CONFERENCE ON SMALL MUNICIPALITIES' ACCESS TO THE CREDIT MARKET

CZECH REPUBLIC

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The objective of this memorandum is to consider whether one or more conferences would help clarify the policy choices facing the Czech government, and help introduce new credit mechanisms that could, in a sustainable way, improve credit market access for small municipalities. In December 1996, Robert Lenna, Executive Director of the Maine Municipal Bond Bank, traveled to Prague to investigate the interest of various Czech ministries, municipal governments, and banking institutions in the establishment of a specialized program which would help small municipalities gain efficient access to the local credit market, through a specialized intermediary program that would pool small municipalities' credit needs in one form or another, then raise capital in the competitive market to finance these credit requirements. Preliminary indications showed a strong and widespread interest in the potential of such a program and a conference was tentatively scheduled for the Spring of 1997 but was not carried out.

A country the size of South Carolina has 6200 units of local governments. The large cities have access to the international and domestic bond markets and can borrow freely from both Czech and international banks. The small communities,[1] the vast majority of the total, have unmet financial needs. Suggested options for increasing the small communities' access to capital have included: creating a subsidized financing instrument especially for small municipalities; using MUFIS to target commercial bank lending on small municipalities; focusing the Environmental Fund's financing on small municipalities. Despite these suggestions, there is nothing to suggest that the financial needs of small municipalities are being met in a systematic way. Indeed, it is the policy of the State, as yet not implemented, to amalgamate these thousands of communities into larger units of government.

There seems to be a growing distance between the central government and local governments. This was not a subject which we were able to explore in detail, but some recent State actions bespeak an attitude that there are too many municipalities, they are budget busters, they are not going to be permitted to sell bonds, and if they continue their alleged profligacy they will be penalized by having their revenues reduced.

[1] In this report, we use the term small communities to characterize communities with a population of 2,500 or less inhabitants.

It is our judgment that the central government will not soon provide additional subsidies to local governments, either direct or indirect. Given the fiscal retrenchment of the Government, this is probably sound national policy.

Having considered the current attitude of the central government, we propose to address this issue by holding a (1) seminar concentrating on pure pooled financing with no central government subsidies and (2) a conference that would consider how to leverage existing subsidies.

POOLED FINANCING

We found in our interviews with banks that lenders are struggling to find a way to lend to "Associations" and, yet, the techniques involved in pooled financings in the US do not appear to be fully understood in the Czech Republic. We believe that exploring the ways that regional and project-specific financings are secured in the US would be very useful to Czech lending institutions. To make creditworthy loans, these lending institutions need assistance in establishing the ability of each participant in a pooled financing to pay their obligation. It is necessary to develop standards for judging creditworthiness of pooled issues with or without government or other guarantees. This, of course, leads inevitably to the need for standardized financial information, audit procedures, methods for presenting financial information and disclosure requirements.

Some of the topics to be covered specifically in a seminar of this type would be a discussion of:

- The pledge of cash flows from the central government to the local government (the possibility of state aid intercepts and how they work)

- The pledge of collateral (securing borrowing with the pledge of the project built with the proceeds of a borrowing

- A discussion of the laws and legal covenants to secure pooled financings (joint obligations vs. joint and several, enforceability of loan covenants, et al.)

- The need for standardizing financial information, auditing, disclosure, and the basic information required by banks for loan appraisal, in order to reduce the costs of lending for pooled financings

- Letters of Credit (from local or foreign ban)
- How to create and protect reserve funds
- How to restrict the use of surplus operating funds
- Limiting the amount of bonds/loans outstanding
- Limiting the amount of financing for any individual municipality
- Do municipalities pool voluntarily or is it compulsory?
- Project design and cost estimates
- Anticipating maintenance and operating expenses
- Use of a Trustee to administer bond funds, operating and debt service funds, and to enforce contract provisions

It is also possible that as part of this program we could include experience relevant to capital financing by the to-be-created Regions and by other local institutions such as the Local Development Agencies.

Attendees at this kind of a seminar could be any institution with a stake in financing small municipalities, including the municipalities themselves and commercial lenders. Presenters can be those representing the kind of institutions being discussed (the Executive Director of the Bergen County New Jersey Sewer Authority, for example, or the director of an institution that has built and operated a solid waste landfill on behalf of several municipalities), the ever present and all important lawyers (both US and Czech), and the bankers who have put these deals together and then sold bonds to finance them.

Again, the objective of the seminar would be to demonstrate that there are ways to finance at least some of the capital investment needs of small municipalities within a market framework, at market rates of interest.

RE-EXAMINING THE UNIVERSE OF CREDIT SUBSIDIES IN THE CZECH REPUBLIC

A conference on leveraging existing subsidies makes sense when the government does not appear to be open to extending subsidies. Planning a seminar on how a bond bank works would not make sense because all US examples of that kind of organization rely, finally, on the indirect credit of the State to support long-term borrowings by the bond banks, their source of funds for on-lending to small municipalities. Instead, this conference would be based on an inventory of all the existing subsidy programs in the Czech Republic (by type, size, eligible borrowers, kind of subsidy, etc.) with the objective of determining how these subsidies could be used more effectively.

Examples of existing direct and indirect subsidy programs include the State Environmental Fund, the MUFIS program, and capital subsidies to local authorities. The State Environmental Fund provides below-market credit for environmental projects for both municipal and corporate borrowers, and even attempts to favor small municipalities that could not otherwise gain access to the credit market. Yet its primary source of money, pollution charges for emitters, is declining. The MUFIS program is made possible through a State guarantee; the State also accepted most of the currency risk on the borrowing in the US. However, the State guarantee cannot be used by MUFIS outside the HG program. Despite this year's fiscal retrenchment, the State still provides substantial capital subsidies to local authorities.

One approach would be to promote a discussion of how this array of subsidies can be used most efficiently, and whether the various subsidy programs in the Czech Republic can be coordinated more effectively to better leverage local capital investment. A conference would examine the types of financial arrangements that can assist small municipalities in capital financing and consider how existing subsidy programs might be applied more effectively to finance small communities' capital needs. It would cover topics such as:

- Direct grants (and the possibility of state aid intercepts)
- No interest or low interest loans (with or without principal repayment forgiveness for x years)
- Direct state guarantees, and the possibility of using the one existing State guarantee for financing from other sources than the HG
- Indirect State guarantees (like a bond bank guarantee which triggers after all else has failed, including work-out arrangements)
- Equity reserves contributed by State grants and/or seed money (such as the US state revolving funds) and a discussion of the

different kinds of direct and leveraged loan programs possible under this arrangement

! *De facto* subsidies in the form of accepting non-payment of debt obligations.

As background for this conference, a paper would be prepared inventorying the different types of subsidies for local capital investment now used in the Czech Republic, their cost, and their impact on markets.

The audience (and participants) for this conference would be mostly those ministries and agencies of the State government that manage subsidy programs for small communities, plus representatives of the recipients of these subsidies. The presenters would be individuals who have had hands-on experience in running these kinds of programs, both in the Czech Republic and elsewhere, and policymakers from outside the Czech Republic who have actually changed their mix of capital market subsidies after an examination of this kind.

This conference might be an appropriate high-level wrap up for the USAID program in the Czech Republic, similar to the high-level conference that initiated MUFIS and the intensive program of bank and municipal training in credit analysis. The subject of re-examining and rationalizing credit market subsidies is one that urgently needs attention in the Czech Republic.

NEXT STEPS

If we prepare a fairly detailed description of what we have in mind to the Ministry for Regional Development, they may be willing to sponsor or co-sponsor either the seminar or the conference. They have expressed, again, an interest in having a small municipalities' financing conference under their auspices. But they want a plan. They promised to let us know their decision within a month after receiving something in writing.