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HO CHI MINH CITY INVESTMENT FUND FOR URBAN DEVELOPMENT (HIFU)

I. INTRODUCTION

Ho Chi Minh City (HCMC) dominates the hierarchy of urban centers in terms of its population size and economic activity. Urban and industrial development in HCMC and the surrounding areas only began in the 19th century, but has progressed rapidly. The City is now one of the fastest growing areas of the country and in 1995 accounted for 18.5% of Vietnam's Gross Domestic Product. The average annual economic growth rate in the past five years was 12.6%. With around 75% of its 4.8 million living in the city's urban districts and a medium range projection of 7.2 million for the year 2010, the Governments' previously planned limit of 5 million will soon be exceeded, particularly so if the unregistered population of at least 400,000 is officially acknowledged. Slum and squatter areas are recorded as accommodating a minimum population of 230,000. Within the urban districts, whose service coverage is higher than that of the city's rural areas, 20% of the households still lack direct access to piped water supply and water-borne sanitation. Untreated household and industrial wastes pose environmental hazards, especially in relation to the city's network of canals and drainage channels. The critical level of housing conditions is reflected in the average provision of just over five square meters of floor space per capita, with less than half the total housing stock constructed from permanent materials and 78% dating from before 1975.

According to the Socio-economic Master Plan of HCMC for the period 1996- 2010, the City will grow at the pace of 14-15% per annum during the next fifteen years. To accommodate this growth, the City will need an investment of US$ 2 billion per annum in 1996-2000 and US$ 7 billion per annum in 2001-2010. Investment in physical infrastructure will account for 22.4% of the total investment.[1] Financing this investment is an extremely difficult task, which is exacerbated by the underdevelopment of the financial market. A stock market is unlikely to come into existence before the year 2000 due to the weakness of the private sector and slow progress in the privatization program. Although the central and local governments have started issuing treasury and municipal bonds, they are not readily tradable and, in most cases, have received very limited participation from the public. Moreover, there is a lack of confidence in the banking system due in part to the historical

[1] The People's Committee of Ho Chi Minh City, Ho Chi Minh City's Socio-economic Master Plan, 1996-2010.

This case study was prepared by Nguyen Xuan Thanh, lecturer at Fulbright Economics Teaching Program. Fulbright Economics Teaching Program's cases are intended to serve as the basis for class discussion, and not to make policy recommendations.

legacy of a monobank system that was not geared to the individual, the rapid devaluation of the currency, and the collapse on many credit co-operatives in the late I 980s, but also due to the financial conditions of banks and delays reportedly experienced in making cash withdrawals. This tack of confidence means that a significant portion of private savings has eluded the formal financial system.

The above problems have prompted the Municipal Authorities to think of establishing a specialized municipal financial institution, which can make efficient public investment in urban infrastructure and, at the same time, encourage the participation of the private and foreign investors. Being local organizations, this type of financial institutions can better utilize the city's own resources as well as cater the development needs of the City. The study on the possibility of setting up an urban development fund for HCMC was taken in early 1996 by the Institute for Economic Research of HCMC. It has got approval from the central government and the Ho Chi Minh City Fund for Urban Development (HIFU) will officially start operating by the fourth quarter of 1997.

This type of financial institutions has been experienced in several countries. Some have succeeded and some have failed. Many developing countries argue that until capital markets are better developed or alternative financing mechanisms are available, establishing these institutions is a pragmatic way to finance high-cost infrastructure projects. As transitional mechanisms, these funds serve two purposes. They allow the leveraging of government resources by attracting co-financing from domestic and foreign private resources. They can also involve in identifying, appraising, and monitoring infrastructure projects. However, these institutions are often blamed of not showing a capacity for sustained investment, largely due to under-capitalization, poor financial discipline, and substantial amount of bad debt.

The objective of this paper is to use the experience drawn from the process of setting up the HCMC Investment Fund for Urban Development (HIFU) to answer the question of whether municipal development funds can serve as an efficient means of channeling funds to and mobilize private capital for urban development projects, and whether they can take the role of strengthening the process of project identification, appraisal, monitoring, and risk management, and to analyze how the Fund is going to minimize the potential threats which are often faced by development financial institutions in developing countries.

II. FUND STATUS AND FUNCTIONS

Status of the Fund

HIFU is a financial institution with its own legal status, and having an independent board of directors and management. This makes it quite different from local development funds of other countries which are not institutionalized and just serve as a means of channeling capital from one level of government to another.[2] HIFU comes under the framework of development banks which provide long-term finance for development projects. These financial institutions provide financial services which a typical commercial bank in less developed countries (LDCs) like Vietnam may not go into. However, HIFU differs from general development banks in a way that it is specifically motivated to direct its financing to bankable business of urban development projects.

[2] Examples of this type of fund are the Municipal Urban Development Fund of Tamil Nadu, the Local Government Infrastructure Fund of the Philippines, and the Town Development Fund of Nepal.

Another aspect is that HIFU is a state-owned institution. Strictly speaking, it is owned by the Municipal Authorities. It is, therefore, different from private investment funds such as the Asian Infrastructure Fund. These private investment funds are financial structures for pooling and managing the monies of multiple investors. In other words, they are a mechanism for making indirect investment. Investors cede significant control over their money to professional managers who in turn buy either listed shares or bonds. In contrast, HIFU's shares are owned entirely by the Municipal Authorities. The City's officials do not want to change this ownership structure until the capital market is well organized. In the future, there are two possibilities for the development of the Fund. It can either go public by offering shares or set up subsidiary funds which are partly owned by it and partly by private investors.

Main and Subsidiary Functions

The overriding function of HIFU is to utilize local government's funds and mobilize medium- and long-term capital from various parties, domestically as well as internationally to finance infrastructure projects in HCMC. It will lend money, take equity positions and provide the technical expertise in appraising investment proposals.

The Fund's main business is project financing where it will provide finance (in terms of equity or debt) to infrastructure projects and look at the cash flows and earnings generated from these projects as the source of funds from which it can get back the loans, interests and returns on equity. Thus, in financing projects it will work alongside other investors, assuming equal commercial risks.[3]

It is expected that the Fund will do more that just provide debt and equity financing. It should serve the promotional and demonstration roles in encouraging the participation of the domestic and foreign private investors. In the process of removing some of the major barriers to new private investment, it will encourage the domestic capital formation needed for the development process. In addition, the Fund will advise the municipal government on restructuring and equitizing its infrastructure utilities, imposes the due diligence process leading to engineering, environmental, legal or financing suggestions that make the project more easily financible.

As mentioned above, HIFU will mainly invest in urban infrastructure projects including roads, water supply, power transmission and distribution, and waste collection and disposal, etc... It will also be expected to provide capital for the development of infrastructure facilities in industrial parks of the City. The Fund will only invest in other industrial projects when these projects are so profitable that their returns on investment are sufficient to be used as financial input to infrastructure projects. One condition imposed on this type of investment is that financing will be made for new industries or expansion of high-demand industrial activities rather on restructuring or bailing-out of existing state-owned enterprises.

Besides the role of mobilizing medium- and long-term fund for urban development projects, HIFU will also serve several subsidiary functions such as corporate advisory services, bond underwriting, and fund guarantee, etc... The most important aspect of securities underwriting is its role as the single most effective means by which government and corporate entities can obtain long-

[3] Project finance will be discussed in detail in the later section.

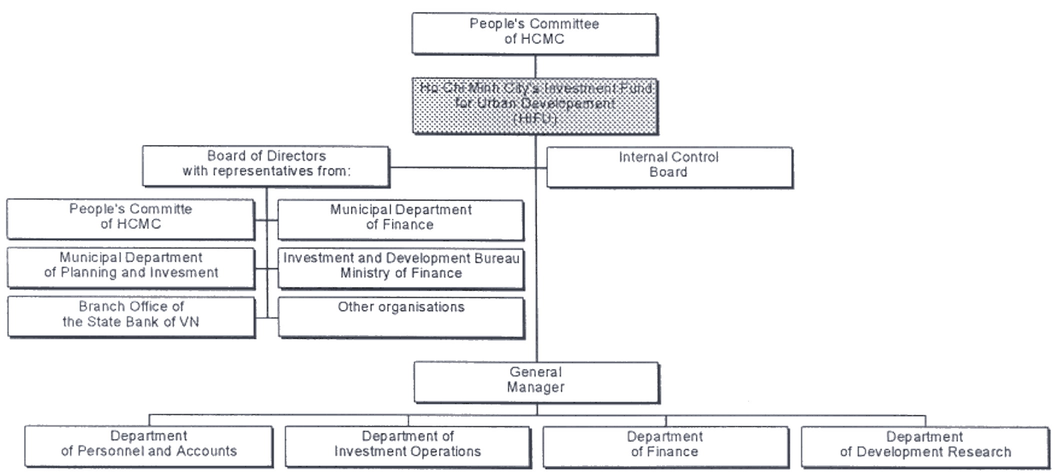
term debt or equity on a permanent basis. Upon requests of the Municipality, the Fund may agree to underwrite on a firm basis the distribution and sale of municipal bonds. In return, it will receive underwriting fees which are a percentage of the value of the bond issue. Guarantees represent the most common method for allocating responsibility for risks. A parent company (the guarantor) may issue a guarantee to creditors of its subsidiary under which the parent undertakes to pay the creditors amount due on their loans if the subsidiary defaults. This is a direct guarantee. What the Fund can do is a third-party form of guarantee in which the Fund provides guarantee to the subsidiary's creditors at the request of the parent company; the parent company, in turn, agrees to reimburse the Fund for all amounts paid to the creditors under guarantee. Guarantees may (i) cover a limited set of specified risks – these constitute 'partial risk" guarantees; (ii) protect certain payments under a loan – these constitute "partial credit" guarantees; or (iii) provide full coverage against all risks.

III. ORGANISATIONAL STRUCTURE, CAPITAL SOURCES AND SUPERVISION

Organizational Structure

As a local institution, the Fund is directly under the authority of the People's Committee of HCMC.[4] The Fund's organizational structure includes the Board of Directors, Internal Control Board, General Manager, Vice General Managers, and several technical departments. Figure 1 depicts this structure.

Figure I. Organizational Structure of HIFU



In order to ensure the managerial autonomy, HIFU is legally made distinct from municipal technical departments by placing it under an independent board of directors. Like many other state-owned commercial banks, the Fund's Board of Directors is composed preponderantly of heads of government departments, serving *ex officio.* This is different from private banks where the board is usually presented independently by shareholders. According to the Charter, the Board has from seven to nine members who are representatives from the HCMC People's Committee (HCMC's PC), the Municipal Department of Finance, the Investment and Development Bureau of the Ministry of Finance, the Municipal Department of Planning and Investment, Branch Office of the State Bank of

[4] Municipal people's committees in Vietnam are equivalent to city halls in other countries. The chairman of a people committee has the authority equivalent to that of a mayor.

Vietnam[5] and other organizations. The term 'other organizations' means that people from the business community and research institutions may have some seats in the Board. However, they will have only a minor voice. All members are appointed as well as dismissed by the Chairman of HCMC PC. They have a fixed term of five years with a staggered turnover to assure continuity and avoid the situation where all board members are up for re-appointment every two years. The Board has a chairman and a deputy chairman working full-time. Other board members are the General Manager and the Chief of the Internal Control Board. The Board is responsible for approving budgets and corporate plans, capital mobilization strategies, investments, major procurements and sales of assets, monitoring performance and advising management, and approving major changes in the Fund's policies vis-à-vis personnel, marketing, internal controls and proposing to the Chairman of the PC for appointment and dismissal of the General Manager and Vice General Managers. The Board works according to the collegial principle and meetings are to be held on a two-month basis except in emergencies where meetings will be held according to the request of the Chairman, the General Manager or the Chief of the Internal Control Board. One negative aspect of this board composition is that the directors' other official duties make it difficult to schedule frequent meetings and board members often have little time to familiarize themselves with the details of investment proposals.

The Internal Control Board is to oversee and inspect the operating activities of the General Manager, Chief Accountant, technical departments with regards to compliance with the law, the Fund's Charter and regulations, financial norms, resolutions and decisions made by the Board of Directors. It has to make annual reports to the Board of Directors on the activities of monitoring and controlling. At the same time, it has to report to the Board of Directors all unusual activities, possibilities of operating losses or abuse of power committed by the management. The Internal Control Board has from two to three members who are appointed by the Board of Directors. The members must not have any family-relationship with the Directors, General Manager or Chief Accountant. They must not hold any position in the Fund (except the Internal Control Board's Chief who serves as one of the member of the Board of Directors) or any position in companies which have business relationships with the Fund. As far as qualification is concerned, members of the Internal Control Board should have professional degrees in accounting and auditing.

The Fund's General Manager is responsible for the management of day-to-day operations, making financial plans and budgets. He or she is also responsible for making quarterly, six-month and annual reports, and formulating the long-term corporate plan. The General Manager is appointed by the Chairman of HCMC's PC according to the single nomination made by the Board of Directors. The General Manager has the right to nominate Vice General Managers and the Chief Accountant. The appointment of other positions in management is fully in the hand of the General Manager .

The Fund' s technical departments include the Department of Investment Operations which is responsible for undertaking investment activities, and the Department of Finance which is responsible for mobilizing fund. Besides, HIFU also has a special department, namely, the Department of Development Research which provides advice to the General Manager on economic issues related to operational, policy or other matters.

[5] The State Bank of Vietnam is the central bank of the country.

Capital Sources

The capital sources of the Fund comprises of registered capital and mobilized capital. The Fund's registered capital is 500 billion Vietnamese dongs (equivalent to US$ 5 million) provided from the municipal budget. This amount of capital is already reserved which comes from the local revenue sources including proceeds from the sale of state-owned properties and land, surcharges on infrastructure services like water, electricity, waste collection...,[6] and part of the local budget surplus. The registered capital can be augmented annually from the above sources plus retained profits and additional funds coming from lottery , contributions of central state-owned enterprises located in the city for development of infrastructure.

Mobilized capital includes medium- and long-term loans from domestic and foreign financial institutions. Loans may be provided from the Central Government through the National Investment Fund. However, under the current financial system, the Fund will get loans from the Central Government through the National Investment Fund. The second source of funds is from commercial banks. Institutional loans which the Fund can obtain from insurance companies and from social security funds will also be available in the near future. As far as foreign borrowing is concerned, the Fund may be eligible to receive assistance from the World Bank groups and various bilateral agencies in the form of pass-through assistance where funds are channeled through the Central Government.

Another way of mobilizing capital for the Fund is to issue bonds. Bonds have certain advantages over loans by providing access to more resources. The cost of bond flotation may be less when the credit rating is high and there is not much inflationary pressure in the economy. Bonds can have longer maturities and may receive a large participation from the business community and the public. When these bonds are traded in the secondary markets, they can give impetus to the development of the domestic capital market by increasing the supply of securities. However, in Vietnam the use of bond financing has been very limited and is still evolving. Almost all bondholders are banks with enterprises being a minority and very limited participation from the public. The problem is illustrated in the case of a toll-road project in HCMC financed by municipal bonds. In this project, the total value of bonds issued was roughly US$ 3 million with an interest rate of 17% per annum and three-year term. 90.2% of the bonds were sold to different banks, 9.7% to enterprises, and only 0.1% to the public. As such, in the coming years HIFU might still have to rely less on bond flotation, but significant steps such as confidence building and credit rating must be taken in order to make bond flotation to be a major source of capital for the Fund.

Other sources of fund include income generated from the activities of payment guarantee, underwriting and agency arrangements. By arranging agency, the Fund will act as a trustee for management of public and private funds on a fee basis. The Fund will receive a source of immediate income from this operation while assume no risk of loss on the loans it makes or administers as agents.

For the first two to three years, the Fund's sources of fund will mainly include equity contribution from the local budget and borrowings from other financial institutions. The former

[6] Surcharges on water and electricity were introduced a few year ago by the Municipal Authorities. These amounts are fully in the hand of the Municipal Authorities.

might account for 40% and the latter might account for 60%. In the uses of fund, money will be invested initially on several road and industrial park projects where investment in equity is expected to account for 30% of the total investment with the rest being medium- and long-term loans. This picture roughly represents the Fund's balance sheet. In the following years, a few more items will be added such as bonds and institutional loans.

Income for the Fund will come from the interest differential between lending and borrowing, dividends generated from equity investment, and fees earned from subsidiary activities such as underwriting, guaranteeing and investment advisory activities. The generated incomes are ploughed back into the operations of the Fund so that the organization becomes self-sustaining and fulfils development objectives. This will also enable the Fund to meet its own administrative and operating expenses.

Fund Supervision

As a state-owned enterprise (SOB), the Fund need closed supervision of the government and at the same time has to follow regulations which are imposed on all financial institutions.

Virtually all developing countries have attached SOBs to a line ministry, with the finance ministry playing the key role. In Vietnam, SOBs are classified into two types. The first type is called central SOBs which are under line ministries at the central government. The second type is called local *SOBs* which are under provincial and municipal authorities.[7] HIFU falls into the second type. The *SOB's* restructuring efforts have attempted to improve the quality of the oversight by shifting from *a priori* to a *posteriori* control, safeguarding against de facto or de jure intervention in decisions that are in the sphere of management or the board of directors, streamlining reporting relationships, and creating a more informed and better trained group in the sectoral and finance ministries, local authorities to review SOBs.

However choosing the appropriate level of the Municipality's oversight of HIFU is more problematic. Excessive intervention by the city's technical departments is still rampant. These departments tend to be advocates of investment in large and economically non-viable projects, and of ineffective instruments for performance evaluation. The first step is to clarify what decisions the municipal government should or should not be involved in. Based on the experience of other development banks, it is suggested that the municipal government should only set the basic direction for investment and resource mobilization, appoint the Board of Directors' members and the General Manager, evaluate performance, review financing decisions that affect public interests and use long-term planning and coordination across its departments to guide the Fund's activities. There have been a lot of arguments regarding whether the municipal government should leave the task of appointing the General Manager for the Board of Directors. But Vietnam is still so far removed from granting anything like the degree of independence implied by this action that filler issues have little immediate relevance. Moreover, since the Fund will use money partly from the local budget to invest in infrastructure projects, it is argued that the local government should retain a certain degree of control over the Fund to ensure that money is invested in the right place.

[7] Strictly speaking, there is another type of SOBs which is under the district authorities. However, they can be incorporated into the local SOBs. In the current reform process, there is a pressure from the central government to move all of these enterprises into the control of the Ministry of Finance.

At the central level, two organizations are responsible for the supervision of the Fund, namely, the State Bank of Vietnam (SBVN) and the Ministry of Finance (MOFI). In fact, these two super organizations will have their respective representatives in the Fund's Board of Directors. For the former, it is the Branch Office of SBVN in HCMC, and for the latter, it is the Ministry's Bureau of Investment and Development in HCMC.

Performance Indicators

Performance evaluation is indispensable. If good performance goes un-rewarded and bad performance unpunished, it should surprise no one that productivity stagnates and drops. The Fund's management should be hold accountable. Performance indicators should give the General Manager a clear signal about desirable behavior and judge him or her on the outcome. The indicators should be few, non- duplicative, easily measured and weighted as to priority. The Fund should be required to submit its own evaluation of its performance. The evaluation report should be prepared by the General Manager and then approved by the Board of Directors. This evaluation should then be submitted to an evaluation council consisting of representatives from the municipal departments, line ministries and also representatives from the private business and research institutes. The performance evaluation should also reveal a number of problems that are government -rather than management -related: political intervention, failure to provide promised guarantees, and so on.

The Fund is basically a financial institution. As such, its performance and efficient utilization of resources is determined on the basis of its financial statement. If the Fund is performing profitably, it means it is able to carry out its development functions and can acquire more resources on the strength of its performance to expand its activities. It is normally done by considering the adequacy of profits and the overall rates of return. The following are main ratios used:

Return on capital employed = (profit before interest and tax x 100) / capital employed

Return on total assets = (profit before interest and tax x 100) / average total assets

Return on equity = (profit after interest and tax x 100) / average ordinary share capital, reserves and retained profits.

Performance tests are the essential means of ensuring not only a project financial liability but also discipline that will encourage its efficient management and use of resources. The outcome of the tests would then be compared with the expected rates of return or the stated standards to determine how efficiently the Fund is being run. These expected or standard rates of return can be determined by the Fund itself and adjusted year by year. For example, the standard rate of return on capital employed can be made equal to the rate of one-year treasury bond (R_{tc}) plus a target rate (R_t). The target rate is determined according to the medium-term development trend of the economy. For the period 1997-2000, R_t is proposed to be 2%.

IV. PROJECT FINANCE

The main business of HIFU is infrastructure project financing. In the beginning, many projects included in the city development plans will be continually proposed to HIFU and other banks for funding. Within the planning context of HCMC, fifteen-year socio-economic master plans of the City with an overall long- term investment program are jointly prepared by various municipal departments and the Institute for Economic Research. Based on the master plan, annual and five-year investment programs are made by the Municipal Department of Planning and Investment. In these programs, specific sectoral projects are identified, prioritized and phased. However, there are a lot of questions regarding the process of prioritizing. Many times, investment projects have been chosen out of political decisions. Moreover, the financial sources of these projects are vaguely defined as public, private or foreign investment. It is, therefore, very important for HIFU to carefully re- appraisal the feasibility studies of those projects proposed by the municipal departments and state-owned enterprises and even reject those "prioritized" projects which do not satisfy the various standards of the Fund.

However, by going in the above direction, HIFU will again fall into the Achilles' heel. Experiences in many countries have shown that development banks and specialized funds have often remained passive and simply reacted to proposals from project sponsors, instead of going out and identifying good ideas and promoting them. As a result, the Fund has to engage in investment opportunity identification and project development. It needs to identify potential infrastructure sub-sectors and choose projects that it thinks the best in terms of profitability, economic feasibility and how quickly they can be implemented. The financing of these sub-sectors should be in conformity with the Fund's investment principles and the national and city development strategies.

Structure of Project Finance

In project financing, lenders look to the project's cash flows to repay the debt and to the project's assets for security. It requires structuring the debt and equity such that the project's cash flows are adequate to service the debt. That is why it is also known as "structured financing". In principle, HIFU can finance projects on a full-recourse basis. However, the idea was to focus the Fund's activities on non-recourse or limited-recourse financing.

Project sponsors seek project finance because it means the project can be funded off their balance sheet. The project finance structure allows a sponsor to avoid providing financiers with "recourse" to its general assets in the case of poor project performance. By participating in this form of finance, the greatest risk for the Fund is losing the amount it has invested in the project rather than its whole assets. Self- standing projects, with no guarantees given by sponsors (or government) to lenders for the project, are called *non-recourse.* What usually happens in practice is *limited- recourse* financing where sponsors commit to provide contingent financial support, above their up-front equity commitment, to give lenders extra comfort. The focus is usually on the construction and start-up period, which is generally the riskiest time in the life of many infrastructure projects.

The financing instruments includes:

Equity. Any project finance begins with equity investment which is long-term capital provided in the form of shares, signifying part ownership of the company. Equity holders share in profits of the project through payments of dividends and are entitled to capital gains (or losses) resulting from any appreciation (or depreciation) in the value of the enterprise. At the same time, the return on equity is generally the first to be adversely affected when the project encounters financial difficulties or there are delays in cash flow generation.

Internally generated cash. Projects may also be partly funded by the cash flows internally generated from the projects themselves. They are also called reinvested profits. In a financial plan reinvested profits are treated as equity, although they are not as certain as the equity available at the project's start.

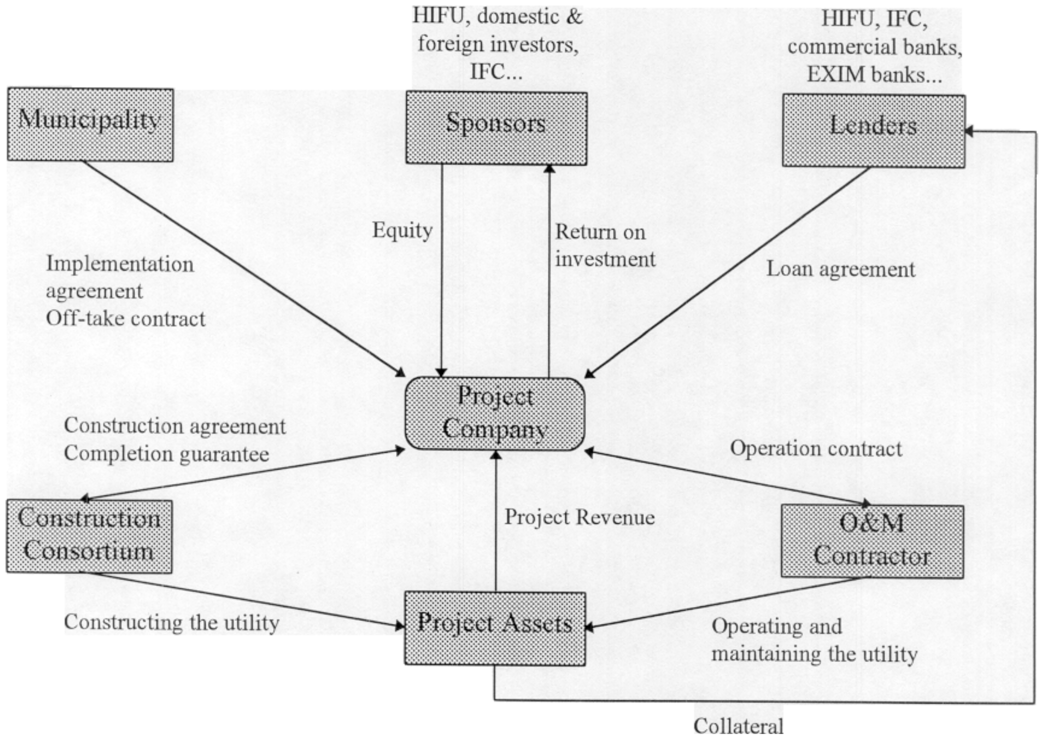
Subordinated debt (also known as quasi-equity or mezzanine finance). This class of investment takes the form of debt, but enjoys many qualities of equity . It contains a schedule for payment of interest and principal, but may also allow participation in the upside potential of an equity position.

Commercial bank project debt. The critical element of a project finance operation is the provision of loans to help finance the project. The main characteristic of this debt is a specified rate of interest with proportionate protection against losses provided principally through the project's assets. Unlike finance provided by governments or multilateral banks, there are no government guarantees to repay loans made by commercial banks to private infrastructure projects. Lenders seek (i) projected cash flow that can finance debt repayment with a safety margin; (ii) enough of an equity stake from sponsors to demonstrate commitment; (iii) recourse to sponsors in the event of specified problems, such as cost overruns. In the past EXIM banks asked host governments to counter-guarantee some risks, such as expropriation. However some are starting to provide debt on a non-guarantee basis.

Revenue bonds. Bonds are financial securities, usually issued by larger firms with a public listing, to borrow long-term finance. Bonds are purchased by long-term institutional investors, such as pension funds. They are risk averse, and will generally only provide funds to companies with a credit rating. Revenue bonds are secured against a project's cash flow and assets rather than those of an established company. Purchasers require a high level of confidence in the project (e.g. strong sponsors, contractual arrangements and country environment) and this is still a new market in developing countries.

Figure 2 depicts the structure of a typical project financing arrangement.

Figure 2. Project Financing Structure



To finance infrastructure projects, sponsors (i.e. equity providers) try to set up what is called a special project company. It is a limited liability company whose paid- up capital is jointly contributed by its sponsors. Here, the sponsors may be existing SOEs, domestic and private investors, and HIFU. The special project company will then borrow money with assistance from its sponsors. The institutions which lend money to the project are commercial banks, EXIM banks, HIFU, multilateral agencies such as IFC... The special project company is responsible for constructing, operating and maintaining the infrastructure facility. In case of a BOT project, the special project company will have to transfer the facility to the Municipality after a certain period of concession.

If the project sponsors have no experience in constructing or operating the facility, the special project company may enter into contractual arrangements with construction and operating companies to construct, operate and maintain the facility. This is undertaken also to diversify the construction and operating risks among different contractors. Typically, the sponsors are either the construction or operating companies in which case contractors are also the shareholders of the vehicle company and are, therefore, linked to the performance of the project, and thus, have an incentive to work in the best interest of the project.

Equity and Debt Financing

Depending on specifice projects, HIFU can particate in project financing by either taking an equity interest or giving syndicated loans together with other financial institutions.

Equity Financing

One way to support project finance operations is equity financing. HIFU can provide equity financing for local infrastructure projects by investing in the shares of the project companies and thus becoming a sponsor of these projects. It can either be an active equity investor where it seeks to participate in the management of the project companies or a passive equity investor where it provides only its funds. At this time, the Fund is expected to act as a passive equity investor .

The proposed approach for the involvement of the fund in equity financing is suggested as follows:

Identifying and assessing projects and sponsors. Turning concept into reality requires identifying core investors. An investor or group of investors, who has an intention to invest in a certain project but may not have technical capabilities and/or may not have enough financial resources, can come up with an investment proposal. The Fund will assess this proposal through considering the financial strength of the investors, the conformity of the proposal with the potential sectors it has identified, and appraise the feasibility study. Afterwards, the Fund can decide whether the proposal is appropriate and whether it can provide additional finance by equity participation and whether it can find a capable technical partner for the project. A technical company (for example, a municipal water supply company) may ask the fund to finance the expansion of the existing facility or a greenfield project. In this case, the Fund still has to assess the proposal in the same way as the first case and invite additional sponsors if necessary. However, the process can happen in the other way around. The Fund can actively identify an investment opportunity and look for potential co-investors. In this case, it will be the project initiator.

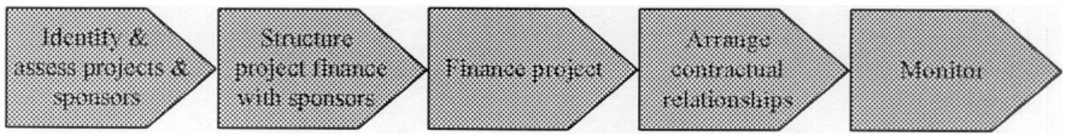
Structuring the project finance together with other sponsors. This process includes setting a project company, determining the project's legal form and the equity-debt structure, and defining the management and profit-sharing frameworks. HIFU plays the active role in discussions with regulators, helps define the project's legal form, and strikes a balance of interests among different parties.

Financing. In this step, the Fund will subscribe to the shares of the project company. With the project's legal form and structure in place, it can help in applying for loans from commercial banks and multilateral agencies. The ability to borrow cheap money will depend heavily on the structure of the project, the credit-worthiness of the sponsors and the reputation and contact network of the Fund.

Arranging contractual relationships. As the financing of the project is fully committed by the sponsors and lenders, the Fund will assist the project company in entering into contractual arrangements with construction and operation companies. This process will be further discussed in the next subsection.

Monitoring. It is essential to constantly monitor the implementation process. Monitoring helps assess the progress of implementation and take timely decisions towards efficient and effective project completion. The Fund will have to evaluate monthly and quarterly reports made by the project companies with regards to construction, equipment, financial position and operation. In the case of equity financing, senior staff of the Fund can sit on the boards of directors of the project companies. But as mentioned earlier, the fund will initially act as a passive equity investor in which it will nominate an outside director instead of taking a seat itself. By having influence on the boards, the Fund can advise on the strategies pursued by managers and other investors.

Figure 3. Steps in equity financing

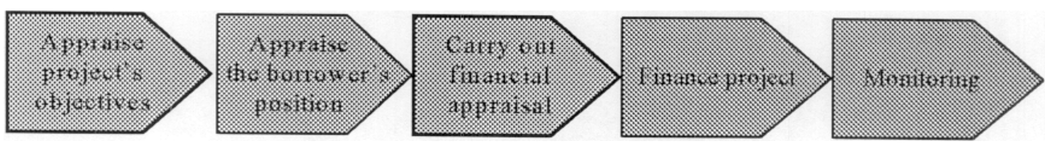


Debt Financing

Another way of supporting project finance operations is debt financing. As have been discussed earlier, besides participating in equity finance, the Fund can provide medium- and long-term loans to infrastructure projects which can cover the construction phase and some initial years of operation. However in this case, the Fund's role will be less active than that in the first case. Nevertheless, it still needs to go through the following steps: (i) appraise the objectives of the proposed project vis-à-vis the lending policy of the Fund; (ii) appraise the borrower, its financial position, management strengths and weaknesses and see how these issues will promote and impede the proposed project; (iii) carry out financial project appraisal; (iv) finance the project, evaluate progress and financing requirements. Carry out post-evaluation of the project.

The above steps are summarized in Figure 4.

Figure 4. Steps in debt financing



The Fund's lending rate is set at 50 basis points below the lending rate of the HCMC Bank of Investment and Development, adjusted for the Fund's funding cost margin for the loans and a risk premium, both as determined by the Fund. The margin of 50 basis points somewhat reflects the interest subsidy that the Fund will give to development projects.

Role of the Fund in Risk Sharing

This role of HIFU is also dependent on whether the Fund is an equity or debt provider. Being an equity provider, it has the role of a sponsor and being a debt provider it has the role of a lender.

Figure 2 depicts many actors and contractual relationships. Hiding behind these contractual relationships is the risk sharing mechanism. Due to the limited extent of the paper, only four types of risks, namely, construction and completion risks, operation risks, economic environment risks, and country risks are mentioned.

Construction and completion risks. Construction and start-up phase is highly risky and requires large volumes of fund. Therefore, mixture of equity, subordinated debt, senior debt and guarantees must be used. Construction risks are usually hedged by using fixed-price, turnkey construction contract. In this type of risks, importance should be placed on contractor performance. Time delays, quality insufficiencies, or cost overruns can be largely attributed to the performance of the contractor, land acquisition, building permits, right of way and public utilities, etc… As mentioned above, project sponsors are usually construction companies in which case they are directly linked to the performance of the project. However, in the case where the sponsors have no construction experience, contractor performance will be an important consideration. Drawing from the experience of other countries, to ensure the contractor performance, HIFU and other project sponsors may design a special structure in which the construction company is allowed to become equity holders with compensation being made partly in cash and partly in equity shares. In addition, sponsors may require to fund cost overruns if the turnkey contractor does not provide a cost guarantee.

Operation risks. The operation phase is considered to be less risky than the construction phase. Refinancing with bonds may be possible. Operation risks may result from the lack of performance incentives, conflict of interests in the case of multiple equity investors, and the policies of the local authorities. To diversify these risks, operation and maintenance responsibilities may be contracted to a specialist company. Another risk is the availability of materials and fuel. This risk can be hedged through procurement contracts with supplier companies.

Economic environment risks. The first category is the market which is important in the sense that it is difficult to predict the demand of consumers. Typically, the sponsors have to bear this risk. Under special cases, the Municipality can absorb part of the risk by signing an off-take contract which is an agreement to buy all the quantity of the products produced at a specified price or by allowing a change in the period of concession when demand falls short of expectation. The foreign exchange rate risk and interest rate risk, both inherently connected with the project's loan structure, are also important, especially when foreign lending exists. The exchange rate risk can be hedged by linking the project's tariff to US dollar, but making payments in local currency. The interest rate risk associated with floating rate loans can be reduced via a government guarantee by putting an upper limit on interest rates.

Country risks. Country risks refer to uncertainties associated with availability of permits, tariff adjustments not being allowed or made on time, restrictions of regulation, risk of expropriation, or the stability of the political system. Ultimately, there is limited scope for the project companies and financiers to avoid these risks. In general, HIFU being an institution under the Municipal Authorities can help in harmonizing the attitude of the local government towards the projects and the resulting working relationships of sponsors with the Municipal Authorities.

Types of Infrastructure Projects

As mentioned earlier, the Fund will mainly invest in local infrastructure projects such as toll roads, bridges and tunnels, market halls, water supply, sewerage and canal rehabilitation, solid collection and disposal, and industrial parks.

With regards to electricity, the Fund will not invest in power generation projects since they are the responsibility of the central level. It will only invest in improving the transmission and distribution networks where investment will likely be made in the form of loan provision rather than in the form of project finance. Telecommunication, airport and seaport projects are also under the responsibility of the Central Government.

Toll roads, bridges and tunnels. In the coming years, major roads including asterial and ring roads of HCMC will have to be upgraded, expanded and newly built. In addition, with the strategy of developing a new urban area at the other the side of the Saigon River, a number of bridges and tunnels will also have to be constructed. These projects require a huge amount of investment, while the financial and managerial capability of the public sector is limited. Project financing, therefore, becomes a possible solution and HIFU can take part in some of these projects.

Water supply. The HCMC Water Supply Master Plan[8] made a proposal of increasing the supply of water from the current level of 735,000 m3/day to 2,500,000 m3/day in 2015. The major projects that will accomplish this increase include rehabilitation and expansion of the existing water treatment plants and the distribution network, and construction of the new Saigon River Water Supply System. A total of US$ 1,054 million in capital investment is required for all scheduled water supply and distribution components of the Master Plan to satisfy requirements up to 2015. Of this total, some US$ 276 million are expected to be financed by private sources under BOT arrangements, while US$ 788 million will have to be financed by public resources, with about 70% of this obtained from international lending agencies. BOT water supply projects can be made possible with full cost covering by raising the current water tariff of US$ 0.13 per m^3 to US$ 0.33 per m^3 of metered water as recommended in the Master Plan. It is also recommended that rates be varied by consumer group and that cross-subsidization be used to ensure support for water use by the poorer population.

Industrial parks. In a vigorous drive for industrialization, thirteen industrial parks have been identified in the outskirts of HCMC. The development of these industrial parks provide investment opportunities for HIFU. The development costs include land clearance and compensation, building and internal road construction, wastewater treatment plants, and even small-scale power plants in a few cases. These costs can be recovered by renting pieces of land to industrial enterprises. Some projects undertaken recently have proved that cost recovering can be achieved within three to five years, particularly when the cost of land compensation is low.

Canal rehabilitation. HCMC is characterized by tens of kilometers of canals which one time provided an important mode of passenger and good transport for the City. However, nowadays the canals are heavily polluted and occupied by many illegal squatter settlements along the banks. Rehabilitation of these canals is an urgent need to improve the environment conditions of the City. The Municipality has fully committed to carry out these projects. In fact, the rehabilitation of some parts of the canal system has been implemented on an experimental basis. The rehabilitation projects comprise of many components ranging from resettlements, dredging, and embankment to conversion of several kilometers to underground culverts. However, the non-revenue generating nature of these projects makes them almost impossible to be carried down in the form of project finance. It is,

[8] The HCMC Water Supply Master Plan was prepared as a technical assistance project TA No.2000 - VIE supported by the Asian Development Bank with technical work being undertaken by GKW Consult and Safege Consulting Engineers. The

therefore, expected that the projects will be eligible to receive grants and soft loans from multilateral and bilateral sources. The Fund together with other state-owned banks can provide loans with payment guarantee from the local government when some mechanism of cost- recovering is worked out. One possible mechanism is to develop the land vacated from the relocation process by constructing market halls and houses. The houses can be sold partly back to the relocatees and partly to higher income groups through cross subsidization.

VI. CONCLUSION

There is currently a general inclination among policy makers towards the establishment of specialized financial institutions for the financing of urban infrastructure. It appears also that resources for urban development are better managed at the local level. Taking into account this view, HIFU has been initiated by the Municipal Authorities of HCMC and received full backing at the central level.

The Fund should initiate concept, appraise feasibility studies, sounds out potential investors, and identifies technical partners for infrastructure projects. It is expected that the Fund will serve the leading role in mobilizing at-risk capital to invest in infrastructure services with innovative new financing methods. The Fund's project finance principle will facilitate the participation of private and foreign investors through BOT and other limited entry arrangements. It will offer prospective financiers several sources of confidence-building comfort both through the quality of its project appraisal and the informal leverage that it exerts as a state-owned financial institution.

However, the expected beneficial outcomes may be offset by considerable threats that the Fund will be facing. Few municipal funds and development banks in developing countries have shown a capacity for sustained investment, largely because of under-capitalization, poor financial discipline, and most importantly political pressure. HIFU will fail if the political pressure on the Fund's activities is so strong that it will only function as a mechanism of directing state money towards preferential projects.

Human resource constraint needs to be considered. The Fund will clearly require a group of high-level professionals who are capable of identifying, appraising and monitoring investment projects. The existing salary and bonus system in the public sector does not allow the Fund to attract high-quality managerial and technical skills. Although the establishment of the Fund is not an ideal solution, it is a pragmatic way to proceed until capital markets are better developed or alternative financing mechanisms are available. Looking ahead, HIFU can playa catalytic role in investment for urban development. The long-term goal of the Fund is commercial orientation and accountability, with diversification of portfolios.

In recent years, a number of private funds have been established to channel domestic and international capital for developing country infrastructure. They pool risk across projects and hence increase the availability as well as lower the costs of finance. HIFU may follow the strategy of being backed initially by the local government and in the future gradually going public where the Municipal Authorities may hold a certain percentage of the Fund's shares and the rest will be sold to the public. In this form, the Fund will actively serve the commercially useful function of

planning work began in February, 1995 and was completed in April, 1996.

infrastructure financing and diversifying investor risks. As the Board will be represented by different sectors of the economy, the Fund will be put further away from political pressure and responds more positively to financing requests of private investors.