Environmental Finance

Local Capital Markets for Environmental Infrastructure: Prospects in selected transition economies

Summary in English

Executive summary

There are good reasons to investigate the issue of the development of local financial and capital market to finance investment in environmental infrastructures in EECCA now:

With only one exception, these countries have engaged in a systematic devolution of responsibilities for the construction and maintenance of urban environmental infrastructure to sub sovereign levels of government;

There is a pressing need to accelerate investment in environmental infrastructure at the local level;

Alternative sources of finance are not very promising in the near future: State financing for environmental infrastructure investment is declining, and it is unlikely that direct private investment (including investment from domestic and international utilities) will play a significant role on the foreseeable future.

Moreover, although some EECCA countries have experienced the negative consequences of mismanaged local debt in the early 1990s, the macro-economic and institutional contexts have changed dramatically in the recent years, providing new opportunities to examine more market-based approaches.

China is a relevant benchmark, as this transition economy has engaged in an alternative strategy: sub-national credit has grown rapidly as a source of urban infrastructure investment financing, replacing a portion of direct expenditures from national and sub-national budgets.

The main objective of this project is not so much to create local markets, but rather to assess how local governments' access to local markets could be strengthened in order to finance investment in environmental infrastructure, allowing municipalities and municipal service enterprises to tap private savings market.

The focus is on the definition and implementation of sound financial policies for the decentralisation of environmental infrastructure and services. A particular framework should be established for the development of local financial markets, which should be consistent with the overall framework for local finance. The role of the central authorities is key in defining and implementing this framework, but it should be supplemented by actions taken at the local level.

As part of the process of fiscal decentralization, the policy and institutional obstacles that prevent the financial sector from playing a greater role in financing environmental projects should be removed; incentives for such an involvement include the right for local authorities to incur debt, support to the development of carriers of long-term savings (insurance companies, banks), regulation of the portfolio of these institutions (and the share that they are allowed to invest in local jurisdictions), etc. Experience from other regions could be applied in EECCA countries to enable local capital and financial markets to play a greater role in financing environmentally-related infrastructure.

A particular framework…

Local capital and financial markets cannot develop without the appropriate legal framework. This framework should clearly state:

Who can borrow: local authorities, utilities (note that for the same service, public authorities will generate municipal debt, while private operators generate corporate debt; how do these two categories cohere?), special asset companies?

For what purpose; long-term debt should be made available for investment only (and not current account deficit);

Subject to what limitations (annual amount of borrowing, stock of accumulated debt);

Which debt instruments are allowed (commercial banks, bonds issuance, access to foreign currency debt?);

What collateral can be pledged by the local borrowers: revenue streams (this has to be legally accepted), real property. In addition, procedures have to be defined for enforcing revenue pledges in the event of default.

This framework should be made compatible with the related system of regulations for banks, pension funds, and insurance companies. In particular, such regulations should state how much these institutions can invest in municipal debt, creating incentive (or disincentive) mechanisms for the market.

This legal framework has to be supplemented by mechanisms that reduce risk to lenders. Such mechanisms rely on:

Strengthened operation and maintenance capacity at utility levels,

Project preparation facilities to develop projects on a financially viable basis,

Guarantees, reserve accounts (which may be partially funded by donors),

Ring fencing revenue flows, to ensure pay back,

Establishing municipal banks and municipal development funds,

Pooling debt of smaller municipalities,

Secondary markets (securizing local loans, re-selling municipal bonds).

Again, the role of central government is key, as the steps have to be identified and planned on a country basis, depending on the current state of the infrastructure and the financial sector, the need for investments, and the political attitude towards future local credit markets. The main dimensions of the part played by central governments, both as direct implication and as facilitation, include:

Effectively control sub-national borrowing, to mitigate the risk of bankruptcy of local governments, and the macroeconomic consequences of the decisions made at the local level;

Support long term savings, for long term credit; this involves support the development of pension funds, and the insurance industry;

Encourage the establishment of rating agencies, for sub-sovereigns, in order to disseminate reliable information on the financial situation of the borrowers;

Support competition between types of lending (banks and bonds);

Support market creation for environmental services;

Facilitate market access, via such means as risk sharing, credit enhancement, subsidies.

… consistent with the broader context of public finance…

Any strategy concerning the development of local capital and financial markets must be compatible with the existing system on which other sources of finance are based, in particular intergovernmental transfers and fiscal autonomy. The objective should be to diminish uncertainties about the resources available to sub sovereign governments, to generate stable streams of revenues for these jurisdictions, and to allow these governments to adapt their revenues to their needs and financing strategies. This would significantly strengthen the creditworthiness of local governments, be they borrowers or providers of guarantees to other borrowers.

Other features of the financial context relate to the way governments, including environmental administrations, mobilize public funds and related means of intervention to stimulate commercial banks' involvement in environmental finance.

Central budget funds can be mobilized to facilitate local governments' access to local financial markets to finance investment in environmental infrastructure. Even very scarce funds can be used creatively to mobilize additional commercial co-financing of environmental projects. For instance, if the lack of access by banks to medium and long term capital is the binding constraint to financing investments, public funds could be used to provide banks with medium/long-term liquidity (e.g. master loans, deposits), earmarked for environmental, commercially-viable projects. In addition to public funds, governments can also use an array of non-financial instruments to facilitate market-based financing of environmental investments, such as commercialization of environmental infrastructure and certain environmental services, information campaigns and reduction of political and regulatory risks associated with environmental investments.

In addition, environmental administrations should carefully review the way they use public money to finance environmental investments in order to phase out practices and financing instruments that discourage banks from financing environmental projects.

Indeed, environmental administrations in EECCA have tended to be part of the problem rather than part of the solution to the banking crisis. Public funds have sometimes been used to finance projects that could have been commercially viable. When financing environmental investments from the budget or extra-budgetary funds, administration at the national or regional levels usually preferred to offer grants covering 100% of project costs or direct loans, rather than using banks as co-financiers or intermediaries. None of the public environmental funds in the region has been encouraged or required to co-finance projects with commercial banks (e.g. by matching grants) or to lend through them in order to increase the leverage effect of public money. Instead, when environmental authorities or even external donors develop new financial products for public environmental funds, they generally chose financing instruments which do not facilitate bank credit to environmental sector, such as direct lending to replace matching grants.

… and with actions taken at the local level

In addition, action taken by central governments on the reform of the WSS sector in EECCA should be implemented in parallel with actions taken at the local level. Here, the focus is on the overall scheme of decentralisation, and on the institutional capacity of local authorities.

Excessive fragmentation can generate sub-optimal provision of public goods. In particular in the water supply and sanitation sector, it can typically fail to exploit economies of scale. In OECD countries, frequent solutions to these problems include:

amalgamation of local authorities. Mergers lead to fewer authorities of larger size; the central government often contributes financially to improve the attractiveness of amalgamation, as it may benefit from lower costs at a local level through the grant system;

a “two-speed” system, where spending responsibilities are assigned in an asymmetric way to jurisdictions with a critical mass and/or sufficient (human, technical) capacity;

ad hoc cooperation agreements among levels of government. One approach relies on a purchaser/provider split: the supply of the service is concentrated in some jurisdictions, which receive some compensation from other jurisdictions benefiting from the service. Another approach is based on joint provision of public services, through jurisdiction associations. Financial incentives may be set out by the central government, as an additional percent of the central governments grants. Many countries have experienced the latter option to provide public utilities, including water supply and waste water treatment.

The impact of the policies envisioned in this paper would be very limited if the local authorities do not develop the capacities to accompany them. In particular, this relates to:

Budgetary decision making at the local level; to make the best use of available resources, and to enhance creditworthiness and the capacity to attract more finance: appropriate planning, realistic strategies, competent management of financial resources, including debt;

Capacity building. Local managers are often given new responsibilities without receiving appropriate training and without corresponding increases in their administrative budgets. Processes for ensuring the prompt flow of resources from the centre to the periphery need to be streamlined, as severe bottlenecks have impeded the local use of allocated funds.

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rights@oecd.org

Fax: +33 (0)1 45 24 13 91

OECD Rights and Translation unit (PAC)
2 rue André-Pascal
75116 Paris
France

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