

Alvina, Niño Raymond B.

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## Credit financing for local development: The subnational debt in the Philippines

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**ADB Working Paper Series**

**CREDIT FINANCING FOR LOCAL  
DEVELOPMENT: THE SUBNATIONAL  
DEBT IN THE PHILIPPINES**

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Niño Raymond B. Alvina

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Niño Raymond B. Alvina is the executive director of the Bureau of Local Government Finance, Department of Finance of the Philippines.

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Please contact the authors for information about this paper.

Email: [nalvina@dof.gov.ph](mailto:nalvina@dof.gov.ph), [nb.alvina@blgf.gov.ph](mailto:nb.alvina@blgf.gov.ph)

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Asian Development Bank Institute  
Kasumigaseki Building, 8th Floor  
3-2-5 Kasumigaseki, Chiyoda-ku  
Tokyo 100-6008, Japan

Tel: +81-3-3593-5500  
Fax: +81-3-3593-5571  
URL: [www.adbi.org](http://www.adbi.org)  
E-mail: [info@adbi.org](mailto:info@adbi.org)

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**Abstract**

Local government units (LGUs) in the Philippines are authorized to borrow or incur debts to finance development, but with certain limitations provided by the Local Government Code of 1991. The main controlling statutory requirement is for provinces, cities, municipalities, and villages not to exceed 20% of their annual regular income going into debt servicing.

The range of purposes for which local governments are allowed to borrow are tied up with their expenditure responsibilities, and this varies according to the type and level of LGU, and their capacity to access financing. These commonly include capital investment projects, socioeconomic enterprises, and self-liquidating and income-generating projects.

This paper describes the experiences of the Philippines after close to three decades of fiscal decentralization in the country, presents trends and patterns of local debt management practices, highlights the roles of national government agencies and regulatory policies, and proposes emerging ideas and recommendations on how to improve debt management as an important pillar in local finance and decentralization.

**Keywords:** local government, debt, credit financing, Philippines

**JEL Classification:** H75, F34, H81

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# 1. INTRODUCTION

Situated in the southeast region of Asia, the Philippines is an archipelagic country with a unitary state and a decentralized system of governance. Subnational governments, commonly referred to as 'local government units' or LGUs, are administrative divisions of the state under the general supervision of the president, and they enjoy constitutionally guaranteed protections for local autonomy. Currently, there are 81 provinces, 145 cities, 1,489 municipalities, and 42,036 barangays or villages that constitute the Philippine LGUs, and all of them are mandated under the Local Government Code (LGC) of 1991<sup>1</sup> to generate their own sources of revenues, in varying degrees and scope.

After nearly three decades of fiscal decentralization, subnational debt invariably figured in financing development given the ebb and flow in the local debt market landscape. This is despite the fact all local governments are authorized under the LGC to decide if and when they will avail themselves of credit financing and use debt instruments, within their respective borrowing capacities, to finance the delivery of basic services.

Following the new decentralization law, local governments navigated various challenges during the transition phase that was characterized by prohibitively high interest rates, records of default payments and debt relief programs for LGUs, and limited availability of lending facilities catering to subnational governments. These factors considerably influenced local leaders' indifference to borrowing as a foremost best option in resource mobilization. Over time, filling the fiscal gaps and addressing expenditure needs of LGUs remained to be a challenge in many fronts, and subnational borrowings continued to be impressed with issues on poor utilization, propensity for misuse, inefficiencies in project implementation.

In FY2017, the estimated aggregate outstanding debt of LGUs already reached Php86.36 billion, most of which was derived from loans with government financial institutions (GFIs). This is a substantial growth during three-decade period marred with several LGUs recovering from bad credit record, and national government must on guard in foreseeing any impending systemic LGU debt crisis that could once again force a debt relief program.

Since the LGC gave anew a fresh mandate to local governments to incur different forms of indebtedness and be relieved of onerous ones, credit financing has since evolved to be regarded as a resource mobilization strategy for speeding up local economic growth and development. Hard budget rules and specific regulations have been laid out in the LGC and enforced through various executive issuances of the Department of Finance (DOF), through the Bureau of Local Government Finance (BLGF), to ensure that the fiscal risks associated with local debts are well managed.

With the changing behavior of the LGUs on borrowings, new measures were set to ensure a responsible and sustainable subnational debt management policy, even if the risk exposure and debt servicing requirements annually in aggregate terms are conservatively very low. Parenthetically, the changing policies somehow impacted the decisions of LGUs to tap credit financing, and the expansion of the debt market in response to LGU needs.

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<sup>1</sup> Republic Act (RA) No. 7160, dated 10 October 10 1991: An Act Providing for a Local Government Code of 1991.

This paper, thus, discusses the experiences of LGUs in the Philippines from the perspective of an oversight agency involved in subnational debt policy, monitoring, and evaluation, taking into account the policy developments and emerging trends and new ideas for consideration.

## 2. LGU FISCAL ARRANGEMENTS AND SOURCES OF REVENUES

The taxing powers and revenue generation mandates of LGUs in the Philippines vary according to type (province, city,<sup>2</sup> municipality, and barangay/village) and level of income<sup>3</sup>, and there are traditional and nontraditional sources of income. The current tax assignments are generally in favor of cities, followed by municipalities, provinces, and the barangays (Table 1). This can be associated with the diverse expenditure responsibilities, particularly with respect to devolved functions, services, and facilities (Table 2). Local governments are also authorized to impose regulatory fees and user charges. The tax rates for LGUs are set under the LGC with maximum rates or a ceiling, and not indexed to inflation. However, upward adjustments of up to 10% may be carried out once every five years, and all local impositions of LGUs and the setting or adjustment of their respective rates must be legislated by the concerned local legislative council, subject to review by a higher LGU council, if applicable.

**Table 1: Summary of Tax Assignments of LGUs in the Philippines**

<b>Tax Base</b>	<b>P</b>	<b>C</b>	<b>M</b>	<b>B</b>
Local business	No	Yes	Yes	No
Real property	Yes	Yes	Share	Share
Idle land	Yes	Yes	None	None
Real property transfers	Yes	Yes	None	None
Printing and publication	Yes	Yes	None	None
Sand, gravel, and other quarry resources	Yes	Yes	Share	Share
Delivery vans and trucks	Yes	Yes	None	None
Amusement places	Yes	Yes	Share	None
Professionals	Yes	Yes	None	None
Community tax	No	Yes	Yes	Share

P = Province, C = City, M = Municipality, B = Barangay/Village.

Source: Local Government of 1991.

<sup>2</sup> Cities in the Philippines are categorized as: (i) independent component cities, (ii) component cities, and (iii) highly urbanized cities. The distinction lies in the charter of the city whereby an independent component city does not allow its residents to vote for provincial elective positions, a component city is still considered part of the provinces and requires ordinances of the city council to be reviewed by the provincial council, and a highly urbanized city has a minimum population of 200,000 inhabitants with an annual income of Php50M based on 1991 constant prices.

<sup>3</sup> The income classification of LGUs is determined and set by the Department of Finance, pursuant to Executive Order No. 249, and the LGC. There are six income thresholds as a basis for classifying provinces, cities, and municipalities. The income classification is used for setting the statutory limitations for budget personnel salaries, access to concessional loans and grants, and other purposes.

**Table 2: Summary of Expenditure Responsibilities of LGUs in the Philippines**

<b>Devolved Services, Facilities, and Functions</b>	<b>P</b>	<b>C</b>	<b>M</b>	<b>B</b>
Agricultural research extensions and on-site research services	Yes	Yes	Yes	
Social welfare services	Yes	Yes	Yes	
Tourism facilities and promotions	Yes	Yes	Yes	
Enforcement of forestry laws	Yes	Yes		
Hospitals and tertiary health services	Yes	Yes		
Infrastructure funded from provincial funds	Yes	Yes		
Investment support services, industrial research, and development services	Yes	Yes		
Low-cost housing	Yes	Yes		
Telecommunication services for provinces and cities	Yes	Yes		
Adequate communication and transportation facilities		Yes		
Support services and facilities for education, police, and fire protection		Yes		
Community-based forestry projects and management of communal forests		Yes	Yes	
Primary health-care services and access to secondary and tertiary health services		Yes	Yes	
Public works and infrastructure projects funded out of local funds		Yes	Yes	
School building projects		Yes	Yes	
Solid waste disposal system and environmental management system		Yes	Yes	
Information services and reading center		Yes	Yes	Yes
Agricultural support services including collection of produce and buying stations				Yes
Health center and day-care center				Yes
Roads and infrastructure funded by the barangay				Yes
Solid waste collection				Yes
Village justice system				Yes

P = Province, C = City, M = Municipality, B = Barangay/Village.

Source: Local Government of 1991.

At the onset of fiscal decentralization, the share of local governments from national taxes through the internal revenue allotment (IRA),<sup>4</sup> a component of intergovernmental transfers, as guaranteed under the Philippine Constitution, increased considerably over time. IRA's nominal shares going to the LGUs have also been increasing due to an improved national tax effort. In the last three years, IRA has been consistently increasing, with a double-digit growth of 14.15% in 2015 and 13.59% in 2017, or with an average growth of 12.56%. In nominal terms, the additional IRA reached Php38.76 billion in 2016, while the increment in 2017 was Php58.27 billion (Table 3). From FY2015 to FY2017, IRA, in aggregate terms, constituted an average of 82% of the provincial regular income, 46% for cities, and 81% for municipalities (Table 4). Conversely, the locally sourced income respectively constituted only an average of 15%, 49%, and 15% of the provincial, city, and municipal regular incomes, or 29% at the aggregate LGU level (Table 5). The rest of the pie accounts for other transfers, grants, and extraordinary aid that LGUs are also authorized to receive, including other shares from the national tax collection such as from the utilization and development of national wealth (mining, forestry, or fishing resources), economic zone operations, shares from the proceeds of the expanded value-added tax, charity sweepstake operations, and tobacco excise tax. From 2010 to 2012, other shares from the national tax collection

<sup>4</sup> The IRA for a current year is computed based on the national government's gross internal revenue collection three fiscal years earlier, as prescribed in Section 284 of the Local Government Code. The IRA is allocated as 23% for provinces, 23% for cities, 34% for municipalities, and 20% for barangays. The share is further determined according to population (50%), land area (25%), and equal sharing (25%) of the LGU. The barangay share is determined according to population (60%) and equal sharing (40%).



constituted less than 5% of the annual regular income of LGUs. However, in tobacco-producing provinces and municipalities, the share could be as high as 60% to 65% derived from their shares from tobacco excise tax.

**Table 3: Historical Growth of IRA of LGUs**

LGU Type	IRA Share (in Php Million)			Growth			Ave
	2015	2016	2017	2015	2016	2017	
Provinces	91,024	99,938	113,339	13.91%	9.79%	13.41%	12.37%
Cities	89,207	98,124	111,526	14.23%	10.00%	13.66%	12.63%
Municipalities	132,953	146,128	165,938	14.10%	9.91%	13.56%	12.52%
Barangays	76,677	84,429	96,082	14.42%	10.11%	13.80%	12.78%
<b>Total</b>	<b>389,860</b>	<b>428,620</b>	<b>486,885</b>	<b>14.15%</b>	<b>9.94%</b>	<b>13.59%</b>	<b>12.56%</b>
<i>Net Increase (YoY)</i>	<i>48,316</i>	<i>38,759</i>	<i>58,265</i>				

Source of Raw Data: Statements of Receipts and Expenditures, BLGF.

**Table 4: Share of IRA to Annual Regular Income (ARI) of LGUs (in Php Million)**

LGU Type	2015			2016		
	ARI	IRA	% Dist	ARI	IRA	% Dist
Province	108,699	90,712	83%	121,912	99,504	82%
City	191,483	89,050	47%	208,649	97,953	47%
Municipality	162,097	132,544	82%	181,668	145,752	80%
<b>Total</b>	<b>462,279</b>	<b>312,306</b>	<b>68%</b>	<b>512,230</b>	<b>343,209</b>	<b>67%</b>
LGU Type	2017			3-Year Ave		
	ARI	IRA	% Dist	ARI	IRA	% Dist
Province	136,925	110,861	81%	122,512	100,359	82%
City	242,021	105,904	44%	214,051	97,636	46%
Municipality	204,995	164,065	80%	182,920	147,454	81%
<b>Total</b>	<b>583,940</b>	<b>380,830</b>	<b>65%</b>	<b>519,483</b>	<b>345,448</b>	<b>67%</b>

Source of Raw Data: Statements of Receipts and Expenditures, BLGF.

**Table 5: Share of Locally Sourced Income (LSI) to Annual Regular Income of LGUs**

LGU Type	2015			2016		
	ARI	LSR	% Dist	ARI	LSR	% Dist
Province	108,699	16,424	15%	121,912	18,042	15%
City	191,483	96,676	50%	208,649	104,954	50%
Municipality	162,097	25,130	16%	181,668	26,967	15%
<b>Total</b>	<b>462,279</b>	<b>138,229</b>	<b>30%</b>	<b>512,230</b>	<b>149,963</b>	<b>29%</b>
LGU Type	2017			3-Year Ave		
	ARI	LSR	% Dist	ARI	LSR	% Dist
Province	136,925	20,088	15%	122,512	18,185	15%
City	242,021	116,156	48%	214,051	105,929	49%
Municipality	204,995	31,214	15%	182,920	27,770	15%
<b>Total</b>	<b>583,940</b>	<b>167,457</b>	<b>29%</b>	<b>519,483</b>	<b>151,883</b>	<b>29%</b>

Source of Raw Data: Statements of Receipts and Expenditures, BLGF.

While it would appear that the aggregate indicators show a modest state of financial affairs across all LGUs, this is largely driven by the performance of big and rich LGUs offsetting other LGUs. In a number of low-income and rural LGUs, IRA would easily constitute at least 90% of their regular income, and this is notably true in more than 800 local governments or 47% of all local governments in the country. In particular, there were 25 provinces, 21 cities, and 776 municipalities in 2016 whose dependence on IRA, as a ratio of the annual regular income, was at least 90%.<sup>5</sup> Funding for local development and investing in priority programs thus continues to be a challenge for most LGUs, notwithstanding the possibility that in their delivery of basic goods and services, the available operating income may be insufficient at the outset to fund long-term plans, given the existing statutory limitations on local budgetary allocations.

In terms of own sources, LGUs generate income from tax and nontax sources. Tax sources include real property taxes, local business taxes, and other taxes. Nontax sources, on the other hand, include regulatory fees, service/user charges, and income from operations of economic enterprise (such as hospitals, public markets, terminals, etc.). The combined tax and nontax revenues, also known as “locally sourced income,” accounted for an average of 15% of the regular income of provinces, 49% for cities, and 15% for municipalities from 2015 to 2017.

Among the local revenues, business tax is considerably the main income driver for cities and municipalities, at an average of 55% and 35%, respectively, of their total local revenues from FY2016 to FY2017, given the concentration of commercial and economic activities, especially in urban areas and capital towns. On the other hand, provinces rely heavily on real property taxes, regulatory fees and user charges, and economic enterprise (Table 6). All these local revenues, however, account for a little over 1% of GDP from 2015 to 2017, which appears to indicate that the local revenue generation capacity has not significantly kept up with the national tax effort and economic growth. This is significantly true in recent years where IRA allocations have grown due to an increased base of national taxes collected.

**Table 6: Share of Individual Local Sources to Total Local Income**

LGU Type	Real Property Tax				Business Tax				Other Taxes			
	2015	2016	2017	Ave	2015	2016	2017	Ave	2015	2016	2017	Ave
Province	17%	16%	19%	17%	8%	7%	7%	7%	4%	4%	5%	4%
City	19%	18%	22%	20%	56%	56%	53%	55%	6%	6%	5%	6%
Municipality	13%	12%	14%	13%	36%	35%	35%	35%	3%	3%	3%	3%
<b>Total</b>	<b>48%</b>	<b>47%</b>	<b>55%</b>	<b>50%</b>	<b>100%</b>	<b>99%</b>	<b>95%</b>	<b>98%</b>	<b>13%</b>	<b>13%</b>	<b>13%</b>	<b>13%</b>
LGU Type	Regulatory Fees				Service/User Charges				Receipts from Econ. Enterprises			
	2015	2016	2017	Ave	2015	2016	2017	Ave	2015	2016	2017	Ave
Province	2%	2%	2%	2%	35%	37%	39%	37%	33%	33%	29%	32%
City	7%	7%	7%	7%	5%	5%	5%	5%	8%	8%	7%	8%
Municipality	12%	13%	13%	12%	9%	10%	10%	10%	27%	27%	26%	27%
<b>Total</b>	<b>21%</b>	<b>21%</b>	<b>21%</b>	<b>21%</b>	<b>49%</b>	<b>52%</b>	<b>54%</b>	<b>52%</b>	<b>68%</b>	<b>68%</b>	<b>62%</b>	<b>66%</b>

Source of Raw Data: Statements of Receipts and Expenditures, BLGF.

<sup>5</sup> Based on the author’s analysis of his ongoing work on the LGU Fiscal Sustainability Scorecard of all provinces and cities in the Philippines for FY2014 to FY2016.

Local governments may also resort to nontraditional sources of financing, such as loans, bonds, joint ventures, and public-private partnerships, among others, as part of their strategies in regard to resource mobilization and in financing medium- and long-term projects.

### 3. POLICY AND LEGAL FRAMEWORK OF CREDIT FINANCING

Credit financing is recognized as an important feature of any decentralization experience. Rondinelli and Cheema (1983) defined decentralization as “the transfer of planning, decision making, or administrative authority from the central government to its field organizations, local governments, or nongovernmental organizations.” As defined by the World Bank, administrative decentralization is the redistribution of authority, responsibility, and financial resources for providing public services among different levels of government. It is the transfer of responsibility in terms of planning, financing, and management of certain public functions from the central government and its agencies to the field units of government agencies, subordinate units or levels of government, semi-autonomous public authorities or corporations, or area-wide, regional, or functional authorities.

The Philippines has had a long history of fiscal decentralization involving two constitutions defining the overall policy on local autonomy, and at least four major local government laws that enabled the evolution of the political and fiscal governance landscapes in the country in the last five decades. In 1959, the Local Autonomy Act<sup>6</sup> empowered the LGUs during the postwar era by reorganizing the provinces and increasing their local autonomy. The Decentralization Act of 1967<sup>7</sup> granted further autonomous powers to local governments by empowering them to undertake field agricultural extension work and rural health work, or supplement existing national programs or services in their respective areas of jurisdiction.

Under the 1973 Constitution, local governments were given the power to create their own sources of revenue and to levy taxes, subject to limitations as may be provided by law.<sup>8</sup> Subsequently, the Local Government Code of 1983<sup>9</sup> was issued under the martial law regime and paved the way for the issuances of several presidential decrees (PDs) concerning the roles and powers of LGUs. Among these are (i) PD No. 1741 for the internal revenue allotments for local governments, (ii) PD No. 231 providing for the local tax code for provinces, cities, municipalities, and *barrios*, (iii) PD No. 752, which decreed the subnational credit financing, and (iv) PD No. 1375, which assigned the local government budget administration functions to the Budget Commission.

With the new 1987 Constitution, Article X defined the broad powers, functions and responsibilities of provinces, cities, municipalities, and villages or barangays, including the autonomous regions, which constitute all local government units in the Philippines. These local governments, being the state’s territorial and political subdivisions, are allowed to enjoy local autonomy. Through the same constitution, it paved the way for payment for the enactment of the LGC in order to “provide for a more responsive and

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<sup>6</sup> RA No. 2264, dated 19 June 1959: An Act Amending the Laws Governing Local Governments by Increasing their Autonomy and Reorganizing Provincial Governments.

<sup>7</sup> RA No. 5185, dated 12 September 1967: An Act Granting Further Autonomous Powers to Local Governments.

<sup>8</sup> Section 5 of Article XI of the 1973 Constitution.

<sup>9</sup> Batas Pambansa Blg. 337, dated 10 February 1983: An Act Enacting a Local Government Code.

accountable local government structure instituted through a system of decentralization with effective mechanisms of recall, initiative, and referendum, allocate among the different local government units their powers, responsibilities, and resources, and provide for the qualifications, election, appointment and removal, term, salaries, powers and functions and duties of local officials, and all other matters relating to the organization and operation of the local units.”

The inception of the government’s policy to allow domestic borrowings as a financing tool of local governments took effect in 1975 when President Marcos signed PD No. 752, also known as the “Decree on Credit Financing for Local Governments.” Under this decree, the state adopted the basic policy that “any local government may avail of credit facilities and resort to borrowings only if the local funds are not sufficient to finance the prosecution, completion, expansion, operation, and maintenance of local infrastructures and other socioeconomic developmental projects.”<sup>10</sup> This stemmed from the state’s recognition that credit financing, in reasonable and moderate terms, augments the insufficient national allotments and taxing powers of local governments to allow for the timely and immediate execution of priority infrastructure and developmental projects to spur socioeconomic growth.

The credit financing schemes authorized for local governments by PD No. 752 included: (i) domestic loans, credits, and other forms of indebtedness with national lending institutions; <sup>11</sup> (ii) deferred-payment financing schemes under a supplier’s credit or deferred-payment plan; (iii) bonds and other long-term securities, such as debentures, securities, collaterals, notes, and other obligations; (iv) inter-local government loans or loans between and among local governments; (v) relending of funds secured by the national government from foreign sources; and (vi) financing contracts with private natural or juridical persons for self-liquidating or income-producing projects.

Access to credit financing at that time, however, was governed by the restrictions on borrowings of local governments set under PD No. 752, namely:

1. The legal borrowing capacity of LGUs was certified by the Commission on Audit (COA);<sup>12</sup>
2. The recommendation of the Secretary of Finance was required in securing provisional advances and in contracting loans, credits, and other forms of indebtedness;
3. Only the national lending institutions were authorized to lend to the LGUs;
4. Private financing tapped by LGUs was subject to the approval of the National Economic and Development Authority (NEDA) and recommendation of the Secretary of Finance;
5. Provisional advances could not exceed 15% of the average annual income actually realized from regular sources by the borrowing LGU for the last three fiscal years, and were payable within the first quarter of the following fiscal year;

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<sup>10</sup> Section 2 of PD No. 752.

<sup>11</sup> Such as the Philippine National Bank, the Development Bank of the Philippines, the Land Bank of the Philippines, and the Government Service Insurance System.

<sup>12</sup> According to Pelligrini and Soriano (2002), the COA computed the borrowing capacity as 7% of the assessed value of all taxable real property as of the end of the immediately preceding year less outstanding loans and other long-term indebtedness. With the enactment of the LGC in 1991, the COA issued Circular No. 94-007, which effectively discontinued issuance by the COA.

6. The Secretary of Finance was authorized to withhold the internal revenue allotments and/or specific tax allotments accruing to the LGU concerned and the direct remittance and settling of the outstanding amount to the lending institution;
7. It was mandatory for the concerned LGUs to provide in their respective budgets the necessary appropriations for the payment of loans or other forms of indebtedness as they fell due and payable until the total obligation had been fully paid;
8. Local government bonds were exempt from taxes and the annual rate of interest payable on the bonds, as well as the mode of payment of the interest, were fixed by the Secretary of Finance upon consultation with the Monetary Board; and
9. The relending to LGUs of loans acquired by the National Government was upon the recommendation of the Secretary of Finance and the NEDA.

With the fiscal decentralization reforms instituted by Republic Act No. 7160 or the Local Government Code (LGC) of 1991, local governments' authority to incur indebtedness and other forms of borrowings had been broadened. The prior review by DOF or NEDA for domestic borrowings was discontinued. The LGC also authorized local governments to avail themselves of credit lines from government or private banks and lending institutions for the purpose of stabilizing local finances.<sup>13</sup>

Among the schemes allowed under the LGC are: (i) loans, credits, and other forms of indebtedness; (ii) deferred payment and other financial schemes; (iii) bonds and other long-term securities; (iv) inter-local government loans, grants, and other subsidies; and (v) loans from funds secured by national government from foreign sources. The decisions of local governments to issue bonds, debentures, notes, and other obligations to finance self-liquidating, income-producing development or livelihood projects are subject to the regulations of the Bangko Sentral ng Pilipinas (BSP), the country's central bank, and the Securities and Exchange Commission. LGUs may also enter into contracts with the private sector for the financing, construction, operation, and maintenance of any financially viable infrastructure facilities under the build-operate-transfer (BOT) scheme or any of its variants, authorized by RA No. 6957<sup>14</sup> as amended by RA No. 7718.<sup>15</sup>

Borrowings of local governments, however, are limited to the following purposes:

1. Construction, installation, improvement, expansion, operation, or maintenance of public facilities, infrastructure facilities, housing projects, acquisition of real property, and the implementation of other capital investment projects;
2. Establishment, development, or expansion of agricultural, industrial, commercial, house financing projects, livelihood projects, and other economic enterprises;
3. Acquisition of property, plant, machinery, equipment, and necessary accessories; and
4. Financing of self-liquidating, income-producing development or livelihood projects.

The interest rates used by GFIs and private financial institutions (PFIs) are generally market-driven and also depend on internal procedures and credit and risk assessments of banks. In the case of GFIs, being the biggest authorized government depository banks

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<sup>13</sup> Section 296 (b) of the LGC.

<sup>14</sup> An Act Authorizing the Financing, Construction, Operation, and Maintenance of Infrastructure Projects by the Private Sector and for Other Purposes, enacted on 9 July 1990.

<sup>15</sup> An Act Amending Certain Sections of RA No. 6957, enacted on 5 May 1994.

for LGUs, especially for IRA, the actual deposits and other banking products and services availed by the LGUs matter in designing the loan terms and conditions. The concept of IRA intercept or pledging the regular IRA deposits transferred by the national government to the depository bank of the LGU, which is usually a GFI, has a bearing. Legally, however, only the Municipal Development Fund Office (MDFO) has the mandate to withhold or intercept the IRA deposits of the LGU, as a form of security or guarantee in cases of default or bad debt repayment of the LGU, and no other banks, government or private, are authorized to do so. On the other hand, PFIs are required not to set any deposit guarantee mechanisms with borrowing LGUs.

The interest rates<sup>16</sup> for medium- and long-term loans for GFIs and PFIs are not often fixed, as in some financing facilities of the MDFO, and are actually subject to repricing and variable adjustments, depending on the negotiated terms of the lending institution and the LGU. Depending on risk assessments and other factors, the rates are either close to or far from the average lending rates, which in the last three years averaged 5.617%. Based on the approved borrowing certificates during the last three years, the average lending rates amounted to 5.40%, but in the post-borrowing reports of GFIs and PFIs, lending rates averaged 5.45% and 5.18%, respectively (Table 7). Only the MDFO offers fixed and concessional interest rates to all eligible LGUs. Currently, the MDFO has nine financing windows aligned to specific LGU priority and national programs, with the corresponding preferential interest rates and applicant grant component summarized in Table 8.

With a view to expanding financing access under the LGU Financing Framework, Executive Order (EO) No. 809<sup>17</sup> was issued in 2009 to cater to LGUs with robust own-revenue autonomy, or first-tier LGUs with at least 60% of their annual regular income generated from local sources, to be allowed to directly contract loans with multilateral financial institutions (MFIs) created by multilateral treaties or agreements to which the Philippines is a signatory. This stems from the segmentized approach for rich and creditworthy LGUs to tap the private sector and not to crowd out the financing channels from GFIs for low-income LGUs.

**Table 7: Average Lending Rates**

Year	Bank Average Lending Rates	Interest Rate per BLGF Certificate	GFIs	PFIs
2015	5.58%	5.75%	5.74%	5.84%
2016	5.64%	5.46%	5.50%	5.10%
2017	5.63%	5.00%	5.10%	4.60%
Average	5.62%	5.40%	5.45%	5.18%

Source of Basic Data: LDMED, BLGF, and BSP.

<sup>16</sup> Lending institutions refer to the Philippine Dealing System Treasury Reference Rates (PDST-R1 and PDSTR-2) if they choose to impose the prevailing interest rate at the time of the loan proposal. According to the BSP, the PDST-R1 and PDST-R2 become the reference rates for the repricing of loans, securities, derivative transactions, and other interest rate-sensitive instruments.

<sup>17</sup> Entitled "Implementing the Financing Policy Framework for Local Government Units by Identifying New Sources of Funding for First-Tier Local Government Units Under Republic Act No. 7160," signed by President Arroyo on 9 June 2009.

**Table 8: Existing MDFO Financing Facilities**

Financing Window	Objectives	Eligible Borrowers	Eligible Proposals/ Subprojects	Interest Rates*
1. Disaster Management Assistance Fund (DMAF)	<ul style="list-style-type: none"> <li>Provide financial support for disaster risk management (DRM) initiatives of LGUs</li> <li>Enhance community resilience to disaster</li> <li>Promote economic growth</li> </ul>	All LGUs nationwide	Emergency Financial Assistance, Restorative Financial Assistance, Anticipative Financial Assistance	0% to 3%
2. Municipal Development Fund Project (MDFP)	<ul style="list-style-type: none"> <li>Provides concessional financing assistance to lower-income-class LGUs with revenue-generating subprojects</li> </ul>	All LGUs nationwide	Revenue-/Nonrevenue-generating projects. Other infrastructure projects	3.75% to 4.5%
3. Revenue Administration and Modernization Program (RAMP)	<ul style="list-style-type: none"> <li>Assist and support in the improvement and strengthening of local government capacities in fiscal management, revenue administration, and resource mobilization;</li> <li>Help LGUs install modernized and disaster-proof resource mobilization system; and</li> <li>Reduce LGU dependence on IRA</li> </ul>	All LGUs nationwide	Real Property Tax Administration Project (RPTAP) – Manual and Computerized; Business Tax Enhancement Project (BTEP)	3% fixed (with 30% grant)
4. Municipio Fund	<ul style="list-style-type: none"> <li>Provide a conducive workplace for local government employees, which in effect leads to effective and efficient delivery of basic services</li> <li>Aid in attracting investments to further encourage economic growth and development within the municipality</li> <li>Aid in improving good governance</li> </ul>	All 1st to 6th Income Class Municipalities	Construction, relocation, rehabilitation, and expansion of municipal halls/buildings.	3.5% to 4%
5. Philippine Water Revolving Fund (PWRF)	Leverages Official Development Assistance (ODA) Private Financing Institution (PFI) funding; Develops financing mechanism acceptable to PFIs but at the same time affordable to water utilities; Develops financing mechanism with revolving capacity; Provides a mechanism to implement EO 279	Water Districts, LGUs Consortium or joint ventures; Privately owned corporations; Private financial institutions	Water extraction, transmission, supply treatment, and distribution; Wastewater collection, treatment, and disposal; NRW reduction and efficiency-enhancing measures; Refinancing of water project loans	Variable
6. Program Lending (ProLend)	Assists provincial LGUs in financing development projects with the provision that they will pursue a policy reform agenda	All Provinces	Revenue-generation; Expenditures planning and management; Service delivery; Congruence with national policy objectives and programs	Fixed based on the 10-year Treasury Bond on the day of the loan approval
7. Project Technical Assistance and Contingency Fund (PTACF)	Assists in accelerating LGU preparation and submission of feasibility studies and detailed engineering design; Creates a fund to finance the actual foreign exchange differentials of LGUs incurred in their project implementation; Provides a source of financing for other TA needs of LGUs	All LGUs except highly urbanized cities	Feasibility studies; Detailed engineering design (DED); Other TA requirements of LGUs	0% to 1.5%
8. Refinancing Facility	Aims to lower the loan amortization payment of the LGUs, reduce the LGUs' risk from paying a variable interest rate offered by other banks by switching to a fixed-rate loan, and lighten the financial burden of LGUs	All Provinces, Cities, Municipalities, and Highly Urbanized Cities (HUCs)	Refinancing of existing debts, such as the outstanding loan and other fees and charges the lending institution may impose due to contract pre-termination	Fixed based on the prevailing market rate at the time of loan approval.
9. Public-Private Partnership Fund (PPP)	Aims to support the current Administration's thrust of moving the PPP to the LGU level	All LGUs, provided there is a certainty that the LGU will partner with a private entity	Public Economic Enterprise/Revenue-Generating Subprojects, Social and Environmental Subprojects, Solid Waste Management Facilities	3.75%

\*Depending on the type of project and the income classification of the LGU applicant.

Source of Basic Data: [www.mdfo.gov.ph](http://www.mdfo.gov.ph).

Unlike the earlier policies, EO No. 809 recognized that since LGUs may tap additional financing from loans secured by the National Government from foreign financial institutions or other international funding agencies pursuant to the power of the president to directly or indirectly relend such loans to LGUs, such authority was considered extended to qualified LGUs to directly access credit financing from MFIs on a stand-alone basis and without sovereign guarantee. This mechanism, however, did not yield any successful LGUs taking the MFI venture, despite being able to meet the threshold for locally sourced income. In 2014, when the initial profile for possible financing via MFI credit was explored, 20 cities and eight municipalities were deemed qualified,<sup>18</sup> but none indicated an interest in attempting the novel financing facility. In 2017, only 17 cities and seven municipalities were able to meet the requirement,<sup>19</sup> but there was no appetite to test the new approach introduced. The traditional loan thus continued to be the most convenient financing channel given the fewer complexities in processing and approval, and relatively lower costs to the LGU.

Considering that most local governments have since adopted a conservative view of credit financing, some local chief executives take pride in being in zero debt during their term of office or being able to pay off all outstanding debts sooner. It becomes a political issue at the local level because borrowing is capitalized by opposition as a sign of weakness in governance, and commonly local constituents, especially in rural areas, do not expressly demand better-quality services and, therefore, there is no compulsion for the LGUs to push for development projects (Tan 2012). Such a view, however, is double-edged since it holds the traditional view of living within available resources without any urgent need to front-load capital to speed up development and improve services. On the other hand, it denotes the natural aversion of local leaders to risk, so that no long-term obligations are imposed upon the local constituency, and future elective officials.

#### 4. *EX ANTE* CONTROLS AND POLICIES IN SUBNATIONAL BORROWINGS

While there are no insolvency mechanisms for LGUs, they are, however, required by law to secure authorizations and approvals when they consider domestic borrowings. The local chief executive (LCE) must be duly authorized by the local legislative council, known as the *Sanggunian*, through a resolution to negotiate, enter into, and sign contracts for and on behalf of the local government. The proposed project to be financed by the loan should be included in the Approved Annual Investment Plan (AAIP), which is an implementation instrument of an LGU for a particular term-based agenda for the current year.

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<sup>18</sup> Cities and municipalities with their corresponding locally sourced revenues as a component of their annual regular income: Makati City (90.73%), Pasig City (83.73%), Mandaluyong City (81.63%), Pasay City (80.50%), Quezon City (78.45%), San Juan City (75.37%), Taguig City (74.84%), Manila City (74.68%), Paranaque City (72.80%), Muntinlupa City (72.05%), Tagaytay City (70.84%), Santa Rosa City (68.32%), Batangas City (64.21%), Valenzuela City (63.34%), Cebu City (62.53%), Marikina City (62.33%), Cabuyao City (62.12%), Olongapo City (61.75%), Iloilo City (61.40%), Lapu-Lapu City (60.85%), Rodriguez (99.46%), Malay (79.50%), Carmona (77.62%), Limay (71.77%), Calaca (71.46%), General Trias (62.58%), Cainta (61.39%), and Villanueva (60.42%).

<sup>19</sup> Cities and municipalities with their corresponding LSR as a component of their annual regular income: Makati City (89.5%), Mandaluyong City (87.9%), Pasig City (85.0%), Pasay City (78.6%), Quezon City (76.3%), San Juan City (75.9%), Taguig City (74.7%), Manila City (74.4%), Paranaque City (74.0%), Muntinlupa City (73.9%), Santa Rosa City (68.9%), Tagaytay City (66.6%), Valenzuela City (66.2%), Marikina City (61.7%), Iloilo City (60.8%), Lapu-Lapu City (60.4%), Mandaue City (60.4%), Malay (78.3%), Carmona (74.3%), Limay (68.6%), Calaca (63.2%), Masinloc (62.4%), Sual (62.0%), and Villanueva (61.8%).



On the other hand, *ex ante* controls are exercised by the national government. The DOF, through the BLGF, and the BSP, through its Monetary Board (MB), have specific policies, issue clearances and approvals, and monitor LGU debts. The following are the legal requisites for all credit operations of local governments:

1. LGUs may create indebtedness and avail themselves of credit facilities with government or private banks and lending institutions;<sup>20</sup>
2. The appropriation of 20% of the LGU's regular income for debt servicing<sup>21</sup> as part of the requirement of the LGC that "full provision shall be made for all statutory and contractual obligations of the local government unit concerned," otherwise the LGU budget becomes inoperative;
3. The DOF should render technical assistance to any LGU in the availment of credit facilities, flotation of bonds, and contracting of loans and issue guidelines for the purpose;<sup>22</sup>
4. The BLGF should develop and promote plans and programs for the improvement of resource management systems, collection enforcement mechanisms, and credit utilization schemes at the local level;<sup>23</sup> and
5. The prior opinion of the MB on the probable effects of the proposed credit operation on monetary aggregates, the price level, and the balance of payments is required whenever the government, or its political subdivision or instrumentality, which includes the LGUs, contemplates borrowing within the Philippines.<sup>24</sup>

Unlike in PD No. 752, the LGC allowed credit financing of LGUs to be sourced from any government or private lending and financial institutions. This is a marked difference where the regulation was relaxed to enable borrowings from private funds, noting that prior to the enactment of the LGC, there was inadequate available financing. Earlier, the DOF reported (Tan 2012) that while government financial institutions (GFIs) opened lending facilities for the LGUs, these were saddled by problems related to high interest rates. In turn, the lower-income-class LGUs were not able to access concessional funds for development projects, and the majority of these LGUs are rural with limited economic interest. There was also a slow process of approval as loan packages were reviewed by several national government agencies, such as the DOF and the NEDA, as required by the presidential decree. The limited lending windows opened by private banks and GFIs closed thereafter, and a debt relief program was initiated whereby the national government initially assumed repayment of debts and, depending on the capability of the LGU, the debts were either condoned or repaid on a staggered basis.

With the New Central Bank Act (RA No. 7653) enacted in 1993, the BSP issued regulations for subnational borrowings in light of its mandate to advise government on all official credit matters, especially with regard to the impact on the monetary sector and external payments position of the economy. Since the enactment of RA No. 7653, the BSP has issued the following regulations relative to requesting MB opinion for subnational loans:

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<sup>20</sup> Sec. 296 of LGC; Art. 395d of LGC Implementing Rules and Regulations (IRR).

<sup>21</sup> Sec. 324 of LGC.

<sup>22</sup> Art. 403 of LGC IRR.

<sup>23</sup> Sec. 43 (c) of EO No. 127, s. 1987.

<sup>24</sup> Sec. 123 of RA No. 7653.

1. BSP Circular Letter, Series of 2002, dated 28 May 2002, on the reminder to all banks and nonbanks with quasi-banking functions;<sup>25</sup>
2. Circular No. 402, dated 4 September 2003, on the Revised Guidelines on the Flotation of Bonds by LGUs Without National Government Guarantee;
3. Circular Letter No. CL-2008-050, dated 6 August 2008, on the reminder to all banks on the requirement for prior MB opinion under Section 123 of R.A. No. 7653;
4. Circular No. 769, dated 26 September 2012, on the Guidelines on Requests for Monetary Board Opinion on the Monetary and Balance of Payments Implications of Proposed Domestic Borrowings by LGUs;<sup>26</sup>
5. Circular No. 797, dated 22 May 2013, on the Enforcement Actions on Banks in Relation to Section 123 of R.A. No. 7653; and
6. Circular No. 819, dated 12 November 2013, on the Amendments to Circular No. 769.

The latest BSP issuance currently in force is Circular No. 926 issued in 2016, which clarified the manner in which LGUs secure a favorable monetary board opinion on the monetary and balance of payments implications every time an LGU considers borrowing, with the additional requirement to submit post-borrowing reports to the BSP, and an ordinance approving the proposed borrowing along with its purpose, terms, and conditions.

Under BSP Circular No. 926, LGUs must also secure a certification of net debt service and borrowing capacity from the BLGF. The debt service ceiling is the maximum amount that an LGU can appropriate in the annual budget for the payment of its statutory and contractual loan obligations. The borrowing capacity is the maximum amount of statutory and contractual obligations that an LGU may incur over a period of one or more years at a specified rate of interest. This, however, stemmed from relending programs of DOF, through the Monetary Board, in determining how much local governments can borrow.

The rules governing the process and requirements for certifying the borrowing capacities and debt service ceilings are issued by the DOF and the BLGF, and include the following:

1. Local Finance Circular (LFC) No. 1-2000, dated 19 January 2000, on “Certification of Borrowing and Debt Service Capacities of Provinces, Cities, and Municipalities”;<sup>27</sup>
2. LFC No. 1-2012, dated 16 April 2012, on the “Certificates of Maximum Borrowing and Debt Service Capacities of Local Government Units”;

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<sup>25</sup> Required each borrowing LGU to present its debt service and borrowing capacity, duly certified by the BLGF.

<sup>26</sup> Listed the updated required supporting documents and information for LGU Borrowings, e.g., certification on the debt service and borrowing capacity of the LGU obtained from the DOF-BLGF.

<sup>27</sup> DOF originally required only five documentary requirements in issuing the borrowing certificate, i.e., (1) Statement of Actual Income and Expenditures for the past three years duly signed by the Local Accountant; (2) Certification from the Local Treasurer of the IRA received (gross and net) for the past three years; (3) Certification from the Local Assessor of the Taxable Assessed Value for the past three years and dates of the last successful conduct of the general revision of real property assessments; (4) Certification of existing loans; and (5) COA Annual Audit Report for the past three fiscal years.

3. LFC No. 1-2014, dated 22 April 2014, on “Guidelines for the Issuance and Validity of Certificates of Maximum Borrowing and Debt Service Capacity of Province, Cities, and Municipalities Affected by Typhoon Yolanda”;<sup>28</sup> and
4. Department Order (DO) No. 054-2016, dated 25 October 2016, on “Streamlining the Certification of Net Debt Service Ceiling and Borrowing Capacity of Local Government Units.”<sup>29</sup>

Prior to LFC No. 1-2000, the MDFO<sup>30</sup> of the DOF had already set the process and formula in determining the borrowing capacity of LGUs borrowing under its relending program. Under Resolution No. 04-95, dated 27 April 1995, of the Municipal Development Fund (MDF) – Policy Governing Board (PGB), the borrowing capacity or loanable amount of LGUs applying for MDF facility was established by classifying projects as either revenue generating or nonrevenue generating. The loanable amount for revenue-generating projects should not exceed 18% of the current year’s estimated annual regular income, plus IRA for the current year, as estimated by the Department of Budget and Management (DBM), multiplied by the annuity factor 5.660 (tenor of 12 years and interest rate of 14% per annum) or the prevailing interest rate.

For nonrevenue-generating projects, the MDFO then required that the borrowing capacity should not exceed 10% of the current year’s estimated annual regular income, plus IRA for the current year, as estimated by the DBM, multiplied by the same annuity factor or the prevailing interest rate. This approach, however, was problematic since the annual regular income was based on an estimate without a clear distinction of what constitutes a regular income, and IRA was again added with a fixed annuity factor using long-term tenor and a very high interest rate, which was prevalent during the early years post-LGC. The more conservative limitations for the actual loanable amount set by the PGB resolution, which is less than 20% of what is required by the LGC, namely 18% of the regular income for income-generating projects and 10% for projects that are not income generating, were standardized. Currently, these distinctions and borrowing capacity parameters are no longer in use, and the borrowing certificates issued by the BLGF have since been referred to in determining the borrowing capacity of LGUs availing themselves of MDF facilities.

In 1996, the DOF adopted the LGU Financing Framework (Figure 1) to categorize the projects of LGUs with respect to their income classification and the financing support that should be made available to them, thereby segmentizing the market for credit providers. Based on the economic disparities and financial capacity of local governments, high-income-class LGUs are regarded as creditworthy, while low-income-class LGUs are deemed marginal or noncreditworthy. The approach was to encourage financing through the private sector, either through public-private partnerships, joint ventures, build-operate-transfer schemes, or private bank financing, with a mix of loans from GFIs, for revenue-generating projects of high-income-class LGUs. Conversely, social and environmental projects, or nonrevenue-generating investments, of low-income-class LGUs were considered to be best financed by

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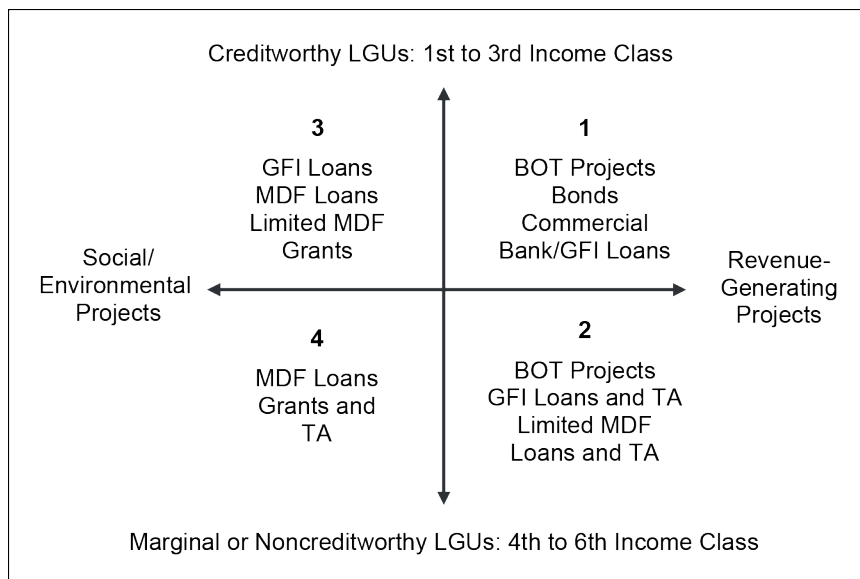
<sup>28</sup> Documentary requirements reduced to four for LGUs affected by Super Typhoon Yolanda (Haiyan) and the validity of issued certificates extended for one (1) year.

<sup>29</sup> Requirements reduced to four for all LGUs and the extended period of validity of certificates maintained for one (1) year.

<sup>30</sup> The MDFO is the administrator and manager of the Municipal Development Fund (MDF), a special revolving fund for relending to LGUs, created through Presidential Decree (PD) No. 1914, dated 29 March 1984. The policies of the MDFO are set by its Policy Governing Board (PGB) comprised of officials from the DOF (chairperson), National Economic Development Authority (NEDA), Department of Budget and Management (DBM), Department of Interior and Local Government (DILG), the DPWH, and the Executive Director of the MDFO.

concessional loans from the MDF and GFIs, or through direct grants and technical assistance from the national government, official development assistance (ODA), or from multilateral institutions.

**Figure 1: Summary of the DOF’s LGU Financing Framework**



Source of Raw Data: LGU Financing Framework, DOF.

Using the vertical axis as a reference to creditworthiness and the horizontal axis to classify the nature of the project to be funded by the loan, whether an income-generating or nonrevenue project, the LGU Financing Framework of the DOF grouped the LGUs into four quadrants, together with the corresponding source/s of financing:

1. The first group covers creditworthy LGUs whose projects are revenue generating; and they can access private sector financing, as well as GFIs, private lending institutions, and float bonds, or undertake public-private partnerships and related schemes;
2. The second group includes noncreditworthy LGUs whose projects are revenue generating, and they can tap GFI and MDF loans with additional technical assistance grants (to build project management and other technical capacities), or undertake public-private partnerships and related schemes;
3. The third group refers to creditworthy LGUs whose projects are for social and environmental protection, with little prospect of return on investments, and the preferred financing sources are the very low-interest-bearing official development assistance (ODA) relented through GFIs or the MDFO, and with limited grants; and
4. The fourth group pertains to noncreditworthy LGUs whose projects are for social and environmental protection, and the preferred financing sources are the loans and grants of the MDFO.

While the financing policy framework provided the overall guidelines on what projects are to be funded and given attention by MDF in response to financing the devolution requirements mandated by the 1991 LGC, the required creditworthiness rating remains to be fully established, with no fully functioning monitoring and updated regulatory mechanisms for LGU borrowings by the DOF at that time, the *ex post* controls and remedies, and policy framework for LGU insolvency.

Nevertheless, in further encouraging LGUs to consider credit financing, the BSP accepted LGU borrowings as compliance with the requirements of RA No. 10000<sup>31</sup> or the Agri-Agra Law, which mandated all banks to utilize 25% of the loan portfolio for agricultural or agrarian projects, which actually caters to the needs of LGUs. Initiatives for facilitating access to private financing led to setting up the LGU Guarantee Corporation (LGUGC), a guarantee corporation for infrastructure projects, in 1998 by the Bankers Association of the Philippines (BAP) and the Development Bank of the Philippines (DBP).

In the late 1990s to mid-2000, a number of LGUs ventured into more complex financing arrangements, particularly municipal bonds, and the LGUGC, as along with the PVB, was a key player in this undertaking. The aggregate cost of the bonds issued by the local governments reached Php2.8 billion in 2005 (Amatong 2005). Between May 1999 and December 2010, the LGUGC guaranteed 19 bonds amounting to Php3.25 billion issued by 16 LGUs, and the projects financed include tourism-related infrastructures, public markets, commercial centers, public terminals, slaughterhouses, housing projects, hospitals, academic centers, gymnasiums, and an integrated solid waste management system (Liu, Llanto, and Petersen 2013). However, in the late 2000s, the appetite for bonds had eventually waned due to the technical capacity requirements involved, the issue of the taxability of bonds, and the absence of a secondary bond market. As of December 2017, the recorded outstanding bonds principal has reached only Php486.20 million, mainly from the PVB and LGUGC.

Recognizing credit financing as an important pillar of fiscal decentralization, subnational debt policy management guidelines must be met (Feruglio and Anderson 2008) to build the capacity of local governments to borrow money to cover their expenditure responsibilities alongside their devolved functions, especially in financing capital infrastructure expenditures. As discussed earlier, these guidelines have continuously changed alongside the shifts in policies of the national government in treating and regulating LGU loans.

From the original policy of the DOF in 2000 of only five documentary requirements, it was eventually increased to 12 in 2012, with some of the previous requirements either removed or modified. Table 9 shows a summary of the required documents under LFC No. 1-2012 and those requirements in LFC No. 1-2000 that were modified and deleted.

This stemmed from the thrust of the new administration to temper the overborrowing of LGUs, especially those whose local chief executives are in their last term of office, and poor implementation of LGU loans, to ensure that good financial housekeeping and accountability measures are in place through compliance with specific documents and approvals from the lending institution and different levels of government, following the special audit undertaken by the COA in 2010 to look into the management of the loans of 16 LGUs.<sup>32</sup>

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<sup>31</sup> An Act Providing for an Agriculture and Agrarian Reform Credit and Financing System Through Banking Institutions enacted on 23 February 2010.

<sup>32</sup> Covered five regions: (1) National Capital Region – (i) Caloocan City, (ii) Malabon City, (iii) Mandaluyong City, (iv) Marikina City, (v) Parañaque City, (vi) Pasay City; (2) Region I

**Table 9: List of the Required Documents under LFC No. 1-2012**

<b>New Requirements</b>
<ol style="list-style-type: none"> <li>1. Letter request from the Local Chief Executive indicating (i) the selected lending institution, (ii) the terms and conditions of the proposed loan (repayment period and interest rate), and (iii) the specific purpose of the loan;</li> <li>2. Certification of absence of loan/s, when applicable;</li> <li>3. Certification by the local accountant that the LGU has not incurred default in the payment of the amortization of an existing loan;</li> <li>4. Certification from the secretary of the Sanggunian or the local legislative body that the proposed project to be financed by the loan is included in the Approved Annual Investment Plan for the current year;</li> <li>5. Authenticated copy of the Resolution/Ordinance authorizing the local chief executive to negotiate and contract a loan on behalf of the LGU;</li> <li>6. For loan applications in relation to foreign-assisted projects: (i) Certified Statement of Income (LBP Form No. 1), and (ii) Statement of Fund Operation (LBP Form No. 8);</li> <li>7. Certification issued by the lending institution stating that it shall not be requiring LGU deposits as compensating balance for the loan, if such a lending institution is (1) not an authorized government depository bank or (2) an authorized government depository bank required to obtain the prior approval of the DOF as provided under DOF Department Order No. 27-05;</li> <li>8. DILG Seal of Good Housekeeping awarded to the LGU; and</li> <li>9. Proof of Compliance with the Full Disclosure Policy of the DILG as embodied in DILG Memorandum Circular No. 2010-83.</li> </ol>
<b>Action on Requirements in LFC 1-2000</b>
<i>Modified</i>
<ol style="list-style-type: none"> <li>1. Statement of Receipts and Expenditures for the past three years uploaded and approved by the BLGF Central Office;</li> <li>2. Certification of existing and approved loans, when applicable, with the following details: (a) Types of loans and other obligations contracted; (b) Purpose of the loans and other obligations contracted; (c) Names of lending institutions; (d) Dates of approval and maturity; (e) Terms and conditions (interest rate and number of years to pay); (f) Annual amortization schedules (segregating the principal from the interest) issued by the lending institution; and (g) Remaining balances of loans and other obligations;</li> <li>3. COA Annual Audit Certificate for the past three fiscal years showing no adverse findings against the LGU, which is supported by the following year-end financial reports: (a) Pre-closing trial balance (general fund); (b) Balance sheet (general fund); and (c) Statement of income and expenses (general fund).</li> </ol>
<i>Deleted</i>
<ol style="list-style-type: none"> <li>1. Certification from the Local Treasurer of the IRA received (gross and net) for the past three years; and</li> <li>2. Certification from the Local Assessor of the Taxable Assessed Value for the past three years and dates of the last successful conduct of the general revision of real property assessments.</li> </ol>

Source of Raw Data: LFC No. 1-2000 and LFC No. 1-2012, DOF, BLGF.

– (vii) Dagupan City; (3) Region III – (viii) Angeles City, (ix) Bataan Province, (x) Cabanatuan City; (4) Region IV – (xi) Antipolo City, (xii) Rizal Province, (xiii) Lucena City, (xiv) Palawan Province, (xv) Puerto Princesa City; and (5) Region XI – (xvi) Davao City.

The 2010 COA special audit concluded that “the LGUs’ loans and borrowings may not be considered effectively managed due to deficient criteria for evaluating LGU’s debt service capacity, unrecorded loans and borrowings, and deficiencies in the implementation procedures.”<sup>33</sup> The COA also argued that the sample LGUs covered by the special audit experienced financial difficulty in meeting their loan obligations and the loans, in effect, led to misuse of government financial resources and the development goals of the loans were not attained. On the policy on determining the borrowing capacity of LGUs, the COA believed that the criteria used by the DOF and the BLGF were deficient because they were established only on the basis of the debt service ceiling set under the LGC, which is 20% of the annual regular income.

For the COA, the net available funds of LGUs prior to contracting, and the economic life of the project, as well as the remaining term of the incumbent local chief executive, should have been factored out in determining the loanable amount of any LGU. This means that the basis for computing should have been the remaining available funds instead of the total 20% of the annual regular income, and the effective economic life of the project, so as not to incur additional interest and penalties, forfeiture of projects funded therefrom and a continuous cycle of loan restructuring, noting that there are LGUs that could not fund the required annual amortization requirements.<sup>34</sup> Deficiencies in project implementation, noncompliance with the legal requirements on the disposition of loan proceeds, and unfunded loan obligations in the annual budget among the sample LGUs aggravate the problems discovered by the COA in 2009.

However, in 2013, with the catastrophic aftermath of Typhoon Yolanda (Haiyan) affecting 173 local governments to varying degrees of damage to life and property, the rules on the documentary requirements were relaxed by the DOF to ensure that the administrative processes involved in accessing credit for LGUs is not burdensome and will enable faster loan processing and fund mobilization for their recovery and normalization efforts. Government recognized the principle of frontloading funds at the local level through domestic borrowings in cases where the nationally funded program for post-Yolanda recovery and rehabilitation is insufficient or will suffer delays in implementation. Thus, the 12 documentary requirements under LFC No. 1-2012 were reduced to four and the validity of the borrowing capacity certificates issued by the BLGF was further extended to one year under LFC No. 1-2014, dated 22 April 2014. This policy, however, was not applicable to LGUs not affected by Typhoon Haiyan, and the LFC was effective until May 2015 only.

In determining the requirements of the affected LGUs, the BLGF took the view that only IRA would be the guaranteed available funding since the local revenue base was presumed to have been depleted due to the effect of Yolanda on local economies. It was estimated that 169 local governments were found to have positive borrowing capacity. Based on the 2014 IRA and on the assumption that the local revenue base of Yolanda LGUs had been eroded and will be recovered only in the next five years, it was estimated that the affected LGUs still have a collective borrowing capacity ranging from Php20.43 billion to Php26.10 billion, with interest costs estimated at Php7.33 billion to Php15.53 billion. These estimates used a loan tenor of 10 to 15 years and interest rates of 6% to 6.5%.<sup>35</sup>

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<sup>33</sup> COA (2010) in “Special Audits Office Report No. 2009-03 – Management of Loans and Borrowings: Local Government Units.”

<sup>34</sup> Ibid.

<sup>35</sup> Based on the author’s estimation as part of the recommendations of the DOF to the president on financing options for LGUs affected by Typhoon Yolanda.

As a result of LFC No. 1-2014, 47 affected LGUs,<sup>36</sup> composed of four provinces, three cities and 40 municipalities, applied for borrowing certification from the BLGF to augment their capital investment requirements, on top of the funding support received from the national government for Yolanda-related recovery and rehabilitation projects. Their aggregate borrowing capacity was computed to be Php13.35 billion, comprised of Php8.27 billion for provinces, Php1.23 billion for cities, and Php3.85 billion for municipalities. Their borrowing certificates issued by the BLGF were valid for two years from the date of issuance by the BLGF.

In 2016, the DOF revised again the documentary requirement pursuant to DO No. 054.2016 with the primary objective of streamlining and clarifying the documentary requirements and improving the LGUs' access to credit financing. A schematic diagram showing the loan application process of LGUs is presented in Figure 2. From 12 documents to be submitted for processing the applications for certificates, the requirements were reduced to four, namely:

1. Letter Request from the Local Chief Executive indicating (i) the specific name of the lending institution, (ii) the terms and conditions of the proposed loan, and (iii) the loan purpose/s;
2. Certification by the Local Treasurer of the presence/absence of loan/s indicating (i) the types and purposes of loans and other obligations contracted, (ii) the name of the lending institution, (iii) the date of approval and maturity, (iv) the terms and conditions of the loan/s, (v) the remaining balances of loans and other obligations, and (vi) annual amortization schedules from the lending institution;
3. Annual Audit Certificate from the Commission on Audit (COA) for the past three fiscal years showing no adverse findings, and supported by the year-end financial reports (i.e., Pre-closing trial balance, and Detailed Statement of Financial Performance); and
4. Certification issued by the lending institution stating that it shall not require LGU deposits as compensating balance for the loan, which applies to banks not authorized to accept government deposits.

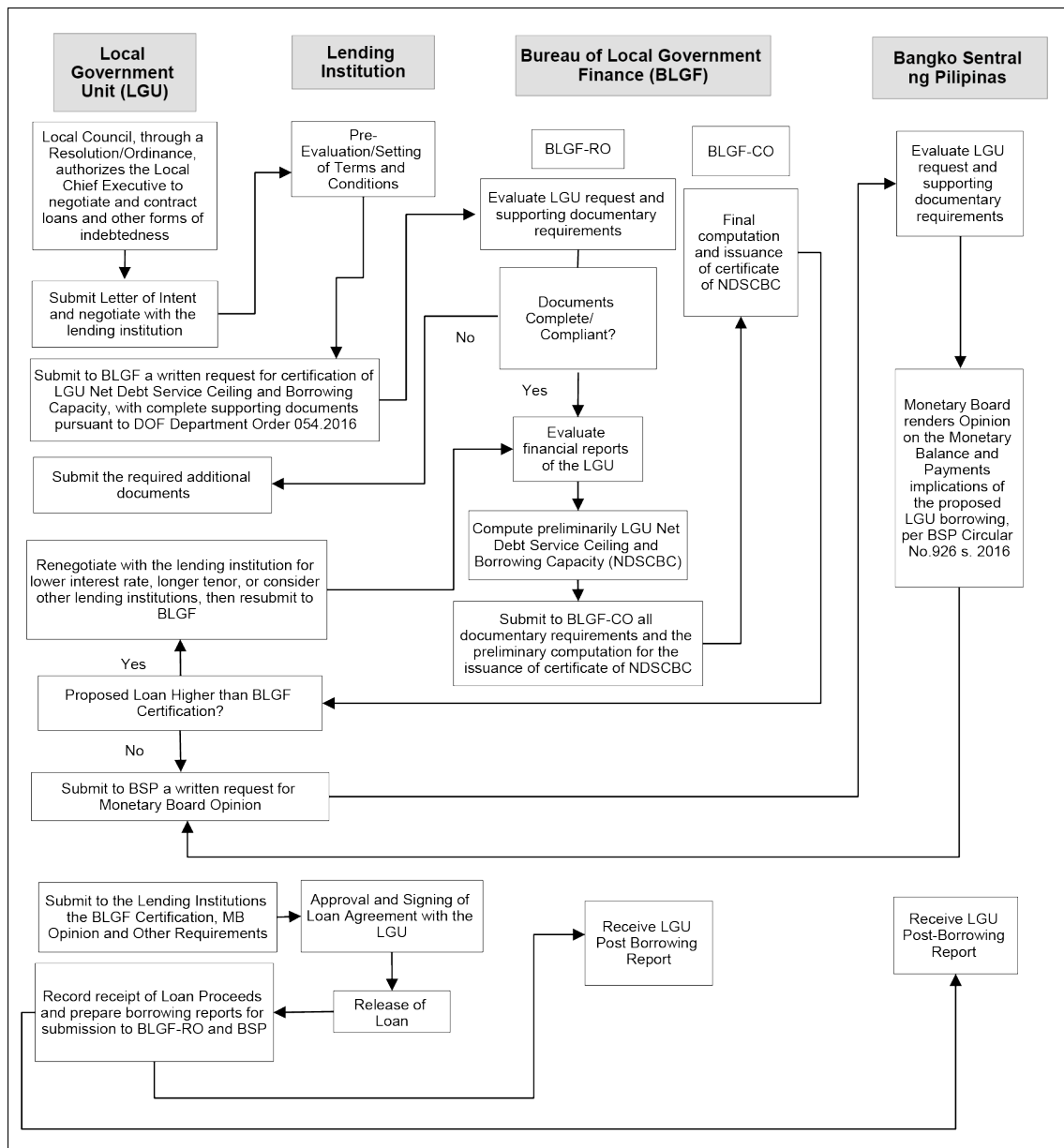
For LGUs affected by natural and/or man-made disasters, the DOF further reduced the requirements to three (documents: items 1 and 2 as listed above, and a certified true copy of a declaration that the LGU is in a state of calamity or has been affected by disasters.

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<sup>36</sup> The Yolanda-affected LGUs that applied for borrowing certificates were: (i) MIMAROPA Region – 2 LGUs (Php2.72B): Province of Palawan and Busuanga, Palawan; (ii) Region VI – 29 LGUs (Php8.71B): Province of Aklan, Province of Capiz, Province of Negros Occidental, Escalante City, Passi City, and Municipalities of Anilao, Iloilo; Balasan, Iloilo; Banate, Iloilo; Banga, Aklan; Batad, Iloilo; Bingawan, Iloilo; Calinog, Iloilo; Caluya, Antique; Dingle, Iloilo; Dueñas, Iloilo; Dumalag, Capiz; Dumarao, Capiz; Janiuay, Iloilo; Lambunao, Iloilo; Laua-an, Antique; Libacao, Aklan; Makato, Aklan; Panitan, Capiz; Pilar, Capiz; San Rafael, Iloilo; San Remigio, Antique; Sara, Iloilo; Valderra, Antique; and Zarraga, Iloilo; (iii) Region VII – 7 LGUs (Php0.66B): Municipalities of Borbon, Cebu; Medellin, Cebu; Poro, Cebu; Sogod, Cebu; Tabogon, Cebu; Tabuelan, Cebu; and Tudela, Cebu; (iv) Region VIII – 9 LGUs (Php1.26B): Province of Southern Leyte, Tacloban City, and Municipalities of Calubian, Leyte; Mahaplag, Leyte; Palompon, Leyte; Salcedo, Eastern Samar; San Isidro, Leyte; Tolosa, Leyte; and Villaba, Leyte.



**Figure 2: LGU Loan Application Process**



## 5. BLGF DEBT SERVICING AND BORROWING CAPACITY CERTIFICATION AND MONITORING

The BLGF’s roles and responsibilities for the processing and issuance of the LGU Certificate of Net Debt Service Ceiling and Borrowing Capacity (NDSC/BC) is in line with its mandate under Sec. 43 (c) of Executive Order No. 127 to develop and promote plans and programs for the improvement of resource management systems, collection enforcement mechanisms, and credit utilization schemes at local levels. The process has evolved in recent years to include thorough evaluation of documentary requirements submitted by LGUs, and to establish a reliable database and monitoring system for LGU loans.

The NDSC and BC are computed by determining the debt service ceiling based on official records of financial reports of the LGU and related documents from COA (latest audit certificate), BLGF (SRE), and DBM (allocation of IRA for the current year).

The DSC is determined by getting the 20% of the annual regular income (ARI), which accounts for the budget ceiling required by law for debt servicing. The ARI, for loan certification purposes, is the average of the locally sourced income of the LGU for the last three years and its shares from national taxes, using official LGU financial reports, validated through the BLGF SRE, plus the actual annual IRA that the LGU will receive for the current year, based on DBM data, at the time the application was made. After determining the DSC, all amortizations payable during the year for principal and interest, and sinking fund, among others, are deducted to arrive at the net DSC (NDSC), which is then multiplied by the corresponding annuity factor,<sup>37</sup> with prorated adjustments if a grace period is provided by the lending institution, to arrive at the LGU borrowing capacity (BC).

In the new DOF policy, the verification of documents and the computation of the NDSC and BC are now performed by the BLGF Regional Office, which has immediate jurisdiction over the applicant LGU, and the processed documents are then submitted to the BLGF Central Office for final computation and issuance of the certificate. The template of the certificate can be found in Figure 3.

In 2018, the BLGF issued the Memorandum Circular (MC) No. 005.2018, dated 22 January 2018, setting the updated implementing guidelines of DO No. 054.2016, and addressing all operational concerns of LGUs, banks, and the BSP MB relative to the four documentary requirements set by the DOF. The goal of the BLGF in issuing the MC is to set service standards in the evaluation, processing, and release of certificates, build staff capacity on the proper monitoring of loans, and provide analysis on the magnitude, trends, and patterns of LGU loans on quarterly and annual bases. One of the service standards set is to limit to a maximum of 15 days the review and approval of the certificates, and the publication of a summary of issued certificates on the BLGF website to inform the public about loan applications of LGUs.

Unlike in previous years, the BLGF discontinued the practice of allowing LGUs to pledge the Special Education Fund (SEF) in computing the borrowing capacity, since the LGC requires only debt servicing to be sourced from the General Fund (GF) constituting the regular income of the LGU. The SEF, as a separate fund, constitutes the additional 1% levy on real property and the proceeds are solely for the release to, and use of, the Local School Board (LSB) of the local government. While it did not appeal initially to LGUs trying to conserve their annual regular income from debt servicing use, those that are close to exceeding their borrowing limits and those opting to use other sources outside the GF eventually heeded the advice to avoid any audit issue on the use of the SEF. After all, the SEF may actually be used or pledged to pay for loan payments without confining it within the 20% limitation since it is not part of the regular income, but this has to be subject to the priority of the LSB and compliance with budget rules.

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<sup>37</sup> The annuity factor is used to calculate the annuities that the LGU will incur. It is the sum of the discount factors for maturities 1 to  $n$  inclusive, when the cost of capital is the same for all relevant maturities. Commonly abbreviated as  $AF(n,r)$  or  $AF n,r$  ( $n$  is the number of periods) ( $r$  is the rate per period).

**Figure 3: Sample Certificate of Net Debt Service Ceiling and Borrowing Capacity**

DEPARTMENT OF FINANCE   BUREAU OF LOCAL GOVERNMENT FINANCE			
CERTIFICATE NO. R__-20__-__-__			
<b>CERTIFICATION</b>			
<p>In accordance with existing rules and regulations, and based on the financial statements submitted and representations made, the <b>NET DEBT SERVICE CEILING (NDSC)</b> and the <b>BORROWING CAPACITY (BC)</b> for <b>FISCAL YEAR 20__</b> of the <b>MUNICIPALITY OF _____</b>, _____, are hereby <b>CERTIFIED</b>, as follows:</p>			
<i>NDSC</i>	(amount in words) _____ <b>Million</b> _____ <b>Thousand Pesos</b>	<b>Php _____ M</b>	
<i>BC</i>	(amount in words) _____ <b>Million</b> _____ <b>Thousand Pesos</b>	<b>Php _____ M</b>	
<b>Details of Loan Application</b>			
<i>Lending Institution</i>			
<i>Repayment Period</i>			
<i>Grace Period</i>			
<i>Interest Rate</i>			
<i>Loan Purpose</i>			
<p>This Certificate shall be effective up to one (1) year after issuance, unless otherwise revoked sooner due to change of terms and conditions, change of financing institution, additional project/s, and other circumstances that may affect the content or integrity of the details provided herein.</p> <p>The Municipality shall obtain all applicable approvals and authorizations, including the Sanggunian Resolution expressly authorizing the Municipal Mayor to negotiate and enter into contract for purposes of securing the loan, the duly approved Annual Investment Plan for the current year covering the projects to be funded by the loan and compliance with the procurement law, rules and regulations.</p> <p style="text-align: center;">Issued on _____, City of Manila.</p> <p style="text-align: right; margin-right: 100px;">Executive Director</p>			
<p><b>Remarks:</b></p> <ol style="list-style-type: none"> <li>1. Computed per Section 324b of the Local Government Code and DOF Department Order No. 054.2016.</li> <li>2. Upon verification with the concerned lending institution/Sanggunian Resolution of the LGU.</li> <li>3. This Certification is not to be construed as an approval by this Office of the LGU project/s and its loan application with any financing institution.</li> <li>4. This Certification is not to be construed as an approval for the LGU to open and maintain an account in banks other than the authorized government depository banks, which is covered by Department Circular No. 01.2017. Otherwise, the LGU shall seek prior approval from the BLGF to open and maintain depository accounts in banks other than those listed in the said DOF policy.</li> <li>5. This Certification is free of charge. This Bureau has not authorized anyone, directly or indirectly, to collect or receive any amount or consideration for the purpose of this certification or related activities.</li> </ol> <p style="text-align: center;">- NOT VALID WITHOUT CERTIFICATE NUMBER OR IF THERE ARE ALTERATIONS -</p>			

Source: LD MED, BLGF.

If a lending institution being considered by LGUs is not authorized to accept government deposits, it must issue a certification that it shall not require LGU deposits as compensating balance for the loan. Separately, this requirement is governed by DOF Department Circular No. 1.2017, issued by the Secretary of Finance in May 2017. This does not apply anymore to government and private banks that have been preauthorized by the DOF in the said circular, such as the LBP, the DBP, the Philippine Postal Savings Bank, Inc. (PPSB),<sup>38</sup> the Al Amanah Islamic Investment Bank of the Philippines (AAIIBP), the United Coconut Planters Bank (UCPB), the PVB, and the MDFO.

Another internal policy adopted by the BLGF in evaluating borrowing applications is to strengthen the compliance of LGUs with the audit findings of the COA on financial management, treasury operations, and other fiduciary matters. For this purpose, the BLGF required the submission of the Agency Action Plan and Status of Implementation (AAPSI), which is a pro forma document of the COA, to assess the responsiveness of management action of the LGU with regard to adverse observations on local financial management and matters specifically concerning the local treasurer, such as unremitted and undeposited collection, unliquidated cash advances, unremitted mandatory contributions to national government creditors and withheld taxes, and unreconciled cash books and ledgers. This policy was deemed necessary to ensure that the minimum financial housekeeping mechanisms are in place and sound, and ready to manage the additional funds that will be drawn from the loan proceeds, otherwise the BLGF will consider undertaking its own initiatives to conduct a direct treasury operations evaluation of the concerned LGU.

The certificate of NDSC/BC is issued with accompanying documents composed of three parts: Letter to the Local Chief Executive, Certificate, and Directives to the Local Treasurer. The release of certificates is controlled and monitored. Once a certificate is approved and released, an original copy is issued to the LGU, to the Lending Institution, and to the BSP. The certificate provides: 1) the terms of the loan regarding the period, the interest rate, and the grace period on the principal; 2) the name of the lending institution; 3) the purpose of the loan as authorized by the LGU; and 4) the certificate number and the date it was issued by the BLGF.

A new certification is required if there is a change in the terms and conditions or financing institution/s, or the loan purpose is no longer reflective of the actual requirement of the LGU at the time of the approval. Similarly, for refinancing or restructuring of an existing loan/s to either extend the duration or increase the principal, or if there are circumstances affecting the content or integrity of the certificate, the LGU is required to apply for a new certificate.

All NDSC/BC certificates issued by the BLGF are free of charge and have a one-year effectivity and validity, or two years for LGUs affected by calamities and disaster. The certificates reiterate the full compliance of the borrowing LGU with all legal requirements of applicable laws and the other existing government rules and regulations, and the need to obtain necessary approvals and authorizations relative to the loan, since the certificate issued by the BLGF does not constitute approval or endorsement of the loan or the specific projects to be funded by the loan proceeds.

In the last five years, the BLGF has received on average 316 LGU requests for NDSC and BC certificates (Table 10), with most applications being received from municipalities (74%), followed by cities (13%), provinces (8%), and barangays (5%). In 2017 alone, 340 LGUs applied and 283 were successfully issued with certificates, while

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<sup>38</sup> This bank has been renamed Overseas Filipino Bank, Inc., a Savings Bank of LBP.

others either withdrew or did not comply anymore with the documentary requirements. During election years, such as FY2013 and FY2016, the number of applications is relatively lower due to the transitioning of new administration and adjustments of priorities and programs. Loan applications normally peak during the middle of the second year until the last year of the three-year term of office of local elective officials. The biggest concentration of applications came from central and southern Luzon regions of the Philippines, with an average of 35 LGUs applying annually (Table 11).

**Table 10: Number of Applications for Borrowing Certificates**

LGU Type	2012		2013		2014		2015		2016		Average	
	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.
Province	31	11%	11	7%	32	8%	26	6%	14	8%	24	8%
City	29	10%	27	17%	51	13%	55	13%	25	14%	41	13%
Municipality	212	76%	114	73%	293	76%	317	77%	128	72%	236	74%
Barangay	7	3%	5	3%	8	2%	15	4%	10	6%	14	5%
<b>Total</b>	<b>279</b>	<b>100%</b>	<b>157</b>	<b>100%</b>	<b>384</b>	<b>100%</b>	<b>413</b>	<b>100%</b>	<b>177</b>	<b>100%</b>	<b>316</b>	<b>100%</b>

Source of Raw Data: Local Debt Monitoring and Evaluation Division (LDMED), BLGF.

**Table 11: Regional Profile of Certifications Issued by BLGF**

Region	2012		2013		2014		2015		2016		Average	
	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.	No.	Dist.
NCR	4	1%	3	2%	4	1%	4	1%	5	3%	8	3%
CAR	11	4%	0	0%	11	3%	6	1%	2	1%	8	2%
I	22	8%	11	7%	20	5%	19	5%	7	4%	19	6%
II	13	5%	2	1%	18	5%	19	5%	9	5%	15	4%
III	27	10%	13	8%	44	11%	55	13%	21	12%	38	12%
IV-A	26	9%	24	15%	39	10%	35	8%	17	10%	31	10%
Mimaropa	7	3%	14	9%	22	6%	13	3%	8	5%	13	4%
V	24	9%	3	2%	32	8%	30	7%	10	6%	23	7%
VI	22	8%	13	8%	41	11%	29	7%	12	7%	26	8%
VII	18	6%	9	6%	15	4%	36	9%	9	5%	18	6%
VIII	28	10%	13	8%	16	4%	36	9%	20	11%	22	7%
IX	16	6%	10	6%	18	5%	32	8%	10	6%	21	6%
X	15	5%	10	6%	32	8%	24	6%	19	11%	22	7%
XI	18	6%	15	10%	21	5%	21	5%	7	4%	17	6%
XII	16	6%	8	5%	27	7%	36	9%	14	8%	22	7%
XIII	12	4%	9	6%	24	6%	18	4%	7	4%	14	4%
<b>Total</b>	<b>279</b>	<b>100%</b>	<b>157</b>	<b>100%</b>	<b>384</b>	<b>100%</b>	<b>413</b>	<b>100%</b>	<b>177</b>	<b>100%</b>	<b>316</b>	<b>100%</b>

Source of Raw Data: LDMED, BLGF.

On the monitoring side, the BLGF requires all local governments to declare annually their status of loans and payments by submitting the Statement of Indebtedness, Payments, and Balances (SIPB). The SIPB is also part of the post-borrowing compliance requirements of the BLGF in order to determine whether the loan applied for and certified by the BLGF has been successfully approved and utilized, or if there were changes to the loan amount and interest.

## 6. SUBNATIONAL DEBT PROFILE AND TRENDS

Loans are the most commonly used credit financing mechanism of local governments. The outstanding balances of LGUs from loans and bonds reached Php85.88 billion and Php0.49 billion, respectively, for FY2017 (Table 12). In the same year, loans constituted 99% of the total debt stock of LGUs, and bonds formed only 0.6% thereof. The main players and most active lenders are GFIs, while the private sector constitutes a fairly small share of the debt supply side, with only one in every 10 local borrowings coming from a private financial institution. The concentration of loans in GFIs, particularly the Land Bank of the Philippines (LBP) and the DBP, indicates that both banks dominate the market for LGU loans with at least three quarters of the total LGU debt stock from GFIs coming from them. From the private sector, the Philippine National Bank (PNB) and the Philippine Veterans Bank (PVB), once GFIs and state owned but later privatized, account for a little over 10% of the total (Table 13).

**Table 12: FY2017 Outstanding Debt of LGUs (in Php)**  
as of 31 December 2017

Particulars	Principal Amount	Past Due Amount	Outstanding Balances	% Dist
Loans	85,385,826,132	491,689,250	85,877,515,381	99.44%
Bonds	486,206,250	–	486,206,250	0.56%
<b>Grand Total</b>	<b>85,872,032,382</b>	<b>491,689,250</b>	<b>86,363,721,631</b>	<b>100.00%</b>

Source of Raw Data: LDMED, BLGF.

**Table 13: Profile of LGU Loans by Lending Institution in FY2017**

Financial Institution	Approved Loan (A)	Availment To Date (B)	Undrawn Balance (C) = (A-B)	Principal Amount (D)	Past Due Amount (E)	Outstanding Balances (F) = (D + E)	% Distribution	
							<i>to GFI</i>	<i>to Total</i>
<b>Government Financial Institutions (GFIs)</b>								
LBP	101,031	74,085	26,945	45,334	25	45,359	60.1%	52.8%
DBP	43,289	28,965	14,324	22,282	10	22,293	29.6%	26.0%
MDFO*	8,749	8,749	–	7,423	–	7,423	9.8%	8.6%
PPSB	579	560	19	303	64	367	0.5%	0.4%
<i>Subtotal</i>	<i>153,648</i>	<i>112,360</i>	<i>41,289</i>	<i>75,342</i>	<i>99</i>	<i>75,441</i>	<i>100.0%</i>	<i>87.8%</i>
<b>Private Financial Institutions (PFIs)</b>								
PNB	16,351	12,664	3,688	6,975	128	7,103	68.1%	8.3%
PVB	6,952	5,114	1,838	2,474	264	2,738	26.2%	3.2%
AB	49	49	–	23	–	23	0.2%	0.0%
BPI	261	260	0.2	47	–	47	0.5%	0.1%
EB	680	537	142	478	–	478	4.6%	0.6%
RB	60	47	13	47	–	47	0.5%	0.1%
<i>Subtotal</i>	<i>24,352</i>	<i>18,670</i>	<i>5,682</i>	<i>10,044</i>	<i>392</i>	<i>10,436</i>	<i>100.0%</i>	<i>12.2%</i>
<b>Grand Total</b>	<b>178,000</b>	<b>131,030</b>	<b>46,970</b>	<b>85,386</b>	<b>492</b>	<b>85,878</b>	<b>100.0%</b>	<b>100.0%</b>

\*Includes Official Development Assistance and MDF Second Generation Fund.

Source of Raw Data: LDMED, BLGF.

The bulk of the LGU loans are intended for construction projects under the category of economic services, which accounted for 54% of the total outstanding loans as of FY2017. Examples of these projects include a commercial building, transportation terminal, public market, slaughterhouse, memorial park, water supply network,

telecommunications, local bridges, farm-to-market roads, environmental protection, concreting and rehabilitation of local roads, terminals, and ports, among others. This is then followed by general public services (e.g., public library, government center, office building, fire service, disaster preparedness program, public broadcasting, and security/emergency services) and other capital investment expenditure (e.g., procurement heavy equipment and automobiles, and lot acquisition), both at 14%. The rest are projects for education, culture and sports (e.g., school building, and education/training centers), health, nutrition and population control (such as hospital building, health center, and medical equipment), housing and community development (e.g., public/socialized housing and water management system), and other purposes, such as refinancing (Table 14).

**Table 14: LGU Loan Purpose by GFI and PFI as of FY2017**

Loan Purpose	Outstanding Balance (in Php Million)			% Dist
	GFI	PFI	Total	
Capital/Investment Expenditure	10,851	993	11,844	14%
Economic Services	38,778	7,507	46,285	54%
Education, Culture, and Sports	6,184	383	6,567	8%
General Public Services	11,173	643	11,816	14%
Housing and Community Development	3,086	62	3,148	4%
Health, Nutrition, and Population Control	3,723	457	4,180	5%
Others	1,646	878	2,524	3%
<b>Total</b>	<b>75,441</b>	<b>10,922</b>	<b>86,364</b>	<b>100%</b>

Source of Raw Data: LDMED, BLGF.

Nevertheless, debt servicing of LGUs continues to be at very conservative levels of 3.40% to 4.56% of the annual regular income of LGUs, which is way below the 20% statutory expenditure limit since LGUs do not max out their borrowing capacities, and less than 20% of provinces, cities, and municipalities combined are contemplating borrowing, or 0.7% if all LGUs, including the barangays, are accounted for (Table 15).

A few barangays have also started tapping loans with GFIs. While interest in borrowings of barangay officials is growing, the actual turnout of applications is still low. Considering their generally very tight borrowing capacities, most of the projects are limited to streetlights, pavement construction, and installation of closed-circuit television systems, and solar panels and lampposts. Indicatively, around 10 barangays, mostly situated in capital towns or urban areas with higher IRA shares and relatively bigger annual regular income, applied for BLGF borrowing certificates.

Over the last five years, the average ratio of LGU debt stock (total outstanding loans) to GDP has been only 0.65%, while the annual LGU debt flow (new loans or additional loan releases) has been only 0.10% of the GDP. Although the trends of the receipts from loans and the outstanding loans of LGUs showed a generally increasing and stable pattern over the last three years, loans averaged in the last five years only 4.1% as a component of the annual regular income of LGUs, and 4.22% of their annual expenditures (Table 15).

In 2016, the total annual receipts from loans reached Php14.9B (US\$301M), representing 3.4% of the total regular income of LGUs. In terms of annual debt servicing, LGUs spent Php16.41 billion (US\$331 million) in 2016, which accounted for 3.71% of their total annual expenditures. Debt stock in 2016 increased by 13.31% (from Php75.91

billion to Php86.02 billion), while debt flow also increased by 16.31% (from Php12.83 billion to Php14.92 billion) in the same year.

**Table 15: PH Subnational Debt Profile (in Php Million)**

<b>Particulars</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
LGU's Receipts from Loans and Borrowings <sup>[1]</sup>	7,798	10,501	8,589
Annual Regular Income	332,057	333,686	381,206
Total Revenue <sup>[2]</sup>	376,786	395,162	450,449
Debt Service <sup>[3]</sup>	14,688	15,218	16,767
LGUs' Outstanding Loans <sup>[4]</sup>	69,984	70,887	68,115
Total Expenditures <sup>[5]</sup>	330,082	343,823	369,331
GDP (in current price, Php M)	10,561,089	11,538,410	12,645,052
Ratio of LGU Loans and Borrowings to GDP	0.07%	0.09%	0.07%
Ratio of Loans and Borrowings to Total Revenue	2.07%	2.66%	1.91%
Ratio of LGUs' Outstanding Loans to GDP	0.66%	0.61%	0.54%
Ratio of Debt Service to Total Expenditures	4.45%	4.43%	4.54%
Ratio of Debt Service to ARI	4.42%	4.56%	4.40%
<b>Particulars</b>	<b>2015</b>	<b>2016</b>	<b>Average</b>
LGU's Receipts from Loans and Borrowings <sup>[1]</sup>	12,828	14,921	11,195
Annual Regular Income	433,488	482,865	359,048
Total Revenue <sup>[2]</sup>	530,421	579,818	423,210
Debt Service <sup>[3]</sup>	16,156	16,411	14,899
LGUs' Outstanding Loans <sup>[4]</sup>	75,914	86,020	70,823
Total Expenditures <sup>[5]</sup>	405,627	442,678	348,680
GDP (in current price, Php M)	13,307,357	14,480,720	11,158,823
Ratio of LGU Loans and Borrowings to GDP	0.10%	0.10%	0.10%
Ratio of Loans and Borrowings to Total Revenue	2.42%	2.57%	2.70%
Ratio of LGUs' Outstanding Loans to GDP	0.57%	0.59%	0.65%
Ratio of Debt Service to Total Expenditures	3.98%	3.71%	4.31%
Ratio of Debt Service to ARI	3.73%	3.40%	4.22%

[1] LGUs' reported receipts from loans and borrowings as submitted through the eSRE system.

[2] Total Current Operating and Nonincome Receipts.

[3] LGUs' reported debt service payments (Principal and Interest) for the period as submitted through the eSRE system. The Principal Cost refers to the Payment of Loan Amortization and Retirement/Redemption of Bonds/Debt Securities while the Interest covers the expenditures for payment of loan principal, interest, and other service charges for debts of LGUs.

[4] The LGUs' outstanding loans data were sourced from the Government Financial Institutions as of December 2015.

[5] Current Operating and Nonoperating Expenditures. Sourced from SRE reports of LGUs.

Source of Raw Data: SRE, BLGF.

In 2017, there were 283 LGUs that were issued by the BLGF with a certificate of borrowing capacity, which is an increase of 71.5% from 2016 (an election year). There were 340 certificates issued in total, which also include certificates that were amended or canceled, in view of a change in lending institution or the loan purpose of the LGUs (Table 16). In aggregate terms, the annual debt service ceiling certified was Php17.12 billion (US\$342 million), while the total borrowing capacities of said LGUs reached Php124.14 billion (US\$2.48 billion).



**Table 16: Summary of Certificates Issued by BLGF from FY2012 to FY2017**

Particulars	2012	2013	2014	2015	2016	2017	Ave
Issued NDSC/BC Certificates	279	157	384	413	177	340	<b>292</b>
Number of LGUs Issued with Certificates	254	146	326	374	165	283	<b>258</b>
Total Net Debt Service Ceiling (Php M)	10,980	5,647	13,533	15,981	7,833	17,118	<b>11,849</b>
<i>Total Net Debt Service Ceiling (US\$ M)</i>	<i>268</i>	<i>127</i>	<i>302</i>	<i>341</i>	<i>158</i>	<i>342</i>	<b>256</b>
Total Net Borrowing Capacity (Php M)	58,634	36,173	93,611	116,151	60,584	124,138	<b>81,549</b>
<i>Total Net Borrowing Capacity (US\$ M)</i>	<i>1,429</i>	<i>815</i>	<i>2,091</i>	<i>2,479</i>	<i>1,222</i>	<i>2,481</i>	<b>1,753</b>

Source of Raw Data: LDMED, BLGF.

## 7. PROPOSED CREDITWORTHINESS RATING INDEX

The BLGF is in the process of setting up the LGU Creditworthiness Rating Index (CRI) to be issued to all provinces, cities, and municipalities on a regular basis to improve planning and resource mobilization strategies, and as a rating mechanism for the fiscal health and credit viability of LGUs. It seeks to determine the conditions, red flags, and relevant signals in which the risk of default on debt obligations may be considered low or the probability of paying back a loan on time is assuredly high. Under the CRI design, debt monitoring and information sourcing and sharing will use electronic data, and information exchange with LGUs and lending institutions is critical.

In determining the individual CRIs, the BLGF will assess five core areas of LGU performance, namely: (1) revenue generation,<sup>39</sup> (2) investment and debt capacity,<sup>40</sup> (3) rigidity of expenditures,<sup>41</sup> (4) financial management capacity,<sup>42</sup> and (5) borrowing history.<sup>43</sup>

Capping of an LGU's borrowing capacity, on the basis of CRI rating, is being explored to foster fiscal discipline and minimize haphazard borrowings and therefore counter any resulting soft budget constraints. LGUs with AAA to A ratings are considered to be automatically certified with 100% of their borrowing capacity, while LGUs with a BBB rating can only avail themselves of 90%, those rated BB 80%, B-rated LGUs 70%, and those LGUs with a score less than 40 and a rating of C will get a 60% cap on the loanable amount that will be certified by the BLGF.

Putting a cap on borrowing could influence lending institutions in negotiating the loan tenor, interest rates, and grace periods. Correspondingly, it will make LGUs look for lending institutions that offer the lowest or most advantageous interest rate. The CRI is envisioned to help LGUs constructively and effectively link their physical and capital investment plans with the appropriate resource mobilization agenda. On the other hand, capping based on CRI will force small and low-income LGUs to start modestly with their borrowings, and eventually expand when capacity is built over time.

<sup>39</sup> Revenue Generation Capacity is the ability of the LGU to grow its revenue base, the nature, reliability, predictability, and stability of its income sources, and its revenue mobilization efficiency.

<sup>40</sup> Investment and Debt Capacity is the measurement of an LGU's capability to service debts or its debt-service cover and LGUs' effort in investing in capital assets.

<sup>41</sup> Rigidity of Expenditures is the degree of flexibility of LGUs' liquidity and disbursement, especially on local development funds, debt services, and personal services.

<sup>42</sup> Financial Management Capacity measures an LGU's fiscal effort on how well it manages available financial resources or exercises prudence in its expenditure flows and its capability to service debts or its debt-service cover and LGUs' effort in investing in capital assets.

<sup>43</sup> Borrowing History is the familiarity with an existing process by creditors and measures the LGU's ability to settle obligations and circumvent the probability of default.

Once established, the CRI will be able to expand further the vision of the LGU Financing Framework to identify the status of LGUs in terms of credit financing, aid the lending institutions, and supplement their risk assessment tools using government-issued creditworthiness ratings, and enable LGUs to plan and strategize on resource mobilization using debt performance rating and related metrics.

## **8. RECOMMENDATIONS AND CONCLUSION**

Credit financing should never be dispelled as a bane to local development, especially when it is judiciously and carefully designed, accessed, managed, and utilized to help address financing gaps in local governance. Instead, it should be leveraged as a strategic tool of the LGU's resource mobilization agenda. In the Philippines, as in any other decentralized country, the right mix of policy, monitoring, and access to a competitive credit market is critical.

Among the long-standing issues and emerging ones that must be addressed are the following:

1. There is an urgent need to revisit the LGU Financing Framework to reassess the supply and demand side of credit financing, since much has changed already since its formulation in 1996, and the current capacity of LGUs and the lending institutions;
2. The fiscal gaps in local governments, especially with regard to the increasing cost of devolved services and expanding priorities and the 2030 Vision under the Sustainable Development Goals, must be thoroughly determined to evaluate the appropriateness of credit financing options that may be tapped by LGUs;
3. The traditional mindset of LGUs not to borrow or to be risk-averse at the expense of poor service delivery and a lack of quality basic services should be overcome by way of a public information campaign (PIC), enhancement of revenue generation capacity, supplementation of grants and technical assistance, and thorough guidance on negotiating and selecting the lending institution that offers capacity buildup of LGUs, especially in project packaging, management, procurement, implementation and monitoring, and geared towards a development-oriented financing partnership;
4. The determination of borrowing capacity has to be improved further so that the certification is not totally dependent on the terms and conditions pre-agreed by the lending institution and the LGU, but on the actual financial position of the LGU, the actual credit market conditions, and the local capacity to manage available fiscal space, especially with regard to net operating surplus available, to sustain debt obligations with minimal fiscal stress on other priority development agendas;
5. In assessing loan applications and determining the borrowing capacity, it is imperative that the assignment of loan tenor and interest rates is driven by the type and nature of the project, economic viability, and the capacity of LGUs to manage the projects within the intended lifespan of the loan obligation;

6. Green financing and its derivatives, debt swap modes, and other facilities in regard to credit financing, such as bond flotation, must be explored and the identified gaps in policies, structures, and mechanisms should be resolved to give LGUs a wide array of financing schemes that would suit best their capital investment requirements;
7. The timing of borrowings or any credit financing facility must be closely linked with the medium- and long-term plans of LGUs, and the term of office of the incumbent local chief executive applying for a loan must be considered, so as to avoid any impression or attribution that loan proceeds are used to advance the political agenda of local incumbents for election purposes and to give the next set of local officials a free hand to determine and/or continue any development priorities and programs that will be committed beyond a three-year time frame, or a nine-year time frame for LCEs aiming for a full term of office; and
8. Timely and effective debt monitoring, as a component of the overall fiscal performance evaluation of LGUs, must be further strengthened, regularly undertaken, and properly communicated and disclosed to all concerned stakeholders.

From a broader perspective, the Philippine experience regarding subnational debts has evolved from its own lessons and external factors. As an important pillar of fiscal decentralization, the availing of any credit financing requires due diligence and the utmost accountability to ensure that it is a means to achieve local development. Although there are emerging discussions on shifting to a new form of government in the Philippines or introducing further reforms in the current Local Government Code, one thing is certain – local governments need support to catalyze their development and enhance their potential as effective partners of the central government in nation building and poverty alleviation. Credit financing has risks and advantages, and the national government is duty-bound to ensure that appropriate and effective policies and tools are in place and working, and that LGUs are using it responsibly and strategically to achieve the vision for progress and better public service delivery.

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