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The Federal Commission for the Securities Market

PROCEEDINGS

**Municipal Bonds and Their Role in the
Development of Regional Infrastructures**

A Conference held at Yekaterinburg, The Russian Federation

September 18-19, 1997

Edward Rossel, Governor, Sverdlov Region

Dear colleagues, friends, and guests Here in the Urals, in the heart of Russia, I would like to extend to our guests personal greetings and greetings of the representative and executive branches of the local authority of the Sverdlov Region

The subject of the conference, Municipal Bonds and their Role in Developing Regional Infrastructure, has attracted representatives of many Russian regions This is namely due to the fact that the social problems in all Russian regions have been aggravated by fiscal deficit The problems include the cost of communal services, and power supply, transportation and telecommunications, consumer services, health care, education, and many other problems faced by the bodies of power of the subjects of the Russian Federation

Presently the market of municipal bonds is developing at a fast rate Until recently the payments arrears were covered by the issue of veksel's of the regional authorities In March 1997 the issue of veksel's was legally banned Therefore in view of the changing tax legislation and the downfall of market income rates short-term bonds are becoming less effective Today certain regions are attempting to make issues of bonds for target programs But such examples are few

Today's conference is symbolic The matter is that the day before yesterday we received first notice on the completion of the work on allocating a credit rating to the Sverdlov Region The rating of the Sverdlov Region corresponds to the rating of Russia This signifies that if the rating of Russia increases, the rating of the Sverdlov Region will increase automatically

We have an agreement with Incombank, in accordance with which we are starting the placement of regional bonds and are planning to obtain 300 mln dollars for local industrial investment

We view the issue of Eurobonds as a source for regenerating investment activities in the region The main advantage is not just hard currency funds, but also to narrow the gap between the basic Western financial institutions and our developing market economy

The allocation of the rating and the issue of eurobonds will definitely make a positive impact on the entire system of regional securities We are aware that there are many problems that need to be resolved in the sphere of regional finances and the securities market Nevertheless our view of the future is optimistic

Today we are signing together with Dmitry Vasiliev an agreement between Russia and the Sverdlov Region that will regulate our relations related to the development and operation of the securities market The agreement provides for a uniform state approach to the formation and development of the Russian securities market It will ensure the interests of investors and entities, and more effective management and state regulation of the market

Within the framework of the agreement the parties will cooperate in resolving some key issues concerning the development of the securities market infrastructure in the Sverdlov Region, registrars, depositories, settlement and clearing organizations, the stock exchange and other settlement systems, as well as overcoming crisis situations, in the regional stock market,

stabilization measures, formation of corporate systems of financial security and investor and shareholder protection, etc

I believe that the present agreement will ensure fast development of the regional securities market I hope that conference participants will find answers to many questions during the period of its work

Dmitry Vasiliev, Chairman of the Federal Commission for the Securities Market

I am very glad that it is here, in the Urals, that we have organized this conference. More than one hundred participants from different regions are present at the conference, which signifies that our joint effort with the administration of the Sverdlov Region and the USAID to whom I wish to extend my personal gratitude for organizing the venue has yielded results. This is exactly what is necessary. If this was not necessary the participants would not have come, would not be present and would be doing something else. Therefore we need to continue moving in this direction step by step towards a civilized securities market, including such a major market component as municipal and regional bonds.

I would like to use the opportunity to express my appreciation of the results of the rating of the Sverdlov Region and congratulate you on this event. The allocation of the rating to the Sverdlov region which is on a par with the Russian rating is indeed a very good result. On behalf of the Securities Commission we wish you success and are ready to assist the region in placing eurobonds, in particular, what concerns establishing a reliable, transparent and investor friendly market, this is exactly what the Commission is called for.

What is the purpose of the present conference? Gradually the Russian regions and municipalities are starting to make bond issues. **The Ministry of Finance has already registered 200 such bonds, both regional and municipal, worth over 18 trillion rubles.** This is a substantial amount. There is nothing exotic about this, because Moscow and St Petersburg have placed Eurobonds. And today we witness the preparation of a eurobond issue by Sverdlov Region.

Such is the everyday practice. We need to learn how to do it the civilized way and with maximum efficiency. In my view the conference should focus on the following issues:

First, the **financial plan** has to be developed during the preparation of any municipal or regional bond issue. We should understand the purpose of the issue and design it properly. Let's assume this is a housing loan or a loan to resolve some fiscal deficit like debt restructuring, or these might be investment projects, say, for the construction of a bridge in some location. These are entirely different objectives, different investors, and mediators.

Further, it is necessary to determine the type of financial reserves required, and how that will fit with the general financial plan of the city's administration. How to select an underwriter or who to ask for finding one, at what stock exchange, and what is the procedure of bonds trading, how to organize subsequent servicing of the loan?

We should achieve world European or American standards of work in the debt market. You can see that the Federal Commission for the Securities Market has been striving to have Russian professional securities market participants and issuers, in particular, enterprises conform with the international requirements. This is a task that has been outlined by the President and the Government. We also enjoy the support of the regional authorities, who are striving to establish a civilized market in Moscow, St Petersburg and the Sverdlov Region.

When we introduced the new requirements on licensing the professional securities market participants such as provided for the requirements of the European Community in relation to the minimal required capital of 50,000 ECU. You must know that market professionals servicing

the loan assist in ensuring that the bonds are traded and quoted in the exchange. Thus we are making the market more reliable, sensible, and attractive for Russian and foreign investors. We therefore are interested in increasing the rating of the Sverdlov Region, just like the rating of the whole of Russia.

I would like to speak briefly about the today's signing of the agreement. Judging objectively we must understand that the Russian stock market greatly depends on three regions in Russia - Moscow, St Petersburg and Yekaterinburg. These are the three main regions accounting for 75% of all professional stock market participants, 75% of all issues, i.e. securities that are placed in the market annually. Therefore we are closely coordinating with the administrations of Moscow, St Petersburg and the Sverdlov Region, which is of principal importance to us. And I believe that the Sverdlov Region has made a great step forward recently. I would like to underline the outstanding work of the local FCSM branch and express gratitude for the support provided by the Sverdlov Regional Administration and the Governor personally.

What is next on the agenda? I think that it is crucial for us to fulfill the agreement and to resolve the issues that are under the focus of the President and the Prime Minister.

I would like to underline two problems that have been addressed by premier Chernomyrdin at the recent meeting with American businessmen in New York and a meeting with Al Gore. **These are the problems of investor rights protection and the problem of depository servicing.**

I believe that these two problems are next on the agenda. You are aware that the President has recently adopted two Decrees on establishing the State Commission on Investor Rights Protection. And I hope that the regions will support this initiative. Today we discussed this issue with the Governor, and it may be that he will head the first Commission in the Sverdlov Region in order to ensure investor rights protection at the regional level. I believe that this will be a major breakthrough.

The second problem is depository servicing of investors. In this relation a Decree was issued on establishing the national depository system and establishment of the central depository. The signed Agreement provides for the support of the Settlement and Clearing Center and development of depository servicing in the Sverdlov Region as a central body for the entire Ural Region. It is essential to ensure that the securities market of the Ural Region becomes an integral part of the all-Russian market, i.e. shares should be in local custody and traded all over Russia.

I will not dwell on the details of the Agreement (its scope is large, including investor rights protection, development of market infrastructure, and coordination on licensing, etc.) I believe that this Agreement will provide an additional impetus to the effective development of the securities market in the Sverdlov Region and the entire Urals.

I would like to thank you for your attention. I wish success to the conference. I believe that we can learn how to work at a high level and in a civilized manner according to the highest international standards, and this conference will help us all in this.

Vladimir Krysov, Chairman of the FCSM Sverdlov Region Branch

Dear Ladies and Gentlemen

The will of the Governor and the Chairman of the Commission has found its expression in today's agreement, which I am holding in front of you

The agreement stipulates the mutual obligations of the parties. Primarily the Commission and the Administration undertake to pursue coordination in regulating the securities market in the Sverdlov Region and terminate illegal activities in the securities market, including fraud and issuance of securities surrogates

The parties will refer to mutual coordination in developing and adopting regulations and provisions on the securities market which present mutual interest, including joint development of regulations, joint involvement of specialists for the development of regulations and decisions on the issues of market development

FCSM and the Sverdlov Region undertake to provide mutual assistance in developing the securities market infrastructure in the Sverdlov Region, establishing Centers for Collective Investments in Yekaterinburg, development of the system of managing the privatized enterprises in the Sverdlov Region, development of the stock market of the privatized companies, market value pricing of shares, regulating the process of trading in large and controlling blocks of shares, mergers, takeovers in the market of corporate securities in the Sverdlov Region, resolving crisis situations in the local securities market, stabilization measures and reduction of the cost of investments, increase of capital expenditure in local companies and ensuring price dynamics in the securities market, establishment of corporate systems, ensuring financial security of investors, ensuring market development rates through openness and transparency, organization of coordination of information agencies, mass media, consulting firms, and professional securities market participants, on the issues of information disclosure, development of independent rating agencies, and introduction of a recognized rating appraisal for local issuers, promotion of ethics among investors, state policies education, and establishing training organizations for specialists in the field of professional activities in the securities market

The Federal Commission undertakes to provide assistance in the following directions: establishment of a developed regional securities market integrated in the Russian and world financial markets, development of an efficient securities market capable to raise investment capital for the local economy and the private sector, including the privatized companies, attracting direct investments in the local economy via the capital market, including the participation of international financial companies, development of the system of loans in the securities market, fostering financial security of the population, establishing the system of collecting and disseminating information, implementation of the housing program, establishing a Center for Collective Investments, market development research, implementation of the regional training program, use of secondary resources, energy preservation and use of natural resources

The Sverdlov Region will assist the Federal Commission in implementing the unified principles of state regulation, development of local legislation which determines liabilities for violations in the securities market and stimulates the development of the local securities market infrastructure

**AN OVERVIEW OF THE MUNICIPAL LOANS MARKET
AND LEGISLATIVE ISSUES**

**State regulation of the issue and circulation of municipal bonds
Draft Law on the issue and circulation of government and municipal securities**

Andrei Perelygin, FCSM, Russia

Ladies and Gentlemen,

I am glad for the opportunity to greet conference participants and I am grateful to USAID and the Pragma Corporation for organizing this conference

It so happened that I learnt today that I am one of the first speakers after the signing of the Agreement, therefore I had to make certain changes in my presentation

The analysis provided by the FCSM Securities Market Monitoring Unit shows that **regional and local authorities started making securities issues from the second half of 1994**. The growth in the number of issues is parallel with the increase in their volume. Today such practices of issuing debt securities by local authorities are quite noticeable. Local authorities are interested in securities issues because of chronic lack of budget funds and the possibility to raise low cost and long-term funds for financing regional investment programs

Along with the general growth of the securities market in 1997 the quantitative indicators of the market of sub-federal and municipal securities also increased. In January-August 1997 Minfin registered 212 issues of bonds of the subjects of the Russian Federation and municipal units worth a total of 18.5 trillion rubles. For comparison in 1992-96 a total of 153 bonds issues worth 20 trillion rubles were registered.

Such a sharp increase in issuance actions of the regional and local authorities in 1997 is due to a number of factors. One reason is that the legislation requirements changed. The Securities Law was adopted which defines the issue of securities. While previously bonds issues with different serial numbers were issued under one registration number, today such series are separate issues and are registered by Minfin separately.

Trends show that the relative growth of the number of issues is small. In 1995 there were 73 issues, in 1996 - 39, while in 1997 - 88 securities issues.

Another reason for the sharp increase of issuance activities of the regions is the issue of rural bonds by many subjects of the Russian Federation. Such issues were essentially voluntary/obligatory in order to reduce the debt to Minfin on commodity loans. Rural bonds constituted 70% of the total number of registered issues of the local authorities in January-August 1997. Otherwise the number of securities issues of the local authorities as compared with last year remained at the same level.

The third reason is the increase of the issue activity of the regions and local bodies, including Moscow, represented by the Moscow Committee on Municipal Loans.

Another less obvious reason is that the Law on the Common and Transferable Veksels was adopted which prohibited the local bodies to issue veksels. Correspondingly the local bodies are searching for other sources of investment primarily via new bonds issues.

The city of Moscow, the Moscow, St Petersburg, Sverdlov and Nizhni Novgorod Regions are the most active in making securities issues.

Regional local bodies are issuing a range of debt securities. The form of issue of certain bonds, circulation and payment of dividends is similar to certain types of government securities like GKO, OFZ or their modifications. Other types of bonds are specific and unique.

It is possible to make a classification of the most popular issues of bonds. Let's start with the **housing loan**. While previously such issues constituted a large proportion of the entire number of issues, presently they are less, constituting 6% of the total number. Housing loans are a vivid example of target financing while the raised funds are used for funding housing construction.

As for payment of dividends and redemption of bonds there are two models. The first model, which is more common, provides for housing as a form of redemption. Such issues were made in the Nizhni, Samara, Ulianovsk, Orenburg, Novgorod regions, Tatarstan, Moscow, Omsk, Kaliningrad, Yekaterinburg, etc.

The second model provides for payment of dividends only in cash out of the funds raised at auctions on the sale of apartments built with the use of the issue funds. Such models were applied in Syktyvkar, Ukhta, Cherepovets, Armavir, Kursk, Octiabrsky district of the city of Stavropol.

Telephone loans, which have been few, are standing close to the housing issues (Nizhni Region). The raised funds are allocated to the construction of telephone exchanges, and purchase of equipment, while bonds are redeemed either by installing telephone lines, or payment of cash dividends. Such regional operators as Uraltelekom, and Uralsvaziinform are most active.

GKO-type loans. The Perm Region was the first to make a GKO-type issue in 1996. The trend shows that the number of such issues is growing. They comprise 34% of the total number of issues made by local authorities. Loans of this type are not designed for target programs, they provide for mixed form of coverage, short-term bonds placed in series through auctions and cash redeemed. Primarily such issues are made for funding fiscal deficit and current expenditures. They are secured either by the budget or property of the issuer. Arbitrage operations are usually the source for providing income on the issued bonds. Sometimes it is the issuer's budget.

The issuers often view GKO-type debt instruments as a source for developing the infrastructure of the regional securities market. Such issues have been successful due to a developed scheme of the GKO market, simplicity and effectiveness of technological solutions.

Industrial and investment loans. Such are rare constituting about 8% of the total number of issues. This is due to the lack of really attractive and profitable investment projects. A large part of investment in the real sector of economy has not been profitable.

According to the prospectus information the issues of the Khabarovsk, Tyumen, Chukotka, Ryazan, Northern Osetia Regions, etc fall in this category

In the conditions of general instability in the financial market debt operations of such type acquire the features of arbitration operations Practically all issues provide for reserves which are subject to placement in high-yield financial instruments Often such reserves substantially exceed the amount directed to investment purposes

The **Eurobonds** are the next type of loans which is gaining ground Presently there is only one document regulating such loans, Decree #304 on the issue of external bonds of the executive authorities of the cities of Moscow, St Petersburg, and the Nizhni Novgorod Region In accordance with the Decree the total amount of borrowings of each subject of the Federation during one fiscal year should not exceed 30% of the volume of own budget revenues of the subject The expenditures on redemption and servicing of all types of debt obligations should not exceed 15% of budget revenues The subjects must obtain credit ratings of at least two leading rating agencies

Presently Moscow and St Petersburg have successfully placed their eurobond issues in the international financial market worth 500 and 300 mln dollars correspondingly In September 1997 the administration of Nizhni Novgorod registered its decision with Minfin to issue eurobonds worth 100 mln dollars

Other regions have announced plans to issue eurobonds The President ordered to prepare a Decree on the full procedure of the issue of such bonds, yet until the present moment, to my knowledge, the Decree has not been signed and it is unclear when this will happen

Rural bonds are issued by the subjects of Federation to cover the arrears to the Federal Budget on commodity loans provided by Minfin of Russia in 1996 The terms and procedures of issue are regulated by Government Decision #224 on the economic conditions of operation of the industrial complex of the Russian Federation in 1997, and Decision #635 on adopting the procedure of debt accounting and repayment of the subjects of Federation to the Federal Budget on the commodity loan of 1996, as well as the corresponding decisions of the legislative bodies of the subjects of Federation and local bodies

The volume of issue is determined by a special protocol on agreeing the debt amount on the commodity loan signed by Minfin and the subjects of the Federation The entire issue is transferred to the ownership of the Russian Federation represented by Minfin

Rural bonds are non-document form securities with a par value of 10 mln rubles with a 10% annual coupon IFC (the International Financial Company) is the general trading agent of Minfin The bonds are accounted for by the ONEXIMbank depository and MICEX performs the trading function

As of the middle of March 1997 the debt of the subjects of the Federation comprised 9 trillion rubles In September 1997, 50 subjects of the Federation registered 147 issues of rural bonds with the Minfin worth a total of 5 trillion rubles

As of today MICEX has put up for the auction the bonds of 34 subjects of the Federation. The issues of 16 have been placed completely worth a total of 2.1 trillion rubles at par value.

It is noteworthy that the secondary market of rural bonds is presently stale and illiquid because the relative volume of each issue is small which is insufficient to form a highly liquid market. Secondary trades are held only on the issues which have been fully placed. This involves 16 subjects. According to certain information, foreign financial institutions are large holders of rural bonds. They acquired these in order to form a long-term investment portfolio, and not for short-term speculations.

One of the factors which weakens the development of the secondary market is the lack of investment openness. In particular, the lack of information is due to the fact that the issuers, having transferred the issues to Minfin, have actually lost interest in their fate.

The analysis of completed placements shows that they were relatively successful. According to 1996 data, such are 62% of completed placements. At the same time, there were certain **loans with problems**. Some of them were canceled, while others were placed only up to less than 50% of the announced issue.

The **reasons** are either lack of practical experience in issuing debt instruments, or lack of objective, investment analysis of potential investors. The issues were separated. They were placed in the regions and therefore the investors' circle was limited, which set back the investment potential. There is lack of access to information on the issue, its purpose, guarantees, and participants. In some cases, issue participants were short of the necessary professional level.

Following are the **major problems of the market of local and sub-federal loans**. The major being the lack of legislation regulating the issue of securities by Federation subjects and municipalities. Subsequent speakers will provide more detailed information about the fate of the draft law on the securities of the subjects of Federation and municipalities which is in the Duma presently. There are no standards on the preparation and registration of issue prospectuses of the subjects of the Federation, standards of disclosure of information on the progress of issue placement. There are no official publications of the register of securities of the subjects of the Russian Federation.

Following are the problems inherent to the securities market due to general and subjective problems, namely, difficulty to forecast the economic and political situation in the country, undeveloped infrastructure of the regional securities markets, limited investment potential of the bulk of the population, negative impact of the numerous scandals in the Russian securities market which aroused suspicion of individual investors to any kind of securities, as well as problems related to the high cost of promotional campaigns.

Considering the above said, it is necessary to note the following **minimal conditions and measures necessary to make a successful placement**. First, assistance of professional mediators in organizing the issue and placement. Special attention should be given to issue guarantees, ensuring reliable sources of revenue and redemption, purpose and use of raised capital, involvement of independent experts in the field of investment project analysis, development of loan schemes, selection and evaluation of potential partners in organizing tender placements.

Second, to ensure full disclosure of issue information, free access of interested parties to all public documents and material, concerning the issues

Finally, strict supervision over loan implementation, use of raised funds in accordance with the adopted guidelines

The Federal Commission pays special attention to the development of the securities market of the subjects of the Russian Federation, local government bodies and can see great potential in its development

Andrei Marchenko, Institute of investors protection

I will speak about the **development of legislation regulating the issue of municipal and government securities**

Presently a number of draft laws is in the Duma which might seriously affect the future organization of municipal and government securities market. These are the Law on the Budget Code, Tax Code, and special conditions of issue and circulation of government and municipal securities.

The interrelation of all three laws is complex. In particular, certain articles of the Law on the special conditions of issue of government and municipal securities directly concerns the Draft Budget Code, and partially the Draft Tax Code. Therefore it is necessary to review all three of them.

Unfortunately the regions did not manage to influence the formation of the legislation. The working group that sits in the Duma comprises the representatives of Moscow. Representatives of St Petersburg can be seen rarely. And there is practically none from the regions. The deputies that express interest in the draft also represent Moscow.

I would like to note that if the regional deputies fail to express interest in the drafts then regional interests will not be reflected in the legislation in full.

I would like to avoid a detailed discussion of all the articles of the Law, although there are only 16. I want to speak about some general concepts underlying the articles of the Law, and how they interact. First of all we need to define several approaches. Presently there are **two approaches to the role of city self-government**. One provides for a **larger share of the socialist system**, the other is **more liberal**. How do these approaches affect the Draft? The socialist approach provides for the municipal authorities to own the property and earn revenue from it, and provide certain services to the population: housing and communal services, police protection, road repairs, etc. At minimal prices. Just like it was under the socialist system. The local bodies are responsible for the operations of the enterprises they own.

The other approach is more liberal providing for all potentially profitable enterprises should be privatized, while municipal bodies should operate on budget funds. The city administration may not initiate any investment projects.

This is directly reflected in the draft Law. For example, Article 2 reads that the funds raised from the placement of government and municipal securities (the article contains a definition of all types of securities) can be used for financing the fiscal deficit of the corresponding level. This means that all funds can be used only according to the GKO scheme. It is therefore impossible to use investments for a profitable project (construction of a paid bridge or parking lot).

Fortunately this approach it seems has been mitigated and the article will be extended to include investment projects. It seems reasonable to support a less liberal and more socialist approach. The matter is that the local governments cannot simply be responsible for the functioning of the sewerage or the police. They are responsible for the economic development of the region and they should have adequate instruments for this. Preferential loans is one in

order to give impetus to the development. The return to the budget will be indirect through the growth of the taxable base and increase of jobs. And growth of the economic activity in the region. If the law prohibits such use of funds this will stall the local administrations.

Now a few words about other approaches. One approach is close to the banking system and provides for regulating fiscal loans. It stipulates how this specifically affects the budget and how it is limited by budget revenues.

On the other hand this creates access to the bonds market. Access to the large-scale market is a special type of activity which requires regulation. There exists a trend that actually limits the capabilities of raising funds only to the bulk market. In other words, if the current draft is not changed the small investor will be denied access to the market or such will be ineffective. This is related with the possibilities on market regulation.

Unfortunately the secondary market of GKO's and municipal bonds is formed not by the market participants, but rather the issuers. For example, when the Moscow issues were planned the market participants and representatives of the stock exchanges, etc. Were asking one and the same question: Which exchange will be used for bonds trading? Where will the market be organized? We prefer MICEX because we have already paid for using the terminals? The market participants have become used to the situation when someone else but them organizes the market. This tendency can be traced further, which may lead to negative effects.

There are **differences between the two schemes of raising funds**. The German and American models. According to the German model the individuals funds are received by the investment institutions, banks, credit organizations who subsequently direct such funds to a specific financial sector. According to the American model small investors can directly access the capital market via securities, investment funds, etc. If we fail to adopt appropriate measures we will be limited to the German model. I do not want to say that the German model is bad, in fact it has certain advantages, e.g. small investors are better protected, and investments are controlled by professionals that are better aware of the risks and can manage them, etc. But there is another risk present, that is the banks gain extreme control over the economy, in particular regional economy.

Another problem is related to regulating the fiscal process, i.e. **issue of veksel's by municipal entities and subject of the Federation**. This problem is viewed by the Central Bank as dangerous, because such effectively is a credit issue which is not subject to its control. When banks create reserves the Central Bank which is responsible for currency circulation in the country, is capable to control this process. When regional entities become issuers, first, the issue volume is very large, second, there is no limiting factor. Therefore virtual local currency appears, which alerts the attention of the agencies responsible for regulating currency circulation. With this in mind, it seems, that the draft will conform the prohibition to issue veksel's by municipal entities.

On the other hand this concerns the question of **regulating relationships between the creditor and the borrower**. It should be noted that in the present context the creditor and borrower are in an unusual situation. If the issuer is a commercial organization and it cannot fulfill its obligations then at least we have a legal procedure for bankruptcy.

What if a municipal entity having issued bonds proved incapable to fulfill its obligations to the investors? Unfortunately, it seems that the process will be regulated following the pattern used to settle accounts with the financial pyramids. It is impossible to make a city bankrupt. There is no such procedure. There will be problems arising if someone demands to sell part of the city's property. Not all municipal property can be sold. If the city decides to sell say a botanical garden for cottage construction in order to cover the debt the city should be prevented from doing this. A mechanism for investor rights protection should be developed, in case the municipal entity cannot meet its obligations. Presently the draft does not have such a mechanism.

The named approaches, like regulating the budgeting process versus regulating the creditor-borrower relations, the socialist approach versus a more liberal one, etc., are not expressed explicitly yet they are traced in various articles of the draft. The most difficult part of the work is to filter the articles of the draft and remove the biased ones.

The Duma is a mechanism of calculating the mutual power of different influential groups. This is a civilized instrument of determining a satisfactory balance of interests. That is why certain articles of the draft are dominated by one approach, while other articles by another approach. As a result the articles of the draft if not directly contradict each other, or hardly complement each other. It is hard to overcome such a situation. Even if the working group agrees on a uniform approach, there will always be individuals that will lobby for their approach over each article.

A few comments concerning some separate articles of the draft. The draft inadvertently promotes the idea that GKO is the best available solution. GKO is indeed very good, it is technologically convenient and allows to effectively use dozens of trillions of rubles. But it is not the only possible solution.

At the same time we are witnessing the following events. The working group is discussing amendments to the draft legislation. The draft stipulates that the issuer should announce the conditions of the issue no later than two working days prior to the actual issue. The Federal Commission proposes an amendment to prolong this period. A discussion takes place. The main argument against the amendment is as follows: why? Everybody knows that the issue is due on Wednesday. Yes, indeed, GKO placements are held on Wednesdays, and everyone knows it. A question to the bankers: do you manage to raise adequate capital to effectively participate in the placement market? As a result the proposal is rejected by voting, because the banking community is oriented to a more rigid scheme of placement of very specific securities, and nothing can be done.

The situation can be changed only if the deputies start working on the legislation draft and follow up on the details. For example, the two day requirement is acceptable to Moscow based professional participants who know when the GKO placement is due and when Moscow issues are placed. The adopted schemes are short-term. They know everything beforehand. Thus, it's only a formality.

Further more, who is considered to be the issuer. This concerns the problem of fiscal management. You know that you have a formal budget of current expenses and the budget for development. Unfortunately, the budget of current expenses requires daily fulfillment, while if

you fail to fulfill the development budget this will only have delayed consequences and will not be as obvious. Therefore the financial structures are tempted to allocate all available funds for filling the gaps. In order to fulfill the development budget special measures have to be taken.

It is fortunate if the budget can be balanced, and there is enough of funds, etc. Another model provides for two administrative departments responsible for the current and development budgets. Naturally, funds can be exchanged between the two budgets, but only in extreme cases, and the decision is made not by the head of the department but at the session of the government. Only then can the development budget be relatively assured.

The funds raised for purposes other than covering the deficit but for the future, investment projects, development of the infrastructure, etc. should be managed by another entity which is responsible for the development budget. The legislation stipulates that the issuer is the entity responsible for drafting or fulfilling the budget. This is the Department of Finance, the Ministry of Finance or the Treasury, if such is introduced. The Ministry of Finance is not mentioned in the Draft because it is not clear if the Budget Code will introduce the Treasury.

If such a scheme is adopted the loans will be used for funding the deficit only. This is tacitly admitted, but in fact this is the case. Therefore it is very hard to track such a decision in the Draft legislation, yet this has to be done if we want to see further development.

Two or three articles out of sixteen provide a detailed description of the securities custody certificate. You must be aware that there is such a category of securities that requires mandatory central custody. This is justified because GKO are issued to be in mandatory custody therefore a legislative base is established for this.

Generally speaking the system of securities in central custody is not a perfect solution. Since GKO are working well, the system should not be disrupted. Yet, in principle such securities from my point of view are odd. The underlying purpose of such a system is to tie the investor to one depository. The difference between the registered non-document form securities and the securities with mandatory custody is that in the first case the owners list is maintained by the register-holder, while in the second, by the depository. All the rest is the same. The relations between the register-holder and the investor are regulated by legislative provisions and regulations. That's why it is hard to manage the investors. But when you have a depository you force the investor to sign an agreement. The agreement can specify absolutely any term, i.e. you have more strict control over the investor.

There are two arguments in support of such a system. First, the investor can always walk away and refuse to buy securities. Second, the GKO system built on such principles is efficient. Unfortunately, there is no assurance that it is effective only due to the legal framework, and not due to high professional level and qualification of specialists involved. If this scheme is duplicated at a less professional level it is hard to predict the consequences.

In conclusion a few words about **investor rights protection**. The draft law does not properly address this problem. There was a proposal to introduce the Debt Book in order to protect the investor. As a result the draft version became incoherent. The problems of bankruptcy were completely ignored. It is not clear what to do if the issuer fails on his obligations.

Furthermore A policy is pursued on central regulation of securities issues The arguments are that if competition lessens prices will increase Therefore it is not beneficial In effect, this is artificial reduction of competition among the issuers in the market At the same time we know that competition is one of the main mechanisms of investors protection Consequently, there is no protection of investors through competition, which makes it more convenient for the government agencies

I call on those present to ask the deputies to participate in the development of the draft law Please, take a careful look at the draft versions, and participate with your comments

THE DEVELOPMENT OF AN ISSUE PLAN

Objectives of the loan Project costs Sources of income for covering timely payment on the coupons and principal Redemption reserves Role of investment banks in organizing the issue Issue construction Credit analysis for issue construction

George Nianias, Denem Hall, Ltd

I would like to speak in more practical terms I will try to give an answer to how municipal entities can borrow long-term

St Petersburg was the first Russian city to which our company gave consultations The city authorities asked us if it was possible to issue a municipal bond issue for two years with quarterly payment on the coupon In other countries municipal issues are made for a longer period of time Our response was that unfortunately even the Federal Government at that time could hardly secure a loan for a period of no more than 12 months For St Petersburg this would prove an impossible task Thus the MKO market started

The objective was to gradually increase the loan period, and quarter by quarter to reach three-four year loans, which would naturally meet the needs of the city

In effect one year later the town of Gdynia in Poland issued the first municipal issue for a term of five years with a slightly higher interest rate than T-bills

In our view the problem of the Russian market of municipal bonds is the lack of a long-term market of GKO's Obviously, during the last two years the Central Bank was reluctant to make large borrowings for a very high fixed rate This reluctance was common to issuers who were afraid of criticism of borrowing at a high interest rate

On the other hand, Poland which had faced similar problems managed to place five- and ten-year T-bills issues, which allowed the municipalities to issue internal issues of bonds for a period of up to five years

Thus, there is the key question what will happen in the GKO market in the next five years? If the rates continue to fall (and we foresee this to happen) the Federation will be more ready to make two-three-year GKO type securities issues with a fixed rate, as has been proposed I do not think that in 1998 the GKO interest rate will fall below 12%, consequently, if the government has plans to gradually start issuing long-term securities at 16, 15 and 13% interest rates, this may just be the beginning of the Russian internal long-term ruble bond issues

At the same time we believe that such securities will be in great demand on the part of western investors When the Federation planned to place one year issues the main investors were the foreign clients of the largest investment banks operating in Russia We have reasons to believe that out of 15-20 bln dollars of foreign investments in the municipal bonds market about five bln dollars could be invested in two-three year fixed income bonds

This is very good news both for new and existing municipal borrowers Foreign investors are particularly interested in non-government as well as government securities GKO rates have already sharply decreased as compare with the previously extremely high rate Presently many foreign investors who have already started to invest in Russia believe that they were late for the

GKO market at which their counterparts had been earning 150-160%, and today investors are looking for more profitable instruments outside the GKO market

Obviously the first option is the market of municipal bonds. Actually foreign internal markets show similar trends. For example, fund managers could invest 50% of their portfolio in government securities, 20% in municipal bonds, 20% in corporate securities and 10% in other special securities instruments.

Thus, the municipalities, mainly Moscow, St Petersburg and Nizhny Novgorod will receive next year a real possibility to place two-three-year bonds. Naturally, investors will seek a bonus over GKO rates of 0.5%, 1 or 2%. Nevertheless the interest has set in the minds of investors.

And now let me switch to the methods of increasing the loan term by the municipalities.

First, borrowing via **credit line**. From the view point of legislation there are certain advantages, like the ease of raising funds as compared to the placement of a bond issue. On the other hand the attracted capital will cost more to the borrower. And if the program or credit line is mismanaged, i.e. the price is put too high, the subsequent bonds issues will be possibly issued at a higher interest rate.

Thus borrowing via a credit line should be viewed against the background of a broader borrowing program. Provided no other options, the municipal borrower should choose this method. On the other hand, if you plan to issue bonds in several months, I would not think it sensible to open a credit line six-nine months prior the planned bonds issue. The higher price for the credit line may lead your issue manager to ask for a higher commission.

The next available source of long-term financing is the issue of **Eurobonds**. And I would like to dwell on this subject substantially, because three months ago a comparison of the cost of borrowing in dollars showed that it is less costly to borrow in any of the leading hard currencies provided the ruble does not sink during a certain period of time.

Yet, ruble rates continue to decrease and you need to thoroughly analyze the real cost of capital when borrowing in the Eurobonds market. The cost has two main components. First, the spread in relation to the initial security of the eurobonds placement. For example, Moscow, having entered this market, has placed an issue with a rate of 315 basic points above the three-year US T-bills which are used as the benchmark security in such loans. At the time of placement it was very cheap, because the Federation has placed its own issue with a spread of 340 points. If the Federation had placed the current issue simultaneously with Moscow, it would have succeeded to raise funds at the same or slightly higher rate than the Moscow Government.

Since then the demand for Russian securities has increased dramatically. Presently the tentative price of the borrowing in this market would be close to 200-250 points, which is cheaper than a few months ago.

Secondly, the lead manager, lawyers, and all those involved in the creation and placement of the issue, wish to receive commissions and reimbursement of costs. One of the services that our company provides to our customers is holding a tender among potential managers in order to put competition at the service of the issuer.

In the case of the Moscow issue we held a tender among 10 leading investment banks. We requested to provide their proposals, calculated the total costs for the city, commented on the strong and weak points of each contender. Then we held talks with the three main contenders proposing to substantially reduce the price, whereas in case of refusal we had plenty of other proposals where such reductions were realistic. In our view, as a result of our activities the government of Moscow saved from 10 to 12 mln dollars and made a firm decision to hold a tender for the next issue.

In Poland tenders are required by law and any municipal entity is required to hold a tender on any acquired services.

The **purpose of borrowing** is another important aspect of the eurobonds market. In order to reduce the cost of capital you have to prove to the investors that you are borrowing for good cause and that you will be able to return the money.

Presently the largest municipalities can easily access the market because the demand for Russian securities is enormous and investors believe that even if something goes wrong with one of the municipalities the federation will rescue the investors and make the borrower solvent. And we believe that Minfin is partially concerned that it actually undertakes the guarantees on municipal issues albeit indirectly. This concern will be the driving force of the coming development of the legislation on municipal issues.

Another key feature is the **term of the loan**. We believe that for Moscow it is possible to place a 20-year issue denominated in Japanese yens in the Japanese market through private placement. The reason being that Japanese investors have special interest in long-term securities denominated in yens, and therefore they are interested in the existing opportunities in Moscow and Russia.

The **plan of the loan** will be in the focus of the work of the city authorities. As you might know, twenty years ago New York was on the verge of bankruptcy because it failed to redeem short-term bonds. New York had issued a huge amount of bonds. At some point in time the investors realized that the amount of debt substantially exceeds the amount of liquid assets of the city or such assets which could be easily accessed, and decided to stop the snowball effect.

This resulted in two things. First, the city adopted the so called capital budget. Second, a supervisory body was set up to oversee the operations of municipal authorities so that their actions were sensible. The mayor of New York, just like elsewhere wants to be reelected for the next term and needs adequate funds to finance social projects and infrastructure development. As a result he is tempted to borrow more than the city is capable to return.

What is the essence of the **capital budget**? Within the budget an attempt is made to calculate all revenues of the city over the next ten years, including current budget revenues, and revenues from special projects or special taxes.

Moscow, and Luzhkov, in particular, has been concerned from the beginning not to borrow enormous funds without clear justification and specific projects which will generate revenues for returning the loan.

We were pleased to learn that Moscow adopted the concept of the development budget. The development budget is looking into the future and it has specific revenue items which will be used to redeem the loan. Raised funds are used for a specific project and therefore cannot be consumed by the budget of current expenditures or to cover short-term deficit or cash shortage.

This is a key factor which foreign investors are eager to observe. They want to see that if the city is borrowing for five years the money is used not for filling the gaps in the budget. Such short-term deficits can be successfully covered by short-term loans, veksels, payment delays, etc (exactly what is happening in Russia today). This is a guarantee that the money that will have to be returned by the future generation in twenty years time will be used properly, i.e. in such projects and programs that will increase the city's potential, facilitate the city's development and bring revenues that will be used to service the debt, in particular, its redemption, and which will not be at the cost of a new borrowing.

Let's review main **differences of the Russian regions and the reasons for investors interest**. The investors understand that Moscow or the Sverdlov Region are not like the western municipalities which have a limited option in using borrowed funds and have less ambitious projects of developing city infrastructure. The investors understand that the Russian issuers are just like small states with their own privatization projects, other revenue sources, such as joint ventures, or the private sector which is building houses and hotels.

All these aspects should become part of the borrowing plan that will be presented to the investors. We believe that such a plan will be developed concerning future Moscow loans and it will be presented to the investors. Such plans will be required in relation to those who want to enter the market, i.e. new issuers.

The establishment of a special agency that will be responsible for balancing the development budget with the budget of current expenditures will be a practical step in developing of such a plan. In the USA such function is performed by the Ministry of Finance and the Ministry of Economy. The Ministry of Economy makes plans for several years ahead and can explain to the public, for example, what will happen with the Economy of Russia or Moscow during this period.

Now I want to switch to the next important question **debt related issuers' risks**. It is just too simple to say that the ruble will remain strong for another several years. Yet Western experience shows that even if stability remains for several years, it will still be disrupted by periods of instability. Consequently, it is necessary to pursue a wise **policy of risk management**, in case the national currency (ruble) becomes weaker. It is necessary to provide for hedging such currency risk, or maintain a balance of the internal and international debt in proportion to the size and ratio of revenues in hard currencies and the national currency.

Usually it is the responsibility of the third city structure - the Treasury. The Treasurer is responsible to see that strong fluctuations in interest rates or currency exchange rates do not affect the city in such a way that it is incapable to continue the borrowing program. Even the most experienced municipal borrowers faced problems that had been hard to predict like the changes in currency exchange rates or interest rates. The general advice is that **principal debt should be in the same currency as the revenues (rubles)**.

Although an international loan in hard currency is less expensive we need to understand that the ultimate cost of capital depends on the subsequent position of the ruble. If the ruble rate decreases you will need much more rubles to cover the loan in dollars and the total cost will be much higher. We have very clear examples of this in the end of the 80s issuers were issuing bonds denominated in yens at 2%, yet, by the time of redemption as a result of conversion they actually were paying 19% in dollars instead of 5-6% which they would have paid normally if they had issued dollar bonds.

Now I want to touch upon the role of **information disclosure** during the process of issue preparation. All that I said above underlines the importance of proving to the investor that the issuer has sensible reasons for borrowing. At the same time investment banks, including foreign banks, would most probably require to provide as much information as possible about the company. A large part of this information is necessary due to legislative requirements concerning the activities of the manager.

The manager is responsible to the investors, and therefore, wishes to learn about the political and financial status of the issuer in order to assure himself. It is very important not to disclose in the memoranda to foreign investors **excessive information**. It is important that all the departments of the administration tell the same. This will prevent the leading managers from finding discrepancies in information provided by the department of the economy, deputy head of the administration, commercial banks, etc. This is a very delicate process and even seemingly minor facts can undermine the position of the issuer.

The most important thing is payments arrears and non-payments. Presently payments arrears are not officially recognized as debt. Thus, during the rating process or economic and legal study it has to be defined clearly whether the arrears need to be explained in detail or the subject should be avoided entirely. I am not calling for cheating the investors, but I propose that you should decide for yourselves what part of the arrears you will disclose and how you present it.

And now I want to speak of a very interesting possibility that may appear in 1998 already. I mean the issue of bonds denominated in rubles by the municipal entities, and placement in the international market.

There already exist mechanisms that allow the Russian issuers to place effectively Russian currency bonds which are repaid in dollars, and we hope that in the future foreign investors will get direct access to long-term securities through international clearing systems.

One of the reasons why access to internal loans is denied is because a special link has to be created, as well as the risk of the Russian stock exchanges or the Russian trading system. All this significantly complicates the activities of foreign investors outside the GKO market.

We believe that regardless of whether the ruble becomes a freely convertible currency the issuers will be able to place large ruble denominated issues among foreign investors for much longer periods of two and more years. The first sign of this was the placement of the bonds issue of the Republic of Tatarstan held by CS First Boston in June 1997. Tatarstan succeeded to place a ruble bond issue at a premium over the GKO rate. The issue was immediately bought and was in demand among the investors. Presently many investment banks wish to repeat a

similar transaction, and I believe that during the next three months even less expensive methods of access to such capital will be developed

In conclusion I would like to speak about another interesting method of raising funds abroad by means of **financing single projects without providing fiscal guarantees** Presently in Moscow there is a number of buildings owned by the city which are put up as collateral against loans without municipal fiscal guarantees

This is possible through leasing the buildings to private persons, organizations, large western companies for a term of 2, 3 or 5 years under the condition that the rent payment is directed to bond owners The creditworthiness of such lease holders as British Petroleum or Shell can be valued much higher than that of the issuer Correspondingly the cost of capital for the city will be substantially less than through borrowing in the owner's name

Such cases are observed elsewhere For example, in New York the Department of water supply can borrow money at more beneficial terms than the city because the income source is independent

In conclusion I would like to say that before selecting one of the proposed schemes of long-term financing you should review all possible options Be careful with the proposed schemes, encourage competition, and I am sure that you will manage to substantially decrease the cost of borrowing

ORGANIZING AND CONDUCTING AN ISSUE

Main stages of holding the issue, decision making, setting the objectives for the borrowed funds, selection of the legal advisor and underwriter, marketing, and attracting institutional investors Reporting requirements and municipal bond information disclosure

Sergey Ivanov, Russian Bank of Development

I will speak about a lesser project than those in Moscow and St Petersburg, yet a genuine regional project

Our Bank is responsible for this project We are developing the concept of the **Novgorod short-term bond issue** And we are speaking about Novgorod the Great not Nizhny Novgorod We have faced with the problems that have a different perspective than those of the capital cities

Therefore I will first of all review the question of cooperation with the regional administration concerning the issue of regional, or as they call it, sub-federal securities

First of all let me say a few words about the legislation I would like to call your attention to the fact that the American legislation on securities has developed on the basis of cases of precedents As is true for Russia - market realities go in front of the legislation, and the efficiency of the executive system leaves much to be desired

Market professionals, as well as those interested, do recall the processes that changed the practices of the US market and became classic in the Supreme Court The Macclak against Maryland case of 1819 The case of Pollak against Farmers Loaning Craft Company of 1995 These cases which were started by regional municipalities and concerned the issues of taxation of income deriving from regional securities These cases were used as a basis for making amendments to the US Constitution

Is this possible in Russia? At first glance, no Try to make a claim in court At second glance, it is not impossible If we analyze the practices of borrowing money by local authorities, such practices can continue until the first payment default As soon as the first of the obligations stop being fulfilled, as Mr Nianias said, as soon as the Federal Government intervenes, the precedent will be set, which the US history is so rich in

The second comment is about the **bankruptcy of local authorities** The current mechanism of borrowing does not provide for guarantees If the region represented by the administration becomes bankrupt, what are the solutions for the investors in the regional securities, what is the mechanism of claiming back the funds? There is no such mechanism in Russia presently And it seems that the interest in the regional securities will persist until the first payments default The American system of claims is aimed at restructuring the debt on the basis of revenues There is absolute transparency in how the local authority uses the money We simply lack such transparency

If you ask the regional representatives who borrow large amounts in the market how do you spend the funds? The answers will be vague They simply do not know Who would argue that the regions need the funds? What the funds are needed for is a more concrete question That is why the answer is always vague

Previous speakers mentioned that the structure of using borrowed funds is such as we see today because many investment projects in the real sector are not profitable. We even observe negative profitability. At the same time I can cite several examples when real sector investments yielded several dozen percent interest in currency.

First of all, the borrowing should be justified. This is very important. Why did the market of municipal and sub-federal securities start to develop now? To be more precise its foundations were laid in the end of the 80s -beginning of the 90s. There were many projects that failed. Those that did not reach the stage of placement or failed at another level (e.g. the Tumen or Rostov projects). The matter is that in the beginning of the 90s the GKO - the investment instrument with the highest liquidity level - was at the same time the most profitable. This is a paradox. This situation starts to change now. That is why the rates are decreasing. That is why municipal bonds are entering the market.

There is plenty of speculative money in Russia today. Speak with the Exchanges, or speculators they will tell you that there is nothing to invest in. There are very few speculative investment instruments in Russia.

I know far from all municipal issues in Russia, but from what I know I can tell you that **conceptual mistakes made by loan managers** in developing the financial and organizational schemes of the issue were one of the hampering factors for these issues. In particular, what concerned the type of security, profitability and placement. I will dwell on this further in my report.

Speaking about our joint work with the Novgorod administration I will skip the initial stage and start with the outcome which may seem to be a surprise.

A decision was made to make an issue of the first pilot tranche of the Novgorod bonds worth a total of only 30 bln rubles with a maturity term of six months.

As of today all documents have been signed and the issue prospectus has been submitted for registration to Minfin. The issue is scheduled for the end of 1997 - beginning of 1998. Presently the pre-placement campaign is underway. The small value of the issue and the short maturity term are differently evaluated by the market professionals, investment bankers and underwriters.

I will try to comment why the Novgorod Region preferred our project of all the other interesting proposals. I believe that this decision is supported by a number of rational arguments.

First, the **administration needs funds**. Sometimes at a high cost. Yet, even the market oriented management and the professionals of the finance department do not have a clear idea of how the funds will be used. Previous speakers touched upon this question. When the classification of the bond issues was made, the GKO-type securities issue was opposed by an investment type issue.

GKO represent the forms and mechanisms of trading, forms and methods of ensuring liquidity level, but not the purpose of the loan. Whereas investment loans are aimed at specific projects.

This misunderstanding reveals the problem **regional administrations do not clearly comprehend what the funds are needed for** As a rule the administration focuses on telephone or housing loans, i.e. something that they can physically see

At the same time **the regions lack entirely the infrastructure necessary for developing investment loans** There are few professionals capable to calculate and justify the project on the basis of western methodologies, not to mention the absence of audit institutions

When you come to a region you can see whole volumes of ready investment projects As soon as you start reading you find mistakes that completely undermine the whole concept of the project Not to mention that the Russian accounting documentation needs to be translated to western standards which in itself is a tremendous problem

All this can be done but in due time and with external assistance Yet it is the time that is short This is one of the arguments in favor of a short-term pilot issue in order to make a start and establish the necessary infrastructure This is what we are working on now in Novgorod We are holding negotiations with the administrations on establishing a non-departmental agency independent from the regional administration which would be responsible for developing, evaluating, auditing investment projects according to western methodologies, and hiring specialists

Due to the lack of international accounting standards the Russian accounting system may mislead in evaluating own creditworthiness This is a drawback that is especially evident in the case of eurobonds As a rule the administration tends to overestimate its creditworthiness It is necessary to prove to the administration that it should have a rating evaluation according to international methodologies in order to base investment activities on such ratings Time is necessary for this and substantial efforts

Besides, transparency or information disclosure start to play a significant role We invited the experts of the Novgorod Institute of City Economy to make a rating evaluation One of the following speaker, Alexei Novikov, who was in charge of this work will share his impressions with you

Since the ultimate goal of the loan is raising of funds in the region, this envisages the creation of a **positive image** of the issuer in the eyes of investors and excludes the possibility of pyramid-type schemes It will be only too simple to make an issue of bonds worth 150 bln rubles And no doubt it will be placed Even rural bonds are being bought And then you can issue an additional tranche for refinancing

In our view if the money is to be used for real projects such schemes must be excluded In other words besides the question of rating we are speaking of creating a positive reputation for the region, what is called credit history or track record The best way to create such record is to make a short-term borrowing and to return the money A short-term issue of small volume would be the best solution Measures should be taken to establish the infrastructure for more wide-scale loans

There is another argument **regional leaders should get used to the idea that to make an issue is not free of cost** There is the question of cost which is determined by the forming

market They should be able to evaluate the cost structure proposed by the financial advisor During the initial stage it is sensible to make small volume issues

Somebody can oppose me saying that the profitability or commercial basis of such small short-term issues is not strong. Maybe it is true to some extent Being more accurately it is true during the first stage of the work But as you know there are few specialized banks in Russia, at least in the common sense of the word, when banks are subdivided into investment, retail, etc And the time of specialized banks in Russia has not come

The fact that the loan is organized by an organization with a wide scope of activities has obvious advantages in that the organization is present in many markets For example, within the frames of the issuance program in the Novgorod Region we are income oriented The income comes not so much from our underwriting services, i.e. services on placing and managing the issue, as the establishment of the secondary market in which I dare say we are experts And I believe that given the proper conditions we will succeed in forming this market

I would like to specifically discuss the question of delineation of functions inside a specific issue In our case, although the functions have not been completely delineated, the Russian Development Bank will tentatively perform the function of manager on the basis of proxy written by the administration, counteragent, secondary market market-maker, payment agent and possibly holder of the special account of the issuer Function concentration during the first pilot stage of the project facilitates infrastructure development, monitoring and secondary market access

In our view the loan is determined not only by the need of the administration, but other strategic consideration as well Other factors include economic situation in the region, credit history, level of development Strategy development proposals were floated by the financial consultant of the administration after the initial evaluation It is important to ensure that the administration realizes its role in the project, costs, openness in the joint work

This was the case in our project The administration was not indifferent and this is why the project received support rather quickly by Russian standards The working group included the representatives of the Russian Development Bank, administration, Institute of City Economy, as well as independent experts The working group evaluated the budget and the socioeconomic situation in the region, and gave a credit evaluation, upon which it developed a final report on the optimal strategy of developing the issuance program and features of the new tranche Proposals were developed for the administration on developing the infrastructure necessary for supporting the issuance program as a whole and not just one tranche

After signing the documents which authorized RDB to act as financial consultant and manager the working group worked on four main guidelines First, rating evaluation Second, development of normative documents of the loan in compliance with the effective legislation Third, development of the features of the new tranche and organization and functional scheme of implementation Forth, pre-sale marketing or investment relations, determining the interest of investors in this security during the preliminary stage in order to better understand the anticipated level of profitability

The final features of the tranche are as follows Issuer - the Administration of the Novgorod Region Issue volume - 30 bln rubles Maturity - six months, or 182 calendar days This is a

registered security with fixed income, coupon rate, non-document form, registered on accounts Par value - one million rubles Thirty thousand bonds issued The coupon rate is determined by the current profitability of the GKO-OFZ market and is announced by the issuer seven days prior the placement Presently we envisage that the profitability rate will be equal to the GKO plus 3% annual interest

Initial placement is in the form of auction or OTC market Investment is made only into highly liquid market instruments which is determined by the maturity term and volume of issue Purpose, to raise funds for social programs, cover fiscal gaps, further development of the issue program Naturally, we cannot write in the prospectus that is the first pilot issue of our investment program

The loan is ensured by guarantees At the decision of the regional representative body the loan is fully ensured by the regional budget The next tranche of the issue of Novgorod bonds is made upon cancellation of the first short-term issue Its features are being determined The issue will be made in mid-1998 The volume will be much greater than 30 bln The maturity will be at least two years considering the favorable background

Why did we decide to tie the bond to the GKO profitability? Simple because there is nothing else to use as a benchmark While analyzing the concepts of other issues I encountered other approaches like three eighths of the Central Bank's refinancing rate or nine tenths of the interbank market rate All these indicators are non-market related and are subject to fluctuations depending on the political leverage Ultimately GKO are similar to these, yet, the basic GKO profitability rate to the cancellation is more market like of all those indicators available today in Russia

You may have heard that in Novgorod a surprisingly comfortable tax microclimate has been created In particular, foreign investments are exempt from taxes to the local budget until complete recoupment This does not give ground to forecast a sharp increase of revenues to the budget from taxation in the near future, which generally speaking decreases the chances of issuing the so called social bonds or public paper bonds mentioned previously, i.e. secretaries for raising funds to develop infrastructure projects like bridges

This leaves us with little space for maneuver, because speculative loans essentially are void of their basis Money should flow into the region for specific projects It is only due to the specific fiscal situation that it is impossible too borrow for infrastructure development It also means that it is actually possible to issue bonds for specific investment projects in the region

In conclusion I will speak about the problem that has been mentioned, namely, **lack of the legal base for municipal loans** We are working in the conditions of legal vacuum or close to that Our legal environment is very narrow which makes it hard on the one hand and easy to work on the other Still it is more hard than easy because in Russia there is no institution like securities lawyers or legal firms specializing on municipal and other type of securities Actually there are no specialists capable to provide such services

In Russia there is no underwriting in the western sense of the word There are no consortia, or companies that buy the issue from the issuer and speculate in the market All these are background problems and I believe we will resolve them, as well as other problems related to the backward system of accounting in the region

It is very hard to work in the regions, but our practice shows that it is possible to gain the assistance of the local administration if you choose the right strategy

Question Could you repeat what is the investment scheme of the issue? What is the calculated profitability?

Ivanov The investment scheme is very simple This is a short-term loan - six months - and the volume is small, so we have a very limited field for investment Most probably this will be investment in GKO and we hope to make profit in the OTC This is a reasonable decision Maybe we will review other investment options but the choice of more or less liquid securities is limited in the Russian market

Liquidity is the main requirement for such a short period Basic profitability was determined on the basis of indicators during the pre-sale research through interviewing the interested investors We wanted to know their expected profitability and we made our own analytical studies of the market and calculations

Presently we believe it is possible to place the securities based on the GKO profitability for the placement period plus 3% annual interest

I would like to avoid the subject of technology of stock exchange trading and trading operations You must know that profitability in the OTC market is much greater than the maturity profitability This is determined by the technology and methods of trading

Naturally, this margin becomes narrower With less profitability it is natural Nevertheless, it is not a big deal to pay 3% annual interest presently, considering the small scale of the loan

Yes, this is a loan for the sake of a loan To borrow in order to pay back We do not plan any losses Yet our primary goal is different from gaining profit from this security at the current stage of the issuance program

The primary goal is to establish a favorable reputation and credit history for the region A confirmation that the region is capable to pay on the bonds, timely, and to establish an infrastructure over a six-month period during which the bonds will be in circulation

Question what is the mechanism of fiscal guarantees of the administration?

Ivanov The budget of the region has a special item

Question Is this the only provision on this matter?

Ivanov Yes

Question You said that the first issue is aimed at establishing a good reputation in the market What are your long-term plans with the local administration?

Ivanov I can repeat once again, that as of the moment of cancellation of the first tranche the second will be launched, which is substantially larger, and longer The funds will be used in

specific projects in the region and will be developed and evaluated by an independent body outside the jurisdiction of the local administration

--- -- - I am afraid I cannot say anything more specific today because the documents have not been signed yet, although an agreement has been reached. We will probably hold a tender of investment projects in the Novgorod Region

Disclosure Of Information On Municipal Loans

Anatoly Levenchuk, FCSM

Good afternoon Ladies and Gentlemen I work as the coordinator of the FCSM Information Initiative It may seem strange at first glance why I am here to speak about municipal bonds instead of speaking about computers and other questions related to information technologies

The previous speaker mentioned some very good things like transparency, and openness Although information disclosure has not been mentioned yet, openness, transparency and subsequently reputation This was a very correct report and you may consider you have heard my presentation already

I would like to review the following question what can you do if you really need the money? Since we all present have gathered here only for this purpose In the case when there is only one person that needs money while all the rest have it this person would have said - Bring it here, - just like in the case of MMM Since only one collecting point was provided everyone who had the money brought it there

The situation has changed since then There is competition not only among those who carry money, but among those who want to get it A line of those who want to get the money has formed, just like the MMM line It is characteristic that in this hall there are more people who want to issue municipal bonds than those who want to invest There are those who want to urgently issue on behalf of one of the subjects of the Federation be it a municipality, rural council, etc , as long as the issue is called a municipal one The matter is that this market sector is not very well regulated and is still in the stage of wild development and not of industrial production Also it is good to make several issues of financial instruments for different time terms And if there are several political factions within a subject of the federation then it is preferable to have various securities from each faction so that everyone could have a share

This is when it becomes clear that those who carry money have a sudden option At the same time it has been said at this conference that **many issues of municipal securities are not so attractive that investors would invest without the slightest pressure from the administration** The following situation is typical an issue is made, then the banks are explained how much they need to invest and what they would loose in case they do not

Mr Levit, chairman of SEC, in his speech at the Conference on the relations between the US and Russian money markets, said that the cash amounts circulating in the Russian market are extremely small, and that real money should come to the market In other terms the difference is like that between the price of a ticket to a local amateur show and that to a concert of Michael Jackson He said that **three things should be established in the Russian market: first, information disclosure, second, power of FCSM to ensure order, third, establish a securities market infrastructure which is critical for development.**

I have been involved in infrastructure development for a long time and I have understood that the priorities can change rapidly Now I am involved in information disclosure I am not mentioning the powers that can be given to the Commission, because while the top echelon is idle the Commission is signing agreements with the regions like the one that was signed today

As a result if somebody is not working properly with the funds of the investors, legal entities, or administration, the local tax police will pay a visit to such person and explain to him on behalf of the Commission at the local level what can happen. In particular, what can happen for failure to disclose information at the corporate level.

On the other hand such issuers like the municipalities or subjects of the federation, and issuers at large who do not fit in the corporate framework are all the same from the view point of investors. And they all face the same question: how shall we return the money? When a neighbor comes to borrow a 'fiver' till next payday you know the neighbor should not be given money because there will be no payday and make a guess what the money is for. Another neighbor is creditworthy because there may come a day that I will ask for something special that he is not aware of.

The same refers to municipalities. When they come to us asking for money we want to know who is actually worth giving. Do you know that the most persistent are those who will never return the money. The case is worse when it comes to municipalities, because you lend money to one, but it is the other that has to return. And here we come to the problem of **succession of obligations**.

We wish that the promises of the issuers that are given personally be transferred to the institutional level. This can be done through information disclosure.

Information disclosure is a method of investor's self-defense. Ratings are a good thing of course. But the question arises **who allocates the ratings?** A person comes calling himself an independent party and says that this issuer has got it right, let's give him a high rating. Yet the investor is less ignorant nowadays. Some investors who are better off have specialists no worse than those working in the rating agency. And they would like to see for themselves whether to give 30 bln rubles for say a small part of the Penza issue or not. Or maybe it is better to give the money to the Yamal-Nenets issue, say 300 bln because they have oil there as a guarantee of returning the money. Also it is useful to know how the funds are used, and what the chances are that the debt is repaid. What was there before they asked for money? What are the taxes? What are the people that will manage the funds? All this information should be in the documents and subject to disclosure.

Notably the case is complicated outside the region. Everyone wants to make a local issue that is circulated in the entire country. One thing is when you borrow inside the region, and you have to pay from the same pocket. Another thing is when the issue is made in one region and the entire country is investing money to your region. It is hard to understand what goes on in Irkutsk if we are in the Sverdlov Region. And it is hard for a resident of the Sverdlov Region to understand if Irkutsk returns the money or vice versa. This requires a lot of correspondence.

What is the difference between the system of information disclosure and publication? The answer: try to find a local Sverdlov Region publication in Vladivostok. Nevertheless the system of information disclosure is a system by definition which brings information to all involved regardless of their objectives. It always amuses me when I hear issuers saying that they would disclose information only if you are an investor. They will show the issue prospectus and all other documentation. But if you are not an investor there is no disclosure for you.

Ideally you show information to potential investors so that they make their decision. Such investors would first read and then make the decision whether to be an investor or not. **Therefore the main requirement of the information disclosure system is to provide the right to access information not only to investors but anyone having interest to become an investor, because it is on the basis of disclosed information that he can make the decision to become an investor.** The system is a means of self-defense or a means of promotion whatever you prefer.

Therefore the information disclosure system must ensure that you will find the information. Just imagine there is a certain number of issuers N disclosing information and a greater number of potential investors M who want to have that information. The number of possible combinations is $N \times M$. It is practically impossible to ensure such links within the scale of such country. In theory there should be a hub point that handles all the information. This would allow to dramatically decrease the number of links to just $N+M$. Such a system is more simple and effective. The idea was to set up such a system for the entire financial market. But it turned out that the Central Bank chose its own direction, while Minfin its own. FCSM also decided to go its own way. There are no funds available to create such a large system, and we do not know how the system should look like.

A new document on information disclosure has been developed which will be available on the Internet next week. The information disclosure system will be different. As for municipal issues the disclosure system remains the same at the level of amateur performances, i.e. the non-professional level. But I must repeat once again that if something is amateurish, it means the price is also amateurish as well as the audience. But if we want to do something professionally we must pay for it. We should use industrial technologies for the funds will be of industrial scale, at the level of not just millions or dozens of millions but at an adequate level.

For the time being everything concerning municipal bonds is amateurish. I know cases when one of the largest issuers visited Minfin and asked if any report is required of how they were using the funds (it was a matter of hundreds of millions of rubles). They were told: Sure, but make it a one page document.

The same concerns issue prospectuses. As far as the format of the prospectus everything seems to be clear. But concerning what you can do with it, what type of reporting it envisages, consolidated reports, it is all unclear. Experts have a term: the vaults of Minfin. I believe many of you know what that means. It means that after having verified the issue prospectus for several times you bring it to Minfin only to be stored in the vaults where nobody will ever see it.

By the way we will disseminate information through the country only in electronic form because even inside one region it proves almost impossible to send paper documents which are routinely 'lost' by the post. Presently because there is no electronic system this information is collected to be never seen again. Correspondingly you will not see many of potential investors who knowing that you are a good guy would have given you the money.

I believe that reporting on the loan should be the focus of your attention. Otherwise if only the debt is recorded, but not the reporting on how you repay it, who will give you the next loan? None will lend you money although you still need it. Consequently, **you should disclose not**

only the issue prospectus, and announce your intention to borrow money, but also disclose information on how you plan to use the money and repay it It means that you will need to disclose the entire information, but not just the initial information. Unfortunately we do not see this happening today. I believe that we must establish such a system.

I would like to switch now to the subject of current status of disclosing information, because previously this information was stored in the vaults of Minfin. The Bank of Russia used to be in a better position because they were disclosing the register of joint-stock banks, and it was always possible to find full versions of issue prospectuses in the Internet. Presently FCSM is maintaining a database for daily access to registers. This is even better than what the Bank of Russia had. They had a monthly update of the database, effectively once in three months. Presently FCSM is daily updating the database from the UIF registers and the number of information fields will reach 30-40. Internet provides access to the pilot database on register-holders and independent registrars. A similar system has been installed for issuers.

Full documents (issue report, issue decision, prospectus) will be available as early as the end of this year.

I believe that this is our primary objective to ensure that at least by the end of this year the first version of the system will start operating, and although a limited amount of information will be available to the entire country during one day. I cannot tell when we will have a system on the municipal issue.

I hope for fruitful cooperation with the Ministry of Finance where the issues are currently registered. We would be able then to add to the existing information disclosure system a component on the registered issue.

I want to underline once again that information disclosure is not dissemination or publication of information. Disclosure is when information becomes available with limited resources. You might know how much money and time is required to search for information for instance on your Sverdlov issue or Vladivostok issue, or an issue of some rural location, or a municipality in some region. Whereas you might not recall the name of the region, or location yet what you recall is that the money will be used for construction of a children daycare center. The objective is to be able to enter the information system and within two-three minutes find all the issues made in the country where the money has been used to finance the construction of children daycare centers.

You would be able to use this information to model your own prospectus. Naturally you would receive information not in paper form, but as an electronic document and your rural council will be able to make its own bonds issue. This is a very convenient system of information disclosure, a so called inter-regional system on sharing experience.

I hope that the next version of the system of information disclosure will be better than the one operating in the US, and that it will bring no less money than the US system, because an effective system must bring no less than those operating in the international markets.

REGIONAL AND MUNICIPAL LOANS RATINGS

Analysis of the risk of obligation default and its effect on the price of placement Rating agencies, customers, and services Information necessary to determine the rating

Alexei Novikov, Institute for Urban Economy

Before I start speaking on the topic I would like to say a few words about the essence of credit ratings I would like to avoid trivialities, because presently there are many publications made on regional ratings Most of them have nothing to do with the credit rating of a region A large part of such publications are about the investment attractiveness of one or another region Quite often such definitions are getting mixed The investment attractiveness of the region, the possibility to get high profits in the region does not mean that the securities issued by such region will be a low risk investment

The Center of Credit Rating of the Institute of City Economy which I am representing, is involved in a very practical aspect of rating, evaluation of the credit risk on the obligations of the cities and regions in Russia Our Institute allocates credit ratings for such obligations

First, the **credit rating is allocated not to the issuer, but to the securities issued** It is often said that Russia received a rating or a region in Russia received a rating Russia received a rating in a sense only, actually only priority obligations of Russia received a rating, i.e. the debt of Russia which it will repay to the international banks and various financial and crediting organizations So, it is not a rating of the country, but only of its obligations

The same refers to the ratings of the subjects of the Federation and municipal units Thus, it is not them or their economic status, but their securities that receive a rating Sometimes rating agencies give a rating not to a specific securities issue, but the issuer, i.e. to all of his obligations, including pensions and lease payments This happens once in a while, and this is called an integrated rating, but once again, this is the rating of the obligations of the issuer, but not the issuer

Thus if the rating is low, it means that it is low not for the region or a city but only for the securities issue, which is not a big deal after all compared to the low rating of the whole region or city This is often a very sensitive question for politicians but in such case any worries will not be grounded

Therefore there is no credit rating without the rating of specific securities

What is evaluated when a credit rating is made? The rating evaluates the possibility of payments default on a specific obligation, and on the other hand the credit risk itself, i.e. the volume of damage which may be effected on such securities in case of non-payment There is an argument among different rating agencies over what exactly it is that they are evaluating the possibility of non-payment or the damage resulting from such

As far as I know the Moody's is oriented basically to evaluating the damage, i.e. risk proper Other companies may be oriented to the possibility of non-payment only

The rating scales provide for a high or low rating rather than good or bad There also is a different price paid for securities with a high or low rating and this is very important for the issuer There are also many investment institutions who buy low rated securities because

according to the theory of investment portfolios they need a certain share of high-yield high-risk securities with a low rating

What types of credit ratings exist? Usually we identify the **comprehensive rating** which evaluates only the securities in free circulation, and provides for the rating which is not only known to the issuer but published and is subject to continuous monitoring. There also exists the so called **opinion on the creditworthiness** which is a brief version of the risk assessment on such obligations and is often known to the issuer only.

I would like to dwell on the analysis of the **risk factors** which is dealt with by rating agencies or any institution interested in the analysis of the creditworthiness of the issuer. Concerning the subjects of the Federation and cities the main risk factor is the budget and related questions.

Speaking of the subject of Federation it is necessary to determine what budget is under scrutiny, the regional or consolidated. On the one hand if the region is the issuer then we should look into the regional budget. Yet, on the other hand, because the regional budget is part of the consolidated budget, and the Law on the regional budget sets the deduction from the main taxes to the budgets of local authorities and the regional budget (this is done every year in violation of the legislation which requires to do this once in five years) and if this is a long-term loan such deductions adopted by the legislative branch of the region can form an additional source of income for the regional budget.

In case of a long-term loan an additional source of revenues is found in the form of changed deduction rates from the main taxes. There is a substantial risk factor. It seems that we are on the verge of a new large tax reform and nothing can be guaranteed in this case. Everything can be changed by the Law on the financial basis of local self-government which has twice passed the Duma and has been twice rejected by the Council of the Federation. There are many other laws which regulate fixed deductions. There is the Decree of the President on the Tax Reform which stipulates that such deductions will be set for each type of taxes after the adoption of the Tax Code.

Thus, we are placed in a difficult situation when the federal legislation is being changed. Yet in the current situation the deduction rate for the main taxes, i.e. profit tax, VAT, income tax are set by the Law on the regional budget. Consequently, speaking of municipal bonds the case is more difficult because here we speak not of just the federal but region legislation as well. The city has no possibility to create an additional source of income through changing the tax deduction rate.

One of the main problems facing the rating agencies is the **method of accounting for budget revenues and expenditures and financial information**. Actually it is hard to say anything about the budget if you do not understand it. And often it is really hard to understand it.

The regions and cities often lack computers and the documents are provided in free format. Besides, there are no records according to economic classification, in particular, in the cities. While there is the functional classification of revenues and expenditures, there is no economic classification. It is difficult to specify the payroll share in the budget or the share of direct expenditures on individuals, capital expenditures, etc.

Although there are special forms filed for Minfin, but in effect it is very difficult to get such classification. In the case of a long-term loan it is desirable to have information for a minimum of three-five cities. In the case of a short-term loan it is desirable to have statistical information for the last 3-5 years and monthly statistics for the last 2 years. Such information is stored somewhere in the archives and to obtain it proves to be a real problem. Besides the data varies because the deduction rates are changed so often. Tremendous work is required to recalculate the budgets. And in this case it is essential work.

Another problem is the **dependency on the federal transfers**. There are many regions which do not depend on the transfers. The transfers comprise 48% of all free transfers of the federal government to the region. The rest are the non-controlled subsidies which are not registered. Yet even the transfers which are registered are divided into two parts: financial support and transfers which are counted as the share of the federal tax share of the VAT.

The larger the share of transfers in the regions which are provided via VAT the better for the regional administrations, because payments are made daily and, correspondingly, cash stays in the region. Less their share the worse it is because transfers from the fund of financial support come only with a two month delay, and sometimes later.

The first type of transfers that are VAT related has a very negative aspect. The federal government often uses this money that is on the so called cash free registers forcing the funds to be transferred to the federal Treasury, regional treasury, and payment of salary to the federal employees in the region. In this case the administration has no possibility to use these funds.

All this has to be considered in order to analyze the budget of the subject of Federation. Fiscal deficit is a special question. Regional administrations often say that their fiscal deficit is sometimes 30%, 40% or 50%. If you review the budgets of the subjects of the Federation you will realize that the fiscal deficit is no more than 1%. The matter is that when they speak of fiscal deficit in this country they mean the difference between the desired, planned expenditures and the actually implemented. This is unacceptable because the deficit is the difference between the real revenues and real expenditures. And this difference the deficit if it is financed through any kind of loans, although this is not a prerequisite.

Very often we have to verify the real situation. Many people cannot understand this speaking of the deficit as a difference between the desired and reality. Another important aspect is the **ratio of tax and non-tax revenues in the budget, as well as the ratio of current and capital expenditures**.

First, it is very difficult to identify capital expenditures, because they are often classified by their function.

Second, Capital expenditures by our definition do not correspond to the capital expenditures which could be, had we used the methodology of the international accounting system. If we apply IAS, capital expenditure figures would not coincide.

Thus, this presents another problem, and the western investor has to be explained. Ideally, non-tax income should coincide with capital expenditures, while tax revenues -with the current expenditures. This is often not the case, and no one makes such analysis. All this forms another risk factor.

Although it is very important to analyze the budget, it does not play an important role in analyzing the credit risk. Many other factors play a role. At the same time the budget can be misleading. For example, one of the major expenditure items is the housing and communal service. This item is responsible for 50-60% of all expenditures, 25% in the regions. These figures are not characteristic because there is a huge amount of cross subsidizing. The service rates for enterprises are much higher than for the residential sector, thus the population is subsidized from the enterprises aside from the budget.

If the share of the expenditures for the housing-communal service is low this is not characteristic either. This expenditure may grow very fast if the company is closed for strike. Just like it happened in the Ulianovsk Region. Such cases are numerous. We tried to clarify why in the Pskov Region capital expenditures are high. It turned out that none of the municipal enterprises of the city have capital expenditures, and they all have passed this function to the local budget.

Correspondingly, what you see in the budget often means little, and you often have to do more research. Another important factor is the **share of real cash proceeds from collecting taxes**. We have figures for 35 regions. The figures vary substantially from 35% to 95%. So if it is a seemingly balanced budget with diversified sources of income which also has 35% of cash proceeds from taxes while the rest is in money surrogates, you can make only one conclusion that such budget is unreliable.

A separate problem is the **narrow taxation base of the subjects of Federation**, cities, in particular. In the Novgorod Region we made a rating analysis and verified that about 39% of all taxes in the region and the city is collected from one enterprise - production association Akron, a large chemical plant. It turns out that the region is entirely dependent on the market of fertilizers. Therefore it is necessary to analyze this specific plant. Only then can you obtain a realistic assessment of risk.

Objects of investments financed through loans are a separate risk factor. I believe that there is a huge threat that city and regional administrations will turn into banks. They actually act like bank already. For example, an article was published in the recent issue of the Securities Market Magazine which describes the situation in Moscow. The department of municipal issues openly admits that it borrows money in the European market (about 500 mln dollars) and then lends it at a higher rate to various enterprises and projects. But this is purely banking activity. What has it got to do with the city administration? It seems that they do not understand that this money is guaranteed by the budget and should be used for social needs, like roads, bridges, engineer facilities, or in socially important projects which can also be very profitable. Tomorrow we will hear the presentation of Mr. Kopeikin on the social sector projects.

Thus this is the first threat that the cities and administrations are becoming banks. It is justifiable when the administration is trying to establish a credit history. Credit history is best established when small amounts are borrowed and duly returned to show that you are a solvent and reliable borrower. What happens now is absolutely unacceptable.

Second, is the issue of guarantees. This is where chaos reigns, because presently many cities and regions do not have any **credit history**. At best a very short history. A record of relations

with the banks. Very few regions have a solid credit history. Yet if you count the number of guarantees issued often to private businesses and the chaotic order of such issuance one can be horrified with the results of such study. At different estimates in some regions guarantees comprise 60% of budget revenues. Understandably, such guarantees may never be fulfilled. Nobody seems to think about this, and as a rule nobody makes a realistic assessment of financial and investment analysis of projects. Special ratings by the way are necessary for this. One of the most evident threats is the **issuance of budget guarantees to municipal or regional, and even business entities**.

Short-term loans are subject to **cyclical tax proceeds**. If the funds are transferred to the budget, and such bonds are guaranteed by budget revenues special attention should be given to the period of payments. If this is July-August, it is good, because this is a reliable period, but if it is September-October it is naturally bad.

I have left out some factors while I focused on the budget related issues. The most recent factor is the **rural bonds**. The risk is related to the limitations on borrowing which can be imposed by the Federal legislation. Such limitations concerning external loans have been imposed in Moscow, St Petersburg and Nizhny Novgorod. The entire annual debt should not comprise more than 30% of own revenues and be up to 15% for servicing the debt. Probably similar limitations will be imposed in other regions and subjects of the Federation. But they already have a debt in the form of rural bonds. In effect this will be the second limitation not a legal but natural. For example, Tatarstan has issued rural bonds worth 500 mln dollars. The Volgograd Region wants to get a credit rating and issue eurobonds worth some 350 bln. This amount is too large, but it is impossible to enter the eurobond market with some 10 mln dollars. 100 mln will be sufficient, but not 10 mln dollars.

We have a list of information required by the rating agencies. We collect such information in order to assess the credit risk on securities. Naturally we use general information which is published, but we are not guided by such information only. We prefer to go to the regions and work there for a lengthy period of time. There are many analysts relying on the information from the presidential network, or Goskomstat, and there is a great number of ratings based on such information. We believe that it is best to perform regular rating research which takes no less than two months and is based on the standards of the best rating agencies.

Alexander Yermak, Skate-press

It is difficult to speak after such a presentation because in your eyes I am one of those who is involved in developing rating products

We have distributed some materials. These are some ratings which we allocated to the regions on the securities locally issued. I would like to clarify that we used the publicly available information. Goskomstat and Ministry of Finance reports.

What concerns our work, we made an attempt to present the ratings not from the view point of issuer reliability or budget fulfillment, but the organization of the market as such. Credit rating is made of the obligations, e.g. eurobonds, under the preconception that the bonds will circulate in a highly efficient and organized market where such risks as the risk of the counteragent or the non-payment risk are minimal.

We used our own database to allocate the ratings. The database includes all the regions represented in the materials and reflects the history of placing, cancellation and the secondary market.

Generally securities are valued along three main criteria: reliability, liquidity and revenue. Concerning reliability there is the reliability of the issuer and market infrastructure in the region or where the securities are traded. This is one of the factors which is added to the evaluation of regional bonds.

Concerning issuers in addition to the reliability, fiscal indicators and financial status we also assessed information disclosure, including openness of operations in the securities market. We believed that the most open is the GKO-OFZ market when all issuer's actions are known which may facilitate the investors activities in the market.

Concerning liquidity, we paid special attention to the trading volume in the secondary market. For example, the volume of the second market over a six month period as of September 1, 1997 in St Petersburg, Tatarstan, Orenburg and Sverdlov comprised from 130 to 150% of the issue volume which was in circulation on September 1, 1997. As for the rest of the regions this figure is smaller. For example in Cheliabinsk, Irkutsk and Moscow it is 25-50%.

PRICE FORMATION, BOND PLACEMENT AND TRADING

**Global program of financing in the securities market
ratio of internal issues and Eurobonds**

Robert Devane, Troyka-Dialog Company

I would like to thank the organizers of this conference for the opportunity to speak to this audience, and primarily for the highly valuable and unique work they are performing in the market presently

I am representing the Troyka-Dialog Company This is a Russian investment bank which has been in existence for already 6 years operating in the Russian market from the time before the securities market was established, and there were no shares nor municipal bonds With the advent of these instruments work has been more interesting day after day

My presentation is a hybrid I will speak briefly about the municipal bonds, and a bit about the Eurobonds I will touch upon some legal questions I will raise some issues relating to the primary market, placement, and secondary market What happens after the placement of municipal bonds, and why it is important to know

Let us start with the first block of question, the Russian issuers The Russian market of debt securities is presently developing at a very fast rate During the last four years when the GKO-OFZ market was formed such were the only fixed income instruments available In particular, this was related to the economic situation because it was not easy and useful to issue, say, municipal bonds Although the first issues were made in 1992

In particular, this depended on the federal policy You must remember very well what the situation was like before the elections of 1996 when the market of government securities practically consumed all free cash It was impossible to compete with this market until recently Our last year analysis showed that practically all deposits of the population of the Russian Federation in all the banks were reinvested in GKO Yet these are very short-term instruments And investors were looking for the best opportunity to earn as much as possible But the situation was very difficult for other potential borrowers in the securities market And the banks did not want to give money and it was very hard to borrow in the market, although during the same time there were issuers like St Petersburg which borrowed funds in the local MKO market

The market is changing very rapidly Rural bonds are one of the indicators of such changes This market did not exist even just three months ago Its capacity is 3.5 trillion rubles This market is being criticized for low liquidity Indeed, today this market is not liquid but judging by the volume of this market it is going to be one of the major segments of debt securities in the Russian Federation Dealers must understand how they will work with these securities, prepare corresponding agreements, and explain to the customers the specific features of this market, etc The customers presently do not have information on the market, issuers, or risks Therefore the customers (not to speak of investors) are not very much interested in this market

Foreign investors have been very active in this market in the last few weeks And if you look at the history of the Russian market you will notice that foreign investors start investing into attractive instruments earlier than the Russian investors

We observe the same in the stock market, and the GKO market Today we see the same trend in the municipal and rural bonds markets Being a dealer, I can assure you that in the last month the interest of the Russian investors, not just the speculators, but real investors, has been growing

Concerning veksel I would like to say the following I believe that veksel have occupied a certain position in the market of debentures mainly due to the crisis in the economy during the last few years and lack of adequate legal provisions on advanced methods of settlement and fund raising I believe this to be a marginal trend And in the near future this market will correspond to the veksel markets in other countries which boast dozens of years of experience This will be a classic payments instrument used in commercial transactions Veksel must not be an issue instrument Its legal origin is different from the origin of the issue security although many Russian issuers have adopted veksel as an issue security

Presently when the interest rates are plummeting in the market as a whole, including the veksel market, I believe that veksel will separate from the securities mainstream and will be replaced by instruments that play similar role in the western markets This refers to short-term instruments, commercial papers, i.e. short-term GKO-type bonds Speaking of long-term securities these will be OFZ-type debentures (to a less degree with a variable coupon, and to a greater degree with a fixed coupon considering the stability of interest rates)

A few word about the eurobonds Please raise your hands those who view the issue of eurobonds as a serious matter I am glad to see only a few hands, because if I saw many hands I would get scared

Presently in Russia there is the 'fashion malaise' One or another financial instrument or transaction, or structure becomes trendy in Russia from time to time This happened to ADRs ADRs are in the plans of almost every Russian company from the smallest to the largest Unfortunately, this is not appropriate for some of the companies, and is even unnecessary

Presently, very many issuers want to issue eurobonds To my mind this is a question of trendiness **Eurobonds or other similar instruments are appropriate for a limited type of companies, this is far from the best instrument to give the issuer the less expensive and manageable resources**

I would say even this Comrades beware of advisors Along with the fashion for certain financial instruments in the Russian market there is a huge number of persons who claim that they are consultants and experts, which is characteristic of any other economy in the post reform period

Such consultants include a very small number of those who can be considered true experts Unfortunately there are too many adventurers in the market That is why in the stock market brokers have a rule Know Your Client The consultants services are expensive and require a lot of attention and involvement Your consultants represent you in the very important market segments, in particular, those who represent you in the external market

When you hire consultants you should consider not just your impression of them but that of your counterparts If these are US, British, French or other country consultants you should

The second class of municipal securities are **revenue bonds**. They are attractive to the investor because they are high yield bonds from the view point of revenues which the issuer receives and collateralizes to secure these bonds.

Let me explain the difference between the general obligations bonds and the revenue bonds. Revenue bonds are used for financing specific projects. For example, the issuer needs to finance the construction of an airport. The issuer borrows the money, invests it in the airport and says that he will repay the debt from the proceeds from the implementation of the project. If the airport project fails, neither the issuer, nor his budget and property are involved. What is involved is the cash flows or income from this specific project.

Another example of such financing are the higher educational establishments, hospitals, housing projects, and plants. There are schemes which provide for municipal entities to finance the industry by the issue of municipal bonds. Such projects include the sewage, river and sea ports, sports facilities, roads, bridges, and tunnels. This is a separate class of municipal bonds and from the view point of risk and the method of market trading.

There are also the so called **double barrel bonds**, which provide for a combination of guarantees. The issuer guarantees the securities not just by its budget and the capability to collect taxes, but also by certain property or enterprises. Such securities are ensured by the cash flows of such enterprises.

The structure of debenture securities (from the viewpoint of the period of cancellation) in the USA and other Western countries varies from the short-term T-bills to long-term thirty-year securities.

In the American market there are many various financial instruments. One can find securities with a fixed coupon, variable coupon tied to a certain rate. There is a great number of municipal derivative instruments, but for Russia it is too early to consider such.

Speaking of the eurobonds, the Russian market is very young. As you know there are three municipal issuers in Russia today: St Petersburg, Nizhny Novgorod, and Moscow. I believe that there will not be many more municipal issuers in the eurobonds market. That is very good because this is a very great risk for the country, the issuers, and for the market in general.

According to Article 73 of the Constitution the subjects of the Federation possess full state power with the exception of the authority of the Russian Federation. The question of borrowing in the eurobond market or any other foreign markets must be agreed with the Federal government because external economic relations are under the jurisdiction of the Russian Federation. Coordination of international and external economic relations of the subjects of the federation is in joint authority of the Federation and its subjects. Concerning the issues made by Moscow, St Petersburg and Nizhny Novgorod a special decree of the President was signed stipulating the procedure of the issue. This represents the agreement of the federal government and the subjects of the Federation.

A number of articles of the Civil Code provide the legal base for the existence of municipal bonds. If you review part one of the comments to Article 143 of the Civil Code of the Russian Federation you will see that the Code refers to three types of bonds: government, municipal and those of legal entities.

A positive aspect is that internal issues are largely in your jurisdiction (local government) They fall under your jurisdiction and a number of agreements between the subjects of the federation and the government of the Russian Federation create a precedent, including the agreement between the Republic of Komi and the Russian Federation, which provides for the Republic of Komi to pursue its own policy as regards internal issues

In order to have the right to place your internal bonds you do not need to obtain any kind of permission from the Federal government The issuers, subjects of the Federation, are required to prepare local regulations to hold a proper issue according to market, local and federal legal requirements

A few words about the **US legal base** In the USA there are two cardinal laws the 1933 Securities Act and the 1934 Stock Exchanges Act These Acts stipulate strict requirements to issuers considering placing their securities in the USA For example, the 1933 Act prohibits public offerings and sale prior to submitting registration documents to the US SEC Upon submitting the documents the issuer can make only verbal offerings The issuer cannot send written offerings The issuer can send out copies of the registration documents submitted to SEC The issuer cannot sell prior to official registration by SEC, etc

The US market is indeed strictly regulated There also is the 144-a Rule adopted 10 years ago It allows foreign issuers to make closed offerings of securities for subsequent trading

Why was this rule adopted? The 1933-34 Acts were adopted during the years of the Great Depression and the State decided that it was necessary to protect the investors from such failures Closer to our times the state became aware of the substantial number of large professional participants which are capable to adopt investor protection measures without the help of the state

And so Rule 144-a was adopted which allows to sale securities to the qualified institutional investors Such are either investors which at any time hold securities worth 100 mln dollars or professional brokers in the securities market that hold securities worth 10 mln dollars

The meaning of this is that it is possible to make placement of non-registered issues (such include eurobonds) among large American investors Yet the Euromarket exists for two reasons after WWII large dollar deposits were established outside the USA and that money had to be used somehow, and, in particular, it could be used in the eurobonds By the way the Soviet Union became one of largest depositors of the eurodollar starting from the 1950, and we can speak of the influence of the Soviet Union on the formation of the Euromarket

Eurobonds are bonds which are placed outside any specific jurisdiction, therefore no one regulates them There exist standard requirements as to the legal procedure of issuance Such bonds are regulated by the local country legislation Anyway the absence of registration requirements considerably simplifies the placement process

Concerning listing of eurobonds it is rarely done in the USA because this is entirely an OTC market There is a listing procedure at the New York Stock Exchange The trading volumes are very small on such bonds compared to the OTC market, and largely speaking no one needs

this and often this is a formal procedure to allow the issuer to say that indeed his securities have been listed at the New York Stock Exchange or any other Exchange

Notably, certain European investors according to their Charter have the right to buy only listed financial instruments. Therefore often eurobonds are listed at the Luxembourg or Dublin Stock Exchanges, where nobody really is trading in such, still formally they are listed there. In reality such bonds are circulating in the OTC market

Let us now focus on our problems. **First, the objectives of issuers in the sphere of issue regulation.** You must adopt a corresponding legislative base in order to properly structure and register the issue and subsequently effect the placement. I must say that communicating with the legislative bodies is a complex process which requires a lot of explaining

The most difficult part is to explain that certain things are hard to forecast accurately until the time of securities placement and explain that this costs money and that money is needed to attract specialists to prepare the issue and placement. Besides, all this is psychologically hard to accept

Nevertheless this has to be done. It is very important to establish a very good **information disclosure procedure.** For me as a professional market participant this is one of the greatest problems - to get information from the people or organizations which seemingly are required to provide it as soon as possible

A few words about the preparation of the report mentioned previously. Our analysts had problems in communicating with the regions because the issuers did not wish to, they refused to respond or provide information. This ultimately worsens the situation for issuers themselves because **failure to disclose information by the issuer means that the market is becoming more suspicious concerning them and the issuance becomes a more lengthy, complicated and costly process.**

As I said in order to register an external loan the consent of the Federal Government must be obtained. Today, quite understandably the government is slow in permitting external loans of the subjects

Concerning internal issues such permission is not required. Nevertheless, an issue should be held timely, correctly and precisely. There should be the decision of the local legislative body on the upper limit of the issue, the decision of the local executive body on adopting the municipal bond issue prospectus and its terms, the decision on adopting the issue prospectus, the decision on the participants, procedure of implementing the issue

In this process the issuer should be assisted by professional securities market participants. I am saying this not for promotion of my own organization, I call on you to review all professional assistants and select on your own judgment from the securities market participants. I strongly believe that a substantial number of issuers are doomed to fail if they continue 'inventing the wheel' every time. Therefore I call on the issuers to use the services of professionals who communicate with market regulators, customers, colleagues, and moreover they know the defrauders and how to deal with them

Generally speaking the **selection of your professional assistants is the key element of successful financing through debentures**

Remember that the market has a deep memory. The market remembers the failures. And mistakes. And if the issuers come to the market for the first time and the market does not know them - the first impression means a lot. If the impression is positive it is naturally good. If the impression is negative the issuer will have to work hard to overcome it.

The issuer has to understand the timeframes and costs of his work with the consultants. The issuer should understand the timeframe of developing the program. The issuer should be able to ask the consultants questions and in case of objective answers accept such answers and disseminate them to his counterparts at the level of issuers. The issuer should have a clear understanding of the program.

Another important question is **the cost**. There is nothing free in this world. If something looks cheap it is probably not what you want. Any issuer should understand that he must finance the issue preparation program to ensure that everything is done properly by the professionals. Professional expertise costs money. Those who offer free consultations probably are worth the same.

And finally it is the process support and **playing by the rules**. We as an organization prefer to work with those issuers who are dedicated to the process, who facilitate the process, because we both understand our common cause.

Main participants. I have described in detail the role of the **leading manager**. This is your main consultant, friend, and comrade. It is the professional securities market participant who must see every aspect of the market. He will try to advise you. He will stand for your interests, and search for a compromise to ensure a long-term borrowing program.

Legal advisor. This notion is not common to Russian practices presently. The role of the legal advisor is in verifying (1) the right of the issuer and legal grounds to make an issue, (2) is the issuer properly prepared? Has the issuer adopted all necessary normative documents and is he complying with the federal or other legislation? (3) Are the bonds adequate guaranteed? In the USA it is simply impossible to issue securities without an objective legal evaluation made by a well-known professional firm.

In Russia there are no firms or record, which poses a real problem. There are only a few firms that are at least known. It is impossible to state that such and such firm is well known in the securities market, and is respected and whose opinion is counted with. Such firms must be introduced.

Last week at my company we had a debate during the organization of a municipal bonds issue, whether we should make a step forward and provide independent legal assessment, despite the fact that such is uncommon in Russia. I believe that we should do this.

Concerning more complex loan schemes the question of independent legal assessment becomes more important. When you switch from the level of discount MKO- or GKO-type securities to more complex transactions, such legal assessment becomes more important, because the number of various legislative acts and regulations, including conflicting legislation, can be

great For example, we are currently reviewing two interesting versions One is the issue of municipal bonds by a region that wants to finance the number one enterprise in the region

A substantial block of shares of this enterprise is state owned We are currently reviewing the scheme according to which the state will transfer its block of shares as collateral for this issue As you may understand, a number of legal questions will arise that need to be verified

The second scheme provides for ruble denominated bonds indexed in hard currency Such bonds can be very interesting for non-resident investors who wish to accept the currency risk Actually this can be a very interesting hybrid between the acquisition of eurobonds which are few and are relatively low-yield bonds and the acquisition of Russian bonds which carry substantially more risk

A few words about the **rating agencies** There are three leading rating organizations in the world the Moody's, Standard and Poor's in the USA and IBCA in Europe They provide an analysis of issuers long-term securities and allocate ratings Such organizations have existed for many years They possess very rich experience They have very many qualified personnel Their staff has a profound understanding of the subject, it has experience, resources, and structure The ratings made by these companies have proved their reliability many times which is confirmed by statistical data on ratings and non-payments by issuers who received such

In the western market where there are thousands of issuers (and issuers may have many issues) ratings are widely used In the Russian internal market such practice is not available There are several agencies working in Russia which collect and analyze data, including the Skate, AKM, Rosbusinessconsulting Some of them are starting to make ratings

Unfortunately, the problem is that Russia does not have any rating record and often it is unclear what such rating can tell us Besides, market participant (investors, dealers, and speculators) are not used to such ratings

What is on the agenda currently? The rating agencies can continue making free ratings as long as they are capable to do so Yet I do not see any economic effect from obtaining a rating presently

Listing This is the most important part of my presentation For lack of time I will omit the eurobonds I already said that this process is formal, because this market is all OTC I will speak about internal Russian bonds Presently there is a substantial number of issues Where are they all? Who works with them?

Historically, each issuer tried 'to invent his own wheel' Unfortunately this is the wrong way to go In Russia, just like in any other country there are several large financial centers There is space in the regional trading floors But if each issuer tries to establish his own exchange, trading system to make trades in his own bonds this will not be an organized market but chaos

Presently four trading floors can be considered useful for placing municipal bonds First, the **Moscow Interbank Currency Exchange** which has a great deal of experience, good technology, a respectable group of participants, and is very rich At the same time it has dealers who have been working there for a long time and it will be easy for them to accept one more security provided it is listed in this Exchange

Second, the **Moscow Stock Exchange** This is a relatively new Exchange This is a serious organization with serious plans Just like we are the dealers of MICEX we are the cofounders and dealers of the Moscow Stock Exchange We have been working with this Exchange and we know about their attention to working with the dealers, understanding of the stock market, vision of their future and the process of implementation of their objectives

The Moscow Stock Exchange as you understand, has very important political and financial support That is why this exchange is the only exchange in Moscow that can potentially compete with MICEX I believe that this exchange will exist in Russia for many years

Third, the **St Petersburg Currency Exchange** This exchange is outstanding and is becoming an alternative to regional issuers During the next step the Leningrad Region will join the listing in this Exchange

Four, the **Russian Trading System**, known as RTS Why did I mention RTS? Bonds are quoted in the OTC market all over the world, in particular, the USA Russian bonds will too be quoted in the OTC market The GKO market is moving away from the primary market at MICEX towards OTC where MICEX will perform only the accounting and clearing functions

The only significant OTC trading system in Russia is RTS, which has experience, technology, a circle of dealers, and investors operating in this market Today it is the market of stocks, but I am assured that this market will become balanced and will accommodate stocks, bonds and derivatives

Answer to a question about spreads

Devane They will continue I can give you a more detailed forecast The spread on Russian eurobonds is still 300 points above the US debentures of the same term

If you take a look at other developing markets used by the world community as indicators of the same type of assets you will see that spreads vary between T+100 to T+200 If you take a look at the credits of other countries like Mexico, Brazil, or Argentina, you will see that the spreads on Russian bonds can decrease It can decrease not just by 100 or 200 but more points over the US federal bonds This is something that we can really expect to happen within the five years that you mentioned

In some 20-30 years we can expect that Russia will be even more creditworthy and enjoy a AAA or AA rating and be traded with a corresponding spread

Devane Today the profitability curve of the internal debt exceeds the year 2005 This happened in 1997, i.e. in the beginning of 1997 we did not have such indicative curve with the exception of OFZ Russia plans to start the placement of bonds with a ten year maturity, i.e. OFZ with a fixed coupon Russia is planning to start the placement of long-term bonds in 1998 This will depend on market conditions, probably it will be 20-30 year bonds

In the internal market it is still too early to speak of 30-year bonds, because the market is not ready for this Russian investors find it hard to adopt to 5-7 year bonds Such are bought by non-residents because they seem to be the most promising

During the next five years we will possibly see Russian securities with such a term of maturity
Not to mention that in 1998 we shall see the first euroruble as an international currency and the
eurorable instruments as euromarket instruments

The Initial Placement of Municipal Bonds The Interaction Between the Initial and Secondary Market

Liudmila Urskova, the Moscow Stock Exchange

I will say a few words about our Moscow Stock Exchange (MSE) It was founded on February 20, 1997 and the first auction took place on July 1, 1997 As you can see, it did not take long for the Exchange to start working At present 105 trade members and 178 members of the Exchange are accredited at the Exchange

These trade participants include major Russian banks, as well as average and small ones, e g , the extremely diversified structure of the stock market is represented on our floor And this also applies to commercial banks and investment institutions

The bonds of the Moscow Government Internal Loan and corporate papers are currently the basic financial instruments in circulation on the Exchange The following corporate papers are traded on the Exchange RAO Gazprom, RAO EES Russia, the Russian Savings Bank, LUKoil, Rostelekom and Dalenergo As of today, our third-level listing includes 18 corporate issuers

As for municipal obligations, MSE began to participate in initial placement auctions starting from the eighth auction The Committee for Municipal Loans under the auspices of the Government of Moscow has held 25 auctions Close to 65% of the funds raised by the Government of Moscow were placed at the 18 auctions held at MSE

And now I would like to say a few words about *the role of trade organizers in creating an initial and secondary municipal bond markets and the assistance it can and must render to issuers* The history of the market of municipal and regional papers in Russia shows that the effectiveness of an issue depends greatly upon the securities market infrastructure that has been established in a region Perhaps, today there are no longer such regions that lack any kind of infrastructures, but these infrastructures may be at different development levels

That is why those issuers who, while preparing an issue of their debt obligations, took into account the status of the local securities market infrastructure were able to provide themselves with liquid securities markets during quite a short period of time A liquid market considerably increases the investment attractiveness of papers

What does a regional securities infrastructure give an issuer that wants its papers to be placed, to circulate and to be repaid, but under the condition that it is modified in regard to the terms of one or another specific loan?

First, the law does not specify a strict limitation of securities circulation According to the Civil Code every owner of a security has the right to use it, dispose of it and own it That is why without even strictly limiting the circulation of its papers, but offering a ready infrastructure as an alternative, the issuer can considerably decrease the cost of the servicing of debt obligations for the security market participants and can also decrease the risk of investors in dealing with these papers

Second, this also reduces the issuer's overheads connected with the servicing of the loan, and this is quite important

Third, the issuer experiences the least possible administrative pressure on its loans and also has a chance to put its new debt obligations on the market in the shortest possible period

Fourth, the trading, depository, clearing and leasing systems that are used during the stage of mutual settlements on concluded deals guarantee the execution of these deals to the investors, and this considerably increases liquidity

Fifth, the issuer is able to influence the market of its debt obligations through a system of authorized professional participants in the securities market within the framework of the used infrastructure

This makes it possible for the issuer to integrate the internal regional market of its debt obligation into the interregional market, which considerably expands the range of potential investors and facilitates the raising of funds on more favorable terms

Unfortunately, during the stages of preparing an issue, and establishing the rules for the issue, circulation and redemption of bonds, not all issuers realize the importance of the secondary market. Most of the attention is paid to the infrastructure of the initial market. To my mind the initial and secondary markets are two components of one living organism. It must be understood that any fault in one of these components will immediately hit the other one by ricochet.

The issuers' attention to the formation of a liquid secondary market of their bonds will help to solve many problems of their initial placement. The professional approach of the issuer to such questions as the establishment of an infrastructure, the design of flexible term of the issue, circulation and redemption of bonds becomes evident at the stage of the establishment of the initial and secondary markets of debt obligations.

As a rule, at the initial stage of the issue issuers of municipal bonds are now trying to set up a system of a strict regulation of this market, depriving themselves of a possibility of introducing any changes in the future. It is absolutely impossible to anticipate and take into account all possible future faults. These will be revealed after the market takes shape and relevant changes will have to be made when the market starts working. That is why the words of the previous presenter are very important. I am referring to his words about the right choice of a general manager which will be consulting you.

Practice has shown that the very fact of consulting, not only with the general manager, but with the professional participants of the stock market has a positive impact on the professional solution of these questions. I think that the practice of the Moscow Government municipal loan has shown the positive impact of involving trade organizers in the preparation of the loan. At the first phase, when the issue was only planned, practically all trade organizers and all exchanges were involved in this process. And I believe that the active consultations of the market participants interested in its future development helped to complete all the necessary paperwork on time.

One of the questions to be solved by the issuer is the *choice of a method of holding initial auctions*. I shall stop at three basic methods that are most commonly used in Russia.

The first method implies the participation of the issuer's authorized dealers in initial auctions. In other words, the bonds are placed through a system of authorized dealers. This method is usually used when issuing short-term bonds of the GKO (Short Term Government Bonds) type. The main good thing about this method is that the agreement between the issuer and the dealers allows the former to control the establishment and the development of the market. It is normal practice when the requirements to the dealers' activity connected with the initial placement auctions are outlined in the agreement between the authorized dealers and the issuer of municipal bonds. Some issuers establish criteria in regard to the secondary market. Although I think that the issuer is only entitled to do this in regard to initial auctions.

The second method is when the initial placement is done through a system of underwriters. For example, coupon bonds of a savings loan are usually placed by the use of this method. In the case of an issue of a savings loan for the population, it might be best to combine a placement through a system of underwriters with a placement through agents (working on commission). In this case agreements are concluded with authorized representatives (underwriters) for the placement of a part of the loan. Thus, the underwriters guarantee a buyout of the loan from the issuers and its placement in the future. Another option is when they take a part of the loan on commission on certain terms and place the papers on the initial market on behalf of the issuer.

Trade organizers may be very useful to the issuer in regard to loans oriented both toward exchange and non-exchange markets. Since these markets are not limited, i.e., they allow a circulation both on an exchange and non-exchange markets, we, as trade organizers, are ready to offer our services to these authorized agents. And we do not limit their actions. But the issuer, as the owner of the bonds, is the one to decide who will use the exchange infrastructure for placing the loan. On the other hand, this requires a specific procedure, coordinated both with the exchange committee and the participants in the auction.

Now I would like to speak about the infrastructure of the MSE. There is a number of standards concerning the infrastructure: the presence of a trading system, a depository system and a clearing system. In regard to the presence of these elements all stock exchanges are basically the same. However, the clearing system we use for cash and paper transactions is not used by any other stock exchange in Russia, although this system of settlements based on limits is used in many countries of the world.

I would like to speak about it in greater detail. Unlike the other exchanges we do not have only one bank for clearing payments. Our clearing system consists of a group of members. These include 12 banks which have signed agreements with the MSE and with the Bank of Moscow (which is the clearing bank) on servicing the deals of our trade participants.

The members of our clearing system are the following: Gasprombank, Savings Bank of Russia, Dialogue Bank, Incombank, the Moscow Bank for Reconstruction and Development, National Reserve Bank, Olmabank, Promradtechbank, Russian Credit, SBS-Agro, Unicombank and Most Bank. The procedure for including a new member in the clearing system is quite complicated and requires the unanimous consent of all the other members.

The system itself is based on the following. All the members of the clearing system keep their accounts in the clearing bank, i.e., the Bank of Moscow. The exchange establishes limits for every bank, i.e., which is actually a line of credit. This is the maximum amount of liabilities a bank can assume. There is also a fixed minimum balance amount for the correspondence accounts of the clearing bank.

This is the first level of the system of limits, i.e., the exchange establishes limits for each member of the clearing system, while each member of the clearing system establishes limits for our trade participants and is fully responsible for the performance of their transactions.

It must be noted that the limits for the trade participants are established by the bank and on the basis of this multi-lateral agreement the given member of the clearing system is responsible for the fulfillment of all these obligations. In effect, the members of the clearing system act as clearing banks.

What are the advantages of such a system? If the trade organizer has only one clearing bank, in this case the latter enjoys extensive powers and is able to dictate its conditions of servicing our participants. In our system there is competition and each bank is compelled to offer more favorable terms.

Besides the fact that the trade participants have a chance to choose a bank which they think is more reliable, the banks compete among themselves and thus provide more favorable conditions for servicing our trade participants. And all responsibility for the fulfillment of deals is assumed by the members of the clearing system.

Trading is always fraught with two kinds of risk: trading risk and the risk of unfulfilled liabilities. As for the trading risk, all such risks at our exchange are covered by the institution of market-makers.

The functions of a market-maker at our exchange are somewhat different from those at the majority of exchanges where market-makers only act as dealers. At our exchange market-makers are responsible for maintaining the market's liquidity.

Our order of trading allows market-makers to provide technical crediting on securities and funds. Crediting by other trade participants considerably increases the market's liquidity, but gives rise to trading risks, since those who accept credit may not fulfill their liabilities.

That is why in this case market-makers have another obligation: they must cover those open positions that have not been closed by the trade participants on the technical loan.

As for the risk of unfulfilled liabilities, it always exists. That is why permanent participants in the securities market and issuers will, probably, turn to that floor on which the trade organizer will offer the most effective system of guarantees.

In our scheme we have a guarantee fund which will cover losses connected with unfulfilled liabilities. And there is also a well-developed system of penalties and responsibilities for unfulfilled liabilities.

I will say a few words about depository services We have an authorized exchange depository - the Depository Clearing Union (DCU) - which services our trade participants The other depositories are associate members of DCU I would now like to proceed to your infrastructure and to ways and means of adjusting it to our floor For example, have your regional loans work on our exchange _____

For this it is enough for the depository that services your loan or the depository that is the trade organizer's nominal holder of a given loan to be an associate member of the DCU

As for clearings, here we can integrate only in regard to those banks which are your general managers or authorized loan dealers, or your clearing banks Since we have quite an extensive range of banks - 12 banks - I am sure that we could integrate our clearings through at least one of these

Speaking about the secondary market we must not forget about the initial market We have an extremely flexible system of initial auctions at our exchange and this means that we do not establish a strict order for every initial placement Each issuer is provided with its own trading order in accordance with its documents and the auction is held in accordance with the issuer's own rules

The Subfederal Securities Market

Alexander Krupkin, ZAO AVK

ZAO (a closed joint-stock company) Alexander Kostikov and Partners is the general agent of the St Petersburg loan and the Orenburg Oblast Administration loan. A lot was said today about *the problems facing the regions during a bond issue* and I would not want to repeat this once again. I will speak mostly about *how these problems have been solved on the example of the Orenburg Oblast Administration loan*.

In the summer of 1996, the Administration of Orenburg Oblast asked our company to assist it in the issue of a bond loan of 1 trillion rubles. After conducting a study of the financial situation, the market infrastructure and all relevant characteristics of the oblast, it was decided, jointly with the administration, to introduce these bonds to one of Russia's financial centers, in this case St Petersburg.

This was done because, according to the Central Bank information, the balances on all the oblast's accounts comprised not more than half of the amount required by the issuer. Besides, at the time only eight local banks and four investment companies were realistically operating in the oblast.

It was obvious to the administration that the placement of such a loan exclusively within Orenburg Oblast was impossible. At the same time the administration realized that the promotion of the bonds to the St Petersburg market with its well-established infrastructure would considerably decrease expenses connected with organizing and servicing the loan, since that market was perhaps the most technologically advanced market among all Russia's markets of subfederal bonds.

Thus, it was decided to bring the bonds to St Petersburg. In the process of this work we were faced with the following problems which may, most likely, face any administrative unit of the Russian Federation.

Together with the administration it was decided to use the scheme which had existed and still exists in St Petersburg, in other words to use all the structures that service the market of St Petersburg bonds: the St Petersburg clearing and depository center (which is one of the first six organizations to which the Federal Commission for the Securities Market (FCSM) granted a license for this type of professional activity) and the trading systems (St Petersburg Currency Exchange and the St Petersburg Stock Exchange).

The clearing system of the St Petersburg loan was used. At first this was done on the basis of Account #135 of the St Petersburg State Department for Managing Securities under the auspices of the Committee on Finance which is now the St Petersburg Clearing Center. The use of the main clearing system of the St Petersburg loan made it possible for Orenburg to sufficiently cut its costs connected with the loan.

The Orenburg Oblast Administration decided to use as dealers those investment institutions and banks which operated on the St Petersburg bond market. These financial institutes had accumulated extensive experience in working with bonds and this helped the Orenburg

Administration minimize the risks that may have appeared when working with financial institutions lacking such experience

Another advantage of St Petersburg's current system is that it has a system of investor rights' protection. This issue was widely discussed in many regions of the country, but not much has been done there in this direction. In St Petersburg this system was based on a depository system in which dealers keep their own subdepository records. The same records are kept by a centralized depository which gives the issuer a chance to keep tabs on both the dealer/subdepository and the loan depository.

Thanks to this system, all investors retained their securities and had coped with this difficult situation without losses (all of you must remember the mass bankruptcies and folding of banks that were active participants of the GKO market and, in particular, Tveruniversal bank and many other St Petersburg banks).

One of the main problems in organizing a market for Orenburg bonds was the fact that the issuer was located far away geographically from the market where the bonds were placed. Thus, a new link appeared on the St Petersburg market: the so-called paying agent.

A paying agent is a bank which controls the flow of payments connected with the servicing of the loan which and provides clearing services to the issuer both in Orenburg and in St Petersburg. Besides, on the basis of an agreement with the issuer the paying agent may provide credit resources to the issuer for covering minor paying gaps and serving as an additional guarantee of timely redemption.

Therefore, this scheme allows to minimize operational risks, excluding the appearance of mistakes on all stages of debt servicing. It is also important that this debt servicing scheme has no additional risks caused by the participation of different organizations that service or manage the flow of payments.

The choice of a paying agent is extremely important in the process of preparing such a loan scheme. Since the management of the flow of payments is one of its main functions it must have a well-developed interregional system of payments. The sooner the money of the issuer is transferred to the market and back, the lower the risk connected with the management of the flow of payments.

Another factor that must be taken into account are those credit risks that can be brought into the loan system by the paying agent. The nature and size of these risks depend on the specific scheme of the market participants' interaction, and that is why there are no strict eligibility criteria for paying agents, however we, as market organizers, had a clear understanding that this should have been one of the leading Russian banks and, at best, one of the twenty top banks. Thus, the Savings Bank of Russia (Sberbank) was chosen for the Orenburg loan.

The issue scheme of the Orenburg loan was basically the same as that of the St Petersburg loan. There is the American auction system in which the issuer, at the first day of the auction, receives full information about the demand for his papers and makes a decision on the rate of the return of his bonds or on the clip price at the auction.

The auction procedure is as important for the issuer as for its participants. The issuer must have the possibility to more or less accurately plan the amount of the auction receipts and promptly receive financial resources raised during the placement.

In particular, Orenburg receives its resources on its budget accounts on the day following the day of the auction in St Petersburg. This means that the systems of quotas that exists for authorized dealers participating in the auction serves as a guarantee of the placement and a quick transfer of the funds received by the issuer. At present, the quota is 1% of the amount of the auction placement for banks and 0.3% for investment companies.

It must be taken into account that the funds are reserved on the clearing system accounts beforehand, i.e., before the auction. This is a strict observance of the principle of delivery against payment. It means that the costs of the dealers connected with the diversion of funds also play an important part and, naturally, affect the price of borrowing.

Systems without prepayment are much more risky and fraught with more expenses than the system that is used in St Petersburg. This is because the buyer receives the papers for ownership not on the day of the placement but with a delay which may sometimes be quite considerable. In a number of systems this delay may be one or two days. However, for the present-day market this quite a long period of time that causes lost profits for the dealers. In St Petersburg the clearing system for dealers transfers funds to secondary trading or to an auction the same day.

During an auction it is important to ensure just conditions for all participants. Any suspicion concerning the correctness of the procedure of establishing the price may affect the size of the demand for newly-placed issues. In our system of auction procedure control information is distributed among all the trading systems (exchanges, the general agent and the issuer). This provides just and equal conditions for all participants.

Not only the issuer's need in funds is an important factor of the price formation. The issuer shapes its financial policy proceeding from the market situation and market forecasts. That is why such an important role is played by the choice of the general agent and the communications support it renders to the issuer, providing information on the market situation and its development prognoses.

In St Petersburg there are both an initial market in the form of auctions and a secondary market which is one of the most active ones in Russia. Trading transactions on St Petersburg and Orenburg bonds take place twice a day, the total time of a session of 2.5 hours and by the size of their return they are the first among all bonds of the RF administrative units, excluding, naturally, GKO and OFZ.

The main risks connected with the work on the secondary market are operational risks, i.e., the risks of the banks which service the clearing, as well as the risks of the counterparts of the deal. The use of a clearing system and the distribution of control among credit risks, as well as an observance of the principle of "delivery against payment" among the clearing system and the trading scheme allowed to create such a system which actually eliminates the risks of the counterpart and the clearing banks.

The trading and clearing systems that are used ensure an efficient management of the securities portfolio at a minimum cost. The trading is done through an electronic system and the dealer has a chance to promptly respond to any changes in the market situation and to participate in the trading from his office, this helps to evaluate the changes in the situation more effectively and makes it easier to process client requests.

Inadequate communication is one of the main obstacles in forming a secondary retail market. A lack of reliable information on the market causes additional difficulties in managing the securities portfolio. Both dealers and their clients must be able to analyze the portfolio and market dynamics and perspectives. This is necessary for the formation of a correct investment strategy meeting a firm's requirements. The risk of a portfolio's uncertainty for the investor and the risk of making a wrong investment decision is the same as the risk of a security and, as all the other risks connected with investment, all of which influence demand and the premiums that are included in the yield.

The clients should also be able to keep track of the number of transactions the dealers make on their behalf. Besides this information about the market, information allowing to monitor credit risks of a given issue should also be available. That is why our company, as the general agent, offers extensive communications support to the market. Our announcements are published by all major information agencies, such as Reuters, Bloomberg, etc. Besides, we distribute, through electronic networks, our own information bulletins for all dealers and interested persons, thus providing communications support to the secondary market.

The secondary market is as important to the issuer as to any market participant, since a high liquidity of the secondary market makes the issue more attractive and also allows to manage the debt portfolio by regulating the flow of funds transferred to the budget.

Additional placement enables the issuer to promptly raise additional funds at a rate that is higher than the auction rate. Prior redemption also allows the issuer to reduce expenses for servicing the debt. The example of St Petersburg Government bonds shows that during the first eight months of 1997 the active position of the issuer on the secondary market allowed to reduce the cost of its borrowed resources on the average by 40% of the initial auction placement price.

In the end I would like to see a few words about what Orenburg managed to achieve as a result of placing its papers on the St Petersburg market. The first auction of Orenburg papers was held on April 3, 1997. At one of the first auctions the issuer deliberately offered the market participants a higher rate of return (roughly 4-5 interest points of the current rate of return of the St Petersburg bond market) only to attract investors to the first auction of its papers.

During the past 5 months the rate of return has stabilized at a level of +1.5% in regard to St Petersburg papers. Today the Orenburg loan is the third after St Petersburg and Moscow, however, it is considerably ahead the Moscow and all other loans in regard to its secondary market yield.

During the past 5 months the Administration of Orenburg Oblast has placed OGKO (oblast government short-term bonds), including today's auction, at a total sum of 700 billion rubles (nominal value). The term of circulation is two years. This seems to be the most long-term

paper after St Petersburg papers. The maximum volume of secondary trading amounted to 23 billion rubles.

We may say that the scheme that we used for bringing the Orenburg Oblast bonds to the all-Russian market can be successfully used by any issuer and by any administrative unit of the Russian Federation.

QUESTION Who represents the interests of the issuer on the day of the initial auction? Is it only the general agent?

KRUPKIN No, the issuer itself.

QUESTION (CONTINUATION) Do you get in touch with the issuer in Orenburg or the issuer comes to St Petersburg?

KRUPKIN Yes, all decisions concerning the price and all the parameters of the secondary trading are made by the issuer.

QUESTION It was announced that St Petersburg has directed part of its receipts from placing eurobonds for the reduction of the size of the MKO market. To what extent was the market reduced and how did this influence the speed of services?

KRUPKIN Yes, there was such information about restructuring. But the latest auction of St Petersburg papers, which was held just a few days ago and whose volume was 120 billion, shows that this is not exactly so.

Municipal Loans Insurance

Robert Manukian, Institute for Independent Appraisal and Audit

I will first say a few words about the things that do not yet exist on our market. But it is desirable for them to be there. As we know, certain political events have taken place in Russia, governor elections which made the regions more or less politically independent of the center. But this political independence must be backed by some kind of economic independence.

Since it is not allowed to issue promissory notes, we should expect a very active initial placement of municipal bonds. And in this connection we believe that the foundation of an agency for insuring municipal bonds in the Russian Federation is a strategic task, the fulfillment of which will help stabilize the securities market.

The insurance of municipal bonds as a stock market service has appeared quite recently. The first time the need for this kind of insurance appeared when the municipalities, say of New York or Cleveland, were unable to fulfill their obligations. In this situation it was only natural that investors demanded a new "protective coating" for their investment. Thus appeared an agency with a very high rating that offered its insurance services, and this solved the issue of credit risk which happens quite often and especially in those cases when a municipality is hardly known or is not experienced enough in securities placement.

As for insurance, I would like to speak about the qualities of municipal papers. These are security, rating force, liquidity, yield and the fact that insured bonds are always within the field of view of the insurance agency. The insurance agency also monitors these papers and for investors this means an appearance of a new market participant concerned about their investment.

In principle, the concept of such an agency already exists, it has already been accepted and approved, on the whole, by regulating bodies. Quite soon a decision will be made to form such an agency in the Russian Federation.

QUESTION What initial capital you would need to start such an agency?

MANUKIAN The initial capital should be quite large, but I must say that the appearance of such an agency depends a lot on political decisions. This is a macroeconomic issue and it really depends on many political decisions.

QUESTION From what you have said I understood that the agency you were describing is much like an insurance corporation in the United States that insures municipal bonds. It insures 60% of all municipal bond issues and this comprises quite a large sum. This company has acquired a considerable amount of capital, has received a 3A rating from Moody's and is now assigning its ratings to municipalities that issue bonds, this allows them to decrease the risk of non-payments both of the principal and the yield. I realize that politics do play a certain part here, but at some point capitalization becomes quite important.

MANUKIAN Capitalization is very important, but it is also important who is the founder of such an agency. For Russia this is very important since this agency will obviously have macroeconomic significance.

QUESTION (CONTINUATION) When you speak about founding such an agency, do you think it will receive a US rating or you think that it will receive a Russian credit rating which will also be accepted in the West?

MANUKIAN This organization can, of course, receive a rating from US agencies. But, at the same time, in the case of normal capitalization or in the case if it is established by quite weighty founders, it will not be necessary to obtain such a rating.

Municipal Bonds and Their Role in Portfolio Formation

Konstantin Svyatny, Russian Credit, a commercial bank

My role here today is probably the most difficult of all to summarize everything that has been said. In a way I am on the other side of the barricade, because figuratively speaking, you are the sellers and we are the buyers. We are the ones who invest in your papers and, to a certain degree, it depends on us whether an investor will purchase your papers or not, and this, in turn, depends on how we present these papers.

In the beginning I would like to speak about *the development dynamics of municipal bonds in investment portfolios* in our country. Local administration issues bonds basically for financing the budget deficit and also for covering various cash gaps.

And, accordingly, the size and the rate of return of a loan depends on how quickly and how much money has to be raised. At the time there already existed quite an advanced and well-developed structure of federal loans with a very high, practically 100% liquidity. It is not surprising that in these conditions the first issues of municipal securities were placed at a yield rate considerably exceeding that of GKO.

But even this circumstance failed to create a mass demand on the part of investors for these new financial instruments. The first operators of municipal markets were local regional banks whose financial flows were concentrated in the given region and for whom, for one reason or another, it was quite difficult to invest in GKO.

The issuers tried to limit the access of big Moscow banks to municipal markets, assuming that big Moscow capital would somehow harm them and that the banks will not only invest in their papers but will start dictating some kind of terms. But in time all this has, of course, changed.

At the same time, Moscow banks were not that eager to begin operating on these markets, because the GKO market was giving them a chance to form quite decent portfolios, both in regard to size, time-frame and yield. Such a situation had suited Moscow banks for quite a long period of time.

However, the credit history of loans left much to be desired, and banks invested in municipal papers mostly at the cost of their risk investment funds or various venture funds, in other words, at the cost of funds the bank could risk and not loose bank liquidity in the case of their loss.

But time passed and the attitude of investors to regional obligation changed for a number of reasons. First, the first issues were successfully redeemed. This immediately decreased the spread between a given regional loan and a GKO loan with a similar term. Second, the size of the loans increased, as well as their temporary structure. Now an investor could come to the market and, without taking away money from this market, form portfolios for any term of papers of one issuer. And, accordingly, the liquidity of the loan also grew.

As the amount of borrowing increased, the financial appetite of the issuers grew as well. Also, the range of loan market-makers became broader, since the local financial structures failed to satisfy the growing needs to a full extent.

Another important and, probably, main reason why the Russian banks had entered the municipal markets was the drastic decline in the yield of federal loans and the mass appearance of on the market of federal loans of nonresident investors. In these conditions many Russian banks could not believe that the yield of federal loans would drop so sharply. These banks could not catch up with the market and began searching for such instruments that would allow them to form portfolios as liquid and profitable as GKO.

Thus, regional papers became if not a full, then at least an adequate replacement of government securities and made it possible, for some time, to form quite profitable portfolios. A correct management of these portfolios made it possible to reach a profitability that exceeded that of federal bond portfolios by 50%. Precisely from that moment, i.e., in the course of 1996, municipal bonds became an integral part of an investment portfolio and were able, to a certain degree, to influence the general return of investment into the bond market.

At that time there appeared a quite stable group of investors oriented toward receiving interest profits on municipal bond markets. A new stage in the life of municipal loans began in 1997: the sharp drop of GKO yield had resulted in an excess demand for municipal bonds by Russian investors. I am referring to the experience of our bank, in other words, to our analysis of the clients' penetration of certain markets and of the dynamics of their portfolios, that is why some of our estimations may arise disputes.

The pace at which client portfolios grew on regional markets turned out to be much higher, sometimes by dozens of times, than that of the GKO market. The yield spread had reached a minimum. One had to decide in what to invest: in municipal papers or in a federal loan. And the last stone in the foundation of the municipal borrowing market was the fact that the leading Russian regions were granted international credit ratings, many of which corresponded to the credit rating of the state. From that moment investors became more interested in the actual presence of a yield spread than in its size.

Investors no longer fear non-repayment at least in regard to loans with a long credit history. However this is still possible and everyone must remember what had happened in Novosibirsk Oblast when there was not even a non-repayment but merely a delay of payment. We all remember how this affected the local administration.

Today we may say that municipal markets are quite dynamic and liquid. A certain group of investor has displayed an interest, apart from an interest in the papers of a certain region, in long-term cooperation with the administration of the region in other commercial programs, or simply in long-term crediting, which to a certain degree can replace the issue of a regional loan.

Now I will say a few words about the range of investors that come to the market. It is quite broad: from individuals to major Russian and international banks. They can be divided into three stable groups: speculators, investors and all the rest which are mixed. Accordingly, these groups have different investment motivations. Adventurous people invest in municipal markets without waiting for an infrastructure and repayment guarantees. They were the ones to take the greatest risk, but in most cases it was justified by the high yield of their portfolios.

Investors following a more conservative policy came to market much later, but unlike the first group they were there to stay. They have made all necessary calculations and are counting on receiving the most the market can give them in the current situation. And though other opinions were expressed here, I believe that there has not yet been a massive inflow of non-resident investors to the municipal bond market. This is due to a number of reasons of which I will speak later.

Investors that come to the market with large funds become interested in a region/issuer. A lot was said here about the openness of information. They spend time, sometimes several months, studying the issuer's budget and its spending. Such investors pay a lot of attention to where funds raised by the issuer are channeled, and sometimes even act as consultants of certain projects. And this tendency is becoming more evident: if a large investor invests in a region it tries, to a certain degree, to help it implement those programs for which the money was raised in the first place. Or such an investor is merely interested in the sources for covering loans.

Non-resident investors have a special approach to municipal papers. Schemes which exist on the GKO market, i.e., the use of "C" accounts, are not applied to municipal markets since this is not specified by the legislation. Besides, foreign investors operate within limits established for each given region. And this limit directly depends on the size of investment risk in a given region. And here the most interesting part begins: determining this risk.

We have a non-resident client which was planning to invest in one of the municipal paper markets. The first thing this client did was to analyze the budgets of the regions and the reports on how these budgets were spent. After that the trading system was studied.

The next question was the clearing system. The client asked to arrange a meeting with the management of the depository and other similar structures. Since personal contacts are very important for non-resident investors, the existing multitude of structures participating in the circulation of municipal papers cannot be regarded as a motivation for non-resident participation.

That is why you should try, if possible, to use the already existing structures. This will not only hasten the appearance of non-resident investors, but will allow to borrow more and cheaper and also use the already existing mechanisms without having to invent a bicycle.

So far we can state that the *main non-resident investors on the municipal bond market are banks of the CIS and Baltic countries, in other words investors from the "near abroad"*

Individual investors also find regional loans quite attractive. For these the yield of the papers of some issuers may be higher than that of bank deposits, the main thing here is the rate of return and the speed at which the money of this particular investor reach the region.

During the inception of the Russian capital market transfers on the territory of Russia took quite a long time: to some regions money would get in only two or three days and to some even in five days, which was a whole week. At present, due to the development of an infrastructure, this time has been reduced to practically one day.

The only obstacle on the way of investors and individuals is the minimal volume of investment which is established by the dealer bank, agent bank or the general manager and which depends on their presence on the market and their investor policies

If a bank has quite a broad client base it is able to organize internal clearing and this way transfer investor funds the same day

Of course, all investors are interested in a loan's reliability and rate of return. Any analysis of these indicators is quite complicated and questionable. And it is most unlikely that the results will give a true picture the situation

There are many methods of assessing the risk of investment in a region. Financial institutions try to design their own criteria and these are mostly those institutions that operate on these markets. Many of these even publish their own ratings which are, undoubtedly, subjective, since these ratings are usually done by active participants in these markets. That is why most of the investors are compelled to use whatever information is available

At the same time, there is hardly any available information about the region, in fact it is non-existent. *A lack of information transparency does not make a loan more attractive and, accordingly, reduces its liquidity and increases return*

Large structures and their clients find themselves in a better position, since thanks to our contacts we can often obtain certain documentation and hand over something to our clients. All the rest mostly use available information coming from news agencies, television, radio and other media

At present the international credit rating of the regions is the main reliability criterion. Such information is still new and has not yet been fully understood by the market operators. But if there is a rating, this is the first sign that an investment can be made. Next investors look at the size of the loan, the dynamics of its yield, term or repayment and other characteristics. On the basis of this information municipal loans can be conditionally grouped along the principles which exists on the stock market. These are, in a way the *"blue chips" of the market of municipal papers*

I would also include in this category the St Petersburg loan and the RKO (regional short-term bonds) of the Republic of Tatarstan. These are loans with a long history, with quite a large volume and high reliability. And also the Moscow loan. It is still in progress and its first issue was repaid just recently. This loan has quite large investors and a set structure of a secondary market

I would also include Orenburg and Moscow Oblast papers in the blue chip category. These are the so-called "second echelon loans". These loans have been on the market for quite a long time and, for a number of reasons, have a closed structure and limited investment possibilities. Among these are the loans of Irkutsk, Novosibirsk, Sakha (Yakutia) and a number of others. These are closed loans and their trading systems are less accessible to Moscow investors

We monitor the market situation and know or at least try to know which administration is planning to place its bond in the nearest future. On the basis of our view of the prospects of the region we can judge how popular this loan will be among investors. Such potentially

perspective loans are, in our opinion, the loans of Saratov, Lipetsk, Rostov and Leningradskaya Oblast

I would like to speak separately about the so-called "village bonds" which have been mentioned here quite often. My attitude toward these bonds is twofold. On the one hand, their yield is quite high and it is most likely that these loans will become the "engine" of municipal loans in Russia. On the other hand, the yield which a Russian investor can receive on these bonds is much lower than that received by a non-resident investor.

The reason for this is that the main income on these bonds is received at the cost of the discount. The coupon of these papers is not large, only 10% annually, which is 8.5% with tax, if this is in hard currency it is still less, close to 3-4% proceeding from the current ruble devaluation rate. The discount revenue of these papers is taxed for Russian investors on the basis of the profit tax rate. This is 43% for banks in Moscow. And that is why the yield of these bonds becomes practically half as much.

At the same time non-residents that are registered in various off-shore zones have a chance to avoid this tax. Besides, these papers are of a clearly investment nature and they practically lack a secondary market, and the existing large number of regions/issuers is quite confusing for the regular investor.

The dynamics of the "village bonds" market are quite interesting. At first the Ministry of Finance had set rigid terms on the price rate of the initial placement: both the price and term of placement were the same for all regions. As a result, investors lost interest in many regions of the country.

That is why the policy of the initial placement price formation was revised, becoming more liberal. And even after this investors remained quite cautious. And only now, due to a decrease of GKO yield, the "village bond" market is on the rise, and non-residents are the first to come and earn a maximum profit.

Moscow investors have quite a subjective view of regional municipal loans. The reason for this is the large distance between Moscow and all the regional markets. Because of this there is always a certain time lag between the moment when an investment decision on a paper is made and when this paper is actually purchased.

QUESTION Please cite the placement prices of certain issuers of "village bonds".

SVYATYI For example, in many regions 3-year bonds with a coupon rate of 10% were placed at a price ranging from 63 to 88% of the nominal value.

Alexander Yermak, Skate-Press

I must inform you that these ratings are our own evaluations and not the ultimate truth

I work at Skate Agency and though we might not be known that well on the Russian market, we are known on the western, since almost 70% of our products are published in English for western companies. Our agency appeared in 1992 and is still in operation. The landmarks of our activity are the creation of the first index back in 1992 or 1993 and the development of a method for calculating MIBOR and MIBID rates.

Starting from 1994 we have been supplying information for calculating the index in Russia. We have our own index family which can be characterized as the Russian stock market indices which are successfully used by western companies.

We were, probably the first to start keeping track of currency loan bonds for which we have created a system of indices. We monitor information on regional loans and when you say that there is no such information or it is unavailable that is not so, since part of the information is available free-of-charge on our Internet server, and part is sent out through e-mail on a daily basis. This information is also available at the Bloomberg system.

**THE ROLE OF MUNICIPAL LOANS IN FUNDING
THE SOCIAL INFRASTRUCTURE**

The Development of Municipal Bond Markets Loans Intended for the Development of a City Infrastructure

Alexander Kopeikin, Institute for Urban Economics

The subject of my presentation is *the role of municipal bonds in the development of a regional infrastructure*

I represent the Institute for Urban Economics which is quite small. Our staff is made up of close to 50 people and our work has become possible thanks to funding provided by the United States Agency for International Development for the Cooperation in Russia's Housing Reform program.

The reform of the housing sector in Russia is a vast and complicated field of activity. In our work we concentrate on the following key areas: the funding of housing construction, mortgages on houses purchased by individuals (i.e., granting loans to individuals for the purchase of a new housing), the creation of the institutions of the secondary mortgage credit market and, in particular, the so-called Mortgage Crediting Agency of Russia.

Besides, we also deal with condominiums, which are partnerships of house-owners, and with the tariff reform of subsidies and housing maintenance tenders. We are interested in municipal bonds because it is not enough to just build a house, it must be supplied with water, heat and electricity. And the issue of municipal bonds for funding such projects is quite common abroad.

That is why we are so much interested in the issue of infrastructure funding. We work as researchers/designers and a joint Russian-American team is studying the situation throughout Russia. We provide general conclusions and try to disseminate our recommendations on a non-profit basis. Alexei Novikov is the head of the project on infrastructure development, he is the one who spoke yesterday about rating agencies.

Speaking about rating agencies, we perfectly well understand that if some Institute for Urban Economics whom no one ever heard of starts assigning an AAA rating to bonds this will mean nothing. That is why we carefully study the financial documents and the political situation in a region or city before preparing a report. Our goal is to conduct a professional analysis of a region's or city's credit standing in connection with the issue of certain debt obligations.

When I spoke about our work I mentioned mortgaging and the Mortgage Crediting Agency. To this end I would like to make two comments. The first concerns our attitude toward housing loans and other targeted loans (telephone loans, commodity loans, etc.). It is my personal opinion that if a housing loan works and as a result a house is built and people are provided with apartments - that is excellent. But what is a housing loan? It is a loan which is expressed in square meters of floor area.

And here we observe a small contradiction. There is the price of money on the market, the processes that take place with money on the market and there are the processes that take place on the housing market. And the two curves reflecting the dynamics of these processes (the cost of one square meter and the cost of money) may not coincide, and most times they do not.

That is why the attempt to use a non-financial instrument (housing bonds) on the financial market is theoretically wrong. If it works, that is fine. But it would be better to do a different thing. I, as an investor, invest my money so as to retain it and receive a yield. For this I will use some reliable and highly profitable instrument, regardless of the purpose for which this money will be used. I simply want to get the money and then buy an apartment. I do not want to take the risk connected with the process of building the house. Let the builders take this risk and they will be the ones responsible for the quality and the location of what they have built. I, as an investor, do not want to be involved in this process. I will come later and buy that apartment if I like it. And if I do not like it I will not buy it.

It is a different situation when I do not have enough money to pay for an apartment at once. That is why I would prefer to do it the old way, i.e. buy a cooperative apartment by making a down payment and then paying out the remaining amount in installments in the course of a certain period of time, the longer the better.

We think that such a model must become the predominating one for buying housing. What do securities have to do with all this? Only "long" borrowed money can make the process of crediting individuals technologically adequate and highly reliable. And this borrowed money can be raised through issuing long-term mortgage securities.

Long-term mortgage securities may be issued in close cooperation with oblast administrations. This should not necessarily be done on a federal level (although there must be a vast market that would allow to "reach out" to all parts of the country). Administrations of large regions can cooperate with mortgage crediting agencies in the issue of long-term mortgage papers directed, in the end, toward expanding the population's solvent demand for housing.

Let us return to the question of *funding the development of an infrastructure*. I think that "social infrastructure" includes everything and not only day-care centers, hospitals and recreation facilities. I think it should also include roads, bridges and airports. Generally speaking we, the voters, by voting for the city or oblast authorities have entrusted them with solving our public problems. We did not ask them to build a factory for producing Snickers bars (this should be a private venture and all risks should be taken by private businesses). We, the voters, would like the authorities of the regions or municipalities to deal with our problems.

Of course, building factories provides new jobs. It is only natural for an administration to be interested in industrial development. However, from my point of view, the investment climate should be influenced indirectly through the development of an infrastructure and an improvement of the tax and political climate.

I am ready to speak about issues connected with a city or regional infrastructure. For example, the question of installing a gas service in a region. This is, to some degree, within our competence.

But let us first concentrate on such city projects as water, heat or energy supply. Mr. Novikov spoke yesterday about the significance of such projects. On the average, 50% of a city's budget is spent on subsidizing public utilities, mostly heating. Right now a lot is being said about the reform of the utilities service, which has boiled down to a mere increase of tariffs.

I absolutely disagree with the opinion that the main goal here is to increase tariffs. If this branch is not restructured, all tariff increases will be pointless. I can give a simple example. An unpleasant incident took place in Rostov-on-Don: the local medical insurance fund had spent all its money and was unable to pay for heating for the hospital. They installed a heating meter at the hospital's entrance and it turned out that they had been paying for eight times more heat than the hospital was actually using.

That is why, from my point of view, the utilities reform should not only mean an increase of tariffs. This requires serious restructuring directed toward increasing efficiency in this branch.

Let us now return to an analysis of borrowed means. I will begin with taxes - they are "scattered" in time. The construction of city infrastructure facilities requires a large amount of money. This money should not necessarily be borrowed, it can be saved. One of the options is to do nothing - just wait until everything collapses: pipes corrode, compressor stations dilapidate, etc.

The other option is to save money. But I must stress that money cannot just be saved. It must be managed, which means that an investment portfolio should be professionally formed for the purpose of deriving relevant revenue.

There is also a third option: borrowing money. Money can be borrowed from various sources. Here, in Russia, it is very popular to borrow from the World Bank.

At present it is equally popular to enter the eurobond market. Not by chance have the previous presenters mentioned the question of currency risks. According to our estimations for the past five years, currency credits at the established rates were much less profitable than ruble credits because of the exchange rate variance. I would like to remind you that currency borrowing is not a panacea. When borrowing, currency risks must be considered very carefully, otherwise the situation may get out of hand.

It is common practice for the local authorities to issue bonds guaranteed by the city's budget: they ask for money but refuse to tell for what it will be spent.

I will give you an example which I believe is a classic. It is about the reconstruction of the water-supply pipeline in the town of Ruzayevka. The project was designed by utilities engineers, construction engineers. We were the consultants. It was calculated that the annual loss of water in this town caused by pipe roughness exceeded 2 billion rubles. The pipe-line system was not big and the cost of reconstructing it was quite comparable with this amount of money. According to the working group estimations, the recoupment of the project (even if the funds were granted at a 20% annual interest in hard currency and without any tax exemptions) would take not more than one-and-a-half years. But such projects are rare.

The essence of *project bonds* is that they are issued for a specific project. The issuer promises the investor to return the money from the receipts of a specific given project. There are not many such projects in the sphere of the infrastructure. But they have to be searched for. We have already pin-pointed such areas. The main one among these is the gas-supply service which promises, from our point of view, the quickest return. Unfortunately, investors are not yet ready to make long-term investment. Traditionally and in accordance with common sense funds for such projects should be raised for a long term.

While there is no “long” money, there are specific highly-effective projects requiring “short” money. The implementation of such projects needs a mixed working group consisting of good engineers aware of modern technologies and good utilities engineers. In a word, what is needed are professionals who can make good use of the raised funds.

We believe that funding capital investment in a city’s engineering infrastructure is, in a number of cases, economically expedient and in line with the principle of social justice.

Recently, there has been a revival on the municipal bond market. Several years ago no one even considered the question of municipal bonds. I predict that in the *near future there will be a revival of the project bond market*.

The implementation of a number of infrastructure projects is connected with considerable economizing. As a rule, all references to international experience are a bit irritating, but this experience shows that on the whole the infrastructure is far from being a social burden. It is highly-profitable, because water and heating are among human basic necessities. The flow of payments for these services is stable and ample. *According to various estimations, the return on investment of infrastructure facilities reaches 60% annually*.

The useful effect of the development of the infrastructure is often of an indirect nature, in other words, it is revealed through an improvement of the investment climate, the appearance of new investors, etc. The philosophy of investing into an infrastructure shows that indirect gain is quite substantial.

What else can be suggested in order to move the problem of project funding from deadlock? Here is an example from Vladimir Oblast. The idea is quite simple: the formation of an oblast gas-supply fund.

And this is how this idea can be implemented: let everyone chip in for the construction of one pipeline today and another one tomorrow. Gas is very effective. A shift from boiler oil to gas allows to economize tremendous means, while the population’s expenses for gas amount to only 5% of the structure of expenses.

Gas tariffs should be raised a little in order to be able to pay those people who have lent the money. We will issue “gas” bonds which will be a normal financial instrument and their yield will be determined by the degree of the investment risk. Our project will be an installation of a gas-supply service. And since the internal structures and the current situation guarantee high receipts, the reliability of our bonds will also be high.

And the second idea which is present here: *the security of claim charges*. We are trying to advertise this idea in regard to all utility services. We have done quite a lot for developing a relevant legal framework, but the point is that this area is connected with “live money”, especially when speaking about payments coming from the population. The population pays “live money” without any surrogates or arrears. And we believe that the flow of payments can serve as quite an effective borrowing security.

Municipal loans are not an end in itself. Naturally, we will always respond to the cheapest offer. But we will definitely consider the alternative of issuing project municipal bonds among

the other alternatives. Although, in my opinion, we are not yet ready for purely project loans. Let us proceed along, so to say, two lines of defense: project loans but with a guarantee of general coverage.

The time has come to start analyzing project bonds. We concentrate on city problems. Even without entering the European market we must bear in mind that there is a number of channels of investing abroad. Foreign investors feel satisfied when a report on a city's or region's credit standing is prepared professionally, according to their rules.

Thus, from our point of view *funding capital investment in the engineering structure is economically effective and socially just*. We assume that the market of mixed project bonds of specific projects will grow considerably and this will happen very soon. Income project bonds will become an effective instrument, since these projects are highly profitable and promise big money.

The Practice of Municipal Funding of the Social Infrastructure in Russia

Sergei Karpukhovich, RENOVA-INVEST

I have the honor to represent RENOVA-INVEST which is a financial and investment company and part of a large Russian-American holding. The company is known as RENOVA, while RENOVA-INVEST is a financial and investment company which serves, primarily, the interests of corporations. It also has a special division that works directly on the securities market. For four years now we have been working with regional administrations assisting them in arranging various loans where we sometimes act as a consulting company and sometimes as the general manager, etc.

Our company has begun this work four years ago and all our projects differ drastically from what you know about, and this is because it has been decided from the very start to implement projects according to the American scheme, the one that is now accepted in the United States.

The new *loan* which we designed was a socially-oriented one. It was placed in 1994 and was called the *Socio-Economic Development of Yaroslavl Oblast*. It was preceded by a large amount of work because at the time loans were rare occurrences and many people did not understand for what purpose they were needed. The most common loans were the so-called *arbitration loans* when the administration, making use of the existing tax exemptions (the status of the papers at that time was governmental) borrowed money and resold it on the market. The small difference was somehow distributed among the dealers and a small amount was spent on something. There were also so-called *commodity and housing loans*.

We decided to give the Yaroslavl Oblast administration a possibility to borrow money and spend it on social needs. At the time inflation was very high, as was the rate of refinancing. As a result, the price for money resources was very high and the longest term of borrowing we could afford was one year. That is why we chose those projects that could be completed within one year and these were mostly incomplete construction projects such as, mainly, village hospitals, schools and day-care centers.

This loan is interesting from many points of view. It was the first to be provided with strong guarantees, and the nature of its benefits was also taken from western experience. The guarantees of the loan were incorporated in specific lines of the oblast budget. A so-called unexpected expenses fund was specially set up for servicing this loan. Besides, the oblast administration backed the loans with those funds which it was supposed to collect in the course of the second stage of privatization. Liquid units of property were chosen from the oblast register of property to be sold in case the administration would not be able to repay the loan.

The money raised by Yaroslavl Oblast was divided into two parts. 50% was spent on projects and the other 50% was managed by our company (this money was invested in government securities).

Since this was the first market experience of Yaroslavl Oblast and it had no idea about the price of the debt we used quite an interesting technique for placing the bonds. These were bearer document form bonds. In other words, these were real papers with four coupons, printed in England and sold in the following way:

Several Dutch auctions were held. We deliberately overstated the profitability and as a result investors, proceeding from their expectations and competing with each other, proposed prices starting from the nominal value and up. Thus, we managed to save quite a lot and despite our first not very lucky auction placements, all the papers were sold at a price of 101-102% of the nominal value.

Since we did not have much experience in such work we hired a large group of western experts to work on this project. These people were paid by our companies and were experts from Harvard, Columbia University Business School, Cambridge and the Russian Academy of Sciences Economics Institute.

This project has shown that even in conditions of galloping inflation, when the state borrowed money at a very high interest, it was possible to implement a socially-oriented loan, collect the money and spend it on specific projects. And our investors, I mean the population, who bought our papers saw for themselves how the money was spent. The loan was absolutely transparent for the investors and this was one of our key principles. This meant that all the goals of the loan were named, as were all the projects for which it was issued.

Besides, it was very interesting for us to make use of the unique situation that existed at the time of our loan in Russia. It was the time of the second stage of privatization, and we designed our bonds as a kind of "oblast voucher". We had to overcome the resistance of various organizations. Our goal was to obtain the money as cheaply as possible, because it was spent on social needs and, obviously, the coverage was mostly from the oblast budget. That is why we provided various benefits for investors that would motivate them to buy the bonds. And the bonds could be used in the course of privatization on the territory of the oblast as a guarantee. They could also be used as a means of payment to the oblast budget. And as you may recall, a certain part of the proceeds from the sale of privatized property went to the oblast budget.

Practically all the ideas of this loan had worked out. Since this project was quite well-known and new for Russia and also because it included a large group of serious experts, a lot was written about it in the West in such publications as *Reuters*, *Business News* and *Wall Street Journal*. Many western specialists interested in our work, came to see what we were doing. Other administrations of the Russian Federation began inviting us to share experience. But we found work in another state more interesting.

Our next project was in a way similar to our first one. We conducted *the first loan in the CIS*, not counting Russia. This time in Kazakhstan in Pavlodar Oblast and the loan was called *Social Support of the Population*.

This work was very interesting, because when we came to Kazakhstan it turned out that they did not have a single law mentioning a securities market, they did not have a commission for the securities market, and they did not have a concept of oblast or municipal property. They only had private and state property. They did not even have vouchers. In fact, they had nothing that could help organize a loan. And that is why it was interesting to design something special that did not exist there at the time.

Besides, this work brought us into contact not only with the oblast leadership but with the country's top leadership. We needed this contact so as to be able to convince the Government of Kazakhstan in the expediency of such loans, and in the need to provide them with a special

status and tax exemptions. We even had several meetings with the prime-minister, and also with the bank, the Ministry of Finance, etc. The loan was issued and I must say that the ideas of a social loan were most accurately realized precisely in Kazakhstan.

In Kazakhstan there were other guarantees of the return of the money, since the budget there is still formed according to another principle: all the money is first channeled to the Russian Federation and only afterwards it returns to the regions. And each year each region has a different budget. It is clear that to borrow purely against the budget was very difficult. But, luckily, the Ekibastus coal basin is located on the territory of Pavlodar Oblast and at the time, due to a lack of money, all tax payments of the mining enterprises to the local budget were made in coal.

Therefore, the Pavlodar administration had accumulated a large amount of coal which we could use as collateral in case we would not have enough money for repayment. The loan was intended for the most urgent social projects.

The Semipalatinsk nuclear testing ground is located not far from Pavlodar. The situation there with cancerous diseases, especially among children, is very bad. That is why the money we raised was spent, in the first place, for public health and for a cancer center. There was also an idea to allocate funds for supporting the German diaspora in Kazakhstan. The local Germans were emigrating from Kazakhstan on a mass scale. A certain amount of funds was allocated for establishing a German cultural autonomy and we placed much hopes on the activity of German banks. But this activity turned out to be quite insignificant.

Almost 100% of the Pavlodar loan was placed. For this a special show was organized in Kazakhstan. All projects for which the money had been intended were either completed or upgraded to the necessary level. It became obvious that such work could be successfully completed in any state, regardless of the degree of its market relations development.

In our next project we sought the possibility to implement *an investment loan* which we did *for the administration of Vladimir Oblast*. Since by that time the administrative units of the Russian Federation still had the right to borrow cheap money on the market, enjoyed tax privileges and had a government status, the debts of the oblast administration were cheaper than those of any corporation.

The administration held a contest of investment projects in which it decided to support its major commodity producer and main supplier of export receipts: the Vladimir Tractor Factory. The administration, on its own behalf, issued a loan which was called *Vladimir Tractor Loan*. This loan was supposed to be non-deficit without any borrowing from the oblast budget. The bonds were 2-year bearer papers in document form with coupons (with quarterly payments). The administration sold the bonds and handed over all the money to the Vladimir Tractor Factory which provided the administration with all necessary guarantees.

Thus, the investors were provided with a double guarantee: the guarantee of the Vladimir budget and the guarantee of the Vladimir Tractor Factory. All this was reflected, in great detail, in the issue prospectus which also specified how the factory intended to spend the money.

At the same time we were continuing the credit history and were preparing a new project which was called the *Environmental Loan of Yaroslavl Oblast*. This is our latest project.

which we like a lot, because we think that we have managed to combine in this project the investment and social components

Since Yaroslavl Oblast could no longer afford to simply spend money from the budget for social projects, it became obvious that money should be returned as a result of certain investment projects. But we still wanted these projects to be socially-oriented and that is why we included in the tender such a factor as ecology

Two projects were chosen. One was a modernization of a varnish and paint production technology used by a plant situated on the bank of the Volga River. It polluted the river by paint thinner that it emitted with its waste water. The project was supposed to install a new technology for producing water-soluble paints. This project promised a quick commercial return.

The site of the second project was Lake Nera located near Rostov Velikiy, a small city in Yaroslavl Oblast. The lake is a famous spot in Russia. The situation there is on the verge of disaster: the lake is being overcome with slimy sapropel, as a result of which fish has disappeared and the land adjoining the lake is being flooded. A group of entrepreneurs have built a factory for extracting sapropel which after processing becomes an excellent nutritious supplement used in the poultry industry and for other purposes as well. This is both an investment and environmental project.

These bonds matured in 2 years. They were bearer bonds issued in document form. This was especially important for us because these projects were intended mainly for local investors, i.e., for those to whom the goals of such loans are closer and more transparent. This proved to be correct, a certain patriotic factor has worked here.

Besides, we believe that *a paperless bond issue is extremely inconvenient when working with small and private investors*. The paper form has a lot of advantages. In particular, when the first securities appear (before a normal secondary market is organized) the unorganized market functions very easily: bearer papers simply change hands.

We are extremely satisfied with the results of this work. Three out of four of our projects are practically completed. There were no delays in coupon payments. We have collected as much money as we had planned. We have financed all the projects we intended to. And the bonds were repaid in time which is, perhaps, what counts most.

Our work attracted the attention of specialists "broadly known in narrow circles". Besides, our work has produced a number of unexpected positive results. For example, the varnish and paint factory which was funded by means from the oblast loan had been striving for quite a long time for the French credit line. As soon as the French side became aware of such a method of funding, it promptly decided to grant this plant a credit. This once again shows the effect of such loans: if some corporation (factory) receives such funding and accurately pays the administration, the "shadow" of the issuer's credit history falls on the corporation which is ready to issue its own debt obligations.

However, everything we do is very different from what is taking place here on the market. In our analysis of municipal loans we were very much assisted by information from the FCSM monitoring group. Russian experience is quite unique because there are only three main types

of loans in this country the so-called GKO-type loans, commodity loans (like telephone or housing) and arbitration loans when the administration simply borrows money, especially in the case of tax privileges, and then resells it From our point of view all this is not very interesting and not always useful, especially when it comes to solving a region's problems The main reason for this is the following

It is obvious that nothing special happens in the case of an arbitration loan money is just resold and this is interesting for all the participants in the deal, including the investors who have a chance to invest their money and protect it from inflation and misuse by financial speculators This also promotes the general development of the stock market

Regional GKO-type loans are, basically not interesting, since the region, by definition, must obtain more expensive money than the state This is too expensive for social and many other types of projects What we have managed to accomplish is quite surprising *Both in Vladimir and in Yaroslavl the money we raised was considerably cheaper than GKO* This allowed us, considering our reserve fund in government papers, to deal with a part of the administration's debt This experience is unique and it tells us that *local papers intended for local investors and given a correct advertising campaign and a relevant set of benefits and preferences allow the issuer to raise cheaper resources*

During the Yaroslavl loan we acted not only as consultants and organizers, but as general managers as well We guide the entire placement process, manage the reserve fund, organize the work of payment agents and are, in general, responsible for everything even for the printing of the bond forms The credit history in Yaroslavl allows now to borrow much more money We are now preparing a new project which will be based on other principles It will be a larger loan and, probably, with a longer term

For a large city, such as Moscow or St Petersburg, it is much easier to issue eurobonds and attract western investors because these are politically significant cities with very large budgets

Unfortunately, Yaroslavl is not that well-known and attractive to foreigners But the experience of careful and patient work on its market and, firstly, with local investors and only afterwards with Moscow investors assures us that we can organize a loan with a 100% underwriting which will be placed mainly among Moscow banks and, perhaps, with the participation of western investors

We organized and issued loans in our own way and that is why our actions were met with resistance on all levels This made our work much more difficult starting from the first loan We had a lot of problems with organizations that were supposed to assist the development of the stock market and, in the first place, with the Ministry of Finance All the bad things that could have happened during the preparation and issue of the first loan had happened We found ourselves in the situation when the Ministry of Finance decided to deprive the administrative units of the Russian Federation of the right to issue government papers That was several days before the placement of our loan We were not allowed to bring in to the country the bond forms that were printed in England, because Goznak experts said that Thomas Dealery cannot print good papers and the bonds might be counterfeited Considering that the best Goznak print shop is equipped with old Thomas Dealery equipment, it is quite obvious that this assessment was not very objective, to put it mildly We were compelled to start selling papers which we sort of did not have and the status of which was quite indefinite

All this continued for quite a long time. We began placing the loan in December 1994 and only in the middle of May 1995 the FCSM made an indistinct announcement about the government status of the papers, but no one seemed to pay any special attention to it.

Besides, from the very start we had this idea to involve western investors who would be interested in acquiring papers issued in accordance with new principles. But in December the war in Chechnya broke out and this discouraged western investors. Nevertheless, the government status was returned to these papers, but tax privileges were excluded. I must say that it is very difficult to work in a situation of a constantly changing legal basis.

Another problem was solved in quite a complicated way. In all our loans we had a variable coupon rate. When we started the first loan, the price of money on GKO was around 300-400% annually. It was clear that first, we did not need such expensive money, and second, this situation was not stable. The price of money could waver to either side. That is why we determined the lowest limit of profitability for investors, linking it with the rate of refinancing. And we made different calculations, modeling the situation at different rates of refinancing.

In the first loan this was 72% of the refinancing rate, i.e., we guaranteed the investors the lowest return of the coupon rate. But by May the refinancing rate became very high and for various reasons the price of money at that time dropped drastically. This was something that was not supposed to happen. Luckily, by that time we had sold most of the papers and had funded the indicated projects. But we had to suspend the placement after 70% of the first loan had been placed, since any further placement simply became unprofitable.

I think that when a local administration or municipality select consultants, their main criteria should be the ability of the company to raise the cheapest resources. Today practically everyone is doing the same: raising funds along the GKO or OFZ scheme. But this is not interesting.

We believe that even *in the case of large loans intended for the major stock market participants, i.e., institutional investors, it is always very useful to keep in mind the population and small investors, providing them with special tranches in document form.* This is much more convenient and attractive for the population and, besides, people have more trust in such papers.

When the administrative units of the Russian Federation or municipal bodies were forbidden to issue promissory bills and attempts were made to ban the circulation of corporate papers and various tax exemptions, we invented a special tranche of issue papers which was sold but was used as a tax exemption. This was not surrogate money, since the papers were sold, and this money could be included in the oblast budget and then the oblast budget, after having accepted it, gave it away to dealers and managers for placement and this allowed to expand the system of non-payments. On the other hand, this tax tranche had a low yield which allowed to additionally raise cheap money.

QUESTION How do you manage to make cheap municipal loans look more attractive for investors than the more expensive federal loans?

KARPUKHOVICH First, there are situations when investors assess local risks as being lower than federal risks. For example, when we were placing papers in 1996 it was the time of the presidential campaign. And at the same time the Governor of Yaroslavl Oblast had been elected. It was clear that someone who had just been reelected and whose signature was on the paper would, most likely, return the money. Government papers were being placed at the same time, but their reliability directly depended on the person who would be elected as president.

Besides, it is easier for the people to understand something when they buy a specific paper with a coupon on it and receive the yield at a local bank. In this sense local bonds are more attractive as, for instance, OFZ. Small investors do not participate in the initial placements of OFZ. Everyone knows that these bonds are bought up by large banks and are afterwards resold to the population. And the announced coupon yield on OFZ is not provided for the final investor.

Also, an investor who buys OFZ is aware of the yield of only one coupon. We give our investors a possibility to forecast the yield of our papers in the course of the entire term of maturity by fixing the lowest level of yield. It is apparent that the yield of the GKO market is in many ways determined by political interests. That is why this is not a very objective indicator.

QUESTION From what sources are environmental loans repaid?

KARPUKHOVICH By the money of the recipients. During the first year the paint and varnish factory did not pay any coupon yield. However, now, during the second term, it is cashing coupons at a double amount and with an account of various coefficients. Thus, the first part of the repayment source is the money of the recipients that have been funded by the money from the loan and the second is a reserve fund which is managed by our company and which allows us, through raising cheap resources, to “work out” a part of the issuer’s debt.

QUESTION Why did the administrations of the oblasts with which you worked had unhesitatingly invested the funds raised during loans in such risky projects as, for example, the Vladimir Tractor Factory of the paint and varnish factory?

KARPUKHOVICH The budget of Vladimir Oblast was so weak that the oblast administration could not afford to fund any social projects. The tractor factory in Vladimir had a great impact on the life of the city. It had a very interesting development program and, besides, there were simply no other projects in Vladimir. As for Yaroslavl, there was a contest which was very strict and consisted of several stages. And I do not consider this a risk because the paint and varnish factory is a strong enterprise with a large amount of property which has a tough agreement with the administration. There was absolutely no risk in this case.

QUESTION You mentioned that the budget was one of the sources of repaying the loans. What part of the budget revenue was spent for servicing the debt?

KARPUKHOVICH A very insignificant part. We managed the reserve fund quite successfully. Besides, the market situation was very favorable, the GKO yield was high and we managed to obtain the money quite cheaply. And we economized a large part of the debt.

QUESTION (continuation) Please be more specific.

KARPUKHOVICH We resorted to budget repayment only once, in Yaroslavl during a social loan. This never happens with investment loans.

QUESTION (continuation) Does this mean that repayment is only made from the reserve fund?

KARPUKHOVICH From the reserve fund and the means of recipients.

QUESTION You said that your loans were based on the American system. What do you mean by this?

KARPUKHOVICH In the first place I mean an elaborate system of guarantees for investors as well as clear and understandable goals and transparency. Investors are aware of how much money, for how long and on what terms is the issuer borrowing. This is the basic principle of a normal, say, American municipal loan. There are no secrets there. An issue prospectus is an absolutely transparent document.

QUESTION I have two questions. First, did you have any instances of a non-fulfillment of financial obligations? Second, did you have a chance to work on such projects as the modification of five-story apartment houses built during the time of Khrushchev? I know that the French have proposed our oblast government such a program. Do you have such projects?

KARPUKHOVICH We do not have such projects and we have not worked with the market of housing. As for your first question, we have never had any defaults, both in regard to coupon or principal repayment. Moreover, investors in an investment loan have received a double guarantee from the budget. Specific budget lines were earmarked as loan guarantees and specific parcels of property were determined to be sold in the case of any unexpected developments, plus there were the recipients' guarantee obligations. On the whole, this was a well-developed system of guarantees.

QUESTION (continuation) Where were these guarantees endorsed by budget administrators?

KARPUKHOVICH Of course, but they, in their turn, had received guarantees from the recipients.

QUESTION How did you launch the advertising campaign and how did you place the bearer bonds?

KARPUKHOVICH The advertising campaign was done through the press, local television and radio. Special booklets were printed. Besides, information was disseminated on a mass scale, for instance, leaflets were pasted in trolleys and buses, in post offices, etc. As for the placements, there is nothing more simple than the sale of bonds in document form.

**REGIONAL EXPERIENCE IN DESIGNING AND ISSUING
MUNICIPAL LOANS**

Specialized Loans for Project Funding, Maturity, and the Targeted Use of Borrowed Means

Dmitry Sokolov, Nizhny Novgorod Administration

In this presentation I would like to tell you about *four loans of Nizhny Novgorod administration*. In 1992 Nizhny Novgorod Oblast was one of the first to join the process of forming the Russian market of regional securities. At present, the 1994 government housing loan and the 1995 telephone loan are being placed in the oblast and the oblast government loans of 1992 and 1994 have been completed.

I will speak separately about each current and completed loan.

The 1992 government loan of Nizhny Novgorod Oblast. The idea to issue this loan first appeared in the middle of 1992 when, after a jump of inflation, the oblast experienced a drastic need in cash for servicing the region's market processes.

Nizhny Novgorod Oblast with assistance from Grigory Yavlinsky tried to create a system of consumer treasury notes' circulation. However, the problem of cash was soon solved and the loan was re-oriented toward preserving the savings of the population.

The placement of the loan began in March 1993 and its bonds were of a low nominal value: 500,00, 10,000, 5,000 and 1,000 rubles. Thus, it was intended for the mass population. These were registered bonds issued in document form. The placement was successfully completed by February 1994, i.e. it took less than one year to place the main and additional issues of this loan at a total sum of 7.3 billion rubles.

The Regional Joint-Stock Nizhny Novgorod Banking House was the general dealer of this first loan. The revenue part of the loan was formed by receipts received from placing the means of the loan on the deposits of a bank that was authorized by the administration to place the loan.

This revenue was in full channeled for fulfilling the issuer's obligations: payment of bond interest, payment of expenditures connected with the issue, circulation and repayment of the loan, and also for holding four consumer-good lotteries among bond holders. Interest was accrued on a quarterly basis after the first 90 days from the moment of the purchase and was paid at a date set for each bond holder.

In the case of prior redemption the payment included the period following the last interest payment. Thanks to this loan, an effective mechanism was created that helped protect the population's savings by means of investing in bonds. This loan was extremely attractive for investors since, first, its interest payments were quite high (fluctuating from 0.6-0.8 of the Central Bank refinancing rate) and second, the bonds were cashed in on demand. And, third, twice a year consumer-goods lotteries were held for the bond holders of this loan.

The loan was successfully completed on January 1, 1995 with the administration fulfilling all its liabilities. The investors received a net income of 8.352 billion rubles. This loan was a savings loan and not a market loan. In other words, despite the fact that such a possibility existed, deals on the secondary market among bond holders did not become common.

Besides, this loan can be characterized as guaranteed deposit which means that the money was placed on deposits and that is how it “worked” The terms of the loan allowed premature redemption at the discretion of the bond holder, which made this instrument extremely liquid

The interest displayed by investors in this loan facilitated the preparation of a new one On April 25, 1994 the Ministry of Finance registered the issue prospectus of a second 1994 100-billion bond loan of Nizhny Novgorod Oblast It was divided into several issues

In July 1994 the first issue of this loan was placed through a closed subscription at 10 billion rubles Altogether there were three issues of a total value of 45 billion rubles After that the administration stopped the placement for the same reasons which were mentioned by the previous presenter the bank rate was too high and it became impossible for these funds to “work” on the market

The orientation and the properties of the new loan were slightly different These were bearer papers and the nominal value was increased to accordingly, 50,000, 200,000 and 1 and 3 million rubles The bonds of the second loan were issued in a document form The form (with 6 degrees of protection) had a set of four coupons Interest was paid quarterly, and was equal to 0.7 of the Central Bank refinancing rate The loan was guaranteed by the budget of Nizhny Novgorod Oblast Fourteen banks took part in the placement

I will now describe the financial scheme of this loan The funds raised through the sale of the papers were placed on bank deposits The income on these deposits was intended for paying an interest and investing in investment projects The net income was quite insignificant, nevertheless, part of this loan - 700 million rubles - was used for reconstructing the city's circus and 300 million rubles were spent for the purchase of equipment for a diamond production plant

Thus, this loan, as the first one, was a guaranteed deposit loans oriented toward free market circulation Paying agents were supposed to repay bonds and pay interest, despite of the place of purchase

The secondary market was supposed to - and this happened - compensate for the lack of premature redemption and provide an adequate liquidity level preserving the funds raised by the issuers in the course of the entire term of the bonds' circulation

I will now speak about *the telephone and housing loans of the administration of Nizhny Novgorod Oblast* It is noteworthy, that these types of loans are the most common ones in Russia These programs are targeted investment projects which are, as a rule, middle-term or short-term

These popular loans constitute a small part of the general amount of municipal issues There are two approaches to organizing such loans from the point of view of redemption and interest payment

The first approach provides for repayment by receipts from the sale of apartments built at the cost of the loan Such loans have been issued in the cities of Syktyvkar, Ukhta, Cherepovets and Armavir

The second approach implies repayment and payment of income in kind. In other words, an investor has the right to exchange a certain number of bonds for an apartment or telephone.

The issue prospectus of the 1994 Government Housing Loan of Nizhny Novgorod Oblast was registered in August 1994. The placement began in October 1994 on the basis of a decision passed by the Governor of the oblast. The last date of the loan's circulation is October 1, 2004. This issue is the first within the framework of the 10-year housing program of Nizhny Novgorod Oblast and it is directed toward the solution of one of the most urgent social issues - providing the participants in this program with housing.

The administration of Nizhny Novgorod Oblast is the issuer of this loan which is guaranteed by Nizhny Novgorod city administration and by the GAZ (Gorky Automotive Plant) joint-stock company. Their guarantees were, accordingly, for 40 and 60% of the amount of the loan.

The third loan differs a lot from the previous two, since it is intended for direct investment in housing construction. The format of this loan's bonds has been changed: it is a bearer document form bond, but without coupons. There was only one issue but the initial placement is taking place in portions at an auction through the loan's agent, Nizhny Novgorod Real Estate Fund, a joint-stock company.

The loan is placed among banks and investment institutions proceeding from the market value of the housing. Considering the long term - 10 years - this is quite a liquid instrument due to the fact that it is quoted by dealers, while the issuer guarantees a premature redemption at a nominal value with an interest payment calculated on the basis of 2/3 of the weighted mean rate of refinancing of the RF Central Bank. However, unlike the first loan, the right of premature redemption can only be exercised once a year, in the course of the month of October.

The papers are issued with a double nominal value: on each one there is an indication of the nominal value in rubles and the nominal value in square meters of floor space. For example, 0.1 square meters and 75,000 rubles, 0.2 square meters and 150,000 rubles, and 1 square meter and 750,000 rubles. The nominal values were established on the basis of the market value of one square meter in the city of Nizhny Novgorod in 1994.

The nominal value of the issue is 60 billion rubles. The funds raised as a result of the initial placement of the housing bonds were invested in housing construction in the following areas for GAZ within the framework of a targeted program entitled "Construction" (in the city of Arzamas, a large raion center of Nizhny Novgorod Oblast) and on the basis of share participation agreements, and on the same type of agreement in various raions and oblast centers of Nizhny Novgorod.

At present GAZ is in the process of implementing an extensive social program on the basis of the housing loan bonds. In particular, it grants considerable compensation of the cost of housing for its citizens entitled to housing. These bonds are extremely attractive for these people, since GAZ provides a number of benefits such as a possibility to obtain an apartment for 20% of its cost, the receipt by every citizen entitled housing of housing paid for by the plant depending on the person's length of service or other criteria, a chance to pay out the rest of the cost in the course of 10 years by installment payments, etc.

Thus, the people buy apartments not for their full cost, while the plant shoulders a share of this cost. A housing loan scheme can also be successfully used for completing the construction of cooperative housing. The point is that in order to complete the construction of cooperative houses that was stopped in 1992 (when inflation skyrocketed) long investment money is required, and the scheme of such a loan allows to raise it.

In the second quarter of 1996 a program for completing cooperative housing construction with the use of the 1994 government housing loan of Nizhny Novgorod Oblast was designed and implemented. Under this program taxes paid by the local companies to the oblast budget were accepted in bonds of the housing loan at a volume that compensated the price rise for the construction of cooperative houses, determined by the oblast program for the corresponding fiscal year. The Nizhny Novgorod Real Estate Fund (NNREF) as the agent of the loan is responsible for the implementation of the program for completing the construction of cooperative housing in the oblast in 1996-997. Trading is held on a monthly basis, all information concerning the dates, terms, bond prices and prices at which bonds are accepted as tax payments is published in the local media.

Enterprises with overdue tax payments or those in the process of paying their taxes purchase these bonds at the trading and deposit them on the "depo" account in an authorized bank. The tax exemptions they receive in exchange serve as grounds for clearing their debts on taxes and dues to the oblast budget: the share of the profit tax, VAT, transport tax, property tax, etc.

To perform this operation, the owner of the company hands in three copies of the tax exemption to the tax organization. The funds received as a result of the bond trading and which were, in turn, exchanged for tax exemptions, are placed by NNREF on bank deposits or other financial instruments with the aim of compensating for the difference between the selling price of the bond at the trading and the prices at which the bond is accepted as a tax payment. Next, these means are used for funding the construction of cooperative housing in a order established by the relevant program at an amount equal to the full sum of issued tax exemptions.

The funding and clearing in regard to housing cooperatives is done through the accounts of NNREF on recommendation from the Finance Department. For this NNREF concludes agreements with each housing cooperative and provides for a gradual funding of the construction process and, jointly with the board of the cooperative, supervises the targeted use of these funds. The first 50% of the established quota is transferred and the remaining 50% is transferred after the receipt from the cooperative of documents reflecting the expenditure of these means and the funds provided by the cooperative's members.

Following are some of the results of this loan. During the three years of its implementation the price of one bond with the nominal value of 1 square meter grew from 750,000 to 2.5 million rubles, i.e., more than threefold. By September 1997, as a result of 30 trading sessions out of the 60 billion rubles (the volume of the loan's issue) 64.8% were placed, while the amount of the raised funds reached 99.5 billion rubles. Investors buy the necessary amount of securities and after presenting them to NNREF receive apartments. In the course of implementing this loan close to 2,000 apartments were received by its participants.

Means received as a result of the sale of bonds were invested in the following areas. NNREF funded the construction of 14,825 square meters (14 billion rubles) for GAZ, four houses with

a total floor space of 23,600 square meters (5.3 billion rubles) were built under the targeted housing program in the city of Arzamas, 18 cooperative houses (21 billion rubles) were completed of which 7 have already been commissioned (with a total floor area of 20,000 square meters)

As many as 188 apartments were built under share participation agreements for the construction and purchase of apartments in various districts of Nizhny Novgorod and its oblast, 22 apartments were bought from individuals and organizations on the secondary market, and the construction of 12,000 square meters (210 apartments in various districts of the city) was funded

Therefore, by August 1995 the volume of purchased, built and funded housing amounted to 71,000 square meters *Housing loan bonds are a realistic and secured instrument of the stock market which gives the investor a chance to invest money in real assets and makes it possible to raise funds from non-budget sources of financing for the purpose of building new housing and completing incomplete construction projects*

I would like to say a few words about the 1995 Nizhny Novgorod telephone loan. Such loans were issued by the administrations of such cities as Lubertsy (Moscow Oblast), Perm and Voronezh. The administration of Nizhny Novgorod Oblast in the person of the Finance Department acted as the issuer of the government telephone loan of the oblast. Means raised through this loan are used for reconstructing and upgrading the already existing automatic telephone exchanges (ATE) and building new ones, including digital ATE, as well as for developing and implementing modern telecommunications services.

The telephone loan was intended for 5 years with a total value of 20 billion rubles (400,000 bonds with a nominal value of 50,000 rubles). The distribution of the bonds began in October 1995, the end date is September 1998, although by September 1997 the whole loan had been successfully placed. The raised funds amounted to 24 billion rubles and 2,259 telephones were installed in the houses of the participants in this loan.

The bonds are distributed in post offices, NNREF offices, and at the regional depository of Nizhny Novgorod Oblast which acted as the loan's placement agent. The bonds are registered and paperless, i.e., their circulation, sale, purchase or exchange for *Svyazinform* (Communication & Information) certificates for telephone installation could only be done through the loan's depository.

The price of the bond placement was determined once a week by a special commission and was announced for all potential buyers through the media. This price depended on the cost of construction, the ATE equipment and installation tariffs. The last placement price was 60,000 rubles.

NNREF used the receipts from the sale of the bonds for the development of the telephone network. Although there are no limitations for the potential buyers of the bonds, only individuals, owners of the necessary amount of bonds (from 45 to 50 in the city and from 20 to 40 in the oblast) were entitled to receive telephones ahead of time.

As of September 1, 1997, 4,800 telephone certificates were issued. Besides, the owner of bonds could reserve, for three months, the right of an ahead-of-time installation of a telephone.

at a specific address For this the investor should possess not less than 60% of the necessary amount of bonds

The terms of the loan provide for a cash redemption of bonds and the payment of a small yield by the issuer before maturity The redemption price is established as the sum of the nominal value and yield, calculated on the basis of the interest rate equal to the weighted average rate of the RF Central Bank on personal accounts

According to the issue prospectus, bonds are redeemed in cash in the course of one month and on the basis of applications filed by bond holders not later than August 15 The redemption takes place once a year in the course of the month of September Besides, the yield on the bonds may be obtained by selling the bonds on the secondary market at free prices with a registration of the right of property for the bonds at the regional depository

Generally speaking, the telephone installation business requires large one-time investment of capital, while the return period is quite long And this requires a financial scheme in which the process of telephonization would begin on the basis of initial capital, for example, a soft credit, and only afterwards the mechanisms of borrowing from the population could be started

At present, the telephone loan provides for the following participation alternatives the purchase of a certificate for an installation of a telephone within one year, six months and three months For this the investor must purchase, accordingly, 100, 110 and 120% of the number of bonds necessary for installing a telephone Telephone numbers are also reserved for those who hand in 60% of bonds with a pledge to pay for the remaining 40% within 3 months

Practical Experience in Issuing Municipal Bonds on the Example of the City of Yekaterinburg

Andrei Gornodut, Yekaterinburg Housing Construction Fund

We have started the program of municipal housing loans three years ago. As compared to the housing bonds of other regions we are feeling very confident. We, in Russia, have this problem: first, our people like to give away their money without knowing exactly for what and, second, our issuers are still mostly concerned about raising money and not about returning it. And this is the reason of most of our problems. I was glad to learn that some issuers (Novgorod, Yaroslavl) are dealing with this problem quite expertly.

We have gone through the experience of municipal promissory notes. I consider this to be the greatest deception in which municipal structures tried to involve banks. As a result, the budgets had suffered considerable losses. What happens in the case of budget borrowing (i.e., borrowing with the aim of covering the budget deficit) is the same what happened with promissory notes: first they get the money and the next thing they are penniless. This has nothing to do with real economics.

What is the essence of housing bonds, why did they appear and for what sake do they exist? Today people can buy housing on the market. And here they will be faced with only two problems: how to save all the money at once and how to buy housing when the money is available. The point is that it is very difficult to buy housing from among the lots that are placed for sale.

Money can be saved in various forms. This would be fine if not for the tax system which imposes income tax on saved money and even if a person receives an 80% yield, 20% more will be taken off.

Our housing bonds provide two alternatives. First, redemption in the form of housing, and second, redemption in the form of money. We prefer when people receive housing since this turns out to be cheaper. Money redemption is more expensive for us, since we pay 75% of the refinancing rate.

When purchasing housing, an individual receives more than the 0.75 of the refinancing rate, since there is a tax exemption on money invested in construction.

In essence, a housing loan tries to cope with the following problem. You all know about so-called installment construction. That is when payments for an apartment house are made in "portions." Say, there will be four such portions. As a rule, the size of the first payment is insignificant, while the second and third payments are less definite (as the builders say "Time will tell"). And this is what happens: by the time the person is ready to make the second payment the price of the apartment becomes practically equal to a market price, by the third payment profits are raked out of a person, and by the time of the fourth payment it is just pure blackmail in the process of which everything possible is pulled out of the person.

Can issuers of housing obligations behave so dishonestly toward an investor who is receiving housing? No, they cannot. Because housing obligations imply the construction of many houses.

and not only one. Of course, everything can be simplified and we can say that one endless house is being built and that is why constant payments are required.

The practice of raising large amounts and letting the construction companies make use of this money is no good. This is exactly what happened during our first issue. The builders, after receiving the contract amount, were supposed to build the houses. In other words, they had received the money before they started to work. They were smart enough to slightly protract the term and then claim 6 billion in losses. We have come to the conclusion that builders cannot be paid in advance.

All the other loans, three altogether, were shaped along a different principle: we paid for work that has been completed. And here we ran into another problem: it is impossible for one organization to control several processes: fund raising, housing construction and making sure the builders observe the work schedule. This implies too many different links which make the organization clumsy and complicated.

Our method cannot be compared with installment construction, it can only be compared with a purchase on the market. In this case the person is either satisfied and leaves with an apartment or if not we discuss the matter and this is a normal situation.

We had to solve a number of problems in the course of this loan. The first, *the problem of the underwriter*. Several banks acted as underwriters, i.e., they bought out our loan and sold it. But as I said, we had had another scheme when we were interested in raising the money quickly and handing it over to the builders.

When we shifted to the principle of paying for completed work, we received a serious blow from our underwriters. We ended up with tremendous discounts on our papers on the secondary market. We have finally solved that. And if after that unsuccessful experience we had close to 80,000 bonds "floating and jumping" on the secondary market, right now we have only 6,000 free bonds. This is a sign that people come to us to buy. This allowed us to relax a bit, but has actually placed us in our initial situation. In other words, we are beginning from the very beginning but this time with much more experience. We have raised 100 billion on these loans and have built 1,000 apartments.

The second problem is *the problem of the secondary market*. Practically all cities that conduct such loans run into the same problem: old apartments sold on the secondary market are cheaper than new ones. And this is the main reason why no one wants to take the risk of participating in such a loan. Although we have carried out such a loan in Yaroslavl to prove to ourselves the progressive nature of our experience. However, Yaroslavl having made use of our experience, has relatively outstripped us. In a city with a 400,000 population they managed to raise 25 billion rubles in the course of 8 months. This means that a loan scheme and organizational experience in issuing such bonds are extremely important.

Because it is taking too long to shape any adequate experience, housing loans do not have the right to exist. There are no such bonds abroad, because people there do not like to invest in a permanent business.

Then what is the purpose of all our efforts? Firstly, housing bonds have the right to exist in Russia while there is a shortage of housing. To buy a new apartment today is either too

expensive or too complicated. Secondly, the city also needs this, because, unfortunately, it lacks an adequate amount of housing which will be necessary in 10 years, although it can still be redistributed. Realtors have been dealing with this for quite a long time. We have started only recently but have already reached a number of positive results. In three months we have gained control over approximately one-third of the secondary market.

The next planned stage of our work is to share experience with other cities. We want other cities to implement similar programs and would like to start working with them. For example, in the area of quoting these securities among cities. For what? Everyone says that housing certificates are nonviable. We hold a different opinion. We think that housing certificates are strong papers if only they have good liquidity.

This year we also had quite interesting experience in *crediting housing*. The terms were the following: when an apartment is sold, the down payment is 60% of its cost and the remaining 40% are paid out in the course of one year at an annual interest of 5%. And everything worked out quite well and even our profit turned out to be quite good. We have realized that the housing market is immense and there is a great deal of work to be done there. When we were implementing the crediting program it took us only one month to sell 200 apartments, thus ending the crediting program.

This crediting program was joined, as a rule, by people willing to improve their housing conditions. For example, those who wanted to move from a one-room apartment to a two-room apartment and pay the difference, because they did not have such a possibility on the secondary market.

After we shift to a more liquid and more "circulating" paper, it will be important to take into account the coefficient applied during the redemption of this certificate. The redemption is done with a scale-down coefficient (0.9 or 0.8). Actually, one-tenth is a lot of money. But this is not an end in itself and in any case, housing bonds as a paper are doomed. The main goal is to create a serious construction corporation that would do business honestly and would base its work not on installment construction but on gradual fund raising. Such a corporation should not be in pursuit of big profits, as is the case in installment construction, but should use our tested crediting schemes.

Incidentally, in the rest of the world the construction business is done the other way round. There are serious building and industrial groups which include banks, construction companies and investment companies. The crediting mechanisms function successfully. Another advantage is that it is very difficult for the builders to sell their product, since the apartment market is flooded with standard apartments. The standard of living of our people is not too high and it takes the average person some time to accumulate the necessary amount of our bonds. There is, of course, another type of clients who are ready to fork out the whole amount, but our work is not intended for them.

Now several words about our problems. A municipality cannot work according to commercial standards. For example, it is very difficult to explain to an official the importance of investing in advertising, because advertising means nothing to an official. And legislative issues are very difficult to solve. You must have also had this problem of registering houses. This is an extremely prolonged process. Condominiums sound good, but if the registration of even a

municipal house takes from 3 to 4 months, there is no point in even mentioning the registration of condominiums which will take much more time. And there are other legislative problems.

QUESTION What is the circulation term of your papers?

GORNODUT Bonds are issued without a circulation end date, i.e., we have a beginning of the circulation and the beginning of redemption - in one year.

QUESTION In other words, this is an eternal procedure and the people can be absolutely sure that within 10 years this paper will still be alive. Who provides such guarantees and how are they specified?

GORNODUT The guarantees were given by the city's administration which is, at the same time, the issuer. In any case, this is more serious than guarantees provided by any other structure.

QUESTION Do you use the same papers in the crediting procedure, I mean do you credit in bonds?

GORNODUT Yes, these bonds are used in the crediting procedure.

QUESTION How do you manage to guarantee such a high yield during redemption?

GORNODUT The price-growth in the construction industry is quite high. The main reason is the fact that housing construction is a process consisting of many links. The "chain" in construction is probably the longest and a price-rise in even one link leads to a greater price of the final product. This means that inflation is accumulated in the various links of this chain.

In the beginning installment construction existed only for enterprises. Afterwards it became available for individuals. And this caused a large inflow of individual investment. The builders were smart enough to immediately increase their prices. We do not want to say that our business is not profitable. But we must bear in mind that most of the apartments we built were received by the administration free-of-charge as so-called deductions. The profit is included in the price of the paper. Although there is quite strong competition here on the part of installment construction. The thing is, they build in the "golden" districts of the city while we build in housing areas away from the city's center. The profitability of installment construction reaches quite a high number around 20%.

QUESTION Is any money allocated from the budget for repaying bonds?

GORNODUT No, we never used budget money. We pay from apartment sale receipts.

QUESTION What portion of the raised funds is used for running your fund?

GORNODUT One per cent. Our staff is four people.

QUESTION Don't you think it would be more profitable and cheaper for you to act as developers using the raised funds?

GORNODUT You cannot embrace the boundless. We would want to do this, but it is not that easy. We should not forget that the construction business is a quite monopolized (I hate to say “corrupted”) branch. That is why it is not easy to take the place of someone who is part of this process.

QUESTION What are your prices for one square meter of housing compared to similar programs in other cities?

GORNODUT In Yaroslavl one square meter in a prefabricated bearing-wall house is 2.5 million rubles, the average price throughout Russia being 2.5 - 2.6 million rubles. But in some places brick houses may be cheaper than these. In our city old housing can be bought on the secondary market for 2.7 - 2.8 million rubles. Our price is 2.9 million which is a bit higher.

QUESTION Does your issue prospectus have any limitations concerning non-residents?

GORNODUT No, not even one. I think that this is what distinguishes us from all the others. We first had the idea of having several limitations, but they are used for receiving subsidies from the budget. But we did not intend to be subsidized from the budget and we held that the city will be wealthier if we attract people with money. And it is none of our business where this money came from. There are special services for this and let them deal with that.

QUESTION Does Yekaterinburg participate in the housing program of the EBRD?

GORNODUT No, it is the Yekaterinburg Savings Bank (*Sberbank*) that participates in this program.

The Development of an Infrastructure for Municipal Investing/Borrowing Systems

Alexander Sysoyenko, Moskomzaim-Market

As Moscow experience shows, the creation of an investment/borrowing system is a relatively independent process. At the same time, since it is being fit into the life of a city or region it should be coordinated with adjacent functional structures: regional administration, securities and capital markets, and the city economy. This means that the structure of an investment/borrowing system should not only be directed toward fulfilling its own goals and tasks, but should be well-coordinated with the outer world, by which the system is influenced. However, there is also a reverse process when an investment/borrowing system influences the milieu which changes in accordance with the goals and tasks of the system. We view investment/borrowing systems and their impact on the city processes as an objective factor. And this impact is revealed in a coordination of functions of various spheres of city life and their change in the interests of an effective functioning of the various spheres of city life and of the investment/borrowing system. An environment that is coordinated and adjusted for a fulfillment of the goals and tasks of an investment/borrowing system is what we call its infrastructure.

The following units can be identified: decision-making, management of investment/borrowing processes, borrowing, investment of borrowed resources in municipal and commercial projects.

The experience of setting up an investment/borrowing system in Moscow shows that in order to establish a relevant infrastructure it is not enough to merely go through a process similar to the establishment of a well-understood nowadays stock market infrastructure. Today, on the level of subfederal administrative formations a creation of a stock market infrastructure is connected, mainly, with a certain reorganization of the interrelations of already existing and functioning institutes (the goal of such a reorganization is to strengthen the stability of municipal investment/borrowing systems in accordance with federal decisions and actions which are not always suitable to the subjects of the Russian Federation). However, the formation of other infrastructure units (decision-making concerning the borrowing and utilization of borrowed resources, management of borrowing and investment processes, investing borrowed resources) has to be dealt with practically from scratch.

Here is a good example: not less than one hundred institutes that are professional participants in the securities market and thousands of staff members of these organizations are involved in the borrowing process of issuing and placing Moscow Bond Loans. However, along with these the investment processes involve not more than two-three dozens of staff members and experts of the Government of Moscow Committee for Municipal Loans and the Development of the Stock Market, and several auditing and analytical companies. And while the securities placement processes are based on standard techniques, each investment project is quite unique and requires an individual approach and painstaking work.

On the other hand, the process of investing also requires certain standard techniques free from the moods of certain people and from possible irrational actions and opinions of certain participants in this process.

The less elaborated areas are the decision-making infrastructure and the borrowing/investment management infrastructure. The first step in Moscow in this direction was the foundation of the Investment Council (decision-making) and the Committee of Municipal Loans and the Development of the Stock Market (borrowing/investment system management).

A systematic approach to an infrastructure presupposes not only a presence of its components, but the techniques and procedures that link them to one another.

The components of all infrastructure units of an investment/borrowing system are the specialized organizations and institutes fulfilling certain fixed functions. Besides internal functions, the participants in a borrowing/investment system also carry out a number of functions related to interaction and exchange of documents and information on this interaction.

Such a description, although quite superfluous, nevertheless allows to identify and formalize the efforts directed towards building an infrastructure of a borrowing/investment system.

One must realize that municipal and subfederal administrative formations are also political formations. That is why the purely economic nature and goals of borrowing/investment processes are always eroded and blurred by political impacts. To withstand these impacts and substantiate the need for constructive actions and technologies is one of the primary tasks of an objective analysis of an infrastructure. Another important task in this respect is an adequate assessment of those efforts and expenditures which a region must inevitably make in order to form a borrowing/investment system. It is quite possible that an earnest intention to act as an authoritative borrower and have its own stock exchange may not be enough, and that this intention may not lead to the most optimum outcome and, thus, the course of action should be different, for example, pooling the efforts of several regions or delegating the issue function to a federal level. Infrastructure analysis is one of the objective instruments of clarifying such issues.

The formation of an Investment Council in Moscow as the main decision-making agency on borrowing/investment systems has not only led to the achievement of the main result (which is the existence of an agency that makes final decisions and initiates infrastructure support activities) but to a very important result for the city's finances: a broad and open discussion of proposed decisions and a professional approach on the part of the city's management to questions connected with the capital and investment markets.

Another example is that the foundation of the Committee for Municipal Loans and the Development of the Stock Market as a single agency managing Moscow's issue obligations helped the city realize the need in strict consolidated recording of all debt obligations and in ensuring the interaction of responsible organizations.

The issue of bonds in Moscow, as well as in other regions undoubtedly serves as a lever of initiating a radical reconstruction of a city's financial process and the creation of an infrastructure necessary for a borrowing/investment system. The planning of a bond issue in 1996 brought about the questions of who and how will deal with this, who and how will transfer the funds from investors into city bonds and from the city to project developers, who will direct this process on the political level and who will manage its operation. Of course, not all questions have been answered and not all blank spots in the plan for setting up an ideal borrowing/investment infrastructure have been filled and even understood. However, one year

of Moscow's work in this direction makes one believe that rapid progress in developing a stock market and investment infrastructure is quite possible

QUESTION (LEVENCHUK) Can you explain the difference between an infrastructure and an institutional system? An infrastructure is, by definition, is what absolutely different people and users (for example a water-supply system or a stock exchange) use for different purposes. But in your case there is only one purpose - the creation of a borrowing/investment system. Such a system is not an infrastructure, but in itself a production process.

SYSOYENKO I agree that all this can be called an infrastructure quite conditionally. But, on the other hand, an infrastructure includes not only an institutional system, but technology, documentation circulation and many other things that unite it. But the main thing is that all this does not work for any one special group. The Investment Committee for the committee for Municipal Loans is an effective instrument of a practical implementation of adopted decisions, while for other city structure it is a instrument of conveying their needs and requirements to the Committee. And they are doing this quite successfully.

And for our respected mayor this also a very strong instrument that allows to make decisions now, at a time when the market is becoming more open and transparent. You must be aware that politics is a complicated thing. And not everything there is done as broadly and openly as we would want it to be. Thus, an investment council is a structure that fully excludes the possibility of non-public decisions, it only provides for public decisions adopted as a result of an open discussion in an exchange of opinion, etc. And this is producing good results.

Moscow Government Experience in Forming an Interregional Investment/Borrowing System

Alexander Klein, Moskomzaim-Regionproekt

I would like to begin with some figures that characterize the scope of the activity of the Moscow Investment and Borrowing System. As of today the volume of borrowing on the internal market amounts to approximately 1.1 trillion rubles. If we add the amount of external borrowing which is 500 million dollars, we will get the total amount of the Moscow City Loan - 4 trillion rubles.

The placement is taking place along three directions. The first is the city bond loan (we call it internal). The second is a GKO-type loan oriented toward institutional investors. The bonds are placed on weekly-held tenders. The average weekly volume of placement is 50 billion rubles. This amount may waver depending on the need in funding the city's current investment projects. The third is a savings loan which is intended for individual investors. It has a smaller nominal value, is issued in document form and matures in one year. It is placed in series. Its total volume is about 600 billion rubles and each series equals to 200 billion rubles.

I believe that as compared with other regions we have reached a higher level of the realization of the issue of municipal borrowing. In Moscow these processes are much more intense than in other cities, due to a number of objective reasons and that is why we are a bit ahead of the other regions active in this area.

The status of the city budget allowed Moscow to borrow money not for covering cash gaps. Moscow's budget is now non-deficit. Moscow hasn't issued a single loan that was irrevocably spent on budget needs.

We may say that Moscow started from the second stage - from issuing investment loans. Although when the issue was only designed it became clear that separate investment loans intended for raising funds for a specific project or a group of projects was a nonviable scheme for a number of reasons. Other schemes of project funding are also nonviable for certain reasons. The issue of housing bonds also has a number of negative features. In the end it was decided to create some sort of a "civilized" and universal paper that would be acknowledged by the stock market and which would be convenient for its participants to work with.

At the same time it was clear that a borrowing/investment system had to be created. Not a separate loan but a system that would include a multitude of elements. This big and complicated system has a nucleus and auxiliary support chains that communicate with the outer world.

If we consider the borrowing and investment processes as a whole and speak about using borrowed means only for financing investment projects, it becomes obvious that in Russia today there are two major problems. The point is that we can borrow for a certain period. And when this system was founded in 1996 this period amounted to 3-6 months. It is clear that this is not enough time for implementing an investment project. On the one hand, there should be a system that would constantly raise money and, on the other, it should be structuring the borrowing chain in such a way so as to provide for a constant investment mass of funds that

could be channeled to specific projects. In other words, there should be a certain integrity in which, nevertheless, the borrowing and investment parts live their own lives.

In connection with the problem of *the length of money* there is the problem of *the price of money*. All our efforts to improve the system are directed toward reducing the price of raised money so as our final project development can receive it at a minimum rate. We give this money to the project developer at an average rate of 21%.

We have 4 types of investment projects: *purely commercial projects, commercial projects with the participation of the city, city projects and privileged projects*. And, accordingly, there are minimal and maximal rates of borrowing. But the spread between the minimum and maximum is only 3%, i.e., one project category differs from another by 0.5-1%, while the average is, as I already mentioned, 21%.

Unlike a bank, a borrowing and investment system which actually credits investment projects is not interested in obtaining profits. If the ultimate goal of a bank is the receipt of profit, the goal of *an investment and borrowing system* is different: to give an impetus to the implementation of investment projects, i.e., to *give an impetus to the development of the city's economy by filling it with additional financial resources*. The effectiveness of the system cannot be measured by the profit it brings the city and in this it differs from municipal loans, and even from investment municipal loans.

At present the investment and borrowing system in Moscow has already provided funding for 20 projects. These are quite large projects among which are Manezhnaya Square, the Luzhniki Stadium, the Olympic Village, the Gostinnyi Dvor, etc. The cost of the smallest investment project is now 5 million dollars. Besides, 150 projects are at the stage of being considered and 12 are ready for funding.

There is a certain inadequacy between the infrastructure of the stock market (which can be used by any administration that borrows money) and that of the investment sphere. And the current situation is so that it is high time the administrations start rendering infrastructure support to investment projects.

We, in Moscow, are trying to do something about this to the best of our ability and have managed to accomplish something. We have also gone to the regions with this philosophy. Together with the Committee for Municipal Loans the other departments of the Moscow Government are turning to the regions. Moscow realizes that it is impossible to create a wonderland in one separate country, to say nothing about one separate city. Besides, the regional suppliers of Moscow's enterprises have to be supported and other problems must be solved within the framework of developing economic cooperation with the regions.

Moscow has a strategic intention to cooperate with the country's regions. As of today 120 agreements on cooperation have been concluded with various cities and administrative units of the Russian Federation. One of the main problems is the source of funding for fulfilling the intention to cooperate. And Moscow has created a mechanism that is able to supply financial resources for the implementation of the cooperation plans.

On the other hand we are sensing a deep interest on the part of the regions in our activity. In particular, a conference of the Association of Russia's Southern Cities was held on May 21.

With surprising force the regions expressed their request to disseminate Moscow experience gained in raising investment for the city and region. And the process has already begun. On August 19, the Government of Moscow decided to develop the Moscow Investment and Borrowing System in the direction of interregional cooperation.

At the same time the Committee for Municipal Loans began concluding agreements, communicating information, sending its experts to seminars and conferences, etc. We are willing to cooperate with local administration. And even when we talk about working on regional stock markets this takes place within the framework of our contacts with administrations.

The Investment Council of the City of Moscow was recently founded and this is a very serious body. It is headed by Mayor Luzhkov and practically all members of the Moscow Government are members of the Council. The Council passes decisions on funding specific investment projects and on the development strategy of the Moscow investment and borrowing system. In the nearest future a commission on interregional interaction will be established, it will be headed by Vice-Mayor Shantsev.

In this connection I would like to say a few words about the placement. It has been assumed that this work with the regions will consist of two main phases. The first, a placement of the Moscow loan bonds in the regions and the second, the organization of joint borrowing. At present different approaches to this joint borrowing are being worked out. It is clear that a loan cannot have two issuers. Nevertheless, after a certain balance of interests, risks and responsibilities is established, such borrowing can be carried out. I think that the joint nature of such loans should make it possible to borrow money in the regions at the same price as Moscow has managed to attain (this is quite cheap money).

We have started to work with regional investment projects before Moscow bonds have been placed on the territory of a city or region. Our common goal is to have the placement line and the investment projects line meet in one point. It is understandable that a certain imbalance may occur: we first place a loan on one territory (for instance, in Krasnodar) and afterwards implement an investment project, while in another territory there first appears an investment project and the money might not be raised for some reason or another.

Nevertheless, the process of preparing for funding regional investment projects has begun. And I would like to stress that the placement of bonds on a territory or a region and the development of regional investment projects are parallel processes which depend on one another.

QUESTION You raise money in one region and implement a project in another. What does Moscow get out of this?

KLEIN When I use the term "regional project" I mean several types of investment projects: regional projects in regions, regional projects in Moscow, Moscow projects in the regions and interregional projects with cooperation among more than two counteragents. As a result of such projects Moscow tries to, for example, provide for a supply of necessary products (if we are speaking about specific benefits) or establish cooperation between a Moscow industrial enterprise and its regional partners. Besides, we should not forget about Moscow's strategic interest in creating an integral and efficient economic system.

QUESTION Don't you think that the Moscow Government is assuming the functions of either the State Planning Committee of the Communist Party Central Committee? In other words, you use budget funds and manage industrial production. The smart people in Moscow take hold of budget money and distribute it through tenders! Question: is there any guarantee that such a structure will be effective?

KLEIN First, we are not speaking about budget money. Moscow does not take hold of budget money. But the guarantees, indeed, come from the budget because no investor in his right mind would deal with a city or a unit of the Russian Federation that cannot provide budget guarantees. Capitalism is present here in the form of competition among project developers seeking funding for their projects. One of the key principles of the system is not to disrupt, both technologically and organizationally, the processes of raising and investing funds.

QUESTION As I understand, any borrowing and investment system is structured in the following way: money is collected for certain projects and the aim is to preserve this money and its return even without securities, but, for example, simply in the form of credits.

But this system has a non-economic advantage which consists of two parts. The first is the "trademark" of Moscow and the second is that municipal guarantees are provided for a private business system. In fact, Moscow has created an ordinary franchising system using its trademark. And the main point here is that Moscow's political orientation toward cooperating with the regions is implemented through the participation of individuals and capital.

KLEIN What Moscow is doing has nothing to do with franchising. We proceed from the fact that such cities as Yaroslavl or Tula are unable to create their own investment and borrowing systems. Even in Moscow, where everything is taking place quite successfully, there remains a number of strategic problems. In general, there can only be a few such systems in Russia, perhaps three or four.

We believe that an integral interregional investment and borrowing system must appear, and the standpoint of the Moscow Government in this issue is honest, decent and open: all information is open and unlike franchising it is provided free-of-charge.

QUESTION This looks like the beginning of Mr. Luzhkov's presidential campaign.

KLEIN All Moscow activities can be interpreted this way. We have been dealing with this system for two years now and this means that Mr. Luzhkov's election campaign has begun two years ago.

QUESTION Today Moscow is turning into a big bank. It has "squeezed out" everything from the regions. The only thing the regions still have are their arrears. The regions will continue to get poorer. Will this not lead to another Great Depression?

KLEIN When you say "Moscow has squeezed out", you probably mean Moscow banks, or rather the situation in which all the main financial flows are concentrated in Moscow. A reverse process has already begun and the Moscow Government is looking at the possibility of attracting investment to projects in the regions. This is a good idea and it should be made use of. Moscow knows what it gains when it invests in Moscow: new jobs, an increase in the tax

base, etc Moscow also needs to know what it will gain by giving its money to the regions products, new markets, etc

QUESTION I am interested in the structural and legal form of such organizations as Moscomzaim-Market, Moscomzaim-Project and others and their interrelation with the Committee for Municipal Loans

KLEIN The Committee for Municipal Loans is within the structure of the Moscow Government On the basis of decisions of the Moscow Government the Committee has established five organizations which are unitarian enterprises

QUESTION How many investment projects are being implemented in Moscow?

KLEIN Moscow is now at the level of 4 5 billion dollars of investment

Municipal Funds as a Source of Financing the Transportation Infrastructure

Yuri Govorukhov, Lukhovitsky Machine-Building Plant

Executives responsible for the distribution of earned means have a very limited choice the money should be either spent for the solution of acute social problems without any material return or on investment projects which promise profits but, as a rule, not too soon

It is now always possible to combine a solution of social problems with a quick return of investments Our proposal is one of the ways of combining these two tasks We think that it will be particularly useful to discuss this proposal at this conference which has been joined by both experienced financiers and executives who decide what areas to finance

I am the head of the marketing department of the Lukhovitsy Machine-Building Plant which is a part of the VPK MAPO-MIG We put out serial MIG-29 planes Under the conversion program our plant produces 4-seat business-class IL-103 planes designed at the Ilushin Aircraft Design Bureau

In the process of marketing our planes we have been faced with a number of problems and that is why we are here We propose to concentrate on the *restoration, on a new technical, organizational and financial basis, of the infrastructure of internal and inter-regional air transportation*

Today the once busy air lines are declining rapidly In some places contract patrolling is practiced and in others crews are set to work in the regions, but, on the whole, airdromes of local air lines are closing There are practically no passengers and no cargo to transport

The promotion flight of IL-103 along the route Lukhovitsy-Tula-Oryol-Kursk-Voronezh-Lukhovitsy which took place a month ago and during which the governors and other top officials were acquainted with the conditions of the flight, has proved that the former local air line system has ceased to exist practically everywhere However, the need in this system has not ceased to exist, especially considering the condition of the roads and the terms offered by other means of transportation

The potential users of air services are the regional officials and managers of large banking and commercial structures At present they make their own business travel arrangements this can be a trip on two Jeeps with security guards on iced roads or on a MI-8 helicopter or an a YAK-40 plane seating several dozen passengers (usually 2-3 people)

This is done because, supposedly, there are no other alternatives But these alternatives exist and require large, but not excess efforts Flying on modern planes is 5-10 time cheaper that for example, on Yak-40s or MI-8s

The structure of regional and interregional air transportation system allows to solve the problems of business-level trips This is common practice in most of the developed countries In many areas Russia is approaching the developed countries and the issue of restoring the system of regional and interregional air transportation is especially timely for us today

After World War II we had a similar system of local air lines equipped with small sports planes. But with the appearance of large passenger planes such as IL-12, IL-14, TU-104, IL-96, etc., small sports planes were excluded from the country's civil aviation concept, while in other countries they continued to successfully develop and occupy their own niche in the system of air transportation.

In our country AN-2 was the smallest plane. It is a good plane but it carries a dozen-and-half passengers. Of course we, in Russia, were aware that planes could be still smaller and more economical, but believed that such planes were not fit for our vast country with its ample oil reserves.

The same happened with the relevant legal framework. The loss of time connected with getting to the airport, checking in and going through other formalities began to exceed all reasonable limits. For light-motor aviation such problems either do not exist at all or, according to the latest Air Code, they have been considerably reduced. The legal framework will be improved quicker and more effective if there is pressure from the bottom which will, in turn, be connected with the creation of relevant structures and aviation subdivisions in the regions.

The system of local air lines can still be restored at a relatively small cost. Local airdromes and landing fields for aircraft that sprayed chemicals and fertilizers on the fields are still intact, as well as subsidiary structures, aircraft parks, and equipment. What is most important, the personnel of these facilities who usually live nearby is also available.

The operating life of the broadly used planes, in particular of An-2, has almost expired. This is a famous plane, but the country is unable to produce it and it is becoming more difficult and more expensive to repair it.

We propose to start with using IL-103 which is the only modern certified plane in Russia and in the CIS. It is of a different class and will not replace AN-2, but it can serve as a basis and provide an international level of air services. Besides, the plane will offer services which did not formerly exist in Russia and the CIS, but which are developing world-wide.

Practically all developed countries of the world design and build light planes. By the end of 1992 the world fleet of light planes counted 297,800 planes. Of these approximately 63% were used in the United States, in 1992 they spent 27 million hours in the air. According to the United States Federal Department for Civil Aviation, during the past 4 years the turnover of cargo transportation by light planes grew (expressed in costs) by 8%. According to the forecasts of this organization the volume of passenger transportation in 1998 will reach 56.9 million people, which is 8.2% of the total volume of US passenger transportation.

The same tendency is obvious in the rest of the world. For a number of reasons, in the former USSR hardly any attention was paid to the development of small aviation. Light planes were only produced in the Warsaw Treaty countries which no longer exists. In 1990-1993 the State Research Institute for Civil Aviation conducted a study of the need in business traveling for 1994. The following was found: in the north-western regions of Russia the need in business air travel was 300-400 thousand hours, in Moscow and the central regions this figure was 530-570 thousand hours and in the southern regions (Rostov and Stavropol) it was 980 thousand hours. All regions of Russia need this type of aviation.

Besides, the social aspect is also quite important. The 2000 army pilots together with a relevant number of aircraft technicians who will resign before 12 31 98 will undoubtedly prefer a job they are familiar with and which they like instead of unsteady earnings and political rallying. Not by chance have the Union of Russia's Industrialists and Entrepreneurs and the Security Council

We are not asking for investment in the production of planes. We propose to put in an effort directed toward restoring the infrastructure of local air lines and creating new jobs for highly-qualified specialists in your regions. According to preliminary estimations, the required resources are not large and promise to be repaid quickly and to bring profit to the regions' budgets.

The objective conditions are so that in Russia, considering its vastness and the condition of its roads, a infrastructure for regional and interregional air lines will inevitably be restored.

The capacity of this market is at least 4 billion dollars. It is obvious that the federal government will not deal with this task. And if we do not act quickly today, the emerging air services market (no matter how strange this may sound to us) will be filled with Cessnas and Pipers, as was the case with Jeeps, computers and Coca-Cola.

At present a working group has been set up consisting of representative of the Union of Russia's Industrialists and Entrepreneurs, the Security Council, the Government of Moscow and the Government of Moscow Oblast. This working group will work on a project designed to put local air lines into use. The name of the project is *Avialine*. I am a member of this group and am speaking here on behalf of it.

It has been decided to establish an integral infrastructure of local air lines. The group has been joined by representative from Tula, Voronezh, Kursk, Oryol, Yaroslavl, Rostov and Krasnodar regions. The project, which will encompass the entire territory of the Russian Federation, will be presented to the Government of Moscow by mid-October 1997.

I believe that the appearance of substantiated regional projects directed toward restoring the transportation arteries along local air lines will considerably increase the attractiveness of municipal bonds for investors, since the need and advantages of such a project are quite obvious. The more so, since if a year ago Russia lacked planes for such a type of service, today it has two certified and serial models: IL-103 and the helicopter MI-34.

AMERICAN EXPERIENCE OF ISSUING MUNICIPAL BONDS

American Experience Of Issuing Municipal Bonds The Development Of The Russian Markets Of Municipal Securities

**Robert Serafini, Pragma Corporation Consultant,
An Expert In Banking Investment Business**

There are approximately \$1.4 trillion of municipal debt outstanding in the United States. That makes municipal bond industry in America the third largest financial market after US government securities, equities.

Rather than deliver a speech of academic interest, I would like to direct your attention to my written remarks, distributed separately. Instead, I would like to invite you to visit my company, a firm, which in many ways is like a manufacturing plant. It has to secure supplies of raw materials, process it and find buyers. Follow me please as we visit this plant and view slides of relevant documents.

We are just getting off the elevator now at our manufacturing plant. It doesn't look like a manufacturing plant, because it's disguised in a skyscraper. But we're walking into a trading room, and try to imagine, if you can, a large room full of tables, monitors, telephones, and people who fall into several distinct categories. The first is the trader, and I think the word is almost the same in Russian, so I won't bother to define it. The second is the underwriter. He's a person who makes risk commitments on new issues. We'll get into a little bit more detail on that in a second. But third, and maybe in some ways the most important, is the sales person. He's the person that finds the customers. He's the one that gets the phone calls. He's the one that makes the phone calls. A little bit later – because he's still back at her apartment, he had a late night with some clients – we'll meet another investment banker, someone who handles negotiated financing, but he's not at the office yet.

The first thing that I'd like to just point out very quickly to you is a sense of the volume in the market, in the American municipal bond market. If you go back to 1987, the volume of bonds in the market was just over \$100 billion, and in 1996 it was about \$160 billion. There is a basic trend, believe it or not, and that's the trend line. The years 1991, 1992 and 1993 were exceptional years in terms of volume because interest rates had dropped in one of the biggest interest rate drops in history and lots of people sought to refinance their debt. That's what responsible for the exceptional volume in those three years above and beyond the trend line.

Another aspect of the municipal bond underwriting business that's worth knowing about is that some municipal bond issues represented by black in the graph are done on what's called a negotiated basis. The banker is chosen by the borrower, usually after a fairly lengthy and somewhat elaborate interview process. Mr. Nianias described the evolution of that process under his control at the city of Moscow. The basic business of the negotiated underwriter is to put together a bond issue. The bond issuer interviews underwriters and picks someone who has a good reputation – and there are plenty of people who do, plenty of firms who do – and also someone who the bond issuer feels that he or she can get along with pretty well, someone who's going to work for them. That's often the person who has spent a lot of time working with the issuer in the past, probably for free, probably chasing the business.

Okay The chart then shows the distribution of long-term volume If we look to the next chart, we can focus on another aspect of the business, and that is the mix of short- and long-term debt securities Many of the speakers over the last several days have expressed as their wish, maybe their number-one wish, the ability of Russian borrowers to borrow for longer and longer periods of time, to get away from the short-term market The short-term market tends to fluctuate fairly wildly It makes it difficult for financial people to plan If they have to be worried about what the interest rate is going to be next year or next week, it's a little bit harder to plan and set rates, set taxes, all that sort of thing

Another aspect of the desire of many of the speakers to move into the longer-term part of the bond market is that a basic principle of finance that has evolved over time is that it makes a good deal of sense to match financing term, financing maturity, with the useful life of an asset If the city of Yekaterinburg were to build a brand new school today, that school would probably be in use in 40 years So, if the people of Yekaterinburg were to pay for it themselves today, the people 25, 30, 35, and 40 years out who were paying taxes would be getting a free ride The people would be paying too much today and not enough in the future There's a basic principle There's a principle of social and financial equity, justice, which tries to match asset life on the one hand with the term financing on the other, and that's the reason It's fairer that way You pay for what you use, and people 20 years from now pay for what they use

The community that I live in, in Illinois, had an election last spring to authorize the issuance of \$40 million worth of bonds for the schools It sounds like a lot of money, but the last bond issue that had been done for the schools was in 1965 So that's over 30 years ago So 30 years of people were able to take advantage of the assets financed with that bond issue 30 years ago And, believe me, the schools are in basically good shape They're going to use the money for improvements that will just carry them further and further out into the future

That's the basic background on the municipal bond market You'll notice that the columns show both long-term bonds and short-term notes Both elements have a role in the market Yesterday Mr Ivanov described a borrowing that he was putting together for a municipality, actually for an oblast, a small borrowing Implicit in his description of the short-term borrowing and in the chart showed by Mr Novikov showing the fluctuations in tax revenues over the course of a year is a concept called revenue anticipation

If you're going to be getting X amount of revenue in the course of a year, but it's going to be coming in throughout the year in an irregular, possibly difficult-to-predict fashion, it makes a great deal of sense to take what you anticipate in terms of revenue, whether it's from taxes or some other source, and borrow it early in the year That permits your managers of whatever enterprise it happens to be to go about the business of managing the enterprise Then the tax collectors worry about collecting the taxes The money is in hand, and you don't face the prospect of closing the doors some weekend because the money's not in hand And that's a very good example of the use of that technique

Try, if you can, to recall the picture, which is always worth 10,000 words, that Alexei showed yesterday of the fluctuation of all the various taxes in the course of the year And that's basically all you need to know

Well, what's the first thing that everybody does when they get to the office? Well, in America, most people pick up this newspaper It's called "The Daily Bond Buyer " This is a newspaper

that is devoted entirely to the municipal finance business, municipal bond business, and to closely related markets. The newspaper contains all kinds of ancillary information. It contains notices of elections that are going to be held in which voters will have to choose whether to back new bonds with taxes. It contains as well notices of bonds that are going out to competitive bid. It contains notices of bonds that will be placed on the market. It contains notices of bonds that have been sold in the past couple of weeks. It tracks interest rates in a variety of different ways.

And I have no doubt that in the very near future Alexander from Skate-Press will be publishing something like this. It may not be as voluminous, but it will probably be very much like it in terms of its content. As the market grows, the market's need for good information grows, and organizations like Skate-Press, I'm sure, will be there when the time comes.

The other thing that's going on, on Monday morning, is that people are thinking about the week – what's happening this week and what happened last week. One of the things that they will look to is their mailbox, because maybe 20, maybe 30 different firms that do municipal finance underwriting in the United States will put out what's called a municipal market comment, which is just a brief description of things that have happened in the market in the past week, things that are coming, and to some extent a status report on bond issues that have been underwritten – has the entire issue been sold, if it hasn't been sold, which parts of the bond issues remain on the shelves as we say, which ones haven't been sold? The reverse of the market comment is also another statistical summary showing charts of various factors relevant to the municipal bond business.

Finally, and perhaps most important of all will be the trader's scale sheet. This is the best judgment of the head trader or traders at a firm about what is the relationship between time of maturity in this column – next year, 1998, going out to 2027 – and quality along here. You'll notice that, as maturities lengthen, so do interest rates. You'll notice that there's a difference in the interest rate across the columns – not much of a difference in short maturities, a little bit more noticeable in longer maturities – reflecting differences in credit quality.

When I first started in the business, scale sheets were much more complicated and tended to track a much wider range of quality. As we go further into the tour of the plant and what everybody's doing, you'll all see several insured bond issues. Last year municipal bond insurance accounted for 63 percent of the long-term municipal bond market.

What is bond insurance? Well, we'll talk about it perhaps a little bit more and answer any questions, but basically what it is, is an extremely powerful credit-worthy organization sells its credit-worthiness to another organization. The other organization that pays a fee for that credit-worthiness is the insured. The insured, in general, is a good credit, in some cases a very good credit. The purpose of the insurance, however, is to not be just a good credit or very good credit, but to be the best credit you can possibly be. You pay a fee for it, but computations – if your investment banker can do the math for you – generally over the course of a bond issue, you will save a large multiple of the cost of insurance.

At any rate, that's the scale sheet, and people will clip that to their telephone at least for the early part of the week when the markets are relatively stable and the new issues that are coming down the road haven't changed things. And when they need a quick reference as to what a bond is worth, they'll look at the scale sheet.

Okay, we have several scenarios that we're going to talk about. It's still 8:30 in the morning, only a half hour has gone by. The first, a salesman – it turns out a very good salesman, someone who covers what we call institutional accounts, large accounts, accounts that tend to buy minimum block sizes of \$1 million or \$5 million worth of bonds – has a customer that he sold some bonds to last December. The customer wants to get them out of his portfolio and put something else in. The salesman brings to the head trader a notice of this. He could walk up to the head trader, whisper it in his ear, but head traders, or traders in general, have the attention span of mosquitoes.

So what the smart salesman does – he writes down for the trader on the top of a sheet "\$4 million worth of Series C". And he writes it on a research comment that was published by the research department of this firm when the bond issue was done last December. Rather than ask a trader, who's living from second to second, who has no time to concentrate on anything really, rather than giving him an official statement, a prospectus, which as you all know can be a fairly voluminous document, he gives him a one-page or a two-page summary of the transaction and writes on the top what his customer wants to sell. The trader says, "Okay, I'll be back to you in an hour with a bid."

The dynamics there, what's really happening there? The salesman wants to perform for the customer. He wants to have the best bid for the customer, because that will make the customer satisfied with after-market service. Anyone can sell a bond when it's a hot new issue, but can you make the best bid later on when it's no longer a hot new issue and you're operating in a secondary market environment with other people competing for bonds? So the salesman wants the trader to buy the bonds. The trader, however, doesn't want to pay too much for the bonds. If he pays too much for the bonds, he's not going to be able to sell them, or he'll have to mark them and change the price to his disadvantage to sell them. And that's what's going to be going on between this trader and the salesman all morning long. The trader is going to be resisting. He's going to be saying, "No, I want a" – what he calls a cheaper price. And the salesman is going to be badgering him for a higher price. In the end, what's going to happen is that the salesman is going to get on the phone and start calling a lot of other customers and see if he himself can find a bid for the bonds. That's the smart salesman.

The second person that we followed into the trading room in the morning was also a salesman, a young salesman. He had no ideas about what to do. He had a tough weekend. His kids were teething. And he was happy when Friday came, and he'll be happy again when Friday comes again. So what he does is he picks up this. It's not big, but it's a daily catalogue of bond issue offerings in the secondary market. The catalogue also exists in electronic form on screens. But the catalogue is organized according to states, oblasts. And this particular salesman has a customer in Massachusetts, so he turns to that page. Now, he knows that the customer is an institutional customer and will not buy a small block of bonds, so he scans the page. He finds a block of \$2 million worth of bonds for Chatham, Massachusetts. He knows who to call, who owns them. Bank of Boston has probably called everybody in Massachusetts ten times, but he has an idea of someone who to call. So he woke up with no ideas and headache, but after a few minutes of looking in the Blue List, he's got an idea. He's got at least his first phone call of the day.

The third person important to our trading room environment is a competitive underwriter. He is the person who will respond to a written, official notice of sale and make a bid on a new

issue of bonds. This is the competitive underwriting side. You may recall it was the little white cap on top of the larger negotiator underwriting band on the graph that we had. But this particular one is for a university, the University of Maryland. The date and place at which the bids are due is listed right here. This is where you have to go to deliver your bid. A description of the issue. A description of the authorizing documents. And so on.

He doesn't care as much about that as he does about this. This is the sheet from which he will have to construct an actual bid. He'll pick up his scale sheet and start writing numbers. Hypothetically, 310, 330, 340, 350 – and out maybe to ten years --360, 370. Bonds are very difficult to sell in this maturity range. People who buy shorter bonds tend to be banks. People who buy longer bonds tend to be casualty insurance companies or bond funds. So, rather than being able to sell these principal amounts, what he's going to do is take all these principal amounts in these years, add them together into a much larger term issue. There'll be approximately – about maybe 40 million. And then finally, he'll take the last group of maturities, add them together, and that's going to be about 12 million.

So he goes out on the telephone to all the salesman and says "This is a bid that's going to become due tomorrow. We won the last time we bid on this credit, and we would like to win again. This is the scale. Everybody's going to have almost the same scale, but I'm looking for a couple of things. Is there anybody out there who can find a buyer for that 2012 maturity? If so, then we can price it as a shorter-term or middle-term bond, rather than as a 20-year bond. That could buy the deal for us. That could buy the bond issue for us."

So he puts together the scale, and after he has the scale together, he has to compute a true interest cost. For those among the audience who are professional economists and what-not, a true interest cost would be the equivalent of the internal rate of return. It's the rate which discounts all future cash flows to the net proceeds of the bond issue. He's asked to compute the true interest cost to four decimal places and to submit his bid with a good faith check. He submits his bid, along with a check for \$667,000, in this case to the University of Maryland. The bids will be opened, and the lowest true interest cost will own the bonds, the firm and the syndicate to which it belongs will own the bonds.

Another person in our manufacturing environment is the syndicate manager for the negotiated underwriting field. He opened his mail this morning and found a preliminary official statement for a City of Chicago water bond issue that's coming later in the week. A couple of things I'd point out to you about that, about this. If your eyes are better than mine, you can tell that there's red printing at the top and on the sides of the official statement. This means it's preliminary, it's subject to change. This is designed to present people with enough information that they can make an intelligent decision about whether to underwrite the bonds or buy them. Everything that's in this official statement is subject to change before the issuance of a final official statement.

A couple of points to be made from this. First, more bond insurance. This is one called Financial Guarantee Insurance Company. It's one of the three largest. \$195 million worth of regular bonds, and \$75 million worth of what are called capital appreciation bonds – they're bonds that are sold at a discount and paid at par, like GKO's. Typical of American bond issues over the last ten years has been a great deal of concern for minorities. The bonds in this particular issue are being approved by a very old, large, and well-established Chicago law firm, Schiff, Harden & Waite – very well-known. In addition, though, along for the ride is Burke,

Burns & Pinelli, who is not experienced in the municipal bond business, maybe a very small firm, but whose city policy has required the underwriters to add to the group of lawyers so that they can learn the business. The same goes on the underwriter's counsel side. Big, well-established law firm, well-known. Sanchez & Daniels, probably a minority law firm. Sanchez is a Hispanic name.

Significant in terms of the official statement is the regional firm, regional firm, local firm, local firm, local firm, regional firm, regional firm, local firm. So – one, two, three, four, five, six, seven, eight – out of the entire group of managers, eight of them are either regional or local firms. That's something to keep in mind as you watch your industry develop. The municipal finance industry, unlike many industries, can't be just a Moscow- St Petersburg industry. It has to have a presence at the local level for many, many reasons. And that's why management groups tend to be composed of a wide variety of firms. The firms without the red marks are household names in America. Some of them are household names in Europe. But those are the highlights of this bond issue. The competitive underwriter gets on what's called the squawk box – it's like a microphone – and he says, "This bond issue is coming on Thursday, get ready."

Okay, the young man who was not on the elevator early this morning has finally arrived at the office. There's a reason for his being late. He was out late last night with the clients celebrating the successful completion of their bond issue. He left the lawyers in charge. The bond issue is for a small university in Michigan. It, too, is insured by the Financial Guarantee Insurance Company. It, too, consists of a range of maturities, extending out as far as the year 2027. That's a 30-year maturity. It has two managers.

We're going to spend a little bit more time on this than on the others because there are actual principles of finance that we go at in a productive way just by looking at some of these pages. The first page that we're going to look at is the one that's titled "Security for the Bonds." If you read the language, it basically says that every nickel that comes to the university, every kopeck, pays the bonds first, before anything else gets paid. And that concept is picked up in the definition section of general revenues of the university. Secondly, as is customary, historical financial data is shown – in this case, for five years. Thirdly is a rate covenant. The borrower agrees to charge rates and fees sufficient in this case to cover debt service by at least two times, 200 percent.

The quality of this credit can be ascertained very quickly by looking at the coverage numbers here. The general revenues available for debt service cover maximum annual debt service by almost 12 times, by more than 12 times, by almost 13 times. It's a good credit. It's a very good credit. It's probably, on its own, a AA or a AA-minus.

This is the annual debt service schedule for the new bonds. These bonds are being issued what's called on a parity with, or "pari par sus" with, existing bonds of the university. The financial structure is such that the bankers have tried to wrap this maturity structure around this one with very small serial principal payments in these years. So the overall debt service remains in the 7, 6, 4, 5, 4, 3, 2 – or, rather, 3 range. It declines, but it's as flat as they could make it.

Finally we get to the meat and potatoes. What's the bond issue all about? Specific projects – Specific costs. Not general corporate purposes. So these are the four projects that are being financed. This is the sources and uses of funds. The underwriter's fee is \$208,000 on a \$40

million issue. It's about 1/2 of 1 percent. Costs of issuance and bond insurance are \$268,000. My estimate is that bond insurance is about \$200,000, or also about 1/2 of 1 percent of the bond issue par amount. That's very low. It's a very low number, and it reflects the very high credit quality of this bond issue.

Another piece of the borrowing that I'd like to point out to you is this one. This is a section called "Permitted Investments." When the bond issue is closed and money changes hands – the money has to sit in the bank while the construction takes place. As the engineers and architects are satisfied that various stages are being satisfactorily completed, money will be paid out. In the meantime, though, the money has to be invested, or should be invested. You'll note, as is typical of most American bond issues, and in some cases required by state law, only the very highest quality investments can be used in the construction fund. Direct obligations of the United States – that's A) B) trust receipts basically representing direct obligations of the United States, obligations of the Federal National Mortgage Association, and perhaps most interestingly, certificates of deposits of banks with capital not less than \$100 million. This is designed in part to insulate the local finance people, the vice president of finance at the university, from the local bank, which would like the money very much in its coffers during the construction period, but the university has agreed that it will only be in a bank which has net capital in excess of \$100 million. That means that the Third National Bank of Ypsilanti, Michigan, a very small bank, will not see this money.

A fourth element of the bond issue which I'd like to point out is that the proceeds are trustee. They are deposited with a trustee bank. The people at the university never touch the money. They might touch the check at closing. They might get a xeroxed copy for their wall. But they don't touch the money. They don't see it. What's the wisdom behind that? Alexander told me a very amusing joke this morning, a Russian joke, and so I don't mind repeating it. He assures me that it will give no offense.

A Russian city official was in the United States visiting a friend, and sitting at a park having a nice coffee, saying to his friend, "How did you afford to put in this park?" The American municipal official pointed to a bridge and said, "We financed that bridge with revenue bonds. We had extra money, we put in the park." About three years later the American official was visiting his Russian friend, and they also were sitting in a park. And he said, "This is wonderful, this is a lovely park. How did you finance it?" "Oh, we financed with it two bridges. The first you see over there." And the American official nodded his head and said, "Yes, that's a nice bridge." "The second bridge is over there." The American official looked at it and said, "Where's the bridge?"

If the money had been with a trustee bank, the bridge would have been built. The people who loan the money, who bought those bonds, expected a revenue-producing asset. They handed over their money in exchange for the promise of a revenue-producing asset that would pay them back. They did not expect someone to take that money and build a park with it. A great public purpose, but it was not the deal.

When the young man left the lawyers last night, they were discussing the Opinion Letter. The auditor marked one or two pages of the opinion letter as unaudited and was unwilling to express an opinion on the accuracy of the data. The lawyers did not like that. The lawyers representing the underwriters didn't like it because it is not in the nature of full disclosure. When you go to the trouble of disclosing financial information and hiring a big accounting firm

to audit that financial information, you don't want exceptions in the Opinion Letter. You want the accounting firm to say unequivocally – we have looked into this information and it is accurate. End of discussion.

So for three hours last night the lawyers argued about it and in the end the woman underwriter said to her lawyer – I am prepared to take a business person's risk that this information is accurate. And, or, that it is not material. So as far as I am concerned we can go forward with this underwriting, we can close this bond issue. I'll take the risk.

Finally we get to the form of the Bond Council opinion. The Bond Council is a law firm who does not really represent the university, does not really represent the underwriter. If he had to really say who he represented, he said he represented the bond holders, the people who are going to buy the bonds.

I am focusing a lot on the Bond Council opinion because I think, to me it is one of the things that I think really needs work in Russia, right now. There is no substantial legal fraternity doing finance law, except for a handful of Western law firms in town. Mr. Devane mentioned Coudert Brothers, Clifford Chance, there is also a couple of other English firms, couple of American firms, but at some point you have to grow your own legal experts.

I recognize that the landscape with the Constitution, the laws and regulations is shifting. But it is always shifting everywhere. And until you have an indigenous industry of legal experts you are going to have a hard time growing the financial side of the business. I personally don't like lawyers. America has far too many, I think. I went to law school and I knew the first day of law school that I was never going to practice law.

Financial lawyers I make an exception for. I am yet to meet a top-flight financial lawyer who is not a truly first-rate, who does not have a truly first-rate mind. As Mr. Devane talked about yesterday, the best lawyers are above all principled and creative. And you need them. But right now you don't have them.

The opinion that the lawyer is called on to render in the second paragraph here, it says here – we are not rendering any opinion on anything relating to the fact as disclosed in the bond issue. This is not a disclosure opinion, this is a legality opinion. He will render an opinion that the trust indenture, that is to say the document which takes those construction funds and puts them in the Mellon Bank, that it is binding. On the bank and on the borrower. He is rendering an opinion that the bonds are valid and binding obligations on the university. He is rendering an opinion that the interest on the bonds is not part of the gross income of the tax payer in the United States. In other words, the bonds are tax exempt.

And finally, he is rendering an opinion, well, that is not important. Finally he is saying that the rights of the trustee to enforce these obligations may be limited by courts. Courts who say, "yes, that is legal, but it is not fair. Well, yes, you are owed the money now, but they do not have it now, you are going to get it in six months." That kind of thing. There is always that possibility of what is called an equitable remedy.

Okay, it is two o'clock in the afternoon now and the negotiated syndicate manager hasn't had a lot to do today. He announced the coming Chicago water bond issue, but he got a call from one of his underwriters down in Texas that they had just got a new award on an issue of housing.

bonds I have chosen this particular issue to illustrate a couple of other features of the American bond business

American municipal bonds are not registered with the Securities Exchange Commission Under either the 1933 Act or the 1994 Act There is no registration requirement for municipal bonds in America However, and it is a big however, the regulation of the municipal bond industry is undertaken by the SEC through its registration and regulation of broker dealers That is the mechanism that you know is going into place now

So the dealers are regulated and registered The bond issues are not The rules for the bond issues, however, are very minutely set by the US Treasury So much so that in this housing bond issue, and I picked the housing bond issue because it is an element of urban infrastructure that the fellow from the Urban Institute right there talked about It is a tricky kind of asset A house or an apartment is by far the biggest thing that anybody here is likely to ever own And yet in the scale of social assets it is small and it is private So it is tricky

The way the government of the United States has dealt with housing bonds is to limit them It froze them into a category called private purpose bonds, in other words, making the judgement that housing is primarily a private activity and tells people who want to buy housing to go get their loans at the bank, mortgage company, a private lender, under possibly some federal program

I understand the situation that the fellow from the Urban Institute was talking about The federal program exists in Russia, but it is not up and running yet And there are also all kinds of other problems But in the United States it has gotten far enough that that's the way it works If you want to borrow money for a house, you go to the private market and you pay a taxable rate

The few exceptions are the small handful of housing bond issues that are done on a tax exempt basis by local municipalities To give you some idea of how they are regulated That middle piece, series B, is 100-percent tax exempt Under some specific rules issued by the Treasury series A is subject to a special tax that is imposed on high-income individuals The series C is entirely taxable

So we don't register our bond issues with the Commission But we definitely worry about the tax authorities We are almost finished I would like to just point out once again local and regional firms In this case a strata, you know, Josa is a Hispanic firm, Seawood, Brandford and Shank is a firm that is primarily, that is majority owned by women, in New York City

So the negotiated underwriter calls from Texas to say that they have the award of the bonds and the senior manager puts out a wire, this is just a long wire, goes out over a wire service to all the syndicate members, confirming all the details of the bonds as they understand them, as well as the rules for the syndicate

Finally, the day is almost over and this young man having argued with lawyers to the wee hours of the morning and having worked hard all day, he is ready to go home But he gets a call from a colleague down in Tennessee who says that a client is being courted by another bank, or another investment bank, that has proposed a bond issue backed by a letter of credit

First thing he does is reach for his shelf next to his desk and pulls down this book. It is a substantial, hefty volume. It is a book called *Municipal Finance Criteria*. It is published by Standard and Poors. What it is basically is a quick study on virtually any kind of bond issue structure that Standard and Poors has ever rated. You can become a quick expert or semi-expert simply by reading a couple of pages in the book. It tells you what Standard and Poors will be looking for when they look at this type of book. Moody's does not produce a comprehensive volume like this, but Moody's does produce occasional reports shorter, so he gets on the phone to the library and the research department and says, "Does Moody's have anything on this?" And, yes, Moody's does have a little brochure called *Rating Letter of Credit-Backed Bonds*.

So he has two things to put in her briefcase on her way home. On the way home, by the way, he walks by the trading desk, the lights are out, it is five o'clock at night and all those people who arrive between five and seven a.m. have long since gone home to their families and loved ones. And he is the one who is leaving late. The day is over. You have seen our manufacturing plant, you have seen some of our people in action. I would like to have shown you actual photos, but couldn't do that. And I will be happy to answer any questions that you may have.

Q What about the housing bonds: what are the purposes of their issuance, how the money are spent, who is the guarantee, and what is the structure of such issues?

A Well, there are a number of different structures. The most common structure is one that is called a loans-to-lenders program, where the bond issue proceeds acquire from a lending institution existing mortgages that have already been on the portfolio for a little while. That provides liquidity to the lending institution.

A I will repeat the question and the translator can do his thing. The question is what do I see as the prospects for the issuance of municipal bonds by the regions of Russia and in particular what possibilities exist for a variety of different types of bonds issued according to different types of revenue streams. Does that sound right, Sergei?

That is why we are all here. I think we all understand and believe that is going to be happening in the next few years here in Russia. Driving with the Dronovs yesterday through town we came across an electric utility and I asked them who owns the electric utility. They said – the state. I then asked Mrs. Dronov, as we passed a hospital, who owns the hospital? She said, the state. And finally we passed one of the many superb technical institutes in town and I asked Mrs. Dronov, whose English by the way is very good, who owns the technical institution? And she said, she wasn't sure about it, but she knew that there was an association, but she thought that they were owned by the state.

Over the next five years you have to do what Mr. Novikov told you to do yesterday. If you are a municipal official, you have to go back and get to work on your books. If you can't do it yourself, you have to find somebody who can do it for you. In a town such as this, there are plenty of experts running around, but you have to rationalize the flow of funds into and out of the municipal enterprise into recognizable streams associated with electricity, schools, health care, housing, all the other things that you do.

One final comment, we have gone beyond the time, relates to the use, relates to comments by many of the Russian speakers yesterday about the use of municipal borrowing for essentially

private purposes – loans to enterprises and what not I can tell you categorically that that type of lending is virtually prohibited by every state constitution in the United States

When I elect a mayor, when I go to the polls to elect a mayor or governor I am looking for someone who will have good schools for my children, good parks for them to play in, who will clear the roads of snow, keep the buses running But when I want to make a business investment I go to someone like Mr Dronov I mention him only because he is a local person that some of you may know and I also happen to know

I make my investments myself I do not look to my city fathers to make investment decisions for me And I do not think that any tax payers in America would be very happy if they felt that their city fathers were doing that on a wide-scale basis There are exceptions but the exceptions are rare Thank you all