# Strategy for the Development of the Bulgarian Municipal Credit Market

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# Executive Summary

This document presents an overview of the current status of Bulgaria's municipal credit market. It analyzes the four market components:

- demand by municipalities to finance investments,
- supply of capital by the lending community,
- policy reform, and
- institutional development,

as well as recommending activities to improve the access of municipalities to the credit market.

It is based upon an assessment conducted in April 2004 by a team of municipal credit market specialists working for the U.S. Agency for International Development's (USAID's) Local Government Initiative (LGI).

The Municipal Credit Market Strategy proposed herein advocates working at two levels: local and national. At the local level, this would mean working directly with a number of municipalities in assisting them to access credit, in addition to improving their financial and debt management. At the national level, it would mean addressing issues that affect the current municipal credit market.

The Strategy is directed to the attention of the major stakeholders of the municipal credit market, particularly the Bulgarian municipalities, Ministry of Finance, financial and regulatory institutions, policy makers, and professional advisors. Implementation of the suggested activities should be the responsibility of the relevant Bulgarian institutions and foreign assistance programs, primarily LGI.

## Credit Market Overview

### Municipal Demand

The current need for municipal investment in infrastructure is large. Only part of this investment is financed either from own sources or from credit, with the major share funded by limited central transfers, resulting in a cumulative and growing investment deficit.

Municipalities appear to understand (1) the nature of the municipal obligation to pay debt that is incurred, (2) that the central government has not implied any guarantee and is not obligated to pay the debt, and (3) that such debt is binding on successor municipal governments.

### Capital Supply

The capital supply for municipal credit has three distinctive components: (1) commercial bank debt, (2) municipal bonds, and (3) financing from international financial institutions (IFIs).

*Banking Sector*

Municipalities are considered by the banking sector to be a group with high potential but limited current creditworthiness.

The primary relationship that banks have with municipalities is providing banking services to the municipalities and their employees. Lending to municipalities is currently a secondary activity and most of this lending is short-term financing directed toward covering cash deficits. Long-term lending is still rare.

Increased interest in the municipal sector is evidenced by the fact that certain banks that have not participated in this market are presently considering applications for financing from municipalities.

*Municipal Bonds*

To date, Bulgarian municipalities have completed five bond issues with diverse structures. Potential investors in municipal bonds are banks, institutional investors, pension funds, insurance companies, and individuals.

*International Financial Institutions*

The IFIs are represented by the European Bank for Reconstruction and Development, the World Bank, the Japan Bank for International Cooperation, and the Council of Europe Development Bank, which have extended loans only to the municipality of Sofia.

### Institutional and Regulatory Environment

Municipal debt, under its two forms—bonds and bank credits—is regulated and overseen by the Commission for Financial Supervision (CFS) and the National Bank of Bulgaria. The public offering of bonds is supervised by the CFS. The National Bank of Bulgaria supervises lending banks.

## Analysis

### Fiscal Decentralization

A municipal credit market fits within a public finance system that assigns significant decision-making power and financing responsibility to municipalities. Before a significant volume of municipal lending can take place, the revenue structure of municipalities will have to be clarified and strengthened, so that their revenues are more predictable and their ability to repay debt is clearer. A precondition for development of a robust municipal credit market is prudent decentralization of public revenues and revenue-raising authority.

### Capital Supply

The commercial banks and the pension fund companies find themselves in a highly liquid position. Within the legal constraints on their investments, they perceive municipal debt as an investment opportunity. In particular for pension funds, municipal bonds offer an opportunity for realizing somewhat higher yields in exchange for accepting some increased risk. As a result of lack of investment options, municipal bonds present an attractive investment instrument for fund managers.

The potential available supply of capital at present itself does not pose a constraint on the expansion of municipal credit market activity.

Bankers rightly recognize that few municipalities have budgets that reliably generate the operating surpluses needed to service debt. Additionally, bankers express concern that many of the projects that the municipalities present for financing, although technically well prepared, are not presented and packaged in a manner conducive to credit analysis—such as prioritization of projects, feasibility and cash flow projections, budget impact analysis, etc. Poorly prepared presentations not only reflect badly on the proposed project but also raise credit concerns about the quality of municipal management.

A standard of lending practice to municipalities does not seem to have been established. Many of the existing financings appear to be structured in a manner that is unique to a particular financing and is not particularly transferable to other municipal financings.

### Municipal Capacity

Bulgarian municipalities are perceived by the financing community as not being creditworthy. There are two main reasons for this conclusion: (1) financial weakness of the municipalities, and (2) lack of financial knowledge of municipal officials.

Another issue is the availability of appropriate collateral. Banks are inclined to require physical property to be used as collateral to secure municipal debt. Additionally, banks have not yet accepted municipal revenues as a source of collateral due to a lack of familiarity with revenues as collateral and certain legal uncertainties relating to perfecting a pledge of revenues. The proposed Municipal Debt Act provides for perfecting a pledge of such revenues. It will be important for the lending community to become familiar with these provisions.

The second determinant of low municipal capacity to issue debt is “lack of financial knowledge.” Even when good technical skills in project preparation are evident, frequently they are not complemented by financial skills.

## Institutional Development

A safe way of improving municipalities’ access to credit markets is by adding credit enhancement features such as a guarantee facility. Reliable guarantees will increase investors’ appetite for debt and will provide municipalities lacking adequate collateral the opportunity to access the credit market.

Adding a reliable guarantee will influence both the *costs* (by decreasing interest and adding the cost of guarantee itself) and the *appeal* of the credit. A caveat: A municipality that is not creditworthy in the first place will not have access to such a guarantee; therefore, the guarantee facility in itself cannot and will not make a noncreditworthy municipality creditworthy.

## Activities

The key objective is to contribute to the development of the capacity of municipalities to access the credit market for financing municipal infrastructure. Specifically, the general methodology is to link technical assistance to specific municipalities and their projects, while simultaneously working on issues associated with the general enabling environment to improve municipal access to credit.

The areas of technical assistance to the local governments could be the following:

- capital investment planning,

- project preparation,
- financial feasibility of investment projects,
- establishment of template documentation and procedures for bond issues and bank lending,
- increased general familiarity with and interest in the municipal credit market,
- increased familiarity with and awareness of the municipal credit market within the lending community,
- development of municipal credit enhancement mechanisms, and
- municipal insolvency.

# 1

# Introduction

The U.S. Agency for International Development's (USAID's) Local Government Initiative (LGI), among its other key objectives, seeks to support the development of the municipal credit market in Bulgaria, in particular to raise the capacity of municipalities to access the credit market to finance infrastructure needs. The Municipal Credit Market Strategy proposed herein represents part of this effort.

The promotion of borrowing by municipalities is clearly not an end in itself. Borrowing by municipalities that finance current-account deficits increases the stock of debt obligations that must be paid by future taxpayers without increasing productivity and means of repayment. Premature borrowing, before a municipality has established its creditworthiness or identified clear investment priorities, is likely to drain local budget resources and add risk to the fiscal system.

The underlying purpose of municipal credit market development is to increase the volume of local capital investment in support of essential municipal services. In Bulgaria, decentralization is increasing the demand on local governments to provide and finance public services. Presently municipalities seek to fund their capital expenditures through own-source revenues and—as available—targeted transfers from the state.

At a time when governments at all levels in Bulgaria face severe budget constraints, prudent borrowing can augment investment capacity. Well-designed investment and borrowing plans often can finance the construction of needed infrastructure facilities today, then repay the debt that is incurred from the future earnings of the facilities themselves through user charges or through cost savings in service operations.

For the moment, Bulgaria has the advantage that no explosion of municipal borrowing is under way. Many other countries have found themselves confronted with the reality of large-scale municipal borrowing, then have been obliged to try to construct ex post facto a legal framework that accommodates the interests of market stakeholders in healthy borrowing and restricts abusive and excessive practices. Bulgaria is in a position to develop the legal and policy framework first, and in fact has taken substantial steps in the creation of a legislative framework, in anticipation of future market development. Bulgaria also can learn from risks that have become clear in other countries. From Brazil to Russia, excessive borrowing by subnational governments, or debt issuance in the absence of an adequate legal framework (one that clarifies critical issues, such as the status of guarantees or the remedies available to lenders in the event of a municipality's nonpayment), has exacerbated national economic crises. The promise of soundly based local borrowing is large, but the risks involved in badly prepared borrowing also are large. All parties (municipalities, national government, banks, and potential investors in municipal debt) share an interest that the policy issues surrounding credit market development should be well understood, and that an appropriate legal framework should be in place before the market develops further.

Establishment of a municipal credit market is likely to become a high-priority policy issue in Bulgaria, as it did during the 1990s in Poland, Hungary, the Czech Republic, and several other countries in the region. The following factors indicate the timeliness of developing the municipal credit market in Bulgaria:

- Over the past decade, significant responsibilities have been assigned to municipalities. However, there has not been an effort to match responsibilities with available resources.

Municipalities are under an increasing burden to undertake required capital investments and thus to provide local services at appropriate standards.

- The central government has limited resources available for capital investments. The central government's need to keep macroeconomic stability will further diminish any such central government transfers and grants.

- Accession to the European Union (EU) will require a massive investment in environmental repair and improvement, much of it in landfills, incinerators, water treatment plants, and other facilities at the local level. As in other countries aspiring to join to EU, the Bulgarian public sector will have to contribute significantly to these investments and to meet the 25 percent country match required to obtain EU preaccession grants. Developing the ability to leverage local investment resources through access to private debt financing will be a precondition for municipalities to contribute their share to this massive undertaking.

- A small number of municipalities have issued debt to finance local investments in the form of bonds and bank loans. This demonstrates the willingness of municipalities and lenders to risk short- and medium-term loan commitments and to explore less familiar forms of loan structures explicitly tailored to the characteristics that distinguish municipalities from private borrowers.

- A draft Municipal Debt Act, setting forth a comprehensive legal framework for municipal borrowing, is presently being considered in the legislative process with anticipated application in 2005. With the adoption of the Municipal Debt Act, and as the macroeconomic situation improves and the financial sector strengthens, lending to municipalities can be expected to increase.

The Municipal Credit Market Strategy is based on an original assessment and analysis of the current status of the municipal credit market in Bulgaria. The assessment was conducted by the LGI Municipal Credit Market Team—consisting of Michael DeAngelis, Viorel Udma, and Mariana Eneva—convened in April 2004. The team visited the municipalities of Plovdiv, Schumen, Sliven, and Dobrich, and met with representatives of the capital markets and institutional and regulatory agencies.[1]

The Strategy reflects the information gathered during the meetings and discusses the major findings of the assessment. Additionally, the Strategy recommends a set of activities that will aim at further developing and protecting the municipal credit market while directly assisting the municipalities to access credit, enhancing the municipalities' capacity as prudent borrowers, and building awareness and capacity of the lending community.

[1] Annex 1 contains a list of interviewed persons.

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# Strategy Objectives

The objectives of the Municipal Credit Market Strategy are:

- to assist creditworthy municipalities to access credit to finance infrastructure needs;
- to increase the number of municipalities that access credit;
- to increase the amount invested in infrastructure through debt financing;
- to establish procedures and practices and to improve the standards of debt and financial management;
- to assist in the implementation of the Municipal Debt Act by identifying and assisting in the activities for its effective implementation, including familiarizing the market stakeholders with its provisions; and
- to develop and implement policy changes to improve the municipal credit market.

The Strategy's approach comprises working simultaneously at the local and national levels. At the local level, working directly with a number of municipalities in assisting them to access credit—in addition to improving their financial and debt management, and addressing policy issues—will mean that impediments to the development of the municipal credit market will continue to be identified. At the national level, the Strategy will address issues that affect the current municipal credit market and issues as they become apparent in the future. The Strategy is designed to address the following components of a municipal credit market:

- the demand by municipalities to finance infrastructure investments,
- the supply of capital by the lending community to finance municipal infrastructure investments,
- policy reform issues, and
- institutional market development.

## 2.1 Capital Demand

The Strategy:

- assesses the need to build the capacity within municipalities to use specific tools for analyzing and demonstrating creditworthiness, optimizing their investment capacity, and preparing financeable projects. The focus will be on enhancing their capacity to borrow through developing their ability to (1) undertake long-term financial and capital investment planning; (2) prepare projects, including economic and financial feasibility analyses; and (3) market and present the project proposals;

- proposes activities for improving municipal debt management and finance management; and
- identifies other issues impeding municipal access to credit.

## 2.2 Capital Supply

The Strategy:

- defines areas—e.g., acquaintance with local government finance, loan structuring, and collateral issues—that need to be developed in order to increase the capital being supplied to the municipal credit market, and determines the role of the stakeholders in facilitating the increased capital supply;
- assesses the need for technical assistance to the banking sector in terms of building capacity to assess the creditworthiness of the municipal borrowers and to reflect the unique characteristics of municipal borrowers in the financing structures and related documentation.

## 2.3 Policy Reform and Institutional Development

The Strategy addresses factors that are impeding the further development of the market by identifying the issues and proposing solutions, including engaging all of the participants in the municipal credit market from the demand and supply sides—as well as other stakeholders—in the resolution of such issues.

# 3

# Overview of Municipal Credit Market

## 3.1 Municipal Demand

Estimates of the current need for municipal investment in infrastructure vary. The World Bank has estimated that meeting of EU environmental standards alone will require between 1,000 and 1,800 million leva annually, largely borne by local governments. Following a conventional benchmark of 15 percent annual spending on capital investments, local government annual capital expenditures should be near 340 million leva. The National Association of Municipalities of the Republic of Bulgaria (NAMRB) has estimated local investment needs to be at about €300 million (600 million leva) per year in the period 2004–2006. Only part of this is being financed either from own sources or from credit, resulting in a cumulative and growing investment deficit.

Under the 25 percent debt service limit of the proposed Municipal Debt Act, in 2003 local governments could assume a theoretical maximum annual debt service of 179 million BGN, corresponding to a total debt of 746 BGN million, under current market conditions. Although this is an improbable maximum debt level allowed under the law, it shows that local debt would be only a small fraction of the total Bulgarian public debt.

The discrepancy between investment needs and actual financing results from several different causes, including a lack of available budget funds to pay for either the capital investment or the debt issued to finance the capital investment, and a lack of projects prepared in a manner acceptable to the lenders.

The demand for municipal credit in Bulgaria can be segmented into three specific categories: (1) Sofia, the capital city; (2) large and medium-sized municipalities; and (3) small municipalities. These categories reflect differences in the ability to access the credit market.

Based on the LGI assessment, municipalities appear to understand the nature of the municipal obligation to pay debt that is incurred, the fact that that the central government has not implied any guaranty and is not obligated to pay the debt, and the concept that such debt is binding on successor municipal governments.[2]

Project financeability and the ability of a project to generate revenues are not a high priority of municipal officials in selecting infrastructure projects. This approach to project selection by municipalities, in an environment where funds available to municipalities are scarce, reflects the lack of understanding by municipal officials of developed criteria for prioritizing, selecting, and financing projects.

## 3.2 Capital Supply

In recent years the Bulgarian economy has been improving, due—in part—to the stability provided by the currency board mechanism. As a result, inflation has remained relatively low, interest

[2] The city of Sliven continued to service municipal debt after the mayor who contracted the debt was replaced as a result of local elections. This assuaged the fear of some investors that a new mayor might not pay debt issued by the previous one.

rates have decreased to single digits, and financial indicators have had minimal volatility. Banks have been able to rebuild their reserves and to accumulate significant resources.

Pension funds introduced as a result of the overall pension reform have accumulated substantial amounts of cash.[3]

Institutional investors, including pension funds, have substantial liquidity and limited investment opportunity. Such investors would be interested in investing in municipal infrastructure for creditworthy municipalities with financeable projects.

The supply side of municipal credit has three distinctive components: (1) commercial bank debt, (2) municipal bonds, and (3) financing from international financial institutions (IFIs). For the purpose of this study we do not consider transfers from the central government or international grants as municipal credit

## Banking Sector

Bulgaria has 35 commercial banks,[4] but only a few of them have municipalities as clients. Municipalities are deemed to be a group with high potential as a business opportunity but limited current creditworthiness. The primary relationship with municipalities is providing banking services to the municipalities and their employees. Lending to municipalities is currently a secondary activity and most of this lending is short-term financing directed toward covering cash deficits. Long-term lending is still rare.

In the area of banking services, municipalities are perceived as desirable clients, so the banks attract them with lower fees than those charged to corporate clients—sometimes as much as a third lower.

A number of banks are serving municipalities: the Municipal Bank,[5] DSK Bank, Biochim, Postbank, and to a smaller extent other banks such as Raiffeisen and InvestBank. Some banks have established departments to work with municipal clients, but the vast majority serve municipalities from their core corporate group.

Costs for bank debt seem affordable, with approximate interest quoted by bank officials ranging between 8 and 9 percent on BGN medium-term bank loans, and additional fees being less than 1 percent on an annual basis, positioning total costs below 10 percent.

The current level of municipal loans is limited; at the end of 2003 municipalities had an aggregate volume of bank debt of 22,082,690 BGN.[6] The limited amount of medium- or long-term credit makes any statistical computation of little value.

Credit lines extended to municipalities are slightly more frequent, but their value is small, below 1 million BGN; they mature in less than 12 months; and they are used by borrowers to cover temporary cash deficits. For this short-term credit no physical collateral is required, promissory notes being accepted as the sole guarantee. However, in order to receive a loan from a certain bank a municipality has to be a client of that bank, and in most cases to move all its accounts to the bank extending the loan.

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[3] Pension funds have assets under management of approximately 500 million BGN and are expected to increase in value by approximately 50 percent in the next year.

[4] A full list of commercial banks is attached as Annex 2.

[5] The Municipal Bank, although owned by municipalities, operates as a regular bank and incorporates the general banking policy of prudence in relation to municipalities.

[6] Attached as Annex 3 are the municipal debt statistics for 2003.

Credit lines established by banks for municipalities (1) establish a business relationship, (2) assist a bank in becoming familiar with municipal financial affairs, and (3) may assist a bank to target project finance and longer-term debt as potential new business.

Increased interest in the municipal sector is evidenced by the fact that certain banks that have not participated in this market are presently considering applications for financing from municipalities.

## Municipal Bonds

To date Bulgarian municipalities have completed five bond issues with diverse structures. Additionally, several municipalities have been unsuccessful in issuing bonds. Of the bonds issued:

- two of them are Euro denominated,
- one was issued in two tranches,
- one was sold on the international markets,
- some were privately placed whereas others were publicly offered,
- the maturity ranged between 3 and 7 years, and
- the interest rate ranged from 5.6 to 9.75 percent.

The total value of bonds outstanding at the end of 2003 was 8,454,570 BGN. During 2003 no new municipal bonds were issued.[7]

Potential investors in municipal bonds are banks, institutional investors, pension funds, insurance companies, and individuals.

Pension funds have assets under management of approximately 500 million BGN and their investment in municipal securities is limited by law to 10 percent of the portfolio assets, providing a current potential of investment in municipal bonds of 50 million BGN. Municipal bonds will be attractive and appropriate investments for pension funds due to the natural maturity match between pension fund liabilities and municipal bond maturities.

There are several financial intermediaries presently operating in the Bulgarian municipal bond market, as described below.

## International Financial Institutions

Larger projects of local interest are financed by IFIs, including the European Bank for Reconstruction and Development (EBRD) and the World Bank.

EBRD has worked to date only with Sofia,[8] but is considering working with other municipalities.[9]

[7] A short description of all Bulgarian municipal bonds is attached as Annex 4.
[8] EBRD financed three projects for the municipality of Sofia with an aggregate value of 100 million BGN and carrying interest at the level of six months' LIBOR plus 200 to 400 basis points.

The World Bank has financed large municipal infrastructure projects (e.g., a district heating project in Sofia). Recently, the World Bank has proposed and prepared a pipeline project, the Rural Development Project (RDP), which will assist the government of Bulgaria in implementing its 2000–2006 National Agriculture Rural Development Plan and in accessing EU financing. The value of the project loan is currently estimated at €50 million, and it includes three components: (1) Rural Infrastructure Investment; (2) Institutional Development; and (3) Project Coordination, Supervision, and Monitoring and Evaluation. The Rural Infrastructure Investment component is further broken down into two subcomponents. The first is Development of Village and Rural Infrastructure (village water supply network, village street infrastructure, village disposal systems, improvements to municipal and agriculture roads, improvements to the existing drinking water supply infrastructure between municipal settlements). The beneficiaries will be small municipalities from the less-developed rural areas. The second subcomponent is Pilot Irrigation and Drainage Infrastructure. The proposed project is expected to be approved by the World Bank Board by December 2004.[10]

## 3.3 Institutional and Regulatory Environment

Municipal debt, under its two forms, bonds and bank credits, is regulated and supervised by the Commission for Financial Supervision (CFS) and the National Bank of Bulgaria. The public offering of bonds is supervised by the CFS. The National Bank of Bulgaria supervises lending banks.

### Commission for Financial Supervision

CFS regulates and oversees all publicly issued securities, the stock exchange, investment funds (including pension funds), and insurance activities in Bulgaria. Municipal bonds are regulated by CFS in two instances: when they are publicly offered and when they are freely traded on a stock exchange.

Bonds either are issued from the very beginning under the supervision of CFS as public offerings or enter CFS supervision at a later stage, namely trading on a stock exchange, in the case of private placements.

Due to regulations, some municipal bonds are sold through a private placement and afterward either traded over the counter or listed on the Bulgarian Stock Exchange. A private placement is subject to a shorter issuance process due to simpler rules and less need of official approvals. The process of publicly offering bonds takes approximately six months and a private placement takes approximately half this time. Listing of municipal bonds on the Stock Exchange is a simple process, even for bonds initially sold in a private placement.

While the approval process for a public bond offer is limited by law to 30 days, CFS officers maintain that the real interval is shorter. In the past, repeated delays in approving the prospectus have led some municipalities to give up the bond issuance, but since the first successful municipal bond, issued in 1999, the approval period has been reduced.

The interaction between CFS and brokerage houses and their municipal clients is good, but there are things each side would like to see changed. Brokers complain that CFS requires too much information and continual reporting. CFS's main complaint about municipalities is that they sometimes miss the legal deadline for disclosure of information.

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[9] EBRD's pipeline contains financing for water utility projects in Plovdiv and Burgas in an advanced stage, and Russe, Sliven, Stara Zagora, and Vratsa in an incipient phase.

[10] Source of information:World Bank web page, www.worldbank.org.

Costs associated with securities issuance are minimal, making bonds an affordable financing alternative for creditworthy municipalities. The regular brokerage fee is around 0.5 percent of the value of bonds effectively sold, the cost of prospectus preparation and printing is around 10,000 BGN, and CFS fees are not to exceed 5,000 BGN. Additional costs are those related to trading on a secondary market: depositary fees of maximum 5,000 BGN and Bulgarian Stock Exchange listing fees.

Since 2003, the issuance of municipal bonds has been regulated by Ordinance 2/2003. To date no public or private offering has been made under these new requirements.

## Credit Enhancement Providers

A Development Credit Authority (DCA) Guarantee mechanism is the only functioning credit enhancement mechanism in Bulgaria in regard to the municipal credit market. Bulgaria was one of the first countries approved as eligible for the DCA. In 1998-1999 USAID issued a Loan Portfolio Guarantee to the United Bulgarian Bank (UBB) based on the Development Credit Authority Agreement. The Agreement has aimed to develop sustainable mechanisms for long-term project financing for energy efficiency investments. Through the DCA, USAID provides guarantees on behalf of potential borrowers to UBB for 50 percent of the due principal loan amount. The loan guarantee covers not more than 50 percent of the lender’s risk of loss upon an event of default. The energy efficiency project portfolio includes investments in city street lighting systems; heating of municipal buildings; water, gas, and district heat supply; and urban solid waste collection and disposal. The 13 successfully financed municipal projects under the DCA are an illustrative example of prudent municipal borrowing.

## Rating Agency

There are mixed feelings among those in the financial community toward ratings assigned by the Bulgarian municipal bond issuers. While most investors acknowledge the value of a rating as a significant ingredient in their analysis of the issuers, they also express doubts that the rating gives a full image of the creditworthiness of the municipality. Both international and local rating agencies have specific drawbacks. International rating agencies are perceived as more reliable compared to their Bulgarian counterparts, but there is a fear that the “rating is offered too fast and after a too short an analysis.” There are two domestic rating agencies in Bulgaria, none of them deemed a reliable source of information by the financial community, not because of the quality of the rating process, but because of lack of transparency regarding their methodologies and short history. However, they are deemed closer to the issuers and have more accurate and timely information about the creditworthiness of the municipality.

Two municipal bonds were rated, the €50 million issued by Sofia in 1999, which matured in 2002; and the 2000 Varna issue of €3 million. Standard and Poor’s was the agency selected for rating the city of Sofia and as a result of its analysis, it determined a “B with positive perspective” city rating. The price of this service is seen as very high, US$40,000 in the case of Sofia, especially if compared with smaller issues. While this amount represented only 0.1 percent of the issue, for a smaller bond it would have been a much higher percentage—for example, 21 percent of the value of the Svistov bonds issued the same year.

A local rating agency started by professionals with backgrounds in an export insurance agency and government, the Bulgarian Credit Rating Agency (BCRA), was incorporated in 2003 and implemented a methodology for analyzing municipal issuers, but has not yet performed such a rating. BCRA’s marketing effort is directed almost exclusively toward issuers and potential issuers, with very little effort dedicated to presenting the rating mechanism to investors. The direct result is the aforementioned lack of confidence in the investment community regarding the quality of local ratings.

# Analysis

## 4.1 Primacy of Fiscal Decentralization

A municipal credit market fits within a public finance system that assigns significant decision-making power and financing responsibility to municipalities. Bulgaria has made substantial progress in fiscal decentralization, having taken the steps described below; however, additional reforms are necessary.

Before a significant volume of municipal lending can take place, the municipalities' revenue structure will have to be clarified and strengthened, so that their revenues are more predictable and their ability to repay debt is clearer. A precondition for development of a robust municipal credit market is prudent decentralization of public revenues and revenue-raising authority.

The development and design of a municipal credit market involves several public policy considerations. Assigning a priority to municipal credit market development presupposes a government commitment to decentralize important parts of local public service delivery, along with the financing of such services and the capital facilities essential for their provision. In an efficiently decentralized system, municipalities and citizens will have some choice about the character of services they provide and the extent of local service coverage. The local government will have responsibility for raising at least part of the costs of service delivery at the local level, in the form of taxes or user fees. It will face the need to finance from own resources at least part of the capital costs required to upgrade or expand infrastructure networks. Ideally, through either "pay as you go" or debt financing, local revenues could be used in conjunction with central grants to maximize infrastructure financing.

The results of the 2003 municipal budgets demonstrate municipal willingness to increase service fees, as allowed since 2003 under the amendments to the Local Taxes and Fees Act. However, further expansion of revenue-generating authority through local taxing powers will require a constitutional amendment.

Additionally, the treating of municipal capital investment related to the mandated services as an element of the expenditure standards, as provided for within the Municipal Budgets Act, will be instrumental in providing a predictable source of revenue to repay debt incurred for the mandated services.

### Accomplishments Under the Fiscal Decentralization Agenda[11]

Bulgaria's Program for Fiscal Decentralization is under way and substantial progress has been made. In March 2002, a Fiscal Decentralization Working Group (FDWG) was established on the basis of Resolution 138/11 of the Council of Ministers. The FDWG prepared a fiscal decentralization concept and implementation program for 2002–2005 (adopted June 13, 2002).

By the time the 2003 State Budget was prepared, the government had adopted a new system of intergovernmental transfers that is straightforward, transparent, and linked directly to expenditure needs of assigned services. It clearly divides service responsibility between municipal services that are "mandated" by the central government (such as education, health, culture) and those that are "local option"—i.e., provided at the discretion of the local government. The FDWG has developed costing

[11] Source of information: presentation prepared by Emil Savov, leader of the LGI Decentralization Team.

standards for the mandated services that set the level of transfers going to each municipality. They have recommended that the capital investment required for the mandated services be integrated to the expenditure standards as a set percentage, however this has not yet been implemented.

The new system of municipal finance places the responsibility for funding local option services on local own-source revenues. Over the past five years, the growth in own-source revenues has been very strong but municipalities still only have partial control over determining those revenues.

### *Key Changes in the Legislation*

Recent policy changes have resulted in a number of new statutes and amendments that affect municipal finance.

*Municipal Budgets Act (amendments to the Municipal Budgets Act enacted in November 2003)*—The changes reflect the delineation of expenditure responsibilities of the state and the municipalities and the way of their financing.

*Local Taxes and Fees Act, enacted December 2002*—Essential changes in the part on fees aimed at (1) establishing general rules for setting service fees and charges; (2) granting maximum discretionary power to the municipalities, and creating opportunities for development of local policies; (3) costing services; (4) establishing rate levels; and (5) determining modes of service delivery.

*Corporate Income Tax Act and Natural Persons Income Tax Act (Personal Income Tax [PIT], - enacted 2002*—The changes aim at better predictability, regularity, and even distribution. The corporate income tax was eliminated as a municipal revenue source and was replaced with the full amount of proceeds from PIT.

*Municipal Property Act, work began on changes, July 2002*—The changes are aimed at streamlining the management and disposal procedures for municipal property.

*Monitoring and evaluation system, adopted by FDWG in September 2002*—A proposed amendment to the Constitution was submitted by the NAMRB in September 2003. The objective is to expand the taxation authorities of the municipalities.

However, the time may be ripe to induce additional progress in fiscal decentralization. The policy reforms required for EU accession cannot be delayed much further without serious negative impact on the accession. This political risk may provide the momentum necessary for additional reform at this time.

## National Funding of Municipal Infrastructure

The current national system of funding investments includes: (1) central government transfers (target subsidy for capital expenditures), (2) central government loans, (3) foreign grants (Instrument for Structural Policies for Pre-Accession [ISPA], Phare, Special Accession Programme for Agriculture and Rural Development [SAPARD], World Bank Social Investment Fund [SIF]) and loans, (4) local general revenues, (5) proceeds from privatization of municipal assets and property, (6) public-private partnerships, and (7) local borrowing. On one hand, local government investment needs are very high; on the other, the available resources are quite limited and thus the government will have to ensure that they are spent efficiently and strategically.

Central funding has increased from approximately 75 million BGN per year from 1999 to 2001, to 123 million BGN in 2002 and 116 million BGN in 2003. Although the national capital grant system has lacked transparency and predictability in the past, it has moved in a positive direction during the past two years with more transparent criteria. Nonetheless, the grants are used on a project basis and are not necessarily administered so as to leverage additional resources through borrowing. As funding for EU projects increases, and with it the need for co-financing, leveraging is likely to become more of a concern.

## 4.2 Capital Supply

The commercial banks and the pension fund companies[12] find themselves in a highly liquid position. Within the legal constraints on their investments, they perceive municipal debt as an investment opportunity. In particular for pension funds, municipal bonds offer an opportunity for realizing somewhat higher yields in exchange for accepting some increased risk (as opposed, for example, to simply rolling over treasury notes). As mentioned earlier, as a result of lack of investment options, municipal bonds present an attractive investment instrument for fund managers. Additionally, the longer-term liability structure of pension funds is a better match with long-term municipal debt.

The potential available supply of capital at present itself does not pose a constraint on the enlargement of municipal credit market activity.[13]

### Competition in Banking Services

The banking sector in Bulgaria is operating in a very competitive environment in most sectors of the banking business. The marketing of banking services, other than lending, is very competitive and—as described earlier—has resulted in municipalities receiving pricing for services that is less than the same services offered to the private sector.

There is recognition that municipal lending represents a future line of business for the banking sector. There appear to be reasonable prospects for competition among institutions on the supply side of the municipal credit market once it begins to coalesce.

### The Desirability of Competition Between Bank Lending and the Municipal Bond Market

Municipal debt instruments themselves can vary. A bank loan to a municipality is structured differently from a municipal bond that pension funds or other investors buy. However, the two forms of credit can serve the same purpose of intermediate-term investment financing for a municipality. Historically, countries in some parts of the world, like Western Europe, have relied more heavily on bank loans than on bonds sold in the capital market for municipal credit financing, while other countries, like the United States, have relied more heavily on bonds. There are some important distinctions between the two instruments: A publicly sold municipal bond requires more publicly disclosed financial and other information than does a loan made by a bank. In a bank loan, information typically is disclosed only to the lenders.

A country like Bulgaria, newly embarking on development of a municipal credit market, however, has no legal reason to choose one form of lending over another. The same basic legal framework can and should apply to both types of debt instruments without discriminating between them. The draft Municipal Debt Act has not created any such discrimination; however, it will be important to continue to monitor the regulatory environment for both bank lending and bonds to ensure that they do not create market distortions.

[12] Bulgaria has implemented a three-pillar reform of its pension system.

[13] The impact of reserve restrictions recently imposed by the International Monetary Fund (IMF) cannot be determined at this time.

Competition between banks and a bond market can help keep the costs of capital as low as possible for municipal borrowers. Additionally, different sectors of the municipal credit market will be served by different debt instruments—e.g. smaller municipalities may more efficiently borrow with a bank loan that does not have many of the issuance costs of a bond issue, while larger bond issues from larger municipalities will be of interest to pension funds.

Presently, both markets are functioning in Bulgaria. Interestingly, ceteris paribus, some banks prefer to finance municipalities through bonds rather than through bank credits. Bonds are more liquid; that is, loans to specific municipalities can be sold to other financing institutions, they can be used as collateral by investors, and they do not require provisions in the balance sheet of the bank as happens with regular bank loans. However, investors have not taken an active position with regard to the municipal bonds that are presently outstanding and are likely to hold the bonds until maturity. As a result, secondary market transactions are rare.

## Perception of Municipalities by Lenders

Banks maintain local branch offices and consequently are familiar with local finances, particularly those banks that service the day-to-day banking needs of local governments. Bankers rightly recognize that few municipalities have budgets that reliably generate the operating surpluses needed to service debt.[14]

Additionally, bankers express concern that many of the projects that the municipalities present for financing, although technically well prepared, are not presented and packaged in a manner conducive to credit analysis—such as prioritization of projects, feasibility and cash flow projections, budget impact analysis, etc. Poorly prepared presentations not only reflect badly on the proposed project but also raise credit concerns about the quality of municipal management.

Some banks are wary of making longer-term loans that extend beyond the tenure of the existing mayor and council. In the event of a change in the political composition of the local government's leadership, there is a concern as to whether the incumbents would honor the debt obligations taken on by their predecessors in office. Such an assessment of political risk can inhibit the utilization of debt with longer maturities.

Additionally, the scarcity of municipal loans reflects lender inexperience in identifying bankable municipal projects and underwriting local governments. For example, few banks seem to have considered alternatives to physical collateral for securing repayment. Also there is a clear preference among bankers to finance revenue-generating projects rather than non-revenue-generating infrastructure projects.

## Lack of Municipal Borrowing Template

A standard of lending practice to municipalities does not seem to have been established. Many of the existing financings appear to be structured in a manner that is unique to a particular financing and not particularly transferable to other municipal financings. For example,

- Off-budget financing vs. budget financing — Some debt is secured and expected to be payable solely from sources of funds that are not part of recurring municipal revenues, e.g., privatization proceeds, while other debt is expected to be paid as a budget expense.

[14] Some international banks, based on international experience and impressions, are not inclined to lend to the municipal sector.

- Collateral — There is wide diversity in the type of collateral that is used to secure debt, as follows:
  - general obligation debt that is unsecured;
  - debt secured by physical collateral;
  - debt secured by shares in municipally owned enterprises; and
  - debt secured by future receivables.

## 4.3 Lack of Municipal Capacity

Bulgarian municipalities are perceived by the financing community as not being creditworthy. There are two main reasons for this conclusion: (1) financial weakness of the municipalities, and (2) lack of financial knowledge of municipal officials.

The financial weakness of local budgets is a direct result of the still centralized approach to budgeting. While recently own-source revenues have increased significantly due to the amendments to the Local Taxes and Fees Act, local authorities are perceived as having low levels of *own income;* therefore, the volume of predictable income that can be used as a reliable source for repayment of debt is limited. Budgets are relying heavily on state transfers as a source for investment. The mandated expenses side of the local budgets is more balanced and predictable due to provisions in the Municipal Budgets Act, and own-source revenues have increased. However, municipal budgets are running deficits primarily in local activities, and therefore are not able to cover potential debt.

Unpredictability of future regulations governing municipal revenues further impedes medium-term financial forecasting. The level of local taxes is set by the central government and the flexibility in identifying new income sources is limited. As a direct result of low resources and high expenses, local budgets run chronic deficits.[15]

Another issue is the availability of appropriate collateral. As described previously, banks are inclined to require physical property to be used as collateral to secure municipal debt. This becomes an issue as successful privatizations reduce the asset base of municipalities that can be used as physical collateral. Additionally, banks have not yet accepted municipal revenues as a source of collateral due to a lack of familiarity with revenues as collateral and certain legal uncertainties relating to perfecting a pledge of revenues. The proposed Municipal Debt Act provides for perfecting a pledge of such revenues. It will be important for the lending community to become familiar with these provisions.

Municipalities are seeking to finance investment projects and loans that are too large for the current size of local budgets. There is a widespread belief among municipalities that the bigger the project, the more likely it is to be financed. Banks comment that projects presented to them are often too large for the municipality to carry—that is, they lack capacity to repay the debt.

The second determinant of low municipal capacity to issue debt is “lack of financial knowledge.” Even when good technical skills in project preparation are evident, frequently they are not complemented by financial skills. Municipal officials often do not have the knowledge necessary for issuing bonds or accessing bank credits. There is a tendency to apply to the financial community with the same approach

[15] Some municipalities, year after year, are recording unpaid expenses of around 10 percent of the local budget.

that has been used with state agencies, i.e., to offer a wide range of projects so that a choice can be made about which ones could qualify for financing, and to support investment projects with subjective arguments instead of financial projections for documenting repayment ability.

This lack of financial knowledge is apparent to the banks, and they perceive it as a poor reflection on the quality of municipal management. In other words, although projects may be perceived to be prepared well from a technical and engineering perspective, they are rejected by banks due to creditworthiness concerns.

During 2003–2004, with the support of the European Union, municipalities have been creating departments of financial planning and project implementation. These new departments can be part of the solution to the “financial knowledge” problem.

Additionally, municipalities are perceived as riskier than corporate clients due to political risks. That is, there may be political reasons for making investment decisions, as well as the previously discussed changes in political commitment to an investment project by a successor administration.

## 4.4 Institutional Market Development

A safe way of improving municipalities’ access to credit markets is by adding credit enhancement features such as a guarantee facility. Reliable guarantees will increase investors’ appetite for debt and will provide municipalities lacking adequate collateral the opportunity to access the credit market.

Analysis performed by investors must continue to adhere to the same quality standards as before, but lenders will take comfort in the fact that someone knowledgeable has reviewed the debt and decided to guarantee it.

Adding a reliable guarantee will influence both the *costs* (by decreasing interest and adding the cost of guarantee itself) and the *appeal* of the credit. Collateral needed may be decreased with the percentage of the debt guaranteed. A caveat, though: A municipality that is not creditworthy in the first place will not have access to such a guarantee; therefore, the guarantee facility in itself cannot and will not make a noncreditworthy municipality creditworthy.

At present only the DCA facility is available in Bulgaria.

# 5

# Proposed Activities Supporting the Development of the Municipal Credit Market

The key objective of the activities proposed in this strategy is to contribute to the development of the capacity of municipalities to access the credit market for financing municipal infrastructure. Specifically, the general methodology is to link technical assistance to specific municipalities and their projects, while simultaneously working on issues associated with the general enabling environment to improve municipal access to credit.

## 5.1 Roundtable on Municipal Debt Act

A roundtable discussion related to the proposed Municipal Debt Act should be held, with the participation of representatives of the stakeholders in the municipal credit market. The key themes of the roundtable will be the Municipal Debt Act and definition of the role of fiscal decentralization for building creditworthy municipalities.

This activity will aim not only to educate the key players in the municipal credit market on the legal framework for municipal debt, but also to bring together the stakeholders required to make the market work successfully. The goal is to raise issues that are important for the effective implementation of the new Municipal Debt Act expected to be adopted by the Parliament in the late summer of 2004.

In addition, this event will be used as a venue for strengthening the links and building synergies among the Bulgarian stakeholders such as the national and local governments, financial institutions, and other institutional and regulatory bodies. The roundtable should provide a basis for the continued participation of the stakeholders in the policy agenda for the municipal credit market.

## 5.2 Selection of Pilot Municipalities to Receive Technical Assistance

New management techniques are best tested and adapted through demonstration activities in a limited number of municipalities. The selection of the municipalities will be based on a number of criteria in order to evaluate the suitability for participation in the pilot phase. Prior to the final selection of municipalities, pertinent Bulgarian local and central government institutions will be consulted. Interviews with mayors and finance directors will be conducted in order to identify what they perceive as the constraints that prevent municipalities from accessing the credit market. These interviews will be an important tool for evaluating local governments' capacity, compatibility, and interest in participating in the program. The selected local governments will be those that demonstrate motivation, commitment, and capability to utilize debt financing.

## 5.3 Technical Assistance Package

The analysis of the municipal credit market in the preceding sections defines the issues that are of significant importance to assist municipalities to access credit. Technical assistance will focus on activities *under the control of the local government* that improve access to the credit markets. For example, a municipality may have a good financial management system, but if the local economy is weak and the city does not have sufficient revenues (own-source or government transfers) to undertake mandated expenditures, a sophisticated financial management system cannot make it creditworthy. On the other hand, a municipality may currently have a low level of own-source revenues because it has not implemented changes to improve tax collection, such as reducing local property tax delinquencies. In this case, the assessment can identify a municipality that is currently not creditworthy, but has the potential to become creditworthy by introducing technical assistance activities to improve revenue collection and project preparation. The term “financial and debt management” includes all of the activities under the control of the city that enhance revenue collection and control current and capital expenditures, improve operating and capital budgeting, and augment project management.

The areas of technical assistance to the local governments will be the following.

## Capital Investment Planning

Currently Bulgarian municipalities prepare a one-year plan for their capital improvements as a part of the annual budget process. Operating budgets and capital budgets are not prepared as separate statements. The economic and financial viability of proposed municipal infrastructure projects receives little attention during the planning process.

Bulgarian municipalities are in transition from seeking central budget grants to finance capital investments, to actively seeking alternative capital sources.

The current approach to municipal capital investment planning and budgeting and pricing of the infrastructure investments needs to be improved. Accessing the credit market requires introducing long-term capital investment planning, and realistically pricing the capital investments to ensure prudent capital spending and viability of the new assets.

Long-term capital investment planning (CIP) is an important public management tool for making financial decisions, assessing capital needs, planning, prioritizing, budgeting, and maintaining a four- to seven-year rolling capital investment program. A good capital investment planning system is crucial to ensure implementation of a municipality’s development strategy and maintenance of the financial stability of the municipality. This activity is a vehicle for facilitating eligibility of municipal project proposals for regional infrastructure funding programs sponsored by the European Union.

This activity will develop and apply the CIP methodology to enable municipalities to analyze and improve their capital investment planning procedures and to put in place their first long-term capital improvement program.

## Project Preparation

This activity is intended to strengthen the municipal governments’ capacity to prepare project proposals for submission to financial institutions. It is essential for municipal governments to have the knowledge and skills to prepare applications for funding of investment projects that will be approved by funding institutions. Diligent project preparation is essential to ensure effective project implementation. Under this activity, the pilot municipalities will be provided with technical assistance in preparing a complete municipal investment project package for financing. This will also involve training the pertinent municipal staff in project development and implementation skills. This activity will promote collaboration among four groups: selected pilot municipalities, potential financial institutions, local credit rating agencies, and technical advisors and specialists. This model will provide a template and be illustrative for other municipalities to follow, requiring dissemination through organizations such as the NAMRB.

## Financial Feasibility

This assistance will provide methodologies and training to the pilot municipalities in detailed financial feasibility assessments of their investment projects. A standardized procedure for project financial feasibility analysis will be prepared that will guide the municipalities to assess the financial feasibility of their proposed investment projects.

The primary purpose of preparing a financial feasibility analysis is to determine whether the cash flows generated by the project or general operating surpluses will be sufficient to make the required payments on borrowed funds used to pay for the project. If the project doesn't require external funding, this analysis may not be necessary. Consequently, a financial feasibility analysis should be completed before any final management decision is made on projects to be implemented. The financial feasibility assessment of the projects will focus on:

- cash flows through the expected project life,
- output pricing,
- capacity of the municipality to serve the debt required for the project,
- the working capital requirements associated with the project, and
- a financial cost-benefit analysis to determine the internal rate of return of the capital invested in the project.

## Generate Familiarity with and Interest in the Municipal Credit Market

Activities in the awareness-raising category will include the following.

- Publicity will be initiated relating to the new Municipal Debt Act.
- A forum will be organized, at which will be presented and discussed successful Bulgarian case studies of municipal borrowing and issuance of municipal bonds. The key objectives are to share the lessons learned and to exchange experiences with other potential municipal borrowers, financial institutions, and stakeholders in the municipal credit market.
- As follow-up to the study tour on the municipal credit enhancement mechanism (see below), a discussion forum will be organized that will bring together potential borrowers, lenders, and key policy makers to discuss the outcome of the study tour, to examine lessons learned, and to reach consensus on the most suitable and appropriate forms of municipal credit enhancement mechanisms in Bulgaria.

## Study Tours

Two study tours are proposed:

- **Learning from the experience of neighboring countries**– A study tour to Romania will be organized in order to learn about the experience and lessons of the Romanian municipalities in regard to securing funds for specific municipal infrastructure projects from bank loans and bond issues. Over the past three years there have been at least 26 issues of municipal bonds and an equivalent number of bank loans. Moreover, this study tour can be used as a vehicle for establishing partnerships with those municipalities.

- **Development of credit enhancement mechanisms in Bulgaria** – This study tour will be organized to visit one Western and one Central European country in the early fall of 2004. It will aim at (1) building awareness among decision makers regarding who will participate in and facilitate the process of developing municipal credit enhancement mechanisms; (2) helping the target stakeholders and policy makers to examine closely the positive and negative aspects of various potential financial intermediaries that could be considered for quick application in Bulgaria; and (3) reviewing and learning about market principles regarding managing municipal resources and building municipal creditworthiness.

The target participants will be selected members of the Ministry of Finance and the Ministry of Regional Development and Public Works; top representatives from the banking, pension fund, and insurance sectors; Members of Parliament; and municipal representatives.

## Establish Template for Bond Issues and Bank Lending

The limited lending to municipalities has not established standard procedures, documentation, or financing structures. As noted previously, each financing appears to be structured as a unique product designed for a single financing.

In connection with bond issues, the establishment of procedures and standards of documentation and disclosure can substantially assist both borrowers and investors for whom municipal finance represents a new product, with different types of risk than they are accustomed to assessing, and with a legal framework that reflects a public sector financial obligation.

In connection with bank lending, experience in other countries has been that the development of documentation and a standard loan template is an excellent way to increase the awareness of the banking sector as to the unique credit characteristics of municipalities, as well as to guide all parties regarding procedural compliance with the provisions of the legal framework governing municipal borrowing.

An objective of the technical assistance is to develop templates for bank lending and bond issuance.

## Increase Familiarity with and Awareness of the Municipal Credit Market Within the Lending Community

In order to facilitate the access of municipalities to the credit market, there is a need for increasing awareness among lenders in the following areas:

- familiarity as to the specific nature of the local governments, and local finance and budgeting;
- municipal credit analysis;
- underwriting and managing municipal credit;
- risks and rewards of municipal credit; and
- familiarity with the provisions of the Municipal Debt Act.

The key outcomes of training on these points will be better perception and understanding of the specific nature of the local governments and an easing of the process of loan/debt structuring. As this happens, the lenders will have the incentive and ability to educate prospective municipal borrowers on how to prepare municipal credit packages that satisfy sound underwriting requirements.

## 5.4 Policy Reform and Institutional Development

Technical assistance activities can play a key role in identifying factors that are impeding further development of the market and in proposing solutions to such issues. This role will be ongoing as the municipal credit market develops.

- Technical assistance activities can build upon previous policy reform activities, develop additional ones, and suggest potential collaboration with other donor-funded projects. In particular, continued fiscal decentralization reforms will be addressed, such as the constitutional amendment to grant local taxing power and rationalization of capital grants from the central government to more effectively leverage investment finance in connection with capital investments for mandated services and the general capacity subsidy.

- Institutional and market development and capacity building can contribute significantly to the emergence of a properly regulated, efficient municipal credit market. Such a process must engage all of the key participants in the municipal credit market from the demand and supply sides as well as other key stakeholders. Major stakeholders and users are:

  - Bulgarian municipalities;

  - Ministry of Finance;

  - municipal associations—both professional and political associations;

  - the financial industry—banks, securities companies, investors, etc.;

  - professional advisors—consulting companies, brokerage firms, etc.; and

  - regulatory institutions—Securities Commission, National Bank of Bulgaria, governmental institutions.

On the private sector side, the success of the recommended reform strategy will rest in large part on the development of the institutional competence within participating private entities to exercise proper due diligence and informed caution before extending credit to municipalities.

- **Commercial lenders.** Commercial banks and other financial institutions that may engage in primary lending to municipalities will need to develop the specialized staff capacity to underwrite municipal credit. Evaluating municipal creditworthiness is a very distinct task from assessing a loan application from a private business for its working capital or investment needs.

- **Bond credit rating organizations.** The recommended reform strategy assumes that, as the volume of municipal bond issues increases, one or more qualified firms will recognize and pursue municipal credit ratings as a profitable business opportunity. In connection with the technical assistance to bring municipal financings to the market, an appropriate role for a rating agency will be illustrated.

- **Municipal bond underwriters and financial legal advisors.** In a fully developed municipal bond market, a number of financial institutions specialize in bringing debt issues to market either as financial and legal advisers (paid on a fee for service basis) or as underwriters who assume some risk of their own in making a market for the bonds they promote. International consultants will collaborate with local financial and legal advisors to develop the capacity to perform these functions and the Strategy activities.

As was pointed out earlier, given the embryonic stage of the municipal credit market in Bulgaria, the opportunity remains for orderly institutional development in advance of significant volumes of borrowing materializing.

## Municipal Insolvency

The current legal framework does not provide for municipal insolvency. Laws and procedures should be developed for managing the affairs of an insolvent municipality, establishing its relationships and rights with regard to creditors, and determining the priorities among them. The procedures should also include establishment of a set of policies to assist a municipality to regain a stable financial position. Depending on the rules that are adopted, such procedures could be initiated by the Ministry of Finance or the Council of Ministers, the municipal government itself, or eventually the municipality's creditors. The definition of municipal insolvency, as well as the rules and conditions under which a procedure to address municipal insolvency may be engaged, should be very clearly determined.

The Municipal Borrowing Working Group, established by the Government to draft the Municipal Debt Act, could be continued to develop a legal framework for municipal insolvency.

## Municipal Debt Guaranties

Private guaranties or insurance of municipal debt has been widely utilized to reduce creditors' risk and enhance municipal borrowers' creditworthiness. Almost half of all municipal bonds in international markets issued today are insured by private insurance companies for timely payment of debt service.

Unlike government guaranties, private insurance does not create perverse efficiency incentives. Municipalities must pay a premium for guaranty coverage. The guarantors have specialized staffs that assess the risks of municipal finances or a project financing. The greater the risk, the greater the premium charged to obtain the guaranty. However, the guarantors will only guarantee the debt of municipalities that they have deemed to be creditworthy. A guarantor's credit analysis will be substantially similar to that of a lender or investor and it will decline to guarantee municipal borrowing that it does not expect will be repaid. Therefore a guaranty function does not obviate the need for creditworthy municipalities.

A recent example of such a guaranty facility is the Local Government Unit Guaranty Corporation (LGUGC) that was created in the Philippines. Private investors and a 51 percent ownership of the Association of Philippine Banks capitalized the LGUGC. In 1999 the LGUGC issued its first guaranties of municipal debt that were offered in the private capital market, thereby providing access to a credit market that would not have been available without the guaranty. The LGUGC has a specialized staff that does credit analysis, assists in the structuring of the debt instruments, and monitors municipal finances during the term of the debt.

Additionally, as described in Section 3.3, USAID has established the Development Credit Authority (DCA), which, upon compliance with certain conditions, will guarantee up to 50 percent of a debt obligation. The Development Credit Authority's obligation is backed by the U.S. Government. DCA is currently functioning in Bulgaria and guaranteeing debt related to energy efficiency for which municipalities are currently eligible. DCA has other lines of business and products that may be utilized in Bulgaria in connection with the municipal credit market.

The Strategy should explore the potential for a guaranty function in the municipal credit market, including:

- the current Bulgarian law and regulations regarding insurance of debt obligations and the insurance industry's activities in this area,
- the increased utilization of USAID's DCA program,
- the World Bank's interest in establishing a guaranty fund, and
- other potential guaranty functions.

## Center for Information on Municipal Credit Market

Consideration should be given to the development of a Web-based information site that would:

- promote municipal credit as a means of financing infrastructure needs of Bulgaria;
- act as an online advisor for municipalities seeking to access debt sources, banks, or bonds: provide templates for all the necessary documents (feasibility study outline, tender book for selecting bank or financial intermediary, models of credit contracts and bonds prospectus), and a schedule of all the steps to be taken in the process;
- maintain an updated public database of all the laws and regulations concerning local debt;
- improve flows of information between the financial sector and the Bulgarian municipalities;
- provide templates of procedures, documentation, and implementation schedules to assist in the debt issuing process; and
- offer resources and links related to the municipal credit market.

Such a center, although very useful for all actors in the municipal credit market (local governments; lenders, both banks and bond buyers; service providers, including brokerage houses, advisors, and rating agencies), cannot and should not be controlled in its infancy by any of the above-mentioned entities. It has to be kept open and transparent to all parties interested, without promoting individual interests. Therefore, during its initial year, until it becomes well established in the market, it has to be nurtured by a disinterested institution. For example, LGI could be responsible for its development (the design and periodic updates); only when the center is well-known and well-used by interested parties should it be transferred to a third party—preferably the NAMRB or an association of local credit market professionals.

## Securities Disclosure

The Financial Regulatory Commission has established guidelines and procedures for the public offering of municipal bonds. Certain of the procedures were established in 2003 and have not yet been applied to an issuance of municipal bonds. A continuing dialogue should be maintained with the Commission to determine the quality and consistency of existing disclosure practices in the municipal securities market.

## Municipal Credit Market Working Group

Other countries have found it valuable to identify a group representing the stakeholders in a municipal credit market. The group meets periodically to assess issues, recommends actions to monitor the functioning of the market as it develops over time, and recommends further policy reform and market development options. Either the establishment of a Municipal Credit Market Working Group or the continuation of the Municipal Borrowing Working Group should be considered to perform this function.

## Municipal Development Bank

As Bulgaria's government weighs its policy options for actively facilitating municipal credit market development, it should consider the mixed lessons that can be drawn from this comparative international experience. On the one hand, a few countries have had, on balance, a positive experience with on-lending international donor funds through some form of "municipal bank" or "development fund." Brazil's municipal development funds lend directly to local governments; thus far they have an excellent record of repayment and have established some positive precedents for the private financial institutions that may follow their lead. The Czech MUFIS offers a relatively unique and exemplary model. MUFIS was established from its inception to operate as a second-tier, financial intermediary that extends a credit line of medium-term funds to private, commercial banks. The banks in turn lend to municipal governments for infrastructure projects and assume 100 percent of the risk for the loans that they underwrite. Repayment history has been essentially default free and the program has motivated participating banks to expand municipal lending using their own resources.

On the other hand, despite the success stories, as often as not, municipal development loan funds have compiled unacceptable default rates and ended up competing with or actively interfering in private credit markets in ways that distort market incentives, and perpetuate public subsidies. Moreover, it is difficult to point to instructive models for how such funds should be wound down, once they have accomplished their initial purpose and a private municipal credit market has firmly established itself. Should they be dismantled, or converted to perform some more modest, residual role (technical assistance provider, regulator, or special-purpose lender)? Complicating this question is the fact that these municipal development funds typically have residual fiduciary obligations that may extend out as long as 30 years until the original donor credit is fully repaid, even though the initial infrastructure loans to participating municipal entities may all have been repaid within 10 or 15 years. Although municipal development funds in some parts of the world have been operating for more than 30 years, they have largely remained captive instruments for on-lending funds provided by international institutions and central governments.

If after carefully assessing the opportunities and the risks, Bulgaria should choose to create some form of municipal development fund, it should do so with the clear intent:

- that the fund be established for the sole purpose of supporting the development of a private credit market;

- that it will operate through commercial banks that will assume the responsibility of underwriting the risk of infrastructure loans extended to participating communities; and

- related to the above points, that it be designed to operate swiftly and predictably, and to refrain from performing time-consuming independent project appraisals that needlessly delay project financing and construction by imposing a redundant layer of review, and that relieve banks and municipal borrowers of their proper decision-making role.

# 6

# Conclusion

In the past three years Bulgaria has taken its first important steps toward the development of the municipal credit market. At the time this Strategy was being prepared, the municipal credit market was in the cradle stage. One of the most important prerequisites is in place: Local banks and pension funds demonstrate high cash liquidity and are looking for investment instruments and lending opportunities. The municipal credit market should build on this base of available capital supply. The Strategy sets forth activities and steps that needs to be undertaken in order to increase municipal access to the credit market over the next several years.

Orderly development of a municipal credit market that meets the large infrastructure finance needs of local governments on the one hand, and that builds and maintains investor confidence, on the other hand, is critical at this time in Bulgaria's development. This market will help fund the existing infrastructure gap, increase the absorption of EU funding, and expand the economic and social development potential of communities. However, for these effects to be realized, progress in a number of key areas is necessary:

- decentralization reform, particularly fiscal decentralization must be pursued vigorously,
- municipal capacities in debt management and project packaging need to be developed, and
- investor awareness of the potential in the municipal credit market must be enhanced.

Beyond these fundamental conditions, further strengthening of the institutional setting and regulatory framework will enable the market to develop successfully.

# Annex 1: List of Interviewed Persons, 19–28 April 2004

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|---|---|---|
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| Name | Institution | Contact Details |
|---|---|---|
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# Annex 2: List of Banks in Bulgaria

**Commercial banks with an international banking license**

Bulgarian Post Bank, Sofia

HVB Bank Biochim

BNP-Paribas (Bulgaria)

Bulgarian American Credit Bank, Sofia

Bulbank Ltd.

Commercial Bank Allianz Bulgaria Ltd. (former Bulgaria Invest Ltd.)

Central Cooperative Bank, Sofia

Emporiki Bank – Bugaria EAD, (former Commercial Bank of Greece)

Corporate Commercial Bank - LTD

Demirbank, Bulgaria

DSK Bank, Plc

Economic and Investment Bank AD (former BRIBank)

Encouragement Bank, Sofia

Eurobank Plc

UNIBANK (former First East International Bank)

First Investment Bank, Sofia

Hebrosbank, Plovdiv

Municipal Bank, Sofia

Investbank, Sofia

ProCredit Bank

Raiffeisenbank (Bulgaria)

DZI Bank, Sofia (former Roseximbank|

SG Expressbank, Varna

Private Enterpeneurial Bank Texim

International Bank for Trade and Development

United Bulgarian Bank AD

CB Unionbank

Tokuda Bank

West-East Bank

# Annex 3: Municipal Debt

**Municipal debt in Bulgaria**
**december 2003**

| | | |
|---|---|---|
| **domestic debt** | **44 037 940** | **BGN** |
| municipal bonds | 8 454 570 | BGN |
| bank loans | 22 082 690 | BGN |
| from state budget | 2 730 000 | BGN |
| from extrabudgetary accts | 6 248 460 | BGN |
| other | 3 527 190 | BGN |
| municipal guarantees | 995 030 | BGN |
| | | |
| **foreign debt** | **17 787 420** | **BGN** |
| all bank loans | 17 787 420 | BGN |
| | | |
| **total** | **61 825 360** | **BGN** |

**Municipal Bonds**
**prior to May 2004**

**bond issues**

| | issued | BGN | EUR | maturity | interest |
|---|---|---|---|---|---|
| Sofia | 1999 | *97 750 000* | 50 000 000 | 3 y | 9,75% |
| Svistov | 1999 | 370 000 | | 7 y | 5,60% |
| Varna | 2000 | *5 865 000* | 3 000 000 | 3 y | 9,00% |
| Sliven | 2002 | 3 000 000 | | 4 y | 9,00% |
| Dupntiza | 2002 | 2 000 000 | | 4 y | 9,00% |
| Dupntiza | 2003 | 1 320 000 | | | |
| | | 110 305 000 | | | |
| | outstanding | 8 454 570 | | | |

*Source: Ministry of Finance; other sources*

# Annex 4: Municipal Bond Issues

***Sofia bond issue (redeemed)***

| | |
|---|---|
| *Issued in:* | 1999 |
| *Total value:* | €50 million |
| *Type of bonds:* | 3,000 bonds, nominal value 1,000 lev, issue value 1,000 lev; types: nominal, interest-bearing, free transferable |
| *Interest rate:* | 9.75% on annual basis |
| *Grace period:* | None |
| *Maturity term:* | 3 years |
| *Repayment schedule*: | The coupon payment shall be made on an annual basis |

**Varna bond issue**

| | |
|---|---|
| *Issued in:* | 2000 |
| *Total amount*: | €3,000,000 |
| *Type of bonds*: | Registered, nonavailable, interest-bearing, freely transferable; number of bonds 3,000; issue value €1,000; nominal value 1,000 |
| *Maturity:* | 1,000,000 per year in each of the next three years |
| *Registry:* | Central Depository |
| *Interest rate:* | 9%; paid semiannually |
| *Financial intermediary:* | Unity Invest |
| *Credit rating*: | Moody's Investors Service "B2" |
| *Method of offering:* | Private placement solely to financial institutions (Article 78 of Securities Law) |
| *Purpose:* | 50% for street lighting/energy efficiency cost saving; 50% for cultural and educational facilities |
| *Collateral:* | Pledge of future revenues |
| *Remedies:* | Pursuant to Article 237 of the Civil Proceedings Law |
| *Investment of bond proceeds:* | Varna will enter into a bank agreement for the investment of the proceeds of the bonds until such time that they are used to pay for the project. The agreement provides that such funds will earn interest at a rate of 5%. |

## Sliven bond issue

| | |
|---|---|
| *Issued in:* | 2002 |
| *Total value:* | 3 million leva |
| *Type of bonds:* | 3,000 bonds, nominal value 1,000 lev, issue value 1,000 lev; types: nominal, interest-bearing, free transferable |
| *Interest rate:* | 9% on an annual basis |
| *Grace period:* | 1 year |
| *Maturity term:* | 4 years |
| *Repayment schedule*: | The principal shall be repaid in three equal installments/ payments; the coupon payment shall be made on a semiannual basis |
| *Source of repayment:* | Proceeds from privatization (subject to privatization are property and municipal companies) |
| *Use of funds:* | Building bus station (1,850,000 lev), building covered pedestrian bridge (850,000 lev), building market for citrus fruits (150,000 lev), and building flower market (150,000 lev) |
| *Guarantee:* | No formal guarantee, only a statement of firm commitment and binding nature of the obligation from the mayor |
| *Financial advisor to municipality:* | Unity-Invest JSC Sofia |
| *Underwriter:* | Investor broker “BFB” Sofia JSC |
| *Debt information:* | Has not incurred any other form of debt; no guarantees extended to third party |
| *Listed on Bulgarian Exchange:* | Yes |

## Dupnitza bond issue

| | |
|---|---|
| *Issued in:* | 2003 |
| *Total value:* | 1,320,000 BGN |
| *Type of bonds:* | 13,200 common, underwritten, interest-bearing; nominal value 100lev, issue value 100 lev |
| *Interest rate:* | 9% |
| *Maturity term:* | 4 years |
| *Repayment schedule*: | Coupon payment on an annual basis |
| *Use of funds:* | Rehabilitation of the road network |
| *Guarantee:* | No formal guarantee; future municipal revenues |
| *Financial intermediary:* | MacKap Brokers JSC Sofia |
| *Debt information:* | Has not incurred any other form of debt; no guarantees extended to third party |
| *Listed on Bulgarian Exchange:* | Yes |

## Svishtov

| | |
|---|---|
| *Issued in:* | 1999 |
| *Total value:* | 0.37 million BGN |
| *Type of bonds:* | 37,151 bonds, nominal value 10,000 lev, issue value 10,500 lev |
| *Interest rate:* | 5.6% |
| *Maturity term:* | 7 years |
| *Repayment schedule:* | Coupon payment on a semiannual basis |
| *Use of funds*: | Rehabilitation of the water supply network |
| *Guarantee:* | No formal guarantee |
| *Debt information:* | Has not incurred any other form of debt; no guarantees extended to third party |
| *Listed on Bulgarian Exchange:* | Yes |