

Llanto, Gilberto M.; Manasan, Rosario G.; Lamberte, Mario B.; Laya, Jaime C.

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## Local Government Units' Access to the Private Capital Markets

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Philippine  
Institute  
for Development  
Studies

LOCAL GOVERNMENT UNITS'  
**ACCESS**  
T O T H E  
**PRIVATE  
CAPITAL  
MARKETS**



GILBERTO M. LLANTO  
ROSARIO G. MANASAN  
MARIO B. LAMBERTE  
JAIME C. LAYA

LGUS' ACCESS TO THE PRIVATE CAPITAL MARKETS





**LOCAL GOVERNMENT UNITS'  
ACCESS TO THE PRIVATE CAPITAL MARKETS**

LOCAL GOVERNMENT UNITS'

# **ACCESS** TO THE **PRIVATE** **CAPITAL** **MARKETS**

Gilberto M. Llanto  
Rosario G. Manasan  
Mario B. Lamberte  
Jaime C. Laya



Philippine Institute for Development Studies



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*Please address all inquiries to:*

**PHILIPPINE INSTITUTE FOR DEVELOPMENT STUDIES**

4th Floor, NEDA sa Makati Building  
106 Amorsolo Street, Legaspi Village  
Makati 1229 Metro Manila, Philippines  
Telefax No. (632) 893-95-89  
Tel. Nos. (632) 893-57-05; (632) 892-40-59  
E-mail: [publications@pidsnet.pids.gov.ph](mailto:publications@pidsnet.pids.gov.ph)  
Website: <http://www.pids.gov.ph>

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# Foreword

The passage of the Local Government Code of 1991 heralded a new era in local government credit financing. The Code liberalized the credit policy framework by allowing local government units (LGUs) to borrow from private and government financial institutions without prior approval by the Department of Finance. It also allowed LGUs to issue their own debt instruments and to enter into build-operate-transfer (BOT) arrangements for local infrastructure projects.

Hailed by many as a significant step for LGUs, this development, however, ushered in new challenges requiring government to provide the guiding policies. This study, therefore, is part of the ongoing attempts to support and strengthen local government finance. Commissioned by the Department of Finance with funding from the World Bank, this study looks carefully at the policy and institutional issues that the government must address for LGUs to have access not only to government financial institutions but, more importantly, to the private capital markets.

It is hoped that this study will further contribute to the public debate and analysis of local government credit financing. Considering the critical role of credit finance in local development, it is indeed timely to have a study which recommends measures to break the barriers LGUs traditionally face to get into the private capital markets. Readers, researchers and, most especially, policymakers will find in this book definite courses of action that the government should take to liberalize LGUs' access to private capital markets.



**Ponciano S. Intal, Jr.**  
President

## Preface

The study attempts to lay down the policy and institutional framework for the establishment of a municipal credit system with substantial private sector participation. The present municipal credit system is underdeveloped. The Municipal Development Fund and the government financial institutions are the only sources of long term credit for local infrastructure and development projects. Because of the limitation of government resources, it is logical for the local government units (LGUs) tap the private capital markets for financing. However, much work has still to be done to make the private capital markets accessible.

The study is a first step toward the objective of providing LGUs access to the private capital markets. It analyzes the problems and constraints in the demand and supply sides of the LGU credit markets and offers some recommendations to address those constraints.

The study benefited from discussions with the members of the Steering Committee, namely: Undersecretary Maria Cecilia G. Soriano of DOF (chairperson from June 1995 to 1996); Undersecretary Juanita Amatong of DOF (chairperson from January to May 1995); Undersecretary Simeon Ventura of DILG; Deputy Director General Aniceto Sobrepeña of NEDA, Executive Director Lorinda Carlos of BLGF-DOF and Dr. Ponciano S. Intal, Jr. of PIDS.

Likewise, it drew useful insights from the constructive comments and suggestions made by participants in two workshops organized by the study team and by representatives from the World Bank, namely: Messrs. Thomas Zearley, Jose Antonio League, Tom Glaessner and Toru Hashimoto. The study tour in Colombia, South America and Washington, D.C., U.S.A. organized by the World Bank was instrumental in providing the team a practical

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exposure to a successful municipal credit institution and in allowing the team to interact with various World Bank experts on local government and credit finance.

Finally, the report would not have been possible without the assistance provided by Ms. Lorinda Carlos and her staff especially Erlito Pardo and Beth Legaspi of the BLGF, and the following PIDS staff: Antonio Avila, Marife Magno, Anicia Sayos, Jeanette Matro, Juanita Tolentino, Meanne Dizon, Melalyn Cruzado, Bing Polistico and Melanita Malvar.

The opinions expressed herein are those of the authors and do not necessarily reflect the position of their respective organizations.

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**Gilberto M. Llanto**  
**Rosario G. Manasan**  
**Mario B. Lamberte**  
**Jaime C. Laya**

**Makati City, Philippines**

## Acronyms

ADB	Asian Development Bank
AGPC	adjusted gross paying capacity
ALGU	Assistance to Local Government Units
BLGF	Bureau of Local Government Finance
BSP	Bangko Sentral ng Pilipinas
BTr	Bureau of Treasury
CCB	Credit Communal Belgique
CDD	Caisse des Depots
CDF	Countryside Development Fund
CEBU	Cebu Equity Bond Unit
CIBI	Credit Information Bureau, Inc.
CLF	Countryside Loan Fund
COA	Commission on Audit
COE	current operating expenditures
CPOs	central project offices
CPVDC	Cebu Property Ventures and Development Corporation
DBM	Department of Budget and Management
DCLA	Danish Credit Institution for Local Authority
DILG	Department of Interior and Local Government
DOF	Department of Finance
DPWH	Department of Public Works and Highways
ESF	Economic Support Fund
FCDU	foreign currency deposit unit
FFDU	Columbia's Urban Development Fund
FIES	Family Income and Expenditure Survey
Findeter	Financiera de Desarrollo Territorial
GAA	General Appropriations Act
GFIIs	government financial institutions
GNP	gross national product
GOP	Government of the Philippines
GR	gross revenue
GSIS	Government Service and Insurance System
HIGC	Home Insurance Guarantee Corp.

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## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

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IBRD	International Bank for Rural Reconstruction and Development
IGLF	Industrial Guarantee Loan Fund
IRAs	Internal Revenue Allotments
LBP	Land Bank of the Philippines
LGC	Local Government Code
LGUs	local government units
LGUCGC	LGU Credit Guarantee Corp.
LLA	local loans account
LWUA	Local Water Utilities Administration
MBC	maximum borrowing capacity
MCIs	municipal credit institutions
MDF	Municipal Development Fund
MDF-PGB	Municipal Development Fund-Policy Governing Board
MDIs	municipal development intermediaries
NALGU	National Assistance to LGUs
NCA	Notice of Cash Allocation
NEDA	National Economic and Development Authority
NGOs	national government organizations
NPC	net paying capacity
ODA	official development assistance
OECD	Overseas Economic Cooperation Fund
PCFP	Presidential Commission to Fight Poverty
PD	Presidential Decree
PFI	private financial institutions
PGB	Policy Governing Board
PIDS	Philippine Institute for Development Studies
PMBI	Philippine Municipality Bank, Inc.
PNB	Philippine National Bank
PSA	program support account
PSCs	Project Steering Committees
PSE	Philippine Stock Exchange
PWLB	Public Works Loan Board
RAICs	Regional Agro-Industrial Centers
RPT	real property tax
RPTA	Real Property Tax Administration
RWSA	Rural Waterworks and Sanitation Association
SEF	Special Education Fund



## *Acronyms*

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<b>SPMS</b>	<b>special project management service</b>
<b>SSS</b>	<b>Social Security System</b>
<b>STD</b>	<b>special time deposit</b>
<b>UPEcon</b>	<b>University of the Philippines School of Economics</b>
<b>USAID</b>	<b>United States Agency for International Development</b>

# INTRODUCTION

## BACKGROUND

---

The Department of Finance (DOF), with funding from the World Bank, commissioned the Philippine Institute for Development Studies (PIDS) to review issues and problems concerning local government units' (LGUs) lack of access to the capital markets. The devolution of key functions and responsibilities to the LGUs has created a huge demand for the improvement of the delivery of public goods and services at the local level, which requires substantial financing that cannot be met by the traditional sources of funds, such as local revenues, grants and transfers from the national government, and loans from government-owned financial institutions. This has led to a discussion of what institutional and financial arrangements will best enable the local authorities to have access to the private capital markets for medium- and long-term credit for their capital investment requirements.<sup>1</sup>

The Philippine municipal credit system is still underdeveloped. A great majority of the LGUs have not relied on borrowing but have instead used their internal revenue allotments (IRAs), local tax collections and grants to finance local projects. Only a handful of LGUs access credit to the

---

<sup>1</sup> The pioneering studies on the issues and problems concerning the LGUs' lack of access to medium- and long-term credit to finance their capital investment requirements were those of Llanto (1992a, 1992b, 1994, 1995), Saldaña (1992), Petersen (1992) and Peterson (1993).

---

Municipal Development Fund (MDF),<sup>2</sup> which is the sole source of long-term credit finance for LGUs,<sup>3</sup> although recently, the government financial institutions (GFIs) have re-opened their LGU loan windows after their disastrous experience with LGU lending in the 1980s. The MDF has been successful in providing long-term credit finance to LGUs through an inter-agency loan review and approving mechanism and the IRA intercept which allows it to recover the loans. Partly because of the restrictions existing before the 1991 Local Government Code, and the unfamiliarity of private banks with LGUs, the LGUs were unable to tap the private capital markets for medium- and long-term credit finance (Llanto 1992a).

However, the funding available in the existing government lending facilities, mainly those in the MDF, is far below the potentially large demand of LGUs for capital financing. To date, the MDF provided loans to some 110 out of 1,452 LGUs. On the other hand, the private financial system controls substantial financial resources, which could be tapped for LGU credit financing. The 1991 Local Government Code encourages the LGUs to tap the private capital markets but private sector borrowing remains a potential source of funds for local capital investment.

## OBJECTIVES

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This study aimed to produce analyses and results that can assist the DOF lay down the policy and institutional framework for the establishment of a municipal credit system that has substantial private sector participation. Given the current state of financial sector development in the Philippines, this study sought to (i) evaluate alternative options of providing LGUs access to private capital markets; (ii) recommend the most

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<sup>2</sup> See Chapter 5 for a detailed discussion on the MDF.

<sup>3</sup> The MDF is also a source of grants for LGUs.

appropriate option; and (iii) define an action plan to implement the chosen option.

The scope of the study follows:

1. Prepare a detailed problem analysis of LGU access to credit financing, with special emphasis on private sector financing.
2. Review and analyze the role of the MDF, the GFIs, private financial institutions and the foreign lenders/donors in LGU financing in order to provide a consistent credit policy framework and a well-defined credit program for LGUs.
3. Identify preferred policy options and interventions for addressing the problem of LGU access to the capital markets. These may include, but not necessarily limited to the following or a combination of them: (i) expanding the role of MDF to include co-financing with commercial banks and development banks; (ii) credit lines to commercial banks for on-lending to LGUs; (iii) secondary purchase facility for LGU loans and municipal bonds; (iv) issuance of domestic bonds by MDF and other intermediary institutions to finance capital expansion; (v) pooling of LGU liquid funds, and others.
4. In consultation with the DOF and the LGUs, prepare a comprehensive action program for carrying out the legislative, regulatory and institutional actions required to create access to credit financing and rationalize the use of the MDF. This activity will draw from the options and interventions considered in item no. 3 and subject to the review and advice of the Project Steering Committee.

5. Conduct workshops to disseminate the results of the policy review and the proposed comprehensive action program on LGU credit to the DOF, the Bureau of Local Government Finance (BLGF), the Bangko Sentral ng Pilipinas (BSP), the LGUs, financial institutions and legislators.
6. Assist the DOF and LGUs in designing a local municipal credit system.

This policy initiative of the DOF is timely considering that (i) the devolution has given the LGUs the main responsibility of spearheading local development, (ii) the government has limited funds available for LGU credit finance, and (iii) the private financial institutions which have the resources have expressed an interest in LGU credit finance.

## APPROACH AND METHODOLOGY

---

The study tried to determine an appropriate municipal credit system that will enable LGUs to have access to the private capital markets. It took into consideration the varying income capacities of LGUs, thus, they were classified into six income classes with varying degrees of access to debt financing. The different sources of LGU financing such as the MDF, the GFIs, and private capital markets were also considered. Thus, it was necessary to follow an approach that examined both the demand and supply sides of a municipal credit system as well as its operating policy, institutional, legal and regulatory environment. Relevant insights into the local and foreign experience on municipal credit systems can assist in designing the policy and institutional framework for the municipal credit system.

Since the ultimate goal is to establish a municipal credit system most appropriate for the Philippines, it was deemed necessary to adopt mechanisms that could solicit the active

participation of the key players. These mechanisms would facilitate the adoption of policy, legal and administrative reforms to make the proposed municipal credit system effective. The mechanisms included (i) the formation of a Project Steering Committee composed of members representing the government agencies that can recommend to the President the appropriate municipal credit system for LGUs; (ii) the participation of technical experts from the supply and demand sides of the municipal credit system as well as the concerned regulatory agencies in forums organized by the Study Team; (iii) the participation of key LGU leaders, private financial sector, and top officers of the MDF and GFIs in forums organized by the Study Team; and (iv) the conduct of informal discussions between the Study Team and the key players working for the development of a municipal credit system.

- *Analytical Framework*

The analytical framework considered both the demand and supply sides and the operating institutional/regulatory environment of a municipal credit system. On the demand side, the general experience with credit finance, the purpose for accessing credit and the capability of the borrowing LGU to repay loans must be ascertained. It is important to identify those factors which constrain the LGUs' access to the capital markets. Although LGUs may be indifferent to the distinction between a commercial bank loan and a bond issue, their preference for a particular type of credit instrument may be conditioned by the types of projects they undertake, their credit standing, the general condition of the capital market (such as the relatively advanced stage of development of the bank credit market over the bond market) and the policy, regulatory and institutional environment.

On the supply side, the study attempted to identify the factors limiting the LGUs' access to the capital markets. Various combinations of credit delivery mechanisms and credit

guarantee facility were analyzed and their relative merits evaluated to determine an appropriate, effective and efficient municipal credit system for LGUs with substantial private sector participation. The credit delivery mechanisms considered include the following: (i) private financial institutions (PFIs), (ii) the MDF, (iii) government financial institutions (GFIs), and (iv) the creation of an independent municipal credit institution.

Each cell in Table 1.1 describes various possible combinations or options for a credit delivery mechanism and lending facilities. Ideally, PFIs, as suppliers of funds, participate in municipal credit system. However, on the demand side, only the most creditworthy LGUs can participate in this credit system, while the rest remain outside the system. Thus, it is necessary to consider some intermediate options in which the government assumes a catalytic role and, at the same time, encourages greater private sector participation in the financing of LGU projects so that more LGUs can have access to the credit system. It is envisaged that the government's role in this credit system diminishes over time as the participation of the private sector increases.

**Table 1.1**

**VARIOUS OPTIONS FOR A MUNICIPAL CREDIT SYSTEM**

Credit Delivery Mechanism	Lending		Guarantee	
	Wholesale	Retail	Loans	Bonds
PFIs				
MDF				
GFIs				
New Corporation				



Within the context of this catalytic role, the present MDF, which excludes PFIs' participation, could be expanded to allow co-financing by PFIs. The present wholesale lending programs of GFIs, which include features that encourage PFIs' participation in lending to private borrowers, can serve as an example. The MDF may be converted into a guarantee fund to provide security to LGU loans from the PFIs as proposed by some quarters. It may also provide liquidity to PFIs that lend directly to LGUs.

The establishment of a new municipal credit institution which provides credit or guarantee or both is another option. It is also possible to assign these tasks to an existing GFI which will absorb the MDF.

Each option covers a number of issues such as viability and sustainability of the credit system, primary sources of funds, organizational structure, and so on, that must be analyzed. The analysis of one option must not be done independently of other options. For example, assigning to an existing GFI the task of providing credit to LGUs with PFIs' participation may imply the elimination of the MDF and the transfer of the MDF resources and responsibilities to the GFI. This raises many issues, such as the receptivity of the GFIs to the option, the capacity of GFIs to assess risks of lending to LGUs, legal obstacles, and so on, that must all be thoroughly considered.

- *Data Collection and Analysis*

The analysis of various options for a municipal credit system draws from existing literature and from primary and secondary data collected for the study.

Primary data were collected from potential users (LGUs) and suppliers of funds (MDF, GFIs, PFIs), from policy-makers/regulators (e.g., DOE, DBM, BSP, etc.) through personal interviews, and during LGU credit financing workshops conducted by the Study Team.

On the demand side, primary and secondary data were used to determine the magnitude of the credit demand by LGUs, types of projects to be financed, repayment capacity, extent of their access to existing government credit facilities and private capital markets, and preferred financing arrangement by LGUs. A simulation analysis was performed to determine the repayment capacity of LGUs.

The sample LGUs, provinces, cities and municipalities were grouped into three tiers (Table 1.2): (i) the first tier consists of first class provinces, cities and municipalities; (ii) the second tier includes the second class and third class provinces, cities and municipalities; and (iii) the third tier includes the fourth to sixth class provinces, cities and municipalities. Table 1.3 shows the distribution of sample provinces, cities and municipalities. The list of sample provinces, cities and municipalities is presented in Annex 1.

**Table 1.2**

**DISTRIBUTION OF PROVINCES, CITIES AND MUNICIPALITIES**  
By Income Class (Per Department Order 35-93)

	Income Class	Provinces	Cities	Municipalities
1.	First Tier			
	1st	6	12	40
2.	Second Tier			
	2nd	9	6	44
	3rd	13	13	92
	Total	22	19	136
3.	Third Tier			
	4th	26	21	316
	5th	11	7	572
	6th	8	2	388
	Total	45	30	1,276

Source: Department of Finance.

**Table 1.3**

<b>DISTRIBUTION OF SAMPLE LOCAL GOVERNMENT UNITS</b>				
Level of Local Government	1st Class	2nd & 3rd	4th & 6th	TOTAL
A. Luzon				8
Province		1	1	
City			1	
Municipality	2	2	1	
B. Visayas				8
Province	1	1	1	
City	1	1		
Municipality		1	2	
C. Mindanao				8
Province	1			
City	1	1	1	
Municipality		2	2	
D. Total				
Province	2	2	2	6
City	2	2	2	6
Municipality	2	5	5	12

On the supply side, primary data were gathered to assess the responses of the potential suppliers of funds for establishing a municipal credit system. Particular emphasis was given to information that can assist in designing features of a municipal credit system that encourages the PFIs' substantial participation.

On the policy and regulatory side, information on policies and regulations affecting a particular option (e.g., establishing municipal credit corporation which absorbs the MDF) were gathered and analyzed. More importantly, views of top government officials on the economic and political feasibility of specific options were sought.

## **FINANCIAL SECTOR: REFORMS AND DEVELOPMENT**

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### **MAJOR REFORMS**

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The march toward a market-oriented financial sector in the Philippines began in 1981 with the restructuring of the banking system and interest rate policies to make the sector more competitive. The reforms first proceeded gradually, then were accelerated starting in the 1985. Table 2.1 summarizes the major reform measures instituted by the government since 1986.

The cheap rediscounting policy of the Central Bank made banks heavily dependent on it for resources and undermined their capacity to mobilize deposits. It also weakened the Central Bank's capacity to institute stabilization measures to manage the liquidity of the system. In November 1985, banks were weaned away from the cheap rediscounting window of the Central Bank so that the latter could concentrate on the conduct of monetary policy, instead of performing developmental functions.

The government sought to enhance competition in the financial system by (i) decontrolling interest rates, (ii) lifting the moratorium on opening of new commercial banks, and (iii) substantially relaxing the rules on branching. Government-owned banks' participation in the credit markets was re-oriented toward supplementing the private banking system's initiatives rather than supplanting them. This is done by having

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# LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 2.1**

## **FINANCIAL SECTOR REFORMS IN THE PHILIPPINES, 1986-1994**

Policy Measures	Before Reform	After Reform	Date
<i>I. Selective Credit Control</i>			
1. Central Bank rediscount window	Rediscount rate: varies by type of economic activities (allowable spread: 1%-11%)  Rediscount value: varies by type of economic activities (value: 60%-100%)	Uniform floating rate for all; no prescribed spread.  Uniform: 80%	November 1985  November 1985
2. Central Bank special credit programs	Directly managed special credit programs.	Central Bank-managed special credit programs transferred to government financial institutions	1987-1988
<i>II. Bank Competition</i>			
1. Bank Entry	New commercial banks – moratorium since 1980; Other banks – no moratorium.  Foreign banks – no entry since 1949.	New commercial banks – moratorium lifted  Ten foreign banks allowed to have 6 branches each; foreign banks may acquire or establish a bank up to 60% of the total equity of each bank.	1989  1994
2. Branching	Restrictive branching policy – the country was divided into 5 service areas: heavily over-branched areas; over-branched areas; ideally branched areas; under-branched areas; and encouraged branching areas.	Branching was liberalized but the Central Bank retained discretionary power with respect to the opening of branches in certain areas considered "overbanked."  Banks may open branches anywhere they like provided they meet the minimum capital requirement.	May 1989  May 1993

**Table 2.1 (continuation)**

Policy Measures	Before Reform	After Reform	Date
3. Government Banks	Largely doing retail lending that directly competes with private banks.	More focus on wholesale using private banks as conduits.	since 1987
4. Interest Rates a. Deposit rates b. Lending rates Private banks Special credit programs	No cap since 1981 No cap since 1983 Cap on end-user rate	same No cap on end-user	1987
III. Prudential Measures		Prohibiting concurrent officerships between banks or between a bank and a non-bank financial intermediary except with prior approval of the Monetary Board.	September 1986
		Requiring each bank to cause an annual financial audit to be conducted by an external independent auditor not later than 30 days after the close of the calendar year.	December 1986
		Requiring all banks and non-bank financial intermediaries to adopt the Statements of Financial Accounting Standards.	December 1987
		The Central Bank declared a policy that it shall refrain from sustaining weak banks, except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency.	May 1989

## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 2.1 (continuation)**

Policy Measures	Before Reform	After Reform	Date
	Deposits of insider-borrower were protected by the Secrecy of Bank Deposits Law.	<p>Including contingent liabilities in the determination of the limit to which banks can lend to a single borrower or a group of affiliated borrowers.</p> <p>Insider-borrower shall waive the secrecy of their deposits for examination purposes.</p> <p>Increasing the minimum capital requirements for banks. Latest:                      Universal banks—P2.25B                      Commercial banks—P1.125B                      Thrift banks—P150M                      Rural banks—P20M</p>	June 1993
<i>IV. Foreign Exchange Markets</i>			
1. Foreign exchange trading	On-floor	Off-floor through an electronic screened-based network for sharing information and undertaking transactions.	December 1992
2. Export receipts	Mandatory surrender of foreign exchange receipts.	Foreign exchange earners may retain 100% of total receipts and can use them freely without prior Central Bank authorization.	September 1992
3. Foreign exchange purchases	Limits on foreign exchange purchases such as travel, educational expenses, etc.	No limit.	September 1992
4. Repatriation and remittances of investments	Staggered from 3-9 years subject to Central Bank approval.	Full and immediate repatriation without Central Bank approval for foreign investments duly registered with the Central Bank or custodian bank.	September 1992

**Table 2.1 (continuation)**

Policy Measures	Before Reform	After Reform	Date
5. Outward investment by residents	Not allowed.	Allowed initially up to US\$1M, but lately increased to US\$6M.	1992-1994
6. Access to domestic FCDU loans.	No access.	Direct exporters allowed access.	September 1992
		Indirect exporters allowed access.	July 1994

the GFIs concentrate on wholesale lending rather than on retail lending and using private banks as credit conduits. The latest reform measure in the financial sector is the liberalization of the entry and scope of operations of foreign banks. The law encourages foreign banks not only to go into wholesale banking but also into retail banking to provide more competition with local banks.

The Central Bank introduced some measures to strengthen prudential regulations. These included, among others, (i) the improvement in banks' reporting requirements and specific guidelines for asset valuation and loan loss provisions to tighten, standardize and apply criteria uniformly to all banks; (ii) regularly reviewing and increasing the minimum capital requirement; and (iii) instituting measures to curb insider abuse.

The foreign exchange market used to be highly regulated. The rigid regulations effectively segmented the market into three sub-markets: the interbank market, the customer market, and the parallel market.

The process of deregulating the foreign exchange market started in mid-1991 and continues today. The Central Bank initially relaxed some rules to test the reaction of the market. For instance, it initially increased the retention limit for the export proceeds of exporters from 2 to 40 percent to be



deposited in special foreign currency deposit account with authorized banks, and then later raised it to 100 percent without any restriction at all. Another example was the removal of the limits on foreign exchange purchases for travel, educational expenses, medical expenses, and others. The ceilings were completely removed later. Some relaxation of the rules did not require any gradual phaseout. For instance, Filipinos working overseas were no longer required to remit specified minimum shares of their earnings.

The foreign exchange market liberalization put more pressure on banks to become more competitive because foreign exchange earners are no longer required to surrender foreign exchange receipts to them for conversion into local currency. An important consequence of this reform is that the Central Bank is no longer able to administratively set the exchange rate. At present, the exchange rate is freely determined in the market. Instead of being a regulator, the Central Bank is now a mere participant in the foreign exchange market. However, as a large participant, it may enter the market on its account to ensure an orderly movement of the exchange rate, but not to lead the market.

Four major policy reforms have a direct bearing on **capital market development**. *First*, the double taxation of dividend income was eliminated through the abolition of the tax on intercorporate dividends and gradual phaseout of the tax on shareholder's dividend income. *Second*, the Securities and Exchange Commission (SEC) formally issued in October 1989 the "Rules and Regulations Governing Investment Companies," signalling the revival of mutual funds. *Third*, as part of the foreign exchange deregulation program, rules and regulations covering foreign investments in Central Bank-approved securities were relaxed. Under the new rules, some of the functions of the Central Bank are passed on to the custodian banks to reduce red tape. *Fourth*, the two stock exchanges in the Philippines were recently unified, eliminating some inefficiencies (e.g., price arbitrage) in the stock market.

The creation of a new central bank, i.e., the Bangko Sentral ng Pilipinas (BSP),<sup>4</sup> is a major institutional measure initiated by the government. It addresses two closely related issues: (i) the independence of the central bank and (ii) the absorption by the national government of loss-inducing liabilities of the old central bank. One of the components of the reform is the transfer of debt management from the BSP to the DOF.

## RECENT DEVELOPMENTS

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- *Weeding Out Weak Banks*

The slowdown of the economy in the 1980s exposed the weaknesses of many banks. The government tried to rescue five commercial banks and eventually ended up owning them. The non-performing assets of these banks were cleaned up and the government sold the rehabilitated banks back to the private sector. Apart from these commercial banks, the government closed three commercial banks, 32 thrift banks and 138 rural banks during the period 1981-1987. The government launched a massive rehabilitation program for the rural banking system, in which about half the remaining 1,000 rural banks participated.

Banks operating today have healthier balance sheets than in the past. The closure of several banks in the 1980s have taught them some lessons. Moreover, the BSP increased the banks' minimum capital requirements at least four times during the period 1986-1994. Some undercapitalized banks merged to meet the minimum capital requirements while others raised capital from the capital market. Today, eight of the 20 domestic commercial banks are listed in the Philippine Stock Exchange.

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<sup>4</sup> Beyond 1993, Central Bank will henceforth be referred to as Bangko Sentral ng Pilipinas or BSP.

The strength of the balance sheets of the banks today can be gauged by the fact that none of them went under during the 1991-1992 economic slowdown and the Treasury bill scam in 1993 that caused a run on some banks. Although the Philippines has not yet adopted the BIS capital adequacy standards, preliminary investigation by the BSP shows that most of the banks will be able to pass said standards.

- *Access to Banking Services*

The liberalization of bank entry and branching makes banking services more accessible to a great majority of the population. Easy access to banking services increases the effective return on deposits and reduces the effective cost on borrowing. One measure of access to banking services is the banking density ratio, which is the ratio of population to the number of bank offices (including headquarters and branches). The lower the ratio, the better is the people's access to banking services. As shown in Table 2.2, the banking density ratio declined during the period 1980-1983, but tended to rise from 1984 to 1990 as several banks closed in the aftermath of the 1984-1985 crisis. The full effect of the bank entry and branching liberalization adopted by the Central Bank was felt in the subsequent years as banking density consistently improved. By end of December 1993, the density ratio stood at 14,000 per bank office.

- *Financial Intermediation*

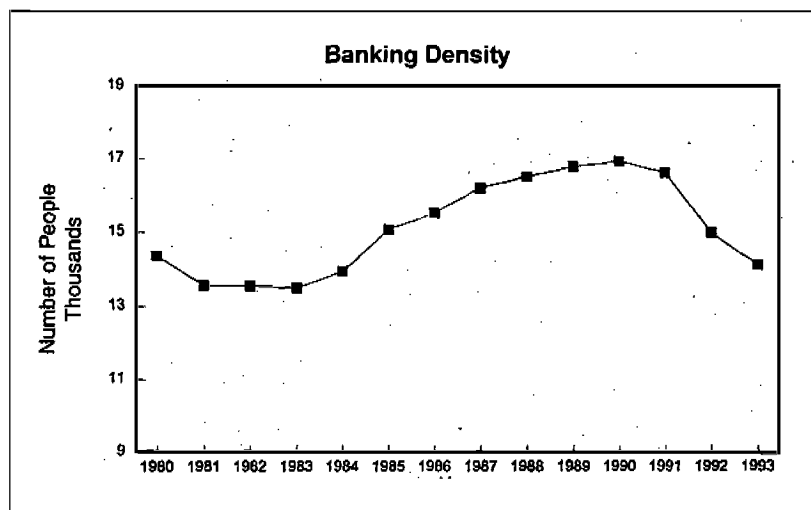
The overall objective of financial reforms is to increase the funds intermediated through the formal financial system, which may be measured by the ratio of money supply to GNP. Money supply (M3) is defined broadly to include currency in circulation, demand deposits, savings deposits, time deposits and deposit substitutes. The behavior of M3/GNP ratio during the period 1980-1994 is shown in Table 2.3. The ratio tended to rise in the early 1980s, but fell precipitously in 1984 and 1985 when the country experienced both severe political

**Table 2.2**

**BANKING DENSITY, 1980-1994**

Year	No. of Banking Offices	Population (In Thousands)	Banking Density
1980	3,364	48,320	14,363.85
1981	3,652	49,540	13,565.17
1982	3,749	50,780	13,544.95
1983	3,861	52,060	13,483.55
1984	3,829	53,350	13,933.14
1985	3,632	54,670	15,052.31
1986	3,614	56,000	15,495.30
1987	3,547	57,360	16,171.41
1988	3,562	58,720	16,485.12
1989	3,588	60,100	16,750.28
1990	3,638	61,480	16,899.40
1991	3,791	62,870	16,584.01
1992	4,296	64,260	14,958.10
1993	4,657	65,650	14,097.06

Source: Bangko Sentral ng Pilipinas, *Philippine Financial Factbook*.



## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 2.3**

**INDICATORS OF FINANCIAL INTERMEDIATION**

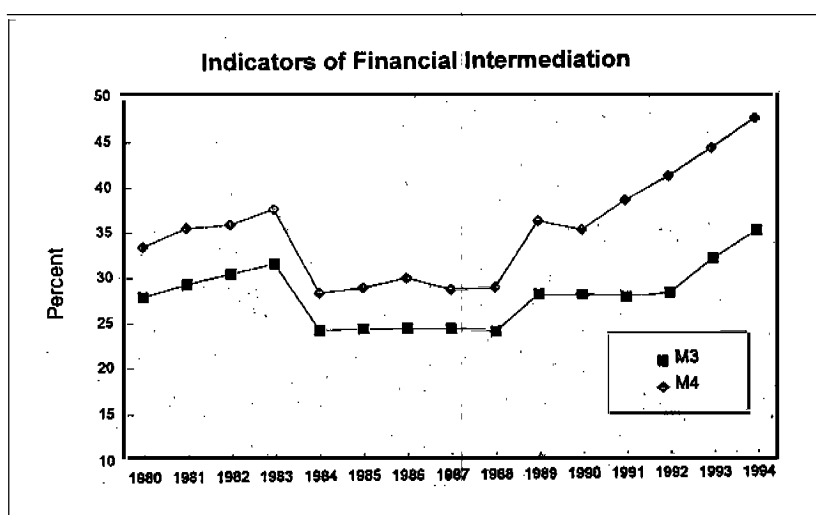
(In billion pesos)

Year	GNP	M3	M3 as % of GNP	Trust Account	M4	M4 as % of GNP
1980	243.3	67.8	27.9	13.5	81.3	33.4
1981	280.5	82.1	29.3	17.4	99.5	35.5
1982	313.5	95.3	30.4	17.1	112.3	35.8
1983	363.3	114.2	31.4	22.1	136.4	37.5
1984	508.5	122.4	24.1	20.8	143.3	28.2
1985	556.1	134.5	24.2	25.1	159.6	28.7
1986	596.3	144.4	24.2	32.9	177.3	29.7
1987	670.8	161.9	24.1	28.9	190.8	28.4
1988	792.0	188.4	23.8	38.3	226.7	28.6
1989	912.0	253.9	27.8	73.8	327.8	35.9
1990	1,082.6	300.5	27.8	77.5	378.1	34.9
1991	1,266.1	347.1	27.4	136.2	483.3	38.2
1992	1,385.6	385.4	27.8	179.5	564.9	40.8
1993	1,519.2	480.0	31.6	185.6	665.7	43.8
1994	1,752.0	607.6	34.7	216.5	824.1	47.0

M4 - is the sum of M3 and trust accounts of the Banking System.

1980-1988 data on Trust Accounts were gathered from monthly submissions of Form 7-1605 by Central Bank's Accounting Dept. of Commercial Banks.

1989-1994 data is the Total Accountabilities of the Banking System Trust and Management Operations, CB's *Philippine Financial System Factbook*.



and economic instability. Although the economy recovered strongly during the period 1986-1988, financial intermediation did not improve due to weak confidence in the banking system, as may be indicated by the closures or government takeover of several weak banks. The M3/GNP ratio rose sharply in 1989, the year Central Bank lifted the moratorium on opening of new commercial banks and relaxed the rules on bank branching. Since 1989, Central Bank approved eight applications of commercial bank licenses. The slowing down of economic growth during the period 1990-1992 weakened the demand for banking services; hence the M3/GNP ratio remained flat during these years. A sharp rise in the financial intermediation ratio occurred in the last two years when the economy showed some signs of strong recovery.

Most commercial banks and some thrift banks have been given authority by BSP to operate a trust account, which is treated as an off-balance sheet activity of banks. The outstanding trust accounts generally grew in the 1980s, despite negative growth occurring in some years (Table 2.3). During the period 1990-1992, trust accounts grew by 55 percent annually on the average. These were the years when reserve requirement ratio was raised to 25 percent. The growth in trust accounts practically halted in 1993 mainly because BSP imposed a 10 percent reserve requirements on all trust accounts and, at the same time, started to reduce the reserve requirement ratio on deposit liabilities, which is now pegged at 15 percent. Accordingly, some funds had moved to the mutual funds, which are a budding industry in the Philippines.

Since trust accounts are truly funds intermediated by the banking system, then they should be included in any measure of financial intermediation. They may be called M4, which is equal to the sum of M3 and trust accounts. As shown in Table 2.3, M4 projects a much deeper financial intermediation for the Philippines, especially in the 1990s.

- *Maturity Profile of Bank Loans*

The financial sector reforms could intensify competition among banks, which would lead to the restructuring of the loan portfolio of banks. More specifically, competition in the short-term loan markets would intensify, thereby inducing banks to look for new markets, particularly the market for medium- and long-term loans. An examination of the maturity profile of banks (Table 2.4) indicates that this has not happened to the banking system in the Philippines. On the contrary, banks seem to have increased the share of their demand and short-term loans at the expense of medium- and long-term loans. That is, banks are changing their lending strategy in favor of short-term loans. Accordingly, they adopted this strategy to reduce their exposure to credit and interest rate risks because during the period 1980-1993, the financial sector experienced three major crises (i.e., in 1981, 1984-1985, and 1991). Short-term loans are sometimes rolled over, while practically all medium- and long-term loans now carry a floating interest rate, i.e., they are re-priced every quarter on the basis of the expected interest rate that will prevail in the forthcoming quarter.

- *Capital Markets Development*

The capital markets, particularly the equities market, have benefited from the liberalization of foreign investment and foreign exchange market in the 1990s. Before 1990, the total capital raised in the exchanges was less than P10 billion and there were fewer firms listing their stocks in the exchanges. In the 1990s, the equities market soared to new heights as several large firms went to the stock exchange to raise capital (Table 2.5). In 1994 alone, 22 firms raised capital amounting to P149.4 billion, which is more than the total capital raised in the past 14 years. Market capitalization reached P1.4 trillion in 1994. Industry analysts believe that there recently has been a shift in focus from debt financing to equity financing due to

**Table 2.4**

**LOANS OUTSTANDING OF COMMERCIAL BANKS,  
BY MATURITY, 1980-1993<sup>1</sup> (In million pesos)**

Year	Demand	Short-term	Intermediate-term	Long-term	Total
1980	10,458.2 <b>13.5</b>	49,843.8 <b>64.6</b>	7,746.8 <b>10.0</b>	9,149.3 <b>11.9</b>	77,198.1
1981	10,667.3 <b>12.3</b>	52,823.4 <b>61.1</b>	14,976.2 <b>17.3</b>	8,038.3 <b>9.3</b>	86,505.2
1982	9,307.8 <b>9.5</b>	58,478.0 <b>59.5</b>	17,778.3 <b>18.1</b>	12,675.5 <b>12.9</b>	98,239.6
1983	11,099.2 <b>9.6</b>	68,501.5 <b>59.4</b>	17,530.0 <b>15.2</b>	18,259.0 <b>15.8</b>	115,389.7
1984	8,690.6 <b>7.2</b>	64,322.0 <b>53.4</b>	29,176.9 <b>24.2</b>	18,165.9 <b>15.1</b>	120,355.4
1985	8,087.3 <b>8.8</b>	52,448.0 <b>57.1</b>	15,645.8 <b>17.0</b>	15,646.1 <b>17.0</b>	91,827.2
1986	10,550.1 <b>11.9</b>	50,586.5 <b>57.3</b>	15,791.5 <b>17.9</b>	11,397.6 <b>12.9</b>	88,325.7
1987	19,104.6 <b>18.9</b>	53,159.9 <b>52.6</b>	22,899.0 <b>22.6</b>	5,948.5 <b>5.9</b>	101,112.0
1988	21,119.8 <b>16.7</b>	68,695.0 <b>54.3</b>	26,564.6 <b>21.0</b>	10,235.2 <b>8.1</b>	126,614.6
1989	30,352.6 <b>18.3</b>	93,491.5 <b>56.4</b>	31,780.3 <b>19.2</b>	10,233.2 <b>6.2</b>	165,857.6
1990	36,693.8 <b>18.4</b>	123,037.4 <b>61.6</b>	33,139.5 <b>16.6</b>	6,774.2 <b>3.4</b>	199,644.9
1991	16,329.7 <b>11.3</b>	96,633.1 <b>67.0</b>	23,554.4 <b>16.3</b>	7,789.0 <b>5.4</b>	144,306.2
1992	35,601.5 <b>13.9</b>	163,480.9 <b>63.8</b>	47,451.2 <b>18.5</b>	9,790.9 <b>3.8</b>	256,324.5
1993 <sup>1</sup>	29,973.6 <b>11.9</b>	159,221.6 <b>63.2</b>	50,579.0 <b>20.1</b>	11,933.9 <b>4.7</b>	251,808.1

Notes: Short-term = 1 year or less; Medium-term = more than 1 year to 5 years

Long-term = more than 5 years

<sup>1</sup> As of June 1993

Source: Bangko Sentral ng Pilipinas, *Annual Statistical Bulletin, 1990-1992*.



## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 2.5**

**PHILIPPINE STOCK MARKET PROFILE, 1980-1984**

(In million pesos)

Year	Combined Turnover	Market Capitalization	GNP (Nominal)	Market Capitalization as % to GNP	No. of Newly Listed Stocks	Capital Raised
1980	4,700	26,432	243,270	10.87	3	220
1981	1,300	14,255	280,543	5.08	3	690
1982	1,200	18,172	313,544	5.80	8	1,292
1983	5,400	19,445	363,268	5.35	7	946
1984	2,100	16,846	508,485	3.31	1	315
1985	2,066	12,741	556,074	2.29	4	494
1986	11,470	41,214	596,276	6.91	7	734
1987	31,423	61,108	670,826	9.11	9	1,261
1988	18,251	88,591	791,822	11.19	6	3,060
1989	49,919	261,022	914,126	28.55	7	4,897
1990	28,531	161,219	1,078,408	14.95	10	18,537
1991	39,713	297,743	1,262,487	23.58	10	25,991
1992	76,627	391,231	1,385,562	28.24	11	22,143
1993	180,690	1,088,820	1,519,814	71.64	11	36,252
1994	362,268	1,386,464	1,751,485	79.16	22	149,381

Source: Research Department, Philippine Stock Exchange.

massive corporate projects (especially in the telecommunications sector which was recently liberalized) and to the high cost of borrowing, not to mention the fact that many corporations have already reached their single borrowers' limit with banks.<sup>5</sup>

The secondary equity market became very active in the last few years, with combined turnover reaching P362 billion. Market capitalization rose sharply from 29 percent of GNP in 1988 to 79 percent in 1994.

The government securities market is the next biggest segment in the capital market, with about P650 billion in outstanding issues in 1994. About 60 percent of the issues

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<sup>5</sup> The single borrowers' limit was recently increased by the BSP from 15 to 25 percent of the unimpaired capital of banks.

are in the form of short-term Treasury bills (i.e., securities with maturities of one year or less).

The government has been trying to lengthen the maturities of its debt instruments. In October 1994, it started auctioning 2-year fixed rate Treasury Notes. This was followed by the issuance of 5-year fixed rate Treasury Notes in June 1995. As of September 1995, the outstanding 2-year and 5-year fixed rate notes stood at P19.4 billion and P12 billion, respectively. The fact that the market has shown considerable appetite for medium-term, fixed-rate notes bodes well for the development of the LGU bond market.

At present, the government is contemplating on the introduction of more reforms to deepen and further improve the efficiency of financial intermediation.

The discussions above clearly suggest that with a favorable policy environment, financial deepening has taken place — a development favorable to LGUs that want to tap the private capital markets.

## **LGUs' DEMAND FOR CREDIT FINANCING<sup>6</sup>**

Section 296 of the 1991 Local Government Code (LGC or the 1991 Code) provides that local government (LGUs) units may borrow (or create indebtedness) for two reasons: (i) to finance local infrastructure and other socioeconomic development projects found in their Local Development Plans, and (ii) to stabilize local finances. However, by custom and tradition, current expenditures of LGUs are financed out of current revenues and LGUs generally abstain from borrowing to fund current and recurrent expenditure. Thus, historically, grants and debt finance are used almost exclusively to cover the cost of capital investment projects. These include projects and facilities like electric and power plants, public markets, slaughterhouses, waterworks and sewerage systems, irrigation systems, telephone and communication systems, government housing, physical infrastructure (e.g., roads, bridges and other public facilities), acquisition of real property, agricultural development projects, development of industrial/commercial estates, equipment pool, and maintenance depots, livelihood projects, and other economic enterprises.

This chapter briefly describes the size and composition of the LGU revenue stream, summarizes the relative importance of the various sources of LGU revenues in financing capital expenditures, reviews and evaluates the different approaches

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<sup>6</sup> The contribution of Mr. Antonio Avila in this chapter is gratefully acknowledged.

in debt-capacity analysis, and delves into the real factors that drive and constrain LGU demand for debt financing. Some indication of the ability of local governments to manage their financial resources is important to assess their ability to access the private capital market. At the same time, an estimate of the magnitude of LGU demand for credit is a useful background information to any discussion of LGUs' credit access.

## **FINANCING CAPITAL EXPENDITURE**

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Capital outlays of LGUs have remained fairly stable in the period prior to the implementation of the 1991 Code (1985-1991) at approximately 0.26 percent of GNP or 16.4 percent of aggregate LGU expenditure. These figures have inched up slightly in the post-Code period, averaging 0.42 percent of GNP and 18.5 percent of total expenditure in 1992-1993.

In principle, capital spending may be financed in a number of ways. Capital expenditure may be funded out of recurrent revenues from both local and external sources, transfers from the national government, or loan proceeds.

- *LGU Revenue Profile*

Total LGU receipts/income was equivalent to 1.7 percent of gross national product (GNP) on the average in 1981-1991 (Table 3.1). This amount is divided almost equally between local source revenue and external source revenue. In 1992-1993, total LGU income jumped to 2.5 percent of GNP, which can be largely attributed to the rapid growth of LGU income from external sources. Thus, the share of income from external sources (largely derived from the internal revenue allotment or the IRA) to total LGU receipts registered a marked increase, from 49.3 percent in the earlier period to 60.3 percent in the later period (Table 3.2). Also, LGU income from external sources doubled from 0.8 percent of GNP in 1981-1991 to 1.5 percent in 1992-1993, compared to the

**Table 3.1**

**REVENUE STRUCTURE OF LOCAL GOVERNMENTS: 1981-1993 (Ratio to GNP in %)**

ALL LGUs	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
<b>A. LOCAL SOURCES</b>	0.84	0.98	0.86	1.02	1.00	0.97	0.76	0.78	0.77	0.73	0.70	0.85	0.86	0.83	0.80	1.16
i. Tax Revenues	0.58	0.73	0.60	0.75	0.71	0.67	0.52	0.52	0.55	0.51	0.49	0.51	0.56	0.55	0.55	0.90
1. Real Property Taxes	0.35	0.34	0.35	0.46	0.44	0.41	0.32	0.32	0.35	0.32	0.29	0.30	0.35	0.34	0.31	0.37
2. Others	0.22	0.39	0.25	0.29	0.27	0.26	0.20	0.21	0.20	0.19	0.20	0.21	0.21	0.21	0.24	0.53
ii. Operating & Misc. Revenues	0.25	0.24	0.25	0.27	0.28	0.29	0.24	0.26	0.22	0.22	0.21	0.27	0.28	0.26	0.22	0.26
iii. Capital	0.01	0.01	0.01	*	*	*	*	*	*	*	*	0.07	0.02	0.02	0.02	*
<b>B. EXTERNAL SOURCES</b>	0.82	1.50	0.93	0.80	0.89	0.88	0.68	0.75	0.68	0.60	0.99	0.82	0.91	1.06	1.18	1.81
1. Shares from National Taxes	0.61	1.40	0.73	0.61	0.72	0.71	0.55	0.59	0.54	0.50	0.53	0.55	0.65	0.75	1.11	1.68
2. Grants-in-Aids	0.19	0.04	0.17	0.15	0.15	0.12	0.10	0.13	0.12	0.09	0.46	0.27	0.25	0.27	0.04	0.04
3. Inter-local Government Transaction	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
4. Borrowings	0.02	0.06	0.02	0.04	0.02	0.03	0.03	0.01	0.01	*	*	0.01	0.01	0.04	0.03	0.09
5. Others	*	*	*	*	*	*	*	0.01	*	*	*	*	*	*	*	*
<b>TOTAL INCOME &amp; EXTRAORDINARY RECEIPTS &amp; BORROWINGS (A+B)</b>	1.67	2.48	1.79	1.82	1.89	1.84	1.45	1.53	1.45	1.33	1.69	1.67	1.77	1.89	1.98	2.98

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

**Table 3.1 (continuation)**

ALL PROVINCES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
A. LOCAL SOURCES	0.17	0.15	0.16	0.19	0.19	0.20	0.15	0.15	0.14	0.13	0.12	0.23	0.17	0.15	0.13	0.16
I. Tax Revenues	0.09	0.09	0.09	0.12	0.11	0.11	0.09	0.08	0.09	0.08	0.08	0.09	0.08	0.07	0.07	0.11
1. Real Property Taxes	0.07	0.07	0.07	0.10	0.09	0.09	0.07	0.06	0.08	0.07	0.06	0.07	0.06	0.06	0.06	0.08
2. Others	0.02	0.02	0.02	0.03	0.02	0.03	0.02	0.02	0.02	0.02	0.02	0.02	0.01	0.01	0.01	0.03
II. Operating & Misc. Revenues	0.07	0.05	0.06	0.07	0.08	0.08	0.06	0.07	0.05	0.04	0.04	0.08	0.09	0.08	0.04	0.06
III. Capital	0.01	0.01	0.01	*	*	*	*	*	*	*	*	0.07	*	*	0.02	*
B. EXTERNAL SOURCES	0.29	0.45	0.32	0.30	0.32	0.32	0.25	0.29	0.26	0.22	0.39	0.28	0.27	0.34	0.34	0.56
1. Shares from National Taxes	0.18	0.42	0.22	0.18	0.21	0.21	0.16	0.18	0.17	0.16	0.15	0.15	0.18	0.21	0.31	0.53
2. Grants-in-Aids	0.11	0.02	0.09	0.11	0.10	0.09	0.07	0.10	0.09	0.06	0.24	0.12	0.08	0.11	0.02	0.02
3. Inter-local Government Transaction	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
4. Borrowings	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	*	*	*	*	*	*	*	0.01
5. Others	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
TOTAL INCOME & EXTRAORDINARY RECEIPTS & BORROWING (A+B)	0.46	0.59	0.48	0.50	0.51	0.51	0.39	0.44	0.40	0.35	0.51	0.51	0.44	0.49	0.47	0.72

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

**Table 3.1 (continuation)**

ALL CITIES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
A. LOCAL SOURCES	0.37	0.38	0.38	0.47	0.46	0.44	0.35	0.35	0.35	0.33	0.31	0.33	0.37	0.36	0.33	0.44
I. Tax Revenues	0.28	0.30	0.28	0.38	0.36	0.33	0.26	0.25	0.26	0.24	0.23	0.24	0.26	0.25	0.25	0.35
1. Real Property Taxes	0.16	0.14	0.16	0.22	0.21	0.19	0.15	0.14	0.15	0.14	0.13	0.13	0.15	0.15	0.13	0.15
2. Others	0.12	0.16	0.12	0.16	0.15	0.14	0.11	0.11	0.11	0.10	0.10	0.11	0.11	0.11	0.12	0.20
II. Operating & Misc. Revenues	0.09	0.08	0.09	0.10	0.10	0.11	0.09	0.11	0.09	0.08	0.08	0.09	0.09	0.09	0.08	0.09
III. Capital	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
B. EXTERNAL SOURCES	0.23	0.46	0.26	0.25	0.29	0.28	0.22	0.23	0.19	0.16	0.20	0.21	0.23	0.26	0.35	0.57
1. Shares from National Taxes	0.20	0.41	0.23	0.22	0.27	0.25	0.19	0.21	0.17	0.15	0.16	0.17	0.20	0.22	0.33	0.49
2. Grants-in-Aids	0.02	*	0.02	0.01	0.02	0.01	0.01	0.01	0.01	0.01	0.03	0.03	0.03	0.03	*	0.01
3. Inter-local Government Transaction	*	*	*				*	*					*		*	*
4. Borrowings	0.01	0.05	0.01	0.02	0.01	0.02	0.02	0.01	0.01	*	*	*	0.01	0.01	0.02	0.07
5. Others	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
TOTAL INCOME & EXTRAORDINARY RECEIPTS & BORROWINGS (A+B)	0.60	0.84	0.64	0.73	0.75	0.72	0.57	0.59	0.54	0.49	0.51	0.54	0.60	0.61	0.68	1.01

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

Table 3.1 (continuation)

ALL MUNICIPALITIES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
A. LOCAL SOURCES	0.30	0.45	0.33	0.36	0.34	0.33	0.26	0.27	0.29	0.27	0.27	0.29	0.33	0.32	0.33	0.56
i. Tax Revenues	0.21	0.34	0.23	0.25	0.24	0.23	0.18	0.19	0.20	0.18	0.17	0.18	0.23	0.22	0.23	0.44
1. Real Property Taxes	0.12	0.13	0.12	0.15	0.14	0.13	0.11	0.11	0.12	0.11	0.09	0.10	0.14	0.13	0.12	0.15
2. Others	0.09	0.21	0.11	0.10	0.10	0.10	0.08	0.08	0.08	0.08	0.08	0.09	0.09	0.09	0.12	0.30
ii. Operating & Misc. Revenues	0.09	0.11	0.10	0.10	0.10	0.10	0.08	0.08	0.08	0.09	0.09	0.10	0.10	0.10	0.10	0.12
iii. Capital	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
B. EXTERNAL SOURCES	0.30	0.59	0.35	0.24	0.29	0.28	0.22	0.23	0.23	0.21	0.41	0.34	0.41	0.46	0.50	0.69
1. Shares from National Taxes	0.23	0.57	0.28	0.21	0.25	0.25	0.20	0.21	0.20	0.19	0.22	0.23	0.27	0.33	0.47	0.66
2. Grants-in-Aids	0.07	0.02	0.06	0.03	0.03	0.02	0.02	0.02	0.02	0.02	0.19	0.11	0.14	0.13	0.02	0.02
3. Inter-local Government Transaction	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
4. Borrowings	*	0.01	*	*	*	*	*	*	*	*	*	*	*	*	0.01	0.01
5. Others	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
TOTAL INCOME & EXTRAORDINARY RECEIPTS & BORROWINGS (A+B)	0.60	1.04	0.67	0.59	0.63	0.61	0.49	0.50	0.51	0.49	0.67	0.63	0.73	0.79	0.83	1.25

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.



**Table 3.2**

**REVENUE STRUCTURE OF ALL LOCAL GOVERNMENTS: 1981-1992 (Ratio to Total Income in %)**

ALL LGUs	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
<b>A. LOCAL SOURCES</b>	50.73	39.68	49.03	56.17	52.69	52.46	52.74	51.09	53.30	54.79	41.32	50.82	48.62	44.07	40.26	39.11
I. Tax Revenues	34.76	29.08	33.89	41.28	37.70	36.57	36.28	34.10	37.96	38.41	28.75	30.55	31.53	29.21	27.98	30.18
1. Real Property Taxes	21.31	14.07	20.20	25.39	23.45	22.45	22.28	20.61	24.02	23.82	16.99	17.91	19.56	17.96	15.72	12.43
2. Others	13.45	15.01	13.69	15.90	14.25	14.12	14.00	13.49	13.95	14.59	11.76	12.64	11.97	11.24	12.27	17.75
II. Operating & Misc. Revenues	15.30	10.00	14.48	14.74	14.83	15.71	16.39	16.81	15.27	16.28	12.47	16.00	15.94	13.45	11.13	8.87
III. Capital	0.68	0.60	0.66	0.14	0.16	0.18	0.07	0.18	0.06	0.10	0.11	4.28	1.15	1.02	1.14	0.07
<b>B. EXTERNAL SOURCES</b>	49.27	60.32	50.97	43.83	47.31	47.54	47.26	48.91	46.70	45.21	58.68	49.18	51.38	55.93	59.74	60.89
1. Shares from National Taxes	36.58	56.31	39.62	33.29	38.22	38.66	37.94	38.73	37.51	37.62	31.37	32.63	36.69	39.77	56.06	56.45
2. Grants-in-Aids	11.42	1.70	9.93	8.31	7.75	6.75	7.14	8.79	8.48	7.10	26.91	16.08	14.12	14.21	1.98	1.43
3. Inter-local Government Transaction	0.06	0.02	0.05	0.02	0.02	0.12	0.07	0.06	0.07	0.14	0.05	0.05	0.01	0.01	0.02	0.02
4. Borrowings	1.06	2.25	1.25	2.04	1.14	1.90	2.03	0.93	0.57	0.15	0.25	0.31	0.51	1.88	1.53	2.97
5. Others	0.14	0.03	0.12	0.16	0.18	0.12	0.08	0.39	0.07	0.20	0.10	0.11	0.04	0.06	0.04	0.02
<b>TOTAL INCOME &amp; EXTRAORDINARY RECEIPTS &amp; BORROWINGS (A+B)</b>	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

Table 3.2 (continuation)

ALL PROVINCES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
A. LOCAL SOURCES	36.02	25.59	34.42	38.76	37.47	38.30	37.34	34.66	34.67	36.36	23.16	45.74	38.69	31.11	28.54	22.65
I. Tax Revenues	20.15	15.11	19.38	24.80	22.34	22.10	21.70	18.75	22.73	24.21	15.82	16.98	17.31	14.93	15.32	14.89
1. Real Property Taxes	16.11	11.94	15.47	19.31	18.23	17.20	16.97	14.71	18.81	19.79	12.76	13.62	13.93	11.92	13.16	10.71
2. Others	4.04	3.17	3.90	5.49	4.11	4.91	4.73	4.04	3.91	4.42	3.06	3.37	3.38	3.01	2.16	4.18
II. Operating & Misc. Revenues	14.48	8.38	13.54	13.61	15.03	16.00	15.52	15.43	11.88	12.01	7.24	15.90	20.97	15.67	9.06	7.70
III. Capital	1.39	2.11	1.50	0.34	0.11	0.20	0.12	0.48	0.07	0.14	0.09	12.86	0.41	0.51	4.15	0.06
B. EXTERNAL SOURCES	63.98	74.41	65.58	61.24	62.53	61.70	62.66	65.34	65.33	63.64	76.84	54.26	61.31	68.89	71.46	77.35
1. Shares from National Taxes	39.35	70.17	44.09	36.31	41.17	41.28	41.66	40.35	43.06	46.31	29.32	29.36	41.73	42.30	66.35	73.96
2. Grants-in-Aids	22.80	3.27	19.80	22.68	19.21	17.14	18.42	23.42	21.99	16.04	47.11	24.23	19.25	21.33	4.24	2.30
3. Inter-local Government Transaction	0.16	0.02	0.14	0.09	0.06	0.43	0.22	0.00	0.19	0.46	0.15	0.11	0.03	0.04	0.03	0.01
4. Borrowings	1.42	0.92	1.35	1.96	1.57	2.52	2.11	1.24	0.02	0.36	0.05	0.45	0.17	5.22	0.79	1.05
5. Others	0.24	0.03	0.21	0.21	0.52	0.32	0.25	0.33	0.07	0.48	0.21	0.11	0.13	0.01	0.03	0.03
TOTAL INCOME & EXTRAORDINARY RECEIPTS & BORROWINGS (A+B)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

**Table 3.2 (continuation)**

ALL CITIES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
<b>A. LOCAL SOURCES</b>	62.21	46.05	59.72	65.09	61.58	61.42	61.88	60.60	65.01	66.60	61.33	61.69	61.09	57.98	48.59	43.50
I. Tax Revenues	45.95	35.64	44.37	51.74	47.80	46.42	45.24	42.51	48.17	49.33	45.42	44.59	42.84	41.43	36.75	34.53
1. Real Property Taxes	26.36	17.07	24.93	30.12	28.03	26.94	26.25	23.90	27.99	28.53	25.03	24.32	24.88	23.96	19.45	14.69
2. Others	19.59	18.57	19.44	21.62	19.77	19.48	18.99	18.61	20.18	20.80	20.40	20.27	17.95	17.47	17.31	19.84
II. Operating & Misc. Revenues	15.65	10.26	14.82	13.33	13.67	14.86	16.60	18.04	16.81	17.22	15.79	16.26	15.41	14.19	11.65	8.88
III. Capital	0.60	0.14	0.53	0.01	0.11	0.14	0.04	0.06	0.03	0.05	0.13	0.84	2.84	2.36	0.19	0.09
<b>B. EXTERNAL SOURCES</b>	37.79	53.95	40.28	34.91	38.42	38.58	38.12	39.40	34.99	33.40	38.67	38.31	38.91	42.02	51.41	56.50
1. Shares from National Taxes	32.85	48.32	35.23	29.81	35.42	34.69	33.34	35.09	31.36	30.39	31.83	31.43	32.71	35.30	47.89	48.67
2. Grants-in-Aids	3.39	0.44	2.93	1.73	2.05	1.73	1.45	1.95	2.55	2.77	6.11	6.29	5.08	5.57	0.30	0.57
3. Inter-local Government Transaction	0.02	0.01	0.01	*	*	*	0.01	0.17					*		0.01	0.01
4. Borrowings	1.39	5.18	1.98	3.21	0.86	2.10	3.30	1.46	1.02	0.08	0.65	0.42	1.11	1.12	3.10	7.25
5. Others	0.14	0.01	0.12	0.17	0.09	0.06	0.01	0.73	0.06	0.17	0.08	0.16	0.00	0.03	0.02	*
<b>TOTAL INCOME &amp; EXTRAORDINARY RECEIPTS &amp; BORROWINGS (A+B)</b>	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

**Table 3.2 (continuation)**

ALL MUNICIPALITIES	1981-91 average	1992-93 average	1981-93 average	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993**
A. LOCAL SOURCES	50.87	42.55	49.59	59.75	54.42	53.76	54.49	54.42	55.50	56.13	39.74	45.64	44.36	41.34	40.07	45.03
I. Tax Revenues	34.93	31.71	34.43	42.20	38.10	37.10	37.57	37.77	39.12	37.64	25.77	29.57	30.75	28.61	27.98	35.45
1. Real Property Taxes	20.35	12.86	19.19	24.65	22.22	21.58	21.92	21.96	23.90	21.99	14.06	15.90	18.56	17.07	14.12	11.59
2. Others	14.58	18.85	15.24	17.55	15.88	15.52	15.65	15.81	15.23	15.65	11.71	13.67	12.20	11.54	13.86	23.85
II. Operating & Misc. Revenues	15.78	10.71	15.00	17.42	16.04	16.46	16.86	16.59	16.30	18.38	13.86	15.85	13.40	12.45	11.88	9.53
III. Capital	0.16	0.13	0.15	0.13	0.28	0.19	0.06	0.06	0.07	0.11	0.10	0.23	0.21	0.28	0.21	0.05
B. EXTERNAL SOURCES	49.13	57.45	50.41	40.25	45.58	46.24	45.51	45.58	44.50	43.87	60.26	54.36	55.64	58.66	59.93	54.97
1. Shares from National Taxes	38.45	54.88	40.98	35.03	39.16	41.13	40.31	41.56	39.65	38.65	32.56	36.32	36.95	41.66	56.91	52.67
2. Grants-in-Aids	10.17	1.84	8.89	4.42	5.27	3.95	4.70	3.93	4.18	5.06	27.55	17.83	18.45	16.50	2.08	1.61
3. Inter-local Government Transaction	0.02	0.03	0.02	*	*	*	0.01	*	0.06	0.05	*	0.03	0.01	0.01	0.02	0.03
4. Borrowings	0.44	0.65	0.48	0.68	1.13	1.14	0.48	0.04	0.54	0.07	0.10	0.11	0.22	0.37	0.68	0.63
5. Others	0.05	0.04	0.05	0.12	0.02	0.02	0.02	0.05	0.07	0.04	0.05	0.07	0.01	0.11	0.07	0.02
TOTAL INCOME & EXTRAORDINARY RECEIPTS & BORROWINGS (A+B)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

\* Less than .01%.

\*\* Adjusted for DOH and DA advances.

sluggish expansion of LGU income from local sources which increased only slightly from 0.8 to 1.0 percent of GNP.

There is a substantial variation in the importance of externally sourced income in the total receipts of different levels LGUs. Provinces are largely dependent on non-local sources, which comprised 64.0 percent of their total income in 1981-1991. On the other hand, externally sourced income contributed 49.1 percent of the total income of municipalities and 37.8 percent of the total income of cities in the same period. In all cases, the contribution of externally sourced income to the total receipt of LGUs increased in 1992-1993 to 74.4 percent for provinces, 57.5 percent for municipalities and 54.0 percent for cities. Moreover, the share of IRA alone in total LGU income rose from 42.3 percent in 1991 to 77.6 percent in 1993 in the provinces, from 41.7 to 52.7 percent in the municipalities, and from 35.3 to 48.7 percent in the cities.

Likewise, LGUs' borrowing rose from 0.02 percent of GNP in 1981-1991 to 0.06 percent in 1992-1993. In contrast, categorical grants (i.e., non-block grants or grants that are granted for a specific purpose) from the national government declined from 0.19 percent in 1981-1991 to 0.04 percent of GNP in 1992-1993.

While LGU's externally sourced income rose consistently in 1992-1993, local revenue effort posted a minimal decline from 0.84 percent of GNP in 1981-1991 to 0.80 percent in 1992 before quickly recovering to 1.16 percent in 1993. This development is traceable to similar movements in the real property tax (RPT) and the operating and miscellaneous income of LGUs.

Taxes accounted for the bulk of locally sourced revenue. The share of tax revenue to total locally sourced income was 68.4 percent on the average in 1981-1991. This expanded to 73.3 percent in 1992-1993. Focusing on the different levels of government, the share of taxes in locally generated revenue had been consistently highest in cities and lowest in provinces

in 1981-1993. Specifically, local taxes contributed 74.4 percent of all local source income of cities, 69.4 percent of that of municipalities and 57.2 percent of that of provinces during the same period.

The RPT is the single major source of locally generated LGU revenue, contributing 41.9 percent in 1981-1991. However, its importance weakened during the period under study, with its share in total LGU local source income dropping to 35.4 percent in 1992-1993. This trend is shown in the declining share of RPT revenue in total local source income of cities (from 42.3 to 36.9 percent) and municipalities (from 39.9 to 30.5 percent). In contrast, the contribution of RPT revenue to total locally sourced income of provinces increased slightly from 45.4 to 46.7 percent.

Consequently, RPT revenue in all LGUs in the aggregate deteriorated almost imperceptibly from 0.35 percent of GNP in 1981-1991 to 0.34 percent in 1992-1993. The RPT effort declined in cities (from 0.16 to 0.14 percent), was stable at 0.07 percent in provinces and increased (from 0.12 to 0.13 percent) in municipalities. This occurred as the LGUs' collection efficiency (i.e., ratio of actual collections to total collectibles based on current year tax liabilities) of the RPT declined from 58.9 percent in 1991 to 49.7 percent in 1992. The deterioration was from 54.1 to 44.3 percent in the case of provinces and municipalities, and from 65.1 to 56.4 percent in the case of cities (Table 3.3). Note that the higher provincial share in the proceeds of the RPT under the Code was not enough to offset the reduced collection efficiency in 1992.

On the other hand, revenue from other local taxes (i.e., non-property) rose from 0.22 percent of GNP in 1981-1991 to 0.39 percent of GNP in 1992-1993. This movement was especially pronounced in the case of cities and municipalities. In contrast, operating and miscellaneous income of all LGUs in the aggregate shrank from 0.25 to 0.24 percent of GNP. This trend was apparent in the case of cities and provinces.

**Table 3.3**

**COLLECTION RATES OF CURRENT YEAR AND BASIC RPT, 1983-1992**

	All LGUs	Provinces	Cities
1983	59.71	58.61	60.87
1984	54.24	50.78	58.76
1985	46.85	41.98	53.20
1986	51.26	49.59	53.36
1987	52.77	49.53	56.74
1988	54.30	49.39	60.67
1989	57.98	55.55	60.98
1990	57.75	53.55	63.30
1991	58.92	54.09	65.06
1992	49.71	44.29	56.41

- *Sources of Capital Finance*

In practice, own-source recurrent revenue of local governments has not been sufficient to cover their current operations in both periods. In contrast, LGUs, in the aggregate, generally have some IRA left after taking care of their recurrent expenditures. Thus, LGUs' IRA in excess of their current operating expenditure financed 27.6 percent of their capital expenditures in 1985-1991. In 1992-1993, their "excess IRA" was even larger than their capital outlays (Table 3.4).<sup>7</sup> It is interesting to note that in the aggregate, LGUs posted surpluses even after they have funded their capital expenditures. Their overall surplus in 1985-1993 was equal to 0.11 percent of GNP (or about 6 percent of total LGU income) on the average.<sup>8</sup>

<sup>7</sup> The large "excess IRA" in 1992 may be attributed to the fact that while the IRA share of LGUs rose for that year as mandated by the Code, the devolution program was not implemented until 1993 and thus, LGUs did not assume the expenditures for the functions that were transferred to them until then. However, it is rather surprising that LGUs registered "excess IRA" in 1993 even after they have started to take over the financing of devolved responsibilities and even after their capital expenditures rose by 63 percent over the previous year's level.

Table 3.4

## CAPITAL OUTLAYS OF LGUs, 1985-1993

	1985	1986	1987	1988	1989	1990	1991	1992	1993	Average 1985-1993	Average 1985-1991	Average 1992-1993
LEVELS (in million pesos)												
Total Expenditure	8,507.923	8,719.157	9,587.172	11,244.606	13,891.618	18,021.521	23,681.952	26206.003	40817.899			
Current Operating Expenditure	7,301.312	7,840.351	8,474.148	9,929.439	11,528.687	14,862.009	18,366.793	21469.794	33113.209			
Capital Outlay	1,206.611	878.806	1,113.024	1,315.167	2,362.931	3,159.512	5,315.159	4736.209	7704.69			
Total Income	8,510.17	8,661.099	8,913.567	13,394.411	15,280.676	19,062.413	23,899.469	2,7433.5	45,215.885			
of which:												
Regular Own Source Income	4,332.713	4,610.98	4,875.156	5,520.433	7,112.37	9,049.02	10,290.485	10,730.984	17,655.221			
Total Own Source Income	4,348.046	4,615.939	4,883.711	5,534.759	7,765.812	9,268.083	10,533.437	11,043.337	17,685.855			
IRA	3,296.297	3,249.154	3,353.089	4,202.112	4,985.726	6,994.654	9,504.039	15,378.502	25,268.148			
Share in National Wealth								30.626	258.222			
Other Grants	747.79	734.213	632.923	3,603.942	2,457.119	2,692.51	3,396.331	543.855	645.428			
Total NG Transfers to LGUs	4,044.087	3,983.367	3,966.012	7,806.054	7,442.845	9,687.164	12,900.37	15,952.983	26,171.798			
Borrowings	79.208	49.698	13.411	33.383	48.032	97.419	448.367	420.916	1,342.456			
Part of Own Source Income												
Used to Fund Capex	-2,953.266	-3,224.412	-3,590.437	-4,394.68	-3,762.875	-5,593.926	-7,833.356	-10,426.457	-1,5427.354			
Part of IRA Used to Fund Capex	343.031	24.742	-237.348	-192.568	1,222.851	1,400.728	1,670.683	4,952.045	9,840.794			
Other Grants Used to Fund Capex	747.79	734.213	395.575	3,411.374	2,457.119	2,692.51	3,396.331	574.481	903.65			
Current Surplus before Borrowing	1,129.65	771.05	426.008	3,431.589	3,703.957	4,102.985	5,084.309	5,542.79	10,760.22			
Overall Surplus	2.247	-58.058	-673.605	2,149.805	1,389.058	1,040.892	217.517	1,227.497	4,397.986			
Capex Plus Financial Investments	1,208.858	820.748	439.419	3,464.972	3,751.989	4,200.404	5,532.676	5,963.706	12,102.676			



**Table 3.4 (continuation)**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	Average 1985-1993	Average 1985-1991	Average 1992-1993
<b>SELECTED RATIOS</b>												
<b>Percent of Capex Funded by:</b>												
IRA	28.43	2.82	-21.32	-14.64	51.75	44.33	31.43	104.56	127.72	68.45	27.57	118.90
Other Grants of NG	61.97	83.55	35.54	259.39	103.99	85.22	63.90	12.13	11.73	55.10	90.12	11.88
Borrowings	6.56	5.66	1.20	2.54	2.03	3.08	8.44	8.89	17.42	9.11	5.01	14.17
<b>% of Capex and Financial Inv. Funded by:</b>												
IRA	28.38	3.01	-54.01	-5.56	32.59	33.35	30.20	83.04	81.31	50.75	21.79	81.88
Other Grants of NG	61.86	89.46	90.02	98.45	65.49	64.10	61.39	9.63	7.47	40.85	71.24	8.18
Borrowings	6.55	6.06	3.05	0.96	1.28	2.32	8.10	7.06	11.09	6.76	3.96	9.76
% of current Surplus to Total Income bef. Borr.	13.40	8.95	4.79	25.68	24.32	21.63	21.68	20.52	24.53	20.83	19.24	23.00
% of current Surplus to Capex	93.62	87.74	38.27	260.92	156.75	129.86	95.66	117.03	139.66	125.76	121.49	131.04
% of current Surplus to Capex & Financial Inv.	93.45	93.94	96.95	99.04	98.72	97.68	91.90	92.94	88.91	93.24	96.04	90.24
% of Capex to GNP	0.22	0.15	0.17	0.17	0.26	0.29	0.42	0.34	0.51	0.32	0.26	0.43
% of Capex & Financial Inv. to GNP	0.22	0.14	0.07	0.44	0.41	0.39	0.44	0.43	0.80	0.43	0.33	0.62
% of Capex to Total Expenditure	14.18	10.08	11.61	11.70	17.01	17.53	22.44	18.07	18.88	17.30	16.39	18.56
% of Capex & Fin. Inv. to Total Expenditure	14.21	9.41	4.58	30.81	27.01	23.31	23.36	22.76	29.65	23.33	20.73	26.96
% of Capex to Total Income before Borrowing	14.31	10.21	12.51	9.84	15.51	16.66	22.66	17.53	17.56	16.56	15.83	17.55
% of Capex & Financial Investment to Total Income before Borrowing	14.34	9.53	4.94	25.93	24.63	22.15	23.59	22.08	27.59	22.33	20.03	25.49

Categorical grants from the national government financed 90.1 percent of LGU capital spending in 1985-1991. In 1992-1993, this source of finance dwindled to 23.8 percent of capital outlay. This occurred as the national government moved away from the practice of providing specific grants for capital spending, like road construction and rehabilitation, because of concerns about macroeconomic stability in the face of higher IRA shares to LGUs.

Finally, debt financing funded only 5.0 percent of LGU capital outlays in 1985-1991. However, the discussion below highlights the need for LGUs to reconsider borrowing as a source of capital finance in the future.

Although the 1991 LGC expanded the revenue-raising powers of LGUs, it also reduced the assessment levels of some kinds and classes of land and improvements for purposes of real property taxation. Also, it should be emphasized that Code provisions are largely enabling rather than executory. Thus, the overall impact of the Code on LGUs' local-source revenue will depend on the extent to which they exercise their taxing powers, the changes in the statutory rates and legal tax bases, and the growth and composition of their tax base. At the same time, it should be noted that the higher IRA levels may have disincentive effects on the local-revenue mobilization.<sup>9</sup>

The law requires that LGUs allot at least 20 percent of their IRA to development projects.<sup>10</sup> However, while the IRA has been a major source of capital finance in the early years of Code implementation, it is not clear that this will be maintained in the post-Code period. The Code transferred

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<sup>8</sup> Many analysts have observed that most LGUs post surpluses in most years because of the conservatism on the part of many local treasurers, arising from the fact that an overdraft in LGU finances subjects them to disciplinary action.

<sup>9</sup> This issue is discussed further in page 70.

<sup>10</sup> This requirement is common to the periods before and after the Code.

substantial expenditure responsibilities to LGUs concomitant with increased IRA share. As a corollary, these new responsibilities mean that LGUs need to have bigger recurrent budgets, to support the operations of a more autonomous local government system. Moreover, even if some LGUs find themselves able to generate higher current surplus after the enactment of the Code, the lumpy and indivisible nature of most capital spending for improvements and additions to physical structures to support the broader powers and functions of LGUs implies that current revenue will, in general, not be sufficient to cover the present needs for capital financing. Also, as Petersen and Strachota (1991) pointed out, "attempts to accumulate funds in a 'savings account' in the form of growing fund balances not only postpone the receipt of the benefits of the desired expenditure, but also require a political discipline that can seldom be sustained." On the other hand, building infrastructure/facilities on a piecemeal basis is not always possible and even where it is, it may not be advisable because of associated cost inefficiencies.

## **ESTIMATING LGU DEMAND FOR DEBT FINANCE**

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In estimating LGUs' potential demand for debt financing, this study examines LGUs' debt capacity. Debt-capacity analysis may be used in determining how much individual LGUs should be allowed to borrow and in determining the size of the credit pool that LGUs may require. In general, there are several methods that have been used to determine the debt capacity of LGUs, including debt-ceiling formulae and cash flow analysis, among others (Mc Master 1992).<sup>11</sup>

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<sup>11</sup> Other approaches involve balance sheet analysis and the existence of credit rating systems. Balance sheet analysis is not deemed applicable to LGUs because most of their assets cannot be sold to liquidate their debt. On the other hand, many developing countries do not have credit rating institutions.

Two criticisms have been raised against debt ceilings. First, debt ceilings do not take into account the fact that many LGUs borrow for revenue-generating projects. In the Philippine context, it is interesting to note that under the Code, LGUs are allowed to issue only revenue bonds (as opposed to general obligation bonds). Second, debt ceilings look at only the revenue side of the fiscal position of LGUs. Most LGUs have little room for maneuver on the expenditure side of their budgets because of the numerous mandatory requirements they have to comply with. Both these shortcomings may be addressed by using cash-flow type of analysis.

- *LGU Borrowing Capacity*

The Code mandates that a local government's appropriation for debt service should not exceed 20 percent of its regular income (Section 324 b). In so doing, it implicitly defines the statutory ceiling on the borrowing capacity of LGUs.

Based on the standard annuity formula, the maximum borrowing capacity (MBC) of an LGU may be expressed as:

$$MBC = R \cdot \left( \frac{1}{1+i} \right) \cdot \frac{1 - \left( \frac{1}{1+i} \right)^n}{1 - \left( \frac{1}{1+i} \right)} \quad (1)$$

where  $R$  = 20 percent of the regular income of an LGU;  
 $i$  = interest rate; and  
 $n$  = number of years to pay the debt.

Note that the maximum borrowing capacity as defined in equation 1 varies positively with the LGU's regular income and negatively with the interest rate.

The maximum borrowing capacity of LGUs was estimated based on equation 1 for different levels of LGUs (classified

by income class) for the years 1991 and 1992,<sup>12</sup> using data from budget operations statement of individual LGUs obtained from the Bureau of Local Government Finance (BLGF). The maximum borrowing capacity for 1995 was projected based on the trend growth in local source LGU income and the expected growth in the IRA.<sup>13</sup> Because of the huge increment in LGU income, particularly from IRA, from 1992 onwards, the maximum borrowing capacity of LGUs in the aggregate surged from P17.8 billion in 1991 (assuming a 15 percent interest rate and debt maturity of 10 years) to P58.9 billion in 1995, reflecting an increase of more than 200 percent (Table 3.5).

Prior to the Code, the legal borrowing capacity was defined by the Commission on Audit (COA) to be equal to 7 percent of the aggregate assessed value of the taxable real properties in a local unit's jurisdiction less outstanding loans. Based on the empirical relationship between the taxable assessed value of real property in the past<sup>14</sup> and the projected LGU income for 1995, the statutory borrowing capacity of LGUs using the old COA formula is equal to approximately 35.1 billion in 1995, roughly 40 percent lower than the maximum borrowing capacity under the 1991 Code. Thus, the 1991 Code clearly liberalizes LGU credit financing to the extent

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<sup>12</sup> Regular income is defined as recurrent receipts. It is equal to total income/receipts less grants-in-aids, inter-local transactions, borrowing, and local source capital revenue (refer to revenue classification in Annex 2).

<sup>13</sup> It is assumed that local source income of provinces, cities and municipalities increase annually by 18.7 percent, 22.2 percent and 34.8 percent, respectively, between 1992 and 1995. On the other hand, it is assumed that the IRA increases by 35 percent yearly on the average over the same period.

<sup>14</sup> Revenue from the real property tax in provinces, cities and municipalities is assumed to grow by 18.9 percent, 14.1 percent and 18.9 percent yearly in 1992-1995. The average RPT rate (inclusive of SEF) is assumed to be 2.5 percent and the collection rate is assumed to be 55 percent, the average in 1985-1992.

**Table 3.5a****AGGREGATE BORROWING CAPACITY (USING LGC DEFINITION), 1991**  
(In pesos)

	$r = .15$ term = 5	$r = .15$ term = 10	$r = .15$ term = 15	$r = .20$ term = 5	$r = .20$ term = 10	$r = .20$ term = 15
<b>PROVINCES</b>						
Class 1	1,359,317,372	2,035,138,334	2,371,140,810	1,212,709,709	1,700,070,544	1,895,929,930
Class 2	459,768,836	688,355,201	802,003,029	410,180,980	575,023,516	641,270,034
Class 3	220,742,879	330,491,101	385,055,366	196,934,901	276,078,622	307,884,707
Class 4	107,810,444	161,411,288	188,060,381	96,182,668	134,836,326	150,370,364
Class 5	103,097,976	154,355,890	179,840,134	91,978,458	128,942,538	143,797,573
Class 6	9,540,083	14,283,190	16,641,353	8,511,148	11,931,587	13,306,185
Total	2,260,277,590	3,384,035,004	3,942,741,073	2,016,497,864	2,826,883,133	3,152,558,793
<b>MUNICIPALITIES</b>						
Class 1	1,494,730,147	2,237,875,189	2,607,349,633	1,333,517,689	1,869,428,543	2,084,799,092
Class 2	361,101,647	540,632,982	629,891,789	322,155,430	451,622,473	503,652,373
Class 3	485,108,482	726,293,129	846,204,531	432,787,646	606,715,295	676,612,916
Class 4	1,125,203,416	1,684,628,367	1,962,761,452	1,003,845,853	1,407,268,989	1,569,395,697
Class 5	1,199,244,606	1,795,481,114	2,091,916,049	1,069,901,413	1,499,870,796	1,672,665,846
Class 6	372,184,631	557,226,168	649,224,519	332,043,072	465,483,735	519,110,545
Total	5,037,572,929	7,542,136,948	8,787,347,973	4,494,251,104	6,300,389,832	7,026,236,468

**Table 3.5a (continuation)**

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	1,615,221,791	2,418,272,474	2,817,530,611	1,441,013,841	2,020,124,987	2,252,856,765
Class 1	2,227,836,031	3,335,464,257	3,886,151,269	1,987,555,254	2,786,309,136	3,107,310,403
Class 2	493,716,313	739,180,573	861,219,699	440,467,089	617,480,934	688,618,827
Class 3	126,071,229	188,750,910	219,913,791	112,473,957	157,674,718	175,839,889
Class 4	88,809,812	132,963,984	154,916,412	79,231,329	111,072,623	123,868,924
Class 5	16,314,270	24,425,345	28,457,984	14,554,713	20,403,925	22,754,592
Class 6	6,766,904	10,131,251	11,803,926	6,037,067	8,463,229	9,438,249
Total	4,574,736,350	6,849,188,794	7,979,993,691	4,081,333,249	5,721,529,552	6,380,687,650
<b>ALL LGUs</b>						
Special	1,615,221,791	2,418,272,474	2,817,530,611	1,441,013,841	2,020,124,987	2,252,856,765
Class 1	5,081,883,550	7,608,477,779	8,864,641,711	4,533,782,652	6,355,808,223	7,088,039,425
Class 2	1,314,586,796	1,968,168,756	2,293,114,518	1,172,803,499	1,644,126,924	1,833,541,234
Class 3	831,922,590	1,245,535,140	1,451,173,688	742,196,504	1,040,468,635	1,160,337,512
Class 4	1,321,823,672	1,979,003,639	2,305,738,245	1,179,259,850	1,653,177,937	1,843,634,985
Class 5	1,318,656,852	1,974,262,349	2,300,214,166	1,176,434,584	1,649,217,260	1,839,218,011
Class 6	388,491,618	581,640,609	677,669,799	346,591,287	485,878,552	541,854,979
Total	11,872,586,869	17,775,360,746	20,710,982,737	10,592,082,217	14,848,802,516	16,559,482,912

**Table 3.5b****AGGREGATE BORROWING CAPACITY (USING LGC DEFINITION), 1992**

(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	2,209,396,608	3,307,857,182	3,853,986,250	1,971,104,594	2,763,247,326	3,081,591,719
Class 2	653,588,985	978,538,217	1,140,095,424	583,096,872	817,430,428	911,603,827
Class 3	410,950,229	615,265,119	716,845,734	366,627,649	513,967,079	573,179,491
Class 4	198,242,346	296,803,827	345,806,304	176,861,138	247,937,663	276,501,724
Class 5	176,502,057	264,254,772	307,883,382	157,465,624	220,747,527	246,179,104
Class 6	25,151,673	37,656,499	43,873,609	22,438,967	31,456,685	35,080,703
<b>Total</b>	<b>3,673,831,698</b>	<b>5,500,375,615</b>	<b>6,408,490,703</b>	<b>3,277,594,845</b>	<b>4,594,786,708</b>	<b>5,124,136,568</b>
<b>MUNICIPALITIES</b>						
Class 1	1,955,015,958	2,927,004,393	3,410,254,453	1,744,159,886	2,445,098,629	2,726,790,185
Class 2	486,657,902	728,612,885	848,907,279	434,169,955	608,653,123	678,773,994
Class 3	645,217,647	966,004,845	1,125,492,784	575,628,415	806,960,566	899,927,768
Class 4	1,611,435,671	2,412,603,983	2,810,926,249	1,437,636,069	2,015,389,764	2,247,576,013
Class 5	1,847,363,466	2,765,829,587	3,222,469,597	1,648,118,134	2,310,459,851	2,576,640,128
Class 6	728,562,713	1,090,787,138	1,270,876,704	649,984,392	911,198,542	1,016,174,649
<b>Total</b>	<b>7,274,253,357</b>	<b>10,890,842,830</b>	<b>1,270,876,704</b>	<b>649,984,392</b>	<b>911,198,542</b>	<b>1,016,197,649</b>



Table 3.5b (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	1,775,549,843	2,658,311,902	3,097,200,682	1,584,049,889	2,220,644,015	2,476,476,913
Class 1	2,967,355,596	4,442,655,738	5,176,140,683	2,647,314,759	3,711,211,190	4,138,767,299
Class 2	779,216,145	1,166,624,277	1,359,234,597	695,174,654	974,549,758	1,086,824,344
Class 3	211,513,484	316,673,066	368,955,966	188,700,932	264,535,605	295,011,859
Class 4	172,886,548	258,841,716	301,576,628	154,240,062	216,225,683	241,136,314
Class 5	46,742,209	69,981,347	81,535,307	41,700,880	58,459,529	65,194,453
Class 6	17,103,744	25,607,327	29,835,112	15,259,039	21,391,304	23,855,724
Total	5,970,367,569	8,938,695,374	10,414,478,975	5,326,440,215	7,467,017,084	8,327,266,907
<b>ALL LGUs</b>						
Special	1,775,549,843	2,658,311,902	3,097,200,682	1,584,049,889	2,220,644,015	2,476,476,913
Class 1	7,131,768,162	10,677,517,312	12,440,381,386	6,362,579,239	8,919,557,144	9,947,149,203
Class 2	1,919,463,032	2,873,775,379	3,348,237,300	1,712,441,482	2,400,633,309	2,677,202,166
Class 3	1,267,681,360	1,897,943,029	2,211,294,484	1,130,956,997	1,585,463,250	1,768,119,118
Class 4	1,982,564,565	2,968,249,526	3,458,309,181	1,768,737,269	2,479,553,111	2,765,214,051
Class 5	2,070,607,732	3,100,065,706	3,611,888,287	1,847,284,638	2,589,666,906	2,888,013,685
Class 6	770,818,130	1,154,050,965	1,344,585,424	687,682,398	964,046,531	1,075,111,077
Total	16,918,452,824	25,329,913,820	29,511,896,744	15,093,731,912	21,159,564,267	23,597,286,213

that it provides a more generous statutory ceiling on the borrowing capacity of LGUs.

*Profile of LGU borrowing capacity.* The BLGF data base included information for 75 provinces, 60 cities and 1,413 municipalities in 1994. In 1992, it referred to 72 provinces, 60 cities and 1,465 municipalities. The distribution of these LGUs into the various income classes is based on the Department of Finance's Department Order 35-93.

Table 3.5c shows that LGUs in the first tier (i.e., LGUs in the first income class and special cities) account for the majority (51.7 percent or P31.2 billion) of the total borrowing capacity of LGUs in 1995, assuming that the rate of interest is 15 percent and that the loan matures in 10 years. LGUs in the second tier (i.e., those belonging to the second and third income classes) contribute 18.9 percent (or P11.4 billion) while LGUs in the third tier (i.e., 4th, 5th and 6th income classes) account for 29.3 percent (or P17.7 billion) of the aggregate borrowing capacity of all LGUs in 1995.

The average borrowing capacity of LGUs exhibits a wide variation across different levels of local government and different income classes. As expected, cities have the highest average borrowing capacity at P335.8 million in 1995 (Table 3.6c). The average borrowing capacity of provinces was estimated to be P185.5 million while that of the municipalities was pegged at P18.3 million.

The variation in the average borrowing capacity within each level of local government is likewise very pronounced. The ratio of the borrowing capacity of the average LGU in the highest income class to that of the average LGU in the lowest income class is highest in cities at (51.9) and lowest in provinces (6.3) in 1995. The ratio for municipalities is 29.9.

- *LGU Net Paying Capacity*

The maximum borrowing capacity of LGUs as defined by the Code is a very crude measure of LGU potential demand

**Table 3.5c**

**PROJECTED AGGREGATE BORROWING CAPACITY (USING LGC DEFINITION), 1995**

(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
1st Class	5,332,203,201	7,983,250,580	9,301,289,662	4,757,104,358	6,668,877,907	7,437,176,819
2nd Class	1,584,929,290	2,372,919,260	2,764,889,541	1,413,988,505	1,982,238,772	2,210,605,810
3rd Class	1,015,494,852	1,520,375,267	1,771,390,063	905,969,784	1,270,059,722	1,416,377,900
4th Class	489,288,544	732,551,424	853,496,069	436,516,872	611,943,213	682,443,125
5th Class	436,581,238	653,639,272	761,555,477	389,494,254	546,023,259	608,928,756
6th Class	62,414,625	93,445,725	108,873,666	55,682,966	78,060,700	87,053,810
Total	8,920,911,750	13,356,181,529	15,561,294,478	7,958,756,739	11,157,202,574	12,442,586,220
<b>MUNICIPALITIES</b>						
1st Class	4,927,055,868	7,376,673,419	8,594,566,276	4,395,653,740	6,162,168,392	6,872,091,012
2nd Class	1,182,548,111	1,770,483,520	2,062,791,328	1,055,005,700	1,478,988,830	1,649,378,140
3rd Class	1,567,422,411	2,346,708,368	2,734,151,216	1,398,369,811	1,960,343,275	2,186,187,807
4th Class	3,934,520,529	5,890,672,600	6,863,225,901	3,510,167,195	4,920,824,665	5,487,736,264
5th Class	4,517,441,352	6,763,408,095	7,880,050,508	4,030,217,741	5,649,871,862	6,300,774,528
6th Class	1,786,140,444	2,674,167,918	3,115,674,519	1,593,498,253	2,233,889,463	2,491,248,327
Total	17,915,128,714	26,822,113,921	31,250,459,748	15,982,912,441	22,406,086,487	24,987,416,077

**Table 3.5c (continuation)**

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	3,485,042,110	5,217,723,969	6,079,173,078	3,109,166,771	4,358,671,164	4,860,818,956
1st Class	6,283,281,817	9,407,183,358	10,960,314,527	5,605,605,448	7,858,372,555	8,763,709,131
2nd Class	1,716,600,676	2,570,054,595	2,994,372,029	1,531,458,620	2,146,917,492	2,394,256,609
3rd Class	472,813,638	707,885,579	824,757,879	421,818,849	591,338,384	659,464,483
4th Class	385,678,341	577,428,640	672,762,428	344,081,433	482,360,044	537,931,116
5th Class	105,155,127	157,435,810	183,428,550	93,813,738	131,515,376	146,666,818
6th Class	39,726,930	59,478,235	69,298,125	35,442,226	49,685,662	55,409,779
Total	12,488,298,639	18,697,190,186	21,784,106,615	11,141,387,085	15,618,860,676	17,418,256,892
<b>ALL LGUs</b>						
Special	3,485,042,110	5,217,723,969	6,079,173,078	3,109,166,771	4,358,671,164	4,860,818,956
1st Class	16,542,540,886	24,767,107,357	28,856,170,465	14,758,363,546	20,689,418,855	23,072,976,962
2nd Class	4,484,078,077	6,713,457,376	7,821,852,898	4,000,452,825	5,608,145,094	6,254,240,559
3rd Class	3,055,730,900	4,574,969,213	5,330,299,158	2,726,158,444	3,821,740,381	4,262,030,189
4th Class	4,809,487,414	7,200,652,665	8,389,484,398	4,290,765,500	6,015,127,922	6,708,110,505
5th Class	5,059,177,717	7,574,483,178	8,825,034,535	4,513,525,734	6,327,410,497	7,056,370,102
6th Class	1,888,281,999	2,827,091,879	3,293,846,310	1,684,623,445	2,361,635,825	2,633,711,916
Total	39,324,339,103	58,875,485,636	68,595,860,841	35,083,056,266	49,182,149,737	54,848,259,189

**Table 3.6a**

**BORROWING CAPACITY OF AVERAGE LGU (USING LGC DEFINITION), 1991**  
(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	48,547,049	72,683,512	84,683,600	43,311,061	60,716,805	67,711,783
Class 2	28,735,552	43,022,200	50,125,189	25,636,311	35,938,970	40,079,377
Class 3	22,074,288	33,049,110	38,505,537	19,693,490	27,607,862	30,788,471
Class 4	15,401,492	23,058,755	26,865,769	13,740,381	19,262,332	21,481,481
Class 5	11,455,331	17,150,654	19,982,237	10,219,829	14,326,949	15,977,508
Class 6	4,770,042	7,141,595	8,320,676	4,255,574	5,965,794	6,653,093
Total	31,392,744	47,000,486	54,760,293	28,006,915	39,262,266	43,785,539
<b>MUNICIPALITIES</b>						
Class 1	41,520,282	62,163,200	72,426,379	37,042,158	51,928,571	57,911,086
Class 2	9,259,017	13,862,384	16,151,072	8,260,396	11,580,063	12,914,163
Class 3	5,844,681	8,750,520	10,195,235	5,214,309	7,309,823	8,151,963
Class 4	3,713,543	5,559,830	6,477,761	3,313,023	4,644,452	5,179,524
Class 5	1,988,797	2,977,581	3,469,181	1,774,298	2,487,348	2,773,907
Class 6	928,141	1,389,591	1,619,014	828,038	1,160,807	1,294,540
Total	3,438,616	5,148,216	5,998,190	3,067,748	4,300,607	4,796,066

**Table 3.6a (continuation)**

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	807,620,896	1,209,136,237	1,408,765,305	720,506,921	1,010,062,494	1,126,428,383
Class 1	85,686,001	128,287,087	149,467,356	76,444,433	107,165,736	119,511,939
Class 2	29,042,136	43,481,210	50,659,982	25,909,829	36,322,408	40,506,990
Class 3	21,011,872	31,458,485	36,652,298	18,745,659	26,279,120	29,306,648
Class 4	14,801,635	22,160,664	25,819,402	13,205,221	18,512,104	20,644,821
Class 5	8,157,135	12,212,673	14,228,992	7,277,356	10,201,963	11,377,296
Class 6	6,766,904	10,131,251	11,803,926	6,037,067	8,463,229	9,438,249
Total	76,245,606	114,153,147	132,999,895	68,022,221	95,358,826	106,344,794
<b>ALL LGUs</b>						
Special	807,610,896	1,209,136,237	1,408,765,305	720,506,921	1,010,062,494	1,126,428,383
Class 1	56,465,373	84,538,642	98,496,019	50,375,363	70,620,091	78,755,994
Class 2	18,258,150	27,335,677	31,848,813	16,288,937	22,835,096	25,465,850
Class 3	8,403,258	12,581,163	14,658,320	7,496,934	10,509,784	11,720,581
Class 4	4,182,986	6,262,670	7,296,640	3,731,835	5,231,576	5,834,288
Class 5	2,147,650	3,215,411	3,746,277	1,916,017	2,686,022	2,995,469
Class 6	961,613	1,439,704	1,677,400	857,899	1,202,670	1,341,225
Total	7,434,306	11,130,470	12,968,117	6,632,487	9,297,935	10,369,119

**Table 3.6b**

**BORROWING CAPACITY OF AVERAGE LGU (USING LGC DEFINITION), 1992**  
(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	78,907,022	118,137,756	137,642,366	70,396,593	98,687,404	110,056,847
Class 2	40,849,312	61,158,639	71,255,964	36,443,554	51,089,402	56,975,239
Class 3	41,095,023	61,526,512	71,684,573	36,662,765	51,396,708	57,317,949
Class 4	28,320,335	42,400,547	49,400,901	25,265,877	35,419,666	39,500,246
Class 5	19,611,340	29,361,641	34,209,265	17,496,180	24,527,503	27,353,234
Class 6	12,575,837	18,828,250	21,936,805	11,219,484	15,728,343	17,540,352
Total	51,025,443	76,394,106	89,006,815	45,522,151	63,816,482	71,168,563
<b>MUNICIPALITIES</b>						
Class 1	54,305,999	81,305,678	94,729,290	48,448,886	67,919,406	75,744,172
Class 2	12,478,408	18,682,382	21,766,853	11,132,563	15,606,490	17,404,461
Class 3	7,773,707	11,638,613	13,560,154	6,935,282	9,722,416	10,842,503
Class 4	5,318,270	7,962,389	9,276,984	4,744,673	6,651,451	7,417,743
Class 5	3,063,621	4,586,782	5,344,062	2,733,198	3,831,608	4,273,035
Class 6	1,816,865	2,720,167	3,169,269	1,620,909	2,272,316	2,534,101
Total	4,965,361	7,434,022	8,661,384	4,429,827	6,210,075	6,925,517

Table 3.6b (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	887,774,922	1,329,155,951	1,548,600,341	792,024,945	1,110,322,008	1,238,238,457
Class 1	114,129,061	170,871,375	199,082,334	101,819,798	142,738,892	159,183,358
Class 2	45,836,244	68,624,957	79,954,976	40,892,627	57,326,456	63,930,844
Class 3	35,252,247	52,778,844	61,492,661	31,450,155	44,089,268	49,168,643
Class 4	28,814,425	43,140,286	50,262,771	25,706,677	36,037,614	40,189,386
Class 5	23,371,105	34,990,674	40,767,654	20,850,440	29,229,764	32,597,227
Class 6	17,103,744	25,607,327	29,835,112	15,259,039	21,391,304	23,855,724
Total	99,506,126	148,978,256	173,574,650	88,774,004	124,450,285	138,787,782
<b>ALL LGUs</b>						
Special	887,774,922	1,329,155,951	1,548,600,341	792,024,945	1,110,322,008	1,238,238,457
Class 1	79,241,868	118,639,081	138,226,460	70,695,325	99,106,190	110,523,880
Class 2	26,659,209	39,913,547	46,503,296	23,783,909	33,342,129	37,183,363
Class 3	12,804,862	19,171,142	22,336,308	11,423,808	16,014,780	17,859,789
Class 4	6,273,938	9,393,195	10,944,016	5,597,270	7,846,687	8,750,677
Class 5	3,372,325	5,048,967	5,882,554	3,008,607	4,217,699	4,703,605
Class 6	1,907,966	2,856,562	3,328,182	1,702,184	2,386,254	2,661,166
Total	10,593,897	15,860,935	18,479,585	9,451,304	13,249,571	14,776,009



**Table 3.6c**

**PROJECTED BORROWING CAPACITY OF AVERAGE LGU (USING LGC DEFINITION), 1995**

(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
1st Class	190,435,829	285,116,092	332,188,916	169,896,584	238,174,211	265,613,458
2nd Class	99,058,081	148,307,454	172,793,096	88,374,282	123,889,923	138,162,863
3rd Class	101,549,485	152,037,527	177,139,006	90,596,978	127,005,872	141,637,790
4th Class	69,898,363	104,650,203	121,928,010	62,359,553	87,420,459	97,491,875
5th Class	48,509,026	72,626,586	84,617,275	43,277,139	60,669,251	67,658,751
6th Class	31,207,313	46,722,863	54,436,833	27,841,483	39,030,350	43,526,905
<b>Total</b>	<b>123,901,552</b>	<b>185,502,521</b>	<b>216,129,090</b>	<b>110,538,288</b>	<b>154,961,147</b>	<b>172,813,698</b>
<b>MUNICIPALITIES</b>						
1st Class	136,862,663	204,907,595	238,737,952	122,101,493	171,171,344	190,891,417
2nd Class	30,321,746	45,397,013	52,892,085	27,051,428	37,922,791	42,291,747
3rd Class	18,884,607	28,273,595	32,941,581	16,847,829	23,618,594	26,339,612
4th Class	12,985,216	19,441,164	22,650,911	11,584,710	16,240,345	18,111,341
5th Class	7,491,611	11,216,265	13,068,077	6,683,612	9,369,605	10,449,046
6th Class	4,454,216	6,668,748	7,769,762	3,973,811	5,570,797	6,212,589
<b>Total</b>	<b>12,228,757</b>	<b>18,308,610</b>	<b>21,331,372</b>	<b>10,909,838</b>	<b>15,294,257</b>	<b>17,056,257</b>

**Table 3.6c (continuation)**

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	1,742,521,055	2,608,861,984	3,039,586,539	1,554,583,386	2,179,335,582	2,430,409,478
1st Class	241,664,685	361,814,745	421,550,559	215,600,210	302,245,098	337,065,736
2nd Class	100,976,510	151,179,682	176,139,531	90,085,801	126,289,264	140,838,624
3rd Class	78,802,273	117,980,930	137,459,646	70,303,141	98,556,397	109,910,747
4th Class	64,279,724	96,238,107	112,127,071	57,346,906	80,393,341	89,655,186
5th Class	52,577,564	78,717,905	91,714,275	46,906,869	65,757,688	73,333,409
6th Class	39,726,930	59,478,235	69,298,125	35,442,226	49,685,662	55,409,779
Total	208,138,311	311,619,836	363,068,444	185,689,785	260,314,345	290,304,282
<b>ALL LGUs</b>						
Special	1,742,521,055	2,608,861,984	3,039,586,539	1,554,583,386	2,179,335,582	2,430,409,478
1st Class	183,806,010	275,190,082	320,624,116	163,981,817	229,882,432	256,366,411
2nd Class	62,278,862	93,242,464	108,636,846	55,561,845	77,890,904	86,864,452
3rd Class	30,865,969	46,211,810	53,841,406	27,536,954	38,603,438	43,050,810
4th Class	15,219,897	22,786,876	26,549,001	13,578,372	19,035,215	21,228,198
5th Class	8,239,703	12,336,292	14,373,020	7,351,019	10,305,229	11,492,459
6th Class	4,673,965	6,997,752	8,153,085	4,169,860	5,845,633	6,519,089
Total	24,623,882	36,866,303	42,952,950	21,968,100	30,796,587	34,344,558

for credit financing because it focuses solely on the revenue side of the LGU accounts and is completely blind to LGU expenditure requirements. One measure which addresses this concern is the net paying capacity indicator used by COA before the Code was put into effect. This measure is akin to an analysis of the cash flow of LGUs.

The COA defined the net paying capacity (NPC) of an LGU as equal to its adjusted gross paying capacity (AGPC) less its outstanding loan balances (D). That is,

$$NPC = AGPC - D \quad (3)$$

In turn, the adjusted gross paying capacity of an LGU is related to the difference between its gross revenue and current expenditure requirements, i.e., its current surplus. It was computed as the average yearly excess of gross revenue over total budget charges (excluding sinking fund installment, loan repayment, and capital outlay) for the past five years grossed up by an annual amortization factor (equal to the sum of the interest rate and  $1/n$ ) and adjusted downwards by 40 percent for revenue generating and 50 percent non-revenue generating projects, to provide an allowance for revenue shortfalls.

The adjusted gross paying capacity can be expressed in the following equation:

$$AGPC = k (i + 1/n)(GR - COE) \quad (4)$$

where  $k$  = 0.6 or 0.5 depending on whether the proposed loan is revenue generating or non-revenue generating;

$GR$  = gross revenue; and

$COE$  = current operating expenditure.

With the implementation of the Code, the COA no longer imposes the net paying capacity ceiling. Table 3.7 shows that the net paying capacity of LGUs based on the COA formula

**Table 3.7****PROJECTED AGGREGATE NET PAYING CAPACITY (USING COA DEFINITION), 1991-1995**

k = 0.5 (In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	1,924,738,041	2,881,673,017	1,103,405,519	2,157,424,681	1,538,953,703	1,379,971,808
Class 2	523,891,315	784,357,888	300,334,152	587,225,913	418,885,304	375,612,280
Class 3	228,459,391	342,044,085	130,970,214	256,078,447	182,668,196	163,797,624
Class 4	167,136,244	250,232,496	95,815,145	187,341,784	133,636,337	119,831,011
Class 5	125,692,412	188,183,756	72,056,404	140,887,699	100,499,288	90,117,191
Class 6	20,123,677	30,128,701	11,536,415	22,556,481	16,090,193	14,427,993
Total	2,990,041,081	4,476,619,943	1,714,117,849	3,351,515,005	2,390,733,021	2,143,757,907
<b>MUNICIPALITIES</b>						
Class 1	1,328,480,065	1,988,969,446	761,585,319	1,489,083,511	1,062,206,529	952,475,089
Class 2	307,206,475	459,942,387	176,114,002	344,345,473	245,631,630	220,256,609
Class 3	359,886,363	538,813,491	206,314,102	403,393,972	287,752,639	258,026,300
Class 4	889,508,164	1,331,750,928	509,933,402	997,043,143	711,219,840	637,747,144
Class 5	843,089,426	1,262,253,874	483,322,668	945,012,722	674,105,029	604,466,486
Class 6	272,930,500	408,625,194	156,464,419	305,925,785	218,225,750	195,681,899
Total	4,001,100,992	5,990,355,320	2,293,733,912	4,484,804,606	3,199,141,418	2,868,653,526

Table 3.7 (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	1,028,483,036	1,539,820,874	589,604,317	1,152,819,053	822,339,322	737,387,408
Class 1	2,297,596,813	3,439,908,495	1,317,156,387	2,575,359,330	1,837,078,629	1,647,298,884
Class 2	679,260,911	1,016,973,633	389,403,764	761,378,548	543,113,438	487,007,004
Class 3	117,856,613	176,452,180	67,564,331	132,104,609	94,234,056	84,499,189
Class 4	133,066,668	199,224,320	76,283,885	149,153,448	106,395,487	95,404,282
Class 5	64,656,467	96,802,159	37,065,981	72,472,958	51,697,066	46,356,491
Class 6	1,630,937	2,441,800	934,976	1,828,105	1,304,040	1,169,326
Total	4,322,551,446	6,471,623,461	2,478,013,641	4,845,116,050	3,456,162,039	3,099,122,585
<b>ALL LGUs</b>						
Special	1,028,483,036	1,539,820,874	589,604,317	1,152,819,053	822,339,322	737,387,408
Class 1	5,550,814,919	8,310,550,958	3,182,147,225	6,221,867,522	4,438,238,862	3,979,745,781
Class 2	1,510,358,701	2,261,273,909	865,851,919	1,692,949,934	1,207,630,371	1,082,875,894
Class 3	706,202,368	1,057,309,755	404,848,646	791,577,028	564,654,891	506,323,114
Class 4	1,189,711,076	1,781,207,745	682,032,432	1,333,538,375	951,251,665	852,982,437
Class 5	1,033,438,306	1,547,239,789	592,445,053	1,158,373,379	826,301,384	740,940,168
Class 6	294,685,113	441,195,695	168,935,810	330,310,371	235,619,984	211,279,218
Total	11,313,693,519	16,938,598,724	6,485,865,402	12,681,435,661	9,046,036,478	8,111,534,018

based on 1991-1995 LGU income/expenditure is P16.9 billion, just about a quarter of the Code's ceiling based on the projected 1995 LGU income. It must be noted that the net paying capacity of the average 5th income class municipality is P2.1 million while that of the average 6th income class municipality is only P1.0 million (Table 3.8).

Most LGU officials interviewed for this study considered the COA formula appropriate in determining the net paying capacity of LGUs. This stems from their concern for the need to make allowance for future projects and for not burdening the next administration with too much debt. However, some local officials opined that the 40 to 50 percent downward adjustment factor is too restrictive and suggested that this factor be lowered to 10 to 20 percent.

It is also worth noting that the COA definition of net paying capacity tends to be conservative because of the following reasons: (i) the use of the amortization factor instead of the annuity formula given in equation 1 tends to underestimate the paying capacity by 20 to 25 percent, and (ii) the use of the average income in the last five years rather than current or projected income.<sup>15</sup> If these issues are addressed, the net paying capacity of all LGUs in the aggregate is projected to reach P53.5 billion in 1995, more than three times as large as the original COA estimate, but 9.1 percent lower than the maximum borrowing capacity set under the Code (Table 3.9).

- *Adjusting LGU Borrowing/  
Paying Capacity by Creditworthiness Criterion*

As indicated earlier, LGUs' demand for credit financing is tempered by the results of their self-evaluation of their ability to repay loans. Saldaña (1992) proposed that LGUs can

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<sup>15</sup> This is particularly important during periods of high growth in income as in the early years of the post-Code era.

**Table 3.8**

**PROJECTED NET PAYING CAPACITY OF AVERAGE LGU (USING COA DEFINITION), 1991-1995**

k = 0.5 (In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	68,740,644	102,916,893	39,407,340	77,050,881	54,962,632	49,284,707
Class 2	32,743,207	49,022,368	18,770,885	36,701,620	26,180,331	23,475,768
Class 3	22,845,939	34,204,408	13,097,021	25,607,845	18,266,820	16,379,762
Class 4	23,876,606	35,747,499	13,687,878	26,763,112	19,090,905	17,118,716
Class 5	13,965,824	20,909,306	8,006,267	15,654,189	11,166,588	10,013,021
Class 6	10,061,838	15,064,350	5,768,207	11,278,241	8,045,097	7,213,996
Total	41,528,348	62,175,277	23,807,192	46,548,820	33,204,625	29,774,415
<b>MUNICIPALITIES</b>						
Class 1	36,902,224	55,249,151	21,155,148	41,363,431	29,505,737	26,457,641
Class 2	7,877,089	11,793,395	4,515,744	8,829,371	6,298,247	5,647,605
Class 3	4,335,980	6,491,729	2,485,712	4,860,168	3,466,899	3,108,751
Class 4	2,935,671	4,395,218	1,682,949	3,290,571	2,347,260	2,104,776
Class 5	1,398,158	2,093,290	801,530	1,567,185	1,117,919	1,002,432
Class 6	680,625	1,019,015	390,186	762,907	544,204	487,985
Total	2,731,127	4,088,980	1,565,689	3,061,300	2,183,714	1,958,125

Table 3.8 (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	514,241,518	769,910,437	294,802,159	576,409,527	411,169,661	368,693,704
Class 1	88,369,108	132,304,173	50,659,861	99,052,282	70,656,870	63,357,649
Class 2	39,956,524	59,821,978	22,906,104	44,786,973	31,947,849	28,647,471
Class 3	19,642,769	29,408,697	11,260,722	22,017,435	15,705,676	14,083,198
Class 4	22,177,778	33,204,053	12,713,981	24,858,908	17,732,581	15,900,714
Class 5	32,328,234	48,401,079	18,532,990	36,236,479	25,848,533	23,178,246
Class 6	1,630,937	2,441,800	934,976	1,828,105	1,304,040	1,169,326
Total	72,042,524	107,860,391	41,300,227	80,751,934	57,602,701	51,652,043
<b>ALL LGUs</b>						
Special	514,241,518	769,910,437	294,802,159	576,409,527	411,169,661	368,693,704
Class 1	61,675,721	92,339,455	35,357,191	69,131,861	49,313,765	44,219,398
Class 2	20,977,204	31,406,582	12,025,721	23,513,194	16,772,644	15,039,943
Class 3	7,133,357	10,679,897	4,089,380	7,995,728	5,703,585	5,114,375
Class 4	3,764,908	5,636,733	2,158,330	4,220,058	3,010,290	2,699,312
Class 5	1,683,124	2,519,935	964,894	1,886,602	1,345,768	1,206,743
Class 6	729,419	1,092,069	418,158	817,600	583,218	522,968
Total	7,084,342	10,606,511	4,061,281	7,940,786	5,664,394	5,079,232



Table 3.9

**PROJECTED AGGREGATE NET PAYING CAPACITY (USING ADJUSTED COA DEFINITION\*), 1995**  
(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	5,403,232,442	8,651,108,424	10,177,723,890	4,914,932,669	7,244,343,117	8,008,610,473
Class 2	1,497,994,384	2,398,436,856	2,821,676,356	1,362,617,954	2,008,424,664	2,220,310,460
Class 3	687,187,275	1,100,254,651	1,294,410,785	625,084,933	921,341,153	1,018,541,265
Class 4	498,326,163	797,869,370	938,665,169	453,291,537	668,127,042	738,613,444
Class 5	365,381,960	585,012,581	688,246,665	332,361,739	489,883,106	541,565,040
Class 6	60,818,909	97,377,076	114,560,694	55,322,595	81,542,493	90,145,104
Total	8,512,941,133	13,630,058,957	16,035,283,558	7,743,611,427	11,413,661,574	12,617,785,786
<b>MUNICIPALITIES</b>						
Class 1	3,786,788,209	6,063,021,668	7,132,931,117	3,444,569,390	5,077,107,711	5,612,734,975
Class 2	909,435,737	1,456,096,374	1,713,046,020	827,248,404	1,219,319,101	1,347,955,441
Class 3	1,074,577,365	1,720,504,419	2,024,112,758	977,465,888	1,440,731,492	1,592,726,508
Class 4	2,752,281,378	4,406,674,129	5,184,296,666	2,503,552,791	3,690,100,486	4,079,400,564
Class 5	2,627,322,128	4,206,602,036	4,948,918,906	2,389,886,331	3,522,562,314	3,894,187,365
Class 6	856,680,966	1,371,630,778	1,613,675,226	779,261,176	1,148,588,539	1,269,762,911
Total	12,007,085,783	19,224,529,404	22,616,980,693	10,921,983,979	16,098,409,643	17,796,767,764

Table 3.9 (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	2,942,330,132	4,719,960,941	5,542,279,366	2,676,426,499	3,944,906,918	4,361,088,693
Class 1	6,898,680,282	11,045,468,012	12,994,603,483	6,275,234,214	9,249,353,522	10,225,146,474
Class 2	2,058,666,739	3,296,128,634	3,877,779,066	1,872,621,346	2,760,141,893	3,051,332,732
Class 3	350,697,853	561,501,876	660,587,150	319,004,661	470,195,500	519,800,422
Class 4	414,030,214	662,903,236	779,882,274	376,613,564	555,107,885	613,670,936
Class 5	201,917,900	323,290,487	380,339,853	183,670,218	270,719,900	299,280,445
Class 6	5,263,702	8,427,706	9,914,899	4,788,012	7,057,269	7,801,800
Total	12,871,586,822	20,608,680,891	24,245,386,092	11,708,358,514	17,257,482,887	19,078,121,500
<b>ALL LGUs</b>						
Special	2,942,330,132	4,710,960,941	5,542,279,366	2,676,426,499	3,944,906,918	4,361,088,693
Class 1	16,088,700,933	25,759,598,103	30,305,258,490	14,634,736,273	21,570,804,350	23,846,491,922
Class 2	4,466,096,861	7,150,661,865	8,412,501,442	4,062,487,705	5,987,885,659	6,619,598,633
Class 3	2,112,462,493	3,382,260,946	3,979,110,692	1,921,555,482	2,832,268,144	3,131,068,194
Class 4	3,664,637,755	5,867,446,736	6,902,844,109	3,333,457,891	4,913,335,412	5,431,684,944
Class 5	3,194,621,988	5,114,905,103	6,017,505,424	2,905,918,289	4,283,165,320	4,735,032,850
Class 6	922,763,576	1,477,435,560	1,738,150,819	839,371,782	1,237,188,300	1,367,709,814
Total	33,391,613,738	53,463,269,252	62,897,650,343	30,373,953,920	44,769,554,104	49,492,675,051

\* Applies standard annuity formula, projected 1995 LGU income and assumes K = 0.8.

**Table 3.10**

**PROJECTED NET PAYING CAPACITY OF AVERAGE LGU (USING ADJUSTED COA DEFINITION\*), 1995**  
(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r=.20 term=5	r=.20 term10	r=.20 term15
<b>PROVINCES</b>						
Class 1	192,972,587	308,968,158	363,490,139	175,533,310	258,726,540	286,021,803
Class 2	93,624,649	149,902,304	176,354,772	85,163,622	125,526,542	138,769,404
Class 3	68,718,728	110,025,465	129,441,078	62,508,493	92,134,115	101,854,127
Class 4	71,189,452	113,981,339	134,095,024	64,755,934	95,446,720	105,516,206
Class 5	40,597,996	65,001,398	76,471,852	36,929,082	54,431,456	60,173,893
Class 6	30,409,454	48,688,538	57,280,347	27,661,298	40,771,246	45,072,552
Total	118,235,294	189,306,374	222,712,272	107,550,159	158,523,077	175,247,025
<b>MUNICIPALITIES</b>						
Class 1	105,188,561	168,417,269	198,136,975	95,682,483	141,030,770	155,909,305
Class 2	23,318,865	37,335,804	43,924,257	21,211,498	31,264,592	34,562,960
Class 3	12,946,715	20,728,969	24,386,901	11,776,697	17,358,211	19,189,476
Class 4	9,083,437	14,543,479	17,109,890	8,262,550	12,178,549	13,463,368
Class 5	4,357,085	6,976,123	8,207,162	3,963,327	5,841,729	6,458,022
Class 6	2,136,362	3,420,526	4,024,128	1,943,295	2,864,311	3,166,491
Total	8,195,963	13,122,546	15,438,212	7,455,279	10,988,676	12,147,964

Table 3.10 (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	1,471,165,066	2,355,480,470	2,771,139,683	1,338,213,249	1,972,453,459	2,180,544,346
Class 1	265,333,857	424,825,693	499,792,442	241,355,162	355,744,366	393,274,864
Class 2	121,098,043	193,889,920	228,104,651	110,154,197	162,361,288	179,490,161
Class 3	58,449,642	93,583,646	110,097,858	53,167,444	78,365,917	86,633,404
Class 4	69,005,036	110,483,873	129,980,379	62,768,927	92,517,981	102,278,489
Class 5	100,958,950	161,645,243	190,169,927	91,835,109	135,359,950	149,640,222
Class 6	5,263,702	8,427,706	9,914,899	4,788,012	7,057,269	7,801,800
Total	214,526,447	343,478,015	404,089,768	195,139,309	287,624,715	317,968,692
<b>ALL LGUs</b>						
Special	1,471,165,066	2,355,480,470	2,771,139,683	1,338,213,249	1,972,453,459	2,180,544,346
Class 1	178,763,344	286,217,757	336,725,094	162,608,181	239,675,604	264,961,021
Class 2	62,029,123	99,314,748	116,840,298	56,423,440	83,165,079	91,938,870
Class 3	21,338,005	34,164,252	40,193,037	19,409,651	28,608,769	31,626,951
Class 4	11,596,955	18,567,869	21,844,443	10,548,917	15,548,530	17,188,876
Class 5	5,202,967	8,330,464	9,800,497	4,732,766	6,975,839	7,711,780
Class 6	2,284,068	3,657,019	4,302,354	2,077,653	3,062,347	3,385,420
Total	20,908,963	33,477,313	39,384,878	19,019,383	28,033,534	30,991,030

\* Applies standard annuity formula, projected 1995 LGU income and assumes K = 0.8.

conduct their own creditworthiness assessment by doing some version of the cash-flow analysis that most banks use to evaluate commercial loans. He suggested that LGUs look at their "net resource after economic enterprise and investments" or their current surplus from regular income including their net income from their economic enterprises and financial investments.<sup>16</sup> He argues that this is the amount available to an LGU on a regular basis from its tax base and from its ability to manage its assets after it finances its recurrent expenditure requirements. Thus, it is the amount available for capital expenditure and debt service. In this sense, LGUs whose net resource after economic enterprise is positive and not declining over a given time period are those that have a demonstrated ability to finance their development projects.

For this study, Saldaña's creditworthiness criterion was applied to all provinces and cities and a 10 percent sample of municipalities using LGUs' budget operations statements that were submitted to the BLGF for 1989-1992. It should be emphasized that the results obtained are crude and should be treated as indicative only of the general trend because data are available for only a short period and numerous changes in the fiscal position of LGUs were engendered by the Code.<sup>17</sup> The incidence of creditworthiness is highest among cities, with 73.3 percent deemed creditworthy. In contrast, only 49.4 percent of municipalities and 58.1 percent of provinces were found to be bankable (Table 3.11). It is interesting to note that the incidence of creditworthiness does not appear to be correlated with the income class of LGUs, except that

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<sup>16</sup> "Net resources after economic enterprises and investments" is defined in greater detail in Annex 2.

<sup>17</sup> Saldaña proposed that the evaluation use a 10-year time frame. Other LGU experts opined that a 5-7 year time frame can capture better the cyclical fluctuation in LGU surpluses. It is noted that LGUs have lower surpluses during election years.

**Table 3.11**

<b>PROPORTION OF LGUs THAT ARE CREDITWORTHY (%)</b>			
Income Class	Provinces	Cities	Municipalities
First Class	60.7	71.4	54.5
Second Class	76.5	70.5	45.5
Third Class	36.4	83.3	31.3
Fourth Class	57.1	100.0	65.6
Fifth Class	60.0	50.0	51.6
Sixth Class	0	0	40.0
All	58.1	73.3	49.4

in sixth income class LGUs, the incidence of creditworthiness is consistently lower than average for all levels of local government.

If the estimates of the net paying capacity (based on the adjusted COA definition) are scaled down by the proportion of LGUs that are not deemed creditworthy based on the Saldaña criterion, it is estimated that the total demand for LGU credit financing amounts to P34.4 billion in 1995, assuming that the interest rate is 15 percent and loan term is 10 years (Table 3.12). This figure is 41.6 percent lower than the borrowing capacity ceiling set under the Code.

## ISSUES IN THE DEMAND FOR LOCAL DEBT FINANCE

The discussions above primarily focused on financial considerations in the determination of LGU demand for debt finance. In this section, the real factors that drive local demand for borrowing are examined using the information gathered from the small survey of LGUs that was conducted for this study. As discussed in Chapter I, the survey covered 24 LGUs: six provinces, six cities and 12 municipalities.

### • *LGU Borrowing Behavior and Preferences*

*Past borrowing behavior.* In recent past, high income LGUs have shown a greater tendency to resort to debt financing

**Table 3.12**

**PROJECTED TOTAL NET PAYING CAPACITY OF LGUs  
(USING ADJUSTED COA DEFINITION\* AND ADJUSTED FOR CREDITWORTHINESS), 1995**  
(In pesos)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>PROVINCES</b>						
Class 1	3,279,762,092	5,251,222,813	6,177,878,401	2,983,364,130	4,397,316,272	4,861,226,557
Class 2	1,145,965,704	1,834,804,195	2,158,582,412	1,042,402,735	1,536,444,868	1,698,537,502
Class 3	250,136,168	400,492,693	471,165,526	227,530,915	335,368,180	370,749,021
Class 4	284,544,239	455,583,410	535,977,811	258,829,467	381,500,541	421,748,277
Class 5	219,229,176	351,007,548	412,947,999	199,417,044	293,929,863	324,939,024
Class 6	0	0	0	0	0	0
Total	5,179,637,379	8,293,110,660	9,756,552,149	4,711,544,291	6,944,559,724	7,677,200,380
<b>MUNICIPALITIES</b>						
Class 1	2,065,503,628	3,307,075,169	3,890,657,278	1,878,840,374	2,769,308,401	3,061,466,292
Class 2	413,374,920	661,854,046	778,647,938	376,017,490	554,229,304	612,699,666
Class 3	335,805,427	537,657,631	632,535,237	305,458,090	450,228,591	497,727,034
Class 4	1,806,184,655	2,891,879,897	3,402,194,687	1,642,956,519	2,421,628,444	2,677,106,620
Class 5	1,356,039,770	2,171,153,509	2,554,285,515	1,233,492,032	1,818,100,087	2,009,906,925
Class 6	342,672,386	548,652,311	645,470,090	311,704,470	459,435,416	507,905,164
Total	6,319,580,786	10,118,272,563	11,903,790,745	5,748,468,975	8,472,930,243	9,366,811,701

Table 3.12 (continuation)

	r = .15 term = 5	r = .15 term = 10	r = .15 term = 15	r = .20 term = 5	r = .20 term = 10	r = .20 term = 15
<b>CITIES</b>						
Special	2,942,330,132	4,710,960,941	5,542,279,366	2,676,426,499	3,944,906,918	4,361,088,693
Class 1	4,776,009,426	7,646,862,470	8,996,263,950	4,344,392,918	6,403,398,592	7,078,947,559
Class 2	1,451,360,051	2,323,770,687	2,733,834,242	1,320,198,049	1,945,900,035	2,151,189,576
Class 3	292,131,312	467,731,063	550,269,096	265,730,883	391,672,852	432,993,751
Class 4	414,030,214	662,903,236	779,882,274	376,613,564	555,107,885	613,670,936
Class 5	100,958,950	161,645,243	190,169,927	91,835,109	135,359,950	149,640,222
Class 6	0	0	0	0	0	0
Total	9,976,820,085	15,973,873,640	18,792,698,854	9,075,197,021	13,376,346,231	14,787,530,737
<b>ALL LGUs</b>						
Special	2,942,330,132	4,710,960,941	5,542,279,366	2,676,426,499	3,944,906,918	4,361,088,693
Class 1	10,121,275,147	16,205,160,451	19,064,799,629	9,206,597,421	13,570,023,265	15,001,640,408
Class 2	3,010,700,675	4,820,428,928	5,671,064,592	2,738,618,274	4,036,574,207	4,462,426,744
Class 3	878,072,906	1,405,881,387	1,653,969,858	798,719,888	1,177,269,622	1,301,469,805
Class 4	2,504,759,108	4,010,366,544	4,718,054,772	2,278,399,550	3,358,236,870	3,712,525,833
Class 5	1,676,227,896	2,683,806,300	3,157,403,440	1,524,744,185	2,247,389,901	2,484,486,171
Class 6	342,672,386	548,652,311	645,470,090	311,704,470	459,435,416	507,905,164
Total	21,476,038,250	34,385,256,862	40,453,041,748	19,535,210,287	28,793,836,198	31,831,542,818

\* Applies standard annuity formula, projected 1995 LGU income and assumes K = 0.8.



than middle- and low-income LGUs.<sup>18</sup> All nine high income LGUs in the sample availed of loans in the last 10 years, compared to six out of nine middle-income LGUs, and two out of six low-income LGUs. These figures are consistent with the trend shown by the totality of all LGUs in 1991 (Table 3.13).

Most non-borrowing LGUs do not want to borrow because they prefer to secure grants and donations to finance their local projects (Table 3.14). The Countrywide Development Fund (CDF) of senators and congressmen emerged as an important source of grant funds to finance local projects (Box 1 and Box 2). Other non-borrowing LGUs cited high interest rates and complicated requirements as reasons for not borrowing. On the other hand, some high- and middle-income LGUs wanted to borrow but were not able to do so because of the lack of support of the local *sanggunian* (Box 3). At the same time, other LGUs feel there

**Table 3.13**

**LGUs WITH LOANS AND BORROWINGS, 1993 (%)**

	Municipalities	Provinces	Cities	Total
GRAND TOTAL				
Special	0	0	7.69	50.00
Class 1	8.33	17.86	26.92	16.67
Class 2	10.26	12.50	5.88	9.72
Class 3	7.23	20.00	0	8.08
Class 4	4.29	14.29	16.67	4.75
Class 5	3.48	11.11	0	3.58
Class 6	1.75	0	0	1.73
Total	3.71	15.28	16.67	4.70

<sup>18</sup> For purposes of this section, "high-income" LGUs refer to those belonging to the first income class, "middle-income" LGUs refer to those in the second and third income classes, and "low-income" LGUs refer to those in the fourth to the sixth income classes.

## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 3.14**

### REASONS FOR NOT BORROWING FROM A BANK/ FINANCIAL INSTITUTION

	Non-Borrowing LGUs		Governor/ Mayor		Vice-Governor/ Mayor		Planning & Devt. Officer		Local Treasurer	
	No.	%	No.	%	No.	%	No.	%	No.	%
ALL INCOME GROUPS	10	100	8	100	9	100	10	100	9	100
1. Not aware of any credit facility							2	20		
2. Did not have the capacity to pay					1	11	1	10	0	22
3. Not able to identify projects					1	11				
4. Not able to prepare feasibility study			1	13	1	11	1	10		
5. No collateral as demanded by the bank							1	11		
6. Procedure is too complicated, tedious, etc.			3	38	4	44	2	20	3	33
7. Interest rate on the loan is too high			2	26	2	22	1	10		
8. Project cannot generate revenue to pay for the loan							1	10		
9. Bank is not interested in the project					1	11	1	10		
10. Preferred subsidies, grants or donations			4	50	3	33	4	40	4	44
11. Others, (specify)										
a. Project identified as part of MCDP			1	13	1	11	1	10	1	11
b. Disagreements/lack of support from <i>Sanggunian</i>			1	13			1	10		
c. Neglect in processing									1	11
d. Not willing to use IRA as collateral			1	13						
e. Projects can be financed through local funds					1	11			1	11
f. Too much bureaucracy			1	13						
g. Mandatory requirement of consultancy							1	10		
h. Not ready to borrowing plans			1	13			1	10		

is no need to borrow because they have sufficient funds from their own resources to finance development projects. For instance, a first-class city in the Visayas has expressed a preference for a "pay-as-you-go" type of financing because of the huge surpluses it enjoys (Box 4).

*Financing scheme used in past/current projects.* High-income LGUs have been more successful in accessing loans from GFIs than low income LGUs. Five out of nine high-income LGUs and five out of six middle-income LGUs with borrowing experience borrowed from GFIs. In contrast, only one low-income LGU in the sample borrowed from a GFI.

Likewise, high-income LGUs appear to have greater access to the MDF than low-income LGUs. Six out of the 24 sample LGUs were able to secure credit from the MDF. Five of these belong to the first income class while the other one is a third-class municipality.

The results of the survey also point to the presence of highly subsidized (with zero rate of interest) financing from non-financial national government agencies like the Department of Interior and Local Government (DILG). Some LGUs have resorted to more innovative financing schemes: bond flotation (by a second class city in southern Luzon as detailed in Box 5) and build-operate-transfer (BOT) scheme. However, some officials of the LGU that issued bonds reported that, in hindsight, bond flotation appears to be more expensive than originally expected after the financial consulting services and underwriting fees are factored in.

The survey results show that low income LGUs have relied on their IRA, own resources and grants to finance their projects.

*Preferred financing scheme for future projects.* The LGUs in the sample will be relying increasingly on debt finance. Twenty-six out of 41 projects identified by high-income LGUs in the sample are planned to be funded out of loans. Similarly, middle-income LGUs in the sample prefer to finance through borrowing 27 out of the 41 projects they have identified. In contrast, only four out of 22 projects identified by low-income LGUs will be financed through borrowing. Again, this observation appears to be borne out by data for the totality of all LGUs. Based on the Bureau of Local Government

**Box 1: THE CDF AS A SOURCE OF LGU FINANCING**

Municipality A is the capital town of a beautiful island province in the Northern part of Mindanao. Its population is 25,207 (1990 census) and its aggregate land area is 89.0 sq km. It is a fifth income class municipality with a total income of P10.3 million in 1994, broken down as follows: P1.9 million from local sources and P8.4 million as IRA. Based on its 1994 income, its borrowing capacity is estimated at P8.2 million and its net paying capacity is roughly P2.3 million. Municipality A's credit-worthiness is poor. Its current fiscal surplus has been on the low side and has behaved in an erratic fashion in 1990-1994.

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POPULATION (as of 1990)	25,207
LAND AREA	89.0 sq km
INCOME CLASS	Fifth Class
TOTAL REVENUE (1994)	P10.3 million
INTERNAL REVENUE ALLOTMENT (IRA)	P8.4 million
LOCAL REVENUES	P1.9 million
BORROWING CAPACITY (1994)	P8.2 million
PAYING CAPACITY (1994)	P2.3 million

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The mayor of municipality A is not really adverse to borrowing from banks or other finance institutions as a means to finance local development projects. She is well aware of the benefits of financing income generating projects, particularly its positive effects on local economic activities.

She decided not to resort to credit financing because of certain realities. First, she felt that the municipality does not have the capacity to repay its loan. Second, she fears that if any anomalies mar the loan transaction, her political foes might use these against her. Third, the majority of the *Sangguniang Bayan* members belong to the opposite political spectrum. Hence, she finds it difficult to secure the *Sanggunian* resolution which is necessary to enter into a loan contract.

Even some of her financial advisers, specifically the municipal treasurer, did not recommend a bank loan to finance local projects for the same reasons. The Municipal Planning and Development Coordinator (MPDC) would have

wanted to recommend borrowing from a bank to finance income-generating tourism projects in order to accelerate the development of the municipality. He agreed, however, that the *Sangguniang Bayan* is not likely to authorize the mayor to contract a loan.

Given this situation, the mayor has no other recourse except to rely on locally generated revenues, the municipality's IRA and the Countrywide Development Fund (CDF) of the congressman who happens to be her husband. Incidentally, she is unable to get funding from the provincial government because the governor is not her politically ally.

The municipal public market, an income-generating project eligible for loan financing, is being renovated through the limited CDF of the congressman. Since the available amount is not enough to construct the entire structure in one year, the construction is being done by phases. The mayor also pointed out that the CDF of the congressman is being used to finance other infrastructure projects, particularly road construction.

Finance (BLGF) data, the number of LGUs that contracted debt rose significantly from 48 in 1991 to 75 in 1993.

The preferred financing scheme for future projects appears to be highly conditioned by the past experience of LGUs. Thus, high-income LGUs, which have been more successful in borrowing from the MDF, show a marked preference for MDF loans in the future, with 11 out of 41 identified projects queuing for MDF funding, compared to six projects to be funded by GFI loans. Middle-income LGUs show a preference for GFI loans, which should finance seven out of the 41 projects they identified. Only four of the projects identified by middle income LGUs will be submitted to the MDF for financing. In contrast, only one project of the sample low-income LGUs will be proposed for MDF financing.

There is an increasing interest in bond flotation and BOT scheme in financing future LGU projects of high-and middle-income LGUs (Box 6).

**Box 2: STILL ON THE CDF**

City A is a fourth income class city located in one of the provinces in Western Mindanao. It has a population of 59,046 (1990 census) and an aggregate land area of 390.53 sq km. Its total income is P125.2 million in 1994, consisting of P3.5 million from local sources and P121.7 million as IRA. Based on its 1994 income, the city's borrowing capacity is P100.2 million while its paying capacity is P99.1 million. Its current fiscal position has been consistently positive. Moreover, its fiscal position has shown considerable improvement in 1990-1994. As such, City A may be considered as a good credit risk. However, it has not performed very well in terms of local revenue mobilization. Its income from local sources declined in 1992 and 1993.

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POPULATION (as of 1990)	59,046
LAND AREA	390.53 sq km
INCOME CLASS	Fourth Class
TOTAL REVENUE (1994)	P125.2 million
INTERNAL REVENUE ALLOTMENT (IRA)	P121.7 million
LOCAL REVENUES	P3.5 million
BORROWING CAPACITY (1994)	P100.2 million
PAYING CAPACITY (1994)	P99.1 million

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With its small population and low income, City A has not resorted to debt financing in the past. It relied primarily on its own revenue from the IRA and from local sources to finance its projects. The ongoing construction and installation of a waterworks system, for instance, is being financed by the Countrywide Development Fund (CDF) of a local congressman through the Local Water Utilities Administration (LWUA).

The City Planning and Development Coordinator, however, is very receptive to the idea of financing some tourism-related income-generating projects through bank loan or the BOT scheme. He is trying to convince city officials to construct a Resort Hotel and Pavilion worth P45 million which may be financed through a loan from a GFI or through the BOT scheme.

**Box 3: EXECUTIVE-LEGISLATIVE GRIDLOCK**

Province A is a first income class province in Central Visayas. It has a population of 891,952 (1990 census) and a land area of 4,087 sq km. Its total income reached P283.6 million in 1994. Its IRA share amounted to P180.8 million or 63.7 percent of its total income in that year while its local source income accounted for P102.8 million or 36.2 percent.

Its maximum borrowing capacity is estimated at P226.8 million while its net paying capacity is computed to be P108.3 million based on its 1994 income. The province has consistently posted current surpluses in 1990-1994. Moreover, these surpluses have increased by significant amounts in 1993-1994.

POPULATION (as of 1990)	891,952
LAND AREA	4,086.9 sq km
INCOME CLASS	First Class
TOTAL REVENUE (1994)	P283.6 million
INTERNAL REVENUE ALLOTMENT (IRA)	P180.8 million
LOCAL REVENUES	P102.8 million
BORROWING CAPACITY (1994)	P226.8 million
PAYING CAPACITY (1994)	P108.3 million

Although the provincial government has identified a number of possible investment projects, it has not actively pursued the possibility of funding some of these projects through credit because the governor finds it difficult to secure *Sanggunian* approval for its initiatives. The executive-legislative gridlock was at its worst in 1994 when the local *Sanggunian* did not approve the projects lined up by the governor for the 20 percent Development Fund. Consequently, the money set aside for this purpose was not touched during the year.

*Preferred projects.* Traditionally, loans have been used to finance public markets, slaughterhouses, bus terminals and the acquisition of heavy equipment (Table 3.15). In recent years, LGUs have borrowed to finance local public infra-

**Box 4: FOUL-UP IN PROJECT DESIGN NOT A PROBLEM**

City B is a highly urbanized city in one of the high-growth centers in the Visayas. It has a population of 180,285 in 1990 and a land area of 11.7 sq km. Its total income of P190.7 million in 1994 was comprised of P113.9 million in IRA and P76.8 million from locally generated revenues.

Its maximum borrowing capacity is estimated at P152.5 million in 1994 while its net paying capacity is computed to be P133.7 million. While the city registered negative current surpluses in 1990-1991, its fiscal position improved significantly in 1992 through 1994. It is also interesting to note that it posted above average rate of growth for its local source income during the five-year period from 1990 to 1994. Moreover, unlike most other LGUs, the city owns 28 hectares of prime real estate (the share of the city government in the reclamation project in its jurisdiction) which is currently valued at P2.8 billion. Because of this development, some local officials think that the city has no need for loan finance in the future. They would rather undertake projects on a pay-as-you-go basis.

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POPULATION (as of 1990)	180,285
LAND AREA	11.7 sq km
INCOME CLASS	First Class
TOTAL REVENUE (1994)	P190.7 million
INTERNAL REVENUE ALLOTMENT (IRA)	P113.9 million
LOCAL REVENUES	P76.8 million
BORROWING CAPACITY (1994)	P152.5 million
PAYING CAPACITY (1994)	P133.7 million

---

City B secured loans for the construction of a bus terminal in 1992 and for the construction of a public market in 1994, both from the Municipal Development Fund (MDF). Both projects were "offered to the city on a silver platter" by the Metro X Development Project (MXDP) which identified the projects and conducted the feasibility studies for the same. These projects were meant to decongest the three adjacent cities in the area, City B, City X and City Y and to link the northern and southern part of the province. On their own, city officials



were interested in the public market but not in the bus terminal. However, they were persuaded by the MXDP to take on both projects.

The bus terminal was completed in October 1994. As of May 1995, it is non-operational. Local officials found out that under present conditions, the undertaking will not generate enough revenues to pay for its upkeep. The feasibility study assumed that City X will pass an ordinance prohibiting picking up of passengers in its jurisdiction, thereby forcing buses to use the bus terminal in City B. However, such ordinance did not materialize as planned because of political differences between the mayors of City B and City X.

The mayor of City B is not worried about repaying the loan used for the construction of the bus terminal. The city has accumulated a substantial net income from past operations. It is also considering the sale of its share in the reclamation project. In fact, the mayor is thinking of pre-paying the loan so that the city will be allowed to convert the bus terminal to a school which the mayor thinks his constituents need more.

The city administrator reported that following up of their loan application with the MDF was time consuming and costly, requiring many trips to Manila. He wished the regional office of the Bureau of Local Government Finance could have been more helpful. In contrast, the city treasurer did not perceive any problems in relation to the processing of their loan application by the MDF.

structure like roads and waterworks (Box 7). Some LGUs are even considering debt financing of social services facilities like school buildings, hospitals and housing (Boxes 4 and 5). In all cases, these projects require long-term financing.

*Preferred lending institution.* When asked directly about their preferred lending institution, most local officials (14 out of 19 who responded) explicitly favor GFIs. They think that GFIs provide reasonable loan terms and process their loan applications relatively quick. Also, some LGUs pointed out that some GFIs have actively marketed their services and offered to help package LGU loans. Although there is no reported LGU borrowing from private banks to date, four of the respondents (three from high-income LGUs and one

**Box 5: GOING TO THE BOND MARKET**

City C is a second income class city located in one of the provinces in the Bicol Region. It has a population of 121,116 (1990 census) and an aggregate land area of 153.70 sq km. Its total income of P177.5 million in 1994 is composed of P65.8 million from local sources and P111.6 million as IRA.

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POPULATION (as of 1990)	121,116
LAND AREA	153.7 sq km
INCOME CLASS	Second Class
TOTAL REVENUE (1994)	P177.5 million
INTERNAL REVENUE ALLOTMENT (IRA)	P111.6 million
LOCAL REVENUES	P65.8 million
BORROWING CAPACITY (1994)	P142.0 million
PAYING CAPACITY (1994)	P136.2 million

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The borrowing capacity of City C (based on its 1994 income) is P142.0 million while its net paying capacity is P136.2 million. City C's past record shows it is creditworthy. Its fiscal position has been in surplus in 1990-1994. Moreover, these surpluses have been growing over time. It also scores high in terms of local revenue performance, as evidenced by the higher than average growth in its income from local sources.

In 1978, City C borrowed P10.2 million from the National Housing Authority (NHA) for a housing project called the Pambansang Nayon Project payable in 25 years. As of December 1994, P6.43 million has been paid. The city also obtained a loan of P16.11 million in 1985 from the now-defunct Economic Support Fund (ESF) for the construction of a public market, payable for 25 years starting 1987. The said public market was burned down in March 1994 and the city government was able to collect P21.04 million as insurance proceeds. This amount, together with a loan from the PNB, will be used to construct a new public market which will cost around P30.79 million.

According to the information supplied by the former city treasurer to the current administration, these two loans were not released to the city treasurer, hence, said loans were not booked. All transactions related to these loans were

done in Manila by and between the then city executive and the officials of NHA and ESF. It is probably because of this reason that the city was not regularly paying the said loans, especially the NHA loan which was supposed to have been fully paid in 1993. An interesting technical issue related to this experience of the city is the treatment of unbooked loans for purposes of computing the 20 percent debt service cap.

In 1995, City C offered to the public a two-year bond with a fixed interest of 15 percent per annum. The P26.0 million that was raised from the bond issuance will be used to finance a socialized housing project (Phase I). The bond is guaranteed by the Home Insurance and Mortgage Corporation (HIGC) as to its principal and interest income of up to 8.5 percent. The remaining 6.5 percent is secured by funds appropriated by the city from its development fund.

According to the City Planning and Development Coordinator who is also the Suerte Bond Flotation Action Officer, bond flotation is more tedious and "bloody" than borrowing from a bank to finance local projects. Moreover, it becomes more expensive if the underwriting costs and guarantee fee are included. HIGC charged the city government 1 1/4 percent guaranty premium and a credit supervision fee of 1 percent of the outstanding bond issue.

Although the City Government intends to sell the house and lot package at prices lower than those charged by private developers, some city officials are skeptical that the low income group will benefit from this socialized housing project. They pointed out that the lowest amortization is P2,500.00 per month which low income families cannot afford.

from a middle-income LGU) said they would like to borrow from private banks. Only two LGUs (both belonging to the first income class) prefer to borrow from the MDF.

*Interest rate and maturity preferences.* Most LGUs in the sample said that an interest rate ranging from 10 to 15 percent is reasonable for loans used to finance income-generating projects. For developmental, physical and social infrastructure projects, a number of LGUs prefer an interest rate of less than 10 percent. However, an almost equal number said that interest rates in the 10 to 15 percent range are reasonable

**Box 6: GROWING INTEREST IN BOT SCHEMES**

Province B is one of the provinces in Western Visayas. It has a total population of 380,497 (1990 census) and an aggregate land area of 1,817.9 sq km. It is a third income class province with a total income of P112.8 million in 1994 broken down as follows: P10.9 million from local sources and P101.9 million as IRA. Based on its 1994 income, the province's maximum borrowing capacity is P90.2 million while its paying capacity is P80.3 million.

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POPULATION (as of 1990)	380,497
LAND AREA	1,817.9 sq km
INCOME CLASS	Third Class
TOTAL REVENUE (1994)	P112.8 million
INTERNAL REVENUE ALLOTMENT (IRA)	P101.9 million
LOCAL REVENUES	P10.9 million
BORROWING CAPACITY (1994)	P90.2 million
PAYING CAPACITY (1994)	P80.3 million

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Most of the officials interviewed were in the provincial government only during the incumbency of the present governor. According to them, they were not aware of any loan, whether from government banks or MDF, that was secured by previous administrations. Early this year (1995), however, the provincial government obtained a "bridging" loan amounting to P10.0 million from the Land Bank of the Philippines (LBP) to finance operational expenses like payment of salaries and wages. The said loan will be repaid from the 1995 IRA share of the province.

The provincial government commissioned a private group to prepare its ten-year (1993-2002) comprehensive development plan (CDP). To date, some of the development projects identified in the CDP are being financed mostly through official development assistance (ODA) and from the national government. The BOT scheme is being eyed as a possible source of finance of some of the big projects identified in the CDP like the proposed hydroelectric plant (estimated cost is P1.0 billion) and irrigation project (P200 million). The provincial government is also planning to secure a bank loan to purchase heavy equipment (worth P25 million) to construct provincial roads. The proposed P50 million sports complex will also be financed by borrowing from a government bank.

Table 3.15

**CURRENT AND PAST LGU PROJECTS AND TYPE OF FINANCING USED**

Type of Project	GFI Loans	Foreign Loans (MDF)	Bonds	BOT	IRA/Own Sources	CDF	Others Credit	Others Non-Credit	Not Specified
Electric power plant									1
Slaughterhouse		1			5		1		
Public market	3	4			4	3	4	1	
Irrigation system	1				3				1
Waterworks system	1				4	1	3		1
Tolls/bridges/roads	1	1			6	1	2	1	1
Commercial building				1					
cold storage							3		
Heavy equipment/machinery	6	1			3		2		1
Sports complex	1				4	3	1		1
Livestock dispersal					7				
Nutrition center					2				
Municipal/city building					6	1			
Public toilet					5			1	
Cadastral survey/RPT					1			5	
Office equipment					3			1	
Waiting shed					3	1			
Basketball court					5	1			
Barangay multi-purpose hall					3	4			
Nursery/demo farm					3				
Dumping site									1

Table 3.15 (continuation)

Types of Projects	GFI Loans	Foreign Loans (MDF)	Bonds	BOT	IRA/Own Sources	CDF	Others Credit	Others Non-Credit	Not Specified
Jeepney/bus terminal		1		1				1	
Satellite markets								1	
Housing projects			1						
River control					1				
Forest & fruit trees seedlings dispersal					1				
Cooperative assistance					1				
Assistance to rebel returnees					1				
Supplemental feeding					1				
Ugnayan (Medical Team)					1				
Schools					2	1			
Drainage		1			1				
Sanitary landfill		1							
Motorpool		1					1		
Health services		1					1		

**Box 7: USING CREDIT FINANCE FOR PUBLIC INFRASTRUCTURE**

Province C is a first income class province in the Southern Tagalog Region with a population of 436,140 (1990 census) and an aggregate land area of 12,913.51 sq km. Its total income amounted to P241.8 million in 1994 consisting of P14.1 million from local sources and P227.7 million from IRA. Based on its 1994 income, its maximum borrowing capacity is P142 million while its net paying capacity is P136.2 million.

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POPULATION (as of 1990)	436,140
LAND AREA	12,913.51 sq km
INCOME CLASS	First Class
TOTAL REVENUE (1994)	P241.8 million
INTERNAL REVENUE ALLOTMENT (IRA)	P227.7 million
LOCAL REVENUES	P14.1 million
BORROWING CAPACITY (1994)	P142.0 million
PAYING CAPACITY (1994)	P136.2 million

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Given the large land area it covers, Province C decided to accelerate its road construction program by securing a loan of P100 million for the acquisition of heavy equipment from Land Bank of the Philippines (LBP). Provincial officials justified the purchase of heavy equipment as a cost-saving and income-generating project. Of the P100 million, around P70 million were already availed of by the province. It seems, however, that the provincial officials are not satisfied with the terms and conditions of the loan, hence, they are negotiating with PNB to refinance the said loan.

The province has already prepared a five-year development investment plan (1996-2000) which includes an ambitious energy program worth P3 billion. Many of the proposed projects are also slated for loan financing and the others for BOT scheme. The secretary to the *Sangguniang Panlalawigan*, however, observed that in the preparation of the budget, the parochial interests of *Sanggunian* members are given more importance even if these are not part of the priority program under the development plan.

because one cannot expect a very low interest rate given existing market conditions.

Many local officials prefer long-term loans of about 10 years. However, others chose a maturity of 20 years or more.

*MDF loans: LGU perspective.* LGUs that secured loans from the MDF cited the following advantages of the MDF: (i) the interest rate on loan is lower; (ii) the tenor of loans is longer; (iii) loans include a grant component (Box 9); and (iv) technical assistance is provided in the preparation of the feasibility study as well as in the implementation of the project. On the other hand, they noted some disadvantages: (i) processing of loans is slowed down by bureaucratic red tape; (ii) processing/approval is too centralized; (iii) interest rates are high; and (iv) the design of the project is controlled by the central government. Many LGUs complained about the cost of having to transact too often with the CPOs in Manila prior to the loan's release (Box 8).<sup>19</sup> A first-class municipality in Mindanao on the other hand, felt that the MDF program is too inflexible. For instance, design of buildings financed by the MDF are prescribed by the PMO/CPO (Box 9). Also, despite the technical assistance extended to LGUs in the formulation of feasibility studies, some borrowers from the MDF suffered from deficient preparatory studies.

Most of the LGUs that did not borrow from the MDF claimed that they were not aware of the financing facility.

*Preferred policy option to enhance LGU credit finance.* The transfer of MDF funds to GFIs for relending to LGUs and the transformation of the MDF into a guarantee fund for LGU loans were the two most preferred options chosen by the respondents. A good number of interviewees also thought it worth considering the retention of the MDF in the DOF

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<sup>19</sup> The loan processing procedures are discussed in detail in Chapter V.



with some modifications, such as increasing its resources and improving its management.

- *Technical Capability of LGUs*

One of the factors constraining LGUs' access to credit is their own technical capability to formulate and implement development plans. The survey revealed that three out of 10 municipalities (all belonging to the low-income group) and two out of three cities did not have updated local development plans. The survey also showed that many times, LGUs' capital investment budgets were poorly related to such plans (Box 7).

The complexity and/or tediousness of the loan procedure is the most frequently cited reason by the respondents for not accessing credit financing. Likewise, those LGUs which borrowed reported that the difficulty of complying with bank requirements and lack of technical expertise in preparing the project feasibility study are some of the more important problems they encountered in applying for a loan (Box 10).

- *Constraints from the Regulatory Framework*

*Depository bank requirement.* The Code explicitly states that LGUs can contract loans from, among others, domestic private banks. To date, no LGU loan from private banks has been consummated. An earlier study (Llanto et al. 1992) has noted that one of the factors that constrain LGU access to the private capital market is information asymmetry.<sup>20</sup> It should be emphasized that COA Circular 92-382, which mandates that LGUs maintain their deposits in GFIs, does not provide a supportive environment within which LGUs and private banks are encouraged to know one another better.<sup>21</sup> The majority of LGU respondents preferred to place their deposits in GFIs (Table 3.16). The primary reason cited for doing so

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<sup>20</sup> See also Chapters V and VI for a related discussion.

<sup>21</sup> It should be emphasized that the Code itself does not limit LGU depository banks to GFIs alone.

**Box 8: ALL OF THREE YEARS**

Municipality B is the capital town of one of the provinces in Western Visayas. It has a population of 51,387 (1990 census) and an aggregate land area of 46.20 sq km. It is a third income class municipality with a total income of P25.4 million in 1994 broken down as follows: P12.4 million from local sources and P13.0 million from IRA. Its maximum borrowing capacity is P20.3 million while its paying capacity is P7 million. Its fiscal position has not been very good in 1990-1994. While it continued to post surpluses during the indicated period, its surplus declined in 1991-1993.

POPULATION (as of 1990)	51,387
LAND AREA	46.20 sq km
INCOME CLASS	Third Class
TOTAL REVENUE (1994)	P25.4 million
INTERNAL REVENUE ALLOTMENT (IRA)	P13 million
LOCAL REVENUES	P12.4 million
BORROWING CAPACITY (1994)	P20.3 million
PAYING CAPACITY (1994)	P7 million

In 1991, the municipality was granted a loan of P300,000.00 by the Technology and Livelihood Resources Center (TLRC) to finance the purchase of a meat van. The loan carries an interest rate of 17 percent per year payable in seven years. The loan was totally repaid in 1993. The meat van, however, was not used as intended but was converted for other purposes.

The municipality also applied for a loan from the MDF which was approved after three years. The P9.2 million MDF loan, which will be used to construct a public market, is payable in 15 years with an interest of 14 percent per year. According to municipal officials, they waited that long (3 years) because of the grant component of the MDF loan. The Municipal Planning and Development Coordinator, however, said that although the loan carries a reasonable interest rate and a grant component, it may become even more expensive than an ordinary bank loan if the cost of following up the loan in Manila for three years were considered.

**Box 9: ANOTHER MDF EXPERIENCE**

Municipality C is the capital town of a medium-sized province in Region 11. Its population, based on the 1990 census, is 96,806 and its jurisdiction covers 192.4 sq km. It is a first class municipality with total income of P46.3 million in 1994. IRA accounted for P22.6 million and locally generated revenue, P23.7 million. Based on its 1994 income, its maximum borrowing capacity is P36.6 million and its net paying capacity is P15.3 million. With its current surplus positive and rising steadily in the last five years, it is a relatively good credit risk.

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POPULATION (as of 1990)	96,806
LAND AREA	192.4 sq km
INCOME CLASS	First Class
TOTAL REVENUE (1994)	P46.3 million
INTERNAL REVENUE ALLOTMENT (IRA)	P22.6 million
LOCAL REVENUES	P23.1 million
BORROWING CAPACITY (1994)	P36.6 million
PAYING CAPACITY (1994)	P15.3 million

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Municipality C borrowed from the MDF to finance the construction of its public market. The municipal treasurer observed that the MDF credit program is too centralized in the Manila office of the MDF. The loan process was reportedly tedious with local officials being obliged to go to the Manila office to comply with documentation requirements even when correspondence would have sufficed.<sup>1</sup> He noted that if some of the procedures were devolved to the regional office, the loan application might have been faster and less expensive for the LGU.

He also pointed out that the program is inflexible. He narrated that MDF required the municipality to follow the prescribed architectural/engineering design in the construction of the public market. He related that the municipality had problems in renting out the stalls in the interior of the building because they were dimly lit and poorly ventilated. The municipality was also not allowed to make any modifications in the building until the loan is fully paid.

The municipal treasurer also reported that the municipality chose to borrow from the MDF because the grant component of the MDF loan made it more attractive than loans from GFIs.

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<sup>1</sup> A similar observation was made by the Provincial Planning and Development Officer of an adjacent province whose staff provided assistance to municipalities within said province in accessing the MDF facility.

is compliance with the said COA mandate. From this perspective, liberalizing the depository bank requirement for LGUs will be a major step toward promoting the improved flow of information between LGUs and private financial institutions. At the same time, it will provide LGUs the opportunity to use their deposits as leverage in securing better loan terms. Note once again that many LGUs post surpluses in most years.

*IRA intercept.* Given the fact that many LGUs have no or poor credit history and have little or no assets acceptable to banks as collateral, a credible IRA intercept mechanism will greatly enhance LGU credit standing. Although Article 401 of the Implementing Rules and Regulations of the Code states that “any LGU... may authorize the National Government to deduct or withhold a portion of its IRA share for the payment of its contractual obligation,” the DBM is not willing to implement the IRA intercept because of the Code provision which states that the IRA share of LGUs should not be subject to any lien or holdback that may be imposed by the national government except loan contracts/agreements arising from foreign loans and international commitments. However, the DOF appears to be in favor of the IRA intercept. (Refer to draft Local Finance Circular on LGU Credit Finance).

**Box 10: LOW TECHNICAL CAPACITY**

City D is a first income class city in one of the fastest growing regions in Region 11. It has a land area of 423 sq km and a population of 250,389. Its total income reached P326.7 million in 1994. Of this amount, 61.8 percent or P202 million came from its IRA share and 38.0 percent or P124.7 million was contributed by local source income.

Its borrowing capacity (based on its 1994 income) is P260.9 million while its net paying capacity is P333.5 million. The city is deemed creditworthy. It has been posting rather hefty current surpluses in 1990-1994. As a result, the city has accumulated balances of P500-P600 million in the form of time deposits at the Development Bank of the Philippines (DBP).

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POPULATION (as of 1990)	250,389
LAND AREA	423 sq km
INCOME CLASS	First Class
TOTAL REVENUE (1994)	P326.7 million
INTERNAL REVENUE ALLOTMENT (IRA)	P202.0 million
LOCAL REVENUES	P124.7 million
BORROWING CAPACITY (1994)	P260.9 million
PAYING CAPACITY (1994)	P333.5 million

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One reason cited (by both the vice-mayor and the city treasurer in separate interviews) for its good fiscal position is the reduction in the cost of government procurement due to the reduction in graft. They said that the old practice of overcosting supplies had been eliminated through more transparent and streamlined procurement procedures. At the same time, an examination of its accounts reveals that it has also been doing well in mobilizing local revenues as evidenced by the rapid increase in local source income in 1993-1994.

The city has borrowed from the Municipal Development Fund (MDF), the DBP and the Land Bank of the Philippines (LBP) in the past. Its loans from the DBP and the LBP were secured through "back-to-back" arrangements, i.e., their loans were secured by their deposits with these banks. With its strong fiscal position in recent years, the city has decided to accelerate payments of their loans with the DBP and the LBP.

On the other hand, local officials noted that the utility of their MDF projects was limited by poor project design. In the case of the food terminal, the project could not be fully operationalized due to the lack of access roads. In similar manner, the abattoir could not be made operational due to insufficient drainage facilities. In both cases, the design failed to take into account ancillary services and facilities required to make the projects operational. These happened despite their reliance on third party services (private consulting firms) in developing the projects.

Government banks such as the PNB and the LBP have devised a way of effectively intercepting the IRA, even without the cooperation of the DBM. They require the borrowing LGU, as part of the loan agreement, to deposit its IRA with the lending bank, a designated depository bank. The loan agreement also authorizes the lending bank to automatically debit from the LGU deposit any loan amortization that is not paid within the prescribed period.

Given this backdrop, a clarification of the IRA intercept provision of the Code is needed to provide an even playing field between GFIs and private banks. If the IRA intercept is indeed not allowed by the Code for most loans, then the depository bank requirement becomes even more important in increasing LGUs' access to the private capital markets.

- *Disincentive to Generate Locally Sourced Revenues*

The discussion of the creditworthiness criterion used earlier in this study noted that one of the principal factors contributing to the bankability of LGUs is their ability to extract income from their tax base. Previous studies have pointed out that the poor performance of many LGUs in generating revenue from local sources stems from two factors. First, poor tax administration has resulted in low collection efficiency in many LGUs. Second, many LGUs do not fully utilize their revenue-raising powers. In this regard, the disincentive effect of the

**Table 3.16**

<b>TYPE OF DEPOSITORY BANK PREFERRED BY LGUs</b>								
	Governor/ Mayor		Vice-Governor/ Mayor		Planning & Devt. Officer		Local Treasurer	
INCOME GROUP/BANK	No.	%	No.	%	No.	%	No.	%
ALL INCOME GROUPS	19	100	12	100	22	100	19	100
Commercial banks	4	21	1	8	6	27	3	16
Development banks			1	8	1	5		
Thrift banks								
Rural banks			1	8	1	5		
Government banks	15	79	7	58	15	68	16	84
Any of the above	2	11	3	25				
<b>REASONS CITED</b>								
1. Can shop around for better yields	1	5	1	8			1	5
2. Accessibility/proximity			2	17	2	9		
3. COA regulation	5	26	3	25	7	32	10	45
4. Stability	7	37	4	33	3	14	7	5
5. Smooth relationship	1	5					1	5
6. High interest rate	3	16	4	33	11	50	4	18
7. Best offer/services			1	8	1	5	1	5
8. Loan contract							1	5

IRA distribution formula on local revenue generation tends to work against improving the creditworthiness of LGUs.

Manasan (1994) found that while the IRA had a neutral effect on local tax performance in 1985 (with mixed results for 1990), it had a negative effect on local tax effort at all levels of local government in 1992 and 1993 (Table 3.17).<sup>23</sup> While the relationship is rather weak for provinces (where a P1 increase in per capita IRA leads to a P0.01 reduction in

<sup>23</sup> These results are based on regression analysis using cross-section data. LGU-level data on local taxes and IRA came from the COA while provincial -level personal income data were obtained from the 1991 Family Income and Expenditure Survey (FIES). The regressions pertaining to provinces made use of data from all 75 provinces, those pertaining to cities made use of data from all 60 cities. However, the regressions pertaining to municipalities made use of data on municipalities aggregated at the provincial level.

# LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 3.17a**

## **LINEAR REGRESSION ON PER CAPITA LOCALLY GENERATED REVENUES OF PROVINCES, 1985, 1990, 1992 and 1993<sup>a</sup>**

	Per Capita Total Local Tax Revenues	Per Capita Real Property Tax Revenues	Per Capita Non-Property Tax Revenues
<u>1985</u>			
Constant	-4.044 (0.000)	-4.054 (0.000)	0.009 (0.036)
Per Capita IRA	-0.023 (0.304)	-0.023 (0.303)	0.0003 (0.091)
Per Capita Income	0.002 (0.000)	0.002 (0.000)	2.998E-07 (0.266)
R <sub>2</sub>	.93	.93	.16
<u>1990</u>			
Constant	-12.365 (0.0005)	-12.515 (0.000)	-0.732 (0.130)
Per Capita IRA	-0.002 (0.474)	-0.009 (0.385)	0.026 (0.006)
Per Capita Income	0.003 (0.000)	0.003 (0.000)	-1.965E-05 (0.399)
R <sub>2</sub>	.58	.60	.11
<u>1992</u>			
Constant	-8.675 (0.000)	-8.152 (0.000)	-0.617 (0.123)
Per Capita IRA	-0.009 (0.067)	-0.008 (0.094)	-0.0007 (0.412)
Per Capita Income	0.002 (0.000)	0.002 (0.000)	0.0001 (0.002)
R <sub>2</sub>	.69	.68	.13
<u>1993</u>			
Constant	-10.616 (0.0)	-0.763 (0.0)	0.026 (0.358)
Per Capita IRA	-0.010 (0.014)	-0.010 (0.016)	-0.0003 (0.005)
Per Capita Income	0.003 (0.0)	0.003 (0.0)	3.462E-05 (0.00005)
R <sub>2</sub>	0.67	.67	.24

<sup>a</sup> Level of significance shown in parentheses.



**Table 3.17b**

**LINEAR REGRESSION ON PER CAPITA LOCALLY GENERATED REVENUES OF CITIES, 1985, 1990, 1992 and 1993<sup>a</sup>**

	Per Capita Total Local Tax Revenues	Per Capita Real Property Tax Revenues	Per Capita Non-Property Tax Revenues
<u>1985</u>			
Constant	100.234 (0.277)	36.384 (0.383)	63.850 (0.108)
Per Capita IRA	-0.452 (0.376)	-0.120 (0.454)	-0.332 (0.219)
Per Capita Income	0.004 (0.278)	0.004 (0.235)	0.0004 (0.415)
R <sub>2</sub>	.08	.07	.10
<u>1990</u>			
Constant	397.465 (0.021)	284.358 (0.056)	113.107 (0.024)
Per Capita IRA	-2.185 (0.013)	-1.579 (0.036)	-0.605 (0.018)
Per Capita Income	0.008 (0.119)	0.005 (0.192)	0.004 (0.046)
R <sub>2</sub>	.53	.46	.57
<u>1992</u>			
Constant	308.591 (0.016)	166.685 (0.044)	151.375 (0.006)
Per Capita IRA	-0.580 (0.018)	-0.314 (0.051)	-0.271 (0.011)
Per Capita Income	0.002 (0.279)	0.002 (0.229)	-1648E-05 (0.496)
R <sub>2</sub>	.30	.24	.30
<u>1993</u>			
Constant	325.25 (0.014)	141.73 (0.084)	183.52 (0.002)
Per Capita IRA	-0.279 (0.038)	-0.084 (0.221)	-0.194 (0.003)
Per Capita Income	0.002 (0.305)	0.0008 (0.39)	0.001 (0.227)
R <sub>2</sub>	.23	.05	.45

<sup>a</sup> Level of significance shown in parentheses.

# LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 3.17c**

## **LINEAR REGRESSION ON PER CAPITA LOCALLY GENERATED REVENUES OF MUNICIPALITIES (by province), 1985, 1990, 1992 and 1993\***

	Per Capita Total Local Tax Revenues	Per Capita Real Property Tax Revenues	Per Capita Non-Property Tax Revenues
<u>1985</u>			
Constant	-4.666 (0.087)	3.719 (0.049)	-0.946 (0.220)
Per Capita IRA	0.195 (0.093)	-0.133 (0.083)	-0.062 (0.122)
Per Capita Income	0.005 (0.000)	0.003 (0.000)	0.001 (0.000)
R <sub>2</sub>	.82	.83	.80
<u>1990</u>			
Constant	-35.959 (0.0005)	-21.744 (0.001)	-14.215 (0.0005)
Per Capita IRA	-0.123 (0.139)	-0.106 (0.077)	-0.017 (0.345)
Per Capita Income	0.012 (0.000)	0.008 (0.000)	0.004 (0.000)
R <sub>2</sub>	.54	.54	.49
<u>1992</u>			
Constant	30.707 (0.001)	18.745 (0.0005)	-11.961 (0.003)
Per Capita IRA	-0.103 (0.008)	0.061 (0.008)	-0.041 (0.015)
Per Capita Income	0.008 (0.000)	0.005 (0.000)	0.003 (0.000)
R <sub>2</sub>	.60	.60	.55
<u>1993</u>			
Constant	-35.43 (0.0002)	-7.517 (0.020)	-27.913 (0.0001)
Per Capita IRA	-0.071 (0.002)	-0.024 (0.005)	-0.047 (0.005)
Per Capita Income	0.0096 (0.0)	0.0032 (0.0)	0.006 (0.0)
R <sub>2</sub>	.69	.63	.62

\* Level of significance shown in parentheses.

per capita local tax revenue in 1992-1993), it is not negligible in the case of cities (where a P1 increase in per capita IRA is predicted to lead to a P0.28 to P0.58 decrease in per capita local tax revenue) and municipalities (where a P1 increase in per capita IRA results in a P0.07-P0.10 decline in per capita local tax revenue). These results suggest the need to include a maintenance-of-effort factor directly and explicitly in the IRA distribution formula.

## **LOCAL GOVERNMENT DEBT FINANCE IN OTHER COUNTRIES**

There are two general sources of debt finance for local governments in other countries: (i) municipal development funds (MDFs) operated out of municipal development intermediaries (MDIs),<sup>24</sup> and (ii) bond or securities markets. The first source is used mostly by European countries, and lately by many Third World countries in Africa, Asia and Latin America, while the second has been the chief financing instrument of local authorities in the U.S. The different institutional structures offer interesting insights into how the municipal credit system in the Philippines may be organized.

Municipal bonds issued by local authorities in the U.S. are traded in the “over the counter” market — an unlisted and specialized market not part of the stock exchange — operated by brokers who specialize in municipal bonds. The exemption of income from municipal bonds from the Federal income taxation makes the municipal bond an attractive instrument for investors (United Nations 1972).

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<sup>24</sup> In general, the MDFs and/or MDIs are operated mostly by central governments, with some participation by municipal governments through representation in the boards of management, either as share holders or by statutory right. There are very few examples of private sector involvement in the management of MDFs/MDIs (Davey 1988).

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Only a handful of LGUs in the Philippines may be capable of using bond financing given the state of development of the bond markets and the requirements of bond issuance. The use of the bond market for LGU capital financing and the constraints upon bond flotation are discussed in detail in Chapter V. This chapter focuses on municipal development intermediaries, also known as municipal credit institutions (MCIs).

## **MUNICIPAL CREDIT INSTITUTIONS**

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Worldwide experience shows that in developing countries, private capital may be unwilling to lend to local governments. Dillinger (1994) observed that "in most developing countries, the private market has been given the opportunity to lend to local government and has declined." This attitude was attributed by Dillinger to (i) the long history of macro-economic instability that has discouraged long-term financial commitments of private capital, and (ii) control over returns to savings that has prevented risk from being properly compensated with the appropriate reward. Furthermore, "as political entities lacking readily marketable collateral, local governments are viewed as particularly unattractive to private capital" (Dillinger 1994). Therefore, the authority to borrow does not necessarily provide the local governments in many developing countries ready access to the capital markets.

In many countries, the central government's response to the unwillingness of private capital to lend to local governments is to create MCIs, described by Dillinger as "organizational hybrids" which attempt "to combine the commercial incentives of private lenders with the financial backing of central governments." The reasoning seems to be that public sector intervention through the MCI mechanism should fill the gap created by the absence of private risk capital.

Davey (1988) points out that MDFs or the institutions which administer them, generally called municipal

development intermediaries (MDIs) or MCIs, are not new ideas. As early as the 19th century, Japan and most Western European countries have some central institution that channels investment credit to local governments. Some examples are the Belgium Municipal Credit Bank, the Danish Municipal Credit Association, the Japan Finance Corporation for Municipal Enterprises, and the German Municipal Bank. In the last 30 years, Davey's survey showed the rapid spread MDFs in many Third World countries. The form of these MDFs and MCIs varies widely, including the following:

- MDFs implemented by ministries of local government, (the Bureau of Local Government Finance of the Department of Finance in the Philippines);
- windows for grants and loans to municipal infrastructure operated by national "Caisses de Prêts" managing state-controlled pension, insurance and savings funds; and
- autonomous institutions for the promotion of local governments with a separate legal and financial identity.

These "autonomous" institutions are of several types: (i) municipal development banks; (ii) municipal "windows" within banks; (iii) municipally controlled savings banks; (iv) institutions providing a range of services to local governments including credit, technical assistance and direct construction of urban infrastructure; (v) an association of municipalities; and (vi) a metropolitan development authority.

Some examples of successful MCIs are those of Belgium, Denmark, France, the United Kingdom and Colombia (Table 4.1). There are many more examples, but these illustrate some of the different successful approaches to municipal debt finance employed by other countries.<sup>25</sup>

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<sup>25</sup> This part draws from the literature on municipal development funds and local authority financial intermediation secured from the World Bank.

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Table 4.1

## COMPARISON OF LOCAL FINANCING INTERMEDIARIES IN OTHER COUNTRIES

Country	Institution/Fund	Structure	Sources	Assistance	Lending (US\$)	Personnel
Belgium	Credit Communal Belgique (CCB)	Limited Company	Private savings, local authorities deposits and bonds	Loans	\$2.25 billion (1990)	4,000
Denmark	Danish Credit Institution for Local Authority (DCLA)	Cooperative Credit Institution	Bonds	Loans	\$345 million (1990)	18
Colombia	FINDETER	Autonomous Financial Corporation	Pension fund deposits external borrowing, government/BCH loans, bonds.	Rediscounts commercial bank loans	\$300 million (1983-86)	90
France	Credit Local (CLF)	Independent subsidiary of central deposit bank (Caisse des Depots-CDD)	Bonds, CDD loans, external borrowing	Loans	\$3.8 billion (1988)	1,000
United Kingdom	Public Works Loan Board (PWLB)	Independent Statutory Commission reporting to Parliament	Bonds	Loans	\$11.3 billion (1987-88)	23

- *Belgium: Credit Communal Belgique*

The Credit Communal Belgique (CCB) or the Municipal Credit Bank of Belgium is an autonomous municipal development bank established in 1860. It is a limited company governed by a shareholders' assembly representing provinces and municipalities. It is managed by an Administrative Council which elects a President and a Managing Director. The state does not participate in the management of CCB. Private demand deposits, temporary surpluses of certain government institutions, current accounts opened by local governments and bond offerings are the main sources of finance. Thus, the terms of CCB's lending depend on the cost of funds. The State does not provide any loan guarantee but CCB is authorized to deduct loan repayments from the transfers made by the central government to the municipal governments. In 1990, CCB's advances to local governments amounted to US\$2.25 billion, of which US\$1.2 billion were long-term loans.

- *Denmark: Danish Credit Institution for Local Authorities*

The Danish Credit Institution for Local Authorities (DCLA) is a specialized credit institution established in the 19th century to provide medium- and long-term credit to municipal governments. Organized as a cooperative, DCLA has municipal and county governments as members. The members elect the Board of Directors who, in turn, appoint a management team. The state does not participate in the management of DCLA although the Ministry of Interior oversees it. The main source of finance is the bond market where it issues bonds with maturities ranging from 5 to 32 years. The terms and conditions of a member's loan are determined by the yield and maturity of the bond issued by DCLA to raise capital. There are no state guarantees for the loans because the members are jointly and severally liable for



the debts. In 1990, DCLA provided loans of US\$345 million to members.

- *France: Caisse des Depots et Consignations/Credit Local*

The Caisse des Depots et Consignations was established as a state bank in 1816, but enjoys autonomy from government. It sources the bulk of resources from tax-exempt savings from the public, from deposits from many public and social institutions, and from mandatory deposits from notaries and other officials. In 1987, the Credit Local de France was established as a separate joint stock company by the Caisse des Depots, with shareholdings from Caisse des Depots, the government of France, banks, pension funds, and foreign financial institutions. Credit Local draws its resources from the bond market, loans from the Caisses des Depots and the European Investment Bank. Credit Local offers a wide range of financial services, including access to the bond market to the local governments. It does this by pooling local governments' capital requirements and issuing bonds for them. The funds raised from the bond offering are then passed on to the individual local government with terms and conditions based on the yield and maturity of the bond. In 1988, it provided loans of US\$5.8 billion, representing about 42 percent of all long-term credit to local governments.

- *United Kingdom: Public Works Loan Board*

The Public Works Loan Board (PWLB) is an independent statutory body established in 1817. It is governed by a Commission appointed by the Crown, representing local authorities and various branches of the financial community. The source of funds is the government, which issues bonds on its behalf and on-lends the proceeds to PWLB at a market-determined rate. The relending terms from PWLB to local governments reflect the government's cost of funds. Loans are secured by local taxes or other revenues. In 1988, PWLB advanced about US\$11.3 billion to local authorities.

- *Colombia: Financiera de Desarrollo Territorial*

The Financiera de Desarrollo Territorial (FINDETER) is an autonomous agency operating under the Ministry of Finance. It is owned by the central government (86 percent) and local governments (14 percent). It does not lend directly to local authorities but instead operates as a discount institution for private sector and state-owned commercial banks that provide loans to the local authorities. FINDETER does not depend on government budgetary allocation, but raises its funds from the bond market, recycling of loans, and foreign credits from bilateral and multilateral sources.

An eligible local government approaches a participating commercial bank for a loan, the bank in turn appraises the projects and the creditworthiness of the borrower. The commercial bank forwards the approved loan to FINDETER for a rediscount amounting to 75 to 85 percent of the amount of the loan. FINDETER charges the bank the three-month certificate of deposit rate plus 2 to 5 percent, depending on the size of the municipality. Large municipalities pay the maximum spread. The term is 15 years with three years grace period. The interest rate charged by the commercial bank is market-determined. To cover the credit risk, the bank charges the local authority an additional spread of up to 2.5 percent over the cost of FINDETER on the amount that has been rediscounted. On the portion of the loan which is sourced from the bank's own resources, the bank generally charges the three-month certificate of deposit rate plus 4 to 5 percent. Between 1975 and 1990, more than US\$1 billion were advanced to 600 local authorities.

## **MIXED PERFORMANCE OF MUNICIPAL CREDIT INSTITUTIONS**

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Not all MCIs are successful. In a recent assessment, Dillinger (1994) noted the mixed track record, and that various administrative and managerial measures can increase the

likelihood of their success. This section presents first the successful MCIs and then briefly discusses the poor performance of some MCIs.

The five MCIs in Table 4.1 have different corporate structures, i.e., institutional approaches to the problem of providing local government access to medium- and long-term credit. It will be instructive to consider the common factors responsible for their success.

- *Market framework and government's non-interference*

The successful MCIs operate within a competitive framework in the sense that the terms and conditions of their loans reflect the cost of their capital. Their financial resources are mobilized from various sources such as deposits, bond issuance and capital contributions, except direct government budgetary allocation, in competition with other financial institutions. Independent Boards of Directors are responsible for policy and decisionmaking, and professional management teams for the MCIs' daily operations.

Just like other financial intermediaries, MCIs are subject to (i) the regulation and supervision of the appropriate government entities to ensure that they adhere to sound banking principles and (ii) regular external audits according to generally accepted auditing principles. This policy helps in maintaining such credit rating that will be necessary to access the private domestic and international capital markets.

- *Political and financial autonomy*

The successful MCIs have political and financial autonomy from central governments. On the other hand, local governments have been motivated by local autonomy to provide for the necessary public goods and services to the local people, and to generate revenues from local taxation, user charges and other cost recovery schemes. The locally generated revenues are also used as leverage to borrow for capital investments. There seems to be a conscious decision

by the governments (central and local) of successful MCIs to move away from grants and subsidized credits for financing capital investments. Thus, capital priced at its opportunity cost does away with (subsidized) transfers from the central government and encourages the local authorities to use user charges and other cost recovery schemes.

- *Credit risks and risk-sharing*

Another important factor is that the MCIs assume credit risks in their lending to local governments.<sup>26</sup> The local governments also share some risk by providing collateral or guarantee, as a lien on local revenues, including transfers from the central government. Thus, both the MCIs and the local governments sharing in the credit risks motivates regular loan repayment.

- *Strong local government performance*

The strong performance of local governments is required for the effectiveness and viability of MCIs. Apart from the accountability of local governments that is guaranteed by the electoral process, an important consideration is whether the local government has a sound revenue base and is operating from a strong local economic base. The local governments of the five sample countries generate local revenues that are used not only as leverage in credit financing, but also as a sound basis for local expenditures.

On the other hand, some MCIs perform poorly. Table 4.2 is a summary of the performance of MCIs in some developing countries. The MCIs in Indonesia, Jordan and Kenya are poor performers compared to their counterparts in Brazil, Colombia and Morocco. It can be observed that the poor performers draw most of their funding from the government and donors. The financial backing of the

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<sup>26</sup> Except perhaps for the DCLA where the members are jointly and severally liable for the liabilities.

## LGUs' ACCESS TO THE PRIVATE CAPITAL MARKETS

**Table 4.2**

### **SUMMARY PERFORMANCE OF SOME MCIs**

Organization Form		Source of Funds	Portfolio Results	Collateral	Share of Total Capital Transfer
Brazil PRAM	managed by unit of state planning secretariat; state bank act as financial agent	IBRD, and state; capitalized to revolve	good	withholding from transfers	large only in small towns towns
Colombia FINDETER	loans originated by private banks; rediscounted by funds administered by Board	compulsory bonds sold to S & L	good	borrow pledges transfers, specific source	small
Morocco FEC	department in CDG-government bank (now being converted to independent board, chaired by the PM who will appoint MOI)	bonds floated by CDG, donors, government capital	good	indirectly financed through government transfers	small
Indonesia RDA	bonds floated by CDG, donors government capital	government loans	poor	none	small
Jordan JVDB	legally independent board, chaired by Minister	compulsory LA deposits, central bank loans, donors	poor	withholding from transfers	large, but LGs have few functions
Kenya LGLA	legally independent board, chaired by Minister	donor on-lending	poor	none	large in small LGs

government is not enough to guarantee an MCI's success. Local governments are also weak and depend greatly on the central government. On the other hand, the successful MCIs operate in a market-oriented, competitive framework.

Dillinger (1994) noted that two conclusions emerge from the experience of MCIs in developing countries. *First*, governments must be committed to the financial integrity of the MCIs' operations. Thus, government interference in the lending decisions of the MCI will undermine the viability of the MCI. The *second* conclusion is that the viability of any lending program depends on the health of the local governments. In this respect, private capital that is expected to fund the capital requirements of local governments in the long haul, will not move in unless the creditworthiness of local governments is firmly established. This also means that the government can ill afford to have an MCI in an environment where local governments are financially weak. The attempt to have an MCI must be done with a resolve to strengthen the financial base of local governments.

Indeed, the MCIs have a mixed track record. The successful ones are those that try to operate in a competitive framework and have a risk-sharing arrangement with local governments. Under the market framework adopted by these MCIs, local governments can reveal their degree of commitment to certain projects and, simultaneously, their willingness to repay the loans. Moreover, there is an attempt to involve private capital in funding local governments. Government's non-interference with the operations of the successful MCIs helped in no small measure in assuring the good performance of the MCIs. The poor performers are those too dependent on government and donor funds and saddled with weak borrowers.

# **SUPPLY OF CREDIT TO LOCAL GOVERNMENTS**

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## **LGU CAPITAL MARKETS**

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The passage of the Code heralded the beginning of LGU attempts to access the private capital markets. No longer confined to sourcing credit from GFIs and the MDF, the LGUs have taken a keen interest in various financing schemes with the private sector. The Code allows the LGUs to float their own bonds, enter into build-operate-transfer contracts and, in general, to tap various sources of private sector financing. LGU credit finance is provided chiefly by the GFIs, which returned to the LGU credit markets after the passage of the Code, and by the MDF, which over the years has been the LGUs' sole source of long-term credit finance. The private banks have taken a "wait-and-see" attitude as they try to assess the profitability of LGU lending. Spurred by the successful flotation of the CEBU bond, a few LGUs have also considered bond issuance as an alternative way of raising long-term capital finance.

LGU borrowing has never been a substantial source of LGU financing, compared to the traditional sources such as IRA, grants and local taxes. LGU borrowing was on the average a mere 1.25 percent of their total income in the period 1981-1993. For the same period, the borrowing of cities was 2.0 percent of their total income, for municipalities it was 0.5

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percent and for provinces, the average was 1.35 percent of their total income.

However, with the return of GFIs to the LGU credit markets in the past two years, LGUs can expect to use borrowings more extensively as they try to explore various financing options to address the huge demand for local infrastructure and improved services. This is also due to the interest taken by the GFIs and MDF in the LGUs as borrowers for local development projects.

The total approved loans to LGUs from different sources amounted to some P12.6 billion as of the third quarter of 1995 (Table 5.1). The biggest source of credit finance is the GFIs that have overtaken the MDF as a major source of borrowing in the last two years. The approved LGU loans from GFIs amounted to P10.8 billion in the same period. The MDF remains an important source of loans, especially for long-term projects, while the GFIs are the source of medium-term loans. In contrast, the private banks have not provided loans to the LGUs.

It is worth mentioning that a water district, which provides the local water supply, may be present in one or more LGUs. Water districts are government-owned or -controlled corporations which operate the local water supply system. The water districts borrow from the Local Water Utilities Administration (LWUA), which was created by PD 178 (as amended), as a specialized lending institution to promote and oversee the development of provincial waterworks systems. As of June 1995, the LWUA has given loans of about P9.4 billion to 409 water districts. The LWUA also extends loans to rural waterworks and sanitation associations (RWSA) which are non-stock, non-profit cooperative associations organized and/or registered with LWUA, and franchised to operate a rural water supply system in remote areas where access to a water district is difficult (*Primer on LWUA and the Water Districts 1994*). In this respect, the LGUs which have water districts may not feel the need to borrow to put up a water



Table 5.1

**LGU LOANS**

(Amounts in million pesos)

MUNICIPAL DEVELOPMENT FUND (MDF)								GOV'T FINANCIAL INSTITUTIONS (GFIs)				
REGION	RCDP	MDP I	MDP II	(as of June 1995)			TOTAL	DBP (Sept. 1995)	LBP (Nov. 1995)	PNB (Oct. 1995)	GSIS (Mar. 1995)	LWUA (June 1995)
				MISORTEI	MCDP I	MDP III						
NCR												
Loans approved			223.8				223.8		1,925.0	4,155.0		
Loans released										2,746.3		
Outstanding balances									75.0	1,300.0		
No. of LGU borrowers			7				7		8	7		
LUZON												
Loans approved		430.9	277.9			86.6	795.4	77.3	821.6	884.5	106.3	3,621.7
Loans released								59.6		577.0	19.4	2,253.3
Outstanding balances								53.5	330.6	550.0		2,053.5
No. of LGU borrowers		28	25			3	56	13	29	47	7	233
VISAYAS												
Loans approved	89.1	67.8			22.3	35.0	214.2	33.0	798.7	485.2	9.5	3,837.1
Loans released										83.7		1,675.8
Outstanding balances									126.2	78.6		1,581.1
No. of LGU borrowers	2	6			1	2	11	3	18	21	1	91

Table 5.1 (continuation)

REGION	MUNICIPAL DEVELOPMENT FUND (MDF)								GOV'T FINANCIAL INSTITUTIONS (GFIs)				
	RCDP	MDP I	MDP II	(as of June 1995)				TOTAL	DBP	LBP	PNB	GSIS	LWUA
				MISORTEI	MCDP I	MDP III	MCDP II		(Sept. 1995)	(Nov. 1995)	(Oct. 1995)	(Mar. 1995)	(June 1995)
<b>MINDANAO</b>													
Loans approved	203.2	154.8		144.4		63.3		565.7	70.0	1,147.8	397.0	5	1,942.8
Loans released									60.0		43.0	1.4	1,132.1
Outstanding balances									33.4	492.8	42.8		1,016.5
No. of LGU borrowers	2	8		1		2		13	5	53	13	1	85
<b>TOTAL</b>													
Loans approved	320.9	653.5	501.7	144.4	22.3	149.9	35.0	1,827.8	180.3	4,693.2	5,921.7	120.8	9,401.6
								21.0			(P9.6B)*		
Loans released	254.0	635.0	387.0	144.4	20.8	29.4	21.6	1,470.6	119.6		3,450.0	20.8	5,061.3
											(P5.4B)*		
Outstanding balances									86.8	1,024.6	1,971.4		4,651.1
No. of LGU borrowers	4	42	32	1	1	5	2	87	21	108	88	9	409

Sources: Bureau of Local Government Finance (BLGF) and Government Financial Institutions (GFIs).

Notes on data:

\*PNB total amount loan approved and released including the GOCCs and GAs.

supply system. It must be emphasized that LWUA does not lend directly to LGUs but to water districts that serve one or more adjoining LGUs.

To show their keen interest in providing credit to LGUs, the GFIs have established seed funds or loanable funds targeted to LGU lending. Table 5.2 shows the seed funds allocated by each GFI to LGUs. Among the GFIs, the Land Bank of the Philippines has the biggest fund allocation for LGUs, with P5 billion, followed by the Social Security System (SSS) with P4 billion. However, the SSS targets the livelihood projects in LGUs. Its funds are not meant for capital financing. The Philippine National Bank (PNB) has no specific allocation but it is ready to provide loans depending on the LGU project requirements and repayment capacity. Part of the available supply of credit is the loan repayment of LGUs to the MDF which amounted to P700 million as of November 1995. The accumulated repayments of principal and interest, or "second generation funds," come to a considerable sum that can fund long-term development projects. It is also a potential source of funds for schemes such as co-financing, venture capital, and the like, which can be used to attract private capital for LGU development projects.

- *GFI Loan Windows*

*Revival of GFI loan windows.* Under PD 752, the GFIs became the only other source of credit finance for LGUs. The DOF reviewed the LGU loan applications to the GFIs to check whether the legal borrowing capacity as required by the COA was observed. It also assessed whether the LGU could meet its annual loan amortization. Loan applications are then forwarded to the GFIs which make the credit decisions. At their peak in 1983, the GFIs granted LGUs loans amounting to as much as P85 million (Table 5.3). However, the GFIs' loans to LGUs in the 1980s turned sour as the loan arrears and loan defaults mounted. Despite the IRA intercept mechanism, unpaid obligations to the GFIs rose to P2.1 billion

Table 5.2

**SEED FUND, TERMS AND CONDITIONS OF MDF AND GFI LOANS**

Programs/Sources	Seed Fund/ Loan Fund	Max. Loanable Amount	Maturity (incl. grace period)	Interest Rate (%) p.a.	Eligible Projects	Eligibility Requirements	Collateral Requirement
<b>MDF:</b>							
1. "Second Generation" (IBRD)	\$47 M	*open depending on project req't. provided that 10% of the total cost of the local sub- project components shall be borne by the LGU	20 yrs.	11%	*Urban transport, sanitation & drainage, municipal enterprise, shelter, livelihood proj. equipment procurement, tech. asst. & training, basically a wide range of infrastructure, public service, facilities & eqp't maintenance	*prioritization is based on geographic focus depending on the project package & passing the project criterion	*withholding from the LGU IRA of the amount equivalent to its amortization
2. MDP I (WB) (IBRD)	\$40 M		20 yrs.	11%			
3. MDP II (WB) (IBRD)	\$40 M		20 yrs.	11%			
4. MISORTEL (KOREAN EXIMBANK)	W3.79 B		20 yrs.	11%	improvement of the telephone service		
5. MCDP I (OECF)	Y2.06 B		20 yrs.	11%	const./impr. of nat'l rd. impr. of traffic mgt., so. bus terminal		
6. MDP III (IBRD)	\$68 M		15 yrs.	14%	basic infra., public services, eqp't maintenance, RPTA		

**Table 5.2 (continuation)**

Programs/Sources	Seed Fund/ Loan Fund	Max. Loanable Amount	Maturity (incl. grace period)	Interest Rate (%) p.a.	Eligible Projects	Eligibility Requirements	Collateral Requirement
7. MCDP II (OECF)	Y4,301 B		20 yrs.	11%	const./dev't. of arterial rds. and causeway, const. of northern bus terminal, upgrading public markets, improvement of solid waste disposal system		
8. "Second Generation" Fund	700 M	depending on the capacity to pay	based on economic life of in- vestments	varies annually	exclusive for financing any investments w/in the range of their responsibilities	pass a creditworthi- ness test specified by MDF Policy Govern- ing Board	IRA deductions
GFI: 1. DBP	P200 M	depends on total project cost w/ min. equity of 15%	3-12 yrs.	14-20%, APA base w/ hurdle rate of 4% or "AAAA", reviewable qtrly/ annually	revenue-generating proj. such as but not limited to p. markets, slaughterhouses, transport terminals, muni- cipal water systems, storage/ref. facilities	rev. >3M (last 3 yrs), no adv. findings fr. banks, eff. in collection of RPTA, passed 1st & 2nd screenings, w/ appr. local dev't. plan, duly endorsed by local council	1st REM; assign- ment of specified portion of LGUs IRA; endorse- ment of insur- ance policies

**Table 5.2 (continuation)**

Programs/Sources	Seed Fund/ Loan Fund	Max. Loanable Amount	Maturity (incl. grace period)	Interest Rate (%) p.a.	Eligible Projects	Eligibility Requirements	Collateral Requirement
2. LBP	P5-B	based on project req. but not more than repayment capability	5 yrs. (max.)	19%, (pool+min. 5% spread)	construction/improvement of public infrastructure, housing projects, capital investment projects, etc., acq. of prop., plant, eqp't.	any LGU w/ no past oblig'n., eith. w/ LBP or oth. creditors no budget def. for the past 3 yrs. pre- processing req't. & oth. documentary req't.	REM; hold-out on deposits, chattel mortgage; assign. of the net profits or income from the project or LGUs regular income
3. PNB	—	based on project req. and repayment capacity	4-7 yrs.	15-20% Prime rate+ 1-5% (max.) floating	infra. proj., public market, water system, bus terminal, acquisition of heavy eqp't.	legal, site evaluation, appraisal and credit requirements, etc.	Real property mortgage; portion of LGUs IRA; other LGU revenues
4. GSIS	—	P20 M/project	6 yrs.	14%, com- pounded monthly	construction/improvement of public infrastructure, housing projects, capital investment projects, etc.	legal, site evaluation, appraisal and credit requirements	1st mortgage on real property and insurance coverage

Table 5.2 (continuation)

Programs/Sources	Seed Fund/ Loan Fund	Max. Loanable Amount	Maturity (incl. grace period)	Interest Rate (%) p.a.	Eligible Projects	Eligibility Requirements	Collateral Requirement
5. SSS	P4 B	a. SMEs-depends on project req. or 100% of the cost but over-all debt to equity not more than 75:25  b. Non-SMEs-not >60% of project cost or P500 M whichever is lower	5 yrs.  20 yrs.	16%	power projects of existing SMEs, any power projects incl. BOT, power projects assisted by Napocor & municipal gov't.	assets of <200T but not >P40M before financing, debt-equity ratio of >75:25 after financing, SSS member of good standing, legal req'ts. (MOA), others	Real property mortgage & guarantee coverage
Others							
1. LWUA (USAID, WB, ADB, DANIDA, JICA)	P3.5 B \$500 M	w/o existing loan; 50-100% of project cost; with existing loan; 45-90%	1-28 yrs. (max)	8.5%-1st P2 M 10.5%- next P5 M 12.5%, any amt. >P7 M	const. of water system, repair & reactivation of non-operational water sys., watershed mgt. proj. etc.	board resolution, program of work, FS, execution of proj. agreement, public hearing documents, etc.	Submission of post-dated checks, assign. of 6th board LWUA membership from adjust. of water rates, etc.

\*applicable to all programs under MDF.

Source: BLGF and GFIs

in 1985. Finally, the GFIs had to stop lending to the LGUs. The national government had a first debt relief program for LGUs in the 1980s and a second one after the enactment of the Code, giving the LGUs a clean slate vis-a-vis the government lenders.<sup>27</sup>

Encouraged by the decentralization and the greater autonomy of LGUs caused by the new policy regime under the Code, the GFIs revived their loan windows for the LGUs. Table 5.1 shows the amount of approved loans from GFIs, the amounts released, and the outstanding balances of LGUs as of the third quarter 1995. For instance, the PNB has approved loans as large as P5.9 billion to 88 LGUs. The average size of a PNB loan is P67.3 million (Table 5.4). The second biggest lender is the LBP, with approved loans of P4.7 billion to 108 LGUs. The average size of an LBP loan is about P43.5 million.

*Terms and conditions of GFI loans.* The loan terms and conditions of the GFIs are shown in Table 5.2. The GFI interest rates range from 14 to 20 percent. DBP Window III provides a maximum loan term of 12 years, inclusive of a maximum grace period of two years. LBP has a five-year maturity period, inclusive of two years grace on the principal. PNB offers a loan with a maturity period of four to seven years. The maturity for a GSIS loan is six years, inclusive of a grace period of one year. The maximum loanable amount depends on project requirements and repayment capacity. PNB provides 100 percent financing of total project cost. GSIS has a ceiling of P20 million per project.

*Collateral and loan security.* The GFIs demand collateral just like any lender (Table 5.2). The usual collateral demanded is real estate mortgage. The assignment of part of the IRA,

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<sup>27</sup> See Llanto's 1992 study of LGU credit financing.



## *Supply of Credit to Local Governments*

**Table 5.3**

**LOANS GRANTED BY THE GFIs TO LGUs, 1975-1990**

(In thousand pesos)

YEAR	TOTAL	FINANCIAL INSTITUTIONS			
		DBP	LBP	PNB	GSIS
1975	11,125	11,125	0	0	0
1976	24,526	24,526	0	0	0
1977	53,159	53,159	0	0	0
1978	19,870	19,370	500	0	0
1979	47,493	21,614	15,879	0	10,000
1980	53,521	41,037	11,192	1,292	0
1981	70,583	36,940	29,858	0	3,785
1982	75,172	28,366	40,552	1,254	5,000
1983	85,606	21,346	51,524	4,236	8,500
1984	34,049	15,073	18,976	0	0
1985	88,055	0	52,984	0	35,071
1986	5,103	386	3,017	1,700	0
1987	38,804	5,600	0	33,204	0
1988	5,610	0	3,610	2,000	0
1989	8,561	149	5,219	3,193	0
1990	56,904	2,204	0	54,700	0
TOTAL	680,308	280,895	233,311	103,746*	62,356

\* Includes the amount of P2,167M for which the year when the loans were granted cannot be ascertained.

Sources: Data supplied by the GFIs and reports on status of LGU loans submitted by the GFIs to COA.

**Table 5.4**

**AVERAGE LOAN SIZE OF LGUs**

(In million pesos)

Sources	NCR	Luzon	Visayas	Mindanao	Philippines
		A	v	e	r
		a	r	a	g
				e*	
Municipal Dev't. Fund (MDF)	32.0	14.2	19.5	43.5	21.0
Dev't. Bank of the Phils. (DBP)	—	5.9	11.0	14.0	8.6
Land Bank of the Phils. (LBP)	240.6	28.3	44.4	21.7	43.5
Phil. National Bank (PNB)	593.6	18.8	23.1	30.5	67.3
Gov. Service Insurance System (GSIS)	—	15.2	9.5	5.0	13.4
Local Water Utilities Adm. (LWUA)	—	15.5	42.2	22.9	23.0

\* Amount approved/No. of LGU borrowers

— No borrower

Sources: Bureau of Local Government Finance and Government Financial Institutions.

assignment of the net profits or income from the project to be financed, assignment of the LGU's regular income, endorsement in favor of the GFI of insurance policies on mortgaged properties, and chattel mortgage are the other types of collateral GFIs accept. Hold-out on deposits was specifically mentioned as a good collateral because of the liquid quality of deposits.

It should be mentioned that the COA ruling favoring the use of GFIs as LGU depository institutions is an advantage to the GFIs. The PNB, which has about P9.6 billion in LGU deposits alone, is a main beneficiary of this policy. The LGU deposits reduce the credit risk because they are usually held as collateral to the loan. Because LGU deposits also provide compensating business to the GFIs, LGUs get favorable loan terms from the GFIs, which may come in the form of a lower borrowing cost. However, the 50-percent reserve requirement for LGU deposits reduces the GFIs' capacity to generate loans and to obtain compensating business from this pool of funds.

*Access to GFIs by all types of LGUs.* A commercial lender such as a GFI prefers to provide loans to higher-income LGUs that have better capacity to repay the loan. The higher income LGUs also have more diverse source of revenues, such as local taxes, IRA, user fees and charges, and grants, assuring loan repayment. They also have the administrative and project management skills needed to carry out loan-financed projects. However, GFI loans are almost evenly distributed across LGUs of different income classes (Table 5.5). DBP has even lent to lower-income LGUs, i.e., those in the fifth and sixth income classes. PNB and LBP have also provided loans to all types of LGUs, as long as they met their respective creditworthiness criteria. It seems that LGUs, irrespective of income class, have access to GFIs, provided the project is viable and their repayment capacity can meet the loan obligations. The liquid

Table 5.5

## LGU LOAN DISTRIBUTION, BY LGU TYPE AND BY INCOME CLASS

SOURCES	PROVINCES				CITIES				MUNICIPALITIES				TOTAL			
	1st-2nd class	3rd-4th class	5th-6th class	TOTAL	1st-2nd class	3rd-4th class	5th-6th class	TOTAL	1st-2nd class	3rd-4th class	5th-6th class	TOTAL	1st-2nd class	3rd-4th class	5th-6th class	TOTAL
MDF	1	1	0	2	19	3	0	22	28	31	4	63	48	35	4	87
(As of June 1995)																
1. RCDP				0	4			4				0	4	0	0	4
2. MDP I				0	12	3		15	8	17	2	27	20	20	2	42
3. MDP II				0	2			2	15	13	2	30	17	13	2	32
4. MISORTEI		1		1				0				0	0	1	0	1
5. MCDP I	1			1				0				0	1	0	0	1
6. MDP III				0				0	4	1		5	4	1	0	5
7. MCDP II				0	1			1	1			1	2	0	0	2
GFI's																
1. DBP	2			2	3		1	4		5	10	15	5	5	11	21
(As of Sept. 1995)																
2. LBP	11	5	1	17	10	1		11	4	8	33	45	25	14	34	73
(As of Dec. 1994)																
3. PNB	3	2	1	6	17	2		19	4	24	25	53	24	28	26	78
(As of June 1995)																
4. GSIS					1			1	1	3	4	8	2	3	4	9
(As of March 1995)																

Sources: Bureau of Local Government Finance and Government Financial Institutions.

collateral provided by the hold-out on LGU deposits and the IRA intercept mechanism have also encouraged GFI lending.

Based on interviews, GFIs prefer to lend to LGUs for revenue-generating projects, which assure the GFIs that their loans will be repaid. Sometimes a GFI will lend for social projects, e.g. local waste disposal system, but will do so rarely and only to higher-income LGUs which have the capacity to repay the loan from non-project income.

*Some weaknesses.* The GFIs have not developed any expertise in appraising and lending to social projects. The field survey results indicate that many LGUs want to implement social projects which are badly needed in their respective jurisdictions. The GFIs' preference for revenue-generating projects puts these LGUs at a disadvantage because, except for the MDF, there are no other lending institutions willing to finance social projects.<sup>28</sup> On the other hand, the GFIs are willing to develop not only their expertise in LGU lending but also to expand their LGU loan windows. However, the GFIs' loan budgets for LGU lending are relatively small compared to the LGU requirements, perhaps because the GFIs' LGU loan windows have only recently been revived and because the GFIs feel the need to be conservative when it comes to LGU loans because of the LGU loan default experience of the 1980s. The other reasons are that the budget for LGU lending has to compete with other loan demands and that LGU lending is not the main mandate of GFIs. For instance, the LBP's main mandate is to lend to agriculture and agrarian reform beneficiaries. The DBP, on the other hand, caters to the financing requirements of industry, and to small- and medium-enterprise development financing.

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<sup>28</sup> The MDF has given loans mostly for revenue-generating projects, but it has recently tried to finance even social projects such as sewerage systems, which are not revenue-generating.

- *The Municipal Development Fund*

*Conduit of grants and long-term finance for LGUs.* The MDF is a revolving fund created by PD 1914, on 29 March 1984, out of proceeds from foreign loans, assistance and grants to the national government. It was created by the national government to synchronize and consolidate the fragmented borrowing and grant system to LGUs. According to the Bureau of Local Government Finance (BLGF), it is just a convenient conduit for foreign loan proceeds which come in two forms: as grants or as sub-loans to the LGUs. Before the creation of MDF, the donor agencies required a central agency to monitor foreign loans and grants for LGUs. The MDF was thus created primarily as a conduit for foreign loans and grants, and also as a monitoring unit and project accountant for the foreign funds directed to the LGUs.<sup>29</sup> For more than a decade, it has served very well as the central mechanism for channelling foreign funds to LGUs in the form of project loans, technical or commodity assistance or grants, performance payments or other incentives.

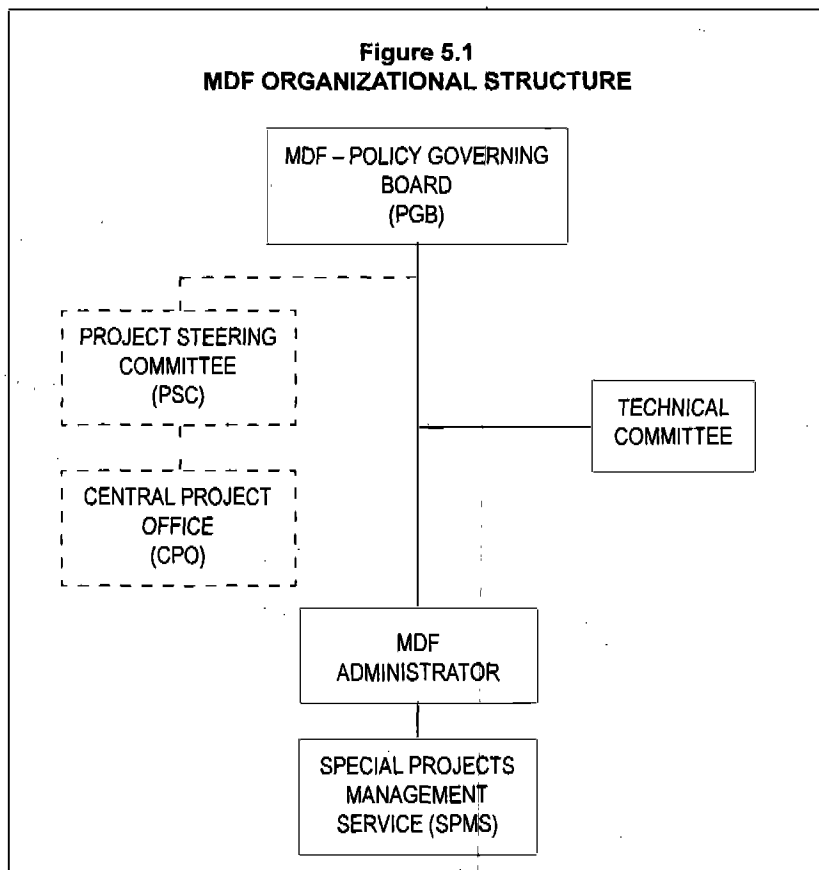
Thus, strictly speaking, the MDF was not envisioned to operate as a credit institution. Under PD 752, the LGUs borrowed from the GFIs for their capital financing requirements. However, when the GFIs stopped lending to LGUs in the 1980s, the MDF assumed a more strategic role because it became virtually the LGUs' only source of capital financing. As shown in Table 5.1, it channelled P1.2 billion of long-term finance to LGUs. The MDF has also been a major source of technical assistance to LGUs. For instance, it has provided assistance to about 800 LGUs to improve their real property tax collection under the Real Property Tax Administration Project (RPTA).

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<sup>29</sup> This information was supplied by Executive Director Lorinda Carlos of the Bureau of Local Government Finance during a workshop conducted by the Study Team.

*Organizational structure.* Figure 5.1 shows the organizational structure of the MDF. It has two broad components: (i) the financial unit administered by the MDF Administrator (concurrently, Executive Director of BLGF) and (ii) the implementation units or Central Project Offices (CPOs) located in lead or participating agencies in the MDF.

The financial unit of the MDF is the conduit of loans and grants, and acts as project monitor and accountant as earlier described. It is under the direction of a Policy Governing Board (PGB), chaired by the DOF with the National



Source: Bureau of Local Government Finance

Economic and Development Authority (NEDA), Department of Public Works and Highways (DPWH), Department of the Interior and Local Government (DILG), the Department of Budget and Management (DBM) as members. The financial unit of the MDF is administered by the BLGF Executive Director, designated as Administrator. The Administrator manages the financial side of MDF, including the consolidation of individual projects into an MDF budget, fund release, financial reporting, replenishment of the funds, recovery of sub-loans, and to a limited extent, cash management. He is assisted by 16 personnel in the Central Fund Management Division under the Special Project Management Service of BLGF. Annex 5.A describes the MDF credit delivery system, including credit processes, budgeting, and fund releasing.

Each project under the MDF is implemented by a CPO, which is located in a lead or participating agency in the MDF. The CPO is headed by a Project Manager/Director with staff personnel support. An Inter-Agency Project Steering Committee provides direction to the CPOs. The financial unit of MDF, more popularly known as the "MDF," and the CPOs coordinate through meetings, workshops, consultation and direct phone calls.<sup>30</sup>

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<sup>30</sup> There are two separate activities under the MDF. The first track consists of the steps undertaken by the DOF to fund the MDF as part of the regular, annual budgetary exercise of the national government, and its administration by the BLGF. The second track is the project identification, review, appraisal and approval undertaken by the CPOs and the Inter-Agency Steering Committee, and the funding of the approved project by the BLGF and the MDF Policy Governing Board. At the local level, the LGU or lead government agency identifies the project intended for MDF financing. The request for foreign funding is evaluated and endorsed by the Provincial Development Council to the Regional Development Council. The latter submits the proposal to NEDA and the President for approval. Upon the approval of the request, the national government negotiates and enters into a loan/grant agreement with foreign financial institutions or foreign governments. The peso counterpart funds of the national

*MDF loan terms and conditions.* The MDF has been conceived as a conduit for long-term finance for LGUs. Thus, it is the only source of credit finance offering a loan with a maturity period of 15 to 25 years. The interest rate is set at 2 percent above the weighted average interest rate of 61-90-day time deposit. No collateral is required since the IRA intercept mechanism is used to guarantee loan repayment. The MDF's experience with the IRA intercept mechanism shows its usefulness as a loan recovery mechanism.

The MDF provides a package composed of a loan and grant, which effectively lowers the LGU's borrowing cost. For example, under the PREMIUMED project financed by a World Bank loan, an infrastructure loan assures the LGU of a grant up to 50 percent of the total project cost, which is a component provided by the national government through the DPWH. The other 50 percent of the project cost is financed by an MDF sub-loan (90 of 50 percent) and the LGU's equity (10 of 50 percent).

*Types of projects financed.* Based on field survey results, although the MDF has also tried to provide loans to social projects (drainage and sewerage systems), most of the loans it extended to LGUs were for financing revenue-generating projects such as public markets, bus terminals, slaughterhouses and the acquisition of heavy equipment. For instance, MDP 2 provided loans for markets, motor pools and maintenance equipment.

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government and the proceeds of the foreign loan that accrue to the MDF must, however, be appropriated in the General Appropriations Act by Congress. The concerned LGU must allocate in its annual budget the required local counterpart funds, utilization of the loan and amortization. Upon receipt by the Bangko Sentral ng Pilipinas of the remittance advice from the foreign lender, a credit advice is issued to the Bureau of Treasury (BTr), which, in turn, provides a certification of the availability of funds to the BLGF. The BTr likewise issues to the DBM a certification that the loan/grant has been deposited with the Bangko Sentral ng Pilipinas.

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*Access to MDF by higher income LGUs.* Although the MDF caters to all classes of LGUs, most of its LGU borrowers belong to the first and second class LGUs (Table 5.5). The average loan size is about P21 million which is beyond the absorptive capacity of lower-income LGUs (Table 5.4). The greater access by higher-income LGUs to the MDF credit facility can be attributed to the project selection criteria, which are biased toward the higher-income LGUs. The requirements of financial capacity and ability to repay, and the other criteria may be more easily satisfied by the higher income LGUs. Among these criteria are: (i) an urban population of 10,000 with a population growth rate of at least the national average, (ii) an annual income of at least P3 million over the last three years, (iii) the capacity to contribute the required equity, and (iv) a commitment to establish a project office with full-time staff.

It must be emphasized that the MDF was organized to cater to urban infrastructure projects thus, it was mostly the higher-income LGUs that naturally had access to it. However, there is now an attempt to address the needs of the lower-income LGUs with the creation of the MMINUTE II. Thus, as pointed out by the MMINUTE II CPO, 16 of 37 MDF loans under this project were provided to 4th and 5th class LGUs.

*LGU preference for the MDF.* Access to the MDF assures the LGU of funding assistance composed of a loan *cum* grant.<sup>31</sup>

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<sup>31</sup> MDF-PGB Resolution No. 01-92, dated 5 February 1992, created two accounts: the Local Loans Account (LLA) and the Program Support Account (PSA) within the MDF. The LLA is a distinct account which covers all lending transactions to LGUs. It is funded from an initial capitalization sourced from 50 percent of the MDF-accumulated balances, foreign funds intended for on-lending to LGUs, all repayments of loan principal and interest by LGUs on their borrowings from MDF-LLA, and any domestically sourced funds from the General Appropriations Act (GAA)

The grant component covers the maintenance of the infrastructure financed from the MDF loan, which will be shouldered by the national government according to the following formula:

*First year*

National government	—	70 percent share in maintenance costs
Local government	—	30 percent

*Second year*

National government	—	50 percent
Local government	—	50 percent

*Third year*

National government	—	30 percent
Local government	—	70 percent

*Fourth year*

National government	—	0 percent
Local government	—	100 percent

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intended to finance loans to LGUs under MDF-LLA terms and conditions, and earnings from investments of LLA cash balances subject to applicable rules and regulations.

The PSA is a separate account in the MDF for financing essential support services to the MDF lending operations. It is capitalized by an initial allocation of 50 percent of the MDF accumulated balances comprised of accrued repayments of principal and interest on loan advances together with accrued interest earned on the MDF cash balances. Thereafter, it receives semestral transfers as determined by the MDF-PGB. The PSA may be used to finance the release of installments of MDF disbursements pending receipt of the Notice of Cash Allocation (NCA) from DBM. Such financing is to be reimbursed to the PSA once the NCA has been received by the concerned LGU. The PSA may also be used to finance training activities and other expenditures essential to the effective implementation of programs and projects financed through the MDF for which no alternative funding is available.

The subsidized loan package makes the MDF loan extremely attractive to LGUs, as confirmed by the results of the field interviews.<sup>32</sup> Another attractive feature of the MDF is the technical support for project identification and feasibility studies given to LGUs by the CPOs. The LGUs send notice of their interest and formal application to avail themselves of an MDF loan. After determining the eligibility of the LGUs for MDF loans, a briefing on the MDF concept, and an evaluation of financial borrowing capacity, the LGUs are helped in the initial round of project identification. Thus, the package of technical assistance, grants and loans provided by MDF is something that lenders without access to technical assistance or donor grants will find difficult to match.

*Limited funding in the MDF.*<sup>33</sup> Notwithstanding the relative advantage of the MDF in providing long-term finance to LGUs, funding constraints tend to limit the MDF's capacity to service the expected increased in LGU demand for credit finance. This has two aspects: (i) the limited funding now currently provided by multilateral institutions and (ii) the constraints imposed by the government's budgetary process. On the first issue, there are few grants and soft loans coursed to the Philippines, compared to several years ago. As it develops, the country is losing its eligibility for this type of funding. It has to rely more on commercial loans and has tried to tap the international capital markets to raise funds. The same thing is true for the MDF. Soon, there will be less and less sweeteners such as technical assistance or grant

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<sup>32</sup> See Chapter III. Llanto (1992a) concluded that the subsidized credits extended by MDF discouraged the participation of private banks in LGU credit markets. In a survey of LGUs, it was pointed out that because of the interest rate subsidies, many LGU respondents were willing to queue for an MDF loan and even postpone the implementation of development projects unless these are financed from an MDF loan.

<sup>33</sup> See Llanto (1994) for an extended discussion of this issue.

money, and more commercially priced loans to be offered to the LGUs. Then the MDF may choose to be very selective of foreign loans that will be tapped for LGU credit finance.

As to the second issue, the MDF's lending capacity is constrained by the budgetary process of government. Each department of the national government observes a budgetary ceiling imposed by the President and the Development Budget Coordinating Committee. The CPOs submit their budgetary requirements for each fiscal year to the BLGF for consolidation into a single MDF budget. The consolidated MDF budget that is lodged within the BLGF's own budget is subject to the budgetary ceiling imposed on the DOF.

This constrains the MDF's capacity to meet the growing requirements of LGUs and has hampered the funding of new local capital investments. A comparison of the MDF's proposed and approved budgets in the last five years is shown in Table 5.6. In 1995, the proposed MDF budget was P2.5 billion while the approved budget was only P600 million. The year before, the proposed budget was P2.5 billion but only P551 million was approved.

In 1992, the MDF was not included in the computation of DOF's budgeting ceiling. Instead, it was placed under the Assistance to Local Government Units (ALGU) of the General Appropriations Act. However, this did not completely solve

**Table 5.6**

**COMPARATIVE MDF BUDGET PROPOSALS VS. APPROVED  
FOR CY 1991-1995**  
(In million pesos)

Year	Budget Proposal	Approved Budget	Amount of Decrease	% Decrease
1991	1,139.7	275.6	864.1	75.8
1992	2,144.7	1,283.0	861.7	40.2
1993	2,856.6	1,137.9	1,718.7	60.2
1994	2,531.8	551.3	1,980.5	78.2
1995	2,463.0	571.3	1,891.7	76.8

the problem of limited funding in the MDF because the ALGU is also subject to budget scrutiny and cuts by the legislature.

In 1996, the DBM proposed taking the relending component of the MDF off-budget to properly reflect it as local government spending and not as a national government expense. The relending component was appropriated as an "unprogrammed fund item" in the General Appropriations Act. The proposed appropriation amounted to about P543.7 million. However, the proposed unprogrammed fund items, including the relending component of the MDF, are still subject to congressional scrutiny and appropriation.

To date, the MDF has accumulated "second-generation" funds amounting to about P700 million, which came from the loan repayments of LGUs. These funds cannot conceivably cover all of the LGUs' demand for credit finance. However, these are "off-budget" funds under the control of BLGF which can be used as a leveraging mechanism to draw co-financing schemes or venture capital from the private investors or as a seed fund for capitalizing a municipal credit institution or as a guarantee fund for LGU bond issuance or LGU credits.<sup>34</sup>

*Project identification and appraisal expertise in CPOs.* The CPOs have gained valuable experience and expertise in the identification, development appraisal and approval of local projects. Some effort has also been made to transfer the responsibility for project identification and project preparation to the LGUs. This has allowed the CPOs to concentrate on the evaluation and appraisal of project proposals, processing of sub-project and sub-loan agreements and monitoring of project implementation. It must continuously upgrade the technical skill of its staff in view of the turnover of staff who decide to seek better opportunities elsewhere.

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<sup>34</sup> The different options for improving the effectiveness of the MDF are discussed in Chapter VII.

*Inefficiency caused by having two separate components.* The MDF is implemented through two distinct components:

- (i) project budgeting, accounting and loan collection under the BLGF, and
- (ii) project identification, packaging and approval under the CPO of each MDF loan.

Project identification, appraisal and approval are undertaken by the CPO in a lead agency, the DPWH, for example, while loan disbursement, monitoring and collection are under the BLGF's responsibility. The CPO appraises the technical merits of a project and submits its recommendations to its Interagency Project Steering Committee which approves or disapproves the proposed project.<sup>35</sup> The MDF/BLGF, i.e., the financial unit of MDF, merely acts as a funding conduit for projects which have been approved by the CPO's Project Steering Committee. Thus, the MDF does not function as a true credit intermediary but as a loan disbursing and collecting unit.

The separation of these components, which have their own steering committees,<sup>36</sup> creates inefficiencies in overall MDF project implementation. An immediate disadvantage of this arrangement is the risk of inconsistency between the technical recommendations and the economic and financial feasibility of a proposed project. Having two distinct steering committees will also pull overall MDF project objectives in different directions, depending on the policy and operational orientation of the members of the two steering committees. On the other hand, it can be argued that the two steering committees have more or less the same membership, which

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<sup>35</sup> The CPO also evaluates the financial aspects of the project, including the expected revenue generation from the proposed project.

<sup>36</sup> The Policy Governing Board for the MDF financial unit and the Project Steering Committee for the CPOs.

should allay concerns about inconsistency in policy direction and the internal inefficiencies of a project as well. However, the fact is that having two separate operational units, — the financial unit and the implementing units (CPOs) — with their own respective steering committees, is bound to create inefficiencies in overall policy direction and project implementation. It seems that housing these two separate but complementary activities under one institution with (i) a wide network of local offices for greater access by LGUs, and more importantly, (ii) a single policy-setting board will clearly be more efficient.

*High transaction costs for LGUs and MDF staff.* The MDF has provided access to long-term credit finance but the transaction cost of accessing MDF credit seems high. The financial unit of MDF is located in Manila and has a centralized operation. It has no branches or divisions outside the main office at the BLGF. Likewise, the operations personnel under the CPOs are also located in Metro Manila, and are attached or under the direct supervision of the lead agency participant in the MDF. For example, the MMINUTE CPO under the DPWH maintains an office in Quezon City. Thus, neither MDF, the financial unit, and the project CPOs are directly accessible to LGUs.

Because of the locational disadvantage of the CPOs and the centralized operation of the financial unit of MDF (in the BLGF), transaction costs for borrowing LGUs tend to be high. The LGU chief executives and officials have to commute to Manila for costly follow-up activities on their loan application.

The other reason for the high transaction cost is that the complete cycle of project identification, preparation, appraisal, approval, and monitoring, in addition to financial evaluation, loan disbursement and collection, is undertaken by two distinct and separate bodies: the CPOs and the MDF financial unit, which are housed in different government agencies. In

addition, the existence of separate CPOs with their own project management staff and personnel leads to larger-than-necessary overhead costs.<sup>37</sup> This situation contributes to a high transaction cost for MDF loans.

Because of the highly centralized operation, it was estimated by some MMINUTE CPO personnel that loan processing, from the pre-qualification stage up to the approval stage, will take on the average 10 months to complete.<sup>38</sup> However, some effort has been done to decentralize operations. For example, during the field interviews, it was indicated that in the case of PREMIUMED II, a Cebu office will be established as part of the overall plan to decentralize and streamline MDF operations.

- *Private Banks*

*Banks' interest and willingness.* In a series of workshops as early as 1992, private lending institutions expressed interest and willingness to lend to LGUs.<sup>39</sup> This is important because the private financial system has extensive resources which can be tapped for financing LGU projects. However, because of several factors, such as the lack of experience of private banks in dealing with LGUs and the dearth of information about the creditworthiness of LGUs, private banks have adopted a wait-and-see attitude toward LGU lending.

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<sup>37</sup> On the other hand, the CPOs also find it costly to send staff to LGUs which have expressed an interest in a loan or have submitted loan applications. Respondents stressed that the CPO also has a limited operating budget.

<sup>38</sup> Field interviews also revealed that a good reason for what appears to be a long processing time for LGU loan applications is the delay caused by the inability of LGUs to immediately respond to the CPOs' advice on revisions required in their loan proposals.

<sup>39</sup> The series of workshops and seminars came after the 1992 national survey of credit finance for LGUs (Llanto 1992b).



*Short-term orientation of private banks.* Commercial loans are mostly short-term. Recently, however, there have been serious attempts to develop the long-term capital markets, with the government trying to create a market by making available long-term notes as alternative investment instruments, and the private sector getting involved in capital markets development. The short-term orientation of private bank lending prevents LGU access to private credit finance. Long-gestating capital investment projects should be financed by long-term capital. However, the example of GFIs seems to indicate that the credit markets, although short-term-oriented, can develop loan instruments suitable to LGUs. The MDF's experience also indicates the viability of long-term loans to LGUs.

*Perception of high credit risk.*<sup>40</sup> The private banks cite as barrier to lending the poor information structure on LGUs, which prevents an efficient evaluation of LGU credit-worthiness and the viability of projects and creates a perception of high credit risk in LGU lending. The short-term political tenure of LGU officials is another source of the perceived credit risk, especially if the LGU project is long-gestating.

As an illustration of the credit risk, some critics of LGU lending cite the case of Cebu province, which has floated a bond to raise development funds, as a discouraging experience for private lenders. The successful bond flotation was done in cooperation with the private business and financial sector. When a new provincial administration took over from the old one, which had packaged the successful Cebu bond offering, questions were raised regarding the appropriateness of the province's transaction with the private sector, creating concern about the future of the bond repayment. However, it must be emphasized that no repayment was ever missed and that the private sector's legitimate interests in this venture with

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<sup>40</sup> Also cited in Llanto (1994).

Cebu province was never compromised. Yet the fact that the succeeding administration raised questions regarding the appropriateness of the transaction was enough to scare private investors.

*Lack of acceptable collateral.* Not all LGUs own real estate which can be used as collateral to loans from banks. The LGU deposits seem to be an acceptable collateral but the COA ruling on the utilization of GFIs as depository institutions has prevented private banks from accepting LGU deposits. A corollary of this is the inability of LGUs and private banks alike to use the IRA intercept mechanism to guarantee repayment of private bank loans.

*Lack of expertise in evaluating LGU projects.* Private banks have never dealt with LGUs, which partly explains their lack of expertise in evaluating LGU projects. They also do not have the expertise to evaluate social projects which are needed in the local areas. This expertise has never been developed because private bank lending has been geared for financing industry, trade and commerce, not long-gestating development projects and socially oriented projects. Nevertheless, private banks have expressed some interest in LGU lending although there are no incentives for them to lend to LGUs.

• *Bond Flotation*

*Legal authority and pre-conditions.* The Code allows LGUs, subject to the rules and regulations of the BSP and SEC, "to issue bonds, debentures, securities, collateral, notes and other obligations to finance self-liquidating, income-producing development or livelihood projects pursuant to the priorities established in the approved local development plan or the public investment program."

Provinces, cities and municipalities are allowed to issue bonds under the following conditions:

1. The obligation should finance self-liquidating, income-producing development or livelihood projects. Accordingly, the proceeds of bond issues may not be used to finance, for example, recurrent expenditures and the general obligations of an LGU.
2. The projects concerned must be pursuant to the priorities established in the approved local development plan or the public investment program. The LGU concerned is, therefore, obliged to formally adopt a public investment program which is expected to support the local development plan and which in turn is consistent with the Medium-Term Philippine Development Plan.

*Government regulation of bond issues.* The Code allows the issuance of LGU bonds with or without a national government guarantee to service the loans obtained by the LGU when the latter is unable to pay the principal, interest or other charges.

The first step, after project identification and development, is for the LGU to pass an ordinance or resolution approved by the *Sanggunian* stating the terms, conditions and purpose of the bonds, and indicating that the project is among those in the priority areas of the approved local development plan or public investment program. A bond issue without a national government guarantee need not have the approval of the Secretary of Finance.

To secure the necessary BSP endorsement, the LGU should present the guarantee approved by the Secretary of Finance, the Sanggunian Resolution and other documents as may be required by the BSP. Upon the rendition of a favorable opinion by the BSP, the bond proposal is submitted for final approval by the respective authority exercising supervision over the proponent LGU as provided by Sec. 25, Chapter 3, Article 1 of the 1991 Code. With such final approval, the LGU is

authorized to coordinate with its underwriter, trustee or other agents for implementation of the bond flotation.

The SEC has not issued any regulations specifically applicable to LGU bond issues. The existing rules and regulations, which were designed to apply to corporate bond issues, therefore apply.

The more significant conditions for registration of unsecured bonds are as follows:

1. net worth of registrants should be at least P25 million at the time of filing;
2. the registrant must be in operation for at least three (3) years; and
3. certain financial standards should be met, in terms of current ratio, debt to equity, debt to average earnings, debt to cash flow, fixed assets to long term liabilities, interest coverage, and others as may be prescribed by the SEC.

A preliminary prospectus of the issue, which includes pertinent information, as well as the audited financial statements for the preceding three years, a long-form audit report, projected cash flows, and other information as may be required by the SEC, are to be submitted. Subsequent to the issuance of the SEC Certificate of Registration, the registrant is required to submit the Trust Indenture, Underwriting Agreement, Printed Prospectus, and other documentary requirements.

Specified minimum collateral coverage is required in the case of secured bonds. Acceptable collaterals are as follows: listed securities (which must have a current market value of at least 200 percent of the face value of the bond issue), registered real estate (appraised value of at least 150 percent), registered heavy equipment and motor vehicles (appraised value of at least 200 percent), government securities (aggregate current market value of at least 100 percent), and other assets

acceptable to the SEC. Documents (e.g., Certificates of Title) shall be physically delivered to the indenture trustee and, where applicable, covered by pledges, real estate or chattel mortgages.

*LGU bond flotation.* Cebu province issued the highly successful and path-breaking Cebu Equity Bond Unit (CEBU) in July 1990. A total of P300 million had a term of three years, earned tax-free interest of 16 percent per annum, and called for principal repayments in five equal semi-annual instalments in the form of class "A" shares of Cebu Property Ventures and Development Corporation (CPVDC), a joint venture of Cebu Province and Ayala Land, Inc. The province contributed real property and Ayala contributed cash for their respective shares in CPVDC. The conversion between CEBU and CPVDC shares was according to a formula based on the current market value of the latter's shares. Security offered was the shares of CPVDC. Interest rate was in effect a high 20 percent before tax and there was a likelihood of capital appreciation in CPVDC shares. The tax-free feature, which is no longer allowed under the provisions of the 1991 Code, has the advantage of allowing investors to earn 20 percent while cost to the province was only 16 percent; the national government in effect shouldered the difference in terms of tax revenue foregone.

The issuance in 1990 of the innovative CEBU was preceded by about seven months of work and waiting to secure the necessary authorizations from the Department of Justice, the Monetary Board, the COA, the DOE, and the Office of the President in addition to the Provincial Board approval. The process was slow since the issuance was unprecedented.

The Code was passed in October 1991 and implemented in 1992. Since then, there have been a number LGU bond flotations, which signals the potential of this form of financing for local projects (Table 5.7). For example, Naga City recently finished a successful public referendum on a proposed bond

flotation to finance the construction of a local bus terminal. The local community expressed support for the proposed project and of its financing through a bond issue.<sup>41</sup> With more LGU debt issues, all concerned will gain experience and will have more models to follow, thus inevitably speeding up review and approval. The formulation of standard operating procedures and policies for the guidance of both LGU proponent and approving agency alike, will be advantageous to all concerned.

*Build-operate-transfer schemes.* The Code allows the LGUs to tap both government and private sources of capital to finance local infrastructure and other development projects. This, together with the greater taxing powers given to LGUs, is a logical progeny of the decision to devolve various central government functions and responsibilities and give LGUs a major role in development. For the first time in the history of local governance, the LGUs can also use build-operate-transfer (BOT) arrangements, which harness private sector expertise in financing, construction and operation of infrastructure. This is provided for in Section 302 of the Code subject to the applicable provisions of Republic Act (RA) 6957, commonly known as the BOT Law.

BOT arrangements are allowed under RA No. 6957 (enacted in 1990), as amended by RA 7718 in 1994. The BOT law is an explicit recognition of the private sector's major role in infrastructure development. Thus, the BOT Law provides the legal and administrative framework as well as an appropriate incentive structure for private sector participation in the financing, construction, operation and maintenance of infrastructure and development projects.

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<sup>41</sup> The actual flotation has been superseded by Naga City pending the result of its loan negotiation with a GFI. Local officials think that a GFI loan is cheaper than a bond flotation.

**Table 5.7**

**LGU BOND ISSUES**

LGU	Issue Date	Amount (In PM)	Maturity (years)	Interest Rate (%) p.a.	Purpose
Cebu Province Development	July 1990	300	3	16	Infrastructure
Victorias, Negros Occidental	Jan. 1994	8	2	1st yr.-15.09 2nd yr.-14.08	Housing
Legaspi City	Jan. 1995	26	2	15	Housing
Claveria, Misamis Oriental	Apr. 1995	20	2	19	Housing
Naga City	Jan. 1996	45	5	above 182-day T-bills	Central Bus Terminal
1st Series		5.00	2	plus 2.5	
2nd Series		6.25	2	plus 2.5	
3rd Series		11.25	3	plus 3.0	
4th Series		11.25	4	plus 3.5	
5th Series		11.25	5	plus 4.0	
Vigan, Ilocos Sur	Jan. 1996*	10M	—	—	Housing

Note: Interest rate excludes guarantee and underwriting fee

\* Still in the negotiation/agreement period

Sources: Guarantee & Credit Insurance Group, and Home Insurance Guarantee Corp.

The central government has successfully used BOT arrangements to solve the serious power crisis that crippled the economy in the early 1990s. A vital lesson from the initial BOT experience in the power sector is that private sector expertise in mobilizing capital, building, operating and maintaining infrastructure projects can effectively help address serious infrastructure bottlenecks that can constrain economic growth and development. At the same time, the government can avoid additional public borrowing which worsens the fiscal deficit. The huge funding requirements of infrastructure projects would have meant more public borrowing with its ill effect on the government's fiscal position and private investment opportunities. Since then, the central government has encouraged the use of BOT and its variants to address the

needs of the economy in infrastructure, energy, transport, telecommunications and information technology.

Despite the limited number of LGU BOT projects to date (so far, only the Mandaluyong Public Market has reached financial closure and one public market in Northern Luzon is currently under contract negotiation), 10 are in an advanced development stage.

Thus, the LGUs have recognized the potential of the BOT approach in financing local infrastructure. The CCPAP LGU BOT Center took off in early 1996. It reports some 79 potential LGU BOT projects ranging from the construction of public markets, water supply and wastewater system, solid waste facilities, international container terminals, circumferential roads, to mini hydropower throughout the country. There are 30 proposed BOT projects in Luzon, 20 in the Visayas and 29 in Mindanao.

## CONSTRAINTS ON LGU ACCESS TO CAPITAL MARKETS

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### • *Constraints on Bank Credit Access*

The local governments are treated just like any other borrower by the lenders. This means that LGUs must pass the regular loan application and screening process which considers creditworthiness, character of the borrower, collateral, loan recovery and the project to be financed. The GFIs state that their LGU lending programs are anchored on the creditworthiness of the LGU borrower and the viability of the project for which credit finance is being sought. The loan terms and conditions are market-oriented and the LGUs have to compete with other borrowers for credit resources. In this regard, both government and potential private lenders have raised certain issues which constrain LGU access to private capital markets. The issues must be addressed satisfactorily in



order that LGUs can access the private capital markets. The issues were identified as follows:<sup>42</sup>

- (i) the information structure on LGUs;
- (ii) loan repayment capacity of LGUs;
- (iii) quality of project management and executive ability of LGUs;
- (iv) collateral and loan safeguards and credit risk;
- (v) type and viability of project to be financed;
- (vi) regulatory framework affecting LGU deposits and bond issuance;
- (vii) short political tenure (three years) of LGU officials;
- (viii) manner of private sector participation in LGU credit markets; and
- (ix) the appropriate role for the Municipal Development Fund.

*Information structure.* Asymmetry of information creates moral hazards and adverse selection problems for transactions in credit markets. Agents may exploit the information asymmetry to conceal their true worth and intentions, which results in sub-optimal transactions from either the borrower's or the lender's end. While the private banks appreciate the liberal credit policy framework provided by the Code to LGU credit financing, they believe that rudimentary information on LGU creditworthiness hinders loan transactions with LGUs. Because of the dearth of information on the creditworthiness of LGUs, private banks expect to incur high transaction costs in lending to LGUs, and thus their immediate instinct is to shy away from LGU lending.

The available information in the marketplace is insufficient to determine the creditworthiness of LGUs and so the

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<sup>42</sup> The following were pointed out earlier in Llanto (1992), but since then, there seems to have been no concerted effort among the LGUs and the national government to address these issues and concerns.

probability of success of an LGU loan becomes an open question. The lenders will need basic information on the financial performance of LGUs, the collateral that LGUs can offer, possible remedial measures in case of loan default, and the viability of projects to be financed. Because of the information constraint, the private banks have a tendency to locate LGUs at the lower end of their lending preference function with the possible exception of a handful of LGUs belonging to the first income class. Thus, the information gap between private banks and LGUs constrains the latter's access to private credit and capital markets.

Part of this gap is explained by the lack of an objective standard, or basis for gauging the performance of LGUs and their creditworthiness. For example, the financial reports of LGUs are extremely different in structure from those of private corporations. Nevertheless, the information asymmetry seems to be more of a problem for private banks than it is for the MDF and GFIs. Because of a government mandate to lend to LGUs, both the MDF and GFIs have tried to lend to LGUs, notwithstanding their limited information on the performance of LGUs and their creditworthiness. It seems that the MDF and GFIs have exerted much effort in assembling the pertinent information on LGUs which may help them make a credit decision.<sup>43</sup> The private banks are more conservative and risk-averse, but they are nevertheless studying carefully the performance of the GFIs' lending to LGUs.

*Loan repayment capacity.* In general, the lenders find no readily available indicators of LGU performance in governance, much less of creditworthiness. This makes it difficult to determine the loan repayment capacity of LGUs. Even for the GFIs and the MDF, the creditworthiness of

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<sup>43</sup> The use of GFIs as official depositories of LGUs, following COA Circular 92-382, helped greatly in establishing a lender-borrower relationship between the GFIs and the LGUs.

LGUs, except for a handful of first- and second-class LGUs, is yet to be established.

The situation for private lenders is much more severe since they have never had any formal relationship with the LGUs, unlike the GFIs, which obtain LGU deposits, and the MDF which benefits from the administrative control and supervision exercised by the BLGF over the LGU treasurers. The varying capacity of very heterogeneous LGUs to service their debt burden is also cause for concern. The local governments are classified into six income classes, and the banks worry that those at the lower end of the income scale will find it difficult to repay their loans.

An important dimension of loan repayment capacity is the LGU's ability to repay the loan. This is determined largely by the income of the LGU generated from local taxes and fees, transfers such as IRA, grants and the operation of economic enterprises such as public markets. The LGUs, just like any other type of borrower, have varying capacities to service debt, given their relative performance in resource generation.<sup>44</sup> A strong local revenue base will be helpful in establishing the capacity to repay the loan. For revenue-generating projects, this depends on the ability of LGUs to implement user fees as a cost recovery mechanism for timely debt service. However, the perceived reluctance of LGUs to raise the local tax effort which will be necessary to present a good income profile, has not helped in convincing lenders about the loan repayment capacity of LGUs.<sup>45</sup> Conversely, a serious effort in mobilizing more local taxes will create a positive impact on the loan repayment capacity of LGUs.

It is important to mention that the LGUs are concerned about their perception as loan defaulters brought about by

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<sup>44</sup> This generic term covers local tax collection, receipts from transfers, grants and operation of economic enterprises and other sources of income.

<sup>45</sup> Chapter III noted that the increase in IRA allocation seems to have a substitution effect on local tax collection effort.

their loan default experience with the GFIs in the 1980s. They believe that this should be altered. According to the LGUs, there are built-in mechanisms such as the IRA intercept and local ordinances sanctioned by the local *sanggunians* which safeguard the loan. The local ordinance is the LGU's assurance to the lender that it will honor the debt contract, even after the three-year tenure of the elected officials. The Code also provides for a system of public consultation or referendum which can be used to generate agreement on a certain project and the manner of its financing and to tie the LGU to regular loan repayments to a lender.

Notwithstanding these claims of the LGUs, lenders claim that they are less concerned with foreclosure of collateral to recover loan losses, than with the commitment and ability of LGUs to service the debt out of their revenue streams. This effort is largely dependent on the quality of the elected officials and those tasked with managing the project financed out of a loan.

*Quality of project management and executive ability of LGUs.* Any attempt to create LGU access to the private capital markets must address the issue of the quality of LGU project management and the ability of LGUs to efficiently execute projects. The lending institutions are very much concerned not only with the debt service capacity of LGUs, but also with efficient project identification, implementation and maintenance. Indeed, there is a great deal of unevenness in the quality of the human resource in the bureaucracy and this is particularly pronounced among the LGUs. The LGUs have varying degrees of executive, managerial, technical and financial capabilities to implement and maintain projects, and those LGUs with higher capabilities will find it relatively easy to secure funding for local projects. This is so because part of the LGU creditworthiness criteria is the quality of the human resource at the local level (Llanto 1992; 1994).

*Collateral, loan security and credit risk.* While banks are more concerned with the viability of a project submitted for financing, they feel more secure in extending loans if the LGUs can offer acceptable collateral. The LGU lending experience of the GFIs in the 1980s was not very encouraging and the LGUs could not, therefore, show a good credit track record to encourage the private banks to lend. However, the GFIs are able to surmount this difficulty because they have relatively more information on the LGUs. They are also used by LGUs as depository institutions, which has helped LGUs to establish a business relationship with the GFIs. Field survey results indicate that the only sources of LGU loans at the moment are the MDF and GFIs.

The collateral or loan security usually demanded by banks is a real estate mortgage. However, the banks also pointed out that real estate devoted to public use cannot be encumbered, limiting the use of real estate as collateral for an LGU loan.<sup>46</sup> In this respect, the IRA intercept mechanism and a hold-out on LGU deposits are very important forms of collateral. In addition, the *Sangguniang Bayan* Resolution authorizing the loan and a public endorsement of a project through a public referendum may also serve as loan security. Nevertheless, these are not sufficient security for the bank because the overriding concern of a lender is project viability and LGU creditworthiness, which are the best collateral and assurance of loan repayment.<sup>47</sup>

*Type and viability of project financed.* Banks prefer to finance revenue-generating projects because of their self-

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<sup>46</sup> Also, not all LGUs have real estate that can be mortgaged.

<sup>47</sup> It was also mentioned that based on an opinion of the Department of Justice, only a maximum of 20 percent of IRA can be used as a lien for LGU loans. The intention seems to be to prevent the LGUs from over-borrowing. If this were true, it seems to limit the flexibility of the LGU to use the IRA intercept in providing security to a loan.

liquidating nature. They will yield revenue streams which will cover loan repayment and thus assure the lender recovery of the loan and profits. With a steady revenue stream, the banks can be assured that the risk that a new set of elected officials will abrogate loan contracts of the previous administration because of insufficient income will be minimized. However, the ability of revenue-generating projects to yield steady revenues depends on the willingness of local governments to impose effective cost recovery mechanisms such as user fees or charges. Public referendums can elicit the support of the local citizens for cost recovery mechanisms. Improvement of the local tax effort will also increase the LGUs' capacity to repay the loans.

The banks indicated that project viability is a major factor considered in lending and LGU projects and the local governments themselves will thus be evaluated in the same manner and with the usual criteria as any other bank borrower. The banks believe that the financing of non-revenue or social projects such as solid waste disposal system, water treatment facilities, environment-oriented projects, etc., is the domain of the government. The prevailing view among banks is that the financing for these public goods should be sourced from local tax collections, the IRA and grants from the national government, and not from bank loans.

*Regulatory framework affecting LGU deposits.* The government should review certain policies which diminish the LGUs' chance to tap the private capital markets. In particular, the private banks cited COA Circular 92-382 which requires LGUs to open and maintain depository accounts "with a government-owned bank located in or nearest the locality." The same circular further states that "in case there is no government-owned bank located in the nearest locality, depository accounts may be opened with a bank duly designated as government depository by the Bangko Sentral ng Pilipinas, upon prior authority of the *sanggunian* and the

approval of the chief executive." This severely limits the LGUs' use of private banks as depository banks. All banks require borrowers to maintain deposits with them because these deposits provide them not only subsidiary business, but also important information on the deposition. The private banks hold the view that the LGUs should likewise hold their deposits with a government or private bank. On the other hand, the GFIs welcome their designation as official depository banks of LGUs. The use of GFIs as depository institutions has encouraged a lender-borrower relationship. For example, this has helped LGUs to obtain loans from the PNB with their deposits as collateral.

*Short political tenure of local officials.* The banks perceive that the short political tenure of local officials adds to the risk of loan default. The risk that a future LGU administration will not repay the loan or loans incurred by its predecessor or lay roadblocks to loan repayment, for example, by questioning the legality of a past loan, bothers the banks. As a defensive posture, banks, therefore, tend to consider only short-term projects. However, the LGUs are quick to emphasize that the loan is a liability of the LGUs, not of the chief local executive. They maintain that the tenure of the elected officials, particularly the local chief executive, should not constitute a major limitation in accessing bank credit. As pointed out earlier, the loan is legally covered by the *sanggunian* resolution which obligates loan repayment. Nevertheless, the short political tenure reinforces the banks' short-term loan orientation.

On the part of the LGUs, this creates an incentive for local executives to submit for funding those projects which are highly visible, wield great political impact, and of limited term (three years). The result is a distortion of the preferences among LGUs, and lenders alike. This brings about projects of limited duration and/or high visibility, and crowds out lumpy, long-gestating but more socially meritorious projects.

The short-time horizon of LGUs coincides with the banks' expressed preference for short-term loans, but in this case, society loses when the socially useful but long-term projects which are badly needed in the local areas, fail to get the necessary financing (Llanto 1994).

*The manner of private sector participation, and MDFs' appropriate role.*<sup>48</sup> The government's lending programs for LGUs do not take into account the possibility that private banks could participate in LGU lending. There seems to be no scheme or program where private sector financing and government funding can have a complementary role. The government lenders adopt independent approaches to LGU lending, which may result in a fragmented and uncoordinated effort to provide LGUs capital financing. Thus, the private banks, which are more conservative than GFIs and MDF, tend to adopt a "wait-and-see" attitude toward LGU lending.

One suggestion to bring in private sector participation is to have government provide seed funding for LGU financing which can be complemented by private financial resources. Both the government and the private financial institutions have enough experience in co-financing schemes for target clientele. An example is the Agricultural Loan Fund and its successor, the Countryside Loan Fund under which the LBP provides "wholesale" loans to the private banks which, in turn, on-lend directly to the target clientele, e.g., agribusiness. The private banks originate the loans directly from the clientele and rediscount the promissory notes with the LBP to generate liquidity and earn a loan spread. If this approach is adopted for LGU credit finance, the private banks can bring in their enormous financial resources, an extensive branching network and the relative efficiency of private lenders to bear on LGU demand for capital finance.

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<sup>48</sup> See Chapter VII for a related discussion.



An important element in cofinancing schemes is the extent of risk-sharing between the government and the private banks. Credit risk, interest rate risk and foreign exchange risk (in case funding is to be secured from foreign sources) are critical aspects of a co-financing scheme. Credit risk can be covered by effective collateral such as the IRA intercept and hold-out on LGU deposits, and by quality project management and execution. Interest rate risk is more difficult to manage, especially when there is a lot of volatility of domestic interest rates. This also constrains the development of the credit markets. Variable interest rates have thus been used by lenders to compensate for the interest rate risk. However, the volatility aspect of interest rates is not taken away by offering variable rates. This may compensate the lender for the interest rate risk, but it does not encourage long-term public investments. Given the long-gestating and lumpy nature of public investments, banks and LGUs alike are wary about the implications of interest rate risk on the LGUs' capacity to repay a long-term loan (Llanto 1994). A relevant point that arises is the ability of the country's macroeconomic managers to contain the fiscal deficits and inflation, and to maintain stable macroeconomic conditions, which will reduce interest rate volatility.

The issue of private sector participation in LGU credit markets is tied to what appropriate role the MDF should take in view of the liberal credit policy adopted by the Code and the interest of LGUs in tapping long-term credit finance. The MDF has control over a sizeable amount of resources and is currently being used as a conduit of foreign loans for LGUs. There must be a clear delineation of the role of MDF vis-à-vis that of the banks. For a long time, the MDF has been the only source of long-term finance for LGUs and, given the short-term orientation of banks, MDF clearly plays a critical role in the municipal credit system. At present, the GFIs provide only short- and medium-term loans. However, it is conceivable that the GFIs and, eventually, the private banks,

will provide long-term credit finance in the future, as the economy develops and the credit markets mature. Thus, the question raised about the appropriate role of MDF vis-à-vis other lenders is very timely and relevant. That role is expected to be catalytic given MDF's track record in funding long-term LGU projects, its capability to provide technical assistance to LGUs which it has developed over the years, and its professed willingness to do business with lower income LGUs.

The banks pointed out possible co-financing ventures with the MDF in long-term LGU projects. This scheme will reduce their credit risks as well as cost of funds. In this regard, there can be a greater role for thrift banks and rural banks which can capitalize on their locational advantage to bridge the information gap between LGUs and lenders. These banks can even go into loan syndication with commercial banks.

On the other hand, the presence of a government lending program such as the MDF encourages LGUs to continue to depend on government resources for medium- and long-term finance,<sup>49</sup> but the problem is that the available resources in government hands cannot adequately meet the huge funding requirements of LGUs. There is, however, a recognition of the strategic role that MDF can play in providing lower income LGUs access to credit finance.

- *Constraints on Bond Flotation*

The Philippine capital market is still in the early developmental stage and it would be unrealistic to expect immediate market acceptance of LGU bond issues. A number of factors constrain the demand and supply of LGU bonds. The long-term capital markets have a narrow investor base and few types of securities issues. However, the government and the private sector cooperation in the development of the

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<sup>49</sup> Some local chief executives said they were willing to queue for MDF loans because their terms are not as restrictive as those in the financial marketplace (Llanto 1992).

long-term capital markets will have a positive impact on LGU bond flotation. This section discusses the constraints on the design and issue of an LGU bond.

*General lack of familiarity with procedural requirements.* The requirements for a bond flotation seem straightforward. Obviously, prevailing market conditions and practices determine coupon rate, term, denomination, selling price and effective interest rate, whether or not the bond is guaranteed by the national government. The formulation of the specifics of the bond indenture would likewise be in the light of prevailing practice. However, LGU operations and accounting are different from those of private corporations and the former would be hard put to produce timely audited financial statements that would be meaningful to financial analysts, let alone comply with announced criteria on current ratio, fixed assets and so on.

Limits on LGU borrowing are imposed by the Code, which provides that an LGU annual budget should provide in full for "...all statutory and contractual obligations... provided that the amount of appropriations for debt servicing shall not exceed 20 percent of the regular income of the LGU concerned," with regular income defined as "estimates of regular income for the budget year as determined by the local finance committee."

Within these broad constraints, an LGU has discretion in the formulation of the detailed terms and conditions of a bond issue, taking into account project cost and ability to pay, specifically the maximum amount available for debt servicing, which is 20 percent of LGU regular income. In designing and marketing securities issues, it is normal to have a financial adviser to assist in the design of the issue and in negotiations with underwriters. However, the Code is unclear as to the consequences of debt service requirements above the 20 percent ceiling. This has to be resolved in order to remove

any uncertainty in the continuity of payment in case there is a violation.

*Lack of skilled technical personnel.* The existing levels of training and experience of LGU planning and finance personnel are such that it may be difficult to expect them to design bond packages. Skills in project identification, analysis and development are necessary as well as skills in the preparation of an LGU plan and investment program, familiarity with financial packaging, detailed guidelines and examples of what can be done, and how to do it. This suggests a program of technical assistance to LGUs and the development of external consultancy expertise in these skills.

*Marketability.* The marketability of LGU bonds depends on the terms and conditions vis-à-vis competing public and private sector issues. In the continuum of risk and return, debt instruments of the national government have the lowest risk and the least returns. Other things equal, LGU and government corporations are next, followed by private corporation debt paper, preferred stock, and common stock. There would be gradations within each category: small LGUs vs. large LGUs, guaranteed and non-guaranteed LGU debt, banks as against non-bank financial institutions, public utilities vs. ordinary corporations, etc.

Private companies have started to issue long-term commercial papers, with maturities ranging from one to seven years. As of March 1994, a total of 21 companies had been authorized by SEC to issue long-term commercial paper with an aggregate face value of P36.8 billion. It is common for long-term paper to have an interest rate that floats with Treasury bill rates. There is a market acceptance of a fixed rate instrument with a five-year maturity and interest at about 200 basis points above 91-day Treasury bills, with corresponding resetting of interest rates. A seven-year issue

could be similarly saleable, but possibly at about 275 basis points above the 91-day Treasury bill rate.

During the necessary period of transition, it may be advisable to design LGU bonds that initially have relatively small amounts, short maturities, attractive interest rates that either float with Treasury Bill rates as latest LGU bond issues have followed, or that carry a fixed rate using the five-year fixed-rate Treasury notes, a mechanism that assures prompt payment and, where possible, added features such as convertibility to an attractive security such as what was done in the Cebu province debt issue. As LGU issues gain market confidence, terms can be more favorable to the issuer.

LGU debt issues no longer have a tax exemption privilege and, like Treasury debt instruments, enjoy mainly the advantages of being eligible as reserve assets of banks and other financial institutions and of interest payments being subject to a lower income tax rate to holders (20 percent rather than the 35 percent imposed on interest earned on private corporate debt). Accordingly, LGU bonds might be of particular interest to certain sectors, as follows:

- (i) cash-rich LGUs might be persuaded (or directed by the authorities concerned) to buy bonds issued by other LGU rather than placing all or most of these funds in private fixed-income instruments;
- (ii) the funds of insurance companies and pension funds are necessarily long-term in character and could be partly invested in LGU bonds; the portfolios of government-controlled pension funds are large and could logically include LGU bonds, the most sizable of which are the GSIS, the SSS, and the Armed Forces of the Philippines Retirement and Separation Benefits System;
- (iii) government securities, including LGU bonds, are eligible as reserve assets of bank and non-bank

- financial institutions, which warrant a focused marketing approach; and
- (iv) the Code provides that LGUs should “preferably” use government banks as depository banks, but the COA has ruled that where there is a government bank in the vicinity, the LGU must deposit its funds with same. A revision of the COA ruling would provide leverage in marketing LGU debt issues. Government deposits, however, are subject to a 50 percent reserve requirement (as against 15 percent for other forms of deposits). At the same time, banks enjoy a longer than average float on government deposits. As matters stand, leverage could be exercised on banks authorized to receive deposits under existing policy.

Government financial institutions presumably can be counted on to protect the interests of LGUs as colleagues in government. As such, they may be appointed as financial advisors to LGU in the design of debt issues, the selection of underwriters and the other decisions that need to be taken in such transactions. The LBP and the DBP could help make sure that LGUs do not pay too much for debt funds.

*LGU bond ratings.* The SEC requires that commercial paper be rated by the Credit Information Bureau, Inc. (CIBI) prior to authorization. Of the 21 long-term commercial papers authorized as of March 1994, five were rated CIB Aa and the rest rated CIB A. Ratings are issued after a thorough analysis of the company and the paper concerned. The CIBI ratings appear to have gained the confidence of investors, to the extent that some limit their portfolio to paper of highest ratings and are content to charge a lower interest rate than those charged by paper of lower ratings.

The rating of LGU debt issues is a fairly well-defined discipline in the more developed countries. As more LGUs float debt paper, a rating mechanism becomes more and more

necessary, to guide investors and LGUs alike. In broad terms, such rating of municipal bonds would necessarily call for an analysis of factors such as the project to be financed by the proceeds and the anticipated benefits and cash flows arising from same; the operating revenues and expenses of the LGUs; the magnitude, disposition and trends of the LGUs' share of national government support to LGU (IRA); the presence of a national government guarantee to the proposed issue; level of outstanding debt and commitments for annual interest and principal repayment; and subjective considerations regarding LGU leadership and management, plans and programs, and the like.

The financial statements of LGUs and of government, in general, are not always revealing or timely. Government accounting is entirely different from private accounting and analysts are often lost. Proper monitoring requires at least the preparation of some special purpose reports or possibly changes in the recording and summarization of LGU accounts.

*Liquidity mechanism.* Buyers of a bond also look for a liquidity mechanism so that their holdings can be converted to cash when so required. Depending on quality, the holder of a debt paper may or may not find ready buyers, possibly among banks, for their own or trustees' accounts, insurance companies, pension funds and other financial institutions, corporate treasurers.

LGU bonds can be used as the underlying security of repurchase agreements and other forms of deposit substitutes and money market instruments. In this, however, they would be on the same footing as paper issued by the Treasury and private corporations which may, in fact, have a more active secondary market. Other things being equal, investors naturally tend to buy money market instruments without attaching particular importance to the underlying security.

Some financial institutions, particularly GFIs, could make a market for LGU bonds. As they would not wish to hold

these instruments until maturity, they would do so once there is broad acceptance of the said instruments and the institutions concerned can also find ready buyers.

The ideal solution for liquidity would be for LGU bonds to be listed in the Philippine Stock Exchange (PSE), which is reportedly studying the possibility. It would help enlarge the market and thus ensure maximum liquidity to bond holders. Just like equity listings, however, applicants for listing must measure up to applicable standards. Tax considerations, as described elsewhere in this paper, must also be resolved for trading to materialize.

*Adjusting to bond trading mechanics.* Government regulations need to be carefully reviewed vis-à-vis the mechanics of bond marketing and administration. With a fixed coupon rate that is not necessarily identical to market interest rate at the date of bond issue, chances are, that the initial sale will not be at face value. Nonetheless, an early draft of government rules and regulations required that LGU bonds be sold at no lower than face value.

The issue would necessarily be at a discount in case the coupon rate is lower than market and at a premium if the opposite happens to be the case. Unless appropriate measures are taken beforehand, all concerned are likely to be charged with graft if the issue is sold at a discount. The alternative of setting a high coupon rate will not necessarily solve the problem, either, since a higher-than-market coupon rate will likewise render the decisionmakers vulnerable. Repayment of principal on the basis of face value could also be questioned and stopped by an auditor or accountant who notices that the bond was originally sold at a discount.

A fall in market interest rate will increase the market value of a fixed coupon bond. All concerned would be charged with graft by an alert prosecutor who notices a lower issue price, particularly if the bond was floated not too long before the fall in interest rate.



Questions about pricing could delay the release of debt service payments to any number of cautious decisionmakers, including budget, accounting, auditing, and cashier's offices. Categorical rulings from the Office of the President, Department of Justice, the DOF, the DILG, COA, and other agencies, such as the Ombudsman, would help assure all concerned. Appropriate policies and a standard mechanism for approval of the original issue and prompt remittance of debt service payments must also be designed and implemented.

*Taxes.* The tax issues pertaining to LGU bonds and bonds in general are rather complex and a detailed study is beyond the scope of this study. It is clear, however, that tax laws need to be rationalized if an active LGU bond market is to develop. Even if LGU bonds are listed on the PSE, there is no assurance that active trading will follow unless tax questions are resolved.

There are certain unsettled issues, but under the Tax Code, interest income on bank deposits, deposit substitutes and government securities is subject to a 20 percent final tax withheld at source. However, it appears that capital gains derived from the sale of bonds are considered as ordinary income and taxed accordingly. In the case of a corporate investor, such gains on sale are subject to a 20 percent withholding tax, creditable against the 35 percent corporate income tax.

The gain on sale of a bond, even if arising entirely from a change in market interest rate, is considered ordinary income and therefore subject to a 35 percent tax. If an LGU bond is listed on the PSE as would be appropriate in a fully developed capital market, the applicable tax would be the 20 percent tax withheld on the coupon rate, plus 35 percent on any difference between the original purchase price, which is likely to have been at a discount, and the face value at redemption or market value upon sale.

On the other hand, a listed common stock is subject to a final tax of  $\frac{3}{4}$  of 1 percent computed on the gross selling price, and deposit substitutes (including repurchase agreements with LGU bonds as underlying security) are taxed at 20 percent.

The Tax Code provision on wash sales also applies. Any loss incurred on the sale of a bond is non-deductible for income tax purposes when substantially identical securities are acquired by the seller within the 61-day period beginning 30 days before the sale and ending 30 days after the sale. In view of the normally high turnover of bond transactions in developed markets, as traders take advantage of slight fluctuations in interest rate, the wash sale rule is both an economic disadvantage and an administrative nightmare.

Unlike shares of stock, bonds are normally bearer instruments and therefore need not be presented for re-issuance when ownership changes. It is unclear, however, whether or not documentary stamp taxes will be imposed. Similarly, uncertainty surrounds the tax liabilities of a foreign investment in an LGU bond, specifically on the base of the withholding tax at time of disposition (whether redemption or sale) of a bond investment.

The net impact of these provisions is to discourage the secondary trading of LGU (and other bonds) and limit possibilities for an exit mechanism.

*Payment mechanics.* Only a few LGUs have gone to the bond market. The bond issue of Cebu province, earlier described, was successful. Unfortunately, a new administration came into power soon after the bond issue. One of its first acts was to attempt to dishonor the bond. The attempt was overruled by higher authorities. The affair ended happily, but the damage was done, renewing the concern of investors about the continuity and seriousness of LGU financial commitments.

It is necessary to design a mechanism that ensures prompt servicing of debt interest and principal. An approach could be built into the Trust Indenture, possibly along the following lines:

1. The LGU would routinely remit to the Trustee, for example, at the end of each month, all proceeds of the revenue-generating project financed by the bond.
2. The DBM would remit to the Trustee a predetermined amount or percentage of the IRA of the LGU concerned, estimated on the basis of the debt service requirement and the 20 percent of LGU regular revenue allowed for purposes of debt service.
3. A committed credit line from an acceptable bank for the term of the bond should be in place, to enable the Trustee to obtain bridge financing to cover a shortfall from the first two sources.

In such cases, the short-term loan would be paid out of IRA allotments or a guarantee fund for such purposes to be established by the DOF. If the credit line is large enough and the LGU concerned reliable enough, then even a direct IRA remittance would not be necessary. The source of the committed credit line would make the necessary arrangements to assure that any disbursements are eventually paid.

The principal of the Cebu province bond issue was paid in installments over the life of the bond. In cases where a bond involves a balloon payment at maturity, it would be advisable for the LGU issuer to set up a sinking fund under the administration of the Trustee, calculated as such to accumulate the amount needed at maturity. A sinking fund would help assure that funds for repayment are set aside each year and that the LGU does not violate the 20 percent ceiling on each year's debt service.

• *Constraints on Use of BOT Arrangements*

Under a typical BOT arrangement, a private sector proponent carries out the financing, construction, operation and maintenance of an infrastructure facility. The proponent operates the facility over a fixed period of time during which it charges users the appropriate tolls, fees, rentals as specified in its contract with government. The fees and charges enable the proponent to recover its investment, cover operating and maintenance expenses, and earn a profit. The facility will be transferred to the government agency or LGU at the end of the fixed term that shall not exceed 50 years. BOT arrangements call for the establishment of special-purpose companies which bring together private sponsors, equity holders, financiers and other interested parties to lend their expertise and capital to the project.

The heart of the BOT arrangement is that financing of the project is done on a limited recourse basis: i.e., recourse is available against the special purpose company and its assets. Under this financing approach, lenders will be repaid only from the cash flow generated by the project. The exposure of each participant — e.g., investor, equity holder in the special company — is limited only to the full extent of its investment or equity holdings in that company. Thus, the project being sponsored is generally secured only by the revenues and assets of the special company implementing the project and/or any guarantees provided by the government. In the event of project failure, the lenders will be repaid from the sale of the special company's project assets or from some guarantee mechanism, if available.

To enhance the credit standing of the BOT project, the government may guarantee political risk, project performance by an implementing agency or exchange rate convertibility, depending on the nature of the BOT project, the type of risks faced by the project, and the allocation of those risks between government, the private proponent and financier. More

importantly, in the Philippines, RA 7718 clarified that, as a rule, there is no cap on a proponent's rate of return on investments. Generally, the rate of tolls, fees, rentals, and charges will be governed by the BOT proponent's contract with the government agencies or LGUs. The approved rate takes into account its reasonableness to end-users of the facility. A project which is both a public utility and monopoly and is awarded through a negotiated contract however has a limit of 12 percent on the rate of return on investments. The appropriate regulatory bodies approve the rate of tolls, fees, and others, based on a reasonable rate of return for projects awarded on negotiated contracts and as a natural monopoly.

The Code and the amended BOT Law, with their respective implementing regulations, provide a clear policy, legal and administrative framework governing the LGUs' use of BOT arrangements. There are major constraints to the LGUs' use of this approach:

*LGUs' lack of familiarity with the use of project financing for local infrastructure.* Local experience in infrastructure financing has been limited to traditional ways of financing, constructing and operating the infrastructure. LGUs have never used project financing, especially the limited recourse type where the lenders will be repaid only from the cash flow generated by the project. BOT arrangements typically require the establishment of special corporations that will construct, operate and maintain the facility. This explains the need for market-based user fees which must sufficiently cover operating and other costs, and generate a reasonable rate of return on investments. Otherwise, the BOT special company becomes unviable and financially unsustainable. Subsidies coming either from the LGUs or the central government (if it agrees to provide such) may keep the corporation afloat but only on a short-term, temporary basis because of local or central government fiscal constraints.

*LGUs' lack the capability to prepare potential BOT projects.* Given the complexity of the project financing approach, LGUs must have the technical expertise or, at least, have access to technical expertise to identify BOT projects. The BOT project must be demand-driven rather than identified through some arbitrary decision of local officials, and must be part of an overall local development plan. A major factor which determines the success or failure of LGU BOT projects is the quality of the proposed project. This will involve the development of well-prepared bidding-grade BOT project proposals that will invite the appropriate private sector response. The CCPAP BOT Center has been conducting institutional LGU capability-building seminars on BOT project development since 1993. The number of LGUs covered and the high turnover of project development staff have hampered the full development of the individual LGU capability.

*Lack of funds for feasibility studies.* The preparation of feasibility studies for BOT projects is a costly undertaking. It was proposed during meetings with LGUs that an LGU BOT Fund be set up to finance these studies.

*The limited (three-year) political tenure of elected officials.* This type of political risk has been cited by private banks as a major problem in extending long-term credits to LGUs. They are not sure whether the succeeding administration will not renege on the LGUs commitment to repay a loan. The same concern can be raised for a BOT project which is more complex and more difficult to arrange than straight credit financing from a bank. The LGUs point out that they are legally bound to honor any contract once a project and its accompanying loan have been sanctioned by the local *Sanggunian* (lawmaking body). Critics cite possible "administrative" delays that may be resorted to by a present administration which disagrees or is not supportive of past policies and programs.

*Need for a solid balance sheet and fiscal position.* As a party to a BOT contract, LGUs have to show responsible fiscal management, adequate financial reporting, and the willingness to follow market-oriented principles of pricing, user charges and tariffs. Because BOT projects are on a limited recourse basis, this is critical to the success of the endeavor.

*Need for an effective mechanism for resolving disputes.* Arbitration procedures must have credibility and transparency. LGU BOT contracts must provide for arbitration before going to court, which includes remedies and a curing period to settle disputes. Compared to other developing countries, the Philippines has an extensive and sophisticated legal and administrative framework for settling disputes. LGUs must ensure that the arbitration provisions in the contract documents are adequate.

*LGUs' ability to provide credit enhancements such as guarantee, tax exemption, and other incentives.* The central government's experience with BOT projects shows the importance of credit enhancements that encourage greater participation and risk-sharing by the private sector. The LGUs must likewise consider an incentive structure that motivates greater private sector participation. Given limited fiscal ability — as evidenced by the dependence on IRA transfers and other grants, and the low revenue-generation capacity — an LGU may not have the capacity to provide guarantees to BOT arrangements. However, LGUs can avail themselves of guarantees once an LGU guarantee facility is in place in the market as currently planned by certain parties.

*Review of the implications of RA 8182, the ODA Act of 1996.* The BOT law as amended allows BOT projects to access official development assistance (ODA) funds. This is consistent with RA 8182, which provides that "rural infrastructure, countryside development... shall be given preference in the

utilization of ODA funds" (Section 4). The law also provides that ODA funds shall be administered by NEDA for project identification, feasibility studies, master planning at local and regional levels, and monitoring and evaluation. However, it also provides that the "NEDA shall ensure that the ODA funds obtained shall be for previously identified national priority projects which are urgent or necessary." It seems that unless an LGU BOT project has been "previously identified" as a "national priority" project, it will not be able to tap ODA funds for feasibility studies and the like.



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# **REQUIREMENTS FOR A VIABLE MUNICIPAL CREDIT SYSTEM**

## **POLICY FRAMEWORK FOR LGU CREDIT FINANCE**

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The flexibility in using credit finance given by the Code to LGUs is an important development in mainstreaming the LGUs to the private financial markets. Given the constraints in the national government budget, the credit demand of local governments cannot be entirely met by the MDF. Neither can the GFIs satisfy the LGUs' credit demand. Thus, a good strategy is to tap the private financial markets for LGU long-term finance.

However, at present there is no clear-cut credit policy framework and delineation of the relationship among the players in the LGU credit markets, particularly among government financial lending institutions, and their respective roles. Instead, a "free-for-all" approach to LGU lending has been adopted: whichever institution has the funds and the motivation can go ahead and lend to LGUs. The existing LGU loan windows are welcome but the "free-for-all" approach also gives rise to inconsistent and duplicative credit programs. It also hinders the progress of LGU credit markets since the lack of a clear-cut credit policy framework and program for creating LGU access to credit excludes many lower-income LGUs which fail to qualify for the traditional bank loans. More specifically, the potential contribution of

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the private financial markets in providing funds for LGU capital investments remains unrealized (Llanto 1992; 1994).

An appropriate LGU credit policy framework and a blueprint for the respective roles of different institutions involved in LGU credit markets should therefore be set in place. The underlying philosophy of this LGU credit policy framework is the principle that government should play a critical and catalytic role in LGU financing and the private financial markets should substantially provide the required LGU financing.<sup>50</sup> This implies that the government, through the MDF or an appropriate institution, will play a large role in LGU credit markets, in view of the absence of private lending institutions in LGU lending. The catalytic role of government is especially necessary in providing lower income LGUs access to credit or in financing social projects which the private capital markets will not care to finance. However, there must be an exit strategy for substantial government involvement in LGU financing once the LGUs are able to tap the private capital markets. Once private capital markets are in place, the government will assume a subsidiary role in providing capital funds.

- *Addressing Demand-Side Constraints*<sup>51</sup>

*Sound fiscal position of LGUs.* Maintaining a sound fiscal position projects the image of responsible management of the local government and convinces the potential lender that the LGU means serious business. It also means that the borrower LGU is on sound financial footing and that there are regular sources of revenues which can be tapped for loan repayment. Improvement of the local revenue collection, prudent fiscal spending, and better fiscal management will

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<sup>50</sup> This is further elaborated in the next chapter.

<sup>51</sup> These have also been pointed out in Llanto (1992), Sanchez (1992) and Saldaña (1992).

send strong signals to potential lenders of the LGUs capacity to manage a project and repay the loan.

*Loan repayment capacity of LGUs, collateral, creditworthiness.* The LGUs can convince lenders about their loan repayment capacity if they have a sound fiscal position. The transparency of local expenditures and the certainty of all sources of revenue will help in establish the LGUs' creditworthiness. Thus, commitment to transparency, financial sustainability and accountability will convince potential lenders of the LGUs' creditworthiness. Revenues can be assigned to ensure loan repayment. On the other hand, the IRA intercept is a useful device for securing the loan, as demonstrated by the MDF's experience. With the IRA as collateral, the concern about the LGUs' credit risk will be minimized. However, there must be a clear policy on the use of IRA as collateral. The BLGF suggested that under the present system where the DBM controls the release of IRA following a recent memorandum from the President, there must be a clear agreement between the LGU and the lender to resort to the IRA in case the LGU cannot repay the loan from the revenues of the project or other sources of revenues.

*Use of cost recovery schemes.* A corollary to the sound fiscal position is the use of cost recovery schemes such as user fees or charges, whenever applicable. This will make the loan financed project self-liquidating and will ease the burden on the regular local revenue collection and the internal revenue allotment, as sources of loan repayment. User fees will also generate the funds needed for the appropriate maintenance of the concerned facility, thereby prolonging its economic life.

*Capacity-building requirements of LGUs.* There must be a closer linkage between project development and capital budgeting in the LGUs. It is common to see LGUs preparing

annual investment plans which seem to be a wish list of local projects divorced from the reality of budgetary constraints. This happens because many LGUs, especially those in the lower income classes, do not have project and financial management capacity. Trainings in project and financial management and enhancing the skills of those with basic knowledge and experience will improve the chances of LGUs to access the capital markets.

*Effective local participation.* Public hearings, referendums, consultations, seminars, workshops and other venues must be utilized by the LGUs to discuss a proposed local project and generate support and commitment to it. The participation of the local *sanggunians* and the public in these discussions will provide greater transparency to the process of project identification and selection. The consensus generated through the public discussions will bolster the confidence of potential lenders in financing the proposed project.

*Better selection of projects.* The LGUs must develop the expertise for better project identification, selection and design. The most common project submitted for financing is the public market, due perhaps to its potential to generate revenues for loan repayment. Based on the field interviews, other revenue-generating projects such as toll roads, and social projects such as waste disposal system, water supply and drainage are in demand at the local level. Properly identified and designed capital investment projects will be a plus factor in trying to access the capital markets. The technical skills for good project identification, selection and design are scarce commodities in the LGUs and thus, local personnel must be given trainings.

*Advantage of a credit rating system.* A credit rating system is an important step to bridge the information gap between LGUs and lenders. A valuable input to such a credit rating

system may be a credit evaluation of LGUs such as that proposed by Saldaña (1992), which considers the amount, certainty and timing of the future cash flows of the LGU. The credit rating system may also use the historical performance of the LGU with regard to funds management, resource-generation through local taxes, grants, local economic enterprises and investments. In addition, information on prospective investments in the local area may significantly raise the LGU's revenue potential, its credit standing and hence, its debt servicing capacity.

- *Addressing Supply-Side Constraints*

*Information structure.* The information asymmetry in LGU credit markets has to be broken down by a concerted effort of the LGUs and lenders. The LGUs have to learn about credit finance, lending procedures, conditionalities, project identification, selection and design. They must have sufficient understanding of capital markets and institutions, which is a pre-condition for accessing credit markets. On the other hand, lenders have an acute need for more information about LGUs, their experiences in project implementation, their fiscal position, the local community's revenue base, and other information to build the confidence of lenders.

*Regulatory framework affecting LGU deposits and bond issuance.* There is a need to liberalize the regulation on LGU deposits. The use of private banks as depository institutions will be the first step in bridging the gap between LGUs and private lenders. The LGU deposits will provide compensatory business to private banks, and may lead to a reduction in borrowing costs through lower lending rates. The reserve requirements on LGU deposits should be reduced in order to have more liquidity in the LGU credit markets, which may also bring down the cost of borrowing. On bond issuance, there is a need to have SEC regulations specifically applicable to LGU bonds because, in the absence of those regulations,

those pertaining to corporate bond issues apply. Furthermore, the requirements for bond issuance may be straightforward, but there is a need for LGUs to produce timely, audited financial statements. This may be addressed by the pertinent SEC regulations. Finally, there is a need to review various issues affecting LGU bond issuance in order to arrive at the policy and institutional measures which will help develop the LGU bond market. The issues which must be addressed are:

- (i) the constraints in the design of an LGU bond issue;
- (ii) marketability of the LGU bond;
- (iii) bond rating;
- (iv) liquidity mechanism;
- (v) taxation of LGU bonds; and
- (vi) bond trading and payment mechanics.

*Expertise in the appraisal of social projects.* The private banks and the GFIs must develop their expertise in social projects. Although there is a bias for financing revenue-generating projects, field interviews indicate that LGUs want to borrow for social projects. The financially capable LGUs can repay the loans used for social projects. Thus, the lenders must have the necessary expertise in evaluating those projects.

*A competitive framework for LGU lending.* The successful municipal credit systems in other countries operate on a sound, commercial basis. They operate within a competitive framework as discussed in Chapter IV. Financial resources are mobilized from various sources and in competition with other financial institutions. They are also subject to the supervisory and prudential regulation framework of the financial system. A market-oriented framework for the country's municipal credit system is the necessary foundation for LGU access to private capital markets.

*Cofinancing, shared costs and risks.* The private banks, and GFIs and, in fact, any lender to LGUs must assume credit risks in lending to local governments. The LGU credit markets will not develop if the government assumes all the credit risks and provides subsidized funds to ensure that LGUs get loans. Charging lending rates that reflect the cost of capital and the LGUs' credit risk will be an important aspect of a successful municipal credit system.

# **IMPROVING THE MUNICIPAL CREDIT SYSTEM**

The discussions in the previous chapters clearly suggest that there is a need to further improve the existing municipal credit system in the Philippines to give LGUs greater access to capital, especially private capital, to finance their development projects. This chapter pulls together the analyses of the previous chapters, recommends some policy and institutional reforms to improve the municipal credit system that has substantial private sector participation, and presents an action plan to implement the recommended option.

## **POLICY RECOMMENDATIONS**

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LGUs are classified into four: province, city, municipality and barangay. Like subnational governments in other countries, these LGUs perform certain basic functions. The Code mandates the devolution of some functions of the national government to the LGUs. More specifically, LGUs are responsible for delivering basic services and facilities within their respective jurisdictions. The Code also mandates LGUs to perform some regulatory functions such as regulating the real estate trade and business, and inspecting food products for public consumption, among others. Thus, LGUs today have much broader functions than before.

To be able to fulfill their expanded functions, LGUs require more resources and must build new capacities. To address this issue, the Code has broadened LGUs' powers to raise

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local revenue. However, due to limited tax base and sometimes, reluctance to increase local taxation, revenues from local taxation do not meet LGUs' increased expenditure needs. The national government has to transfer funds to LGUs so that the latter can perform their functions. To address the issue of efficiency, equity and transparency, the inter-governmental transfers (or IRA system) follow a certain formula, which is found in the Code (Fig. 7.1).

Although LGUs have greater autonomy to allocate their financial resources, they are not entirely free to spend the IRA. The Code stipulates that no less than 20 percent of LGUs' annual IRA should be spent for development projects, but LGUs are free to choose the projects they will undertake. Aside from the IRA, another non-tax source of revenue for LGUs is their share in the proceeds from the use and development of national wealth, which is to be used to finance local development and livelihood projects.

The Code should be praised for mandating a certain amount of the IRA and share in the national wealth for development projects because it induces LGUs to realize current surplus that can be used for capital investment, which is needed to increase the capacity of LGUs to provide basic services. Unlike current expenditure, the benefits from capital investment extend over a number of years. This, of course, has differential impact on the finances of various LGUs, that is, relatively well-off LGUs can very well spend more than the minimum capital investment required by the Code, whereas some LGUs might find it difficult to meet the minimum required capital investment.

Indeed, current surplus is the best way to finance capital investment. Some development projects do not require lumpy capital investment and therefore can be undertaken by LGUs on a piece-meal basis and financed out of their annual current surplus. For example, a municipality may cement one street a year. However, some development projects, e.g., slaughter house, bus terminal and others need lumpy investment, which

**Figure 7.1**  
**FORMULA FOR DETERMINING THE VOLUME**  
**AND ALLOCATION OF INTERGOVERNMENTAL TRANSFERS**

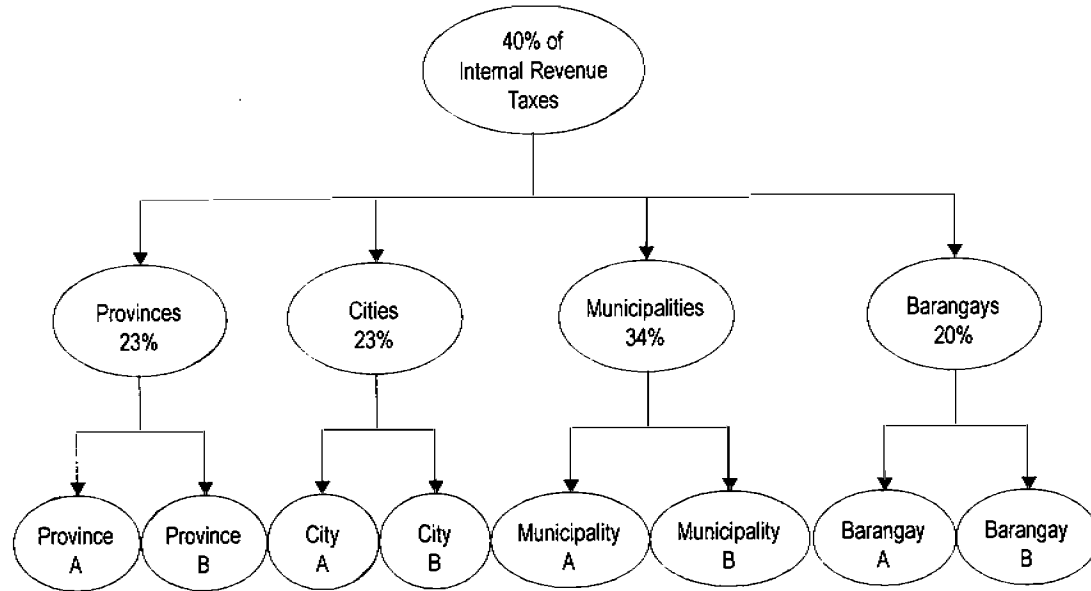
1. Aggregate

2. By Level of LGU

3. Individual LGUs

Formula:

- |                  |     |
|------------------|-----|
| 1. Population    | 50% |
| 2. Land area     | 25% |
| 3. Equal sharing | 25% |



can easily exceed the current surplus of LGUs. No matter how economically justifiable such projects are, no LGU will ever undertake them because doing so can seriously impair their finances. While some of the projects can be undertaken on a piece-meal basis to accommodate the current surplus constraint, it would be more cost-effective if they were undertaken and completed in one setting. In such cases, it would be best for LGUs to access external sources of funds to finance lumpy investment.

LGUs have two possible external sources of financing, which are not necessarily mutually exclusive: grants and loans. Under the Code, LGUs may receive grants from the national government, local NGOs and other external donors. It is worth emphasizing here that grants, which LGUs may obtain from the national government, refer to LGU subsidies over and above the regular intergovernmental transfers or IRA. In the past, the national government's grant system was incorporated in the National Assistance to Local Government Units (NALGU). However, the Code did not retain this because the IRA for LGUs had been increased.

LGUs may borrow from the private capital market or from the national government through a conduit lending agency or from GFIs. As discussed earlier, LGUs have little access to the private capital market, their borrowings mainly come from GFIs and MDF.

Loans granted by GFIs to LGUs in the past carried substantial interest rate subsidies. Despite these cheap loans, many LGUs failed to repay their loans. This only shows that cheap loans cannot improve the viability of the project nor the creditworthiness of borrowers. The decision of the national government to include in the Code a similar debt condonation program effectively converted the loans into a grant. The MDF also provides credit and subsidies to LGUs. The MDF subsidy consists of interest rate subsidy and grant. LGUs that have access to the MDF credit are automatically given access to these two forms of subsidy.

While there are reasons for the national government to continue providing grants and credit to LGUs, there are certain policy issues that must be addressed squarely if improvement in the municipal credit system that has substantial private sector participation is to be attained.

Below is a package of policy recommendations needed to improve the municipal credit system.

### **Policy Recommendation No. 1**

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*Decisions involving the grant system should be isolated from the credit system.*

There is a large difference between a grant and a loan, that is, the former does not have to be repaid by the recipient, while the latter has to be repaid. Because of this, the economic justifications for giving an LGU a grant are different from those for providing credit.

It is beyond the scope of this study to discuss at length the justifications, appropriate design and delivery mechanisms for a grant system for LGUs.<sup>52</sup> Nevertheless, it would be worthwhile to say a few words on this issue because it will help clarify some points related to LGU credit and because the design and implementation of the grant system substantially affect the effectiveness of a well-designed municipal credit system.

Economic efficiency and equity are the two established justifications for giving grants.<sup>53</sup> These objectives are complementary, but poor design in the grant system can turn them into opposing objectives. This can be aggravated by having uncoordinated, if not inconsistent, development plans.

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<sup>52</sup> A study commissioned by NEDA and conducted by U.P. ECON Foundation deals with these issues.

<sup>53</sup> For more discussion, see Shah and Qureshi (1994) and Dillinger (1995).

For instance, the establishment of Regional Agro-Industrial Centers (RAICS) in 14 locations in the country focuses on growth. Understandably, any assistance to be provided by the national government to host LGUs will have to be evaluated primarily on the basis of the growth criterion. On the other hand, the Presidential Commission to Fight Poverty (PCFP) has identified 19 priority provinces, which will be the target for the government's poverty alleviation program. This will focus on the equity objective of intergovernmental transfers. Many of these provinces are far from the RAICS (Annex 4). It is not clear how these two development plans will be coordinated to provide a better framework for designing a grant system. Given the limited resources of the government, it will be difficult to achieve a healthy balance between growth and equity objectives if these plans are not well coordinated.

The decision to grant an LGU a credit, on the other hand, rests on its creditworthiness. It suggests that the general revenue position of the LGU should be sufficiently strong to enable it to repay the loan, or that the loan is used for revenue-generating projects that can pay for themselves. Many have argued for the use of credit to achieve the government's equity objective. Thus, they insist that the interest rate on loans is to be kept at below-market rates to make them affordable to poor LGUs or to LGU projects that cannot afford to pay the market rates of interest. This argument is grossly misguided.<sup>54</sup> Subsidized credit cannot make LGUs creditworthy, nor can it make economically unviable projects viable. As mentioned earlier, many LGUs that obtained cheap credit from GFIs failed to repay their loans. On the contrary, subsidized credit can undermine the government's equity objective if credit at below-market interest rates is made available to LGUs or to projects that can well afford to pay the market rates. If there is a strong justification for a subsidy, an outright grant is better

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<sup>54</sup> This view is reflected in Shah and Qureshi (1994).

than hiding the subsidy in the interest rate on credit.<sup>55</sup> Besides, below-market interest rates can undermine the long-term viability of the credit program, penalizing those who are last in the queue of credit applicants. The world is littered with many such cases.

## **Policy Recommendation No. 2**

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*Government's degree of control over the use of a grant should be different from that over the use of a credit.*

Because of the nature of the grant, which is a resource of the national government donated to LGUs over and above their IRA, the national government is justified in exercising greater control over LGUs with respect to the use of a grant. Thus, the grant system for LGUs, if there is any, must be conditional so that the national government can use it as a policy instrument to achieve certain priority objectives. For the grant system to be effective, it has to be centralized and guided by a well-thought-out policy framework.

In contrast, the national government should have minimal say with respect to LGUs' use of the loan proceeds so long as LGUs meet the creditworthiness criteria, and the projects that are going to be financed by the loans are those that are assigned to them under the Code. After all, LGUs will be responsible for paying these loans, and being able to choose the projects to be financed by loans will make LGUs more responsible for promptly paying the loans they contract.<sup>56</sup> It is to be noted that access to credit will free some resources that can be

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<sup>55</sup> Because a subsidy to an LGU is over and above its IRA, it must be transparent. Also, there must be a transparent system of allocating the subsidy to LGUs.

<sup>56</sup> The implication is that lending institution should not dictate what projects LGUs should undertake so long as those projects fall within the responsibility of LGUs.

allocated to other projects or to basic services that LGUs must provide.<sup>57</sup>

In reality, however, government credit programs for LGUs have fairly limited funds, which cannot meet all the credit demands of LGUs. They therefore have to resort to prioritizing the projects they support. But once these priority projects are clearly defined, LGUs should be left to decide for themselves which projects they want to propose for credit financing.

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### Policy Recommendation No. 3

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*Access to a grant should not be considered a guarantee for access to credit, and vice-versa.*

Since the criteria used for evaluating a grant application are different from the criteria for evaluating a loan application, it follows that an LGU that has access to a grant should not be automatically given access to credit, or vice-versa. However, this does not mean that an LGU cannot access both external sources of financing at the same time. To access both, the LGU must provide solid justifications separately for each of them.

Separate evaluation of grant and credit is important in enhancing LGUs' access to the private capital markets. As mentioned earlier, the national government could be the only supplier of grants to LGUs. When it comes to credit, however, both the private capital markets and the national government (including GFIs) could be the suppliers of credit, and there could be a situation in which an LGU is able to secure simultaneously a grant from the national government and credit from the private capital market for related or unrelated

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<sup>57</sup> This is only true if the project to be financed by credit is revenue-generating. Otherwise, there is a need to allocate from existing resources to service debt.

development projects. Thus, private credit will be able to supplement grants to LGUs, or vice-versa.

What needs to be emphasized here is that government credit and grant to LGUs should not be bundled up together because it will effectively yield a subsidized credit program even if the credit component is priced at market rates.<sup>58</sup> This will encourage LGUs to be dependent on the government's subsidized credit program. Consequently, they will shy away from private sector loans. On the other hand, the private capital markets, which usually do not give grants, will never be encouraged to respond to the credit demands of LGUs. If grant and credit were not bundled up together, it would be easier to wean LGUs away from the government credit program and accelerate the graduation process.<sup>59</sup>

There may be cases in which LGUs that are about to access a grant may want to demonstrate their sincerity in putting such grant to good use by contributing some amount to the project. But for lack of funds, they may want to borrow to finance their equity.

#### **Policy Recommendation No. 4**

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*A credit policy framework for LGUs should be consistent with the government's overall credit policy.*

The government used to intervene heavily in the credit markets by implementing several credit programs for the so-called "basic sectors" of the economy, such as agriculture, small enterprises, the ultra-poor, and others. These credit programs used to carry varying degrees of subsidies which

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<sup>58</sup> It should now be clear that the grants referred to here are those subsidies that reduce the cost of credit to borrowers. It should be distinguished from technical assistance, which can enhance the creditworthiness of LGUs (see also Policy Issue No. 5).

<sup>59</sup> See Policy Issue No. 5 for related discussions.



discouraged private sector lending to those sectors. Lately, the government decided to adopt a market-oriented interest rate policy and a policy of promoting greater reliance on private lending institutions. This new policy is based on results of several studies here and in other countries showing that the basic sectors' problem is access to credit, not the price of credit, and that the private sector can be encouraged to lend to the basic sectors if the incentives are right.

A credit policy framework for LGUs should adhere to the interest rate policy of the government. Like other special credit programs, the credit program for LGUs should address the problem of access to credit by LGUs and provide an environment for greater private sector participation.<sup>60</sup> In this regard, there is a need to review Article 395-(c) of the Rules and Regulations Implementing the Local Government Code of 1991 which states that "Government financial and other lending institutions are authorized to grant LGUs such loans,... preferably at concessional interest rates lower than the prevailing rates..."

#### **Policy Recommendation No. 5**

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***Government lending programs for LGUs should pave the way for private sector lending to LGUs.***

Some aspects of this policy issue (i.e., market-oriented interest rates on LGU loans, unbundling of grants and credit, and others) were mentioned earlier. Two things should be added and emphasized here. First, it must be clear that the role of the government credit program in the credit market is to fill some gaps left out by the private credit institutions, hoping that in the future the latter will re-assert themselves. Thus, government credit programs for LGUs should have a

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<sup>60</sup> As indicated in the MDF-PGB resolution No. 01-92-MDF (Feb. 5, 1992), MDF is moving toward this direction.

built-in graduation program, in which LGUs with good credit track record can readily graduate into a borrower from the private capital markets, assuming that all constraints to private sector lending have been eliminated. In other words, government financial institutions should make a market for their creditworthy LGU borrowers. In the private credit markets, it is natural for banks to hang on to their creditworthy clients for obvious reasons. But this should not be the case for government lending institutions because their role is to support the government's policy of improving LGUs' access to the private capital markets. Second, technical assistance, if available, can be provided to LGUs but should be directed at improving LGUs' creditworthiness. The technical assistance could be focused on the following three areas for capacity building.

1. LGUs must develop capacities for making their financial operations transparent to lending institutions.
2. LGUs must develop capacities for evaluating both the technical and internal financial viability of development projects.
3. LGUs must develop capacities to determine and implement user charges for self-liquidating investments and to improve the collection of tax revenues for non-self-liquidating projects.

#### **Policy Recommendation No. 6**

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*Government financial and other lending institutions authorized to grant loans to LGUs should coordinate their credit programs for LGUs.*

In many countries, there is only one government-owned municipal credit institution providing credit to subnational

governments. This is not the case in the Philippines. Aside from the MDF, GFIs are also involved in lending to LGUs, as provided for in the Code. There is no framework for coordinating the credit programs of these government institutions. They have overlapping clientele and in some cases, compete with each other. On the other hand, LGUs have no clear idea of which government lending institution or credit program they can tap and the projects that can be funded out of credit. It is, therefore, necessary that government financial and other lending institutions or funds such as the MDF coordinate their lending programs for LGUs.

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**Policy Recommendation No. 7**

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*The mechanisms for reducing risk for LGU borrowing must be instituted and enforced, and should be available equally to government and private lending institutions.*

A lender is subject to different types of risk, such as credit risk, interest rate risk, political risk, and others. This is usually accentuated by an asymmetric information problem. A lender may be encouraged to lend to LGUs if risks are reduced to an acceptable level. The government, therefore, should exert effort to minimize such risk. In this regard, there are several things that the government should do.

*Reduce the asymmetric information problem.* Private lenders know very little about assessing LGUs' creditworthiness. The LGUs' accounting system is very different from that of private enterprises. It is also costly for private lenders to collect such information. A credit rating system may address the problem, but it will take some time for it to be profitably established. Initially, the government could come in to formulate creditworthiness and use these indicators to regularly monitor and publish the degree of creditworthiness of LGUs. This is

short of having a credit rating system. The DOF is the appropriate agency to perform this function.

Another but complementary way of reducing asymmetric information problems is by encouraging LGUs and banks to establish a firmer bank-client relationship through collateral business such as deposits. The Code allows LGUs to deposit their funds with any bank of their choice, preferably a government bank, but COA interprets this provision very restrictively. Since branches of government banks are usually located in capitals of provinces, cities and large municipalities, these LGUs will be prevented from establishing a good private bank-LGU relationship. Ironically, many of these LGUs can easily pass the creditworthiness criteria of private banks. The provision of the Code should be interpreted in the context of the policy of the government to encourage private lending to LGUs.

*Present acceptable collateral.* Private lenders will treat LGUs like any borrower and, as usual, they will demand a collateral for their loans. The IRA of LGUs can serve as a good collateral. The recent revival of GFI lending to LGUs has been helped by the increase in IRA. Specifically, GFIs have required borrowing LGUs to deposit their IRAs with them. The loan contract usually includes provisions that allow the lending GFI to secure payment from the LGU through the latter's IRA deposit in case of loan default. Again, private banks can enjoy this only if the regulation on LGU's depository bank is liberally interpreted.

#### **Policy Recommendation No. 8**

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*Regardless of the source of funds, government credit programs for LGUs should adhere to all the policies stated above.*

In developed countries, the government-owned municipal credit institutions are funded internally, either through the

national budget, borrowing from the domestic capital market, or both. The situation in the Philippines is quite different. In the case of GFIs, their lending programs for LGUs are funded out of their own funds. In the case of the MDF, a large part of it is funded by multilateral and bilateral assistance and the remaining part by the national government. Donor agencies usually pre-determine the target LGUs to be supported by the MDF credit program. Obviously, the grant element that is bundled up together with the credit element has dominated the choice of target LGUs for this credit program.

The role of ODAs in funding the government's credit programs for LGUs must be reviewed. Although ODAs may target specific sectors or projects, donors should not pre-determine which LGUs should receive credit. ODA's role is to augment the limited resources of government credit programs for LGUs. Donors will surely understand this so long as the government has a clear, coherent policy framework and institutional mechanism for delivering credit and grants to LGUs.

## INSTITUTIONAL REFORMS

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As discussed in Chapter V, the current municipal credit system consists of GFIs and MDF supplying credit to LGUs. There is also an emerging bond market, which has already been tapped by a few LGUs. So far, the role of private financial institutions (PFIs) in meeting the credit demands of LGUs has been limited to the provision of fee-based services, such as underwriting LGU bond issuance. This section proposes some institutional reforms that will lead to greater access of LGUs to the private capital market.

- *The Bond Market*

Excluding Cebu province, three LGUs successfully issued bonds after the passage of the Code and two LGUs are in the process of issuing their bonds. The issuance by the national

government of five-year, fixed-rate Treasury Notes is indeed a welcome development to the LGU bond market.

The market is still cautiously looking at the emerging LGU bond market. It is to be noted that all three recently issued LGU bonds are guaranteed by the Home Insurance Guarantee Corp. (HIGC).<sup>61</sup> Naga City will be the first LGU after the passage of the Code to issue bonds without guarantee from any government agency.<sup>62</sup>

There are no SEC guidelines specifically for LGU bond issues. Thus, the existing rules and regulations applied to corporate bond issues have been applied to LGU bond issues. Yet, three LGUs already successfully issued bonds and two LGUs already completed all the necessary documents for the issuance of bonds. The process of issuing bonds experienced by the first few LGUs was understandably slow since all concerned parties (i.e., proponent and the approving agency) had little precedent to follow. With more LGU debt issues, all concerned will gain experience and will have more models to follow, inevitably speeding up the review and approval. However, the formulation of standard operating procedures and policies to guide of both proponent and approving agency alike will be advantageous to all concerned. Although the existing SEC requirements for bond flotation are straightforward, it is to be noted that LGU operations and accounting are different from those of private corporations and the former will be hard put to produce timely, audited financial statements that are meaningful to financial analysts, let alone comply with announced criteria on current ratio,

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<sup>61</sup> All the proceeds of the bond issues will be used to finance housing projects. For such projects, HIGC provides a guarantee for the principal and interest income of up to 8.5 percent.

<sup>62</sup> Naga City is reexamining its decision to issue bonds because its total cost (i.e., interest plus underwriting fee plus the cost of maintaining a liquidity fund) appears to be higher than the cost of borrowing from a GFI. LGUs that obtained a guarantee from HIGC incur an additional cost of 2-1/4 percent.

fixed assets and so on. The experience of the five LGUs mentioned above should be documented and included in the proposed operating procedures and policies for LGU debt issues.

The complexity of bond pricing, if not taken into account in government accounting and auditing policies, could discourage LGUs from floating bonds. In the absence of clear regulations on bond pricing and repayment, cautious LGU officials may be discouraged from issuing bonds for fear of being charged with graft later on. This could also result in the delay in paying maturing bonds, a situation which drives away investors. Thus, all government regulations and accounting and auditing procedures for bond marketing and administration need to be adjusted to take into account the peculiarities of bond pricing.

There is no urgency to establish a credit rating agency that will rate LGU debt issues, because there are few LGUs planning to issue bonds. However, as the LGU bond market picks up, many LGUs will likely consider bond flotation as a means of financing their development projects, in which case a rating mechanism must guide both bond issuers and investors. It is therefore worthwhile to start now to figure out how to establish a credit rating agency and the mechanics of rating LGU bonds.

- *Role of GFIs*

Section 297-c of the Code provides GFIs with the authority “to grant loans, credits, and other form of indebtedness out of their loanable funds to local government units...” GFIs are expected to remain a part of the municipal credit system in the coming years.<sup>63</sup>

Having learned from their mistakes, GFIs now treat LGUs like ordinary borrowers of a private bank. They evaluate the

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<sup>63</sup> The PNB will continue to provide loans to LGUs even if it is majority-owned by the private sector.

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projects proposed by LGUs for financing, assess various types of risk that may be associated with the LGU loans and demand collateral.<sup>64</sup> They sometimes competed with each other in getting the loan accounts of certain LGUs. With very limited loan budgets, GFIs will not likely be able to meet all the credit demand of LGUs.

This study found out that GFIs lend to low-income LGUs which they deem creditworthy. The study, therefore, does not propose any major institutional changes in the existing GFIs.<sup>65</sup> Instead, the study would like to emphasize the need for GFIs to adhere to the policy recommendations discussed above, particularly Policy Recommendation Nos. 4, 5 and 6. Efforts by LGUs to float bonds in the private capital markets should be supported rather than subverted by offering LGUs subsidized credit.

At present, GFIs find it difficult to meet the credit demand of high-income LGUs. Their loan budgets are almost exhausted and they continue to receive loan applications from LGUs involving large amount of money. This is the best time for GFIs to orient high-income LGUs to the private capital market through some co-financing scheme with private lending institutions or through a referral system, with the GFIs assisting the private lending institutions in project and credit evaluation.

Aside from providing credit to LGUs, GFIs are expected to continue providing fee-based services to LGUs, such as underwriting bonds, acting as fiscal agents and fund managers of LGUs issuing bonds, providing financial advice, conducting feasibility studies, and others.

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<sup>64</sup> As already discussed in Chapter V, being depository banks of LGUs substantially reduces GFIs' risk in lending to LGUs.

<sup>65</sup> This statement will be qualified in Option 2, wherein the Study Team proposes to transfer the MDF to an existing GFI.



• *The Role of MDF*

In the short- and medium-term, both the GFIs and the bond market will likely leave out a large number of LGUs, especially those deemed less creditworthy. These LGUs may be serviced by the MDF.

At the outset, it is easier to coordinate the credit programs of the government for LGUs if the target clientele of the MDF is well defined. The study proposes that MDF focus on servicing the credit needs of LGUs belonging to the third tier, i.e., LGUs belonging to the fourth, fifth and sixth income class, especially those that need assistance to improve their creditworthiness. However, this should not be considered as the exclusive clientele of the MDF. GFIs may also lend to low-income LGUs as they have done recently.

As discussed in Chapter V, the MDF has played a key role in channelling foreign loans and grants to LGUs. In the past 11 years, the MDF channelled about US\$350 million to some 800 LGUs. The funds were obtained mainly from international donor agencies such as the World Bank, Overseas Economic Cooperation Fund (OECF), Asian Development Bank and USAID. In fact, from the mid-1980s to early 1990s, the MDF was the only lending facility available to LGUs.<sup>66</sup> Despite this, the MDF has reached a limited number of LGUs — 110 out of 1,452.<sup>67</sup> Also, it has financed mostly urban infrastructure projects, whereas LGUs have a wider array of development projects which need external financing.

Recently, the MDF obtained US\$60 million from the World Bank under the Third Municipal Development Project. It is also sitting on a relatively huge second-generation fund, i.e., receipts from loan amortization and interest payments,

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<sup>66</sup> As mentioned in Chapter V, GFIs re-started their lending program to LGUs only after the passage of the Code in 1991.

<sup>67</sup> As pointed out in Chapter V, MDF was not designed primarily as a lending institution but as an institution for channelling ODA to LGUs.

of about P700 million. The second-generation fund is expected to amount to about P1.5 billion by the end of 1998 (Peterson 1993). Notwithstanding these additional resources, the MDF cannot single-handedly meet the ever-increasing demand for credit by a large number of LGUs which will not be serviced by GFIs and the bond market.<sup>68</sup> Also, the prospects for securing more foreign assistance to augment its funds are fairly limited. It is, therefore, important that LGUs have access to the private capital market, which has a large reservoir of funds.

### **FINANCING LGUs' BASIC SERVICES AND DEVELOPMENT PROJECTS: A NEW VISION AND CREDIT POLICY FRAMEWORK**

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This section presents a new vision and the proposed policy framework for financing local governments' basic services and development projects. The new vision intends to wean the LGUs away from their dependence on the national government and to promote more effective private sector participation in developing and funding local projects. The credit policy framework aims to direct and make LGUs creditworthy to the private sources of capital.

The proposed policy framework will enable the LGUs to better deliver the devolved services and activities, such as municipal infrastructure (public markets, bus terminals, slaughter houses, roads, and others), water supply and sanitation, solid waste management, school-building construction, basic health services, social welfare, environmental protection and agricultural extension.

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<sup>68</sup> It was pointed out in Chapter III that by using the creditworthiness criterion, the estimated demand for credit by LGUs would amount to P34.4 billion.

- *Toward Self-reliant LGUs*

The Code provides LGUs with various financing sources. These include the IRA, ODA, loans from government and private banks, bonds, local taxes and enterprise revenues, and BOT arrangements. The objective is to enable LGUs to rely less on transfers from the national government and ODA, to use more locally generated funds, and to encourage private sector participation through loans, bonds and BOT arrangements. The passage of the Code paved the way for many positive steps in this direction.

However, despite the Code's many positive features, heavy involvement of certain national government agencies in devolved activities continued. Despite the strong IRA growth, some LGUs claim that their financial burden has increased. What compounded the problem was the lack of clear policies, programs and mechanisms to properly channel IRA funds and ODA to the local governments.

- *ICC Policy Resolution on National Government Grants*

The Investment Coordination Committee (ICC) Policy Resolution on National Government Grants provides some guidelines for channeling grants to LGUs. Under the ICC Policy Resolution, national government grants to LGUs will be given selectively on the basis of equity, externalities, and economies of scale. Such government funds will complement the provision of IRA, and will support local accountability, autonomy, needs and preferences. The government recognizes that LGUs are better implementors of devolved functions because they are closer to the people, can target programs better, and have greater accountability for public funds. Under this ICC guideline, community involvement and equity contributions, and LGU counterpart funding are essential. This arrangement ensures that there will be increased ownership of local projects, better maintenance, and better chances of cost recovery through user charges.

Under the ICC Policy Resolution, an LGU will match the national government's grant through a 50-50 percent cost-sharing formula, depending on the type of project and the LGU's income class. The national government grant will be closed-ended (i.e., limited and temporary), and specific (i.e., performance-based for specific projects), and targeted at specific groups. To ensure goal congruence, national government assistance will be implemented through a formal cost-sharing arrangement between a national government agency and the recipient LGU.<sup>69</sup>

- *Expanding LGU Access to Private Capital Markets*

It is widely recognized that government resources are insufficient to meet LGU demand for funds. This is the rationale for expanding LGUs' access to private capital. However, at present, there is no credit policy and institutional framework that will ensure LGUs' access to adequate financing, both from government and private sources of capital. As pointed out in this study, the roles of the key players in the LGU credit markets such as the MDF, the GFIs and the private sector are not well delineated.

This has resulted in a "free-for-all" approach, leading to inconsistencies and duplications in LGU credit programs. There is thus a need to define the "catalytic" role of the government, the GFIs and especially the MDF, which has been the LGUs' only source of long-term credits. Also, there is a need to harmonize the policy framework for national government grants<sup>70</sup> and those under the GFI/MDF credit programs.

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<sup>69</sup> There are, however, some unresolved issues such as (i) the sponsoring agency for intersectoral projects, (ii) budgetary treatment and channelling mechanism for grants, and (iii) a clearer delineation of functions between national government agencies and LGUs at national, regional, provincial and municipal levels.

<sup>70</sup> The ICC Policy Resolution on National Government Grants to LGUs

- *Present Situation of LGU Financing*

The LGU credit market is still undeveloped. The GFIs have re-opened LGU loan windows but these are mostly for medium-term, revenue-generating projects. The BOT projects are being actively explored although, so far, only a handful are being developed.<sup>71</sup> Private banks have adopted a “wait-and-see” attitude because of insufficient information on LGUs, their short-term orientation, the perception that LGUs are high credit risk, and the banks’ limited if not total lack of expertise in financing social/development projects. While some LGUs have floated bonds, the bond market is yet to be developed.<sup>72</sup> Thus, only the GFIs and the MDF are there to provide financing to the LGUs, with the latter serving as the main conduit for ODA loans/grants.

- *Toward Realizing the New Vision*

The vision is anchored on two premises.

1. LGUs have varying levels and records of credit-worthiness and bankability, and their financing needs are huge.
2. The private sector (composed of BOT investors, bondholders, commercial banks), the GFIs and MDF have roles to play in meeting LGU financing needs.

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<sup>71</sup> For example, Mandaluyong City has a public market constructed under a BOT arrangement. Lucena City has a public market to be operated through a concession. The water supply of Cebu City and Zamboanga City are proposed BOT projects.

<sup>72</sup> The following have floated bonds: Cebu province, the City of Legaspi, and the municipalities of Victoria and Claveria. The last three LGUs floated housing bonds guaranteed by the HIGC and purchased by HDMF. Naga City and the provinces of Pangasinan and Laguna are exploring the issuance of bonds for revenue-generating projects.

To increase creditworthy LGUs' access to private capital, the national government must use the GFIs and the MDF as catalysts to bring them to the mainstream of private capital markets.

### **OPERATIONALIZING THE CREDIT POLICY FRAMEWORK<sup>73</sup>**

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- *Role of Government Financial Institutions*

The following roles are proposed:

1. The GFIs will continue to extend loans to creditworthy LGUs that still cannot tap private capital.
2. The GFIs will develop co-financing arrangements or project referral schemes with commercial banks.
3. The GFIs will provide limited technical assistance to enhance the creditworthiness of LGUs.

- *Role of Municipal Development Fund<sup>74</sup>*

1. The MDF will target its financing to less creditworthy LGUs and to social/environmental projects.
2. The MDF will refrain from providing grants and credits to LGUs that are qualified to obtain GFI loans or to those with viable BOT projects.
3. The MDF will provide technical assistance to improve LGUs' capacity and creditworthiness, enabling them to graduate to GFI credit, and eventually, to private sources of capital.

- *Role of Commercial Banks and Private Sources of Capital*

1. The commercial banks and private sources of capital will be encouraged to provide commercial loans to creditworthy LGUs/resource-generating projects.

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<sup>73</sup> See Llanto and Soriano (1996).

<sup>74</sup> Annex 6 show alternative options for achieving such objective. All these options essentially revolve around reforming the present MDF.

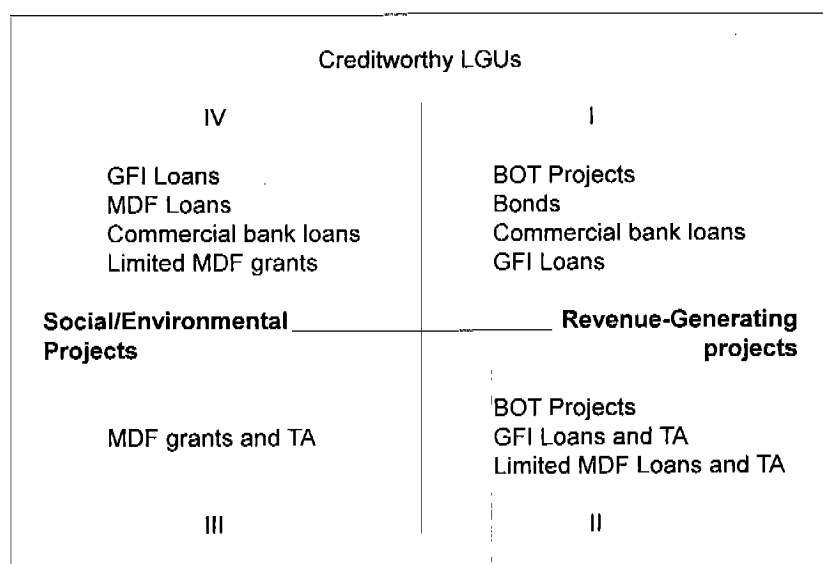
2. Cofinancing schemes with the GFIs/MDF will be promoted.

Fig. 7.2 summarizes the new vision and credit policy and institutional framework for LGUs.

The first quadrant shows that creditworthy LGUs with revenue-generating projects must get financing from commercial banks, GFIs (that can cofinance with commercial banks), BOT arrangements and the bond market. The rationale is clear: revenue-generating projects of creditworthy LGUs can be funded mostly from private sources of capital.

The second quadrant shows that marginal or non-creditworthy LGUs with revenue-generating projects may get funding from BOT arrangements, GFI loans with technical assistance, and limited MDF loans and technical assistance. The key element here is the revenue-generating nature of LGU projects. With viable and sustainable projects, the LGU may

**Figure 7.2**  
**NEW VISION AND POLICY/INSTITUTIONAL FRAMEWORK**



qualify for BOT schemes, and GFI or MDF loans with technical assistance grants from the latter two to improve their creditworthiness.

In the third quadrant, the marginal or non-creditworthy LGUs with social/environmental projects must rely on MDF grants and technical assistance. The LGUs are not credit-worthy and their projects do not yield the necessary revenues to repay a loan, hence, the reliance on MDF or on national government grants.

In the fourth quadrant, the creditworthy LGUs with social/environmental projects will tap the GFI, MDF and, if possible, commercial banks and receive limited MDF or national government grants.

## **THE NEXT STEPS<sup>75</sup>**

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The following are recommended to fulfill the new vision and the credit policy and institutional framework.

1. *Promote LGUs' use of BOT arrangements by coordinating and pursuing the government's overall efforts through the Coordinating Council for Philippine Assistance Program (CPAP)-BOT Center. This will include activities that will:*
  - (i) develop project pipeline for BOT financing;
  - (ii) develop market-oriented financing techniques to reduce BOT projects' risks and guarantees;
  - (iii) determine the feasibility of an "equity fund" for infrastructure projects;
  - (iv) promote educational campaign for BOT projects; and
  - (v) assist in arranging financing for LGU-BOT projects.

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<sup>75</sup> See Annex Table A7.1 for actions to be undertaken immediately.



2. *Develop the LGU bond market. To do this, the following must be done:*
  - (i) review the tax treatment of LGU bonds;
  - (ii) streamline the regulations and procedures for LGU bond issuance and marketing; and
  - (iii) help set up a credit rating agency and rating mechanism for LGUs/bonds.
3. *Promote LGU access to private banks. To do this, the following are necessary:*
  - (i) allow LGUs to deposit funds in accredited private commercial banks;
  - (ii) provide IRA intercept provision to GFIs and accredited private commercial banks;
  - (iii) improve and make available to banks and other private lenders information on the financial condition of LGUs; and
  - (iv) address the issue of mitigating political risks.
4. *Optimize the involvement of GFIs in LGU financing. The following must be done:*
  - (i) continue the market orientation of interest rate policy;
  - (ii) adopt a scheme so that the most creditworthy LGUs can eventually graduate to private credit markets;
  - (iii) develop co-financing schemes or adopt a project referral system with private commercial banks;
  - (iv) improve LGUs' creditworthiness through limited technical assistance; and
  - (v) coordinate LGU credit programs with MDF and the private commercial banks.
5. *Restructure and reorient the MDF. This calls for the following actions:*
  - (i) develop a new policy framework for MDF for its

- new role of helping build the creditworthiness of LGUs;
  - (ii) delineate the core functions of the new MDF;
  - (iii) develop an implementation plan for the new MDF;
  - (iv) strengthen the capacity of the new MDF; and
  - (v) encourage co-financing with private commercial banks.
6. *Improve the capacity of LGUs to raise own revenues. These must be done:*
- (i) improve the monitoring of LGUs' revenues and expenditures;
  - (ii) intensify training and supervision of local finance officials;
  - (iii) review/revise real property taxation rules and procedures; and
  - (iv) propose amendments to the Code to strengthen local treasury operations.
7. *Tap ODA technical assistance and financing.<sup>76</sup> The following can be undertaken:*
- (i) prepare LGU projects that are eligible for BOT arrangements;
  - (ii) help develop LGU bond market;
  - (iii) strengthen MDF as mechanism to target grants and long-term credits for marginal or non-creditworthy LGUs and/or social/environmental projects;

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<sup>76</sup> Some examples are the World Bank's assistance to the Local Government Academy for the LGUs' capacity building, the technical assistance to MDF; the ADB's assistance to capital market development, the creation of regional/national credit rating agency; and USAID's funding and technical assistance to the BOT Center.

- (iv) support training and capacity-building programs for LGUs to enhance their creditworthiness and revenue-generation activities;
  - (v) promote innovative, LGU-implemented projects and encourage greater LGU participation in national government-sponsored projects; and
  - (vi) support activities to gather and disseminate information on LGUs to facilitate lending and targeting of projects.
8. *Support new LGU financing initiatives including the LGU Infrastructure Fund through the:*
- (i) development of a secondary market for LGU financial instruments.

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**ANNEX 1**

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**LIST OF LGU RESPONDENTS**

LGU	A. High Income LGUs	B. Middle Income LGUs	C. Low Income LGUs
PROVINCE	Davao del Norte Palawan Bohol	Southern Leyte Aklan Ilocos Norte	
CITY	General Santos Mandaue Bacolod	Legazpi Ozamis	Dapitan
MUNICIPALITY	Digos, Davao del Sur Muntinlupa Tarlac, Tarlac	Kalibo, Aklan Malaybalay, Bukidnon ( ;	Hilongos, Leyte Aborlan, Palawan Mambajao, Camiguin Polanco, Zamboanga del Norte Binalbagan, Negros Occidental

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**ANNEX 2**

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## **RESOURCES GENERATED AND EXPENDED SCHEDULE**

	Local Resources before Economic Enterprises and External Flows
	Resources Generated:
1	Real Property Tax
2	Local Taxes
3	Local Licenses and Fees
4	TOTAL TAX REVENUE
5	Add: Internal Revenue Allotment
6	TOTAL LOCAL RESOURCES
	Less: Resource Expended: Local
7	General Administration
8	Government Finance
9	Adjudication
10	Protective Service
11	Social Improvement
13	TOTAL EXPENDITURE
14	NET RESOURCES BEFORE ECONOMIC ENTERPRISES AND INVESTMENTS
15	Add: Resources from Economic Enterprises
	Government Business Operations
16	Income from Investments/Interests
17	TOTAL
	Less: Expenses for Economic Services
18	Operation of Economic Enterprises
19	Net Resources from Economic Enterprises and Investments

20	NET RESOURCES AFTER ECONOMIC ENTERPRISES AND INVESTMENTS
	Add: External Resource Generation
21	Specific Tax Allotments
22	Loans and Borrowings
23	National Aids
24	Sale of Assets
25	Share in Excess of SEF Collection
26	Aids from Municipalities/Cities/Provinces
27	Aids and Contributions
28	Inter-fund Transfer
29	Current Surplus Adjustments
30	Others
31	Total External Resource Generation
32	NET RESOURCES WITH EXTERNAL INFLOWS
	Less: Financial and Capital Expenditures
33	Inter-Government Aids
34	Loans, Advances and Transfers
35	Debt Service
36	Real Property
37	Equipment
38	Others
39	Total Financial and Capital Expenditures
40	NET RESOURCE GENERATION

Source: Saldaña, 1992.

**ANNEX 3**

## **PREMIUMED (MDP III) PRE-IMPLEMENTATION ACTIVITIES**

State	Activities	CPO Requirements	CPO Output	LGU Requirements	Remarks
A. Prequalification	<p>(1) initial visit to qualified project centers (LGUs)</p> <p>(a) assessment of existing infrastructure</p> <p>(b) gathering and validation of necessary data for the preparation of the Pre-FS</p> <p>–Income and Expenditure</p> <p>–Simplified Project Screening and Prioritization</p> <p>(c) assessment of technical capability</p>	<p>(1) Letter of Intent from the Mayor</p> <p>(2) SP/SB Resolution availing/endorsing the project for financial assistance</p>	<p>(1) <i>Aide Memoire</i></p> <p>(2) Back-to-Office Report –original copy to Assistant Project Director (APD) for comments –3 copies</p> <p>(a) Financial, Economic Evaluation Section (FEES)</p> <p>(b) Planning and Design Evaluation Section (PDES)</p> <p>(c) Executive Staff</p>	<p>(1) Inform LGUs to prepare/accomplish the following:</p> <p>(a) 1st public hearing on the proposed project</p> <p>(b) Regional Development Council (RDC), Provincial Development Council (PDC) Endorsement</p> <p>(c) RDC/SB Resolution authorizing DOF thru BLGF to withhold IRA in case of default in payment of amortization</p>	Telegram to inform initial visit by CPO

State	Activities	CPO Requirements	CPO Output	LGU Requirements	Remarks
	<p>(d) orientation to LGUs/ <i>Sangguniang Panlalawigan</i> (SP) <i>Sangguniang Bayan</i> (SB) session on the program if necessary</p> <p>(2) preparation of the Pre-Feasibility Study (FS)</p> <p>(3) briefing of LGUs by CPO</p>		<p>(3) Pre-Feasibility Study Letter of Prequalification</p> <p>(4) Minutes/Results of the briefing</p>	<p>(d) SP/SB Resolution authorizing the Mayor to negotiate/enter into contract with PREMIUMED</p> <p>(e) Survey on "willingness" and resolution from the end-users of the project</p> <p>(f) Issuance of Ordinance based on proposed break-even rate</p> <p>(2) Preparation of the Feasibility Study based on CPO outline and cost</p>	<p>Telegram to inform briefing</p> <p>Distribution of FS outline –Main Report –Sectoral Report Deadline of Submission</p>
B. Project Preparation	<p>(1) review of submitted Feasibility Study by LGU –institutional –technical</p>	SP/SB Resolution endorsing the projects for financial assistance	(1) Comments/suggestions/recommendations in memo form to APD thru J. Gregorio	(1) Attachments to FS: –result of the 1st public hearing	As per result of review



State	Activities	CPO Requirements	CPO Output	LGU Requirements	Remarks
	<ul style="list-style-type: none"> <li>-financial</li> <li>-economic</li> <li>-environmental</li> <li>-structure plan</li> <li>-maps and plans</li> </ul> <p>(2) 2nd visit if necessary</p>	<p>Result of the 1st public hearing</p> <p>Result of the survey on the end-users "willingness"</p> <p>PDC/RDC endorsement</p>	<p>(2) Executive Summary preparation</p>	<p>-survey on "willingness" resolution from the end-users of the project</p> <p>-PDC/RDC endorsement</p> <p>(2) Inform LGUs to prepare/ conduct the following: -authorizing Mayor to enter into agreement/contract with PREMIUMED</p>	
C. Appraisal	<p>(1) conduct appraisal</p> <p>(2) prepare PSC resolution</p> <p>(3) prepare Preliminary Evaluation for DOF</p> <p>(4) prepare the Sub-Project Appraisal Report (SPAR)</p> <p>(5) submit SPAR to WB/ WB consultant</p>	<p>SP/SB Resolution authorizing Mayor to enter into agreement/contract with PREMIUMED</p>	<p>(1) Comments/suggestions/recommendations in memo form to APD</p> <p>(2) Project Steering Committee Resolution</p> <p>(3) Preliminary Evaluation based on LGUs loanable amount</p> <p>(4) SPAR</p>	<p>(1) 2nd public hearing on</p> <ul style="list-style-type: none"> <li>-project cost</li> <li>-increase in fees</li> </ul>	<p>Awaits for the PSC/ PGB approval</p> <p>Submission to BLGF-DOF</p> <p>For transmittal</p> <ul style="list-style-type: none"> <li>-World Bank</li> <li>-L. League</li> </ul>

State	Activities	CPO Requirements	CPO Output	LGU Requirements	Remarks
	(6) prepare Sub-loan Agreement (SLA) Sub-project Agreement (SPA)		(5) Finalization of SPAR based on comments  (6) Sub-project and Sub-loan Agreements		(all comments must be complied with)
D. Signing of Agreements	(1) Briefing of LGUs on the agreements	(2) SP/SB Resolution on the public hearing	(1) Signed Re-Lending Agreements	(1) 3rd public hearing on the cost and fees to be increased based on approved: -SPAR -SLA -SPA  (2) issuance of Ordinance  (3) SP/SB Resolution authorizing DOF thru BLGF to withhold IRA in case of default payment of the amortization  (4) Signing of LGUs	

State	Activities	CPO Requirements	CPO Output	LGU Requirements	Remarks
E. Approval	(1) Signing of the SPA/SLA by respective Secretaries	(1) SP/B Resolution on the 3rd public hearing  (2) Ordinance on -IRA intercept -Proposed breakdown of fees	(1) Original SLA/SPA for transmittal to DOF	(1) Notarial Fee	Provide copies to LGUs, Regional/ District Office, Coordinator, Technical Planning and Evaluation Division (TPED)

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**ANNEX 4**

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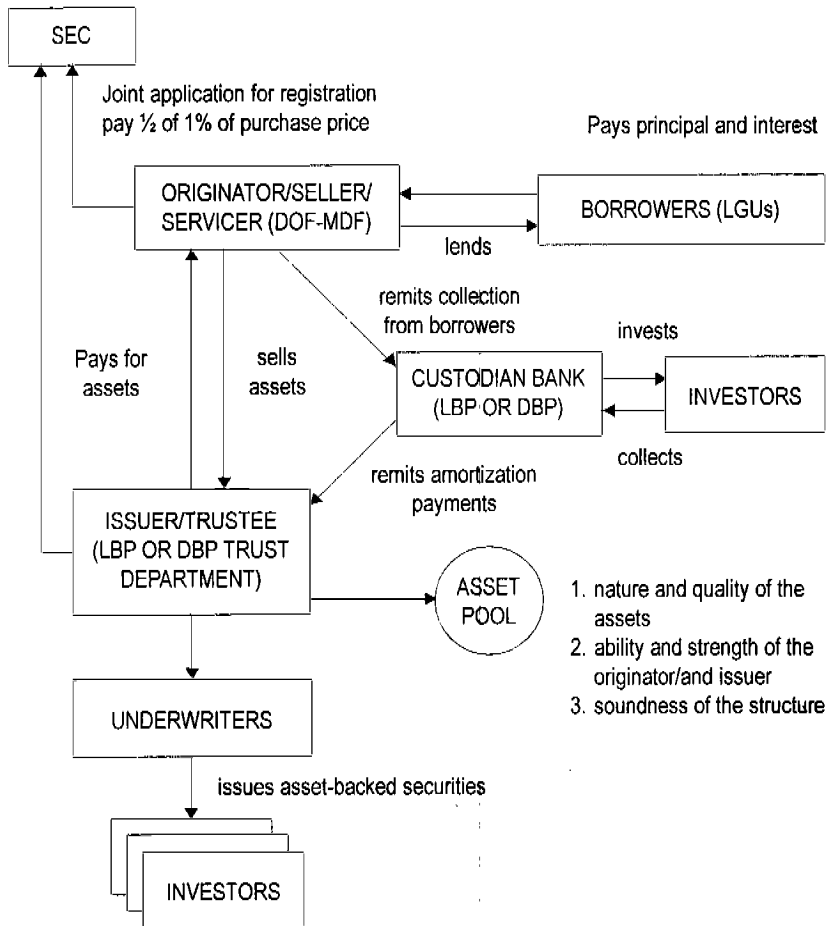
## PRIORITY PROVINCES

### PRESIDENTIAL COMMISSION TO FIGHT POVERTY

REGION	PROVINCES
CAR	Abra* Benguet* Ifugao* Kalinga Apayao* Mt. Province*
Region II	Batanes*
Region IV	Romblon* Aurora*
Region V	Masbate*
Region VI	Antique* Capiz Guimaras*
Region VII	Negros Oriental
Region VIII	Eastern Samar* Leyte Southern Leyte* Biliran*
Region IX	Basilan* Sulu* Tawi-tawi* Zamboanga del Sur
Region X	Agusan del Sur*
Region XI	Surigao del Sur*
Region XII	Maguindanao North Cotabato

\* 19 Priority Provinces

# SECURITIZATION OF MDF



## SECURITIZATION OF LOANS GRANTED THROUGH THE MDF

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*by Cesar Parlade, SGV*

- *The Concept*

Securitization is the process by which a lending institution's assets are bundled, removed from the balance sheet and are funded instead by investors who purchase a negotiable financial instrument evidencing the asset-backed indebtedness. Each investor is secured by a share in all the original assets in proportion to his investment.

Securitized deals closed since May 1992 total P1.35 billion. These include three public issues originated and offered by Citibank, N.A. and one private placement offering which was originated by the HDMF/Pag-ibig funds and underwritten by PNB.

Illustration on page 216 shows how securitization of MDF can be done.

- *Objectives/Benefits*

1. To offer an LGU-related debt instrument that employs a credit-enhancement mechanism involving the spreading of the risk of various LGU loans as a way to prepare the private capital market for direct LGU lending.
2. To partially liquify resources in preparation for MDF's bigger role in encouraging LGU credit financing, as may be recommended by the PIDS study.
3. To increase the amount of available funding to meet the large demand of LGUs for debt capital in the meantime that legal, policy, and institutional issues have not been resolved.
4. To create a benchmark for longer-dated debt issuances and pave the way for the establishment of the 3-7 year segment of the yield curve.

5. To allow for experimentation that can possibly enhance the broader framework of the PIDS study by providing specific, concrete, and practical inputs to it.
6. To offer an alternative investment vehicle to foreign and domestic investors that want to diversity out of equity issuances during the bear market.
7. If the issue will be rated by CIBI, pave the way for the emergence of a secondary market for domestic bonds.

## **THE MDF CREDIT DELIVERY SYSTEM**

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### **INTRODUCTION**

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The Municipal Development Fund (MDF) has served for more than a decade as a fund channelling system of foreign assistance to LGUs in the form of project loans, technical or commodity assistance or grants or other incentives. Its formal creation was an attempt by the National Government in the mid-1980's to synchronize and consolidate the fragmented borrowing and grant system to LGUs. The MDF was established to also provide a means of monitoring the fund distribution, whether on loan or grant basis, which may eventually lead to the national system of allocation.

The MDF started in 1981 with a single World Bank-assisted project, i.e., the Regional Cities Development Project (RCDP). From thereon, 14 other foreign-assisted projects followed. The donors/creditors include the World Bank, USAID, ADB, OECF, Spanish Government, and Korean Eximbank, thus, pooling enough resources to make the MDF as the principal conduit mechanism for channeling foreign assistance fund to LGUs.

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### **ORGANIZATION OF THE CREDIT DELIVERY SYSTEM**

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Credit delivery is basically undertaken by two institutional structures — the Central Project Offices (CPOs) and the Project Steering Committees (PSCs) which are located in the lead agencies of the MDF projects. The MDF is administered



by the Bureau of Local Government Finance (BLGF) of the Department of Finance (DOF).

The CPOs and the PSCs are steered by a Policy Governing Board (MDF-PGB) which is composed of undersecretaries of five National Government Agencies namely, the Department of Finance (who acts as presiding chairman), the Department of Interior and Local Government (DILG), the Department of Budget and Management (DBM), the Department of Public Works and Highways (DPWH) and the National Economic and Development Authority (NEDA). The broad policy guidelines are in the form of resolutions issued by MDF-PGB based on meeting discussions held once every quarter and occasionally conducted when problems requiring immediate attention arises.

Each project has a Central Project Office (or its equivalent) headed by a Project Manager. It is principally in charge of technical preparations for project executions. The responsibilities of the CPO include the following:

- prequalify LGUs/Project Cities to receive funds and/or assistance under the program;
- assist the Implementing Agencies and LGUs/Project Cities in the preparation of their overall plans and physical programs and the fiscal measures required to meet their development proposals;
- appraise/evaluate projects and project revisions of reprogramming proposed by the Implementing Agencies and LGUs/Project Cities for funding purposes and submit corresponding recommendations to the Project Steering Committee for approval;
- prepare/review annual budgetary proposals and cash flow requirements of the implementing Agencies and LGUs/Project Cities and prepare appropriate recommendations or actions thereon;

- advise LGUs/Project Cities on problems of implementation and establish linkages with other local and national government agencies;
- organize training program for LGU/Project City staff;
- review/evaluate impact of projects and with the assistance of the Implementing Agencies, LGUs/Project Cities, prepare evaluation and other terminal reports for submission to the Project Steering Committee; and
- consolidate the various reports submitted by the Implementing Agencies and LGUs/Project Cities for submission to the MDF.

An interagency Steering Committee normally exists to guide the CPOs.

Day-to-day activities are performed by the MDF Administrator who is concurrently held by the BLGF Executive Director. The Administrator takes care of financing activities that includes the consolidation of individual projects into an MDF Budget, fund releasing, financial reporting, replenishment of disbursement through special accounts, recovery of sub-loans and to a limited extent, cash management. As Executive Director of the BLGF, she/he takes keen attention on financial evaluation of projects presented for funding because the DOF approves all sub-loan agreements. The Administrator is regularly supported by the Special Projects Management Service (SPMS). The SPMS is composed of four divisions namely, the Plans and Programs Division, the Project Execution Division, the Project Monitoring and Evaluation Division and Central Fund Management Division.

The CPOs, PSC, and MDF maintain close coordination through meetings, consultations and establishment of regular liaisons. Normally, the PSC meetings are easily converted to MDF-PGB meetings because these bodies have almost identical representatives.

## CREDIT PROCESSES

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The Projects under the MDF began to vary recently such as the health project called "Urban Health and Nutrition Program." The discussions, however, focuses on the infrastructure projects under the WB-assisted MDP 1, 2 & 3, which can be considered typical for MDF in the 1980s and early 1990s.

## PROJECT APPLICATION AND APPROVAL

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LGUs regularly apply for loans and grants. This is initiated through a formal application by the LGU to the CPO. The CPO responds by briefing the LGU on the program concept and project requirements. At the same time, an evaluation of financial capacities and other LGU characteristics are conducted to assess creditworthiness of the LGU. If there are substantive reasons to accept the request for assistance, the LGU is properly informed. Shown below are the criteria for LGU participation.

1. Urban population of 10,000 with population growth rate of at least the national average;
2. High incidence of adverse environmental conditions and infrastructure deficiencies;
3. Substantial concentration of people with per capita income below urban poverty threshold;
4. An annual income of at least P3M over the last three years and should have the capacity to contribute the required equity;
5. Prepared to establish a project office with full-time staff;
6. Prepared to commit a package of fiscal and management reform required for effective project executions and debt servicing; and

7. Endorsement by the Regional Development Council (RDC) and where applicable, by the Provincial Development Council (PDC).

As the LGU confirms interest to participate, they shall organize a Local Advisory Committee and counterpart staff. A detailed engineering design, feasibility study shall be prepared with assistance from CPO. The LGU shall further secure the routinary clearance from Regional Councils and package for final appraisal of the CPO. While the CPO evaluates the project, it is apparently not as tedious as it looks because of the preliminary inputs provided by the CPOs during the details feasibility study stage. The submission, once completed with reasonable detail, enables the CPO to prepare the on-lending agreement for approval of the Steering Committee.

## **BUDGETING**

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- *The Process, Problems, and Issues*

The CPOs submit their budgetary requirements for each calendar year to the BLGF for consolidation into a single MDF budget. The MDF budget is submitted to the DBM and eventually to Congress for approval. This budget is subject to the DOF budgetary ceiling.

In 1992, the MDF was taken out of the DOF ceiling and was placed under the Assistance to Local Government Units (ALGU).

As soon as the General Appropriations Act is passed by Congress and the MDF allocation is determined, the BLGF requires CPOs to submit an annual Work and Financial Plan and monthly allocation. Since the MDF budget is always less than the CPO requirements, the BLGF-MDF predictably calls for a budget allocation workshop composed of the MDF staff and the different CPOs. The consultation determines

indicative CPO allocation for the calendar year and becomes the basis for the DBM in issuing the Advice of Allotment (AA) and the Notice of Cash Allocation (NCA).

## FUND RELEASING

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Fund releasing of the first generation fund can be categorized into three cases depending on who the borrowers and beneficiaries are. Considering that the different CPOs have submitted their respective proposals, the DOF/BLGF/MDF have consolidated the budgets and DBM/Congress have allocated funds in the GAA, the procedures are as follows:

*Case 1:* National Government borrows for the LGUs (the beneficiaries).

1. Based on the approved Work and Financial Plan, the DBM shall release the AA and the corresponding NFWI to the DOF/BLGF/CFMD, copy furnished the Bureau of Treasury. Simultaneously, it shall issue and deposit the Funding Warrant to the Current Account (CA) of CFMD.
2. Based on the AA and NFWI, DOF/BLGF/CFMD shall obligate and liquidate the allotment received for transfer to the Municipal Development Fund. CFMD shall request its servicing bank to transfer so much amount deemed needed from its Current Account (CA) to the current account of MDF Revolving Fund which amount shall be covered by a Request for Obligation of Allotment (ROA).
3. In accordance with the on-lending/memorandum of agreement and the AA, the MDF shall release funds to the LGUs/Project Cities in the form of cash advance.
  - 3.1 The MDF, at the start of the implementation of NDS, shall automatically release to the LGUs/

Project Cities their three months cash requirement five days before the start of each operating month.

- 3.2 The fourth and succeeding months requirement shall be released only upon proper liquidation of at least 50% of the amount received, or as loan/on-lending agreements; or upon the satisfaction of project completion requirements.
4. The LGUs/Project Cities, through the treasurer shall, upon receipt of the checks/banks/bank credit advise deposit the same to their current account and record the amount received accordingly.

In case of money deposited for the account of a municipality, the Provincial Treasurer shall notify the Municipal Treasurer that such amount has been deposited to the project current account. The Municipal Treasurer shall record the amount accordingly.

*Case 2:* LGUs are borrowers through on-lending agreement with the DOF.

1. Based on the approved WFP, the DBM shall release the AA and the corresponding NFWI to the DOF/BLGF/CFMD. Simultaneously, it shall issue and deposit the funding warrant to the current account of CFMD.
2. Based on the AA and NFWI, DOF/BLGF/CFMD shall obligate and liquidate the allotments received for transfer to the MDF. It shall likewise request its servicing banks to transfer the amount deemed needed from its current account to the current account of the MDF revolving fund.
3. Based on the on-lending agreements, funds shall be released to the LGUs/Project Cities as loans.

4. At the start of the implementation of NDS, loans for the first three months shall be released automatically to the LGUs/Project Cities five days before the start of the operating month. Subsequent loan releases shall be made upon proper liquidation of at least 50% of the loaned amount, or as prescribed in the covering project/loan/on-lending agreements or upon satisfaction of project completion requirements.
5. Subsidiary ledgers shall be maintained for account 8-84-100 by the availing LGUs/Project Cities.
6. The LGUs/Project Cities, through the treasurer, shall upon receipt of the checks, deposit the same to the project current account and record the amount received accordingly.

In case of money deposited for the account of a municipality, the Provincial Treasurer shall notify the Municipal Treasurer that such amount has been deposited to the project current account. The Municipal Treasurer shall record the amount accordingly.

*Case 3:* Fund is released to NGA or to a Government Corporation as implementing agency.

1. DBM shall release the AA and the corresponding NFWI to DOF/BLGF/CFMD, copy furnished the IA. Simultaneously, it shall deposit the FW in favor of the DOF/BLGF/CFMD.
2. Based on the AA and NFWI, the DOF/BLGF/CFMD shall request LBP to effect the transfer of funds from Fund 102 to Fund 161 of MDF.
3. Based on the memorandum of agreement, funds shall be released to an NGA as implementing agency through commercial checks drawn in favor of each IA.
4. At the start of the implementation of NDS, MDF shall automatically release to the IA its three months cash

requirement five days before the start of each operating month. The fourth and succeeding months requirements shall be released only upon proper liquidation of at least 50% of the amount received, or as prescribed in the covering project/loan/on-lending agreements, or upon the satisfaction of the project completion requirements.

5. The DOF/BLGF/CFMD shall treat the amount as a direct expense while the IA shall take the same as trust liability.

Upon completion of the Project, unexpended balance of the trust funds shall be refunded by the IA to DOF/BLGF/CFMD by issuing a commercial check.

#### **REPLENISHMENT WITH FOREIGN LENDING INSTITUTION**

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Replenishment with foreign lending institution is undertaken following these procedures:

1. IA/PC/LGU – submit to CPO the necessary documents of application for replenishment.
2. CPO – evaluates, consolidates, and prepares application for replenishment and submits the same to BLGF/CFMD.
3. BLGF – reviews and examines validity of request and recommends for approval of the foreign lending institution.  
– submits to the Undersecretary-DOF for signature of the application.  
– submits application for replenishment to foreign lending institution.
4. IBRD-WB/ADB/OECF – evaluates application for replenishment of loan proceeds.



- approves application and remits corresponding amount of replenishment of loan proceeds to CBP.
- 5. CBP
  - receipt of loan proceeds replenishment credited to the Special Account of MDF and issues corresponding credit advice to BTr.
- 6. BTr
  - issues certification that funds are deposited to the Special Account with CBP.
- 7. BLGF
  - notifies CPO and furnishes copy of certification and credit advice.
  - transmits to DBM-BTr Certification and BLGF letter-request for issuance of funding warrant.
- 8. DBM
  - processes request and releases fund corresponding to the peso equivalent of the loan proceeds replenishment (repeat fund release procedure).

## **OPTIONS IN REFORMING THE MDF**

### **OPTION 1: CONVERT MDF INTO A SEMI-AUTONOMOUS FINANCIAL INSTITUTION**

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- *Concept*

The MDF can play a key role in facilitating LGUs' access to the capital markets. However, it requires changes in the mission and organizational set-up of MDF. At present, the MDF's mission is to provide credit to LGUs that need additional external funds to finance development projects but cannot access the private capital markets. The present MDF is structured to run projects, rather than to perform functions essential for a credit institution. Separately funded projects have their respective Project Steering Committees (PSC) and Central Project Offices (CPOs), which use their own evaluation criteria and approval processes. The evaluation focuses on the technical and financial feasibility of the projects to be financed, less on the overall creditworthiness of the prospective borrower. Although the MDF approves loan applications, it plays very little role in evaluating such applications. There is, therefore, a need to introduce institutional and organizational changes to the MDF.

Under this option, it is envisioned that the MDF be transformed into a semi-autonomous financial institution whose mission is to improve LGUs' access to the private capital

markets. This is a departure from the present mission of the MDF mentioned above, in the sense that it urges the MDF to take a proactive role in improving LGUs' access to the capital markets, which should be incorporated in the design of MDF's credit program. Since the MDF will be assuming greater responsibility in the municipal credit system, it is necessary that it be separated from the BLGF and organized as a distinct unit within the Department of Finance. It will not be a completely autonomous organization like GFIs which have their corporate character, but it will have greater autonomy with respect to credit decisions. In this regard, all functions of the CPOs and PSCs should be centralized in this new MDF.

Viewed in this context, the MDF should be organized as a temporary institution intended to fill some gaps in the municipal credit system. Its role in the municipal credit system will diminish over time as more LGUs migrate to the private capital markets or to GFIs. Thus, its performance should be assessed in terms of how many LGUs successfully graduate into the private capital markets. Given the expected long-term impact of the MDF on LGUs' access to the private capital markets, it is recommended that MDF's performance be assessed every five years and determine from the results of the assessments whether MDF should continue or not.

- *Core Functions*

It is proposed that the MDF perform the following three core functions.

*Project and Loan Appraisal.* For the MDF to act like a real lending institution, it must perform both project and loan appraisal functions and assess creditworthiness of LGUs, similar to what ordinary lending institutions do. A substantial part of what PSCs and CPOs currently do should be transferred to the MDF.

*Resource Mobilization and Management.* This function pertains to funds mobilization for on-lending purposes, loan disbursement, and loan collection functions. As part of its loan collection functions, the MDF must monitor not only the projects being financed but also the overall finances of the borrowing LGUs. Most of these functions are currently done by the Special Projects Management Service (SPMS), which is directly under the MDF Administrator. The MDF may use GFIs and private financial institutions for loan disbursement and collection.

*Technical Assistance.* The technical assistance envisioned here is one that enhances LGUs' creditworthiness. It is not enough that a borrowing LGU has sufficient acceptable collateral that backs up its loans. More importantly, the LGU must be able to demonstrate that it is following sound financial management practices. First of all, the LGU must be able to do financial analysis, forecasting, planning and programming. Lenders would like to know past financial performance of the LGU and its financial picture in the future with or without additional debt.

Second, the borrowing LGU must be able to demonstrate that it is exerting efforts to raise local revenues.<sup>1</sup> One way of raising local revenue is to impose user charges on publicly provided services. The principle of imposing user charges is well known, that is, to the extent benefits of those services can accrue specifically to individual citizens, properties or businesses, the appropriate policy is to charge the beneficiaries directly. Charges should be levied at a level that will recover the cost. If charges are below the recovery-cost level, subsidies, will again be required and this is considered inconsistent with sound financial management. The imposition of user charges

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<sup>1</sup> The finding in Chapter III that shows that increases in IRA had a negative effect on local tax effort at all levels of government in 1992 and 1993 must be avoided by LGUs to improve their creditworthiness.

on publicly provided services by LGUs should be applied not only to loan-financed projects but also to internally financed projects.

Another way of raising local revenue is to improve the general tax effort of LGUs. Many LGUs have not exerted enough effort to tap existing tax potential, not because of unwillingness to do so but simply because they do not know that such potential exists and/or how to tap it. Some loan-financed projects may yield additional tax potential, which must be captured by the LGU.

LGUs must have the capacities to design and implement some methods of raising revenues. Although the actual preparation of detailed project feasibility may be outsourced, still LGUs need to develop capacities for: (i) identifying development projects, (ii) project preparation and management of loan finance, and (iii) assessing results of feasibility studies.

The MDF must be able to supply technical assistance to develop LGUs' capacities along the lines mentioned above.

As suggested earlier, the government grant system should be isolated from the credit system. Ideally, therefore, these two functions should be performed by two separate institutions. However, the MDF may be designated by the government as a financial manager of the grant funds, mainly providing accounting, bookkeeping, and grant disbursement services for a fee. It should be clear that it is not an essential function of the MDF; hence, it should be considered an off-book activity of the MDF.

- *Mechanisms for Delivering Credit to LGUs*

The mechanisms being proposed take into account the MDF's new mission of the MDF, which is to improve LGUs' access to the capital markets.

There are two alternative approaches that the MDF may utilize in delivering credit to LGUs. One approach is for the MDF to serve as a second tier or wholesale lending institution.

This approach has two variants. In the first, the MDF grants long-term block loans to participating PFIs which, in turn, on-lend them in smaller amounts to several LGUs.<sup>2</sup> The MDF may require PFIs to shoulder a certain percentage, some 15 to 25 percent, of the individual loans to LGUs. A ceiling should be imposed on the MDF's individual loans to PFIs to prevent loan concentration to a few PFIs. A ceiling should also be imposed on PFIs' individual loans to LGUs to prevent the concentration of loans to a few LGUs. However, individual loans to LGUs financed entirely by PFI funds should not be subjected to the ceiling.

In the other variant, the MDF provides a rediscounting facility to PFIs that are lending to LGUs. For example, the MDF may rediscount up to 75 or 85 percent of the PFIs' loans to LGUs with the same maturity as the PFIs' loans to LGUs. However, the MDF must clearly lay down the eligibility criteria for tapping the rediscounting facility and stand ready to rediscount eligible loans of PFIs to LGUs. Again, the loan ceilings as discussed above apply. This second variant is similar to FINDETER's scheme.

These two variants are actually similar in the following areas: (i) PFIs are responsible for credit evaluation, approval, disbursement and collection; (ii) PFIs assume the credit risk for their loans to LGUs whereas MDF's risk exposure is limited to its loans to PFIs; and (iii) PFIs' own funds augment MDF's funds. Where they differ is the way MDF provides additional liquidity to PFIs. In the first variant, PFIs first receive block loans from the MDF before they lend to LGUs, whereas in the second variant, PFIs first lend to LGUs and later rediscount the loans with the MDF. In the latter, PFIs may not rediscount all or some of their loans to LGUs

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<sup>2</sup> The MDF may place Special Time Deposit (STD) with accredited PFIs. Ideally, STD should not be subject to the reserve requirement ratio applied to deposits.

with the MDF, depending on their need for additional liquidity.<sup>3</sup>

Wholesale lending is not new in the Philippines. In fact, an important objective of the government financial sector reforms introduced in the second half of the 1980s was for the GFIs to shift from retail lending to wholesale lending. As a result, wholesale loans of the DBP and LBP now consist of about three-quarters of their total loan portfolios.

The second approach is for the MDF to do retail lending, i.e., lend directly to LGUs. This has two variants. One is retail lending with cofinancing with PFIs. The cofinancing shares between the MDF and PFIs may vary on a case-to-case basis, and the risk is proportionately shared. The MDF and PFIs will jointly conduct the project and loan evaluation. However, the MDF may delegate such responsibility to the PFIs. Loan disbursement and collection should be done by PFIs because they have clear comparative advantage in these activities.

The other is straight retail lending without cofinancing with PFIs, which is what the MDF currently does. Under this scheme, the MDF does project and credit evaluation, loan disbursement and collection, and completely assumes the risk in lending to LGUs. Clearly, private lending institutions have no participation if the MDF goes into straight retail lending. However, the crucial role of the MDF in doing retail lending is to enhance the creditworthiness of LGUs so that later on, they can have access to the private capital markets.

The four mechanisms in lending to LGUs are summarized in Fig. A6.1. All four mechanisms assume that barriers to building a good relationship between private banks and LGUs have been eliminated and that some of the risks associated with lending to LGUs have been reduced.

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<sup>3</sup> This is similar to the rediscounting facility which the Bangko Sentral ng Pilipinas provides to banks, except that the tenor is short.

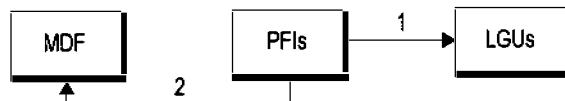
**Figure A6.1**  
**MECHANISMS FOR LENDING TO**

**A. Wholesale Lending**

1. Block Loans

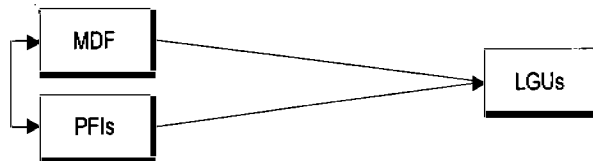


2. Rediscounting



**B. Retail Lending**

3. Retail Lending with Cofinancing



4. Straight Retail Lending



Risk Exposure to LGU Credit

PFIs

PFIs

MDF and PFIs  
(proportionately)

MDF



Each of these mechanisms has its own advantages and disadvantages. In both types of wholesale lending mechanisms, the MDF can achieve some economies of scale and reduce its transaction costs and risk. It can focus on the provision of technical assistance to LGUs and resource mobilization and give less emphasis to its credit function because this can be done by PFIs. Participation of PFIs is maximized, and with PFIs' nationwide branching network, the MDF does not have to establish branches in several parts of the country. A major disadvantage of this approach is that the MDF will be completely dependent on PFIs for its lending program to LGUs. If PFIs do not wish to lend to LGUs for some reason, then the MDF as a lending institution solely for LGUs will be completely useless.

There are some advantages if the MDF goes for retail lending with cofinancing. One is that it immediately involves the PFIs in lending to LGUs in a more flexible manner (i.e., PFIs can choose the amount of their participation in a loan), reducing the MDF's risk exposure while increasing the loanable funds for LGUs. The other advantage is that the MDF can save on transaction costs if PFIs voluntarily do the project and credit evaluation, loan disbursement and loan collection. However, this scheme has the same disadvantages as those of wholesale lending schemes.

In retail lending, the MDF has complete control over the delivery of credit to qualified LGUs. To be able to do this, the MDF must have the capacity to perform all the three core functions described above. However, this approach has several disadvantages. The MDF will incur higher transaction cost and face higher risk for its loans to LGUs. One glaring disadvantage of this approach is that it will not immediately involve PFIs in LGU lending, although in the long-run it may lead to the improvement in LGUs' creditworthiness, which is important in increasing their access to the private capital markets. Another disadvantage is that the funds for

LGU lending will be smaller than in the first three approaches because of the lack of participation of PFIs.

Given the present situation and the scenario in the next few years, private sector lending to LGUs will most likely be very limited and will mostly focus on large LGUs even if most of the barriers to developing a good relationship between private banks and LGUs relationship are removed. This is because it will take some time for PFIs to familiarize themselves with LGU lending and also because many LGUs still need to shape up and improve their creditworthiness to private banks. **It is therefore necessary that the MDF take a more flexible approach, by concentrating on retail lending, if possible with cofinancing with PFIs, without necessarily closing the possibilities for doing wholesale lending to create a market for LGU credit. Over time, however, it should gradually increase the share of its wholesale loan in its total loan portfolio.**

The manner of delivering technical services to LGUs will differ in these various schemes. For the two schemes under wholesale lending, PFIs may request the MDF to provide technical assistance to their prospective LGU borrowers and/or to assist them in evaluating development projects. In the case of the two schemes under retail lending, the MDF must provide technical assistance together with credit to improve LGUs' creditworthiness.

- *Graduation Program*

The gradual shift of the MDF from retail to wholesale lending is one of the mechanisms for graduating LGUs into the private capital markets. That is why it is important that the MDF adopt a program and a definite time frame for shifting the concentration of its loan portfolio from retail to wholesale loans. But even while its loan portfolio consists largely of retail loans, the MDF must shepherd LGUs to the capital markets by imposing a strict policy on the number of times an LGU is allowed to borrow from it and by aggressively

disseminating information about the creditworthiness of LGUs to potential private lenders. The government must evaluate the MDF's performance not only in terms of outreach but also in terms of how many LGUs it is able to shepherd to the private capital markets.

- *Resource Mobilization*

MDF lending operations are funded out of ODA and budgetary support. To the extent possible, the MDF should continue securing ODA in order to augment its loanable funds. Consistent with policy recommendation no. 8, the MDF should try to obtain an agreement with donors that will give it greater flexibility in allocating funds to LGU borrowers. The second-generation fund is another source of loanable funds for the MDF. In this regard, it is to the best interest of the MDF to maintain a high repayment rate so that it can have more funds for on-lending. Petersen (1993) suggested that any arrears incurred by LGUs should not be allowed to lapse for more than 30 days and that the MDF and DBM establish automatic mechanisms for enforcing the intercept. As much as possible, MDF should have no loan arrears in order to establish a foundation for private sector lending (Petersen 1993).

The legal framework that created the MDF has given it very limited powers to do financial intermediation in the domestic financial market. More specifically, it cannot mobilize deposits and, as a consequence, its loanable funds are limited to the amount contributed by donors and the national government and loan amortization. Therefore, it should explore other means of augmenting its loanable funds by tapping the domestic capital markets. One way is to sell outright its good accounts to private banks. This could help develop the secondary mortgage program. It may also explore securitization of MDF loans (Annex 5).

One way of increasing the loanable funds of the MDF is for the national government to issue five-year and seven-year

fixed rate LGU Notes (say P1 billion for each tenor every year for the next five years) using the current auction system for the five-year Treasury Notes.<sup>4</sup> As mentioned in Chapter II, there is already a market for these types of securities. The maturity of these notes could be lengthened as the market's appetite for long-term securities increases. Of course, these LGU Notes should be the liabilities of the national government. But payment for these bonds could come from loan proceeds of the MDF.

- *Loan Pricing*

The MDF should continue offering term loans to LGUs. The determination of the maturities of these loans should follow the current practice of MDF; that is, the MDF Policy Governing Board (PGB) issues a schedule showing maximum repayment periods per investment category based on the estimated average economic life of the project. Also, the MDF should comply fully with its policy of using a market-oriented interest rate on its loans because it is important both for graduating LGUs from government credit program to the private capital markets and for the sustainability of MDF.<sup>5</sup>

Currently, MDF charges a fixed rate on its term loans to LGUs. The MDF should allow LGUs to choose either fixed rate or a floating rate term loan, which is the current practice in the private credit market. LGUs that are attuned to these loan modalities will find little difficulty in shifting to the private capital markets.

In determining its lending rate, the MDF should recover cost (i.e., cost of funds and administrative cost) and add a certain margin. For the MDF's fixed-rate term loans, the appropriate benchmark rate should be the rate on the five-

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<sup>4</sup> This is similar to what the UK government does to raise funds for the Public Works Loan Board (see Chapter IV).

<sup>5</sup> It is pointless for the MDF to raise funds, for example, from the secondary mortgage market, if it lends at a rate lower than its borrowing rate.

year Treasury Notes, not the three-month weighted average interest rate on time deposits of 61 to 90 days as prescribed in Resolution No. 01-99-MDF of the MDF PGB.<sup>6</sup> For floating rate term loans, the MDF should use the 91-day Treasury bill rate.

The administrative cost it will incur for retail lending is expected to be higher than for wholesale lending. Such differential costs should be taken into account in pricing its loans.

- *Organizational Structure*

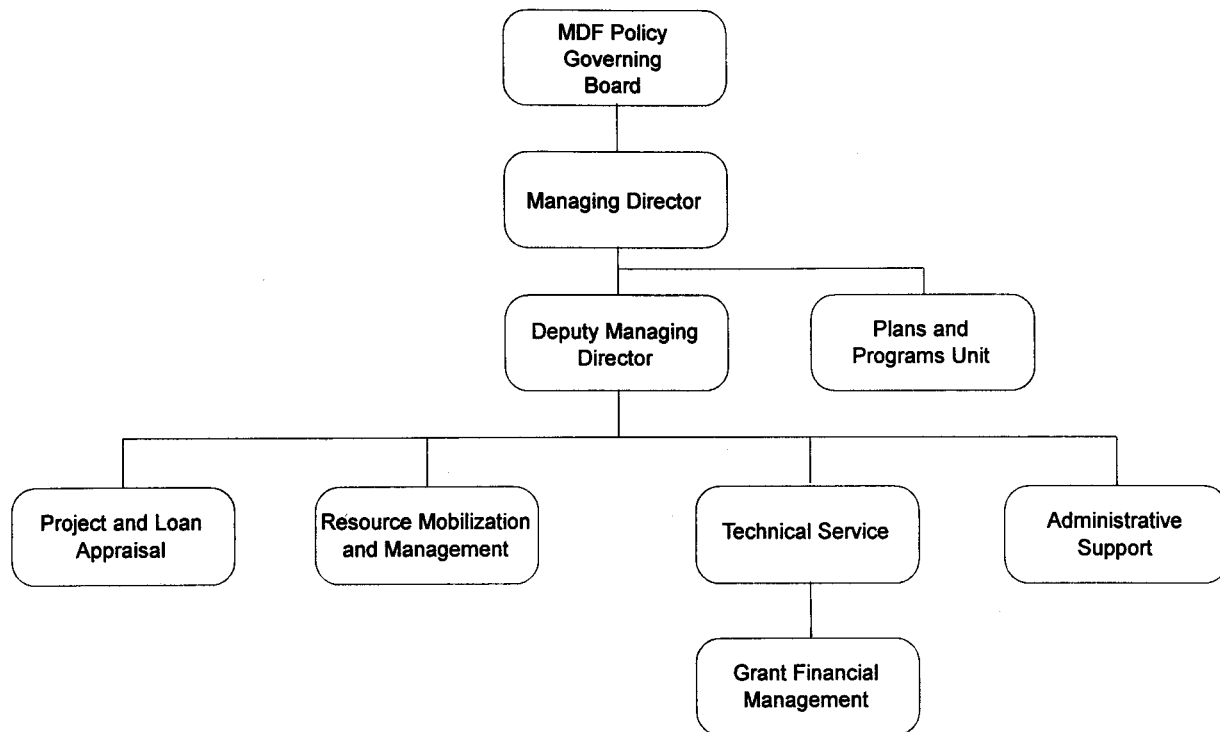
The proposed organizational structure of the new MDF follows the functions described above (Fig. A6.2). At the top is the PGB which performs functions similar to the present MDF PGB described in Chapter V. The board is a policy-making body which lays down policies on mobilization of funds and credit allocation. It should retain minimal operational functions, specifically appointment of MDF personnel and loan approval. However, it may delegate to the MDF management appointment of personnel up to a certain level and approval of LGU loans up to a certain size.

Unlike the present MDF PGB, the board of the new MDF shall have wider representation and shall be composed of the following: DOF undersecretary as chairperson; DBM undersecretary; DILG undersecretary; DPWH undersecretary; NEDA deputy director general; presidents of the DBP, LBP and PNB; a representative from banks; and a representative from LGUs. The inclusion of GFI representatives in the board is intended to improve coordination between the MDF and GFIs. The presence of a representative from banks will hopefully bring to the MDF private sector views on LGU

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<sup>6</sup> In the auction conducted on 9 September 1995, the yield on the five-year note was 14.75 percent while the three-month weighted average interest rate on time deposits of 61 to 90 days during the April-June 1995 period was 9.4 percent. Usually, the time deposit rates are lower than the Treasury bill rates for the same maturities.

**Figure A6.2**  
**PROPOSED ORGANIZATIONAL STRUCTURE OF THE MDF**



lending, enhance professionalism of the MDF as a lending institution, and ensure the MDF some degree of autonomy from the national government and political groupings.<sup>7</sup> This will also improve coordination between the MDF and private lending institutions. The LGU representative can bring to the MDF its clients' varying and changing credit demands so that the board can formulate policies that truly reflect the concerns of their clients.

The day-to-day affairs of the MDF shall be conducted by a management team, consisting of a managing director who reports directly to the board, deputy managing director and four managers. A small unit attached to the office of the managing director shall assist the managing director in formulating strategic plans and programs for the MDF. A manager shall be assigned to head each of the three core functional groupings. The fourth manager shall be assigned to head the administrative support group.

Some of the CPO and BLGF staff could be absorbed by any of the four functional groups depending on their present skills and potentials.

- *Required Capability Building*

The increased responsibilities of the new MDF will require corresponding capabilities. Some of these capabilities already exist within the CPOs and the MDF proper. However, they still have to be enhanced in view of the need for the MDF to function like a credit institution and to provide LGUs with technical assistance that could enhance their creditworthiness. This can be addressed partly by training the MDF staff and partly by recruiting qualified people, i.e., those who have sufficient background in credit evaluation and financial management.

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<sup>7</sup> As discussed in Chapter V, political and financial autonomy is one of the characteristics of a successful municipal credit institution.

- *Legal Implications*

The proposed modifications of the MDF can be worked out within the existing legal framework and, therefore, do not require any legislative action.

## **OPTION 2: A DEPARTMENT WITHIN A GFI**

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- *Concept*

This option involves the transfer of the MDF to an existing GFI and the creation of a department or window within said GFI that will provide credit solely to LGUs.<sup>8</sup> For easy reference, it shall be called LGU Credit Department of a GFI. This is similar to Colombia's Urban Development Fund (FFDU), a window within a mortgage bank, before it was converted into a self-standing institution now known as FINDETER.

The mission of this department is similar to that mentioned in Option 1. The GFI's clients should be those LGUs that are not being accommodated by other GFIs under their existing lending programs and need some assistance to improve their creditworthiness.

- *Core Functions*

The LGU Credit Department is expected to perform two core functions: project and loan appraisal and technical assistance.

Lending to LGUs is a highly specialized function because of the nature of development projects to be financed, the

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<sup>8</sup> The transfer of the administration of the Industrial Guarantee Loan Fund (IGLF) from the defunct Central Bank to the DBP can serve as an example. The IGLF was established in 1952 by the governments of the Philippines and the U.S. for the purpose of encouraging the establishment and expansion of economically sound small- and medium-scale industries. The Fund is owned by the national government represented by NEDA.



character of the borrower and the creditworthiness criteria that apply to LGUs. It therefore deserves to have a department within a GFI to carry out such function. However, the Department is expected to utilize existing resources of the GFI, specifically the regular credit department of the GFI, so that it needs only a small staff to do project and loan appraisal.

A major function of the LGU Credit Department is the provision of technical assistance to LGUs as described in Option 1. The department will probably not be able to draw resources from other departments within the GFI considering that none of the existing GFIs ever do this function presently. Therefore, it needs to develop its own capabilities to provide technical assistance to LGUs.

Resource mobilization and management function could be done by an existing department within a GFI that has already been doing such function. Therefore, there is no need for the department to duplicate the said function.

It is not the GFI's core function to administer the grant system. However, like the MDF in Option 1, it may be designated by the government as the financial manager of the grant system.

Aside from the two core functions discussed above that have to do with credit, the GFI may also provide some fee-based services to LGUs mentioned earlier.

- *Mechanisms for Delivering Credit to LGUs*

The GFI may do both wholesale and retail lending in the same manner described in Option 1 since some GFIs, specifically LBP and DBP, are already doing this for other credit programs. It is expected, however, that the GFI will do straight retail lending to LGUs initially, as the GFIs are currently doing when they lend to LGUs, hopefully with some cofinancing with PFIs, but that they will eventually shift toward wholesale lending.

The existing GFIs already have branches in most provinces of the country. The GFI chosen to carry out these

functions will, therefore, be accessible to many LGUs for retail loans.

- *Graduation Program*

The graduation program discussed in Option 1 applies here.

- *Resource Mobilization*

The lending program for LGUs to be managed by the Department can be funded initially out of the existing second-generation funds of the MDF. The GFI shall take care of collecting outstanding loans of the MDF, which can be used to beef up its loanable funds.

Aside from this, the GFI will have other sources of funding for its lending program to LGUs. As is being done by the MDF, the GFI may secure ODA from foreign donors for the purpose of augmenting its loanable funds.

Unlike the MDF, the GFI can mobilize deposits from surplus LGUs. Although most LGUs will probably prefer short-term deposit instruments, a few of them might want to place their surplus funds in medium- and long-term deposit instruments. Even if a large proportion of deposits mobilized by the GFI from LGUs are short-term, the GFI can nevertheless find room for doing term transformation.<sup>9</sup>

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<sup>9</sup> Under the Code, LGUs are permitted to extend loans (subsidies and grants) to other LGUs. During the survey, most LGUs do not see this to happen in the future. One of the major reasons is that LGUs are not lending institutions and, thus do not have the capability to assess creditworthiness of borrowing LGUs and to price the loans. Also, they do not have the means to monitor the borrower and collect the loan repayments. Politics is another deterrent factor because no local politician will ever approve a proposal to lend to other LGUs, especially if the borrowing LGUs are headed by politicians belonging to another political party, notwithstanding the merit of the loan request and the creditworthiness of the borrowing LGU. The neatest and most efficient means of transferring funds from surplus LGUs to deficit LGUs is through financial intermediaries or through the securities markets.

The GFI may issue medium and long-term "LGU bonds" in the domestic and/or international capital markets.<sup>10</sup> This method of raising funds increases the private sector's participation in financing development projects of LGUs.

As pointed out in Chapter II, there is already an emerging market for medium-term bonds in the domestic capital market, as demonstrated by the series of successful auction of five-year Treasury Notes conducted by the Bureau of the Treasury in the last six months and the successful sale of bonds made by a few LGUs since 1992. The appetite for long-term bonds will soon be developed by the market as the country continues to experience stable economic growth rates in the coming years. The GFI may adopt various modes of selling the "LGU bonds" to the public, but one of the most convenient way of doing it is to auction them through the existing auction system of the Bureau of the Treasury.

There is an ample room for the GFI to issue medium- and long-term bonds in the international capital markets. Some GFIs and private corporations have already tested this market since 1993 with favorable results. The recent return of the country to economic and political stability has prompted international credit rating agencies to upgrade the credit rating of the country. The credit rating of the country is expected to improve further in the coming years, which will be translated into reduced premium demanded by foreign investors on Philippine-issued securities.

The issuance of bonds by a GFI to finance credit to LGUs can address many of the problems the small but potentially creditworthy LGUs are facing in creating a market for their securities. *First*, the creditworthiness of most LGUs is not known to the general public due to the absence of a credit rating agency. It may take some time for this credit rating agency to be established and to operate viably. This is less of a

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<sup>10</sup> This is similar to what the Credit Local de France does (see Chapter IV).

problem to a GFI, which can even issue its own securities in the international credit market without government guarantee. *Second*, the GFI can issue bonds at larger amounts than individual LGUs do, thereby realizing some economies of scale. *Third*, under the Code, LGUs are allowed to issue bonds only to finance income-generating projects. This restriction does not apply to a GFI's bond issuance, the proceeds of which could be lent to LGUs that want to use them for financing non-revenue-generating development projects.

- *Distribution of Credit Risk*

The Memorandum of Agreement between NEDA and DBP effecting the transfer of the administration of the IGLI from the defunct Central Bank to the DBP can serve as a model for assigning risk. All foreign loans already contracted by the MDF and to be contracted by the GFI with donor agencies for the purpose of augmenting its loanable funds for LGUs shall remain the liability of the national government. The credit risk of all loans to LGUs made by the MDF before the transfer of the MDF to a GFI shall continue to be borne by the national government. However, credit risk of all loans granted by the GFI to either PFIs or directly to LGUs after said transfer shall be borne by the GFI.

It is preferable that the national government does not guarantee any bond issuance to be made by the GFI in the domestic or international capital markets to raise funds for LGU lending so as not to confer on it an undue advantage over the bonds issued by individual LGUs.

- *Loan Pricing*

The GFI should follow the same loan pricing policy as discussed in Option 1.

- *Organizational Structure*

As already mentioned, the GFI creates a separate department or window solely to provide a lending facility to

LGUs. Therefore, it does not need a separate structure like that outlined in Option 1. However, the PGB, whose function is to set policies with respect to the GFIs' credit program for the LGUs belonging to the third tier and the manner of mobilizing resources to finance such credit program, should be maintained. It should not be involved in any administrative issues, which are the responsibility of the GFI. The PGB's membership should be the same as those enumerated in Option 1.

The GFI provides a Secretariat for the PGB, which shall be headed by the senior GFI official assigned to manage the LGU Credit Department.

This organizational structure is similar to the present organizational structure of the IGLF. Some of the staff of the CPOs and BLGF could be absorbed by the GFI.

- *Required Capability Building*

The GFI requires the same capability building as described in Option 1.

- *Proposed GFI*

There are three GFIs that could qualify as an institution to house the MDF, namely the PNB, LBP and DBP. The PNB will soon be privatized and it cannot be expected to maintain the same level of interest in providing credit to LGUs as it has shown in the past three years.<sup>11</sup> Between the LBP and DBP, the latter is in a better position than the former in providing a home for the MDF for several reasons. One is that the types of LGU projects that need credit financing are much closer to the DBP's concerns than that of the LBP's. The other reason is that the DBP already had substantial experience in bond issuance both in the domestic and international capital markets. Although the DBP has fewer number of branches than the LBP, its existing branches,

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<sup>11</sup> The PNB is now majority-owned by the private sector.

however, are well distributed across the country and are readily accessible to most LGUs.

- *Legal Implications*

Unlike the transfer of the IGLF from the Central Bank to the DBP, which required only a Memorandum of Agreement between NEDA and the DBP, the proposed transfer of the MDF to the GFI will require an amendment of PD 1914, specifically Section 4, which designates the DOF as the administrator of the MDF.

### **OPTION 3: AN INDEPENDENT MUNICIPAL BANK**

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- *Concept*

This option involves the conversion of the MDF into an independent municipal bank, which may be called the Philippine Municipal Bank, Inc. (PMBI).<sup>12</sup> It shall be owned and managed by the national government but allow equity participation by LGUs.<sup>13</sup> As a development bank for LGUs, the PMBI shall provide medium- and long-term loans to LGUs. This is similar to institutions established in Germany, Belgium, Norway, Denmark and the Netherlands.

The mission of this institution is similar to that mentioned in Option 1. Therefore, it should have a definite life span. Given the pace of development of the domestic private capital markets, it is expected that the PMBI will substantially accomplish its mission in 30 to 35 years. After this, the PMBI may either be dissolved or privatized.

The PMBI should consider all LGUs as its potential clients; however, in view of the presence of GFIs that have been

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<sup>12</sup> This is similar to the Credit Communal Belgique of Belgium, Credit Local de France and FINDETER of Colombia.

<sup>13</sup> LGUs' equity participation is not a pre-condition for organizing the PMBI. They may buy shares of stocks of the PMBI after it is organized.

lending to LGUs, PMBI should focus on LGUs belonging to the third tier, i.e., LGUs belonging to the fourth, fifth and sixth income class.

- *Core Functions*

The three core functions discussed in Option 1 — project and loan appraisal, resource mobilization and management and provision of technical assistance to LGUs — should be performed by the PMBI.

It is not the PMBI's core function to administer the grant system. However, like the MDF in Option 1, it may be designated by the government as the financial manager of the grant system, implementing decisions of a separate policy governing board for such grant system. The PMBI shall treat the management of the grant system as an off-balance sheet activity.

Aside from the three core functions, the PMBI may also provide some fee-based services to LGUs similar to those the GFIs can provide to LGUs.

- *Mechanisms for Delivering Credit to LGUs*

The PMBI may do both wholesale and retail lending in the same manner described in Option 1. It is expected, however, that the PMBI will initially do straight retail lending to LGUs, possibly with some cofinancing with PFIs, but that it will eventually shift toward wholesale lending.

- *Graduation Program*

The graduation program discussed in Option 1 applies here.

- *Resource Mobilization*

The authorized capital of the PMBI should be P5 billion with initial paid-in capital of at least P1.25 billion. The P700 million existing second-generation fund of the MDF, supplemented by P325 million budgetary appropriations,

should constitute PMBI's initial paid-in capital. The initial paid-in capital could be higher than P1.25 billion, depending on the interest of LGUs in buying some shares of the PMBI.

Future second-generation fund of the MDF shall be used to increase its paid-in capital. As long as its paid-in capital is below its authorized capital, the PMBI should be exempted from the law requiring government-owned corporations to declare 50 percent of their profits as dividends to the national government so that it can use its entire profits for building up its capital.

As a corporation, the PMBI will have greater flexibility in mobilizing resources to finance its lending program to LGUs. Like the MDF, the PMBI may secure ODA from foreign donors for the purpose of augmenting its loanable funds. It may mobilize deposits from surplus LGUs.

The PMBI may issue medium- and long-term "LGU bonds" in the domestic and/or international capital markets, which increases the private sector's participation in financing development projects of LGUs.

- *Distribution of Credit Risk*

The national government should treat the PMBI like other GFIs. Since resources will be transferred from the MDF or secured from foreign donors and will be on-lent by the PMBI, there should be some method of assigning risk. All foreign loans already contracted by the MDF and to be contracted by the PMBI with foreign donor agencies for the purpose of augmenting its loanable funds for LGUs should remain the liability of the national government. The credit risk of all loans to LGU made by the MDF before the transfer of the MDF to the PMBI should continue to be borne by the national government. However, credit risk of all loans granted by the PMBI to either PFIs or directly to LGUs should be borne by PMBI.

The national government should, as much as possible, refrain from providing guarantee for any bond issuance to be



made by the PMBI in the domestic or international capital markets to raise funds for LGU lending, so as not to confer it an undue advantage over the bonds issued by individual LGUs.

- *Loan Pricing*

The GFI should follow the same interest rate policy as that discussed in Option 1.

- *Organizational Structure*

The PMBI shall follow a corporate organizational structure.<sup>14</sup> It shall have a Board of Directors, which formulates policies for the PMBI. The board shall consist of the following: chairman; president, who shall act as chief executive officer; a representative from the GFI; a representative from the LGUs; a representative from the PFIs; and three other members who should come from the private sector. All, except the president, shall work on a part-time basis and be appointed by the President of the Philippines for a definite term, preferably six years. LGUs' representation in the board may be increased depending on their voting shares.

The PMBI president shall be assisted by a senior vice president. A vice president shall be assigned to each of the four functional groups.

To make it accessible to a greater number of LGUs, the PMBI shall maintain three branches, one each for Luzon, Visayas and Mindanao. Each branch shall be authorized to approve loans up to a certain size.

Some of the staff of the CPOs and BLGF may be absorbed by the GFI.

- *Required Capability Building*

The PMBI requires the same capability building as described in Option 1.

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<sup>14</sup> The organizational chart may be similar to that of Figure A6.2.

- *Legal Implications*

This option requires legislative action.

#### **OPTION 4: LGU CREDIT GUARANTEE CORPORATION<sup>15</sup>**

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- *Concept*

A lot of government-designated priority sectors in the economy, such as small and medium enterprises, export-oriented enterprises, and others, have been perceived by lenders as high-risk borrowers. They, therefore, lack access to credit from the private financial markets. The government has partly addressed this problem by creating fully government-owned credit guarantee agencies/programs, which provide guarantee to loans made by private lending institutions to the priority sectors.<sup>16</sup>

LGUs have similar problems as those of the priority sectors; that is, they are perceived by private lenders as high-risk borrowers. However, there is no credit guarantee facility for the LGUs that can enhance their access to credit from the private financial markets. This option proposes to fill this gap by converting the MDF into a credit guarantee institution, which may be called LGU Credit Guarantee Corporation (LGUCGC).<sup>17</sup> It should be owned and managed by the

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<sup>15</sup> Joaquin Cunanan & Co./ Price Waterhouse completed a study titled "Feasibility Study for LGU Guarantee Corporation," 1 September 1995, funded by the USAID-Manila. This shall be referred to as the Cunanan Study. Some of the ideas contained in that report are reflected in this section.

<sup>16</sup> There are about seven guarantee programs/agencies of the government.

<sup>17</sup> The Cunanan Study proposes to establish a Local Government Guarantee Corporation (LGGC) with equity participation from GFIs and with MDF contributing "both resources and policy directions for the corporation" (p. 29).

national government but should allow for equity participation by GFIs. Considering the nature of the development projects LGUs are required to undertake, LGUCGC should guarantee only medium- and long-term debts of LGUs.

All lending operations of the MDF shall cease immediately upon its conversion into the LGUCGC. The collection of outstanding loans of the MDF shall be done by the LGUCGC.

While the LGUCGC specializes in the provision of credit guarantee, GFIs such as the PNB, LBP and DBP may continue their respective lending programs to LGUs. However, their loans should not be guaranteed by the LGUCGC.

- *Core Functions*

LGUCGC should perform three core functions. One is the provision of credit guarantee to loans made by PFIs to LGUs.<sup>18</sup> The mechanics for the provision of guarantee cover to PFIs are discussed in detail below. The second core function of the LGUCGC is the provision of technical assistance to LGUs to enhance their creditworthiness.<sup>19</sup> The details of this core function were already discussed in Option 1. The third core function is the management of the financial resources of the LGUCGC to ensure that its reserves are invested optimally.

LGUCGC may be designated by the government to be the financial manager of the grant system, which involves mainly the implementation of decisions made by a separate policy governing board on the allocation and disbursement of grants to selected LGUs. However, such should not form part of the core functions of the LGUCGC.

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<sup>18</sup> The LGUCGC should not provide guarantee to loans made by LGUs to finance housing projects because the Home Insurance Guarantee Corp. (HIGC), a government-owned guarantee corporation, can take care of this type of loan.

<sup>19</sup> This is emphasized in the Cunanan Study.

- *Mechanics for the Provision of Guarantee Cover*

To encourage risk-sharing with PFIs, LGUCGC should provide guarantee cover up to a maximum of 85 percent of the LGU outstanding loan balance, including interest and penalties. That is, in case of a loan default by an LGU, the LGUCGC should pay the PFI concerned 85 percent of the outstanding loan balance, including interest and penalties. However, the responsibility for collecting the loan and foreclosing on the collateral presented by the borrowers should remain the responsibility of PFIs.

Although PFIs normally undertake their own evaluation of the viability of the projects to be financed by loans and the creditworthiness of LGUs, LGUCGC may conduct an independent evaluation of the loan applications proposed by LGU borrowers for guarantee cover to determine their merits and assess the risk involved so that an appropriate premium may be imposed. Thus, the provision of the guarantee cover to PFIs' loans to LGUs should not be automatic. However, once the LGUCGC grants the guarantee cover, payment for calls on the guarantee should be automatic. This automaticity is necessary to maintain the credibility of the LGUCGC as a guarantee institution.

To protect itself from irresponsible private financial institutions, the LGUCGC should accredit PFIs that will grant loans under its program. The policies and guidelines for accreditation will be set by the Board of Directors of the LGUCGC. The performance of the accredited PFIs should be reviewed annually by the LGUCGC.

- *Resource Mobilization*

The LGUCGC should have an authorized capital of P5 billion with initial paid-in capital of at least P1.25 billion. The P700 million existing second-generation fund of the MDF supplemented by P325 million budgetary appropriations should constitute LGUCGC's initial paid-in capital.

Repayments of principal and interest on outstanding LGU loans of the MDF should be used to increase the paid-in capital of the LGUCGC. This can be augmented by revenues in the form of guarantee fees and interest income on its reserves.

Assuming a gearing ratio or leverage of 5:1, the P1.25 billion initial paid-in capital of the LGUCGC can support at least P6.25 billion worth of PFIs' loans to LGUs.

- *Guarantee Fees*

The LGUCGC shall charge a fee of 2 to 4 percent of the LGU loans guaranteed, depending on the riskiness of the LGUs.<sup>20</sup>

- *Organizational Structure*

The corporate organizational structure of LGUCGC is shown in Figure A6.3. The Board of Directors, which formulates policies and procedures for managing the affairs of LGUGC should consist of the following: chairman; president who shall act as chief executive officer; a representative from the GFI; a representative from the LGUs; a representative from the PFIs; and three other members. All shall be appointed by the President of the Philippines for a definite term, preferably six years. Their appointments may be renewed for an unlimited number of times.

The LGUCGC president shall be assisted by a senior vice president. A vice president shall be assigned to each of the following four functional groups: credit evaluation; financial management; technical services; and administration.

Some of the staff of the CPOs and BLGF may be absorbed by the LGUCGC.

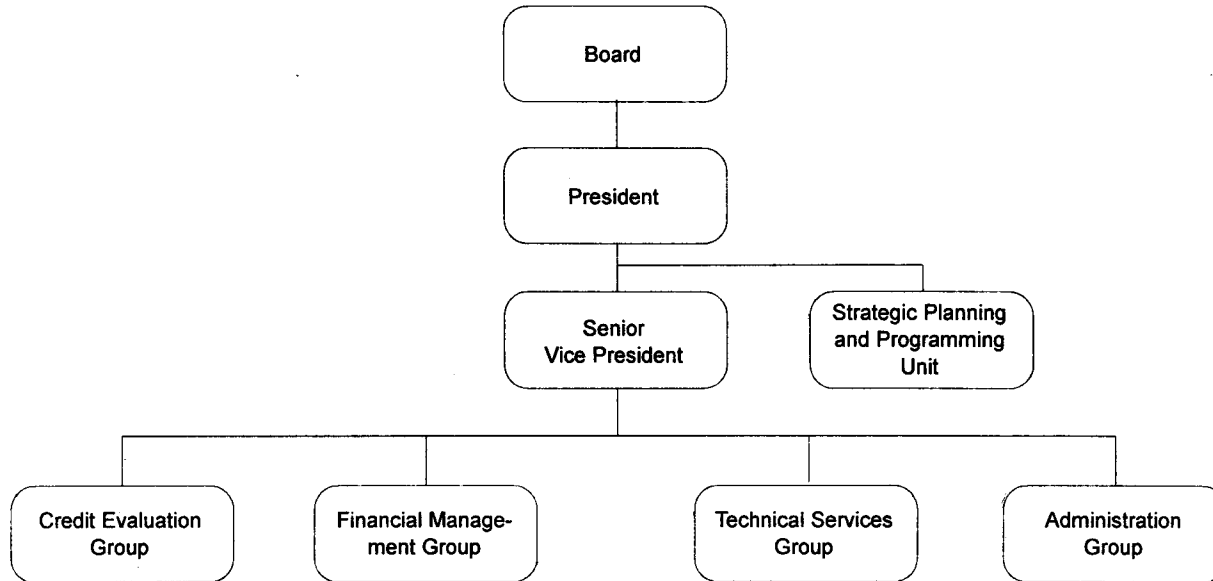
- *Required Capability Building*

The LGUCGC requires the same capability building as described in Option 1.

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<sup>20</sup> This is based on the recommendation of the Cunanan Study.

**Figure A6.3**  
**LGU CREDIT GUARANTEE CORPORATION**  
**Organizational Chart**



- *Legal Implications*

The creation of LGUCGC requires legislative action.

## ASSESSMENT OF THE VARIOUS OPTIONS

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Before assessing the four options discussed above, it is worth emphasizing that, regardless of the option chosen by the government, the recommendations of this paper regarding the role of GFIs and the bond market in the municipal credit system hold.

The four options may be classified into two general forms of government intervention in the LGU credit market: (i) straight lending program and (ii) credit guarantee program.<sup>21</sup>

Many prefer the credit guarantee program over the straight lending program because of the perceived advantages of the former over the latter.<sup>22</sup> *First*, a credit guarantee program can encourage more PFIs to lend to LGUs. As pointed out in Chapter V, PFIs perceive LGUs as highly risky borrowers. Such perceived credit risk could be reduced if LGUs could offer hard collateral acceptable to PFIs, which many LGUs cannot present. Thus, a credit guarantee is needed to serve as a collateral substitute. *Second*, a credit guarantee program is a less costly form of government intervention in the municipal credit system. Assuming a gearing ratio of 5:1 and no loan default, the government needs to raise only P1 to support P5 worth of PFIs' loans to LGUs. In a straight lending program, the government has to raise P5 to be able to lend P5. And *third*, the credit risk is shared between the government and PFIs.

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<sup>21</sup> There have been some discussions regarding the pros and cons of a credit guarantee program vis-a-vis a straight lending program. The following discussions paraphrase the major points made by Virata, Lamberte, Tiaoqui and Santos (1994) on this issue.

<sup>22</sup> The word "perceived" highlights the fact that these advantages are not real, as will be clarified later.

The perceived advantages of a credit guarantee program over a straight lending program deserve some comments. *First*, PFIs' perception regarding the risk of lending to LGUs does not actually change if loans are guaranteed by the national government. What changes is the risk exposure of PFIs to the same risky borrowers since part of the risk will be shifted to the guarantor, i.e., the national government. *Second*, a credit guarantee leads to asymmetric distribution of benefits and cost between the lender (i.e., PFIs) and the guarantor (i.e., national government). PFIs share a large proportion of the benefits whenever LGUs perform their loan contracts. On the other hand, when LGUs default on their loans, a large proportion of the cost of loan default will be borne by the guarantor. *Third*, credit guarantee is not regarded by banks as collateral substitute. Various studies have shown (e.g., Llanto and Magno 1994) that lenders still require borrowers to put up hard collateral on top of the credit guarantee secured from a guarantee institution. *Fourth*, creditworthy borrowers who do not need a guarantee cover to obtain a loan are usually required by lenders to secure a guarantee whenever a guarantee facility is available. This unnecessarily increases the cost of borrowing. Conversely, less creditworthy borrowers who need the guarantee the most will never be able to access the guarantee facility because they will be immediately screened out by lenders. The credit guarantee institution will do the same in order to preserve its viability. This is one weakness of a guarantee program that was underscored in the Cunanan Study, which proposes that in the initial years "stronger LGUs should form a larger portion of its guarantee coverage" (Cunanan & Co. 1995: 24). *Fifth*, a credit guarantee can be a potentially more costly form of government intervention in the credit market than straight lending. Guarantees are contingent liabilities of the guarantor, which usually exceed the capital of the guarantor. A loan default by a few borrowers can easily wipe out the capital and force the guarantor to raise more money to cover the difference between the contingent



liability and the capital.<sup>23</sup> Many of the credit guarantee programs here and abroad are not doing well financially. And *lastly*, resources mobilized by the government from ODA cannot be passed on to LGUs if the only mechanism used by the government in the municipal credit system is the credit guarantee program.

A straight lending program for LGUs also has several weaknesses. One, it does not encourage greater participation of PFIs in the municipal credit system. Two, it does not reduce the risk in lending to LGUs. Three, it crowds out PFIs especially if it includes some subsidies to borrowers. However, these weaknesses can be addressed through proper design of the lending program. Earlier discussions on various mechanisms for lending to LGUs that can elicit greater participation from PFIs in the municipal credit system are deemed sufficient and need not be repeated here. Nevertheless, it is worth emphasizing one decided advantage of a straight lending program over a credit guarantee program: it has a built-in check on government's exposure to credit risk for the simple reason that the government's total exposure to credit risk cannot go beyond the amount being lent out by the government credit institution, unlike in the case of a credit guarantee program.

On the basis of the discussions above, the study does not recommend Option 4 or any of its variants.

Option 3, that is, creating an independent municipal bank has all the desirable features of an effective and viable municipal credit institution discussed in Chapter IV. It can be given fiscal and financial autonomy. More importantly, it can involve the private sector in financing development projects of LGUs

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<sup>23</sup> For example, a P1 capital put up by a guarantee institution can support five borrowers borrowing P1 each. A default by one borrower can immediately wipe out the capital of a guarantee institution; a default by two borrowers can force the guarantor to look for additional funds elsewhere to pay the lending institution.

on both sides of its balance sheets. On the liability side, it can mobilize private sector deposits and/or issue bonds and on-lend the funds to LGUs either through retail or wholesale lending.<sup>24</sup> On the asset side, it can involve private banks through cofinancing of LGU loans and/or wholesale banking.

There are, however, disadvantages with Option 3. First, it requires legislative action to simultaneously create the bank and abolish the MDF and transfer MDF's funds and some of the MDF's functions to the bank. Given the record of Congress in passing bills, this may take a long time. This is not to mention the aversion of both Congress and the executive to any proposal creating a new government-owned corporation, especially since the government is currently trying to rationalize and streamline its operations and accelerate the privatization of government-owned corporations. Moreover, there is some risk that the legislative outcome will be inferior to what is being proposed in this study.

In terms of mobilizing resources, the bank will have to be firmly established first before it can attract deposits from the private sector and issue bonds either in the domestic or international capital markets. Unless it opens several branches in major cities of the country,<sup>25</sup> the municipal bank will have difficulty in competing with firmly established private banks in mobilizing private savings.<sup>26</sup> Thus, it will take some time for this bank to be able to mobilize more resources from the private sector to support its on-lending programs for LGUs.

Option 2 has some desirable features. It can do many of the things that the municipal bank can do for LGUs. For

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<sup>24</sup> It can also involve LGUs as shareholders and/or depositors of the municipal bank.

<sup>25</sup> The study team does not recommend this as it is inconsistent with the Team's proposal to shift the concentration of the loan portfolio of the bank from retail to wholesale loans.

<sup>26</sup> Some have proposed to require all LGUs to deposit their funds with the municipal bank. This is inconsistent with the study team's proposal to relax further the regulation on LGU depository accounts.

instance, the GFI can mobilize deposits from the private sector and issue bonds to the general public and do co-financing or wholesale lending with private banks.<sup>27</sup> It can have some fiscal and financial autonomy. Also, the GFI can exploit economies of scale and scope.

There are, however, some disadvantages with Option 2. *First*, like Option 3, legislative action is required to transfer the administration of the funds and some of the MDF functions of the MDF to the GFI. This involves some risks because the legislative outcome can be different from that proposed in this study. However, it can be argued that the transfer of the MDF to a GFI is consistent with the streamlining program of the government, which could encourage both Congress and the executive to give this option a high priority in the legislative agenda. *Second*, it is not the GFI's main function to lend to LGUs. GFIs were created to address credit needs of specific sectors of the economy. For instance, the LBP provides financial services to the agricultural sector, and the DBP, to the industrial sector. Because of lack of focus on the credit needs of LGUs, the GFI may not exert extra effort to expand its LGU loan portfolio. Colombia's experience with this problem is instructive. Colombian LGUs complained that the mortgage bank, which managed the Urban Development Fund, a window for LGU lending, was much too preoccupied with its primary lending programs and gave less importance to its LGU loan portfolio. This issue was resolved by creating FINDETER, an autonomous institution.

Option 1 does not require legislative action; an executive action is sufficient. It therefore entails less problem in implementation. Unlike the GFI, the new MDF will maintain its primary function of lending to LGUs or encouraging private sector lending to LGUs, especially LGUs belonging to the

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<sup>27</sup> The DBP, which is the proposed home for the MDF, is already an established bank with better reputation and image than in the past.

third tier. However, it has some drawbacks. Its resources will be limited because it lacks the authority to mobilize deposits and issue its own debt instrument unless the national government secures more ODA and/or issues bonds in order to augment the existing funds of the MDF. The other proposals to raise more funds for the MDF will take time to materialize. The limited resources that the MDF would have under Option I provide an additional reason why its lending program should target the third tier LGUs.

It is important to consider these three options in the context of the existing municipal credit market. Although it has been shown that there is a large potential demand for credit among LGUs, it is not easy to translate this potential demand into actual demand. The majority of the LGUs still need to enhance their capacity to identify, evaluate and manage projects as well as strengthen overall fiscal management. This is important in improving their creditworthiness. The MDF can play a big role in assisting LGUs attain this objective.

Given the discussions above, the study considers Option 3 as an ideal set-up to improve the existing municipal credit system. However, in view of the problems that will be encountered in implementing Option 3, the study recommends that the government adopt Option 1 as an intermediate step toward Option 3. Many of the advantages of Option 3 over Option 1, such as the ability to mobilize long-term deposits and issue long-term bonds without any government guarantee, cannot be realized immediately because the capital market is just beginning to develop. The experience with Option 1 is important in deciding later whether it is worthwhile to move to Option 3.

## **PROPOSED ACTION PLAN TO IMPLEMENT THE RECOMMENDATIONS**

### **LGU BOND ISSUANCE**

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It is recommended that a task force be created to perform the following tasks:

1. to draft standard operating procedures and policies for bond issuance to guide the LGU bond issuers and the approving agency;
2. to recommend modifications to the existing regulations and accounting and auditing procedures for bond marketing and administration, taking into account the peculiarities of bond pricing; and
3. to formulate a framework for establishing a credit rating agency and the mechanics of rating LGU bonds.

The members of this task force should come from the DOF as lead agency, Securities and Exchange Commission (SEC), Bureau of Internal Revenue and Commission on Audit (COA).

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## TRANSFORMING THE MDF INTO A SEMI-AUTONOMOUS LENDING INSTITUTION

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Technical assistance is required to reorganize the MDF to conform to Option 1.

- *Scope of work for the technical assistance*

*Policy framework development.* This activity will lay down the policy framework and the operating principles or guidelines of the new MDF. Among others, it will define the role of the new MDF in the municipal credit system vis-à-vis donors, government financial institutions, and the private financial markets, and provide the framework for creating a greater role for private financial markets in LGU credit finance.

*Delineation of the core functions of the new MDF.* This activity will determine the core functions of the new MDF, taking into account the present functions of the CPOs, the new organizational structure, manualization of operations, staffing pattern, the statement of duties and responsibilities, qualification standards for MDF officials and staff, and the compensation scheme. The business plan for the new MDF will be prepared under this activity.

*Development of an implementation plan for the establishment of the new organization.* This activity will provide an implementation plan for the new MDF that will provide for a transition period to reorganize it into a semi-autonomous entity within the DOF structure. Among others, the implementation plan will define the new MDF's role vis-a-vis the BLGF, and set up the criteria and procedures for integrating CPO and BLGF functions and personnel with the new MDF.

*Strengthening of the new MDF and program development.* This activity is intended to overcome the present institutional

weaknesses of the MDF. It will have two components: training and automation.

The activity will develop a training program for the new MDF staff in such areas as financial management, credit evaluation techniques, risk assessment, environmental impact analysis, project appraisal and other basic operations of the new MDF. The training program will also build the capacity of the staff to provide technical assistance to LGUs in the areas of project identification, development, and others. Training workshops and study tours will be used to transfer LGU credit financing technology from selected successful municipal credit institutions in other countries. Part of this activity will be a study tour for a small group in such countries as France, Mexico or Brazil to learn first-hand how a municipal credit institution can effectively and efficiently carry out its responsibilities.

The automation activity will provide technical assistance to modernize the operations of the new MDF. Thus, the technical assistance will provide the following: (i) a manual of operations; (ii) the automation of the systems and operating procedures; (iii) installation of appropriate performance standards; (iv) setting up of an internal financial and management audit system; and (v) standardized accounting and reporting systems for the new MDF operations and projects.

Assistance in automation will consist of hardware acquisition and the development/adaptation and installation of appropriate softwares.

### **LIBERALIZING THE DEPOSITORY BANK REQUIREMENT AND CLARIFYING THE POLICY ON IRA INTERCEPT MECHANISM**

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To help establish a bank-client relationship between LGUs and private financial institutions, the depository bank requirement for LGUs must be liberalized and clearly spelled

out in the Code to avoid misinterpretation by regulatory government agencies and the COA. The same is true with the IRA intercept. An LGU must be allowed to enter into a loan contract with private financial institutions using the IRA intercept mechanism as a collateral substitute for the loan. Both measures require legislative action. This is the best time to submit to Congress such recommendations because, by law, Congress is mandated to review the Code five years after its passage.

Table A7.1 summarizes the key actions that need to be undertaken by the government. The actions are grouped into two categories: actions that should be undertaken immediately and actions that may be undertaken later.

**Table A7.1**

**KEY ACTIONS, AGENCIES RESPONSIBLE, LEGAL INSTRUMENT AND TARGET DATES**

Objectives and Key Action	Agency Responsible	Legal Instrument	Target Date
<b>A. For Immediate Actions</b>			
1. Transform MDF into a semi-autonomous financial institution			
a. MDF-PGB to pass a resolution	MDF-PGB	MDF-PGB board resolution	April 1996
b. Department of Finance (DOF) to make a decision	DOF	DOF Department Order	April 1996
c. Prepare proposal for funding a two-year technical assistance to strengthen the capacity of the new MDF	DOF	Proposal submitted to funding agency	April 1996
d. Implement the technical assistance for capacity-building	DOF/New MDF	Technical assistance grant to DOF for MDF's capacity-strengthening	May 1996 to April 1998
Phase I: 1. Policy framework development			May to July 1996



**Table A7.1 (continuation)**

Objectives and Key Action	Agency Responsible	Legal Instrument	Target Date
2. Delineation of the core functions of the new MDF			May to July 1996
3. Development of an implementation plan for the establishment of the new organization			May to July 1996
Phase II: Strengthening of the new MDF and program development			August 1996 to April 1998
2. Formulate and adopt Standard Operating Procedures (SOP) for LGU bond issuance			
a. Organize a Task Force to draft the SOP	DOF and SEC	DOF Department	May 1996 Order
b. Draft SOP	Task Force		May to July 1996
c. Review and adopt SOP	DOF and SEC	SEC Circular	July to September 1996
3. Formulate and adopt a policy framework for the Grant System and Municipal Credit System			
a. Create an interagency committee	DOF, NEDA, DILG	Administrative Order	May 1996 <sup>1</sup>
b. Formulate a policy framework	Inter-Agency Committee	NEDA Board Resolution	May to July 1996
c. Review and adopt a policy	NEDA Board		August 1996
4. Recommend amendments to the Local Government Code <sup>2</sup>			
a. Liberalize the depository requirement to allow LGUs to build relationship with private banks.	DOF	Amendment of the Code	May 1996
b. Clarify the IRA intercept provision of the Code to province an even playing field between GFIs and PFIs	DOF	Amendment of the Code	May 1996

**Table A7.1 (continuation)**

Objectives and Key Action	Agency Responsible	Legal Instrument	Target Date
<b>B. Actions to be undertaken later</b>			
1. Modify the existing regulations and accounting and auditing procedures for bond marketing and administration			
a. Create an interagency committee to draft the necessary modifications	DOF, SEC, BIR, COA	Administrative Order	October 1996
b. Analyze and recommend modification of existing regulations, accounting and auditing procedures	Interagency Committee		October to December 1996
c. Review and adopt the recommendations	DOF, SEC, BIR, COA	Administrative Order	January 1997
2. Establish a credit rating agency			
a. Formulate a framework for the establishment of a credit rating agency	SEC	SEC Circular	May 1997

<sup>1</sup> This assumes that the UPECON Foundation study that looks into the grant system will be completed by April 1996.

<sup>2</sup> The law prescribes a mandatory review of the Code starting 1996. Congress has already initiated steps for the conduct of the review.

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## About the Authors

**Gilberto M. Llanto** is a Research Fellow at the Philippine Institute for Development Studies. He conducts research and policy analysis on financial markets and public economics, specifically fiscal policy, local government finance and housing finance.

He has a Ph.D. in Economics from the University of the Philippines School of Economics and has served as adviser and consultant to various government and international institutions.

**Rosario G. Manasan** is a Research Fellow at the Philippine Institute for Development Studies. She coordinates the Institute's research program on public finance and fiscal policy, specifically on taxation, government expenditure and public enterprises. She holds a doctoral degree in Economics from the University of the Philippines School of Economics and has served as adviser and consultant to government, international and private institutions.

**Mario B. Lamberte** is Vice-President at the Philippine Institute for Development Studies. He conducts research on money and banking and development economics. He has a Ph.D. in Economics from the University of the Philippines School of Economics. He has served as consultant to government and international institutions.

**Jaime C. Laya** is President of the Philippine Trust Co. (Philtrust Bank), chairman of Laya Mananghaya Salgado and Company, and a trustee and member of the Rating Board, Credit Information Bureau, Inc. He was formerly chairman of the Monetary Board and Governor of the Central Bank of the Philippines; Minister of the Ministry of Education, Culture and Sports; Minister of Budget; and Chairman of the Philippine National Bank, among others. He has a Ph.D. in financial management from Stanford University.

