UN-HABITAT
SLUM UPGRADING FACILITY (SUF)
WORKING PAPER 8






SUF LOCAL FINANCE FACILITIES
what they are, why they are important, and how they work

FOR A BETTER URBAN FUTURE

UN-HABITAT

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Introduction

It is estimated that up to 1 billion people live in slums in the cities of the world – one sixth of humanity – and that the numbers are rising. The UN-HABITAT Slum Upgrading Facility (SUF) Pilot Programme of UN-HABITAT was established in 2004 to help address this problem. SUF is a technical cooperation and seed capital facility with a central purpose: to test the potential for increased access to formal credit for slum dwellers' organisations, enabling them to implement slum upgrading projects.

The Slum Upgrading Facility (SUF) operates under the premise that slums can be upgraded successfully when the existing slum dwellers are involved in the planning and design of upgrading projects. SUF works with local actors to make slum upgrading projects "bankable" – that is, attractive to retail banks, property developers, housing finance institutions, service providers, micro-finance institutions, and utility companies. SUF has pilot projects in Ghana, Indonesia, Sri Lanka and Tanzania, where various approaches are being tested to support the purpose of the Pilot Programme.


Ibbagwette, informal settlements in Colombo, Sri Lanka.
© Suzi Mutter, January 2005.

A key element of the SUF Pilot Programme work is that of establishing local finance facilities with a specific remit to support slum upgrading. These local finance facilities are designed to improve access to credit for slum dwellers.

Each local finance facility is being set up as an independent not-for-profit company. In other words, the local finance facilities have no share capital per se and any profits realised must be applied back into the finance facility and used to support their core remit. This is an appropriate arrangement for multi-stakeholder institutions.

The local finance facilities are "owned" by their founder bodies and are representative of the community, public and private sector agencies that sign up as stakeholders [2]. However, in the case of the local finance facilities having to wind down, all assets must be distributed to one or more bodies able to fulfil the original remit of the finance facility.

2 The exception is Indonesia where, when established, the initial founders are required to resign from the Board of the new organisation. More details on the legal requirements in Indonesia can be obtained by contacting suf@unhabitat.org.

What are Local Finance Facilities?

Five local finance facilities are currently in development. Four are being promoted at the city level in Solo and Jogjakarta in Indonesia and in SAEMA and Tema in Ghana. The fifth facility is being established as a national facility in Sri Lanka.

A local finance facility is an institution set up to help community groups access credit from local commercial banks. In the case of SUF, the finance facilities take the form of independent not-for-profit companies that are hosted by existing local financial bodies, such as a local bank.

In order to provide a strong fiduciary base for the facilities, they are being hosted by existing local banks. For example, the national facility in Sri Lanka is to be hosted by the National Development Bank. This arrangement has two advantages:

- The projected scale of financial transactions in the first two or three years of each finance facility's operations is relatively small, due to the complexity involved in assembling slum upgrading projects. Given this low transaction level, the expense of setting up a totally stand-alone facility cannot be justified.

- The finance facilities are new and have no track record of financial management. Host agencies, contracted for the purpose, are in a position to provide an important level of fiduciary oversight while the new finance facilities build up their own capacity over their first few years of operation. Such oversight should provide external contributors with the confidence they require to disburse grants for local credit enhancement use.

Why are Local Finance Facilities so important?

Put simply, local finance facilities offer more than just finance; they offer *Finance Plus.* The concept of Finance Plus, and what it includes, can be understood through the aims of the finance facilities themselves:

1. To bring together key players involved in city & national level slum upgrading strategies to address the challenge of financing

Ensuring effective slum upgrading means more than just bridging the finance gap. Land allocation and tenure, infrastructure planning and options for livelihood developments are all very important issues that need to be addressed. For this to happen, a range of institutional collaboration and commitment needs to be secured from slum dwellers themselves, from local and central government, from traditional councils (where relevant) and from commercial and professional stakeholders.

One of the advantages of the proposed local finance facilities is that their governance structure encourages the participation of all these actors while retaining a clear focus on slum and settlement upgrading that will benefit low income households. This is a large part of the Finance Plus role that conventional finance institutions find difficult to take on board – but which is vital if complex projects are to be adequately supported.

2. To catalyse the integration of commercial finance into slum upgrading

Jangwani, informal settlement in Tanzania. © Suzi Mutter, January 2005.

As the last decade has shown, accessing commercial finance for slum upgrading is extremely difficult. Formal finance institutions have little, if any, experience in assessing the risks involved. There is a lack of understanding on how lending in this area might fit into the core business models of banks and other lending agencies. Even where successful lending agreements have been negotiated (usually backed by guarantees), the time involved has been enormous, sometimes taking years.

One of the most significant problems is that of staff turnover within commercial lending agencies, particularly where financial markets are developing rapidly and there is a high demand for financial and banking staff. Lessons learned through implementing projects on the ground often fails to translate into systematised delivery processes, because the knowledge moves when personnel relocate.

One of the big advantages of having a permanent local finance facility dedicated to supporting financing of slum upgrading is that continuity in learning and knowledge sharing based on the practical experience of projects on the ground can be ensured. This is because the facilities have a strong local governance base and are not dependent on highly mobile financial professionals.

3. To provide mechanisms to blend different forms of funding to maximise affordability

Slum upgrading requires a mix of financial services. Project lending, individual and collective lending, short, medium and long term lending, direct subsidies, cross subsidies within projects, bridge finance and guarantees are just some of the elements that might be required. The local finance facilities are designed to have the flexibility and capacity to ensure that blending results in optimum leverage and affordability.

A market in Old Fadama, Accra, Ghana. © Suzi Mutter, December 2004.

4. To provide a financial mechanism to support the implementation of city-based slum and settlement upgrading strategies

The local finance facilities have been designed to support city-based interventions. All have high levels of engagement by local government as well as community, professional and private sector representation. In Ghana, for example, the local finance facilities are being established within the context of a broader development initiative – the Municipal Finance and Management Initiative – that is expected to lead to a new Local Government Finance Act aimed at strengthening local government's capacity to generate and manage investment finance.

Upgrading slums is a complex process and is certainly about more than just finance. The structure and purpose of local finance facilities is intended to capture the elements of that complexity, and translate it into a Finance Plus approach – one that is more likely to mean successful projects for slum dwellers.

How will Finance Facilities work?

The local finance facilities are being established to be responsive to local contexts and conditions. These will vary between cities and between countries, but each facility has the remit to provide the following three generic forms of assistance:

- Loan guarantees to facilitate access to commercial bank loans;
- Technical assistance to ensure the development of bankable projects and programmes, and;
- Catalytic grants to provide inputs that will make a critical difference to successful project planning and implementation.

A range of grant funds have been identified to capitalise the local facilities. To begin with, the most significant input will come from UN-HABITAT, drawing on Slum Upgrading Facility Pilot Programme funds provided by the governments of the United Kingdom, Norway and Sweden. However, important inputs are also projected, and in most cases have already been assured, from local and central government (who are also expected to make annual allocations to the facilities). Other potential donors will be approached once the facilities are operational.

The largest amount of finance to be used for slum upgrading projects and programmes should, in the long term, come from the commercial finance sector in the form of loans. Where appropriate, local and regional development banks may be approached, as will other global facilities such as Guarantco. To reach this stage, however, it is important that each facility be enabled to establish an initial successful track record of projects delivered on the ground. This is what the SUF Pilot Programme is all about.

There are two main types of initiatives that will initially be supported by the local facilities:

- Area upgrading projects – with project finance loans being negotiated from commercial lending institutions and combined with other inputs such as local authority infrastructure installation, secure tenure allocation, cross subsidies from additional commercial components developed within projects etc., and;

- Individual home improvement programmes – with wholesale loans being secured for on-lending through local savings and loan schemes and/or micro finance institutions.

The table below gives a summary overview of the services to be offered by the facilities currently being established and the sources of funds to initially be utilised.[3]

COUNTRY	Ghana		Sri Lanka	Indonesia	
CITY	Tema	SAEMA	National	Solo	Yogja
SERVICES TO BE OFFERED	√	√	√	√	√
Guarantees for wholesale loans	√	√	√	√	√
Guarantees for project loans	√	√	√	√	√
Occasional bridge financing loans	√	√	√	√	√
Technical assistance for project design	√	√	√	√	√
Technical assistance for loan negotiations	√	√	√	√	√
Grants for initiating projects	√	√	√	√	√
SOURCE OF FUNDS					
SUF PMU	√	√	√	√	√
Local Government	√	√		√	√
National Government			√		
Other					
TYPES OF INITIATIVES					
Planned home improvement programme		√	√	√	
Planne are improvement project	√		√		?

Figure 1 Financial flow