AFRICAN DEVELOPMENT BANK GROUP

GUIDELINES ON SUBNATIONAL FINANCE

SNSP DEPARTMENT

November 2019

Acknowledgments

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Contents

Acronyms and Abbreviations

ADF	:	African Development Fund
ADB	:	African Development Bank
AfDB	:	African Development Bank
ALM	:	Assets and Liabilities Management
Bank Group	:	AfDB, AfDF, NTF, and the Special Funds affiliated to the Bank
Bank’s Charter	:	Agreement Establishing the African Development Bank
CRC	:	Credit Risk Committee
CSO	:	Civil Society Organization
CSS	:	Climate Safeguards System
CSP	:	Country Strategy Paper
ESW	:	Economic and Sector Work
FI	:	Financial Intermediary
Fund’s Charter	:	Agreement Establishing the African Development Fund
FSDPS	:	Financial Sector Development Policy and Strategy
GAP	:	Governance Strategic Framework and Action Plan
ISP	:	Institutional Support Project
ISS	:	Integrated Safeguards System
IMF	:	International Monetary Fund
LOC	:	Line of Credit
MDF	:	Municipal Development Fund
MSME	:	Micro, Small and Medium sized Enterprises
NDP	:	National Development Partnership
NFPS	:	Non-Financial Public Sector
OBA	:	Output Based Aid
PBA	:	Performance Based Allocation
PRSP	:	Poverty Reduction Strategy Paper
PSD	:	Private Sector Development
PEFA	:	Public Expenditure and Financial Accountability
PFM	:	Public Financial Management
PPP	:	Public Private Partnership
PSE	:	Public Sector Enterprise
RDG	:	Regional Directorate General
RMC	:	Regional Member Country
RBF	:	Results Based Financing
SME	:	Small and Medium Sized Enterprise
SPV	:	Special Purpose Vehicle
SDGs	:	Sustainable Development Goals
TA	:	Technical Assistance
UMDF	:	Urban and Municipal Development Fund

1 Introduction

1.1 Rationale for Bank Group Support at the Subnational Level

1. Subnational governments / entities[1] play an increasingly important role in support of RMCs' development goals. The Bank Group recognized this at the outset and provided for engagement in subnational finance in its Charter and sub-sequent policy and strategy frameworks. Given the vital link to achieving the Sustainable Development Goals (SDGs),[2] the Bank Group's Ten Year Strategy 2013-2022 and High 5 Priorities, the Bank Group has committed to enhancing subnational financing in its Regional Member Countries (RMCs).

2. There are several challenges that affect the nature and form of subnational financing in Africa. These include:

(i) The varying degree of self-governance and fiscal devolution to the subnational governments / entities;

(ii) The increasing devolution of responsibilities for service delivery to subnational governments / entities is not accompanied by a corresponding transfer of financial resources or of the power to raise such resources, nor strengthening of the relevant human capital/institutional capacities;

(iii) Increasing urbanization is exerting growing pressure on the finances and human capital/institutional capacities of cities, towns and municipalities;

(iv) Subnational governments and entities are increasingly devolving their responsibilities to the private sector, mostly in the context of Public Private Partnership (PPPs), often without the latter having the necessary skills and resources, nor a formal empowering institutional framework with clear objectives;

(v) Globalization of capital markets has increased opportunities for subnational governments / entities to access capital, thus exposing them and their national governments to a new set of risks;

(vi) All these challenges are occurring within an enabling environment that is often inadequate or unstable.

3. In view of the ongoing evolution at subnational levels, subnational governments and their entities, including public utilities, are *de facto* or *de jure*, becoming central to the provision of poverty-reducing and growth-generating infrastructure and social services, but they generally lack the institutional and financial ability to assume their obligations. This situation, if not addressed, will lead to an increasing deterioration in the quality and quantity of public services and/or to increased budget deficits as well as social unrest. Ultimately, this would be a wasted opportunity for reform and would result in further delays in reforms and in quality of life improvements for Africans.

4. Major international and regional financial development institutions are engaged in subnational finance using a variety of methodologies and intervention practices including technical assistance (TA), capacity building, as well as financing urban infrastructure through direct and indirect lending to subnational governments and/or lending to and investing in related

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[1] Defined as any administrative organ within a Regional Member Country (RMC) with delegated powers for a defined degree of self-governance such as a federative state, county, province, district, city, municipality, or commune, or their departments or corporates pursuing specific activities (e.g., energy and water utilities, waste management, transportation systems, education and health institutions, etc.)

[2] Common position paper by the MDBs/IMF: "From Billions to Trillions: Transforming Development Finance, Post-2015 Financing for Development: Multilateral Development Finance". Development Committee Discussion Note, March 2015.

non-sovereign entities. An overview of these methodologies is presented in Annex 1 along with a comparison of these with proposed Bank Group interventions.

5. The Bank Group, as Africa's premier development institution, needs to position itself, both at the national and subnational levels, to be more relevant to its RMCs, by playing a central role in supporting subnational governments and entities to discharge their mandates in an effective way. The Bank Group needs to do so, not only by engaging directly with these subnational governments/ entities, but also by promoting appropriate legal and regulatory frameworks for their optimal functioning, by engaging at the national level as well. Direct Bank Group engagement at the subnational level will improve Bank Group responsiveness to RMCs' needs and will assist the Bank Group in making an increasingly effective contribution to fulfilling the Bank Group's mandate of promoting sustainable economic and social development of its RMCs individually and jointly. There is a clear institutional and financing gap at the subnational level that the Bank Group can help fill.

1.2 Purpose of the Guidelines

6. The purpose of these Guidelines is to provide clear guidance and business procedures for Bank Group engagement at the subnational level with regard to the prevailing policy and strategic framework, including eligibility criteria, areas of intervention, financing instruments, and modalities of Bank Group support, within an overarching vision, goal, and objectives.

7. After this introduction, the document is organized as follows. Section 2 lays out the vision, goal and objectives of Bank Group subnational finance; Section 3 presents succinctly the policy framework for subnational finance; Section 4 summarizes the current strategic framework for subnational finance; Section 5 details the eligibility criteria for subnational finance; Section 6 covers areas of special emphasis in subnational finance; Section 7 provides guidance on how to address subnational finance during country programming and addresses specificities of subnational finance project processing; Section 8 discusses implementation considerations and; Section 9 concludes.

2 Vision, Goal, and Objectives

2.1 Vision

8. Subnational governments are increasingly entrusted[3] with new and expanded responsibilities in their jurisdictions, including: promoting economic development, providing and/or regulating the provision of infrastructure and social services[4] and improving environmental management. The Bank Group's vision envisages subnational governments and entities that are able to effectively and efficiently discharge their functions through clear mandates, adequate institutional capacity, appropriate sources of finance, and good governance systems.

2.2 Goal

9. Bank Group support for subnational governments and their entities aims to enhance their ability to increase, diversify and better utilize their financial resources with a view to improve their delivery on the socio-economic agenda entrusted to them through the devolution

[3] This may be *de jure*, in line with a decentralization process being implemented, or *de facto*, as the central or other upper level of government defaults on its responsibilities.

[4] E.g., water, sewerage and waste collection, roads and drainage, public lighting, markets, abattoirs, transportation terminals, etc.

of responsibilities by the national governments. In pursuing this goal, the Bank Group will seek to promote inclusive growth and the transition to green growth, in particular through its High 5 priorities, namely *Light Up and Power Africa*, *Feed Africa*, *Industrialize Africa*, *Integrate Africa* and *Improve the Quality of Life for the People of Africa.* This will contribute to social and environmental sustainability, and enhance the effectiveness and accountability of the subnational governments and their entities through a better alignment between beneficiaries' needs and the services provided.

2.3 Objectives

10. The success of subnational governments and their entities in discharging their expanding responsibilities in a sustainable manner depends on: (i) the structure of the relations between the national and subnational government / entity; (ii) the structure of governance; (iii) the institutional and human capital capacity of subnational governments / entities; (iv) the mechanisms for financing subnational governments / entities; and (v) the existence of suitable and predictable legal and regulatory frameworks to support subnational development in RMCs.[5] Therefore, the objectives of the Bank Group subnational finance are to:

(i) Improve the system of incentives that lead to sustainable subnational entities' development outcomes, including the structure of intergovernmental relations, the system of governance, the mechanisms for financing subnational entities, and the legal and regulatory frameworks within which the subnational entities operate; and

(ii) Provide support to subnational governments and their entities by building their capacity, improving their governance, and enhancing their access to financial resources for the effective delivery of services and infrastructure.

3 Policy Framework for Subnational Finance

11. ***The African Development Bank (ADB) Articles of Agreement allow for the provision of financing to subnational governments and their entities***. Chapter III Article 14 (1) of the Agreement Establishing The African Development Bank states that: *In its operations, the Bank may provide or facilitate financing for any regional member, <u>political subdivision or any agency thereof</u> or for any institution or undertaking in the territory of any regional member as well as for international or regional agencies or institutions concerned with the development of Africa.*

12. ***The African Development Fund (ADF) Articles of Agreement allow for the provision of financing to subnational governments and their entities.*** Chapter V Article 16 (3) (b) of the Agreement Establishing the African Development Fund states that: *The Fund may provide financing for: (a) any member <u>or any geographical or administrative subdivision or agency thereof</u>; (b) any institution or undertaking in the territory of any member; and (c) any regional or sub-regional agency or institution concerned with development in the territories of members.*

13. ***Other financing facilities such as Trust or Special Funds administered by the Bank Group under its policies and procedures*** consequently allow the provision of financing to subnational governments and their entities, unless this is in conflict with specific provisions governing said facilities.

14. ***Bank Group subnational finance operations are governed by all relevant Bank Group institutional and sector policies, rules and safeguards***. Sovereign operations in support of

[5] See Annex 7 for lessons learnt and a General Policy Framework for Subnational Borrowing.

subnational entities are governed by the relevant policies of the Bank Group that guide its sovereign public sector operations. Non-sovereign Bank support is governed by the *Policy on Non-Sovereign Operations*.[6] These Guidelines set out additional guidance to cater to the particularities of subnational finance operations.

4 Strategic Framework for Subnational Finance

15. The Bank Group's corporate and sector strategies include several priorities and entry points for Bank Group support at the subnational level, most of which are summarized in the following paragraphs.

16. The Bank Group's Ten Year Strategy 2013-2022[7] emphasizes fiscal decentralization, promoting sustainable infrastructure, and leveraging Bank capital and new instruments, in particular, evaluating the merits of financing sub-sovereign and municipal entities that have a direct and inclusive impact on the quality of life. The Bank Group's High 5s priorities *Light Up and Power Africa, Feed Africa, Industrialize Africa, Integrate Africa* and *Improve the Quality of Life for the People of Africa* also require better-enabled subnational governments and their entities to the extent that social and infrastructure services as well as the business environment fall under their mandates.

17. The Bank Group's Urban Development Strategy[8] seeks to boost the viability and competitiveness of African cities to ensure that they perform their role as real engines of economic growth and social development. Priority areas are infrastructure delivery, governance, private sector development, and cross-cutting themes, including knowledge generation, regional integration, environmental protection and adaptation and resilience to climate change, gender equality, and the empowerment of vulnerable segments of the population, as well as the strengthening of the urban-rural linkages.

18. The Bank Group's Governance Strategic Framework and Action Plan[9] prioritizes Public Financial Management (PFM) at national and subnational levels, and aims for, *inter alia*: (i) strengthening the PFM framework at the subnational level; (ii) supporting capacity building for implementing PFM reforms at the subnational level; and (iii) implement PFM dimensions of the Bank Group's 2011 Urban Development Strategy, specifically its fiscal decentralization, revenue collection, transparency and anti-corruption dimensions.

19. The Bank Group's Strategy for Addressing Fragility and Building Resilience in Africa[10] commits the Bank Group to building resilience and government capacity at the subnational level, without bypassing the national government. It aims to contribute to strengthening the central government's relationship with the concerned area and population with a view to promoting inclusive growth and development.

20. The Bank Group's Financial Sector Development Policy and Strategy (FSDPS)

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[6] ADB/BD/WP/2018/49/Rev.2 – ADF/BD/WP/2018/30/Rev.2.

[7] African Development Bank Group Long Term Strategy 2013-2022 Revised Version (African Development Bank ADB/BD/WP/2012/110/Rev.2; African Development Fund ADF/BD/WP/2012/76/Rev.2).

[8] The Bank Group's Urban Development Strategy - Transforming Africa's Cities and Towns into Engines of Economic Growth and Social Development.

[9] Governance Strategic Framework and Action Plan (GAP II), 2014 – 2018 Promoting Good Governance and Accountability for Africa's Transformation.

[10] African Development Bank Group Strategy for Addressing Fragility and Building Resilience in Africa 2014-2019.

2014-2019[11] relies on two pillars: the first is increasing access for the underserved to the full range of financial services, and the second is broadening and deepening Africa's financial systems. Cutting across the two pillars is the need for sound governance of Africa's financial systems. In implementing the FSDPS, the Bank Group plans to lead investment in local currency-denominated, sovereign and sovereign-guaranteed subnational bonds including infrastructure bonds. Furthermore, the Bank's Assets and Liabilities Management Guidelines provide for Bank investment in sub sovereign debt obligations under specific conditions. This will contribute to the development of local bond markets by issuing local currency bonds that could be used to finance subnational projects.

21. The Private Sector Development (PSD) Policy[12] and PSD Strategy[13] guide the Bank Group's support for PSD aiming at broad-based, inclusive and sustainable economic growth, development, and social well-being. They affirm the role of African enterprises as drivers of the Continent's development and partners in delivering the Bank's mandate. They frame the Bank's PSD role as one that directly and/or indirectly contributes to the growth of African-owned enterprises. Subnational governments contribute to the development of the private sector by reducing regulatory barriers to private investment and by creating a favorable environment for new direct investment through the provision of local infrastructure and appropriate policies and regulations. Furthermore, current approaches both at the national and subnational levels seek to harness private sector participation for infrastructure development by allowing private developers to charge user fees when feasible under various Public Private Sector Partnership (PPP) forms and approaches.

22. In the context of the sustainable development agenda post 2015, the Bank Group further committed to a number of actions in support of subnational finance. They include[14]: (i) strengthening the capacity of local governments, including to raise their own revenues, to manage expenditures (including investment programming and monitoring) and service delivery, and to borrow and manage debt prudently; (ii) developing inter-government fiscal transfer arrangements that take into account investment needs of subnational governments, equalize fiscal capacity and expenditure needs across levels of government, and clearly delineate spending responsibilities between the different layers of government; and (iii) promoting access to long-term finance to minimize risks in the lifecycle of infrastructure investments.

5 Eligibility of Subnational Governments / Entities for Bank Group Assistance

5.1 Definition of Key Terminology

23. For the purposes of these Guidelines, Subnational Finance Operations are defined as the provision of direct or indirect grants; direct or indirect loans; lines of credit; guarantees or equity (in the case of subnational public sector enterprises or Special Purpose Vehicles) to subnational governments and their entities that meet the eligibility criteria laid out in this Section 5 of these Guidelines.

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[11] Financial Sector Development Policy and Strategy 2014-2019 - Revised (ADB/BD/WP/2014/101/Rev.2; ADF/BD/WP/2014/69/Rev.2).

[12] The Private Sector Development Policy of the African Development Bank Group (2013).

[13] The Private Sector Development Strategy, 2013-2017 of the African Development Bank Group.

[14] Common position paper by the MDBs/IMF: "From Billions to Trillions: Transforming Development Finance, Post-2015 Financing for Development: Multilateral Development Finance". Development Committee Discussion Note, March 2015.

24. Subnational governments and their entities are defined as follows:

a) Subnational governments are states in a Federation, provinces, regions, counties, districts, departments, municipalities and other subdivisions[15]– hereafter referred to as "subnational governments";[16]

b) Subnational Public Sector Enterprises (PSEs) are enterprises in which one or more sub-sovereign entities, any of their political or administrative subdivisions, agencies and/or affiliated (non-sovereign) entities hold either (i) more than 50% of the voting stock (or voting rights), or (ii) a percentage of the voting stock (or voting rights) enabling said persons to direct the policies and management of the enterprise (a 'controlling interest'[17]) and whose competence is delimited for the service of said subnational governments' territories, hereafter referred to as "subnational public sector enterprises";

c) Subnational Special-Purpose Vehicles (SPV) are SPVs established by central and/or subnational governments/entities to finance subnational entities, and in which the public sector entities hold either (i) more than 50% of the voting stock (or voting rights), or (ii) a percentage of the voting stock (or voting rights) enabling said persons to direct the policies and management of the SPV (a 'controlling interest') and whose competence is delimited for the service of said subnational governments' territories, hereafter referred to as "subnational SPVs";

d) Subnational development finance institutions and other financial intermediaries (FIs) such as municipal development funds established by central and/or subnational governments to finance subnational entities, and in which the public sector entities hold either (i) more than 50% of the voting stock (or voting rights), or (ii) a percentage of the voting stock (or voting rights) enabling said persons to direct the policies and management of the enterprise (a 'controlling interest') and whose competence is delimited for the service of said subnational governments' territories, hereafter referred to as "subnational FIs"; and

e) Public-Private Partnerships (PPP) where the public partner is a subnational government, a subnational SPV, or a subnational public sector enterprise, hereafter referred to as "subnational PPPs".

5.2 Eligibility Criteria for Bank Group Subnational Support

25. When considering a subnational government or subnational entity's eligibility for Bank Group financial support, several factors have to be considered: (i) whether the subnational government/entity are eligible to support from a specific financing window; (ii) whether they are able to demonstrate ownership of national and subnational governments of their subnational development in general, and in particular of the Bank Group support being sought; (iii) whether they are eligible for direct sovereign-guaranteed financial support by the Bank Group if such support is being sought, and if not, indirect[18] financial support should be considered; (iv) whether they are eligible for direct non-sovereign-guaranteed financial support by the Bank

[15] The International Monetary Fund's Government Finance Statistics Manual (2001) distinguishes three levels of subnational administration: national, state (federated), provincial or regional, and local administrations.

[16] They are also commonly referred to as "local authorities".

[17] The assessment of a 'controlling interest' will be made on a case-by-case basis, having regard to, *inter alia*, the legislation of the RMC of incorporation (the 'host RMC'), the constitutional documents of the enterprise, and any relevant contractual arrangements (e.g., shareholders' agreement).

[18] Indirect lending is also referred to as on-lending or relending. In subnational finance, it involves: (i) the sovereign government borrowing from the Bank Group (therefore on sovereign-guaranteed terms) and on-lending/granting the proceeds to subnational governments or entities; or (ii) a subnational government or entity directly borrowing from the Bank Group on sovereign-guaranteed or non-sovereign-guaranteed terms and on-lending/granting the proceeds to lower levels of subnational governments or subnational entities.

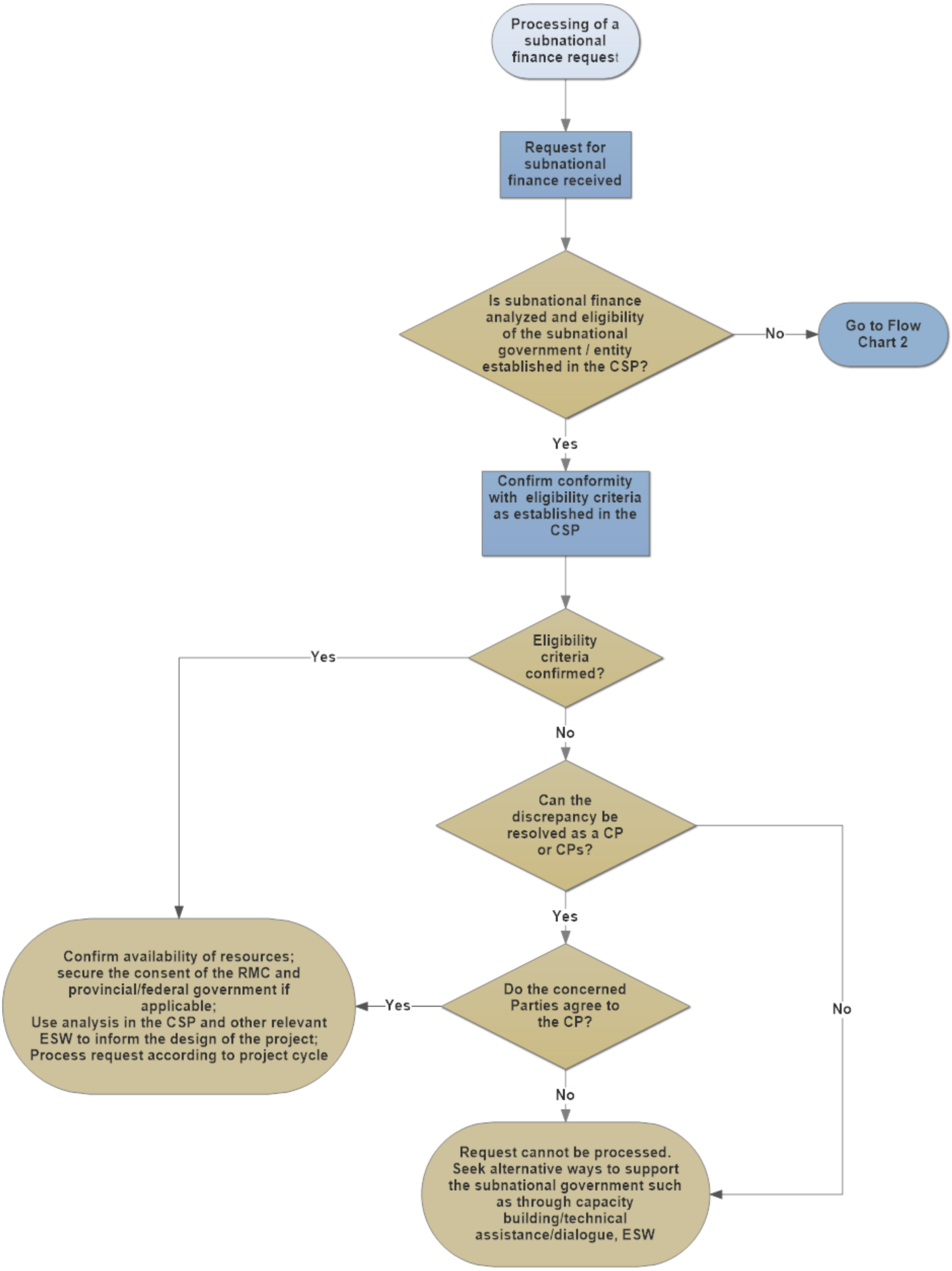
Group if such support is being sought, if not, direct sovereign-guaranteed or indirect financial support need to be considered; and (v) whether they are eligible for a specific financing instrument of the Bank Group. Flow Charts 1-3 summarize these decision processes, and Annex 2 summarizes the eligibility criteria in 4 levels: (1) eligibility for resources; (2) ownership and commitment to subnational development; (3) qualification as a subnational government/entity; and (4) sound banking principles.

26. In all cases, actual loan processing would require the application of sound banking principles, criteria, and/or the identification of the financial and reform steps needed to help the subnational governments / entities achieve a sound financial standing and operational efficiency over a reasonable time period. This flexibility will enable the Bank Group to build a virtuous cycle in subnational finance (see Paragraph 73).

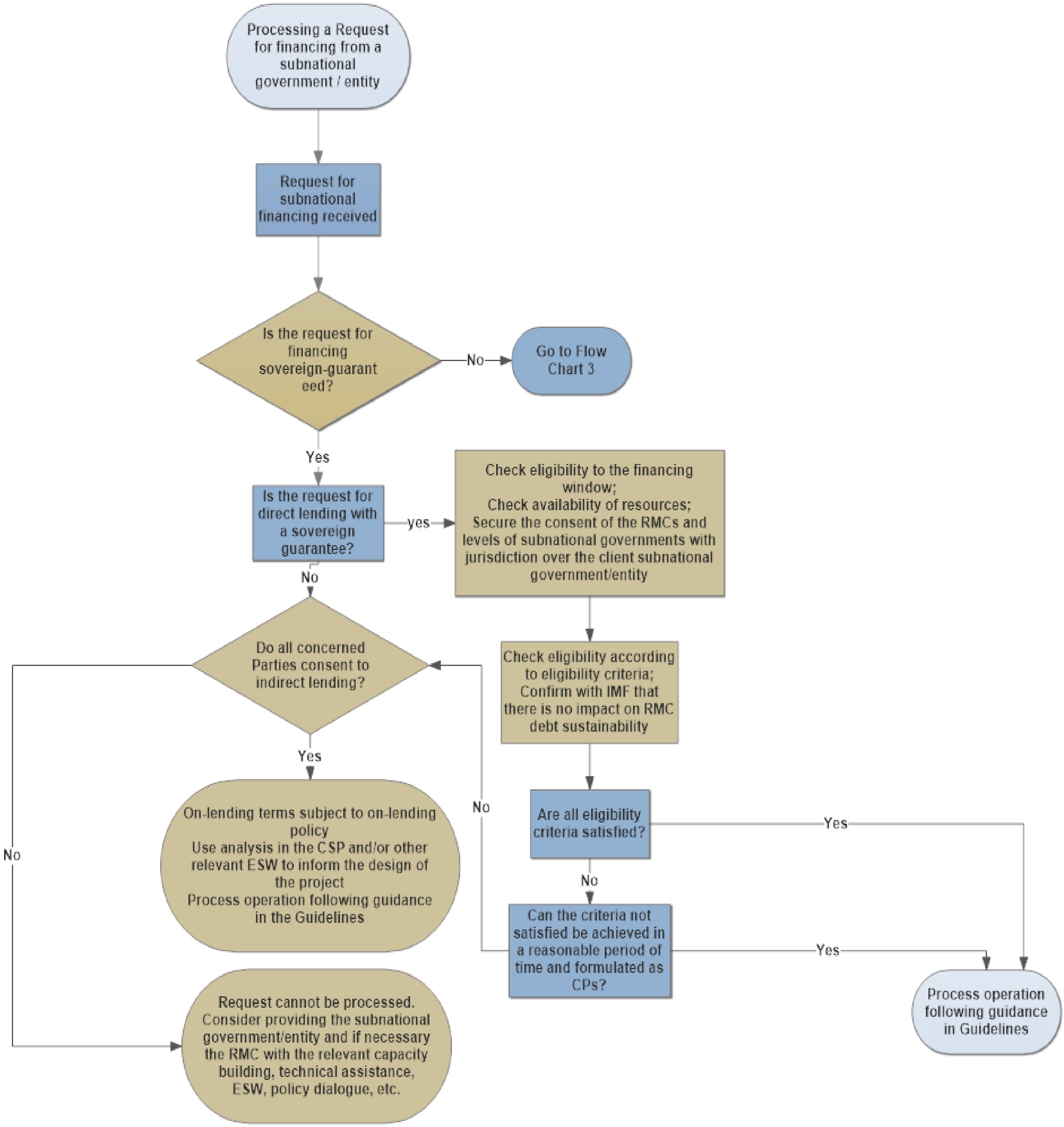
5.2.1 Eligibility to Support from Specific Bank Group Financing Windows

27. ***Subnational governments' / entities' eligibility to ADB and ADF windows is determined, inter alia, by their country classification***. RMCs and their subnational governments' / entities' access to concessional (ADF) and non-concessional (ADB) resources of the Bank Group is governed by ADF and ADB Articles of Agreement, the 1998 *Bank Group Credit Policy* and the *2014 Diversifying the Bank's Products to Provide Eligible ADF-Only Countries Access to the ADB Sovereign Window*. In reaching its financing decision and in line with the process adopted in all its financing decisions, the Bank Group will take into account macro-economic conditions, policies, laws, regulations, judicial institutions, and political and social situations, with a view to prudent risk management.

Flow Chart 1: Processing a Subnational Finance Request

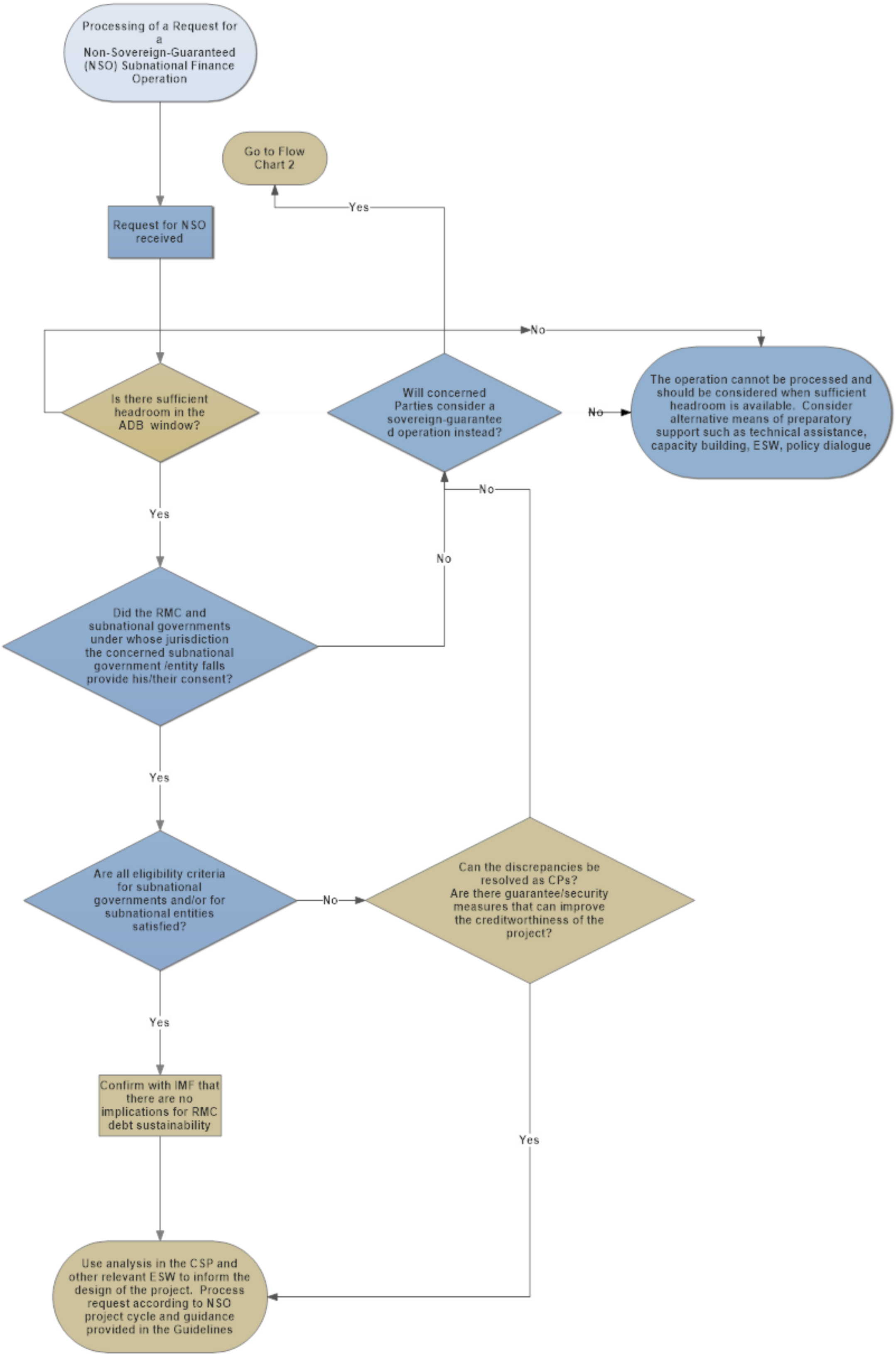


Flow Chart 2: Processing a Request for Sovereign-Guaranteed Subnational Finance



Flow Chart 3: Processing a Request for Non-Sovereign-Guaranteed Subnational

Finance



28. ***Subject to resource availability under the specific financing window, eligibility of***

subnational governments to specific financing windows is as follows:

a) **Subnational Governments in Category "A" Countries**.

   i) Subnational governments in Category "A" countries are eligible for concessional resources (ADF) only and on sovereign-guaranteed terms only. In order to qualify for grant financing out of the ADF window, the RMC in whose territory the concerned subnational government is located must be eligible for concessional financing on grant terms only ("red" category RMCs) or for a mix of loans and grants ("orange" category RMCs);

   ii) If the Category "A" country meets the four eligibility criteria[19] to access resources from the ADB sovereign window, then their subnational governments / entities would also be eligible for such non-concessional financing through on-lending/on-granting[20] by the sovereign, if the proposed transformational project involves such on-lending/on-granting.

b) **Subnational Governments in Category "B" Countries and in Category "C" "in Transition"[21] Countries**.

   Subnational governments in Category "B" countries and in Category "C" "in transition" countries are eligible for ADB resources and for ADF resources. ADF resources will be on sovereign-guaranteed terms, whereas ADB resources may be on sovereign-guaranteed or non-sovereign guaranteed terms depending on specific eligibility criteria (See sections 5.2.3 and 5.2.4).

c) **Subnational Governments in Full Category "C" countries.**

   Subnational Governments in full Category "C" countries are eligible for ADB resources only. These resources may be on sovereign-guaranteed or non-sovereign-guaranteed terms, depending on specific eligibility criteria (see sections 5.2.3-5.2.4).

29. Subnational governments in countries eligible for ADF resources may access the Regional Operations/Regional Public Goods envelope only through indirect lending/granting, and subject to the project's selection under the regional operations prioritization framework.

30. ***Eligibility of Subnational public sector enterprises, subnational SPVs and subnational FIs.*** Subject to eligibility criteria (Section 5.2.3), these subnational entities can access the financing window(s) the RMC is eligible for through sovereign-guaranteed loans/Lines of Credit (LOCs), guarantees or grants, or through on-lending or on-granting. Under certain eligibility criteria (Section 5.2.4), they may access the ADB window through non-sovereign-guaranteed loans/Lines of Credit (LOC), guarantee or equity investment regardless of the window the sovereign is eligible for.

31. Eligibility of national and subnational governments / entities to resources from Trust

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[19] The 2014 policy on Diversifying The Bank's Products to Provide Eligible ADF-Only Countries Access to the ADB Sovereign Window proposes that ADF countries be granted eligibility to ADB sovereign-guaranteed loans subject to the fulfillment of the following 4 criteria: (i) a sustainable debt profile, with low or moderate risk of distress; (ii) sufficient headroom for the requested non-concessional borrowing as determined by Management based on a detailed Debt Sustainability Assessment; (iii) a sustainable macroeconomic position as determined by Management; and (iv) a positive recommendation by the Bank's Credit Risk Committee.

[20] i.e., the central government borrows from the Bank Group and then on-lends or on-grants the proceeds to the sub-sovereign governments / entities. See Section 5.2.3.2

[21] Category "C" "in transition" countries are countries that are in transition from one credit status to another. The transition framework adopted in 2011 provides the criteria which determine the length of the transition period and the financing mix of ADF and ADB resources during this period. The minimum transition period is 2 years, and the maximum is 5 years.

and Special Funds administered by the Bank Group based on Bank Group rules, and from Funds administered by the Bank Group based on Funds' own rules depends on the rules and regulations governing such Funds as reflected in the governing Memorandum of Understanding.[22]

32. **Availability of Financing Resources**: ADF resources used for subnational operations are subject to the availability of, and are deducted from, the RMC's Performance-Based Allocation (PBA), unless there is a specific set-aside for subnational operations from ADF resources. ADB resources used for subnational operations are subject to, and are deducted from, the RMC's available headroom, unless there is a specific risk capital set-aside for subnational operations.

5.2.2 Ownership by RMCs' National and Subnational Governments of their Subnational Development Agenda

33. Sustainable subnational development outcomes require ownership and commitment both on the part of the subnational governments / entities as well as on the part of the central governments who control, to a large part, the operating environment of the subnational entities. To ensure ownership by the national government, subnational finance activities must be aligned with the country's development agenda as embodied in a national development plan or strategy. The activities shall also be reflected in the RMC's CSP with the relevant analysis and justification.[23] Furthermore, the Policy on Expenditure Eligible for Bank Group Financing spells out conditions that demonstrate ownership, and that are applicable to subnational governments when they contract directly with the Bank Group for sovereign-guaranteed investment projects. The Bank Group shall secure the consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation, including for non-sovereign-guaranteed operations in support of public sector enterprises.[24] When warranted, a tripartite[25] letter of agreement between the subnational government(s) /entities, the central government(s), the Bank Group, and other financiers shall be entered into to lay out necessary actions that need to be undertaken by each Party to ensure the success of the operation.[26]

5.2.3 Subnational Eligibility for Sovereign-Guaranteed Financing

5.2.3.1 Direct Financing with a Sovereign Guarantee

34. The ADB sovereign window and the ADF always require a sovereign guarantee.[27] If

[22] The AfDB is in the process of establishing the Urban and Municipal Development Fund (UMDF) whose objective is to support technical assistance and capacity building in urban planning and governance, project preparation, municipal fiscal management, improved service provision, and climate mitigation and adaptation strategies.

[23] See Section 7.1 on Country Programming. The requirement of the inclusion of subnational finance in the CSP may be waived until the following CSP /CSP mid-term review or similar country programming document, with a view to take advantage of subnational finance opportunities that satisfy relevant eligibility criteria as presented in these Guidelines.

[24] This is in accordance with the provisions of Chapter III Article 17(1) (b) of the Bank's Charter and Chapter V Article 15(1) of the Fund's Charter, *except that it shall not be necessary for the Fund to assure itself that individual members do not object in the case of financing provided to a public international, regional or sub-regional organization.*

[25] In a federal system, there may be four levels of government, in which case the letter would be a quadripartite letter.

[26] This may include reforms to be undertaken at the national or subnational levels and national and subnational risk mitigation measures.

[27] Chapter V Article 16 (3)(b) of the Agreement Establishing the African Development Fund states that: *Where the borrower is not itself a member, the Fund shall require a suitable governmental or other guarantee or guarantees*.

the fiduciary and credit risk assessments are not favourable, then indirect financing may be the better option (See Section 5.2.3.2).

35. In addition to the eligibility for resources from a specific financing window (Section 5.2.1) and to the ownership criterion (Section 5.2.2), the following paragraphs set out the eligibility criteria to sovereign-guaranteed resources for subnational governments / entities.

36. Eligible ***subnational governments*** have to satisfy the following criteria:

a) The subnational government has demonstrated a clear and sustained commitment to a well-defined reform agenda, and the proposed financing is likely to play a clear and unambiguous role in achieving the core development objectives of the subnational government;

b) It has demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency, and the proposed financing helps address those objectives;

c) It has an adequate expenditure program and adequate fiscal arrangements with the central government and/or with the applicable political subdivisions;

d) It can contract and obtain financing independently from the related sovereign and/or applicable subdivisions and in foreign currency when the Bank cannot provide financing in local currency;

e) It has a distinct legal personality and capacity to sue and be sued, as well as to incur debts or place investments on its own account and in its own right. It is not protected by any immunities or exemptions from environmental or social regulations, legal process, seizure or attachment of its property, or other forms of execution of judicial due process. If such immunities or exemptions do exist, an express waiver of such must be submitted to the Bank;

In addition, based on a fiduciary and a credit risk assessment, and in order to institute a virtuous cycle in subnational finance, it must at least be willing and able to undertake the necessary steps to satisfy the following criteria within an appropriate time frame and possibly posited as conditions precedent to disbursements:

f) The subnational government will be managed competently, efficiently, transparently and will be accountable to its constituency. Its accounts and general operations will be subject to periodic review by reputable independent auditors and will consistently be found to be managed in a satisfactory manner over an extended period. It will have a good track record in development-related spending with demonstrable developmental impacts;

g) It will be financially sound, based on an evaluation of relevant ratios recorded in independently audited accounts. Its projected cash flow will be predictable and adequate to meet financial obligations with a sufficient margin of safety;

h) It will have a sound, forward-looking, and comprehensive debt management structure;

i) It will be able to demonstrate its commitment to fiscal discipline.

37. Similarly, an eligible ***subnational PSE, SPV or FI*** must satisfy the following criteria. It must:

a) be incorporated and located in any of the Bank's RMCs' subnational governments' territories and the project benefits accrue to one or more subnational territory;

b) have legal personality, be subject to liquidation, bankruptcy and/or insolvency proceedings and not be protected by immunities or exemptions (e.g. immunities from legal process, seizure or attachment of its property and assets; exemptions from environmental or social regulations, etc.). If such immunities or exemptions do exist, an express waiver of such must be submitted to the Bank;

c) have formally been granted, by the sub-sovereign and/or sovereign governments or public entities that own or control the majority of its shares, a statutory charter bestowing upon it full operational and financial autonomy, providing it full control over its funding, budgeting, and investment decisions; and
d) be at least willing and able to undertake reforms to become financially sound and have sustainable capacity to generate substantial revenues directly from its mandated operational activities over an extended period, within an appropriate time frame (short term, preferably as conditions precedent to disbursements);
e) be at least willing and able to undertake the necessary steps to become managed in a manner that fosters private sector development, and;
f) be at least willing and able to undertake the necessary steps to become managed competently, with the same level of efficiency, transparency and accountability as comparable private enterprises in the country, within an appropriate time frame (short term, preferably set out as a condition precedent to disbursement).

38. Subnational financing of sovereign-guaranteed operations may be provided using the available financing instruments for sovereign-guaranteed operations (investment project, national program-based operation (PBO), subnational program-based operation, institutional support project, and results-based financing). Subnational PBOs are governed by the *Bank Group Policy on Program-Based Operations* and related operational guidelines.[28] Further guidance on subnational PBOs is presented in Section 6.2.1.

5.2.3.2 Indirect Lending or Granting of Bank Group Resources

39. Indirect lending is also referred to as on-lending or relending. In subnational finance, it involves: (i) the sovereign government borrowing from the Bank Group (therefore on sovereign-guaranteed terms) and on-lending/granting the proceeds to subnational governments or entities; or (ii) a subnational government or entity directly borrowing from the Bank Group on sovereign-guaranteed or non-sovereign-guaranteed terms, and on-lending/granting the proceeds to lower levels of subnational governments or subnational entities under their purview.

40. When the Bank Group is not able to provide direct financial support to the concerned subnational government or entity because one or more of the eligibility criteria for such support are not satisfied, then indirect support is the alternative. On-lending of ADB or ADF resources is guided by the Bank Group's *On-Lending Policy*.[29] The Bank Group generally prefers to lend directly to the government / entity responsible for the implementation and operation of the project or program for which the loan is made to ensure that the proceeds of the loan are used in accordance with Bank Group policies and procedures. However, direct lending to said government or entity may not always be feasible or practical such as in the following cases: (i) the government / entity does not have the legal authority to borrow or when its financial situation precludes it from assuming the responsibilities of a borrower; (ii) when the concessionality of the resources is justified by the RMC's economic situation but is not suitable to the nature of the project or to the subnational government's / entity's activities; (iii) when the efficient implementation of the project or program necessitates the participation of several beneficiaries (e.g., several municipalities); and (iv) when it is necessary to establish the

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[28] The *Operational Guidelines on the Programming, Design and Management of Program-Based Operations presents the eligibility criteria for national-level PBOs as applicable to sub-national PBOs, in addition to further considerations (P. 19).* The *Bank Group Policy On Program-Based Operations,* approved in May 2012, presents eligibility criteria for national PBOs, which are applicable to sub-national-level PBOs.

[29] See ADB/BD/WP/90/36 – ADF/BD/WP/90/38 *On-Lending Policy*, April 1990.

beneficiary entity (executing agency) within the framework of the project. Therefore, the Bank Group may have to undertake on-lending of its resources to the concerned subnational governments / entities. Transaction costs of the intermediation process should be borne by the beneficiaries.

41. ***On-lending of ADB Resources to Subnational Governments and Entities***. The ADB requires that loans provided to RMCs from ADB ordinary resources should be on-lent to subnational entities on no more favorable conditions than those that would have been offered to the subnational government / entity if the subnational government / entity were the direct borrower. The duration and grace period should be determined by the capacity of the project and the subnational government / entity to manage the repayment scheme.

42. However, the ADB may accept that the terms of on-lending may be more concessional than those stated above such as for example for public enterprises operating in the basic infrastructure sector, or because of the social aspect of water and sewerage projects, or because of the RMC's laws on on-lending to subnational governments / entities. In any case, on-lending terms need to be justified and be acceptable to the Bank.

43. ***On-Lending of ADF Resources to Subnational Governments and Entities.*** On-lending becomes necessary when the proceeds of an ADF loan or grant are passed on to a beneficiary that is not the direct borrower or grantee of the ADF financing. The terms of on-lending depend on the nature of the beneficiary and RMC's laws on on-lending to subnational governments / entities, while maintaining the principle that the benefits of the concessionality of ADF assistance should accrue to the RMC. However, the Fund may allow on-lending on the same terms as those of the ADF loan, if the beneficiary is a subnational government or other subnational entity entrusted with implementing special social and economic policies of the government. If the beneficiary is a commercially operated subnational SPV or a subnational government whose creditworthiness would qualify it for ADB lending terms, on-lending is generally to be on terms harder than those of the ADF financing, using the terms of lending from the Bank's ordinary capital resources as the minimum acceptable on-lending terms. This means that grant resources can be on lent (provided as a loan through on lending). The justification depends on the special economic or social nature of the project and/or the need to strengthen the financial position of the subnational entity. For ADF loans, an additional factor in the determination of on-lending terms is whether the foreign exchange risk is borne by the borrower or the beneficiary. In cases where such risk is borne by the borrower, a reasonable fee, included in the on-lending spread, may be charged by the borrower under the on-lending terms.[30]

44. On-lending ADF resources through the sovereign Government for the benefit of a subnational government / entity or a group of subnational governments / entities may be a better option than providing direct ADF support to each subnational entity as this enables the Fund to tailor interest rates and maturities to each subnational government's / entity's circumstances. Furthermore, it shields subnational governments / entities from exchange rate risk, which they generally cannot bear as their revenues are essentially denominated in local currency.

45. ***On-Granting of ADF or ADB Loans***. When justified by the country's laws and the special economic or social nature of the project and the need to strengthen the financial position of the beneficiary, the ADB or ADF may examine an RMC's request to assume responsibility for repayment of the loan or part of the loan and to pass on the proceeds of the loan to the subnational government / entity in the form of an un-refundable or partly un-refundable contribution. For example, an ADB-only or ADF loans-only country may borrow and on-grant the proceeds of the loan to poor provinces or municipalities for social infrastructure projects.

[30] See ADB/BD/WP/90/36 – ADF/BD/WP/90/38 *On-Lending Policy*, April 1990.

Another example is, when a municipal development fund with a poor balance sheet due to weak governance may benefit from a fully or partly un-refundable contribution to strengthen its balance sheet through the sovereign Government while undertaking the necessary reforms to improve governance.

5.2.4 Subnational Eligibility for Financing without a Sovereign Guarantee

46. Non-sovereign-guaranteed operations are governed by the Bank Group's *Policy on Non-Sovereign Operations* (as updated from time to time), which spells out eligibility criteria, financing instruments and risk products, as well as financing terms and conditions for non-sovereign entities.

5.2.4.1 Eligibility Criteria for Non-Sovereign Operations

47. When it is not feasible to secure a sovereign guarantee, the ADB may provide financing from the non-sovereign window. Subnational governments / entities must be eligible based on an assessment of credit risk and on the eligibility criteria spelled out in the *Policy on Non-Sovereign Operations*[31] for subnational PSEs, SPVs, FIs and private partners in subnational PPPs, and in Annex 3 for subnational governments.[32] The ADB may seek alternative acceptable guarantees or security (see Section 5.2.4.2).

48. If the subnational entity is protected by immunities or exemptions (e.g. immunities from legal process, seizure or attachment of its property and assets; exemptions from environmental or social regulations, etc.), then an express waiver of such must be submitted to the Bank.

5.2.4.2 Guarantee and Security Arrangements

49. When an RMC guarantee is not possible and the Bank considers that partial recourse is sufficient, the Bank may seek a contingent[33] sovereign guarantee, Third Party guarantee and/or some form of property collateral or security that would provide ample coverage for debt service. For example, the Bank may resort to:

- Securing real property as collateral. This property must be easily transferrable to private ownership, and must be reasonably liquid;
- "Ring-fencing" certain revenues and channeling these revenues through an escrow account, managed by an independent party, and giving the Bank first call on the money in the escrow account;
- Acquiring the right to "intercept" transfers from the central and/or state/provincial government.[34] Recourse to intercepts reduces the incentives for private lenders to fully develop capacity to assess the risk posed by individual subnationals, thus weakening the borrowing discipline that the market can exercise, in addition to crowding out lending to the private sector. Good practice has shown that intercepts should be capped on the basis of a small proportion of own-source revenues and used only when subnational indebtedness

[31] See eligibility requirements set in sub-sections 4.1 and 4.3 of the *Policy on Non-Sovereign Operations*.

[32] Due to their special character, specific eligibility criteria are spelled out for subnational governments. These criteria are based on eligibility criteria for public sector enterprises, specificities of subnational governments, and good practice in financing subnational governments.

[33] A contingent guarantee is a guarantee that becomes applicable when certain events are triggered. Examples are when the Borrower is downgraded, or if the newly elected subnational government is from an opposition party.

[34] Revenue intercepted at the central level retains the credit rating of the central government, which in general is higher than the credit rating of the sub-sovereign. Intercept provisions limit sub-sovereign governments' budget choices.

is fully disclosed;

- requiring the establishment of irrevocable trust funds by subnational governments / entities to guarantee repayment of loans;
- requiring a "contingent" guarantee from the sovereign in case specific political events take place, or in case the sub sovereign is downgraded in its credit rating. If the country is an ADF country, then the contingent guarantee would be an ADF guarantee; and/or
- Guarantees provided by Third Parties such as those from bilateral and multilateral Guarantors.

6 Areas of Special Emphasis in Subnational Finance

6.1 Subnational Areas for Support through Technical Assistance and Capacity Building

50. The lack of sufficient institutional capacity at the subnational level is one of the foremost impediments to the realization of the dividends of decentralization. Limited capacity is a significant issue for small and poor subnational entities, but it also affects large and better-off ones. The Bank Group will therefore emphasize support to reform, capacity building and institutional development of subnational entities to help them discharge their functions in an effective and efficient manner. In particular, the Bank shall aim to strengthen the capacity of local governments to: (i) raise their own revenues (particularly from land-value capture and property taxes); (ii) manage expenditures (including investment programming, project development and implementation, procurement, portfolio management, financial management and fiscal transparency) and service delivery; and (iii) borrow and manage debt prudently, with a view to enhance their creditworthiness and ability to contract debt on more favorable terms from access to financial and capital markets. Similarly, subnational PSEs such as public utilities' capacities should be enhanced to help them achieve creditworthiness.

51. Support can also be provided to enhance the legal and regulatory frameworks for the provision of infrastructure services and enabling the flow of long-term private sector finance to the infrastructure sector, including from sovereign wealth funds, pension funds and life insurance funds.

52. Capacity building and technical assistance can also be provided to help structure transactions to issue subnational (state in a federal system or municipal) bonds, preparing the subnational governments / entities for credit ratings and facilitating the issuance process. The Bank Group may finance credit risk ratings with a view to identify weaknesses that would need to be addressed if ADB financing is provided.

6.2 National and Subnational Areas of Reform

6.2.1 Decentralization Reforms

53. The Bank Group shall support well-conceived decentralization reforms that provide subnational governments with the incentives to increase own-source revenues (Annex 4 lists principle revenue sources for subnational governments and the main steps in revenue enhancement programs; Box A4 in Annex 4 provides an example for the City of Maputo) as well as to efficiently allocate resources to the most socially profitable uses. The Bank shall support developing inter-government fiscal transfer arrangements that take into account investment needs of subnational governments, equalize fiscal capacity and expenditure needs across levels of government, and clearly delineate spending responsibilities between the

different layers of government. This implies that subnational governments will: (i) have clearly defined responsibilities; (ii) transparent and sufficient resources to discharge the assigned functions; and (iii) face hard budget constraints that force decision-makers to assume full responsibility for, and understanding of, the trade-offs involved in collecting, allocating and managing a limited pool of resources. Additionally, own-source revenues should be the principal source of financing for subnational governments in the long run, using fees for services rendered wherever possible. Otherwise, services should be financed from taxes borne by local residents. Transfers from higher levels of government should be used to finance subnational services that are associated with national or regional priorities, or to solve vertical and horizontal imbalances.

54. In addition to Program Based Operations (PBOs) provided directly to national governments and indirectly to subnational governments through the national government, the Bank Group may provide subnational program-based operations directly to subnational governments.[35] The Bank Group may use subnational PBOs to support policy reforms and the provision of social and infrastructure services for the purposes of inclusive growth and poverty reduction at the subnational level. Subnational PBOs may be used for example to support urban development programs (multi-year, multi-sector, multi-locality programs), or to improve the enabling environment for infrastructure finance and project development such as the setting up of PPP project development facilities or subnational finance institutions such as municipal development funds.

55. When a subnational PBO is provided directly to states, regions or provinces, these subnational governments can use the financial proceeds to provide support to lower-tier governments (through on-lending or on-granting) subject to the terms and conditions for subnational on-lending. In all cases, the Bank Group shall be engaged directly with the subnational authorities as well as other stakeholders such as Civil Society Organizations (CSOs) in policy dialogue and the design and implementation of the subnational PBO.

56. Implementing fiscal, administrative and political decentralization is generally a slow, gradual process and therefore programmatic PBOs are more appropriate than stand-alone PBOs. Jurisdictions with legislative autonomy and independent budgetary authority immediately below the national government such as states in a Federation, provinces and regions tend to have significant responsibility for social and economic development in their territories and may present significant state-level distortions that affect the country's growth and poverty reduction. They also tend to exercise some legislative and oversight powers over lower levels of government such as counties, districts and municipalities. Due to the size of the economies under their purview, their economic policies can have a sizeable impact on the macroeconomic stability and debt sustainability of the country. They may also be responsible for devolution reforms. They are therefore more likely candidates for subnational program-based operations. Counties, districts, departments, municipalities and other small subdivisions tend to vary extensively in their level of autonomy, the size of their own-source revenues, and their social and economic mandates. Individually, their impact on country macroeconomic stability and debt sustainability is more limited than that of a group of such jurisdictions in a single country or of that of a region or province.

6.2.2 Land Finance Reforms

57. Land finance is an important source of capital financing for subnational infrastructure investment. When appropriately managed, land transactions can generate substantial own-source revenues and contribute to economic growth. Investment in infrastructure increases the

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[35] Subnational PBOs are governed by the Bank Group Policy on Program-Based Operations (2012) and related Guidelines.

market value of land, and the public sector can recover part of the additional value so that more infrastructure can be financed. There are several methods for subnational governments to mobilize domestic revenue through their land assets (Figure A4 in Annex 4).

58. Betterment levies are a way for the public sector to tax some or all of the private windfall gain created by the infrastructure. The main steps in valorization are[36]: (i) calculate the cost of the project; (ii) divide by the number of beneficiaries; (iii) determine the zone of influence of the project (where will property values increase as a result of the project? Rail stations will have a larger zone of influence than a school or a theater); (iv) distribute the tax within the zone (closer properties will pay a higher portion; the distribution involves a considerable amount of administrative discretion); and (v) collect the tax before construction (often, the tax will not cover the total cost of the project, and project costs are often underestimated.)

59. In order to strengthen subnational governments' reliance on own-source revenues, the Bank Group shall support the transparent reporting on subnational public land inventories, public land valuations, land sales, and land contributions to public-private partnerships or subsidiaries using standardized instruments and the reflection thereof in the budget or its annexes and financial statements. Land finance is subject to land market volatility and risk mitigation measures such as ceilings on land finance need to be considered.

6.3 Financial Sector Support

60. Mechanisms for financing subnational entities depend on the development of local financial markets and their regulatory framework. The Bank Group shall promote access of subnational entities to long-term finance to minimize risks in the lifecycle of infrastructure investments. The Bank shall also build the capacity of local and regional financial institutions such as commercial banks, sovereign wealth funds, pension funds and insurance funds, in providing finance to subnational entities. In those countries where the market and regulatory environment are not adequately developed for the Bank or similar issuers to issue bonds, the Bank may provide reform support, technical assistance and capacity building towards developing such markets. In addition, the Bank Group shall provide technical assistance and capacity building to lenders and guarantors of subnational debt to promote their focus on borrower-specific credit risk evaluation factors (including willingness to pay, ability to pay, and the priority placed by the community on the investments to be financed) and undertake their own due diligence.

61. **Support to Subnational Financial Intermediaries and SPVs**. To remedy market failures in subnational borrowing, some central governments, in collaboration with subnational governments and international organizations have created financial intermediaries to build the capacity of subnational governments to access debt markets, both by providing them with technical assistance and capacity building, as well as providing them with grants and loans (e.g., Municipal Development Funds or MDFs), or with credit enhancement mechanisms (e.g., guarantee corporations or guarantee funds) or special purpose vehicles (sectoral pooled funds that provide finance for small municipalities, or urban development investment corporations that borrow in the market for municipalities). Box 1 provides examples of successful MDFs. Generally, FIs such as MDFs are public financial intermediaries that provide loans and grants to local governments, enterprises and associations for local infrastructure investments (Box 2).

[36] Slack, 2009 in Vitkovic and Kopanyi, 2014.

More than 60 countries worldwide have established such FIs; there are about twenty such funds in Africa. Such FIs may be nationally and/or subnationally-owned, or of mixed public-private ownership.

Box 1. Successful Municipal Development Funds
Senegal. Senegal's Fund for Local Communities, created under the Urban Development and Decentralization Program, played a major role in strengthening the capacity of the local authorities to manage investment resources, raise revenues, abide by borrowing constraints, and prioritize expenditures. With the help of municipal contracts (introduced at the same time), the Fund was a key piece in consolidating the decentralization process in Senegal.
South Africa. The Infrastructure Finance Corporation lends to municipalities (especially large metropolitan areas) to finance infrastructure and water supply. The sources of funds include domestic and international markets, raised through bond issues and long-term loans extended by international financial institutions. The loans granted to municipalities are in general at a fixed rate with up to twenty-year maturities.
India. The Water and Sanitation Pooled Fund is a fund common to small cities in the state of Tamil Nadu set up to finance water and sanitation projects. In 2003, this common fund issued a bond of US$ 6 million to be repaid from the water tariffs of municipalities. To be successful, the issue required three levels of guarantees: (1) an escrow account where the municipalities deposit their payments; (2) a reserve fund that carries 1.5 times the annual debt service; and (iii) a partial credit guarantee (provided by USAID DCA) that covers 50 percent of the loan. The final rate was 3 percent below the market rate charged by the Tamil Nadu Urban Development Fund. In addition to funding, the pooled fund also provides advice to member municipalities.
Source: Sood 2009; Alam 2010; Freire and Petersen, 2004; USAID 2003.

62. The Bank Group will consider financing such financial intermediaries with exposure to subnational entities in the presence of market failures and will support restructuring of these entities to help them become more viable and efficient.[37] For example, the Bank may provide support in the form of grants, loans/guarantees, as well as for strengthening the balance sheet of an eligible subnational entity (such as a municipal development fund), directly or through on-lending/on-granting. The Bank Group shall also use its convening power, reform and investment instruments to support the establishment, funding and development of such entities where this financing mechanism is deemed most appropriate.

Box 2. Borrowing from Development Banks and Financial Institutions
The Development Bank of Southern Africa established a development Fund in 2001 to provide grants and technical assistance to municipalities for implementing infrastructure projects. The bank raises funds from domestic and international capital markets, institutional investors, and bilateral and multilateral development finance institutions. It provides loans for municipal infrastructure, urban renewal, water, sanitation, health care, transportation, and education, amongst others.
Source: Vitkovic and Kopanyi, 2014

63. **Bank Group Investing in Sub-Sovereign Debt Obligations.** The Bank Group's Assets and Liabilities Management (ALM) Guidelines[38] authorized investment transactions are classified by type of investment counterparty, remaining final maturity,[39] and/or type of fixed income instrument. Subject to the limitations set forth in the ALM Guidelines, the Bank may invest in debt obligations issued or unconditionally and explicitly guaranteed by a province, region, state, city or municipality. The remaining final maturity for such securities shall not

[37] Privatization of such financial intermediaries has to be managed very carefully by ensuring the existence of an appropriate regulatory framework. For example, in September 2008, the French and Belgian government's recapitalization of Dexia undid 20 years of the bank's progress in positioning itself as one of the world's leading bond issuers and financiers of local governments.

[38] Revised as of June 2017, and as revised from time to time.

[39] Remaining final maturity means the time remaining until final maturity measured from the time the security is purchased (as opposed to the original final maturity when the security is issued) after the settlement period. In the event of an inter mediate call option with a high probability of exercise or an intermediate put option, the remaining time to the call or the put may be considered, with FIFM.2 endorsement, as the remaining final maturity for compliance with the Guidelines.

exceed 10 years for AAA/Aaa rated securities, 5 years for securities with a minimum rating of AA-/Aa3 and 6 months for securities with a minimum rating of A/A2.[40]

6.4 Private Sector Development Support

64. Subnational governments contribute to the development of the private sector by reducing regulatory barriers to private investment and creating the favorable environment for new direct investment through the provision of local infrastructure, appropriate policies and regulations that enhance the profitability of the private sector, including rural sector productivity through rural linkages and the provision of feeder roads to promote national integration and ensure national and regional food security. Micro, Small and Medium-Sized Enterprises (MSMEs) are essential players in the local economy and are particularly affected by the business environment provided by subnational governments. In turn, they provide revenues to subnational governments / entities. The Bank Group shall therefore support subnational governments' legal and regulatory reforms that improve the investment climate and improve subnational governments' revenues from the private sector.

65. Current approaches to the provision of infrastructure both at the national and subnational levels seek to harness private sector participation and charging user fees when feasible. Subnational governments are moving from a model of direct providers of water, sewerage, waste collection services, roads and drainage, public lighting, markets, abattoirs, and transportation terminals to regulators, overseers, and shareholders of/in such facilities. A well-developed local private sector can thus participate in the provision of subnational services through PPPs, which are an effective mechanism for promoting local economic development (Annex 5 presents the roles of public and private sectors in the provision of local services, and the types of PPPs). Experience has shown that PPPs in the municipal services have contributed significantly to improving the efficiency of service delivery, particularly in such sectors as energy, water supply and solid waste management. For example, in Uganda, local governments can contract out the provision of services and are encouraged to do so. Contracts are in place for solid waste management, road maintenance, retail markets, car parks, and even property tax collection. For land development, property is leased to private contractors for fifteen years.[41] PPPs can also provide innovative products specifically designed to meet the needs of the poor at prices they can afford, and delivered in ways that fit their lifestyles. Potential areas include energy, financial services (e.g., Kuyasa Fund in Cape Town, SKS microfinance for housing in India), and solid waste management and recycling. The Bank Group shall therefore support promoting PPPs for effective local public service delivery, particularly with the local private sector.

7 Project Processing

66. Sovereign-guaranteed subnational operations are guided by Bank Group rules and procedures for processing public sector operations and these Guidelines. Non-sovereign-guaranteed subnational operations are guided by the rules and procedures for processing non-sovereign-guaranteed operations and these Guidelines.

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[40] Paragraphs 2.5.8 and 2.5.9 of the ALM Guidelines.

[41] Source: *Financing Africa's Cities: The Imperative of Local Investment*. Thierry Paulais 2012. Washington, DC: World Bank.

67. In addition, whenever feasible[42] and to ensure economies of scope in preparation and supervision, small size (e.g., for small municipalities, towns, townships or rural local governments) projects should be clustered in a consortium. The legal and financial structure for the clustering arrangement should be clearly spelled out.

7.1 Country Programming

68. Treatment of subnational financing should be incorporated in the CSP or relevant country programming document as appropriate, based on the relevant analytical work and dialogue with stakeholders. The CSP should demonstrate alignment of subnational operations with the Bank Group's strategic and policy framework. Subnational finance operations should be framed within the vision, goal, and objectives. In an annex to the CSP, eligibility to subnational finance (Section 5) should be demonstrated.

69. Country programming of subnational finance operations should be guided by the standard country programming principles of selectivity, complementarity and partnership, etc. as reflected in the *Operations Manual*.

70. ***Economic and Sector Work (ESW).*** The CSP will indicate the types of ESW undertaken to analytically support subnational finance, as well as the types of ESW to be undertaken during the CSP period to substantiate further subnational support. The knowledge gap with respect to decentralization, financial markets, land markets, subnational entities' capacities and urban planning and governance in African countries is significant. There are significant differences amongst RMCs in their degree and structure of decentralization,[43] the nature of the regulatory and fiscal framework under which the process of transferring responsibilities is taking place, as well as the development of their financial and private sectors. Subnational entities in each RMC differ in size, resources, institutional capacity, and mandates. The appropriate programming and undertaking of subnational finance operations requires the generation and management of appropriate economic and sector works at national and subnational levels to inform and guide Bank Group programming and interventions and tailor them appropriately. The Bank may provide support for diagnostic work such as subnational Public Expenditure and Financial Assessments (PEFAs), municipal audits, urban audits and credit ratings to identify areas of weakness and support reforms that address these weaknesses. Monitoring and evaluation tools in expenditure management such as benchmarking shall also be supported. More information on these diagnostics tools is included in Annex 6.

71. ***RMCs' Debt Sustainability.*** The annex to the CSP will also address the impact of subnational finance on the RMC's debt sustainability, in collaboration with the International Monetary Fund (IMF). Debt management systems and monitoring and reporting systems between subnational governments / entities and the central government are essential, so that national governments have a clear picture of the changes and volatility of subnational debt in order to make it part of nationwide debt and risk management systems. The Bank Group will therefore support financial management and reporting practices in subnational governments / entities to increase fiscal responsibility, and will take the appropriate measures to ensure that subnational borrowing is consistent with fiscal space and debt sustainability, in line with a prudent macroeconomic framework.[44] For borrowing to be an efficient source of finance for

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[42] From a practical point of view, this may not always be achievable (e.g. different types of projects, risk profiles, cash-flows, etc.).

[43] See Technical Annex for Decentralization Status in 10 RMCs.

[44] Subject to data availability, RMCs' fiscal and debt assessments are based on general government or Non-Financial Public Sector (NFPS) data. When NFPS data is used, both enterprises and subnational entities are included in fiscal and debt totals,

subnational entities, a hard credit discipline must be imposed on them through the appropriate regulations, intergovernmental relations and financial markets (Box 3). Annex 7 presents a general policy framework for subnational borrowing.

Box 3. Municipal and Provincial Debt Controls in Selected Countries

- ✓ ***Austria***. Individual criteria; no general rule for local governments and differing absolute or relative limits.
- ✓ ***Brazil***. No foreign debt is allowed; debt service should be at most 15 percent of net revenues; debt stock should be at most 100 percent of net revenues. Borrowing from the central bank and upper levels of government is forbidden. Brazil's **Fiscal Responsibility Law** governs the expenditures and debt of municipalities. The law includes explicit hard budget constraints (caps on how much a municipality can borrow and caps on particular expenditures). If a municipality does not respect the spending limits, it is not allowed to make contracts or conduct credit operations. In addition, municipalities produce quarterly reports to the central government. Mayors are not allowed to incur any new expenditures six months before then end of their term.
- ✓ ***Czech Republic and Poland***. Debt service must be less than 15 percent of revenues. Five-year debt service projections are required.
- ✓ ***Denmark***. No municipal borrowing is allowed with a few exceptions. Automatic permission is granted for fee-based borrowing for public utilities.
- ✓ ***France***. Operational surpluses from prior years must exceed debt service payments. No other restrictions.
- ✓ ***Germany***. Each local government has borrowing limits, and explicit approval is needed from the state.
- ✓ ***Ireland***. Each municipal borrowing must be approved by the Ministry of Finance.
- ✓ ***Italy***. Municipalities must have balanced accounts. Debt service payments may not exceed 25 percent of current revenues. Loans must have terms of at least 10 years. The State Treasury sets the maximum legal interest rate.
- ✓ ***Norway***. Borrowing is allowed for investment only.
- ✓ ***South Africa*** established hierarchical controls to manage the budgets of provincial governments to ensure *ex-post* balanced budgets.
- ✓ ***Spain***. Total municipal debt may not exceed 110 percent of annual revenues.
- ✓ ***United Kingdom***. Credit approval ceilings are given each year by the government to each local government.

Source: Platz, 2009; Melo 2005; World Bank 2002; in Vitkovic and Kopanyi, 2014; *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, 2003

and it does not matter whether there are explicit or implicit central government guarantees for subnational entities' debt. Where only central government data are available, it is more important to assess fiscal risks of operations outside the central government and to monitor – where possible – the central government's guarantees.

72. ***Seeking a Virtuous Circle***. The CSP annex should further demonstrate that Bank Group financing modalities (mix of grants and loans and other types of support) will build subnational credit markets by providing time-consistent incentives for good governance on the part of subnational governments (Box 4; Figure 1).

Box 4. Seeking a Virtuous Circle

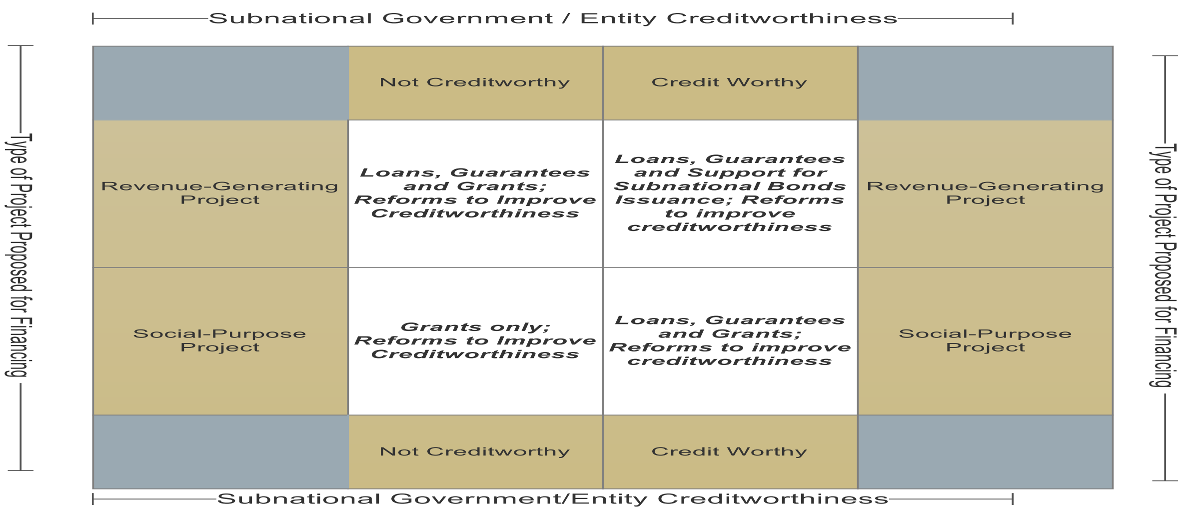
Some Donors' projects rely on the use of lending to teach certain virtues. Within a donor's overall grant to strengthen project management and governance, donors instill a small dose of lending in urban governments that have the repayment ability. An initial operation may involve a revenue-generating investment: receipts will replenish the city's budget and raise its credit capacity so that it can borrow more and invest more. Donors may also introduce a number of incentives to encourage good administrative management at this stage for example, city contracts, performance contracts, and output-based aid.

Urban governments gradually see improvements in their ability to implement and manage projects and to repay loans. The share of lending within a grant may also increase gradually. A virtuous circle can be considered triggered when this process of progression goes into effect and national officials politically support it, making it part of their decentralization support strategy. Depending on the size of the local investment market and characteristics of the financial sector, a self-sustaining municipal credit market becomes possible.

Success in such efforts demands time consistency. We note that this process resembles the process that prevailed in a number of European countries. Local governments in Europe have long received financing with favorable terms from monopolistic credit institutions and institutional or specific support programs, for example, in the fields of financial and technical engineering

Source: *Financing Africa's Cities: The Imperative of Local Investment*. Thierry Paulais 2012. Washington, DC: World Bank

Figure 1 - Structured Finance Matrix



73. ***Local Currency Financing.*** The CSP annex shall also explain the Bank's efforts in extending local currency financing rather than foreign exchange financing. To the extent possible, the Bank Group shall provide financing denominated in local currencies for subnational operations so as to reduce foreign-exchange exposure of subnational entities whose inflows and outflows are generally denominated in local currency. When direct local currency financing is not possible and currency swaps are prohibitively expensive, indirect financing through the sovereign should be considered as an alternative. Furthermore, Bank Group assistance shall aim to enhance domestic resource mobilization, by, *inter alia*, providing a partial credit guarantee to crowd in local banks.

74. ***Support for Performance-Based Contracts***. The Bank shall also support the use of performance-based contracts such as municipal contracts (Annex 8), Results-Based Financing (RBF) and Output-Based Aid (OBA). OBA is blended finance that links the payment of subsidies to the demonstration of specific service delivery or outputs. In the case of PPPs, OBA is increasingly used to structure subsidies to the private sector to ensure that performance targets, particularly those related to service delivery to the poor (such as connections to the electrical grid or the water distribution network), are adequately met. For example, OBA has been very effective in extending water connections to slum or rural areas through one-time fee subsidies for network extension and connections as in cities in Ethiopia, Indonesia, Kenya, Mozambique and the Philippines.

75. Further guidance on areas of support is provided in Section 6 above.

7.2 Identification

76. After receipt of the request for subnational finance from a subnational entity, the Regional Directorate General (RDG) undertakes the *initial screening*. For subnational operations, part of the *initial screening* checklist is for the RDG to secure the consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation, and to ascertain alignment with these Guidelines (strategic alignment and eligibility criteria).

77. Once the proposal has passed the initial screening, the RDG/Sector Department(s) undertake the *technical review* and possible further processing.

78. The Regional/Sector(s) Manager(s) assigns the project development responsibility to a Task Manager and if necessary a co-Task Manager in the concerned Regional/Sector Division. The Regional/Sector Manager(s) should also, at this stage set up a team that will assist the Task Manager/co-Task Manager with the technical review of the proposed operation.

79. Because of the complexity of subnational operations, a multi-disciplinary team approach will be taken in processing and implementation supervision of subnational finance operations. For each operation, the team will comprise the Task Manager/co-Task Manager from the lead regional/sector department(s), field office and sector department(s), plus representatives from General Counsel and Legal Services (PGCL), Financial Control (FIFC), Financial Management (FIFM), Fiduciary and Financial Management, Inspection and Procurement Policy Department (SNFI), and Strategy and Operational Policies Department (SNSP). For non-sovereign-guaranteed operations, the team will also include experts from Syndication and Financial Technical Services (FIST), Treasury (FITR), and the Credit Risk Department (PGCR). Staff from other departments of the Bank may also be included in the team as necessary.

80. During the technical review, the Task Manager/co-Task Manager shall also determine whether a tri- or quadripartite letter of agreement between the subnational government(s)/entities, the central government(s), the Bank Group, and other financiers needs to be entered into to lay out necessary actions that need to be undertaken by each party to ensure the success of the operation. If so, the Task Manager/co-Task Manager secures in principle commitments on said actions from the involved parties.

81. In the case of small size (e.g., for small municipalities, towns, townships or rural local governments) projects that need to be clustered in a consortium, the Task Manager/co-Task Manager ensures that the legal and financial structure for the clustering arrangement is clearly spelled out and secures in-principle agreement on said structure from all Parties.

82. The Identification Report and Project Brief shall demonstrate that the relevant eligibility criteria in these Guidelines are satisfied, and where some flexibility is allowed under the eligibility criteria, shall indicate the necessary actions that need to be undertaken by each Party and related timelines.

7.3 Project Preparation, Appraisal, Negotiation and Approval

83. During the preparation and appraisal process, the Task Manager/co-Task Manager continues to address the strategic framework and eligibility criteria as indicated in these Guidelines. The Project Concept Note and Project Appraisal Report shall also demonstrate alignment with the Strategic Framework and relevant eligibility criteria in these Guidelines.

84. If a tri- or quadripartite letter of agreement between the subnational government(s)/entities, the central government(s), the Bank Group, and other financiers needs to be entered into to lay out necessary actions that need to be undertaken by each Party to ensure the success of the operation, then a draft form of said actions is signed by all concerned Parties.

85. If the projects were clustered in a consortium, a draft form of the legal and financial structure for the clustering arrangement should be signed by all concerned Parties.

86. **Credit Risk Assessment**. Besides the sovereign risk assessment, and as part of its due diligence, the Bank will undertake its own credit risk assessment of the subnational government / entity being considered for financing.

87. Credit shall be granted primarily on the basis of the viability of the project and the ability of the borrowers directly benefiting from the Bank's financing to meet their obligations to repay the Bank. The Bank will not assume credit exposure unless the risks can be assessed through the use of specific criteria and factors to determine a credit rating of the obligor or project.

88. When a subnational government borrows under a general obligation debt which is backed by the full faith and credit of the subnational government, and the debt service is paid out of general revenues (the subnational government pledges general revenues for debt service), credit rating criteria include: economic base, diversity and growth; analysis of outstanding debt; financial operations, revenue and expenditure flexibility; government's administrative structure, legal factors, political dynamics; and sovereign credit rating ceiling. Box 5 provides an example of a general obligation debt issued by the City of Johannesburg.

89. When a subnational entity borrows under project-revenue-backed debt which is backed by operating revenues generated by the project (this is generally associated with public sector infrastructure projects), rating criteria focus on the economic feasibility of the project; credit risks during the development of the project; efficient management and long-term economic health of the project; and covenants in the context of the legal and policy framework of the country.

Box 5. Examples of Bond Issues in the City of Johannesburg
The City of Johannesburg has, issued seven bonds since 2004. In 2014, it issued its first green city bond, making it the first C40[45] city to tap into this innovative financing mechanism. Green city bonds raise funds from fixed income investors to support city government projects that mitigate climate change. Johannesburg's green city bond is worth ZAR1.5bn (US$143m). Green initiatives to be funded through the green bond include the Bio Gas to Energy Project, the Solar Geyser Initiative and dual-fuel buses, as well as other projects that are critical to reducing the city's greenhouse gas emissions. The bond was priced at 185bps above the 2023 government bond, it was 1.5x oversubscribed and it was a 10-year bond, underwritten by Standard Bank Group. Johannesburg had a BBB rating from Fitch. Green city bonds help cities access additional funding and tap into a new investor base with socially responsible investment; they have great potential to drive climate action in

[45] The C40 Cities Climate Leadership Group (C40) is a network of the world's megacities committed to addressing climate change.

cities around the world. Johannesburg will be working with the C40 Sustainable Infrastructure Finance Network and the Climate Bonds Initiative to share its successful model with cities across C40.

In 2004, the City of Johannesburg tried to access the bond market with a general obligation bond to lower the general cost of the debt. The bond issue had several objectives: (a) to extend the maturity of existing debt; (b) to finance long-term infrastructure projects; (c) to refinance existing high-cost bank debt; and (d) to diversify funding sources beyond bank lending. The city looked for funding beyond ten years, but to do so at a reasonable price required credit enhancement. The International Finance Institution (IFC) assisted in structuring the operation and provided a partial credit guarantee (for 40 percent of the total) shared with the Development Bank of South Africa. As a result, in June 2004, Johannesburg managed to issue a US$53 million 11.9 percent bond to mature in 12 years. Fitch Ratings gave the city an A- rating. The bond issue was oversubscribed 2.3 times.

Sources: IFC 2004; Platz 2009; Amim, 2010 in Vitkovic and Kopanyi, 2014

90. The criteria for analyzing both types of debt are similar with two key differences: First, since debt service is paid out of the user fees generated by the project, the key focus of credit analysis is not on the Borrower's financial stability, but more on the financial health of the project that will generate the revenues. If the project is backed by a dedicated revenue stream such as property taxes, intergovernmental transfers or oil royalties, then the credit analysis will focus on the reliability, predictability, and strength of the dedicated revenues and the certainty that they will be segregated from general government revenues to pay off the debt.

91. The Bank's rating scale applies to subnational finance operations, ranging from 1+ to 10, with direct correspondence to rating agencies' ratings.

92. **Procurement, Disbursement, Integrity and Fiduciary Safeguards.** The Bank Group will consider participating in the financing of subnational operations subject to the assessment that the procurement process followed by the subnational government / entity does comply with national laws and regulations and is acceptable to the Bank Group, having regard to, *inter alia*, the Bank's Procurement Rules and Procedures for sovereign-guaranteed operations and non-sovereign-guaranteed operations.[46] If the procurement process is not acceptable, then the financing will be undertaken using the Bank Group's own rules and procedures. Requests for disbursement for subnational operations shall be made promptly and in conformity with the Bank's disbursement rules and procedures and the instrument being used. Subnational finance operations are also subject to the Bank's integrity and fiduciary policies applicable to sovereign-guaranteed and non-sovereign-guaranteed operations.

93. **Environmental and Social, and Climate Safeguards.** Subnational operations are subject to the Bank's Integrated Safeguards System (ISS) and Climate Safeguards System (CSS), which apply equally to sovereign and non-sovereign operations and cover (among others): environmental, climate change and social assessments; involuntary resettlement, land acquisition, population displacement and compensation; core labour standards; health and safety; pollution prevention and control of hazardous materials and 'greenhouse' gases; biodiversity and ecosystems' services; and resource efficiency. Subnational finance clients are responsible for adhering to the ISS and CSS throughout the project lifecycle and complying with the requirements and principles set out there in. The Bank will ensure that environmental, climate and social safeguards are monitored for compliance. Sanctions will be applied in the event that clients persist in not complying with the Bank's safeguards.

94. If a tri- or quadripartite letter of agreement between the subnational government(s)/entities, the central government(s), the Bank Group, and other financiers needed to be entered into to lay out necessary actions that need to be undertaken by each party to ensure

[46] These are, respectively: the *Rules and Procedures for Procurement of Goods, Works, and Non-Consulting Services*; the *Rules and Procedures for the Use of Consultants*; and, the *Guide for the Procurement of Goods, Works and Services in Private Sector Operations Financed by the Bank.*

the success of the operation, then said actions need to be finalized and signed by all concerned Parties during negotiation.

95. If the projects were clustered in a consortium, then the legal and financial structure for the clustering arrangement should be finalized and signed by all concerned Parties during negotiation.

96. In all other respects, processing of sovereign-guaranteed operations follows regular Bank Group rules and procedures for processing public sector operations. Processing of non-sovereign-guaranteed operations follows normal Bank Group rules and procedures for processing non-sovereign-guaranteed operations.

97. Bank Group subnational finance operations are submitted for approval in line with the provisions under *Streamlining of Approval Procedures for Operations Proposals Submitted to the Boards of Directors*.

7.4 Project Monitoring and Completion Reporting

98. Management will ensure that all subnational finance operations are properly monitored and supervised, in order to ascertain that the borrower implements the project with due diligence in view of the risks associated with these operations and to achieve the agreed objectives. The resources allocated shall be commensurate with the nature, the complexity, the size of the project, and the borrower's institutional capacities. Field offices will play an essential role in the efficient project monitoring and supervision and timely resolution of implementation problems.

99. Project completion and reporting is undertaken in line with the rules governing project completion reporting for sovereign and non-sovereign operations, as the case may be.

8 Implementation Considerations

100. **Cautious Approach to Early Implementation**: In light of the novelty of sub sovereign operations to the Bank, and in order to preserve the Bank's AAA rating, a cautious approach will be adopted in the early implementation stage. To this effect, ***all non-sovereign-guaranteed subnational operations will be submitted for CRC consideration and clearance for further processing at project concept stage***. For non-sovereign-guaranteed subnational operations with subnational governments, only creditworthy subnational governments will be considered, unless an exception is granted by the CRC. Until the Bank Group builds in-house capacity for subnational government credit risk rating, the Bank Group will hire external expertise when and as needed. Subnational financing will be initially piloted for a period of two years, with Bank Group exposure to subnational governments being limited to UA 500 million cumulatively during these two years. An assessment of the outcomes of the pilot phase will dictate the future course for these operations.

101. **Ad-Hoc Support.** Although subnational finance needs to be justified and programmed in an RMC's country's programming document, the Bank Group may consider subnational financing opportunities that present themselves on an ad-hoc basis in the early stages of the implementation of these Guidelines. ***If the ad-hoc support is on non-sovereign-guaranteed terms, it will only be provided to eligible creditworthy subnational governments/entities, unless an exception is provided by the CRC.***

102. **Pricing of Non-Sovereign-Guaranteed Operations**. The Bank Group will review its pricing of NSOs in 2019. It will align its pricing with the new probability of default provided by the Global Emerging Markets Risk database. Thus, the Bank Group's pricing is expected to change to some extent. The Bank will also eventually move to base its pricing on a Risk-

Adjusted Return on Capital model. In line with sister institutions, the Bank will adopt the following approach: (i) it will consider the actual credit default swap prices and Z spreads of sovereign bonds, and will apply a risk premium on a case-by-case basis subject to the probability of default rating difference between the sovereign and sub sovereign; (ii) benchmarking will take into account pricing of existing loans and bonds of the given borrower or similar sub-sovereign entities with the same probability of default rating and; (iii) the estimated Risk-Adjusted Return on Capital of the transaction once the Bank Group develops its own model. It is expected that pricing of non-sovereign-guaranteed operations extended to subnational governments will be in line with the pricing for the risk premium over the sovereign. This is justified based on the socio-economic mandate of the sub sovereign government, as compared to the profit mandate of a SOE or private sector company.

103. **Bank Group Exposure to Subnational NSOs.** Exposure to subnational NSOs will be treated like exposure to any other NSO. Exposure will be consolidated at the country level for headroom computation in line with current practice.

104. **Identification of Subnational Operations in the Bank Group's IT systems**. In order to track its subnational finance operations, the Bank Group will introduce the necessary tags in its IT systems (namely SAP).

105. **Roll-Out of Continuous Training for Staff.** Continuous training for staff through workshops will start immediately after the approval of the Guidelines, and will be conducted on a bi-annual basis. It will aim to ensure that staff understand the goals and applicability of the guidelines and the opportunities it offers so that they are better able to capture these opportunities for the benefit of Bank Group's RMCs. It will draw on internationally renowned experts in this domain and will disseminate good practice in subnational finance. To cut costs, training for field- and resource center-based staff will be undertaken through video conferencing.

106. **Dissemination in RMCs.** Annual *in situ* workshops in field offices and regional resource centers will be conducted to sensitize RMCs to the guidelines, theirs goals and how they are applied, and to ensure their awareness of the opportunities they provide for them. Field offices will take the lead in disseminating and sensitizing RMCs' national and subnational governments/entities about the Guidelines. They will lead policy dialogue with the relevant authorities to include subnational development as part of the PRSP/NDP process and eventually in the CSPs.

107. **Cost Implications.** The most immediate costs are related to the launching of the Guidelines in the form of staff training and dissemination in RMCs. These costs will be largely offset by increased efficiency in Bank Group operations, enhanced quality at entry, risk management and implementation, expected increased lending, *inter alia*, to non-borrowing regional member countries, and better responsiveness to Client needs.

108. **Review of the Subnational Finance Guidelines.** The Strategy and Operational Policies Department will monitor the implementation of the Subnational Finance Guidelines. An assessment of the pilot phase will be conducted and recommendations made after the first two years, with an information note submitted to the Board. Thereafter, every five years, an Information Note will be submitted to the Board to report on subnational financing statistics as well as flag issues, lessons learned, and potential need for guidelines revision. Lessons learned will also be incorporated in the training and dissemination workshops.

109. The Guidelines will be reviewed based on the outcome of the review of their implementation.

9 Conclusion and Recommendation

110. These Guidelines on Subnational Finance lay out the strategic, policy and processing framework for Bank Group engagement at the subnational level. They enable the Bank Group to remain relevant and responsive to its RMCs who are facing the challenges of, and capitalizing on the opportunities of decentralization, urbanization, and globalization, as well as the demands of the post-2015 development agenda.

111. The Guidelines will be effective upon their approval by the President. The President is requested to approve the Bank Group's Guidelines on Subnational Finance.

ANNEX 1- International Finance Institutions Practice in Subnational Finance and Bank Group's Proposed Entry Points

1. **The World Bank Group:** The World Bank has provided billions of dollars over the years to subnational governments around the world, but always with sovereign guarantees, as required by the World Bank's charter. The World Bank has also provided advice and knowledge support in decentralization. The IFC has invested in a range of municipal/sub-sovereign sectors: water, roads, and ports. However, it has focused on projects with majority ownership by the private sector. Due to the existing gap for investment in well-run subnational operations without sovereign guarantees, the World Bank Group established the Municipal Fund in 2003, a joint World Bank/IFC initiative that invests in subnational development projects without a sovereign guarantee. The Fund invests from IFC's balance sheet and has access to IFC's full line of financial products. The appraisal processes are modelled on private equity funds. The Fund supports investments made by a wide range of subnational entities (local, provincial and state governments, enterprises, financial intermediaries) in areas including water, wastewater, transport, electricity, solid waste and district heating. The typical size of investments is US 5-50 million. Subnational entities manage their investments directly or in the context of public-private partnerships. The Fund uses a wide range of products such as convertible bonds and subordinated loans and provides non-refundable technical assistance.

2. In 2007, The World Bank Group established the Subnational Development Program in an effort to increase direct engagement at the state/municipal level, building on the Municipal Fund initiated in 2003. The purpose of the Subnational Development program is to provide technical assistance and financing for subnational entities without sovereign guarantee, and preferably in local currency. The Subnational Technical Assistance (SNTA) program was launched in 2007 under the Public Private Infrastructure Facility (PPIAF) and it helps subnational entities to access market-based finance without sovereign guarantees. The program aims to improve the borrowing capacity of local governments and utilities by providing financing for credit ratings, creditworthiness enhancement programs, assistance in the preparation of financing without sovereign guarantees, and for knowledge generation and dissemination. The World Bank Group also relies on financing instruments to strengthen domestic capital markets by launching specific programmes such as the Global Emerging Markets Local Currency Bond (GEMLOC) Program.

3. **The French Development Agency (AFD)**: AFD's strategy is primarily based on support for decentralization and the strengthening of local autonomy by building the capacity of local governments and maintaining their financial equilibrium. The AFD also finances investment programmes through the provision of loans and decentralized technical assistance based on the needs of the local government and/or city concerned. Technical assistance is provided mostly via financial intermediation projects in the form of restructuring of local government financing sector, usually including institutional support to municipalities as well as to national-level specialized institutions. The Agency provides direct loans (without sovereign guarantee) to local governments to finance specific investments or support part of an investment budget. It also provides loans for financial intermediation (direct financial support, via loans and grants to national institutions on-lending to local governments) and which is often provided under co-financing arrangements with other donors. Loans for financial intermediation are also provided to support mechanisms improving local governments' direct access to financial markets and to instruments such as guarantees or credit enhancement. Before providing financing, the AFD carries out an appraisal at the national level (regional and land

diagnosis) and on the project itself (intrinsic project feasibility appraisal)[47]. It then conducts the financial analysis and organizational and management diagnosis of the local government based on financial and accounting documents and on discussions with the local government's elected representatives and officials. The AFD also grants non-sovereign loans to creditworthy enterprises of the commercial public or private sector at subsidized interest rates.

4. **The Inter-American Development Bank (IADB)**: In 2006, with growing lending to subnational governments, the IADB increased lending and technical assistance activities directed toward decentralization and institutional strengthening of subnational governments. The IADB established a pilot program for lending to private sector and subnational entities in 2004. The focus is on assistance via Partial Credit Guarantees (PCGs) to help these entities graduate from central government-channelled loans to making them sufficiently credit-worthy to attract private sector finance. In 2006, the scope of the program was expanded to include direct lending to subnational entities without sovereign guarantees, whether private, state-owned or of mixed-capital ownership. The IADB also operates in cities through the Emerging Sustainable Cities Initiative (ESCI), which is a technical assistance programme that helps cities to identify projects and set priorities. Lending to subnational governments has been a growing part of activities in most borrowing member countries.

5. **The Asian Development Bank**: Development Member Countries (DMCs) of the Asian Development Bank (AsDB) are increasingly divesting their service provision responsibilities to the subnational level, with local governments and their entities increasingly becoming central to the provision of urban infrastructure. DMCs are also increasingly requesting the AsDB to provide support directly at the subnational level, including lending to subnationals without sovereign guarantees, with a view to improve their own fiscal standings. Asia's cities are experiencing the same challenges that Africa's cities are experiencing: high urbanization rates outgrowing local governments' capacities, with vital infrastructure and basic services being put at risk. Despite serious decentralization efforts, most subnational governments and their entities lack sufficient resources and capacity to deliver the growing services for which they are accountable. There is also a wide variety of subnational circumstances with different degrees of political effectiveness, financial administration rules, institutional capacity, legal and regulatory frameworks, incentives and market structures. Thus the AsDB acknowledges that each country needs a response that it tailored to the country's specific circumstances.[48]

6. As part of its Innovation and Efficiency Initiative (IEI), in August 2005 the AsDB approved five new financing instruments on a pilot basis, including the Sub sovereign and Nonsovereign Public Sector Financing Facility which was later mainstreamed. AsDB experience has shown that financing infrastructure at the subnational level requires transparent governance, financial management, and technical and institutional capacities. Where not present, accompanying strengthening measures to the projects are necessary.

7. The AsDB works with subnational entities, for example, through sovereign loans that have been made for municipal infrastructure projects. Its private sector arm works with subnational entities/State Owned Enterprises (SOEs) on infrastructure projects. It also provides technical assistance to help prepare subnational governments and entities for financing infrastructure projects. It has provided policy-based lending for public resource management programs which in turn support sustainable financing and provision of urban

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[47] Presentation by François TIROT during the *African Development Bank Annual Meeting* – Marrakech, 29 May 2013.

[48] ADB sustainable Development Working Paper Series No. 20, April 2012.

infrastructure. National governments of several of its DMCs have set up initiatives and mechanisms to support subnational financing with own and/or development agency assistance. They are clearly increasingly aware of how development agency support can be better utilized to foster fiscal responsibility and accountability at the subnational level and therefore to sustainably finance infrastructure. The AsDB is working on enhancing its approach and instruments for subnational finance.

8. **The European Investment Bank (EIB):** The EIB provides limited technical assistance grants on need basis for project preparation and implementation, made available as grant. Lending assistance is focussed on member countries, traditionally requiring a sovereign guarantee. The EIB is gradually entering into business with investment-grade municipalities and state-owned enterprises and utilities in non-member developing countries without sovereign guarantee.

9. **Kreditanstalt für Wiederaufbau (KfW):** KfW provides technical assistance as grants, as accompaniment to investments, for project preparation and technical and institutional strengthening. KfW does not provide direct lending to local governments/subnational entities. Long term loans at preferential rates are routed via national government (with state guarantees). It provides grants to LDCs. Loans are provided for the promotion of banks, credit cooperatives and similar institutions (such as MDFs), usually within the framework of financial systems development. Loans for financial systems development generally have much longer maturities than the sub-loans they finance, and as long as the return flows from these are not needed for the redemption payments on the loan, they can be re-utilized i.e., like revolving funds. For example, in India, KfW provided a Line of credit to Tamil Nadu Urban Development Fund to promote private financing for urban environmental infrastructure projects and develop municipal bond market via Master Financing Indenture. Another example is support to the Orissa Urban Development fund

10. **The United States Agency for International Development (USAID):** The USAID provides technical assistance for programs/ projects aimed at increasing the financing of urban services via (i) improving overall municipal financial management; and (ii) improving municipal revenue streams (own-source and transferred). When appropriate, technical assistance is used for facilitating municipal market-based borrowing. For example, the Financial Institutions Reform and Expansion -Debt project 1993-2010 provided support to central state and city governments in the provision of water and sanitation, especially to urban poor, through the identification and structuring of bankable projects and accessing market-based financing.

11. The USAID also provides lending/borrowing support through the Development Credit Authority's (DCA) risk-sharing guarantee tool which provides partial credit guarantees (PCGs), generally covering up to 50% of loss on loans made by financial institutions and investors to stimulate lending by financial institutions to lend to creditworthy but underserved borrowers. For example, In India, the DCA guaranteed the assurance of 2 municipal bond (Tamil Nadu in 2002, Kamataka in 2003) to raise capital for water and sanitation projects for low-income areas). In Bulgaria, the guarantee capitalized on legislative changes allowing municipalities to borrow to support better municipal management. In the Philippines, the DCA provided credit risk guarantees for lending to creditworthy water service providers under Philippine Water Revolving Fund. Since being established in late 1999, more than 267 DCA PCGs have facilitated over $ 2.3 billion of private capital debt financing in more than 64 countries.

12. **<u>The Global Fund for City Development (GFCD)</u>:** the GFCD, which was established in 2010 on the initiative of Metropolis, United Cities and Local Governments (UCLG) and 34 founding members (cities and city networks), is an international political organization aimed at building the financial capacity of local governments. It seeks to create solidarity between local governments while building their financial capacity through the establishment of an advocacy network. The GFCD also provides technical expertise and financial engineering to local governments throughout the urban development project process (identification, sourcing for financing, organization, etc.).

13. **<u>The WAEMU Regional Integration Assistance Fund (RIAF)</u>:** RIAF is often cited as a partner of decentralization in the WAEMU zone. It is a structural fund for the financing of balanced development planning to contribute to efforts aimed at reducing regional disparities. According to the regulations laying down the conditions for its intervention and management, RIAF may grant credits to local governments to strengthen urban infrastructure. The specificity of this experience lies in the fact that the financing of local governments was provided for within the framework of a regional institution that seeks to consolidate regional integration. RIAF grants loans or lines of credit for income- and employment-generating activities; provides loan interest subsidies or West African Development Bank lines of credit to finance economic and social infrastructure; and grants subsidies to finance economic and social infrastructure. To be eligible for RIAF financing, projects must: (i) be located in an eligible impact area; (ii) meet at least one of RIAF's three specific objectives; (iii) be consistent with the priorities set forth in RIAF's programming framework paper; (iv) be relevant and credible and include information helping to decide on these two criteria; and (v) be submitted by a target beneficiary.

14. The following table compares Bank Group proposed subnational financing to that of the World Bank Group and the European Bank for Reconstruction and Development.

Subnational Operations in World Bank Group, European Bank for Reconstruction and Development, and as Proposed in African Development Bank Group

World Bank –IFC	EBRD	AfDB
Technical Assistance	**Technical Assistance**	**Technical Assistance**
• Mostly routed through project loans • Grant funds available under the dedicated multi-donor Subnational Technical Assistance Program to help local governments, publicly-owned utilities, other subnational entities access market based finance without sovereign guarantee by helping: - Improve their credit worthiness to access market-based financing (bonds or banks) for infrastructure without sovereign guarantees - Obtain or improve credit rating from a recognized rating agency - Take measures to enhance their creditworthiness for potential lenders **Sample activities** (improving financial controls, developing capital financing plans, improving corporate governance of public enterprise, obtaining or improving credit rating, developing innovative credit structures, preparing a bond or share issuance, negotiating with lenders	Long term client engagement including capacity building, governance, and service and financial management improvement **Municipalities and Utilities** Project preparation, loan application and project implementation; improving credit-worthiness, tariff setting and revenue enhancement/cost control in utility companies **Financial Sector** Improve bank capacity to appraise municipal infrastructure projects, assess risks and manage portfolios	Routed through project support or as stand-alone grants or loans **Subnational governments**: improve own-source revenues; improve debt-absorption, management and monitoring; improve project development and implementation and portfolio management; improve financial management and fiscal transparency and discipline improve credit worthiness to access market-based financing (bonds or banks) for infrastructure without sovereign guarantees; Obtain and/or improve credit rating from a recognized rating agency; Enhance creditworthiness for potential lenders; **Subnational public sector enterprises**: support for tariff changes, support to revenue enhancement/cost control in utility companies Take measures to enhance their creditworthiness for potential lenders **Financial Sector** Improve legal and regulatory frameworks for the provision of infrastructure services and enabling the flow of long-term private sector finance to the infrastructure sector, including sovereign wealth funds, pension funds and life-insurance funds. For example, build bank's capacity to appraise municipal infrastructure projects, assess risks and manage portfolios; **Private Sector**: promote PPPs at subnational level with emphasis on the local private sector.

World Bank –IFC	EBRD	AfDB
Lending / Borrowing Assistance	**Lending / Borrowing Assistance**	**Lending / Borrowing Assistance**
IDA normally makes credits only to national governments which may on-lend IBRD prefers to lend directly to entity responsible for implementation but allows on-lending when direct lending is not feasible Eligible subnational entities for Development Policy Lending (Program-based operations) are only states or provinces or similar jurisdictions. Lending to subnational entities not allowed without sovereign guarantee(IBRD); lending to subnationals without sovereign guarantee allowed(IFC) Loans for projects with subnational finance components Credit lines to Municipal Funds to facilitate subnational governments and their entities' access to private finance and capital markets (e.g., FINDETER-Colombia;TNUDF-India.mufis-Czech Republic) **WB-IFC Subnational Development Program** is an innovative approach to finance without sovereign guarantee to provide states, provinces, municipalities, and their enterprises with: - Senior; subordinated and convertible loans - Partial credit guarantees and risk sharing facilities for bonds, loans - Equity, quasi equity	Loans Investment grants for smaller municipalities Grants to enhance municipal utilities' creditworthiness and operational sustainability during and after project implementation **Municipal Finance Facility**(with EC) Develop and stimulate commercial bank lending to small and medium-sized municipalities and their utility companies: - Long-term loans; - Guarantee/risk sharing with partner commercial bank's risk on portfolio of loans to municipalities; - Maturity enhancement fee (paid to partner banks at a rate depending on loan tenor. In the event of loan cancellation, prepayment or default within 5 years, partner banks required to repay fee in full).	ADB and ADF direct lending and on-lending Eligible subnational governments/ entities for Program-based operations are all levels of subnational government under specific criteria Lending with sovereign guarantee from ADF window; Lending with or without sovereign guarantee from ADB window under specific criteria Loans, grants, and loan and grant combinations directly and via the central government to subnational governments and their entities Loans, lines of credit to municipal development funds Partial credit guarantees and risk sharing facilities for loans from banks and for bond issuance Other Bank instruments for non-sovereign guaranteed operations (senior, subordinated, convertible loans, equity, quasi-equity) subject to eligibility

ANNEX 2- Summary of Eligibility Criteria for Sovereign- and Non-Sovereign-Guaranteed Operations

Criteria Level	Eligibility Criteria for Direct Sovereign-Guaranteed Subnational Operations (SOs) for a Subnational Government or Entity		Comments
	Subnational Government	Subnational Entity	
(1) Eligibility to Resources	Same as the sovereign; Trust/Special Funds if allowed by the Trust / Special Funds governing MOUs	Same as the sovereign; Trust/Special Funds if allowed by the Trust / Special Funds governing MOUs	Resources are deducted from the ADF allocation/ADB headroom of the sovereign. There must be sufficient headroom/ADF resources for the sovereign unless there are specific set-asides for subnational SOs. Eligibility to ADB sovereign window for ADF-only countries is only through indirect lending
(2) Ownership and Commitment to subnational development	consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation must be submitted to the Bank	consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation must be submitted to the Bank	The Policy on Expenditure Eligible for Bank Group Financing applies.
	a)The subnational government has demonstrated a clear and sustained commitment to a well-defined reform agenda, and the proposed financing is likely to play a clear and unambiguous role in achieving the core development objectives of the subnational government;		
	b)It has demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency, and the proposed financing helps address those objectives;		
(3)Qualifications as a Subnational Government / Entity	c)it has an adequate expenditure program and adequate fiscal arrangements with the central government and/or with the applicable political subdivisions;	(a) be incorporated and located in any of the Bank's RMCs subnational governments' territories and the project benefits accrue to one or more subnational territory;	If the criterion is not satisfied, then indirect lending is the alternative
	d)It can contract and obtain financing independently from the related sovereign and/or applicable subdivisions and in foreign currency when the Bank cannot provide financing in local currency;	(b) have legal personality, be subject to liquidation, bankruptcy and/or insolvency proceedings and not be protected by immunities or exemptions (e.g. immunities from legal process, taxes, seizure or attachment of its property and assets; exemptions from environmental or social regulations, etc.). If such immunities or exemptions exist, then an express waiver of such must be submitted to the Bank;	If the criterion is not satisfied, then indirect lending is the alternative
	e)It has a distinct legal personality and capacity to sue and be sued, as well as to incur debts or place investments on its own account and in its own right. It is not protected by any immunities or exemptions from environmental or social regulations, legal process, seizure or attach-ment of its property, or other forms of execution of judicial due process. If such immunities or exemptions do exist, an express waiver of such must be submitted to the Bank;	(c) have formally been granted, by the sovereign and/or sub-sovereign governments or public entities that own or control the majority of its shares, a statutory charter bestowing upon it full operational and financial autonomy, providing it full control over its funding, budgeting, and investment decisions;	If the criterion is not satisfied, then indirect lending is the alternative
(4)Sound banking principles In addition, based on a fiduciary and a credit risk assessment, and in order to institute a virtuous cycle in subnational finance, it must at least be willing and able to undertake the necessary steps to satisfy the following criteria within an appropriate time frame and possibly posited as conditions precedent to disbursements:	f)The subnational government will be managed competently, efficiently, transparently and will be accountable to its constituency. Its accounts and general operations will be subject to periodic review by reputable independent auditors and will be consistently found to be managed in a satisfactory manner over an extended period. It will have a good track record in development-related spending with demonstrable developmental impacts;	(d) be at least willing and able to undertake reforms to become financially sound and have sustainable capacity to generate substantial revenues directly from its mandated operational activities over an extended period within an appropriate time frame (short-term, preferably posited as a condition prior);	If the criterion is not satisfied, then indirect lending is the alternative
	g)It will be financially sound, based on an evaluation of relevant ratios recorded in audited accounts. Its projected cash flow will be predictable and adequate to meet financial obligations with a suffi-cient margin of safety;	(e) be at least willing and able to undertake the necessary steps to become managed in a manner that fosters private sector development, and	If the criterion is not satisfied, then indirect lending is the alternative
	h)It will have a sound, forward-looking, and comprehensive debt management structure;	(f) be at least willing and able to undertake the necessary reform steps to become managed competently, with the same level of efficiency, transparency and accountability as comparable private enterprises in the country, within an appropriate time frame (short-term, preferably set out as condition prior).	If the criterion is not satisfied, then indirect lending is the alternative
	i)It will be able to demonstrate its commitment to fiscal discipline.		If the criterion is not satisfied, then indirect lending is the alternative

Criteria Level	Eligibility Criteria for Non-Sovereign-Guaranteed Subnational Operations (NSOs) for a Subnational Government or Entity		Comments
	Subnational Government	**Subnational Entity**	
(1) Eligibility to Resources	ADB NSO Window Trust Funds if allowed by the Trust / Special Fund governing MOU	ADB NSO Window Trust Funds if allowed by the Trust / Special Fund governing MOU	There must be sufficient headroom for the sovereign, unless specific risk capital is allocated to subnational NSOs
(2) Ownership and Commitment to subnational development	consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation must be submitted to the Bank	consent of the central and state/provincial (if applicable) government(s) of the RMC(s) hosting the operation must be submitted to the Bank	
	a)The subnational government has demonstrated a clear and sustained commitment to a well-defined reform agenda, and the proposed financing is likely to play a clear and unambiguous role in achieving the core development objectives of the subnational government;		
	b)It has demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency, and the proposed financing helps address those objectives;		
(3)Qualifications as a Subnational Government / Entity	c)It has an adequate expenditure program and adequate fiscal ar-rangements with the central government and/or with the applicable political subdivisions;	(a) be incorporated and located in any of the Bank's RMCs subnational governments' territories and the project benefits accrue to one or more subnational territory;	
	d)It can contract and obtain financing independently from the related sovereign and/or applicable subdivisions and in foreign currency when the Bank cannot provide financing in local currency;	(b) have legal personality, be subject to liquidation, bankruptcy and/or insolvency proceedings and not be protected by immunities or exemptions (e.g. immunities from legal process, taxes, seizure or attachment of its property and assets; exemptions from environmental or social regulations, etc.). If such immunities or exemptions exist, then an express waiver of such must be submitted to the Bank;	
	e)It has a distinct legal personality and capacity to sue and be sued, as well as to incur debts or place investments on its own account and in its own right. It is not protected by any immunities or exemptions from environmental or social regulations, legal process, seizure or attach-ment of its property, or other forms of execution of judicial due process. If such immunities or exemptions do exist, an express waiver of such must be submitted to the Bank;	(c) have formally been granted, by the sovereign and/or sub-sovereign governments or public entities that own or control the majority of its shares, a statutory charter bestowing upon it full operational and financial autonomy, providing it full control over its funding, budgeting, and investment decisions;	
(4) Sound banking principles	f)The subnational government is managed competently, efficiently, transparently and is ac-countable to its constituency. Its accounts and general operations are subject to periodic re-view by reputable independent auditors and are consistently found to be managed in a satisfactory manner over an extended period. It has a good track record in development-related spending with demonstrable developmental impacts;	(d) be financially sound and have sustainable capacity to generate substantial revenues directly from its mandated operational activities over an extended period;	Security or Third Party guarantee may be needed
	g)It is financially sound, based on an evaluation of relevant ratios recorded in audited accounts. Its projected cash flow is predictable and adequate to meet financial obligations with a suffi-cient margin of safety;	(e) be managed in a manner that fosters private sector development, and	
	h)It has a sound, forward-looking, and comprehensive debt management structure;	(f) be managed competently, with the same level of efficiency, transparency and accountability as comparable private enterprises.	
	i)It has demonstrated its commitment to fiscal discipline.		

ANNEX 3 Eligibility Criteria for Subnational Governments on Non-Sovereign Guaranteed Terms

In addition to the eligibility for resources from a specific financing window, to the availability of resources, and to the ownership criterion, eligibility criteria for subnational governments' access to ADB non-sovereign-guaranteed financing are as follows:

a) The Subnational Government has demonstrated a clear and sustained commitment to a well-defined reform agenda, and the proposed financing is likely to play a clear and unambiguous role in achieving the core development objectives of the subnational government;
b) It has demonstrated commitment to building public sector institutional capacity and public sector expenditure efficiency and transparency, and the proposed financing helps address those objectives;
c) it has an adequate expenditure program and adequate fiscal arrangements with the central government and/or with the applicable political subdivisions;
d) It can contract and obtain financing independently from the related sovereign and/or applicable subdivisions and in foreign currency when the Bank cannot provide financing in local currency;
e) It has a distinct legal personality and capacity to sue and be sued, as well as to incur debts or place investments on its own account and in its own right. It is not protected by any immunities or exemptions from environmental or social regulations, legal process, seizure or attachment of its property, or other forms of execution of judicial due process. If such immunities or exemptions do exist, an express waiver of such must be submitted to the Bank;
f) The subnational government is managed competently, efficiently, transparently and is accountable to its constituency. Its accounts and general operations are subject to periodic review by reputable independent auditors and are consistently found to be managed in a satisfactory manner over an extended period. It has a good track record in development-related spending with demonstrable developmental impacts;
g) It is financially sound, based on an evaluation of relevant ratios recorded in audited accounts. Its projected cash flow is predictable and adequate to meet financial obligations with a sufficient margin of safety;
h) It has a sound, forward-looking, and comprehensive debt management structure;
i) It has demonstrated its commitment to fiscal discipline.

ANNEX 4 - Enhancing Own Source Revenue for Local Governments

1. Principal Own-Source Revenues for Local Governments[49]

Own Source Revenues (OSRs) for local governments can be grouped into the following categories: taxes, charges, fees, asset and investment proceeds, and other small revenues. Taxes are levied to finance general expenses; charges finance the costs of services; fees are supposed to cover the direct costs of specific services or functions such as issuing marriage, birth, or death certificates; licenses; or permits. These distinctions are less clear in practice. Some taxes and charges may be called "fees" (as a "water fee"). Some fees are set far above the direct cost of the respective services; for example, business licenses, vocational fees, or building permits, which in fact are taxes, may be called fees to make them politically more acceptable.

1. Property tax (rates) on land and/or buildings;
2. Tax on the transfer of immovable property;
3. Tax on motor vehicles;
4. Local sales tax and/or tax on the sale of local products (or surcharge);
5. Tax on local businesses and services;
6. Tax on electricity consumption (surcharge);
7. Tax on non-motorized vehicles;
8. Tax on tourism, hotels, restaurants, and entertainment;
9. Tolls on roads, bridges, etc., within the limits of the local government;
10. Charges for public works and public utilities such as waste collection, drainage, sewerage, and water supply;
11. Charges for markets and rents for market stalls;
12. Charges for the use of bus stations and taxi parks;
13. Fees for approval of building plans and erection and re-erection of buildings;
14. Fees for fairs, agricultural shows, cattle fairs, industrial exhibitions, tournaments, and other public events;
15. Fees for licensing of businesses, professions, and vocations;
16. Fees for other licenses or permits and penalties or fines for violations;
17. Fees for advertisement;
18. Fees on sales of animals in cattle markets;
19. Fees for registration and certification of births, marriages, and deaths;
20. Fees for education and health facilities established or maintained by the local government;
21. Fees for other specific services rendered by the local government;
22. Rent from land, buildings, equipment, machinery, and vehicles;
23. Surpluses from local commercial enterprises;
24. Interest on bank deposits or other funds.

2. Main Steps in Revenue Enhancement Programs[50]

[49] Source: Devas, Munawwar, and Simon, 2008 in Vitkovic and Kopanyi, 2014

[50] Source: World Bank 2007, inVitkovic and Kopanyi, 2014

1. Develop baseline indicators on both current subscribers and current taxpayers. Estimate the actual number of beneficiaries and the potential number of taxpayers to compare performance before and after the implementation of any proposed revenue management plan of action.
2. Update databases (registers) of service subscribers and taxpayers, through third party information, direct field surveys, and self-reporting requirements.
3. Expand street nomenclature to update addresses, which are needed for billing, collection, and enforcement of user charges, local taxes, and other revenue sources.
4. Upgrade the current billing and collection system for both user charges and local taxes (including hardware, software, office equipment, and staff training).
5. Update the property tax information on property owners, physical characteristics of the properties, valuations, and their corresponding tax assessments (i.e., the municipal cadastres), and make the updating automatic and electronic.
6. Implement a transparent system of incentives to reward early compliance with tax payments and user charges.
7. Implement a transparent system of disincentives (penalties) for late payment of user fees and local taxes.
8. Develop baseline indicators for actual and potential user charge collection by service, and actual and potential tax collections by tax source, to measure performance in local revenue collection efficiency.
9. Establish minimum standards in the provision of the different municipal services, determine actual standards, and evaluate performance in adherence to standards.
10. Determine the number of units of services supplied and establish the unit cost per service.
11. Compute expected cost based on minimum standards; determine actual cost, and measure expenditure efficiency performance.
12. Compute the user fees (user charges) that reflect the actual cost of providing each service. This information constitutes basic input for monitoring and assessing performance in expenditure efficiency by municipal service.
13. Develop benchmarks, indicators regarding unit cost for main municipal services. The unit cost indicators should differentiate between construction costs (i.e., capital outlays per unit of public works) and associated operations and maintenance (O&M) costs.
14. Develop a system for the legal enforcement of user fees and local taxes, together with a system of appeals.

Box A4. Increasing Own-Source Revenues in Maputo

The City of Maputo, Mozambique, has increased its own-source revenues by almost 30 percent since 1998 through revenue management reforms. These have enabled Maputo to increase its tax base, taxing more properties and initiating adjustments in user fees for certain services (notably a new, incremental solid waste fee). Legislative reform, tariff studies to inform policy and management decisions, and prioritization of both revenue and expenditure management have created institutional shifts for revenue enhancement. The use of rigorous analysis, initiated through tariff studies, has identified the ratio of expenditures that can be financed with own-source revenue, the relative proportions of fiscal and non-fiscal revenues, and measures to increase revenue collection efficiency. It has provided an empirical basis for decisions to expand the property tax base and improve tariff setting and collection of user fees.

Source: World Bank 2007, in Vitkovic and Kopanyi, 2014.

Figure A4. Land Finance Instruments

Instrument	Description	Requirements	Problems
Sale of public land	Public land assets are sold, with proceeds used to finance infrastructure investment	Inventory of land assets, market valuation, and strategic decisions about best use, open auctions for disposing of land that is sold	Needs competency for inventory and sale. It may result in sprawl (China). Difficult to implement if the agency does not benefit directly from the sale
Betterment levies (also known as land-value capture taxes or valorization taxes)	Public sector taxes away a portion of land value gain coming from infrastructure projects	Difficult to implement on a parcel-by-parcel basis. Approach adopted by Bogota is better	Need experience with the instruments as in South America
Impact fees	Developers pay the cost of system-wide infrastructure expansion needed to accommodate growth	Strong analytical capacity to estimate the infrastructure cost implications of development at different locations	Need to develop simplified approaches that capture the concept of recovering the off-site cost of growth without overwhelming technical demands
Acquisition and sale of excess land	Public sector acquires land surrounding the infrastructure project and sells land at a profit when project is complete and land value has increased	Social contract is needed on who should benefit from land value gains resulting from public infrastructure, the original landowner, public sector, displaced occupants, etc.	It is difficult to reach agreement on the proper exercise of eminent domain

Source: Peterson 2009 inVitkovic and Kopanyi, 2014.

ANNEX 5 - Roles and Types of PPPs in the Provision of Local Services

(1) Public and Private Sector Roles in the Delivery of Local Services

Local Service	Type of Good	Public Sector Role	Private Sector Role
Urban transport	Private with positive externalities, merit good	Ensure efficient solutions and inclusive solutions	Construct and operate systems
Piped sewerage systems	Public good, monopolistic with positive externalities	Direct public provision	Can be contracted for specific works
Water supply	Quasi-public good; has positive externalities	Regulations for public health	Can deliver but with public regulation
Land service, infrastructure, and household connections	Private and can be delivered by the private sector	Regulations for environment and safety considerations and zoning	Deliver infrastructure, finance development, charge consumer
Slum upgrading	A large component is public good	Finances public good (water and sanitation)	Community can deliver and build large part of the services
Solid waste collection	Private good (with positive externalities)	Ensures provision and coverage	Delivers the service
Waste disposal	Quasi-public good	Public direct provision	Deliver under contract

Source: Batley 2001, in Vitkovic and Kopanyi, 2014

(2) Types of Public-Private Partnerships

Type of PPP	What they do	Characteristics
Management contracts and BOT	Transfer responsibility for operation and maintenance of a subnational government-owned business to the private sector for generally up to five years	Subnational government retains ownership and funding of the project. It offers some performance objectives by which to judge the effectiveness of the firm in charge of the maintenance and operation (e.g., composting plant BOT, bus transport service)
Leases	Subnational authority owns the assets but the private sector leases the asset and handles the maintenance and operation	Risks are shared; leases can go 5-20 years
Concessions	Private sector takes responsibility for the maintenance and operation and for the investment in the facility	Concessions are for 25-30 years. Contracts are very detailed, outlining performance standards, required investment, and mechanisms for adjusting prices and tariffs (e.g., bus system, urban water concession)
Joint ventures	Private sector holds shares in this structure. Over time, the local government may sell the other shares to the private sector.	Local authority may give daily management to the private partner
Full/Partial ownership	Private sector owns all or part of the service or structure	With complete divestiture, the private sector takes full responsibility for operations, maintenance, and investment. All assets become private as well

Source: Delmond 2009, in inVitkovic and Kopanyi, 2014

Note: BOT: build, operate transfer

ANNEX 6- Diagnostics Tools

(1) Basic Subnational Diagnostics Tools: PEFA, Municipal Audit, Urban Audit

The PEFA framework has been adapted to subnational governments, with the entire indicator set being applied at the Subnational level, although depending on the particular features of the intergovernmental system in place, some indicators or dimensions may not be relevant. An additional indicator has also been added to the set and is designed to assess the impact of transfers from a higher-level government. As of 2014, 28 countries across the world have conducted 136 subnational PEFAs. Nigeria has 22 subnationals assessed, the most in a single country. In Africa, besides Nigeria, countries with subnational PEFAs include: Tunisia, Morocco, Mauritania, Senegal, Sierra Leone, Ghana, Cameroon, Ethiopia, Uganda, Tanzania, Rwanda, Mozambique, Madagascar, and South Africa. The PEFA Secretariat has issued guidelines for the application of the PEFA framework to the subnational governments.[51]

Municipal audits were developed by the World Bank to enhance transparency, accountability, and performance in local finances. The Municipal Finances Self-Assessment (MFSA), which uses some PEFA indicators, goes into municipal finances in greater details, including (a) assessment of the financial situation of a municipality; (b) review of revenues and expenditures on an annual basis; and (c) identification of specific, monitorable measures for improvement. Along with the MFSA or independently of it, the Urban Audit (methodology developed by the World Bank and customized to local contexts by local users themselves) can be a powerful investment programming tool. It aims to help local governments (1) assess their level of services and infrastructure, (2) locate and quantify the gaps and (3) prioritize and select municipal investments programs. Both audits/self-assessments contribute to enhance transparency, participation and accountability in the decision-making process over what and how priorities should be financed, shedding light on the use of public funds in the municipal space. Municipal audits can form the basis of municipal contracts. Municipalities may sign contracts with their central governments containing performance indicators defined by the municipal audits and supported by performance grants. A municipal contract has as its foundation a comprehensive analysis of the municipality's characteristics, its urban features, and its organizational and financial capacities (MFSA + Urban Audit). The analysis enables management to establish priorities for investments, programming, and the funding needed to support the operation of municipal services and any needed adjustments to the municipal staffing and organizational structure.

Source: Vitkovic and Kopanyi, 2014.

[51] Supplementary Guidelines for the application of the PEFA Framework to Subnational Governments. PEFA Secretariat January 1, 2013, http://www.pefa.org/sites/pefa.org/files/attachments/SNG-Supplementary-Guidelines-eng001%20(Jan%2017).docx_.pdf

(2) Benchmarking Service Delivery Standards

Municipalities and their utility companies are increasingly obtaining International Organization for Standardization (ISO) certificates in the United States, Europe, and the developing world. For instance, many municipalities in Eastern Europe have obtained ISO certification, including ones in transition countries such as the Czech Republic and Hungary. Municipalities in the United States typically certify their key service entities, such as those for fire protection, water and sanitation, education, and health, and those overseeing building codes or public housing. The ISO helps streamline services, reducing the cost of operation, and also lowers the costs of insurance and financing. Municipalities in Eastern Europe start with ISO 9001 certification of the entire municipal administration. Some argue that it may help them obtain cheaper insurance or even bank borrowing if a credit rating has not yet been obtained.

Source: http://www.iso.org/iso/home/about.htm., in Source: World Bank 2007, inVitkovic and Kopanyi, 2014.

ANNEX 7 - General Policy Framework for Subnational Borrowing

1. The size of and the match between the demand and supply of subnational credit in domestic markets are influenced by a broad range of national factors (such as laws and regulations, capital market development and fiscal and institutional frameworks) and local variables (e.g. the size, tax base and fiscal policy of subnational governments). A sub-sovereign's freedom to choose between borrowing from banks or in the capital markets depends on a variety of factors, including the sovereign's regulatory restrictions, market demand, and legal constraints. The options available to a sub-sovereign are also constrained by the macroeconomic conditions in a country and the state of development of its capital markets. The potential of a country to develop a well-functioning domestic capital market depends further on the degree of financial sector development such as ability to assemble pools of savings for investment.

2. However, the availability of multiple credit tools, favourable institutional set-ups and financing schemes does not always guarantee that a satisfactory solution can always be found by simply tailoring the lending ingredients according to specific circumstances. In fact, there is no easy recipe to help bridge the gap between the increased financial needs of African subnational governments and the supply of subnational credit on domestic markets. Side effects may jeopardize the implementation of even the most agreed-upon subnational credit enhancement strategies.

3. The various subnational credit experiments worldwide help to draw a number of common lessons:

- Subnational credit markets can only be established progressively through the introduction of various institutional and tax reforms and implementation of public support programmes. During the initiation phase and in order to encourage subnational governments to build their capacity, public sector lenders should establish a clear link between the progress of reforms and the disbursement of investment funding.

- The level of subnational access to private markets directly depends on the level of fiscal decentralization, particularly on the degree of taxation autonomy of the subnational entity, and the magnitude and reliability of shared taxation.

- Opportunities for financing small urban or rural subnational governments will always be limited due to their size and limited resources. They should therefore benefit from other types of financial support in the form of grants, subsidies and technical assistance. For risk management reasons, nearly all loans should be limited to subnational governments with large constituencies such as states, provinces, regions, and large political and economic cities.

- Subnational credit enhancement strategies should be complemented by control mechanisms aimed at limiting the potential dangers of subnational borrowing and at providing market discipline. These mechanisms include debt ceilings, prior central authorizations, budget verification, supervision and control procedures and the dissemination of timely and reliable information on subnational finance in the capital marketplace.

- The development of intergovernmental information systems and the reliable classification of the financial performance of subnational governments to improve communication in credit markets is a very important element for improving domestic market disclosure. In addition, the existence of a clear interest rate policy can encourage the private sector to participate in subnational lending.

- Among the structural fiscal reforms introduced, intercept provisions have proved a fundamental tool to jumpstart subnational borrowing and minimize the use of central government guarantee.

- Public support to subnational borrowing is not endlessly needed and the system of subnational loan incentives and subsidies should be progressively removed within the framework of a medium- and long-term strategy and substituted by increasingly market-oriented processes once the preconditions are in place.

- In the absence of credit enhancement strategies to promote the relationship between local governments and financial markets, access to commercial credit remains expensive and limited to short-term loans.

4. The following policy framework is recommended to facilitate the creation of a subnational capital market[52]:

• Consistent accounting, auditing, budgeting and reporting mechanisms for subnational entities;

• Unambiguous legal authorization for subnational entities to incur debt in all possible forms—including loans, leases, and bonds—as well as the ability to enter into concession and privatization contracts;

• Thoughtfully designed regulatory limitations on all forms of indebtedness for subnational borrowers, and enactment of effective means of enforcing such limitations;

• Substantial negative consequences imposed on subnational borrowers in the event of non-payment;

[52] Adapted from: Credit Rating and Bond Issuing at the Subnational Level, Training Manual, IBRD 1999.

• Collateral laws or analogous legally binding provisions which permit subnational entities to pledge defined tax- and fee-based revenue streams, inter-governmental transfers, financial instruments such as stock shares, and other assets to debt-holders;

• Disclosure standards for all subnational issuers of debt, with appropriate differentiation in disclosure requirements for each category of debt;

• Tax law treatment of principal and interest on debt incurred by subnational issuers that is consistent with the treatment afforded principal and interest on other forms of debt; specifically, potential borrowers and investors in subnational debt must be afforded tax incentives (i.e. the ability to deduct interest expenses and/or tax-free interest income) comparable to those applicable to sovereign and corporate debt investors so as not to create distortions in the market;

• Development of a stable, predictable intergovernmental fiscal system that provides shared revenue and/or the capacity to raise own-source revenues which are reasonably matched to the needs of subnational entities (where "needs" are often best defined as responsibilities that have been devolved downward within political systems undergoing decentralization);

• Collateral law improvements which spell out how specified revenue streams, physical assets, and financial assets can be dedicated on a senior lien basis to the repayment of debt in whatever form the subnational entity chooses;

• A "subnational aid intercept system" which would allow subnational entities to pledge the use of intergovernmental transfers such as revenue sharing and other resources due to them to cure delinquencies or defaults;

• Transparent and appropriately competitive procurement laws (or regulations with the force of law) for subnational entities to ensure that borrowing proceeds are spent in the most cost effective manner possible; and

• A system of tariff-setting regulations for municipal enterprises that is governed by a clear and predictable process that can be relied upon by all involved parties.

ANNEX 8 - Performance-Based Financing Instruments: Municipal Contracts[53]

The Municipal Contract has emerged as a useful tool to facilitate the selection, implementation and financing of urban services and infrastructure and push the envelope on municipal management reforms. A municipal contract is usually a consensual and binding, performance-based agreement between a municipality and the central government for a four- or five-year period. It typically includes a priority investment plan, a municipal maintenance plan, and a municipal adjustment or reform program. Many countries in Europe have adopted the Municipal Contract approach (e.g., France, the Netherlands, the UK, Sweden, Belgium, Germany and Canada). In North Africa, municipal contracts have also been used in Tunisia and Morocco. In Sub-Sahara Africa, municipal contracts have been widely implemented with the support of the World Bank and AFD in countries such as Senegal, Guinea, Mali, Burkina Faso, Mauritania, Cote d'Ivoire, Niger, Cameroon, Madagascar, Benin, Rwanda, and Chad. Evidence suggests that municipal contracts have been very effective in supporting local governments, even where decentralization reform has been a difficult process (World Bank 2009). They have enhanced municipalities' financial capacity and contributed to investments in infrastructure and service delivery.

The key objectives of municipal contracts are to: (i) support integrated urban and local development through an increase in urban investments in infrastructure and service delivery and by focusing on improving municipal governance and management; (ii) give the municipality greater responsibility in the selection and financing of municipal investments by putting its role on a contractual footing; (iii) ensure prioritization of investments and greater visibility and transparency on the use of public funds; (iv) ensure strong commitment, through signing of a municipal contract between the central government and the municipal government, based on the provisions of the contract and publicly acknowledged obligations; (v) enhance citizen participation in developing the strategic vision of the municipality for its future growth and development and develop stronger accountability between the municipality and its citizens; (vi) define and monitor the implementation of the key components of the Municipal Contract (Municipal Investments Program and Municipal Adjustment Program -- including the Municipal Finances Improvement Plan).

The Process of Municipal Contracts. A municipal contract is developed based on an assessment of the municipality's characteristics, particularly urban features and organizational and financial capacities and weaknesses. The assessment leads to a municipal program which includes clear investments priorities (Priority Investments Program) as well as clear capacity development measures (Municipal Adjustment program). Development of municipal contracts can be divided into four stages:

1. <u>The diagnostic/audit/self-assessment stage</u>: This stage includes (1) the completion of a financial and organizational audit/self-assessment which aims to assess a city's financial health and to identify specific actions to improve mobilization of local resources, public spending, public assets management and maintenance, investment programming and access to external financing. The MFSA leads to a very concrete Municipal Finances Improvement Plan; and (2) an Urban Audit which aims to locate, identify and quantify existing gaps in service delivery and infrastructure and which leads to (a) a Priority Investment program and (b) a Municipal Maintenance Program.

2. <u>The validation/consultation stage</u> examines the key findings of these assessments/ audits. It is a

[53] Source: Farvacque-Vitkovic and Godin 1998 Farvacque-Vitkovic, Godin, Sinet, 2013; Goudrian 2010

very important stage because it involves a set of consultations with the key stakeholders in order to reach a consensus on a "municipal program" which would consist of (1) a set of very concrete and monitorable capacity development and revenue enhancement measures and (2) a program of investments based on the financial capacity and the priorities of the citizens.

3. The third stage consists of drafting the municipal contract, itself, with a clear set of commitments from the local and central governments in order to close the deal on a financing and technical program. It will specify the content of the priority investment programs (PIPs) and of the Municipal Adjustment/Improvement Program (MAP).

4. The implementation and monitoring stage requires a coordinated effort to align the financing with the technical and human resources, as well as the political commitment to implement the contract. The success or failure of a municipal contract depends on two main factors: the quality of the municipal contract process itself and the political and institutional environment in which it is developed and implemented. The quality of the municipal contract depends on the capacity-building efforts that municipalities engage in to enable better preparation, implementation, and monitoring, auditing, and strategic development. The level of political commitment and ownership at the central and local levels, the degree of participation by stakeholders and citizens, and the extent of harmonization and alignment among various donors working in the local government sector are also important influences.