

**CONTINUING THE  
DEVELOPMENT OF  
POLAND'S SUBSOVEREIGN  
DEBT MARKETS:  
IMPEDIMENTS AND  
OPPORTUNITIES**

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## **EXECUTIVE SUMMARY**

### ***Assessment of Current Situation***

Several studies have chronicled the growth of Poland's subsovereign debt markets over the four years, 1994 through 1997. The market has grown rapidly and is characterized by i) the exercise of prudence by borrowers, ii) a mixture of short term debt for cash flow and "bridge" financing, iii) competition among debt formats, iv) competition among domestic and foreign financial institutions, and v) the emergence of risk-adjusted pricing.

While concessionary lending has clearly increased the use of debt finance by sub-sovereign borrowers, and helped the market grow, it has also served to segment the market for environmental infrastructure. Here, concessional financing often "crowds out" market rate borrowing.

There has been substantial development of the legal, regulatory and institutional framework for subsovereign debt, as well as the competencies of the appropriate capital demand and supply side participants. Much of the framework and competency development has benefited from the assistance of donor organizations, including prominently USAID.

The development of the subsovereign debt market has occurred in a difficult macro-economic setting, i.e., high inflation and high interest rates and within a "debt-wary" political culture.

There are substantial barriers and impediments to the continued development of the subsovereign debt market, inter alia, i) existing and impending issues relating to the effectiveness of the legal, regulatory and institutional framework, ii) challenges of willingness to incur debt and other shortcomings of subsovereign borrowers and issuers and iii) issues effectively limiting the financial institutions' ability to further develop this market.

Over the medium-term, the potential inflow of large sums of grant money for municipal infrastructure could significantly dampen the growth of the sub-sovereign credit market, especially if no sound criteria for means testing are developed to direct these grant monies to poorer jurisdictions.

The team's assessment of the current state of the subsovereign debt market suggests the importance of continued efforts for the development of this market, particularly in the areas of i) empirical research and policy advisory efforts, ii) transaction facilitation, and iii) training and technical assistance.

## ***Legal, Regulatory and Institutional Framework***

Analysis of the existing legal, regulatory and institutional framework for all types of subsovereign debt has identified certain substantial impediments. Most immediately, there are urgent issues raised by the impending Law on Public Finance which could materially inhibit the further development of the subsovereign debt market:

- Debt limitations to be imposed on subsovereign entities based upon certain formulas which tie all national, regional and local public sector debt (state and local) to percentage of national GDP.
- An additional limitation which would prevent the principal amount of debt maturing beyond a fiscal year from exceeding 60 percent of that year's revenues. This provision could substantially inhibit the development of demand for longer maturities.
- A requirement that the full value of a credit be stated in zlotys on the day the transaction is entered into, a requirement which may restrict borrowing in other currencies.
- A requirement that local government management provide voluminous and not necessarily pertinent capital asset, a requirement that will present enormous compliance issues for such management.
- The draft new Law on Public Finances, while making possible multi-year capital improvement plans, still does not clearly separate capital and operating budgeting and accounting. One of the major problems here is that under Polish public accounting rules, subsovereign entities use debt to fund a "deficit" (either capital or operating or both) and not to meet specified capital investment purposes.

The current budgeting and accounting processes do not make capital versus operating cost distinctions. Certain provisions of the pending Law on Public Finances may encourage such distinctions.

The Law on Competencies passed earlier in 1998 resulted in new levels of subsovereign self-government: powiats and Voivodships. The pending draft new Law on Revenues may result in new formulae for intergovernmental transfer and sharing. The financial and other impacts on local subsovereign borrowers (gminy, local utilities, etc.) will need to be assessed and analyzed.



### ***Opportunities for Development Assistance in Improving the Legal, Regulatory and Institutional Framework for Subsovereign Debt***

These opportunities primarily relate to empirical research and policy advisory efforts with regard to, inter alia:

- The impact of the Bond Law and Procurement Law on procedural flexibility in the financing process.
- Clarification of the role of RIO's with regard to debt approval and training related thereto.
- Appropriate and relevant initial and continuing disclosure requirements for public offerings.
- The impact of both the Law on Public Finances and the Law on Revenues in the form adopted.
- The promotion of tariff reform for full cost recovery, capital planning and budgeting, and other best practices, e.g., a) development of appropriate policies at the Water Standards Board, Anti-Monopoly Offices and HUDA.

### ***Issues Related to the Demand for Debt by Subsovereign Entities***

There is a cultural reluctance by Polish subsovereign governments to utilize debt which has not yet been fully overcome by the pressures of deferring long delayed and much needed capital projects or the arguments supporting the principle of achieving inter-generational equity in the financing of long term facilities. Indeed, while the creation of self-governing counties and regions in 1999 will no doubt create some new risks, Poland's fundamental subsovereign capital market problem seems to be less the danger of an explosion of sub-sovereign debt, than the failure to responsibly expand subsovereign investment borrowing. Polish local governments have inherited huge deficits in capital infrastructure, deficits that they will not be able to overcome if their overall borrowing does not move closer to 5 percent of the GDP from its current levels of 0.5 percent.

- There is a continuing lack of competency of local government officials in the areas of planning, budgeting, project preparation and the financial structuring of projects.
- The continued availability of concessional loan money suppresses demand for commercial rate debt, particularly in the



environmental sector.

- There is a critical need for the development of cash management skills as well as prudential guidelines for the investment of municipal funds.
- RIO's continue to have substantial and growing responsibilities while their resources and competencies are limited.
- There appears to be a great deal of misunderstanding and confusion regarding the strategic and appropriate pledging of collateral.

The new debt limitation regime in the new draft Law on Public Finances may further constrain or suddenly eliminate the use of debt by general purpose subsovereign governments. It may also prompt a rush to the market by local utility enterprises not covered by the debt limitation well before either enterprises or gminas have come to live with full cost recovery tariff pricing and other critical aspects of their financial and political relationships.

***Opportunities for Development Assistance to Continue to Stimulate the "Capital Demand Side" of Potential Subsovereign Borrowers or Issuers, Including:***

- The creation of responsive financial engineering advisory services, i.e., an "honest broker", to facilitate the financing of viable projects.
- Continued technical assistance and training in the areas of, i) planning, ii) budgeting, iii) cash management, iv) project preparation, and v) the financial structuring of projects.
- Guidance on the strategy of pledging sufficient and appropriate collateral.
- The development of an effective state aid intercept structure that's utility will increase as the intergovernmental finance system makes the transition from grants to subventions.
- The promotion of utility commercialization and privatization, including providing assistance to them to borrow on their own and without support from gmina budgets.
- The continued development of basic financial management, project preparation and financial structuring competencies

among key subsovereign utility managers and the use of performance contracting experiments with gminy and utilities, with an analysis and dissemination of the results.

- The development of means testing criteria to guide the allocation of European Union grants for infrastructure investments.



***Issues Related to Supply of Debt for Subsovereign Entities:***

- There is a barrier between well prepared projects of quality issues in an substantial aggregate financing size and availability of institutional pools of złoty denominated mid-to-long term capital. The expected sources of such capital are either prohibited from such investments (e.g., the Law on Pension Funds has substantial limitations on the percentage of assets that may be invested in "non-publicly traded" investments, or show little interest due to the size and lack of name recognition of the borrowers (e.g., insurance funds).
- There is an absence of any retail market.
- There is an insufficient secondary market.

***Opportunities for Development Assistance to the Capital Supply Side, Including:***

- Exploration of possible changes in the prudential investment requirements of the Law on Pensions.
- Research and analysis on loan contract provisions (e.g., covenants which may enhance security provisions) and the development of standard loan formats which may assist in the pooling of such loans in asset backed securitized financing.
- Assistance to interested private institutions in the research and development of financing instruments such as the structuring of loan packaging and sale, and bond pooling, as a means of increasing the capital supply.
- Continued efforts to increase the supply of publicly offered transactions in conformance with the new SEC regulations as to initial and continuing disclosure requirements.

***Conclusion: Possible Next Steps for USAID***

The viability of the subsovereign debt market is dependent on many components, actors and processes. There is no single factor which, if addressed fully, will assure the continued successful growth of this market. It is necessary to "corral" as many of these components, actors and processes in order to effectively bring about further development of the market.

The team recommends that as an immediate next step a series of roundtable discussions with appropriate representatives of the State, subsovereign borrowers, banks, other investors, and possibly donors. The purpose of these roundtables would be to support the existing and expanding community of interest in the field of subsovereign debt market development and prioritize the challenges and opportunities discussed in this report. The roundtables could be structured around the following groupings of topics:

- Continuing efforts to promote long time capital planning and budgeting, task based budgeting, and project preparation.
- The facilitation of creditable local infrastructure financing.
- An intensified focus on the role of utility enterprises in infrastructure finance as well as service delivery and tariff reform.
- The bridging of the gap between creditable projects and long term, z»oty denominated capital.
- RIO's and their role in debt approval and other related aspects of intergovernmental oversight.

Although the official convenor of such fora may be different depending on the issues presented, it would be beneficial to identify a Polish institution with a sufficiently broad perspective and institutional capacity and credibility to oversee and structure the participants and the processes necessary to bring about the reforms and improvements needed for the further development of the subsovereign capital market into a market that can effectively meet the needs of its market participants.

# CONTINUING THE DEVELOPMENT OF POLAND'S SUBSOVEREIGN DEBT MARKETS: IMPEDIMENTS AND OPPORTUNITIES

## CURRENT STATUS OF THE POLISH SUBSOVEREIGN DEBT MARKETS

### *Four Years of Growth: 1994-1997*

The development of Poland's subsovereign debt markets is a remarkable achievement. Several studies have chronicled the growth of Poland's subsovereign debt markets over the four years, 1994-1997<sup>1</sup>. The market, while still quite small relative to the entire Polish public and private debt market system, has grown swiftly over the four-year period. This debt market development has been characterized by:

- A healthy level of prudence—for example, there have reportedly been no defaults among 44 completed bond issues<sup>2</sup>.
- A mix of short term debt used for cash flow management and possibly construction “bridge” financing purposes, and short- to mid-term debt for capital infrastructure purposes.
- A degree of competition among debt formats (bonds, loans and possibly leases<sup>3</sup>) on the basis of interest rates, appropriateness of purpose and structure, and other factors.
- A substantial competition among financial institutions providing market rate loans and bonds, including foreign and domestic institutions.
- A substantial degree of bifurcation of the market between capital for environmental needs and most other infrastructure finance requirements, due to the ready availability of highly

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<sup>1</sup> We rely here principally on 1) "The Development of the Polish Municipal Capital Market: 1994 - 1996", October 1997, Tony Levitas, Research Triangle Institute; 2) "Municipal Bonds in Poland: General Overview of the Bond Market", December 1996, Municipal Bond Center at MDA and "Municipal Bonds in Poland—Market Characteristics", Michel Bitner, November 1997, Municipal Bond Center at MDA; 3) "Commercial Credits Drawn by the Communes and Communal Companies in the years 1995-1997", Regional Clearing Office in Kozalin for the Council of Regional Clearing Houses, September 1998; and 4) "Municipal bond Market as of October 15, 1998" and "Pending Issues of the Municipal bond Market", CERA, October 1998.

<sup>2</sup> The team has heard that there may have been some concerns about timely bond debt service payment in a few instances and that some loans were restructured, although we have no information on the purpose of any such loan restructurings.

<sup>3</sup> Municipal government officials have advised us that leases are commonly used for equipment and other capital acquisitions but the team could find no data about the size or other characteristics of this segment of the municipal debt market.

concessional debt and grants for water supply, wastewater treatment and other environmental purposes from such sources as the National Environmental Fund and the relative scarcity of subsidized debt or grants for other local infrastructure purposes.

This subsovereign debt market has developed as many of the key legal, regulatory and institutional frameworks have appeared and improved, and as necessary competencies among appropriate capital demand and capital supply side players have developed. Moreover, it is noteworthy that the macro-economic environment in which this debt market has been developing has been characterized by high (though falling) rates of inflation and high (though falling) nominal and real interest rates. It is perhaps equally noteworthy that the Polish subsovereign debt market has developed in a social and political culture generally held to be suspicious of debt and in a sector with a long history of "pay-as-you go" capital infrastructure investment<sup>4</sup>.

### *1998: The Year-to-Date and Immediate Prospects*

The team has acquired complete data only on bond activity for the year 1998 to date. That data demonstrates a level of activity approximately on a par with 1997. Thus far in 1998, 14 bond issues have been closed while an additional 17 are pending, of which 15 are presently scheduled to close in 1998. If only a fraction of these issues actually close in 1998, the number of issues in 1998 will approximately equal or exceed that of 1997.

With respect to loan activity, particularly commercial rate loans, we have anecdotal evidence that 1998 may prove to be a higher volume year than 1997, which substantially exceeded prior years. However, as 1998 comes to close, major changes are contemplated in the legal and regulatory framework, which could sharply curtail or even stop the subsovereign debt market completely. Provisions of the Law on Competencies already passed, the draft Law on Public Finances, the draft Law on Revenues, changes contemplated in the SEC public offering disclosure requirements and other changes will substantially alter the national legal, regulatory and institutional frameworks within which the Polish municipal debt market now functions. As discussed more thoroughly below, positive, negative or mixed impacts on such key issues as sub-sovereign credit-worthiness and the procedures for accessing debt could result from this diverse range of potential changes.

Although the team has not been able to verify this empirically, we understand that the National Environmental Fund and a number of voivodship environmental funds may have been drawn down more heavily in the last year than in prior years, for two reasons. First, a number of funds appear to have been drawn down to assist flood-damaged gminas with basic infrastructure repair and reconstruction. Second, some of the voivodship funds that will be eliminated with the creation of regions in 1999 apparently choose to spend themselves out in 1998 in order to avoid residual monies being carried over into the new funds.

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<sup>4</sup> This debt-wary social and political setting is said to have caused by the public debt excesses and lasting financial consequences of the Gierek era.



This seems likely to reduce the environmental funds' ability to provide concessional loans for water, wastewater and other local environmental infrastructure, at least for some period of time to come. This may have already had the effect of reducing the credit market bifurcation between lending for environmental and other kinds of infrastructure noted earlier. In addition, the creation of powiat funds, and the diversion of some fines and user fees away from the national and voivodship funds may further reduce the amount of money available for concessional loans. Over time, the environmental funds can also be expected to collect less and less in fine money as pollution problems are resolved, often by the very projects financed by the environmental funds themselves.

While substantial attention has been paid to the development and growth of the subsovereign bond market, the longer established and fastest growing of the sub-sovereign debt markets in modern Poland appears to have been the loan market<sup>5</sup>. This appears to have been a natural consequence of several factors including the history of relatively plentiful concessional loans available from a variety of sources since the early part of the decade, as well as the slower growth in general knowledge and gaps in the specific necessary frameworks and competencies needed to facilitate the successful issuance of privately or publicly placed bonds. Furthermore, sub-sovereign bond issues in Poland have tended to be relatively small. Investors, particularly those other than banks, such as commercial firms and insurance companies, are described as having an appetite for substantial size and to be relatively averse to issues of all but the largest, best known subsovereign names. This description matches well with the team's experience with institutional investors in the U.S., as well as other transitional economies and emerging markets.

The team is concerned that some key impending changes in the national legal, regulatory and institutional frameworks and the intergovernmental finance system could chill the promising new subsovereign debt market. However, the team is also heartened by evidence of a consistent and growing interest by some national policy-makers and advocates of local interests in the need for continued healthy, prudent growth in the breadth, depth and quality of these markets.

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<sup>5</sup> See "The Development of the Polish Municipal Capital Market: 1994 - 1996", October 1997, Tony Levitas, Research Triangle Institute for a description of the empirical confusion that has plagued the review of loan data. Some of this confusion may be resolved by "Commercial Credits Drawn by the Communes and Communal Companies in the years 1995 - 1997", Regional Clearing Office in Kozalin for the Council of Regional Clearing Houses, September 1998 and by further research being conducted by Agnieszka Kopanska of the Foundation for Banking Education and Research.

Decisions likely to be made by Parliament and interpreted by regulatory action of ministries and other bodies over the next several months will be critical to the life of the subsovereign debt markets and, therefore, to the ability of local self-governments to exercise the authority and responsibilities granted them by the Polish Constitution and other fundamental laws.

## **SHORT TO MEDIUM-TERM FUTURE: IMPEDIMENTS AND OPPORTUNITIES**

Building on remarkable progress of last five years, there is a need for continued development of the many building blocks that contribute to an effective and efficient subsovereign debt market system. The identification of continuing impediments and opportunities for further development can be grouped in three fundamental areas:

- The components of the overarching legal, regulatory and institutional framework that deal with the systemic risk (risks associated with the prevailing debt market system) of the subsovereign debt markets and affect the willingness and ability of subsovereign borrowers to pay debt service on time.
- Challenges facing the "capital demand side" (gminy, local utility enterprises, etc.) that effect their interest and ability to borrow for infrastructure purposes.
- Issues effecting the "capital supply side" (banks, investment banks, institutional and retail investors, etc.) which need to be addressed in order to ensure that competitive loan and bond markets continue to develop and thrive.

The following sections provide summary assessments of key components in each area and identify areas for further development of policies and practices in each area.

Further Reducing Systemic Risk and Improving Willingness and Ability to Pay Debt Service: Additional Development of the Legal, Regulatory and Institutional Framework for Subsovereign Borrowing. From both policy and program perspectives, there are no "magic bullets" in the development of indigenous subsovereign debt markets. The systemic risks embedded in most areas of subsovereign borrowing are influenced by many different areas of law, regulation and institutional procedure; many of which are not immediately obvious. No one element—fully developed—can definitively reduce systemic risk and improve the willingness and ability of subsovereign borrowers to pay. Instead, it is the interaction of many diverse elements which will set the constraints on systemic risk and create the necessary but not always sufficient conditions for borrowers and lenders to come to terms in specific transactions. The sufficient conditions for successful individual transactions will arise from the careful analysis and mitigation of credit risks of individual borrowing situations as well as the dynamics of structuring, processing and completion of particular financing transactions.

Private, bi-lateral and multi-lateral donors active in Poland such as USAID, the British



Know-how Fund, EC-PHARE and others have explicitly or implicitly recognized the diffuse nature of the subsovereign debt market challenge over the past five years. They have assisted in the reform and improvement of legal, regulatory and institutional framework elements, development of "capital demand side" competencies and "capital supply side" components as the needs became apparent and the opportunities to supply effective assistance have arisen. The team sees no reason for this multi-dimensional approach to cease in the near- to mid-term, even as donors such as USAID prepare to end their physical presence in Poland. Indeed, the team feels that USAID in particular, has done a remarkably good job over the last five years in identifying critical problems and working both to improve the regulatory environment for subsovereign debt and to strengthen the capacities of particular gminy to borrow in responsible ways.

This combination of regulatory work and specific capital improvement planning, project preparation and borrowing or issuing "demonstration" projects did much to help create a community of reformers and a consensus about needed reforms among national policy makers, local government officials, investors, and financial institutions. However, it is the teams view that since 1997, work on such demonstration projects has slowed or been abandoned and that this has weakened the reform community's ability to make further and much needed changes in the regulatory environment.

The team's experience in both developed and emerging subsovereign borrowing systems suggests that essential elements of the legal, regulatory and institutional framework of a sound subsovereign debt market system include:

- The national legal system's treatment of financial and other commercial contracts and property rights, as well as the system's longevity, stability and responsiveness, as well as the court system's willingness and ability to enforce contractual and property rights, including:
  - The degree of development of banking and securities laws, regulations, and enforcement mechanisms as they apply explicitly to subsovereign borrowing (e.g., disclosure requirements for issuers, credit standards for such potential investors as pension funds, etc.).
  - The clarity of the lien position of subsovereign debt-holders and the ability of such debt-holders to perfect security interests in: cash flows of public or quasi-public subsovereign entities; "hard assets" such as rolling stock, land, commercial and industrial properties, etc; and stock shares and other financial instruments held by subsovereign entities.
  - The ability of debt holders to enforce in a timely fashion their security interests in assets of subsovereign entities pledged as collateral to debt holders.
- The intergovernmental fiscal system, including:
  - The clarity of the assignment of expenditure responsibilities to different levels of

government.

- The stability of the overall system of expenditure responsibilities and sources of revenue for subsovereign entities.
  - The adequacy of the revenues available to subsovereign governments to meet their expenditure responsibilities.
  - The dependence of sub-sovereign governments on the central government for revenue, and the freedom of subsovereign governments to levy taxes, surcharges and user fees in order to meet debt-service requirements.
- The intergovernmental oversight environment within which subsovereign entities operate, including:
    - The nature and content of prudential regulations limiting the debt of subsovereign entities.
    - The transparency of the financial reporting required from sub-sovereign entities by the central government.
    - The capacity of the government agencies reviewing and analyzing subsovereign budgets and reports and their ability to make reasonable judgements about the willingness and ability of sub-sovereign entities to meet their debt service obligations.
    - The extent to which subsovereign entities enjoy an explicit or implicit sovereign guarantee and the resulting moral hazard effects.
    - Strong negative consequences and a "work-out" system for subsovereign governmental units which fail to pay creditors (e.g., a subsovereign insolvency statute or analogous provisions in law or regulations).
  - The system of budgeting and accounting used in common practice by subsovereign debt issuers including:
    - The clear separation of operating and capital expenditures in budgets and accounting at the sub-sovereign level.
    - The transparency and uniformity of the budget classification system.
    - The ability to segregate and/or dedicate (particular) budget revenues for the future payment of debt service charges.



- The transparency and uniformity of municipal charts of account and the use of treasury systems for cash flow management.
- The comprehensiveness and timeliness of financial reporting requirements.
- The system of local and regional public utilities and the manner in which:
  - Tariffs are set and regulated by higher authorities.
  - Other legal and operating relationships between general purpose local governments and local or regional utility entities are structured.
  - The planning, budgeting, financing and other related competencies of local utilities.
- All of these elements interact to effect the fundamental creditworthiness—the willingness and ability of individual potential subsovereign borrowers—to pay principal and interest on time. "Willingness to pay" summarizes a group of basic credit quality measures including:
  - The degree to which subsovereign governments can issue debt in their own right, with the authority to create or raise revenues to secure that debt.
  - The strength of specific legal obligations to repay debt, embodied in transaction-specific documents like loan agreements, bond indentures or resolutions, lease agreements, etc..
  - Expressions of political commitment by citizens and/or their legal representatives (e.g., referendums approving issuance of debt to be repaid through taxes or other levies, traditionally viewed as the strongest form of such commitment within the U.S. public finance debt markets).
  - Demonstrations by decision-makers of their political capacity to raise taxes or rates in order to produce the additional revenues required to meet debt service coverage requirements when economic or other circumstances do not meet original expectations.
  - The financial performance of the debtor during prior periods of political or economic stress.

- "Ability to pay" is shorthand for a second cluster of basic credit quality indicators including:
  - Measures of the social and economic base of borrowing jurisdictions (e.g., demographic and economic indicators like population growth trends, effective buying incomes, etc.).
  - The ability to levy and collect taxes and/or other revenues from the people and businesses that comprise the jurisdictions (using measures like current and maximum expected or allowed tax rates, measuring the ability of constituents to support current and projected future levies).
  - The financial and procedural ability to apply collected revenues to the payment of debt service now and in the future, as measured by the analysis of the structural flow of funds and legal or regulatory constraints on future indebtedness, as well as calculation of historical and projected future debt service coverage ratios and other indicators.
  - Assessments of the quality of management and governance of borrowing jurisdictions.
  - Measures of the anticipated financial performance of borrowing jurisdictions under both "normal" and "stress" circumstances.
  - Reasonable projected demand and revenue estimates. For example, careful risk analysts scrutinize feasibility studies very critically and tend not to approve of transactions in which payment relies on substantial growth.

### ***Comparative International Experience***

Subsovereign debt markets are developing in different ways in different countries—even in the same region. However, it is possible to state clearly a common goal for national and local decision-makers, financial regulators, project developers and sponsors, regulators of financial institutions, institutional, corporate and individual investors in subsovereign debt, and the many assistance agencies and donors that are now focusing on this subject.

- That goal is:
  - The development of a "hard credit culture" for subsovereign borrowers, issuers, lenders and investors—the commonly shared expectation that timely repayment of principal and interest will be made with a high degree of certainty—among a set of borrowers (regional governments, local governments, local utilities, special purpose public agencies and/or NGO's responsible for delivering public goods) which has



been used to a soft credit culture, or has had no prior experience with credit.

The team's experience from around the world is that subsovereign debt market systems tend to develop spontaneously, for better or worse. This seems to be particularly true when there has been even some degree of deliberate devolution/decentralization and often when there hasn't, but an intergovernmental vacuum has been allowed to develop. Poor quality transactions and/or ill-considered projects are likely to result when local debt market innovations are undertaken spontaneously by subsovereign governments in the absence or major under-development of the five key framework elements.

Thus far however, and to its credit, Poland has avoided the spontaneous, under-regulated growth of irresponsible subsovereign borrowing that has been seen in many Latin American countries and some transitional economies. Indeed, while the creation of self-governing counties and regions in 1999 will no doubt create some new risks, Poland's fundamental subsovereign capital market problem seems to be less the danger of an explosion of sub-sovereign debt, than the failure to responsibly expand subsovereign investment borrowing. Polish local governments have inherited huge deficits in capital infrastructure, deficits that they will not be able to overcome if their overall borrowing does not move closer to 5 percent of the GDP from its current levels of 0.5 percent.

In some areas of the legal, regulatory and institutional framework within which the subsovereign debt market system operates, there is need for further and substantial improvement. And in one area of the legal framework, certain gmina debt limit provisions of the pending new Law on Public Finances, there is a real threat to the progress that has been achieved.

Using the five fundamental framework components outlined above, it is useful to inventory in summary fashion the gains already made and the opportunities for further improvement (or possible ways to avoid the threat to hard-won progress already achieved). The following sections constitute that inventory.

*The national legal system's treatment of financial and other commercial contracts and property rights, as well as the system's longevity, stability and responsiveness (including the court system's willingness and ability to enforce contractual and property rights)*<sup>6</sup>

### Summary Assessment

The basic rule of contract law appears now to be well-established in Poland, including with respect to financial contracts such as bond resolutions, debt contracts, etc. The basic legal statutory framework in existence appears to provide a sufficient basis for the issuance of valid and enforceable long-term debt obligations. However, the apparent absence of known defaults makes it difficult to assess judicial responsiveness to the enforcement of such contractual on behalf of creditors.

Existing banking laws and regulations,<sup>7</sup> the Bond Law of 1995, donor activities and the strong interest of some gminas led between 1995 and 1997 to an estimated 611 internationally or domestically denominated bank loans worth an estimated PLN 979,984,000, as well as to the issuance of 44 locally denominated bond issues with a total par value of PLN 481,900,000, all but one executed in the private placement market<sup>7</sup>.

The number and par value of commercial bank loans and bond issues closed in the last four years and the team's inability to detect any bona fide payment defaults testifies to the fact that the initial banking and securities laws and enforcement mechanisms, and the accompanying institutional developments have permitted a reasonably sound fledgling subsovereign debt market. (Total Concessional lending for the same 3-year period has been estimated at PLN 801,700,000).

Nonetheless, other indicators suggest that it is time for a significant refinement of this crucial part of the subsovereign debt market framework. These indicators include the fact that only one public offering has been executed to date and that, as a result, no retail market has developed despite anecdotal evidence suggesting that some citizens would like to become municipal stakeholders in this fashion. In addition, the advent of the voluntary pension funds will add demand for subsovereign fixed income securities that meet the prudential requirements for all but 5 percent of pension fund investments. However, there is virtually no supply of loans or bonds that would

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<sup>6</sup> Including: The degree of development of banking and securities laws, regulations, and enforcement mechanisms as they apply explicitly to subsovereign borrowing (e.g., disclosure requirements for issuers, credit standards for such potential investors as pension funds, etc.); the clarity of the lien position of subsovereign debt-holders and the ability of such debt-holders to perfect security interests in: cash flows, hard assets" stock shares and other financial instruments of public or quasi-public subsovereign entities; and the ability of debt holders to enforce in a timely fashion their security interests in assets of subsovereign entities pledged as collateral to debt holders.

<sup>7</sup> See "Commercial Credits Drawn by the Communes and Communal Companies in the years 1995 - 1997", Regional Clearing Office in Kozalin for the Council of Regional Clearing Houses, September 1998; and "Municipal bond Market as of October 15, 1998" CERA, October 1998.



presently meet those requirements.

There appears to have been no defaults in the Polish subsovereign debt market, as noted above. Thus far, then, it can be argued that subsovereign borrowers and issuers have been demonstrating a healthy willingness to pay, documented with appropriate governing body resolutions and contracts<sup>8</sup>.

The legal requirements for debt approval are perceived as procedurally burdensome and do not provide financing participants sufficient flexibility to respond to changing market conditions in a timely and efficient manner. The process of obtaining RIO approval is perceived as time consuming with such approval often granted within narrow financing parameters, e.g., interest rate and maturity structures. At the time the issuer is ready to enter the capital market, the financial conditions upon which such approval was granted may no longer relate to current market conditions.

Additionally, the legal approval process exercised by the RIOs is considered to be applied in an inconsistent manner among RIOs. Moreover, many RIOs are perceived as exercising their jurisdiction beyond a determination of legality and substituting their subjective judgement on the desirability of the project and for the appropriateness of the financing structure. Additionally, there seems to be a disparity as to the information required to be set forth in the Bond Resolution. A review could be undertaken to establish the consistent standards to the RIO approval process as well as set forth the terms that must be set forth in a Bond Resolution to obtain RIO approval.

With regard to the legal requirements for a public offering, there was a consistent commentary on the administrative and financial burdens associated with:

- The audit requirement for a public offering, including the present requirement that there be an annual independent audit for the life of the publicly-offered debt. These requirements are seen as enormously burdensome since independent audits are not required for local entities not issuing publicly offered debt<sup>9</sup>.
- The inability to set appropriate the fees associated with the Avague@ and broad responsibilities of the Bank Representative set forth in the Act on Bonds. The role is perceived as too vague and perhaps not needed at all in the case of institutional investors. It has been suggested that a depository function is all that is needed and upon an event of default that a representative could then be appointed. A review of the specificity and

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<sup>8</sup> However, the team has not had the opportunity to directly examine sample loan and bond contract language. We believe this would be a fruitful area for empirical study and the development of best-practice model documents.

<sup>9</sup> A provision in the Draft Law on Public Finances requiring independent audits for all local governments, regardless of whether they had issued debt, was recently removed by parliament.

necessity for these provisions could be undertaken to clarify and abbreviate the essential functions for a gmina public offering.

- The initial and continuing disclosure requirements. The initial requirements are perceived as not relevant to a gmina credit. Additionally, the frequency of the continuing disclosure requirements creates an additional administrative burden. A review of gmina disclosure requirements should be undertaken to assess its materiality, appropriateness and timeliness.
- Although the adoption of the collateral law in 1997 and the existing mortgage law have clarified the procedures and enforceability of liens on property securing debt, there was much commentary on perceived "confusion" regarding the use of collateral financing. The source of confusion may be the "appropriateness" of certain collateral as security. Although foreign banks frequently seek collateral or mortgages to secure debt, certain domestic bank have discontinued their use of mortgaged property. Comments on the discontinuance indicated that the "practical value" of a mortgage on essential public property was questionable. There seems to be a lack of understanding by the debtor and creditor communities of the strategic use of property as security. This situation could be addressed in part by training and assistance in the area of effective and appropriate use of collateral.

### **Opportunities for Development**

Substantial refinement is needed in the full range of bond, procurement, disclosure and other law and regulation discussed above. USAID should consider undertaking policy advisory efforts on i) the impact of the Bond Act and other laws on the procedural flexibility in the financing process, and ii) clarification and standardization with regard to debt approval, and training related thereto. Some of this work is already underway; for example in the drafting of new disclosure regulations by the SEC. Technical assistance to such agencies as the SEC and other key players in drafting the necessary clarifications and other changes could be a useful contribution by a donor such as USAID.

There are substantial and critical opportunities for development assistance in improving the legal, regulatory and institutional framework for subsovereign debt. These opportunities primarily relate to empirical research and policy advisory efforts with regard to, inter alia:

- The impact of the Bond Law and Procurement Law on procedural flexibility in the financing process.



- Clarification of the role of RIOs with regard to debt approval and training related thereto.
- Appropriate and relevant initial and continuing disclosure requirements for public offerings.
- The impact of both the Law on Public Finances and the Law on Revenues in the form adopted.
- The promotion of tariff reform for full cost recovery, capital planning and budgeting, and other best practices, e.g., a) development of appropriate policies at the Water Standards Board, Anti-Monopoly Offices and HUDA.

### *The intergovernmental fiscal system*<sup>10</sup>

#### **Summary Assessment**

As the team sees in most transitional and emerging market economies, the Polish intergovernmental finance system has been far from stable in terms of its specific functions. Frequent changes in important aspects of tax sharing and other individual components of the intergovernmental fiscal system have caused uncertainty in the minds of many local decision-makers and probably account for some of the conservative attitude toward debt financing. Nonetheless, the system has thus far provided municipalities with adequate overall revenues to meet their expenditure responsibilities as evidenced by the fact that on average they have been running operating surpluses equal to about 20 percent of their revenues since 1992. Moreover, the relatively high level of own-revenues, general subventions, and shared taxes—as opposed to special purpose grants—in their overall revenues has provided them with a significant level of expenditure flexibility. Given this flexibility, the operating surpluses can be regarded as unused capacity for servicing mid- to long-term debt, if the local decision-makers have sufficient confidence that such capacity will be available over time.

Unfortunately, however, the government's hope to increase this level of confidence by converting shared personal and corporate income taxes into own local taxes under the new law on Local Government Revenues were postponed because of problems in determining the tax bases of individual jurisdictions. Similarly, the government has still has not passed enabling legislation that would allow local governments to transform the existing, area based local property tax into an ad valorem tax. Both the creations of local "piggy back" income taxes and an ad valorem property tax

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<sup>10</sup> Including: the clarity of the assignment of expenditure responsibilities to different levels of government; the stability of the overall system of expenditure responsibilities and sources of revenue for subsovereign entities; the adequacy of the revenues available to subsovereign governments to meet their expenditure responsibilities; and the dependence of sub-sovereign governments on the central government for revenue, and the freedom of subsovereign governments to levy taxes, surcharges and user fees in order to meet debt-service requirements.

would significantly increase the autonomy and buoyancy of local government finances, and with it the willingness and capacity of local governments to borrow.

There is also substantial differentiation in the robustness of municipal revenues across cities of different sizes and the picture in rural gminas is substantially worse than average. In part this is because of lower own-revenues from the property tax and other local taxes. In part, however, it is because farmers have yet to be included in the personal income tax system. Until this year however, rural gminas received some of the shared personal income taxes generated in urban jurisdictions because tax shares were calculated on a per-capita basis for the entire voivodship. The draft new Law on Local Government Revenues eliminates the voivodship basis for calculating shared taxes and thus will give each local government shares of only those taxes generated within its jurisdiction. This will improve the finances of most urban areas, but will work against rural jurisdictions.

More importantly, it is unclear how robust the budgets of the newly created powiats and voivodships will be. Unlike gminas, much of their revenues will come in the form of special purpose grants, and at least until (anticipated) amendments are made to the new Law on Local Government Revenues, they will have both extremely modest tax powers and extremely limited claims on shared income taxes. Thus, the revenue generating capacity and expenditure flexibility of these new jurisdictions will be highly constrained. Moreover, it remains unclear whether their total revenues will be adequate to meet their substantial expenditure responsibilities in the areas of secondary education, social welfare, and road maintenance.

Powiats and voivodships will however have the right to borrow and this right could prove dangerous when combined with their low revenue generating capacity, limited expenditure flexibility, and the possibility of significant unfunded or under-funded mandates. Indeed, comparative experience suggests that irresponsible sub-sovereign borrowing is most prevalent among subsovereign entities that are at once highly dependent on the central government for their revenues, relatively constrained in the expenditure choices, and overall short of funds. Thus, it is possible that while Polish gminas have approached borrowing with extreme caution, Polish powiats and voivodships may not simply because their financial and institutional circumstances are different. It is thus extremely important that the borrowing of these entities be carefully monitored so that their behavior does not negatively impact on the overall subsovereign debt market, and the generally healthy practices of municipalities.

### **Opportunities for Development**

It is important that USAID continue to support the Polish government's efforts to create an ad valorem property tax and to transform shared personal and corporate income taxes into local (piggy back) taxes for all levels of subsovereign government. On the one hand this is necessary because over the long term the best way to create a sound subsovereign debt market is to increase the autonomy and buoyancy of local government finances. On the other hand, it is necessary to prevent the irresponsible borrowing that may be encouraged by the current fiscal circumstances of powiats and voivodships. On both fronts, it is worth adding that the Polish



government has explicitly defined the draft new law on Local Government Revenues as a temporary bill and seems to be expecting further USAID support in reforming it, and in developing appropriate legislation for an ad valorem property tax.

Finally, it is also important that USAID monitor the fiscal health of Poland's 2000 rural jurisdictions because these will suffer under the new law - and quite significantly until farmers are integrated into the personal income tax system. Their financial difficulties will reduce their already limited access to credit markets and may warrant efforts to promote bond or credit pooling mechanisms for smaller jurisdictions.

### *The intergovernmental oversight environment within which subsovereign entities operate<sup>11</sup>*

#### **Summary Assessment**

The draft Law on Public Finances<sup>12</sup> will introduce very substantial changes in the existing regulation of subsovereign debt if passed—as expected—in its current form.

The new law clarifies the existing "flow" type debt limit for subsovereign governments by explicitly stating that interest and principal payments in a given year cannot exceed 15 percent of revenues<sup>13</sup>. The law will also introduce a new "stock" type regulation that limits overall outstanding principal to 60 percent of total revenues. This new limitation could prove to be a tighter limit than the 15 percent debt service limit calculated against total revenues for some municipalities, particularly larger ones (such as Krakow) that have managed to find sources of relatively long maturity debt. These "flow" and "stock" limitations are restrictive, but they are not untypical of the types of limits central governments use to regulate subsovereign debt.

Less typical, and in the team's view much more problematic, are a new set of debt limits that link the borrowing of subsovereign governments to the borrowing of the central government if the

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<sup>11</sup> Including the nature and content of prudential regulations limiting the debt of subsovereign entities; the transparency of the financial reporting required from sub-sovereign entities by the central government; the capacity of the government agencies reviewing and analyzing these reports to make reasonable judgements about the willingness and ability of sub-sovereign entities to meet their debt service obligations; the extent to which subsovereign entities enjoy an explicit or implicit sovereign guarantee and the clarity of such a relationship; and strong negative consequences and a "work-out" system for subsovereign governmental units which fail to pay creditors (e.g., a subsovereign insolvency statute or analogous provisions in law or regulations).

<sup>12</sup> This analysis relies on an English translation of the May draft of the Law; on conversations with the MOF Department of Sejm of Public Debt; and an October version of the Law in Polish that included amendments made by the Sejm's Public Finance Committee.

<sup>13</sup> Minus debt secured by real property.

total consolidated public debt (national and subnational debt combined) exceeds 50 percent of the GDP.

If the consolidated public debt is over 50 percent but less than 55 percent of the GDP, then the ability of subnational governments to borrow will be limited to the same deficit to revenue ratio as enacted for the central government in the national budget. Thus, if the national government's deficit is equal to 4 percent of its revenues, and the 50 percent threshold has been passed, then no local government can issue new debt worth more than 4 percent of its revenue. By extension, and in the extreme, this means that if the 50 percent threshold is crossed and the central government decides to balance its budget, then no local government can borrow at all.

Moreover, once the 55 percent threshold is crossed local government borrowing will be limited—through the application of an algorithm—to a percentage of the central government's current deficit to current revenue ratio. The more total public debt exceeds 55 percent of the GDP, the lower local government borrowing can be. If the 60 percent level is reached, all borrowing both the central government and subsovereign governments must stop borrowing.

The Ministry of Finance placed these limitations in the law in order to insure that Poland does not have trouble meeting the macro-economic standards set by the Maastricht Treaty for members of the European Union. And like the law, these standards limit the consolidated public debt of member states to less than 60 percent of the GDP.

Nonetheless, no EU member has written such provisions into their own laws. It is also not entirely clear how individual countries will be able to calculate commensurable figures on their consolidated public debts when accounting and budgeting standards still differ widely within the Union itself.

But whatever the wisdom of the Maastricht provisions in general, or their insertion into Polish law in particular, two things are clear. First, the debt of the Polish central government is estimated to be very close to the 50 percent threshold and could be above it, if the złoty loses value against Western currencies<sup>14</sup>. Second, if and when this threshold is crossed, the ability of local governments to borrow will be placed in direct competition with the borrowing prerogatives of the central government.

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<sup>14</sup> Information from the Budget Department of the Ministry of Finance.



In such a competition it is likely that local governments will lose and that central government borrowing—primarily for current expenditures—will crowd out local governments borrowing—primarily for investment purposes.

Moreover, this rather mechanical way of meeting the Maastricht guidelines may produce unexpected behavior from local governments. On the one hand, they may rush to incur (ill-advised) debt before the restrictive thresholds are crossed. On the other hand, once the thresholds are crossed, they will probably try to push borrowing from their budgets onto their commercialized utilities<sup>15</sup> because under both the Maastricht guidelines and the draft law, borrowing by these entities is not considered part of the consolidated public debt.

Over the medium and long term, shifting substantial public borrowing responsibilities onto commercialized and ultimately privatized utilities is unquestionably desirable. However, at the moment, most municipal utilities are not operating on a full cost recovery basis and many of the transactions between them and their municipal owners are far from transparent. Thus, without the development of sound accounting and budgeting practices governing the relations between local governments and their utilities, and a clearer adoption of full cost recovery pricing this downward shift of borrowing could be prove dangerous.

The Law also contains a provision that states that the maximum nominal value of all credits must be stated in PLN on the day that the transaction is entered into<sup>16</sup>. Though this provision may be open to interpretation, it seems to render borrowings denominated in other currencies or at floating rates illegal under the law. If so, this provision would significantly restrict the markets overall development, radically restricting both the number and types of investors in the sector, as well as the types of investment instruments available for you. It is worth adding that a number of large municipalities have already taken on loans denominated in other currencies, and that these practices will have to stop.

The Draft Law on Public Finances also contains provisions that will force local governments to settle all cash borrowing by the end of the calendar, as well as provisions that increase the sanctions that can be imposed on public entities that fail to pay their suppliers and contractors. These provisions should help clarify the overall debt position of subsovereign entities, and are thus a step in the right direction. These provisions can also help develop the distinction between long term debt for infrastructure and short term debt for cash flow management.

The draft law however, does not set out procedures for local governments that default on debt service payments. Thus, while the central government has been careful to avoid granting implicit or explicit guarantees of subsovereign debt, it has not taken the opportunity presented by the Law on

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<sup>15</sup> Commercialized utilities are those which have been organized as Limited Liability or Joint Stock companies.

<sup>16</sup> Article 51 of Draft Law of November 26, 1998.

Public Finances to introduce insolvency and remediation procedures for subsovereign entities, including very strong negative consequences (e.g., loss of political control over financial decisions, etc.) for defaulters. This is important, because comparative experience suggests that clearly defined insolvency procedures act as an extremely strong disincentive to irresponsible borrowing by local governments.

Under present circumstances, it seems reasonably clear to debt market players that neither an explicit nor implicit sovereign guarantee exists for market rate bank loans or bonds. Possible moral hazard confusion arising from the role of RIO's in approving debt transactions has apparently not materialized. With respect to subsidized loans originating from capital sources such as the National Environmental Fund, we have also seen little direct evidence of moral hazard with respect to the repayment of principal and (subsidized) interest. Even in those programs where partial principal forgiveness is part of the subsidy, the ground rules for principal forgiveness (typically the successful, on-time completion of the financed project) appear well understood by the transaction participants.

Nonetheless, as long as these programs carry below market interest rates, the team believes there will always be a danger that their loans (and potentially all debt undertaken by localities) will be perceived as carrying an implicit sovereign guarantee. This danger derives largely from the fact that the interest rate subsidy "gift from the State" is embedded in the loan terms and not separated out and made completely transparent as a grant. As noted above, the reorganization of the voivodship environmental funds opens a possible avenue for promoting this kind of possible change in the operation of the funds, a change that could help end the environmental funds' current dominance of the subsovereign debt market for water, waste water and other environmentally friendly capital investments.

Finally, under present legal and institutional conditions, Poland's Regional Accounting Offices bear the primary responsibility for auditing local government finances and approving the legality of their debt resolutions. This system of intergovernmental oversight appears to be functioning well enough for the Ministry of Finance to withdraw from the draft law provisions which would have mandated independent annual audits for all jurisdiction of more the 50,000 people.

Nonetheless, there appears to be substantial variation in how RIO's go about reviewing and approving debt financing transactions undertaken by gminy, and it is clear that some have used their oversight powers with respect to the legality of a borrowing to challenge the nature of the investment project itself. Worse, it has been difficult to standardize RIO practices because thus far each has an been operationally independent. Anticipated amendments to the Law on Regional Accounting Offices however with establish a governing council for all RIOs, increasing the possibility of rapidly disseminating best practices in this and other areas.

### **Opportunities for Development**



It is unlikely that the Ministry of Finance will agree to remove the Maastricht debt guidelines from the Law on Public Finances. It is however, possible that Ministry will consider replacing the rather mechanical procedures that go into force when particular GDP thresholds are crossed with other more flexible prudential regulations.

Here, it seems that Poland would do well to move towards a more cooperative model of subsovereign debt regulation in which—as in Australia—national and local government officials meet during the course of the year both to review prevailing trends on the subsovereign debt market and to set debt limits for the coming year. Indeed, this model seems to be particularly well suited to Poland because a legally recognized forum for intergovernmental cooperation already exists—the Joint Commission for Intergovernmental Affairs—and its competencies could be easily expanded to include the setting of subsovereign debt limitations.

Also, while there is no question that subsovereign borrowing in other currencies carries specific and serious risks, the Ministry of Finance may want to revisit its apparent blanket prohibition on all borrowings not conducted in zlotys or at floating rates.

Similarly, and independent of the particular debt limitations ultimately enacted in the Law on Public finances it is clear that the RIO's will need guidelines, training, and possibly technical assistance to carry out their responsibilities in a reasonably uniform fashion. Moreover, the anticipated amendments to the Law on Regional Accounting Agencies, and the creation of a single governing council create a clear opportunity for USAID to disseminate best practices in the area of subsovereign debt regulation to all sixteen RIO's in a cost effective way.

In addition, select subsovereign officials, as well as bankers, attorneys and rating agencies personnel attorneys will need training and technical assistance in how to most usefully play their appropriate roles in under the new system.

The debt limits already in place and the refinements contemplated for the Public Finances Law, in addition to the role of the RIO's and the sanctions for mismanagement in the draft Public Finances Act and other statutes already in effect appear to be adequate if indirect negative consequences for governmental units that fail to pay creditors. Probably because there have been no clear payment defaults by subsovereign loan or bond issuers, we have detected no substantial interest in the development of a stand-by workout system for such situations.

However, due to the likelihood of less certain times ahead combined with possible restrictions of the ability of gminy to borrow for cash flow management purposes, the need for close monitoring of gmina, powiat and voivodship operating budget performance over the course of each current fiscal year may have increased. The team strongly recommends that the issue of developing local government insolvency and workout procedures<sup>17</sup> should be raised with the Ministry of Finance

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<sup>17</sup> e.g., Financial Control Board-type mechanisms.

both to help prevent irresponsible borrowing by local governments, and to provide a clear set of guidelines for action when the probably inevitable first local fiscal crisis does occur.

As discussed further, the organization of the environmental funds appears likely to change as the result of administrative reforms pending in the new draft Law on Local Revenues and other changes. This could be the occasion for changes in the methods by which the environmental funds provide their interest rate subsidies, moving from concessional interest rates to grants used to help defray the costs of commercial rate loans or bonds for environmental infrastructure investments.

### *The system of budgeting and accounting used in common practice by subsovereign debt issuers*<sup>18</sup>

#### **Summary Assessment**

It is clear that over the past five years, and in part because of significant support from USAID and the British Know How Fund, Polish gminas have made very significant improvements in their municipal accounting and budgeting practices. In particular, it is clear that donor support has vastly improved the gminas' ability to develop strategic plans, capital improvement plans, and program-based budgets. Indeed, increased awareness of these issues led the local government community to demand that the new Law on Public Finances legally separate of capital and operating budgets, and that the Ministry of Finance reform the existing Budget Classification System.

Although the current budgeting standards do not establish a capital budget or distinguish the operating budget from the capital budget, the draft Law on Public Finances<sup>19</sup> does contain provisions which require the budget resolution of the local government unit i) to determine expenditures related to long-term investment programs with the separation of expenditures for funding particular programs, and ii) set forth the authorizations to contract debt and to pay the liabilities.

These provisions are of particular importance since debt financing is authorized as a source of revenue to balance a budget which would otherwise operate at a deficit, without distinguishing debt issued to finance capital assets from debt to finance current expenses. Appropriate regulations to implement these budget provisions could substantially enhance the clarification of capital budget and finance as well as recognize and disclose the multi-year nature of the debt obligations.

Unfortunately, while the new Law opens up the possibility for the development of multi-year capital improvement plans, and seems to make multi-year budget appropriations legally possible, the

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<sup>18</sup> Including: the separation of operating and capital budgets at the sub-sovereign level; the transparency and uniformity of the budget classification system; the ability to segregate of dedicate (particular) budget revenues for the future payment of debt service charges; the transparency and uniformity of municipal charts of account and the use of treasury systems; and the comprehensiveness and timeliness of financial reporting requirements.

<sup>19</sup> Article 121 of the May 1998 draft.



law did not call for the clear and definitive separation of operating and capital budgets, nor for the adoption of fund accounting. In general, this is less because of opposition to either set of best practices within the central government, than it is because both will require a profound overhaul of the Ministry of Finance's Ordinance on the Budget Classification System, an overhaul which Ministry officials clearly decided they could not undertake during the last year of rather frenetic reform.

Nonetheless, the Ministry is well aware that both the budget classification system and the existing financial reporting formats for local governments will have to be changed in order to bring Poland closer to the (not entirely clear) public sector accounting and budgeting standards of the European Union. Moreover, it is also clear to the Ministry that the current regulations governing transactions between local governments and their utilities are problematic and need to be made transparent, particularly if utilities themselves are expected to bear the debt burden of their investment needs.

### **Opportunities for Development**

The consensus on the need to reform the existing budget classification scheme, and the external pressure provided by the European Union with respect to Poland's public sector accounting and financial reporting standards create opportunities for further improvements in this area. Here, it seems that USAID support for such changes through the Democratic Governance and Public Administration Project, or other programs should be intensified and sustained.

Moreover, the Polish Security and Exchange Commission has recently created a Foundation for the Improvement of Accounting Standards and is clearly interested in support for developing better accounting standards for public sector entities interested in issuing debt and equity on the Polish stock exchange.

It is also clear that USAID should sustain its efforts to promote full cost recovery pricing among water utilities because it is clear that the financial transparency of these entities will be of critical importance if they are to attract the investment capital needed to upgrade the countries technical infrastructure. Indeed, it would seem desirable to extend this program to other types of utilities and to support initiatives designed to bring private capital of all types into the municipal utility sector.

Finally, it would be desirable for USAID to provide support in the i) swift development of guidelines for multi-year capital planning and budget presentation; ii) rapid implementation of training for local officials in how to meet those guidelines; iii) design and promulgation of uniform guidelines for independent audits; and iv) training for subsovereign officials, auditing company staff and RIO staff in how to play the demanding roles required of each constituency if cost effective audits are going to be carried out and used in such critical areas as management improvement and debt market disclosure.

## *The system of local and regional public utility management, rate setting and capital finance*<sup>20</sup>

### **Summary Assessment**

The present system of local and regional public utility organization, management, oversight and capital finance varies substantially by sector and sub-sector. For Example, cost recovery tariff setting and competitive privatization have seen substantial progress in the hauling sub-sector of the solid waste management field, far less so in the landfill sub-sector of the same field and apparently even less progress in the water supply and waste water treatment sector. Thus far, commercial credits taken by the local utility sector have been approximately 25 percent of those taken by gminy<sup>21</sup>, reflecting the inability of many utilities to service debt from their own revenues and other factors.

Some progress is being made from the policy levels in moving key utility sectors such as water toward operating cost recovery through the combined efforts of actors such as HUDO, the Anti-Monopoly Office and support from key donors, including USAID. However, the team understands that the progress has been difficult and that full cost recovery (capital as well as operating costs) pricing of tariffs is still virtually unknown in the water and possibly other local utility sectors. Subsidies from Gmina budgets are still prevalent in the water, wastewater, landfill and other local utility sectors. The transparency of these subsidies often needs substantial improvement.

As discussed more fully above and below, the financial relationships between utilities and gminy typically lack transparency and also don't have the benefit of a structure in which the expectations of each party are clearly understood and actions are predictable. All these conditions lead to questions about the creditworthiness of local utility enterprises.

### **Opportunities for Development**

Existing legal and regulatory reform efforts should be continued and intensified, particularly in view of the possibility that local utilities will become increasingly important borrowers. Other suggestions related to these borrowers or issuers are included below.

### ***The Capital Demand Side***

Further Developing the Willingness and Creditworthiness of Subsovereign Borrowers or Issuers, Poland remains characterized by a widespread reluctance to use debt for subsovereign

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<sup>20</sup> Including: the policies and practices of tariffs setting and regulated by higher authorities; the legal and operating relationships between general purpose local governments and local or regional utility entities are structured; and the planning, budgeting, financing and other related competencies of local utilities.

<sup>21</sup> See "Commercial Credits Drawn by the Communes and Communal Companies in the years 1995 - 1997", Regional Clearing Office in Kozalin for the Council of Regional Clearing Houses, September 1998.



infrastructure investment. The reluctance seems to be only loosely connected to the willingness or ability to pay debt service of the possible borrowing or issuing entity and probably has roots fairly deep in Polish political culture, including the national debt binge of the late Communist era. When concessional loan money has not been available (and often when it is available) the standard method by which most gminy have invested in infrastructure has been "pay-as-you-go" financing from annual operating surpluses which have been running in the 20 percent-25 percent range in recent years.

Thus, developing the demand side of the subsovereign municipal capital market will continue to involve not only developing the financial credit-worthiness of borrowers or issuers, but also continuing to promote the very idea of debt financing for long-lived infrastructure financing, as USAID and other donors have been doing for the past five years. We must also recognize that local governments are, by their nature, characterized by turnover: newly elected decision-makers and/or newly appointed officials need to be exposed in an almost constant fashion to the fundamental ideas of infrastructure finance. Concepts like intergenerational equity, and cost savings associated with dramatically shortened construction cycles should continue to be woven into efforts to educate and train a continually shifting set of local elected and appointed decision-makers about infrastructure finance.

In addition, there are a number of more specific areas that should be addressed to increase the ability of the demand side entities to explore and close transactions. In the most general sense, each of these areas can be seen as improving the credit-worthiness of subsovereign entities, often through increasing the financial management capacity of the sector.

## **A BRIEF INVENTORY OF THE AREAS WHICH NEED TO BE ADDRESSED ON THE DEMAND SIDE**

### ***Financial Management***

#### **Summary Assessment**

A major theme of a significant amount of USAID and other donor assistance has been to improve financial management of Polish gminy through the introduction of capital improvement planning, capital budgeting and accounting, financial forecasting, task based budgeting and other practices. These efforts are showing signs of not only improving the financial management of individual gminy but have begun substantially to redefine the best practice standards to which many local officials are now aspiring. Nonetheless, due to turnover and the complexity of the changes being attempted, much further work in these areas is needed. Moreover, it seems that USAID efforts to improve overall finances at the Gmina level were particularly successful when they were focused around bringing particular projects all the way to the debt market.

#### **Opportunities for Development**

Some provisions in the draft Law on Public Finances do introduce the concept of multi-year planning and budgeting and may provide an opening for further donor-supported work in this area. Technical assistance and training for sub-sovereign officials should continue to emphasize the value of long-term capital improvement planning and transparent budget procedures.

### ***Project Preparation***

#### **Summary Assessment**

In contrast with other transitional and emerging subsovereign capital markets, the team has not detected a serious problem with the use of Polish subsovereign debt for "non-essential uses" (e.g., sports and entertainment, cultural purposes, etc.). However, much remains to be done in the area of project preparation, according to participants and observers from both the supply and demand side of the market. Our experience is that the better prepared a project, the more likely it is to reflect the true needs of its sponsors and constituents and the more likely it is to succeed at its stated purpose. A high priority in the minds of those who must decide whether to continue to pay debt service even in times of fiscal stress is thus substantially enhanced by good project preparation.



## **Opportunities for Development**

Virtually all debt financings concluded thus far in both the loan and bond markets have quite broadly specified purposes and lenders or investors do not appear to have demanded much in the way of economic or other justification for the projects being financed. This seems likely to be directly connected to the fact that most issues are general obligations of the borrowers and issuers: the lenders and investors have simply been satisfying themselves of the general ability and willingness of the issuer to pay. However, as subsovereign borrowers take on increasing amounts of debt, it will become increasingly important for the borrowers and issuers to fully and carefully justify their projects economically and to demonstrate in every possible way their lasting essentiality to those who must pay principle and interest into the future, as well as to increasingly wary lenders or investors.

While donor assistance is being used to provide help in building project preparation capacity on the demand side of the debt market, the crucial link of using that improved capacity to help bring such projects to the capital markets is not being made, except in a few instances<sup>22</sup>. The transaction facilitation service envisioned below would make a real contribution here. In addition, a series of seminars highlighting instances in which high quality project preparation has led to a favorable transaction could be useful. Spotlighting instances where this has occurred (e.g., the Krakow high speed tram project) for places which have already taken on debt for other less specifically defined purposes in the past could be particularly helpful to foreshadow the coming period in which lenders are likely to be more wary lending to places that already have outstanding debt. A substantial amount of donor assistance continues to be applied to improving project preparation and, in the team's view these efforts will need to continued for the foreseeable future.

### ***Financial Structuring/Facilitation for Projects***

#### **Summary Assessment**

There will be a continuing (and perhaps heightened) need for technical assistance to both the demand and supply side of the subsovereign debt markets, focused tightly on helping design and close additional bond, loan and perhaps other forms of financing (e.g., leasing). The team has familiarized itself generally with the relevant work programs of the present Local Government Partnership Program and does not believe that the LGPP is designed to provide the "opportunistic" transaction facilitation service we envision. This is due in part to the limited number of gminas the program is designed to serve, and in part to the highly comprehensive nature of the LGPP work programs and consequent difficulty such work programs will have accommodating a deliberately narrow focus on helping to conceive and close capital financing transactions.

## **Opportunities for Development**

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<sup>22</sup> e.g., when the EBRD provides or arranges for up-front project preparation assistance on loans it is seeking to close.

The highly responsive operating style of the Municipal Infrastructure Investment Unit (MIIU) housed within the Development Bank of Southern Africa could be a useful analogue to the capacity that could usefully be put into place in Poland, staffed largely or exclusively with indigenous financial and technical consultants, attorneys and others with the appropriate competencies. At least one other specific factor may also be playing a role in holding down the rate of growth in the subsovereign bond market. The team has heard anecdotal evidence that bond issue structures (which require either immediate draw-downs of all money raised by the issue or step-wise "tranching" issuance and draw-downs) may be producing substantial negative arbitrage on reinvestment of funds "waiting" to be used to pay for actual project expenses. Commercial and concessional loans can more easily be structured to prevent this problem (e.g., with the use of formats allowing the actual drawdowns to occur upon the presentation of construction cost invoices, etc.). While the use of short-term construction loans that are then "taken out" by bond issues would also prevent this problem, this solution does not seem to have been used<sup>23</sup>.

A second way to avoid this problem would be for sub-sovereign issuers to use budgetary money to pay for construction costs and then reimburse the budget from tranching bond proceeds. It is unclear to the team whether this is already being done by some borrowers or what the legal status of the practice would be. There is also discussion of a "shelf-registration" option by for sub-sovereign issuers of debt, but this would presumably continue to require public issuance standards, still considered a formidable barrier by gminy. In addition, it is not clear to the team how substantially this technique would reduce the negative arbitrage problem.

In addition, the changes in the environmental funds and particularly their subordination to voivodship councils when combined with the recent drawing down of their working capital may provide opportunities to work with a handful of these funds to bring about the kinds of changes discussed further elsewhere in this report, particularly moving from a reliance on subsidized interest rates to use of grants to write down the costs of commercial loans.

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<sup>23</sup> One knowledgeable market observer/participant estimated that 60 or 70 percent of those towns which have used bond issues would express a substantial level of dissatisfaction with this debt issuance technique compared with commercial credits, if surveyed with anonymity.



## ***Prudential Guidelines/Expertise on Cash Management***

### **Summary Assessment**

Deficiencies in managerial judgement or competence can call into sudden question a local borrower's ability to pay, or wipe it out entirely. For example, investments of cash flow or of the proceeds of a borrowing can be made imprudently and if these investments don't yield the returns planned (as in famous cases from Orange County, California to Odessa, Ukraine) or completely fail, the credit quality of the borrower or issuer can suddenly decline or be eliminated completely. The team has not found any clear prudential guidelines for municipal investment of cash and we understand that careful but effective cash investment yield maximizing techniques (daily cash account sweeps into interest yielding accounts, etc.) are rare.

### **Opportunities for Development**

Other best practices and training initiatives that would enhance the subsovereign borrowers or issuers ability to pay could address such issues as cash management, with the dual purpose of i) providing better prudential guidance to guard existing subsovereign safety; and ii) enhance subsovereign revenues<sup>24</sup>.

## ***Prudential Position on Subsovereign Assumption of Exchange Risk***

### **Summary Assessment**

Mid- to long-term currency exchange risk hedging mechanisms are unavailable in Poland as in most transitional and emerging market economies. Sub-sovereign general-purpose governments and utility enterprises have virtually no ability to collect revenues in foreign "hard" currency. (Although they may be able to try to collect certain revenues in a hard-currency indexed fashion, the political realities of doing this when even ordinary devaluation occurs make this a very difficult option at best.) While subsovereign borrowers can use past experience and well-understood projective techniques to calculate the "fully loaded" local currency costs of cross-border borrowing, these techniques are imperfect at best. Recent international currency crises underline the fundamental unpredictability of foreign exchange rates in the mid- to long-run.

Hence, subsovereign borrowers must be extremely wary of foreign currency borrowing (or as in some countries, prohibited from the practice altogether). Although only a few Polish municipalities have ventured into the foreign-denominated debt markets, several of the larger and

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The team was advised of one instance in which a local financial official was able to so improve cash management practices that the increase in (safely earned) interest income amounted to 10 percent of the localities' capital investment for one year.

a few of the mid-sized loans pending or closed are foreign denominated<sup>25</sup>. We understand that the risks of foreign denominated borrowing have been disclosed to subsovereign borrowers by most and possibly all lenders currently active in this market. Nonetheless, there is no guarantee that this responsible tradition will continue, particularly as new lenders continue to enter the Polish subsovereign market.

### **Opportunities for Development**

At a minimum, clear written guidelines for foreign denominated borrowing by subsovereign market participants should be developed and promulgated. Such guidelines should include a well-understood methodology for calculating foreign exchange risk, disclosure requirements for lenders and some system of formal acknowledgement by the relevant elected and appointed subsovereign decision-makers that they understand and accept the exchange risk of the transaction. This element could be built into the common procedures developed for RIO's in approving subsovereign debt transactions.

### ***Rio Competencies and Resources Despite Large and Growing Responsibilities***

#### **Summary Assessment**

Other efforts have focused on improving the quality and consistency of the Regional Accounting Chambers apparatus. All these efforts have borne some fruit in terms of best practice guidance and some models and have doubtless had some positive impact at the local and regional levels. However, the creation of best practice guidance and some demonstration model applications alone do not lead inexorably to nationwide adoption and application. In addition, possible new policy directions that may be taken by Parliament could directly effect such areas as auditing in major ways.

As discussed elsewhere, the May 1998 Law on Public Finances had been drafted with a requirement that all municipalities under 50,000 in population be required to have an independent audit at least once every three years and that all those over 50,000 have an independent audit every year. The current draft has had this requirement removed and the new act is now considered highly likely to pass both houses without. However, the fact that there was serious Parliamentary consideration of the idea perhaps suggests how ill-equipped the RIO's are considered in many quarters to be in their practical capacity to fulfill the full range of oversight and auditing functions

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<sup>25</sup> For example three on-lending transactions already closed by BISE using World Bank capital, direct loans concluded by EBRD and EIB, and at least one loan closed by WestLB.



that they are assigned or the capacity to provide<sup>26</sup>. This appears to be particularly true in the subsovereign utility sector where RIO oversight seems to be particularly thin.

### **Opportunities for Development**

If independent audits will not be required (unless a public offering is being prepared or is in continuing effect under present disclosure requirements), serious additional policy and technical assistance will need to be directed toward continued substantial improvement of the RIO's, particularly with the advent of new RIO responsibilities toward Powiats and Voivodships.

The Council of RIO's is proving to be a useful forum through which some bi-lateral assistance is already flowing. It is also proving to be a means of accomplishing valuable empirical research. It seems likely the RIO Council mechanism can be a primary channel through which to deliver intensified assistance. Emphatic endorsement of guidelines now only imperfectly implemented by RIO's and/or direction from the Ministry of Interior which the team understands to have the current oversight responsibilities for RIO's could also be a useful way of increasing the rate and impact of change among the RIO's.

### ***Understanding Re: Pledging of Collateral***

#### **Summary Assessment**

As noted above, there appears to be a lack of understanding about various aspects of collateral by borrowers and issuers, including the value of pledged collateral as an enhancement of credit quality, what collateral is appropriate to pledge, and related issues.

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<sup>26</sup> The Regional Audit Chambers (RIO's) have been assigned enormous responsibility under present law for: prospective budget review, prospective review of all financial resolutions adopted by local governments, semi-annual review of budgetary compliance with adopted resolutions, ad hoc audits to address specific exceptional circumstances; and "full audits" every four years for every local general purpose local government. A description of what RIO's are supposed to do amounts to a truly impressive description of a comprehensive governmental oversight and correction system. However, by many accounts, RIO's are simply unable to carry out all their responsibilities efficiently and effectively throughout the country. From the team's perspective as assessors of the subsovereign debt markets, one indicator of how short the RIO's are widely perceived to fall in the performance of their work is that no lenders believe RIO documents are useful in helping assess local government credit quality. Other specific shortcomings of RIO audits mentioned to the team included an inability to effectively audit accounts receivable and an inability to find accounting errors discovered by independent auditors brought in for the purposes of helping prepare a public debt offering, and the lack of a mandate to judge anything but the strictly legal appropriateness of expenditure and accounting decisions. Although several observers labeled the RIO's as "expensive", it is probably their lack of resources relative to their huge responsibilities that is their most glaring problem, a problem that could get the positive attention of decision-makers about to assign the RIO major new responsibilities for Powiats and Voivodships.





## **Opportunities for Development**

The development of prudential guidelines regarding what collateral is appropriate to pledge (e.g., raw land, buildings not in essential public use, etc.) would be a useful step in stimulating more discussion of the issue of collateral pledges, their value and their propriety.

### ***Subsovereign Utility Sector***

#### **Summary Assessment**

There continue to be substantial demand side problems with the willingness and ability to pay in at least some subsovereign utility sectors such as water and wastewater treatment. These problems will become far more urgent if gmina debt limits lead this sector to borrow more heavily. It is the team's understanding that in many parts of the subsovereign utility sector, cost recovery pricing of tariffs is only just beginning to take hold—this presents an enormous barrier to the continued growth of this part of the subsovereign debt market. Much of the problem seems rooted in the inability of municipal governing bodies to fully play to oversight and tariff-regulating roles currently assigned to them.

Central to any sub-sovereign unit's ability to demonstrate its willingness and ability to pay is its willingness and capacity to effectively disclose all the facts about its past financial performance (particularly during periods of fiscal stress). The current systems and competencies of planning, budgeting, investment management, accounting and external auditing appear to the team to leave much to be desired, although there appears to be a high level of interest in making improvements. Such weaknesses as the lack of task-based budgeting and the lack of a distinction between operating and capital expenditures in the planning, budgeting and accounting systems in general use at the local level has been the subject of sustained attention by donors such as USAID.

## **Opportunities for Development**

Some progress has been made in some local utility sectors (e.g., water and waste water treatment) to increase the understanding of operating cost recovery and, to a lesser extent, capital cost recovery through the setting (typically by local decision-makers) and approval (typically by the anti-monopoly authorities) of economically appropriate tariffs. However, by several accounts, much more remains to be accomplished in this field. For example, additional progress in the field of water and sewerage tariff reform might be accomplished through a sustained effort to support the work of the new Water Standards Board, and additional legislative reform is likely to be needed as well. This work is likely to require several years of continued work with the Water Standards Board, the Anti-Monopoly Office, the Office of Housing and Urban Development and other key actors.

As policy reform is accomplished, technical assistance and training (including project preparation and financial engineering help targeted at practitioners in the local utility sectors will be vital. The mere presence of improved policies and a few good models will not ensure that a steady stream of high quality, economically sound utility projects using cost recovery principles will be designed and financed, perhaps by utility enterprises themselves, without the total or even partial "back-up" of a general obligation pledge of local general purpose governmental units, which will be under increasing pressure to finance non-utility projects (such as educational facilities, etc.) or utility projects with far less ability to fully recover costs, such as mass transit projects. Perhaps most crucial will be intensified efforts to develop a cadre of Polish technical and financial consultants able to providing this assistance with a consistently high level of professional skill anywhere that it is needed in Poland. This will be particularly important as the sources of concessional financing for environmental projects decline and/or disappear.

Equally important will be promoting a more productive relationship between general purpose local government governing bodies and the utilities they should be overseeing and whose tariffs they are approving. This relationship often needs a written framework to be made more fully predictable and effective. The use of performance contracting techniques where each local utility and governing body party sets forth in significant detail what it will provide or how it will proceed under defined circumstances instances could be tested in Poland. Such performance contracts should include a pledge by the governing body to approve tariffs necessary to cover debt service for financing undertaken by the utility enterprise for agreed-upon projects.

### ***Review and Possible Development of Effective State Aid Intercept Mechanism as Gop Moves from Grants to Subventions***

#### **Summary Assessment**

One of the clear themes in the ongoing debate over the reform of the intergovernmental fiscal system is the continuing effort to move from a reliance on the use of discretionary grants (which tend to reward "grantsmanship" skills of local decision-makers over such other more fundamental skills as personnel and financial management) toward the greater use of formula-based subventions, tax sharing and, in the longer run genuine own source revenue sources like the property tax and a possible personal income tax surcharge.

#### **Opportunities for Development**

The growth of subventions and the increasing stabilization subvention flows as well as the continued use of tax sharing and possible increased use of genuine own source funds from piggy-backed personal and corporate income taxes and ad valorem property taxes, will underline the need to examine the desirability of a well-conceived system of stand-by state aid "interception" which can be used at the discretion of sub-sovereign borrowers to provide increased comfort to lenders and investors. Long the subject of discussion and some ambiguous legislation in Poland, the basic idea would appear to be given a firmer grounding by language in the currently available draft



of the Law on Public Finances<sup>27</sup>. However, turning the state aid intercept idea into concrete prudent reality would require a significant sustained policy advisory effort over the near- to mid-term.

### *The Capital Supply Side*

Further Developing the Ability of Indigenous Institutions to Provide Capital to Subsovereign Borrowers. A mature and fully developed subsovereign market will be characterized by a capital "supply side" which includes:

- A variety of institutional and retail investors competing to lend capital for cash flow, construction bridging and long term infrastructure investment in short, medium and long maturities.
- A variety of fixed income products including floating and fixed rate loans, bonds and leases or lease/purchase instruments competing to best fit the needs of borrowers/issuers and investors.
- The risk-adjusted pricing of debt.
- Both primary and secondary markets.

In the team's view, and as the previously cited market evidence demonstrates, the supply side of the Polish subsovereign debt market has developed rapidly and appears to be continuing to do so in 1998. The bankers interviewed cited healthy growth in demand for long maturity debt until a short time before the subsovereign elections recently concluded:

- One banker who expects an increase of about 10 percent in the par value of loans closed in 1998 had also been comparing notes with other bankers and stated that substantial increased in demand had continued with for all the banks active in the subsovereign credit market.
- A competing bank has already closed approximately three times the number of loans in the first three quarters of 1998 as in the first three quarters of 1997 and expects year-end results in 1998 to exceed year-end results in 1997 by about the same proportion.

Of 44 bond issues completed since 1996, 14 (32 percent) have been completed thus far in 1998 and another 15 are reportedly still pending issuance in 1998<sup>28</sup>. If even a small number of the

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<sup>27</sup> See Article 22 of the May 1998 draft.

<sup>28</sup> Bond issues from CERA survey data of 10/98. The CERA definition of "pending" is ambiguous: it was not clear to the team how seriously committed the issuers involved are to undertaking the issue. Moreover, because newly, elected gmina administrations will certainly

pending issues are closed, 1998 will see approximately as many subsovereign bond issues as 1997 (18) and far more than 1996 (9).

We can speculate from the anecdotal data on loans and complete data on bonds issued to date that the overall subsovereign debt market has grown in 1998. Much of that growth—if indeed complete data bears out the impression of growth received by the team—would appear to be accounted for by the loan sector of the supply side rather than the bond sector.

It is useful to evaluate the supply side of the current subsovereign debt market by assessing each of the three indicators of a mature fully developed market cited above and exploring possible opportunities for further development associated with each<sup>29</sup>.

*A variety of institutional and retail investors competing to lend capital in short, mid and long maturities*

**Summary Assessment**

The team saw evidence of a competitive debt market comprised almost entirely of Polish and International banking institutions and a few investment banking firms. There appears to be no retail market and little interest by market intermediaries in creating one. However, we were provided with one vivid anecdote suggesting strong interest by relatively wealthy individuals in a small town offering a small bond issue who wanted to be members of the maximum number of 300 investors<sup>30</sup> allowed under the Bond Law and their demand was eventually accommodated with a specially designed tranche. Further research would be required to discover whether this incident is simply an aberration or whether there is a pool of un-tapped capital supply among potential retail investors.

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want to review and possibly revise or nullify the timing and substance of bond issuance plans agreed to by their predecessors, it is entirely unclear how many of the 15 issues planned for late 1998 will close.

<sup>29</sup> During interviews representatives of the Office of Housing and Urban Development expressed an interest in establishing a municipal lending facility, or a municipal mortgage bank through the state owned Bank for the National Economy (BGK). Given the growth and diversity of the existing Polish capital market, as well as the prospects for significant inflows of EU grants, the team felt that these plans were unnecessary. It also felt that it would be unwise for a state bank, such as the BGK to be the primary agent for securitizing municipal debt so that it could be publically traded. The team felt that this would create an implicit state guarantee of such debt. As a result, such securitization projects are best left to the private sector.

<sup>30</sup> This limited circle of investors need not meet "sophisticated investor" criteria as in the U.S.



From the available evidence, institutional investors such as insurance companies, commercial firms other than financial institutions, etc. are not significant players in the capital supply side. The team understands that one reason for the apparent lack of supply from such insurance sectors as life or property and casualty companies is a lack of interest in the modest size of the issues and the issuer's lack of name recognition. In addition, insurance companies are not permitted to make direct non-mortgage loans to subsovereign borrowers or purchase subsovereign non-mortgage loans from banks.

The advent of voluntary pension funds under the 1997 Law on Organization and Operation of Pension Funds could bring this new source of mid- to long-term capital to the subsovereign debt markets. However, the pension funds will be constrained by analogous prudential investment requirements that, in essence, require that 95 percent of their investments either be "secured" investments or meeting the public offering requirements.

With respect to maturities, banks are stretching their final maturities into the range beyond five year, although few have achieved 10-year maturities with unsubsidized capital<sup>31</sup>. The environmental funds have, in general, kept their maturities in the short- and mid-range (e.g., 2 to 6 years) apparently in an effort to speed up their loan "recycling" speed. Environmental loans often also include level principal payment structures often causing large "spikes" in the earliest years of debt service repayment, often the period when a project is least able to generate revenues sufficient to pay debt service. Nonetheless there is little doubt that the deeply concessional interest rates and principle forgiveness provisions of environmental fund loans have been crowding out much of the supply of market rate debt for environmental purposes. Bond issue final maturities are similar to those in the loan market, with most being in the 2 to 6 year range, and one of 7 and one of 10 years' final maturity.

While there is no visible secondary market, the team understands that at least a modest degree of trading activity has occurred among sophisticated investors in privately placed subsovereign bonds. In particular, the team understands that corporations participate as significant buyers of subsovereign bonds from banks. There is no known reporting mechanism for such trades.

The team also encountered significant apprehension from investors concerning the impact of European structural funds on the future development of the Polish subsovereign debt market. Over the next three to five years between 400 and 600 million ECUs in grant monies could flow to Polish local governments under various programs of PHARE II. Moreover, with ascension to the European Union, the amount of these funds could double or even treble.

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<sup>31</sup> Banks cite the severe mismatch between the maturities of the deposits (generally 1 year or shorter) that are their primary source of capital and the maturities they now supply or would like to supply to subsovereign borrowers as the principal source of the constraints they face on maturities.

The availability of grant funds of this magnitude could put a serious damper on the growth of the Polish municipal capital market if clear and transparent procedures for the co-financing of investments by local governments are not developed.

### **Opportunities for Development**

The team found that at least some current players in the market are exploring methods by which loans and/or bonds which do not now meet the prudential requirements of non-bank institutional investors could be re-packaged as some form of pool or as asset backed securities that are structured to meet the public offering requirements, and thus qualify under the prudential requirements for the voluntary pension funds now coming into existence. There is merit in actively encouraging such activity, perhaps through the provision of technical and/or legal expertise to one or more institutions now exploring the idea. If it can be done, it would build a secondary market "bridge" to the very investors which both possess (or, in the case of voluntary pension funds, will soon begin building up) pools of mid- to long-term capital and need to both:

- Make domestic z»oty-denominated fixed income investments of high quality.
- Diversify their portfolios geographically and within the government sector.

A second means of overcoming the prudential investment problem faced by supply side investors would be to encourage more demand side "production" of "secured" obligations and/or those that meet the public offering requirements. USAID has supported at least one such effort with the second Ostrow Wielkopolski bond issue (12/97). However, this effort also demonstrated the high hurdles facing any issuer wishing to meet these requirements. Setting more realistic public offering requirements for local governments could not only help increase the volume of such instruments directly available to institutional investors other than banks, but also make a retail bond market more possible.

With respect to the environmental funds, ways should be found to reduce or eliminate their "crowding-out effects" from the commercial sub-sovereign debt markets, eliminating the fundamental lender bifurcation noted earlier. This "crowding-out" problem (as well as the potential for "moral hazard", noted above) derives largely from the fact that the interest rate subsidy "gift from the State" is embedded in the loan terms and not separated out and made completely transparent as a grant. Both the temporary depletion and the reorganization of the voivodship environmental funds open possible avenues for promoting this kind of change in the operation of the funds. This type of change could help reduce the environmental funds' current dominance of the subsovereign debt market for water, waste water and other environmentally friendly capital investments, turning them into market collaborators, instead. These avenues should be fully and energetically explored in the possibly brief period during which they may be open.



With respect to the prospect of large inflows of grant monies for infrastructure development from the European Union, it is imperative that the national government develop co-financing standards for local governments that include means testing. Without means testing, it is likely that the local governments most capable of developing capital improvement plans, and not necessarily those that have the greatest need for grants, will have first access to EU funds. This would be irrational from a national perspective, and would also unnecessarily dampen the growth of the subsovereign debt market.

*A variety of fixed income products including variable and fixed rate loans, bonds and leases or lease/purchases competing to best fit the needs of borrowers or issuers and investors*

### **Summary Assessment**

As discussed amply above, loans and bonds appear to be competing for the attention of issues. However, the team was unable to learn much about the availability of lease or lease purchase instruments and this is worthy of further investigation. This form of secured lending is particularly well-suited to subsovereign investment in rolling stock, computing and telecommunications equipment and other categories against which a security interest can be readily exercised.

Due to Poland's prevailing high nominal and real interest rate environment<sup>32</sup>, virtually all unsubsidized and most subsidized loans and all bonds are in made in a variable rate format, benchmarked by the Polish Treasury note market (in the case of z»oty-denominated instruments) or WIBOR and LIBOR (in the case of foreign denominated transactions. It is a natural consequence of the interest rate environment (and widespread expectations that interest rates will decline) that neither the capital demand nor capital supply sides of the unsubsidized market are presently showing much enthusiasm for fixed rate instruments.

### **Opportunities for Development**

Further investigation of the availability of lease and lease purchase formats to subsovereign entities should be undertaken. If instruments of this kind are found not to be in the current product lines of the subsovereign debt market supply side, technical assistance or other steps should be considered to encourage their addition.

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<sup>32</sup> The current high interest rate for loans and bonds appear to the team to result from a combination of persistent though dropping inflation rates and State bank reserve and other policies designed to both curb inflation and facilitate many banks' legacy of poor quality outstanding loans.

## *The Risk-Adjusted Pricing of Debt*

### **Summary Assessment**

It appears that the use of risk premiums of up to 200 basis points has become common practice among banks in their loan pricing. However, it is difficult to isolate risk premiums in any given loan as banks are likely to factor in a variety of other factors to their pricing decisions, (including, in some cases, the depository relationship). Also, the factors effecting loan pricing are not revealed to the customers, except possibly by multi-lateral lenders. The team has not been advised that risk premiums are included in bond issue pricing. Foreign credit rating agencies have begun providing credit ratings in Poland, but, thus far, only the domestic rating agency CERA has made distinctions among subsovereign bond issuers.

### **Opportunities for Development**

The use of risk premiums should be promoted as a fundamental principle of subsovereign capital market development. Thus, the multi-lateral banks playing a role in sub-sovereign debt finance (through direct or on-lending) can lead the way in demonstrating explicitly how risk premiums are applied and how, by mitigating risks, borrowers or issuers should be able to reduce the costs of their borrowing. Seminars and other devices which spotlight the use of risk-adjusted pricing are important ways of helping lenders develop their won systems and discuss with their clients how risks can be mitigated and interest costs reduced.

The experience to date suggests that credit ratings are not a necessary precursor to the initial introduction of risk-adjusted pricing. However, if rating agencies succeed in selling their products either to borrowers and issuers or lenders and investors, this should also help encourage the more and more explicit and widespread use of risk premiums. The team's experience is that it takes significant amounts of time for rating agencies to gain the trust and credibility of both sides of the market, and that only lengthy and persistent marketing of high quality products can accomplish this. Donors such as USAID should consider ways of continuing the direct or indirect support of indigenous agencies like CERA until they are more firmly established in the Polish marketplace.

## *Primary and Secondary Markets*

### **Summary Assessment**

A reasonably vigorous primary market clearly exists in Poland, although with the limitations noted above (e.g., virtually no publicly offered instruments, etc.). No visible secondary bond market exists, although, as noted above, the team understands that occasional direct trading may be taking place among a few sophisticated investors. Moreover, the team was able to detect no instances in



which loans to subsovereign entities were sold by one bank to other banks or other investors<sup>33</sup>. The lack of a robust secondary market severely limits liquidity and thus puts major constraints on existing supply side players and helps prevent entry by such new potential suppliers as insurance companies and voluntary pension funds.

### **Opportunities for Development**

As noted above, the following steps will assist in:

- Pooling and sale of existing or new bonds or loans as either "secured" package obligations and/or as packaged obligations that meet the public offering requirements.
- Increasing the supply of publicly offered and/or secured obligations would both be likely to help develop secondary markets.

These steps are also likely to increase the interest in and demand for credit ratings by such indigenous sources as CERA as well as potentially the international rating agencies. Ratings and other information provided by rating agencies<sup>34</sup>, in turn, can play an important role in developing the trading and packaging operations characteristic of a healthy secondary market.

### **CONCLUSION: POSSIBLE NEXT STEPS FOR USAID**

The viability of the subsovereign debt market is dependent on many components, actors and processes. There is not a single factor, which, if enhanced, will assure the success of this market. It is necessary to "corral" as many of these components, actors and processes in order to effectively bring about further development of the market.

We would recommend a series of roundtable discussions with appropriate representatives of the State, subsovereign and other Polish actors in the market together with USAID officials and contractors, and possibly other donors, structured around particular issues of mutual interest. Such topics might include:

- Continuing efforts to promote long time capital planning and budgeting, task based budgeting, and project preparation.
- The facilitation of creditable local infrastructure financing.

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<sup>33</sup> One bank did advise the team that they do syndicate loans to subsovereign borrowers, acting as syndicate organizer/manager. However, this should not be confused with secondary market activity in loans.

<sup>34</sup> e.g., the semi-weekly bond survey results presently provided by CERA on a subscription basis.

- An intensified focus on the role of utility enterprises in infrastructure finance as well as service delivery and tariff reform.
- The bridging of the gap between creditable projects and long term, z»oty denominated capital.
- RIO's and their role in debt approval and other related aspects of intergovernmental oversight.

Although the convenor of such fora may be different depending on the issues presented, it would be beneficial to identify a Polish institution with a sufficiently broad perspective and institutional capacity to oversee and structure the participants and the processes to bring about the reforms and improvements necessary for the further development of the subsovereign capital market into a market that can effectively meet the needs of its participants.

## **APPENDICIES**

## APPENDIX I

### WRITTEN SOURCES CONSULTED

- A new state for new challenges; State System Reform Department Sept 1998
- A model issue prospectus. After corrections to comply with New Legislation on the Public Trade in Securities Commission prepared by RTI; Wieslaw Oles; Kraków Sept 1997
- Comments on "A model issue prospectus" and "Financial Statements"; USAID Sept 1997
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## APPENDIX II

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