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**Concept Paper:  
Introduction to Pooled Financing**

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## **Introduction**

In 2003 at the Third World Water Forum in Kyoto, the United States proposed that a lesson it had learned about financing water facilities in its own back yard could help the rest of the world meet the millennial goals for water supply and sanitation. This lesson was that by helping our states create capital pools to facilitate water investments, our national government had found a way to bring the power of private capital markets to local utilities.

Our states had already begun this process by creating their own “bond banks” to build economies of scale. Lots of little projects could be funded better and more cheaply if they were pooled. The national government went further by helping the states and changed what had been grants to cities for water systems into block grants to states to create "revolving funds." The essence of revolving funds is that the money, once repaid, does not go to a general fund, but rather back to the loan fund so it can be re-loaned. States got even smarter in many cases and used the funds as collateral and borrowed into the capital markets against these funds by issuing bonds and were able to lend even more to their cities and utilities.

In Kyoto the US argued that revolving funds and/or bond banks can be created in most developing countries. Their precise structure only needs to be tailored to the state of development of the domestic financial services industry as well as the local legal regime for commercial credit. Creating these institutions takes time and patience, but it is neither impossible nor even very difficult, and it is an extremely worthwhile thing to do.

## **What This Paper Covers**

This paper provides an overview of the US state pooled financing facilities including benefits, operations, ownership, management, financial structures, security provisions and credit enhancements. It also provides brief summaries of special lending programs in developing countries that have operations similar to U.S. pooled financing programs. It is intended to help Missions assess the value of a pooled financing facility in their respective countries and identify issues than need to be addressed in moving a pooled financing initiative forward.

Several countries in the Europe and Eurasia region are currently considering establishment of pooled financing facilities to accelerate investments in local infrastructure projects. Pooled financing is a well established and highly successful means of mobilizing private financing for municipal projects in the United States.

U.S. pooled financing facilities generally fall into two main categories: state revolving funds (SRFs) and state bond banks (SBBs).

In the U.S., a mechanism known as a State Revolving Fund has been used by many states to develop credit support for the financing of local government water and sanitation projects. The SRF structure is recognized by the credit rating agencies as being very strong. It justifies investment grade ratings without federal or state guarantees. Using this mechanism, municipal projects can be financed with private capital obtained from lenders at excellent terms.

While U.S. revolving funds receive capital grants from the U.S. federal government on an annual basis and are based on common objectives, each state's fund is unique to the legal and regulatory environment of that state. SRFs also reflect special state policy considerations regarding technical assistance, leveraging strategies, management structures, and lending policies.

In addition to revolving funds, many states have established SBBs that are similar to revolving funds but often do not rely on government grants for capitalization and often support financing of infrastructure projects in a number of sectors such as education, public buildings, transportation, energy, and health care facilities. Although all SBBs access private capital markets by issuing debt, there is no typical type of financial assistance that all bond banks offer -- each has developed differently based on statutory mandate, political backing, state financial support, and local financial needs. Thus, it is not surprising that the composition of programs and program structures of each bond bank are markedly different from one another.

Several SBBs offer numerous financial products including long-term debt financing, lease financing, short-term cash-flow financing, refinancing of long-term debt, and public/private partnership financing.

State pooled financing programs therefore provide a wide variety of structures and approaches to financing local infrastructure projects.

## **Pooled Financing Facilities**

### **Overview**

In the United States, where many small municipalities lack the knowledge of financial markets and need to borrow relatively small amounts of capital, the process of raising private financing can be difficult and costly. Local governments in Eastern Europe and Eurasia face similar challenges.

Municipal bond banks or pooled financing facilities first appeared in the United States in 1970 for the purpose of lowering the cost of debt for municipalities. Since that time, they have been offering a unique and advantageous mechanism for small communities to finance municipal projects.

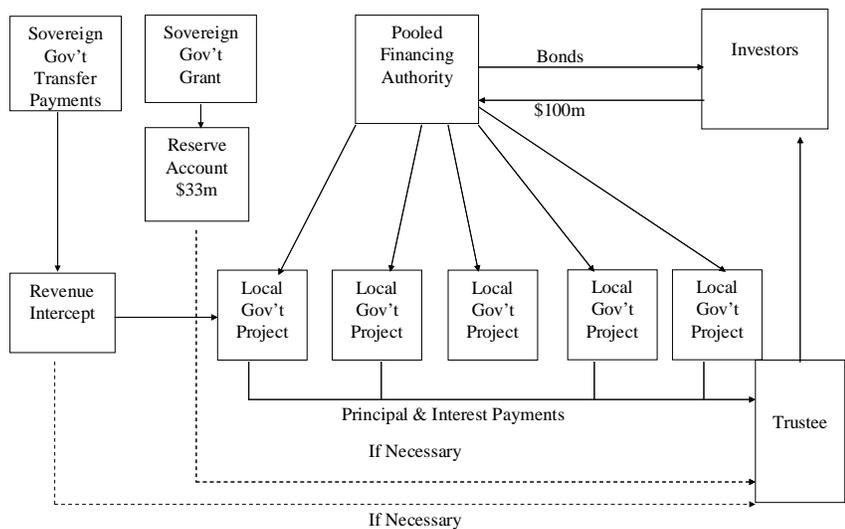
These institutions are established as government entities or agencies that pool a number of local projects for financing. By “pooling” multiple municipalities’ borrowing needs together, SBBs can offer larger debt issues, with better credit ratings. Because pooled issues can be structured to achieve high credit ratings in the primary market, debt servicing costs will be reduced. Savings are also realized through a reduction in transaction costs associated with the economies of scale in the underwriting process.

Pooled financing entities usually operate without state guarantees. As such, they mobilize private financing for local governments without adding to sovereign/state debt or contingent liabilities. Many of these institutions, however, do involve some commitment of state government funds in the form of grants to enhance the pooled financing. In these cases, the government funds are designed to leverage private investments.

Detailed below is a representative example of flow chart for a pooled financing entity.

Chart I

Simplified Flow of Funds for Pooled Financing  
100 Million



This structure is often called a “reserve account” model, where U.S. government grants are placed in a reserve account and held as collateral for investors in the event any local project fails to make a required debt service payment. The grants typically equal 1/3 of the pooled facility financing. As a result, the federal grants leverage private sector financing on a 3:1 ratio. In this model, intercepts of grants to local governments are also used to credit enhance the financing.

## **A. Benefits**

### **1. Improve Market Access**

SRFs and SBBs provide access to private capital markets for communities lacking the financial, scale, expertise and credit history to go to the private credit markets on their own. Pooled financing institutions serve as a creditworthy link between local projects and sources of capital. In addition, SRFs and SBBs can provide finance and project development expertise to local governments through technical assistance services. In this manner, these institutions can perform functions that local governments are unable to undertake using existing staff resources. They also perform functions that private sector lenders/investors do not want to undertake in the form of project preparation and development.

### **2. Lower Transaction Costs**

By pooling a number of smaller projects for financing, the transaction costs of borrowing for the localities can be substantially reduced. This is due to the fact that the transaction costs of one financing can be spread over multiple projects. Moreover, to pool projects for financing, individual loan agreements with local governments must be standardized. This also reduces transaction costs.

Standard loan agreements with specific terms, conditions and collateral requirements also allow local governments to determine at the outset of project development whether local governments can qualify for financing. This is in contrast to project financing where local governments engage in negotiation with private investors without knowing the exact terms of the financing until the negotiations are completed.

The standard loan agreements and eligibility requirements of pooled financing facilities serve as a screening device for local governments and their proposed projects. By reviewing these documents, local governments know in advance what must be included in a pooled financing program. This is helpful in emerging economies where local governments may be inexperienced in private sector financing.

Table I provides an example of the size of projects that are commonly pooled for financing. Note that the average size of projects for many pooled financings is below \$5 million.

**Table I**

**Profile of Pooled Financing of Waste Water Treatment Plants in New York State**

EFC Financing (US\$ in Millions)				
Offering	Number of Borrowers	Bond Amount	Average Project Size	Average Interest Rate of bonds*
1999	29	\$ 80.3	\$5.6	3.50% to 4.75%
1998	59	\$248.3	\$4.2	3.50% to 5.20%
1997	29	\$147.6	\$5.6	3.40% to 5.65%
1996	42	\$326.7	\$8.0	2.95% to 5.20%
1995	15	\$ 75.5	\$5.0	3.45% to 5.40%
1994	18	\$ 56.6	\$3.1	3.00% to 6.85%
1994	41	\$261.2	\$6.3	4.10% to 6.85%

\*Tax-exempt

**3. Lower Borrowing Costs Through Credit Enhancements**

Most states provide additional interest rate savings to local borrowers by providing some form of credit enhancement to pooled financing issues. As a result, the credit ratings of pooled financing facilities are generally higher than those of most local governments included in the financing.

The type and level of state credit support can vary and is dictated by statutory, financial, and political limitations.

**(a) Reserve Accounts**

Many SRFs will place their annual U.S. federal capital grant in a reserve account which is pledged as collateral to investors in the event any borrower fails to meet debt service obligations. This is referred to as the reserve account model. See Chart I.

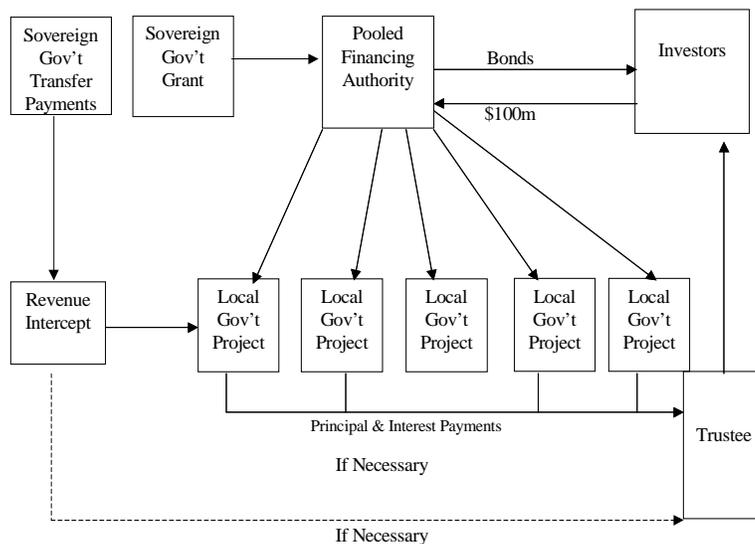
**(b) Cash-Flow Over-collateralization**

Some SRFs lend their annual capital grant funds to local governments and pledge the repayment of those loans to investors. In this case, the investors will

have as collateral the repayment of loans from the pool of projects they finance plus the repayment of loans made with federal funds. This is referred to as the cash-flow model as presented in Chart II.

Chart II

Simplified Flow of Funds for State Revolving Fund Financing  
\$100 Million



(c) Transfer Intercepts

Many SBBs and SRFs have statutory authority to intercept state transfers to local governments if the latter should default on obligations to repay loans. This intercept mechanism is viewed favorably when the local governments depend on state transfers for a large portion of their revenues and when the state transfers can be redirected from the pooled financing facility to investors. Intercept mechanism have been used extensively in the U.S. and emerging markets as a source of security for local government financing.

Credit enhancements provided by the national government for local borrowers through a pooled financing facility can help mobilize private sector financing of local projects in countries where local governments are perceived as a higher credit risk. It is also economical and administratively simple to provide credit enhancement through a pooled financing program rather than on a case-by-case basis.

Depending on the circumstances, a bond bank may use a combination of state credit enhancements.

#### **4. Leveraging Government Resources**

Another advantage of pooled financing is that by lowering the costs of borrowing, more local jurisdictions can transition from reliance on national government grants to private sector financing of local projects. In the grant reserve model, every dollar of federal government support typically leverages three to four dollars of private sector financing.

Cash-flow models can obtain higher leveraging ratios depending on the structure of the program.

In countries where the national government is providing long-term financing to local governments by on-lending funds from multilateral banks, pooled financing can help transition local governments from dependence on sovereign loans resources to private financing. Financing local infrastructure projects through national sovereign loans is not sustainable in the long term.

#### **5. Self-supporting Operations**

Most well designed pooled financing facilities are financially self-supporting, and are not reliant on the government to provide new capital grants each year. Sustainable pooled facilities rely on a variety of sources to pay for operations, the most common being interest charges and fees charged to local borrowers. Some SBBs levy lump-sum fees at closing while others charge an annual fee based on outstanding loan amount, or mark-up interest rates. No particular fee method is predominant. However, given the expanded access to financing, lowered costs of borrowing, and lowered general transaction costs of pooled financing institutions, local governments find the fee structures reasonable.

#### **B. Ownership**

All pooled financing institutions in the United States are owned and operated by government agencies.

There are several reasons for this. First, it allows the institution to issue bonds on a tax-exempt basis. This is a unique feature of the local government finance system in the U.S.

Second, and more importantly, publicly owned and managed pooled financial institutions keep the costs of financing to local governments at a minimum. Public institutions do not pay dividends, seek rates of return to satisfy equity investors, or pay taxes. If these costs were added to the operation of the

institutions, they would be charged to local borrowers. This would conflict with the objective of mobilizing private capital at the lowest possible costs to local borrowers.

Third, Bond Banks were created because the private capital markets showed little interest in lending to small-scale projects. Transaction costs and the difficulty of dealing with local governments with limited project development and finance experience made this market unattractive. As a result, U.S. state governments created Bond Banks to facilitate financing of smaller infrastructure projects.

In general, smaller local governments need to finance a major water or sewerage project once every ten or twenty years. They do not keep project financial experts on staff. Bond Banks can offer special transactional expertise and capacity building to local governments.

Most pooled financing facilities are created by state law and have no taxing authority. In most cases, they are considered independent authorities and are not backed by the credit of the state government. In some cases they are located within and subordinate to other parts of their state government. However, in these cases they generally do not have the full faith and credit backing of the state government.

Creating a pooled financing institution by legislative enactment may be time consuming and impractical in some countries. In these cases, existing institutions such as government loan facilities for local governments and national environmental funds may be able to transition to a pooled lending role without legislative approval. If these existing institutions have a strong performance record (low levels of loan defaults), they may be able to transition to a capital market-linked revolving fund or bond bank.

Experience in the U.S. tells us that the institutions do not need to be privately owned or managed to attract private financing. Some specialists have advocated the privatization of on-lending institutions to facilitate the transition to private sector financing. In most cases, it may be most effective to transition to the revolving fund or bond bank model.

There may be cases where the private sector lacks confidence in a public sector institution's capacity to operate a financial facility. This perception may be driven by the poor performance of an on-lending institution such as the RDA in Indonesia (with a 50% default rate), or the collapse of the Environment Fund in the Ukraine due to perceived corruption and bad management. The final arbiter on the ownership of the pooled financing institution will be private lenders. However, given the basic goal of lower costs of financing, public ownership is often the preferred option.

### **C. Management**

Sound, professional, and competent management is critical to the success of a pooled lending institution. Management must be able to command the respect of the private sector and the cooperation of local borrowers. The principal responsibilities of management are to:

- Prepare business plans for the facility;
- Develop project application and evaluation procedures and documents
- Assess proposed projects against established underwriting criteria
- Develop transaction documents for financing
- Interact with potential investor/lenders to market the pooled financing
- Manage disbursement of funds from the pooled financing
- Monitor project development and borrowers' repayment activities
- Manage the facility's cash flows and financial obligations.

Senior managers of pooled financing institutions are typically drawn from the private sector or other state agencies with extensive municipal finance experience. Given the depth of municipal finance in the U.S., several state agencies (housing, transportation, health care, education, and others) that are engaged in public finance and produce qualified experts in this area. Governors often draw from this talent to manage pooled lending institutions.

This may not be the case in most countries in the region. In cases where on-lending institutions are currently well managed with an excellent track record of performance, management of these institutions may be able to undertake the task of running a pooled lending institution. In circumstances where there are no on-lending or government sponsored lending institutions from which to draw talent, a country may consider contracting management to a private sector firm.

Selection of a local private bank to run the pooled financing facility could be another option as long as the terms of the management agreement reflect the principals of lowest costs capital to local borrowers. To ensure best efforts by private management of a facility, the contract could include penalty and incentive clauses for management compensation.

### **D. Investor/Rating Agency Views of Pooled Financing Facilities**

Because pooled financing institutions differ from state to state, U.S. rating agencies do not have a rigid set of criteria that are applied to each pooled

structure. Facilities with the highest ratings, however, share several characteristics including:

- strong state support
- solid management
- creditworthy borrowers
- thorough loan underwriting and monitoring practices
- effective legal protections
- conservative investment policies

Rating agencies will review each of these measures in reaching a determination of the rating to be provided for a particular financing.

The composition of the pool of projects will also be a factor, especially if one project represents a large percentage of the total financing or if the pool of projects is relatively small. For pools of projects less than 10, most rating agencies will rate the pool against the “weakest link” or least creditworthy project in the pool. Similarly, if one project in a pool represents more than 25% of the total borrowing, the benefits of risk diversification are mitigated and the rating for that pool of projects may be reduced due to concerns about concentration of risk.

### **E. Legal Arrangements**

When investors consider lending through a pooled financing institution, they generally consider three key factors - the management of the entity, credit enhancements and the legal agreements that underpin the financing of projects. One advantage of pooled facilities is that they use standard transaction documents which reduce transaction costs for each project.

The typical set of transaction documents are:

- the offering memorandum or official statement
- trust agreement or indenture for the pooled financing
- loan agreements between the facility and local borrowers in the pool
- authorizing resolutions of the local borrowers
- legal enforceability opinions by local counsel

An effective way to develop standard transaction agreements is to begin by selecting a project that fits the proposed lending institution’s target market and develop the full compliment of legal transaction agreements necessary to finance that project. Once these agreements are tested in the market, by successfully financing a project, they can be replicated for all future projects.

If an on-lending institution is a candidate for a pooled lending entity, the best approach is to review the institution’s existing financial documents to determine if they meet prevailing lending standards. Revising existing documents can be more efficient and less costly than drafting new transaction agreements.

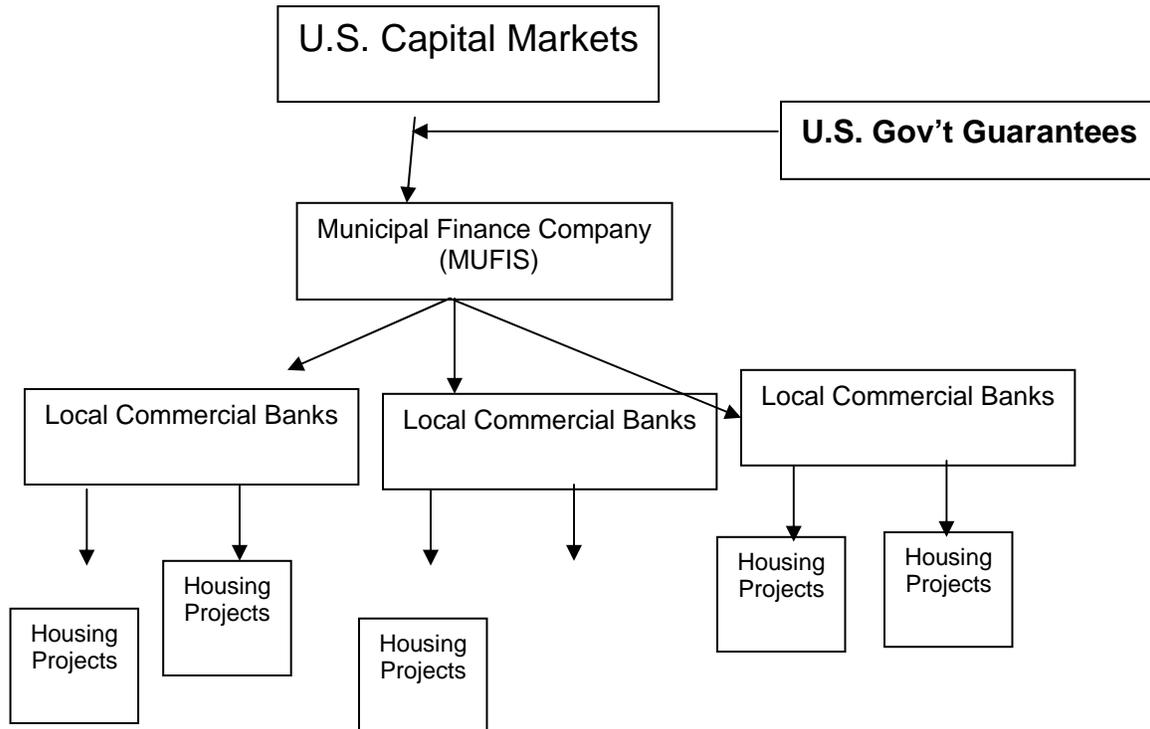
**F. Similar International Models**

Local government financing in many countries is based on centralized funding agencies or joint guarantee systems.

Many cities, communities and their associated entities in developing countries are too small to enter directly into the capital markets. It is therefore only natural that local governments have created public funding agencies to take advantage of joint efficiencies. Many of these institutions have characteristics similar to SBBs and SRFs. A few examples are detailed below to provide additional input for pooled financing program approaches.

Chart III

**Czech Republic MUFIS Program**



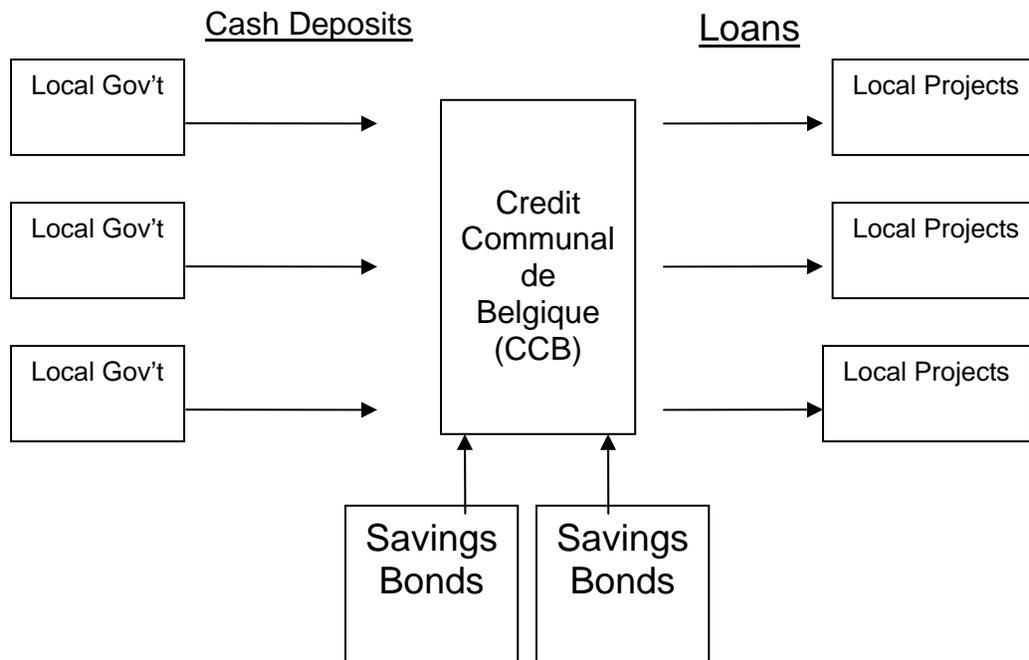
The Municipal Finance Company (MUFIS) was created in 1994 as part of a USAID municipal infrastructure finance program.

MUFIS is a joint stock company established by parliamentary legislation. Shares in MUFIS are owned by the Ministry of Finance and the Czech and Moravian Guaranty and Development Bank, each with 49%. The remaining 2% is held by the Association of Czech municipalities and the Union of Towns and Communities.

MUFIS has borrowed \$44 million from U.S. investors backed by U.S. Government guarantees. MUFIS on-lends these funds to commercial banks participating in the process. In turn, municipalities borrow funds from the banks for periods between 7-15 years. The credits must be used to finance housing-related infrastructure projects.

Chart IV

**Credit Communal de Belgique (CCB)**



Credit Communal de Belgique (CCB) was created by the Belgian Ministry of Finance in 1860. CCB has been the principal banker for its shareholders, Belgian municipalities and provinces, for 136 years. It currently enjoys a market share of 90% of local public sector loans.

In addition to providing financing, CCB helps local authorities prepare budgets and modernize accounting systems.

CCB accepts deposits from individuals, undertakes cash management for municipalities, and issues variable rate savings bonds on a daily basis. Savings bonds are a major source of stable financing which enables CCB to lend to local governments. All provincial and local tax collections and national government grants pass through CCB as the depository and paying agent.

The activities of CCB have expanded in recent years to include banking and fiduciary services for the general public and companies. However, more than 70% of total outstanding commitments are in local sector loans.

Until 1996, the capital of CCB was owned by 10 provinces and 509 municipalities. Pursuant to the partial acquisition of CCB by Dexia, a French commercial bank, 30% of CCB holding's were offered to the public and listed on the Brussels stock exchange, under the bank Dexia Belgium.

### **USAID/JBIC Cooperation**

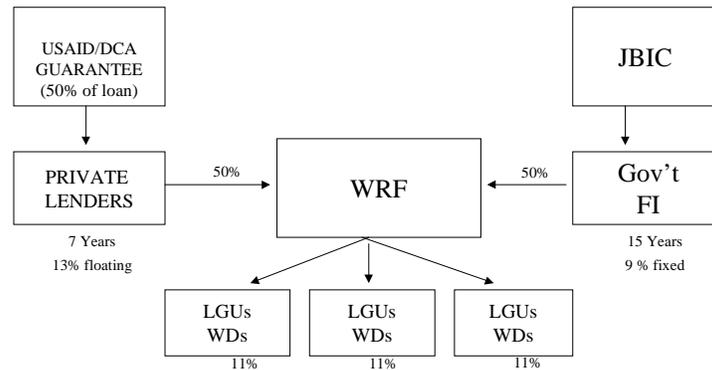
At the World Summit on Sustainable Development in Johannesburg in August 2002, the United States and Japan launched the Clean Water for People Initiative, a joint endeavor to provide safe water and sanitation to the world's poor. As part of this initiative the USAID Development Credit Authority (DCA) has developed a working relationship with the Japanese Bank for International Cooperation (JBIC).

Under this initiative, USAID DCA and JBIC are seeking ways in which they can combine their resources to mobilize local private sector lending for water projects in the Philippines.

Work under these initiatives has advanced to the point where financial options have been presented to the Ministry of Finance. Two such models are provided below as possible structures for combining on-lending programs with local private bank lending for water projects.

## Chart V

### USAID/DCA -JBIC (Option 1)



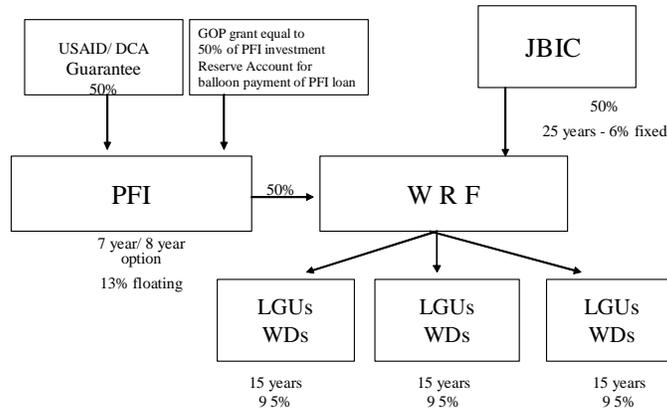
Under this option, JBIC makes a sovereign loan to the government of the Philippines and provides the loan proceeds to a Government Financial Institution (GFI). The GFI on-lends those funds to a Water Revolving Fund (WRF). The balance of the WRF resources would be provided by private commercial banks loans backed by a USAID DCA guarantee.

This model would combine on-lending funds with local private capital. Because JBIC financing is less expensive than local bank lending, the blended interest rate for local government units (LGUs) and Water Districts (WDs) is lowered.

Although interest rates of GFI and private banks can be blended for loans to LGUs, the different loan maturities can not be blended. As a result, the WRF would need to execute two separate loans to LGUs, one for 7 years and another for 15 years. The annual debt service for the first 7 years of financing under the two loan agreements would be extremely high under this arrangement and is not affordable.

To deal with the mismatch in maturities, a second option was developed where a government grant equal to ½ of private sector lending would be placed in a reserve account. The private banks would lend for seven years but the principal of these loans would be amortized over 15 years. At year 8, a balloon payment would be due. If banks decide to continue lending to LGUs, repayments would continue

**Chart VI**  
**USAID/DCA -JBIC (Option 2)**



If a bank decides to exit the program, funds in the reserve account would be used to make the balloon payment and the LGUs would execute new loans with the WRF. This structure substantially reduces annual debt service payments to LGUs. It is a delayed revolving structure. If banks decide to continue lending after year 8, a 1 billion peso government grant would leverage 9.4 billion pesos in total loan volume over 15 years.

**G. Useful web sites**

Virtually all SBBs and SRFs have websites that contain background material on each program including official statements, annual reports and transaction documents. In addition, associates of state agencies have helpful information on their web pages. Detailed below are a few useful examples.

- Maine Bond Bank: [www.mainebondbank.com](http://www.mainebondbank.com)
- Michigan Municipal Bond Authority: [www.michigan.gov/mmba](http://www.michigan.gov/mmba)
- New York State Environmental Facilities Corporation: [www.nysefc.org](http://www.nysefc.org)
- Council of Infrastructure Finance Authorities: [www.cifanet.org](http://www.cifanet.org)

**Useful Contacts:**

Carl Mitchell - CTO - Europe and Eurasia Bureau - US Agency for International Development  
Tel. (202) 712-5495 - Fax: (202) 974-4318 - [cmitchell@usaid.gov](mailto:cmitchell@usaid.gov)

Allen Eisendrath - Senior Infrastructure Finance Advisor - US Agency for International Development  
Tel: (202) 712-0483 - Fax: (202) 216-3172 - [aeisendrath@usaid.gov](mailto:aeisendrath@usaid.gov)

Brad Johnson - President - Resource Mobilization Advisors  
Tel: (202) 624-3310- Fax: (202) 624-3340 - [bjohnson@rmaconsult.com](mailto:bjohnson@rmaconsult.com)

Michael Curley – Executive Director – International Center for Environmental Finance  
Tel. (443) 691-1874- Fax: (410) 823.8707 - [mcurley@icf.getf.org](mailto:mcurley@icf.getf.org)