of domestic finance.

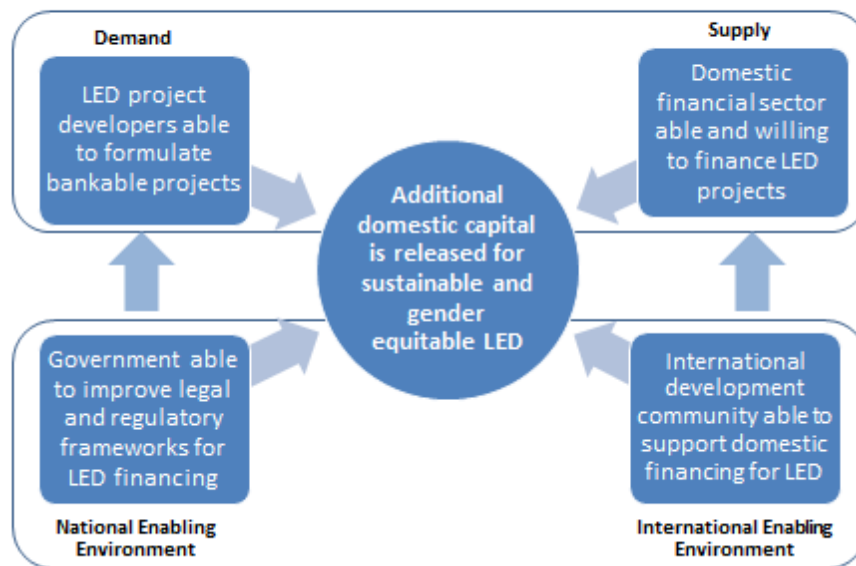


Figure 2: Local Finance Initiative (LFI): Strategy and Approach

LFI Programme approach will be executed through **four main programmatic features**:

1. Project development activities that enable the identification and development of up to 4 demonstration projects in each LFI country to create “proof of concept” financing models that facilitate access to the domestic financial sector for investments in strategic, smaller scale infrastructure projects.
2. Finance and credit enhancement facilities to enable jumpstarting the process of project identification, development and deal/financing structuring. Where appropriate, and depending on availability of funds, UNCDF will provide and / or facilitate financing to project sponsors that will enable access to sustainable domestic finance;¹²
3. Capacity-building activities that provide for the training of public and private stakeholders and increased government capacity to facilitate finance, project development, and business-enabling environments
4. Monitoring and Evaluation and impact verification. One important outcome of the LFI project will be its contribution to the measurement of investment impact. The Impact Reporting and Investment Standards (IRIS) network will be involved in designing a framework for measuring the impact on local economic development in the economic, social, environment and institutional spheres.

The targeted amount of private sector finance to be mobilized directly by the LFI Programme will depend on the size of the investment projects themselves. It is expected that the demonstration effect and experience gained will lead to greater leverage with additional funds flowing through the LFI programme and / or additional credit enhancement becoming available from partners. In addition domestic markets may respond with further funding, either through the LFI project or in parallel for similar projects.

¹² This may include access to a corporate credit enhancement or first loss guarantee facility should one be established

3. Programme Goal, Outcomes and Outputs

The overarching goal of the LFI Programme is poverty reduction and the achievement of the Millennium Development Goals, specifically Goal 1: Eradicate extreme poverty and hunger as well as contribute towards Goals 3 and 7. The programme is well aligned with the post-2015 development agenda and is relevant for the support of the sustainable development goals currently being developed.¹³

Programme Overall Outcome: Increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

The programme includes two intermediate outcomes and their associated outputs.

Outcome 1: Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive local development in a number of target developing countries.

This outcome targets the demand side of the equation and will result in an increased number of technically sound strategic infrastructure projects ready for funding. It includes the following outputs:

1.1: Processes, methodologies, and enabling tools are designed and introduced to identify and develop infrastructure projects essential for inclusive local development. These include tools, instruments and mechanisms for public-private partnerships, project financing (including non- or limited recourse project finance and SME finance). This will include the issue of Requests for Proposals from potential project sponsors.

1.2: Local capacity established to enable stakeholders (national and local government officials and the private sector) to identify and develop infrastructure projects essential for local development with support from development partners.

1.3: Four “proof of concept” demonstration projects identified, developed and structured in each LFI country to jumpstart process and create a multiplication effect through "learning by doing" and incentivizing stakeholders.

Outcome 2: Increased ability and willingness of the domestic financial sector to provide financing for small to medium-sized infrastructure projects.

This outcome targets the supply side of the equation and will result in an increasing number of infrastructure projects developed at the local level that are actually financed. It includes the following outputs:

2.1: An enabled environment is created that includes tools, instruments and mechanisms that to accelerate finance for local economic development infrastructure. These include appropriate regulations and investment vehicles.

¹³ A New Global Partnership: Eradicate Poverty And Transform Economies Through Sustainable Development. The Report of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda, 2013. United Nations.

2.2: Local capacity is established to increase the ability of the private sector to finance local development projects with appropriate credit enhancements.

2.3: Capacity is established to effectively evaluate and monitor the local development impact of public and private sector infrastructure investments in the context of LDCs.

4. Global Programme Implementation

The LFI Programme is structured around implementation of selective strategic catalytic projects at the local level, in at least eight **target countries** during a period of four years. These projects will be critical for unleashing the economic potential of local economies; they include both traditional and industrial infrastructure projects such as energy projects, transport, warehouses, and food processing plants. The initial countries are Tanzania, Uganda and Bangladesh.

4.1 Key Programme Components

Implementation of these projects will require activation of all programmatic features, which include:

- **Project development activities** supporting: a) project identification and informed decision-making (including through the UNCDF's core approach to local development, through the LOOKING diagnostic tool and involving Requests for Proposals from potential project sponsors), b) project development (feasibility studies, environmental and social assessments, project design, equipment selection, and negotiation of construction, input, output and project management contracts), and c) deal/financing structuring.
- **Credit enhancement support** to enable jumpstarting the process of project identification, development and deal/financing structuring (e.g., seed capital, guarantees and first loss facilities, buyer of first resort for bonds etc.) required to access the domestic financial sector (commercial banks, institutional investors, e.g., pension funds) for investments in strategic, smaller scale, traditional and industrial infrastructure projects. This will depend on the availability of funds. UNCDF will seek to facilitate access to such funding and develop its own corporate capacity for credit enhancement.
- **Capacity-building activities** which provide training and appropriate tools for public and private stakeholders and increase government capacity to facilitate finance, project development, and business-enabling environments (using modern on-line tools to enable national scaling up, identification of impediments and possible remedies, and tracking accountability). This includes the preparation and certification of local Technical Service Providers (TSPs) who will extend high quality capacity-building services to local banks, local and national level government officials and project sponsors (e.g., farmers associations).
- **Performance tracking activities** that provide benchmarking the dissemination and incentives for the replication of all programme components, delineating the type, amounts etc. of financial transactions, including the degree of leverage from targeted use of credit enhancement and ODA to facilitate transparency, replication and leveraging, both nationally and internationally. These indicators will be linked to the impact investment industry standards developed by institutions such as GIIN and IRIS. UNCDF will engage with these institutions.

Within each LFI country, the **LFI implementation process** will unfold as follows:

1. Once the programme is staffed with the needed TSP and country LFI Team a number of catalytic projects will be identified and developed including following the application of a LOOKING diagnostic, a scan of local development plans and the issuing of RFPs. Where appropriate the LFI team may work in unison with UNCDFs programmes on food security, women's economic

empowerment, climate resilience, fiscal decentralisation and local economic development to source potential project sponsors.

2. Implementation of these catalytic projects will feed into the national process of policy, legislative, regulatory, and operational review to create an adequate enabling environment for local development financing through the domestic financial sector. At the same time, the experience accumulated during implementation of the projects in LFI countries will help refine, activate and enhance national and international mechanisms for supporting local development.

Improved national and international frameworks, systems, and tools will, in turn, encourage more bankable projects and facilitate their financing through the domestic financial sector. At the same time, implemented projects will serve as a “proof of concept” of the viability of the programmatic concept and approach, encouraging more investments into local development infrastructure projects. As a result, more domestic capital will be released for small and medium-sized infrastructure projects.

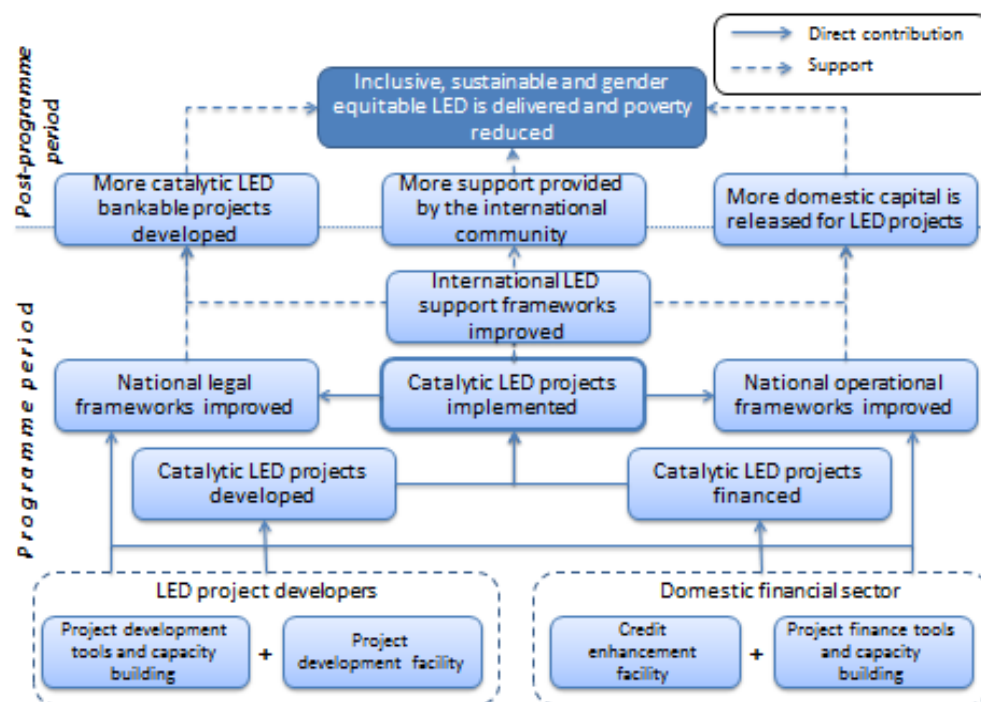


Figure 3: Local Finance Initiative: Theory of Change

4.2 Selection of LFI Projects

LFI Projects must be “bankable” projects that are catalytic to local economic development. Project sponsors can be private sector firms, public sector entities, or a combination of public and private sector entities. Where appropriate, projects will be set up in a “project company” as a separate legal entity to enable the ring-fencing of revenues required to access private sector finance (i.e., non-recourse

financing).¹⁴

The LFI Programme will also support the issuing of bonds and other municipal debt instruments by local governments. In this case whilst the bond may be secured on the general obligation principle it will be used to finance specific development projects that meet the local economic development criteria defined above. These include EcoBonds that are used to finance activities linked to improving the sustainability of cities. See Annex for the EcoBond concept.

The total cost of the proposed projects should be between US\$100,000 and US\$20 million¹⁵ with demonstrated local economic impact and financial viability, as detailed below. The specific criteria used for evaluating projects are based on best practices in infrastructure and development finance and are summarized below.

Local Development Criteria: The purpose of the LFI Programme is to catalyze local development. All LFI projects should therefore have a positive economic and social impact within the local region.

The types of alternative contributions to local development that projects can make include:

- Increased revenues to the suppliers of inputs to the project (for example, increased farmer income, etc.);
- Spillover effects on the local value chain (for example, enabling linkages between local suppliers and regional, national, or international markets);
- Improvement of the local business-enabling environment (for example, reducing cost of energy, water, transport, other services, etc.);
- Improved resilience to climate change and economic shocks.
- Job creation (direct and indirect);
- Improvement of skills in local labor market; and
- Increased tax revenues to local government.

These contributions are reflected in the Local Development Finance output and outcome indicators that capture progress in local social and economic development. All LFI projects will advance gender equality and conform to environmental sustainability guidelines.

Financial Criteria: A fundamental purpose of the LFI Programme is to unlock the country's financial sector so that local development projects can be financed with private finance (i.e., commercial banks, pension funds, etc.). Therefore the only projects that can be considered are those that generate a

14 National and Local Governments are often the originators of infrastructure projects for public use that can be developed through private companies or public ventures. In developed countries the usual approach has been the Administrative Concession by which the contractor (usually private) builds the infrastructure and revenues can come from real toll, shadow toll or transfer of rights of government revenue. Also in recent times, the new trend was the PPP / PFI (Public Private Partnership), where there are a number of risks that are transferred to the private sector (construction, operation, financial). In this case, it is a separate legal project entity (i.e., Special Purpose Vehicle) that assumes the risk.

15 As noted in earlier sections, while projects drafted for the pooled financing facility are likely to require up to approximately US\$5 million in financing, the LFI Programme will also include one –off larger projects up to US\$ 30 million for development and finance.

revenue.¹⁶ Those projects financed through municipal debt will seek to generate revenue for the municipality to cover the debt service. The bond will be secured on the general obligation principle but the resources raised by the bond will finance specific projects that are planned to generate the revenue for debt service.

For the LFI Programme to be successful in unlocking the private financial sector for catalytic local development projects, it will be critical to select 4 demonstration projects in each of four countries that will in fact prove the concept – demonstrating that the projects can indeed succeed as viable operations and be able to service their debts in a timely manner over the time period of the loans. Therefore, the selected demonstration projects will need to meet private sector finance standards that require the highest credit quality.

To ensure the quality and sustainability of these first demonstration projects, it is important that projects have strong project sponsors that have financial capacity and technical expertise with a track record in such operations. A critical requirement is that project sponsors provide at least 25% of the total cost of the project as equity and also contribute to the cost of developing the project with feasibility and other studies.

Further, to ensure adequate ability to pay debt service, most projects may need to be incorporated as a stand-alone legal entities (“Special Purpose Vehicle”), with “ring-fenced” revenues dedicated to paying debt service to the bank.

Project Identification and Selection Process:

- As referred to in sections above, projects may be identified and proposed to the LFI Programme by UNCDF’s country-based projects and programmes, government officials (national and local), private sector entities, community organizations, nonprofit organizations, and development partners. As a rule, a transparent selection process involving an RFP will be applied.
- Projects will be reviewed and selected in accordance with the criteria outlined in this document by the LFI Technical Team given their responsibility for evaluating proposed projects against the below technical criteria. All proposed projects will be validated with the respective local government as to their potential contribution to local economic development.

One of the LFI’s financing modality is structured project finance. The below detailed “bankability” criteria are based on “best practice” credit standards using this modality. These standards are important in ensuring the success of the selected projects, proving to the private financial institutions that LFI projects can meet the required performance in paying back their debts. Depending on the nature and size of the selected projects, the below bankability criteria may be modified and amended.

Detailed Project Finance Bankability Criteria: Projects need to conform to standard project finance criteria.

- 1) Projects need to consist of a single plant/industrial facility (which may have ancillary off-site

¹⁶ UNCDF will continue to support other infrastructure investments important for local economic development that do not generate revenues will need to be funded through grants and local government own revenue. The programmes in fiscal decentralization and local capacity strengthening address this type of infrastructure and service provision.

operations) that:

- Is capital intensive (i.e., its capital cost is relatively high in relation to annual sales);
- Employs proven technology;
- Has a relatively long physical and economic life;
- Can be managed successfully by any competent management team (i.e., management skill at operating this machinery is almost a “commodity”, rather than there being wide differences in outcome between the best operators and average or below average operators); and
- Has an economic output that is determined primarily by its design and successful construction (this point is closely related to the previous point).

2) The project’s revenues should be in the form of:

- Commercially reasonable charges for its output, sufficient to pay all project operating expenses and debt service, plus provide an adequate return on equity to the project’s investor(s); or
- Commercial revenues supplemented by output-based aid payments (where there appears to be a relatively high probability at the time of initial project development that the project will be successful in attracting output-based aid).

3) The project should have revenues that:

- That are sold pursuant to a long-term contract, or
- That are sold on the open market where projected sales can be validated.

4) The project should have an assurance of its supply of critical inputs that are purchased either:

- Pursuant to long-term contracts, or
- Are sourced locally under arrangements that assure an adequate supply at a reasonable cost.

5) The project will be managed by an experienced management team that is:

- Provided by the project sponsor, or
- Hired pursuant to a management contract.

6) The project can be structured so that it is owned by a separate legal entity has revenues that are “ring fenced” to assure their control and availability to pay project debt service.

7) The total cost of the project should range between US\$100,000, and US\$20 million. In exceptional cases, the projects chosen could be somewhat above or below these thresholds.

8) The project should be sponsored by a firm or organization that can provide, either from its own resources or in combination with other shareholders, equity equal to at least 25% of the total cost of the project.

9) The project should (a) have no adverse environmental or social impacts that cannot be effectively mitigated as part of the cost of the project, and (b) be in conformity with UNCDF’s environmental and gender guidelines.

10) The project will capitalize the cost of the technical studies and seed capital provided by the LFI programme and return those costs to the UNCDF on project closure with the bank.

4.3 Sustainability

LFI will ensure that the systems and methodologies developed under the programme are incorporated into national policies, legal, regulatory, and operational frameworks and are available as international best practices.

The financing approach that will often be utilized (non-recourse project finance) is frequently applied only for very large projects. Usually large, international consulting firms are contracted for this work, and it is common for hundreds of thousands of dollars to be spent on the preparation of studies. This is acceptable as these costs amount to only a small percentage of the overall project financing. The work needed to prepare feasibility studies for smaller projects is not proportionately less. Thus in order to keep down the cost of this work, it will be essential that local consultants be used as often as possible. It is reasonable to assume that most local consultants in developing countries are not adequately versed in developing project finance structures and conducting the required technical studies to access bank finance. Therefore it is proposed that training programmes be developed and provided to local TSPs who will undertake the various types of work (market research, engineering studies, financial analysis, etc.) needed to put together professional feasibility and other studies.

In addition, the LFI Global Programme will adhere to three principles key to sustainability of each LFI country's programme: (1) national ownership, (2) alignment with existing country structures, and (3) incorporation into national policies (4) reinvestment of the seed capital provided by LFI.

- **National ownership:** The design and introduction of methodologies, systems and tools for local development finance will build upon local experiences and be integrated into the existing national and sub-national frameworks and structures. The projects designed, financed and implemented with the support of the programme will be aligned with and contribute to the achievement of national and sub-national development goals and programmes.
- **Alignment with on-going country programming and existing coordination structures:** LFI is to be implemented in close coordination with other UNCDF, UN, DP, and DFI programmes currently implemented in the LFI countries. Where possible, each Country LFI Steering Committee is to be set up using existing development partner coordination structures, facilitating synergy, partnerships, and aid effectiveness with other interested UN agencies, DPs, and DFIs. These will include relevant ongoing UNCDF supported initiatives in climate resilience, women's economic empowerment and food security.
- **Incorporation into national policies:** LFI will make sure that systems and methodologies developed under the programme are incorporated into national policies, legal, regulatory, and operational frameworks and are available as international best practices. LFI will provide relevant government agencies with scalable investor after care tools that enable identification of specific impediments and remedies, and intra-governmental coordination in resolving issues. Once the systems are established, the cost of maintaining them could be absorbed by public and/or private sponsors, thereby enabling long-term sustainability.

- ***Sustainability of UNCDF inputs:*** LFI will negotiate with project sponsors to ensure the capitalisation of the costs, upon project closure, of technical studies and other inputs during the project preparation phase. This sum will be returned to UNCDF on financial closure of the investment project that UNCDF is supporting.

5. Stakeholders, Target Groups and Ultimate Beneficiaries

5.1 Stakeholders and target groups at the global and country level:

Funders and providers of credit enhancement, guarantees and specialized expertise:

- Central, regional, and local governments
- National Banks and Investors (including subsidiaries and affiliates of international banks, funds, etc.)
- Institutional investors (including Pension Funds, Insurance Companies)
- Financial Services Providers (FSPs¹⁷), including equity investors that would finance projects
- Technical Service Providers (including Engineering and Consulting Companies)
- Development programmes and foundations aimed at providing support to projects (funding of development costs and credit enhancements)
- Development Partners (UNCDF and other UN Agencies, Bilateral and Multilateral Aid agencies, International Financial Institutions and Development Financial Institutions)
- Other Development Partners, including expert NGOs and Foundations

Implementing Institutions (Project Sponsors):

- Regional and local governments
- National and International Companies interested in sponsoring projects, linking to projects critical to local development
- Professional associations (Farmer/Agricultural Associations, Industry Associations, etc.)
- Cooperatives and SMEs

5.2 Ultimate beneficiaries:

- Local communities (including women and youth) and households (including female-headed households)

¹⁷ Financial Service Providers (FSPs) would not be direct recipients of funds from this programme. UNCDF's work in building the capacity of FSPs is done through its Financial Inclusion programming.

6. Scalability of Programme

The LFI Programme is scalable on several levels:

- **Internally**, LFI interventions will increase in complexity, building on demonstration projects, lessons-learned and capacity-building programmes. As programme methodologies and tools are developed and integrated into local public and private sector processes, the programme's ability to facilitate the release of domestic capital will increase. Simultaneously, the programme will experience vertical scaling-up, feeding the acquired knowledge into national and international policies, legal, regulatory, and operational frameworks.
- **At the country level**, the LFI Programme will use a component-based approach to scale up. The project development, finance, capacity development, and performance tracking so that the relevant capacities are built locally throughout the target countries. With limited financial resources initially available for the credit enhancement component, actual project development and implementation will be targeted on a few carefully selected demonstration projects to maximize the impact of demonstration and the programme's execution. This may be scaled up if significantly increased resources become available.
- **At the global level, LFI is designed to facilitate the participation of international champions from the public and private sectors – including international development partners and their related programmes and risk mitigation tools, as well as international investors (banks, funds, project sponsors, etc.).** Furthermore the programme is set up to facilitate South-South exchange, with LFI Countries sharing lessons learned through the performance benchmarking activities and using the on-line tools to track investments operational and financial performance, share success stories, new finance approaches, and possible remedies to longstanding issues. The programme will also strengthen UNCDF's role as a repository of best practices for local development finance, increasing its capacity to provide advisory services and technical assistance to other developing countries and act as a conduit to other related DFI and DP programs and services.

7. Cross-cutting Issues

Gender

Gender will be mainstreamed into the programme in two main ways. Firstly, the programme will ensure that the criteria for ensuring gender equity are embedded in the tools developed by the programme for project identification and development. The programme will also focus on increasing women's participation as active members within institutional arrangements put in place and supported for the promotion of local development at the local level and within the target local government structures. This work will be in coordination with the UNCDF programme for women's economic empowerment (IELD) where relevant. This will ensure that the views of women producers, consumers, entrepreneurs and women active in civil society are equitably represented at all levels of decision making. Secondly, the programme will ensure that the investments financed and leveraged through the LFI increase women's access to productive resources and improve the business-enabling environment for women and the businesses they establish/manage and others within which they are equitably employed.¹⁸

Environment

The programme will ensure that projects financed under the LFI programme are environmentally friendly, based on effective and prudent management of local natural resources, and, whenever possible, contribute to improvement of local environment. Financing through the LFI programme will only be channelled to projects and interventions that adhere to environmental sustainability. Particular attention will be paid to links between LFI and the LoCAL project.

Food security

Food security and natural resources management are important areas in which UNCDF is involved. After decades of experience in food security financing at the local level, UNCDF as many others entities considers the urgent need to include the private sector and SMEs in its approach and develop new financial mechanisms for food production and exchanges. Infrastructures and services remain weak. Therefore, LFI will contribute to food security programs, especially in Africa, with a specific emphasis on investments that can improve the four pillars of food security: availability, stability, accessibility, and utilization.¹⁹ Increasing availability through public and private investments will be one of the main area of LFI especially in Africa.

¹⁸ For example, the fruit processing facility identified in Uganda's Nwoya District is owned by a women recognized as one of the top female entrepreneurs by the Uganda Investment Authority (UIA); the selection of her project would provide a model case study for female business ownership in the country that can also be shared with other LFI countries.

¹⁴ **Availability** of food. Food supplies must be sufficiently adequate to feed the population. Food availability thus covers food production (domestic production or imports), productivity, processing and marketing, post-harvest management;

Stability of the food supply, without fluctuations or shortages from season to season or from year to year. Food stability thus includes seeds and food stocks, disaster mitigation and management etc;

Accessibility to food or affordability. People must have physical, social and economic access to sufficient food. Where appropriate, access thus includes food safety nets for vulnerable groups in combination with income generating activities; and,

Utilization through adequate diet, clean water, sanitation and healthcare. Nutrition security is described as a situation where all people at all times have the ability to utilize biologically sufficient nutrients to live an active and healthy life. The nutritional dimension is integral to the concept of food security. Food must be safe, culturally

8. Geographical Coverage

Due to its catalytic nature, the LFI may be implemented in a wide range of modes as appropriate for the country given its development priorities and existing internal processes. LFI implementation modes include:

- In conjunction with a LED Programme (as is the case in Uganda) or another UNCDF programme such as food security, climate change, or urban and municipal development.
- As a stand-alone programme preceding a LED Programme, facilitating the entry and implementation of other LED-related programmes and interventions; or,
- As a standalone programme.

The Global LFI Programme is designed to include eight countries. The targeted countries are in Africa and Asia, where the domestic financial markets could be mobilized to lend to well-designed bankable small and medium-sized local development infrastructure projects that have risks mitigated by adequate credit enhancements. LFI Programmes are now being developed in **Bangladesh, Uganda and Tanzania**. **Examples of other candidate countries include: Senegal, Cambodia, and Rwanda.**

Background on the existing LFI pilot programme in Tanzania is detailed below.

8.1 Tanzania

In 2009 UNCDF commissioned a financial scan of Tanzania and a preliminary investigation of the key opportunities and challenges associated with financing of small and medium-sized infrastructure projects critical to local economic development. The Tanzania financial scan showed that there are several positive factors that work in favour of being able to access bank finance for local infrastructure projects, such as decentralized authority for project finance; local eagerness to find financing for essential infrastructure; income-generating projects; local capacity readiness; possible user fee levies; potential of central government support; potential mortgage-able asset securitization; commercial bank willingness to lend; and local demand for long-term local currency assets.³

As a direct result of this study, the Tanzania government requested that the One UN Programme include US\$3.5M allocation for the “Local Economic Development Finance Initiative of Tanzania” (LFI). In 2011, UNCDF contracted a consultancy company to design the Tanzania LFI Programme Document. The document was developed on the basis of the above-mentioned 2009 Tanzania report including both finance and tools components, and refined through subsequent research and government consultations. The LFI Tanzania initiative is approved by the Tanzania government and is incorporated within this global project.

8.2 Uganda

Since 1985, UNCDF has been providing support to local development in Uganda through a series of consecutive programmes at the district level. The strategy used has evolved from project-driven infrastructure delivery (for DDPI) to institutional development and policy impact as well as local development model (for DDPII) to LED support (for DDPIII). During implementation of DDPIII, the

accepted and nutritious.

demand for infrastructure for both local and national development became apparent. The need for traditional infrastructure projects such as energy, as well as agricultural processing facilities, was articulated by the districts and their stakeholders, as well as by national government officials and the private sector. Therefore, to complement the DDPIII LED approach and methodologies, a new approach was introduced from 2010 under the name of the Local Finance Initiative (LFI). This approach puts emphasis on tapping into existing domestic capital for financing to make up for the lack of public funding for infrastructure projects at the local and national level.

8.3 Bangladesh

For 30 years, UNCDF has been providing support to local development in Bangladesh through infrastructure and housing developments and then, from 2000 through a programme of support to infrastructure and service provision through local governments that led to reforms in fiscal decentralization and to government negotiating an IDA credit to upscale the system.

Central to local government grants will be not be able to sustainably finance the infrastructure requirements of growing towns and cities, in particular in delivering the essential climate resilient investments that are urgently required. From 2011 UNCDF has begun to work with central and local institutions to develop a capacity to access other forms of municipal finance including project finance, PPPs and municipal debt issues. The LFI programme will work with these local governments.

Additionally, the Government of Bangladesh has agreed to develop a local women's economic empowerment programme in the same local government jurisdictions covered by the fiscal decentralization initiative. This will provide a further pipeline of projects for LFI.

9. Strengths and Capabilities of UNCDF

The programme will build on UNCDF's internal strengths and comparative advantages in the area of local development finance, local economic development and policy advisory services.

- UNCDF will use its unique mandate as the only UN agency that can provide risk capital to the private sector and deploy its accumulated knowledge, experience, networks and presence in financial markets across 24 least-developed countries in sub-Saharan Africa and Asia-Pacific to effectively implement the LFI programme.
- UNCDF also has experience in the management of global thematic programmes such as the Local Climate Adaptive Living Facility for local climate finance and several microfinance initiatives including Microlead, YouthStart, Mobile Money for the Poor (MM4P), CleanStart, The Better Than Cash Alliance (BTCA) and The Pacific Financial Inclusion Programme (PFIP).
- UNCDF has helped build strong public sectors globally using sound financial management to improve allocation of scarce public resources and better delivery of basic services - essential components of sustainable, inclusive growth. UNCDF experience in public finance for local development includes relevant experience in:
 - Supporting fiscal decentralization and building local government capacities. UNCDF supports

decentralization and provides local governments with development funds that improve public investment and service delivery, while building long-term capacities for the effective mobilization, planning, budgeting, delivery and accounting of public resources.

- Strengthening public financial management and investment. UNCDF promotes sound public financial management, best practice investment programming and best value in local procurement to ensure public money is wisely spent. This includes helping to develop the regulations and operating mechanisms of decentralized of public finance, transparency and audit requirements, and promoting newer mechanisms such as performance-based funding.
- Promoting local innovation and developing local sources of revenue. UNCDF also helps to develop instruments and capacities for local governments to mobilize their own revenues (e.g. fees, taxes, public private partnerships) to complement central government resources.

PROGRAMME DOCUMENT

LOCAL FINANCE INITIATIVE (LFI) 2014-2017

Geographical Coverage: Global (Initial pilots in Tanzania, Uganda and Bangladesh)

Programme Overall Outcome: Increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

Programme Intermediate Outcomes:

- (1) Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive local development in a number of target developing countries.
- (2) Increased ability and willingness of domestic financial sector to provide financing for small to medium-sized local development infrastructure projects.

□ Programme Duration: 5 years

Anticipated start/end dates: 2014-2017

Funding Management Options: Parallel and Pass-Through

Administrative Agent for Pass-Through: UNDP

□ **Total Estimated Budget *:** US\$ 30,519,000

Out of which:

1. Funded Budget: US\$ 3,150,000
UNCDF \$800,000
SIDA (PFIS) \$1,650,000
ONE UN \$700,000

2. Unfunded budget: US \$ 27,369,000

Approved on behalf of United Nations Capital Development Fund
Marc Bichler, Executive Secretary, UNCDF
Signature
Name of Organization
Date & Seal

1. Situation Analysis

1.1 The development challenge addressed by the Local Finance Initiative (LFI)

Least developed countries include some of the world's fastest growing economies and also include countries whose growth in real terms is limited. Not all are growing at the rate required to keep pace with population increases. The balance of LDC economies and the growing sectors is unevenly spread across their territories and inequitably distributed through their societies, often producing relative disparities and disequilibria. These structural problems present serious challenges for equitable and sustainable development.

"With the global economy still struggling to return to a strong and sustained growth path, the external environment faced by the LDCs has been less propitious in the past five years than previously. The recent slowdown [in the growth of] of world trade, which is now at a near-standstill, has weakened the demand for LDC imports, most notably in the case of developed countries but also in emerging economies. In addition to weaker demand for their exports, the LDCs have been confronted with a heightened volatility of commodity prices and capital flows.

As a result, economic growth in the LDCs has been weaker by a full two percentage points in the past five years (2009–2013) than during the previous boom period (2002–2008). It has also been below the target rate of 7-per- cent annual growth established in the Istanbul Programme of Action (IPoA) for the Least Developed Countries for the Decade 2011–2020."¹

The same report highlights the differential growth rate within LDCs, with 15 of the 49 countries growing at rates in excess of 6% during the previous five years and 10 countries effectively falling behind with growth of less than 3%.

Yet the key challenge LDCs face over the next 5 years is not only aggregate growth, it is the quality of that growth and its ability to transform the economic and social structure across the whole territory. This can be reflected in two ways: Sustainable and equitable growth on the one hand and resilience to shocks on the other.

The overall picture in LDCs hides significant disparities and risks. Over 2 billion people continue to live on less than a dollar a day and whilst absolute levels of poverty are falling and inequalities are increasing.² Additionally, natural disasters, changing weather patterns and globalized economic relationships threaten the resilience of communities to external shocks. There are still many least developed countries mired in conflict.

The situation is even more polarised within developing countries themselves. Even the fastest growing countries, like Mozambique, report that poverty levels in many rural and peri-urban areas have not significantly changed over the last decade. Lao People's Democratic Republic (PDR) is on course to begin graduation to middle income status yet inequalities are growing and the median Gross National Income (GNI) per capital is still well below the threshold for a middle income country status, despite the increase in the mean figure.

¹ UNCTAD Least Developed Countries report, 2013

² UNCDF, Inclusive Future, 2013

This picture of overall growth, increased inequalities and stubborn pockets of poverty within LDCs reveals **a more uncertain and differentiated world in which many localities are not sharing the benefits of growth.** How can resources be reinvested locally to build resilience and reduce inequalities?

This is the challenge of local economic development and it is a challenge that becomes more and not less important as developing countries experience growth and capital accumulation but lack the means to reinvest that capital to promote sustainable, equitable and inclusive development. The result is localities lacking in infrastructure and capital investment that could support a more sustainable and equitable inclusion into the growing economy. Without this investment there is a tendency for value chains to be extractive and for a reduced scope to develop the clustering, linkages and labour markets that could recycle the proceeds of growth at the local level.

UNCDF's work on local development finance aims at ensuring that people in all regions and locations benefit from growth. This means dealing with the specific local development challenges of, for example, peri-urban areas and remote rural locations. It means re-investing domestic resources back into local economies and services through, for example, fiscal decentralisation on the one hand and the demonstration of innovative forms of private capital mobilisation on the other hand. Together this can improve the effectiveness of public and private investments in fostering local economic development. Both these approaches lead to increases in local revenue (through taxes and fees) for local institutions that again can be reinvested in the local economy.³

The growing differentiation at the local level is accompanied by two broad trends in development finance. Firstly the general decline of Official Development Assistance (ODA) since the 2008 economic crisis and secondly the above mentioned accumulation of significant capital surpluses in LDCs that are not reinvested locally due to perceived risk and a lack of investment opportunities, instead they are often held in unproductive real estate or in overseas accounts. These trends complicate the task of investing in public and private infrastructure for local development in those regions that are lagging behind.

Inclusive and sustainable growth requires resilient local economies that include a varied mix of public sector and private sector investment and that are not over dependent on one activity. Economic activities can contribute to inclusive local growth if they leverage and utilize other local resources, or they can be of an 'enclave' nature where the activity has little impact on the surrounding economy. Therefore not all local economic activity has the same impact on local development. Many local economic development programmes seek to apply both public and private capital in synergy and to use land use zoning, training and other incentives to create clusters of economic activity that link inputs and outputs, therefore adding value within the locality and diversifying the base of the local economy. This issue is explored in detail in Annex 1 that describes trends in local economic development.⁴

What is local development? It is not simply development that happens locally, as all activities happen somewhere. Instead it has been usefully defined as:

³ This process leads to an increase in Local Fiscal Space, one of the impact indicators for local development finance applied by UNCDF. Fiscal space is defined by the IMF as the "room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy" UNCDF applies this concept at a local level, taking into account both public and private finance. See *Finance and Development*, June 2005, Volume 42, Number 2, IMF Washington, and also www.uncdf.org for the set of Local Development Finance indicators.

⁴ Annex 1 is based on a paper by D Jackson on Local Economic Development presented at Duke University, July, 2011.

“ ... development that leverages the comparative and competitive advantages of localities and mobilizes their specific physical, economic, cultural, social and political resources. Said differently, in the expression local development the adjective local does not refer to the where, but to the who and the how of development promotion. It refers to the actors that promote it and the resources they bring to bear on it. Development is local if it is endogenous, open and incremental, that is: if it makes use of locality-specific resources, combines them with national/global resources and brings them to bear on the national development effort as additional benefit in a positive sum game.”⁵

Local Development means ultimately reducing poverty in its various forms by increasing the prosperity and wellbeing of localities and strengthening their resilience to economic and environmental shocks. This requires:

- Leveraging and using local resources;
- Providing benefits, employment and services to local people - In economic terms, promoting forward and backward linkages and positive externalities;
- Strengthening and using local institutions;
- Increasing local environmental resilience and sustainably exploiting environmental resources;

The Local Finance Initiative (LFI) is a global programme for local development finance that will work in harmony with ongoing local development programmes, to test ways of unlocking (preferably domestic) private finance for infrastructure projects as part of local economic development strategies and policies in least developed countries and in doing so will address the challenges outlined above.⁶ The LFI programme does this with the purpose of seeking a demonstration effect and paving the way for further capital investment in local infrastructure, thus realising UNCDF's mandate and comparative advantage in applying seed capital and technical assistance to policy reform and creating enabling environments for further capital flows. This contributes to achieving the targets of the UNCDF's Local Development finance programme, which include applying UNCDF's capital investment mandate to demonstrate how increased local fiscal space and increase rates of local gross fixed capital formation can accelerate local economic and social development, thereby leveraging further public and private resources to the local level.⁷

1.2 The challenge of mobilising private capital for infrastructure investment in the LDCs

There is a recognition of the critical role of the private sector in fostering economic growth, poverty reduction, and the attainment of the Millennium Development Goals (“MDGs”) and other

⁵ L Romeo, The Imperative of Good Local Governance, Chapter 3, 2013

⁶ The reference to local development strategies is about the overall policy environment and objectives of government. It does not necessarily refer to overly prescriptive strategies but to the indicative local economic planning practiced in much of the world.

⁷ In addition to Local Fiscal Space (see footnote 3) Gross Fixed Capital Formation is an impact indicator for local development finance applied by UNCDF. Gross Fixed Capital Formation is measured by the total value of a producer's acquisitions, less disposals, of *fixed assets* [as defined in public finance] during the accounting period plus certain specified expenditure on services that adds to the value of non-produced assets. See UNDESA, System of National Accounts, 2008, Chapter 10 – the capital account. This is a useful measure at local level because it captures both public and private capital assets that contribute to economically productive activity including service delivery, agricultural and industrial activity, processing etc. UNCDF applies an adapted measure of Gross Fixed Capital Formation at the local level.

internationally agreed development goals.

This was again highlighted at the 2008 Financing for Development (FfD) Summit in Doha and the UN 2010 MDG Summit in New York. Despite the consensus on the critical role of the private sector, the basic financial, legal and fiscal infrastructure required for private sector development is still widely lacking in many developing countries, arresting private sector development at local and national levels.

The recent global financial crisis has led to additional challenges, given the decreases in official development assistance and reduced availability of finance and risk capital in developing countries. Therefore the longstanding imperative for mobilizing private sector capital and leveraging limited official sector funds has escalated in importance. The Doha Declaration stresses that “greater efforts are required to support the creation and sustenance of an enabling environment [for mobilizing domestic financial resources for development] through appropriate national and international actions.”

Whereas the engagement of the domestic and private financial sectors in larger industries in developing countries has somewhat improved in recent years, financing of local economic development remains a matter of concern. Despite the fact that in many cases there is untapped domestic and private capital, which could be used to support small and medium-scale infrastructure development at the sub-national level, this capital is not available for LED actors, whether they are local governments or private businesses.

However, private sector capital can be successfully mobilized using financial structures and instruments that mitigate risks. For example, some infrastructure projects in developed countries and developing countries use the financial approach of non-recourse financing, in which the project is a legal entity with “ring-fenced” revenues that are earmarked for paying debt service. Furthermore, many risk mitigation instruments are already available that have proven successful in leveraging limited official sector support, such as the partial guarantees offered by the World Bank,⁸ regional development banks, and many donors such as USAID.⁹ The LFI Programme employs these proven financing techniques to mobilize private financing for relatively small infrastructure projects that are critical for supporting local economic development hand-in-hand with capacity building mechanisms to empower both government officials and the private sector to scale up local development finance, while providing inputs that improve the business-enabling environment. A second potential area is through municipal finance, particularly where the debt is secured on a general obligation basis (that is against the total revenue and assets of the municipality) but the bond itself is issued to finance an infrastructure project designed to increase revenues that will themselves support the servicing of the debt. Revenues can be increased through land taxes, rents, fees. For LDCs these instruments are not yet developed but would increase the scope for innovative public private partnerships that foster local economic development.

Yet there are many obstacles to take into consideration. Even if official bilateral and multilateral financing is available to a country for investment in bankable projects, such financing usually requires

8 See World Bank definition of their partial guarantee products:
http://siteresources.worldbank.org/INTGUARANTEES/Resources/IBRD_PRG.pdf

9 A recent USAID press release states: “As the momentum for partial credit guarantees builds, DCA’s portfolio has increased from \$1.8 billion of local wealth mobilized at the end of 2009 to \$2.3 billion today. The \$2.3 billion in available credit has helped 87,000 enterprises at a cost of only \$82 million to U.S. taxpayers. The \$82 million has been set aside as a provision for defaults.” See http://www.usaid.gov/press/releases/2010/pr101028_1.html Actual losses from the DCA program have so far amounted to only \$7.6 million on \$981 million in loans disbursed.

sovereign guarantees, which are often unavailable due to fiscal constraints at the national level. As mentioned above, one of the most promising of these capital sources are the country's own domestic savings that have been mobilized by domestic banks and institutional investors (primarily pension funds and insurance companies). Nevertheless there is a need to develop sources of local currency financing for local infrastructure projects. Moreover, there is a lack of bankable projects and little funding for developing them and experience from the LFI pilots in Tanzania and Uganda demonstrate that project development costs can be significant.

Analysis has identified three major reasons that restrict the availability of domestic and private capital for LED. These include:

Inadequate national legal and operational frameworks impede engagement of the domestic financial sector in LED. There is a lack of a coherent approach in developing countries to engage the private sector in LED. There is a lack of clear definition of the competencies and respective roles of LED public and private sector actors for channelling private sector investments into infrastructure projects. Business-enabling environments for LED, including the appropriate regulations and laws, remain inadequate in many developing countries, requiring the development of new communication venues between stakeholders that can articulate the needed changes for private sector growth and development.

In other cases, adequate regulations and legal frameworks exist but fail to translate regulations and legal provisions into effective operational guidelines. Local governments may be legally allowed to finance local development but in the absence of relevant regulatory and operational guidelines are not in a position to do so. If borrowing is more appropriate through a private sector project company, governments are not adequately trained to set up such a vehicle. In most of the cases in developing countries, Local Governments (LGs) need to develop their own knowledge of project development requirements and sources of possible ways to finance and support the needed development of business plan, feasibility studies, engineering studies, legal contracts, etc.

Inadequate technical capacity and poor skill sets deter development of bankable development projects. Very often in developing countries there is a lack of technical skills, technological know-how, and tools required to develop bankable projects or address development challenges. A lack of knowledge usually means the inability to make informed decisions; identify, design, develop, finance and manage viable projects; and address any specific problems that may arise during such a process. Project proposals developed locally are often insufficient in fleshing out viable business models and controlling for risks, therefore failing to attract private sector lenders and institutional investors and convince them of project credit-worthiness.

Banks have little interest in financing small and medium-sized infrastructure projects. Private sector lenders and institutional investors in developing countries tend to steer away from investing in small- and medium-sized infrastructure projects because of the high transaction costs, low profit margins in relation to the time required by bank personnel, and the perceived risks and lengthy borrowing period usually associated with such projects. Moreover, the need for long-term investment in infrastructure projects does not usually match with the tendency for commercial banks in developing countries to lend short term. The effect is two-fold: the limited access of LED stakeholders to domestic and private capital and a lack of willingness on the part of these financial sectors to invest in LED.

1.3 The relevance of UNCDF's core approach to local development finance

The UNCDF approach to local development finance in least developed countries recognises the need to unlock existing sources of capital for local development and attract new investment capital to the local level. To this end UNCDF applies its seed capital and technical assistance to develop innovative solutions that leverage or mobilize, allocate, and invest resource flows to the local level for local development, thus meeting the capital funding gap. This means that the key factors are the demonstration effect of the innovation and the additional fund flows unleashed for local development. This requires strengthening the capacity of existing public and private institutions and the procedures they use as well as providing the seed capital itself.

This is illustrated in figure 1 that shows the approach of UNCDF to local development finance. purpose of as poverty reduction through. LDFP programmes mobilise, allocate, invest and account for these increased flows through improved and strengthened local public and private institutions. The circle at the bottom left shows how UNCDF seed capital and technical assistance is applied towards this end. The term “capital” is applied in its wider sense, encompassing its multiple definitions as: a factor of production; an accounting term in public finance (i.e. not a recurrent cost); a large scale fiscal or financial flow; an income generating resource; and finally a valuable and / or expendable resource. LDFP seed capital leverages these flows to the local level, promoting poverty reduction through sustainable, inclusive and equitable local development.

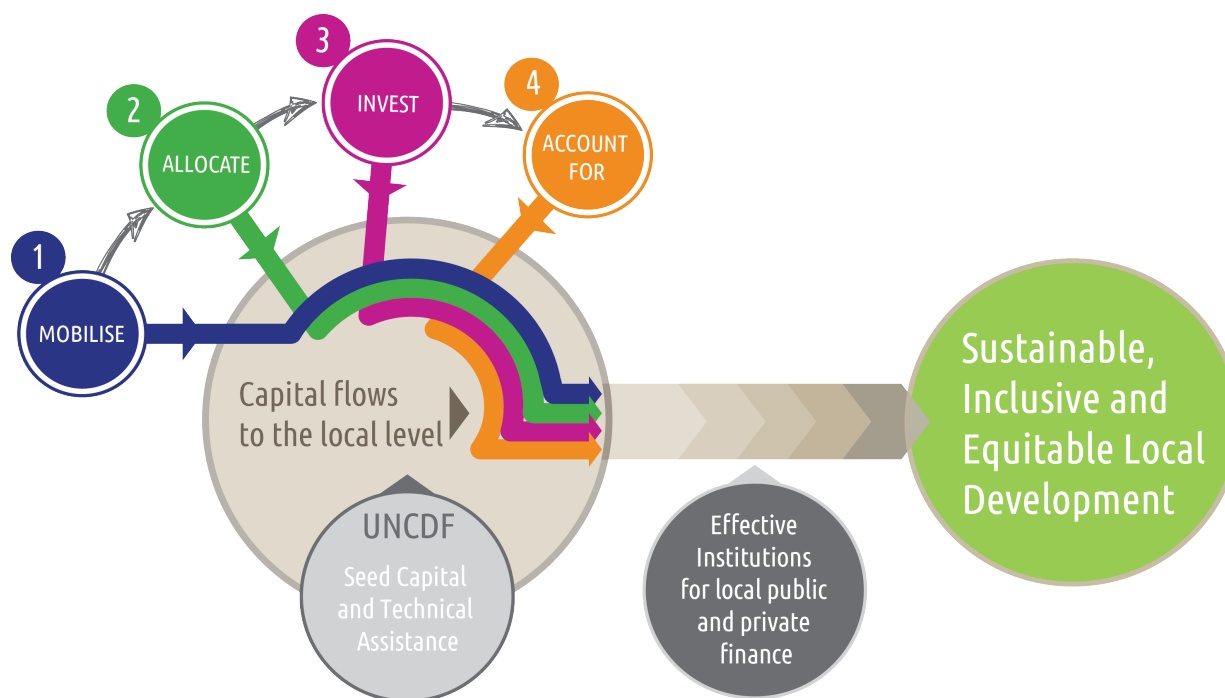


Figure 1.

Least Developed Countries are already working with UNCDF on local development programmes for infrastructure and service delivery, food security, gender, climate resilience and economic development.

UNCDF-LDFP (Local Development Finance Programme area) aims to improve life of people in localities by strengthening financial mechanisms for infrastructures and services and delivering resources through

locally appropriate means. According to its Business Plan 2014 - 2017, LDFFP will intervene both through national and global programs that will be articulated at country level to maximise UNCDF's intervention relevance and impact. LFI is one of the Global programs that will be embedded in countries programs in most of the places where UNCDF intervenes. The Global coverage of this program, as all others UNCDF-LDFFP programs aims to build a south-south thematic cooperation, improve the quality of UNCDF support (especially on the monitoring and evaluation side) and develop a piloting based knowledge.

The LFI global programme will combine expertise in public and private development finance to enable support for those revenue generating infrastructure projects that support national development priorities in the pilot countries. These are relatively new financing modalities for Least Developed Countries and UNCDF is leveraging its two decade experience in developing local public financial management and local public infrastructure in LDC environments to introduce these new methods of financing local development, therefore providing a demonstration effect and building confidence for other actors.

LFI will work in harmony with other ongoing local development programmes, to test ways of unlocking (preferably domestic) private finance for infrastructure projects as part of coordinated actions with the public sector. UNCDF local development finance projects support the efficient and effective use of public and private finance for local economic development. Through fiscal decentralization and the investment of own revenue local governments can have a comparative advantage in the provision of public economic goods such as roads, bridges, market places, irrigation and drainage systems, aqueducts, canals and storage facilities. This extends to a role in stimulating best practice amongst private sector contractors and to capitalizing the local economy through the employment and demand created. The local public sector is a large economic actor in many LDC localities. These ongoing programmes will seek synergies with the LFI global project.

LFI will apply a variety of investment modalities including municipal finance, structured project financing, Small and Medium (SME) finance and public private partnerships. In all cases the objectives are to demonstrate how domestic private capital can work in synergy with public investments and provide targeted interventions in support of infrastructure projects with proven local development impact. UNCDF will provide inputs where appropriate together with technical assistance in the form of feasibility studies, market research, cash flow analysis etc.¹⁰ In the case of municipal debt finance LFI will work with local governments and national entities to create the capacities and regulatory environment to test responsible municipal finance instruments such as the EcoBond being piloted in Bangladesh. UNCDF can be a buyer of first resort to provide confidence to this new market. The program will be initially piloted in Bangladesh, Tanzania and Uganda and extended to five more countries during 2014 – 2017.

¹⁰ UNCDF will seek to provide access to grants and credit enhancements where appropriate, dependent on availability of funding

2. Programme Strategy

2.1 Lessons Learned

There are a number of efforts currently underway to increase funding for infrastructure projects in developing countries. However, most of these focus on large traditional infrastructure projects—major roads and ports, national power production and distribution systems, urban water and sewer systems, and telecommunications. But the relatively small infrastructure projects that local governments have begun to identify through their LED efforts have received much less attention and financial support. This is a problem that UNCDF began to address in its pilot activities in Bangladesh, Uganda and Tanzania. Financial scans in Uganda and Tanzania were performed with the aim of developing solutions to this problem and in Bangladesh UNCDF began to explore alternatives for municipal finance such as bonds. The governments of all three countries subsequently asked UNCDF to develop programmes based on the preliminary assessments and proposed financial approaches and pilot LFI programmes were launched in Uganda and Tanzania and a pilot Bond initiative was launched in Bangladesh. In Uganda this was part of an on-going Local Economic Development Programme¹¹ and pioneered the use of risk mitigation instruments combined with proven non-recourse project finance principles to smaller-scale local infrastructure projects.

Based on the experience of UNCDF's assessments and work to date in Bangladesh, Uganda and Tanzania, in addition to other UNCDF programmes worldwide, some reasons for inadequate domestic financing of local development would appear to be the following:

Local development in general and LED in particular is a complex undertaking requiring time and national and international partnerships. Delivering economic development to a locality or region is complex as it is subject to influences beyond the control of local, regional or national governments. Equally, the time-frame for seeing results is closer to a business cycle (12-15 years) than to the electoral cycle (3-4 years). As a result, local economic development is more likely to succeed if it is treated as a long-term partnership between public, private, and institutional sectors, both at the national and international levels. This is especially true since the private sector is the natural choice from which to launch LED, with greater resources and continuity, ensuring broad-scale development impact and sustainability.

Bankable projects are the starting point for unblocking domestic and private finance. The most critical bottleneck to accessing finance is the lack of bankable and investment ready projects. Finance is not available because requests for finance tend to be just “concepts” or “wish lists,” lacking business plans, feasibility studies, market assessments, engineering and legal inputs, etc. where feasibility studies exist they lack finance fundamentals that enable the sponsors to take them over the last mile. The skills and capital required for developing bankable projects and businesses are lacking in developing countries. Often the large equity investment requirements imposed by commercial lenders and high costs of accessing legal and financial advice to structure projects and business deals make it almost impossible for small investors to develop projects. Targeted donor intervention can be the fulcrum for jumpstarting the development of projects and mitigating the risks that impede their bankability.

11 The UNCDF District Development Programme (DDPIII) in Uganda

Economically viable projects with significant development and transformative impact take time to identify and develop. UNCDF aims at projects that have significant transformative impact at the local level. However, these projects may have relatively low economic returns despite their high social returns. Although such projects may be socially highly desirable, developing countries do not have enough expertise, resources and sometimes political will to develop these projects to a stage where they become bankable and or investment ready.

Risk perception of lenders must be addressed. The perception of risk is another critical bottleneck preventing small-to-medium sized infrastructure projects from accessing private capital from banks and institutional investors, such as pension funds and insurance companies in developing countries. Local financial institutions often have less experience and limited expertise in evaluating the technical and market risks of non-recourse project financings. Coupled with limited experience in risk mitigation measures this produces a distorted perception of risk causing lenders to sometimes deny financing to potentially viable projects. Therefore local banks and institutional investors need to be induced into the development and financing of the local development projects, through targeted credit enhancements supplemented with overall training, so they can assume their inherent role as leaders of the country's local development finance.

2.2 Programme Approach

The overall **outcome of the programme** is to increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

To achieve this goal, the programme will focus on addressing the widely acknowledged problem of blocked domestic and private financial sectors, resulting in a suboptimal allocation of funds to productive uses critical to development. As a result, social resources are used at a suboptimal level, resulting in diminished total social benefits. In essence, the programme strategy consists of bringing the supply and demand to an optimal level by reducing perceived risks and transaction costs of financial services for all local development stakeholders and participants of the finance market. The approach will be systematic and technical in nature, focused on jump-starting the process of mobilizing private sector financial resources in both commercial banks and institutional investors through the selective targeted use of public resources.

The supply side is represented by domestic and private financial institutions, and the demand side is represented by project developers which may include private businesses as well as local governments and the non-government sector. Since LED project developers, particularly those dealing with small and medium-scale infrastructure, are unsure about their ability to formulate financially sound and viable projects, the demand for financial services is relatively low. Since domestic providers of financial services are unconvinced about the ability of borrowers to repay, the costs of providing financial services are high, and supply of such services remains limited.

For the purposes of strategy formulation, the programme distinguishes **five major institutional groups engaged in local development**:

- **Project developers:** Private businesses, local governments, domestic non-government sector. This includes SMEs and farmers suffering from a lack of basic industrial infrastructure such as warehouses and logistic services, processing plants, cold storage facilities, and traditional

infrastructure services as irrigation, water, energy, transport, communications, etc.

- **The financial sector and related services:** Commercial banks, institutional investors such as pension funds and insurance companies, as well as service providers such as public and private credit bureaus, consulting and accounting firms, lawyers and others providers that are needed to building internal capacity for developing and financing infrastructure projects.
- **Local governments:** Local institutions with a mandate to promote the economic and social development of their territorial jurisdictions. These institutions produce social and economic development plans, engage with local chambers of commerce and also have responsibilities to promote an enabling environment for local economic development.
- **Government agencies:** ministries and agencies defining policy development and finance, and regulatory and operational frameworks, such as ministries of local government, finance, investment promotion, investment, trade and commerce, government regulators, and others.
- **International development community:** UN family and Bretton Woods institutions, bilaterals development partners, multilateral development agencies and international non-government organizations which provide invaluable technical assistance at the local level.

The LFI Programme thus aims to improve the ability and willingness of stakeholders to use domestic finance for local development and to create enabling national and international environments for sustained participation of the domestic financial sector in local development. This can be either through investing domestic finance itself or by deploying non-domestic finance in a way that demonstrates effect and creates confidence for the investment of domestic finance.

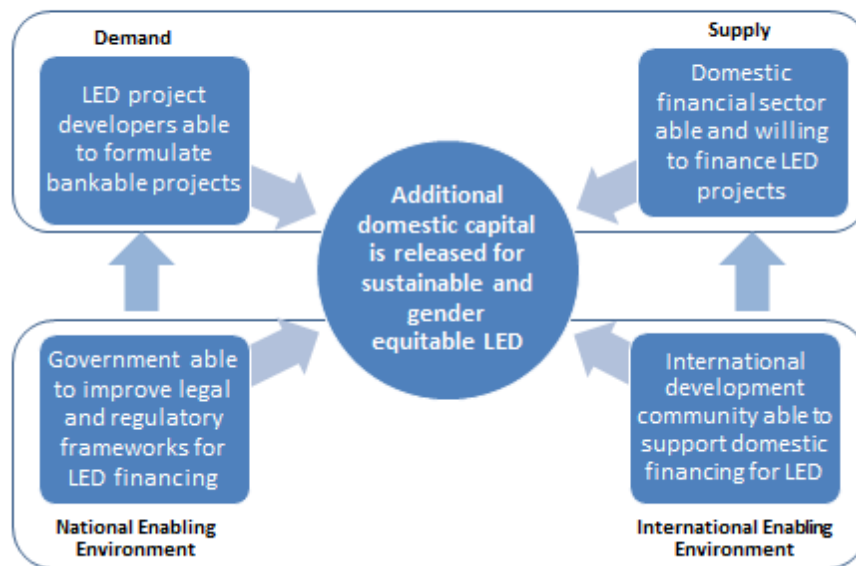


Figure 2: Local Finance Initiative (LFI): Strategy and Approach

LFI Programme approach will be executed through **four main programmatic features**:

1. Project development activities that enable the identification and development of up to 4 demonstration projects in each LFI country to create “proof of concept” financing models that facilitate access to the domestic financial sector for investments in strategic, smaller scale infrastructure projects.
2. Finance and credit enhancement facilities to enable jumpstarting the process of project identification, development and deal/financing structuring. Where appropriate, and depending on availability of funds, UNCDF will provide and / or facilitate financing to project sponsors that will enable access to sustainable domestic finance;¹²
3. Capacity-building activities that provide for the training of public and private stakeholders and increased government capacity to facilitate finance, project development, and business-enabling environments
4. Monitoring and Evaluation and impact verification. One important outcome of the LFI project will be its contribution to the measurement of investment impact. The Impact Reporting and Investment Standards (IRIS) network will be involved in designing a framework for measuring the impact on local economic development in the economic, social, environment and institutional spheres.

The targeted amount of private sector finance to be mobilized directly by the LFI Programme will depend on the size of the investment projects themselves. It is expected that the demonstration effect and experience gained will lead to greater leverage with additional funds flowing through the LFI programme and / or additional credit enhancement becoming available from partners. In addition domestic markets may respond with further funding, either through the LFI project or in parallel for similar projects.

¹² This may include access to a corporate credit enhancement or first loss guarantee facility should one be established

3. Programme Goal, Outcomes and Outputs

The overarching goal of the LFI Programme is poverty reduction and the achievement of the Millennium Development Goals, specifically Goal 1: Eradicate extreme poverty and hunger as well as contribute towards Goals 3 and 7. The programme is well aligned with the post-2015 development agenda and is relevant for the support of the sustainable development goals currently being developed.¹³

Programme Overall Outcome: Increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.

The programme includes two intermediate outcomes and their associated outputs.

Outcome 1: Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive local development in a number of target developing countries.

This outcome targets the demand side of the equation and will result in an increased number of technically sound strategic infrastructure projects ready for funding. It includes the following outputs:

1.1: Processes, methodologies, and enabling tools are designed and introduced to identify and develop infrastructure projects essential for inclusive local development. These include tools, instruments and mechanisms for public-private partnerships, project financing (including non- or limited recourse project finance and SME finance). This will include the issue of Requests for Proposals from potential project sponsors.

1.2: Local capacity established to enable stakeholders (national and local government officials and the private sector) to identify and develop infrastructure projects essential for local development with support from development partners.

1.3: Four “proof of concept” demonstration projects identified, developed and structured in each LFI country to jumpstart process and create a multiplication effect through "learning by doing" and incentivizing stakeholders.

Outcome 2: Increased ability and willingness of the domestic financial sector to provide financing for small to medium-sized infrastructure projects.

This outcome targets the supply side of the equation and will result in an increasing number of infrastructure projects developed at the local level that are actually financed. It includes the following outputs:

2.1: An enabled environment is created that includes tools, instruments and mechanisms that to accelerate finance for local economic development infrastructure. These include appropriate regulations and investment vehicles.

¹³ A New Global Partnership: Eradicate Poverty And Transform Economies Through Sustainable Development. The Report of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda, 2013. United Nations.

2.2: Local capacity is established to increase the ability of the private sector to finance local development projects with appropriate credit enhancements.

2.3: Capacity is established to effectively evaluate and monitor the local development impact of public and private sector infrastructure investments in the context of LDCs.

4. Global Programme Implementation

The LFI Programme is structured around implementation of selective strategic catalytic projects at the local level, in at least eight **target countries** during a period of four years. These projects will be critical for unleashing the economic potential of local economies; they include both traditional and industrial infrastructure projects such as energy projects, transport, warehouses, and food processing plants. The initial countries are Tanzania, Uganda and Bangladesh.

4.1 Key Programme Components

Implementation of these projects will require activation of all programmatic features, which include:

- **Project development activities** supporting: a) project identification and informed decision-making (including through the UNCDF's core approach to local development, through the LOOKING diagnostic tool and involving Requests for Proposals from potential project sponsors), b) project development (feasibility studies, environmental and social assessments, project design, equipment selection, and negotiation of construction, input, output and project management contracts), and c) deal/financing structuring.
- **Credit enhancement support** to enable jumpstarting the process of project identification, development and deal/financing structuring (e.g., seed capital, guarantees and first loss facilities, buyer of first resort for bonds etc.) required to access the domestic financial sector (commercial banks, institutional investors, e.g., pension funds) for investments in strategic, smaller scale, traditional and industrial infrastructure projects. This will depend on the availability of funds. UNCDF will seek to facilitate access to such funding and develop its own corporate capacity for credit enhancement.
- **Capacity-building activities** which provide training and appropriate tools for public and private stakeholders and increase government capacity to facilitate finance, project development, and business-enabling environments (using modern on-line tools to enable national scaling up, identification of impediments and possible remedies, and tracking accountability). This includes the preparation and certification of local Technical Service Providers (TSPs) who will extend high quality capacity-building services to local banks, local and national level government officials and project sponsors (e.g., farmers associations).
- **Performance tracking activities** that provide benchmarking the dissemination and incentives for the replication of all programme components, delineating the type, amounts etc. of financial transactions, including the degree of leverage from targeted use of credit enhancement and ODA to facilitate transparency, replication and leveraging, both nationally and internationally. These indicators will be linked to the impact investment industry standards developed by institutions such as GIIN and IRIS. UNCDF will engage with these institutions.

Within each LFI country, the **LFI implementation process** will unfold as follows:

1. Once the programme is staffed with the needed TSP and country LFI Team a number of catalytic projects will be identified and developed including following the application of a LOOKING diagnostic, a scan of local development plans and the issuing of RFPs. Where appropriate the LFI team may work in unison with UNCDFs programmes on food security, women's economic

empowerment, climate resilience, fiscal decentralisation and local economic development to source potential project sponsors.

2. Implementation of these catalytic projects will feed into the national process of policy, legislative, regulatory, and operational review to create an adequate enabling environment for local development financing through the domestic financial sector. At the same time, the experience accumulated during implementation of the projects in LFI countries will help refine, activate and enhance national and international mechanisms for supporting local development.

Improved national and international frameworks, systems, and tools will, in turn, encourage more bankable projects and facilitate their financing through the domestic financial sector. At the same time, implemented projects will serve as a “proof of concept” of the viability of the programmatic concept and approach, encouraging more investments into local development infrastructure projects. As a result, more domestic capital will be released for small and medium-sized infrastructure projects.

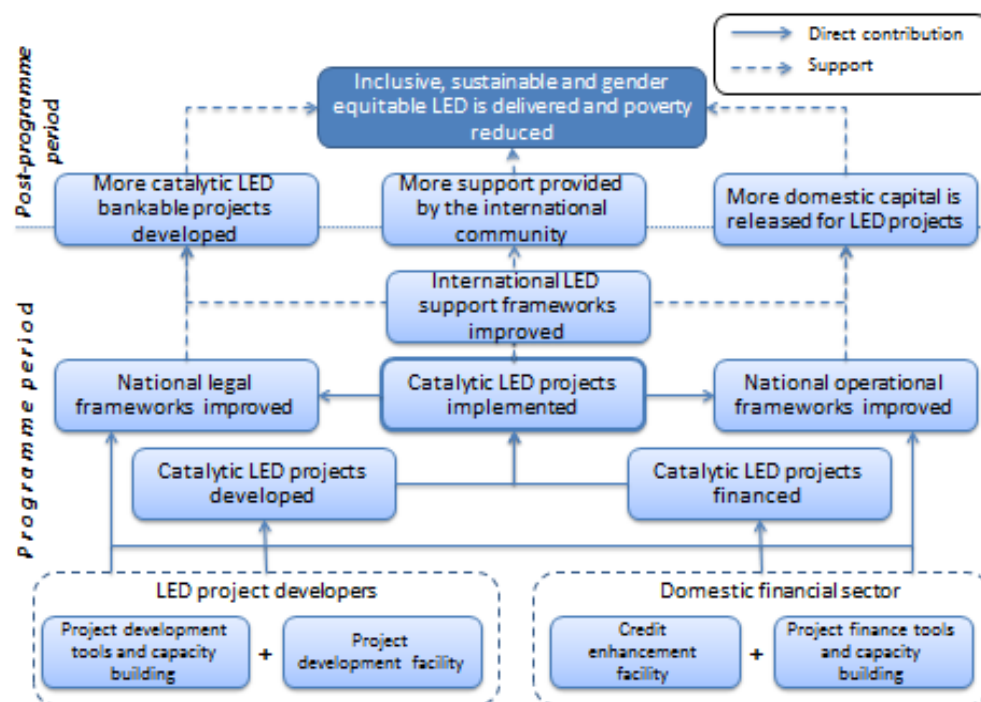


Figure 3: Local Finance Initiative: Theory of Change

4.2 Selection of LFI Projects

LFI Projects must be “bankable” projects that are catalytic to local economic development. Project sponsors can be private sector firms, public sector entities, or a combination of public and private sector entities. Where appropriate, projects will be set up in a “project company” as a separate legal entity to enable the ring-fencing of revenues required to access private sector finance (i.e., non-recourse

financing).¹⁴

The LFI Programme will also support the issuing of bonds and other municipal debt instruments by local governments. In this case whilst the bond may be secured on the general obligation principle it will be used to finance specific development projects that meet the local economic development criteria defined above. These include EcoBonds that are used to finance activities linked to improving the sustainability of cities. See Annex for the EcoBond concept.

The total cost of the proposed projects should be between US\$100,000 and US\$20 million¹⁵ with demonstrated local economic impact and financial viability, as detailed below. The specific criteria used for evaluating projects are based on best practices in infrastructure and development finance and are summarized below.

Local Development Criteria: The purpose of the LFI Programme is to catalyze local development. All LFI projects should therefore have a positive economic and social impact within the local region.

The types of alternative contributions to local development that projects can make include:

- Increased revenues to the suppliers of inputs to the project (for example, increased farmer income, etc.);
- Spillover effects on the local value chain (for example, enabling linkages between local suppliers and regional, national, or international markets);
- Improvement of the local business-enabling environment (for example, reducing cost of energy, water, transport, other services, etc.);
- Improved resilience to climate change and economic shocks.
- Job creation (direct and indirect);
- Improvement of skills in local labor market; and
- Increased tax revenues to local government.

These contributions are reflected in the Local Development Finance output and outcome indicators that capture progress in local social and economic development. All LFI projects will advance gender equality and conform to environmental sustainability guidelines.

Financial Criteria: A fundamental purpose of the LFI Programme is to unlock the country's financial sector so that local development projects can be financed with private finance (i.e., commercial banks, pension funds, etc.). Therefore the only projects that can be considered are those that generate a

14 National and Local Governments are often the originators of infrastructure projects for public use that can be developed through private companies or public ventures. In developed countries the usual approach has been the Administrative Concession by which the contractor (usually private) builds the infrastructure and revenues can come from real toll, shadow toll or transfer of rights of government revenue. Also in recent times, the new trend was the PPP / PFI (Public Private Partnership), where there are a number of risks that are transferred to the private sector (construction, operation, financial). In this case, it is a separate legal project entity (i.e., Special Purpose Vehicle) that assumes the risk.

15 As noted in earlier sections, while projects drafted for the pooled financing facility are likely to require up to approximately US\$5 million in financing, the LFI Programme will also include one –off larger projects up to US\$ 30 million for development and finance.

revenue.¹⁶ Those projects financed through municipal debt will seek to generate revenue for the municipality to cover the debt service. The bond will be secured on the general obligation principle but the resources raised by the bond will finance specific projects that are planned to generate the revenue for debt service.

For the LFI Programme to be successful in unlocking the private financial sector for catalytic local development projects, it will be critical to select 4 demonstration projects in each of four countries that will in fact prove the concept – demonstrating that the projects can indeed succeed as viable operations and be able to service their debts in a timely manner over the time period of the loans. Therefore, the selected demonstration projects will need to meet private sector finance standards that require the highest credit quality.

To ensure the quality and sustainability of these first demonstration projects, it is important that projects have strong project sponsors that have financial capacity and technical expertise with a track record in such operations. A critical requirement is that project sponsors provide at least 25% of the total cost of the project as equity and also contribute to the cost of developing the project with feasibility and other studies.

Further, to ensure adequate ability to pay debt service, most projects may need to be incorporated as a stand-alone legal entities (“Special Purpose Vehicle”), with “ring-fenced” revenues dedicated to paying debt service to the bank.

Project Identification and Selection Process:

- As referred to in sections above, projects may be identified and proposed to the LFI Programme by UNCDF’s country-based projects and programmes, government officials (national and local), private sector entities, community organizations, nonprofit organizations, and development partners. As a rule, a transparent selection process involving an RFP will be applied.
- Projects will be reviewed and selected in accordance with the criteria outlined in this document by the LFI Technical Team given their responsibility for evaluating proposed projects against the below technical criteria. All proposed projects will be validated with the respective local government as to their potential contribution to local economic development.

One of the LFI’s financing modality is structured project finance. The below detailed “bankability” criteria are based on “best practice” credit standards using this modality. These standards are important in ensuring the success of the selected projects, proving to the private financial institutions that LFI projects can meet the required performance in paying back their debts. Depending on the nature and size of the selected projects, the below bankability criteria may be modified and amended.

Detailed Project Finance Bankability Criteria: Projects need to conform to standard project finance criteria.

1) Projects need to consist of a single plant/industrial facility (which may have ancillary off-site

¹⁶ UNCDF will continue to support other infrastructure investments important for local economic development that do not generate revenues will need to be funded through grants and local government own revenue. The programmes in fiscal decentralization and local capacity strengthening address this type of infrastructure and service provision.

operations) that:

- Is capital intensive (i.e., its capital cost is relatively high in relation to annual sales);
- Employs proven technology;
- Has a relatively long physical and economic life;
- Can be managed successfully by any competent management team (i.e., management skill at operating this machinery is almost a “commodity”, rather than there being wide differences in outcome between the best operators and average or below average operators); and
- Has an economic output that is determined primarily by its design and successful construction (this point is closely related to the previous point).

2) The project’s revenues should be in the form of:

- Commercially reasonable charges for its output, sufficient to pay all project operating expenses and debt service, plus provide an adequate return on equity to the project’s investor(s); or
- Commercial revenues supplemented by output-based aid payments (where there appears to be a relatively high probability at the time of initial project development that the project will be successful in attracting output-based aid).

3) The project should have revenues that:

- That are sold pursuant to a long-term contract, or
- That are sold on the open market where projected sales can be validated.

4) The project should have an assurance of its supply of critical inputs that are purchased either:

- Pursuant to long-term contracts, or
- Are sourced locally under arrangements that assure an adequate supply at a reasonable cost.

5) The project will be managed by an experienced management team that is:

- Provided by the project sponsor, or
- Hired pursuant to a management contract.

6) The project can be structured so that it is owned by a separate legal entity has revenues that are “ring fenced” to assure their control and availability to pay project debt service.

7) The total cost of the project should range between US\$100,000, and US\$20 million. In exceptional cases, the projects chosen could be somewhat above or below these thresholds.

8) The project should be sponsored by a firm or organization that can provide, either from its own resources or in combination with other shareholders, equity equal to at least 25% of the total cost of the project.

9) The project should (a) have no adverse environmental or social impacts that cannot be effectively mitigated as part of the cost of the project, and (b) be in conformity with UNCDF’s environmental and gender guidelines.

10) The project will capitalize the cost of the technical studies and seed capital provided by the LFI programme and return those costs to the UNCDF on project closure with the bank.

4.3 Sustainability

LFI will ensure that the systems and methodologies developed under the programme are incorporated into national policies, legal, regulatory, and operational frameworks and are available as international best practices.

The financing approach that will often be utilized (non-recourse project finance) is frequently applied only for very large projects. Usually large, international consulting firms are contracted for this work, and it is common for hundreds of thousands of dollars to be spent on the preparation of studies. This is acceptable as these costs amount to only a small percentage of the overall project financing. The work needed to prepare feasibility studies for smaller projects is not proportionately less. Thus in order to keep down the cost of this work, it will be essential that local consultants be used as often as possible. It is reasonable to assume that most local consultants in developing countries are not adequately versed in developing project finance structures and conducting the required technical studies to access bank finance. Therefore it is proposed that training programmes be developed and provided to local TSPs who will undertake the various types of work (market research, engineering studies, financial analysis, etc.) needed to put together professional feasibility and other studies.

In addition, the LFI Global Programme will adhere to three principles key to sustainability of each LFI country's programme: (1) national ownership, (2) alignment with existing country structures, and (3) incorporation into national policies (4) reinvestment of the seed capital provided by LFI.

- **National ownership:** The design and introduction of methodologies, systems and tools for local development finance will build upon local experiences and be integrated into the existing national and sub-national frameworks and structures. The projects designed, financed and implemented with the support of the programme will be aligned with and contribute to the achievement of national and sub-national development goals and programmes.
- **Alignment with on-going country programming and existing coordination structures:** LFI is to be implemented in close coordination with other UNCDF, UN, DP, and DFI programmes currently implemented in the LFI countries. Where possible, each Country LFI Steering Committee is to be set up using existing development partner coordination structures, facilitating synergy, partnerships, and aid effectiveness with other interested UN agencies, DPs, and DFIs. These will include relevant ongoing UNCDF supported initiatives in climate resilience, women's economic empowerment and food security.
- **Incorporation into national policies:** LFI will make sure that systems and methodologies developed under the programme are incorporated into national policies, legal, regulatory, and operational frameworks and are available as international best practices. LFI will provide relevant government agencies with scalable investor after care tools that enable identification of specific impediments and remedies, and intra-governmental coordination in resolving issues. Once the systems are established, the cost of maintaining them could be absorbed by public and/or private sponsors, thereby enabling long-term sustainability.

- ***Sustainability of UNCDF inputs:*** LFI will negotiate with project sponsors to ensure the capitalisation of the costs, upon project closure, of technical studies and other inputs during the project preparation phase. This sum will be returned to UNCDF on financial closure of the investment project that UNCDF is supporting.

5. Stakeholders, Target Groups and Ultimate Beneficiaries

5.1 Stakeholders and target groups at the global and country level:

Funders and providers of credit enhancement, guarantees and specialized expertise:

- Central, regional, and local governments
- National Banks and Investors (including subsidiaries and affiliates of international banks, funds, etc.)
- Institutional investors (including Pension Funds, Insurance Companies)
- Financial Services Providers (FSPs¹⁷), including equity investors that would finance projects
- Technical Service Providers (including Engineering and Consulting Companies)
- Development programmes and foundations aimed at providing support to projects (funding of development costs and credit enhancements)
- Development Partners (UNCDF and other UN Agencies, Bilateral and Multilateral Aid agencies, International Financial Institutions and Development Financial Institutions)
- Other Development Partners, including expert NGOs and Foundations

Implementing Institutions (Project Sponsors):

- Regional and local governments
- National and International Companies interested in sponsoring projects, linking to projects critical to local development
- Professional associations (Farmer/Agricultural Associations, Industry Associations, etc.)
- Cooperatives and SMEs

5.2 Ultimate beneficiaries:

- Local communities (including women and youth) and households (including female-headed households)

¹⁷ Financial Service Providers (FSPs) would not be direct recipients of funds from this programme. UNCDF's work in building the capacity of FSPs is done through its Financial Inclusion programming.

6. Scalability of Programme

The LFI Programme is scalable on several levels:

- **Internally**, LFI interventions will increase in complexity, building on demonstration projects, lessons-learned and capacity-building programmes. As programme methodologies and tools are developed and integrated into local public and private sector processes, the programme's ability to facilitate the release of domestic capital will increase. Simultaneously, the programme will experience vertical scaling-up, feeding the acquired knowledge into national and international policies, legal, regulatory, and operational frameworks.
- **At the country level**, the LFI Programme will use a component-based approach to scale up. The project development, finance, capacity development, and performance tracking so that the relevant capacities are built locally throughout the target countries. With limited financial resources initially available for the credit enhancement component, actual project development and implementation will be targeted on a few carefully selected demonstration projects to maximize the impact of demonstration and the programme's execution. This may be scaled up if significantly increased resources become available.
- **At the global level, LFI is designed to facilitate the participation of international champions from the public and private sectors – including international development partners and their related programmes and risk mitigation tools, as well as international investors (banks, funds, project sponsors, etc.).** Furthermore the programme is set up to facilitate South-South exchange, with LFI Countries sharing lessons learned through the performance benchmarking activities and using the on-line tools to track investments operational and financial performance, share success stories, new finance approaches, and possible remedies to longstanding issues. The programme will also strengthen UNCDF's role as a repository of best practices for local development finance, increasing its capacity to provide advisory services and technical assistance to other developing countries and act as a conduit to other related DFI and DP programs and services.

7. Cross-cutting Issues

Gender

Gender will be mainstreamed into the programme in two main ways. Firstly, the programme will ensure that the criteria for ensuring gender equity are embedded in the tools developed by the programme for project identification and development. The programme will also focus on increasing women's participation as active members within institutional arrangements put in place and supported for the promotion of local development at the local level and within the target local government structures. This work will be in coordination with the UNCDF programme for women's economic empowerment (IELD) where relevant. This will ensure that the views of women producers, consumers, entrepreneurs and women active in civil society are equitably represented at all levels of decision making. Secondly, the programme will ensure that the investments financed and leveraged through the LFI increase women's access to productive resources and improve the business-enabling environment for women and the businesses they establish/manage and others within which they are equitably employed.¹⁸

Environment

The programme will ensure that projects financed under the LFI programme are environmentally friendly, based on effective and prudent management of local natural resources, and, whenever possible, contribute to improvement of local environment. Financing through the LFI programme will only be channelled to projects and interventions that adhere to environmental sustainability. Particular attention will be paid to links between LFI and the LoCAL project.

Food security

Food security and natural resources management are important areas in which UNCDF is involved. After decades of experience in food security financing at the local level, UNCDF as many others entities considers the urgent need to include the private sector and SMEs in its approach and develop new financial mechanisms for food production and exchanges. Infrastructures and services remain weak. Therefore, LFI will contribute to food security programs, especially in Africa, with a specific emphasis on investments that can improve the four pillars of food security: availability, stability, accessibility, and utilization.¹⁹ Increasing availability through public and private investments will be one of the main area of LFI especially in Africa.

¹⁸ For example, the fruit processing facility identified in Uganda's Nwoya District is owned by a women recognized as one of the top female entrepreneurs by the Uganda Investment Authority (UIA); the selection of her project would provide a model case study for female business ownership in the country that can also be shared with other LFI countries.

¹⁴ **Availability** of food. Food supplies must be sufficiently adequate to feed the population. Food availability thus covers food production (domestic production or imports), productivity, processing and marketing, post-harvest management;

Stability of the food supply, without fluctuations or shortages from season to season or from year to year. Food stability thus includes seeds and food stocks, disaster mitigation and management etc;

Accessibility to food or affordability. People must have physical, social and economic access to sufficient food. Where appropriate, access thus includes food safety nets for vulnerable groups in combination with income generating activities; and,

Utilization through adequate diet, clean water, sanitation and healthcare. Nutrition security is described as a situation where all people at all times have the ability to utilize biologically sufficient nutrients to live an active and healthy life. The nutritional dimension is integral to the concept of food security. Food must be safe, culturally

8. Geographical Coverage

Due to its catalytic nature, the LFI may be implemented in a wide range of modes as appropriate for the country given its development priorities and existing internal processes. LFI implementation modes include:

- In conjunction with a LED Programme (as is the case in Uganda) or another UNCDF programme such as food security, climate change, or urban and municipal development.
- As a stand-alone programme preceding a LED Programme, facilitating the entry and implementation of other LED-related programmes and interventions; or,
- As a standalone programme.

The Global LFI Programme is designed to include eight countries. The targeted countries are in Africa and Asia, where the domestic financial markets could be mobilized to lend to well-designed bankable small and medium-sized local development infrastructure projects that have risks mitigated by adequate credit enhancements. LFI Programmes are now being developed in **Bangladesh, Uganda and Tanzania**. **Examples of other candidate countries include: Senegal, Cambodia, and Rwanda.**

Background on the existing LFI pilot programme in Tanzania is detailed below.

8.1 Tanzania

In 2009 UNCDF commissioned a financial scan of Tanzania and a preliminary investigation of the key opportunities and challenges associated with financing of small and medium-sized infrastructure projects critical to local economic development. The Tanzania financial scan showed that there are several positive factors that work in favour of being able to access bank finance for local infrastructure projects, such as decentralized authority for project finance; local eagerness to find financing for essential infrastructure; income-generating projects; local capacity readiness; possible user fee levies; potential of central government support; potential mortgage-able asset securitization; commercial bank willingness to lend; and local demand for long-term local currency assets.³

As a direct result of this study, the Tanzania government requested that the One UN Programme include US\$3.5M allocation for the “Local Economic Development Finance Initiative of Tanzania” (LFI). In 2011, UNCDF contracted a consultancy company to design the Tanzania LFI Programme Document. The document was developed on the basis of the above-mentioned 2009 Tanzania report including both finance and tools components, and refined through subsequent research and government consultations. The LFI Tanzania initiative is approved by the Tanzania government and is incorporated within this global project.

8.2 Uganda

Since 1985, UNCDF has been providing support to local development in Uganda through a series of consecutive programmes at the district level. The strategy used has evolved from project-driven infrastructure delivery (for DDPI) to institutional development and policy impact as well as local development model (for DDPII) to LED support (for DDPIII). During implementation of DDPIII, the

accepted and nutritious.

demand for infrastructure for both local and national development became apparent. The need for traditional infrastructure projects such as energy, as well as agricultural processing facilities, was articulated by the districts and their stakeholders, as well as by national government officials and the private sector. Therefore, to complement the DDPIII LED approach and methodologies, a new approach was introduced from 2010 under the name of the Local Finance Initiative (LFI). This approach puts emphasis on tapping into existing domestic capital for financing to make up for the lack of public funding for infrastructure projects at the local and national level.

8.3 Bangladesh

For 30 years, UNCDF has been providing support to local development in Bangladesh through infrastructure and housing developments and then, from 2000 through a programme of support to infrastructure and service provision through local governments that led to reforms in fiscal decentralization and to government negotiating an IDA credit to upscale the system.

Central to local government grants will be not be able to sustainably finance the infrastructure requirements of growing towns and cities, in particular in delivering the essential climate resilient investments that are urgently required. From 2011 UNCDF has begun to work with central and local institutions to develop a capacity to access other forms of municipal finance including project finance, PPPs and municipal debt issues. The LFI programme will work with these local governments.

Additionally, the Government of Bangladesh has agreed to develop a local women's economic empowerment programme in the same local government jurisdictions covered by the fiscal decentralization initiative. This will provide a further pipeline of projects for LFI.

9. Strengths and Capabilities of UNCDF

The programme will build on UNCDF's internal strengths and comparative advantages in the area of local development finance, local economic development and policy advisory services.

- UNCDF will use its unique mandate as the only UN agency that can provide risk capital to the private sector and deploy its accumulated knowledge, experience, networks and presence in financial markets across 24 least-developed countries in sub-Saharan Africa and Asia-Pacific to effectively implement the LFI programme.
- UNCDF also has experience in the management of global thematic programmes such as the Local Climate Adaptive Living Facility for local climate finance and several microfinance initiatives including Microlead, YouthStart, Mobile Money for the Poor (MM4P), CleanStart, The Better Than Cash Alliance (BTCA) and The Pacific Financial Inclusion Programme (PFIP).
- UNCDF has helped build strong public sectors globally using sound financial management to improve allocation of scarce public resources and better delivery of basic services - essential components of sustainable, inclusive growth. UNCDF experience in public finance for local development includes relevant experience in:
 - Supporting fiscal decentralization and building local government capacities. UNCDF supports

decentralization and provides local governments with development funds that improve public investment and service delivery, while building long-term capacities for the effective mobilization, planning, budgeting, delivery and accounting of public resources.

- Strengthening public financial management and investment. UNCDF promotes sound public financial management, best practice investment programming and best value in local procurement to ensure public money is wisely spent. This includes helping to develop the regulations and operating mechanisms of decentralized of public finance, transparency and audit requirements, and promoting newer mechanisms such as performance-based funding.
- Promoting local innovation and developing local sources of revenue. UNCDF also helps to develop instruments and capacities for local governments to mobilize their own revenues (e.g. fees, taxes, public private partnerships) to complement central government resources.

10.Results and Resources Framework

10.1 Results and Resources Framework

<p>Programme Overall Outcome: Increase the effectiveness of financial resources for local economic development through mobilisation of primarily domestic private capital and financial markets in developing countries to enable and promote inclusive and sustainable local development.</p>				
<p>Indicators: % Gross increase in fixed capital formation comprised of individual projects / investments under \$20m located within sub national territorial jurisdictions supported by LFI programme</p>				
<p>Baselines:</p> <ol style="list-style-type: none"> 1. 0 2. 0 3. 0 				
<p>Targets: To be determined by baseline studies in each country</p>				
INTENDED OUTCOME AREAS	OUTCOME TARGETS FOR 5 YEARS	INDICATIVE ACTIVITIES	RESPONSIBLE PARTIES	INPUTS and BUDGET (USD)

<p>Outcome 1: Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive LED in a number of target developing countries.</p> <p><u>Indicator 1.1.</u> Number of public and private stakeholders participating in the programme, using new processes and tools</p> <p><u>Indicator 1.2.</u> # of projects essential for LED identified initially for screening</p> <p><u>Indicator 1.3.</u> Success rate of projects financed (in financial terms and in terms of their transformative impact as indicated during the appraisal phase)</p> <p><u>Baseline (2013):</u> TBD</p>	<p><u>Year 1 and 2:</u></p> <p>1.1 LFI programmes designed and adopted in 3 countries in Asia and Africa. Methodology and processes developed and adopted.</p> <p>1.2 At least 20 projects are identified, screened in 3 countries but only a select few will pass the initial screening process</p> <p>1.3 At least 2 projects reach financial closure or are substantially completed</p> <p><u>Year 3:</u></p> <p>Increase scale in year 3</p> <p>1.1 LFI programmes designed and adopted in 2 more countries (total now is 5 countries) in Asia and Africa, in addition methodology and process flow and other tools introduced to new countries and others enhanced</p> <p>1.2 Increase scale in year 3, At least 30 projects are identified, screened in 5 countries but only a select few will pass the initial screening</p> <p>1.3 Increase scale in year 3, LFI programmes now designed and adopted in 5 countries.</p> <p>6 projects total reach financial closure or are substantially completed</p> <p><u>Year 4:</u></p> <p>increase scale in year 4,</p> <p>1.1 LFI programmes designed and adopted in 3 new countries (total now is 8 countries) in Asia and Africa, in addition methodology and process flow and other tools introduced to new countries and others enhanced</p> <p>1.2 Increase scales in year 4, At least 40 projects are identified, screened in 8 countries.</p>	<p>1.1: Processes, methodologies, and enabling tools are designed and introduced to identify and develop infrastructure projects essential for inclusive LED. These include tools, instruments and mechanisms for public-private partnerships, project finance (including non-recourse, and municipal bonds).</p> <p>1.2: Local capacity established to enable stakeholders (national and local government officials and the private sector) to identify and develop infrastructure projects essential for LED with support from development partners.</p> <p>1.3: “Proof of concept” demonstration LED projects identified, developed and structured in each LFI country to jumpstart process and create a multiplication effect through "learn by doing" and incentivizing stakeholders</p>	<p>UNCDF technical team</p> <p>ITSP</p> <p>Central Govt.</p> <p>Local Gov't</p>	<p>Consultants</p> <p>Travel</p> <p>Workshops</p> <p>Communications</p> <p>Miscellaneous</p> <p>Staff Costs (International and National)</p> <p>Operations</p> <p>\$1,799,000</p> <p>\$6,779,216</p> <p>\$12,837,130</p>
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	<p>1.3 Increase scale in year 4, 20 projects in 8 countries are considered viable for further due diligence.</p> <p>10 projects reach financial closure or are substantially completed</p> <p><u>Year 5:</u></p> <p>1.1 LFI programmes have been adopted and customized for 8 countries.</p> <p>1.2 Increase scales in year 5, at least 50 projects are identified and screened in 8 countries using LFI methodology for identification and development of projects</p> <p>1.3 14 projects reach financial closure or are substantially completed</p>			<p>Sub-total for Outcome 1: \$21,415,716</p>
<p>Outcome 2: Increased ability and willingness of domestic financial sector to provide financing for small to medium-sized LED infrastructure projects.</p> <p><u>Indicator 2.1:</u></p> <p>Number of stakeholders participating in the programme, using new processes and tools</p> <p><u>Indicator 2.2:</u></p> <p>Number and type of institutions engaged in in PPP finance and project finance</p> <p><u>Indicator 2.3:</u></p>	<p><u>Year 1-2:</u></p> <p>2.1. 3 scans conducted of local economy focused on LED investment opportunities, impediments, including any existing processes of identifying and developing LED projects.</p> <p>2.2. 20 developers from private, public and local governments engaged in project development.</p> <p>2.3 4 LFI stakeholder groups participate in technical forums in each of the 3 countries</p> <p><u>Year 3:</u></p> <p>Increase scale in year 3</p> <p>2.1 Repeat financial scans in 2 new countries</p> <p>2.2 One training session per new country conducted for awareness raising and outreach events on LED investment opportunities and financing modalities to release investment by domestic financial institutions.</p>	<p>2.1: An enabling environment is created to accelerate finance for local economic development infrastructure, including tools, instruments and mechanisms, regulations and investment vehicles.</p> <p>2.2: Local capacity established to increase the ability of the private sector to finance LED projects with appropriate credit enhancements.</p> <p>2.3: Capacity established to effectively evaluate and monitor the local development impact of public and private sector economic infrastructure investments in the context of Least Developed Countries.</p>	<p>UNCDF ITSP Local Gov't</p>	<p>Communications Workshops Travel Miscellaneous Consultants Operations \$3,430,709</p> <p>\$5,273,376</p> <p>\$400,000</p>

<p>Number of stakeholders participating in the programme, using new processes and tools</p> <p>Indicator 2.4: Number of Local Economic Development investment projects financed (corresponding to the criteria for local economic development applied by the LFI programme).</p> <p><u>Baseline (2012):</u> TBD</p>	<p>2.3 Identified 2 potential providers of private finance and credit enhancement in each of the 5 countries</p> <p><u>Year 4:</u> Increase scale in year 4</p> <p>2.1 Update information collect from financial scans</p> <p>2.2 Secure partners for credit enhancement structure, refining as needed, and secure required financing</p> <p>2.3 Set up and secure 3 partners in each country for credit enhancement and bank guarantee arrangements, refining as needed, and secure required financing.</p> <p><u>Year 5</u> Increase scale in year 5</p> <p>2.1 TBD</p> <p>2.2 TBD</p> <p>2.3 TBD</p>			<p>Sub-total for Outcome 2: \$9,104,084</p>
Total Budget (5 Years)				\$30,519,800

10.2 Annual Work Plan (2014)

Expect Outcome	Outputs	Time Frame				Responsible Party	Planned Budget		
		Q 1	Q 2	Q 3	Q 4		Funding Source	Budget Description	Amount
Outcome 1: Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive LED in a number of target developing countries. <u>Indicator 1.1.</u> Number of public and private stakeholders participating in programme, using new processes and tools <u>Indicator 1.2.</u> # of projects essential for LED identified initially for screening <u>Indicator 1.3.</u> <u>Indicator 1.3.</u> Success rate of projects financed (in financial terms and in terms of their transformative impact as indicated during the appraisal phase)	Output 1.1: Processes, methodologies, and enabling tools are designed and introduced to identify and develop infrastructure projects essential for inclusive LED. These include tools, instruments and mechanisms for public-private partnerships, project finance (including non-recourse, and municipal bonds). Activities: 1.1.1: Conduct scan of local economy focused on LED investment opportunities impediments, including any existing processes of identifying and developing LED projects. 1.1.2: Design methodologies and processes to identify and develop projects essential for inclusive, sustainable LED, including needed development partner interventions and sources of funding for project development.					UNCDF Technical team ITSP Local Gov't	UNCDF	Consultants Travel Workshops Communications Operations	\$256,000
		X	X	X					
		X	X	X	X				

<p><u>Target Year 1:</u></p> <p>1.1 LFI programmes designed and adopted in 3 countries in Asia and Africa. Methodology and process flows developed and adopted</p> <p>1.2 At least 20 projects are identified, screened in 3 countries but only a select few (12) will pass</p> <p>1.3 At least 2 projects reach financial closure</p>		X							
			X						
	Output 1.2: Local capacity established to enable stakeholders (national and local government officials and the private sector) to identify and develop infrastructure projects essential for LED with support from development partners.						UNCDF		\$250,000
	Activities:						SIDA		\$500,000
	1.2.1: Design and deliver training programmes for Technical Service providers (TSPs), including scalable versions such as webcasts, e-learning modules, LED Project Development Toolkit.	X	X	X	X		Other non-core resource mobilization efforts		
	1.2.2: Design and deliver training programmes, including scalable on-line tools enabling sustainability and replication.	X	X	X	X				
	1.2.3: Design and conduct outreach events to improve dialogue between LED stakeholders.		X	X	X				
	1.2.4: Set up communities of practice and knowledge-exchange								

[illegible]

<p>Number of stakeholders participating in the programme, using new processes and tools</p> <p><u>Indicator 2.2:</u> Number and type of institutions engaged in in PPP finance and project finance</p> <p><u>Indicator 2.3:</u> Number of stakeholders participating in the programme, using new processes and tools</p> <p><u>Target Year 1:</u></p> <p>2.1. 3 scans conducted of local economy focused on LED investment opportunities, impediments, including any existing processes of identifying and developing LED projects.</p> <p>2.2. 20 developers from private, public and local governments engaged in project development.</p> <p>2.3. A complete Project Monitoring and Reporting framework is established in year</p>	<p>Activities:</p> <p>2.1.1: Conduct national finance scans assessing the willingness and ability of the domestic national financial sector to finance LED projects with credit enhancements provided by development partners.</p> <p>2.1.2: Design credit enhancement structures and loan guarantee structures (to be conducted on an on-going basis.</p> <p>Output 2.2: Local capacity established to increase the ability of the private sector to finance LED projects with appropriate credit enhancements.</p> <p>Activities:</p> <p>2.2.1: Design training materials and deliver workshops and training sessions to domestic financial institutions, including scalable ICT-based tools enabling sustainability and replication.</p> <p>2.2.2: Design and conduct awareness raising and outreach events on LED investment opportunities and financing modalities to release investment by domestic financial institutions.</p> <p>2.2.3: Secure partners for pooled</p>	X	X	X	X				
		X	X	X	X				
							SIDA Other non-core resource mobilization efforts		\$550,000
		X	X	X	X				
		X	X	X	X				

	finance facility or another credit enhancement structure, refining as needed, and secure required financing	X	X	X	X				
	<p>Output 2.3: Capacity established to effectively evaluate and monitor the local development impact of public and private sector economic infrastructure investments in the context of Least Developed Countries.</p> <p>Activities:</p> <p>2.3.1: Develop LED Finance Programme Performance and Business-Enabling Environment Metrics.</p> <p>2.3.2: Scale up new measurement systems through the creation of a LED Finance Performance Index to advance LED finance.</p> <p>2.3.3: Project monitoring and reporting is undertaken in a timely fashion (quarterly, annually)</p>		X	X	X		SIDA Other non-core resource mobilization efforts		\$130,000
Subtotal for Outcome 2									\$1,141,000
TOTAL BUDGET YEAR 1-2 (2014)									\$3,782,000

11. Major Challenges and Risks

The LFI is built around an innovative approach to financing infrastructure and incentivizing improved business-enabling environments that has yet to be fully tested and requires a dynamic private sector orientation than is **different from many development programmes**.

Challenges that will be faced include the following:

Political Interference: The success of the LFI Programme requires that the technical processes of identifying, developing, and financing projects and capacity-building is done by the LFI Technical Team using the best practices required for securing private sector finance. It is critical therefore that the management of the Programme be controlled by the Technical Team without political or bureaucratic interference or influence. The design, governance structure, and implementation guidelines of the LFI Programme are designed to mitigate this risk

Risk of Ineffectiveness through none alignment with wide range of relevant public and private entities: The LFI Programme needs to build on the existing country initiatives related to local economic development and finance. The Programme is designed to partner widely as needed with public and private sector entities that can advance its success and development impact. LFI will be linked to concomitant ongoing programmes and national / local strategies for local development

Difficulty of Developing Projects: The greatest initial challenge is identifying and developing bankable projects. It will be critical that the LFI Team can immediately work with a wide range of public and private sector entities, including development partners, in sourcing possible projects, and very importantly, project sponsors with the capacity to develop and manage the projects. The Programme has an initial fund that can be used to address this issue, providing initial funds for feasibility studies, development of market studies. RFPs will be used to ensure transparency in selection of project sponsors.

Potentially High Cost of Borrowing: The cost of borrowing will be a major determinant of whether project developers can successfully obtain financing for their infrastructure projects from commercial sources. At this time it is not clear what the interest rates and other costs of borrowing long term will be. In any case interest rates will be higher than the benchmark rates for lending to the government, which in turn are related to the rate of inflation. For the lenders, the initial level of uncertainty about repayment risks will be high, even if the actual risks are not. But commercial lenders must price according to the combination of the uncertainty and risk they perceive. As experience with this type of financing is gained, the uncertainties will diminish and the costs should come down. The extra cost of uncertainty will need to be borne in whole or in part by the LFI Programme, in combination with government, DFIs, or donor support until such time as the cost of commercial borrowing is reduced to the point that project pools can be financed on their own. This support may be provided via low cost, direct subsidies to the borrowers, long term, low cost funding to the lenders or the provision of first loss or partial credit guarantees and the programme will seek to make this available through partnerships or an in-house capacity according to available funding.

Impediments to Long Term Bank Financing: Even if national banks are willing to lend to project sponsors of local infrastructure projects, they are constrained as to the tenor of their loans by the nature of their own sources of capitalization. These banks depend primarily on very short-term

liabilities and demand deposits to fund their lending. This kind of mismatch between potential assets and existing liabilities would expose them to several risks that they are not prepared to assume and which their regulators would not allow them to assume even if they were inclined to. However, if such institutions can obtain access to long-term local currency financing, they will be well placed to enter this market and seem prepared to do so. Long-term funding could come from indigenous sources such as pension funds and life insurance companies, development finance institutions, or development partners. Tenor extension might also be achieved by put options²⁰ or guarantees of longer tenor tranches provided by such organizations. There is a role for national development banks in providing exemplary financing of local investments therefore reducing perception of risk. These issues are amongst the criteria for selection of LFI countries.

Impediments to Pooling: Putting a number of small infrastructure projects together for pool financing is not easy. The number and diversity of loans in a pool are major factors in determining the credit enhancement provided by pooling. Creating such pools takes time and money. This can be achieved in a number of ways – for example, by primary lenders making loans using their own funds and “warehousing” them until a sufficient number have been collected. As with the pooled finance facility, engaging credit enhancement support from development partners will be critical to mitigating the risks impeding access to private finance.

In the LFI Programme, the difficulty of setting up a pooled facility would be reduced by the envisioned small initial structure and credit enhancement support from development partners. Initially the structure would consist of a small number of banks jointly lending to a pool of a small number of projects. This pooled structure would serve to reduce and diversify the individual credit risk of each bank, with additional risk mitigation provided by development partners. These issues are amongst the criteria for selection of LFI countries.

Difficulties Posed by User Fees: While some project will designed to generate revenues by selling products or services on the open market, others will be dependent on collecting user fees set by LGAs. If user fees are used to repay loans, they should be set at socially and politically viable levels. Without experience, it is difficult to judge what these might be, but given the public’s lack of experience with user fees, initially they may need to be low. Collection of user fees can also be a problem, especially when the population is not accustomed to paying such fees. User fees can also be subject to considerable political risk. Projects will be carefully designed to mitigate these risks, with input from local governments and expert assessments.

A summary of risks and corresponding mitigating actions for the above challenges are below

Risk	Level of Risk	Mitigation actions
1. Political interference in Programme undermines ability to mobilize private sector	High due to intense government pressures given overwhelming financing needs	Defined Programme structure protects government (i.e., UNCDF Technical Team to make all technical decisions and have a direct reporting line to LFI Steering Committee). This will be a fundamental criterion for the

20

A put is an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying asset at a set price within a specified time. The buyer of a put option estimates that the underlying asset will drop below the exercise price before the expiration date. Please see the Glossary for a more detailed definition.

finance		selection of LFI countries.
2. Ineffectiveness	High due to challenge of developing bankable projects	Defined Programme strategy of leveraging partnerships and working proactively with private sector (for example aligning existing programmes)
3. Difficulty of Developing Projects	High given lack of funds for project development	LFI Fund or other LFI support facilities will jumpstart the project development process; also partnerships as needed in item 2 above will facilitate the identification of viable projects
4. Potentially High Cost of Borrowing	Medium given the historical track record of reduced interest rates when risk is reduced	LFI financing approach incorporates proven techniques that lower risk. Creating financial structures that reduce risk will reduce the high cost of borrowing; options include direct subsidies to the borrowers, long term, low cost funding to the lenders or the provision of first loss or partial credit guarantees.
5. Impediments to Long Term Bank Financing	Medium given the historical track record of longer tenors when risk is reduced	LFI financing approach incorporates proven techniques that lower risk. Also initial long-term funding could come from indigenous sources such as pension funds and life insurance companies, development finance institutions, or development partners.
6. Impediments to Pooling	Medium given ability to warehouse loans	LFI financing approach includes options for warehousing loans. This can be achieved by primary lenders making loans using their own funds and “warehousing” them until a sufficient number has been collected. Also development partners can help by co-financing loans, or providing a first loss facility. As with the pooled finance facility, engaging credit enhancement support from development partners will be critical to mitigating the risks impeding access to private finance.
7. Difficulties Posed by User Fees	Medium given inability of many people to pay fees	LFI financing approach includes options for output-based aid approaches that subsidize the poor people that cannot pay for services. As each of the selected projects will provide critical local services, it will enable the beneficiaries to increase their income. Therefore their ability to pay will be greater and create the basis for the sustainability of the project.

12. Management, Coordination and Implementation Arrangements

12.1 Implementation

The programme will be implemented through phases over a four-year period.

- **Phase I:** Programme Inception across two countries in Africa and one country in Asia. Key activities in Phase 1 include: (1) Assessments: country economic scans and finance scans, (2) Country training, outreach and development of appropriate tools, (3) LED project development, and (4) LED finance. During this phase, detailed analytical work will also be carried out to refine programme design for programme implementation in years two to four. Furthermore, the Programme Implementation Unit (PIU) will be established to ensure the human resources and instruments needed to deliver the programme components are in securely in place.
- **Phase II:** Programme Roll-out across two more countries. Also during this phase, arrangements for sustainability of the programme will be put in place.
- **Phase III:** Programme Consolidation and Global Scale-up includes activities to consolidate the programmes in the five countries. At the same time, the LFI Global Programme will prepare proposals for global scaling up, possibly including replication of LFI activities beyond the initial eight countries through a follow-on programme.
- **Phase IV:** Programme Phase-out in the eight countries. This will include an orderly phase-out of support in the programme countries together with activities to consolidate learning and ensure sustained impact of the knowledge generated by the LFI Programme.

Implementation Modality

Due to its innovative nature, which requires highly specialized expertise and rigorous programme assurance, the programme will be implemented under a Direct Execution Modality (DEX). In accordance with the UNCDF Operations Manual, UNCDF will serve as the Implementing Partner for LFI, under the management of the Local Development Finance programme area. The Implementing Partner is the entity to which the Executive Secretary has entrusted the implementation of UNCDF assistance specified in a signed Global programme document along with the assumption of full responsibility and accountability for the effective use of UNCDF resources and the delivery in line with its established rules and regulations.

At the same time, UNCDF will increasingly engage various national agencies as the Responsible Parties for LFI implementation with the view to develop their capacities, gradually phasing out UNCDF direct implementation to eventually hand the programme over to local authorities. A Responsible Party is defined as an entity that has been selected to act on behalf of the Implementing Partner on the basis of a written agreement or contract to purchase goods or provide services using the project budget. In addition, the Responsible Party may manage the use of these goods and services to carry out project activities and produce outputs. UNCDF will identify and engage national Responsible Parties in order to take advantage of their specialized skills, to mitigate risk and to relieve administrative burdens.

The following table summarizes the legal instruments to be used by UNCDF to engage a responsible party in implementing a project.

UNCDF (DIM)		
Responsible Party	Government institution	<ul style="list-style-type: none"> Standard LOA between UNCDF and a Government Ministry/Institution/IGO on the implementation of a project when UNCDF serves as implementing partner Memorandum of Understanding (LD)/Performance Based Grant Agreement (IF)
	UN agency	<ul style="list-style-type: none"> Standard LOA between UNCDF and a UN Agency on the implementation of a UNCDF project when UNCDF serves as Implementing Partner (i.e. under Direct Implementation or DIM) Standard LOA between UNCDF and UN or UN funds or programmes when UNCDF serves as Implementing Partner (i.e. under Direct Implementation or DIM)
	CSO	<ul style="list-style-type: none"> Model Contract for Professional Services UNCDF's Standard Loan Agreement
	Private Firm	<ul style="list-style-type: none"> Model Contract for Professional Services UNCDF's Standard Loan Agreement

12.2 Management and Coordination

The Global LFI programme will be managed by UNCDF through a Programme Implementation Unit (PIU) based in one of the LFI operational countries (currently in Tanzania). The PIU will be headed by the Global LFI Chief Technical Advisor who reports to the LDFP Practice Director. The PIU may also be comprised (as needed) of a Knowledge Management (KM) specialist, Technical Advisor on Municipal Finance, other technical advisors, finance specialists, investment officers, a junior research and advocacy specialist and/or other support analysts. PIU will develop as the programme expands but a light structure is envisaged.

The LFI Chief Technical Advisor will work closely with the Regional Technical Advisors (RTA) based in the three regions in which UNCDF operates (Asia-Pacific, Southern and Eastern Africa, Western and Central Africa) in managing the programme. The Global LFI Chief Technical Advisor will be responsible for coordinating all global programme activities and for reporting to the directorate at UNCDF/HQ). The CTA will develop, and implement following approval, templates and methodologies for project identification and appraisal and pipeline management. These include RFPs (requests for proposals), MoUs and PBAs (performance based agreements to be used in the programme).

The LFI Chief Technical Advisor will form a Task Force comprised of UNCDF Local Development Finance technical staff working on the project and other staff assigned by the LDFP Director to the Task Force. The purpose of the Task Force will be to assist the CTA in the selection and appraisal of projects meeting the LFI criteria and also to provide technical assistance to those projects leading to financial closure and subsequent monitoring and support (if appropriate) of the project, including in the implementation of any MoU and or PBA (Performance Based Agreement) signed. The Task Force will facilitate and support the development of a rolling pipeline of 20 investible infrastructure projects drawn from UNCDF's global portfolio in Local Development Finance. This include bankable projects with specific impact in Climate Change or Food Security and other thematic areas of UNCDF interest, drawn from its projects in those areas. The terms of reference of the Task Force will be developed by the Chief Technical Advisor and approved by the director LDFP.

Each country participating in the global programme will sign a framework agreement with UNCDF on programme implementation and establish an LFI Steering Committee (PSC) which will oversee the programme in that country, consistent with UN rules and regulations; the PSC will consist of (and not limited to):

- The Coordinating/Executing Agency (Ministry of Finance for example)
- Other national implementing partners such as the Prime Minister's Office or Ministries of Local Government;
- Other UN partner agencies (if relevant) UN Capital Development Fund (represented by the UNCDF Headquarters LFI Programme Manager and the Regional Technical Advisor)
- Other relevant ministries
- Relevant Country Investment/Business Councils
- Representative of Financial Institutions and Funds
- Associations of Local Governments
- Representatives of development partners/donors

In the case of Tanzania the programme board and steering committee of the existing LFI-T project will perform the functions of the LFI steering committee for that country and the global project will assume all remaining activities of the LFI-T programme. To the extent possible, the global programme will strive to use the existing coordination and steering bodies as the PSC (e.g., relevant thematic Outcome Boards in One UN countries).

In brief, the PSC will provide oversight and strategic direction to the Programme Implementation Unit:

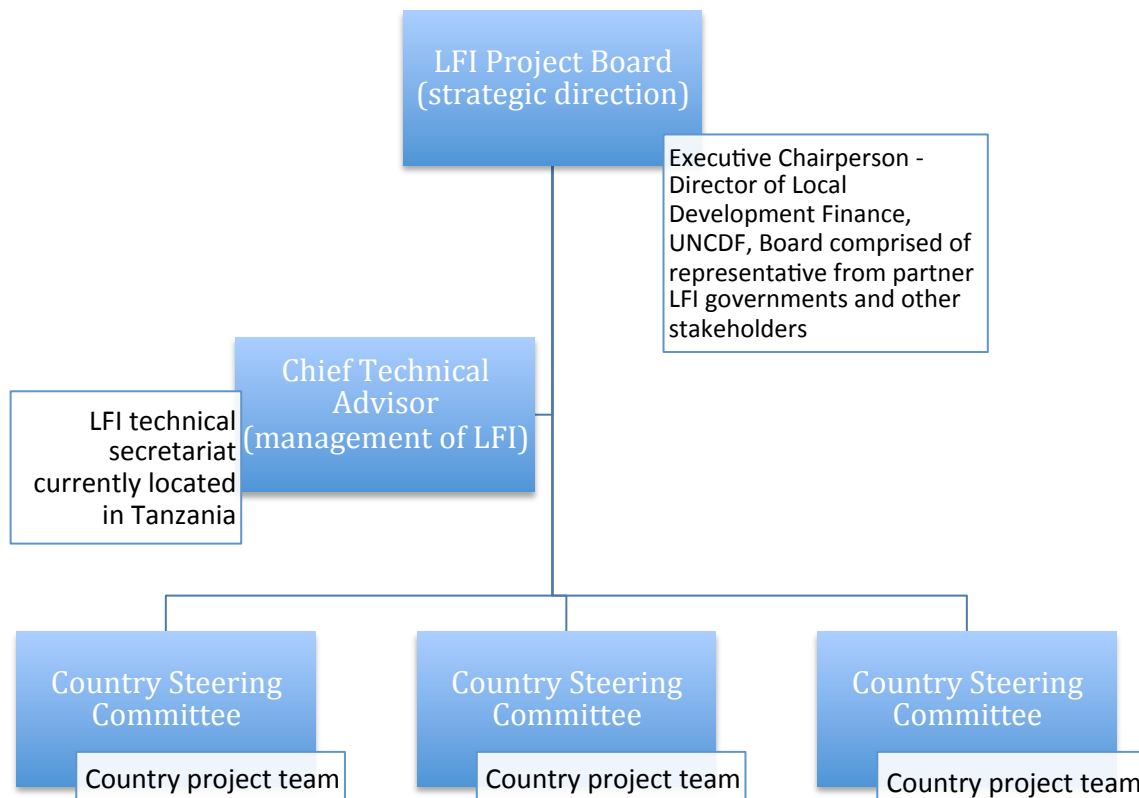
- Advise on and approve the strategy of the programme for that country;
- Approve strategic and programmatic policies as they relate to funding allocations, etc.;
- Provide advice and 'no objection' to partners from the capital grant and loan facilities (if required);
- Regularly review programme reports and contribute to annual project reviews;

The overall Global LFI programme board will be chaired by the UNCDF LDFP Director and be comprised of one government representative from each LFI participating country. Other stakeholders with experience in impact investing at the local level and local economic development may be invited to join the global project board as observers. This body will perform the functions of project board as stipulated in the arrangements for UNCDF global projects stipulated in the UNCDF operations manual:

- Advise on and approve the strategy of the global programme
- Approve strategic and programmatic policies as they relate to funding allocations, etc.;
- Provide approval to partners from the capital grant and loan facilities (if required);
- Approve annual work plan and budget;
- Regularly review programme reports and conduct annual project reviews;
- Contribute to the performance appraisal of the Programme Implementation Unit;
- Review and approve terms of reference of all reviews and evaluations; and
- Delegate some of these responsibilities to the Programme Manager.

The Global LFI Programme and related Country LFI Programmes will conform to the Standard Basic Assistance Agreement (SBAA) between the host-governments in programme countries and UNCDF. UNCDF will obtain a minimum of three developing country government signatures prior to final approval of programme documents. Government buy-in will facilitate the programmes' ability to encourage policy changes in line with its objectives.

Organisation chart for LFI



12.3 Roles and Responsibilities

UNCDF

UNCDF will be responsible for day-to-day oversight of the programme and ensuring that all operations are conducted in compliance with the UNCDF Operations Manual and other policies. As with all its programmes, the LFI programme will draw on UNCDF and UNDP human resource, finance and administration units for its basic services.

Global LFI Chief Technical Advisor (see Job Description, **Annex 3**) will oversee the Global LFI Programme. The programme will be implemented by the PIU, The PIU can also be comprised (as needed) of a Knowledge Management (KM) specialist, Technical advisor on Municipal Bonds, other technical advisors, finance specialists, investment officers, a junior, research and advocacy specialist and/or other support analysts.

- The Global LFI CTA will function as the Team Leader and will be an expert in programme management, familiar with UNCDF policies and procedures and responsible for the overall technical implementation and project management, including planning, fundraising, donor coordination and support to the IC.
- The Knowledge Management specialist will manage the implementation of the research agenda, oversee research and learning events, networking and reporting, as well as overall coordination with UNCDF field staff. The LFI programme will develop a comprehensive knowledge management strategy for the duration of the implementation of the programme. The strategy will look at capturing lessons learned and how they link to development impact and results on the ground. The strategy will also link the policy impact at the national, regional and international levels. A series of publications will be envisioned combined with seminars and workshops to bring further advocacy to LFI and its impact on local economic development.
- The Investment Officer/Finance Specialist will pursue the key results of the programme, working under the supervision of the Chief Technical Advisor, focusing on the following result areas:
 - Organization and facilitation of key programme activities related to project development and technical project financing
 - Organization and facilitation of key programme activities related to capacity building and knowledge management
 - Project management and resource mobilization
- The Junior Specialist will facilitate all administration, procurement, and finance activities, acting as primary liaison with UNCDF operations. Finance and administrative support would be provided by UNCDF headquarters and/or regional centres, with local logistical support provided by UNDP country offices.

Technical Service Providers (TSPs)

The role of the finance experts will be to provide advisory and management support to the LFI Programme, with timely technical input and advice to partners, both implementers and policy makers, covering project development, finance, and the on-line tools to institutionalize LED. The experts will also work with the team to identify projects, foster partnerships and develop appraisals and help monitor progress. The general overall functions (detailed in a TOR included in **Annex 4**) expected of the TSPs are listed below:

- Identifying, Developing, and Financing Infrastructure Projects;
- Capacity Building and Knowledge Management;
- Programmatic Quality Assurance and Portfolio Management; and,
- Financial Advisory and Corporate Support.

Development Partners

Support for LFI must be continuously developed with development partners, including bilateral donors, DFIs, and foundations. Development partners may participate in the LFI Programme at three levels:

- 1) Providing support to the Global LFI Programmes (grants, credit enhancement, project development support)
- 2) Providing support to specific Country LFI Programmes;
- 3) Providing support at the infrastructure project level through existing programmes at the global or national level:
 - a) Debt financing: Co-financing - Senior debt financing on a *pari passu* basis with financing provided by local, regional, and/or international banks First Loss - Subordinated debt
 - b) Partial Guarantees (Credit and Risk) that cover political, regulatory, and credit risks impeding access to private capital
 - c) Equity
 - d) Pre-investment loans for project development, on a grant basis or to be repaid at closing of project financing (with a portion of the proceeds of the project financing).

Host Governments

While all developing countries are eligible, host countries will be limited to those countries and partners which provide the best opportunities to achieve the programme's outcomes, first and foremost amongst the Least Developed Countries. The administration of the LFI Programme shall be governed by UNCDF rules and procedures within the policy context defined by the Executive Board. The project conforms to the provisions of the Standard Basic Assistance Agreement (SBAA) between the host Governments and UNCDF. The host-country implementing partners shall, for the purpose of the SBAA refer to the Government co-operating agency described in the Agreement. In countries that have not yet signed an SBAA with UNCDF, the UNDP SBAA shall apply.

Host country governments that have signed to the programme document agree to make a best effort to address constraints where they exist. Finally, the host country government agrees to facilitate the appropriate inclusion of the country specific intervention in their CCA/UNDAF/CPAP at the earliest available opportunity.

13. Fund Management Arrangement

13. 1 Management of Contributions

The Programme will be initially financed through UNCDF core resources and non-core resources mobilized by UNCDF from Country One UN Funds, bilateral donor agencies, multilateral organizations as well as private foundations and corporations. For example, for the Tanzania LFI Programme the ONE UN Funds in Tanzania has allocated USD 3.5 million to the programme.²¹

For the Global LFI Programme, there is a funding gap indicated in the cover page which will need to be mobilized incrementally during the initial years of the programme as LFI rolls-out in the first three countries (Tanzania, Uganda and Bangladesh). If funds are mobilized, two additional two countries can be added in Year Two of programme implementation. Developing country governments have expressed interest and potential partners have been identified.

The fund management modality will be a combination of **pass-through** and **parallel funding**.²²

21 Any new funding made available to the Global LFI project will initially be applied to the Tanzania LFI initiative until the funding gap in the approved Tanzania programme is filled.

22 Details of the pass-through arrangement and accountability and responsibility of UNDP as the administrative agent is described in the document: http://www.undg.org/archive_docs/4554-Finalized_Guidance_Note_on_Joint_Programming_main_text_only_-_English_version.doc

14. Visibility and Outreach

For all of its knowledge management and promotional materials, all LFI Global Programme materials will include the logos of LFI partners and UNCDF. To the extent possible, it will acknowledge the important role of the partners in supporting the expansion of the Global Programme, while ensuring such branding and attribution remains in compliance with UNCDF branding standards and requirements. All programme-related publications (documents, brochures, press releases, websites, newsletters, results-reporting, banners etc.) and events (press conferences, programme seminars, public events and visits) would bear the names of all partners (with the appropriate logo of the organization).

UNCDF has a communications unit in New York with sufficient capacity to ensure adequate visibility, outreach and communication of development activities and results in the region. UNCDF global programmes receive very strong support and ownership by the Governments of the countries covered by them. Hence, contributions to UNCDF programmes would generate considerable attention among the respective Governments.

In order to maximize visibility, new partnerships will be announced by means of a targeted communication e.g., press releases to all relevant programme country stakeholders, including Government ministries in the region and relevant permanent UN missions in New York, as well as, the general public (on UNCDF, UNDP and UN global and regional websites). In addition to the Steering Committee acting at the global level, local Investment Committees in each programme country will provide partners with important visibility with a number of donor development partners. Partners will be mentioned in our contacts with the Governments in the region and their representatives in New York e.g., via a direct email or in combination with the above-mentioned press release.

15. Partnerships Strategy

The Local Finance Initiative (LFI) Programme will rely on partnerships and cooperation with a wide range of international and national stakeholders to maximize programme impact and to ensure that its interventions are harmonised with and complement the efforts of other partners, including the UN family and Bretton Woods institutions; private sector; national and sub-national governments; national and international development agencies; and civil society.

The LFI Programme will build on the current “global market” of development partners such as international private sector firms and foundations that would potentially embrace and support the LFI approach. LFI is very attractive to traditional development partners as it resonates with the current imperative of leveraging limited official resources (both those of developing country governments and those of development partners) by mobilizing private sector capital. In addition, development partners recognize the critical importance of developing the private sector in terms of both unlocking domestic resources (such as financial institutions and institutional investors), as well providing the capital and enabling business environments critical to SMEs and market access.

At the country level, the programme will promote local economic development (LED) and access to finance by improving the capacity of local governments (LGs) and other relevant local actors to create business-enabling environments and engage the private sector; develop infrastructure projects; and access local capital markets to provide local currency financing for projects globally. This will enable the institutionalization of finance mechanisms and facilitate up-scaling by national governments and UN country programmes.

The programme aims at mobilizing the private sector, and therefore requires that all its activities in-country be governed by the preconditions required to access domestic finance. To access private sector finance, it is vitally important to adopt private sector hard credit and engagement approaches that have been proven to work.

Therefore the LFI Programme structure fully integrates the private sector and the expertise of the UNCDF Technical Team in providing the essential guidance to the country programme on how to achieve its objectives of mobilizing domestic private finance and improving the local business-enabling environment. The programme will be applying the following strategies useful for partnerships building:

- Ensuring coherence with national development processes such as Poverty Reduction Strategy Papers (PRSPs) and decentralization strategies;
- Aligning the country implementation plans with UN programmes and UNDAFs;
- Coordinating with key programmes on local government reform, decentralization and capacity building programmes by other development agencies; and
- Pursuing a strong communication and policy advocacy component to address the broader context within which local governments operate as defined by decentralization policies.

At the global level, the programme will approach a variety (traditional and non-traditional) development partners in the private sector and foundations that are very supportive of innovative ways to mobilize the private sector and have direct interests in building market linkages and supply chains. For example, large agriculture firms have shown huge interest in working with small farmer organizations to access needed crops for exports to industrial countries, as shown in our UNCDF Uganda

and Tanzania work. Also there are local companies that are committed to corporate responsible investments such as the Aga Khan's Industrial Promotion Services, which can provide invaluable leadership from the private sector in sponsoring important projects of large impact for local economic development.

Resource mobilization efforts for additional non-core funding will be targeting various sources, for example:

1. **Bilateral Donors:** Consultations were held with SIDA resulting in funding of LFI global programme for 2012 as part of a multi-year Global Partnerships Framework agreement (with a target contribution of US\$2.6 million dollar provision for LFI 2012-2015). They have also been initiated with Spain, Switzerland and USAID regarding a partnership related to the UNCDF Global LFI programme. As well, UK, Holland, Australia, Germany and France have called for innovative approaches to mobilization domestic resources
2. **Multilateral Institutions:** The European Commission (EC)
3. **Development Finance Institutions:** DFIs make up the second category of parallel funds (for example, the World Bank, African Development Bank, and other financial institutions) that go directly at the project level and provide credit enhancement and other financial support.
4. **One UN Funds:** One UN funds is another potential funding source, as evident in Tanzania where the LFI Programme was strongly aligned with national priorities outlined in the country UNDAF. The ONE UN funds mechanism is a joint, multi-year resource mobilization and allocation system based on the One UN Budgetary Framework.
5. **Private Foundations:** Bill and Melinda Gates Foundation, Rockefeller Foundation, Ford Foundation, among others.

16. Monitoring, Evaluation and Reporting

16.1 Monitoring and Reporting

Regular monitoring of the LFI Programme will be conducted by UNCDF through its Technical Regional Team and LFI Technical Team (LFI Country Team and International Technical Service Provider), with the participation of stakeholders and implementing partners.

A Programme Monitoring Framework (PMF) has been developed for LFI for the purposes of monitoring and evaluating the global programme for each country. UNCDF will make use of the existing monitoring tools as well as the performance tracking tools to be introduced under LFI Country to ensure continuous and efficient monitoring at the country level where the LFI programme is implemented. These will incorporate principles of IRIS impact investing indicators. At the intermediate outcome level, the monitoring efforts in countries will be based on performance indicators incorporated within UNCDFs overall performance measures for Local Development Finance, these capture issues such as:

- Change in the number of LED projects identified, developed, and financed;
- Change in the amount of domestic private finance mobilized for LED projects;
- Number and impact of the changes effected in national policy, legal, regulatory and operational frameworks to facilitate domestic resource mobilization; and
- Number of new partnerships, programmes, and services with the support or participation of the international development community.

The Programme Implementation Unit (PIU) will prepare and submit quarterly reports (QPRs) and annual progress reports (APRs) on individual LFI Programmes. Specifically, the reports will include information on progress toward intended programme outputs as well as constraints and opportunities for developing and enabling environment for access to LED project finance, the policy changes needed to remove the constraints or seize opportunities, and lessons learnt.

Moreover, The UNCDF Strategic Framework Integrated Results and Resources Matrix (IRRM) translates the UNCDF Strategic Framework 2014-2017 into results that allow UNCDF and stakeholders to monitor and evaluate achievements, learn lessons, and hold the organization accountable for the funds given to it.

It is backed up by a results-focused monitoring and evaluation system which will enable regular internal assessment and external evaluation of progress towards results and allow informed, evidence-based management of the full range of UNCDF's interventions.

The IRRM consists of a detailed planning matrix covering two distinct categories of results:

- i. Planned development results, starting with three programme outcomes that UNCDF aims to contribute to, and the outputs that will lead to their achievement.
- ii. Improvements in institutional effectiveness within UNCDF, which will support the achievement of the programme outcomes.

These are all measured with indicators, which in turn will guide the development of activities to deliver the outputs.

Both sets of results are also accompanied by a series of indicative budgets disaggregated by programme outcome

To this Effect, the IRRM has captured the specific indicators of the LFI approach, methodology and targets. Through the IRRM, the LFI indicators and approach will contribute in its results to show clearly how strengthened internal capacity and capability will allow UNCDF to deliver on its programmatic commitments; how the commitments will be achieved and how these will contribute to work of partner UN entities as well as to overall internationally agreed development goals.

16.2 Evaluation

The programme is subject to:

- A review of the **Annual Work Plan** taking into consideration the available core and non-core resources mobilized by end of 2014.
- **An Annual Review** conducted by international independent consultant. This annual review will focus on lessons learned, continually provide recommendation to improve the programme technical performance and adjust indicators where needed; and,
- A **Mid-Term Global Evaluation** scheduled at the end of the second year of the programme period, managed by the UNCDF Evaluation Unit. The global evaluation will assess the programme's overall performance, the outputs and outcomes produced against its initial target, the impact it has had on unlocking domestic capital for small and medium-sized strategic bankable infrastructure projects. The global evaluation will build on the findings from the Global Knowledge and Learning Facility of the programme and fill in any gaps needed to highlight programmatic and technical lessons learned. This evaluation is in compliance with the UNCDF mandatory evaluation requirements in the UNDP Evaluation Policy, to which UNDCF is party. An evaluation plan will be formulated at the start of the programme and UNCDF will solicit the input of donor partners for its development.
- A **Final Evaluation**, as specified by programme partners.

These evaluations will be managed through a multi-disciplinary, multi-cultural team, led by independent evaluation specialists, but with input from field-based staff, including the LFI Programme Manager, RTAs and CTAs.

The LFI Evaluation will build on policy and knowledge products produced under the programme and fill in any gaps needed to highlight programmatic and technical lessons learned for the benefit of the local development finance industry, and advocate for improvements in financing small and medium-sized infrastructure projects. The programme budget includes separate funding (totalling **5% of programme costs**) for monitoring and evaluation.

17. Legal Context

The programme will conform to the **Standard Basic Assistance Agreement (SBAA)** between the host governments and UNCDF.

18. Gender Responsive LFI

Women's economic empowerment can be defined as the ability of women to bring about positive changes in their lives, in their household's lives, and in their societies as a result of their participation in economic activities. These activities include their ability to: function effectively in the economy; participate in labour and product markets on equal terms with men; shape the gender division of labour within the household and the labour market; accumulate and exert control over their own and shared assets; and influence governance and institutional structures that inform the relationship between the market and the state and the processes that determine the pace of economic development. Women's economic empowerment must be underpinned by a broad spectrum of individual and collective rights, because it cannot be achieved without women having agency in other areas of their lives. Social norms, cultures of discrimination, inequitable laws, power structures, and gender divisions of labour—both in and outside of the home—can significantly impact on women's economic position, their autonomy, and their feelings of self-worth. These wider structures cannot be challenged individually. As such, while a woman's agency might be individually held, it is created and supported by collective action⁶.

However, while gender equality and the empowerment of women is recognized as one of the main prerequisites for achieving internationally-agreed development goals such as the MDGs in the LDCs, progress on such fronts will remain possibly the most challenging development goal hindering the achievement of all the other MDGs unless the gender dimensions in all the priorities of the Programme of Action are systematically addressed. While it is documented that women perform 66 percent of the world's work and produce 50 percent of the food, they earn only 10 percent of the income and own only one percent of property, including land⁹. This data especially applies to the rural areas of the developing countries, where the majority of the world's women work, the majority of the world's food is produced, and where gender discrimination continues to widely prevail. Indeed, according to research undertaken by the United Kingdom's Department for International Development, total agricultural output in Africa might increase by up to 20 percent if women's access to agricultural inputs was equal to that of men.

Thus, there are many elements for a country to consider when pursuing gender-inclusive and equitable local development. One critical element is generating productive and gainful employment¹¹. Targeted and sustainable investments that facilitate women's inclusion and access to local economic opportunities will be instrumental in achieving both socio-economic empowerment and sustainable growth. When women are given the opportunity to participate in the local economy, not only are they empowered, but so too is the entire community. When women earn income, women are more likely to share their economic gains with their families and their communities at large, spending disproportionately more earned income on food, healthcare, home improvement and schooling for themselves and their children¹². Thus, investing in women produces multiplier effects that benefit the whole community and contribute to socio-economic stability.

The aim of the LFI approach is to unblock sources of local domestic finance for small and medium infrastructure projects by reducing private sector risk. UNCDF has been piloting the application of such practices in the field of project finance. While these approaches have been successfully employed to

access long-term private finance for infrastructure projects worldwide, this approach is now being applied to small scale projects in LDCs.

The LFI approach is structured around selective, strategic and catalytic local economic development projects. These projects are selected because of their key role in unleashing the economic potential of local economies, and include both traditional and industrial infrastructure projects such as energy projects, transport, warehouses, and food processing plants. Projects are identified through an inclusive, participatory process, and their implementation requires activation of all LFI programme components. However, to successfully account for the gender components of the LFI approach, UNCDF is working through its Global Programme Inclusive and Equitable Local Development (IELD) to “engenderize” the LFI financing instrument and methodology with the aim to ensure that gender equality and women’s economic empowerment and entrepreneurship efforts are taken into consideration in the design, selection and technical support provided, including:

Project development activities: a) project identification derived from UNCDF’s local economic development approach and the LEA; b) project development, including feasibility studies, environmental and social assessments, project design, equipment selection, and negotiation of the construction, input, output and project management contracts, and c) structuring of the project's financial arrangements.

Credit enhancement support: this is designed to enable a jumpstarting of the process of project identification, development and financing. UNCDF provides resources from the LFI Fund, other seed capital mechanisms, guarantees and first loss facilities in order to leverage resources from the domestic financial sector, including commercial banks and institutional investors, in order to facilitate investments in strategic, smaller scale, traditional and industrial infrastructure projects.

Capacity-building activities: this provides training and the appropriate tools for public and private stakeholders to facilitate finance, project development, and business-enabling environments. For the public sector, capacity is enhanced because of the use of tools that identify impediments and possible remedies, track accountability, and facilitate national scaling up. As part of LFI capacity building, the preparation and certification of local Technical Service Providers extends high quality capacity-building services to local banks, local and national level government officials, and project sponsors such as farmer's associations.

Performance tracking activities: this provides the benchmarking needed for the dissemination of programme components as well as the incentives needed to propagate the replication of programme components both nationally and internationally. Performance tracking delineates the type and amount of financial transactions involved in an intervention, including the degree of leverage from the targeted use of credit enhancement and official development assistance, and in so doing facilitates transparency.

Through the gender tools being developed by UNCDF’s Global “Inclusive and Equitable Local Development Programme” (IELD), and the incorporation of a comprehensive gender audit across all domains of the LFI, this will bring into focus the need to increase women’s participation as active members of the community, within institutional arrangements that are put in place to support the promotion within target local government structures of inclusive and equitable local economic development. This will also ensure that the views of women producers, consumers, entrepreneurs and women active in civil society are equitably represented at all levels of decision making. The local economic development investments directly financed or leveraged through the LFI approach will increase women’s access to productive resources and improve the business-enabling environment for

women and the businesses they establish and manage, and others within which they are equitably employed. As well, the performance tracking tools designed for monitoring local economic development financing will be designed to reflect the programme's success in accomplishing these gender-responsive goals.

19. ANNEXES

ANNEX 1: Themes and issues in Local Economic Development, D Jackson, 2011. - Paper on Local Economic Development delivered at Duke University

ANNEX 2: Financing small scale infrastructure investments in developing countries, Bond, Magnusson et al, 2011, UNDESA – Paper on type of financing modality applied by LFI

ANNEX 3: Terms of Reference for Global LFI Chief Technical Advisor

ANNEX 4: Terms of Reference for Technical Service Provider

ANNEX 5: Legal status of local institutions involved in project implementation – Tanzania

ANNEX 6: LFI process flow - Private Sector - Project Finance LFI methodology

ANNEX 7: The Special Purpose Corporation – explanatory note

ANNEX 8: The EcoBond concept and associate material.

Strategies for Local Economic Development

A critical and comparative analysis

discussion note

Introduction

This discussion note is prepared for practitioners, policy makers and decision takers involved in issues around Local Economic Development (LED), based on a course given at Duke University.¹ The discussion note does not focus exclusively on LED in Least Development Countries but instead provides a broader review of the topic. The objective is to promote discussion and awareness of the policy options and economic theory that surrounds the issue. The discussion note is

Local Economic Development (LED) is about development in a specific space and place. There are circumstances in which public institutions can shape the economic and social destiny of the territories and populations over which they have jurisdiction. There are also choices to be made in the model of LED. Many central and local authorities develop plans and targets for promoting the economic development of geographical areas – but this is not always the same as a coherent LED strategy. In addition, the conditions under which institutions can successfully implement an effective strategy are not always present. In thinking about LED it is important to review whether the building blocks for its implementation are in place – and if not to develop measures for putting them in place as part of the strategy.

This document:

- ≡ Proposes a categorisation of the different types of LED in practice today that helps understanding of how LED works.
- ≡ Describes why effective LED requires a strong public sector and strong institutions, and why it can be combined with capacity building if those institutions are not in place.
- ≡ Discusses some methods for financing LED and links them with the principles of public financial management and fiscal decentralisation.

Part 1: Two different interpretations of LED

What is LED? We can get to the roots of the idea by unpicking the term itself. Different interpretations place emphasis on different parts of the phrase. A review of literature and practice leads to two broad and overlapping interpretations, not mutually exclusive but each representing different approaches to LED. These are the definitions of two. Following a review of literature and practice over the last 20 years suggests I suggest two broad definitions, each embracing many types of LED. For want of a better term these will be referred to as *mainstream* LED and *locally driven* LED.

In terms of practical measures, there is a good degree of overlap between the tools, instruments and policies used in pursuing LED strategies for both types. However the emphasis and mix of instruments may be different. This categorisation is broad and it is accepted that many LED strategies do not fall neatly into this division. Some may exhibit elements of both. The two types are presented as an entry point to understanding the debates and choices within LED. Why are there different interpretations? The answer lies in the awkward relationship between *space* and *economic theory* and the different ways that different economic theories deal with the spatial dimension – this is explored further in the part 2 of this discussion note – for now let's move on to the two types.

Mainstream LED

This school focuses on the word *economic*. Economic development is taken to mean the growth of economic activity (the sum of goods and services produced). The local economy therefore comprises the sum of goods and services produced within a circumscribed area. So LED is the growth of economic output within that locality. The three factors of production (Land, Labour and Capital) each have a different relationship with the locality. Land is fixed and there is a defined amount, Labour is relatively mobile but there are limits to its movement and the degree to which it can be attracted into or removed from the locality, Capital can move in or out, but is also constrained to some extent by legislation, regulations and features such as the banking system. The term LED refers to development that involves (as far as possible) local manifestations of all three factors of production. For LED, as opposed to 'regular' economic activity, the objective is to retain or re-invest within the local economy a significant portion of the output, or at least the surplus value generated from the output. Land can be recycled; resources can be distributed through local wages leading to greater local consumption; and there can be an increase in sum of local capital and concomitant local investment.

The World Bank's definition of Local Economic Development is a good example of this approach.

*The purpose of local economic development (LED) is to build up the economic capacity of a local area to improve its economic future and the quality of life for all. It is a process by which public, business and nongovernmental sector partners work collectively to create better conditions for **economic growth** and **employment generation**.*² (my emphasis)

For *Mainstream* LED the strategy is often to improve the competitiveness and economic performance of the locality, by developing a particular comparative advantage or by attracting inward investment. Success is measured by an increase in economic activity and can also include an increase in the value of basic socio-economic indicators (household income and other indicators). A Mainstream LED strategy can include the following policies or measures:

- ≡ Value chain analysis, SWOT analysis and other forms of research to define the comparative advantage of the locality (tourism, low labour costs, highly specialised workforce, unique agricultural product, etc).
- ≡ Incentives designed to attract capital from outside the locality to invest in the area and / or incentives that encourage investment from capital within the locality. These can include tax incentives, training of human resources, land use planning and zoning incentives and a relaxing of regulations. The incentives are sometimes tied to investments linked to the comparative advantage.
- ≡ The establishment of a development board or committee that overrides other forms of local government and has the powers to drive through the reforms deemed necessary. This can be top down - led by central government targeting a particular locality and run by a *quango* or central government department. However it can equally be the result of a coalition of local political and business leaders.
- ≡ *Mainstream* LED is often combined with other measures to expand the scope and role of private sector activity. This can include contracting out of local government functions to the private sector or the involvement of the private sector through public private partnerships.

In some cases *Mainstream* LED has been criticised as a “race to the bottom” in which localities compete to reduce their labour costs and lower taxes in a bid to attract fickle businesses that can then cherry pick the most attractive locations.³ However this is not always the case. Value chain analysis and other forms of looking at comparative advantage can involve the application of some of the principles of ‘high development theory’ described earlier.⁴ Forms of protectionism can also be introduced early on, but on the premise that the objective is not to isolate the locality from the wider economy but instead to improve its comparative advantage within it.

2) Locally driven LED

A second school places emphasis on the word *development*. Development itself has many definitions but in economic and social science there is broad agreement that it involves a degree of *transformation* and not just growth, for example for Nobel prize winning economist Amartya Sen development is defined as:

*“...the establishment of conditions and institutions that foster the realization of the potential of the capacities and faculties of the **human mind** in **people**, communities, and in turn, in places”*.⁵
(my emphasis)

For this second interpretation not all increases in economic activity within the locality necessarily constitute LED, even if local resources are leveraged and capital is retained. Instead the key questions are what type of economic growth is preferred and for what purpose? Who will benefit? This second interpretation usually involves a more refined interpretation of the term *local*, which becomes more than a territorial unit of economic analysis, such as “the north west” or the “mountain region”. Instead *local* is linked to a specific set of local institutions, including their politics and their territorial administrations. The LED strategy is connected to a local institutional environment and indeed that same environment shapes the strategy. The OECD adopts this approach when it states the objective of LED is:

“to reduce persistent inefficiency (underutilisation of the full potential) and inequality (share of people below a given standard of well-being and/or extent of interpersonal disparities) in specific places, through the promotion of bundles of integrated, place tailored public goods and services, designed and implemented by eliciting and aggregating local preferences and knowledge through participatory political institutions, and by establishing linkages with other places”.⁶

Whilst this type of strategy can also include elements of *Mainstream* LED, its purpose is to bring about qualitative institutional and societal changes within the locality and not just quantitative changes in the level of economic activity. These can include, for example, making a city more ‘liveable’ or making the economy and public finances of a region more resilient to changes in prices of the commodities it exports. Success is not only equated with an increase in economic growth nor does it necessarily require an increase in net output. For *Locally driven* LED the objectives are not only to insert the local economy in the world economy but also to increase its internal integration, resilience to outside shocks and the *quality* of its development path – recognising that quality is a subjective term whose meaning will vary from place to place. *Locally driven* LED can include the following policies or measures:

- ≡ A pro-active local government and other local institutions that actively intervene to produce a local development strategy that includes social and political outcomes in addition to purely economic ones. This could include the improvement of a cities ‘liveability’ or quality of life irrespective of its ranking in terms of economic product.
- ≡ Value chain analysis, SWOT analysis and other forms of research to define the comparative advantage of the locality are also included in this type of LED – however the focus may be less on defining a particular niche and more on forging both backwards and forward linkages and actively reducing dependence on external links in the chain.
- ≡ Like the *Mainstream* LED there can be incentives designed to attract capital from outside the locality to invest in the area and / or incentives that encourage investment from capital within the locality. These can include tax incentives, land use planning and zoning incentives and a relaxing of regulations. There may be a greater focus on a broader training of human resources in this type of LED and a reduced focus on tax breaks.
- ≡ *Locally driven* LED is often co-existent with a strong local government and other local institutions. Compared with *Mainstream* LED it is less likely to be a top down initiative from central government and more likely to result from a coalition of local political and business interests. It may or may not include the contracting out of local government functions to the private sector or the involvement of the private sector through public private partnerships.

Locally driven LED can be criticised for being unrealistic in the face of global economic and social currents. There is an argument that it is almost impossible for all but the biggest or richest cities or regions to attempt to create a holistic development strategy and that it is preferable to seek full integration into the world market. Other criticisms include its tendency to be state led and that public resources may be diverted to support infrastructure and other schemes that may be wasteful and ineffective.

LED driven by regionalism

In some cases the LED policy forms an integral part of a political movement for increased autonomy or even independence from the national authorities. Pike, Rodriguez Pose and Tomany refer to the local cultural and political characteristics important for *Locally driven* LED.⁷ These can extend to autonomy movements. Similar cases exist of *Mainstream* LED that seeks to capitalise on a natural resource or other comparative advantage to further autonomy. Conversely there are examples of LED policies driven by central governments seeking to consolidate control over restless territories by economic growth,

assimilation and migration. Examples of the links between LED, regionalism and conflict are found in Jackson 2013.⁸

Why LED requires strong local public institutions (and strong public financial management).

There is a common feature all examples of successful LED of both types; They require strong public institutions. Effective public bodies are important for key activities such as:

- ≡ Land use planning and zoning to enforce policies that encourage the location of certain industries.
- ≡ Contract management and compliance supervision to ensure that favoured business practices are being followed - e.g. that companies are doing what they promised to do in furtherance of the strategy.
- ≡ Revenue collection.
- ≡ Litigation against those who do not pay or comply.
- ≡ Lobbying of businesses and central government agencies, including overseas institutions.
- ≡ Provision of basic services and public goods to business (including water, electricity, solid waste management, drainage, roads, internet and telephony)
- ≡ Provision of more complex services to business such as support to import, export, customs and excise, links with training, research and educational institutions.
- ≡ Policies that encourage the optimal supply of labour at the skill level and wage level required for the LED policy.

These points are important for both *Mainstream* and *Locally driven* LED. For the UN Capital Development Fund capacity building of state institutions should not be seen as an activity diverting resources away from economic development and the private sector. Instead, the right sort of capacity building is a pre-requisite for a strong and sustainable local economy.⁹ This consideration enables us to link LED with the principles of Fiscal Decentralisation covered in the course. The reader can reflect upon how fiscal decentralisation, on both the revenue and expenditure side, impacts the bullet points above. We can also note that for some cases of LED (often *Mainstream*) there may be a concomitant fiscal *centralisation*. This can occur when accountable and democratic local government bodies are replaced with *quangos* or central agencies that are empowered to lead the strategy.¹⁰ Most importantly, these points enable us to identify the practical application for local development of some of the principles of Public Financial Management and Fiscal Decentralisation covered in the course. The next section of financing LED brings this into sharper focus.

Financing LED: Local Public Financial Management and LED strategies

Public Financing. LED related expenditure can be financed from own revenue, block grants or categorical grants. Whilst there is no fixed rule, there are issues with regard to the type of revenue applied to LED spending. The LED strategy is often pursued as part of the general mandate of local governments rather than as an agency function. This means that block grants and own revenue tend to be a principal funder of LED strategy related investments and activities. Yet central bodies can sometimes contribute to LED promotion through categorical grants. These may be from the ministry of commerce, of trade etc. If a development agency or *quango* has been established, this body may receive a generous block grant allocation with wider discretionary powers than 'mainstream' local government bodies. Successful LED strategies also involve intelligent alignment and leverage of categorical grants - whether or not their original purpose for the central agency is explicitly linked to the LED strategy.

Expenditure assignments and budgeting. There are various types of local public expenditure relating to LED. Public infrastructural goods such as roads, bridges, market places, drainage and irrigation structures, ports and quays etc. have local economic impact and the choices can be dependent on the strategy pursued. This will require application of the local government's own development / investment / project resources in the development budget (assuming these exist) and successful lobbying for the concomitant responsibilities of other bodies responsible for other public goods such as the energy grid, rail and major highways. A second form of expenditure for LED is for the soft side of strategy implementation. This is normally resourced from the recurrent budget and includes the staff, lobbying, communications, publicity and negotiation required to push the strategy forwards. Where recurrent resources are tight a 'project' within the development budget is sometimes created as a vehicle to further the strategy. In larger local governments special departments for economic development often include these features, and staffing, under their budget allocation.¹¹ However in both small and large local bodies many of these items are billed under the office of the mayor / chief executive / administrator. Indeed this can be another way to pursue such a strategy under recurrent budget constraints. Finally departments responsible for planning, and for land use planning, are usually involved.

Private investment. LED is about increasing the investment and retention of capital within a local space. The debates within LED are about the purpose to which that capital is put, not about the desirability of increased investment. Public money can be used to attract, co-finance with, and leverage private resources.

In this context policy makers need to ensure that the distinction between local government responsibility for public goods and its accountability to the citizen is not confused with private investment, private goods and the importance of a rate of return and profit for private investors. This is an important yardstick for evaluating whether financing mechanisms that encourage private resources are relevant, legal, ethical and appropriate. Some methods for using public resources to promote local investment include:

≡ Public private partnerships, of which we can highlight four types:

- *Contracting out / outsourcing* in which local government contracts private companies to provide services or investments, which themselves can be part of an LED strategy. For example the contracting out of road maintenance, port and shipping facilities, customs and excise services to private providers as part of a drive to increase import and export capacity.
- *Private Finance Initiative*, where the private sector provides investment capital (financed from debt and equity) to finance infrastructural investments and /or run public services whilst the public sector both underwrites the debt and pays regular fees for the services themselves. For example private finance builds a hospital and then runs the hospital. Public money underwrites the loan taken out to build the hospital and then also guarantees a contract to the private entity to provide healthcare for at least 10 years.

The two types of PPP listed above are often applied to generic public services - the examples given are of how they could apply to LED. They are not always more efficient than direct public sector investments and indeed can sometimes be more wasteful, particularly if there is weak local government capacity for the analysis, development, negotiation and management of the Public Private Partnership.

- *Non-recourse project financing*, in which the public sector provides collateral (land or property) and maybe takes an equity stake in part of a private project, assuming some of the risk. This enables a private borrower to raise capital without providing collateral and without assuming liability for the money borrowed (the public sector becomes liable and in the last resort can use the land or property to repay the loan if the private initiative fails). The purpose of non-recourse project financing to LED is that it can attract in private investment to a LED strategy by making key components of the strategy more viable. For example a rural coastal area may require a large cold storage warehouse and a network of cold storage trucks in order to transform the local fishing industry from artisanal to a value added and consumer oriented business - that also improves nutrition. All the other pieces of the supply chain are in place (market demand, retail network, potential processors and packagers, regular supply of fish etc.) and the non-recourse project finance will make it profitable / viable for a private operator to provide cold storage.¹²
- *Credit enhancements or grants* to private companies to encourage investment. These can range from straightforward grants, discounts, and other subsidies to more complex arrangements involving commitments from both the public and private sector.

≡ Other forms of public finance for private investment that do not involve public private partnerships

- *Tax, fee and regulatory support*. This involves favourable zoning policies for the location of certain economic activities and variable tax and fee rates to favour those activities or to discourage other activities that do not fall within the LED strategy. An example could include the encouragement of both public and private educational and training institutions in an area that was originally industrial but now derelict. This could be part of an LED strategy to improve the skills of the local workforces and to attract other skilled workers - in order to move the locality away from low value added processing towards other activities.
- *Labour market support*. For example the subsidy or provision of specific training or the provision of incentives (such as housing discounts) for staff to move to an area. Labour market support is usually targeted towards specific sectors that are related to the LED strategy.
- *Provision of public goods and services with economic impact*. Finally, all successful LED strategies involve the leverage of local investments and services to further the strategy. Many weak and ineffective LED plans are characterised by holistic approaches

that look good on paper. These may be written by the planning department but not followed through by the local government's own spending priorities (including that of the sectors and agency functions). For example there is little point in an LED strategy that favours developing the mountain region if health, education and transport services continue to favour the lowland region. A successful development of the mountains would require a re-focussing of line agency priorities to provide a conducive environment for investment and employment in the mountains.

Conclusion of part 1

This discussion note has demonstrated that whilst there is a huge range of literature, analysis and case studies, the real world examples of LED strategies can be understood and appreciated through the lens of *Mainstream* and *Locally driven* LED - whilst accepting that in practice these two types are not always mutually exclusive and can co-exist within a single LED strategy. The discussion note has emphasised that effective LED requires strong and effective public institutions, and that LED is not a substitute for local government capacity building in public financial management and fiscal decentralisation. Finally, the discussion note has outlined the various ways in which public finance can contribute to an LED strategy, recognising again that this requires strong institutions to ensure the protection of the public interest, the effectiveness of the strategy and minimise the potential for conflicts of interest and corruption. The reader can reflect on how the principles of fiscal decentralisation and public expenditure management referred to elsewhere in the course can be applied to the specific case studies of LED presented. In discussion note is further detail on the role of LED within economic theory and a list of LED resources.

Part 2: LED in economic theory

The roots of LED in economic theory help us understand why there are different approaches to LED amongst policymakers and which type is most appropriate for a given situation.

Economic theory rests on its basic premises about what creates value. There are three sets of economic assumptions that underpin most analyses.¹³

- ≡ Neo liberal economics is based on the assumption that there is no intrinsic value apart from market value, and individuals maximising their utility determine market value. Therefore the price of something is equal to its value and is a reflection of its utility;
- ≡ Keynesian economics considers that value is derived from inputs to the production process and is influenced by wider factors such as aggregate demand and social institutions.
- ≡ Marxist thought holds that value is created by labour in the production process and capital accumulated from the surplus extracted from this process (the net profit) - the price of a good only represents a nominal and ephemeral exchange value.

Whichever set of assumptions you choose, neither incorporates space and distance into its calculations, all three are spatially blind. The roots of Local Economic Development theory within economics, therefore, can be found in the attempts to introduce a spatial dimension into the equation - linking economics on the one hand with distance and with factors such as the effects of topography (mountains, rivers) on travel time on the other hand. Below we briefly review how economists from all three traditions of thought have accommodated considerations of spaces and places.

Neo liberal thinking was dominant from the 1980s until the recent economic crisis. For this model a key objective of economic policy is to "get the prices right". This means limiting the effect of subsidies, regulations and taxes so that the true market price of land, labour, goods and services can be set free. When correct price signals are sent the *invisible hand* will be most effective and resources will be efficiently allocated. The ideal of perfect competition is used as a compass to guide policy measures. Yet space means introducing a friction of distance. There cannot be perfect competition over space because some places are closer to the market, to labour, to information and to usable land than others. This produces imperfect competition which affects prices in ways that cannot easily be modelled by micro economic analysis and regression equations.

Economic geographers or spatial economists such as Von Thunen, Weber and Christaller developed early LED models to explain why firms locate in certain places and how distance means different types of economic activities are clustered or arranged in concentric circles around the core of an urban centre. Or how markets have hexagonal shapes and are nested, like Russian dolls, in a hierarchical order (for example the local market for perishable goods or for FM radio stations are nested within larger markets for nationally distributed food or for national media channels. These attempts to explain the spatial manifestation of economic activity were largely ignored by mainstream neo liberal economists and policy makers because it was difficult to apply microeconomic modelling and regression analysis to them.¹⁴

A different type of spatial economics emerged within the Keynesian tradition. This includes what Krugman refers to as 'high development theory' and a separate but connected set of ideas known as

'dependency theory'. Both were influential in development thinking and in LED models applied in development policy between the 1950s and 1980s. 'High development theory' assumes economic activity within a locality creates benefits (known as pecuniary externalities) to other economic activity in that locality. However the amount and type of benefit will depend on the type of economic activity. For example 'backward linkages' are created if investment in the production of a particular good or service creates demand for local producers of inputs for the production process. This is not always the case. For example apart from labour, an export-oriented mineral mine may not require any locally produced services or goods. Dependency theory highlights geo-economic centres and peripheries and argues that if a locality in the periphery prematurely opens up trade with the centre this creates a situation in which the centre systematically underdevelops the periphery.¹⁵ This is because, for example, exporting raw agricultural produce rather than processing it within the locality weakens local economic integration and instead inserts the local economy within the global economy under worsening terms of trade. The policy response was to limit and control trade with measures such as import substitution and local protectionism. Incidentally the discussions about *Mainstream vs. Locally driven* LED echo these earlier debates.

There is value in Marxism as an analytical tool – yet it is also largely spatially blind. The labour theory of value describes how capital is accumulated by the extraction of the surplus value from the production process and that this process tends towards growing polarisation and inequalities as a *necessary* part of the process of capitalist growth (Marxism does not admit the notion of sustainable and equitable growth). Scholars have linked the process of capital accumulation with the locality and its specific institutional qualities and political culture. This helps to explain how factors such as the strength or weakness of trade union movements, or the level of education of workers, can affect LED. It also helps an appreciation of who benefits and who loses in each policy option.¹⁶ In conclusion, whilst economics has a problem with space there are notable exceptions and in some forms of LED have been around for a long time.

Further resources on LED

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OECD resources

<http://www.oecd.org/cfe/leedprogrammeloaleconomicandemploymentdevelopment/leedtrendocentreitaly.htm>

World Bank resources

<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTURBANDEVELOPMENT/EXTLED/0,,contentMDK:20196572~menuPK:402644~pagePK:148956~piPK:216618~theSitePK:341139,00.html>

ILO resources

<http://www.ilo.org/global/topics/employment-° - promotion/local-° - economic-° - development/lang-° - ° - en/index.htm>

Global LED portal

<http://www.ledknowledge.org/>

- 1 This discussion note is based on a lecture on Local Economic Development delivered at Duke University in July 2012 by David Jackson, Director of Local Development Finance at UNCDF.
- 2 Swinburn, Goga and Murphy (2006) Local Economic Development: A primer. Developing and Implementing Local Economic Development Strategies and Action Plans. World Bank. Washington. For more WB resources see below <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTURBANDEVELOPMENT/EXTLED/0,,contentMDK:20196572~menuPK:402644~pagePK:148956~piPK:216618~theSitePK:341139,00.html>
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Financing small-scale infrastructure investments in developing countries

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Abstract

In most developing countries a shortage of long-term, local-currency financing for small-scale infrastructure projects impedes local economic development. Inadequate fiscal transfers, little own source revenue and low creditworthiness make it difficult for local governments to fully fund projects on their own. This paper proposes the use of project finance as a means to attract financing from domestic banks and institutional investors. Donors can play a catalytic role by providing technical assistance to develop projects and credit enhancement to attract commercial financing.

JEL Classification: H54, (Infrastructures, Other Public Investment and Capital Stock); H41 (Public Goods); H81 (Governmental Loans, Loan Guarantees, Credits, and Grants)

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Contents

Small-scale infrastructure financing needs in developing countries.....	1
Potential sources of financing for small scale infrastructure.....	3
A proposal for a pooled financing facility to tap domestic capital.....	5
Overcoming technical and capacity challenges to financing small-scale infrastructure projects in developing countries	7
Conclusion	11
Bibliography	12
Appendix	14

Tables

1. Table 1: Infrastructure finance from World Bank and regional development banks (2010)	1
2. Table 2: Deposit money bank assets/GDP by income group (mean averages)	4

Figures

1. Figure 1: Pension fund asset growth for non-OECD countries by region in billions of USD (2001-2009)	5
2. Figure 2: Possible finance mechanism for small-scale infrastructure.....	6

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Small-scale infrastructure financing needs in developing countries

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The inadequacy of their core, economic and social physical infrastructure is a common characteristic in most developing countries.² The World Bank estimates that \$1.1 trillion in annual infrastructure expenditure is needed in developing countries through 2015, of which the greatest needs, as a share of GDP, are in low-income countries, estimated at 12.5 percent of GDP (World Bank, 2011). Efforts are underway to increase infrastructure spending in developing countries. However, most finance has been directed towards large-scale projects. Specifically, large transportation infrastructure, energy production and distribution, communications, water and waste management projects receive substantial funding from national governments, development finance institutions and donors. For example, large multilateral development finance institutions tend to focus their financing on large-scale projects that exceed \$30 million (Table 1).

Table 1
Infrastructure finance from World Bank and regional development banks (2010)

	<i>World Bank</i>		<i>Regional Development Banks</i>			
	<i>International Bank for Reconstruction and Development, International Development Association</i>	<i>International Finance Corporation</i>	<i>African Development Bank</i>	<i>Asian Development Bank</i>	<i>European Bank for Reconstruction and Development</i>	<i>Inter American Development Bank</i>
Total size of infrastructure programs	\$19.4 billion	\$1.62 billion	\$4.11 billion (urban)	\$10.37 billion	\$620 million*	\$5.4 billion
Focus of the programs	Power, transport, and water	Private power, transport, and water	Power, transport, and water	Power, transport, ICT, and water	Municipal infrastructure	Power, transport, and water projects
Typical size of infrastructure projects	> \$30 million	\$1 million to \$100 million	\$86 million (average)	> \$30 million	\$19.4 million (average)*	> \$30 million

Source: World Bank, IFC, AfDB, ADB, EBRD, IADB, Annual reports for 2010.

* Total amount refers to targeted programme for small and medium-scale municipalities only. Other support programmes in the power, transport and water sector exist within the EBRD, which are typically large –scale.

The problems of small-scale infrastructure, especially that in rural areas, has received far less attention.³ The UN system has been supporting small scale infrastructure since the 1970s through the ILO's Employment Intensive Investment Programme (ASIST). Some development finance institutions have recently begun contributing indirectly to investment funds that are targeted to small and medium sized

- 1 The underlying concepts and proposed pooled financing structure were developed by the UN Capital Development Fund (UNCDF) in Partnership with the Global Clearinghouse for Development Finance for the UNCDF "Local Finance Initiative (LFI)," launched in 2010 with support of the Swiss Agency for Development and Cooperation (SDC). For information, see <http://www.uncdf.org/local-finance-initiative>. We would like to thank Christina Martell (University of Colorado), Christian Kingombe (Overseas Development Institute), and DESA colleagues Anisuzzaman Chowdhury, Krishnan Sharma and Michael Kunz for comments on an earlier draft.
- 2 In this paper we focus on physical infrastructure characterized by high initial capital costs. Here we use the term "core" infrastructure to refer to public works facilities that provide for transport, water/waste management, power generation/distribution and communication (ICT) services; "economic" infrastructure to refer to facilities such as warehouses, transport depots, markets, processing plants, etc.; and "social" infrastructure to refer to schools, hospitals, clinics, etc.
- 3 For the purposes of this paper we use the term "small" infrastructure to refer to projects that require less than the equivalent of \$30 million in initial capital expenditures.

enterprise (SME) development and smaller scale infrastructure projects. However, these amounts have been small (e.g., IADB contributed \$60 million through the “Corporación Interamericana para el Financiamiento de Infraestructura S.A” in 2011). Similarly, some bilateral agencies have recognized the need to increase small-scale project support. For example, the Japanese government has vowed to increase small-scale projects, which currently make up for only 0.3 percent of its total official development assistance (VNA, 2011). More recently, the UN Capital Development Fund (UNCDF) has launched the “Local Finance Initiative (LFI)” to address the specific issue of mobilizing domestic finance for smaller scale rural economic and industrial infrastructure projects, with pilot programmes on-going in Tanzania and Uganda.⁴

Small-scale infrastructure is the missing last mile—quite literally in many cases. While there is a need for more air and seaports, railroads and highways, in developing countries, these alone do not allow people and goods to reach their final destinations. Local feeder roads are needed to connect homes, farms and factories to the national transportation system. Likewise small crop bulking stations are needed to facilitate the storage of crops before they are sent to larger warehouses and processing facilities. Local markets are needed to provide the end of the retail distribution system. Small-scale power generators are needed to fill the gaps remaining in the national power grid. Small-scale processing facilities such as a powered hammer mills are needed to provide the first stage of processing for industrial value chains. Moreover, small-scale social infrastructure such as health centres, clinics and (primary community) schools are necessary in order for key services to be readily accessible to communities. In many countries, small-scale infrastructure needs are taken care of by local governments and private entrepreneurs, but in developing countries, especially low-income countries, local governments and private entrepreneurs have great difficulty in fulfilling this role on their own (Billand, 2006).

A trend towards decentralization and the pursuit of local economic development has further amplified local needs for small-scale infrastructure finance.⁵ For the past several decades, governments in both developed and developing countries have been decentralizing fiscal, political and administrative responsibilities (UCLG, 2007). In many cases, local governments are now promoting local economic development (LED). LED is a “bottom up” process in which public, private and civil society actors work collectively towards improving the competitiveness and employment prospects of a defined territory (LEDNA, 2011).

Usually it involves promoting productive sectors and value chains in which the area has or could have comparative advantages. In pursuing LED, local governments often find that inadequate small-scale infrastructure is the major impediment they face.

Yet, with lower fiscal transfers from the central government, little direct support from donors (who prefer to deal directly with central governments) and little own source revenues they frequently cannot provide the necessary funds on their own. With the rather scarce financial resources at their disposal, they face difficulties in meeting operating expenditure requirements and have little revenue to invest in infrastructure. While local governments in high-income countries can rarely fund all their infrastructure needs out of

4 The UNCDF Tanzania LFI Programme is funded by UNCDF and the Tanzania One UN Fund, and the UNCDF Uganda LFI Programme is funded by the Swedish International Development Cooperation Agency (Sida). For more information on LFI, see <http://www.uncdf.org/local-finance-initiative>.

5 Technological progress provides a further rationale for these small-scale investments into infrastructure. Specifically, recent advances in technology, materials, telecommunications and other developments (e.g., progress with regard to the decentralized generation of power from locally available renewable resources) have helped provide infrastructure services even more cost-effectively through small-scale investments.

current revenues, they usually can borrow from banks or issue bonds. Unfortunately, this is rarely an option for local governments in most developing countries due to their limited creditworthiness or the lack of credit ratings at the local or international level (Platz, 2009).

Likewise, the private sector is rarely prepared to provide either equity or debt financing for small-scale infrastructure projects on its own. Local entrepreneurs and poor communities demonstrate skill, knowledge, and willingness to shoulder risks, but are often not recognized by formal institutions and lack access to the longer-term finance necessary for infrastructure development and scale-up. For example, based on its field experience, DFID identifies certain barriers, including high market and project development costs, difficulty to access pre-investment financing, high commercial risks given the low effective demand and limited knowledge about best practice and scaling up, as the reasons for low private sector financing in small-scale decentralized energy services (DFID, 2007).

Resolution of this dilemma will require external assistance. Local governments need external assistance in finding ways to overcome the limitations of weak financial systems, in putting together “bankable” projects and in mitigating the perceived technical and financial risks involved in small infrastructure investment.

Potential sources of financing for small scale infrastructure

In developing countries, funding for capital expenditures on infrastructure can come from a number of sources. The primary ones are:

- Public sector budget
- Official development assistance (ODA)
- Private sector

The public sector provides the largest share of funding for infrastructure. This comes either from current revenues or public borrowing. In low-income countries, a significant share of funding comes from ODA, mostly in the form of grants. The private sector’s share of infrastructure funding in low-income countries is also important, although it tends to be concentrated in specific sectors such as ICT. It is provided in the form of equity or debt invested primarily in large infrastructure projects. Public-Private Partnerships (PPP), where the private sector participates directly with the public sector in projects, is another form of financing. According to data compiled by the Africa Infrastructure Country Diagnostic (AICD), capital expenditures for large-scale core infrastructure projects in Sub-Saharan Africa in 2001-2006 averaged \$24.9 billion annually. Of this 38% came from the public sector, 24% from ODA (both OECD and non-OECD countries) and 38% from the private sector. If small-scale infrastructure spending were included, the public sector’s share would likely be significantly higher (World Bank, 2009, Table 0.4, page 9).

Given the nature of infrastructure—high initial sunk cost and long service life—most public and private sector expenditures come not from current revenues but from longer-term forms of financing and the bulk of this financing comes from domestic sources (Irving & Manroth, 2009).⁶ In developing countries the

⁶ Local currency financing is needed as in the majority of cases, since most small-scale infrastructure generates revenues in local currency. In such cases, foreign currency financing is less desirable as it entails exchange rate risk or the added expense of hedging (if this protection is available). In the past many infrastructure projects have gotten into financial difficulties when exchange rate movements have greatly increased the domestic currency costs of their foreign currency debt service obligations.

Table 2
Deposit money bank assets/GDP by income group
 (mean averages)

Country income group	Deposit money bank assets/GDP	
	2000	2009
High income	88%	129%
Upper middle income	45%	63%
Lower middle income	36%	48%
Low income	16%	25%

Source: World Bank, 2010.

institutions that can best serve as the channels through which private domestic savings are gathered and then allocated to productive long-term investments of various types are banks, pension funds and other institutional investors.⁷ Banks have served as the primary source of financing for infrastructure in developing countries (Sheppard, 2003). Moreover, their assets have grown significantly, in relative and absolute terms over the last decade (table 2).

However, they are limited in their ability to provide long term financing as their major source of funding is short-term deposits. To avoid maturity mismatches banks normally cannot provide loans with tenors of more than five years. If banks receive longer term funding, most commonly via long-term loans from development finance institutions (DFIs), they can provide longer tenors. However, the amount of such DFI funding is limited. To circumvent the maturity mismatch problem, banks can offer short term financing that requires that the loans be refinanced in the future. Yet, this exposes the banks to refinancing risks that must be passed on to the infrastructure project through increased risk premiums on the loans (Rostogi and Rao, 2011).

An important potential source of long term financing for infrastructure are pre-funded pension plans that have experienced rapid growth in many developing countries in recent years. Pension funds in developing countries have risen from an estimated US\$422 billion in 2001 to US\$1.4 trillion at the end of June 2010 (JP Morgan, 2010) (figure 1). Following the advice of international financial institutions, particularly the World Bank, many developing countries have established such pension systems. Given the rather young population of most of these countries and the recent introduction of such pension plans, the assets held by such pension funds are accumulating very rapidly in many countries.

Since payments from these funds occur over a long term and are highly predictable, these pension funds should be investing in long-term assets. Thus, they are an appropriate source for funding for infrastructure, which can provide stable long-term returns. However, in many countries pension funds do not have the skills needed for investing in infrastructure projects. And in most countries, the government regulates pension fund investments and often limits their ability to invest in infrastructure projects directly. To the extent that they are engaged in funding infrastructure it is most commonly through the purchase of government bonds which are then used by the government to fund projects.

In addition to pension funds, there are other institutional investors, such as insurance companies, mutual funds and other collective investment schemes that may invest in infrastructure projects. Usually some portion of their assets needs to be invested long-term in order to match their liabilities. Assets from whole life insurance policies are a particularly appropriate source of funds for long-term investments.

7 Long-term financing is needed as the initial costs of infrastructure projects are high but their service lives are long. In order for revenues to cover debt service payments, operating and maintenance costs and produce a positive return, it is usually necessary for the capital costs of the infrastructure to be spread over many years. The revenue generated by an infrastructure project must be sufficient to cover operating costs and debt service payments, and provide a return to equity investors. In terms of obtaining a sustainable level of debt service payments, often the length of the repayment period is critical. While operating costs and return on equity should be roughly the same every year, once the infrastructure is in place and generating revenue, the level of debt service payments depends on the length of the period allowed for repayment of the debt.

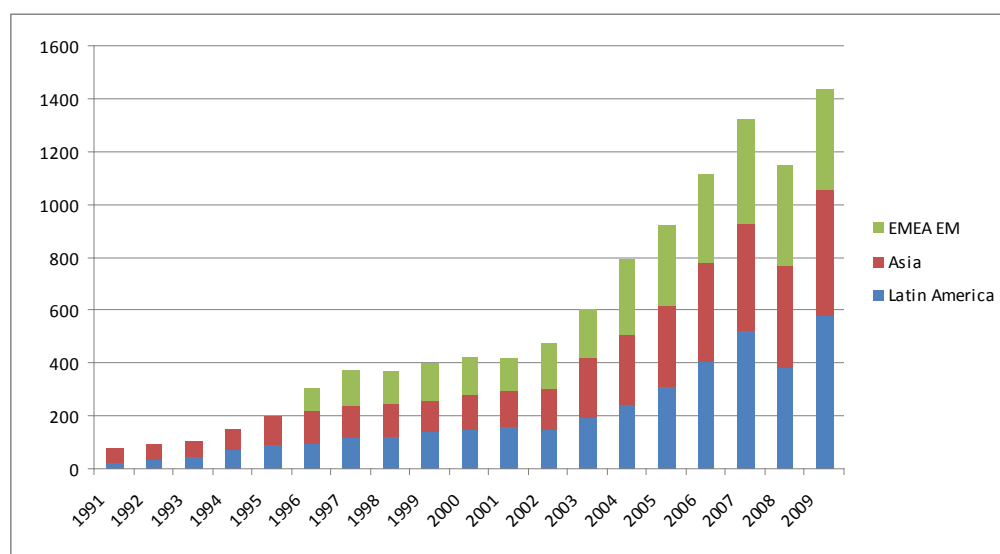
Whether these entities do invest in infrastructure is determined by the regulatory guidelines under which they operate, their ability to analyze infrastructure projects and the availability of creditworthy infrastructure projects offering good returns.

In many developing countries the growth of pension funds and other institutional investor assets has been so rapid that they have outstripped the capacity of the local markets to provide the types of investments such institutions need. Lacking suitable long-term investment options, these assets end up being deposited in banks, earning relatively low rates of return and even distorting the local financial markets by creating excess liquidity. If these assets could instead be used to safely finance small scale infrastructure projects this would not only help develop the economy but it would strengthen the local capital markets as well.

The question is whether the domestic savings held by institutional investors in developing countries can be mobilized to provide long-term funding for small infrastructure projects.

Figure 1

Pension fund asset growth for non-OECD countries by region in billions of USD (2001-2009)



Source: Bloomberg LP, J.P. Morgan estimates.

Note: EMEA EM refers to emerging economies in Europe, Middle East and Africa.

A proposal for a pooled financing facility to tap domestic capital

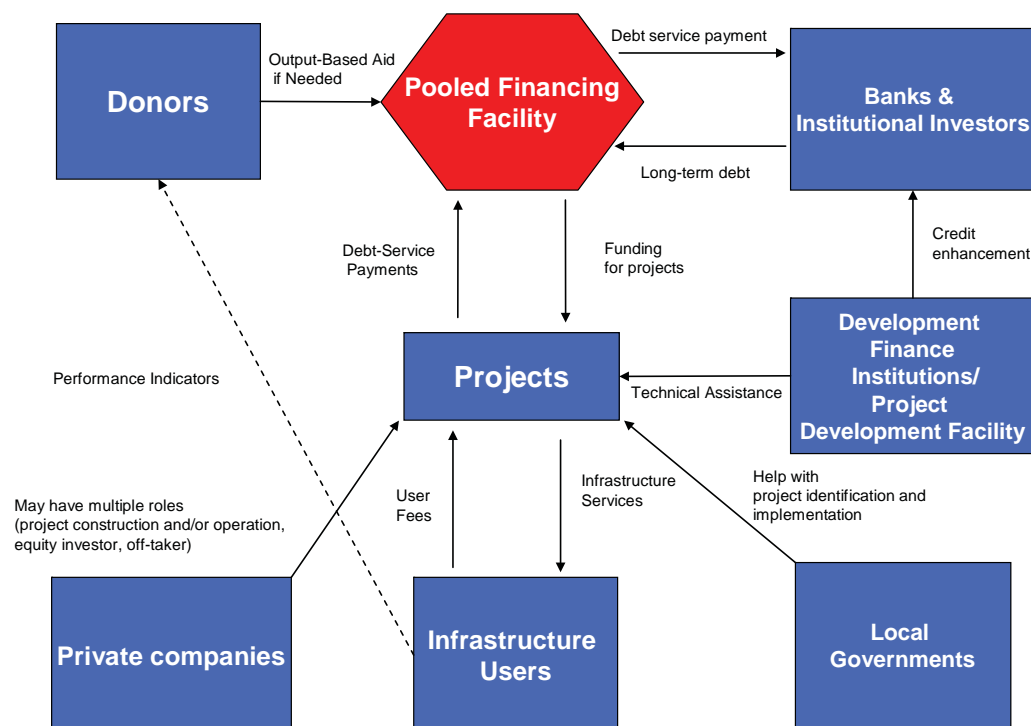
To facilitate financing for small-scale infrastructure projects in a developing country setting we propose using donor resources to leverage domestic savings. A pooled financing approach designed especially for financing small rural infrastructure on a multi-sector basis was developed in 2009 by the UNCDF “Local Finance Initiative (LFI)” in partnership with the Global Clearinghouse for Development Finance.⁸ This approach includes technical assistance, risk mitigation tools and incentives that can mobilize private sector finance,

⁸ The use of pooled facilities and related financing mechanisms have been developed in a wide range of countries. Examples include the United States (state bond banks, water and waste water treatment revolving loan funds, equipment lending pools); Kenya (K-Rep Bank pooled water facility); Czech Republic (MUFIS); South Africa (MIU); India (Tamil Nadu pooled water facility); and other applications in the Philippines, Colombia, and Morocco. For the UNCDF approach initially set forth in 2009 for diversified pools of rural infrastructure projects, see “Financing Local Infrastructure: Part One Report—The Tanzania Environmental Scan,” page 43, <http://uncdf.org/gfld/docs/infradev.pdf>

banks as well as institutional investors, including pension funds, over the longer term. All the elements of this proposal have been tested in infrastructure financing programs already carried out in a number of countries. Some of these programs are described in the appendix to this paper.

Figure 2.

Possible finance mechanism for small-scale infrastructure



Source: “Local Finance Initiative (LFI)”—A partnership between the UN Capital Development Fund and Global Clearinghouse for Development Finance.

The above structure illustrates how the projects are financed through a pooled facility by the domestic debt markets. This basic structure would be modified as needed to fit the country requirements, targeted investors, and projects sponsors from the public and private sectors.

Development finance institutions would provide the technical assistance and funding necessary to develop “bankable” project proposals. The projects would need to be able to generate sufficient revenue to cover the projected debt service payments. The revenue can be generated by market sales, off-take agreements, user fees, output-based aid payments by donors, etc.

Local governments would not borrow themselves. However, they could identify the small infrastructure project most critical for local economic development. They can also facilitate and support the projects or even invest in them (in cash or in kind, for example by providing land or access/usage rights).

In many instances, private companies would also play an important role. They can contribute their knowledge and skill in arranging for financing, in carrying out construction projects and in operating infrastructure facilities. Moreover, they can provide equity investment for projects or they may provide off-take contracts to help secure future project revenues.

A number of projects would be financed through a pooled financing facility, or similar credit enhancement financial mechanism. The investors in the facility would have support from one or more development finance institutions that would provide credit enhancement (such as partial credit guarantees or a first-loss facility).

The facility would be structured using a non-recourse project finance approach, whereby loans made by the facility would be repaid solely from the cash flows generated by the projects—not from the general financial resources of the project sponsors or local governments. This would shield local government revenue from external creditor claims. Individual projects would be structured so that certain risks, such as construction cost, technical performance, and environmental compliance, are mitigated through contractual undertakings by third-parties.

The pooled financing facility would be managed by a strong local bank (the Fund Manager), that would take the principal responsibility for credit analysis of prospective projects. The Fund Manager would seek to obtain participation in the facility from several other local banks and institutional investors. This would spread the credit and reputational risks of participation and enable the participants to improve their skills in credit analysis of project finance.

After the initial portfolio of projects has been operating successfully for a few years, it may be possible to restructure the loans into securities that could be refinanced on the local capital market. Pension funds and other institutional investors could invest into senior tranches (those tranches that have the highest repayment priority) thus freeing the banks funds to be redeployed in additional projects. The projects being refinanced would have established good payment performance records and thus be viewed as lower risk, which would make them more attractive to institutional investors such as pension funds.

This model stands in contrast to the more traditional on-lending model of assistance: In order for on-lending to work, there is a need for a lender who has the ability and willingness to make the necessary loans.⁹ The proposed mechanism assumes that there are few local banks that are prepared to help local governments identify projects, find private sector project sponsors and prepare “bankable” projects. It is too costly for the banks to do this and often the necessary skills are in short supply. Thus, we propose that donors take the lead in the area of project preparation. We are also assuming the local banks have no experience in financing small rural infrastructure projects and will require incentives to provide the funding on acceptable terms unless the donor community is willing to assist them in overcoming this barrier. Hence, we propose that this can be done by risk sharing between banks and donors and/or DFIs.

Overcoming technical and capacity challenges to financing small-scale infrastructure projects in developing countries

To illustrate the benefits of our proposal we will discuss how the mechanism would help overcome typical financing constraints for small-scale infrastructure in developing countries.

9 For example, the USAID DCA has many successful on-lending programs in low-income countries designed to provide financing for SMEs, farmers, micro-finance institutions, etc. For these programs they try to find a local bank that has the ability—for the specific sector involved—to make the necessary credit decisions to make good loans, adequate surveillance capacity to monitor loan performance and recovery capabilities to deal with defaults. They then provide financial support (largely via partial credit guarantees) to incentive the banks to expand their lending in the targeted sector. There may be some effort by the banks or the USAID to find borrowers and help them apply for financing from the participating banks, but this is a relatively modest effort, usually involving publicizing the availability of funding (USAID 2010).

Financing infrastructure projects is seldom easy—anywhere. In part, this is because of their “lumpiness”—they require the commitment of a relatively large amount of capital at one time—and their uniqueness—every infrastructure project is different due to the necessity of engineering for local conditions, dealing with local actors and serving local customers.

Additional problems may arise with financing small-scale infrastructure projects in developing countries.

High transaction costs

- When infrastructure projects are small (say below the equivalent of US\$30 million), it is especially difficult to engage banks and institutional investors. The costs of evaluating, executing and monitoring infrastructure projects are always high. For small projects, the ratio of such costs to the returns that can be earned is simply not very attractive to lenders.

Financial sector impediments

- Domestic bank and capital markets are usually under-developed and are ill-prepared to channel domestic savings into financing for local governments to fund small-scale infrastructure projects needed for local economic development.

Lack of project development capacity

- Local governments usually have difficulty in formulating “bankable” projects, in part due to their inexperience and in part due to the lack of precedents upon which to base their projections of costs and revenues.

Lack of credit history

- Lenders are wary of infrastructure financing because there is little historic evidence concerning the credit risks that local infrastructure projects will entail.

Cost recovery challenges

- The cost of financing may be too high to allow for politically and socially sustainable pricing of infrastructure services in developing countries.

Below we discuss each of these barriers and outline how they could be broken down with the help of the proposed pooled financing facility in order for domestic savings to be channelled more freely into small-scale infrastructure projects.

High transaction costs

Efforts related to identifying and bundling viable projects, matching potential investors with project owners, and the securing of experts needed to prepare the necessary market, engineering and financial analyses to prepare “bankable” projects create large up-front costs for small-scale infrastructure projects. These costs represent a much larger share of the overall costs in small projects compared to large-scale projects. Thus donors will need to cover a significant portion of these costs. In addition these transaction costs are lowered if a common project development team is established. Then the process of project formulation and documentation can be standardized, local expertise can be developed and utilized effectively and overhead costs can be spread across a number of projects. Pooling projects can also make it more economical for investors to evaluate, execute and monitor the projects.

Financial sector impediments

While the assets held by banks and institutional investors in developing countries are growing rapidly, very little of these assets are being channelled into small-scale infrastructure. Based on the experience of the developing economies, financial systems evolve over time to a stage where local governments have the ability to borrow on their own and fund the small projects they feel will promote local economic development. Normally, the process of establishing a relationship with the lender or obtaining a credit rating to access capital markets takes decades. However, there may be opportunities for accelerating the process. Rather than waiting for local governments to become creditworthy on their own, it may be possible for small-scale local infrastructure to be financed using the “non-recourse” project financing approach proposed here. Instead of lending decisions being based on the ability and willingness of local governments to repay, it is the financial viability of the infrastructure projects themselves that is paramount. If a project fails (does not service its debts) the burden is shared among the participating parties. The lending banks and any providers of credit enhancement would bear the costs of the payments not made. The local governments and private sector project sponsors would lose the equity they put into the project. Thus the risks are shared in such a way that there should be little risk of moral hazard.

The approach proposed here can also be a bridge to more traditional funding of infrastructure via the domestic bond markets. In recent years, many low income countries have achieved the necessary regulatory and legal environment and sufficiently credible monetary policies to allow issuance of long term, fixed rate local currency bonds.¹⁰ Once pools of small infrastructure loans have been established and financed, the next step could be to re-structure these loans into asset based securities that will be attractive to long term investors such as pension funds and life insurance companies.

Lack of project development capacity

Local governments are in a good position to identify projects that are needed to support local economic development. However, they are often not capable of identifying those projects that can be financed by banks and institutional investors or of preparing projects for such financing. This is an impediment that outside intervention can help overcome.

If a project is to be funded on its own, there must be sufficient revenue generated to cover its operating costs and to service the debt that will be incurred to pay for the capital costs. (The revenues can come from sales, user fees or governments payments for services or capacity.) Thus, there needs to be a detailed and realistic financial analysis of the project. Inputs to this financial analysis include a marketing study to establish the likely project revenues and an engineering/design study to establish the likely project costs. There is also a considerable amount of legal work needed to establish the rights and responsibilities of the various parties involved in the project, and to define ownership rights to the financial flows and assets associated with the infrastructure.¹¹

10 These countries have shown that it is possible for even lower income countries to escape the domestic component of so-called “original sin” (Mehl and Reynaud, 2005). For example, at least four low income countries in Sub-Saharan Africa (Burundi, Kenya, Mozambique, Tanzania and Uganda) and five lower-middle income countries (Angola, Cape Verde, Lesotho, Nigeria, and Zambia) have issued government fixed interest rate bonds with tenors equal or greater than 10 years (AfDB, 2010). Issuance of such government bonds leads the way for the issuance of longer tenor non-sovereign bonds.

11 Non-recourse project financing normally requires the establishment of a special purpose vehicle (SPV), a legal entity created to fulfill a narrow, specific function while isolating the associated parties from financial risk.

The costs of putting together a “bankable” project proposal for an infrastructure project can therefore be substantial. Thus, there may be a need for external assistance in order for local government to be able to deliver “bankable” project to lenders. The proposed arrangement in Figure 2 illustrates that development partners could help with the formulation of “bankable” projects, through targeted technical assistance. Over the longer term, local governments and other project sponsors would gain experience in project development, without being at risk of having to pay project debts. Moreover, to facilitate project preparation and to reduce their costs, “project development facilities” can be created. A project development facility can take a variety of forms and perform different roles depending on the need. In smaller or centralized countries, the facility may be national in character. In larger or decentralized countries, the facility may operate at a regional or state/provincial level. For instance, the Municipal Infrastructure Investment Unit (MIIU) in South Africa provided financial, technical, and managerial support to municipalities to secure financing for infrastructure projects. (See appendix for more details). A project development facility may also help to structure and market structured finance securities to pension funds and other domestic investors seeking long term assets.

Lack of credit history

Whether funding can be secured from the financial system—and at what costs—will be determined in large part by the risks creditors think the project entails. Often the level of risk is estimated by looking at the experience creditors have had with similar projects in the past. However, since little non-recourse project financing has been undertaken for infrastructure projects in developing countries, particularly in low-income countries, history cannot provide much guidance. Instead, the project’s creditworthiness will likely be judged based on (1) a critical analysis of the information provided in the project proposal and (2) the availability of assets pledged by the borrower. Lenders are normally cautious and focus on all the problems that occur in the construction and operation of the infrastructure project and they are likely to require collateral that can be taken in the event of default. (In fact, banks often make lending decisions largely based on the value of assets pledged by a borrower rather than a borrower’s expected revenues and cash flows. Borrowers such as small businesses often must satisfy collateral requirements well in excess of 150% of the loan amount.)

Even if lenders are willing to finance the project they may charge a high risk premium, which pushes up the cost of financing and may make it non-viable from the perspective of achieving socially and politically sustainable service pricing. In consequence, for some projects to be financed, it may be necessary for some external group to assume part of the credit risks. The proposed mechanism meets the lack of credit history with extra measures to reassure investors wary of venturing into the largely unknown territory of small-scale infrastructure finance. Project performance would be ensured through independent consultants (including engineers) who would perform market assessment studies (including capacity to pay) and audit the costs of construction. Segregated accounts would control cash flow and insure that cash is used to pay, first, operating expenses; then maintenance expenses; next, debt service and, finally, dividends to project owners. The syndicated lenders would assure financial accountability and transparency to the pooled financing facility, which would be at risk and would use typical project finance structures to protect their interests. Over the longer term, lenders would gain experience in project finance credit analysis and, having gained a better understanding of project risks and how they can be mitigated, these lenders would eventually be able to provide financing with lower or no credit enhancements.

Cost recovery challenges

Revenues generated by small-scale infrastructure finance projects may be relatively modest. In order to have politically and socially sustainable pricing of infrastructure services subsidies may be necessary to finance the

spread between lending interest rates and feasible borrowing interest rates. Development Finance Institutions (DFIs) could help subsidize the cost of financing through output based aid. For example, a programme for small community managed piped water projects in Kenya uses output based aid payments, combined with technical assistance and subsidies to mobilize market based financing from a domestic private sector microfinance institution, K-Rep Bank. (K-Rep Bank is a licensed commercial bank that specializes in microfinance products and services.) The output-based subsidy repays up to half the loan which makes the monthly repayments more affordable for the community. The subsidy payments are made upon successful delivery of the outputs. Outputs are measured by change in the service coverage and change in revenues collected, as a result of increased service and improved payment collection (see appendix for more details). Moreover, DFIs could help strengthen revenue collection capacity where the autonomy of the local government or project owner may be limited.

Conclusion

While funding for traditional large infrastructure in developing countries is still inadequate, the mechanisms for providing such funding are well established. It is the “last mile” of infrastructure needs—small-scale infrastructure essential for local economic development—that now needs to be addressed. Financing for small infrastructure presents special challenges that will require new financing mechanisms. Little fiscal autonomy and insufficient fiscal transfers from the central government have left local governments with few resources to finance small-scale infrastructure. We have argued that a carefully calibrated pooled project finance approach combined with technical assistance and credit enhancements as set forth in the UNCDF Local Finance Initiative, could help generate the necessary resources. For our proposed mechanism, local governments would not take on loans they could not shoulder (or could not access due to low creditworthiness). Rather, they could work with donors and private sector companies to identify and put together bankable infrastructure projects that can be financed by local banks and capital markets on a non-recourse basis. Consequently, those projects would benefit local economic development without an increase in municipal debt.

While we believe this financing approach holds significant potential, it would require a concerted and well-coordinated effort of a range of stakeholders and the private sector. In this connection, DFIs and donors have an important role to play. In the context of this proposed finance approach, DFIs and donors could significantly leverage their limited funds by using them to mobilize funding from local institutional investors through partial guarantees, loan subsidies, technical assistance and capacity building.

For the proposed mechanisms, we have recommended that donors and DFIs work directly with local governments, private companies and banks to provide this support. However, central governments could be brought into the picture. This could be done if donors and DFIs help increase the central government capacity to assist in project development and credit enhancement (and provide funding for this when necessary). If a central government is willing and able to take on this role, this could work and may be a more effective and sustainable model in the long run.

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Appendix: Field-Tested Local Infrastructure Financing Approaches

There have been many efforts to fund small infrastructure projects that have successfully tested various elements of the approach discussed in this paper. Below we briefly describe a few of these.

K-Rep Bank's Maji Ni (Water is Life) Program—Kenya

The Maji Ni Maisha Program illustrates the use of project development assistance, output based aid payments and partial credit guarantees to catalyze bank lending.

This programme for small community managed piped water projects in Kenya uses output based aid payments, combined with technical assistance and subsidies to mobilize market based financing from a domestic private sector microfinance institution, K-Rep Bank. (K-Rep Bank is a licensed commercial bank that specializes in microfinance products and services.) The project was created by three multi-donor trust funds. The World Bank administered Water and Sanitation Program (WSP) developed and manages the project. The Global Partnership on Output-Based Aid (GPOBA) provides output-based aid grants. The Public-Private Infrastructure Advisory Facility (PIIAF) provides initial feasibility studies and provides on-going technical support. To reduce the collateral required from the borrowers, K-Rep Bank purchased a partial credit guarantee from USAID's Development Credit Authority which covers 50 percent of the loan principal.

The projects vary in size from US\$60,000 to US\$200,000, providing from 50 new water connections to 600. The financing is provided on a project finance basis. The community provides equity (20 percent of project cost) and K-Rep finances the remaining 80 percent through a loan with a maximum tenor of five years. The output-based subsidy repays up to half the loan which makes the monthly repayments more affordable for the community. The subsidy payments are made upon successful delivery of the outputs. (Outputs are measured by change in the service coverage and change in revenues collected, as a result of increased service and improved payment collection.)

As of mid-2011 a dozen water systems have been financed with over \$1 million in debt finance from K-Rep Bank and \$300,000 in equity contributions from local community organizations. The pilot project has now been expanded nationally, targeting over 165,000 beneficiaries in 55 communities, using additional subsidy funds from the European Union.¹²

Philippine Water Revolving Fund

This Revolving Fund illustrates the use of subsidized long term funding to banks and partial credit guarantees to catalyze bank lending for small infrastructure projects in the water sector.

The Philippine Water Revolving Fund (PWRF) was one of the first large scale revolving loan programs tested in a developing country. The program targeted creditworthy local water supply and sanitation service providers in the Philippines. These providers previously had no experience in borrowing from commercial sources. And commercial loan tenors were too short and the interest rates too high for them to afford to borrow on fully commercial terms.

The crux of the PWRF's design is the leveraging of overseas development assistance with private sector resources. The program combines Japan Bank for International Cooperation (JBIC) funds lent to

12 Kameel, Viji (2009). "Leveraging Private Sector Finance for Rural Piped Water Infrastructure in Kenya: The Use of Output-Based Aid", Note Number 30, Global Partnership on Output based Aid.

the Development Bank of the Philippines (DBP), and funds from the Private Financing Institutions (PFIs), i.e. commercial banks, using their own sources of funds. JBIC extends highly concessional loans to DBP with maturity of up to 30-40 years with at least 10 years grace. The JBIC loan is guaranteed and covered for foreign exchange risk by the Government of the Philippines. The co-financing arrangement is a means to initiate PFI participation in local water service provider lending, which heretofore has been largely provided by government financing institutions and other government agencies.¹³

The co-lending arrangement is carried out on a transaction by transaction basis. DBP as the administrator acts as the main loan originator and lead arranger. One important feature is the ring-fencing of the reflows from the DBP/JBIC loan during the grace period, to build a special account that could provide liquidity cover to PFIs, as well as use for new loans or credit enhance future bond issues.

The Philippine Government (GRP) is involved by providing a sovereign guarantee to JBIC. U.S. AID is also involved, as it provides a partial (30%-50%) credit guarantee to the PFIs through a Local Government Unit Guarantee Corporation (LGUGC). The LGUGC provides the participating banks with an 85% credit guarantee. Under this guarantee scheme, the PFI, in case of loan default, is assured of continuity of payment of scheduled amortizations due, up to maturity of loan. (There is no acceleration of payments in the event of default.)¹⁴

The blending of funding from DBP and PFIs means that the water and sewer service providers are able to obtain loans with 7 to 15 year tenors (up to two years grace period) at interest rates of 9% to 11%. (The DBP lends up to 75% of the loan requirement of LGU, which percentage can decrease to 50% as the private banks gain confidence in lending under the program.)

Tamil Nadu Pooled Financing - India

The Tamil Nadu program illustrates the use of project pooling and partial credit guarantees to catalyze bank financing for small water and sanitation infrastructure projects.

Pooling arrangements allow small and medium cities to aggregate their financing needs and diversify credit risk, which serve to attract investors as well as spread the transaction costs among a number of borrowers. In 2002, using a pooled financing facility, thirteen small municipalities in the State of Tamil Nadu, India obtained funding for water and sanitation projects at longer tenors and lower cost than would have been otherwise possible.

The Tamil Nadu's Municipal Urban Development Fund issued pooled bonds for water and sanitation projects of participating urban local bodies (ULBs), with a partial (50%) credit guarantee from U.S. AID's Development Credit Authority. Other credit enhancement measures were used as well, namely, (a) escrow accounts funded by the ULBs, (b) a debt service reserve fund set up by the state government that would be replenished by diverting ULB transfer payments and (c) a sinking fund for principal repayment.¹⁵

13 Alma D. Porciuncula (2009). Philippine Water Revolving Fund, Development Alternatives, Inc., 2009. http://d130148.u37.wsiph2.com/eascongress/docs/post-congress/Theme6/01_Public_Private_Sector_Invstmt/09_Alma%20Porciuncula.pdf

14 US Agency for International Development (2009) Concept Paper for Water Supply and Sanitation Project Development Facility, The Philippine Water Revolving Fund Support Program. http://pdf.usaid.gov/pdf_docs/PNADO029.pdf

15 World Bank (2003) Project Finance Model for Water and Sanitation Projects: The Tamil Nadu Water and Sanitation Pooled Funding (WSPF), Note No. 31, 2003. http://info.worldbank.org/etools/docs/library/86463/ses2.1_pooledfinmodelwater.pdf

The escrow accounts were funded by the ULBs from general revenues and before bond issuance, in an amount equal to one year's worth of their respective loan obligation to TNUDF. These funds were held in secure, short-term fixed deposits in the name of the ULB and available to cover debt service payment shortfalls. The state government funded the DSRF at a level equal to 1.6 times annuity payments (or comparable market negotiated level). The debt service reserve is also held in short-term fixed deposit investments or other liquid instruments in the name of the fund. If drawn upon to make annuity payments to bondholders, the state government will replenish it through either a government order or by diverting municipality transfer payments. U.S. AID guarantees 50 percent of DSRF repayments and is triggered when the DSRF is exhausted and has not been replenished by the state government within 90 days. Critical to the success of this transaction was a relatively stable regulatory framework and transparent ULB budgets. These factors were positively influenced by long-term and intensive U.S. AID technical assistance.

Tamil Nadu's Municipal Urban Development Fund, a legally registered trust, issued bonds and used the proceeds to provide financing for the individual projects. This trust has joint public-private ownership. U.S. AID also provided intensive and long-term technical assistance to the municipalities. (A similar \$21.7 structure has been established in the state of Karnataka in 2003.)

The local currency bonds (totaling 304 Indian rupees, or approximately US\$6.4 million) had a maturity of 15 years. There are equal annual principal payments starting year one at an interest rate of 9.2% per year. The bonds were rated on the local scale AA by Fitch, which was sufficient to attract Indian institutional investors. (Before this transaction, the term of municipal bonds had been confined to a maximum of seven years.)

Municipal Infrastructure Investment Unit (MIIU) – South Africa

The MIIU Program illustrates the use of project development assistance and partial credit guarantees to catalyse bank financing for municipal infrastructure projects of various types.

The Municipal Infrastructure Investment Unit (MIIU) was created by the Government of South Africa in 1998 as a non-profit corporation with the mission to provide technical and grant assistance to municipalities to help them access private financing and expertise to meet their municipal services infrastructure needs. Over the period 1998 to 2006 USAID and the Development Bank of South Africa provided funding for technical assistance to help municipalities prepare projects and secure bank financing. In most instances, without the grants, municipalities would not have been able to finance the project development work or negotiate effectively with potential private partners. USAID also provided partial credit guarantees to provide an incentive for the banks to lend to the projects. The projects were designed as partnerships between the municipalities and private sector investors in a number of services, including water/wastewater, solid waste, airports, markets, bus service, municipal revenue management, electricity, and parking facilities. Some projects were able to achieve full cost recovery from users and beneficiaries, but other projects providing services to the poor were structured similarly to the out-output based subsidies model. The MIIU also helped municipalities improve their collection of charges and taxes through revenue enhancement.¹⁶

16 PADCO (2006). "Municipal Infrastructure Investment Unit (MIIU) Final completion Report" Volume 1, Main Report prepared for USAID.

CHIEF TECHNICAL ADVISOR - TANZANIA LOCAL ECONOMIC DEVELOPMENT FINANCE INITIATIVE (LFI-T) UNCDF

Location :	Dar-es-Salaam, TANZANIA
Application Deadline :	25-Dec-12
Additional Category	Millennium Development Goals
Type of Contract :	FTA International
Post Level :	P-5
Languages Required :	English
Starting Date : (date when the selected candidate is expected to start)	15-Jan-2013
Duration of Initial Contract :	One year (renewable)

Background

UNCDF is the UN's capital investment agency for the world's least developed countries. It creates new opportunities for poor people and their communities by increasing access to development finance and investment capital. UNCDF focuses on Africa and the poorest countries of Asia, with a special commitment to countries emerging from conflict or crisis. It provides seed capital – grants and loans – and technical support to help development finance institutions reach more poor households and small businesses, and local governments finance the capital investments – water systems, feeder roads, schools, irrigation schemes – that will improve poor peoples' lives.

UNCDF works to enlarge peoples' choices: it believes that poor people and communities should take decisions about their own development. Its programmes help to empower women – over 50% of the clients of UNCDF-supported development finance institutions are women – and its expertise in development finance and local development is shaping new responses to food insecurity, climate change and other challenges. All UNCDF support is provided via national systems, in accordance with the Paris principles. UNCDF works in challenging environments – remote rural areas, countries emerging from conflict – and paves the way for others to follow. Its programmes are designed to catalyze larger investment flows from the private sector, development partners and national governments, for significant impact on the Millennium Development Goals, especially Goal 1: Eradicate Extreme Poverty and Hunger, Goal 3: Promote Gender Equality and Empower Women, and Goal 7: Ensure Environmental Sustainability.

Established by the General Assembly in 1966 and with headquarters in New York, UNCDF is an autonomous UN organization affiliated with UNDP.

All stakeholders worldwide have recognized the critical role of the private sector in fostering economic growth, poverty reduction, and the attainment of the Millennium Development Goals ("MDGs"). At a time of tight public budgets and a need for local economies to deal with a global world, public funding alone is not a solution; if local development is to be successful and sustainable over the longer term, the private sector needs to be mobilized. Yet, despite the commitment of all UN Member States to mobilizing the private sector in the 2002 Monterrey Consensus and many other initiatives, concrete results on the ground have been insufficient.

The Local Economic Development Finance Initiative of Tanzania (LFI-T) is an innovative programme of the

Tanzania Government designed by the United Nations Capital Development Fund (UNCDF) that strives to make an impact by ensuring that the Tanzania domestic financial systems is unblocked to enable and promote inclusive, gender-equitable and sustainable local economic development (LED). The programme intends to achieve this goal through implementation of a Tanzania national development program to ensure long-term sustainability coupled with demonstration small and medium-size LED infrastructure projects during a period of four years.**

Capacity development will include training of local Technical Support Providers, national and local government officials, bank officers, and project sponsors, as well as the provision of information-enabling resources and communication and management platforms. The demonstration infrastructure projects will be strategically selected as critical for unleashing economic potential, including both traditional and industrial infrastructure projects such as energy projects, transport, warehouses, and food processing plants.

The LFI-T Programme aims to improve the ability and willingness of the relevant stakeholders in Tanzania to use domestic finance for LED and to create enabling national environments for sustained participation of the domestic financial sector in LED. There are five main outcomes:

- Outcome 1: Improved capacities of Tanzania public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive LED.
- Outcome 2: Increased ability and willingness of domestic financial sector to provide financing for small to medium-sized LED infrastructure projects.
- Outcome 3: Improved Tanzania business-enabling environment for domestic resource mobilization for inclusive LED, insuring integration into existing government processes, programs, and structures.
- Outcome 4: Increased interest and support of the development community for Tanzania inclusive LED project development and finance.
- Outcome 5: Increased effectiveness and leverage of limited public sector funds, both of the host government and development partners, by mobilizing significant levels of private sector finance for catalytic LED projects.

The Tanzania LFI-T Programme will be implemented in concert with the UNCDF Global LFI Programme, using the UNCDF International Technical Service Provider (TSP) that is selected to provide the overall technical and management guidance required for ensuring programme results. Given the innovative nature of the programme, the role of the UNCDF International TSP will be significant in providing overall technical guidance on all aspects of the Tanzania LFI-T Programme, including project development and finance as well as capacity building, training, and tools.

The overall Tanzania "LFI-T Technical Team" will therefore consist of both the International TSP and the in-country UNCDF Team. The LFI-T Chief Technical Advisor will work closely in a dynamic responsive manner on a daily basis with the National Implementing Partner and with the UNCDF International TSP and need to use their inputs on an ongoing basis to develop and implement the programme in all its dimensions.

Under the direct supervision of the Regional Technical Adviser and Team Leader for LDFP in Africa and with secondary supervision of the Head of UNCDF Regional Office for Africa, the Chief Technical Advisor will be responsible for implementing the LFI-T Programme in Tanzania in collaboration with the International Technical Service Provider.

The LFI-T Programme is programmed to end in June 2015.

This is a Development Project funded position.

Duties and Responsibilities

Functions/Key Results Expected:

The key result expected is the successful implementation and attainment of targets of the LFI-T Programme, including coordination with/reporting to the LFI-T Steering Committee, LED Technical Team and the fund contributors to the programme. The LFI Chief Technical Advisor will pursue the key results of the programme, working with the guidance and input of UNCDF's International TSP and in close collaboration with the National Implementing Partner, focusing on the following result areas:

- Well-designed and technically sound key project activities for identifying, developing and financing infrastructure projects;
- Capacity-building and knowledge management;
- Results monitoring and reporting;
- Partnerships, policy advocacy, and resource mobilization.

The result areas are defined below.

Well-designed and technically sound programme activities aimed at identifying, developing, and financing infrastructure projects

- Facilitate and oversee the processes of identifying and developing projects essential for inclusive, sustainable LED and oversee their systematic application;
- Support the process of identifying, defining, contracting, funding and overseeing the required technical studies required to secure private sector financing;
- Facilitate the processes to finance projects essential for LED, including credit enhancement structures;
- Support the development of guidelines and mechanisms for a pooled finance facility or other credit enhancement structures, and secure partners for required risk mitigation;
- Facilitate the establishment and operationalisation of the LFI-T Fund, including the preparation of operational guidelines and leading on negotiations with project sponsors;
- Contribute to the designing of a system for monitoring funded projects, tracking project revenues, expenses, and risk factors on an ongoing basis;
- Facilitate the development of Tanzania LED Finance Programme Performance and Business-Enabling Environment Metrics and oversee the scaling up of new measurement systems through the creation of a LED Finance Performance Index;
- By the end of the programme, to have contributed in self-evident concrete terms to the successful transfer of the core skills needed for project identification, development, and finance from the International TSP to the UNCDF LFI Team.

Capacity building and knowledge management:

- Contribute to and oversee the LFI-T capacity building and training programme in Tanzania, ensuring programme knowledge generation and dissemination, including the development of LFI-T tools and toolkits, case studies, briefs, research documents, client impact evaluations, and mid-term and final evaluations;
- Facilitate and provide specialist input to the development of guidelines for communities of practice and knowledge-exchange mechanisms for TSPs and other experts to facilitate knowledge building and exchange among LED and LFI practitioners;
- Provide specialist input to and oversee the implementation of LFI communication, coordination and training programmes, including scalable on-line tools enabling sustainability and replication, oversee

their delivery and deliver relevant training modules as necessary to advance the improvement of local business-enabling environments and access to domestic finance;

- Ensure regular updates and contributions on LFI issues through the UNCDF website and Teamworks, the UNDP internal online collaboration platform;
- Facilitate the development of processes and tools to facilitate the transfer of knowledge, training, and scaling up of LFI-T nationally and at a local level, building the capacity of stakeholders in the public and private sectors;
- Provide specialist input to the design and oversee the implementation of tools and programmes for knowledge building and sharing in the framework of South-South cooperation.

Results monitoring and reporting

- Continuously monitor and report on project implementation and results achieved;
- Report, on a quarterly basis, to UNCDF Regional Office for Africa and to UNCDF Headquarters on milestones and results achieved, highlighting any areas of concern and proposing concrete follow-up actions.

Partnerships, policy advocacy and resource mobilisation

- Design and support the implementation of the LFI-T stakeholder mobilization and communication plan and advice on outreach activities with a variety of stakeholders;
- Provide UNCDF LFI-T advisory support to other UN agencies active in Tanzania on scaling up inclusive LED through improved access to domestic private finance and coordination with DFIs;
- Develop and provide the government with evidence-based policy recommendations on national legal and regulatory frameworks;
- Develop policy positions and represent UNCDF at meetings and conferences;
- Network with funders and practitioners and ensure global meetings are effective opportunities to build knowledge partnerships;
- Develop strategies to secure new partnerships and mobilize additional resources based on programme resource requirements and new opportunities.

Impact of Results

- Improved ability and willingness of the relevant stakeholders to use domestic finance for LED and to create enabling national and international environments for sustained participation of the domestic financial sector in LED;
- Substantive partnerships strengthened with domestic financial providers, development partners in providing project development and credit enhancement support, and Technical Service Providers;
- UNCDF Regional and Country Technical Advisors/Managers supported to facilitate programme design and implementation for local development finance;
- Planned programme outputs and outcomes are fully achieved in a timely manner, consistent with the expectations of private sector actors, and optimal output quality assured, through sound and efficient internal business, quality assurance, monitoring and evaluation and reporting processes;
- Profile of UNCDF and its development partners as leaders in development finance strengthened;
- Substantive partnerships strengthened with leading private sector foundations and development partners.

Competencies

Functional Competencies

Advocacy/Advancing A Policy-Oriented Agenda

Influencing the public policy agenda

- Builds consensus concerning UNCDF's strategic agenda with partners on joint initiatives;
- Dialogues with national counterparts and other stakeholders to strengthen advocacy efforts, incorporating country, regional and global perspectives.

Results-Based Programme Development and Management

Achieving results through programme design and innovative resourcing strategies

- Makes use of a variety of resources within UNCDF to achieve results, such as cross-functional teams, secondments and developmental assignments, and collaborative funding approaches;
- Ensures the full implementation of country programme and financial resources to obtain results;
- Strong programme management experience with emphasis on monitoring, evaluation and incorporating lessons learned into development finance projects and programmes.

Building Strategic Partnerships

Building strategic alliances

- Makes effective use of UNCDF's resources and comparative advantage to strengthen partnerships;
- Creates networks and promotes initiatives with partner organizations;
- Strong networking capabilities and ability to associate him/herself with a range of actors (including policy makers, regulators, FSPs and donors) with a view to building relations and facilitating links;
- Resource mobilization experience and record of success in reporting to and managing donor grants and reporting mechanisms.

Innovation and Marketing New Approaches

Fostering innovation in others

- Creates an environment that fosters innovation and innovative thinking;
- Conceptualizes more effective approaches to programme development and implementation and to mobilizing and using resources.

Promoting Organizational Learning and Knowledge Sharing

Participating in the development of policies and innovative approaches and promoting their application throughout the organization

- Promotes UNCDF as a learning/knowledge sharing organization.

Job Knowledge/Technical Expertise

Expert knowledge of development finance

- Possesses expert knowledge of advanced concepts in private sector development, project finance as well as an in-depth knowledge of relevant organizational policies and procedures;
- Deep technical knowledge and experience in finance good practices for industry building, and development of inclusive financial markets and products in emerging markets, especially through private sector partnerships;

- Applies a broad knowledge of best management practices; defines objectives and work flows, positions reporting relationships in such a way as to obtain optimum effectiveness for the unit/branch;
- Keeps abreast of new developments in area of development finance and job knowledge and seeks to develop him/herself personally;
- Demonstrates comprehensive knowledge of information technology and applies it in work assignments;
- Demonstrates expert knowledge of the current programme guidelines and project management tools and manages the use of these regularly in work assignments.

Client Orientation

Meeting long-term client needs

- Anticipates constraints in the delivery of services and identifies solutions or alternatives;
- Proactively identifies, develops and discusses solutions for internal and external clients, and persuades management to undertake new projects or services;
- Advises and develops strategic and operational solutions with clients that add value to UNCDF programmes and operations.

Core Competencies:

- Managing complex projects and processes, with strong organizational and communication skills;
- Promoting ethics and integrity, creating organizational precedents;
- Building support and political acumen;
- Building staff competence, creating an environment of creativity and innovation;
- Building and promoting effective teams;
- Creating and promoting enabling environment for open communication;
- Creating an emotionally intelligent organization;
- Leveraging conflict in the interests of UNCDF and setting standards;
- Sharing knowledge across the organization and building a culture of knowledge sharing and learning;
- Fair and transparent decision-making; calculated risk-taking.

Required Skills and Experience

Education:

- Master's in Economics, Finance, Business or Public Administration or related field with at least 10 years of professional experience in development finance, business development, or related fields of finance, development, research, advocacy, and policy development with a focus on economic development, investment promotion and private sector support, is required.
- Candidates with a Bachelor's Degree in the above fields with 12 years' experience would also be considered.

Experiences:

- A minimum of 10 years of professional experience in development finance, business development,

or related fields of finance, development, research, advocacy, and policy development with a focus on economic development, investment promotion and private sector support;

- Demonstrated results in project finance is a distinct advantage;
- Clear evidence of entrepreneurial success in building new programmes and business services, and their management, particularly in developing countries;
- Experiences with similar assignments in developing countries, including LDCs will be considered as an advantage.

Languages:

- Strong English written and spoken. A working knowledge of Swahili is an advantage.

Section 3: Terms of Reference (TOR)

Technical Services Provider in support of the Local Economic Development Finance Initiative (LFI)

I. Background

The United Nations Capital Development Fund

UNCDF is the UN's capital investment agency for the world's least developed countries. It creates new opportunities for poor people and their communities by increasing access to development finance and investment capital. UNCDF focuses on Africa and the poorest countries of Asia, with a special commitment to countries emerging from conflict or crisis. It provides seed capital – grants and loans – and technical support to help development finance institutions reach more poor households and small businesses, and local governments finance the capital investments – water systems, feeder roads, schools, irrigation schemes – that will improve poor peoples' lives.

UNCDF works to enlarge peoples' choices: it believes that poor people and communities should take decisions about their own development. Its programmes help to empower women – over 50% of the clients of UNCDF-supported development finance institutions are women – and its expertise in development finance and local development is shaping new responses to food insecurity, climate change and other challenges. All UNCDF support is provided via national systems, in accordance with the Paris principles. UNCDF works in challenging environments – remote rural areas, countries emerging from conflict – and paves the way for others to follow. Its programmes are designed to catalyze larger investment flows from the private sector, development partners and national governments, for significant impact on the Millennium Development Goals, especially Goal 1: *Eradicate Extreme Poverty and Hunger*, Goal 3: *Promote Gender Equality and Empower Women*, and Goal 7: *Ensure Environmental Sustainability*.

Established by the General Assembly in 1966 and with headquarters in New York, UNCDF is an autonomous UN organization affiliated with UNDP.

The Local Development Finance Initiative Programme ("LFI Programme")

All stakeholders worldwide have recognized that the mobilization of the private sector in fostering economic growth, poverty reduction and the attainment of the Millennium Development Goals is critical to success. While many programs are designed to stimulate private sector investment in projects that contribute to the MDGs, there is still a significant absence of private sector engagement in many development sectors. This absence is compounded when assessed through the lens of small-scale infrastructure projects that are key to local economic and private sector development. An even dimmer situation is the nearly complete absence of such projects that are financed through the domestic capital markets.

The Local Development Finance Initiative (LFI) is an innovative global programme of the UN Capital

Development Fund designed to unlock domestic financial sectors in developing countries for financing small and medium-sized infrastructure and agriculture-processing projects that are needed for local economic and private sector development.

LFI is designed to mobilize private sector capital for the development of bankable infrastructure projects. The goal is to advance economic development at both the national and district levels, engage private sector financial institutions, and stimulate the critical government functions that are needed for identification, development, and finance of projects. The objective is to stimulate a systemic change in local business practices that will facilitate domestic financing of local infrastructure projects, strengthen the country's regional and global competitiveness and enhance the national and local business environment. Local living standards will be improved by increasing incomes and reducing poverty. The LFI approach is unique, implementing for the first time in developing countries the application of proven practices in the field of project finance to small and medium-sized projects. This approach has been employed successfully in accessing long-term private finance for infrastructure projects worldwide, but is not a common approach in developing countries, creating a game-changing opportunity to leverage limited official funds to unleash private capital for widespread development.

LFI is implemented through programme components that include capacity building for public, private stakeholders and advisory services to project sponsors, and the structuring of small and medium-sized infrastructure projects that will be financed by domestic private capital. The LFI innovation is the introduction and application of a wide array of risk mitigation approaches and instruments, leveraging both project structuring techniques and the full spectrum of risk mitigation instruments and credit enhancement options.

The LFI Programme was launched in May 2012, championed in Uganda by the Ministry of Local Government and the Uganda Investment Authority. In Tanzania, the programme began in March 2012, led by the Prime Minister's Office, Regional Administration and Local Government, with the support of the Tanzania Investment Centre. In each country, an initial pipeline of project finance opportunities have been identified and consultations undertaken with relevant local financial institutions and development partners. LFI hosted introductory workshops in late 2012.

II. Scope and expected outputs

The LFI Programme aims to improve the ability and willingness of the relevant stakeholders to use domestic finance for local economic development (LED) and to create the foundation of experience for sustained participation of the domestic financial sector in LED. All or some of the five main results below are to be achieved over the course of the programme in a given country:

- **Result 1:** Improved capacities of public and private project developers to identify and develop small-to-medium sized infrastructure projects essential for inclusive LED.
- **Result 2:** Increased ability and willingness of domestic financial sectors to provide financing for small to medium-sized LED infrastructure projects.
- **Result 3:** Improved business-enabling environments for domestic resource mobilization for inclusive LED, insuring integration into existing government processes, programs, and structures.
- **Result 4:** Increased interest and support of the development community for inclusive LED project development and finance.
- **Result 5:** Public sector funding has been effectively leveraged to mobilize significant private

sector financing for catalytic LED projects.

III. Key Tasks and Activities

The **Technical Service Provider** will support UNCDF in pursuing the key results of the programme **in two countries: Tanzania and Uganda for a period of up to 3 years**, focusing on the following key function areas:

- (1) Developing financially viable small scale infrastructure projects
- (2) Capacity-building and knowledge management; and
- (3) Programmatic Quality Assurance and Reporting

Key Functions and Outputs:

1. Developing Financially Viable Small Scale Infrastructure Projects (60%)

- Support the process of developing and facilitating the finance of projects, including review of business plans, financial models, technical studies, legal structures, legal documents and independent reports. Support will include the application of risk mitigation strategies including entire project life cycle due diligence.
- Provide financial advisory services to project sponsors to guide establishment of the requisite project structure for obtaining finance, this includes engagement with local service providers (e.g. lawyers) on innovative aspects of project structuring.
- Develop necessary investment documents for projects to reach financial close (e.g., bank information memorandum and project financial model).
- Support the process of reviewing and negotiating project documents such as term sheets, and shareholder agreements. Support solicitation of bank financing of projects in a competitive bidding process.
- Support management of issues related to project development and execution, e.g., equipment suppliers, contractors, and consultants.
- Advise on integration of innovative project finance structures.
- Support research and design of credit enhancement structures for UNCDF that engage domestic financing.
- Facilitate closing of private sector finance for selected projects

Outputs:

- | | |
|-----|---|
| 1.1 | Completed drafts of legal documents for closing on one project, including bank offering memorandum |
| 1.2 | Completed drafts of legal documents for closing on two projects, including bank offering memorandum |
| 1.3 | Two additional projects advancing through technical studies, due diligence assessment and financial structuring |
| 1.4 | Facilitation of project negotiations with financial institutions |

2. Capacity Building and Knowledge Management (30%)

- Design and implement LFI capacity building and training programmes on project finance

methodology (e.g., risk mitigation approaches and structuring alternatives) for UNCDF LFI staff, project sponsors, government, local financial professionals and local technical service providers, including toolkits, case studies, briefs, research documents and client impact evaluations.

- Enable “learn by doing training” of UNCDF regional and country teams, as well as local stakeholders (government officials, private sector banks, project sponsors, etc).
- Provide support to UNCDF on policy, legal and regulatory framework improvements that will encourage resource mobilization and investment for sustainable and inclusive LED through research and preparation of roadmaps for action.
- Collaborate with UNCDF, key partners and development finance practitioners for research and development of innovative, cutting-edge strategies and approaches to sharpen delivery of development finance products and services in order to better achieve programme objectives.
- Provide key documentation to be made available on the UNCDF Intranet and other corporate Internet resources to facilitate the access of UNCDF staff and other stakeholders to programme information and training materials.

Outputs:

- | | |
|-----|--|
| 2.1 | Outline of training program for UNCDF staff |
| 2.2 | Outline of capacity building program for project sponsors, government partners and local technical service providers, including a “Project Finance Approach for Small Scale Infrastructure Projects” Toolkit |
| 2.3 | Implementation of training programs, (utilizing Project Finance Toolkit) |
| 2.4 | UNCDF Regional and Country staff training |
| 2.5 | “Train the trainer” modules, case studies and training materials to be posted on UNCDF website |
| 2.6 | Project Finance Toolkit for project sponsors to be finalized and up loaded to UNCDF and government websites |

3. Programmatic Quality Assurance and Reporting (10%)

- Provide technical support as needed to the Country LFI Programme Teams.
- Develop annual Learning Plans and Implementation Plans with UNCDF Regional and Country management.
- Support development, research and preparation of a Case Study on an LFI supported project in Uganda.
- Provide required information for regular performance monitoring and reporting on project achievements, delivery and other areas of accountability.

Outputs:

- | | |
|-----|---|
| 3.1 | First Year Learning Implementation Plan |
| 3.2 | Case Study on LFI Supported Project |

IV. Duration

This solicitation is for a Long-Term Agreement (LTA) for one year and renewable up to three years. “LTA” refers to a mutual arrangement whereby the firm will provide services as required,

over a specific period of time. An LTA specifies the unit price, allowing for a framework agreement to be used when the firm's services are needed.

LTAs are framework agreements that do not imply a financial commitment from UNCDF. Financial commitments will be established on an ad-hoc basis every time services are requested within the scope of the LTA and a specific contract will be issued for each project (please refer to the guidelines in Section 11).

V. Implementation Arrangements

UNCDF will provide overall programme oversight and implementation and will coordinate the programme activities in Tanzania and Uganda with due regard to the following guiding principles of implementation:

- National ownership
- Alignment with ongoing country programming and existing coordination structures
- Sustainability of results

UNCDF will provide and ensure overall coordination of activities included in the programme work plan.

The Task Manager of the TSP will report to UNCDF Chief Technical Advisor, Tanzania on all activities undertaken in the programme countries.

VI. Bidder's Qualifications

1. Specific Competencies

Development and Execution of Viable Project Finance Transactions

- Demonstrated track record in structuring infrastructure projects in developing countries, using risk mitigation structures, including specific elements such as equipment procurement contracts;
- Demonstrated track record in securing private sector financing for projects with project sponsors, including sponsors that are SMEs;
- Demonstrated track record of innovating in the above project development and financing processes, adapting the development, structuring, risk mitigation, and financing as needed to secure private sector finance;
- Demonstrated experience in processes of syndicating project debt.
- Demonstrated ability to develop and close transactions in developing countries.

Credit Assessment Required for Successful Project Development and Finance

- Demonstrated ability to provide the project finance and country risk due diligence assessments required for securing finance from the private sector (e.g., credit skills related to assessment of project risk working for the credit function of banks, rating agencies, and development banks);
- Demonstrated research abilities to identify risks, risk mitigation structures, and providers of independent assessments of markets (demand, price) and macro risks (political, economic, financial, etc).

Capacity-Building for Project Finance

- Demonstrated ability to develop and present project finance training courses; ability to adapt to local situations;
- Experience in structuring and presenting training courses to a variety of stakeholders (e.g., UNCDF staff, project sponsors, and government officials);
- Experience in developing training and information tools, including on-line tools, to enable large-scale access to enabling-information on project finance, including access to information on risk mitigation services from development banks, transaction structures, and project development services.

Engagement with Development Finance Institutions (DFIs)

- Knowledge of development finance, leading institutions and services/products, development of domestic financial markets, existing credit enhancement mechanisms used to mobilize the private sector, and best practices
- Demonstrated ability to develop innovative services and products working with DFIs in order to maximize the leverage of public funds to mobilize the private sector and build domestic capital markets

Advisory to Developing Country Governments

- Experience in working with developing country governments, including investment promotion agencies and ministries of finance, in aspects related to mobilizing the private sector and building domestic capital markets

Experience in Tanzania and Uganda

- Prior work in the East Africa region
- Direct knowledge of Tanzania and Uganda economic and market situation

2. General requirements (competencies)

- Analytical and problem solving skills of a high order, including the ability to formulate recommendations and advice;
- Demonstrated excellent written and oral communication skills in English (a technical writing sample may be requested);
- Promoting ethics and integrity, creating organizational precedents;
- Creating an environment of creativity and innovation;
- Creating and promoting enabling environment for open communication;
- Sharing knowledge and building a culture of knowledge sharing and learning;
- Strong ability to communicate and function effectively in international/multicultural environment;
- High level planning, organizational and time management skills, including flexibility, attention to detail and the ability to work under pressure to meet changing deadlines;
- Fair and transparent decision-making; calculated risk-taking;
- Anticipates constraints in the delivery of services and identifies solutions or alternatives; and
- Well-developed interpersonal skills

VII. Additional requirements

Recruitment Qualifications for Implementing Partner

- Availability: Immediate

- Letters of commitment from key principals is requested.
- Team Composition:
 - **At least 2 Senior Project Finance Experts** (including one as Task Manager) able to provide financial advisory, project development support, credit assessments, and training.
 - Support services for facilitating and posting **on-line training and knowledge management and facilitating in-country logistics**
- Organization:
 - Organizational chart
 - Current list of board of directors, if applicable
 - Board minutes for the fiscal year
 - 2-years audited financial statements
 - Proof of legality and copy of by-laws and articles of incorporation
 - Additional documents as set forth in the UNCDF RFP, Section C.15.1
- Experience:
 - Senior experts should possess a minimum of 15 years of experience in project finance (i.e., closing transactions), development of projects for private sector finance, provision of financial advisory services.
 - Masters of Finance and/or Business Administration
 - Experiences with similar assignments in developing countries, including LDCs.
- Language: Fluent English written and spoken. Proficiency in Swahili preferred.
- Ability to travel overseas (and to secure visas in timely fashion).
- Existing Professional Staff and office in Tanzania preferred.

VIII. Language

All project-related written materials and correspondence with UNCDF-LFI shall be in the English language unless otherwise specified by UNCDF.

IX. Reporting

The following reports shall be submitted to UNCDF (to the attention of the Chief Technical Advisor, UNCDF Tanzania) in form and substance acceptable to UNCDF:

- (i) Project Inception Report, within two weeks from start of assignment;
- (ii) Project Monthly Report to UNCDF CTA, within 2 weeks from the start of each calendar month (except for the months of project launch and completion dates);
- (iii) Mission Reports, within 2 weeks of designated in-country missions;
- (iv) Quarterly Review Meetings with CTA; and
- (v) Project Completion Report, within 2 weeks from the project completion date.

X. Location of Project

The project will be implemented in Uganda and Tanzania during the duration of the agreement.

XI. Price Proposal

The price proposal shall include and clearly itemize all fees, costs and expenses the Offeror proposes are reasonable for carrying out the Project in accordance with this TOR and in a manner consistent with

international standard and best practice.

XII. Payment Terms

Payment shall be made according to a Payment Schedule, to be approved by UNCDF, which will be worked out based on the annual work plan of the corresponding country programme (and expected outputs). Payments will be made within 30 days from receipt of invoice following successful completion of deliverables as specified in the work plan.

Section 4: Proposal Submission Form¹

[insert: Location]

[insert: Date]

To: [insert: Name and Address of UNDP focal point]

Dear Sir/Madam:

We, the undersigned, hereby offer to provide professional services for [insert: title of services] in accordance with your Request for Proposal dated [insert: Date] and our Proposal. We are hereby submitting our Proposal, which includes the Technical Proposal and Financial Proposal sealed under a separate envelope.

We hereby declare that :

- a) All the information and statements made in this Proposal are true and we accept that any misrepresentation contained in it may lead to our disqualification;
- b) We are currently not on the removed or suspended vendor list of the UN or other such lists of other UN agencies, nor are we associated with, any company or individual appearing on the 1267/1989 list of the UN Security Council;
- c) We have no outstanding bankruptcy or pending litigation or any legal action that could impair our operation as a going concern; and
- d) We do not employ, nor anticipate employing, any person who is or was recently employed by the UN or UNCDF.

We confirm that we have read, understood and hereby accept the Terms of Reference describing the duties and responsibilities required of us in this RFP, and the General Terms and Conditions of UNCDF's Contract for Professional Services.

We agree to abide by this Proposal for [insert: period of validity as indicated in Data Sheet].

We undertake, if our Proposal is accepted, to initiate the services not later than the date indicated in the Data Sheet.

We fully understand and recognize that UNCDF is not bound to accept this proposal, that we shall bear all costs associated with its preparation and submission, and that UNCDF will in no case be responsible or liable for those costs, regardless of the conduct or outcome of the evaluation.

We remain,

¹ No deletion or modification may be made in this form. Any such deletion or modification may lead to the rejection of the Proposal.

Yours sincerely,

Authorized Signature [*In full and initials*]: _____

Name and Title of Signatory: _____

Name of Firm: _____

Contact Details : _____

[please mark this letter with your corporate seal, if available]

Section 5: Documents Establishing the Eligibility and Qualifications of the Proposer

Proposer Information Form²

Date: *[insert date (as day, month and year) of Proposal Submission]*

RFP No.: *[insert number]*

Page _____ of _____ pages

1. Proposer's Legal Name <i>[insert Proposer's legal name]</i>		
2. In case of Joint Venture (JV), legal name of each party: <i>[insert legal name of each party in JV]</i>		
3. Actual or intended Country/ies of Registration/Operation: <i>[insert actual or intended Country of Registration]</i>		
4. Year of Registration: <i>[insert Proposer's year of registration]</i>		
5. Countries of Operation	6. No. of staff in each Country	7. Years of Operation in each Country
8. Legal Address/es in Country/ies of Registration/Operation: <i>[insert Proposer's legal address in country of registration]</i>		
9. Value and Description of Top three (3) Biggest Contract for the past five (5) years		
10. Latest Credit Rating (if any)		
10. Brief description of litigation history (disputes, arbitration, claims, etc.), indicating current status and outcomes, if already resolved.		
12. Proposer's Authorized Representative Information Name: <i>[insert Authorized Representative's name]</i> Address: <i>[insert Authorized Representative's name]</i> Telephone/Fax numbers: <i>[insert Authorized Representative's name]</i> Email Address: <i>[insert Authorized Representative's name]</i>		
13. Are you in the UNPD List 1267.1989 or UN Ineligibility List ? <input type="checkbox"/> YES or <input type="checkbox"/> NO		

² The Proposer shall fill in this Form in accordance with the instructions. Apart from providing additional information, no alterations to its format shall be permitted and no substitutions shall be accepted.

14. Attached are copies of original documents of:

- ☐ All eligibility document requirements listed in the Data Sheet
- ☐ If Joint Venture/Consortium – copy of the Memorandum of Understanding/Agreement or Letter of Intent to form a JV/Consortium, or Registration of JV/Consortium, if registered
- ☐ If case of Government corporation or Government-owned/controlled entity, documents establishing legal and financial autonomy and compliance with commercial law.

Joint Venture Partner Information Form (if Registered)³

Date: *[insert date (as day, month and year) of Proposal Submission]*

RFP No.: *[insert number]*

Page _____ of _____ pages

1. Proposer's Legal Name: <i>[insert Proposer's legal name]</i>		
2. JV's Party legal name: <i>[insert JV's Party legal name]</i>		
3. JV's Party Country of Registration: <i>[insert JV's Party country of registration]</i>		
4. Year of Registration: <i>[insert Party's year of registration]</i>		
5. Countries of Operation	6. No. of staff in each Country	7. Years of Operation in each Country
8. Legal Address/es in Country/ies of Registration/Operation: <i>[insert Party's legal address in country of registration]</i>		
9. Value and Description of Top three (3) Biggest Contract for the past five (5) years		
10. Latest Credit Rating (if any)		
1. Brief description of litigation history (disputes, arbitration, claims, etc.), indicating current status and outcomes, if already resolved.		
13. JV's Party Authorized Representative Information Name: <i>[insert name of JV's Party authorized representative]</i> Address: <i>[insert address of JV's Party authorized representative]</i> Telephone/Fax numbers: <i>[insert telephone/fax numbers of JV's Party authorized representative]</i> Email Address: <i>[insert email address of JV's Party authorized representative]</i>		

³ The Proposer shall fill in this Form in accordance with the instructions. Apart from providing additional information, No alterations to its format shall be permitted and no substitutions shall be accepted.

14. Attached are copies of original documents of: *[check the box(es) of the attached original documents]*

- ☐ All eligibility document requirements listed in the Data Sheet
- ☐ Articles of Incorporation or Registration of firm named in 2.
- ☐ In case of government owned entity, documents establishing legal and financial autonomy and compliance with commercial law.

Section 6: Technical Proposal Form

TECHNICAL PROPOSAL FORMAT

INSERT TITLE OF THE SERVICES

Note: Technical Proposals not submitted in this format may be rejected. The financial proposal should be included in separate envelope.

Name of Proposing Organization / Firm:	
Country of Registration:	
Name of Contact Person for this Proposal:	
Address:	
Phone / Fax:	
Email:	

PART 1: EXPERTISE OF FIRM/ ORGANISATION

This section should fully explain the Proposer's resources in terms of personnel and facilities necessary for the performance of this requirement.

1.1 Brief Description of Proposer as an Entity: Provide a brief description of the organization / firm submitting the proposal:

- Its legal mandates/authorized business activities
- A brief description of present activities and areas of expertise
- Year and country of incorporation,
- Location of physical offices and staff
- Governance and management arrangements
- Include reference to reputation, or any history of litigation and arbitration in which the organisation / firm has been involved that could adversely affect or impact the performance of services, indicating the status/result of such litigation/arbitration.

1.2. Financial Capacity: Provide the latest Audited Financial Statement (Income Statement and Balance Sheet) duly certified by a Public Accountant . Include any indication of credit rating, industry rating, etc.

1.3. Track Record and Experiences: Provide the following information regarding corporate experience within the last five (5) years which are related or relevant to those required for this Contract. Proposers may provide no more than ten (10) relevant experiences. In addition to the table below, proposer may provide a one page detailed description of the relevant project.

Name of project	Location	Client	Contract Value	Period of activity	Types of activities undertaken	Status or Date Completed	References Contact Details (Name, Phone, Email)

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PART 2 - APPROACH AND IMPLEMENTATION PLAN

This section should demonstrate the Proposer's responsiveness to the TOR by identifying the specific components proposed, addressing the requirements, as specified, point by point; providing a detailed description of the essential performance characteristics proposed; and demonstrating how the proposed methodology meets or exceeds the requirements.

2.1. Approach to the Service/Work Required: (must not exceed five pages)

Please provide a detailed description of the methodology for how the organisation/firm will achieve the Terms of Reference of the project, keeping in mind the appropriateness to local conditions and project environment. Areas to be addressed are:

- Knowledge of project finance and how to provide financial advisory services, models of structured finance and credit enhancements, particularly in the context of challenging environments such as LDCs
- Demonstrated understanding of the challenges and approaches to developing quality projects for structured finance approaches and interactions across a range of stakeholders including: private sector project sponsors/developers, local government representatives, financial institution representatives, local technical service providers (e.g. lawyers and accountants) and multilateral and development agencies (e.g. bi-lateral funding institutions)
- Design and execution of knowledge products and/or the development of tools to transmit project finance approaches and skills development.

2.2. Technical Quality Assurance Review Mechanisms: The methodology shall also include details of the Proposer's internal technical and quality assurance review mechanisms.

2.3. Risks / Mitigation Measures: Please describe the potential risks for the implementation of this project that may impact achievement and timely completion of expected results as well as their quality. Describe measures that will be put in place to mitigate these risks.

2.4. Reporting and Monitoring: Please provide a brief description of the mechanisms proposed for this project for reporting to the UNCDF.

2.5. Anti-Corruption Strategy: Define the anti-corruption strategy that will be applied in this project to prevent the misuse of funds. Describe the financial controls that will be put in place.

2.6. Partnerships: Explain any partnerships with local, international or other organizations that would be proposed for the implementation of the project. Special attention should be given to providing a clear picture of the role of each entity and how everyone will function as a team. Letters of commitment from partners and an indication of whether some or all have successfully worked together on other previous projects is encouraged.

2.7 Statement of Full Disclosure: This is intended to disclose any potential conflict in accordance with the definition of "conflict" under Section 4 of this document, if any.

2.10 Other: Any other comments or information regarding the project approach and methodology that will be adopted.

--

PART 3: PERSONNEL

3.1 Management Structure: Describe the overall management approach toward planning and implementing this activity. Include an organization chart for the management of the project describing the relationship of key positions and designations.

3.2 Geographical Coverage and language requirement. The proposer should describe its experience in East Africa. Specifically the proposer should state if: it has a local presence (office, staff or subcontractors included in this proposal); If it has experience working in the country, and; list the local languages its personnel speak (if any).

Country	Presence	Experience	Local Language(s)
<i>e.g. June 2004-January 2005</i>			

3.2 Qualifications of Key Personnel. Provide the CVs for key personnel (Team Leader, Managerial and general staff) that will be provided to support the implementation of this project. CVs should demonstrate qualifications in areas relevant to the Scope of Services. To summarize the CVs, please use the format below:

Name:		
Position for this Contract:		
Level (Junior Finance Expert, Senior Project Finance Expert, Senior Project Finance Expert/Task Manager)⁴		
Nationality:		
Contact information:		
Countries of Work Experience:		
Language Skills:		
Educational and other Qualifications:		
Summary of Experience: <i>Highlight experience in the region and on similar projects.</i>		
Relevant Experience (From most recent):		
Period: From – To	Name of activity/ Project/ funding organisation, if applicable:	Job Title and Activities undertaken/Description of actual role performed:
<i>e.g. June 2004-January 2005</i>		
<i>Etc.</i>		
<i>Etc.</i>		

⁴ Junior Finance Expert is the equivalent of a bachelors' degree and 0 – 4 years' relevant experience; Senior Project Finance Expert is the equivalent of a master's degree and 15 years' relevant experience; Senior Project Finance Expert/Task Manager is the equivalent of a master's degree and 15 or more years' relevant experience. For candidates without a master's degree, an additional three years of experience is required to qualify for the Senior Expert level.

Declaration:

I confirm my intention to serve in the stated position and present availability to serve for the term of the proposed contract. I also understand that any wilful misstatement described above may lead to my disqualification, before or during my engagement.

Signature of the Nominated Team Leader/Member

Date Signed

Section 7: Financial Proposal Form⁵

The Proposer is required to prepare the Financial Proposal in an envelope separate from the rest of the RFP as indicated in the Instruction to Proposers.

The Financial Proposal must provide a detailed cost breakdown. Provide separate figures for each functional grouping or category.

Any estimates for cost-reimbursable items, such as travel and out-of-pocket expenses, should be listed separately.

The format shown on the following pages is suggested for use as a guide in preparing the Financial Proposal. The format includes specific expenditures, which may or may not be required or applicable but are indicated to serve as examples.

The cost proposal will be evaluated as follows:

Comparative cost of 5 days of work for one staff at each level (Senior Project Finance Expert/Task Manager; Senior Project Finance Expert, Junior Finance Expert)	Lowest Priced Offer / Price of the Offer Being Reviewed * 30	Maximum 30 points
Comparative cost of airfare and DSA for one person for 5 days in Tanzania	Lowest Priced Offer / Price of the Offer Being Reviewed * 30	Maximum 30 Points
Comparative cost of implement the sample TOR in Section 8 using the template in Part C of this Section	Lowest Priced Offer / Price of the Offer Being Reviewed * 40	Maximum 40 points
Total		Maximum 100 points

As noted the cost proposal will account for 30% of the total score of the proposal.

A. Cost Breakdown by functional group or category:

Provision of services

1. Remuneration⁶

⁵ No deletion or modification may be made in this form. Any such deletion or modification may lead to the rejection of the Proposal.

⁶ If a range is provided, the highest value in that range will be used for calculation of the financial proposal.

Staff Level	Characteristics ⁷	Name(s) of the Consultant(s) at this level	Daily fee	Offsite	Daily fee	On site
Junior Finance Expert	Equivalent of a bachelors's degree and 0 – 4 years' relevant experience					
Senior Project Finance Expert	Equivalent of a master's degree and 15 or more years' relevant experience					
Senior Project Finance Expert/Task Manager	Equivalent of a master's degree and 15 or more years' relevant experience					

2. Other expenses

B. Cost Breakdown for travel and Daily Sustenance Allowance

Country	Travel	DSA
Tanzania		
Uganda		

C. Cost of Implementing the Example Terms of Reference in Section 8: Terms of Reference

The proposer should read the terms of reference (TOR) provided in Section 11 and provide a sample cost proposal for completing these terms of reference. This will allow UNCDF to compare the cost of implementing the TOR across different proposers.

Staff	No. of Days	Rate	Total
Junior Finance Expert			
Senior Project Finance Expert/Task Manager			
Senior Project Finance Expert			
Sub-total			
Travel expenses			

⁷ If candidate has no masters' degree, the equivalent is three additional years of relevant work experience

Daily Sustenance Allowance			
Terminals			
Sub-total			
Total			

***Travel expenses:** refer to the estimated airfare (return ticket for one consultant to the countries specified) and terminal expenses (transportation from the working site to airport).

****Daily Sustenance Allowance (DSA):** refer to the living costs of one consultant when working on the countries specified including meals and hotel expenses.

These costs are indicative and may be subject to revision upon award of the contract.

Section 8: Sample Terms of Reference

This is a sample of a typical assignment (assignments can vary in length)

TITLE: Project Finance Specialist(s)

AGENCY/PROJECT NAME: Local Finance Initiative Tanzania

PLACE OF ASSIGNMENT: Off site and on site in Tanzania

1) GENERAL BACKGROUND

UNCDF is the UN's capital investment agency for the world's 49 least developed countries. It creates new opportunities for poor people and their communities by increasing access to microfinance and investment capital.

In 2012, UNCDF launched the Local Development Finance Initiative (LFI), an innovative global programme designed to unlock domestic financial sectors in developing countries for financing small and medium-sized infrastructure and agriculture-processing projects that are needed for local economic and private sector development.

LFI is designed to mobilize private sector capital for the development of bankable infrastructure projects. The LFI approach is unique, implementing for the first time in developing countries the application of proven practices in the field of project finance to small and medium-sized projects. This approach has been employed successfully in accessing long-term private finance for infrastructure projects worldwide, but is not a common approach in developing countries, creating a game-changing opportunity to leverage limited official funds to unleash private capital for widespread development. The program is implemented through the provision of capacity building for public, private stakeholders and advisory services to project sponsors, and the structuring of small and medium-sized infrastructure projects that will be financed by domestic private capital. The LFI innovation is the introduction and application of a wide array of risk mitigation approaches and instruments, leveraging both project structuring techniques and the full spectrum of risk mitigation instruments and credit enhancement options.

UNCDF wants to contract a firm to assist in supporting UNCDF in the design and delivery of financial advisory services and capacity building to project sponsors, domestic financial institutions, and government partners in Tanzania. The objective is to prepare small scale infrastructure projects to receive financing and to institutionalize the project finance approach in Tanzania.

2) OBJECTIVES OF THE ASSIGNMENT

UNCDF's Local Finance Initiative Tanzania has established a pipeline of small scale infrastructure projects that, if successfully financed, will contribute to local economic development. These projects are in various stages of development, e.g., completion of feasibility studies, market studies and environmental assessments; design of financial model and draft project structuring. LFI-Tanzania has engaged with project sponsors, government officials and domestic financial institutions on the process and opportunities.

For each of the project sponsors, UNCDF will sign a Memorandum of Understanding (MOU) defining the objectives to be reached for the project as well as the roles and responsibilities of UNCDF and the project sponsor during the project development process. Part of this Agreement will be specifying the financial advisory services and capacity building that will be supported through a technical service provider (i.e. an expert in project finance and financial advisory services) who will provide long distance and on-site information and support to the project sponsors. In some cases this MOU will be followed by a loan agreement for UNCDF funding of required technical studies.

Within this context, the objective of this TOR is to provide support to UNCDF in completing the following activities:

- (4) Developing and financing of small scale infrastructure project and
- (5) Capacity-building and knowledge management

3) SCOPE OF WORK

These terms of reference cover some activities and objectives of the LFI Tanzania program with a primary focus on assisting one project sponsor in developing their infrastructure project to the stage of presenting a bank information memorandum to local financial institutions.

These terms of reference are for project finance experts to support both the project sponsors and facilitate the capacity building of the UNCDF staff. It is expected that this will involve both in-country, on-site delivery of services, as well as remote support via internet, Skype and long distance engagement.

A. Developing and financing small scale infrastructure project

LFI Tanzania is assisting a company in the development of a sunflower processing plant. The project sponsor wishes to implement multi-site sunflower processing facilities for the domestic market. LFI-T is working with the project sponsor to prepare the infrastructure project for financing, and the engagement includes review of existing studies, site characteristics, supply chain fundamentals, market assessment, risk assessment and mitigation, and financial analysis of debt and equity requirements and structuring. Included will be recommendations for establishment of a special purpose vehicle and for specific credit enhancements, if needed to secure financing.

The consultant will advise and assist UNCDF and the project sponsor on the review of project development to date in order to establish the specific steps necessary to prepare the project for financing. Specific activities include: application of risk mitigation strategies in the project finance development and structure; development of a project financial model; inputs into the terms of reference of additional studies if required, and review of studies; and development of investment documents necessary for the project to reach financial close. The consultant will also support the process of reviewing and negotiating documents such as term sheets, and equity and shareholder agreements needed to syndicate the financing with a pool of financial institutions/development agencies.

The deliverable of the work is a bank offering memorandum and accompanying documents, including a financial structure to be presented to local financial institutions.

B. Capacity Building and Knowledge Management

It is acknowledged that there is limited experience among the stakeholders on the attributes of project finance for small scale infrastructure projects. The LFI program sets forth the objective to further develop the project finance capabilities within the UNCDF LFI staff and as well as facilitate the understanding of project finance and risk mitigation strategies by local project sponsors, government officials, local financial professionals and other necessary stakeholders.

The consultant will design and implement capacity building and training programmes on project finance methodology (e.g., risk mitigation approaches and structuring alternatives) for LFI stakeholders, including UNCDF LFI staff, project sponsors, government and local financial professionals. The deliverable of this will include toolkits, case studies, briefs, research documents and templates for client impact evaluations.

4) TIMELINE, DURATION OF ASSIGNMENT, DUTY STATION AND EXPECTED PLACES OF TRAVEL

The consultant shall accomplish the below given milestones over the period of 12 months, October 2013-September 2014, through in-country and, if necessary, remote engagement. The consultant is expected to travel to project site locations in Tanzania.

5) FINAL PRODUCTS

All activities/ deliverables listed in these terms of reference should be delivered over the course of the 12-months from the start of the project.

The consultant shall agree/plan with UNCDF LFI-T on project specific deliverables. The deliverables shall include:

- A work plan to reach financial close
- A financial model
- A bank information memorandum
- A project finance road-map reflecting risk mitigation strategies identified through the specific project development process
- The consultant shall design and provide a training plan, including at least 2 workshops, and training materials for UNCDF staff, project sponsors, financial institutions and government officials.
- The consultant shall submit a progress report against plans every month at the end of the month in a format to be provided by UNCDF.

6) PROVISION OF QUALITY, MONITORING AND PROGRESS CONTROLS

Monitoring of progress shall be measured both according to the activities of the consultant as well as the performance of the UNCDF partners.

- The consultant will report to the Chief Technical Advisor (CTA), UNCDF Tanzania.
- The consultant shall submit a timesheet for his/her activities for every fortnight and should mention the deliverables he/she intends to achieve during the period.
- The consultant shall organize a meeting, via Skype or in person, as appropriate, with the CTA on a biweekly basis to brief him on progress.
- The consultant will participate in a monthly conference call with the UNCDF LFI-T team and the project sponsors to discuss progress on project development.

7) STANDARD TRAVEL COSTS AND DAILY SUPPLEMENTAL ALLOWANCE (DSA):

The consultant should specify the expected number and duration of trips to Tanzania over the 12 month period. The cost of international air fare and terminals⁸ shall be included with the bid.

8) QUALIFICATIONS

Senior Finance Experts (at least 2) must be able to provide financial advisory, project development support, credit assessments, and training. One expert should have experience as the Task Manager of such assignments.

Support Services for facilitating **on-line training and knowledge management and facilitating in-country logistics**

Senior experts should possess:

- a minimum of 15 years of experience in project finance (i.e., closing transactions), development of projects for private sector finance, provision of financial advisory services
- Masters of Finance and/or Business Administration
- Experiences with similar assignments in developing countries, including LDCs.

Specific experience should include:

- Development and Execution of Viable Project Finance Transactions
- Credit Assessment Required for Successful Project Development and Finance
- Capacity-Building for Project Finance
- Advisory Services to Developing Country Governments
- Specific knowledge of Tanzania and Uganda

General requirements (competencies)

- Analytical and problem solving skills of a high order, including the ability to formulate recommendations and advice;
- Demonstrated excellent written and oral communication skills in English (a technical writing sample may be requested);
- Promoting ethics and integrity, creating organizational precedents;
- Creating an environment of creativity and innovation;
- Creating and promoting enabling environment for open communication;
- Sharing knowledge and building a culture of knowledge sharing and learning;
- Strong ability to communicate and function effectively in international/multicultural environment;

⁸ Terminals refers to the cost of transport to and from the airport.

- High level planning, organizational and time management skills, including flexibility, attention to detail and the ability to work under pressure to meet changing deadlines;
- Fair and transparent decision-making; calculated risk-taking;
- Anticipates constraints in the delivery of services and identifies solutions or alternatives; and
- Well-developed interpersonal skills

9. Sample Proposal

For the purpose of this proposal, proposers should provide the following:

- **A cost proposal using the format in Section 7: Financial Proposal Format**
- **The staff person(s) and/or consultants to be assigned to this TOR and their role. Staff persons and consultants must be included in this proposal as per Section 6: Technical Proposal Form, Part 3**

SUMMARY

COMPANIES ACT (2002)

(Attachment 1)

By this Act a company can register/deregister (**Sec. 3-44**); a Company limited by shares and a Company limited by guarantee. Public Company/Corporation can be registered under Public Corporation Act, 1992. It stipulates the administration of the registered companies (**SS3-8**).

- Memorandum and Article of association
- General administration of the company
- Winding up of the company (**s157-285**) by court, voluntary or court supervision

This is the most common investment vehicle for private sector investments and joint ventures.

Example #1 – Limited Liability Companies

Vodacom Tanzania Limited is Tanzania's leading cellular network company. Vodacom Tanzania is a subsidiary company of Vodacom Group (Pty) Limited, South Africa which is also a subsidiary of Vodafone Group UK. Vodacom Group (Pty) Limited owns a majority share portion of 65%, with the remaining 35% being owned by Tanzanian shareholder, Mirambo Limited. Each of the shareholder group will look for investment funds from different private sector investors or from their own capital.

PUBLIC PRIVATE PARTNERSHIP (PPP) ACT, 2010 and PPP Regulations (2011)

(Attachment 2)

The Act provides for the institutional framework for the implementation of the public private partnership agreements. It sets out rules, guidelines and procedures for procurement, development and implementation.

Example project #2:

These are example large scale PPP projects involving the private sector and the government. The Kigamboni Bridge which is currently under construction using the PPP format. The bridge is being financed by the National Social Security Fund (NSSF) 60% and Tanzania Roads Agency/Ministry of Works 40% Source:

http://www.tanroads.org/index.php?option=com_content&view=article&id=193:construction-of-kigamboni-bridge-launched&catid=39:tanroads-news

It is believed that other government would not have been involved in this project if private sector investors would have turned out.

Example Project # 3:-Local Government/District and Municipal Councils

Kibaha District Council is implementing a modern bus terminal and a market in partnership with prospective private companies, individuals and development banks i.e. Tanzania Investment

Bank (TIB). This is possible through the mandate provided by the PPP Act, 2010 and Local Government Act, 1982. There will be an SPV set up and owned by both the LGA and a private companies(s) and lenders. The same approach and principles have been deployed by TIB in construction of Himo Market in Moshi-Kilimanjaro

PPP Concept:

PPP entails an arrangement between public sector and private sector entities whereby the private entities renovate, construct, operate, maintain, and/or manage a facility in whole or in part in accordance with output specifications. The private entity assumes the associated risks for a significant period of time and in return, receives benefits/financial remunerations according to agreed terms; which can be in the form of tariffs or user charges. PPP is therefore a cooperative venture built on the expertise of each partner that best meets clearly defined public needs through the most appropriate allocation of resources, risks and rewards.

Responsibilities of the Public party;

Identifying projects carry feasibility studies, monitoring and evaluation, risk sharing, ensuring favourable policies, implementation strategies, legal and institutional framework.

Responsibilities of the Private Sector;

Feasibility studies, resource mobilization, risk sharing, M&E, technical expertise and managerial skills.

NATIONAL SOCIAL SECURITY FUND (NSSF) Act, 1997

(Attachment 3)

Just like NSSF, Tanzania has several agencies which have semi-autonomous power separate from their parental central government ministries. This includes Tanzania Roads Agencies, Tanzania Port Authorities, Tanzania Building Agencies, National Housing Corporations, Tanzania Airports Authorities, Special Economic Zones Authorities and several others. These institutions have separate enactments and legislations which empowers them to enter into different economic ventures through their Boards approvals. The good example is the mushrooming of commercial buildings in Dar es Salaam between National Housing Corporation (NHC) and Private Companies.

Example of NSSF-one of the pension funds in Tanzania is provided below;

Legal Capacity to Invest: NSSF Board is vested with the power to invest in **any viable venture** as it may consider appropriate (ss62). However the Board has to abide to the Social Security Investment guidelines of 2012 issued by the Central Bank of Tanzania.

Example Project #4:

In 2012, NSSF invested in Katani Limited (www.katanitz.com) in exchange for shares in the privately owned limited liability company. This investment was possible because of the powers granted by the Act to the NSSF Board as noted above.

In addition, 'Tanzania's National Social Security Fund plans to pump millions of dollars into key infrastructure projects as it seeks to raise funds to meet growing pension obligations. The

projects include highways, bridges and power generation — to be implemented and managed through special purpose vehicle (SPVs). The fund also plans to assume either full control of the companies it has shares in or will partly own them through joint ventures, as it seeks to enhance members' wealth' Source:

<http://www.theeastafrican.co.ke/business/NSSF+to+invest+in+bridges+power+projects+/-/2560/1368188/-/yrovpw/-/index.html>

LOCAL GOVERNMENT Act, 1982

Background: For more than a decade, even before the enactment of PPP (2010) and the related regulations (2011) local government authorities have been borrowing from the commercial lenders i.e. banks for construction of social amenities like bus terminal and markets. Recently they have expanded the horizon to include special economic zone infrastructures like the one under construction in Kigoma. The facility will include warehouses and other structures that facilitates packaging and processing before selling to the domestic markets or/and neighbouring regional markets i.e. Democratic Republic of Congo, Burundi etc.

The LGA's managed to borrow because of financing guarantee from the Central Government i.e. PMO-RALG and Ministry of Finance. However, the Ministry of Finance has of recent being reluctant to guarantee the LGA's loans because of inability to repay the loans mostly because of poor management of these facilities i.e. financial management. To circumvent the challenges, the PPP structure using Special Purpose Vehicles are now preferred to bring in private sector investors and managers with necessary skills and are profit oriented.

(Attachment 4)

The act allows the Local Government to establish a profitable venture of company or enter into agreement to establish a venture company or SPV under Public-Private Partnership arrangements.

Sect 59-Power to acquire land;

Sect 60- Power to let and mortgage land;

Sect 63-Power to contract;

Sect 66-Power to charge fees.

See the example project # 3 under PPP above.

THE TRUSTEES' INCORPORATION ACT

Background:

Tanzania's legal and regulatory space for establishing not for profit companies is not flexible. The development agencies and social investors have opted to invest their investment vehicles under Trustees Incorporation as it addresses some of ownership (shareholding) and tax issues which are difficult to address under the companies limited by shares and guarantee. Two good examples in private agriculture and microfinance subsectors are The Private Agriculture Sector Support (PASS TRUST) and Financial Sector Deepening Trust (FCDT)

PASS Trust is a facility established in the year 2000 in order to stimulate investments and growth in Agriculture and related sectors. It is registered as a not-for profit and non-

governmental organization under the Trustees Incorporation Act, 2002 and is taxed as a charitable organization

<http://www.pass.ac.tz/>

FSDT

The Financial Sector Deepening Trust (FSDT) is a consortium of five development partners: CIDA, DANIDA, DFID, SIDA, and the Royal Netherlands Embassy. It was registered on 1st July 2004 and officially launched on 11th October 2005. The FSDT was established to channel development partner resources to support the development of pro-poor financial markets in response to the Government's National Microfinance Policy and National Strategy for Growth and Poverty Reduction (NSGPR)

The FSDT is essentially an investment fund of which the overall aim is to achieve greater access for more people to the financial sector in Tanzania. In practice, this means identifying and funding investments and other projects that promote this objective. The FSDT uses range of funding instruments: for weaker clients and other instances where appropriate, it can provide grants; for more established financial institutions, the FSDT opt for loans (senior and subordinated debt), debt-equity hybrids such as convertible debt, preference shares or some combination of these. The FSDT is not able to invest in common shareholders' equity.

<http://www.bot-tz.org/mfi/Library/FSDT.htm>

(Attachment 5)

Trusteeships are formed under this act.

Concept:

A trustee or trustees appointed by a body or association of persons bound together by custom, religion, kinship or nationality, or established for any religious, educational, literary, scientific, social or charitable purpose, and any person or persons holding any property on trust for any religious, educational, literary, scientific, social or charitable purpose, may apply to the Administrator-General for incorporation as a body corporate (ss1).

Trustee upon registration becomes body corporate that enjoys benefits and responsibilities of a body corporate (ss8).

Trustees remain personally liable notwithstanding incorporation (ss13).

In case of two or more trustees, not less than two trustees shall be ordinary resident of Tanzania (ss15).

The registrar general is responsible for overseeing the general conduct of the trustees and has power to revoke or suspend incorporation in some cases (ss24). The aggrieved trust may appeal to the Minister responsible for legal affairs.

OTHER CONSIDERATIONS:

Source of Capital – (a) Equity: - If the vehicle to be deployed will utilize equity investment from private or institutional investors it requires a legal entity that clearly stipulates it in its

principal documents i.e. Memorandum and Articles of Association (MERMATS). This must be a company limited by shares as it is the only one form of legal entity that offers options/flexibility in the ownership, return on equity, transference of ownership, etc. The tax issue depends on the place or location of entity's incorporation.

Source of Capital – (b) Debt: this has two perspectives –The terms and condition of the provider and the recipient's legal capacity to manage debts instrument or raising money through debt. All must be permitted in the company MERMATS or Trust Deed. Under existing legislative environment of Tanzania the company limited by shares and guarantee can borrow money for particular activities provided they are well stipulated in their objective clause (primary and secondary activities). The company is not allowed to operate *ultra vires* i.e. beyond the power conferred to it by the MERMARTS.

Source of Capital - (c) Grant/ Concessional Financing: From Accounting and taxation perspectives the grant can be treated differently depending on the legal status of the recipient company. If the proposed vehicle intends to raise money/grant for on-lending revolving fund or for re-investment/reimbursable grant this will be treated as capital item. If the grant is to be used for overheads it will be treated as recurrent revenue and thus contribute to taxable profit if it is a company limited by shares. If it is a company limited by guarantee, trust or NGO it will be treated as recurrent revenue with no tax implications.

Legal Status of the Company/Promoters or Owners: Once it acquires its legal status the company is viewed separate from the owners. However this legal provision doesn't exclude the real owners or investors from being visible. Which form will the potential investors or promoters prefer? A company limited by shares, guarantee or a trust? A company can be limited by shares but it is still owned by developmental companies. Depending on how the objectives have been stated in the Principal documents (MERMATS) it can request for a tax exemption.

Flexibility for PPP status: It is not crystal clear that PPP Act, 2010 merry very well with Companies' act 2002 or Trust Incorporation act. Generally, the legal entity which is flexible to match PPP requirements is a company limited by shares.

Opportunity to Partner with Pension Funds: Under the Tanzanian laws the legal status which addresses legal requirements to partner with Pension Funds is limited to a company limited by shares.

NATIONAL/LOCAL LEGAL STRUCTURE (TANZANIA)

Legislations	Legal Status	Motive /mandate	Kind of Business/Engagement	Types of Investors	Source of Capital	Taxation/ Profit Repatriation	Liquidation
Companies Act (2002)	Limited (by shares) Liability Company	Business/Profit Driven	Business or commercial vehicle with mandate to generate and appropriate profit (dividend) among the share/equity holders	Allows both individual and institutional investors (Governments, companies, eligible organizations) share/equity holders	Should clearly be stipulated in the company Memorandum and Articles of Incorporation (MERMATS) including legal mandate to raise debt.	The company is subjected to pay 30% corporate taxes on profit. Shareholders/ investors are allowed to repatriate dividend/ interest subject to % withholding tax	Can be voluntary (members) or forced liquidation
	Company Limited by Guarantee	Business/ Developmental or Both (Not suitable for PPP Companies)	Services with business and developmental orientation to ensure long term financial and institutional sustainability upon cessation of grant financing or subsidized/concessional financing	Individual professionals, government projects/ programs, -Normally they are donor driven or expired donor projects transformed into legal entity to preserve assets and staff employment beyond the project/program tenure	Concessional government guaranteed loans, donor funds, commercial loans etc.	Legally they generate profits which are ploughed back into the company i.e. recapitalized and not divided among members/promoters because the company does not have share/equity holders. No tax on profit/corporate tax	Upon liquidation the members or promoters are not entitled to anything on the personal front.
PPP Act	Applicability is limited to a company limited by shares.	Business or/cum development	PPP Company can be involved into productive and non-productive such as agriculture. Infrastructure,	Private (Individuals, institutions, companies) Vs. Public (Government Ministry, Department or agency, local government Authority or any other	Public (Government treasurer, domestic and foreign loans (guaranteed by the government) and developmental	Subjected to 30% corporate tax on profit	Can be voluntary (members) or forced liquidation

			industry and manufacturing, exploration and mining, education, health, ICT, trade and marketing, natural resources and tourism and energy ¹	person acting on behalf of these institutions ²	support (capitalized) Private (Traditional sources i.e. core equity, debt from commercial sources, developmental support (capitalized grants))		
Public Corporation Act, 1992	Limited by Shares but the Government of Tanzania has to own a minimum of 51%	President Can establish a Public Corporation for a particular purpose ³ i.e. Business cum developmental	Utility companies i.e. Electricity and water companies, railways are good examples where government owns 100% of shares	Government and private investors (foreign and domestic investors)	Treasurer/ Ministry of Finance- Shares are owned by the Registrar of Treasurer on behalf of the government		Can be voluntary (members) or forced liquidation
Local Government (Urban Authority) Act, 1982	LGA's can establish a company under PPP arrangement	Profitable venture	When read together with PPP Act the local government can enter into a profitable/ business venture	Local Government and Private Sector	District/Municipal Revenue/ Loan from commercial sources; Private capital	30% Corporate tax on profit	Can be voluntary (members) or forced liquidation
Trustees' Incorporation Act (2002) - Trustees Ordinance (1957)	Trust (i.e. <u>FSDT</u> , <u>PASS</u>), www.utt-tz.org	Business/ Developmental or Both	Mandated to do social intervention or commercial undertaking with business focusses/ Do not have share/equity holders	Developmental entities that deploys businesses to achieve the objectives i.e. Financial Sector Deepening Trust (FSDT), Private Agriculture Sector Support (PASS), Unit Trust of Tanzania (UTT) etc.	Raised by Trustees or development partners (multi-donor) intervention which requires legal vehicle rather than a program with a limited tenure	No Corporate Taxes for the Trust	

¹ PPP Act, 2010 Sect 3

² PPP Act, 2010 Sect 3

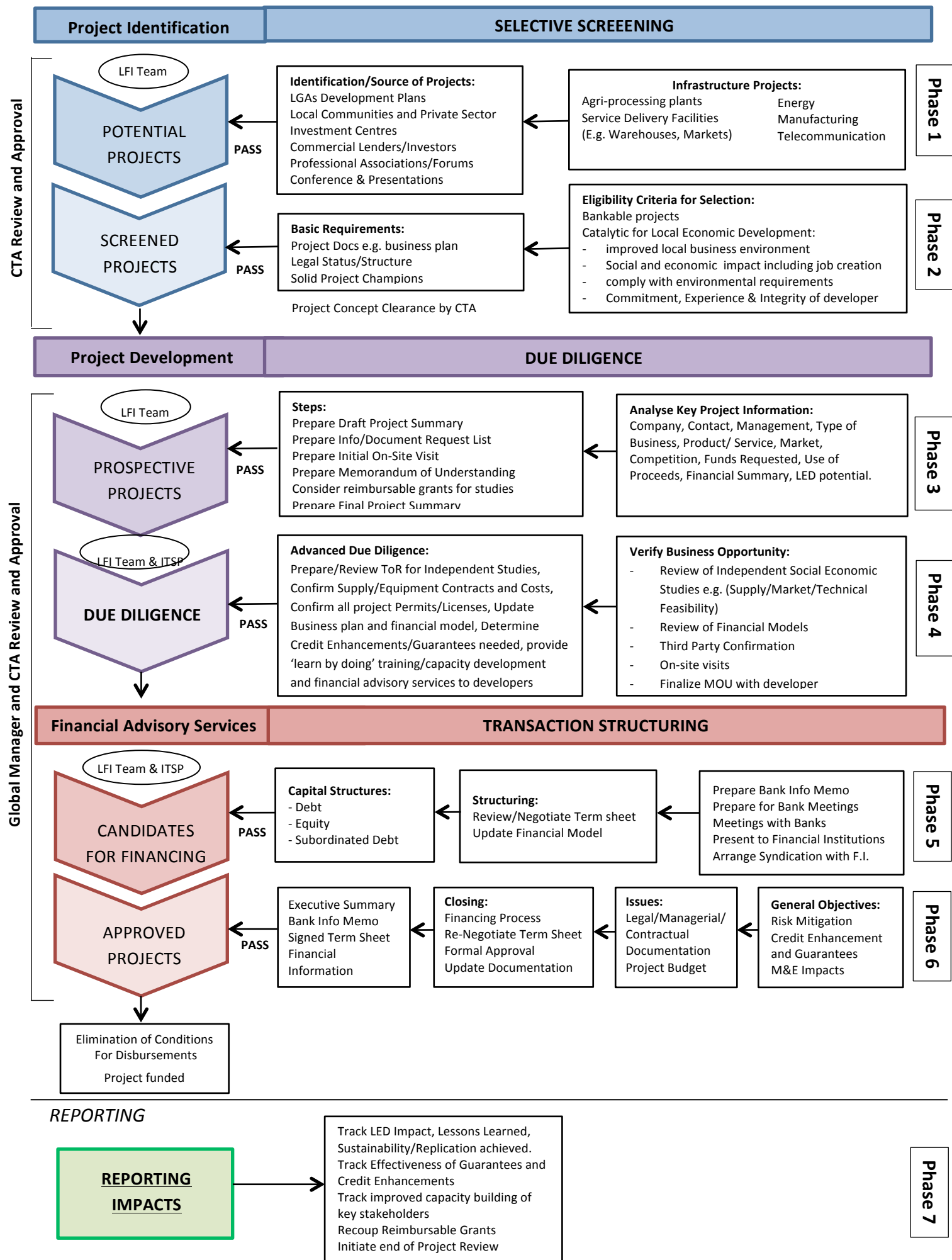
³ Public Corporation Act, 1992, Section 4

Non-Governmental Organizations Act (2002)	Non for Profit NGO	Developmental/ Social	No share capital. Requires “certificate of compliance” to be eligible for carrying out business/ development	Promoters Both Local and Foreigners	No share capital and thus no shareholders	Not taxed	Perpetual life/ Not Liquidated
Cooperative Societies Act (2003)	Cooperatives	Business/ Community Developmental	Profit oriented	Cooperative members – Depending on whether it is primary secondary or apex organization. Foreigners are not allowed to invest in cooperatives	Member-shares, deposit and savings. Coops can also access debt from commercial windows	Taxable	Voluntarily or forced

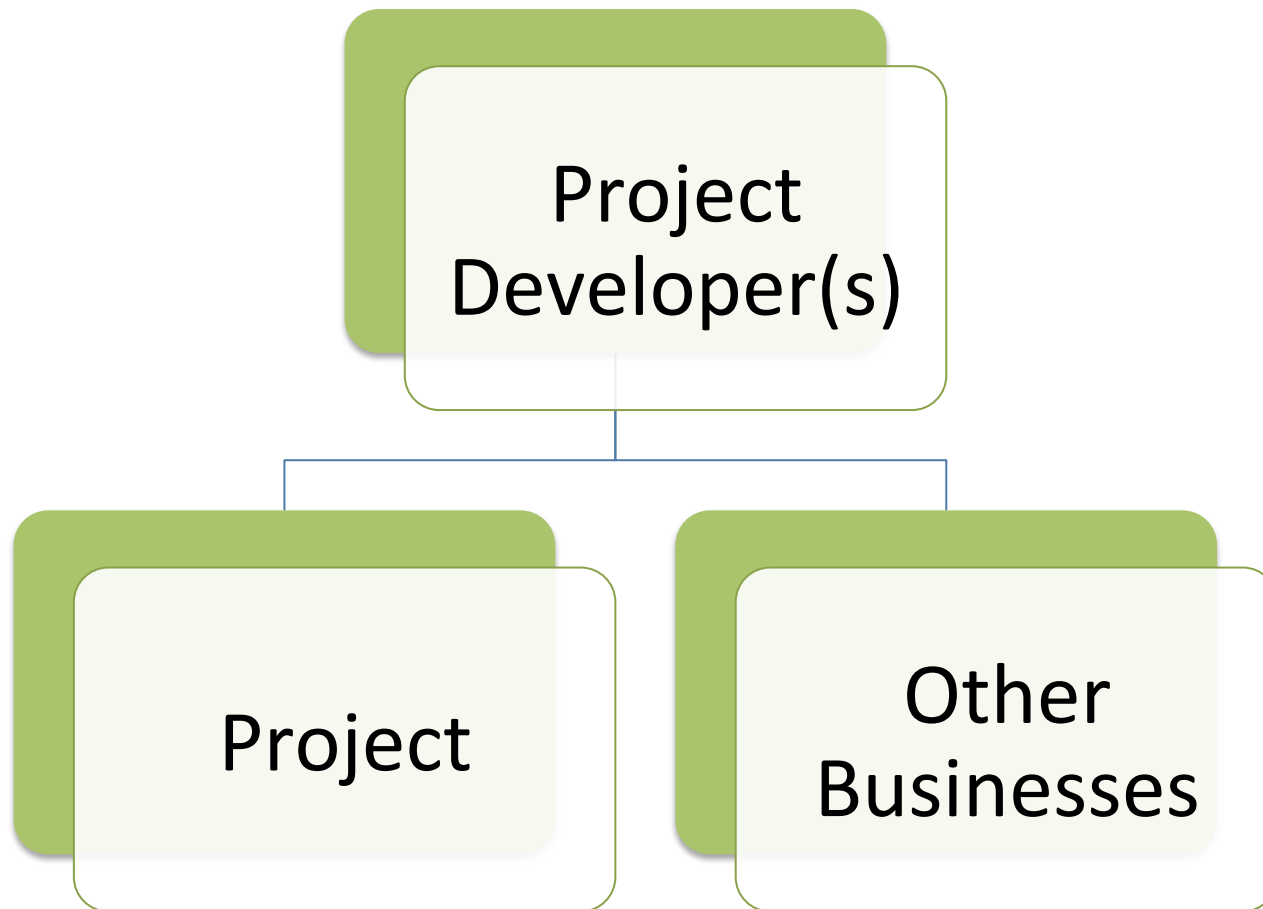
See Attachments, Example Projects and Summary below

LFI Financing Methodology

Process for Identification, Development and Financing of Projects

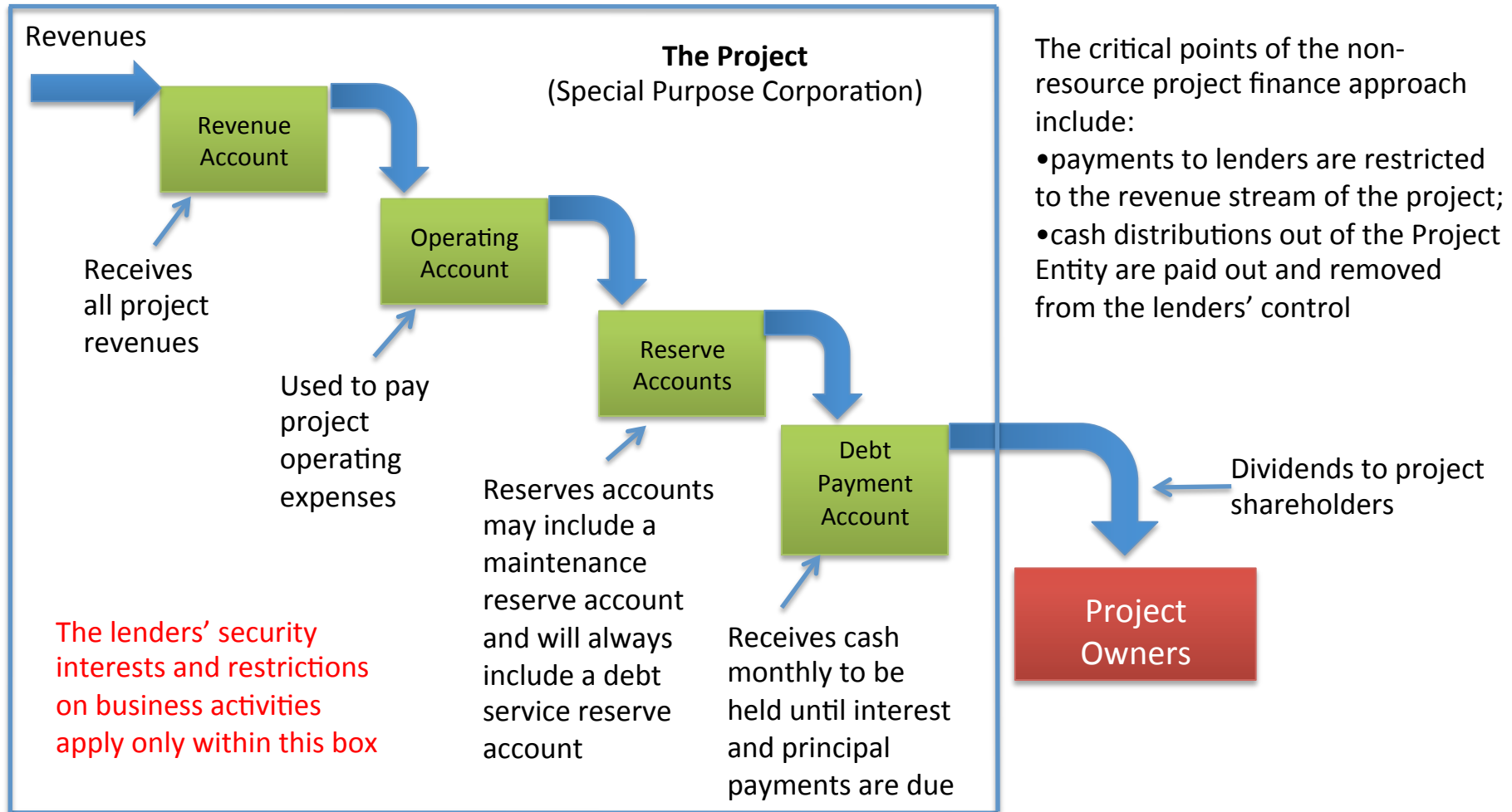


The Special Purpose Corporation



UNCDF Local Finance Initiative

Cashflow Waterfall for the Project



Bangladesh

**Feasibility Study for Development of Municipal Bonds
and Other Approaches to Private Finance
for Local Government Infrastructure**

**Final Report
March 2013**

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Asia Pacific Regional Centre**

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Bangladesh

Feasibility Study for Development of Municipal Bonds and Other Approaches to Private Finance for Local Government Infrastructure

TABLE OF CONTENTS

EXECUTIVE SUMMARY

ACRONYMS

I. INTRODUCTION	1
II. BASIC INFORMATION ON THE FEASIBILITY STUDY	3
A. GOALS OF THE FEASIBILITY STUDY	3
B. APPROACH ADOPTED.....	4
III. BACKGROUND ON MUNICIPAL DEBT MARKET DEVELOPMENT.....	5
A. ESSENTIAL ELEMENTS FOR ENABLING PRIVATE FINANCE OF URBAN INFRASTRUCTURE	5
B. MODALITIES FOR ACCESSING PRIVATE FINANCING	8
IV. THE POLICY, INSTITUTIONAL, AND LEGAL FRAMEWORK FOR LOCAL GOVERNMENT FINANCE..	9
A. POLICY AND INSTITUTIONAL ISSUES	9
1. Organization of the local state	9
2. Functional decentralization	10
3. Fiscal decentralization	11
4. Policy reforms in process.....	12
B. GOVERNANCE ISSUES	13
1. Accounting and auditing in local governments.....	13
2. Elections and transparency in local government.....	15
C. LEGAL FRAMEWORK GOVERNING LOCAL GOVERNMENT AND MUNICIPAL FINANCE.....	15
1. Basic legal concerns	15
2. Constitutional framework.....	16
3. Statutory framework governing urban local government	16
4. Legal framework governing finances of local government	18
D. CONCLUSIONS RELATED TO THE POLICY, INSTITUTIONAL, AND LEGAL FRAMEWORK	19
V. THE DEMAND FOR AND SUPPLY OF MUNICIPAL FINANCING.....	21
A. DEMAND: POTENTIAL USERS OF BOND FINANCING	21
1. Current system for funding of public capital investment projects	21
2. Indicative financing needs of potential borrowers	22
3. Emerging sectors of local finance	28
4. Conclusions Related to the Demand for Private Finance	30
B. SUPPLY: CAPITAL AND FINANCIAL MARKET OVERVIEW	32
1. The financial system of Bangladesh	32
2. State of the capital market.....	32
3. Other sources of financing	38

C.	POTENTIAL INVESTORS IN MUNICIPAL BONDS.....	39
1.	Insurance companies.....	40
2.	Pension funds.....	41
3.	Mutual funds.....	43
4.	Banks and NBFIs.....	44
5.	Donors supporting ULBs.....	45
D.	CONCLUSIONS RELATED TO THE SUPPLY OF PRIVATE FINANCE	45
VI.	PROSPECTS FOR MUNICIPAL BOND MARKET DEVELOPMENT	47
A.	STAKEHOLDER INPUT	47
B.	CONCLUSIONS REGARDING OPPORTUNITIES PRESENT AND RISKS TO BE ADDRESSED	48
VII.	OVERALL FINDINGS AND RECOMMENDATIONS	53
A.	RECOMMENDED ACTIONS FOR GOVERNMENT	53
1.	Policy and legal framework (Elements #1 and #4)	53
2.	ULB capacity and bankable project/plan development (Elements #2 and #3).....	54
3.	Market capacity and investor interest (Elements #5 and #6)	55
B.	PRIORITY ACTIONS TO BE TAKEN	56
C.	SPECIFIC AREAS FOR UNCDF ASSISTANCE	57
VIII.	ANNEXES	59
1.	Local government revenues and expenses by level of government	
2.	Sreepur Pourashava PDP capital investment plan	
3.	Bangladesh Climate Change Strategy and Action Plan (BCCSAP) themes and programs	
4.	List of Stakeholders Interviewed	
5.	Pilot Project Work Plan and Schedule of Key Activities	

EXECUTIVE SUMMARY

Countries worldwide are involved in a global experiment to encourage local governments to communicate with and mobilize citizens, plan with them for the future, organize their territory, and deliver needed services. Mobilizing resources to finance investments and improved services is one of the most challenging aspects of this institutional change, and climate change adds pressure as it increases investment requirements at the local level.

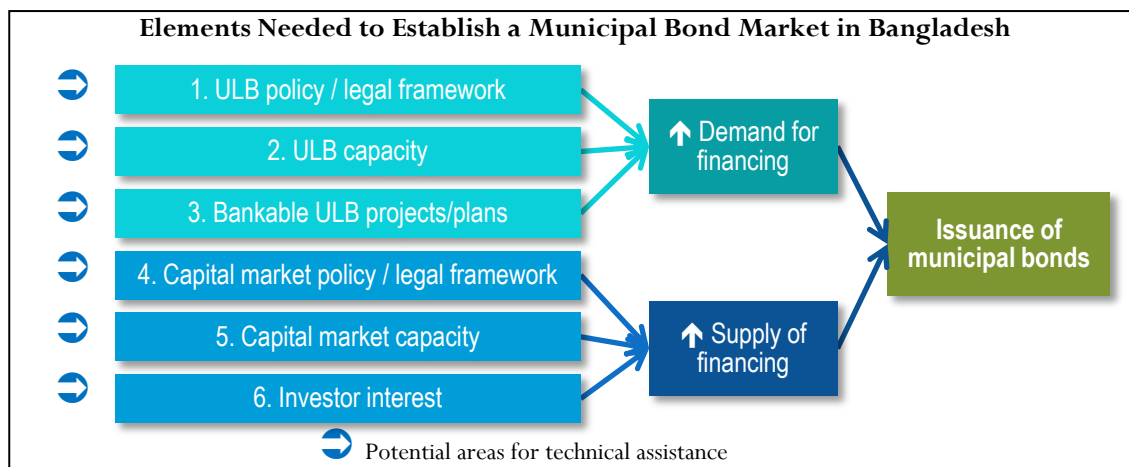
This feasibility study is meant to provide the Government of Bangladesh (GOB) with a framework for evaluating options for increasing private financing of local infrastructure, including infrastructure that contributes to local climate adaptation, mitigation, and economic development. It is based on the premise that government and donor grant funding will not be adequate to address all these investment needs in the future, and proposes that there are actions the GOB can take to mobilize the private capital market to provide some of the needed financing.

The study is being supported by the United Nations Capital Development Fund (UNCDF) Asia-Pacific Regional Centre (APRC) under its mandate to assist developing countries supplement their existing financing sources for economic development in ways that are socially and environmentally sustainable; and in the context of a new project initiative called LoCAL (Local Climate Adaptive Living). UNCDF views climate change mitigation and adaptation and economic development not as competing goals, but as goals that are mutually reinforcing.

Background

Private involvement enables greater capital, management expertise, and technology to flow into the design, implementation, and operation and maintenance of local infrastructure and infrastructure-related services. Because market financing is most feasible in an urban context, the focus of the study is on City Corporations and municipalities (Pourashavas) (collectively, the urban local bodies or ULBs), and certain autonomous entities.

The study analyzes both the issuer or "demand side" of the municipal finance market, and the market or "supply side." The necessary elements for an efficient market are shown in the graphic below and explained in the study. On the demand side, these elements are: (1) ULB policies, (2) ULB capacities, and (3) a pipeline of bankable projects or capital plans. On the supply side, they are (4) market policies, (5) market capacities, and (6) investor interest.



Five modalities for raising private finance are considered here. They include: (i) general obligation bonds, (ii) revenue bonds, (iii) project finance, (iv) pooled financing, and (v) bank loans. Any of these approaches can use a mix of public and private financing. While banks can potentially play a number of roles from structuring transactions to investing in project structures, banks in Bangladesh are not yet motivated to serve this market.

There are common conditions that are necessary to encourage private involvement by means of any of the modalities named above. These conditions are related to: (i) the state of the capital markets and investor demand, (ii) conditions in the local sector and the local entities themselves, and (iii) the financial transactions in which the investor and the local entity are involved. The following is a list of the necessary conditions.

Necessary conditions for private finance

Demand (issuer) side

1. ULB policy/legal framework

- a. Policy framework that encourages ULBs and other local entities to raise private finance.
- b. Legal framework that provides the fiscal and legal means to mobilize private funds.
- c. Certainty and continuity of the legal framework.
- d. Standards for the preparation and reporting of financial information.

2. ULB (local entity) capacity

- a. Capacity to provide accurate information about themselves and their transactions.
- b. Capacity to identify bankable projects.
- c. Capacity to provide a strong repayment stream and local willingness to pay.
- d. Capacity to manage the financed projects during the life of the bond issue or financing.

3. Bankable ULB projects/plans

- a. Availability of bankable local infrastructure projects or capital investment plans.
- b. Sufficient volume of financial transactions.
- c. Presence of enforceable tariff or taxation mechanisms.
- d. Other means to mitigate risk of transactions.

Supply (market) side

4. Capital market policy/legal framework

- a. Policy framework that encourages market actors to address the financing needs of ULBs and other local entities.
- b. Legal framework that allows private investors to invest in ULBs' or other local entities' projects.
- c. Bankable risk distribution.
- d. Certainty and continuity of legal framework.

5. Capital market capacity

- a. Ability to support the development of bankable local infrastructure projects.
- b. Presence of capable intermediaries and trustees.
- c. Existence of a yield curve.
- d. Presence of a secondary market or market makers.
- e. Volume of standardized transactions.

6. Investor interest

- a. Investor familiarity with the local sector.
 - b. Financial return commensurate with risk.
 - c. Means to evaluate risk.
 - d. Volume of investable funds available.
 - e. Acceptable level of political risk.
-

[For more information on the topics in this section, please refer to Section II, *Basic Information on the Feasibility Study* (page 3) and Section III, *Background on Municipal Debt Market Development* (page 5) in the feasibility report.]

Policy, Institutional, and Legal Framework

Bangladesh has a unitary form of government, so all local governments are administrative units created by Parliament. There is a concentration of power in the central government, and successive changes in local government structure, roles, and responsibilities have affected their capacity for service delivery.¹

The 2009 laws allow ULBs to provide services in many sectors, but they are handicapped by having limited resources. Even where functions are legally assigned to local bodies, they may be carried out by deconcentrated national agencies, which are better-funded, leaving local governments to serve at times more as supervisors than as providers of services.² The culture of payment for services is weak and ULBs are reticent to collect taxes.

An urban policy that addresses both fiscal and functional decentralization is needed, in order to improve efficiency, motivate local actors, and reduce duplication of governmental responsibilities. Otherwise, local infrastructure projects are less likely to be developed, and private finance will be more difficult to raise.

A legal framework that reflects development policy, grants enforceable rights to private investors, and ensures the smooth functioning of markets is also required for market-based financing. The current legal framework of City Corporations and Municipalities is not adequate for either municipal bonds or other forms of private finance.³

Some of the other policy, institutional, and legal issues that would need to be addressed before private finance for local infrastructure will be readily available are the following.

- Frequent changes in the policy and legal framework governing ULBs create legal and political risks for investors. Autonomous entities such as urban development authorities (UDAs) have a more stable legal and policy regime, and, if financially sound, could be better candidates for bond issuance or other forms of private finance.
- Public-private partnerships (PPPs) could be useful for encouraging private investment in local public services, but assistance will be needed to evaluate project opportunities at the local government level.
- Government powers in the present legal framework to suspend and override ULBs create risks for potential investors.
- While the legal framework related to ULB finances is in place, revenue collection is minimal, which will discourage private investment. Even urban development authorities have limited revenue collection. Reforms that incentivize local revenue mobilization have been decisive in other countries to improving this situation.
- Approval of the draft National Urban Sector Policy (NUSP), being promoted by the Ministry of Local Government, Rural Development, and Cooperatives (MLGRDC), will send a signal to stakeholders about GOB's decentralization intentions. Once approved, an implementation plan and communication within government will be important.
- Updating of local government accounting and auditing standards, and improvement of financial reporting, would have a high impact on municipal financial market development. The Office of the Comptroller General of Accounts (OCAG) and the Comptroller and Auditor General (CAG), should work with the Institute of Chartered Accountants of Bangladesh (ICAB) to establish a program of reform in this area.
- A number of legal and administrative reforms are necessary, such as updating Bangladesh Bank (BB) procedures to allow the sale of municipal bonds; new rules for escrow accounts; and an increase beyond 12 months of the maximum term for local government borrowing.

¹ World Bank, 2011, Second Local Governance Support Project, Project Appraisal Document, p. 80.
<http://documents.worldbank.org/curated/en/2011/10/15528441/bangladesh-second-local-governance-support-project>.

² World Bank, 2011, Second Local Governance Support Project, Project Appraisal Document, p. 11.
<http://documents.worldbank.org/curated/en/2011/10/15528441/bangladesh-second-local-governance-support-project>.

³ Legal issues related to capital markets regulations are discussed in Section IV.C.

[For more information on the topics in this section, please refer to Section IV, *The Policy, Institutional, and Legal Framework for Local Government Finance* (page 9) in the feasibility report.]

The Demand for Municipal Financing

Development of a private financing system for ULBs depends on having a pipeline of projects to finance. Bangladesh's constitutional system does not preclude local governments mobilizing private financing; but a fiscal decentralization policy would encourage this to happen. The proposed NUSP would be the basis for developing practical guidelines for functional and fiscal decentralization, including market finance.

The study discusses potential demand for financing by looking at (i) planned, ongoing, and completed capital projects and (ii) past borrowing and the demand for future borrowing by analyzing commercial bank and Bangladesh Municipal Development Fund (BMDF) borrowing, and capital plans of the Sreepur Pourashava, the Chittagong Development Authority (CDA) and the Khulna Development Authority (KDA), the Bangladesh Bridge Authority (BBA), and the Dhaka Water and Sewerage Authority (WASA).

Conclusions related to the demand for financing include the following.

- There is a strong need for local infrastructure finance in Bangladesh, including for investments related to climate change adaptation. Demand could come from ULBs, urban development authorities, or other autonomous entities. If financing could be raised, it could be used to finance specific projects or broader investment plans. Defining acceptable financing terms and developing regulations will be necessary.
- An increasing number of municipalities are preparing investment plans and more should do so, since this allows demand to be estimated. However, there is a lack of understanding of the costs and benefits of market-based financing, and of the procedures and requirements, especially with respect to municipal bonds.
- The Annual Development Programme (ADP) system creates a financing bottleneck that can delay infrastructure projects for years, and causes projects to compete for funding on non-economic criteria. In a market-based system, investors help decide whether the project has economic worth. There could be significant economic benefits for the country from having a market financing option for local governments and autonomous entities.
- Due to its established practices and its knowledge of the ULBs, the BMDF could be a good candidate to provide market access for ULBs, for instance, by using a pooled financing or other intermediary arrangement. The GOB should analyze the BMDF's potential for accessing the financial markets, and identify forms of support for accomplishing this, such as technical assistance, recapitalization, and credit enhancements.
- Autonomous and semi-autonomous entities could be good candidates for market financing, due to their autonomy and fiscal powers, if they were managed with this objective in mind. The feasibility of using the market to finance the four urban development authorities should be analyzed in more detail, paying particular attention to their financial structure and the profitability of individual projects.
- Certain climate change adaptation or sustainable cities projects may be financeable with market finance or through PPPs. The GOB should consider initiating a project aimed specifically at identifying adaptation projects suitable for private finance.
- Because most ULB capital projects are grant-financed, there is little attention to revenue generation. Developing market financing means articulating a fiscal decentralization policy that encourages tax mobilization, cost recovery, and financial strengthening, and uses grants as incentives or for socially-oriented projects. Even without approval of the NUSP, ULB credit financing rules should be developed.
- Capacity is needed in central and local government to help strengthen the demand in the municipal finance market. Skills needed include: capital planning, project identification and preparation, municipal financial administration, and community mobilization, as well as training on the functioning of the financial markets.

[For more information on the topics in this section, please refer to Section V, *The Demand for and Supply of Municipal Financing* (page 21) in the feasibility report.]

Supply: Capital and Financial Market Overview

Bangladesh has made great progress in capital and financial markets development in the last decade. According to measures such as the number of securities listed, transaction volume, and total market capitalization, market development is accelerating. But bond issues are rare, and are generally undertaken on a private placement basis.

Both debt and equity can be traded on the stock exchanges. The debt market consists largely of government debt which pays relatively high interest rates, including treasury bills and bonds and national saving certificates. Significant demand for treasury securities comes from institutions satisfying statutory liquidity requirements. Some conclusions regarding the supply of financing in the capital and financial markets follow below.

- Reforms taking place in the capital markets should contemplate the future issuance of municipal bonds, for instance, revisions to private placement and public issue rules to allow their application to municipal bonds.
- There is a lack of trust in the stock exchange, where bonds would be issued and traded. The recent introduction of the Trader Work Station (TWS) for online secondary trading of future government treasury bonds is an important step. If other reforms are carried out, investor confidence should increase over time.
- Blending debt and grant funds will allow the effective interest rates to be lowered for municipal projects. Grant funds in the sector would have to be reprogrammed to be used in this way.
- Intermediaries are unfamiliar with municipal bonds, and would have to be educated. Credit rating agencies can play a vital role in the development of a municipal bond market, including developing ratings criteria and carrying out early evaluations of local government finances.
- In the short run, pilot municipal bond issues could be floated with support from donors and the GOB. These pilots should be accompanied by technical assistance to support development of systems and procedures.
- Donor grants shouldn't compete with market financing when the latter is more appropriate. Otherwise, there will be no economic incentive for market financing, as donor funding will always be cheaper.
- Potential investors in bonds include: (i) insurance companies; (ii) pensions funds (although the largest pension fund, the Government Pension Scheme (GPS), is largely unfunded); (iii) mutual funds; and (iv) banks, including banks which conform to Islamic principles. It will be necessary to consult with investors, and to familiarize them with the sector. Reforms taking place in the insurance industry, and expansion in both the pension fund and mutual fund industries, make these sectors important stakeholders for development of the municipal bond market, but reforms are needed here.

[For more information on the topics in this section, please refer to Section V, *The Demand for and Supply of Municipal Financing* (page 21) in the feasibility report.]

Stakeholder Input

During the UNCDF missions, meetings were held with parties who were considered stakeholders in the process of creating a private finance system for local infrastructure. These include public agencies, including local governments; donors; and entities that operate in the financial markets, including investors and rating agencies.

Many stakeholders seemed genuinely interested in the effort to identify new financing options. However, they were also frank about the potential difficulties. The most commonly-mentioned concerns were the following: (i) lack of trust in institutions affects everything from the development of the bond markets to citizen support for local government projects; (ii) the basic concepts of debt financing are not widely understood, so training and technical assistance will be needed; (iii) unwillingness to pay for services creates a need for subsidies, which often produce distortions in prices and therefore demand; (iv) the willingness to endure long waits for grant funding for

public infrastructure doesn't take into consideration the opportunity cost of delays; and (v) the GOB should make it illegal to repudiate the debt obligations of prior municipal administrations.

Recommended Actions and Priority Actions for Government

Introducing a sustainable system for the issuance of municipal bonds in Bangladesh will take a number of years, even with the enthusiastic support of all stakeholders. But it is possible to accelerate this process. The study recommends a series of actions that the GOB could take to facilitate the development of the private municipal finance market along two lines of action: (i) design and approve a Pilot Project that would terminate in the issuance of one or more pilot bond issues, and (ii) provide technical assistance to help implement the actions recommended below, in order to implement the Pilot Project and to develop the broader market.

Technical assistance is needed on several fronts: (i) policy, (ii) municipal/local agencies, (iii) market participants, and (iv) investors. A number of the important reforms (such as those to make the capital markets more transparent, efficient, and competitive) are already underway and can be supported indirectly. Please see Section VII. *Overall Findings and Recommendations* (page 53) for the full set of recommendations. Only the priority actions from these recommendations are shown below.

- Create a MLGRDC-led government Working Group to coordinate the municipal finance Pilot Project, with UNCDF support.
- Prepare and approve the project documentation for the Pilot Project.
- Develop guidelines and rules for municipal credit, which support the Pilot Project.
- Develop eligibility criteria for ULB and other local entity participation in the Pilot Project, disseminate this information, and select ULBs and other entities to participate.
- Assist Pilot ULBs to develop Capital Improvement Plans (CIPs), to carry out Debt Capacity Analysis (DCAs), and to strengthen revenues.
- Work with the BMDF to identify the regulatory and programmatic reforms that would allow it to become an intermediary for municipal credit. Mobilize funds for technical assistance and BMDF recapitalization.
- Define new municipal accounting and auditing norms based on international standards and implement them in the Pilot ULBs.
- Work with key private sector actors to establish a Task Force to coordinate private sector involvement in promoting market reforms required for the Pilot Project.
- Identify and implement the most critical legal and administrative reforms in the ULBs and the capital markets, which could otherwise undermine the success of the Pilot Project.
- Organize study tours for the Working Group and the Task Force on municipal finance in the Philippines, China, Vietnam, and/or Indonesia.

Specific Areas for UNCDF Assistance

UNCDF continues to facilitate access to funding for capital investment, but strives to develop new, sustainable locally-based systems and corresponding financing means. The specific ways in which UNCDF can facilitate implementation of the recommended and priority activities will be defined in consultation with the GOB.

UNCDF can provide support to the two recommended lines of action: (i) development of the Pilot Projects and technical assistance to various institutions to carry out some of the recommended actions listed above. In the short run, UNCDF is particularly interested in helping MLGRDC organize meetings with the private sector, ULBs, and other local entities to present the findings of the feasibility study. Based on the results of those meetings, UNCDF proposes to define next steps for UNCDF support with MLGRDC.

ACRONYMS

ADP	Annual Development Programme
AMC	Asset Management Company
APRC	Asia-Pacific Regional Centre
APUF-5	Asia-Pacific Urban Forum
BAS	Bangladesh Accounting Standards
BB	Bangladesh Bank
BBA	Bangladesh Bridge Authority
BCCRF	Bangladesh Climate Change Resilience Fund
BCCSAP	Bangladesh Climate Change Strategy and Action Plan
BCCTF	Bangladesh Climate Change Trust Fund
BDT	Bangladesh Taka
BFRS	Bangladesh Financial Reporting Standards
BIA	Bangladesh Insurance Association
BMDf	Bangladesh Municipal Development Fund
BPC	Bangladesh Planning Commission
BSA	Bangladesh Standards of Auditing
BUF	Bangladesh Urban Forum
CAG	Comptroller and Auditor General
CDA	Chittagong Development Authority
CDBL	Central Depository Bangladesh Ltd
CDM	Clean Development Mechanism
CEO	Chief Executive Officer
CIP	Capital Investment Plan
CMDP	Capital Market Development Program
CRAB	Credit Rating Agency of Bangladesh Ltd
CRC	Credit rating company
CRISL	Credit Rating Information and Services Ltd
CSE	Chittagong Stock Exchange
DCA	Debt Capacity Analysis
DANIDA	Danish International Development Agency
DSE	Dhaka Stock Exchange
DWASA	Dhaka Water Supply and Sewerage Authority
ESCAP	UN Economic and Social Commission for Asia and the Pacific
FCB	Foreign Commercial Bank
GDP	Gross Domestic Product
GHG	Greenhouse gas
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GO	General Obligation
GOB	Government of Bangladesh
GPS	Government Pension Scheme
IASB	International Accounting Standards Board
ICAB	Institute of Chartered Accountants of Bangladesh
ICB	Investment Corporation of Bangladesh
IDA	International Development Association
IDRA	Insurance Development and Regulatory Authority of Bangladesh
IFAC	International Federation of Accountants
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial Public Offering
IPSAS	International Public Sector Accounting Standards
JICA	Japanese International Cooperation Agency

KDA	Khulna Development Authority
KfW	Kreditanstalt für Wiederaufbau (German Reconstruction Credit Institute)
LGD	Local Government Division
LGED	Local Government Engineering Division
LoCAL	Local Climate Adaptive Living
LRAD	Local and Revenue Audit Directorate
MDP	Municipal Development Plan
MFIs	Microfinance Institutions
MIDP	Municipal Infrastructure Development Plan
MLGRDC	Ministry of Local Government, Rural Development and Cooperatives
MOU	Memorandum of Understanding
MSP	Municipal Services Project
NAPA	National Adaptation Programme of Action
NBFI	Non-bank financial institutions
NGO	Non-governmental organizations
NSS	National Savings Scheme Certificates
NUSP	National Urban Sector Policy
OCAG	Office of the Comptroller General of Accounts
O&M	Operations and maintenance
PAYG	Pay as you go
PBCRG	Performance-Based Climate Resilience Grant
PCB	Private Commercial Bank
PDP	Pourashava Development Plan
PFM	Public Financial Management
PIR	Public Issue Rules
PMBP	Padma Multipurpose Bridge Project
PMF	Public Financial Management
PPCR	Pilot Program for Climate Resilience
PPDR	Private Placement of Debt Rules
PPP	Public-Private Partnerships
PSIG	Private Sector Infrastructure Guidelines
PUDP	Participatory Urban Development Program
RAJUK	Rajdhani Unnayan Kartipakkha
RDA	Rajshahi Development Authority
RPO	Repeat public offering
SEC	Securities and Exchange Commission
SLR	Statutory Liquidity Reserve
SPV	Special Purpose Vehicle
STIFPP-2	Second Secondary Towns Integrated Flood Protection Program
TWS	Trader Work Station
UDA	Urban Development Authority
UGIIP-2	Second Urban Governance and Infrastructure Improvement (Sector) Project
ULB	Urban Local Body
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Program
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UP	Union Parishads
USAID	U.S. Agency for International Development
UZP	Upazila Parishad
WASA	Water and Sewer Authority
WTTENEI	Welfare Trust for Teachers and Employees of Non-Government Educational Institutions
ZP	Zila Parishads

I. Introduction

As national populations grow and urbanization increases, citizens demand safer, healthier living conditions, and an economic environment where they can prosper and to contribute to the greater development of the country. To respond to these demands, countries are involved in a global experiment to design the tools that will allow local governments to communicate with and mobilize citizens, plan with them for the future, organize their physical territory, and deliver needed services.

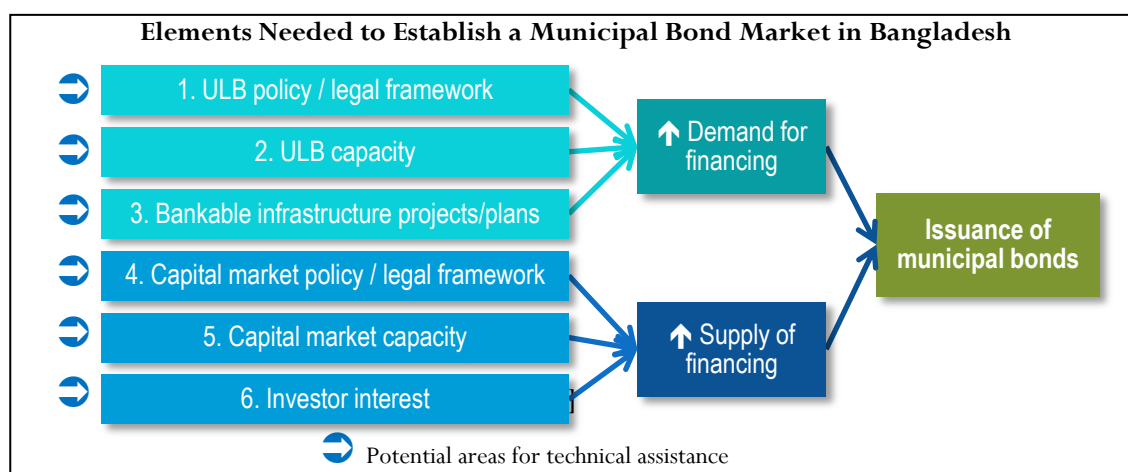
Perhaps no aspect of this capacity-building process is more challenging than the need to mobilize resources to finance the investments and improved services that citizens increasingly expect. Climate change only adds pressure to solve the financial puzzle, as it increases investment requirements at the local level.

This feasibility study is meant to provide the Government of Bangladesh (GOB) with a framework for evaluating options for increasing the funding of investment in local infrastructure, particularly municipal or urban infrastructure that contributes to local climate adaptation and economic development, using capital market instruments such as municipal bonds. The study is based on the premise that over time the capital market will have a crucial role to play in providing the financing necessary for local development in Bangladesh, and that building the "pathway to the market" for local government could begin right away.

Because market financing is most feasible in an urban context, where the demands for infrastructure are greater, economic return is higher, and there are economies of scale, the most likely beneficiaries of the activities discussed in this study are City Corporations, municipalities (Pourashavas), and certain autonomous entities located in urbanized areas. These three classes of entities are therefore the focus of the study, and when City Corporations and municipalities are discussed, they are collectively referred to as urban local bodies (ULB).

The study uses municipal bonds as a municipal financing "benchmark," and uses "municipal" synonymously with "urban local government." A financial system in which municipal bonds could be issued would also likely support a range of other market-based municipal financing approaches. In fact, these other approaches (such as pooled financing or public-private partnerships) could be implemented more easily, and before reaching the bond benchmark. Therefore, when municipal bonds are being discussed, these other options are included by inference.

The study analyzes both the issuer or "demand side" of the municipal finance market--that is, the demand for financial resources by ULBs and other local entities, and the market or "supply side" of the market--that is, the market capacity to channel funds to transactions, and the willingness of potential investors to invest. For each, there are necessary elements, as shown in the graphic below. These elements are used to organize the study's recommendations (Section VI), and could be used to organize the needed technical interventions as well. On the demand side, these elements are: (1) ULB policies, (2) ULB capacities, and (3) a pipeline of bankable projects or investment plans. On the supply side, these elements are (4) market policies, (5) market capacities, and (6) investor interest.



II. Basic Information on the Feasibility Study

A. Goals of the feasibility study

The objective of this feasibility study is to support the Government of Bangladesh and the United Nations Capital Development Fund (UNCDF) Asia-Pacific Regional Centre (APRC) in the formulation of a proposal for the development of private financing mechanisms for urban local government infrastructure in Bangladesh. The particular focus is on the development of a municipal bond market, as an instrument for funding of capital expenditures related to climate change adaptation.

The UN General Assembly (1966) gave UNCDF the mandate to “assist developing countries in the development of their economies by supplementing existing sources of capital assistance by means of grants and loans.” The mandate was modified in 1974 to focus, first and foremost, on the least developed countries.

The original mandate—to promote economic development in the least developed countries—remains highly relevant today. Economic growth is necessary to enhance living standards, reduce poverty, and cope with the world’s growing population. And this growth must be socially and environmentally sustainable to deliver maximum benefits for current and future generations.

Within its economic development mandate, UNCDF focuses on public and private financing mechanisms. Effective and efficient finance in both the public and private sectors can spur economic growth and make it more sustainable and inclusive. UNCDF’s focus on financing mechanisms has special relevance for the least developed countries, where public financial management is often weak and private financial systems often underdeveloped and inaccessible to poor people.

UNCDF APRC in Bangkok is currently implementing a new project initiative called LoCAL (Local Climate Adaptive Living), a facility which channels global adaptation finance to local governments—who are on the front line of the effects of climate change—and enables them to invest in building local resilience. LoCAL connects to existing national intergovernmental fiscal transfer systems and supplements capital grants to local governments with performance-based climate adaptation funding. This innovative mechanism is based on the Performance-Based Climate Resilience Grant (PBCRG), and provides a fast and effective means to channel adaptation finance to where it is most needed, while at the same time ensuring ownership, accountability, and results. The methodology used is derived from UNCDF’s experience in setting up systems for effective capital investments and capacity building in sub-national governments.

The goal of UNCDF APRC in Bangladesh is to address the significant capital expenditure financing needs of local governments and the need to expand livelihoods in local communities by finding a suitable financing vehicle that can help jumpstart development and be used with the full support of stakeholders. In this regard, private market-based municipal financing could be an avenue to address the financing challenges faced by both the GOB and municipal and city governments, and could provide a complementary and alternative source of public investment funding by engaging existing donor partners as well as domestic capital and new private sector investors.

The GOB has recognized that “climate change policy, particularly adaptation, becomes a part and parcel of the development policies of the country.”¹ Climate change mitigation and adaptation and the promotion of economic development are not competing goals, but are in fact mutually reinforcing, and can be pursued simultaneously. This study is meant to offer approaches to increase the financing options for local governments that both promote local economic development and local adaptation to the impacts of climate change.

¹ Government of the People’s Republic of Bangladesh, 2005, Ministry of Environment and Forest, 2005, National Adaptation Programme of Action (NAPA), Final Report.

B. Approach adopted

The feasibility study was developed based on interviews conducted during two missions in Bangladesh in September 2012 and January 2013, and subsequent communications with interviewees. Interviews were held with government officials, and representatives of the private sector, the donor community, and international organizations. These interviews are summarized in Section VI.A, *Stakeholder input* (page 47). Research was also conducted using government documents, technical studies, other written materials, and international development databases.

This report was circulated for comment in draft form to key stakeholders. Comments received were incorporated, and additional comments are still welcomed by UNCDF.

The report has been prepared under the supervision of Christopher Kaczmarek (UNCDF APRC), by a team composed of Jesmul Hasan (UNCDF Bangladesh), Daniel Yang (UNCDF APRC), Priscilla Phelps (TCG International, Washington DC), Piyush Joshi (Clarus Law Associates, New Delhi), and Reajul Hasan Shohag (Dhaka).

III. Background on Municipal Debt Market Development

A. Essential elements for enabling private finance of urban infrastructure

The principal purpose of seeking private involvement in the development of local infrastructure is to enable a greater flow of capital, management expertise, and technology required for the design, implementation, and operation and maintenance of infrastructure-related services.

The conditions necessary to enable private involvement in urban infrastructure, and particularly to enable the issuance of municipal bonds, are related to the state of the capital markets and market demand, the issuer (a ULB or other local entity), and the transactions in which they are involved. These conditions can be organized according to supply and demand, and categorized using the elements shown in the Introduction. These conditions are common across markets, although the specifics of how these conditions are met will vary. Sections IV and V of this feasibility study analyze the current state of these conditions in Bangladesh.¹

Elements/Conditions	Explanation of conditions
Demand (issuer) side	
1. ULB policy / legal framework	
1.a. Policy framework that encourages ULBs and other local entities to raise private finance	A proper policy framework will provide clear signals to key institutions that need to collaborate in the market development effort, including those in central government. It should also provide incentives to ULBs and other local entities to take steps that will contribute to market development.
1. b. Legal framework that provides fiscal and legal means to mobilize private funds	A clear legal framework is needed that governs all aspects of municipal operations and finance, and provides the legal means to enter into financial transactions, and to fulfill the obligations investors rely on to be repaid.
1. c. Certainty and continuity of the legal framework	Since investment in infrastructure projects is always a medium to long-term affair, it is of critical importance to issuers that the legal framework governs and enables the private investment for the duration of the project.
1.d. Standards for the preparation and reporting of financial information	Financial and operational information presented in a standardized manner is needed by investors and by credit rating agencies to evaluate issuing entities and their projects. Addressing weaknesses in financial reporting can be an important step toward market development.
2. ULB (local entity) capacity	
2.a. ULB (local entity) capacity to provide accurate information about themselves and their transactions	Financial information plays a crucial role in the functioning of the private capital market. Information allows issuers to explain who they are and why they are raising funds, and it allows investors to analyze both the financial and risk aspects of the proposed transaction.
2.b. ULB (local entity) capacity to identify bankable projects	ULBs need basic skills to develop capital investment plans (CIPs) and to identify potentially bankable projects. The structuring to make projects and CIPs bankable, and to market them with investors, is generally carried out by experts.

¹ Piyush Joshi, “Law Relating to Infrastructure Projects”, Second Edition, 2003, Lexis Nexis. www.lexisnexis.in/law-relating-to-infrastructure-projects.htm.

Elements/Conditions	Explanation of conditions
2.c. ULB (local entity) capacity to provide a strong repayment stream and to ensure local willingness to pay	Either the project seeking private financing or the issuer itself needs to be capable of generating enough revenue to pay all project costs plus a return to the private investors or municipal bond holders, through taxes, fees, or project revenues. Tax- or ratepayers provide this support. General obligation bonds rely on general municipal revenues, including taxes, for repayment. Revenue bonds rely on specific revenues related to the investment, such as tariffs or fees.
2.d. ULB (local entity) capacity to manage financed projects during the life of the issue.	Proper maintenance and operation (O&M) of projects helps ensure repayment and reduces default risks. Project feasibility studies analyze management capacity. Project structuring can provide support if O&M capacity is weak.
3. Bankable projects/capital investment plans	
3.a. Availability of bankable local infrastructure projects or capital investment plans	Certain types of projects (revenue-producers) are more likely to appear bankable than others (social investments). Bankable projects are developed beginning with analysis of the physical, technical, and financial aspects, and by properly structuring features such as asset ownership, and the distribution of responsibilities and risk.
3. b. Volume of financial transactions	ULBs and other local entities should eventually be capable of generating a flow of transactions of relatively standard structure and quality, in order to interest investors. This does not preclude developing pilot projects that can test the market and the adequacy of the policy framework.
3.c. Presence of enforceable tariff or taxation mechanisms	In projects being repaid with tariffs or fees, tariff calculation, revision, and recovery must be legally enforceable through the general legal framework and/or through contractual agreements related to the transaction.
3.d. Other means to mitigate risk of transactions	Risk can be mitigated through internal and external mechanisms. Internal mechanisms include, for example, reserve funds and structures that "ring-fence" revenue sources being used for bond repayment. External mechanisms include partial or full guarantees from an outside body and bond insurance. Risk mitigation mechanisms should not undermine market development by—for example—protecting investors to the point they fail to conduct due diligence.
Supply (market) side	
4. Capital market policy/legal framework	
4.a. Policy framework that encourages market actors to address the financing needs of ULBs and other local entities	A proper policy framework will provide clear signals to key institutions that need to collaborate in market development, including those in central government. It should also provide incentives to market actors to participate in market development, for example through development of credit ratings or model transactions, or understanding local infrastructure financing needs.
4.b. Legal framework that allows private investors to invest in ULBs' or other entities' loans or bonds	A legal framework is needed that provides clarity to investors regarding their rights, and obligates issuers to fulfill the obligations investors rely on to be repaid on schedule.
4.c. Bankable risk distribution	Financial transactions must be structured to enable risk distribution attractive to investors. The legal framework and project documentation must guarantee that the risk allocation agreed is enforceable. The legal system must be capable of enforcing contracts and enabling recovery of damages, such as for exit in the event of default or termination events (force majeure). The legal system should be flexible enough to allow the negotiation of risk allocation among the parties.

Elements/Conditions	Explanation of conditions
4.d. Certainty and continuity of legal framework	Since investment in infrastructure projects is always a medium to long-term investment, it is of critical importance to investors that the legal framework governs and enables the private investment for the duration of the investment.
5. Capital market capacity	
5.a. Ability to support development of local infrastructure projects or capital investment plans suitable for debt financing	Capital market actors need to work with ULBs and other local entities to identify potential projects and to structure them to make them good subjects for credit. Pilot projects help show market actors how to identify projects and how to make them financially feasible for ULBs and users, and attractive to investors.
5.b. Presence of capable intermediaries and trustees	Intermediaries such as merchant banks and trustees provide essential services to investors and issuers that increase the efficiency and transparency of the market. Knowledgeable intermediaries also reduce risk associated with transactions. Technical assistance may be needed to improve intermediary capacity.
5.c. Existence of a yield curve	A yield curve provides the basis for setting interest rates on newly-issued bonds. Ideally, a yield curve from the secondary market is needed. In its absence, the primary market yield curve might be usable to price municipal issues.
5.d. Presence of secondary market or substitute	Without a secondary market, buyers of bonds are exposed to resale risk (potential losses on sale or inability to sell), which will affect bond yields. In the absence of a secondary market, the most suitable buyers will be those who can hold to maturity, which will significantly reduce demand. A volume of issues will encourage secondary market development. Substitutes such as repurchase agreements can be built into transactions as second-best solution.
5.e. Volume of standardized transactions	Standardized transactions contribute to the efficiency of the market by lowering transaction costs for both the issuer and the investor. Investment banks can contribute to development of an efficient market by designing prototypes for common types of projects (for instance, terminals or solid waste systems).
6. Investor interest	
6.a. Investor familiarity with the local sector	Investors and intermediaries need to feel comfortable with the types of projects for which ULBs and local entities seek financing. Education programs with market participants can help provide familiarity and address their concerns.
6.b. Financial return commensurate with risk	Municipal bonds have the potential to lower the cost of financing and improve the access to it. If bonds are more expensive than loans, and loans are available, the market will not develop. Costs associated with developing the market should not be charged to the transaction, but should be subsidized by government.
6.c. Means to evaluate risk	Evaluations of risk need to be objective. Credit ratings are the principal tool used to evaluate the risk of the transaction and of the issuer/borrower. Credit ratings depend on the availability of audited financial information.
6.d. Volume of investable funds	Suitable investors must be available to purchase the bonds put on the market. Investor interest can be raised through activities to familiarize them with issuers.
6.e. Acceptable political risk	If political risk is perceived to be so great that it affects the value of the investment, there will not be a demand for transactions in that market without excessive external risk mitigation measures, which raise transaction costs.

B. Modalities for accessing private financing

While municipal bonds are used as the financing benchmark in this study, there are effectively five modalities for accessing private finance for local government infrastructure investments through either the capital or financial market, each of which addresses the conditions described above in its own manner. All of these options are being considered to some extent in this study, as explained in the Introduction, with an emphasis on municipal bonds.

General obligation (GO) bond. With a general obligation bond, the investment may not be revenue-producing, but the ULB has other general revenues and the repayment comes from these revenues, backed by the entity's taxing authority. Example: U.S. GO market (approximately US\$90 billion in 2011).

Revenue bond. The source of debt repayment with a revenue bond is the revenue generated by the public project and/or by other related facilities (an airport bond, for example). These revenues are generally “ring-fenced” in some way to ensure they are directed to repayment of debt, sometimes after payment of certain expenses such as salaries. Example: Water, stadium, or hospital bond; regional airport authority bond, U.S. municipal revenue bonds.

Project finance. A project-finance structure is generally used to finance a specific project. The project and its financing may be structured as a special purpose vehicle (SPV), a type of independent entity or corporation. Most Public-Private Partnerships (PPP) are project finance structures. The project may involve one or more development activities. The entity may be public, private, or a combination. Example: Mixed-use development project that includes public space, housing, retail and office space.

Pooled financing. With a pooled financing, the loan or bond proceeds are used to finance or refinance a portfolio of revenue-producing projects. In this case, the specific projects to be financed may not be known before the issuance of the bond or contracting of the loan. The lender depends on an agreement regarding the conditions for the loans to be made with the funds, and on the track record of the intermediary that will make the loans. Example: U.S. state bond banks, and the Tamil Nadu Water and Sanitation Pooled Fund (India).

Bank loan. Lastly, direct bank loan financing is an alternative form of municipal infrastructure finance. Whether this is preferable varies, depending on the state of development of the market, and on the structure and financing practices of banks. In countries with efficient bond markets and a competitive demand for municipal investments, such as the United States, issuing bonds is a more cost-effective way to raise funds for local infrastructure. In countries such as France, banks are accustomed to financing local governments, and may have more cost-effective access to the bond market or other long-term capital. In a number of countries, banks originate most municipal debt, and then discount these loans to a second-tier bank or intermediary. Examples: FINETER (Colombia), Local Government Unit Guarantee Corporation (Philippines).

Any of these five approaches can incorporate a mix of public and private financing. A project structure for an infrastructure project may involve only private investment, but be backed by public sector commitment, such as a guarantee or a “take-off” (purchase) agreement for a power plant.

In addition, banks can play a number of roles in these five options. For instance, they may help structure transactions, purchase bonds issued in the capital market, or become investors in project financing structures. As a result, the five options listed here should not be considered completely independent of each other.

IV. The Policy, Institutional, and Legal Framework for Local Government Finance

A. Policy and institutional issues

1. Organization of the local state

Bangladesh has a unitary form of government according to the Westminster model, with a unicameral parliament. Urban and rural local governments take different legal forms, but all are administrative units created by Parliament. There is a concentration of power and discretion in the central government, and numerous changes over time in sub-national government structure, roles, and responsibilities have affected their capacity for service delivery. While the 2009 laws allow local bodies to intervene in many sectors, key services such as education, health, nutrition, family planning, irrigation, agricultural services, and secondary roads are all managed directly by central government entities with little role for or input from elected local governments.¹

a. Local governments

Functionally, the local public sector consists of a combination of deconcentrated central government entities and elected local governments. The sections below briefly describe both the rural and urban local authorities. Urban authorities are the focus of this feasibility study.

(1) Districts

There are 64 Districts, or Zila Parishads (ZP), that operate below the 6 Administrative Divisions of the country. About 30 Ministries and line agencies have offices at the ZP level, whose headquarters are located in urban centers. As of 2011, the average population in a District was 2.2 million. The Zila Parishad Act (2000) stipulates that there shall be a District Council for each District except for the three Hill Districts. While the chairman and members of the Council are supposed to be elected by an electoral college, elections have not taken place since the country's independence in 1971. In 2011, the government appointed District Council Administrators, who are mostly district level leaders of the ruling party.

(2) Rural local bodies

Upazila Parishads. The second lowest tier of local government after the Zila Parishad is the Upazila Parishad (UZP) or Sub-Districts, of which there are currently 485.² UZPs were created in 1982, abolished in 1991 and subsequently re-established in 2008 with elections held in 2009 under the Upazila Parishad Ordinance, 2008 (which never entered into force). The Upazila Parishad Act of 1998 was re-enacted and adopted in 2009. In addition to planning and implementing development programs, the UPZ is responsible for overseeing activities of government departments. It has taxation power and developmental, operational, financial, and inter-departmental coordination responsibilities. UPZs face both administrative and political impediments, both from within the government hierarchy and directly from Members of Parliament. While UZPs are expected to undertake a range of functions, their ability to perform independently of the influence of other actors is very limited.³

Union Parishads. The 4547 Union Parishads (UP)⁴ make up the lowest and longest-serving tier of elected local government in Bangladesh operating as a representative local government institution, in existence continuously since 1880. The UP elected body comprises a directly-elected Chairperson and a Council comprised of 13 ward members, including 3 women. The Chairperson is the key executive functionary of the UP. Staff salaries and members payments are met from a combination of government grants and own-source revenues. UPs are

¹ World Bank, 2011, Second Local Governance Support Project, Project Appraisal Document, p. 80.

² <http://documents.worldbank.org/curated/en/2011/10/15528441/bangladesh-second-local-governance-support-project>.

³ Government of the People's Republic of Bangladesh Cabinet Division, www.cabinet.gov.bd/view_area.php?page=all_area&lang=en.

⁴ Nizam Ahmed, et al, [no date], Working of Upazila Parishad in Bangladesh, UNDP, p. 10.

www.undp.org.bd/projects/prodocs/UZP/12%20UZP%20Final%20Report.pdf.

⁵ UP Wing, Local Government Division, Ministry of LGRDC.

empowered to generate their own resources from taxes as well as income from property and services, though tax collection is almost non-existent.¹ The UP Act, 2009, describes identifies 38 functions of UPs including “planning and implementation of social and economic development activities.”

(3) Urban local bodies

City Corporations. There are ten City Corporations that govern metropolitan areas in Bangladesh: Dhaka North, Dhaka South, Chittagong, Khulna, Rajshahi, Barisal, Comilla, Rangpur, Sylhet and Narayanganj. The heads of City Corporations are Mayors. Members of the City Corporation Council are known as Councilors. Both Mayors and Councilors should be directly elected every five years, with specific seats reserved for women. Historically, Mayors were appointed, although Ward Commissioners were elected from the respective wards. In March 1994, Mayors were first elected directly. Each City Corporation has a Chief Executive Officer (CEO) seconded from the central civil service, and all other officials—whether directly recruited by the City Corporations or working on secondment—report to him/her. In 2011, the Dhaka City Corporation was dissolved by the Local Government (City Corporation) Amendment Bill and replaced by Dhaka North City Corporation and Dhaka South City Corporation. As of late 2012, elections have not yet taken place in these newly-created entities.

Pourashavas. There are currently 316 Pourashavas, or Municipalities, in Bangladesh, which provide services to towns with populations of at least 15,000. The Head of the Pourashava Council is the Mayor. Members are known as Councilors, and both Mayors and Councilors are directly elected every five years, with specific seats reserved for women. Pourashavas are divided into three categories based on annual income levels: Class A have an income of more than BDT 6.0 million (US\$73,475); Class B have an income of more than BDT 2.5 million (US\$30,600), and Class C have an income of less than BDT 2.5 million (US\$30,600). A number of Pourashavas have a CEO seconded from the central civil service, who directs all other staff.

b. Autonomous and semi-autonomous entities

Autonomous and semi-autonomous entities are public sector entities established under legislative acts or ordinances to perform specific functions. They carry different organizational designations including authorities, boards, corporations and institutes. The administrative and managerial responsibilities of the entities belong to either a Board of Directors or Governing Council. The head of the entity may be known as Chairman, Managing Director, Director General, or Executive Director. These entities enjoy a higher degree of autonomy in both administrative and financial decision-making. However, the degree of autonomy granted to them varies according to the acts under which they were created and are governed. Examples include the urban development authorities (UDAs), bridge authorities, and water and sewer authorities.

2. Functional decentralization

The unitary state structure does not preclude granting autonomy at the municipal level for service delivery.² Individual unitary government experiences with decentralization vary widely, as demonstrated by experiences in Indonesia (an ambitious “big-bang” approach started in 2001) and Senegal (a halting and underfunded process beginning in 1996), for example.

The list of responsibilities of local authorities far exceeds their ability to raise resources to implement them. Most local development decisions are carried out by deconcentrated national agencies, which are better-funded.³ Local governments are primarily supervisory rather than service-providing units.

¹ Nizam Ahmed, et al, [no date], Working of Upazila Parishad in Bangladesh, UNDP, p. 252-253.

www.undp.org.bd/projects/prodocs/UZP/12%20UZP%20Final%20Report.pdf.

² Panday and Asaduzzaman, p. 168.

³ World Bank, 2011, Second Local Governance Support Project, Project Appraisal Document, p. 11.

<http://documents.worldbank.org/curated/en/2011/10/15528441/bangladesh-second-local-governance-support-project>.

An effective decentralization strategy will eventually require a clear redistribution of both resources and responsibilities, with the goal of reducing duplication and improving efficiency. Without this, any local infrastructure financing project will need to be designed on a case-by-case basis and require the involvement of all stakeholders.

3. Fiscal decentralization

Fiscal decentralization is limited in Bangladesh, as all local government financial decisions—including the annual budget—require central government approval.¹ Clientelism at the local level creates inequities in spending and reinforces a lack of fiscal discipline.

Subnational expenditure as a share of total government expenditure has never exceeded four percent in Bangladesh, and less than two percent of total government revenue is collected at the local level. This ratio is among the lowest in the world; comparable figures for Indonesia and South Africa, two unitary countries that decentralized within the last 15 years, are 34 percent and 52 percent respectively.²

Revenues for local governments come from both central grants and own source revenues. From central government, local governments receive, for example, block grant through the Annual Development Program (ADP), special grants for development projects, Octroi compensation grants, and salary subvention.³

The table below shows the sources of local government revenue, and categories of expenditures, for the consolidated local government sector.⁴ (Data on revenues and expenses for each level of government are shown in Annex 1.) According to these data, municipal revenues totaled BDT 78,039 million (US\$975,488,000) in 2008, of which 30 percent came from taxes, rates, and fees, and 47 percent (BDT 37,037 million or US\$462,963,000) came from capital transfers. Of the entire expenditure budget, 75 percent (BDT 51,915 million or US\$648,938,000) was spent on capital investments. The ten city corporations account for 44 percent of both revenues and expenses.

¹ Munawar Alam, 2010, *Municipal Infrastructure Financing, Innovative Practices from Developing Countries; Bangladesh-The Case of Dhaka*, Commonwealth Secretariat Local Government Reform Series No. 2, p. 75.

² World Bank, [no date], *Basic Facts about Local Government System in Bangladesh*.

³ Amiral Islam Chowdury, 2004, *Instruments of Local Financial Reform and their Impact on Service Delivery: Institutional and Development Concerns-Case Studies of India and Bangladesh*, p. 9.

⁴ Bangladesh Statistical Yearbook, 2010, Chapter 9: Finance, Foreign Aid, Banking, Insurance, Co-Operative, and Credit Distribution, Tables 9.17 to 9.23. www.bbs.gov.bd.

Consolidated Receipts and Expenditures of Local Government¹

	Million BDT							000 US\$	
	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08	2008 %
Receipts:									
Taxes	3,574	4,430	4,731	5,834	6,899	8,384	13,037	162,963	17%
Rates	867	1,004	1,027	1,632	1,952	2,522	4,026	50,325	5%
Fees & tolls	2,291	2,232	2,879	2,794	3,007	4,444	6,416	80,200	8%
Interest receipts	165	169	253	360	380	567	837	10,463	1%
Misc. receipts	1,421	1,235	1,503	1,748	1,954	3,229	5,406	67,575	7%
Govt. grants	1,348	1,515	1,488	1,475	1,860	3,082	4,081	51,013	5%
Works programme grants	8,505	9,316	9,934	15,910	16,491	18,806	37,037	462,963	47%
Error					(1)	(1)	7,199	89,988	9%
Total	18,171	19,901	21,815	29,753	32,542	41,033	78,039	975,488	100%
Expenditure:									
Wages & salaries	3,087	3,669	3,852	4,387	4,828	5,324	6,205	77,563	9%
Contingency (Commodities)	2,190	2,490	2,612	3,185	3,856	5,756	8,037	100,463	12%
Infrastructure development (Gross fixed capital formation)	11,365	12,913	13,700	20,846	22,324	26,753	51,915	648,938	75%
Interest paid	8	5		3	2	2	4	50	0%
Works programme	159	182	250	464	471	1,220	1,407	17,588	2%
Scholarship, grants. etc. (Transfer)	310	343	603	594	776	979	1,505	18,813	2%
Total	17,119	19,602	21,017	29,479	32,257	40,034	69,073	863,413	100%
Net revenues	1,052	299	798	274	285	999	8,966	112,075	
National Gross Domestic Product (GDP)						4,724,800	5,458,200		
Total receipts as % of GDP						.87%	1.43%		

The list of revenue-raising mechanisms approved for local governments under different ordinances since 1976 is quite comprehensive, but local governments are failing to exploit their revenue-generating ability. Dependence on the central government is attributed to inefficiency in tax collection, the narrow base on which to raise taxes, and the lack of incentives to encourage own-source revenue mobilization in central government grant mechanisms.²

4. Policy reforms in process

Central governments in Bangladesh repeatedly cite decentralization as an important element of the state's approach to both citizen participation and local development, but to date no government has put forward a clearly-defined decentralization strategy. Most attempts have resulted in only partial responses to what are complex and multidimensional problems.³ Efforts at local governance reform have sometimes been hampered by government transitions, whether by military force or elections, where the new administration has reversed policies adopted by its predecessor. This was most recently seen in the Awami League government not ratifying the Local Government Commission Ordinance, 2008, soon after assuming office and instead enacting the Local Government (Union Parishad) Act, 2009.

One question is whether demographics will eventually tip the balance toward a more ambitious decentralization process. Bangladesh has one of the largest urban populations in the region, yet one of the lowest levels of

¹ Bangladesh Statistical Yearbook, 2010, Chapter 9: Finance, Foreign Aid, Banking, Insurance, Co-Operative, and Credit Distribution, Tables 9.17 to 9.23. www.bbs.gov.bd.

² William F. Fox and Balakrishna Menon, 2008, Decentralization in Bangladesh: Change has been Illusive, International Studies Working Paper 08-29, Georgia State University, p. 10. <http://ideas.repec.org/p/ays/ispwps/paper0829.html>.

³ Panday and Asaduzzaman, p. 154.

urbanization. This means its cities will most likely continue to grow rapidly during the coming decades. In this context, the need for local governments to be effective service providers could become increasingly evident. While decentralization is always a process rather than an end state,¹ the approval of the National Urban Sector Policy (NUSP), currently in draft form, would provide a clear message to stakeholders about how the central government intends to approach the process of decentralization.² The draft NUSP recognizes the multi-dimensional nature of urbanization, and establishes the objective to “devolve authority at the local urban level and strengthen local governments through appropriate powers, resources and capabilities so that these can take effective responsibility for a wide range of functions.”³

The NUSP would provide local governments with a mandate to adopt innovative measures and financial strategies for increasing their resources (including explicitly permitting municipal bonds) and reducing their dependence on central government. It also underscores “sustainable urbanization” as key to tackling the challenges facing Bangladesh, and reinforces the importance of the role of local governments in local economic development and poverty reduction, while also encouraging the involvement of stakeholder groups.

Two other policy documents, the National Rural Development Policy and the Poverty Reduction Strategy Paper, also highlight the importance of local government involvement and accountability. In addition, GOB’s Sixth Five Year Plan explicitly mentions “promoting devolution to local governments” as one of four pillars of development management.”⁴ This recognition of the importance of local governance is the necessary starting point for the transfer of public service capacities to municipal governments.

B. Governance issues

1. Accounting and auditing in local governments

The capacity to provide reliable financial information to investors is a prerequisite for market-based municipal financing. Information should be available on a timely basis, for a period of years, and most importantly presented in conformity with generally-accepted accounting standards. In addition, this information should be audited by an independent auditor according to accepted audit standards. Audited financial information is particularly critical for entities seeking financial market access because it serves as the basis for credit ratings as well.

All government accounting in Bangladesh—including that of local bodies—is cash-based, and uses a government chart of accounts issued by the Office of the Comptroller General of Accounts (OCAG). Financial reporting procedures for Pourashavas are briefly explained in the Local Government (Municipality) (Amendment) Ordinance 2010, in the 4th Part, 2nd Chapter, entitled “Financial Management, Budget and Account.” Government auditing standards and procedures are issued by the Comptroller and Auditor General (CAG) of Bangladesh, communicated through training and manuals.⁵ The CAG also conducts all public audits, within the constraints of its human resources. The Local and Revenue Audit Directorate (LRAD) audits local bodies.

Around the world, both private sector and public sector accounting standards are converging toward a set of international financial reporting standards (IFRS) being developed under the leadership of the IFRS Foundation in collaboration with the International Accounting Standards Board (IASB), a standard-setting body. The international standards are based on accrual accounting and shared rules that produce financial information that is

¹ Nizam Ahmed, et al, [no date], Working of Upazila Parishad in Bangladesh, UNDP, p. 252-253. www.undp.org.bd/projects/prodocs/UZP/12%20UZP%20Final%20Report.pdf.

² National Urban Sector Policy (Draft).

³ National Urban Sector Policy (Draft), Objectives, Section 3.0, e), p. 2.

⁴ GOB, Sixth Five-Year Plan FY 2011-FY2015, p. 238. http://www.plancomm.gov.bd/sixth_five_year_plan.asp.

⁵ Local Audit Manual, Chapter 7: Audit of Autonomous and Local Bodies, and Chapter 11: Reporting and Follow-up, <http://www.cagbd.org/in.php?cp=methd>.

comparable, understandable, reliable and relevant to both internal and external users. The goal is to transition government accounting over time from cash to accrual accounting since cash accounting ignores asset management, accumulating arrears, future liabilities (e.g. pensions), and contingent liabilities (e.g., guarantees).¹

The Institute of Chartered Accountants of Bangladesh (ICAB) is the professional association of the accounting profession in Bangladesh. Bangladesh Financial Reporting Standards (BFRS) are set by ICAB. ICAB has been working with the International Federation of Accountants (IFAC) to adopt IFRS.

In most countries, including Bangladesh, the initial focus has been on the adoption of accounting standards for the private sector that are consistent with the IFRS, in an effort to support the development of financial markets. As of July 2012, a version of all but two standards issued by the IASB had been adopted as BFRS by ICAB.²

In August 2011, ICAB issued an Action Plan that includes a commitment to promote the adoption of International Public Sector Accounting Standards (IPSAS).³ ICAB has also formed a Committee on Public Finance and Public Sector Accounting to encourage the adoption of the IPSAS in the public sector, and in November 2012 signed a Memorandum of Understanding (MOU) with the GOB to collaborate on adoption.⁴ The Action Plan and MOU are focused on the accounting of central government agencies and enterprises; no mention is made of local bodies. However, ICAB has expressed interest in incorporating local bodies, if OCAG were in agreement.

There are no local governments in Bangladesh currently capable of presenting financial statements prepared and audited according to generally accepted accounting and auditing standards. It is even unlikely that the autonomous agencies discussed in Section V.A, *Demand: Potential users of bond financing* (page 21) could supply this information. Consequently, none could meet the disclosure requirements for public and private issues in the stock market.

Improving the capability of these institutions to provide financial information that can be audited and used as the basis for credit ratings should be a very high priority for the GOB in the effort to encourage the development of private financing options for local infrastructure.

Technical assistance on accounting for local bodies. It is common in countries where municipal accounting practices are inadequate for financial management purposes, for donors to independently design and develop norms and/or information systems meant to improve municipal financial administration. In Bangladesh, the focus seems to be on the administration of the holding tax, given the complexity of the data it requires, and the potentially positive fiscal impact that could result from improving its administration.

Under the World Bank International Development Association (IDA)-funded Municipal Services Project (MSP), consultants developed software for holding tax collection billing and collection system, and Pourashavas received computers for managing tax and water fee billing and collection and for general accounting purposes. (There may be other examples of project-based systems that have been developed.)

Government should provide guidelines for the design and implementation of these types of systems. Ideally all these initiatives should conform to international public sector accounting and auditing standards and procedures.

¹ World Bank, 2007, Bangladesh Public Sector Accounting and Auditing: A Comparison to International Standards, Country Report, <https://openknowledge.worldbank.org/handle/10986/7624>.

² Deloitte Global Services, 2012, IAS Plus: Bangladesh, <http://www.iasplus.com/en/jurisdictions/asia/country2>.

³ Institute of Chartered Accountants of Bangladesh (ICAB), 2011, Action Plan. www.ifac.org/sites/default/files/compliance.../part_3/BANG2.pdf.

⁴ "Memorandum of Understanding (MoU) Between ICAB and OCAG with the Assistance of World Bank and DFID," http://www.icab.org.bd/index.php?option=com_content&view=article&id=243:mou-between-icab-and-ocag&catid=1:news-a-events&Itemid=123.

In the absence of complete standards, provision of even basic guidance—such as the development of a local government chart of accounts harmonized with an IPSAS-based GOB chart of accounts—would help ensure the future relevance and consistency of these technical assistance investments.

2. Elections and transparency in local government

Local government elections are supposed to take place every five years in City Corporations and Municipalities in Bangladesh. Municipal elections are held in phases; not all elections take place at the same time. Elections were held in 242 of the 316 municipalities in 2011. Elections in the newly-created Dhaka North City Corporation and Dhaka South City Corporation are overdue, and are not expected to be held before the national elections in 2013.

Bangladesh ranks 144th among 174 countries rated by Transparency International in 2012. It ranges 129th out of 185 countries in the "Doing Business" ranking of the International Finance Corporation (IFC), a decline from the previous year. Corruption in local governments is considered to be quite extensive, as it is considered to be in central government, the police, the Parliament, and other key institutions. A recent joint evaluation of donors' anti-corruption technical assistance efforts concludes that these efforts have been largely ineffectual, except in certain areas such as public financial management (PFM).¹

While PFM activities were not aimed at local governments, they did involve the Comptroller and Auditor General, which sets standards for local government financial administration. Reforms to accounting and auditing systems are medium to long-term reforms, but should be considered a priority both for reasons of transparency and to allow compliance with private issue and public placement rules (see discussion in next section). Corruption in local government does not preclude bonds issuance or the implementation of other private finance structures, but it adds an element of risk that would have to be overcome with careful project structuring and controls.

C. Legal framework governing local government and municipal finance

A legal framework that promotes market finance and protects private investment is essential for bringing investment funds into the infrastructure sector.² Market-based financing requires a legal framework that reflects development policy and, among other things, empowers the issuers of debt (local governments or others), grants enforceable rights to private investors, and ensures the smooth functioning of markets. Without this, any project for the participation of the local bodies in the development of infrastructure will fail to attract private funds. This section covers legal issues related to local authorities and their finances. Other legal issues related to capital markets regulations are discussed in Section V.B.2.g, *SEC Regulation relevant for municipal bonds* (page 36). A more detailed version of this section is available on request.

1. Basic legal concerns

A municipal bond or other financing arrangement is essentially a contract between the borrower (local government) and investor (bond holder or lender). The terms of this contract are affected by the overall legal framework of the jurisdiction in which the bond is issued, although even within that framework there can be significant variation among contracts.

Private investors in infrastructure development will be most concerned about the legal authority by which private entities are given rights to participate in infrastructure financing, including:

- Presence of a strong legal and regulatory framework governing the infrastructure sector, the financial sector, and the stock and debt markets

¹ NORAD, 2011, Joint Evaluation of Support to Anti-Corruption Efforts, Bangladesh Country Report. <http://www.norad.no/en/tools-and-publications/publications/publication?key=384730>.

² Piyush Joshi, "Law Relating to Infrastructure Projects," Second Edition, 2003, Lexis Nexis.

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- Stability of the legal system, particularly the regulatory framework governing the infrastructure sector and the financial sector
 - Nature of the enforceable rights that can be granted to a private developer
 - Position of the developer in the event of nationalization of the infrastructure facility
 - Track record of the legal system in addressing contractual disputes, including the treatment of liquidated damages and compensation
 - Foreign exchange regulations (in the case of foreign investors)

2. Constitutional framework

Bangladesh is a unitary, independent and sovereign Republic, as defined in its Constitution.¹ [Article 1] Consequently, the administrative units of governance in Bangladesh derive their authority from and exercise only such powers as they are delegated by the central government.

The term “administrative unit” has been defined under Article 152(1) of the Constitution to mean a district or other area designated by law for the purposes of Article 59. Article 59 also provides for local government in every administrative unit to be created by an act of Parliament.

Therefore, the powers and functions of municipalities and City Corporations are completely dependent upon the specific powers and functions vested in it by a statute enacted by Parliament, including the power to impose taxes and prepare budgets and maintain funds. [Article 60]

3. Statutory framework governing urban local government

The statutes create separate local authority structures for rural areas and urban areas, and an administrative structure for the Chittagong Hill Districts. This report focuses principally on the financing needs of urban local authorities.

a. Pourashavas: Local government for municipal areas

The Municipalities in Bangladesh are presently regulated by the Local Government (Municipality) Ordinance, 2009, under which the GOB can declare any rural area a city or municipality based on criteria related to occupation, land use, population density, and population size (population of 50,000 for a municipality).² [Section 3] The UZP which the proposed municipality occupies can raise objections to this change with the GOB. The GOB can also eliminate, merge and subdivide existing municipalities. [Section 4]

Municipal responsibilities include: (i) urban development planning including building controls; (ii) infrastructure development, including water, sanitation, and waste management; (iii) economic and social justice; (iv) construction of roads, footpath, and other communication systems; traffic management; street lighting; and transport management; (v) development of markets and slaughterhouses; (vi) public health and environmental conservation; (vii) other functions specified in the Second Schedule to the Ordinance, depending on the availability of funds; and (viii) other functions vested by the Government. [Section 50]

A municipality has access to a range of revenue sources, including taxes, rates, tolls, and fees, and it can receive rents, profits, and grants. However, it cannot levy any tax, rate, cess, toll, or fee without the prior permission of the GOB. [Section 98]

¹ The Constitution of the People’s Republic of Bangladesh.

² Local Government (Municipality) Ordinance, 2009.

A municipality is required to have a single fund, known as the municipal fund, into which all revenues are credited, including taxes, tolls, rents, grants, profits, etc. [Section 89] The monies in the municipal fund must be kept in a government treasury account or in other account specified by the Government. [Section 91]

The Local Authority laws prescribe the order of preference of expenditure towards which all revenues of the municipality will necessarily have to be first used. First priority is for payment of salaries and only the fourth is meeting expenditures declared by the municipality with the previous sanction of the GOB. Thus, any payment to bondholders or private entities pursuant to contracts for private financing would come fourth in priority, which would present a major hurdle for financing the repayment of which relies on municipal funds.

b. City Corporations: Local Government for Large Cities

The Local Government (City Corporation) Act, 2009 repealed all the individual acts regulating each individual city corporation, namely: (i) the Chittagong City Corporation Ordinance, 1982; (ii) the Dhaka City Corporation Ordinance, 1983; (iii) the Khulna City Corporation Ordinance, 1984; (iv) the Rajshahi City Corporation Act, 1987; (v) Sylhet City Corporation Act, 2001; and (vi) Barisal City Corporation Act, 2001, and created a uniform law governing city corporations as well as providing a mechanism for notification of municipalities as city corporations.

The criteria for transforming a municipality into a City Corporation include: (i) population density, (ii) local revenue source, (iii) economic importance of the area, (iv) transportation infrastructure, (v) municipal income, and (vi) public opinion. Each city corporation is an administrative unit of Bangladesh under Article 59(1) of the Constitution.¹ [Section 3]

The framework under the Local Government (City Corporation) Act, 2009 is similar to that established for the municipalities under the Local Government (Municipality) Ordinance, 2009, including its constitution, powers of the GOB, and finances. City corporations are required to establish a city corporation fund, and cannot levy any tax, rate, cess, toll or fees unless it has been approved by the GOB, which has similar powers to suspend, abolish, or discontinue any such tax, rate, cess, toll or fees that it may have approved.

c. Autonomous and semi-autonomous entities

Based on an analysis of their legal framework, the Urban Development Authorities could be better candidates than ULBs for issuance of debt instruments such as bonds, as mentioned above. However, their creditworthiness depends on their financial and operating practices, which might need to be upgraded.

The Urban Development Authorities (UDAs). The Chittagong Development Authority (CDA) is an executive authority created for the development, improvement and expansion of the city of Chittagong and was incorporated pursuant to CDA Ordinance, 1959. Under this Ordinance, the authority is authorized to: (i) develop the master plan for the areas under its jurisdiction² [Section 26]; (ii) develop five-year programs of development and submit them to the government for approval [Section 26]; (iii) declare ‘controlled areas’ in order to prevent haphazard development of colonies and buildings [Section 26]; (iv) impose a betterment fee on owners and any person having interest in land whose value has increased as a result of any improvement scheme of the Authority [Section 77]; (v) borrow money to meet any capital expenditures or to repay any previous loan [Section 26]; (vi) use the Authorities Fund to deposit any government grants, loans, foreign aid, and proceeds of betterment fee, water rate or any other rate levied by the Authority [Section 44].

¹ Local Government (City Corporation) Act, 2009.

² Chittagong Development Authority Ordinance, 1959.

The Khulna Development Authority (KDA), Rajdhani Unnayan Kartipakkha (RAJUK), and Rajshahi Development Authority (RDA) have similar powers, including preparing master plans¹ [Section 22], development planning and borrowing funds for the purpose of meeting capital account expenditures.

In light of their track record and the stability of their legal framework, the UDAs would appear to be more suitable than the City Corporations to undertake issuance of municipal bonds for infrastructure development. [See further discussion of the UDAs in Section V.A.2., *Indicative financing needs of potential borrowers* (page 22)]

Other autonomous agencies. Autonomous and semi-autonomous agencies such as the Bangladesh Bridge Authority (BBA) should also be considered as issuers of bonds. The BBA was created from the Jamuna Multipurpose Bridge Authority, whose original purpose in 1985 was to construct and operate the Jamuna Bridge. In 1998, its ordinance was amended to give it a national, multi-facility scope and its name was changed to the Bangladesh Bridge Authority (BBA). The BBA is vested with the function of preparing comprehensive plans for the establishment of bridges, construction of toll roads for approval of the government and taking all necessary actions for the implementations of the plans approved by the government which includes securing required funding and entering into agreements for securing funding as well as for the construction, management, operation and maintenance of such toll roads and bridges.² [Section 7] The authority has been vested with the power to borrow money for carrying out the purpose of the Ordinance and for securing any loan obtained by it, provided that prior approval of the government is granted before borrowing. [Section 15]

The Ordinance mandates the constitution of the Jamuna Multipurpose Bridge Authority Fund into which all sums received by the authority including grants from the government, loans from the government, grants from local authorities, loans raised from local authorities, sale proceeds from the bond issues by the authority, toll fees collected by the authority has to be deposited. These features mean that the Jamuna Multipurpose Bridge Authority has the legal framework to structure and issue toll-based bonds.

4. Legal framework governing finances of local government

This section lists the relevant statutes affecting local authority finances and their purposes. These will be important to take into consideration as options for financial market access are evaluated. A more detailed analysis of these laws is available from the UNCDF team.

The Local Authority Loans Act, 1914	<ul style="list-style-type: none"> Consolidates the law relating to borrowing by local authorities. Stipulates that if the local authority borrows more than BDT 25 lakhs (US\$3,000), it must secure the prior approval of government. Stipulates that the local authority may borrow up to a maximum period of 12 months.
The Bangladesh Bank Order, 1972	<ul style="list-style-type: none"> Prescribes the business and functions of the Bangladesh Bank. Allows the Bangladesh Bank (BB) to purchase and sell the securities of Local Authorities if specified by the Government in the Official Gazette.
The Public Debt Act, 1944	<ul style="list-style-type: none"> Consolidates and amends the law relating to government securities and management of public debt. Does not cover bonds issued by local authorities; this would require new legal provisions.

¹ Khulna Development Authority Ordinance, 1961, Section 3 read with Section 18.

² Jamuna Multipurpose Bridge Authority Ordinance, 1985.

Public Demands Recovery Act, 1913	<ul style="list-style-type: none"> ▪ Provides the legal framework for recovery of public demands, to include any money due to any local authority including a Pourashava. ▪ Has never been used to recover payments to local authorities, according to information provided to the UNCDF team.
The Development Act, 1935	<ul style="list-style-type: none"> ▪ Empowers the Government to impose “an improvement levy on agricultural land within a notified area.” ▪ Could potentially be used by local governments to raise revenues to back bond issues for infrastructure improvements that benefit a defined group of property owners, including those related to climate adaptation.
Draft National Urban Sector Policy, 2012	<ul style="list-style-type: none"> ▪ Intended to provide a framework to allow local governmental bodies to adopt new, innovative measures and financial strategies for increasing their resources. ▪ Will not provide a framework for enabling private finance initiative or issuance of municipal bonds by itself; new legal provisions and legal reforms will also be necessary.

D. Conclusions related to the Policy, Institutional, and Legal Framework

A review of the policy, institutional, and legal framework governing urban local authorities highlights several problematic areas that would need to be addressed before expanded private finance initiatives or the issuance of municipal bonds for local infrastructure will be readily feasible.

In particular, the legal framework of City Corporations and Municipalities is not adequate for promoting either the use of municipal bonds or of other forms of private finance.¹ The policy and institutional reforms may be less urgent, but such reforms will lower risks for investors, and help provide a policy environment conducive to market development.

- Frequent changes over time in the policy and corresponding legal framework governing urban local authorities creates a high legal and political risk for investors. Autonomous entities, particularly urban development authorities, have had a more stable legal and policy regime under their specific statutes, and could be lower-risk candidates for bond issuance, if they had sufficient revenue flow.
- The Policy and Strategy for Public-Private Partnership, 2010, could be a useful approach for encouraging private investment in local public services, but assistance would be needed so that the private sector and the agencies involved seriously evaluate project opportunities at the local government level.
- Government powers in the present legal framework to suspend and override local government bodies, and in particular to suspend, abolish, or revoke, any taxes, fees, rates, toll or cess create particular risks. In light of the history of constant political changes in Bangladesh, a municipal bond structured on the basis of prior approval of the government and existing revenue sources is subject to the risk that the approval could be later revoked or the revenue source abolished.
- Underutilized local revenues sources will discourage private investment. In this case the legal framework appears to be in place; the constraint is political will and management capacity in local government. The government has received prior advice on using transfers to incentivize local revenue mobilization, and should seriously consider this approach. These types of reforms have been decisive in other countries to the establishment of municipal financing systems.

¹ Legal issues related to capital markets regulations are discussed in Section IV.C.

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- Approval of the draft NUSP will send a signal to stakeholders that the government is serious about decentralization. Once approved, the Bangladesh Urban Forum (BUF)¹ could develop a joint inter-agency implementation plan. Communication within government of the implications of the NUSP and the intentions of the GOB regarding its implementation will also be important.
 - Updating of local government accounting and auditing standards, and improvement of financial reporting practices, are among the highest-impact activities to promote financial market development. They should be given very high priority by government and other stakeholders. The Office of the Comptroller General of Accounts (OCAG), the CAG, and the ICAB are important stakeholders for such an effort.
 - Weak governance in the sector also creates risks for investors. Elections are overdue in some local governments, and this conveys the impression that rules are not being respected. Municipalities have also attempted to repudiate debt obligations assumed by prior administrations, and this legal loophole should be closed.
 - A number of minor but important legal/administrative reforms will be necessary in order to allow market access for local governments, for example:
 - ♦ Approval of directives to allow the BB to subscribe and sell municipal bonds.
 - ♦ New rules to allow specific escrow accounts to be created by a municipality for bond issues (such as to channel revenue bond payments to the trustee).
 - ♦ Increase in the maximum term for local government borrowing, which is currently set at twelve months.
 - ♦ Revision to the law prescribing the specific order of preference of expenditure of municipal revenues, to give the repayment of financial obligations a higher priority.

¹ A formally constituted group that includes ministries, local governments, academics, professionals, non-governmental organizations, and civil society partners. See Declaration of the First Bangladesh Urban Forum, Dhaka, December 5-7, 2011, <http://www.buifbd.org/index.php>.

V. The Demand for and Supply of Municipal Financing

A. Demand: Potential users of bond financing

1. Current system for funding of public capital investment projects

Development of a municipal bond market, or other private financing system for local infrastructure, depends partially on there being a predictable pipeline of investments seeking financing, as discussed in Section III.A, *Essential elements for enabling private finance of urban infrastructure* (page 5). For this reason, it is important to understand how capital projects are currently prepared and financed in Bangladesh, and to analyze the benefits and drawbacks of this system for market development.

The ADP is a list of development projects—and their corresponding funding sources—that forms part of the GOB's annual budget. It is not a complete catalog, since capital investment projects are also found in the accompanying revenue budget, but the vast majority of projects are here. The ADP is normally revised mid-year. For example, in 2011-12, the original ADP totaled BDT 46,000 crore, which was subsequently reduced to BDT 41,080 (US\$5.1 billion). By the end of 2011, BDT 37,872, or 92 percent, of the ADP had actually been spent.¹

ADP projects are proposed by ministries each year to the Programming Division of the Bangladesh Planning Commission (BPC) (Ministry of Planning). The ADP process includes six stages: programming, identification, appraisal, financing, implementation, and evaluation. Final approval is given during the appraisal stage. All funding sources, including donor grants and multilateral financial institutions loans, are included as sources of funding for ADP projects. It is not known whether any concerted effort is made during this cycle to identify or divert projects that could be funded by means other than government grants, such as private finance or privatization. Once approved, the ADP is monitored by the Implementation Monitoring and Evaluation Division of the Department of Planning. Each year's ADP includes approximately 1,000 projects.²

Local infrastructure projects enter the ADP through the ministry or other government agency responsible for implementing them. Funding for direct local government allocations and the Bangladesh Municipal Development Fund (BMDF) enter the ADP through the Ministry of Local Government, Rural Development and Cooperatives (MLGRDC). In the 2012-13 budget, the allocation to the MLGRDC is BDT 121 billion.³ Urban development authority projects enter through the Ministry of Housing.

Projects can appear in the ADP as “approved” or “unapproved” projects. There is no specific waiting period for unapproved projects to be approved. The ADP also includes technical assistance projects. The 2009-2010 ADP included 886 projects, of which 131 were unapproved, and 163 were technical assistance projects.⁴

Sometimes project implementation is delayed because inadequate ADP funding was received. One study points out the problem of “token funding”—that projects are not able to be completed because they have been entered into the ADP with a funding allocation insufficient to complete them.

Bangladesh's economic and social development depends on the timely completion of the ADP. The ADP is praised by international agencies such as the International Monetary Fund (IMF) as a system that imposes significant

¹ ADP Utilization, Ministry of Finance, GOB, http://www.mof.gov.bd/en/budget/adp/adp_june%2012.pdf.

² Government of the People's Republic of Bangladesh, “Annual Development Programme 2010-2011,” http://www.plancomm.gov.bd/adp_2010_2011.asp.

³ Statement X: Development Expenditure by Ministry/Division,” http://www.mof.gov.bd/en/budget/12_13/brief/en/st10.pdf.

⁴ Saleh Ahmed, 2010, “Problems of ADP Implementation in Bangladesh: An Analytical Review,” <http://dspace.bracu.ac.bd/bitstream/handle/10361/1509/Problems%20of%20ADP%20Implementation%20in%20Bangladesh-%20Saleh%20Ahmed.pdf?sequence=1>.

discipline on the public investment planning process, in contrast to many developing countries. These agencies also spend significant effort monitoring ADP implementation, and working with the government to identify the ways to make these expenditures more efficient and more effective.

2. Indicative financing needs of potential borrowers

The financing needs of potential ULB borrowers can be estimated by looking at (i) planned, ongoing, and completed capital projects and (ii) past borrowing and the demand for future borrowing. None of this information is readily available in Bangladesh. ADP data was not available in a form that shows spending by or demand from local governments, and no other systematic source was identified. This section uses anecdotal information to give an indication of the scale of financing needs, and covers commercial bank and Bangladesh Municipal Development Fund (BMDF) borrowing, and capital project information for the Sreepur Pourashava, the CDA and KDA, the BBA, and Dhaka Water and Sewerage Authority (WASA).

a. Current borrowing by local bodies

(1) Commercial Bank credit

Local governments currently have had access to a miniscule and diminishing quantity of bank credit, whether for investment or operating purposes. The following table shows the history of bank lending to the public and private sectors. Ninety-six percent of all lending in the 2011 fiscal year was to the private sector. Of the four percent lent to the public sector, the portion lent to local bodies was less than one-tenth of one percent. It was not possible to confirm the purposes of the bank borrowing by local bodies. Non-bank financial institutions (NBFIs) report no funding or investment in local body projects.¹

Bank Credit by Sectors (All Banks), 2005 – 2011 fiscal years

In million Taka

Sectors	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Share
I. Public Sector	68,864	74,631	66,869	64,793	84,670	98,788	119,215	4%
Government	3,246	3,390	3,696	3,997	4,990	2,174	3,360	0%
Autonomous and semi-auto bodies	2,144	756	4,896	792	17,033	21,239	11,132	0%
Financial institutions	33	24	174	4	171	4	-	0%
Non-financial public enterprises	62,982	69,569	57,303	59,410	61,899	75,270	104,650	3%
(a) Nationalized sector corporations	61,685	68,629	56,365	58,620	61,899	74,823	104,051	3%
(b) Others n.e.c.	1,297	940	938	790	500	447	598	0%
(Error)	-	-	-	-	(500)			0%
Local bodies	457	323	183	155	128	100	73	0%
Others	2	570	617	435	-	0	-	0%
(Error)	-	-	-	-	450	-	-	0%
II. Private Sector²	1,048,458	1,217,022	1,398,864	1,750,732	2,005,816	2,475,647	3,093,633	96%
Grand Total million BDT	1,117,322	1,291,653	1,465,733	1,815,526	2,090,486	2,574,435	3,212,849	100%
Grand Total million US\$	\$ 13,967	\$ 16,146	\$ 18,322	\$ 22,694	\$ 26,131	\$ 32,180	\$ 40,161	

Source: Bangladesh Bank Bulletin

b. Bangladesh Municipal Development Fund

The BMDF provides financial and technical support to ULBs to increase their capacity to plan, finance, implement and operate infrastructure in a cost-effective and efficient manner. It was created under the Ministry of Finance in 1999 to manage the World Bank Bangladesh MSP, and in 2002 was registered under the Companies Act, 1994, as a “Company Limited by Guarantee without share capital.” The BMDF is empowered to “arrange and receive loans,

¹ Bangladesh Bank reports show no NBFI support to local bodies.

² Private sector lending by sector: agriculture and fishing (6%); manufacturing companies (41%); commerce & trade (29%); transport and storage companies (1%); construction companies (2%); private trust funds & non-profit organizations (0%); financial institutions (2%); professionals & self-employed persons (1%); and others (13%).

aid, grants and donations from any lawful source” and to make these funds available to ULBs on transparent terms and conditions.¹

The BMDF describes its vision as: (i) self-reliant urban-based local government body; (ii) planned infrastructure for comfortable urban livelihood; (iii) healthy and environment-friendly clean city; (iv) to be a hub of modern information technology; and (v) achievement of the Millennium Development Goals.²

From two World Bank International Development Association (IDA) credits (2004 and 2010) received by the Economic Relations Division of the Ministry of Finance, funds were transferred to the BMDF under a Subsidiary Loan and Grant Agreement. The BMDF is required to repay the government fifteen percent of total civil works costs over 20 years, including a 5-year grace period.

As of June 2012, the BMDF has used more than 97 percent of the World Bank fund and has implemented 594 sub-projects in 153 ULBs including 7 City Corporations. Total expenditures were US\$ 94.78 million (BDT 7582.3 million), of which US\$ 85.30 million (BDT 6824.1 million or 90%) came from IDA credit and US\$ 9.48 million (BDT 758.2 million or 10%) from the contributions made by the ULBs participating in the programs. Of the IDA portion, US\$ 12.80 million (BDT 1023.6 million) was loaned to ULBs; the balance was given as a grant. The major development works implemented so far are shown in the table below.

The BMDF receives funding requests from ULBs on a demand basis, and allocates funds based on availability, and the needs of the project. The financial packages include a combination of grants, loans, and the ULB’s own contributions for any infrastructure project. Project development entails participation of the beneficiary, the government, and donors or other organizations involved in project implementation.

To begin a project, the 10 percent ULB share must be deposited in an escrow account. Of the remaining 90 percent, 85 percent is given as a grant and 15 percent as a loan. The BMDF transfers money to the escrow account against contractor billing and evidence of project progress. ULBs repay the loan portion in 37 quarterly installments over 10 years after a one-year grace period.

Component	# ULBs	Quantity	Unit
Roads	141	1128	km
Drains	103	260	km
Kitchen markets	59	211	each
Water supply pipeline	24	173	km
Deep tube well and water treatment plants	16	36	each
Water treatment plants	2	2	each
Public toilets	36	87	each
Box culverts	13	32	each
Street lights	24	24960	set
Bus/truck terminals	9	9	each
Community centers	13	13	each
Slaughter houses	6	8	each
Office complex buildings	8	8	each
Solar led street lights	1	122	set

Recapitalization of BMDF. The BMDF is trying to raise BDT 97,056 million (US\$ 1.2 billion) to expand its operations. In this context, it has prepared a project proposal, entitled “Block Fund for BMDF for Participatory Urban Development (PUDDP).” Potential funders include: the World Bank, the Asian Development Bank (ADB), and bi-lateral donors. The BMDF has presented the PUDDP to government via the ADP in eight different sectors, and has asked government for BDT 600 million as seed money.

The new program would greatly expand the scope of BMDF’s lending, and include a special focus on revenue-producing projects and projects that could easily be categorized as climate-change mitigation and adaptation.

¹ Memorandum and Articles of Association of Bangladesh Municipal Development Fund. <http://www.bmdf-bd.org/Home>.

² Bangladesh Municipal Development Fund web site. <http://www.bmdf-bd.org/Home>.

The BMDF has already received applications from 125 ULBs for revenue-producing projects that include deep tube wells, water tanks, water treatment facilities, and other potable water-related infrastructure; low-cost housing schemes; municipal trade centers, community and health care centers; public toilets; slaughter houses; bus and truck terminals; compressed natural gas stations; kitchen markets; cold storage; and office buildings.

The BMDF would like develop specific loan products for: (i) municipal infrastructure maintenance;* (ii) solid waste management in the urban areas;* (iii) slaughter houses; (iv) healthcare projects; (v) water supply and sanitation service in the educational institutions; (vi) digitalization of City Corporations and municipalities; (vii) solar-based power supply to ULB office buildings;* (viii) solar street lighting;* (ix) environmental development and rehabilitation (such as water bodies, woods and forests, hills, etc.).*

Observations on BMDF funding. The BMDF could potentially serve as a pooled financing intermediary to raise market funding to on-lend to the ULBs, however, it would need to on-lend on more strict credit terms than it has offered in the past. One approach might be to have different financing “windows” for different types of funding or projects, with market-rate windows having a quicker turnaround and more technical assistance.

Due to its long association with the World Bank, the BMDF has established procedures for loan application and appraisal, and for project preparation and implementation. However, these procedures were established to manage what is largely a grant program and would have to be upgraded.

Until recently, BMDF borrowers have demonstrated good repayment performance. Repayment deteriorated during the national and ULB election periods, and as a result, the BMDF arranged with the Local Government Division (LGD) of the MLGRDC to assist with loan recovery from ULBs.

The BMDF apparently has no guarantees or credit risk mitigation arrangements built into its loan contracts with ULBs. Arrangements such as intercepts, lock boxes, or reserve accounts could reduce repayment risk, as would solidarity groups and direct deductions from bank accounts at the household level. Loan procedures, repayment arrangements, and contract terms would all have to be carefully reviewed and updated under a scenario where the BMDF became an intermediary for market financing.

c. Future borrowing needs

(1) Case Study: Sreepur Pourashava

With support from the Second Urban Governance and Infrastructure Improvement (Sector) Project (UGIIP-2), 35 Pourashavas have developed Pourashava Development Plans (PDP) according to guidelines developed by the MLGRDC with technical support from Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).¹ In addition, all UGIIP-1 Pourashavas developed a Municipal Infrastructure Development Plan (MIDP). In the Second Secondary Towns Integrated Flood Protection Program (STIFPP-2), nine participating Pourashavas developed a Municipal Development Plan (MDP).² PDPs, MIDPs and MDPs all contain a list of projects (mainly infrastructure related) with cost estimations and prioritization through participative processes. However, none of these plans include an analysis of the potential for cost recovery of the investment projects, since the norm for Pourashavas is

* Projects that could be categorized as climate change mitigation or adaptation projects.

¹ See a discussion of UGIIP-2 in Section V.C.5, Donors supporting ULBs, page 50.

² The Second Secondary Towns Integrated Flood Protection Program (STIFPP-2) is a US\$128 million project funded by the ADB and implemented by the Bangladesh Water Development Board (BWDB), Ministry of Water Resources (lead), and Local Government Engineering Department (LGED), Ministry of Local Government, Rural Development and Cooperatives.
<http://www.adb.org/sites/default/files/projdocs/2004/rpp-ban-26427.pdf>.

to solicit grant funding. GIZ generously provided the UNCDF team with the PDP prepared by Sreepur Pourashava, which is summarized in this section.¹

Sreepur Pourashava has a population of approximately 110,000 and an area of 46.97 km², and is situated 65 km north of Dhaka, surrounded by Telihati, Gosingga, and Mauna unions. The municipality is relatively prosperous, with a diverse employment base. The Dhaka-Mymensingh highway and Dhaka-Mymensingh railway serve it.

Sreepur's capital investment plan for 2011 to 2015 is shown in detail in Annex 2 and summarized below. The proposed funding sources are mostly grants, supplemented by the municipality's own surplus.

Sreepur PDP capital investments, 2010-11 to 2014-15

Goal	Lakh BDT Budget	US\$ Budget
1: Prepare master plan for Sreepur Pourashava	15.00	18.75
2: Provide quality physical infrastructure and urban services	5,173.00	6,466.25
3: Socio-economic development	240.00	300.00
4: Pourashava governance improvement	30.00	37.50
Total	5,458.00	6,822.50
Funding source	Budget	Budget
UGIIP-2 Local Government Engineering Department (LGED) Project	3,000.00	3,750.00
Local Government Department grants	500.00	625.00
Local Government Department project	9.00	11.25
Sreepur revenue surplus	949.00	1,186.25
BMDf grants/loan	500.00	625.00
Department of Public Health Engineering (MLGRDC)	500.00	625.00
Total	5,458.00	6,822.50

Sreepur's capital plan contemplates an expenditure of BDT 5458 Lakh or US\$6,822,000 over five years. Assuming a population of 110,000, this represents a very modest capital investment of US\$62 or BDT 4,962 per resident per year.

Even though PDPs projects are not categorized according to their revenue-producing potential, a review of the Sreepur PDP shows several projects that appear to be good subjects for private financing, including: (i) bus terminal; (ii) truck terminal; (iii) parking areas; (iv) green markets; and (v) animal slaughter houses.

Observation regarding capital investment needs. Extrapolated to the entire population of the country, the level of expenditure in Sreepur's capital investment plan represents an annual national demand of US\$9 billion or more than BDT 74,000 crore. This estimate could be refined to identify financing opportunities by (i) analyzing a sample of PDPs and categorizing ULBs and ULB projects by their revenue-producing potential, and (ii) researching the financial condition of the ULBs and the population's willingness to pay user fees, or other forms of cost recovery. It is recommended that this type of research be carried out during the next phase of the feasibility process, as a way to further develop estimates of ULB financing demand.

(2) Urban Development Authorities

The four UDAs (RAJUK, CDA, KDA, and RDA), are situated under the Ministry of Housing and Public Works, and carry out projects such as housing development, including affordable housing, infrastructure, roads, commercial development, markets, and industrial estates. As described in Section IV.C, *Legal framework governing local government and municipal finance* (page 15), the ordinances of the development authorities give them significant

¹ Sreepur Pourashava, District- Gazipur, July 2010, "Pourashava Development Plan (PDP)," Parts 1 and 2.

land-use and fiscal powers, including the capacity to raise funds through sales of land, to levy betterment taxes, and to borrow.¹ The activities of two of the development authorities—CDA and KDA, are briefly discussed below.

(a) Chittagong Development Authority²

Chittagong is the second largest city in Bangladesh, with a population of 3.5 million, and the principle city of the Chittagong Division. Chittagong is home to Bangladesh's most active seaport, a major center of commerce and the site of many industries. Bangladesh's only steel mill and oil refinery are located there.

Chittagong is run by the city corporation, yet the orderly development of this rapidly-growing city is attributed also to the work of CDA, including master planning, planning and development control, and preparation of long- and short-term development programs. With the support of the UN Development Program (UNDP) and UNCHS, CDA has put in place the Urban Development Plan, a Structure Plan, Storm water Drainage and Flood Control Master Plan, and a Long-Term Development Strategy for Traffic and Transportation. CDA has completed 6 projects, and has 18 ongoing and 5 upcoming projects. These include roadways, shopping complexes, industrial and residential estates, commercial plots, and other urban developments.

CDA is funded via the ADP, by donors, and from its own funds. Some CDA projects are being partially self-supporting, since they entail the sale of land which raises project funds. Other projects, such as the development of housing estates, should generate revenue in their operation. The CDA does not always execute the projects it prepares. Portions of the storm water drainage plan prepared with the assistance of CDA are being executed by Chittagong WASA with World Bank funding.³ (Information on CDA's current funding needs was not located.)

(b) Khulna Development Authority (KDA)⁴

Khulna is the third-largest city in Bangladesh, with nearly 1.2 million people, and is the capital of the Khulna Division. The city has a strong industrial base and provides a link to the second seaport of the country, Mongla, just 38 km away. The Khulna zone is known for its cultivation of shrimp, lobster, prawn, catfish, and crab. The Sundarbans, the world's largest mangrove forest, is located near Khulna, and attracts both domestic and international tourists.

Khulna City is run by the city corporation. KDA was created in 1961 to promote planned development and expansion of Khulna City and its suburbs. Similar to CDA, the authority is responsible for master planning, city development, and development control. Its planning has produced a Structure plan, Master plan and Detailed Area plan. KDA has a lead role in housing (including low-income housing), traffic and transport, drainage and solid waste management.

Since its inception, KDA has developed 40 projects, including planned residential areas, commercial areas, industrial estates, roads, markets, bus-terminals, community centers, and "welfare projects," for a total expenditure of US\$120.62 million.⁵ It has 8 projects in construction, and 15 projects in development, including major residential estates and commercial developments.

KDA receives funds for projects from donors via the ADP and uses its own funds. It is one of the beneficiary institutions of the ADB "City Region Development Project."⁶ Some KDA projects are self-supporting, since they

¹ The financial statements of the urban development authorities have yet to be analyzed as part of this feasibility study.

² Chittagong Development Authority web site, <http://portal.cda.gov.bd/index.php>.

³ US\$185.4 million Chittagong Water Supply Improvement and Sanitation Project, approved in 2010.³

⁴ Khulna Development Authority web site, <http://www.kda.gov.bd/index.php>.

⁵ Khulna Development Authority web site, http://www.kda.gov.bd/City_Development.php.

⁶ Asian Development Bank, 2010, "Report and Recommendation of the President to the Board of Directors, Project Number: 39298, Proposed Loan and Technical Assistance Grants, City Region Development Project, <http://www2.adb.org/documents/rpps/ban/39298/39298-01-ban-rrp.pdf>.

entail the sale of land. Other projects, such as the development of housing estates, should generate revenue in their operation. (Information on KDAs current funding needs was not located.)

(3) Other autonomous public agencies

In a number of countries, autonomous and semi-autonomous public agencies have a relatively easy time raising funds in the private market, because of their autonomy to operate and set tariffs that cover their costs. (The authority's legal functions are described in Section IV.C, *Legal framework governing local government and municipal finance* (page 15).) It is recommended that the GOB analyze feasibility of assisting these agencies to access the private financial market via PPPs or direct financing, including through refinancing existing grant-financed assets. This section analyzes two entities: the Bangladesh Bridge Authority and the Dhaka Water and Sewer Authority.

(a) Bangladesh Bridge Authority

BBA's financial objectives are: (i) to levy tolls at minimum levels so as not to discourage traffic from using the bridges, and (ii) to raise enough funds from road users and other uses to meet all operations, maintenance, and debt servicing obligations.¹ The World Bank, the Asian Development Bank, the Japanese International Cooperation Agency (JICA) and the government financed the Jamuna Bridge construction, which was completed in 1998. The loan portion of the financing had a 10-year grace period.

Toll bridges and toll roads are generally relatively easy to finance with private credit, due to the high value of the service provided (including time savings), and the ease of collecting the revenue. However, this depends on collecting tolls that are both economically viable and socially acceptable, and maintaining the value of the service through proper operations and maintenance. In its early years, the Jamuna Bridge operated with financial surpluses.

BBA now is responsible for development of the US\$2.9 billion Padma Multipurpose Bridge Project (PMBP). The original plan was to use surpluses from the Jamuna Bridge to cover certain costs of the PMBP. However, the lack of toll adjustments has led to operating losses in recent years, just as the end of debt service grace period approached. Therefore, toll increases close to 100 percent will be needed on the Jamuna Bridge in the next year, simply to cover debt service and deferred maintenance, and to begin rebuilding operating surpluses and reserves. Financing for the PMBP will be provided by the World Bank, the Asian Development Bank, JICA and the Islamic Development Bank.²

(b) Dhaka Water Supply and Sewerage Authority

Dhaka Water Supply and Sewerage Authority (DWASA) was established in 1963 to provide water and sewerage services to the city of Dhaka. In 1989, DWASA assumed responsibility for the city's storm water drainage system from DPHE. In 1990, DWASA assumed responsibility for the water, drainage and sanitation services of Narayanganj City. DWASA's activities were reorganized under the Dhaka WASA Act, 1996, to permit it to operate as a service-oriented autonomous commercial organization in the public sector. The jurisdiction of DWASA covers more than 360 Sq. km, divided into 11 geographic zones, with a population of roughly 125 million people.

There is no independent regulator for the water sector in Bangladesh. DWASA is regulated by the MLGRDC. The MLGRDC is also responsible for mobilizing grant funding for DWASA's capital projects. DWASA has some of the lowest tariffs in the world, according to its management staff, but the tariff is not economically sustainable.

¹ World Bank, 2011, Bangladesh: Padma Multipurpose Bridge Project, <http://documents.worldbank.org/curated/en/2011/01/13720556/bangladesh-padma-multipurpose-bridge-project>.

² In 2012, the project encountered delays due to procurement issues, which are expected to be resolved so construction can proceed.

DWASA operations essentially break even before paying for capital replacement, so the organization depends on grants (and an occasional concessionary loan) to fund its capital investment projects.

DWASA has tremendous capital investment requirements for expansion as Dhaka continues to spread out geographically and for technological improvements in its operations. Funds are needed to reduce non-revenue water, to expand sanitation coverage and storm water management, for sewage treatment plants, and for water pre-treatment as it shifts from 70 percent groundwater (which is rapidly being depleted) to a target 70 percent surface water over the next several years. The transition to surface water alone is estimated to cost US\$1.8 billion.

DWASA has received and continues to receive extensive donor support through the ADP. The principal donors currently are Danish International Development Agency (DANIDA), the World Bank, and the ADB. Other donors have included the U.S. Agency for International Development (USAID), UNDP (for technical assistance), and JICA. Higher tariffs would send better signals regarding the true cost of service usage, and would ensure sufficient revenue for its long-term sustainability, including its capital financing.

3. Emerging sectors of local finance

a. Climate change mitigation and adaptation

Bangladesh is ranked as the sixth most vulnerable country to flooding in the world, and the most vulnerable to cyclones.¹ Dhaka is classified as the most at risk city globally from the changing temperatures and weather systems that are forecast to occur in the coming years.² Climate change and the resulting sea level rise are causing floods, droughts, clogged drainage, erosion of river banks, salt water contamination of aquifers, and increased frequency of cyclones and intensity of storm surges.

Bangladesh's risk reduction efforts since the 1970s, include both structural investments and non-structural initiatives, including: rural and urban flood management; over 6,000 km of coastal embankment projects; over 2,000 cyclone shelters; irrigation projects; coastal mangrove planting along 9,000 km of shoreline; community-based programs and early warning systems; and agricultural research.

Bangladesh has also exhibited international leadership in defining strategies and policies. In 2005, it developed the National Adaptation Programme of Action (NAPA) and in 2008 approved the Bangladesh Climate Change Strategy and Action Plan (BCCSAP) (revised 2009). The Ministry of Environment and Forests is the lead agency for policymaking in this domain.

Bangladesh Climate Change Strategy and Action Plan. The BCCSAP programs are shown in Annex 3 of this report. The themes include: (i) food security, (ii) disaster management, (iii) infrastructure, (iv) research and knowledge management, (v) mitigation and low-carbon development, and (vi) capacity-building and institutional strengthening. BCCSAP programs are still predominately focused in rural and coastal areas; however, the document acknowledges the need for more effort to improve the resilience of towns and cities, in order to safeguard Bangladesh's economic growth, which is increasingly based in urban areas.

The GOB has yet to develop detailed cost estimates for the program, but interim estimates are US\$500 million of expenditures in years one and two, and US\$5 billion over the first five years.

¹ Ministry of Environment and Forests, 2009, "Bangladesh Climate Change Strategy and Action Plan, 2009," http://www.moef.gov.bd/climate_change_strategy2009.pdf.

² Maplecroft, Climate Change Vulnerability Index (CCVI), http://maplecroft.com/about/news/ccvi_2013.html.

A multi-pronged financing effort is underway. To date, PPPs and private financing are not featured in discussions about the financing of this program. The GOB dedicated US\$100 million of its own resources to activities covered by the BCCSAP in FY 2009–10 and budgeted US\$100 million in FY2010–11. Bilateral and multilateral agencies have provided considerable financing, and the GOB continues to seek more.¹ A multi-donor trust fund, the Bangladesh Climate Change Resilience Fund (BCCRF) was created and is being managed by the Ministry of Environment and Forests, with assistance from the World Bank. Contributions as of the third quarter 2012 total €112.3 million from eight donors.² In June 2012, the fund had approved projects worth US\$153 million.³

With its own resources, the government has created the Bangladesh Climate Change Trust Fund (BCCTF). A total of BDT 2,100 crore (US\$262.5 million) has been allocated to the BCCTF over the last three years, and a total of 82 projects of various types have been supported by the fund. The 2012-13 budget allocates BDT 400 crore (US\$50 million) to BCCTF.⁴

Pilot Program for Climate Resilience (PPCR). Bangladesh has also been accepted to participate in the PPCR by the PPCR Expert Group in 2009. This makes Bangladesh eligible for financial and technical assistance to strengthen its climate resilience.⁵ Because PPCR entails a consultative process among stakeholders including the ADB, the IFC, and the World Bank, it is also intended to assist the government with the coordination of its total pool of adaptation resources.

Local Climate Adaptive Living. UNCDF APRC in Bangkok has launched a new and innovative project called LoCAL (Local Climate Adaptive Living), a facility for investments in local level climate resilience. LoCAL seeks the most efficient and effective means for generating or leveraging resources for subnational climate change adaptation. It employs the PBCRG to channel global adaptation finance to local governments—who are often on the frontlines of climate change. The PBCRG enables local governments to invest in building local resilience, using existing national intergovernmental fiscal transfer systems and capital grants.

The LoCAL project is funding the bond feasibility study, and UNCDF expects the project to support follow-on activities recommended by the study, in order to promote market-based financing for climate change adaptation.

Climate change mitigation. This section is focused principally on adaptation projects; however, market financing could also support municipal mitigation projects. Funding could potentially be mobilized for mitigation-related local infrastructure projects through the Clean Development Mechanism (CDM) or other mechanisms that provide financial incentives and resources to reach emission reduction targets.⁶ Urban projects such as those to improve public building energy-efficiency, or improve greenhouse gas (GHG) emissions from solid waste facilities could comply with the conditions of these programs, and use them to enhance the feasibility of market financing for related mitigation investments.

International dialogue on climate change financing. The position taken by the GOB is that “all funds for adaptation [have] to be on a purely grant basis as the need for adaptation arise because of climate change due to the historical emission of GHGs by the industrialized countries.” While this position may be justified, it is probably unrealistic. The arguments in favor of looking for non-grant sources include the following.

¹ The World Bank, 2010, “Bangladesh: Economics of Adaptation to Climate Change,” http://climatechange.worldbank.org/sites/default/files/documents/EACC_Bangladesh.pdf.

² Global Climate Change Alliance, [no date], “The Bangladesh Climate Change Resilience Fund (BCCRF),” <http://www.gcca.eu/national-programmes/asia/the-bangladesh-climate-change-resilience-fund-bccrf>.

³ bdnews24, Jun 12, 2012, “Climate Fund approves \$153mn projects,” retrieved from <http://www.bdnews24.com/details.php?cid=2&id=226286>.

⁴ Ministry of Finance, 2012-13 Budget, http://www.mof.gov.bd/en/index.php?option=com_content&view=article&id=202&Itemid=1.

⁵ Other pilot countries in the PPCR include Bolivia, Cambodia, Mozambique, Nepal, Niger, Tajikistan, Yemen and Zambia.

⁶ Note that Sreepur Pourashava has included a CDM project in its capital investment plan (Annex 2).

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- There are no mechanisms to coerce industrialized countries to finance adaptation costs (estimated by the World Bank at between US\$75 and US\$100 billion per year globally), so contributions are likely to be short of goals.¹
 - The useful life of adaptation projects is often long enough to justify long-term financing arrangements.
 - The economic returns on some adaptation investments are high and time-sensitive, which makes private finance feasible. Where the returns are private, beneficiaries may even be willing to pay.

Internationally, a consensus is developing that private finance must be an element of any adaptation financing strategy. The UN's High-Level Advisory Group on Climate Change Financing estimated that up to US\$500 billion of private finance might be able to be mobilized, backed by public flows and carbon market revenues.² Bangladesh may be able to diversify adaptation funding by using public funds as incentives to encourage mobilization of private finance. In this context, municipal bonds or similar private funding mechanisms could be viable options.

b. Sustainable urban development

The sustainability agenda is not new in Asia, but it has acquired an increasingly urban focus. Goals include reducing energy use, integrating nature into development plans, and improving the social, economic, and environmental conditions in cities. Sustainable urban development often implies capital investments (new infrastructure or retrofitting of existing systems), and some of these investments have mitigation impacts.³ However, the focus of sustainable cities projects tends to be on improving on the quality and sustainability of urban life more generally. Two recent initiatives are summarized below.

United Nations Economic and Social Commission for Asia and the Pacific (ESCAP). ESCAP held its fifth Asia-Pacific Urban Forum (APUF-5) in Bangkok in 2011 on the topic of “Cities of Opportunity: Partnerships for an Inclusive and Sustainable Future.”⁴ The GOB participated through the Ministry of Housing. In 2010, ESCAP partnered with UN Habitat and others to issue “The State of Asian Cities, 2010-11.”⁵ Both ESCAP and UN Habitat could potentially support the design of a program to finance these sorts of efforts.

Asian Development Bank. The ADB recently issued a document entitled “Green Urbanization in Asia,” in which it identifies both the positive and negative externalities of urbanization.⁶ The report emphasizes that interventions are needed so that Asian cities reach the inflexion inflection point where environmental conditions begin to improve, sooner in their economic growth trajectory than has happened in other countries. While not a strategy document of the ADB, *per se*, it can be expected to orient ADB's future lending and technical assistance activities. Therefore, the ADB should be considered a stakeholder in the implementation of sustainable urban development activities, especially those which promote market finance.

4. Conclusions Related to the Demand for Private Finance

Bangladesh's constitutional system does not preclude allowing local governments to mobilize private financing. It is its fiscal decentralization policy that will allow this to happen. The proposed NUSP can be the basis for

¹ World Bank, 2010, “The Costs to Developing Countries of Adapting to Climate Change,” <http://siteresources.worldbank.org/EXTCCC/Resources/EACC-june2010.pdf>.

² United Nations, 2010, “Report of the Secretary-General's High-Level Advisory Group On Climate Change Financing,” http://www.un.org/wcm/webdav/site/climatechange/shared/Documents/AGF_reports/AGF%20Report.pdf.

³ UN Framework Convention on Climate Change, CDM.

⁴ UN ESCAP, Sustainable Urban Development Section, <http://www.unescap.org/esd/suds/>.

⁵ UN Human Settlements Program (UN Habitat), 2010, “The State of Asian Cities 2010/11,” <http://www.unhabitat.org/pmss/listItemDetails.aspx?publicationID=3078>.

⁶ Asian Development Bank, 2012, “Green Urbanization in Asia: Key Indicators for Asia and the Pacific 2012 (Special Chapter),” <http://www.adb.org/sites/default/files/pub/2012/ki2012-special-chapter.pdf>.

developing more practical guidelines for functional and fiscal decentralization, and its full implementation needs to be supported. Other conclusions related to the demand for financing include the following.

- There is a strong demand for financing for local infrastructure in Bangladesh, including for investments related to climate change adaptation. Demand is coming from ULBs, and could come from urban development authorities and other autonomous entities. It is necessary to develop a clearer idea of the acceptable terms and conditions of this financing, as well as to develop the rules and regulations for its use.
- An increasing number of municipalities are preparing investment plans and more should be encouraged to do so, since this will allow better estimates of the potential market. However, there is a lack of understanding of both the economic costs and benefits of using market-based financing for local infrastructure, and of the procedures and the requirements for market-based financing, especially municipal bonds.
- The current ADP system creates a financing bottleneck that can hold up infrastructure projects for years, and causes projects to compete for funding on criteria other than their economic value. In a market-based system, investors decide whether the project has economic worth. There could be significant economic benefits for the country from having a market financing option for local governments and autonomous entities.
- Due to its established financing systems and practices, and its knowledge of ULBs, the BMDF is a good candidate to provide market access for ULBs as an intermediary using a pooled financing arrangement. The GOB should carry out an analysis of the BMDF's potential for accessing the financial markets. To operationalize such a strategy, several actions would be necessary by the BMDF:
 - ◆ Analyze its pipeline to identify projects that would be appropriate for private financing.
 - ◆ Establish credit enhancements such as intercepts on ULB transfers, to lower repayment risk.
 - ◆ Revise its funding procedures to create separate funding windows with different ratios of subsidy and debt for different types of projects, based on the type of project and level of revenue generation.
 - ◆ Reach an agreement with donors to avoid undercutting lending conditions by providing grant funding when it is not necessary.
 - ◆ Update its rules and procedures with borrowers.
- Autonomous and semi-autonomous entities could be stronger candidates for market financing than ULBs, due to their autonomy and fiscal powers, if managed properly. The BBA and DWASA cases show that autonomous entity operations are not always economic, due to political pressures or management decisions. The four UDAs should be analyzed in more detail, with particular attention to their financial structure, payment streams, and the profitability of individual projects. Market financing could be used for these entities' new projects, or to refinance existing stable projects in order to recycle funds for new projects.
- Certain climate change adaptation or sustainable cities projects, including local infrastructure projects whose benefits accrue to specific property owners, may be financeable with market finance or through PPPs. Grant funds can be blended with market financing to lower financing costs and to expand the overall pool of financing for this purpose. The GOB should consider initiating a project aimed specifically at identifying adaptation projects suitable for private finance.
- Because most ULB capital projects are financed with grants, there is little attention paid to revenue generation. Developing market-based financing means articulating a fiscal decentralization policy that encourages tax mobilization, cost recovery, and financial strengthening generally, and uses grant funding (or full grant funding) more strategically as incentives or for socially-oriented projects. Successful implementation of the NUSP will depend greatly on the attention given to this topic. The GOB and donors should collaborate to develop a financial strengthening program for ULBs.
- Capacity is needed in central and local government to strengthen the demand side of the municipal finance market. These skills include, among others: capital planning, project identification and preparation, municipal

strengthening, financial administration, and community mobilization, as well as training on the functioning of the financial markets.

B. Supply: Capital and financial market overview

1. The financial system of Bangladesh

The country's financial system is composed of three sectors, categorized according to their degree of regulation: (1) the Formal Sector, (2) the Semi-Formal Sector, and (3) the Informal Sector.

The formal sector includes all regulated institutions like banks; NBFIs; insurance companies; capital market intermediaries like brokerage houses and merchant banks; and microfinance institutions (MFIs). The semi-formal sector includes regulated institutions that do not fall under the jurisdiction of the BB (the Central Bank of Bangladesh), the Insurance Development and Regulatory Authority (IDRA), the Securities and Exchange Commission (SEC) or any other financial regulator. These are mainly specialized financial institutions like House Building Finance Corporation, Palli Karma Sahayak Foundation, Samabay Bank, Grameen Bank, etc., non-governmental organizations (NGOs) and discrete government programs. The informal sector includes private intermediaries which are completely unregulated.

Each of these institutions conducts business in one or more parts of the financial market, which include:

- **Money market:** The primary money market is comprised of intermediaries (banks, NBFIs and primary dealers) and short-term financial instruments (savings and lending instruments, and treasury bills). The money market in Bangladesh is regulated by the BB.
- **Capital market:** The primary capital market operates to provide longer-term capital through private and public offerings of equity and bond instruments. The secondary capital market (where issues acquired through the primary market are traded) is composed of the Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE). The instruments in these exchanges are equity securities (shares), debentures, corporate bonds, and treasury bonds. The capital market is governed by the SEC.
- **Foreign exchange market:** The Bangladeshi currency, the Taka, became convertible on current account transactions in March 1994. The BB is the regulator of the foreign exchange market.

Because taka are not convertible in capital accounts, transfers of resident-owned capital abroad is subject to prior approval by the BB. In theory, this restriction should create a stronger demand for local infrastructure bonds.

2. State of the capital market

The capital market is still in development in Bangladesh. According to market measures such as the number of securities listed, transaction volume, and total market capitalization, development is accelerating. However, most listed companies are small, and the turnover of capital is low. According to many sources, investors lack confidence in the market, as the result of scandals experienced in 1996 and 2011.

Government has made a concerted effort over the past decade to address institutional weaknesses in the financial sector, beginning with the creation of the National Commission on Money, Banking and Credit and the Capital Market Development Committee, both in the 1980s. The ADB has lent considerable support to strengthening capital markets, and the IMF and the World Bank have supported banking sector reform.

a. Institutional development

The capital market in Bangladesh is relatively advanced in terms of the development of institutions. Their functions are described in this chapter. At present, the following capital market intermediaries are in place:¹

Intermediary	Purpose
Stock exchanges	Dhaka Stock Exchange (created in 1954; trading began in 1956) and Chittagong Stock Exchanges (created in 1995). The exchanges principal functions are to: list companies; provide trading facilities; administer, control, and provide surveillance to the market; monitor the activities of listed companies; and disclose price-sensitive information about traded companies. They can list any share, scrip, debenture, term finance certificate, bond, pre-organization certificate or other instruments accepted for listing in accordance with the Listing Regulations.
Central depository	The Central Depository Bangladesh Ltd (CDBL) was formed in 2000 for the transaction and settlement of financial securities.
Stock dealers and brokers	These entities are licensed and must be a member of at least one of the two stock exchanges. At present, DSE has 238 members and CSE has 136 members.
Merchant banker and portfolio manager	45 of these institutions are licensed to operate under SEC (Merchant Banker & Portfolio Manager Rules), 1996.
Asset management companies (AMCs)	15 AMCs act as issue and portfolio managers for mutual funds, which are issued under SEC (Mutual Fund) Rules, 2001.
Credit rating companies (CRCs)	5 CRCs in Bangladesh are licensed under Credit Rating Companies Rules, 1996.
Trustees/custodians	All asset-backed securitizations and mutual funds must have an accredited trustee and security custodian. SEC has licensed 9 Trustees and 9 custodians.
Investment Corporation of Bangladesh (ICB)	A specialized intermediary, it was established by the Investment Corporation of Bangladesh Ordinance, 1976, with three subsidiaries: ICB Capital Management Ltd., ICB Asset Management Company Ltd., and ICB Securities Trading Company Ltd.

b. Market capitalization

Market capitalization is low, signaling low participation of companies in the stock market, given the size of the economy. The graphic below shows that while stock market capitalization relative to Gross Domestic Product (GDP) doubled to 21 percent of GDP between 2007 and 2011, the market capitalization was still low compared to capitalization of 46 percent of GDP in Indonesia and 55 percent of GDP in India.²

c. The debt market

Both debt and equity can be traded on Bangladesh's stock exchanges. Treasury bills and bonds are issued in the Dhaka market, but are not traded there.

¹ Bangladesh Bank, "Capital market," <http://www.bangladesh-bank.org/finansys/capmarket.php>.

² World Bank, Data, Bangladesh. <http://data.worldbank.org/country/bangladesh>.

The debt market of Bangladesh is dominated by government debt securities, such as treasury bills, treasury bonds, and national saving certificates, which account for two-thirds of the total domestic debt market. Buyers of treasuries are largely institutions such as banks that are buying to satisfy statutory liquidity requirements (SLR), and who hold to maturity. The primary issuance of these securities takes place through allocations to the primary dealers.

The private bond market is very small and effectively no trading takes place. Interest in bonds has been adversely affected by the failure of some debentures¹ to repay, and by the successive crashes in the equity market.² Corporate bond issues are undertaken only very occasionally, and often on a private placement basis. Currently, there are 8 debentures listed on the DSE, with a total value of BDT 42.74 crore, and 6 corporate bonds on both the Dhaka and Chittagong Stock Exchanges, with a combined market value of BDT 1.3 crore.³

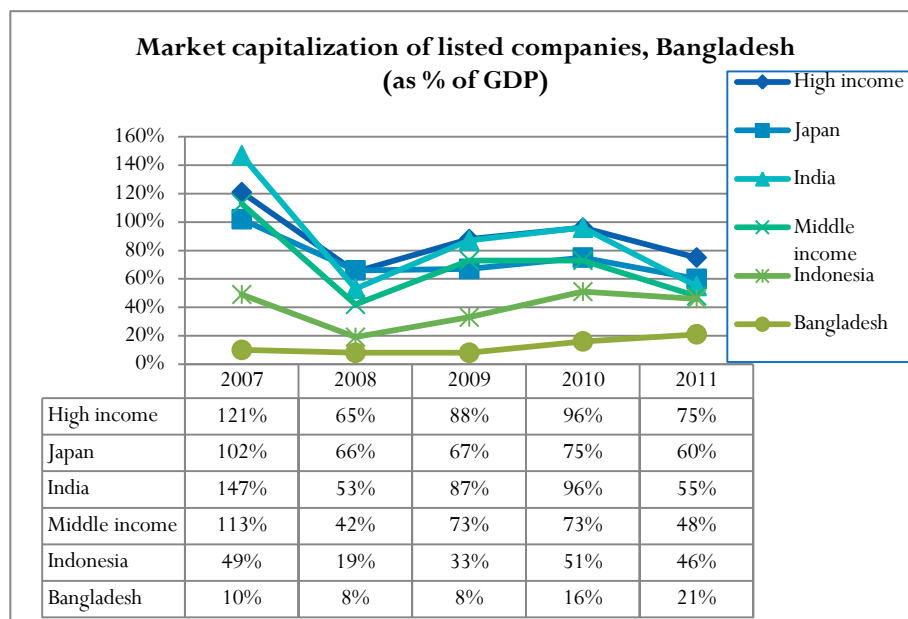
d. Interest rates

Interest rates are high in Bangladesh, which is likely retarding the development of the bond market, and will also impede development of a municipal bond market, especially if the bond terms are long (more than 5 years).

Inflation is high due to a range of factors, including excess demand for certain goods. Interest rates are high as a result of high inflation, as well as the operational inefficiency in the banking sector, high interest rates spreads (savings rate versus lending rate), and high levels of non-performing loans in the portfolio.

Government bonds and the National Savings Scheme (NSS) also pay high interest rates (an average of 12 percent in the past three years), and establish a benchmark with which banks must compete. The government has committed with the IMF to reduce both the inflation rate and the interest rates over the next few years, and to encourage the use of market financing or public-private partnerships for certain types of investment projects now funded fully by government, including infrastructure.

Bond issues are also subject to high transaction costs in Bangladesh, including registration fees, stamp duties, annual trustee fees on outstanding amounts and ancillary charges, all of which lower the return on the bond.



¹ Debentures are private debt instruments similar to treasury bills or bonds; that is, they are secured only by the cash flow of the issuer, rather than by any physical collateral.

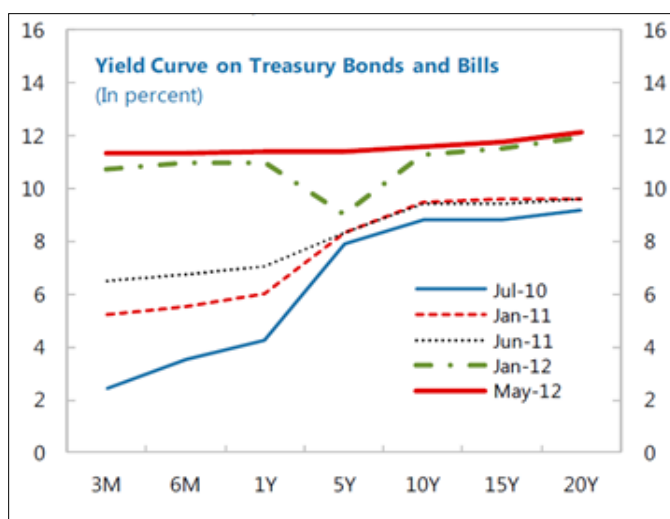
² Aljazeera News, January 10, 2011, "Clash in Bangladesh as stocks dive."
<http://www.aljazeera.com/news/asia/2011/01/201111084516632519.html>.

³ Figures on debentures and corporate bonds provided by Md. Sirajur Rahman at StockBangladesh, Ltd, closing price Dec. 12, 2012.

e. Yield curve and secondary market

A yield curve is a set of interest rates for income-earning securities of equal quality but different maturities (terms). They also communicate information to economists about future market performance. They are generally based on secondary market trades of treasury securities and represented graphically for a point in time. Treasury securities are considered to have the lowest risk, so their yields are a baseline for other (higher-risk) issues. The yield is not the same as the interest rate on the security, since security values change over time. For that reason, yield curves are developed using secondary market trades.

It is difficult to sell securities such as municipal bonds without having a yield curve on which to base the interest rate, since yield is one of the main selling points. The chart to the right shows an estimated yield curve developed by the IMF.¹ The BB recently announced that as of December 17, 2012, it will operate an on-line Trader Work Station (TWS) for secondary trading of all future government treasury bonds. Duly registered banks, insurance companies, financial institutions, pension funds, mutual funds, and provident funds, as well as individuals and institutional investors can use in the system. Information on trades will be available at the Bangladesh Bank website.²



Moving the treasury securities secondary trades into the open market and making trading information available is an important step toward the development of the bond market.

Secondary markets generally depend on market makers, which are broker-dealer firms that both buy and sell bonds, in response to investor demand. They sell from an inventory of securities that they maintain, and they buy whether or not they are sure another buyer is immediately available. In an active market, market making is a profitable activity for broker-dealers and there may be several firms that compete for the business. In emerging markets, such as Bangladesh, governments or issuers may pay broker-dealers to play role and underwrite losses.

f. Credit ratings

Credit ratings are a risk management tool for investors in debt. They provide reliable, standardized information regarding the financial condition and the risks associated with issuers of debt and/or specific financial transactions or structures such as special purpose vehicles. In some developing markets, including India and Mexico, credit rating agencies have also advanced municipal market consolidation by helping to establish

Credit Rating Agencies in Bangladesh

- Credit Rating Information and Services Ltd (CRISL)
- Credit Rating Agency of Bangladesh Ltd (CRAB)
- National Credit Ratings Ltd
- Emerging Credit Rating Ltd
- ARGUS Credit Rating Services Ltd
- WASO Credit Rating Company (BD) Ltd
- Alpha Credit Rating Ltd
- The Bangladesh Rating Agency Ltd

¹ International Monetary Fund, June 2012, "Bangladesh: Selected Macroeconomic Indicators," <http://www.imf.org/external/country/bgd/rr/2012/060112.pdf>.

² Bangladesh Bank ticker web site, <http://180.211.208.61/bbwebsite/ticker/miticker.php>.

the norms by which municipal financial condition is evaluated. In the case of these two countries, ratings agencies began producing "shadow" (non-public) ratings well in advance of the entry of municipalities into the market. These shadow ratings pointed out financial weaknesses that would require strengthening before the municipality should consider market financing.

There are currently eight credit rating agencies in Bangladesh, as shown in the text box above, all located in Dhaka, and all of them established between 2002 and 2012.

None of the ratings agencies has yet issued municipal rating criteria, since there is no pipeline of municipal securities to rate. Developing criteria and carrying out ratings will be difficult given the poor quality, quantity, and standardization of financial information available, and the lack of municipal accounting norms. Lack of credit ratings will prevent municipal bond issues, assuming they would follow the Private Placement of Debt Rules (PPDRs). [See explanation in next section.] Once work begins to improve municipal accounting and auditing, government should engage the credit rating agencies in a process to define municipal ratings criteria.

g. SEC Regulation relevant for municipal bonds

The Bangladesh capital markets and debt markets are regulated by the SEC, which was constituted pursuant to the Securities and Exchange Ordinance, 1969. Securities under the Ordinance, include: (a) any instrument creating a charge or lien on the assets of the company; and (b) any instrument acknowledging loan or indebtedness of the company and guaranteed by a third party or entered into jointly with a third party, such as includes bonds, debentures, debenture stock.¹ [Section 2(l)] The Ordinance stipulates the SEC must approve sales of issues of capital and public offers of securities, and renewal or postponement of maturity dates or repayment dates of any security. [Section 2A]

The SEC has formulated various rules and regulations. The most relevant of these for issues of municipal bonds are: (i) SEC (Private Placement of Debt Securities) Rules, 2012 (which were notified on October 29th, 2012) (the "Private Placement of Debt Rules [PPDR]"); and (ii) Securities and Exchange Commission (Public Issue) Rules, 2006 (the "Public Issue Rules [PIR]").

(1) Private Placement

The PPDRs are applicable to issuance of debt securities by an issuer unless it is otherwise specifically exempted by the SEC, or is regulated another rule. Issuers include government, or public or local authorities, or development or credit institutions. [Section 2i] Thus, the PPDRs would govern any issue of municipal bond on a private placement basis, unless the SEC by notification either specifically exempts municipal bonds from the applicability of the PPDRs, or the SEC formulates specific rules governing municipal bonds. Since initial municipal bond issues are likely to be issued on a private placement basis to identified government agencies, banks or financial institutions, these rules are the most relevant regulations for any pilot municipal bond issue.

Private placement of debt securities requires compliance with a range of financial and bureaucratic requirements:²

- (i) total debt of the issuer (including the proposed issue) should not exceed 60 percent of its total tangible assets;
- (ii) the forecasted financial position of the issuer should indicate a significant profitability, liquidity, and ability to pay back, with reasonable basis of making such forecasts;
- (iii) the issue is rated by a credit rating agency and will be periodically reviewed by the same rating agency until redemption;

¹ Securities and Exchange Ordinance, 1969.

² Securities and Exchange Commission (Private Placement of Debt Securities) Rules, 2012, Rule 3.

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- (iv) the issuer has a valid enforceable interest over its assets and the right to create charges thereon;
 - (v) the issuer has obtained all necessary approvals from its primary regulator for undertaking the issue;
 - (vi) the issuer has appointed a trustee for the issue, who is registered with the SEC; [Rule 9]
 - (vii) the financial statements of the issuer has been prepared as per Bangladesh Accounting Standards (“BAS”) and audited as per Bangladesh Standards of Auditing (“BSA”);
 - (viii) the trustee should have examined all the documents including the legal and title documents, and provided a due diligence certification in the prescribed format;
 - (ix) the issue has been approved by the Board of Directors or the governing body of the issuer;
 - (x) the issuer has obtained the consent of the SEC; [Rule 4]
 - (xi) the issuer has paid the fee of 0.1 percent of face value of the securities to be issued; [Rule 7]
 - (xii) after obtaining the consent of the SEC, and before issuing the securities, the issuer must: (a) execute the deed of trust appointing the trustee, (b) create charges over the assets for secured bonds, (c) execute guarantees in favor of the trustee, (d) certify the proper execution of the required documents, and (e) list the securities. [Rule 8]

The contents of the Information Memorandum that must be issued are mandated under the PPDRs include the results of the audit and the calculation of a range of financial ratios. [Rule 4]

(2) Public Issue

The PIRs govern any offering of security to the general public through either an initial public offering (“IPO”) or a repeat public offering (“RPO”). IPO is the first offering of security by an issuer to the general public, while an RPO is a further issuance of security from which capital has been raised from an earlier IPO.

IPOs and RPOs require the consent of the SEC and submission of a draft prospectus in accordance with the Public Issue Rules (PIRs). The PIRs stipulate extensive disclosure requirements in the prospectus. It should be noted that although the PIRs are not limited only to companies, the disclosure rules could not be easily applied to a municipality or a development authority since they relate to a company incorporated with equity shares.

Thus, in order to enable even pilot issues of municipal bonds to be undertaken, a specific exemption would be needed from the SEC or the SEC should be requested to formulate specific rules covering issuance of municipal bonds.

h. Policy and institutional reforms underway in the capital markets

Bangladesh has worked with the support of donors on key reforms in both the capital and financial markets over more than 15 years, with additional reforms in the works.

The first Capital Market Development Program (CMDP) was approved in 1997. The CMDP aimed to broaden market capacity and develop a fair, transparent, and efficient domestic capital market to attract larger amounts of investment capital to augment the capital resources provided through the banking system. The project aimed to restore investor confidence, following the 1996 stock market crash (which was caused by widespread irregular activities) and supported reforms such as the creation of the CDBL.

The ADB is currently negotiating the Second CMDP with the government, a policy loan of US\$215 million, but has not reached final agreement with the GOB on the operation's benchmarks.¹ The goal is to strengthen the SEC

¹ Asian Development Bank, Second Capital Market Development Program, <http://www.adb.org/projects/43477-013/main?ref=countries/bangladesh/projects>.

and the regulation of the country's capital market. Some of the reforms are expected to be the following:¹

- Establishing a special capital market tribunal and a state-of-the-art surveillance system at the SEC.
- Establishing a national central pool of funds by Bangladesh Bank, including provident funds and pension funds, and thus making those available for investment in government securities.
- Creating an independent financial reporting council to lead adoption of international accounting standards.
- Eliminate government approval of the SEC budget, expenditure from the SEC fund, and hiring and pay of SEC officials.

The country also receives support from the IMF, and, in the context of its latest Letter of Intent, signed in March, 2012, has agreed to a series of reforms aimed at improving the competitive environment, and strengthening the supervision and regulation of both the capital and financial markets.²

3. Other sources of financing

a. The banking sector

Most debt in Bangladesh is borrowed from banks. The amount of bank credit in circulation dwarfs all the activity in the stock exchange. Banks raise their funds from attracting savers and from issuing their stock in the stock market. Of the 252 companies listed on the DSE, 52 are categorized as banks or financial institutions. Banks rarely lend to ULBs in Bangladesh, as shown in Section V.A, *Demand: Potential users of bond financing* (page 21), yet certain conditions in the banking sector contribute to the demand for bond market development, and are therefore relevant to the feasibility study.

According to the BB, the banking sector consists of 47 scheduled banks, which operate under the Bank Company Act, 1991 (amended in 2003), and four non-scheduled banks, established for special purposes and operating under other acts. Non-scheduled banks cannot perform all the functions of scheduled banks.

The scheduled banks include: State-Owned Commercial Banks (4); specialized banks operating for specific objectives like agricultural or industrial development, fully or majorly owned by the government (4); conventional private commercial banks (PCBs), which perform conventional banking functions (23); Islami Shariah based PCBs, whose banking activities conform to Islami Shariah based principles (7); Foreign Commercial Banks (FCBs) (9), which operate in Bangladesh as branches of foreign banks.

At 71 percent of GDP, banks credit is three and a half times stock market capitalization (21 percent of GDP). Outstanding credit from banks totaled BDT 3.2 trillion (US\$40.2 billion) in June 2011. BB data shows that short-term loans (working capital and trade finance) comprise nearly 50 percent of all loans. Industry and infrastructure (water and sanitation, transport, and communications) makes up 38 percent. When banks finance long-term investments, they create a mismatch between the term of the deposits and the term of the loan. This mismatch adds risk to the financial markets, and has been identified as a concern by the IMF in its latest letter with Bangladesh.³ Reducing the amount of financing subject to this mismatch is a motivation for bond market development in emerging markets.

¹ Center for Enterprise and Society web site, <http://cesulab.wordpress.com/2012/07/09/adb-suggests-reform-measures-to-revamp-the-capital-market-of-bangladesh/>.

² IMF, 2012, Bangladesh: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, <http://www.imf.org/external/np/loi/2012/bgd/032712.pdf>.

³ IMF, 2012, Bangladesh: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, <http://www.imf.org/external/np/loi/2012/bgd/032712.pdf>.

In sectors where private banks cannot provide enough long-term capital, the government has continued to operate and/or finance specialized banks such as the Bangladesh Development Bank Limited¹ and the National Housing Finance and Investments Limited,² both scheduled banks.³

The financial sector has been undergoing a transition whereby relatively more assets are held by private banks, similar to the insurance sector. There have also been significant improvements in the regulatory system over the past decade, in conformance of banks with international standards (Basel).

b. Public-Private Partnerships

The PPP model is relatively new in Bangladesh. The GOB's strategy is two-pronged: to attract investment for new and expanded infrastructure projects; and to attract innovation and sustainability in public service delivery. The 2004 Private Sector Infrastructure Guidelines (PSIG) were succeeded by the Policy and Strategy for Public-Private Partnership in 2010.⁴

Successful implementation means controlling numerous risks, including political, commercial and natural disasters risks. Challenges with PPPs in Bangladesh have included insufficient competition, poor specification by the government, inexperienced bidders, delays in project implementation, absence of penalties for renegeing on contracts, and irregularities in bidding and contracting processes.⁵

The country is still on a learning curve with PPPs. Not all PPP projects attempted have been successful, for example: (i) the AES Meghanaghat 450 megawatt power project (successful); (ii) the Sonamasjid Land Port (unsuccessful); (iii) the Jatrabari-Gulistan Flyover project (distressed); and (iv) the Patenga Container Terminal (canceled).⁶

A PPP Office under the Prime Minister's Office supports line ministries with the identification, development and tendering of PPP projects to international standards.⁷ A PPP unit within the Ministry of Finance supports the financial aspects of PPP initiatives. The 2009 Local Government Ordinances allow City Corporations and municipalities to undertake PPPs. The draft NUSP, if approved, would provide further impetus from a policy standpoint. Technical assistance and possibly legal reforms aimed specifically at these entities will also be needed.

C. Potential investors in municipal bonds

Investors in municipal bonds must find the risk/return trade-off attractive, as with any security. There is a tendency to think that bond buyers will be only those looking for long-term investments, such as insurance companies and pension funds, but this is not necessarily the case. If there is a secondary market, bonds can be traded before redemption, thereby increasing the number of potential buyers.

In developed markets, demand for bonds comes from many sources. As of late 2011, the U.S. municipal bond market had US\$3.733 trillion outstanding. Retail investors owned 52 percent of all municipal securities.⁸ Other buyers of municipal bonds are: (i) securities dealers; (ii) government-sponsored enterprises; (iii) money market

¹ Bangladesh Development Bank Limited web site, <http://www.bdbl.com.bd/>.

² National Housing Finance and Investments Limited web site, <http://www.nationalhousingbd.com/index1.html>.

³ International Monetary Fund, 2010, IMF Country Report No. 10/38, Bangladesh: Financial System Stability Assessment. <http://www.imf.org/external/pubs/ft/scr/2010/cr1038.pdf>.

⁴ Government of Bangladesh, 2010, Policy and Strategy for Public-Private Partnership, <http://www.pppo.gov.bd/wp-content/uploads/2012/03/policystrategyforpppaug2010.pdf>

⁵ Fouzul Kabir Khan, France-Bangladesh Chamber of Commerce & Industry, PPP workshop, Dhaka, Oct 2, 2012.

⁶ The Daily Star, Five Factors Set Back PPP: Analyst, Oct 3, 2012. <http://www.thedailystar.net/newDesign/news-details.php?nid=252275>

⁷ Public-Private Partnership Office web site, <http://www.pppo.gov.bd/>.

⁸ This compares to US\$15.236 trillion of U.S. treasury securities outstanding in January 2012.

funds; (iv) mutual funds; (v) property-casualty insurance companies; (vi) life insurance companies; (vii) the Federal Reserve; (viii) U.S. chartered depository institutions (banks). The tax-exempt status of municipal bonds in the U.S. makes them an attractive security for high-income individuals, but they are owned by households across the income spectrum.

The likely investors in Bangladesh are: (i) insurance companies, (ii) pension funds, (iii) mutual funds, and (iv) banks and NBFIs.

1. Insurance companies

In Bangladesh there are 17 private life insurance companies, 43 private general insurance companies, and two government insurance companies. The insurance industry is regulated by IDRA and operates under several laws including: The Insurance Act, 1938; Insurance Rules of 1958; Bangladesh Insurance (Nationalization) Order 1972; The Insurance Corporations Act, 1973; Insurance (Amendment) Ordinances of 1984; The Insurance Act, 2010. The 2010 Insurance Act was passed to modernize the sector, and includes provision for micro-insurance companies and for foreign investment in the sector.

IDRA regulates both the types of securities insurance companies can hold, and the proportion in the portfolio. For example, thirty percent of company investments must be in government treasury instruments. The balance can be in other investments such as corporate shares, corporate bonds, real estate, mortgages, etc. These restrictions will be phased out under the 2010 law. Insurance companies also hold a significant amount of cash in financial institutions.

The Bangladesh Insurance Association (BIA) represents the life insurance and general insurance companies. It promotes the interests of member companies and of the industry, and supports the industry's transparency by publishing information about the structure and performance of the companies.

BIA's latest annual report points out the small size of the insurance industry relative to other countries in the region.¹ The rate of growth in the sector is significant; the life sector grew at 26.7 percent in 2009. However, the penetration of insurance (measured as premium as a percent of GDP) is only 0.9 percent (0.7 percent for life insurance and 0.2 percent for non-life). This is compared to penetration in other countries in the table below.

Combined Insurance Penetration by Year as % of GDP²

Year/Country	2006	2007	2008	2009	2010
Czech Republic	3.8%	3.7%	3.8%	3.9%	4.2%
Japan	7.1%	7.5%	8.2%	8.8%	8.7%
Korea	11.3%	11.8%	10.8%	11.0%	11.2%
Malaysia	--	--	--	--	5.2%
Mexico	1.8%	2.0%	1.7%	2.0%	1.9%
Poland	3.5%	3.7%	4.6%	3.8%	3.8%
Turkey	1.1%	1.3%	--	--	1.3%
United States	10.7%	10.8%	10.6%	11.3%	11.1%
OECD - Total	9.1%	9.3%	8.7%	9.4%	9.0%
Bangladesh	0.6%	0.7%	n.a.	n.a.	0.9%

¹ Bangladesh Insurance Association, 2012, Insurance Year Book 2010, http://bia-bd.org/index.php?option=com_content&view=article&id=23&Itemid=76.

² Organization for Economic Cooperation and Development, OECD StatExtracts (table designed by author), <http://stats.oecd.org/Index.aspx?DatasetCode=INSIND#>.

The low penetration, as well as the statutory investment requirements, reduce the funds available for investment in infrastructure projects or municipal bonds. It is assumed that the updated regulations will call for investments to be made based on ratings, rather than imposing statutory investment requirements. If this is the case, it may provide more flexibility to the insurance companies to invest in municipal infrastructure projects, assuming these can be structured to maintain risk at acceptable levels.

The table below shows funds invested at the end of 2010 (Investments = total of Investments and Fixed Deposits). This table demonstrates that the insurance sector should be considered an important stakeholder in the development of the municipal investment system, for several reasons. First, insurance penetration is likely to rise as GDP increases, thereby increasing the supply of investable funds; the industry is implementing regulatory reforms that should be monitored to ensure that municipal infrastructure is permitted as an investment option; and insurance companies may be more comfortable investing in municipal bonds, even in an absence of a secondary market, because of their need for long-term investments.

Consolidated Balance Sheet of Insurance Companies, Bangladesh, December 31, 2010
In Millions of Taka

	Life Insurance	General insurance	Total	Total In Millions US\$
Assets				
Investments	81,066	9,558	90,624	\$ 1,133
Fixed deposits	43,036	13,369	56,405	\$ 705
Cash and bank balances	18,699	3,016	21,715	\$ 271
Debtors	15,136	11,783	26,919	\$ 336
Other assets	9,535	6,853	16,388	\$ 205
Total assets	167,472	44,579	212,051	\$ 2,651

2. Pension funds

In the terminology of the pension policy field, every pension or old age security program belongs to one of three "pillars," which include:¹

Pillar 1: Public-financed, publicly managed social assistance scheme	<ul style="list-style-type: none"> ▪ Social safety-net programs that attempt to reduce poverty in the elderly through income redistribution. ▪ Nearly always funded from the current public budget on a pay-as-you-go (PAYG) basis. In Bangladesh, this is called Old Age Allowance.
Pillar 2: Public pension plan (defined benefit or defined contribution)	<ul style="list-style-type: none"> ▪ Mandated savings programs intended to smooth consumption between a person's working years and retirement. ▪ Participants contribute during working life, usually through a payroll tax. Employee, employer or both may contribute. Funds may be managed publicly or privately. The Government Pension Scheme falls in this category.
Pillar 3: Privately managed occupational or personal pension plan (defined benefit or defined contribution)	<ul style="list-style-type: none"> ▪ Privately managed, mandated or voluntary savings programs, which supplement retirement income provided by mandatory schemes. ▪ Participants may be eligible for incentives such as tax preference. ▪ These plans are sold by institutions selling mutual funds in Bangladesh.

¹ Asian Development Bank, 2003, Technical Assistance Performance Audit Report on the Reform of Pension and Provident Funds in Selected Developing Member Countries. <http://www.adb.org/documents/reform-pension-and-provident-funds-selected-developing-member-countries>. A 5-pillar variation is found in Holzmann and Hinz, 2005, "Old-Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform," The World Bank, <http://go.worldbank.org/NOHR1Y9LU0>.

Both Pillar 3 plans and some Pillar 2 plans accumulate funds that could be invested through the capital markets.

Old Age Allowance (Pillar 1). The Old Age Allowance was introduced in Bangladesh in 1998. In FY 2011-2012, Government allocated 891 crore Taka (US\$111 million) to the program, which benefits approximately 2.5 million people. Beneficiaries get approximately BDT 300 (US\$3.75) per month, and are selected by a UP committee as the neediest in the jurisdiction.¹ These payments are funded from current public revenue.

Government Pension Scheme (Pillar 2). The public pension scheme in Bangladesh is available only to salaried government employees, including those of certain autonomous bodies. It is a mandatory, contributory, defined benefit pension system that provides various benefits, including Compensation, Invalid, Superannuation, Retiring, and Family pensions. Employees must begin contributing to the pension fund after two years of employment, and continue until they reach the age of 52. Ten years of service are required to receive a pension, which varies depending on salary and length of service. The scheme is managed by the Ministry of Public Administration.

Employees can also make contributions to a Benevolent Fund and a Group Insurance Fund. These funds are governed by the Board of Trustees of the Government and Autonomous Bodies Employees Benevolent and Insurance Fund.

The cost of government employee pensions in the GOB budget was BDT 5041 crore (US\$630,181,000) for 2012 (revised) and BDT 4519 crore (US\$564,935,000) for the 2013 fiscal years.² The portion of these payments that is covered by the contributions made by employees could not be determined. (A 1999 ADB report cited a 5% contribution.)³ Nor is it known whether contributions are kept in separate reserves and invested separately. Most likely, they are merged directly into the public treasury.

If public pension contributions were kept in separate funds, and managed by a private investment manager, this would represent a huge quantity of funds that could be invested in local infrastructure. Even if this fund provided only fifty percent of the payments, its value could be more than BDT 16,500 crore (US\$2 billion).⁴

Private pensions (Pillar 3). Bangladesh has low participation in private pension plans. Some plans are available in institutions such as universities and in the private sector. A special entity entitled the Welfare Trust for Teachers and Employees of Non-Government Educational Institutions (WTTENEI), headed by the Minister of Education, manages the pensions of these classes of employees. This trust fund received modest initial capital from government, but it is funded by employees and students. In some key sectors such as agriculture, which employ a large segment of the population, there is no pension system. Informal sector employees are also not covered.

Microcredit institutions offer some long-term savings programs, such as Grameen Pension Savings, aimed at savers in the informal economy.⁵ All borrowers with loans above BDT 8,000 (US\$138) must contribute a minimum of

¹ Armando Barrientos, 2012, "What is the Role of Social Pensions in Asia?," Asian Development Bank Institute, No. 351. <http://www.adbi.org/working-paper/2012/04/11/5044.role.social.pensions.asia/>.

² Government of Bangladesh, 2012-13 budget. www.mof.gov.bd/en/budget/12_13/safety_net/en.pdf.

³ Asian Development Bank, 2003, Technical Assistance Performance Audit Report on the Reform of Pension and Provident Funds in Selected Developing Member Countries.

⁴ Calculated based on fifty percent of US\$620 million discounted at 15%.

⁵ Cheolsu Kim and Gautam Bhardwaj, 2011, South Asia Pension Forum: Fostering Inclusive and Sustainable Pension Systems in the Region. <http://www.adb.org/publications/south-asia-pension-forum-fostering-inclusive-and-sustainable-pension-systems-region>.

BDT 50 (US\$0.86) each month in a pension deposit account. This program is now bringing in over US \$ 1.75 million per month to the Bank.¹ These funds might be available for investment in long-term projects.

Pension Funds could be an important source of financing for ULBs, but they not now an active participants in the capital market or in PPP infrastructure projects because of restrictions limiting their investments to Government and Government –approved securities and lack of experienced investment managers. They also may need better incentives, such as approval by the National Board of Revenue for tax deduction and incentives under the income Tax Ordinance, 1995.

3. Mutual funds

Mutual funds are pools of money of individual and institutional investors that are invested in securities such as stocks, bonds, treasuries, derivatives, etc. For investors, mutual funds create economies of scale and therefore increase investment returns by reducing costs. They also allow for diversification, provide flexibility in buying and selling, and allow investors to have access to superior fund management. In Bangladesh, they also provide tax-efficiency, due to the tax-exemption of earnings.

As of November 2012, there were 41 mutual funds in Bangladesh, according to the DSE.² Mutual funds represented 1.8 percent of total market capitalization as of July 2012 (BDT 42,406 million or US\$519,050,685).³

Most of the mutual funds in Bangladesh are close-end funds, in which the number of shares is fixed at inception. Close-end funds are traded on the stock exchange and priced based pm secondary market trades, similar to stocks. In theory, this allows close-end fund managers to concentrate on long-term capital investment and yield.

Open-end fund are priced according to their net asset value computed at close of each trading day based on the market value of fund assets and liabilities, divided by the number of outstanding shares.

The establishment of a mutual fund entails several institutional actors, including sponsors, trustees, asset management companies, and custodians.⁴ The SEC publishes a list of asset management companies, custodians, and trustees.⁵ The most relevant institutions for purposes of this study are the sponsors and asset management companies, due to their involvement in investment decisions:

- Sponsors: Entity (or entities) that provide the primary capital, and sets the policies and guidelines of the mutual fund. It must own at least 10 percent of the fund.
- Asset Management Companies (AMCs): Entities authorized as issue and portfolio manager of mutual funds under SEC (Mutual Fund) Rules 2001. There are presently 15 AMCs in Bangladesh, including ICB Asset Management Company, Ltd.

Mutual funds differ in terms of their investment objectives, investment strategy, risk profile, fees charged, etc. Some are marketed as private (Pillar 3) pension funds. The investment objectives will determine whether a

¹ Grameen Bank web site, "Pension Fund: Leading to Financial Self-Reliance," http://www.grameen-info.org/index.php?option=com_content&task=view&id=30&Itemid=764&limit=1&limitstart=5.

² Dhaka Stock Exchange, "List of Companies by Selected Industry: Mutual Funds," <http://www.dsebd.org/companylistbyindustry.php?industry=12>. Bloomberg.com lists 36 mutual funds in Bangladesh: <http://www.bloomberg.com/markets/funds/country/bangladesh/>.

³ The Daily Star, July 29, 2012, "Hard Times for Mutual Funds," <http://www.thedailystar.net/newDesign/news-details.php?nid=243951>.

⁴ Mohammad Nayeem Abdullah and Kamruddin Parvez, 2012, "Corporate Governance of Mutual Fund In Bangladesh," Research Journal of Finance and Accounting, Vol 3, No 6, <http://www.iiste.org/Journals/index.php/RJFA/article/view/2406>.

⁵ SEC web site, http://www.sec.gov/CR_TRUSTY_ASSETManager_MF.htm.

particular mutual fund might be interested in investing in, for example, municipal bonds. Alternatively, sponsors may eventually be interested in creating special funds specifically of municipal bonds.

4. Banks and NBFIs

Banks and NBFIs issue their own bonds to raise funds for lending, but they also make investments. Whether banks or NBFIs would buy municipal bonds will depend on their regulatory framework, investment strategy, and the quality of the bonds. Their interest and ability to invest in bonds should be discussed with these institutions and their regulators in more detail. Other possible roles for banks and NBFIs include:

- **Project structuring:** Local government infrastructure financing is more similar to corporate financing than to treasury bond financing; therefore, NBFIs and banks that provide merchant (investment) banking services might be interested in working with ULBs to design municipal bonds or infrastructure project finance structures.
- **Loan origination:** In some emerging markets, banks have played an important role originating municipal loans, which were later discounted (repurchased) by a second-tier bank or other financial intermediary.
- **Financial administration:** Banks already collect fees and taxes from many local governments and autonomous agencies. This type of financial administration can be very useful in municipal bond structures, since it reduces the risk that the trustee (and therefore the bondholders) will not be paid.

Given the number of policy reforms underway in the financial sector, it is an opportune time to ensure that new regulations allow investment of financial institutions in municipal bonds, under acceptable risk conditions.

Institutions operating under Islamic finance principles. While Islam accepts the profit motive and private ownership, Islamic finance put restrictions on certain economic activities, in an effort to maintain balance, distributive justice, and equality of opportunities. Restrictions include *riba* (usury or interest), gambling, hoarding, dealing in unlawful goods or services, short sales and speculative transactions.¹ Islamic financing is generally asset-backed financing that creates real assets and inventories, rather than financing based on the value of currencies or intangible goods. For this reason, it lends itself to the financing of physical infrastructure projects.

Islamic merchant banks help clients issue Islamic bonds, called sukûk, which are structured to generate returns to investors while prohibiting interest. Where a conventional bond issuer has a contractual obligation to pay interest and principal to bondholders on fixed dates, the issuer of a sukûk gives the bondholder a share in the underlying tangible assets of the particular project or investment activity, and the bondholder receives a share of the revenues generated by the asset.² There are a variety of sukûk structures, which may convey partial ownership of (depending on the structure): an asset, a debt, a project, a business, or an investment.³

The sukûk market is active, for both public sector and private sector issues, and is projected to grow in the future, although the peak year for this type of financing was 2007. One report projects a tripling of global sukûk demand to US\$900 billion by 2017.⁴ Asia is one of the centers of sukûk activity. Bangladesh has seven banks operating under Islamic banking principles who could be interested in bringing their expertise to bear on municipal sukûk market development.

¹ Mufti Muhammad Taqi Usmani, 2009, "An Introduction to Islamic Finance,"

<http://islamicfinancenews.files.wordpress.com/2009/09/an20introduction20to20islamic20finance.pdf>.

² Financial Times Lexicon, "Sukuk (Islamic bonds)," [http://lexicon.ft.com/Term?term=sukuk-\(Islamic-bonds\)](http://lexicon.ft.com/Term?term=sukuk-(Islamic-bonds)).

³ Financial Times Lexicon, "Sukuk (Islamic bonds)," [http://lexicon.ft.com/Term?term=sukuk-\(Islamic-bonds\)](http://lexicon.ft.com/Term?term=sukuk-(Islamic-bonds)).

⁴ Ernst & Young, 2012, "Global demand for Sukuk to reach US\$900b by 2017," http://www.ey.com/SG/en/Newsroom/News-releases/News-release_20120910_EY-Global-demand-for-Sukuk-to-reach-US900b-by-2017.

5. Donors supporting ULBs

The MLGRDC is engaged with donors in a number of programs to provide financial and technical assistance to ULBs. The largest project is UGIIP-2, financed by the GOB and the ADB, with co-financing from Kreditanstalt für Wiederaufbau (German Reconstruction Credit Institute or KfW) and GIZ.

UGIIP-2 is a US\$167 million project providing support to 35 Pourashavas under the execution of the Local Government Engineering Department (LGED) and the LGD of the MLGRDC. The project will be implemented over a period of 6 years that began in 2009 and will strengthen the institutional, administrative and financial capacities of the Pourashavas and the LGED. It has three components: (i) Urban infrastructure and service delivery; (ii) Urban governance improvement and capacity development; and (iii) Project management and implementation support. The project budget by funding source is shown below.

UGIIP-2 project budget by funding source

Source	Crore Taka	%	US\$	
Bangladesh Government	217.54	18.94	\$31,725,723	
Asian Development Bank	596.55	51.94	87,000,000	Loan
KfW	247.35	21.53	36,073,171	Grant
GTZ	32.23	2.81	4,700,377	Grant
Pourashava	50.06	4.36	7,300,679	
Beneficiaries	4.80	0.42	700,025	
Total	1,148.53	100.00	\$167,499,975	

Other donor projects. There have been numerous donor projects in the urban sector in Bangladesh over the past three decades. One ADB document lists fifteen urban projects approved since 1985 totaling nearly US\$600 million.¹ Another lists thirty-two projects totaling nearly US\$2 billion.² The variation in these figures reflects the difficulty of categorizing urban development projects, since they can include a range of sectors (water, sanitation, social investment, flood protection, etc.).

D. Conclusions related to the Supply of Private Finance

Bangladesh has both the issuers and the investors but it has not been able to link them effectively through a bond market. Financial markets would be made more competitive, and reduce excess dependence on the banking system, if they generated market-based interest rates that corresponded to maturities. In absence of a well-functioning bond market, borrowers cannot diversify their sources of funding by credit risk and maturity that match expenditure needs. Initiative from the government to issue municipal bonds could help in diversifying, and therefore deepening, the bond market.

Strengthened tools for rating and assessing infrastructure projects and ULBs will make it easier to establish and define specifications and requirements for the development of project financing structures and will allow the private sector to innovate and assume risks. These tools would also allow the estimation and pricing of risks and the definition of required performance indicators for projects. The skills for developing tools resides in the private sector. For this reason, it is critical to involve the private sector in the development of the municipal market from the very beginning.

¹ Asian Development Bank, 2008, "Project Number: 40559, Second Urban Governance and Infrastructure Improvement (Sector) Project, TA No. 4863-BAN, Final Report, Appendix 3, <http://www2.adb.org/Documents/Produced-Under-TA/40559/40559-BAN-DPTA.pdf>.

² Asian Development Bank, 2008, "Project Number: 40559, Proposed Loan to the People's Republic of Bangladesh: Second Urban Governance and Infrastructure Improvement (Sector) Project," Appendix 3, <http://www.adb.org/sites/default/files/projdocs/2008/40559-BAN-RRP.pdf>.

Some key conclusions regarding the supply of financing in the capital and financial markets, and the institutions involved, are listed below.

- Bangladesh has made enormous progress in developing its capital and financial markets in the last decade, but bond issues are rare, and are generally undertaken on a private placement basis.
- Investors are unfamiliar with municipal bonds, and would have to be educated. Intermediaries are also unfamiliar and would have to take part in the development of the market.
- There is a lack of trust in the stock exchange, where bonds would be issued and traded. A number of reforms that should be underway in the capital market over the next few years should increase investor confidence. Recent reforms related to the development of the secondary market are encouraging, and address what has been a major constraint on potential users of the bond market.
- Potential investors include: (i) insurance companies; (ii) pensions funds, although the largest pension fund, the GPS, is largely unfunded; (iii) mutual funds; and (iv) banks, including Islamic banks.
- Reforms are taking place in the insurance industry, and there is also an expansion underway in both the pension fund and mutual fund industries. These sectors are important stakeholders for development of the municipal bond market.
- Pension funds may need better incentives such as approval for tax deduction, and the lifting of restrictions limiting their investments to Government and Government–approved securities, if they are to become active participants in a municipal market.
- Interest rates and inflation are high in Bangladesh. In order for a municipal bond issue to be attractive, it would have to compete with the other government bonds and the NSS, which on average have paid 12 percent over the past three years. High rates mean the ULB revenues being used to repay the bonds might have to be indexed. Grant funds (of which there are significant quantities in the sector) can be used to lower the effective interest rates, but they would have to be reprogrammed to be used in this way.
- Credit rating agencies can play a vital role in the development of a municipal bond market. They can develop ratings criteria and begin to evaluate the finances of the stronger local governments. The GOB should immediately seek their support if a municipal bond market project is launched.
- Donors such as the ADB and the World Bank are key stakeholders for municipal bond market development. Since the capital market would most likely not support a fully independent municipal bond issue in the short run, an initial series of bonds could be issued with support by donor agencies.
- Donor grants can be used to co-finance projects with private credit, and thereby reduce the cost for ULBs and the risk for investors. Grants can also fund the technical assistance needed to prepare both the clients and the market for new private deals. However, if grants are offered to finance projects that could be financed with credit, there will be no economic incentive for municipalities to undertake market financing, as donor funding will always be cheaper than a municipal bond issue.
- Reforms taking place in the capital markets should contemplate the future issuance of municipal bonds. For instance, the revisions needed in the public placement and public issue rules to allow their application to municipal bonds, might be able to be undertaken by existing programs supporting the SEC.
- Public-private partnerships are discussed in a prior section, but it bears repeating here that PPPs are another potential funding source, and that private investment mobilized via PPPs could also fund ULB infrastructure projects. Legal, policy and institutional reforms to promote PPPs should be oriented to incorporate and encourage infrastructure projects promoted by ULBs.

VI. Prospects for Municipal Bond Market Development

A. Stakeholder input

During the initial UNCDF mission and the two subsequent consultant missions in Bangladesh, meetings were held with a number of parties who could be considered stakeholders in the process of creating a private finance model for local infrastructure. These include implicated public sector agencies, including local governments; donors working on local government finance issues; and a wide range of entities who operate in the financial markets, from investors to rating agencies. (A list of stakeholders is included as Annex 4.)

Especially in the case of developing a municipal bond market, the list of parties involved can be quite extensive. More importantly, these stakeholders must work closely together over a period of time to establish the market rules and conditions, so having a common understanding of the rewards and challenges of the undertaking is extremely important.

All stakeholders met were extremely generous with their time and were aware of the financing situation being analyzed by the UNCDF team. In addition, many were genuinely interested in the effort to identify new financing options. However, they were also frank about the many difficulties such an effort would entail, including pointing out failed attempts at financial innovation in the past in Bangladesh. Before an initial decision is made to proceed to develop a “private finance for local infrastructure” strategy, more consultation with stakeholders would be in order. Additional meetings during the third consultant mission will contribute to this effort.

The conversations held were wide-ranging. However, a number of common concerns arose in these meetings. Many of these concerns are discussed in detail in other sections of the paper, and a detailed summary of the stakeholder meetings is available from the UNCDF team. None of the concerns expressed are unique to Bangladesh; all countries with emerging municipal finance markets are confronting these same challenges to some degree. The most commonly-mentioned concerns are the following:

Lack of trust in institutions. The lack of trust mentioned in these meetings applies to both public and private sector institutions, and affects everything from the development of the bond markets to citizen support for local government projects. This factor is particularly important given the relatively long-term nature of municipal bonds (normally between 7 and 30 years). Pilot projects can build confidence in these types of environments, as does the use of evaluation criteria that incorporate this factor in selecting participating local governments.

Inexperience with debt financing. The basic concepts about financing local infrastructure with debt, repaying the debt from project revenues, and designing projects to make this feasible, are not widely understood in Bangladesh. Training, information programs, and other forms of technical assistance can be employed to address this gap.

Unwillingness to pay for services. Infrastructure and services must be paid for, or they either deteriorate, or never get built at all. If users do not pay, someone else must, and this can create distortions in prices and excess demand. (Even under a payment-for-services scheme, there can still be subsidies for poor consumers.) A culture of payment for services, or of tax and fee collection, does not exist in Bangladesh. Pilot financing programs should break this vicious cycle by rewarding ULBs with earlier access to financing and consumers who agree to pay with earlier provision of services, higher quality services, and/or more involvement in service design.

Availability of grant money. Similarly, the normal practice in Bangladesh is to seek grant funding for public infrastructure, without taking into consideration the opportunity cost of delays in this process. In addition, having significant amounts of donor funding represents a challenge as donors have been known in many countries to discourage local governments from choosing the debt option by offering grants at an opportune moment.

Repudiation of municipal obligations. Weak governance and weak enforcement of contractual obligations have allowed mayors to renounce the debt obligations of their predecessors. Such behavior discourages investors from considering municipal projects throughout the world. This underlines the importance of community

participation in decisions regarding service improvements, so that officials consider the risks for the community of such acts, not just their own political ambitions. Government should reform laws to strengthen disincentives against repudiating obligations inherited from prior administrations.

B. Conclusions regarding opportunities present and risks to be addressed

It may be premature to think about developing a municipal finance market in Bangladesh now, or it may be just the right time to get started. It makes sense to begin the process early, since some of the needed policies and capacities need time to develop. Much of the work of building a municipal finance market has to do with reducing risks by addressing weaknesses and building on existing strengths in both the local government sector and the financial market. This section returns to the list of necessary conditions for a successful municipal finance market introduced in Section III.A, *Essential elements for enabling private finance of urban infrastructure* (page 5), and lays out the opportunities and existing strengths, as well as the weaknesses to be addressed and the associated risks.

The classic definition of risk is "uncertainty of outcomes." In the case of municipal bonds, or other market-based municipal financing, these risks may be found on either the demand side (the local government sector), the supply side (the capital market) or both.

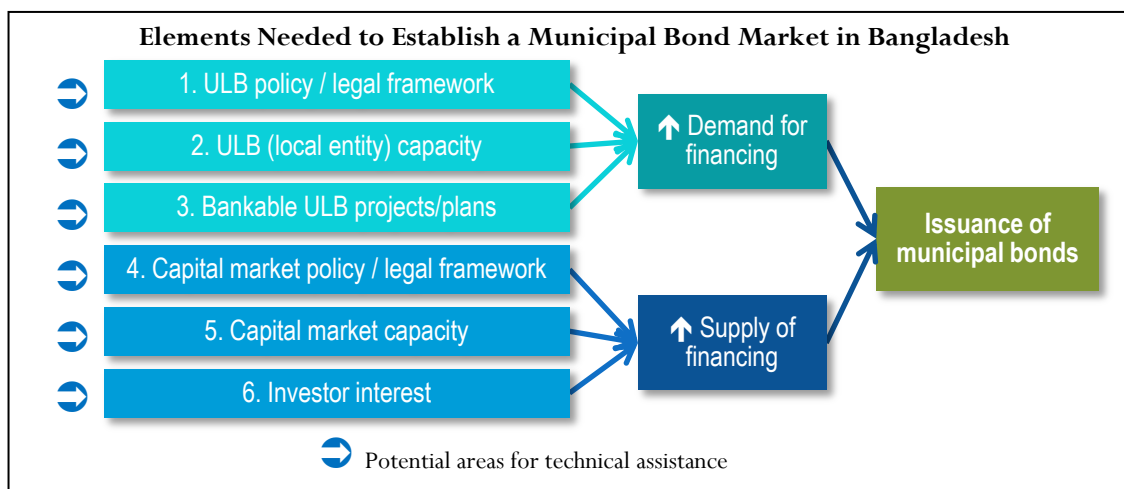
Elements/Conditions	Risks/weaknesses	Opportunities/strengths
Demand (issuer) side		
1. ULB policy / legal framework		
1.a. Policy framework that encourages ULBs and other local entities to raise private finance	<ul style="list-style-type: none"> ▪ No policy directive to encourage ULBs or other local entities to raise own funds. ▪ The policy must discourage entities with projects from seeking 100% grant funding. ▪ Weak governance (e.g. lack of local elections in City Corporations) raises investor perception of risk. ▪ Frequent institutional changes create legal and political risks for investors. ▪ Duplication of functions at local level discourages ULB innovation. 	<ul style="list-style-type: none"> ▪ Policy and Strategy for Public-Private Partnership, 2010 can be adapted to encourage ULB activity. ▪ NUSP approval will send clear policy signals.
1. b. Legal framework that provides fiscal and legal means to mobilize private funds	<ul style="list-style-type: none"> ▪ High degree of discretion of GOB over ULB financial activities creates risks for investors. ▪ Financial transactions must be approved on a case-by-case basis ▪ ULBs have underutilized fiscal instruments (fees and taxes). 	<ul style="list-style-type: none"> ▪ Once NUSP is approved, it will provide a framework for legal reforms. ▪ Donors are working with ULBs to strengthen their capacity. ▪ Bangladesh Urban Forum can support government to design and implement legal reforms.
1. c. Certainty and continuity of the legal framework	<ul style="list-style-type: none"> ▪ Frequent changes create legal risks for investors. ▪ Establishing "continuity" takes time. 	<ul style="list-style-type: none"> ▪ Autonomous and semi-autonomous entities such as UDAs have more stable legal frameworks.
1.d. Standards for the preparation and reporting of financial information	<ul style="list-style-type: none"> ▪ Current financial reporting and auditing standards for ULBs is completely inadequate for market financing purposes. ▪ Without standardized, audited financial information, credit ratings will be impossible to carry out. 	<ul style="list-style-type: none"> ▪ ICAB already has a public sector standards project underway, which should incorporate ULBs. ▪ Government has project to improve its own financial reporting. ▪ The CAG is interested in improving ULB reporting and auditing standards.

Elements/Conditions	Risks/weaknesses	Opportunities/strengths
2. ULB (local entity) capacity		
2.a. ULB (local entity) capacity to provide accurate information about themselves and their transactions	<ul style="list-style-type: none"> Current financial and audit information is inadequate for financial market purposes. 	<ul style="list-style-type: none"> Other local entities may use better financial reporting standards. Donors may have resources to support improvement of financial information including definition of new standards.
2.b. ULB (local entity) capacity to identify bankable projects	<ul style="list-style-type: none"> The capacity to identify and develop bankable projects needs to be strengthened, in the ULBs, local entities, and the GOB. 	<ul style="list-style-type: none"> Donors have resources to support the definition of criteria for bankability. UDAs have this capacity. Pilot projects can help establish what is "bankable" in the local market.
2.c. ULB (local entity) capacity to provide a strong repayment stream and to ensure local willingness to pay	<ul style="list-style-type: none"> Financial mobilization is growing in ULBs but is relatively weak. Need to overcome resistance to billing customers and paying for services. There are not yet established cost recovery mechanisms for adaptation projects. 	<ul style="list-style-type: none"> Social communication can change nonpayment culture; GOB has effective social communication campaigns in various sectors. Participation of beneficiaries in project development improves willingness to pay; participation is growing in ULBs. It is easier to mobilize payments from projects with high economic return, such as those of the UDAs.
2.d. ULB (local entity) capacity to manage financed projects during the life of the issue.	<ul style="list-style-type: none"> Management capacity of project will need to be strengthened. 	<ul style="list-style-type: none"> PPP can be used to provide O&M expertise to reduce this risk. ULBs have some good experiences (e.g. terminals and markets). Donors can support strengthening of this condition.
3. Bankable projects/investment plans		
3.a. Availability of bankable local infrastructure projects or capital investment plans	<ul style="list-style-type: none"> It is a challenge to find expertise to identify and structure bankable local infrastructure projects and to develop capital investment plans. Historical use of only grant funding for local infrastructure means establishing new approaches and criteria, even for BMDf. 	<ul style="list-style-type: none"> Bankable projects exist. More ULBs are preparing investment plans. Local entities such as UDAs have a track record of investment planning. Climate change adaptation could increase project demand. BMDf can identify bankable projects. Launching one or more pilot will help establish criteria for projects, and serve as a training ground for experts. If pilots are successful, ULBs will compete to present investment opportunities.
3. b. Volume of financial transactions	<ul style="list-style-type: none"> Time is needed to create a volume of transactions. 	<ul style="list-style-type: none"> Focusing on specific sectors or types of projects can help increase volume and lower transactions costs. BMDf has already identified a large pipeline of projects for its next phase, some of which may be bankable
3. c. Presence of enforceable tariff or taxation mechanisms	<ul style="list-style-type: none"> This is a new concept that will need to be established both legally and operationally, in ULBs and other local entities. 	<ul style="list-style-type: none"> Should be considered a priority legal reform once the NUSP is approved.

Elements/Conditions	Risks/weaknesses	Opportunities/strengths
3. d. Other means to mitigate risk of transactions	<ul style="list-style-type: none"> This is a new concept that will need to be established both legally and operationally, in ULBs and other local entities. 	<ul style="list-style-type: none"> Activities proposed here, such as improving financial information or tax collection, also serve to mitigate risk in financial transactions.
Supply (market) side		
4. Capital market policy/legal framework		
4.a. Policy framework that encourages market actors to address the financing needs of ULBs and other local entities	<ul style="list-style-type: none"> No policy directive to encourage capital market actors to work with ULBs or local entities on municipal market development. ADB Second Capital Market Development project is not yet approved. 	<ul style="list-style-type: none"> Policy reforms underway in financial and capital market will support municipal market development. Policy projects may be able to also address policy issues specific to municipal market development.
4.b. Legal framework that allows private investors to invest in ULBs' or other entities' loans or bonds	<ul style="list-style-type: none"> Several legal or regulatory changes may be needed, in order to allow: <ul style="list-style-type: none"> Bangladesh Bank to sell municipal bonds. ULBs to create special escrow accounts. ULBs to borrow for over 12 months. Modification of ULB payment order. Rules are needed to prohibit repudiation of debt by newly-elected officials. Neither private placement nor public issue rules currently allow the issuance of municipal bonds, for different reasons. 	<ul style="list-style-type: none"> Policy projects may be able to provide support to carry out legal modifications needed for municipal market development.
4.c. Bankable risk distribution	<ul style="list-style-type: none"> No precedents to demonstrate acceptable risks for investors. May require additional legal reforms. 	<ul style="list-style-type: none"> Pilot financial transactions will help reveal what is acceptable risk/return tradeoff for investors.
4.d. Certainty and continuity of legal framework	<ul style="list-style-type: none"> Establishing "continuity" takes time. 	<ul style="list-style-type: none"> Autonomous and semi-autonomous entities such as UDAs have more stable legal frameworks that may be more attractive to investors.
5. Capital market capacity		
5.a. Ability to support development of local infrastructure projects or capital investment plans suitable for debt financing	[See 3.a.]	[See 3.a.]
5.b. Presence of capable intermediaries and trustees	<ul style="list-style-type: none"> Intermediaries and trustees have limited experience with debt issuance, due to small size of market. Intermediaries and trustees have no experience with debt-financing of ULBs. Institutions are skeptical of ULBs as issuers. Institutions and investors consider stock exchanges to be risky. 	<ul style="list-style-type: none"> Unlike many emerging markets, multiple intermediaries exist and there is competition among them. Market experience could be gained using pooled financing approach through BMDF, to increase familiarity of intermediaries with local sector. Market reform projects should reduce market risks over the next few years.
5.c. Existence of a yield curve	<ul style="list-style-type: none"> No available yield curve due to lack of secondary market for treasury securities. 	<ul style="list-style-type: none"> New measures to encourage trading of treasury securities in stock markets, if successful, will produce yield curve.

Elements/Conditions	Risks/weaknesses	Opportunities/strengths
5.d. Presence of secondary market or substitute	<ul style="list-style-type: none"> ▪ Lack of a secondary debt market will limit demand to those willing to accept trading risk or hold to maturity. 	<ul style="list-style-type: none"> ▪ If treasury secondary market develops, secondary trading of other debt securities becomes more likely. ▪ Pilot bonds could be structured with repurchase or redemption agreements to increase marketability of the bonds.
5.e. Volume of standardized transactions	See 3.b.	See 3.b.
6. Investor interest		
6.a. Investor familiarity with local sector	<ul style="list-style-type: none"> ▪ Investors have no experience with the local infrastructure sector, and don't trust ULBs. 	<ul style="list-style-type: none"> ▪ Success of pilot projects should be communicated to market participants.
6.b. Financial return commensurate with risk	<ul style="list-style-type: none"> ▪ Interest rates are already high. If a premium were required for local infrastructure projects, the financing might become unaffordable. 	<ul style="list-style-type: none"> ▪ Grant funding can be used to supplement market finance, which both reduces investor risk, and lowers the overall cost of financing for ULBs.
6.c. Means to evaluate risk	<ul style="list-style-type: none"> ▪ There are presently no credit rating criteria for ULBs or local entities. 	<ul style="list-style-type: none"> ▪ CRAB and potentially other credit rating agencies are interested in working on this issue.
6.d. Volume of investable funds	<ul style="list-style-type: none"> ▪ SLR and other rules that allocate funding reduce the availability of investable funds. ▪ Pension plan participation is low; larger plans such as the GPS are generally unfunded. ▪ Insurance sector is extremely small, compared to other countries. ▪ Government competes with all other debt issuers for funds. 	<ul style="list-style-type: none"> ▪ The GOB has stated its intention to move more capital funding to private markets. ▪ Several pension plans have investable funds, including the WTTENEL. ▪ The mutual fund industry is growing. ▪ Banks, including Islamic banks, may see benefits in supporting municipal financial market development.
6.e. Acceptable political risk	<ul style="list-style-type: none"> ▪ There is a history of political instability related to national elections. ▪ Dhaka North and South City Corporations elections are overdue. These are two potential candidates for pilot projects. 	<ul style="list-style-type: none"> ▪ As the capital market develops, it should be less exposed to political risk. ▪ Tools to protect investors from political risks could be developed. ▪ Transactions could be timed to accommodate the political calendar. ▪ ULBs with stable political environments will be rewarded by investors, and therefore have preferential access to markets.

VII. Overall Findings and Recommendations



A. Recommended actions for government

The findings of the feasibility study are summarized by topic in **Section IV.D, Conclusions related to the Policy, Institutional, and Legal Framework** (page 19); **Section V.A.4, Conclusions related to the Demand for Private Finance** (page 30); **Section V.D, Conclusions related to the Supply of Financing** (page 45); and **Section VI.A, Stakeholder Input** (page 47).

The prior section summarizes these conclusions as a set of risks and opportunities present in the Bangladesh market that will affect the development of a municipal finance market.

This section presents actions that UNCDF recommends that the GOB take to encourage the development of the private municipal finance market. The recommended activities relate to two principal lines of action: (i) designing of a Pilot Project that would terminate in issuance of one or more pilot bond issues, and (ii) providing technical assistance to help carry out the recommended actions listed below, necessary to implement the Pilot Project and to develop the broader market.

1. Policy and legal framework (Elements #1 and #4)

The private municipal finance market will not develop without specific policy, legal, and regulatory support. This includes defining a fiscal decentralization and local financing policy that not only permits, but encourages greater autonomy in financing local infrastructure, and identifies the actions that will be taken to make this possible.

There are crucial policy reforms currently underway that will support this new direction, including reforms in the capital market and financial market, fiscal and macroeconomic reforms, and municipal sector and urban policy reforms. Government can support municipal finance market development by ensuring that these reforms advance on schedule. Some of these have unpredictable outcomes, but ones which are important for municipal bond market development. An example is reforms that will lower market interest rates.

But even if successful, a sustainable municipal finance market will not spontaneously emerge from these reforms. Government must define and implement a fiscal decentralization and local financing strategy.

Therefore, the priority policy and institutional reforms under this element include:

- Approve the NUSP, and design and implement a dissemination plan with government and the private sector.

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- Define a fiscal decentralization and local financing strategy to implement these specific aspects of the NUSP.
 - Approve the Second Capital Markets Development Program and implement the benchmark reforms on a timely basis.
 - Strengthen specific aspects of local sector governance, including conformance to the election calendar.
 - With ICAB and donors, launch an urgent initiative to define and implement new municipal accounting and auditing norms based on international standards. Identify ongoing technical assistance programs that could support this effort.
 - Analyze the current ADP pipeline to identify projects that may be partially bankable with credit financing, and consider developing new ADP criteria that encourage "mixed financing" (blending of debt and grant funding).
 - Analyze (medium-term) and implement (long-term) a consolidated agenda of capital markets and ULB legal and regulatory reforms, to ensure that local governments are explicitly allowed to issue bonds or use other forms of private or public-private finance, and that private investors can purchase them.
 - Identify the regulatory and programmatic reforms necessary to allow the BMDF to serve as a pooled financing intermediary for municipal bonds, or to provide other sustainable sources of municipal credit. Involve donors in analyzing these recommendations, and in supporting the reforms, through technical assistance and recapitalization of BMDF. Require that BMDF develop new policies and procedures to implement the proposed approach.

2. ULB capacity and bankable project/plan development (Elements #2 and #3)

Many priority local infrastructure projects are subject to long delays while waiting for an allocation of ADP funds. But ULBs have few alternatives, and local technical capacity in ULBs must be built if local bodies are to gain access to the financial markets.

Donors have made a significant commitment to the local government sector. Some of their technical assistance interventions are already contributing to the preconditions for market-based financing. Efforts to improve planning and capital budgeting by local governments, and to strengthen financial administration as part of UGIIP-2, are important. However, additional skills are needed if the ULB investment plans are to be supported with market-based financing or public-private investment. And donor efforts need to be aligned to support financial market development, if that is the GOB priority.

In general, local entities have no idea how to finance local infrastructure projects with credit. And not all local bodies are subjects for such an approach. An effort is needed to narrow down the universe of projects and ULBs and other entities in order to begin a process of education and training, leading toward the preparation of some pilot projects. In this regard, the GOB should:

- Create a MLGRDC-led government Working Group to coordinate the municipal finance Pilot Project, with UNCDF support.
- Enlist donor agencies to adapt their training and technical assistance manuals to more directly address financial strengthening, use of credit by ULBs, and design of financial viability projects.
- Identify candidate local governments and other local entities that meet the following qualifications: (i) are financially seeking financing in sectors and for types of projects where private financing might be viable, (ii) meet or exceed benchmarks for financial viability, (iii) are in possession of existing projects that might be fully or partially refinanced in the market; and (iv) local officials who demonstrate leadership and willingness to participate in pilot projects.

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- Having identified the universe from which viable projects might emerge, design and deliver a training program that expands the understanding of market financing mechanisms and explains the types of changes that will be necessary within the ULBs or other local entities.
 - Work with the Ministry of Environment and Forest to identify local projects eligible for climate mitigation or adaptation finance, and the grant funding available that can be used to co-finance local infrastructure projects, and incorporate this information into the local financing strategy.
 - Work with the private sector to develop guidelines for local agencies to use in the identification and qualification of projects; for instance, guidelines on cost recovery for different types of projects, including gaining support of fee- or taxpayers.
 - Ask donors to support study tours to (for instance) the Philippines, China, Vietnam, and Indonesia. Each of these countries is taking a particular approach to municipal finance development, and there are significant lessons to be learned.
 - Establish a project to identify and prepare pilot projects, with the assistance of donors and the private sector task force (see following section).

3. Market capacity and investor interest (Elements #5 and #6)

The process to develop a municipal finance market should be carried out in collaboration with the private sector, including private market intermediaries, even if pilot projects may be privately placed, as they are likely to be. Market intermediaries know the local market and can assist in the definition of financing options, based on other emerging financial instruments, and in the identification and preparation of pilot projects.

Typically, market actors will not have been exposed to the financial operations of ULBs and other local entities, so early involvement will allow them to cultivate these relationships, which is important for confidence building. Many of these initiatives—such as the development of credit rating criteria—will take time. The GOB should:

- Design and deliver a program of information exchange and training to analyze the feasibility of market financing and to identify with the private sector the necessary legal and administrative reforms in the financial sector or at the municipal level. (The initial meeting could present the findings of this study.)
- If the reaction from these initial meetings is positive, ask private actors to create a financial/capital market Task Force to develop an private market agenda and support its implementation over a period of time.
- Work with the Task Force to develop prototype project designs by sector (e.g. a prototype bus terminal, solid waste management, or energy efficiency financing structure).
- Develop a process for the Task Force to review project proposals from ULBs and BMDF at an early stage, in order to provide guidance on project parameters and feasibility.
- The Task Force should work on strategies for risk reduction in the market, identifying mechanisms and reforms that will address the risks identified in Section VI.B, *Conclusions regarding opportunities present and risks to be addressed*, above.
- The Task Force should propose financing vehicles that will allow small investors to buy municipal bonds.
- Enlist one or more credit rating agencies in the development of initial municipal ratings criteria. Request donor funding to pay for the development of these criteria and their application in an initial set of local governments to develop "benchmark ratings."

Without investors, there is no municipal finance market. Therefore it is important to understand the specific requirements of potential investors, and to ensure that the financial instruments being developed will be attractive to investors. With respect to investors, government should:

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- Work with the Task Force to identify potential investors, and carry out a detailed analysis of investor requirements and of their perception of risks in the market.
 - Ensure the involvement of potential investors in training or information exchange activities.
 - With investors, identify the legal and administrative reforms that will be necessary in the market or ULB sector, to make these projects more attractive to investors.
 - Analyze options for the involvement of Islamic investors in the municipal market. Their profit-sharing may lend itself to financing local infrastructure projects, and there may be expertise available that can be applied.

B. Priority actions to be taken

Introducing a sustainable system for the issuance of municipal bonds or provision of municipal credit in other forms in Bangladesh will take a number of years, even with the enthusiastic support of all stakeholders. But it is possible to accelerate this process by taking certain strategic actions in the short run. UNCDF recommends that the GOB (i) develop a Pilot Project in municipal finance that would terminate in the issuance of one or more pilot bond issues or the offering of other private financing arrangements, and (ii) undertake a series of technical assistance activities. A proposed work plan to implement these activities is included as Annex 5 of this report.

Technical assistance is needed on several fronts: (i) policy, (ii) municipal/local agencies, (iii) market participants, and (iv) investors, but a number of the important reforms (such as those to make the capital markets more transparent, efficient, and competitive) are already ongoing and can be supported indirectly. The private sector must be engaged. Donors working with ULBs, the UDAs, and the MLGRDC should also be engaged, perhaps via the BUIF, to align activities within their technical assistance programs to support this effort. Support is also needed from within government. MLGRDC must communicate its intentions and engage other ministries in the municipal financial market project, in order to ensure their collaboration.

From among the recommended activities listed above, several priority activities can be identified. Some of these will contribute directly to the development of a Pilot Project, such as selection of Pilot ULBs. Other priority activities will mobilize stakeholders who can carry out additional activities needed to support the Pilot Project—such as the implementation of new accounting and audit norms. The proposed priority activities are the following:

1. Create a MLGRDC-led government Working Group to coordinate the municipal finance Pilot Project, with UNCDF support.
2. Prepare and approve the project documentation for the Pilot Project.
3. Develop and disseminate guidelines and rules for municipal credit, which support the Pilot Project.
4. Develop eligibility criteria for ULB and other local entity participation in the Pilot Project, and disseminate this information through a training program regarding municipal credit rules, other aspects of market financing, and the Pilot Program requirements.
5. Select ULBs and other entities to participate in the Pilot Project.
6. Assist Pilot ULBs to develop Capital Improvement Plans and to carry out Debt Capacity Analysis, and to strengthen revenues from tax collection and project-related cost recovery.
7. Begin a process with the BMDF to identify the regulatory and programmatic reforms that would allow it to serve as a pooled financing intermediary for municipal bonds, or to provide other sustainable sources of municipal credit. Involve donors in analyzing these recommendations, and in supporting the reforms, through technical assistance and recapitalization of BMDF.
8. With ICAB and donors, launch an urgent initiative to define and implement new municipal accounting and auditing norms based on international standards. Identify and mobilize technical assistance to support implementation in Pilot ULBs.

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9. Identify key private sector actors and seek their involvement in steps to improve market financing and in the Pilot Project. (The initial meeting could present the findings of this feasibility study.) Ask these organizations to create a financial/capital market Task Force to coordinate private sector activities.
 10. With the Task Force, initiate a detailed review of needed legal and administrative reforms that affect the capital markets and the investment potential of ULBs, to ensure that ULBs and local entities can legally issue bonds or use other forms of private finance; that market institutions can sell them; and that private investors can invest in them. Identify and implement priority reforms that could impede the Pilot Project.
 11. Ask donors to support study tours on municipal finance for the Working Group and the Task Force to (for instance) the Philippines, China, Vietnam, and Indonesia.

These priority activities will help create the conditions for the preparation and issuance of bonds or the offering of other financing arrangements. This is followed by the selection of the underwriter (merchant bank or other), and the structuring and sale to investors of the financing deal. All these activities will require the support of the government Working Group, the private sector Task Force, donors, and other stakeholders. See Annex 5 for a complete Pilot Project work plan.

C. Specific areas for UNCDF assistance

UNCDF works in Asia and the Pacific Region to enhance good governance and service delivery at the local level, in order to increase the access of residents of low-income countries to a wide range of affordable financial services. UNCDF's mandate is directed toward providing a mix of capital grants and other financing instruments such as credit and guarantees, along with technical assistance for implementation and capacity-building services to public and private sector actors.

In this context, a program to develop a municipal finance market in Bangladesh falls squarely within the mandate of UNCDF, and provides potential new avenues for innovation in local finance, including finance for climate change adaptation.

UNCDF continues to facilitate access to funding for capital investment, but strives to develop new, sustainable locally based systems and corresponding financing means. The donor funding for capital investment projects related to climate mitigation and adaptation is currently on a rise. However, even this presently-observed positive trend cannot be viewed as sustainable and faces significant threats from global economic situation affecting public sector spending. Alternative and supplemental forms of climate change adaptation funding are needed from private investors. It is therefore important to identify ways to program this type of leveraged private financing for local investments and to encourage the reforms needed to create an effective municipal finance system.

The process of merging public and private sectors interests, whether in the initial stages of development or under longer term interventions, will still benefit significantly from engagement of international donor organizations and UNCDF is perfectly positioned to facilitate this collaboration. The specific ways for such facilitation will be defined during the subsequent phase of municipal bonds pilot project and implementation.

However, at this stage it can be stated that UNCDF can provide support to the two recommended lines of action: (i) development of the Pilot Project, and (ii) technical assistance to various institutions to carry out some of the recommended actions listed below.

In the short run, UNCDF is particularly interested in helping MLGRDC organize meetings with the private sector and ULBs and other local entities to present the findings of the feasibility study. Based on the results of those meetings, UNCDF proposes to define next steps for UNCDF support with MLGRDC.

VIII. Annexes

- 1. Local government revenues and expenses by level of government**
- 2. Sreepur Pourashava PDP capital investment plan**
- 3. Bangladesh Climate Change Strategy and Action Plan (BCCSAP) themes and programs**
- 4. List of Stakeholders Interviewed**
- 5. Preliminary Pilot Project Work Plan and Schedule of Key Activities**

Annex 1. Local government revenues and expenditures by level of government

9.17 Consolidated Receipts and Expenditures of All Local Governments (Million Taka)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	3,750	3,574	4,430	4,731	5,834	6,899	8,384	13,037	17%
Rates	895	867	1,004	1,027	1,632	1,952	2,522	4,026	5%
Fees & tolls	2,021	2,291	2,232	2,879	2,794	3,007	4,444	6,416	8%
Interest receipts	168	165	169	253	360	380	567	837	1%
Misc. receipts	1,165	1,421	1,235	1,503	1,748	1,954	3,229	5,406	7%
Govt. grants	1,403	1,348	1,515	1,488	1,475	1,860	3,082	4,081	5%
Works programme grants	9,807	8,505	9,316	9,934	15,910	16,491	18,806	37,037	47%
Error						(1)	(1)	7,199	9%
Total	19,209	18,171	19,901	21,815	29,753	32,542	41,033	78,039	100%
Expenditure:									
Wages & salaries	3,252	3,087	3,669	3,852	4,387	4,828	5,324	6,205	9%
Contingency	2,952	2,190	2,490	2,612	3,185	3,856	5,756	8,037	12%
Infrastructure development (Gross Fixed capital formation)	12,943	11,365	12,913	13,700	20,846	22,324	26,753	51,915	75%
Interest paid	13	8	5		3	2	2	4	0%
Works programme	163	159	182	250	464	471	1,220	1,407	2%
Scholarship, grants. etc. (Transfer)	306	310	343	603	594	776	979	1,505	2%
Total	19,629	17,119	19,602	21,017	29,479	32,257	40,034	69,073	100%
Net revenues	(420)	1,052	299	798	274	285	999	8,966	

Source: Local Government

9.18 Consolidated Receipts and Expenditure of Municipalities (Million Taka)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	1,022	1,185	1,230	1,538	1,709	1,211	2,419	4,260	17%
Rates	423	507	532	628	688	495	988	1,739	7%
Fees & tolls	738	648	1,234	1,112	1,245	876	1,749	3,080	12%
Interest receipts	84	99	166	203	225	160	319	562	2%
Misc. receipts	946	753	520	967	1,054	762	1,521	2,678	11%
Govt. grants	86	67	220	182	204	157	242	311	1%
Works programme grants	3,044	3,212	3,580	4,511	5,287	3,553	7,095	12,495	50%
Error									0%
Total	6,343	6,471	7,482	9,141	10,312	7,213	14,333	25,126	100%
Expenditure:									
Wages & salaries	852	895	1,035	1,157	1,279	571	1,523	1,611	6%
Contingency	776	787	891	1,067	1,200	1,397	1,975	3,026	12%
Infrastructure development (Gross fixed capital formation)	3,725	4,252	4,714	6,233	7,137	4,568	9,838	19,353	77%
Interest paid	-	-	-	1	1	1	2	3	0%
Works programme	121	148	71	175	185	229	324	496	2%
Scholarship, grants, etc. (Transfer)	213	229	251	276	302	361	511	783	3%
Total	5,687	6,311	6,962	8,909	10,104	7,127	14,173	25,272	100%
Net revenues	656	160	520	232	208	86	160	(146)	

Source: Budget of Municipalities

(Thousand US\$)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	46,875	44,675	55,375	59,138	72,925	86,238	104,800	162,963	17%
Rates	11,188	10,838	12,550	12,838	20,400	24,400	31,525	50,325	5%
Fees & tolls	25,263	28,638	27,900	35,988	34,925	37,588	55,550	80,200	8%
Interest receipts	2,100	2,063	2,113	3,163	4,500	4,750	7,088	10,463	1%
Misc. receipts	14,563	17,763	15,438	18,788	21,850	24,425	40,363	67,575	7%
Govt. grants	17,538	16,850	18,938	18,600	18,438	23,250	38,525	51,013	5%
Works programme grants	122,588	106,313	116,450	124,175	198,875	206,138	235,075	462,963	47%
Error	-	-	-	-	-	(13)	(13)	89,988	9%
Total	240,113	227,138	248,763	272,688	371,913	406,775	512,913	975,488	100%
Expenditure:									
Wages & salaries	40,650	38,588	45,863	48,150	54,838	60,350	66,550	77,563	9%
Contingency	36,900	27,375	31,125	32,650	39,813	48,200	71,950	100,463	12%
Infrastructure development (Gross Fixed capital formation)	161,788	142,063	161,413	171,250	260,575	279,050	334,413	648,938	75%
Interest paid	163	100	63	-	38	25	25	50	0%
Works programme	2,038	1,988	2,275	3,125	5,800	5,888	15,250	17,588	2%
Scholarship, grants. etc. (Transfer)	3,825	3,875	4,288	7,538	7,425	9,700	12,238	18,813	2%
Total	245,363	213,988	245,025	262,713	368,488	403,213	500,425	863,413	100%
Net revenues	(5,250)	13,150	3,738	9,975	3,425	3,563	12,488	112,075	

(Thousand US\$)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	12,775	14,813	15,375	19,225	21,363	15,138	30,238	53,250	17%
Rates	5,288	6,338	6,650	7,850	8,600	6,188	12,350	21,738	7%
Fees & tolls	9,225	8,100	15,425	13,900	15,563	10,950	21,863	38,500	12%
Interest receipts	1,050	1,238	2,075	2,538	2,813	2,000	3,988	7,025	2%
Misc. receipts	11,825	9,413	6,500	12,088	13,175	9,525	19,013	33,475	11%
Govt. grants	1,075	838	2,750	2,275	2,550	1,963	3,025	3,888	1%
Works programme grants	38,050	40,150	44,750	56,388	66,088	44,413	88,688	156,188	50%
Error	-	-	-	-	-	-	-	-	0%
Total	79,288	80,888	93,525	114,263	130,150	90,175	179,163	314,063	100%
Expenditure:									
Wages & salaries	10,650	11,188	12,938	14,463	15,988	7,138	19,038	20,138	6%
Contingency	9,700	9,838	11,138	13,338	15,000	17,463	24,688	37,825	12%
Infrastructure development (Gross fixed capital formation)	46,563	53,150	58,925	77,913	89,213	57,100	122,975	241,913	77%
Interest paid	-	-	-	13	13	13	25	38	0%
Works programme	1,513	1,850	888	2,188	2,313	2,863	4,050	6,200	2%
Scholarship, grants. etc. (Transfer)	2,663	2,863	3,138	3,450	3,775	4,513	6,388	9,788	3%
Total	71,088	78,888	87,025	111,363	126,300	89,088	177,163	315,900	100%
Net revenues	8,200	2,000	6,500	2,900	3,850	1,088	2,000	(1,838)	

9.19 Consolidated Receipts and Expenditures of City Corporations

(Million Taka)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts :									
Taxes	1,540	1,371	1,748	1,903	2,537	3,277	3,255	5,472	17%
Rates	431	378	398	420	850	1,084	1,342	1,969	6%
Fees & tolls	965	984	979	1,211	856	868	1,529	1,727	6%
Interest receipts	13	14	15	8	17	9	19	24	0%
Misc. receipts	206	197	197	351	241	279	668	1,310	4%
Govt. grants	500	582	529	473	107	48	122	165	1%
Works programme grants	5,323	4,362	529	4,582	9,537	9,254	8,853	20,631	66%
Error									0%
Total	8,978	7,888	4,395	8,948	14,145	14,819	15,788	31,298	100%
Expenditure:									
Wages & salaries	1,184	1,149	1,248	1,375	1,537	1,644	1,773	2,293	7%
Contingency (Commodities)	928	766	929	1,225	1,466	1,891	2,325	3,026	10%
Infrastructure development (Gross fixed capital formation)	6,706	5,484	5,929	6,088	10,937	11,002	10,554	24,769	81%
Interest paid	3	5	1					1	0%
Works programme	41	37	33	2	96	77	467	296	1%
Scholarship, grants, etc. (Transfer)	47	32	39	166	119	205	146	308	1%
Total	8,909	7,473	8,179	8,856	14,155	14,819	15,265	30,693	100%
Net revenues	69	415	(3,784)	92	(10)	-	523	605	

Source: Budget of City Corporation.

9.20 Consolidated Receipts and Expenditures of Zila Parishad

(Million Taka)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	601	524	544	644	845	1,027	971	941	20%
Rates	128	66	99	75	154	128	193	317	7%
Fees & tolls	254	243	211	126	328	299	241	351	7%
Interest receipts	66	67	55	51	85	91	123	107	2%
Misc. receipts	13	11	11	2	17	28	18	28	1%
Govt. grants	209	149	220	126	342	614	1,002	1,270	27%
Works programme grants	882	725	705	919	1,095	1,371	1,249	1,724	36%
Error									0%
Total	2,153	1,785	1,845	1,943	2,866	3,558	3,797	4,738	100%
Expenditure:									
Wages & salaries	229	167	193	170	262	301	329	377	7%
Contingency (Commodities)	125	94	108	106	152	219	232	262	5%
Infrastructure development (Gross Fixed capital formation)	1,785	1,477	1,704	1,505	2,338	3,084	3,101	4,292	85%
Interest paid	11	3	4		1	-	-	-	0%
Works programme	2	1	1	1	6	2	4	11	0%
Scholarship, grants, etc. (Transfer)	80	65	75	59	105	82	92	103	2%
Total	2,232	1,807	2,085	1,841	2,864	3,688	3,758	5,045	100%
Net revenues	(79)	(22)	(240)	102	2	(130)	39	(307)	

Source: Budget of Zila Parishad.

(Thousand US\$)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	19,250	17,138	21,850	23,788	31,713	40,963	40,688	68,400	17%
Rates	5,388	4,725	4,975	5,250	10,625	13,550	16,775	24,613	6%
Fees & tolls	12,063	12,300	12,238	15,138	10,700	10,850	19,113	21,588	6%
Interest receipts	163	175	188	100	213	113	238	300	0%
Misc. receipts	2,575	2,463	2,463	4,388	3,013	3,488	8,350	16,375	4%
Govt. grants	6,250	7,275	6,613	5,913	1,338	600	1,525	2,063	1%
Works programme grants	66,538	54,525	6,613	57,275	119,213	115,675	110,663	257,888	66%
Error	-	-	-	-	-	-	-	-	0%
Total	112,225	98,600	54,938	111,850	176,813	185,238	197,350	391,225	100%
Expenditure:									
Wages & salaries	14,800	14,363	15,600	17,188	19,213	20,550	22,163	28,663	7%
Contingency (Commodities)	11,600	9,575	11,613	15,313	18,325	23,638	29,063	37,825	10%
Infrastructure development (Gross fixed capital formation)	83,825	68,550	74,113	76,100	136,713	137,525	131,925	309,613	81%
Interest paid	38	63	13	-	-	-	-	13	0%
Works programme	513	463	413	25	1,200	963	5,838	3,700	1%
Scholarship, grants, etc. (Transfer)	588	400	488	2,075	1,488	2,563	1,825	3,850	1%
Total	111,363	93,413	102,238	110,700	176,938	185,238	190,813	383,663	100%
Net revenues	863	5,188	(47,300)	1,150	(125)	-	6,538	7,563	

(Thousand US\$)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	7,513	6,550	6,800	8,050	10,563	12,838	12,138	11,763	20%
Rates	1,600	825	1,238	938	1,925	1,600	2,413	3,963	7%
Fees & tolls	3,175	3,038	2,638	1,575	4,100	3,738	3,013	4,388	7%
Interest receipts	825	838	688	638	1,063	1,138	1,538	1,338	2%
Misc. receipts	163	138	138	25	213	350	225	350	1%
Govt. grants	2,613	1,863	2,750	1,575	4,275	7,675	12,525	15,875	27%
Works programme grants	11,025	9,063	8,813	11,488	13,688	17,138	15,613	21,550	36%
Error	-	-	-	-	-	-	-	-	0%
Total	26,913	22,313	23,063	24,288	35,825	44,475	47,463	59,225	100%
Expenditure:									
Wages & salaries	2,863	2,088	2,413	2,125	3,275	3,763	4,113	4,713	7%
Contingency (Commodities)	1,563	1,175	1,350	1,325	1,900	2,738	2,900	3,275	5%
Infrastructure development (Gross Fixed capital formation)	22,313	18,463	21,300	18,813	29,225	38,550	38,763	53,650	85%
Interest paid	138	38	50	-	13	-	-	-	0%
Works programme	25	13	13	13	75	25	50	138	0%
Scholarship, grants, etc. (Transfer)	1,000	813	938	738	1,313	1,025	1,150	1,288	2%
Total	27,900	22,588	26,063	23,013	35,800	46,100	46,975	63,063	100%
Net revenues	(988)	(275)	(3,000)	1,275	25	(1,625)	488	(3,838)	

9.21 Consolidated Receipts and Expenditures of Union Parishads
(Million Taka)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	'08 %
Receipts:									
Taxes	888	675	953	954	914	1082	1738	2363	24%
Rates	0	0	0						0%
Fees & tolls	383	326	394	308	499	576	925	1258	13%
Interest receipts	0	0	0	28	55	66	105	143	1%
Misc. receipts	279	267	27	630	523	636	1022	1389	14%
Govt. grants	659	531	699	669	844	1069	1717	2335	24%
Works programme grants	551	374	609	853	767	1002	1609	2187	23%
Error	1	-18	247	0	0	0	0	2	0%
Total	2761	2155	2929	3442	3602	4431	7116	9677	100%
Expenditure:									
Wages & salaries	1186	919	1333	1272	1431	1039	1699	2001	21%
Contingency (Commodities)	650	554	666	390	500	775	1224	1767	19%
Infrastructure development (Gross Fixed capital formation)	1005	679	1028	1393	1338	2064	3260	4708	50%
Interest paid	0	0	0						0%
Works programme	0	0	0	176	187	269	424	612	6%
Scholarship, grants, etc. (Transfer)	0	0	0	127	93	146	230	332	4%
Total	2,841	2,152	3,027	3,358	3,549	4,293	6,837	9,420	100%
Net revenues	(80)	3	(98)	84	53	138	279	257	

Source: Budget of Union Parishad.

(Thousand US\$)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	08%
Receipts:									
Taxes	11,100	8,438	11,913	11,925	11,425	13,525	21,725	29,538	24%
Rates	-	-	-	-	-	-	-	-	0%
Fees & tolls	4,788	4,075	4,925	3,850	6,238	7,200	11,563	15,725	13%
Interest receipts	-	-	-	350	688	825	1,313	1,788	1%
Misc. receipts	3,488	3,338	338	7,875	6,538	7,950	12,775	17,363	14%
Govt. grants	8,238	6,638	8,738	8,363	10,550	13,363	21,463	29,188	24%
Works programme grants	6,888	4,675	7,613	10,663	9,588	12,525	20,113	27,338	23%
Error	13	(225)	3,088	-	-	-	-	25	0%
Total	34,500	27,163	33,525	43,025	45,025	55,388	88,950	120,938	100%
Expenditure:									
Wages & salaries	14,825	11,488	16,663	15,900	17,888	12,988	21,238	25,013	21%
Contingency (Commodities)	8,125	6,925	8,325	4,875	6,250	9,688	15,300	22,088	19%
Infrastructure development (Gross Fixed capital formation)	12,563	8,488	12,850	17,413	16,725	25,800	40,750	58,850	50%
Interest paid	-	-	-	-	-	-	-	-	0%
Works programme	-	-	-	2,200	2,338	3,363	5,300	7,650	6%
Scholarship, grants, etc. (Transfer)	-	-	-	1,588	1,163	1,825	2,875	4,150	4%
Total	35,513	26,900	37,838	41,975	44,363	53,663	85,463	117,750	100%
Net revenues	(1,013)	263	(4,313)	1,050	663	1,725	3,488	3,188	

	Project costs						Proposed funding sources						
	2010-11	2011-12	2012-13	2013-14	2014-15	Total	UGIIP-2 LGED	LG Dept grants	LG Dept project	Revenue surplus	BMDP grants/ loan	DPHE	Total
Goal 1: Prepare master plan for Sreepur Pourasha													
1. Master plan	9.00				6.00	15.00			9.00	6.00			15.00
Total	9.00	0.00	0.00	0.00	6.00	15.00	0.00	0.00	9.00	6.00	0.00	0.00	15.00
Goal 2: Provide quality physical infrastructure and urban services													0.00
1. Development of urban communication	431.20	576.70	501.20	711.20	685.60	2905.90	1255.90	250.00	0.00	900.00	364.00	136.00	2905.90
21 Road paving projects													
Construction/re-construction of Bridges and culverts													
Development of vehicle management													
Neighborhood street paving													
2. Construction/re-construction/repair of drainage system	104.28	106.72	103.28	104.28	55.14	519.38	491.38	0.00	0.00	28.00	0.00	0.00	519.38
3. Development of waste management system	0.00	83.90	1.00	67.52	19.38	171.80	163.80	0.00		8.00	0.00	0.00	171.80
Construction of transfer station													
Privatization contract for waste management													
Landfill development													
Clean Development Mechanism (CDM)													
Industrial waste program													
Clinical waste management													
4. Development of water supply system	35.00	45.00	35.00	75.00	473.80	663.80	163.80	0.00		0.00	0.00	500.00	663.80
Deep tube-well													
Treatment plant													
Installing/extending water supply lines													
Public stand pipe													
Leakage management													
Supplying water meters													
Installation of iron and arsenic removal plants													
5. Development of sanitation system	19.51	29.55	22.10	22.50	15.54	109.20	109.20	0.00		0.00	0.00	0.00	109.20
Twin-pit latrine													
Single-pit latrine													
Public toilet													
Wash station													
6. Pourashava service facilities	164.93	187.77	160.29	112.48	77.53	803.00	546.00	250.00		7.00	0.00	0.00	803.00
Bus terminal and truck terminal construction													
Development of parking areas													
Development of green markets													
Development of animal slaughter houses													
Street lights and landscaping													
Development of graveyard/ cremation ground													
Development of tanks and wetland													
Community center													
Pourashava building and community center													
Total	754.92	1029.64	822.87	1092.98	1326.99	5173.08	2730.08	500.00	0.00	943.00	364.00	636.00	5173.08
Goal 3: Socio-economic Development													
Implementing all the activities described in Poverty Reduction Action Plan (PRAP) and Gender Action Plan (GAP)													
Total	73.00	73.00	72.00	11.00	11.00	240.00	240.00	0.00	0.00	0.00	0.00	0.00	240.00
Goal 4: Pourashava governance improvement													
Realization of activities as defined in the Urban governance improvement and capacity development project (UGIAP)													
Total	8.20	6.20	5.20	5.20	5.20	30.00	30.00	0.00	0.00	0.00	0.00	0.00	30.00
Grand Total	845.12	1108.84	900.07	1109.18	1349.19	5458.08	3000.08	500.00	9.00	949.00	364.00	636.00	5458.08

Source: Sreepur PDP, summarized by authors, 2012.

Annex 3

BANGLADESH CLIMATE CHANGE STRATEGY AND ACTION PLAN 2008

Themes and Programmes

Theme	T1: Food Security, Social Protection and Health
Programmes	P1. Institutional capacity for research towards climate resilient cultivars and their dissemination P2. Development of climate resilient cropping systems P3. Adaptation against drought P4. Adaptation in fisheries sector P5. Adaptation in livestock sector P6. Adaptation in health sector P7. Water and sanitation programme in climate vulnerable areas P8. Livelihood protection in ecologically fragile areas P9. Livelihood protection of vulnerable socio-economic groups (including women)
Theme	T2: Comprehensive Disaster Management
Programmes	P1. Improvement of flood forecasting and early warning P2. Improvement of cyclone and storm surge warning P3. Awareness raising and public education towards climate resilience P4 Risk management against loss on income and property
Theme	T3 : Infrastructure
Programmes	P1. Repair and maintenance of existing flood embankments P2. Repair and maintenance of cyclone shelters P3. Repair and maintenance of existing coastal polders P4. Improvement of urban drainage P5. Adaptation against Floods P6. Adaptation against tropical cyclones and storm surges P7. Planning and design of river training works
Theme	T4: Research and Knowledge Management
Programmes	P1. Establishment of a centre for knowledge management and training on climate change P2. Climate change modelling at national and sub-national levels P3. Preparatory studies for adaptation against sea level rise P4. Monitoring of ecosystem and biodiversity changes and their impacts P5. Macroeconomic and sectoral economic impacts of climate change
Theme	T5: Mitigation and Low Carbon Development
Programmes	P1. Improved energy efficiency in production and consumption of energy P2. Gas exploration and reservoir management P3. Development of coal mines and coal fired power stations P4. Renewable energy development P5. Lower emission from agricultural land P6. Management of urban waste P7. Afforestation and reforestation programme
Theme	T6: Capacity Building and Institutional Strengthening
Programmes	P1. Revision of sectoral policies for climate resilience P2. Main-streaming climate change in national, sectoral and spatial development programmes P3. Strengthening human resource capacity P4. Strengthening institutional capacity for climate change management P5. Main-streaming Climate Change in the Media

Annex 5














UNCDF Bangladesh / Government of Bangladesh / Development of Municipal Bonds and Private Finance for ULB Infrastructure

PRELIMINARY PILOT PROJECT WORK PLAN AND SCHEDULE OF KEY ACTIVITIES

ACTIVITY			TIMEFRAME							
	Agency Responsible / Support Role	Outputs	2013 2 nd Q	3 rd Q	4 rd Q	2014 1 st Q	2 nd Q	3 rd Q	4 rd Q	
Project preparation and coordination										
1. Establish MLGRDC-led government Working Group (WG) to coordinate municipal finance Pilot Project, with UNCDF support	MLGRDC / other ministries / UNCDF	WG created and meeting regularly								
2. Prepare and approve project documentation for Pilot Project	MLGRDC / WG / UNCDF	Project document, work plan, budget								
3. Organize study tours on municipal finance for MLGRDC and private sector (Philippines, China, Vietnam, Indonesia)	WG / UNCDF / Donors	Findings from study tours								
I. Policy and legal framework strengthening										
1. National Urban Sector Policy (NUSP)										
a. Approve and promote NUSP	MLGRDC / Cabinet	Approved NUSP								
b. Design and implement a dissemination plan	MLGRDC	NUSP dissemination plan								
2. Address legal and regulatory constraints										
a. Initiate legal and administrative review to identify constraints that affect ULB use of market-based credit and propose reforms	WG / UNCDF	Legal review and descriptions of proposed reforms								
b. Engage private sector to support review	UNCDF	Expression of interest from private sector								
c. Develop legal and regulatory reform plan	WG / UNCDF	Legal and regulatory reform plan								
d. Implement and oversee reforms	WG / UNCDF	Reforms implemented								
3. Modernization of BMDF										
a. Identify reforms to allow BMDF to support municipal access to market financing	WG / UNCDF	Diagnostic study BMDF and recommended reforms								
b. Mobilize technical assistance to plan and implement reforms	WG / UNCDF	Terms of reference for technical assistance								
c. Help GOB enlist donor support for BMDF recapitalization	WG / UNCDF	Recapitalization commitments								

ACTIVITY			TIMEFRAME							
	Agency Responsible / Support Role	Outputs	2013 2 nd Q	3 rd Q	4 rd Q	2014 1 st Q	2 nd Q	3 rd Q	4 rd Q	
4. Develop municipal credit guidelines and rules to support Pilot project										
a. Develop credit guidelines and rules (with or without approval of NUSP)	MLGRDC / MOF / UNCDF	Financing guidelines and rules								
b. Disseminate credit financing guidelines and rules with ULBs and Donors	MLGRDC / UNCDF	Dissemination plan and results of dissemination activities								
II. ULB and BMDF preparation										
2. Disseminate information on Pilot project										
a. Establish eligibility criteria for ULB and other local entity participation in Pilot Project	WG / UNCDF	Eligibility criteria								
b. Design dissemination activities for ULBs and other local entities on Pilot Project	WG / UNCDF	Dissemination plan								
c. Disseminate Pilot Project requirements with ULBs and receive feedback	WG / UNCDF / Donors	Results of dissemination activities								
3. Select pilot ULBs										
a. Receive expressions of interest to participate in Pilot Project	WG / UNCDF / Donors	Expressions of interest								
b. Select Pilot Project group (8-10 ULBs)	WG / UNCDF	Results of selection process								
c. Deliver training to Pilot ULBs	WG / UNCDF	Training materials; training evaluation by ULBs								
4. Modernize accounting and auditing systems in pilot ULBs										
a. Define and implement new municipal accounting and auditing standards based on international standards.	ICAB / MOF / MLGRDC / UNCDF	Guidelines on municipal accounting and auditing standards								
b. Provide technical assistance to support implementation of new municipal accounting and auditing standards	ICAB / MLGRDC / UNCDF / Donors	Terms of reference for implementation of standards; results of technical assistance activities								
5. Develop Capital Investment Plans (CIP) and Debt Capacity Analysis (DCA)										
a. Identify source of technical assistance for each Pilot ULB	MLGRDC / UNCDF / Donors	Technical assistance providers identified								

ACTIVITY			TIMEFRAME							
	Agency Responsible / Support Role	Outputs	2013 2 nd Q	3 rd Q	4 rd Q	2014 1 st Q	2 nd Q	3 rd Q	4 rd Q	
b. Agree on standard method and format for CIPs and DCAs	MLGRDC / UNCDF / Donors / Private sector	Method and format for CIP and DCA								
c. Prepare, review and finalize CIPs and DCAs	MLGRDC / UNCDF / Donors	CIP and DCA for each Pilot ULB								
d. Establish criteria for identification of investments for bonds/market financing and identify investment projects	MLGRDC / UNCDF / Donors / Private sector	Project identification criteria								
e. Assist ULBs to strengthen debt capacity, including tax collection and project-related cost recovery	MLGRDC / UNCDF / Donors	Debt capacity strengthening plan for each ULB; results of technical assistance								
f. Assist ULBs with user/ taxpayer consultation	UNCDF / Donors	Agreements with users and/or taxpayers								
III. Market capacity strengthening										
1. Private sector engagement										
a. Identify key private sector actors (including investors) and seek their involvement in market development and Pilot Project	Private sector / UNCDF	Plan for approaching private actors								
b. Organize meetings w/ private actors to exchange information on market financing (Initial meeting could cover findings of bonds study.)	Private sector / WG / UNCDF	Meeting agenda; meeting materials								
c. Create a financial/capital market Task Force to develop definitive development agenda and support implementation	Private sector	Terms of reference for financial market task force								
2. Market legal and administrative reforms										
a. Work with Task Force to identify and address legal and administrative reforms needed in the financial markets	Private sector / WG / UNCDF	Legal and regulatory reform plan								
b. Mobilize technical assistance to support implementation	Private sector / WG / UNCDF	Terms of reference for technical assistance								
c. Implement and oversee reforms	Private sector / WG / UNCDF	Reforms implemented								

ACTIVITY			TIMEFRAME							
	Agency Responsible / Support Role	Outputs	2013 2 nd Q	3 rd Q	4 rd Q	2014 1 st Q	2 nd Q	3 rd Q	4 rd Q	
IV. Bond issuance										
1. Prepare credit ratings										
a. Engage credit rating agencies (CRAs) in development of municipal credit criteria	CRAs / WG / UNCDF	Municipal ratings criteria, draft and final								
b. Facilitate training by CRAs with ULBs	CRAs / WG / UNCDF	Training materials								
c. Assist CRAs to conduct shadow and final ratings of pilot ULBs	CRAs / WG / UNCDF	Shadow and final ratings								
2. Prepare and issue bond										
a. Select underwriter (merchant bank)	WG / UNCDF	Terms of reference; underwriter contract								
b. Select bond counsel	WG / UNCDF	Terms of reference; bond counsel contract								
c. Select trustee	WG / UNCDF	Terms of reference; trustee contract								
d. Structure bond issue	Private sector	Bond structure and documents (official statement, legal documents, etc.)								
e. Identify need for credit enhancements and arrange	WG / UNCDF / Private sector	Credit enhancement structure and documentation								
f. Carry out marketing activities	WG / UNCDF / Private sector	Marketing materials								
g. Conduct bond sale	Private sector	Proceeds of sale								
3. Monitor ULB performance and compliance										
a. Provide technical assistance to ensure proper use of bond proceeds	WG / UNCDF / Donors	Implementation reports								
b. Provide technical assistance to ensure BMDF and ULBs comply with all bond requirements, including repayment schedule	WG / UNCDF / Donors	Financial reports								
c. Evaluate project	WG / UNCDF / Private sector	Project evaluation								

March 2013