UCLG Committee on Local Finance and Development

COLOMBIA 2005

LOCAL GOVERNMENTS – LOANS FROM COMMERCIAL BANKS THROUGH FINDETER

LONG TERM EXTERNAL RESOURCES

Local governments

- Colombia is a unitary state. It is divided into 32 states (departments). These in turn are divided into 1,064 municipalities, of which four are special districts with the status of department.

FINDETER, Financiera de Desarrollo Territorial

- FINDETER was established in 1989 by Law 57, and officially began operating in 1991. Its predecessor was the Urban Development Fund (FFDU), a window for financing infrastructure that opened within the National Mortgage Bank in 1975.
- FINDETER is a legally independent, quasi-public financial institution : as of 1998, the Republic of Colombia owned 91.5 percent of its shares, with the remaining 8.5 percent owned by Colombia's departments.
- FINDETER's highest authority is a board of directors, composed of four central government officials, with the Minister of Finance chairing the board, and two representatives of subnational entities. The President of FINDETER leads senior management, including senior executives in charge of principal operational areas.

DESCRIPTION & STAKEHOLDERS

- Colombia is something of an anomaly in the developing world in having developed an active market in sub-sovereign debt. The market grew rapidly in the early 1990s with market liberalization and the increasing financial strength of subnational governments.
- The Financiera de Desarrollo Territorial (FINDETER), or Territorial Financing Institution, also played a role in this development, as its financial intermediation helped introduce a number of banks to municipal lending.
- FINDETER primarily operates as a second-tier development bank: it rediscounts loans that commercial banks make to local borrowers.
- Under this arrangement, a subnational government (or one of its agencies or enterprises, including private or mixed-capital companies) applies to a first-tier lender for a loan. FINDETER appraises the proposal and authorizes the first-tier lender to lend to the requesting entity. The bank makes the loan to the subnational government. The bank then receives a loan of that amount at a discounted rate from FINDETER. The subnational borrower continues to repay its debt to the first-tier bank under the terms and conditions of the original loan. The bank remains responsible for servicing its rediscounted loan from FINDETER, regardless of its own repayment experience from the local borrower. The first-tier bank thus absorbs 100 percent of the credit risk. This second-tier role distinguishes FINDETER from most municipal development funds (MDFs) that lend directly to local governments and assume the credit risk.

SPECIFICITIES OF LOANS

- On its loans to FINDETER in the 1990s, the WB sought to limit the cost of capital to the end-borrowers. Loans from participating banks to municipalities could be at a rate no more than 5.0 % above the market average rate for fixed term deposits. FINDETER then would rediscount all or a portion of that loan amount at the market average rate plus 2.5 percent, providing banks with a spread typically of 2.5 percent But even as early as 1994, banks were able to offer municipalities loans at similar rates to loans supported by FINDETER, while bonds could achieve even lower rates.
- As of June 2004, under flexible variable rate terms FINDETER is able to offer attractive refinancing on loans of six years or more. For such loans, banks may typically charge sub-sovereign borrowers competitive interest rates of 800 basis points over the Fixed Deposit Rate (DTF), an index of bank deposit rates. FINDETER may typically rediscount such loans at 650 or 700 basis points over the DTF rate.
- From the 1990s until today, the long-term capital available from international financial institutions (with conditions) has helped extend the tenor of loans to better match the expected life of the asset being financed. Depending on the expected life of the asset in question, WB conditions provide for loans for up to 12 years. Such tenors (and other terms) compare favorably with conditions that borrowers would otherwise obtain; maximum loan maturities of three to five years without FINDETER support are typical. While municipal bonds can achieve periods of around 8 years, typically only the largest cities can directly access those markets.

INSTITUTIONAL AND REGULATORY CONTEXT

- Colombia is a unitary state. It is divided into 32 states (departments).These in turn are divided into 1,064 municipalities, of which four are special districts with the status of department.
- For several decades Colombia has been engaged in a process of decentralizing resources and responsibilities to the subnational level. The 1991 constitution marked a milestone in that process. It called for transfers of central government revenues to subnational governments to increase from an already substantial 36.5 percent of current revenues in 1993 to 46.5 percent in 2002. The result of this and other recent fiscal changes has had different results at the subnational level.
- Under Law 358 of 1997, subnational governments operate under a set of debt restrictions known as the “traffic light” system. Subnational governments face progressively restrictive limitations on borrowing as their financial positions erode.
- FINDETER is constrained in its exposure to risk. Colombian law requires FIs such as FINDETER to maintain minimum ratios of equity-to-total funding of nine percent. At present (April 2004), FINDETER is maintaining a ratio of around 40 percent. This level is actually lower than peak levels during recent years when FINDETER was less active, but still is substantially higher than legal minimums. This relatively high level is due to various factors: (i) FINDETER does not distribute profits; (ii) the Government of Colombia initially serviced a portion of the debt on the World Bank’s project lending to FINDETER so as to help to capitalize the organization; and (iii) low levels of activity in recent years

Figure A-1. FINDETER as a Second-Tier Financial Institution: Flow of Funds

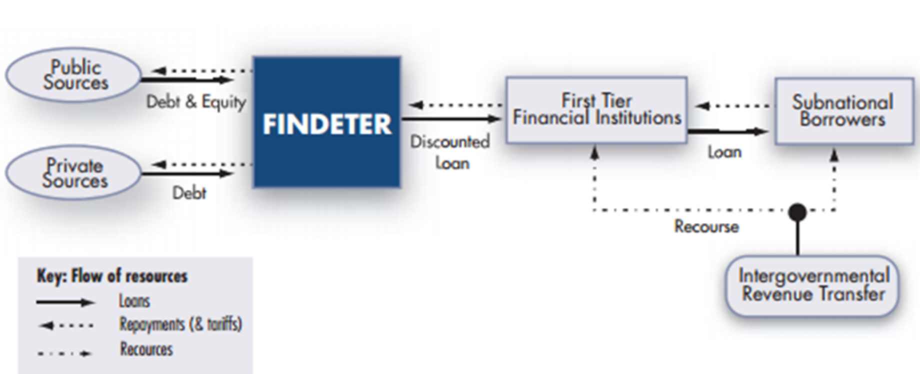

Table 1: "Traffic Light" System for Regulating Subnational Borrowing

Rating	Indicator	Restrictions on Borrowing
Green	Interest as % of operational savings* < 40% & debt stock as % of current revenues ≤ 80%	No restrictions
Yellow	Interest as % of operational savings 40 – 60% & debt stock as % of current revenues ≤ 80%	Lending only with Ministry of Finance authorization
Red	Interest as % of operational savings > 60% or debt stock as % of current revenues >80%	No lending, unless agrees to adjustment plan

* Operational savings are the surplus from the operating budget (i.e., what is left over after operating expenditures are subtracted from current revenues), carried over to the capital budget where it can service debt.

USES

◊ Credit Activity

- Between its creation in 1989 and 1997, FINDETER financed about $1 billion in loans to more than 700 municipalities.
- FINDETER is sensitive to changes in economic conditions. Annual credit approvals declined to $99 million in 2001—a drop of 58 percent from highs of $235 million just two years earlier. These declines coincided with a period of deteriorating economic conditions, coupled with high levels of municipal indebtedness.
- In 2002, the volume of credit approvals rebounded by 43 percent over the previous year, and again by 144 percent in 2003. A retooled core product (discussed below), as well as stabilizing economic conditions, contributed to this resurgence.

◊ New investments cover a wide gamut of sectors where subnational governments have responsibilities for service provision. The relative importance of various sectors has changed over time.

- One general trend is that lending for water and sewer facilities has declined in recent years. Between 1989 and 1999, loans to these sectors accounted for nearly half of FINDETER's portfolio (30 percent for water infrastructure and 15 percent for sewer facilities), and rose even higher in the years following.
- By contrast, in 2003 the funding of household utilities had declined until it represented only 25 percent of FINDETER's disbursements for that year.
- FINDETER has also managed to broaden its clientele in recent years. Initially, it focused on departmental and municipal administrations. In the early- to mid-1990s most of these were smaller localities, unable to access capital from either international institutions (like Bogota), or from domestic capital markets via bonds.
- In recent years, FINDETER has expanded in its lending to service companies. Between 1992 and 1995, FINDETER only provided, on average, between 1.5 and 2.3 percent of the financing for service companies at the departmental and municipal levels, respectively.

◊ The sectors financed by FINDETER in 2003: Most financings (87.2 percent) are for new investments; the remainder are for debt management that includes refinancing (11.4 percent) and fiscal adjustment (1.4 percent). As is prudent practice, Colombian law prohibits local governments from using long-term debt to pay for current expenditures.

RESOURCES

◊ Sources and Uses of Funds: the sources of FINDETER's capital base have varied over the years.

- In 2003, FINDETER's "current revenues" accounted for more than 80 percent of its current refinancing activities. While FINDETER traditionally has attracted support from international FIs (IFIs) in 2003 loans from IFIs accounted for only about five percent of rediscountings. This represents a sharp decline from previous years: in 1994 some 37 percent of funds were from donor loans and grants. This reduction in reliance on international funding reflects in part FINDETER's growing stock of retained earnings, coupled with several years of slow activity beginning around 2000.
- To date, FINDETER has not succeeded in markedly expanding (or recently has not needed to expand) its capital base through domestic capital markets. Domestic long-term borrowing was not a source of funds in 2003. In the early 1990s, FINDETER attempted to sell $50 million equivalent of bonds in the competitive market, but the nascent organization only succeeded in placing $10 million, or 20 percent, of the bond issue. Low levels of activity in the early 2000s, coupled with a strong capital base, have kept FINDETER out of the capital markets, and almost no bond is outstanding today (0.003 percent of its total liabilities at the end of 2003.)

◊ FINDETER played a co-financing role using non-reimbursable government funds: in 1997 it channeled approximately as much in grants as in loans. The distribution of free money makes the organization an attractive target for undesired political influence. Also, by playing the role of grants manager, FINDETER, like any other lender, runs the risk of weakening its reputation as an enforcer of a hard credit culture. Today, FINDETER does not manage grants to local governments, but its charter does not proscribe it from playing such a role in the future.

MANAGEMENT

- Compared to some financial institutions, the traditional review process for FINDETER rediscounting has been excessively time-consuming. Under this process, the commercial bank performed its own financial analysis while FINDETER reviewed local investment projects from technical, economic and developmental standpoints. At one point, the average wait time for loan approval was 18 months; and even a decline to six to eight months in recent years undoubtedly drove many sub-sovereign borrowers to seek capital by other means.
- In response to such criticisms, in 2003 FINDETER launched an improved financial product: a streamlined approval process. Loans for projects less than $2.6 million equivalent now can qualify for a streamlined procedure (known as the rediscuento automático); larger loans still entail the more lengthy in-house review (the rediscuento tradicional procedure).18 Under the streamlined process, the onus is on the tier-one banks to confirm that candidate loans meet FINDETER guidelines. In those cases FINDETER conducts only an ex post review of bank-approved loans—rediscounting is authorized "automatically" with no ex ante review. This development reflects FINDETER's increasing comfort with the loan origination work undertaken by banks with which it has developed a long-term relationship.
- Finally, in addition to its financier roles, FINDETER has also played the part of financial adviser and provider of training and technical assistance to local governments. Such activities were particularly important in the mid-1990s and they continue today. FINDETER currently collaborates with the Ministerio de Hacienda in providing assistance to financially troubled municipalities, and also helps smaller local governments that wish to obtain credit to approach commercial banks.

CREDITWORTHINESS / CREDIT ANALYSIS / RISK

- Under Law 358 of 1997, subnational governments operate under a set of debt restrictions known as the "traffic light" system. Subnational governments face progressively restrictive limitations on borrowing as their financial positions erode.
- FINDETER's assets and liabilities are unbalanced: FINDETER is investing short-term but lending long-term. This strategy exposes the institution to interest rate risk. FINDETER has not effectively hedged against such risks, a weakness observed when it lost capital during the reevaluation of the Colombian peso in 2003.
- FINDETER's own credit risk is based on the credit risk of the banks whose loans it acquires. For this reason, FINDETER employs criteria to determine to which tier-one financial institutions (FIs) it will potentially lend. While these criteria may vary somewhat over time and by source of funding, eligible FIs typically share the following characteristics: habitually receive and invest voluntary savings from the public; are supervised by, and are in good standing with, the Banking Superintendency; and have been appraised by FINDETER as being creditworthy, able to assess sub-sovereign credit risk and having appropriate financial controls, especially with regard to portfolio performance.

ADVANTAGES

- FINDETER has succeeded in establishing itself as a viable financial institution. The institution has rediscounted loans and extended maturities. FINDETER has paid off debt from international sources while building up its patrimony over time. Duff and Phelps of Colombia has awarded FINDETER its highest AAA credit rating.
- Part of FINDETER's financial viability is due to the fact that it has managed to keep its losses to a minimum. Unlike many first-tier municipal development funds, FINDETER in its role as a second-tier FI appears to have avoided the problem of moral hazard. Along with being positive for the sustainability of the institution, this has also helped local governments to build up solid credit ratings. Ultimately, this has burnished the creditworthiness of the sector as a whole and allowed a market to flourish (conversely widespread defaults would have tainted the sector's image in the market). FINDETER's survival has also been due in part to its willingness to take on various roles. While this versatility has helped ensure survival during lean times, ultimately some roles may prove incompatible with the institution's core niche. FINDETER may find that an important part of institutional maturity comes with learning "when to say 'no'."
- Turning to FINDETER's broader mandate, the institution apparently has played an important role as a market builder. The institution appears to have encouraged market development by engaging commercial banks to become familiar with lending to subnational governments. The banks' successful experience with municipal lending through FINDETER prompted them to enter the municipal credit market with their own resources, and subsequently led other suppliers of capital to enter the market as underwriters and purchasers of municipal bonds.

DISADVANTAGES / ISSUES RAISED

- While FINDETER is financially and institutionally viable, to date it has not succeeded to any significant extent in expanding its market share or in using its high credit rating to mobilize long-term resources on domestic capital markets. Until recently this may well have been due largely to a surplus of available cash, the availability of long-term money from IFIs and a flagging economy. However, a growing market share coupled with a prudent level of borrowing on domestic capital markets would be an ultimate sign of long-term sustainability.

Sources : T.Paulais (2012)