KEY FINANCIAL RISK FACTORS FOR UKRAINE'S CITIES

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Scope of the Analysis

This analysis considers the financial risks of cities in the Ukraine. Along with the State, they are the only bodies of government authorized to borrow by the Budget Code. The report does not look specifically at risks affecting other local self-governments nor oblasts or rayons that are not authorized to borrow.

Credit risk analysis seeks to identify financial and other factors that could affect adversely the ability of a borrower to repay its debt obligations fully and in a timely manner. It also considers the ability of the borrower to limit or mitigate that risk over time.

This reports looks at systemic or structural aspects of the finances of cities that may impair the ability of the city itself and of external analysts to identify credit risks. It also looks at factors that may constrain the ability of cities to mitigate or limit that risk over time. This includes:

- The system of financial reporting and accounting
- The local budget process and structure
- Local revenue and expenditure authority

The report concludes with a review of the current ATCI credit risk methodology in light of the risks that cities face in the management of their finances and makes recommendations for possible adjustments to that methodology.

The System of Financial Reporting and Accounting

Disclosure – ideally based on clear rules consistently applied – is a key factor in credit risk analysis. The financial statements prepared and issued by the potential borrower are the primary source of information for any credit risk analysis. When looking at those statements it is vitally important to understand the underlying system of financial reporting and accounting – what it measures, when assets and liabilities are recognized and recorded, the rules on the content and presentation of the statements. The key issue is whether the financial statements provide a comprehensive picture of the finances of the reporting entity that shows all its assets and all its obligations. When it appears that not all assets and/or obligations are reflected in the financial statements, or if supporting information is not available through notes to the financial statements, disclosure is incomplete. This of and by itself adds an element of risk.

Cities in the Ukraine must deposit all their funds and keep all their accounts in a unified national treasury. The State Treasury handles all their receipts and payments. Ti also prepares and issues the financial statements for the cities. It was not possible during the short trip to establish clearly either the measurement focus or the basis of accounting used in the public sector in Ukraine. Information provided by the former director of local budgets in the Ministry of Finance suggests that transactions are recognized when actual funds are received or paid, that is, on a cash basis. There is a uniform chart of accounts for all the public sector, including cities. The State Treasury records a commitment against the city budget when the city issues a contract or purchase order. By comparing outstanding commitments with payments, the State Treasury can estimate payables at the end of the year (a feature not normally available in cash accounting).

The focus of financial reporting is on legal and budgetary compliance. By law and regulation, each city must issue the following financial reports:

1. Report on financial state (balance) (a summary of accounts balances)
2. Report on local budget execution (based on budget classification – social protection, education, communal economy, etc.)
3. Report on local budget execution results (based on economic classification – operating revenues, operating expenditures)
4. Cash flow report
5. Budget indebtedness report (accounts receivable/payable)
6. Special fund revenues and expenditures report as regards own revenues of budget institutions financed by the local budget;
7. Information on execution of protected expenditures of local budgets;
8. Information on reserve fund utilization
9. Information on changes in goods and foodstuffs of budget institutions financed by the local budget;
10. Report on changes in fixed assets of budget institutions financed by the local budget;
11. Report on lack of and pilferage of cash and valuables in budget institutions financed by the local budget;
12. Information on changes to the local budget general fund figures during the year;
13. Report on revenues and other receipts (international donor assistance) of the special fund;
14. Report on receipt and utilization by local budgets of the State Budget grants and subventions;
15. Explanatory note to the annual report

The Budget Code requires that the budget include all city revenues and other sources of financing and all city expenditures. There are no off-budget funds. The information in the reports is consolidated accordingly. This is a positive feature of the system of financial reporting in the Ukraine.

The Treasury issues the reports monthly, quarterly and annually. The reports are designed for internal users. There are no notes to the financial statements that normally would inform external users of key facts and information underlying the figures in the various reports. This limits the value of the financial statements. It is a practice common to all transition countries where the very notion that someone outside the public authorities would want to read and understand the reports was inconceivable.

A specialized office in the Ministry of Finance conducts a limited audit of these financial reports. These audits generally look at some specific aspect of local finances and do not cover the entire scope of those finances. There are no other independent external audits of city financial reports.

ATCI financial analysts that have been conducting the credit risk assessment of target cities indicate that in reality not all of the reports listed above are available from the cities and not for all years. They face considerable difficulties collecting the reports and other financial and economic information from cities.

The lack of notes to the financial statements to inform external users, the limited external audit review and the difficulty in obtaining all reports for all years adds up to limited disclosure of city finances. This is a risk that lenders or investors interested in Ukraine cities must accept.[i]

Cities maintain their own records but these are not kept together by one office in one place. Rather each "key spending unit" (as defined in the Budget Code) maintains its own revenue and expenditure records. The City Finance Department is but one of several such spending units that also include the various line departments (responsible for education, culture and so on).

There are indications that the records of the key spending units may not always reconcile fully with the information kept and reported by the State Treasury. The differences may represent 3 to 5 percent of aggregate figures. While not that significant, ***the fact that internal records of the city may not reconcile with those of the State Treasury adds to the risk of uncertain disclosure of city financial information***.

The Local Budget Process and Structure

Even the most solid local governments in any country can and do encounter circumstances that affect their finances adversely. What differentiates one local government from another is its ability to manage the problem. What differentiates the system of local government in one country from that in another is the extent to which the rules and procedures for managing local finances provide a reasonable basis for managing such problems. The first set of rules and procedures to consider are those on the local budget process and structure.

The Budget Code of the Ukraine defines the city budget process and structure. The Code establishes a process that allows city officials to plan, adopt, amend and execute their budget independently of other budgets. This is a positive aspect of the system of local finances in Ukraine – one that is not found commonly in other transition countries.

The Ministry of Finance provides information that cities need to prepare their budgets once at the beginning of the process and again after the Council of Ministers has adopted the draft State Budget. The second instance is particularly important. It includes "the estimated amount of intergovernmental transfers, the methodology for their definition, other amounts as necessary for development of draft local self-government budgets and other parameters needed for formulation of local budgets." (Article 75 (7)) This effectively allows cities in the Ukraine to develop their own budget on the basis of an estimate of all their revenues and other sources of financing. Further, city budgets are not subject to review by any external body prior to adoption. As noted above, the Budget Code requires that the budget include all revenues and other sources of financing and all expenditures. There are no off-budget funds. Together these features promote sound, independent budgeting by cities.

The Budget Code provides a clear classification of revenues, other sources of financing and expenditures that simplifies the task of calculating the operating (or current) balance in city finances separate from the overall or total balance. This facilitates the credit risk assessment by identifying the recurring funds that might be available to service debt.

The Budget Code divides the city budget (and all budgets) in "general" and "special" budget funds. The special budget fund includes all earmarked or special purpose revenues, related expenditures and any fund balances. The general fund includes all other revenues and related expenditures. By authorization of the City Council it is possible to transfer resources from the general to the special budget fund. In 2004, actual end-of-year expenditures of the general budget fund accounted for 82 percent of aggregate local expenditures. The special budget fund accounted for the remaining 18 percent.[ii]

The Budget Code also establishes a Local Development Fund that includes all earmarked capital revenues and other sources of financing for capital expenditures. These include proceeds from the sale of assets and dividends on investments. They also include all the proceeds from any bond or loan. The revenues and expenditures of the Development Fund are recorded and reported as part of the special budget fund.

The prevailing interpretation of the Budget Code is that it requires that any repayment of principal on a bond or loan be made from resources available to the Development Fund. Interest payments are made from resources available in the general budget fund.

Finally, of interest to this report, the Budget Code also provides for certain "protected items" in the budget that may not be sequestered.

The rules and procedures governing the budget process in Ukraine are a positive factor when considering credit risk of cities. The segregation of capital expenditures in the Development Fund, the provision dividing debt service between the general and special budget funds and the protected items all add rigidity to the local budget that could become a constraint in times of severe budget stress (more on this below).

Local Revenue and Expenditure Authority[iii]

Aside from those governing the budget process and structure, the other set of rules and procedures to consider when assessing the ability of local governments to manage problems that may arise in their finances are those regarding revenues and expenditures, that is, the ability of a local government to raise revenues and/or decrease expenditures if needed. In looking at this question the focus has to be on the general budget fund, as by definition the revenues and expenditures of the special budget fund are all earmarked or dedicated.

On the expenditure side of the general budget fund, there are two factors that limit the discretionary authority of cities to manage their finances. Protected items, as defined by the Budget Code, are one. These are types of expenditures that may not be sequestered in times of budget constraints. At present they include wages and related social insurance payments as well as certain items such as medicines. In 2004 in aggregate such items accounted for 79 percent of general budget fund expenditures.[iv] The second factor limiting the ability of cities to manage the expenditure side of the general budget fund is the fact that a large share of their responsibility is to implement State programs in areas such as education, health and social assistance. For all of 2004, these "delegated" expenditures accounted for 84 percent of general budget fund expenditures.[v] To the extent that service policy in these sectors is a central government function, it suggests that cities have limited discretion in managing a large share of the general budget fund.

If we consider these two limitations on the expenditure side of the general budget fund and the absolute constraints on all special fund expenditures, then local governments have limited discretion to manage roughly 87 percent of their total expenditures (including both budget funds).[vi] Or, conversely, local governments in aggregate have full discretionary control over approximately 13 percent of their total expenditures. The rigidity of local expenditures – be they “delegated” or “protected” – suggests that cities would find it difficult to adjust expenditures to meet debt service obligations if they found themselves in a situation of financial distress. In fact, the source of financial distress could easily be a change in central government policy affecting one or more of the “delegated” functions in health, education or social assistance.

There are even greater constraints on the revenue side of the general budget fund. Local governments are heavily reliant on shared taxes. Their share of the PIT and the tax on small businesses and entrepreneurs accounted for 75% of all general budget fund revenues in 2004. Conversely, local taxes and fees (those over which the local government has discretionary authority) represented 3% of total general budget fund revenues in the same period. They declined by 6% in nominal terms from 2003 to 2004. Local governments have virtually no ability to make adjustments on the revenue side of the general budget fund. In fact, as with their expenditures, a change in central government policy – in this case regarding one or more of the various shared taxes – could easily become the source of financial distress for cities.

The ATCI Credit Risk Assessment Methodology

ATCI has developed and applied a sound methodology for assessing the credit risk of cities in Ukraine. It focuses on the recurring or operating surplus (deficit) as the key variable when considering the debt service capacity of cities. It uses various financial indicators or ratios to identify specific characteristics of the structure or trends in revenues or expenditures that may signal current or future problems in the finances of the cities. The following recommendations are intended solely as a complement to the existing methodology. They are intended to reflect some of the systemic problems discussed in the preceding sections. They are not meant to suggest that the assessments prepared to date do not meet the needs of the program. ATCI staff already adopted several of the recommendations.

Obtain additional information to that provided in the financial reports on possible obligations or liabilities. ATCI should ask the city to provide full and current information on the following:

- Outstanding loans or other debt obligations of the city and the current and historical status of compliance with the terms of those obligations
- Arrears as reported by key spending units (for comparison with arrears as shown in the financial reports)
- Arrears of key locally owned enterprises and trends in those arrears
- Ongoing capital projects and their claim on future revenues
- Investments or ownership shares of the city in private or mixed capital enterprises
- Outstanding guarantees or other financial commitments of the city to any other institution or enterprise
- Fines assessed by other public authorities (such as for environmental issues) and not paid
- Pending litigation and its potential financial impact
- Other contingent liabilities

Develop and monitor indicators of "rigidity" on the expenditure side of the general budget fund. ATCI should review the extent to which a city is constrained in managing the expenditure side of its general budget fund using indicators such as the following (some already in use, others new):

- Expenditures for delegated functions as a percent of recurring revenues
- Percent change in expenditures for delegated functions over percent change in recurring revenues
- Protected items as a percent of recurring revenues
- Percent change in protected items over percent change in recurring revenues
- Percent change in city payroll over percent change in national wages
- Operating surplus as a percent of expenditures for delegated functions
- Operating surplus as a percent of protected items

The last two ratios are very important and should serve as a complement to the ration of operating surplus to recurring revenues. The threshold value of the ratios should reflect historical experience. What has been the largest one-year increase in real terms of aggregate delegated expenditures? What has been the largest one-year increase in real terms of expenditures for protected items? The ratio of the operating surplus to each type of expenditure should be some multiple – probably not less than twice – the rate of the corresponding one-year increase.

So, for example, if aggregate national delegated expenditures increased by up to 10 percent in one year, the operating surplus should be no less than 20 percent of total city delegated expenditures. This will provide a cushion against possible changes in central government policy regarding health, education or social assistance that may not be accompanied by a corresponding increase in transfers from the State budget. There is a precedent for this when Parliament ordered an across-the-board increase in public sector wages in 2004. Many cities faced immediate serious financial problems.

Identify potentially troublesome ratios or trends in advance of interviews with city officials as the basis for assessing a) the city's own understanding of its current financial condition and b) the willingness and ability of the city to address and resolve current or future causes of fiscal stress.

Aside from providing a quantitative assessment of the finances of a city, the indicators and ratios that are part of the ATCI credit assessment methodology provide an opportunity to develop an approximate qualitative assessment of the city's financial management capacity. After ATCI staff have completed the entry of data in the financial model and identified areas of potential problems, they should conduct an interview of key decision makers in the city regarding these problem areas. Are the officials aware of the problem? Do they have a reasonable explanation for the underlying causes of the problem? Are they taking steps to mitigate the risks?

The following is an example of how this might work:

> The analysis of the finances of city X shows that rate of change year-to-year in operating expenditures in city X is greater than the corresponding rate of change in its recurring revenues. A further look at the indicators shows that this has been driven in large measure by increases in the payroll of city X at a higher rate than the corresponding national average.

> The interview with officials in city X would seek to find out more about these two trends. Is the change in payroll the result of having hired more people or having increased the wages of current staff? If the latter is the response, is this part of a plan to retain good staff? Or, has city X simply been adding staff for essentially political motives. Is the increase in operating expenditures part of a plan to improve city services? Or, is it driven, as with the payroll, by political motives? What steps is the city planning to take to bring the trend under control before it incurs an operating deficit?

Following such an interview, ATCI staff will be in a better position to interpret the straight-line projection of trends in key city indicators. They also will have the basis to assess the willingness and ability of city officials to manage their finances prudently going forward. If that assessment is not fully positive, they may want to compensate by reducing the estimate of debt carrying capacity.

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[i] There are precedents in other transition countries such as the Czech Republic for an *ad hoc* request by lenders or investors for a complete independent audit of a given city's finances. Normally this would be limited to a very large bond issue or loan, given the substantial cost of such an audit.

[ii] Data is from *Budget Monitoring: Analysis of Execution of Consolidated and theState2004 State Budget*, RTI, May 2005

[iii] All figures in this section of the report are from RTI 2005

[iv] Payroll 45%, Subsidies and current transfers 29%, Foodstuffs 3% and Medicines 2%

[v] Of these expenditures (less transfer and social protection payments to the population), 73 percent were for wages and related costs.

[vi] Calculated as share of general fund in total expenditures X share of delegated expenditures in the general budget fund plus share of special fund in total expenditures or

$$(.82 \times .84) + .18 = .87$$

WORKSHOP ON CREATING A MUNICIPAL FINANCE FACILITY FOR UKRAINE

The Workshop is co-sponsored by the Ministry of Finance; the Ministry of Construction, Architecture and Housing and Communal Economy; and the United States Agency for International Development/The Access to Credit Initiative

Date: Friday, January 27, 2006

Place: Academy of Science, Volodymyrska Street 55 (3rd floor), Kyiv

Attendees:

Senior leadership of the Government of Ukraine involved in policy decisions affecting local infrastructure financing and investment; city mayors and finance directors; Association of Ukrainian Cities; communal service enterprise executives; investment bankers; international donor agencies; potential investors.

Purpose:

The workshop will consider the creation of a new finance facility that specializes in making long-term infrastructure loans to cities and communal service enterprises. The institution would raise capital at market interest rates, and lend to creditworthy cities and utilities. Loan repayments would be pledged as collateral to the investors who provide capital to the institution. The institution's staff would become expert in evaluating the creditworthiness of cities and communal enterprises. At the workshop, nine experts from three continents including three former Chief Executive Officers of bond banks, will make presentations. They will describe infrastructure finance facilities that have operated successfully around the world. New research on the creditworthiness of Ukraine's cities and communal enterprises will provide context for evaluating international practice in infrastructure finance. Russia's ongoing effort to create a municipal finance facility will be described. To conclude, all experts will jointly discuss key issues for the proposed finance facility's business plan, including:

- Financial structure, including sources of core capital and lendable funds; credit enhancement
- Operating policies: standardized loan documents, credit evaluation, loan monitoring
- Enabling legislation and regulatory oversight.

Conference Chairman: *Dr. Vitaly Lisovenko, Deputy Minister, Ministry of Finance*

Agenda

Friday, January 27, 2006

8:30 – 9:00	**Registration**
9:00 - 9:20	Welcome and Introduction: *Dr. Vitaly Lisovenko; Earl Gast, Director USAID Regional Mission to Ukraine, Byelorussia & Moldova*
9:00 – 9:10	Dr. Vitaly Lisovenko, *Deputy Minister of Finance*
9:10 – 9:20	Earl Gast, *Director, USAID Regional Mission to Ukraine, Byelorussia & Moldova*

9:20 - 10:15 Introduction to Municipal Finance Institutions, and the Benefits They Offer to Transition Economies

Dr. John E. Petersen, Professor of Public Policy and Finance, George Mason University, USA

10:15 - 11:00 Municipal Finance Institutions in Western Europe: Structure, Operating Policies, and Track Records; Feasibility of Creating a Municipal Finance Facility for Ukraine

Nicholas Anderson, Senior Vice President, Swedish Export Credit Corporation
Lars Andersson, Coordinator for Regional and Local Authorities, Swedish Export Credit Corporation

11:00 - 11:15 **Convenience Break**

11:15 - 12:00 How to Succeed in the Business of Municipal Finance

Johan Kruger, Founder and Former CEO, Infrastructure Finance Corporation Ltd., South Africa:

12:00 - 13:00 Evaluating the Creditworthiness of Ukraine's Cities and Utilities

Part I. Ukrainian Intergovernmental Finance: Theory and Practice

Dr. Wayne Thirsk, Senior Advisor, The Access to Credit Initiative

Part II. Municipal Creditworthiness and Fiscal Decentralization: How does Ukraine Compare with Other East European Countries?

Francis Conway, Senior Associate, The Urban Institute, USA

13:00 - 14:00 **Lunch**

Friday, January 27, 2006, *continued*

14:00 - 14:45 Legal and Regulatory Issues to Consider in Establishing an Infrastructure Finance Facility; Assessment of Ukraine's Draft Law on Local Borrowing

Michael DeAngelis, Municipal Finance Legal Expert / The Access to Credit Initiative

14:45 - 15:30 Lessons Learned from Planning a Municipal Finance Institution for Russia

Dr. Sergey Sivaev, Institute for Urban Economics, Moscow

15:30 – 15:45 **Convenience Break**

15:45 – 16:15 Considering A Municipal Finance Institution for Ukraine: Strengths, Weaknesses, Opportunities, and Threats

Michael Curley, Director, Global Environmental & Technology Foundation, Washington
(The presentation is provided under financial support of the Office of International Affairs of United States Environmental Protection Agency)

16:15 - 17:15 **Panel Discussion**

Outlook for Creating a Municipal Finance Institution for Ukraine; Comments on the Proposed Recommendation to the Government of Ukraine

Moderator: John E. Petersen

Panel members: Dr. Vitaly Lisovenko; Pavlo Kachur, Minister of Construction, Architecture and Housing and Communal Economy; Nicholas Anderson, Lars Andersson, Johan Kruger, Francis Conway, Wayne Thirsk, Michael DeAngelis, Sergey Sivaev, Michael Curley

I. Options for Financial Structure
II. Operational Issues for an Infrastructure Finance Institution
III. Legal and Regulatory Issues for a Municipal Finance Institution

17:15 - 17:45 Discussion and Comment by Workshop Participants

17:45 - 18:00 **Closing Remarks**

Dr. Vitaly Lisovenko, *Ministry of Finance*; Pavlo Kachur, *Ministry of Construction, Architecture and Housing and Communal Economy*

18:00 – 19:30 **Reception**