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Municipal Bond Issue by the Municipality of Tlalnepantla de Baz (Mexico)

August 2016

Summary Overview

Location: Tlalnepantla de Baz, Mexico

Approach to Blended Finance: To support a local water conservation project, the Municipality of Tlalnepantla de Baz (Mexico) and its Municipal Water Company (OPDM) issued unsecured revenue bonds on the local capital market through a specially created Trust. The bond, issued in local currency was bought by domestic institutional investors.

Strong and reliable revenue sources from the investment, combined with several credit enhancement mechanisms, allowed for expanding the borrowing capacity of the municipality and its water utility by reducing interest rates and extending the tenor. Credit enhancement mechanisms included a partial credit guarantee provided by IFC, and a letter of credit provided by a local bank.

Context

During the 1990s and early 2000s, institutional and regulatory reforms in Mexico's financial markets facilitated the growth of a sub-national securitization market. The Government of Mexico provided increased autonomy to municipalities and started to explore better options to finance investments by state and local governments. The development of the sub-national bond market was further supported by the reform of the pension fund system, which brought new investors looking for long-term investment opportunities. In the early 2000s the Mexican market registered a number of bond issues launched by municipalities or state administrations that had no prior experience with issuance.

Financial Structure and Approach to Blended Finance

In 2003, the Municipality of Tlalnepantla de Baz and its Municipal Water Company (OPDM) issued a bond through a Mexican trust. This was the first municipal bond in Mexico to finance infrastructure investments by using the project's revenues instead of depending directly on federal transfers. The bond was intended to support capital expenditure for water conservation projects undertaken by the municipally owned water utility. There was a pressing need for longer-term financing to better match the life of the water utility's assets, and to expand its financing options for infrastructure. As the municipality, home to approximately 800,000 people, is located in one of the most industrialized areas of Mexico, specific works included the construction and operation of a wastewater treatment plant, so as to reuse residential and industrial wastewater, and an assessment and rehabilitation of the water distribution network to reduce losses. All these works were for activities that could eventually generate savings or revenues to reimburse associated costs.

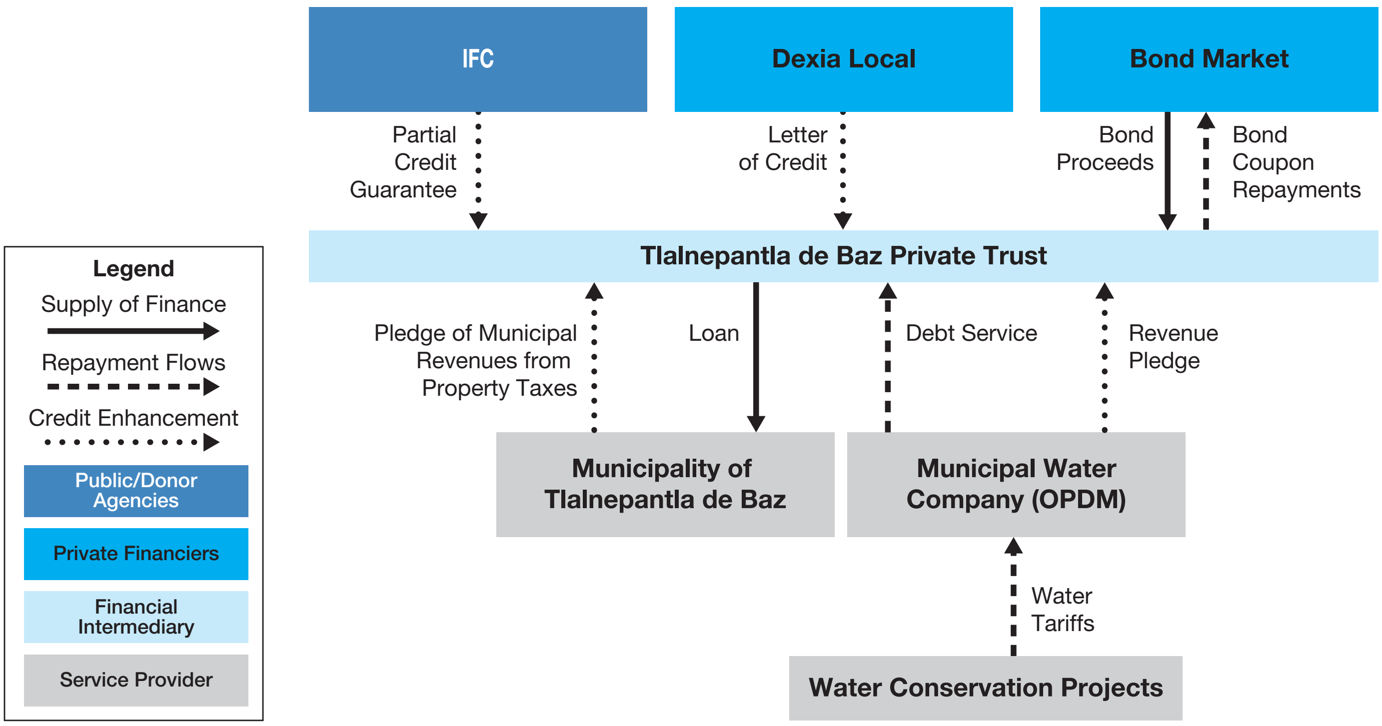
The revenue bond was issued in local currency for the equivalent of approximately US$9.1 million, with a tenor of 10 years (extendable by one year). Normal tenors in Mexico at that time were three to six years; such lengthening in tenor was achieved through transparently assigning OPDM's revenues to service the debt, combined with credit enhancement mechanisms.

The International Finance Corporation (IFC) and Dexia Crédit Local (a development bank subsidiary of the Dexia Group—a large financial group in Europe), acted as co-guarantors. In Mexico, subnational governments could not borrow from non-Mexican based financial institutions, and this included guaranteeing bonds sold directly by municipalities. The issue was resolved with the establishment of a trust to conduct the bond sale, while the proceeds were on-lent to OPDM, with the Municipality as joint obligors to finance the water conservation project. A trust is a type of special purpose vehicle (SPV) that usually has minimal management responsibility and is frequently used for financial transactions. The selection of a trust as the conduit offered many advantages, including fiscal discipline for the Municipality and OPDM.

The external credit enhancements provided by IFC and Dexia were administered in Mexican Pesos for close to the amount of the borrowed capital, and were to be issued on behalf of the bondholders in the case that funding was insufficient. The enhancements took the form of a letter of credit issued by Dexia Crédit Local, and a partial credit guarantee from IFC to cover part of Dexia's exposure under the letter.

While the bond issue was chiefly backed by the OPDM revenue pledge, additional reinforcement was provided through a second municipal revenue pledge in the event that the water revenues proved insufficient. The additional revenue pledge came from municipal tax revenues from the parent municipality. This double-barreled pledge of revenues has been regularly used for municipal bond issues in the U.S. market, and guarantees an additional level of security to the trust. Figure 1 shows the financial structure for the water conservation project.

FIGURE 1 Municipal Bond Issue by the Municipality of Tlalnepantla de Baz, Mexico: Financial Structure



Results

This was the first municipal bond issue in Mexico designed to finance infrastructure investments and supported through the local entities' own revenue sources, without using direct federal transfers. The bond issue obtained a AAA rating (by Standard and Poor's and Moody's Mexico), which was higher than the municipality's AA rating, thanks to the partial guarantee. It was fully subscribed by eight domestic financial institutional investors. The rating allowed the Municipality and OPDM to access financing at lower costs and over a longer term without a sovereign guarantee or backing of intergovernmental transfers. The bond was issued in local currency, and this reduced the foreign exchange risk as the utility's revenues are also denominated in local currency.

Lessons Learned

Legal and regulatory frameworks dictate subnational governments' capacity to engage in innovative financing. In Mexico, reforms during the 2000s gave local government greater financial autonomy by allowing them to issue debt based on their own financial practices, and independent of the national government. The reforms were a large factor in the emergence of a domestic municipal credit market.

Revenue streams from the investment assigned in a transparent manner proved to be an effective way to repay debt. In the case of Tlalnepantla, OPDM's revenue stream was clearly set aside, and the municipal tax revenue pledge provided an additional guarantee. Furthermore, credit enhancements helped strengthen the deal.

Mexico's domestic capital markets benefited from the bond issue. It allowed diversification of longer-term investment opportunities. Banks have shown increased willingness to provide funding for longer maturities to better match the life span of infrastructure investments required by municipalities for water projects.

This financial structure is a successful model; however, it may only work for larger and financially healthy municipal governments. It may not be economically feasible for smaller municipalities looking to issue a bond on their own.

References

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This case study is part of a series prepared by the World Bank's Water Global Practice to highlight existing blended finance experiences in the water sector.

Blended finance refers to "the strategic use of development finance and philanthropic funds to mobilize private capital flows to emerging and frontier markets," as per the OECD definition (WEF OECD, 2015). Concessional funds can be used in a catalytic manner to open up new opportunities for commercial financing, by providing technical assistance to borrowers and lenders to help them become more familiar with each other, help structure transactions, provide credit enhancement mechanisms, etc.

Private capital flows can help with meeting immediate financing needs for investment in the water sector but ultimately need to be repaid. Repayable financing from private sources to the water sector can come in various forms, including as commercial bank loans, bonds or equity. To obtain such financing, water-sector actors need to be able to repay the borrowed amounts and the associated funding costs, which means that they need to be deemed "creditworthy" by providers of finance.

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