Technical Report

Municipal Development Fund Office (MDFO) Program Lending Facility (PROLEND) Phase 2: Field Test of Operations Manual

by Raymund Fabre and Jose Antonio League

Prepared for

DOF Undersecretary Roberto B. Tan, and
Ms. Helena Habulan, Executive Director
Municipal Development Fund Office
Department of Finance (DOF)
Republic of the Philippines

Submitted for review to

Office of Economic Development and Governance (OEDG), USAID/Philippines

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Preface

This report is the result of technical assistance provided by the Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE) Activity, under contract with the CARANA Corporation, Nathan Associates Inc. and The Peoples Group (TRG) to the United States Agency for International Development, Manila, Philippines (USAID/Philippines) (Contract No. AFP-I-00-03-00020-00, Delivery Order 800). The EMERGE Activity is intended to contribute towards the Government of the Republic of the Philippines (GRP) Medium Term Philippine Development Plan (MTPDP) and USAID/Philippines' Strategic Objective 2, "Investment Climate Less Constrained by Corruption and Poor Governance." The purpose of the activity is to provide technical assistance to support economic policy reforms that will cause sustainable economic growth and enhance the competitiveness of the Philippine economy by augmenting the efforts of Philippine pro-reform partners and stakeholders.

Department of Finance (DOF) Undersecretary Roberto B. Tan requested EMERGE, by letter dated June 15, 2005, to assist the DOF Municipal Development Fund Office (MDFO) to develop guidelines, selection criteria, and a menu of options for policy objectives and conditionality for its Local Government Unit (LGU) Program Lending Facility (PROLEND). EMERGE engaged Raymund Fabre, LGU Credit Finance Expert and Team Leader, Erlito Pardo, LGU Policy and Institutional Expert, and Benedicto Rayco, Media Specialist, for this task, who worked closely with Ms. Helena Habulan, Executive Director of MDFO. The results of their extensive process of consultations with the multi-agency MDFO Policy Governing Board, MDFO operations staff, LGU leaders and others have been distilled in a draft MDFO Operations Manual for the PROLEND program, as reported previously. The second phase of this TA, to help MDFO field test the manual and reconsider its interest rate provisions, was undertaken by Raymund Fabre and Jose Antonio League, whose summary reports are included here. MDFO held a formal launching workshop of its PROLEND Program on August 6, 2007, at the Pan Pacific Hotel. Around 100 participants, mostly from local government units, attended the launching ceremony.

Municipal Development Fund Office (MDFO)
Program Lending Facility (PROLEND)
Phase 2: Field Test of Manual

by Raymund Fabre and Jose Antonio League

Status Report:
Jose Antonio League
EMERGE-PROLEND Consultant
August 12, 2007

1. Iloilo Province Policy Program Proposal

1.1 The Policy Program Proposal consists of the Hospital Based Quality Assurance program and the Real Property Assessment Computerization Program. The Hospital-Based Quality Assurance Program seeks to provide sustained and improved quality of hospital services through the increase of revenues from hospital operations; improvement of expenditure management and expansion of PHIC coverage. The proposal aims to achieve these with the construction of 80 additional private rooms; procurement of laboratory and medical equipment for all District Hospitals and the Iloilo Provincial Hospital; renovation and expansion of laboratory and radiology areas in all District Hospitals; hospital personnel recruitment; conduct of training programs; improvement of expenditure management (through computerization of procurement, inventory, billing and collection, and financial management; establishment of medical data base and establishment of e-network covering all district hospitals); and expansion of PHIC coverage. The target beneficiaries of the program are the 11 District Hospitals and the Iloilo Provincial Hospital which together provide medical care to residents of all 42 municipalities and 1 component city in the province.

1.2 The RPTA Computerization Program seeks to improve the revenues of the provincial and municipal governments by establishing and maintaining a computerized real property tax assessment system in the 42 municipalities of the Province to ensure accurate and efficient real property tax assessment records; ensure fast and easy access to tax information, improve billing, increase tax collection; and reduce cost of real property tax administration. The proposed real property tax assessment system includes the installation of real property tax assessment software with data export facility for interfacing with existing computerized real property tax collection system; deployment licenses for 43 users; hardware and LAN connection of the 42 municipalities to the Provincial Assessor's Office and key departments; training and mentoring on system installation, set-up and configuration; customization to needs of users; technical support during data entry and real property database build up. Because the Provincial Treasurer's Office is already computerized, the proposed real property tax assessment system will be designed for interfacing with the existing real property tax collection system which includes forms and cash disbursement modules.

1.3 The draft of the Policy Program Proposal was prepared in June 2007 but could not be finalized because of the uncertainty of the Provincial Technical Committee, led by the Provincial Planning and Project Development Officer, regarding the final allocation of the policy loan between two policy programs: the Hospital Based Quality Assurance Program and the Real Property Tax Assessment Computerization Program. Both programs aim to increase locally sourced revenues and lessen IRA dependence of the Province.

1.4 Compounding the impasse was the continuing debate among the Office of the Provincial Treasurer, the Management Information System Office and the Office of the Provincial Assessor on the best approach to the computerization program. The Office of the Provincial Assessor strongly favored the Negros Occidental system which was being marketed by a private software firm, Infoman. However, the Office of the Provincial Treasurer and the MIS Office believed that the Negros Occidental system is too expensive particularly if it will be given to all 42 municipalities in the Province. Furthermore, the Office of the Provincial Treasurer and the MIS office cited provisions in the Infoman proposal which they considered disadvantageous to the Province.

1.5 The new Sangguniang Panlalawigan (Provincial Board) is headed by Vice Governor Rolex Suplico, an avowed political adversary of the Governor. The opposition holds the majority in the Provincial Board and this has further delayed the approval of the Policy Program Proposal.

1.6 The consultant traveled to Iloilo in early July and August 5-10, to work with the Iloilo provincial officials in finalizing the Proposal. Last week the Provincial Technical Committee decided to support the Hospital Based Quality Assurance Program and provide it with PhP153 m. out of the proposed P200m policy loan. The Committee decided to treat the Real Property Assessment Computerization Program as a development project and not a policy program. The Committee allocated the remaining PhP 47 m. for the Computerization Program which will now cover only 14 of the 42 municipalities.

1.7 The Province has agreed to finance the initial phase of the Computerization Program which will focus on the Office of the Provincial Assessor. The Bidding and Awards Committee reviewed the Terms of Reference and the bid documents prepared by the Office of the Provincial Treasurer last week and agreed to an open bidding for the program.

1.8 The consultant met with Governor Neil Tupas who reiterated his desire to pursue the programs and tasked the Provincial Administrator and the Head, Provincial Planning and Development Office to undertake all necessary actions to have the Proposal submitted to MDFO at the earliest possible time. The Head of the Provincial Planning and Development Office assured the consultant that the Proposal will be submitted to MDFO before the September Policy Governing Board meeting.

2. <u>Rizal Province Policy Program Proposal</u>

2.1 The Policy Program Proposal aims to undertake strategic policy reform in the area of local finance by strengthening, expanding and mobilizing its local revenue base and decreasing its dependence on IRA. The Provincial Government proposes a program for computerization of the revenue generating operations as a strategy to attain greater resource sufficiency and improve efficiency in revenue generation and management; internal control and financial management; resource management; service delivery; and monitoring and regulatory capabilities. The policy program consists of the provision of a comprehensive package to automate income generating and fiscal management operations of the Provincial Government and linking the Provincial Government with its thirteen (13) municipalities. The comprehensive package includes: hardware and government application software such as Real Property Tax Administration System; Treasury Operations and Income Monitoring System; Government Appropriation and Accounting System; Budget Management and Monitoring System; Personnel Management Information and Payroll System; Integrated Geographic Information System; General Services Management System; Legislative Information System; and Executive Information System. The proposed Program also includes technical services and data build up including on-site supervision of data encoding; and consolidation, cleansing and generation of predefined records.

2.2 Priority development projects reflected in the Provincial Development Plan and Annual Investment Program such as the: upgrading of tertiary hospitals in Angono, Jaja-jala, Morong, and Antipolo City; and the upgrading and expansion of the solid waste disposal facility in Rodriguez are also proposed to be financed from the Program Loan. The proposed Program Loan package amounts to P200 million.

2.3 Similar to the Iloilo Proposal, the core of the Proposal including deliverables, work program and program cost was prepared in June. However, key data required to finalize the Policy Program Proposal have not been submitted yet. These data includes historical data on real property tax performance; detailed description of software modules and expected benefits from each module; cost breakdown by component; and detailed project description of proposed development projects.

2.4 In several meetings with the consultant, the new Governor clearly defined his vision and emphasized the importance of the proposed policy program to the fulfillment of his vision. He also gave full support to the head of the team in the preparation of the proposal and loan negotiations.

2.5 However, work in Rizal is hampered by the lack of participation of the concerned provincial offices such as the Provincial Assessor’s Office, Provincial Treasurer’s Office, Provincial Planning and Development Office and the Provincial Engineering Office. The team is headed by the Provincial Economic Development and Special Projects Officer and composed of two of his staff with occasional participation of the Provincial Accountant. The limited access to other offices hampered the preparation of the policy proposal. The limited technical expertise of the Rizal team necessitated a much deeper involvement of the PROLEND consultant in the preparation of their policy program proposal.

2.6 The Head of the Technical Team assured the consultant that the data will be ready and submitted by the middle of August. The Provincial Board is allied with the Governor and does not seem to pose any obstacle to the approval of the proposal. The consultant and the Team agreed that the Policy Program Proposal will completed and submitted to the MDFO prior to the September Policy Governing Board meeting.

3. **Misamis Occidental Policy Program Proposal**

3.1 The Misamis Occidental Policy Program Proposal aims to enhance real property tax collection and improve locally sourced revenues of the Province through the expansion and rationalization of the existing real property tax assessment and billing collection which have two different software systems funded by USAID and AusAID.

3.2 Five municipalities are covered by the USAID funded LGSP and have computerized assessment and billing and collection systems. The rest of the municipalities received assistance from the AusAID funded PALS to computerize assessment with linkage to the Provincial Government. Of these, six municipalities have already been linked to the Provincial Assessor’s Office.

3.3 The Policy Program consists of the following: completion of deployment of PALS assessment system to the remaining 8 municipalities; development of computerized billing and collection systems for 9 municipalities; reprogramming of billing and collection systems of the 5 LGSP municipalities; and computerization of Provincial billing and collection system and completion of provincial and municipal assessment and billing/collection linkage/network. The total policy loan is estimated to be PhP 100 million.

3.4 The deliverables, work program and total project cost have already been determined and completed. However, additional data required to complete the proposal have yet to be submitted and all attempts to follow up with the Provincial Team proved futile. The Governor, who is also the newly elected President of the League of Provinces, was invited to the PROLEND launching but did not attend. Provincial officials contacted regarding the interest of the province to pursue the PROLEND proposal could not give any definite answer.

3.5 The consultant will complete the Proposal using available data and submit it to the MDFO and the Provincial Government by the end of August. However, if the Misamis Occidental Provincial Government confirms its interest to pursue the program, the consultant is prepared to travel to the Province to complete the work as planned.

4. Observations

4.1 The time allotted to prepare the proposals is too short considering that the undertaking was started during the height of the campaign period for the local elections when local government officials and staff were too busy with the campaign and could not devote ample time to prepare the proposal.

4.2 Due to the uncertainty regarding the eventual composition of the provincial governments, governors and other provincial government officials could not assure early on that the proposed programs will be pursued until the new set of officials assumed office in early July.

4.3 Even under normal circumstances, the two and a half months given to prepare the proposal is not sufficient. Given the inadequacy of technical staff and expertise in many of the provinces, even a simplified Prolend process will take a longer time to complete. Moreover, technical staff with experience and expertise to prepare the proposals are few and are normally overworked and engaged in several key activities in the provincial government. Thus, the time they can allocate for proposal preparation is extremely limited.

4.4 The experience of the consultant in the three provinces, showed that there is a need not only to provide advise and guidance but to do a “learning by doing” capacity building exercise. If the provincial teams will be left to prepare the proposals themselves with minimal guidance from MDFO or consultants, the process will definitely take much longer.

4.5 The consultant initially provided technical advise and guidance but realized that the provincial teams were not undertaking the agreed tasks during periods between missions. Thus, the consultant assumed a greater role by engaging the provincial teams in technical workshops and overseeing data gathering. The consultant prepared the drafts for review of the provincial teams and conducting workshops to explain how particular parts of the proposal were prepared. This process continued for two and a half months until the final drafts were prepared.

4.6 The MDFO or its consultants will have to provide extended technical assistance to applicant provincial governments through a ‘learning by doing’ process if it aims to build the capacity of its client provincial governments and ensure the successful implementation and management of the policy reform programs proposed. It is observed that many of the provincial officials and staff have already undergone numerous ‘classroom-type’ training programs over the years but there seems to be a disconnect between the ‘knowing’ part and the ‘doing’ part.

4.7 Provincial governments like many local governments are not a homogenous class. They are as varied as there are provinces. Politico-administrative cultures differ from one province to the other. The technical capacity and expertise vary widely from one province to the other. Thus, they cannot be expected to respond to PROLEND (or for that matter any lending facility) in similar ways. It will take time and a lot of effort to bring them to a level of competence in preparing proposals and much more in managing programs.

4.8 It may be necessary for MDFO to assess the proposed policy reform against the development framework of the province. Because of the predominance of real property computerization programs among the initial policy programs proposed, it may become the main policy program adopted by provincial governments even if the impact of such may be limited in some provinces, particularly highly rural provinces. The MDFO team must be aware of the conditions and problems in the provinces prior to the initiation of talks regarding the preparation of proposals. In this way, the MDFO can provide guidance and advise on policy reform programs which have the greatest impact on the provinces concerned.

4.9 A factor to consider is the active marketing being undertaken by GFIs like the Landbank, and DBP. These GFIs aggressively push lending facilities and credit lines to provincial and other local governments with very lenient consideration on whether these are priority projects or not; or whether the proposals have undergone rigid review and technical study. It seems that the main consideration is the IRA intercept. This may promote imprudence among borrower local governments and lead to a debt problem in the near future.

4.9 There is a need to revisit the LGU Financing Policy Framework in view of the foregoing and rationalize the LGU financing system to better address the long-term financing, capacity building and development requirements of local governments beyond short-term project needs.

EMERGE MDFO PROLEND
NEGROS OCCIDENTAL PILOT

SUMMARY REPORT
of
Raymund C. Fabre, Consultant
August 14, 2007

I. Assistance to the Provincial Government of Negros Occidental:

EMERGE MDFO PROLEND Consultant Raymund Fabre joined the office MDFO PROLEND Appraisal Team consisting of Ms. Jocelyn Pendon, Mr. Mark Pagulayan, and Ms. Arlene Naag for a 5-day appraisal meeting with key Negros Occidental Provincial officials at the provincial capitol in Bacolod City. These officials were as follows:

1. Mr. Enrique S. Pinongan - Provincial Administrator
2. Mr. Percival Salado, Jr.-Provincial Budget Officer
3. Mr. Ramon Johann Christopher Navarro –EDP
4. Mr. Tito Del Rosario – EDP
5. Mr. Ronnie Almoneda – EDP
6. Ms. Mina Pellejo - Operations Manager DBM-PS
7. Mr. Roy Balicas - Provincial Consultant on Financial & Mgt. Affairs

The Provincial officials explained that since 2001 the Province of Negros Occidental had been working to improve resource generation, expenditure management, and more efficient public service through the electronic interconnection of its component cities and municipalities as well as the province-run hospitals. In this regard, the provincial government would now like to focus on implementing reforms in resource generation and budget management (Revenue-Related Reforms) and hospital service reforms (Health-Related Reforms) in a majority of its component LGUs and selected provincial-run hospitals.

Under the Section 271 (a) of the Local Government Code of 1991, the province and the city share the proceeds from the collection of real property taxes 35-40 with the greater share going to the municipality and the balance of 25% to the barangay. Under the Code, the province is responsible for the conducting the real property assessment needed to determine the amount of the tax while the municipality is responsible for collecting the tax. Consequently, there is substantial incentive on both the province and the municipality to cooperate in real property tax collection in order to maximize their revenues from this tax. However, much of the tax-related information needed from the municipality is not available in a timely and organized manner to the provincial government due to the lack of telecommunications and computer-related investments on the part of the municipality. The lack of accurate and current information from the municipality and delays from having to rely on physically delivering the information to the province has resulted in inefficient collection of real property taxes. Given this, the Province has determined that the best way to break this information impasse is to improve coordination between the municipality and the province by electronically linking the taxing operations of the province and the municipality. The Province believes that this will result in a more efficient synchronization of real property tax assessment and tax collection.

Under this governance reform program, the Province will utilize the loan proceeds to 1) acquire the necessary computer hardware; 2) install and configure the hardware in the provincial capital and the selected municipalities; 3) set-up broadband internet access; 4) train provincial and municipal personnel who will man and maintain their respective systems; 5) ensure the activation of the broadband internet access and the FTP server. Given the existing state of communications technology available in the province, the reform is targeted at eleven (11) municipalities.

Under this same ICT infrastructure, the Province will also pursue improvements in service delivery. More specifically, the Province will build on this ICT infrastructure to improve service delivery in the health sector or the provision of hospital services. Currently, the provincial government operates a provincial hospital, nine district hospital and two primary hospitals. The farthest hospital in the north is 130 kilometers from the capitol while the farthest hospital in the south is 190 kilometers from the capitol. The distance between the provincial-run hospitals and the provincial capitol has prevented the Provincial Government from effectively addressing the financial and administrative concerns of the hospitals which has resulted in the weak ability of these district hospitals from effectively servicing their respective communities.

In order to address these issues resulting from physical distance, the Province will be building on the aforementioned ICT infrastructure to link the financial and administrative functions of four (4) hospitals, the provincial hospital and the three (3) district hospitals, with that of the Provincial Capitol’s key departments. For this policy reform, the Province will 1) acquire the necessary computer and communication hardware for the hospitals; 2) install and configure the hardware in these hospitals; 3) establish the networking of the provincial and district hospitals; 4) establish the outsourcing of hospital billing and patient management systems; 5) set the hospital’s broadband internet access; 6) train the relevant personnel; 7) set up and activate the IPVPN connection; 8) activate WiFi areas in the Capitol, the Provincial Hospital, and at least the 3 aforementioned district hospitals; and 9) activation of VoIP services.

As a result of the investment in these activities, the Province is expected to provide an electronic link-up which will 1) fast-track the processing of documents; 2) cut expenses on travel and other administrative costs; 3) provide real time information to the Provincial Capitol on the financial status and administrative concerns of each hospital; 4) provide access to the hospital chiefs to the Governor through teleconferencing facilities; and 5) improve hospital services by utilizing application systems on patient's medical information/history, medicines and hospital supplies inventory, billing and revenues.

In the course of the 5-day appraisal mission, Mr. Fabre provided the following assistance to the MDFO PROLEND Appraisal Team and the Negros Occidental Provincial Government:

1. Participated in the briefing of the key provincial officials and technical staff on the objectives of the policy reform and the details of the policy reform project;

2. Provided comments on improving the focus and operational details of the policy reform project;

3. Assisted in moderating the discussion on the identification and formulation of the policy deliverables consistent with the approved MDFO PROLEND Operations Manual and the schedule of delivery;

4. Assisted in the identification and estimation of project benefits;

5. Assisted in the negotiation for the amount of the tranche releases;

6. Liasoned with the MDFO Executive Director and the Provincial Administrator on negotiations for the applicable interest rate; and

7. Drafted a Development Policy Letter for the Provincial Government.

As a result of the 5-day appraisal mission, the Provincial Government agreed to:

1. Apply for a PROLEND loan for policy reforms in improving real property tax collections and hospital services. These policy reforms will be achieved by focusing investment in appropriate information and communications technology (ICT).

2. Apply for a PHP 200 million loan for this project.

3. Earmark PHP 50 million or 25% of the total loan for the policy reform project.

4. Ensure a more than 50% plus one number of cities and municipalities covered by the policy reform for both the real property tax reform component and health sector-hospital service improvement

component. With regards to the real property tax reform, the Provincial Government has committed to downstreaming the reforms to 11 out of 19 municipalities, namely, Manapla, Ilog, Banalbagan, Hingaraan, San Enrique, Pontevedra, Pulupandan, Calatrava, EB Magalona, La Castellana, and Moises Padilla. With regards to the improvement in health/hospital services, the Provincial Government has committed to improvement in the hospital services of the province in general and for the following 20 cities and municipalities: Kabankalan City, Sipalay City, Cauyan, Candoni, Hinoba-an, Himamaylan, Ilog, Cadiz City, Sagay City, Victoria City, Escalante City, Manapla, Tuboso, Calatrava, Valladolid, San Enrique, Pulupudan, Pontevedra, Binalbagan and Hinigaran.

5. Negotiate with the MDFO for an interest rate lower than 9% for the loan.

As a result of the 5-day appraisal mission, the Provincial Government agreed to the submitting the following documents to the MDFO for the purpose of drafting the appraisal report:

1. Detailed proposal on the policy reform project based on the discussion;

2. Detailed budget for the policy reform project with fund utilization consistent with the tranche releases;

3. Estimate of the potential financial benefits from the implementation of the real property tax reform program;

4. Development Policy Letter signed by the Governor;

5. A listing, brief description and indicative amount for the development projects to be funded out of the loan proceeds; and

6. A Sanggunian Panlalawigan resolution authorizing the Governor to negotiate for the PROLEND loan.

II. Assistance to the Municipal Development Fund Office:

With the inputs from the Provincial Government, the consultant drafted the appraisal report utilizing the format used for the Surigao del Norte PROLEND appraisal report. The appraisal report was circulated for the review of the members of the MDFO PGB one week prior to the August 6 Board Meeting. The consultant also prepared the PowerPoint presentation for the Board Meeting.

During the meeting, the consultant conducted the presentation of the proposed Negros Occidental PROLEND loan for the approval of the Board Members. The

Board Members approved the loan but raised concern about the amount requested since this would leave only a little over three-fourths of the 2 billion pesos PROLEND fund available for lending (Note: Negros Occidental is a repeat borrower. It had already borrowed 120 million from PROLEND in 2003. Given that Davao del Norte borrowed 60 million, a loan to Negros Occidental of 200 million would result in the PROLEND facility having a balance of 1.52 billion at the time of it launching last August 6). The Board decided during the meeting to approve the loan project but to reduce the amount to PHP 100 million to allow other provinces a chance at accessing the fund. The Board left the MDFO to communicate the decision to the Provincial Government. Additionally, the Board agreed to amend the MDFO PROLEND Operations Manual to limit the total loan amount for any LGU borrower of PROLEND to PHP 200 million or their current borrowing capacity, whichever is lower. The consultant took note of this and has incorporated this in a policy memo. (Note: Please see attached memo).

Prior to the submission of the report, the consultant was in discussion with MDFO Executive Director Helena Habulan and MDFO LOGOFIND Program Manager Jocelyn Pendon on the timing of the Sanggunian Resolution. As a result of the disapproval of the Surigao del Norte Sanggunian of the PROLEND loan after the MDFO PGB had given its approval, the MDFO PGB is now requiring that the Sanggunian Resolution be passed prior to the presentation to the MDFO PGB. The consultant took note of this and has incorporated this in a policy memo. (Note: Please see attached memo).

Finally, prior to the submission of the report, the consultant was in discussion with both DOF Undersecretary Roberto Tan and MDFO Executive Director Helena Habulan to review the PROLEND's interest rate policy in view of the declining T-Bill rates and the current irrelevance of the 9% ceiling. The consultant took note of these discussions and has addressed this in a policy memo.
(Note: Please see attached memo).

Annex 1

13 August 2007

TO: Executive Director Helena B. Habulan, Municipal Development Fund Office, Department of Finance

FROM: Raymund C. Fabre, Consultant-PROLEND Technical Assistance, Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE) Project

RE: MDFO PROLEND Interest Rate Policy and Other Provisions – Review and Recommendation

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1. As part of my terms of reference, I am providing the following review and recommendation on the interest rate policy for the Municipal Development Fund Office (MDFO) Program-Policy Lending (PROLEND) facility as well as other matters related to the MDFO PROLEND Operations Manual (August 31, 2006) arising from the August 6, 2007 MDFO PGB Meeting. This memo is also being written in response to discussions between myself and MDFO Executive Director Habulan as well as concerns raised by Department of Finance Undersecretary Roberto Tan last August 6, 2007 on the MDFO PROLEND interest rate policy vis-à-vis the Treasury Bill rate. Usec Tan expressed concerns that the current interest rate policy of PROLEND may be too low and therefore may not adequately capture the financial risk or the opportunity cost on the use of the funds.

2. Section IV.F.1 of the MDFO PROLEND Operations Manual provides that:

   "The interest rate shall be fixed for the entire term of the loan and shall be priced based on the 2-year Treasury Bill on the day of the loan approval or nine percent (9%), whichever is lower."

3. The formulation of the policy arose from the need to provide an interest rate that was attractive to the potential LGU borrowers interested in borrowing for policy reform activities as well as ensure an adequate return on the funds of the MDFO since the PROLEND would be lending corporate funds or the loan reflows from the Second Generation Fund. The nine percent (9%) ceiling was utilized since this was the rate that was utilized for the pilot PROLEND program in 2002. The 2-year Treasury Bill Rate was used to provide some link to movements in the financial market. Originally, there were suggestions that the 1-year Treasury Bill Rate was to be used since MDFO money market placements did not exceed one year. However, there were also comments that this would not be sufficient to fully capture the risk since there was general agreement in the MDFO and the MDFO PGB to used a fixed interest rate for the loan. The 2-year Treasury Bill Rate was therefore utilized as a compromise.

4. In the process of formulating the MDFO PROLEND Operations Manual, the DOF instructed me to conduct consultants with Drs. Noet Ravalo and Dante Canlas. Both Drs. Ravalo and Canlas were at that time advising the DOF on rationalizing the interest rates being charged by the different government lending entities. It was during this meeting that Dr. Ravalo recommended that the MDFO PROLEND should only be charging an interest rate equivalent to the 1-year T-Bill rate and re-price the rate annually. However, it was pointed out also to Dr. Ravalo that the development policy of the MDFO was to provide a fixed interest rate for the entire period of the loan. To this Dr. Ravalo commented that the relevant interest rate should then match the term of the loan. If the loan term was 10 years, then the relevant rate should be the 10-year T-Bill rate.

5. When these comments were first presented to the MDFO PGB in 2006, there was great concern that the interest rate would no longer be competitive and that no province would be interested in availing of PROLEND especially if a service charge of 2% were to be tacked on to this rate. However, given the recent downtrend in the T-Bill rates, there is now room and comfort to consider a revision in the interest rate policy.

6. In recommending a new interest rate policy for PROLEND, two factors should first be considered. First, the MDFO is an office of the Department of Finance and therefore its costs are borne by the National Government. Because of this, there is no financial obligation on the part of its products to support the operating cost of the office since no part of the loan reflows currently go to financing the regular staff or daily operations. Because of this, the PROLEND interest rate need not include a charge to cover for administrative operations.

7. It has been argued that this is no reason not to charge for services since this should be accumulated for the eventual spinning off of the MDFO as an independent financing institution. However, this is still in the uncertain future and no timetable has been currently adopted as to when this will happen. Even if it is decided that the PROLEND should cover the cost of administration, this cost should be equitably spread among all the financing facilities of the MDFO not only the PROLEND since they all share the same administrative support system. Until such a study has been completed, there is very little economic reasoning to tack-on a 2% service charge on the T-Bill rate other than it may be common practice among other government financial institutions.

8. Secondly, because the MDFO enjoys an IRA intercept, the risk of default is practically zero. In the event the LGU defaults on the payment of its interest and amortization of principal, the Department of Budget and Management can deduct this payment from the LGU's IRA prior to release. This action is legally supported by both the Local Government Code of 1991 and its IRR.

9. Under the Code, the risk of default is also minimized, at least for the MDFO. First, the LGUs are restricted from utilizing more that 20% of their regular

income for the payment of interest and amortization of principal. This effectively puts a limit on the amount that they can borrow. Second, under the Code, the local treasurers are appointed by the Finance Secretary subject to three recommendations by the Local Chief Executive (LCE). This allows the DOF, or more specifically, the Bureau of Local Government Finance some measure of moral suasion on the local treasurer who is responsible for ensuring the servicing of the loan.

10. Given the two conditions where administrative cost is zero and default risk is nil, then the only financing risk is the opportunity cost of capital or the alternative use of the fund. Since the MDFO's major treasury operation is investing in Treasury Bills, then the T-Bill rate should be the appropriate measure of the opportunity cost of capital. Given that the loan will be tied up with the LGU for 10 years, then the opportunity cost of capital should be the 10-Year T-Bill Rate. Furthermore, if we agree that the administrative cost and the default risk are both zero, then the appropriate interest rate should be equal to the opportunity cost of capital or the 10-Year T-Bill Rate.

11. Given this reasoning, it is recommended that Section IV.F.1 of the MDFO PROLEND Operations Manual be revised to the following:

    "The interest rate shall be fixed for the entire term of the loan and shall be priced no higher than the 10-year Treasury Bill on the day of the loan approval."

    The rationale for the original wording of the provision remains applicable for this amendment.

12. Given this amendment, adjustments need to be made on one other section of the MDFO PROLEND Operations Manual. This is Section IV.F.2 which reads:

    "In the event that the borrower LGU commits forty percent (40%) or more of the loan amount for the policy reform, the interest rate shall be fixed for the entire term of the loan and shall be priced one percent (1%) less than 2-year Treasury Bill on the day of the loan approval or nine percent (9%), whichever is lower."

13. The following amendment for Section IV.F.2 is recommended to make it consistent with the amendment on Section IV.F.1 and to provide some flexibility to the MDFO PGB in the extent that it may wish to reward the LGU for its dedication to the policy reforms:

    "In the event that the borrower LGU commits forty percent (40%) or more of the loan amount for the policy reform, the interest rate shall be fixed for the entire term of the loan and shall be priced no higher than one percent (1%) less than 10-year Treasury Bill on the day of the loan approval."

The rationale for the original wording of the provision remains applicable for this amendment.

14. Due to concerns about the funds available for interested provincial borrowers, the MDFO PGB has recommended a maximum loan amount of PHP 200 million for each LGU borrower. This will require an amendment to Section IV.Q.1 which currently reads:

    "There are no restrictions on LGUs who have borrowed from the PROLEND facility from applying for and availing of another PROLEND loan. The repeat borrower must apply again and their application will again be subject to the same procedures as above. However, the approval of subsequent PROLEND loans to the repeat borrower will be subject to an appraisal of their performance in the use and servicing of previous PROLEND loans, evaluation of the LGU's performance in servicing debt on other borrowings, the MDFO's assessment of the merits of the new proposed policy reform program, and the discretion of the MDFO Policy Governing Board. "

15. The proposed amendment to the above is as follows: ***(Note: Amendments in bold italics.)***

    "There are no restrictions on LGUs who have borrowed from the PROLEND facility from applying for and availing of another PROLEND loan. ***"However, the maximum loan amount for each LGU borrower under PROLEND should not exceed PHP 200 million or their current borrowing capacity, whichever is lower. Eligible return borrowers may only avail of a loan amount equivalent to PHP 200 million or their current borrowing capacity, whichever is lower, less their remaining loan balance."*** The repeat borrower must apply again and their application will again be subject to the same procedures as above. However, the approval of subsequent PROLEND loans to the repeat borrower will be subject to an appraisal of their performance in the use and servicing of previous PROLEND loans, evaluation of the LGU's performance in servicing debt on other borrowings, the MDFO's assessment of the merits of the new proposed policy reform program, and the discretion of the MDFO Policy Governing Board. "

16. It has also been recommended by MDFO PGB that the issuance of the Sanggunian Panlalawigan Resolution should now be moved up from the Loan Effectivity Stage to the Appraisal Stage.

17. For your information.