Central and Eastern Europe
Local Government and Housing Privatization

Prepared for the Office of Housing and Urban Programs
Agency for International Development

Making Cities Work

ICMA
International
Municipal
Programs

ICMA
Consortium Report

Consortium Members

International City/County Management Association
Urban Institute
Urban Land Institute
National League of Cities

EAST EUROPEAN MUNICIPAL CREDIT SEMINAR

JUNE 7-10, 1994 IN BUDAPEST, HUNGARY

CONFERENCE PROCEEDINGS AND ANALYSIS

Prepared by

George E. Peterson

and

Juliana H. Pigey

The Urban Institute
2100 M Street, N.W.
Washington, D.C. 20037

July 1994

Prepared for

INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION
Local Government and Housing Privatization
USAID Project No. 180-0034
United States Agency for International Development
Contract No. EUR 0034-C-00-2034-00, RFS No. 83
UI Proj. No. 6283-83

2

TABLE OF CONTENTS

LIST OF ACRONYMS

CEE	Central and Eastern Europe
CZ	Czech Republic
CZK	Czech crown
EBRD	European Bank for Reconstruction and Development
FRA	France
HUF	Hungarian forint
HUN	Hungary
IBRD	International Bank for Reconstruction and Development (the World Bank)
MUFIS	Municipal Infrastructure Financing Corporation (Czech Republic)
OTP	Országos Takarékpénztár és Kereskedelmi Bank, R.T. or National Savings Bank (Hungary)
PDB	Polish Development Bank
PKB	Prvá Komunálna Banka--First Communal Bank (Slovak Republic)
PLZ	Polish złoty
POL	Poland
SKK	Slovak crown
SLO	Slovak Republic
UK	United Kingdom
USAID	United States Agency for International Development

4

INTRODUCTION

Faced with pressing infrastructure investment needs, local governments in Central and Eastern Europe (CEE) are responding to the challenge of obtaining financing for their projects, in part by contracting loans or issuing bonds. Municipal credit operations are growing at a very fast pace, and are likely to continue to accelerate. However, in all four countries municipal credit markets are still in their infancy.

From June 7 to 10, 1994, a seminar on Municipal Credit in Eastern Europe, sponsored by USAID and the Ministry of Finance of Hungary was held in Budapest, Hungary. Participants in the seminar included representatives of central government, local governments, and domestic banks of the Czech Republic, Hungary, Poland and Slovakia. In addition, representatives of the World Bank, EBRD, USAID, and international private financial and credit-rating institutions participated, as did municipal credit experts from the United States and Western Europe, and observers from Bulgaria and Romania.

The following conference proceedings summarize the themes discussed in the seminar, giving special attention to the recent experience of local governments and domestic financial institutions in the region. Among the topics addressed during the seminar were: credit needs of local governments, bank lending to municipalities, assessment of municipal creditworthiness, municipal bond issuance and the creation of a municipal bond market, the central government's role in municipal credit regulation, the interaction between credit and grants, and construction of a national system of municipal credit.

This summary is presented in terms of the main policy and operational issues arising from the conference and therefore does not always follow the chronological order of the actual proceedings and debate. The objective is to pinpoint the larger issues which were threaded throughout the conference and to inform future exchanges on these topics among the participants.

Boxes have been used to summarize parts of the discussion. Discussants are identified by last name, institution, and country. A full list of participants in the seminar can be found at the end of the report.

I. POLICY ISSUES IN ESTABLISHING MUNICIPAL CREDIT MECHANISMS

Although a number of policy issues were addressed during the conference, four salient issues were particularly relevant to the needs of the participants and their capacity for finding (and repaying) appropriate financing. These policy issues are: (1) a general reluctance in the region to use debt to finance local investment needs and the associated questions of inter-generational equity in infrastructure finance; (2) the extent to which municipal credit operations should be controlled through government regulation vs. private market discipline; (3) the degree of subsidy, if any, that is appropriate for municipal borrowing and the interaction between market-rate borrowing, subsidized credit, and central government grants, and (4) the sources and stability of local government revenues used to repay debt.

The way in which these policy issues are addressed by each of the participating countries will help shape the ultimate form of their municipal credit systems.

1. Aversion to debt and generational equity

The assignment to local governments of major responsibilities for infrastructure construction, maintenance, and finance is quite recent. Previously, central government executed much of this investment directly. During the first stages of democratization, local investment projects often were carried out by local authorities but paid for by central government transfers. Investments financed by local governments from own sources typically have been financed from current savings, either from municipalities' current account surpluses or the proceeds of asset sales. Until very recently, municipal borrowing has been a negligible part of the overall financing picture.

For many municipalities in Central and Eastern Europe, there is a general aversion to debt, which is viewed as something not to utilize except as a last resort, and certainly not to leave to future generations. Thus when municipalities contract loans, they often seek to repay them as quickly as possible. However, the projects for which local governments require financing are frequently long-term in nature and will be used over more than one generation of residents/taxpayers. Taking on short-term debt to finance such long-term equipment may inappropriately constrain the investment budget and places the burden of financing entirely on one generation of beneficiaries, while the following generations will essentially be free-riders, who benefit from services which their predecessors have financed. This issue becomes particularly important if the current local administration is trying to finance a large investment budget to compensate for under-investment in the past.

Financing projects from own resources in an equitable manner will require local governments to access longer-term loans than have been generally available, allowing them to finance, for example, road or sewage projects over 10 to 15 years rather than the current three- to five-year terms. This implies the development of longer term capital financing systems. At present only in the Czech Republic have banks made municipal loans with maturities longer than five years.

Although municipal indebtedness starts from a very low base, it is growing rapidly. In the Czech Republic, outstanding municipal debt was negligible at the end of 1991; CZK 1 billion at the end of 1992; and CZK 2.9 billion at the end of 1993. During the first half of 1994 approximately CZK 10 billion of longer-term municipal borrowing took place. In Hungary, local government borrowing rose from 4.8 billion forints in 1991 to 7.5 billion in 1992, and 25.7 billion in 1993.

BOX 1
ATTITUDES TOWARD MUNICIPAL DEBT

Jezek Pardubice (CZ): Pardubice has decided not to sell its municipal property for now, because asset valuations are so uncertain. Therefore, we are borrowing to finance capital investment. However, we have had to educate both the municipal council and the public to accept debt as a responsible choice.

Chojna, Polish Development Bank (POL): Municipalities' debt repayment record has been good. Still, commercial banks would prefer to buy government paper, get involved in inter-bank transfers, or finance spectacular commercial projects. They do not have much interest in lending to municipalities. For their part, Polish municipalities are interested only in subsidized credits.

Sladky, Liberec (CZ): The city has an ambitious investment program. To finance it, we have incurred debt from diversified sources, including supplier-tied loans in deutschemarks and dollars, domestic commercial-bank loans, and a domestic bond issue. Debt service amounts to 3.6% of our budget in 1993-94, moving to 8.5% in 1994-95. The city's financial planning calls for debt service to rise to 15-17% of the budget in the future.

Sivak, Ministry of Finance (HUN): The Hungarian people really don't like to borrow, but as central government transfers fall behind inflation, localities will be forced to make much greater use of borrowing if they want to address their infrastructure deficits.

Beňuška, Bratislava (SLO): Bratislava has been relying heavily on asset sales to finance its capital budget. In 1993, 33% of city revenues came from sale of assets; in 1994, asset sales are budgeted to produce 49% of all revenues. Obviously, this cannot continue indefinitely. The city will have to move toward borrowing supported by recurring revenue streams.

2. Market discipline or government regulation?

Establishment of viable municipal credit markets requires local governments to exercise financial discipline. This includes establishing a positive track record of repaying loans on time, keeping total debt within the financial capacity of the municipality, initiating and completing cost-efficient investment projects that citizens value, and adopting transparent financial disclosure standards.

Local financial management is of highly variable quality throughout the CEE region. There are generally two frameworks within which financial management upgrading can take place. One emphasizes central government regulation, the other discipline by the market. To date, one of the four participating countries (Poland) has leaned heavily toward regulation, while the Czech Republic, Hungary, and Slovakia all have relied more on market mechanisms and local governments' own restraint. Finding the right mix of regulation and market discipline for the future is an active issue in all of the countries.

The regulatory approach adopted in Poland includes some governmental involvement in assessing creditworthiness before local governments actually borrow as well as numerical ceilings on local borrowing. The objective is to ensure that municipalities do not overextend themselves financially during the learning period, thus obliging (more through an implicit rather than explicit requirement) the central government to bail out a municipality in default.

When a Polish municipality requests a loan from a bank other than its main deposit institution, the potential lender can request the appropriate Regional Audit Chamber to issue an opinion on the creditworthiness and repayment capacity of the municipal borrower[1]. Local governments are limited to an annual debt service of 15 percent of all revenues, although loans secured with real estate as collateral are excluded from calculation of this ratio. Also, since 1994, the government has provided the possibility for local governments to request a debt guarantee from the Ministry of Finance; in case of default, the Central Government general subsidy transfer to the municipality would be intercepted and paid over for the defaulted loan. All applications for this guarantee received to date by the Ministry of Finance have been rejected, as they were said not to meet the criteria of the Ministry for approval.

---

[1] The 17 Regional Audit Chambers in Poland were established in 1993 by decree of the Prime Minister (based on Parliamentary legislation). Their role is to ensure the financial supervision and oversight of municipal budgets and to conduct a complete audit at least once every four years. Opinions on the creditworthiness of a local governments are issued only at the request of the bank which is planning to extend a loan to a municipality; it is up to the bank to decide whether to follow the Regional Audit Chamber's opinion.

The regulatory emphasis is consistent with Poland's overall approach to credit markets. As there is very little private, market-rate lending to municipalities, the threat of losing access to commercial lending carries little weight with municipalities. The conditions for market discipline do not exist. Further, since the principal lenders to local government are central government funds of one kind or another, the central government has a direct financial interest in determining the repayment capacity of municipal borrowers.

In contrast, in the Czech Republic, Hungary and Slovakia, decisions about municipal lending have been left to the market. It is the responsibility of municipalities to decide whether and how much they want to borrow, and of banks to determine the creditworthiness of potential municipal borrowers. Municipalities have an incentive to establish good financial management and propose viable projects in order to make themselves "attractive" to the banks; for a creditworthy municipality, the potential payoff is access to capital and, eventually, lower interest rates for loans. Nonetheless, all of the central governments recognize that they have a stake in avoiding substantial municipal defaults, which could destabilize both the banking system and the intergovernmental financing system, and so are considering the desirability of imposing central limits on local indebtedness.

Most banks in CEE are still novices in assessing municipal credit risk, and in fact there is little empirical record over the last half century to help make risk determinations. No specialized credit-rating institutions yet exist in these countries. The capacity to reliably assess credit risk will depend in part on the speed with which standardized, meaningful budget planning and clear financial reporting are adopted. Resolution of the legal status of municipally owned public utility enterprises, including their legal authority to adjust tariff rates to cover debt obligations, likewise is needed to clarify repayment capacity.

Some local governments have voluntarily adopted debt limits to enhance their creditworthiness. Currently engaged in a major borrowing program, including World Bank and EBRD loans, the municipality of Budapest, for example, has recently set its own debt limits through internal regulations[2]. [See Box 2]

---

2 In 1993 Budapest borrowed HUF 13.5 billion, of which 7.5 billion came from the EBRD for investment in public transportation and 6 billion from a consortium of Hungarian banks. A combined credit line of $110 million US has been proposed by the EBRD and the World Bank. The city is planning to draw on this credit for the equivalent of HUF 3.9 billion in 1994 and 7.3 billion in 1995. A further HUF 3 billion is expected to be borrowed from the Hungarian banking sector in 1994.

BOX 2
REGULATORY APPROACHES TO LOCAL BORROWING

Sivak, Ministry of Finance (HUN): Hungary has one of the most liberal local government systems in the world. There are no rules restricting local government spending, and no rules governing the magnitude or form of municipal debt--except that public issue bonds must comply with the rules of the Securities Act. The state no longer will guarantee local bonds.

Szekely, Budapest (HUN): Budapest has elected to set its own debt limits by internal regulations. Annual debt service cannot exceed 15 percent of municipal revenues. The total amount of loans taken in a fiscal year cannot exceed the amount of expenditures on capital projects.

Kamenickova, Ministry of Finance (CZ): Local governments in Czech Republic have complete freedom over their expenditure decisions, including debt obligations. Whatever loan terms a municipality and its lender negotiate are acceptable. This is the quid pro quo for having no state guarantees. Bond issues must be approved by the Ministry of Finance, but this is primarily for legal form.

Szumlińska, Regional Audit Office (POL): Regional Audit Offices in Poland will give an opinion on the financial condition of a local government at the request of a bank considering a loan. There are centrally established limits on local debt service. There is the possibility of obtaining centrally administered guarantees through transfer intercepts. Central government restrictions are necessary because local governments are inexperienced in debt management.

3. Interest rate subsidies and tax status of municipal borrowing

One of the principal policy issues surrounding municipal credit markets is whether lending to local governments should be subsidized. Opinion on this issue was sharply divided at the seminar. Representatives from the Czech Republic and Hungary generally were committed to market-rate lending, complemented only by highly targeted central-government grants or subsidized credits for projects having substantial externalities, such as some types of environmental investments. Although more costly to local governments, market-rate credit was viewed as more consistent with decentralized decision-making, where municipalities could decide their own investment priorities, then borrow from the market to finance this investment.

Representatives from Poland, in contrast, argued that, at least in their country, substantial subsidies for municipal lending were necessary and appropriate. In part, this reflects higher market rates of interest in Poland because of higher inflation. In part, it reflects a desire on the part of central government authorities to have a more direct role in investment choices, including decisions as to which local government investments should be favored by credit subsidies. Some of the Polish participants argued that central government, local governments, and banks should view themselves as partners in social investment in a manner that goes beyond market-based relationships.

In Slovakia, the policy toward municipal credit subsidies is just starting to be sorted out. There is a predisposition toward using subsidies, but recognition that the central government's budget constraints make it difficult, if not impossible, to sustain a subsidy policy.

Investment subsidies can come in many forms. One instrument is targeted capital grants from the central government, which can be combined with local resources, including loans, to co-finance local investment projects. Hungary employs a targeted subsidy system, where the central government grant share varies by type of investment project. A second instrument is below-market loans, which can be subsidized by central government or other parties in a variety of ways. A third possibility is to subsidize local borrowing through the tax code. In the United States, for example, the interest on municipal bonds is exempt from income taxation. This favorable tax treatment has been an important factor in the volume of municipal bond issuance.

Several U.S. experts at the seminar counseled against adopting the U. S. system of favoring one form of investment over others through tax exemptions, and argued for a level playing field. At present, however, in most CEE countries the playing field is not level, but tilted against municipalities relative to central government debt, which is typically at least partially tax exempt.

In the Czech Republic, interest on state bonds have been made tax exempt, while interest on municipal bonds is taxable at a rate of 25 percent, the same rate that applies to interest on corporate bonds. Interest earned on bonds in Hungary is taxed at a rate of 10 percent. This rate applies equally to State, municipal, and corporate placements. However, investment in State bonds is deductible for individuals up to 30 percent of personal income, which does give a considerable tax advantage to these instruments.

In Slovakia, municipal bonds have an intermediate position. Municipal bonds issued for the purpose of financing public transportation and housing projects (only) enjoy a 10 percent income tax rate, which is lower than the tax rate on corporate paper (15 percent). The tax rate for interest on municipal bonds was reduced by the Ministry of Finance after the first bond issue by the city of Žilina encountered difficulties in placement. Still, Slovak municipal bonds must compete with State bonds, which are fully tax exempt.

BOX 3
SUBSIDIES FOR MUNICIPAL LENDING

Tajcman, Urban Research (CZ): All bank lending to municipalities in the Czech Republic has been at market rates, without subsidy of any kind (except for some external loans tied to supplier credits). It is a high priority of the Government to encourage the development of a competitive, private market in municipal lending. The Environmental Fund in the Czech Republic currently provides grants for municipal environmental projects; it also provides very low interest loans. There has been discussion of converting part of the Environmental Fund to a revolving investment fund that might provide less subsidized credits. It will be important to design such a program so as not to undermine the market-rate credit system.

Bertalan, Budapest Bank, (HUN): Municipal lending in Hungary has not been subsidized. However, the Government provides localities with targeted subsidies for capital investment, which localities must partially match from own resources. A good deal of the borrowing that has occurred is to raise local funds for this investment match.

Beňuška, Bratislava (SLO): Municipal borrowing generally in Slovakia has not been subsidized. The State Environmental Fund subsidizes municipal environmental investment through grants; there has been discussion of converting part of this Fund to a loan fund providing subsidized credit. The Environmental Fund already makes some no-interest loans. However, requests for funding from the Environmental Fund far exceed its resources (annual funding runs at about 7-8% of municipal requests), and resource allocation decisions are made exclusively by central government authorities.

Herbst, Ministry of Physical Planning and Construction (POL): Some subsidy system is needed to bring down interest rates to a level that is affordable to local governments. We need to look at central government lending to municipalities as a substitute for central government grants. In 1993, the State provided Polish local governments with about $1 billion in grants for infrastructure investment. Non-interest bearing loans would have stretched the central government resources farther.

Szumlińska, Regional Audit Office (POL): In Frankfurt, Germany, total municipal indebtedness is roughly four times the annual city budget. Banks have waived repayment of principal and are collecting interest only. They know that trying to collect principal would precipitate a financial crisis for both the city and the banks. This kind of relationship, where banks and cities become financial partners, makes sense for Poland, too.

Dretkiewicz, Plock (POL): One reason that local governments in Poland are so averse to market-rate borrowing is that the Environmental Protection Bank and the Environmental Fund lend funds at highly subsidized rates (a few percentage points when inflation is running at over 30%, plus grace periods) and also lend for a variety of investment projects. Cities would rather wait for the chance to get a subsidized loan than pay market rates.

Studniarska, Environmental Protection Bank (POL): The Environmental Protection Bank allocates low interest loans and the Environmental Fund provides grants for environmental projects. The loans are for four-year terms. Interest rates are about one-fifth of commercial rates. Loan amounts are limited to 50% of the cost of a project. About 70% of subsidized loans go to municipalities, mostly for water projects.

Briggs, Dept. of Treasury (US): U.S. system of tax exemption for municipal bonds has its roots in American constitutional issues, which have been interpreted to prohibit the national government from imposing taxes on state or loccal government bonds. It is an expensive form of subsidy and not a system to be copied by others.

Peterson, Urban Institute (US): Every sector has special claims for below-market capital funds: agriculture, small business, municipalities etc. If the State takes on the responsibility of deciding how deep an interest-rate subsidy will be provided to each sector, and how much credit will be made available, the State replaces the market in allocating capital. This almost always leads to inefficient investment.

The tax situation for municipal bonds in Poland depends on the type of investor. For individuals, there are three levels of a progressive tax rate, at 21, 33 and 45 percent. A flat rate of 40 percent applies to corporations. Polish municipal bonds are in a disadvantaged position compared to government bonds, as individual investors receive a tax exemption and corporate investors a 20 percent allowance for purchasing State bonds.

4. Local government revenue streams and debt capacity

The long-run capacity for local governments in CEE to contract and reimburse debt will depend on their revenue streams. Local government revenue sources include local taxes, fees and service charges, and shared taxes and transfers from central government. Currently, there is a high but variable dependence on central government transfers throughout the region. The high level of central government funding could be an advantage, if the transfers and shared revenues were viewed as stable and flexible enough to be used for debt repayment. However, revenue-sharing formulas have been changed frequently, and central governments, wrestling with their own budget deficits, often are tempted to cut back on funding for lower levels of government. In this case, dependence on central government transfers heightens uncertainty. In addition, many of the transfers from central government are restricted to specific current-account spending purposes and are not available for capital investment or debt repayment.

Over the intermediate term, most governments in the region plan to provide local authorities with greater choice regarding local tax rates and local fee schedules. Greater flexibility in setting user fees, especially for utilities, should increase the feasibility of financing investments from project revenues. This possibility exists now to a large extent for Polish and Hungarian municipalities, where the most progress has been made in transferring major services such as water/sewer to municipalities and in according them rate-setting authority. For Poland, only rents and gas charges are still determined by the central government; other fees and charges (water/sewer, solid waste, public transportation) are at the discretion of the municipalities. Hungarian local governments have discretion for all utilities under their jurisdiction, including rents as well as water/sewer charges (these were set by the Ministry of Water Management until January 1994). In the Czech Republic transfer of water and sewer activities to the local level will be completed in 1994, and it is expected that rate-setting authority also will be delegated at some point. At present, the central government sets ceiling rates throughout the country. In Slovakia, water and sewer authorities are still centrally operated enterprises, though there has been much discussion of decentralizing service delivery and pricing.

Even where the legal authority exists to raise tariffs at the local level, this has been done sparingly. Rate hikes are politically sensitive and compound the financial problems of companies on the edge of bankruptcy. Also, although the utility enterprises have been transferred to local authorities, they are still in the process of being transformed and privatized; their management and collection systems need improvement.

Until rate increases become politically and legally more routine, revenue bond financing or its equivalent (that is, securing debt only with pledged project revenues) will remain rare.

In addition to their recurring revenues, all of the municipalities in the region have important municipal assets in the form of land, housing, municipal enterprises, and often shares in privatized companies. Proceeds from the sale of such property are being used to finance local capital investment. Indeed, development of a long-range asset management/disposition strategy is one of the principal choices that local government officials must make. One aspect of this strategy is to decide whether it is more prudent to borrow capital funds, using municipally-owned property as collateral and for income generation, or to sell such property and use the proceeds either to finance infrastructure investment directly or to set up financial reserves for borrowing.

BOX 4
LOCAL GOVERNMENT REVENUE STREAMS TO SUPPORT DEBT REPAYMENT

Kamenickova, Min. of Finance (CZ): Czech local governments have a large degree of freedom regarding expenditures, but the revenue system is highly centralized. There are centrally established ceilings for all tax rates and all fees. Central government subsidies amount to only 30% of local revenues, but there is no true local taxation. The principal revenue source is the personal and corporate income tax, which is collected centrally, then shared with local governments on a formula basis. In 1993, the share of all centrally collected revenues allocated to local governments rose from 17% to 20%. Although local government debt is rising rapidly, it is from an extremely small base, and there is a much greater capacity for debt payment. At the end of 1993, outstanding municipal debt amounted to only 3% of municipal revenues. It is central government policy to encourage higher levels of local government borrowing on the private market.

Wawrzynkiewicz, State Budget Dept. (POL): In Poland, some taxes are assessed and collected by the Regional Tax Offices of the Ministry of Finance (business license tax, agricultural tax), while other taxes are assessed and collected directly by the local government administrations (real estate tax). In all cases, the ceiling rate is set by the central government; local governments may lower this rate and award additional exemptions to taxpayers. Local governments have greater flexibility regarding user fees. In the past there was a great deal of direct negotiation between individual municipalities and individual ministries over grants, especially capital grants. But since Jan. 1994, no ministry can make grants to local governments on its own. There is a fierce debate in Poland over the best structure of capital grants. Municipalities face large capital investments, in excess of 100 billion zlotys annually, and it is unrealistic to expect them to finance these from current-account savings and market-rate borrowing.

Pakoński, Kraków (POL): In Poland, we are too dependent on central grants and central subsidies. Krakow this year introduced five-year capital planning and program budgeting, following a model used by our sister city, Rochester, N.Y. We have transformed municipal enterprises into independent companies. Most borrowing is done by these companies, pursuant to a business plan, without state guarantees. For example, we are using $25 million in credit to improve the district heating system; the investment will reduce the annual costs of maintenance by 25 percent. The water and sewer company also is borrowing; it can repay the loan through maintenance savings and service revenues. The City of Krakow can provide backup guarantees for these loans, without getting the State involved.

Dziekoński, Warsaw (POL): Municipalities in Poland are becoming aware of the risks in borrowing. Previously, no one was concerned with the exact form of repayment. Now we are recognizing some of the specific impediments to accessing revenue streams for debt repayment. For example, in Poland income transferred from municipal enterprises, like sewer and water companies, to the municipality itself is subject to income taxation. This means that it is very difficult to use utility enterprise revenue streams to repay municipal debt.

Beňuška, Bratislava (SLO): Bratislava has gone ahead and invested in its water distribution system. But the assets have to be turned over to the state-owned water company, even if we pay for the investment from our own resources. No one knows what is going to happen to the water companies, whether they will be decentralized or under what structure. So we may simply lose our investment. These matters have to be cleared up before we take on debt to finance large capital projects.

II. OPERATIONAL ISSUES FOR BORROWING BY MUNICIPALITIES

Munic.pal governments and domestic financial institutions in CEE have acquired a grea deal of experience in municipal credit operations in a very short time. This experience ha helped identify the strengths of regional institutions, as well as the gaps that need to be filled i creating stable municipal credit systems.

1. Borrowing experience—loans and bonds

In most of the participating countries, proceeds from borrowing and bond issuance nov represent less than 10 to 15 percent of total local investment expenditure (see Pigey and Petersor background paper, prepared for the seminar). Nevertheless, as economic restructuring advances capital markets develop and local governments gain financial management experience, recours to credit finance will increase. Credit operations already are growing rapidly. Several domesti banks in the participating countries presented their experience with lending to the loca government sector and raised issues for the future development of this market. Local governmen representatives presented specific examples of loan and bond experience, including hurdles ofte faced, and recommendations for improvement of local government access to credit.

A. Loans

Loans are generally available in some form to local governments in all of the participatin countries. The most widely accessed form of lending is short-term bridge loans. For som infrastructure financing, medium-term loans of two to five years are available, with mostl subsidized loans for environmental protection projects in Poland and unsubsidized loans in th Czech Republic and Hungary. Only in the Czech Republic have domestic banks made loans wit terms longer than five years; three loans of seven year terms have been made and banks hav proposed making loans up to ten years.

The municipal credit market has proved quite attractive to domestic banks in the Czec Republic, as the Czech National Bank has rated municipal debt as low risk. Falling domesti inflation and competition within the banking sector has brought lending rates to levels tha municipalities regard as affordable. Presently, there is considerable competition among bank to develop municipal loans--partly because municipalities are regarded as low risk borrowers an partly because banks see lending as a good entry point for generating municipal deposits an winning the right to handle municipalities' fee-paying financial operations.

The situation in Hungary is an extreme example of a condition also found in the Czec Republic and Slovakia. Almost all local government accounts are placed in a single bank, th National Savings Bank, or OTP. This provides a captive market for OTP, as its loans are secure through municipalities' deposit accounts. OTP also has detailed knowledge of the cash-flov situation of its municipal clients. Other banks have been trying to enter the market, but the near monopoly on deposit accounts has been one of the perceived barriers. The city of Budapest has been meeting infrastructure financing needs through a major borrowing program including EBRD and World Bank loans, as well as loans from a consortium of Hungarian banks and funds.

Polish municipalities have access to subsidized loans for specific projects (related to sewage and solid waste treatment) from the National/Voïvodship Funds for Environmental Protection and the Bank for Environmental Protection. In a situation in which the average interest rate is 35 to 40 percent, the environmental funds provide credit to local governments at preferential rates of 7 to 21 percent; these loans represent over 90 percent of medium-term borrowing by all Polish municipalities. With these conditions, few other banks have to date been active in lending to local governments. Those which have succeeded in placing loans generally finance projects which are ineligible for Environmental Fund financing.

In Slovakia, a bank established at the initiative of the Association of Slovak Towns and Cities, the Prvá Komunálna Banka, has become the major source of loans for municipalities. The bank is owned by municipal governments. Other commercial banks have begun to enter the field for one- to three-year loans. Various proposals have been made for converting part of the State Environmental Fund to a loan fund aimed largely at municipalities, including a proposal to tap part of the financial capital of the Slovak Insurance Company for municipal lending. At this point, such discussions remain at the preliminary design stage.

B. Bonds

Municipal bonds account for a much lower part of municipal credit than do direct loans. However, bond issues are growing surprisingly quickly. The most active markets for municipal bonds are the Czech Republic, with a preference for public issues, and Hungary, where private placement bonds have been favored.

For a municipality to raise capital through a bond issue, there must be an active investor market. The Czech Republic has had the most success in developing a secondary market. Two municipal bonds are traded on the Prague Securities Exchange (Liberec, Smržkovka). Other bonds have been resold privately by bank underwriters. One bond (Čáslav) was underwritten by a securities firm rather than a bank. In addition, the city of Prague has the first example in Eastern Europe of a municipal bond issued on the international market, for $US250 million. The entire issue sold out within a few hours on the London Exchange.

BOX 5

BONDS VS. LOANS AS SOURCES OF MUNICIPAL CREDIT

Kello, Istrobanka (SLO): Bank has decided to enter the bond market for municipal lending. Why bonds rather than loans? Primarily because there is potential for a good secondary market; can tap other than bank capital. The privatization investment funds will need to adjust their portfolios. Now they are overloaded with equities (essentially 100%). But we estimate they will gradually move toward 30% bonds in diversified portfolios. Also, bonds can be sold in small denominations to individual retail purchasers.

Lovas, VEKTOR (HUN): Bond issuance in Hungary has been small relative to loans. Twenty of 300 municipal credit operations have involved bonds. All except one have been private placements to avoid regulatory costs of public issues. The group of investors for private placements is small, mostly banks and insurance companies, and there is not yet a secondary market. Both bank loans and bonds are sure to grow in the future, as the state budget comes under increasing pressure and grants are reduced.

Goname (IBRD): One disadvantage of bonds is that the municipality gets all the proceeds at once. With a bank line of credit, you can make payments as construction expenses are incurred and draw down the loan as a project progresses. There is poor municipal cash management throughout Eastern Europe, so it is preferable to avoid having municipalities receive large cash infusions.

Dretkiewicz, Plock (POL): We are the only city in Poland so far to have issued bonds. Why bonds? City is able to get all of the proceeds at once--for us that is an advantage. Only part of the proceeds are tied to a specific project, the rest can be used at our discretion. The bond issue was very small, done as an experiment. Total volume of bond issue: $200,000 from a $400 million budget. It was private placement to avoid securities act provisions. Interest rate was the rate of inflation plus 6%. The city tried all sorts of incentives, including discounting the price of the bonds for people or companies also purchasing real estate sold by the municipality, companies undergoing privatization, etc. Still we were only able to sell 46% of the issue. Conclusions? Poland has very little experience in this field. It is difficult for municipal lending to compete with high returns expected from the stock market. From a municipal perspective, it is vastly cheaper to get a subsidized loan from the Environmental Bank.

Tordi, National Savings Bank (HUN): Loans carry lower administrative and preparation costs than bonds. We think they are a more appropriate form of credit at this stage. However, bonds have a better public image. Why? They do not so obviously represent "debt," which carries a negative connotation in Hungary.

Sladky, Liberec (CZ): It is in our interest to diversify lending instruments and help broaden the municipal credit market. Liberec has used both bonds and loans. Interest rates are roughly the same. For bond issue, the Czech Savings Bank served as underwriter and charged a one-time fee of 0.5%. Another 0.9% one-time fee was charged for out-of-pocket costs like registration, printing, etc. The fact that our bond went to a premium in secondary trading on the stock market helped lower subsequent borrowing costs.

Javornicka, Prague (CZ): The City of Prague issued US$250 million of bonds in the London market, without state guarantees of any kind. The City was given a BBB rating by Standard and Poor, the same rating as Czech Government bonds. Comparing bids before and after the rating, we estimate that the S&P rating cut our interest costs by almost one full percentage point. The bond has a 5-year term, 7.75% interest rate. We received bids from 40 institutions worldwide, and are convinced that this kind of international competition, possible only in the bond market, minimizes our borrowing costs.

Seidl, Czech Savings Bank (CZ): We provide credit both through bonds and loans. Administrative costs of loans are slightly lower. However, we want to develop bond issuance. It allows us to sell some of our municipal debt holdings on the secondary market, which is not possible with loans. Bonds also increase our liquidity, and allow us to enter into longer term obligations.

Hungary has also had a considerable number of bond issues. All except one have been relatively small private placement issues. Private placement bonds avoid the requirements of a public audit and authorization of the Public Securities Commission. The underwriter is in a position to arrange a small circle of investors, which may include banks, insurance companies and investment funds.

In Poland, there has been only one bond issue, with mitigated success. Polish municipal bonds are faced with onerous requirements of the Public Securities Commission, the inexperience of Polish banks in dealing with municipal bonds, and unfavorable tax rates.

The first bond issued in Slovakia, by the city of Žilina, encouraged the Government to reduce the tax rate on these bonds from 15 to 10 percent in order to stimulate purchases. A second bond, for the city of Detva, is under preparation.

The cost of issuing bonds may be a barrier to the development of this market in the short- to medium-term. The overall cost of bond issuance is higher than for contracting a loan; in addition to the underwriting fee, for example, there are also additional material costs to contend with, such as printing the information circular, publicity and printing the actual bonds. However, banks desirous of entering the field have absorbed most of these costs for the initial issues. The bonds issued by the city of Liberec were book entry, which saved CZK$250,000 in printing costs.

Budapest has been studying the possibility of issuing a municipal bond, but has been reticent due to the cost of such an operation. In the case of Detva, Istrobanka is using this issue as a promotional tool and has taken on most of the additional costs, with a minimal fee charged to the city. The city of Prague had most of its costs absorbed by Nomura, who served as the underwriter. Normally the cost of the Standard & Poor's rating, would be US$30-$40,000 credited against a final cost of 3 basis points of the amount of the issue.

The principal advantage of municipal bonds as a form of indebtedness is their ease of transfer on the secondary market and their potential for tapping capital holders other than banks, like insurance companies, individuals, and investment funds.

2. Terms of credit

The usefulness of credit as a financing tool depends on its terms. Infrastructure projects, such as wastewater treatment plants or public transport networks, often last over several generations and require longer-term maturities (at least 10-15 years) for their financing. Currently, only in the Czech Republic do banks offer maturities for local government loans that exceed five years. In Hungary, Poland and Slovakia, where inflation has not yet descended and mostly short-term deposits are available to banks, loan maturities offered to municipalities are usually two to three years. Medium-term loans are sometimes available at preferential rates through environmental funds. However, these maturities do not allow time for a project t become operational and generate sufficient earnings to recover capital costs by the time th principal payments fall due.

A second variable which the local government will examine closely is the interest rate Municipal rates reflect the overall cost of money in the economy, which is tied to the expecte level of inflation, the level of risk perceived to be associated with municipal lending generally and the conditions of the individual municipality. As Poland, Hungary and Slovakia are stil experiencing high rates of inflation, interest rates offered to local government borrowers are see to be very high. They are currently 35 to 40 percent (variable rate) in Poland, and 23 to 2 percent (variable rate) in Hungary. Curiously, the interest rates offered in Slovakia are belov the estimated rate of inflation. Only in the Czech Republic, where inflation has bee considerably reduced, have interest rates become "affordable." The interest rates for the mos recent loans have been in the range of 11 to 14 percent.

A third element in credit terms is the choice between variable-rate and fixed-rate loans Traditionally, lenders have preferred variable-rate loans to protect themselves against interest rate fluctuations. Such protection has special importance in CEE, where bank deposits are overwhelmingly short term. Once inflation is seen to be coming under control, however, variable rates work to the advantage of the municipal borrower. The interest-rate structure of the Čáslav bond recently issued in the Czech Republic reflects expectations of falling inflation rates. The seven-year bond starts at 16 percent but is adjusted according to a prearranged schedule to fal 0.5 percent every six months, ending at 12.5 percent.

As international lenders begin to enter the regional market, there is the additional variable of foreign exchange risk. It must be decided who will bear the exchange risk. Is it the Centra Government, the lending bank, the local government, or some combination of these entities? In a recent loan in deutschemarks to a medium-sized Polish town, it is the town which is exposed to the risk (and cost) of further devaluation of the Polish złoty. Likewise, in the recent bond issue of the city of Prague on the London market, it is the Czech capital which must manage the foreign exchange risk. In most of the programs supported by international donor organizations however, at least part of the foreign exchange risk would be absorbed by national governmen agencies.

3. Legal authority for bond issuance and borrowing

In all four countries participating in the seminar, the basic municipal law defining the rights and responsibilities of local governments includes the legal authority to contract loans and issue bonds.

Within a municipality, the appropriate authority must approve the use of loan finance or bond issuance. This is usually the municipal council, directly or through delegation to the municipal board. Borrowing and debt issuance authority may be accorded on a case by case basis, with the municipal council debating the merits of each loan contracted by the municipality. Or, a general regulation covering borrowing principles may be established, with each specific loan decision decided by a smaller body than the full municipal council.

In the Czech Republic and Slovakia, the Central Government does not generally intervene in the realm of local government debt, except for the requirement to review bond issues and indebtedness for legal form. Five Hungarian local governments issued bonds in April 1992 that were guaranteedbox 2 by Posta Bank, with a counter-guarantee by the Government; these bonds required the approval of the Ministry of Finance. All subsequent municipal bond issues are no longer eligible for a government guarantee and they do not require approval of the Ministry of Finance. Public issue bonds are overseen by the Public Securities Commission; however, almost all municipal bonds issued to date in Hungary have been private placement bonds which do not require prior authorization from the Commission.

Only in Poland does the Central Government take an active stance in regulation of local government debt. In addition to the general limits on municipal indebtedness, discussed earlier, the Security Commission must approve municipal bond issues of more than one year maturity.

4. Credit risk and debt security

Municipalities are compiling a generally good record of debt repayment. In the Czech Republic, Hungary, and Poland, there have been no cases of municipal default, although there appears to have been some cases of late payments in Poland. In Slovakia there have been some repayment problems for loans issued by the Prvá Komunálna Banka.

All of the loans made to date have been "general obligation" loans; that is, the loans are secured by all the revenues a municipality has access to. In some cases, however, it has been the intention of the municipal borrower to generate sufficient revenues from a particular project to repay its debt, even if the obligation is formally against all sources of revenue.

In addition to the security represented by a viable project and an efficient well-managed municipality, four forms of collateral were mentioned as a means of further securing municipal debt: mortgaging of real estate or municipal property, pledging of financial assets, pledging revenues streams generated from certain projects, and intercept/payover of central government transfers to municipalities.

BOX 6
CREDIT RISKS, RISK ANALYSIS, AND SECURITY AGAINST RISK

Effenbergerova, Komerční Banka (CZ): One of the greatest risks is that a project will not get completed. Banks must work closely with municipalities to ensure that they have the technical and managerial capacity, as well as the finances, to finish the projects they borrow for. So far we have required municipal property as collateral for all of our loans and bond issues. However, municipalities in the Czech Republic are a very good credit risk. We can lessen our overall portfolio risk by expanding municipal lending.

Szumlińska, Regional Audit Chamber (POL): True risk-assessment must be forward looking. What will be the impact of borrowing on the municipality's financial position in the future, as debt is repaid? Regional The Kraków Audit Chamber in Poland has carried out 25 analytical assessments for proposed loans; all but two have received a positive opinion. These are not commercial loans, but loans financed by parastatal institutions.

Tordi, National Savings Bank (HUN): We are making loans to local governments at 3-4 percentage points below rates on commercial loans. Why? The risk is lower. Municipalities have more financial discipline. Regarding collateral: Our bank wants its money back, with interest. We do not want to end up owning municipal dumpsters or other kinds of property. Therefore, financial assets are the best kind of collateral; our preference is to use municipal deposits at our bank as collateral.

Seidl, Czech Savings Bank (CZ): The Savings Bank is willing to accept revenue streams as security for loans, but also has required property collateral. Project risk should not be underestimated; most municipalities are not sufficiently focused on just what has to be done to finish a project and start revenue generation. Overall, municipalities rank second to the State in creditworthiness.

Knazik, First Communal Bank (SLO): Our bank uses a scoring system to assess municipal credit risk. The most important element to us is management quality. Next, we do a budget analysis and an assessment of the value of municipal assets offered as collateral.

Szekeres, Budapest Bank (HUN): We have to think of municipal property in two categories. Property that is essential to the delivery of core services cannot be foreclosed and should not be offered by municipalities or accepted by banks as collateral. Only commercial-type property or vacant land can be used as collateral.

Gouarné (IBRD): Using municipal property as collateral ties up the property and keeps it in municipal ownership. It may make more sense for municipalities to sell such property and use the proceeds for investment purposes.

Łyszcak, University of Wrocław (POL): Lenders in Poland do not feel comfortable relying solely on revenue streams as loan security. Pure project financing lies far in the future. Meanwhile, banks are likely to continue to demand real property or financial assets as collateral.

Javornicka, Prague (CZ): Under our agreement, the City set aside one-third of the $250 million bond proceeds as an invested financial reserve. So far, this has been extremely profitable. We have benefitted from investing funds at much higher interest rates domestically, and also have gained from exchange rate changes. Plus having such a reserve allowed us to borrow at a lower rate.

Dziekoński, Warsaw (POL): Banks' demands for security make it difficult to use credit. When the city of Warsaw obtained a loan from an Italian bank to finance an incinerator, the lender required that we mortgage properties having 50% of the value of the loan and maintain a cash deposit equal to 25% of the loan.

Most loans to date have been secured by municipal property. Securing debt with physical collateral can be a time-consuming and costly process, which in Poland, at least, is subject to the payment of rather high fees. In addition, finding collateral which is marketable may be problematic, as many municipalities either have sold/privatized their commercial assets, or wish to retain the flexibility to do so. Finally, the legal steps to foreclose on property collateral are difficult, expensive, and without significant precedent in the case of municipal loans. In the Czech Republic, for example, municipal lenders must go through exactly the same court procedures as any private parties seeking payment of a bad debt.

Because of the difficulty of foreclosing on physical property or selling it, some of the banks at the conference expressed a preference for collateral in the form of easily marketable financial assets--e.g., shares of publicly-traded companies, other types of financial securities, or bank deposits.

The use of dedicated revenue streams as loan security will depend on the legal and political capacity of local governments to adjust fee structures and banks' willingness to accept this form of guarantee. For some types of investments, fee generation will never be sufficient to cover operating and maintenance costs as well as loan repayments. In fact, some investments, such as a flue in the municipal incinerator due to environmental imperatives, are not intended to be revenue-generating. Other investments may be undertaken for the purpose of operating cost reduction. How these recurring cost savings (which can be substantial) can be converted into budgetary funds and made available for debt repayment is a challenge for local budgetary practices. In general, participants agreed that issuing debt against pledged project revenues was a natural next step in the evolution of regional credit markets, but that lenders would be slow to relinquish requirements for physical or financial collateral.

A final factor in debt security may be the perception of an implicit or "moral" guarantee behind municipal loans on the part of the national government. Would the default of a substantial municipal borrower be too devastating to emerging capital markets to let the national authorities stand by without taking action? Some banks and some central government participants believed this to be the case. Such reasoning should be handled with caution, however, as recent French municipal loan defaults demonstrate that national governments are capable of letting banks and municipalities take the heat for their financial imprudence, even when market participants believed there would be government rescue.

III. DESIGNING A MUNICIPAL CREDIT PROGRAM

Until now, municipal credit instruments in CEE have grown without much coordination or overall design. The four countries participating in the seminar are in various stages of designing or putting into place specific programs and institutions to establish systems of debt finance for infrastructure. Many of these programs will channel international donor monies to supplement the funds currently available through the domestic banking system.

The Czech Republic has established the Municipal Infrastructure Financing Corporation or MUFIS, which will channel USAID and other donor monies for on-lending to municipalities through commercial banks. In Hungary, the Budapest Bank is negotiating with European partners and the EBRD to create a specialized municipal lending bank. Poland has been discussing with IBRD and USAID the creation of a municipal credit agency, which would also channel donor money for on-lending through commercial banks. The Slovak Environmental Fund, in collaboration with the EBRD and USAID, has been looking into the possibility of transforming part of the Fund into a municipal lending program. These programs are intended to complement and help coordinate the private market lending initiatives already underway.

When designing a municipal credit program, at least six main issues need to be taken into consideration. These issues are discussed below.

1. What purpose is a national municipal credit program intended to serve?

All national credit initiatives, of course, are designed to improve the flow of investment capital to municipalities. However, the strategy adopted should rest on an analysis of the specific deficiencies in a country's current situation. For example, in the Czech Republic market-based lending already is expanding rapidly. The most important contributions that a national program can make are to lengthen loan maturities (up to 15 years) to make possible the financing of long-term investment projects, to improve the quality of credit analysis and financial preparation on both sides of the credit market, and to encourage competition among financial institutions in supplying funds to the municipal market. The national system has been designed with these roles in mind.

In Poland and Slovakia, the objectives of a national credit system are more basic. There, systems should serve to demonstrate that the credit risks associated with municipal lending are moderate and manageable, so that in the future the private sector will be willing to assume the credit risk of lending to local authorities. Further, the systems need to acknowledge and deal with an uncertain inflation and interest-rate environment. Some kind of State guarantees or subsidies may be necessary to meet these objectives, but the national systems should be designed in such a way as not to create permanent dependence on state intervention.

2. Who bears the credit risk?

Many internationally sponsored programs involve intermediate agencies for on-lending to commercial banks. The question of who bears the credit risk then becomes critical. The purpose of such credit programs, in addition to channeling funds to municipalities for infrastructure finance, is to encourage the domestic banking sector to enter the municipal credit market; when the programs are wound up, the local financial sector should be in a position to sustain the municipal credit market. Consequently, commercial banks and other domestic lenders either should bear the credit risk of their loans from the beginning, or should gradually be introduced to such risk over time. Only if they bear credit risk will lenders have adequate incentives to do good credit analysis.

The program under development in Hungary will involve a single bank, which will be obliged to take the credit risk. The Czech system is designed for the commercial banks on-lending the funds to take the full credit risk for the loans they make; there also will be requirements for using banks' own funds for lending. The position of the Municipal Credit Program in Poland has not yet been determined. Domestic banks will be responsible for managing the loan disbursement and payments; however, for the moment, few seem willing to engage their own funds for co-financing municipal projects and it is unclear whether they will be at risk for on-lent funds. The Slovakia environmental loan fund is still in its early design stage. However, the various draft proposals prepared by EBRD all would provide partial or complete guarantees to lenders against municipal credit risks.

If banks are to take the credit risk, they will require training in conducting credit analysis and choosing credit worthy projects. If government intermediaries are to play this role, they will need training even more urgently, as long as the objective is to prepare the way for eventual private market operations by establishing a track record of low default rates.

3. How much subsidy should be incorporated into municipal lending and under what form?

All the participating countries currently have some form of grant or preferential loan program to finance certain kinds of municipal infrastructure. The design of a municipal credit program cannot ignore the existence of these instruments. Where they exist, the Central Government should reflect on the structure of both systems so that they can be made complementary. Worldwide experience indicates that as long as municipalities believe it is possible to gain access to highly subsidized credit, they will resist market-rate loans.

One way to reconcile subsidized and unsubsidized lending systems is to narrowly target subsidized capital funds on projects of national priority which have externalities beyond the local level. Non-income generating environmental projects are one example of such priorities.

BOX 7
INTERNATIONAL PERSPECTIVES ON CREDIT RISK AND CREDIT ASSESSMENT

Reuss, Standard & Poor's (UK): When it assigns a credit rating, Standard & Poor's aims to provide the market with information on (a) a municipality's willingness to repay debt, (b) its capacity to pay, and (c) whether it is likely to make payments in a timely manner. Each bond issue is rated separately, based on the security behind that issue, and a municipality's economic and political conditions at the time of issue.

Jacquemain, Credit Local de France (FRA): Today, 90% of the credit provided by Credit Local de France to municipalities is of the General Obligation type, not secured by project revenues alone. Therefore, in our risk appraisals we look at the overall financial picture of the municipality. State grants are especially important, because they are such a large part of local authority funding. Are the grants automatic entitlements or discretionary? Is the law governing grants stable or changing? What is the trend in grant levels and other revenue sources, and how does this compare with the profile of debt payment obligations? We learned from our experience in France that state grant reductions constitute the biggest financial risk for local authorities.

Clark, U.S. Securities (US): One factor that impedes risk appraisal today, and is an obstacle to development of the credit market, is the lack of meaningful, transparent, standardized financial reporting by municipalities. Of course, the change in government structure makes it impossible to put together meaningful historical records. But even today, it is hard to go to a municipality and get documents that present the financial situation clearly. Financial reporting to state authorities often misses what is most important.

Warner, Public Resources International (US): Municipalities have to perform their own version of risk assessment for themselves. How much debt are they willing to assume? How stable is the revenue picture and the underlying economy? What mix of short-term and long-term debt best fits the locality's investment needs and repayment capacity? Local government should not underestimate the risk involved in foreign currency debt. The benefits of saving a few percentage points in interest can be wiped out if there is currency devaluation and the municipality has to absorb it.

Briggs, Department of Treasury (US): Over the long term, perhaps the biggest issue in risk assessment, either for a lender or for a municipal borrower, is this: does the local authority have continuing, long-term revenues it can count on, either from own sources or from guaranteed intergovernmental transfers?

Alternatively, subsidized or government-guaranteed capital can be used to extend the maturities of loans beyond the terms available in the commercial market, also for priority projects involving externalities.

The Hungarian system of targeted subsidies specifies sectors (sewer pipes, potable water supply, primary school construction) eligible for grant financing, as well as the percent of total project cost which will be covered by the subsidy (from 25 to 90 percent, with most projects in the 30 to 40 percent range). Local governments must prove they have the matching funds to finance the remaining cost of the project; these matching funds may include loans. Given a number of weaknesses of the system, the Hungarian Ministry of Finance is set to launch a re-examination of the targeted subsidy system.

Whether even market-oriented credit programs should include a shallow subsidy during the transitional period is another important policy issue. Most of the international donor programs that have been proposed contain some implicit subsidies. The international loans generally are provided at somewhat below the international market terms that would otherwise be available, because of IBRD, EBRD, USAID or other donor support. Secondly, some or all of the foreign exchange risk is typically assumed by the national government. The national government also guarantees the external loan. How much of these costs should be passed on to the local borrower is a significant design question. The true costs of foreign exchange risk obviously are much greater in a high inflation environment than in an environment of moderate and declining inflation. Some sharing of foreign exchange risks between the central and local government seems appropriate during the transition period to introduce a municipal credit system. In contrast, designing the system so that make localities and lenders bear a large part of credit risk from the beginning is essential to establishing a market oriented system.

4. Centralized or decentralized credit allocation?

In supporting a municipal credit program, the central government can either take the lead in allocating credit or it can allow banking institutions and local governments to negotiate their own credit arrangements.

Two of the proposed programs discussed at the conference are designed to be quite decentralized. Under the Czech MUFIS, individual commercial banks will make their own decisions about which municipalities they will lend to; the banks and municipal borrowers will negotiate the terms of loans (between 7 and 15 years), the type and extent of collateral, and the interest rate (subject to a ceiling of a 2.5 percent margin between the banks' lending rate and their fixed cost of capital through the program). All credit risk rests with the banks. Eventually, MUFIS credit lines will be equally available for bank loans and bond issues. Under the Hungarian program that is being designed, the newly-established municipal lending bank would make its own loan decisions, based on market principles.

Poland is initially undertaking a more centralized system. It foresees the establishment of a public lending agency operating under the auspices of the Ministry of Finance. The initial pilot projects also are less decentralized, as the donors will be dealing directly with the commercial banks to identify and appraise projects for on-lending. Projects will have to be approved by the public lending authority. The success of this first phase may eventually lead to a less centralized program design.

The emergence of the Prvá Komunálna Banka (First Municipal Credit Bank or PKB) in Slovakia is a decentralized solution to municipal credit needs. However, municipal ownership of the PKB--and in particular, majority ownership by a single city, Žilina--raises questions of whether the Bank can maintain market independence in its credit decisions and collection procedures. To date, the PKB has made loans exclusively to the municipalities which contributed equity to its formation. The municipal loan activities proposed for Slovakia's Environmental Fund are very highly centralized. State authorities would decide which projects to finance and would protect lenders against municipal credit risk.

5. Comprehensive system or a smaller process to initiate a system?

When initiating a new program, it is possible to immediately start up with a comprehensive design. Alternatively, a limited pilot program can be launched, which starts by funding two or three projects. This approach enables the backers to test the initial design hypotheses and to make necessary modifications before implementing a more comprehensive system.

The MUFIS of the Czech Republic involves a relatively comprehensive process. Given the relatively favorable conditions of the domestic credit market (11 commercial banks, including the four largest in the country, applied to participate in MUFIS) and the greater success of private-sector lending to municipalities to date, this approach is quite logical. In Poland, the Municipal Credit Program will begin as two pilot programs, one financed by USAID and the other by the World Bank; this will allow a test of two alternative implementing procedures.

6. Looking forward: Making sure first steps support final objectives

Experience in other countries suggests that it is difficult to dismantle parastatal loan authorities once they are created. Such institutions can become powerful bureaucracies with their own objectives. Then, lending decisions often become more "political" over time. Using these institutions as a transitional bridge to private markets requires a good deal of self-discipline, as well as well-defined rules for winding down public involvement. Even if the intention is to retain a parastatal loan authority for a long period of time, its market orientation needs to be built into the initial design.

BOX 8
NATIONAL DESIGNS OF MUNICIPAL CREDIT SYSTEMS

Czech Republic

Kamenickova, Ministry of Finance (CZ)
Tajcman, Urban Institute (CZ)
Peterson, Urban Institute (US)

Commercial lending terms to municipalities have improved greatly over the last year. Interest rates have declined from about 17% to about 13%. Five- to seven-year loan maturities have become common. Municipal bonds have been well received and a secondary market in bonds has been established.

It is important for the Government to support and build on this market progress, not try to construct a new municipal credit system. What are the next steps? To provide municipalities access to 10-15 year fixed-rate loans; to improve capital budgeting and project preparation of municipalities; and to ensure competition within the financial sector for municipal lending.

The system being implemented involves up to US$100 million in long-term loans from the U.S. capital market, guaranteed by USAID and the Czech Government. These will pass through an intermediary institution and be available to commercial banks at fixed rates. The banks will on-lend to municipalities at about current market rates but for longer maturities than are now possible. The external loan will augment banks' lending from own funds to municipal governments. A large number of commercial banks are expected to participate in the system, thereby strengthening financial sector competition. Project selection and credit allocation will be fully decentralized. The banks will bear all credit risk, and will be required to demonstrate that they are committing their own resources to municipal lending.

Poland

Herbst, Ministry of Physical Planning and Construction (POL)
Wawrzynkiewicz, Ministry of Finance (POL)
Greytak, Maxwell School (US)
Hammam, USAID
Oks, IBRD

The conditions for private market municipal lending are less advanced in Poland. The central government believes it should have a strong role in coordinating municipal investment and credit. It intends to establish investment priorities for any credit system, and will approve individual projects for financing. Under one model, a specialized central government agency would be established to set financing priorities, approve projects, and provide localities with technical assistance. Commercial banks will be used as pass-through vehicles for municipal lending. However, banks are unlikely to commit their own capital, and may not be willing to accept credit risk.

Loans to support the system would be provided by IBRD or from U.S. capital markets with USAID guarantee. Given the relatively high inflation rate in Poland, a key design question is, "Who will bear the foreign exchange risk?" If this is passed on to municipalities, they may be unwilling to borrow. If it is absorbed by Government, this is equivalent to a sizable subsidy which may further impede development of a market-rate system.

Over the long run, it will be important to reconcile the lending terms of a municipal lending facility with the loan terms available from the Environmental Protection Bank.

BOX 8 (cont.)

Hungary

Szekeres, Budapest Bank (HUN)
Bastin, EBRD
Lallemand, Credit Local de France (FRA)

Municipal loans are now limited to two- to three-year terms. OTP, the National Savings Bank, dominates savings deposits and handles 96% of municipal accounts. The basic proposal is to fund through an external credit, and possibly through some EBRD equity participation, a specialized private-sector municipal lending institution which would lengthen maturities for municipal lending, provide competition for OTP in municipal activities, and provide technical assistance to municipalities.

If such an institution follows the evolution of Credit Local de France, eventually it could raise capital competitively in domestic and international private credit markets, then use the proceeds to lend to local governments. This form of permanent intermediary is found in many Western European nations.

Slovakia

Beňuška, Bratislava (SLO)
Knozik and Krasner, Prvá Komunálna Banka (SLO)
Kezer, Financial Services Volunteer Corp. (US)
Bastin, EBRD

A number of different models are being explored in Slovakia. EBRD is lending to the city of Bratislava for enterprise activity and also may invest in joint public service enterprises. The Prvá Komunálna Banka, formed and owned by municipalities, has become very active in municipal lending, already having made more than 130 municipal loans. It faces the challenge of maintaining arm's length credit relations with municipalities which are the Bank's owners.

At present, other commercial banks are not willing to lend to municipalities on a significant scale. All banks face severe credit restrictions imposed by the Slovak National Bank, as well as portfolios loaded with bad loans to commercial enterprises. In this environment, one mechanism for municipal lending that is being explored is to create an intermediary facility that would tap for the municipal sector long-term capital held by Slovak Insurance Company. There are also proposals to correct part of the Environmental Fund to a revolving credit facility.

Both the MUFIS in the Czech Republic and the Polish Municipal Credit Program are designed as temporary transitional expedients, to on-lend donor funds to commercial banks. When donor funds are no longer available and the domestic banking sector has become the main provider of infrastructure funds to municipalities, then either the remaining loan portfolios should be sold off and supporting agencies should be dissolved, or the intermediary institution should become purely market-based, raising funds domestically and internationally through bond sales. Publicly-supported municipal credit institutions have evolved in this manner in France, Austria, and Spain. Expectations for the duration of a transitional program should be made clear from the start. Specific milestones should be defined which can measure progress toward agreed-upon goals, leading to termination of the transitional institutions.

Participant List

East European Municipal Credit Seminar

Czech Republic

Ing. Helen Effenbergerova
Komerční Banka

Ing. Zdena Javornicka, Advisor
Magistrat HI Mesta Prahy

Dr. Vladimer Jezek, Financial Director
Magistrat Mesta Pardubic

Ing. Vera Kamenickova, CSC.
Local Finance Advisor to Minister
Ministry of Finance

Mr. Jan Matejcek
Squire, Sanders & Dempsey

Mr. Petr Seidl
Department of Securities Emissions
Česka Spořitelna

Ing. Milos Sladky, Economic Director
Liberec Magistrat Mesta

Mr. Petr Tajcman
Urban Research

Hungary

Mr. Imre Bertalan
Strategic Department Budapest Bank

Mrs. Imre Darázs
Local Government Department
Ministry of Interior

Mr. József Kéri, Deputy Mayor
Szolnok

Mrs. Edit Nyitrai Kustos, Head
Local Government and Finance Directorate
Ministry of Interior

Mr. Pál Lippai
Mayor of Szeged

Mr. Támas Lovas, Director
VEKTOR kft.

Mr. Aladar Madarász
Advisor to Mayor of Budapest

Marton Nagy
Local Government Department
National Savings Bank (OTP)

Dr. József Sivák
Head, Local Government Department
Ministry of Finance

Gábor Szèkely
Deputy Mayor, Budapest

Szabolcs Szekeres
Advisor, Budapest Bank

Mr. László Tordi, Head
Head Directorate of Local Government
National Savings Bank, OTP

Beatrix Viktor
City Hall, Szeged

Poland

Jerzy Chojna, Deputy Director
Credit Department
Polish Development Bank

Mr. Andrzej Drętkiewicz
Mayor of Płock

Mr. Olgierd Dziekoński, Deputy President
City of Warsaw

Mr. Aleksander Galos
Hogan and Hartson

Ms. Irena Herbst, Deputy Minister
Ministry of Physical Planning & Constsruction

Jerzy Kulik
City of Warsaw

Mr. Marek Łyszczak
Academy of Economics
Finance Department
University of Wroclaw

Mr. Krzysztof Pakoński
Deputy Mayor
City of Kraków

Ms. Stanislawa Szumlińska
Head of the Regional Audit Office
Formerly City Treasurer, Kraków

Ms. Wanda Studniarska
Director Credit Department
Environmental Protection Bank

Ms. Danuta Wawrzynkiewicz
Deputy Director
State Budget Department
Ministry of Finance

Slovakia

Mr. Petr Beňuška
Deputy Mayor
Bratislava

Jan Brsel
Mayor of Detva

Mr. Jan Kello
Istrobanka

Mr. Miroslav Knazik
Prvá Komunálna Banka a.s.

Mr. Miroslav Krasnan
Prvá Komunálna Banka a.s.

F. Krutek
Ministry of Finance

S. Slezakord
Ministry of Finance

Bulgaria

Mr. Anatoli Belchev, Financial Analyst
Deloitte Touche

Ms. Evgenia Mincheva Kostadinova
Municipality of Rousse

Romania

Mr. Christian Sorin Ilea
Vice Mayor of Arad

Mr. Gheorghe Vlad
Department for Local Administration
Government of Romania

International Experts

Johann Bastin
European Bank for Reconstruction & Development

Thomas Briggs
U.S. Treasury

Thomas Clark
US Securities

Thomas Cochran
Resources Development Foundation

Marie Alice Lallemand Flucher
Credit Local de France

Vincent Gouarné
World Bank

David Greytak
Maxwell School
Syracuse University

Christophe Jacquemain
Credit Local de France

Richard Kezer
Financial Services Volunteer Corps

Daniel Oks
World Bank

George Peterson
Urban Institute

Konrad Reuss
Standard and Poor's Ratings Group

Miner Warner
Public Resources International

USAID

Ms. Rebecca Black
Ms. Sonia Hammam
Ms. Amy Hosier
Mr. Leos Jirasek
Mr. David Olinger
Ms. Alina Popescu
Mr. Fred Van Antwerp
Mr. George Williams
Ms. Sarah Wines

Administrative Programming

The Urban Institute

Ms. Marcellene Hearn
Ms. Katharine Mark
Ms. Juliana Pigey

International City/County Managers Association

Mr. Robert Dubinsky

Metropolitan Research Institute

Ms. Fruzsina Balas
Mr. József Hegedüs
Ms. Ágnes Locsmandi
Mr. Ivan Tósics

Program Organizers

Sonia Hammam, USAID
George Peterson, Urban Institute

A G E N D A
EAST EUROPEAN MUNICIPAL CREDIT SEMINAR

Tuesday, June 7

Reception: 18.30-19.00
Hotel Kempinski, Budapest (Foyer I/III.)

Opening Dinn. · 19.00-23.00
Hotel Kempinski (Room: Regina III.)

Welcoming Remarks

Gábor Székely
Deputy Mayor of Budapest

David Cowles
USAID Representative to Hungary

Wednesday, June 8

Morning Session: 9.00-12.00
Hotel Kempinski (Room: Bandini/Marzio/Bonfini)

Credit Needs of Local Governments
Bank Lending to Municipalities
Assessing Municipal Creditworthiness

Moderator: George Peterson

Presenters:

Aladár Madarász
Advisor to the Mayor
City of Budapest

Peter Benuska
Deputy Mayor
City of Bratislava

Discussants:

Miner Warner
President
Public Resources
International

Break: 10.30-10.45 (Foyer II/II)

Jerzy Chojna
Polish Development Bank

László Tordi
Head, Local Government Directorate
OTP, Hungary

Miroslav Knazik / Miroslav Krasnan
Prvá Komunálná Banka, Slovakia

Richard Kezer
Municipal Credit
Markets Specialist

Lunch: 12.15 (Room: Regiomontanus/Salon IV)

Wednesday, June 8

Afternoon Session: 13.30-16.30
Hotel Kempinski (Room: Bandini/Marzio/Bonfini)

Municipal Bond Issuance
Creating a Municipal Bond Market

Moderator: Petr Tajcman

Presenters:

Milos Sladky
Director, Economic Department
Liberec, Czech Republic

Tamás Lovas
Director, VEKTOR
Budapest

Discussants:

Konrad Reuss
Standard and Poor
Ratings Group

Break: 15.00-15.15 (Foyer II/II)

Marek Lyszczak
University of Wroclaw
Poland

Aleksander Galos
Hogan and Hartson

Zdena Javornicka
City of Prague, Czech Republic

Thomas Clark
Managing Director
U.S. Securities

Jan Matejcek
Squire, Sanders &
Dempsey

52
+

Thursday, June 9

Morning Session: 9.00-12.00
Hotel Kempinski (Room Bandini/Marzio/Bonfini)

The Central Government Role in Municipal Credit Regulation
Interaction between Credit and Grants

Moderator: Imre Bertalan

Presenters:

Stanislawa Szumlinska
Regional Audit Office, Poland

Vera Kamenickova
Ministry of Finance, Czech Republic

József Sivák
Ministry of Finance, Hungary

Discussants:

Olgierd Dziekonski
Deputy President
City of Warsaw

Break: 10.35-10.45 (Foyer II/II)

Wanda Studniarska
Environmental Protection Bank
Poland

Thomas Briggs
Senior Advisor
U.S. Treasury

Jan Smolen
Ministry of Environment, Slovak Republic

Lunch: 12.00 (Room: Regina I.)

Tour of Budapest Infrastructure Facilities: 13.30-17.00

The tour explores the capital's most important investment decisions

Budapest Incinerator: Expansion of incinerator capacity versus development of new land fills: the trade off between cost and environmental considerations.

Káposztásmegyer Housing Estate: improvement of transportation to service a housing estate on the city outskirts.

North Pest Sewage Treatment Center: Improvement of wastewater treatment capacity (most wastewater now flows directly into the Danube)

Reception: 18.30-21.00
Hotel Kempinski (Room Regina I)

Friday, June 10

Morning Session: 9.00-13.00
Hotel Kempinski (Room Bandini/Marzio/Bonfini)

Constructing a National System of Municipal Credit

Roundtable on the Lessons from International Experience: Pitfalls to Avoid, How International Lenders Can Help

Moderator: József Sivák

Sonia Hammam
USAID

Christophe Jacquemain
Credit Local de France

Vincent Gouarne
World Bank

Break: 10.30-10.45 (Foyer II/II.)

Three New Municipal Credit Programs

Moderator: Sarah Wines

Czech Republic
Municipal Infrastructure Finance System

Vera Kamenickova
Ministry of Finance

George Peterson
Urban Institute

Poland
Municipal Credit Program

Danuta Wawrzynkiewicz
Ministry of Finance

David Greytak
Maxwell School
Syracuse University

Hungary
New Municipal Lending Bank

Szabolcs Szekeres
Advisor
Budapest Bank

Lunch 13.00 (Room: Regina I)

EAST EUROPEAN
Municipal Credit
SEMINAR

AGENDA

USAID Office of Housing and Urban Programs
Ministry of Finance, Hungary