GUIDELINES

NALAS

On Local Government Borrowing And Recent Developments In **NALAS Countries**

GUIDELINES ON LOCAL GOVERNMENT BORROWING AND RECENT DEVELOPMENTS IN NALAS COUNTRIES

2011

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Acknowledgements

This guide was prepared under the NALAS Task Force on Fiscal Decentralization for the Association of Romanian Communes (ACoR) and financed by Open Regional Fund for South East Europe / German Technical Support Agency, through a collaborative effort among the expert team consisted of:

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Information on NALAS countries was provided by the local experts assigned by the NALAS member associations. We highly appreciate their inputs, responding on our survey and discussing with our team-members the issues of local government borrowing.
We hope that our efforts for developing this Guide will assist the local governments' officials in preparing themselves for borrowing and will prove to be a useful asset.

Foreword

This project intends to share best experiences available in the region of South East Europe in debt financing and managing complex capital investment projects, and thus support capacity development of both advanced and less advanced local governments. Improved information is intended also to lead to proposals for changes in laws and regulations that are restricting local borrowing in some countries.

The overall goal of the project is to support local governments in finding appropriate solutions for the financing and implementation of capital investment projects, also through policy improvements at national level advocated for by local government associations.

In this guide the project team analyzed recent trends (2010) in local government borrowing in Albania, Bulgaria, Croatia, Kosovo, Macedonia, Moldova, Montenegro, Republika Srpska – BiH, Romania, Serbia and Turkey.

The Guide consists of eight chapters. The first chapter of the Guide provides information on basic principles of local government borrowing and a summarized overview of the different financing policies, preconditions for local government borrowing and necessity of establishing a sound debt management.

The second chapter gives an overview of the present status of national legislation and the current practices in terms of borrowing. It also emphasizes the local government authority to borrow, issues related to municipal borrowing that are not addressed or are poorly addressed in the existing national legislation, and the reporting procedures.

Third and fourth chapters deal with the information related to available debt instruments and local governments' creditworthiness. These chapters provide both local governments and lenders with the fundamental understanding they need to consider debt financing in a prudent way. Fourth chapter is complemented with 5th chapter that describe the conceptual framework for local governments to undertake assessment on their creditworthiness and their general credit condition as well as to identify the underlying risks associated with their abilities to borrow and to repay its debt obligations. On the other hand they provide the financial community with the most important information it needs to assess the creditworthiness of local government borrowers. The issue on how local governments can improve their creditworthiness along with the fiscal indicators and assigning of the credit rating is also presented.

Chapter six of the Guide is to introduce potential local government creditors associated with different examples from the region of South East Europe. It also deals with market failures, the procurement procedures necessary to secure financial service providers and securing liquidity for EU funded projects.

Debt management practices and recommendations accompanied with loan structure and its' components is explained in detail in chapter 7.

The last chapter provides an overview of the role of the local government associations and how they can help the local debt legislation and credit market to be improved. The relations with different stakeholders in this process is described i.e. lenders, local governments, central governments, national parliaments, donors and international financial institutions.

We sincerely hope that this guide will enable municipalities to better understand their own financial situation and plan capital investment measures and eventually get better access to loans. These in turn will help to improve local infrastructure and service delivery from which all citizens and businesses alike will profit.

Executive summary

- Implementation of local governments' investment projects depends on their ability to raise the necessary funds from a combination of own resources and external financing. Debt financing enables municipalities to carry out more infrastructure projects in a shorter time period as compared to the financing from own funds. However, the risks associated to borrowing have to be well understood and documented in terms of their potential impact on local budget in the future. Thus, before borrowing is undertaken, it is recommended that each local government has in place a debt management strategy and a written debt policy. The debt management strategy should ensure that the local government maintains at all times an adequate level of indebtedness (i) which would not impair its financial stability and (ii) which would enable it to implement the investment objectives.
- The financial framework of local governments plays a key role in the sustainable development of local credit markets. The design of intergovernmental fiscal structure together with the accounting system and reporting procedures are important factors that are taken into consideration by financial institutions when assessing the opportunity to finance local governments. By establishing the general structure of local revenues and expenditures, the intergovernmental fiscal framework determines in broad terms the borrowing capacity of local governments from within a country.
- Financial institutions need readable, credible, transparent and comparable financial documents and reports as an input in the credit risk analysis of local governments. This can only be achieved if local governments adhere to national accounting standards, which accurately reflect the true financial position of local governments.
- Authorisation process of local borrowing should ensure that (i) all legal aspects related to local indebtedness are met, (ii) there is a real necessity to pursue external financing which benefits the local economy, (iii) the financial stability of the local government is not threatened by the future debt repayment. The central government's involvement in the authorisation process should be limited to

the control of the legal aspects related to local borrowing.

- Limits to local indebtedness should be clearly stipulated in legislation on local public debt and should include at least the purpose of borrowing and maximum debt thresholds. Short term borrowing should be pursued only to cover temporary liquidity shortages while long-term borrowing is warranted to finance capital expenditures.
- There are two major types of debt instruments available to finance municipal capital expenditures: (i) loans and (ii) bonds. Loans are granted by a financial institution (e.g. commercial bank) directly to the local government. Applying for a loan is less complex than the procedures required for bond issuance. From this point of view, loans are more advantageous to small and medium size municipalities seeking external finacing.
- Many international financial institutions have dedicated programmes aimed at supporting and financing local governments' infrastructure projects, especially in the emerging markets. The financing occurs either directly or indirectly, via intermediated loans to local banks in target countries. The terms and conditions of such loans are more favorable to the local governments than in case of typical commercial banking loans.
- Bonds are the preferred form of financing for large capital investment projects which require long term financing. Bonds are issued by local governments either directly or via financial intermediaries (e.g. funds, banks) to institutional or individual investors. The cost of borrowing using bonds is usually lower than in case of a loan. There are two types of municipal bonds. **A. General obligation bonds** are secured by the local governments' revenues stream. Such bonds are used to finance investments in public goods (public safety, streets and bridges, public parks and open space, public buildings etc.). **B. Revenue bonds** are backed by the stream of revenues generated by the project financed from the bond sale. Revenue bonds are not backed by the taxing power of the local government. Typical projects financed by revenue bonds include: municipally-owned airports, water and sewer systems, electric utilities, athletic and sport facilities and limited access highways.
- Prior to establishing the terms and conditions of a financing agreement (be it loans or bonds), investors evaluate local governments' creditworthiness. The creditworthiness of a local government measures both quantitatively and qualitatively its ability to repay debt. This is a rather complex process and covers (i) a thorough analysis of the local governments' financial position, (ii) an assessment of the local economy in which the municipality operates (e.g. economic and political context) and (iii) an evaluation of the national macroeconomic environment. The depth of such analysis differs across financial institutions, depending on the degree of specialisation and knowledge on/ of the local governments' segment.

- Local governments should perform a self-assessment of their creditworthiness prior to approaching financial institutions. Thus they will be able to determine roughly how much money they can borrow without impairing their financial stability. Moreover, this self-assessment prepares local governments for the discussions with financial institutions which will take place at the time when they want to issue debt. It can also be used as a diagnostic tool by local governments to better understand the factors which may affect their financial stability as well as to perform certain scenario analysis.
- Adequate, accurate and timely financial information on local governments' operations benefits both investors and local governments. A uniform financial reporting format, which suites both local/ central governments' and investors' requirements, should be a top priority for national regulators, as a precondition for improved financial management performance. Local governments' annual reports should include at least an administrative report, a balance-sheet and income statement as well as a cash-flow analysis (if accounting system is accrual based). Public disclosure of financial reports should be mandatory. Independent audits should be conducted on a regularly basis.
- Local governments could also improve their financial management performance by applying for an external credit rating. By obtaining the credit rating, the local government will better understand what the main determinants of its creditworthiness are and can decide what changes are needed to improve its credit risk profile and thereby reduce its borrowing costs.
- Depending on which type of debt instrument (loans or bonds) a local government wants to issue, there are different specialised financial institutions which should be approached. Local government loans are originated by: (i) municipal banks, (ii) commercial banks, (iii) international financial institutions and (iv) municipal development funds. Bonds are intermediated by commercial/ investment banks or brokerage houses. The existence and availability of these financial institutions to finance local governments depends on the architecture (bank lending model or bond model) and development of the local credit market. Central and local authorities should promote specific measures aimed at supporting the development of sustainable credit markets by minimizing the risk of market failures.
- Meeting lender's expectations will increase local governments' chances to borrow under good conditions. Local economic conditions, budgetary performance, financial and political flexibility, project management capacity, transparency and disclosure, the quality of the budgeting process, the existence of a debt management and capital investment strategy, available guarantees are all important aspects that influence a local government's borrowing capacity.
- In the process of contracting new loans or issuing bonds local governments have to undergo tender procedures in order to select the lending/ underwrit-

ing financial institution. Thus it is essential for local governments to draft the tender documentation in a way which ensures (i) that eligible bidders have the adequate level of knowledge and experience for the project to be financed and (ii) that selection criteria used to assess lenders' offers enables local governments to obtain the most competitive loan structure in a transparent way.

- Besides financial institutions, local governments in EU member and accession countries can tap on financial resources from grants offered by the European Union (EU). In member states such local government projects may frequently exceed 15 million EURO. The value of the projects put forward by local governments in accession countries is smaller, but the benefits of financing local capital investment through EU grants are unquestionable nevertheless.
- Local governments can obtain external resources using a wide range of borrowing instruments. However, each instrument is suited to finance only certain types of activities. Short term financing instruments include: (i) working capital credit line – local government draws funds from the credit line, on which they pay interest, to finance temporary revenue shortages; principal is usually rolled over, (ii) bridge loans – are a special type of short term loan where financing for a capital investment project is provided for a transitory period until the main (long term) financing is obtained. Medium and long-term borrowing should be pursued by local governments when financing capital investment projects. Long-term borrowing to cover current expenditures is usually prohibited by law and must be avoided anyway.
- Planning the structure of a financing package should be in line with a local government's debt management and capital investment strategy. When negotiating with the financial institution(s), local governments have to think at maturity, grace period, interest rates, fees, drawdown (loan disbursement), refinancing etc. After securing the financing package local governments have to generate enough revenues to pay for debt service and also allow for additional lending or direct investment. Unfortunately, when things do not go as planned, local communities must deal with loan restructuring and sometimes default.
- Restructuring of a loan should be contemplated as an option when local governments enter a period of financial distress. Restructuring should be foreseen, whenever this is possible, from the beginning when the financing contract is signed with the bank. Restructuring of a bank loan usually involves the following elements: (i) refinancing, (ii) maturity extension, (iii) reshaping the debt service schedule to match the client's projected cash-flows, (iv) writing off a portion of the debt (haircut).
- The establishment of local government associations can help the development

of the local credit market. Local government associations are voluntary membership organizations, which comprise local governments from within a country or region, acting as an effective and authoritative advocate on members' behalf in relation to central government, the parliament, potential investors and other stakeholders. With regard to local public debt local government associations should aim to (i) create and/or improve appropriate legislation, (ii) monitor the impact of relevant legislation, (iii) provide information and statistics to potential lenders, central government and other stakeholders and (iv) assist member local governments to develop and improve debt management plans and operations.

- In relation to lenders, local governments associations should mediate communication and information flows between local governments and potential investors.
- In relation to member local governments, associations should (i) provide assistance to members in structuring and financing investment; (ii) maintain ongoing communication with member local governments to set/develop best practices in accordance with international standards.
- In relation to central governments and parliaments, associations should lobby and campaign for changes in policy, legislation and funding on behalf of its members.

1. Basic Principles of Local Government Borrowing

Implementation of local governments' investment projects depends on their ability to raise the necessary funds from a combination of own resources and external financing. Debt financing enables municipalities to carry out more infrastructure projects in a shorter time period as compared to the financing from own funds. However, the risks associated to borrowing have to be well understood and documented in terms of their potential impact on local budget in the future. Thus, before borrowing is undertaken, it is recommended that each local government has in place a debt management strategy and a written debt policy. The debt management strategy should ensure that the local government maintains at all times an adequate level of indebtedness which (i) would not impair its financial stability and (ii) would enable it to implement the investment objectives.

1.1. Background, Issues and Challenges

The prospect of improving municipal credit worthiness and increasing local governments' ability to access and use credits (loans and bonds) as an additional source for local infrastructure investment has been discussed extensively in the public sector over the past several years in almost all NALAS countries. However, local credit markets are still in their infancy.

Every fiscal decentralization effort includes a legislative reform agenda that guides the further refinement of the national policy framework. The frameworks vary across countries in their comprehensibility but also in terms of their maturity (see chapter 2). In general fiscal decentralization processes in South Eastern Europe (SEE) have opened up the opportunity for local governments to use various instruments of borrowing to finance their local investment financing needs.

1.1.1. Issues and challenges

There are large policy issues about the role of credit markets in meeting municipal infrastructure finance requirements.

According to the results of our survey, in all NALAS countries the primary obstacle to the use of municipal credit has been largely on the demand side, i.e. the municipalities' readiness to borrow. Moreover, according to the national legislation related to municipal finance and municipal borrowing, local governments were prohibited from taking on debt until recently (Moldova 2003, Serbia and Montenegro 2005, Albania and Macedonia 2008, Kosovo 2009). On supply side, i.e. within financial institutions, funds for lending to local government were theoretically available. However, (i) the weak financial position of local governments coupled (ii) with a low experience of banks in assessing the credit worthiness of municipalities restricted the development of local credit markets.

Although the supply side of the municipal credit market in SEE countries appears to have sufficient liquidity and capacity to actively enter into transactions, the demand side of the market is currently limited to larger municipalities with sound financial position. Therefore, to enable municipal credit market development, the ongoing fiscal decentralization programs must strengthen local government financing capacities. To this end, creating and enforcing adequate legislation, building and supporting financial management capacity at local level are critical for the success of decentralisation process.

Municipal debt legislation that comprehensively addresses all key elements in an internally consistent manner would substantially benefit the development of municipal credit markets in this region. The existing frameworks in all respective countries provide to some extent clear principles and guidelines required for market development. Clear debt rules, stable revenues and expenditures assignments and objectively allocated transfers should be the governing principles of the local debt legislation framework.

There are some important distinctions between various debt instruments utilized in financing of local government capital investment projects. Among the most popular are bank loans and municipal bonds. Variations of these instruments are widely known and utilized in other countries in Central and Western Europe, USA and Canada. A basic legal framework can and should apply to all types of debt instruments.

A properly structured and competitive market for local borrowing instruments can help keep the costs of capital as low as possible for municipal borrowers. Furthermore, the availability of a local credit market helps municipalities to play a larger role in selecting and implementing capital investments.

The development of a domestic credit market for local governments is conditional upon the existence of a public finance system that assigns significant decision-making power, autonomy, responsibilities and corresponding financial resources to local governments.

Transparency and disclosure are also key elements upon which the development of local credit market depends. In order to assess credit worthiness of local governments, credit institutions need adequate, accurate and timely information related to local governments' financial performance and condition.

International financial institutions (IFI) including World Bank, EBRD, European Investment Bank and KfW, are becoming more active in the region, especially in the municipal sector. Credit enhancement mechanisms and guarantee funds established with donor or international lenders' support will significantly improve local governments' access to external financing.

Following the financial and economic crisis, many commercial banks started to diversify their credit portfolios by investing into sectors with higher resilience to economic downturns. In this context, lending to local governments is becoming increasingly attractive for financial institutions.

The establishment of state-funded development funds for regional/municipal investments could represent another solution to increase local governments' external financing sources. Examples of such funds from the region include: the Slovenian Environment Fund, the Slovenian Regional Development Fund, the State Development Fund in Serbia, the Agency for Regional Development in Macedonia, the Investment development Fund of Montenegro, Fund of Social Investments in Moldova.

European Union (EU) funds – pre-accession, structural and cohesion – can and should be used intensively by local governments from the region to finance infrastructure projects of regional importance.

1.2. How to Finance Capital Items? Current Revenue or Debt Financing?

When considering what resources are available to fund capital investments, it is most important to consider all possible financial alternatives. A wide range of sources are possible, for example current revenues, grants from central governments or the EU (or other donors), private sector investments (PPP). Long-term debt is only one option out of many.

Local governments rarely maintain cash surpluses large enough to pay for the entire cost of big capital projects. They can either finance a capital project from own resources, by accumulating savings in their current account budget (pay-as-you-go financing) or by tapping credit markets (pay-as-you-use financing[1]).

Borrowing allows a local entity to carry out more ambitious investments than otherwise would be possible. In principle, it also promotes intergenerational equity by having the future generations of citizens which will benefit from a facility's services pay for its construction.

However borrowing is not always an appropriate financing strategy. Borrowing to cover current expenditures or account deficits has just the opposite effects. It shifts the costs to future generations, while today's taxpayers enjoy the benefits.

Many municipalities practice a combination of Pay-as-you-use and Pay-as-you-go policies.

There are mixed views as to whether long-term debt financing is a superior method of capital financing than pay-as-you-go. There are advantages and disadvantages to both approaches, municipalities need to consider the merits of both methods to guide their future financing in accordance with a long term plan. In doing so, municipalities should establish parameters to guide the financing of their capital budgets, and develop policies to implement these guidelines.

"Pay-as-you-go" financing is normally useful for low cost repair and maintenance projects or the purchase of equipment with short useful life. "Pay-as-you-use" is appropriate for capital improvements with a high cost and a long useful life.

"Pay-as-you-go" financing has important advantages over pay-as-you-go financing schemes:

- lets municipalities build more projects sooner;
- allows for greater inter-generational equity, and
- spreads out capital expenditures over time.

Many capital investments that municipalities can undertake yield benefits in the form of economic development. Even the so-called social investments such as water and wastewater systems and education contribute to the local economic development. When projects are built sooner, people benefit earlier. When projects are deferred, the benefits are postponed as well.

[1] Using debt financing to fund capital investments and paying back debt over the life of the project

When considering debt financing as an alternative to finance an investment project, the risks associated to borrowing have to be well understood in terms of their potential impact on local budget in the future. For a borrower, the main risks of a plain vanilla loan are related to the dynamics of interest rate and exchange rate (if the loan is denominated in foreign currency). If the loan is originated at variable interest rate, then an increase in reference interest rate would be reflected into a higher debt service. Volatility of exchange rate has also to be considered when evaluating the possibility to borrow in hard currency (e.g. euro, U.S. dollar). During the recent financial and economic crisis, emerging market exchange rates from almost all NALAS countries have depreciated significantly. This led to an increase in debt burden of unhedged foreign currency borrowers (e.g. local governments, households) and a deterioration of their financial position.

1.3. Debt Management

Before long term borrowing is undertaken, it is recommended that each local government has in place a debt management strategy and a written debt policy.

Any decision to fund local government investment needs through borrowing has to be accompanied by debt management capability and capacity at the local level. In the immediate future, it is imperative that debt management capacity and capability should be enhanced as local borrowing also bears substantial financial risks for local governments (e.g. when debt repayment exceeds the financial capacities of local budgets).

Debt management may be defined as the process of providing for the payment of interest and principal payments on existing debt, and the planning for incurrence of new debt at a level which will optimize borrowing costs and not weaken the financial position of the local government. Estimating the impact of the current and future debt burden on the local budget in future years is also part of the debt management process.

The financial position of a debtor determines its maximum borrowing capacity as well as the cost of borrowing. Thus, the maximum indebtedness capacity of a local government varies in time, depending on economic and market conditions.

1.3.1. Debt Policy[2]

Any local government planning to issue a debt should adopt a written debt policy. A formal debt policy is essential to effective financial management. Debt policies are written guidelines and restrictions establishing maximum debt thresholds, the type of debt to be issued and at the same time documenting the issuance process. Such policy helps establish limits and provide general direction to local government executive officials in the planning and issuance of debt. A carefully crafted and consistently applied debt policy signals lenders and rating agencies that the local government is committed to sound and sustainable financial management.

The policy must be developed within the framework of existing laws and based on projections of the local government's future condition. It anticipates future financing needs and limitations that the policy imposes. Specifically, it should address the following questions:

- What are acceptable levels of short and long term debt? Debt issuance involves a trade-off. In exchange for funds for current capital improvements, future spending is limited. The degree to which a local government is willing to make these trade-offs depend on the urgency of its capital needs, its expected rate of growth, economic trends, and the stability of its overall finances.
- What are acceptable purposes for which debt can be issued? Does the investment have a life-span which equals at least the duration of the debt-repayment schedule?
- To what extent and for what purposes will the local government use general obligation debt vs. revenue debt3?
- What covenants, pledges, or securities is the local government willing to give, in order to make borrowing possible and/or lower the cost of borrowing (interest rates)?
- How will the local government make sure that it is borrowing under competitive conditions (i.e. obtain the lowest possible cost)?

Furthermore a debt policy: 1) establishes maximum debt thresholds and ensures proper procedures are in place to keep debt within limits; 2) communicates to citizens the importance placed on financial management and to investors that the local government is being prudent with its resources; 3) communicates to the financial community that the local government is prudent and has a policy basis for debt.

2 More detailed information on the local government debt policy is available on www.nalas.eu as additional material to this guide (only in English)

3 General obligation debt is backed by the issuer's ability to tax. It is serviced from the local governments' current revenues. Revenue debt is serviced from the revenues generated by the business/ service built from loan proceeds. Thus, revenue debt puts less pressure on the general financial position of local governments.

2. What to consider in the national legislation?

The financial framework of local governments plays a key role in the sustainable development of local credit markets. The design of intergovernmental fiscal structure together with the accounting system and reporting procedures are important factors that are taken into consideration by financial institutions when assessing the opportunity to finance local governments. By establishing the general structure of local revenues and expenditures, the intergovernmental fiscal framework determines in broad terms the borrowing capacity of local governments from within a country. Financial institutions need readable, credible, transparent and comparable financial documents and reports as an input in the credit risk analysis of local governments. This can only be achieved if local governments adhere to national accounting standards, which accurately reflect the true financial position of local governments. Authorisation process of local borrowing should ensure that (i) all legal aspects related to local indebtedness are met, (ii) there is a real necessity to pursue external financing which benefits the local economy, (iii) the financial stability of the local government is not threatened by the future debt repayment. The central government's involvement in the authorisation process should be limited to the control of the legal aspects related to local borrowing. Limits to local indebtedness should be clearly stiplulated in legislation on local public debt and should include at least the purpose of borrowing and maximum debt thresholds. Short term borrowing should be pursued only to cover temporary liquidity shortages while long-term borrowing is warranted to finance capital expenditures.

2.1. General Financial Framework of the local governments in the region

In formulating a municipal debt policy, policy-makers must decide a number of important issues which must comply with the corresponding legal framework concerning municipal debt as well as borrowing procedures. The frameworks vary across countries, although the underlying issues are largely the same. Developing a coherent, efficient and prudent debt policy requires first of all thorough knowledge and understanding of the laws and regulations that govern all the fields related to municipal borrowing.

The legal framework for local borrowing (should) provide a set of clear and comprehensive rules that would guide municipalities seeking external financing. The legal framework defines the overall objectives for debt management, sets out borrowing restrictions, clarifies the transparency and accountability, outlines the budgetary and financial reporting and auditing requirements. Procedures for local government default, insolvency or what happens in case of financial market failures are other areas which should be regulated in the legal framework for borrowing.

2.1.1. Local public administration competencies, revenues and intergovernmental fiscal relations

Intergovernmental fiscal frameworks are crucial in determining local governments' overall financial health (i.e. solvency, financial situation). They define the assignments of revenues (taxes and transfers) and expenditures, the financial autonomy and the fiscal authority of local governments to set taxes, tariffs or fees.

Financial health of a local government determines its creditworthiness. It is ultimately reflected in the cost of credit (i.e. interest rate): higher credit risk – willingness and ability to repay debt is relatively poor – is associated with higher interest rates. Stable, predictable and certain revenue streams correlated with expenditures incurred as budgeted result in an improved creditworthiness (reflected in lower interest rates).

Regulatory framework alone cannot support the development of a healthy municipal credit market. Unless local governments can demonstrate that they have a track record of reliable revenues from which to repay debt, financial institutions will not enter into financing agreements with municipalities .

In general, own revenues and shared taxes account for the largest share in local governments' budgets. Such revenues include local taxes, local fees, local charges, revenues from ownership, share of personal income tax, profit tax, VAT and property taxes. It is from these revenues, that local governments would pay pack in the future the debt incurred to finance capital investment projects.

The intergovernmental transfer system plays a key role in establishing the local governments' revenues base. It constitutes an important share of municipalities' total revenues and may act as security on local government debt. Very often intergovernmental transfers, if not tied to particular investments, are a key feature of local government budgets and play a crucial role in financing of capital expenditures.

In Annex 2, we briefly outline the general financial framework of local governments from the analyzed countries[4].

2.1.2. Accounting systems and reporting procedures

National standards for local financial management and accounting are fundamental components of fiscal frameworks. They set the rules and procedures for local budgeting, accounting, financial reporting and control, and are thus a precondition for sound financial management as well as for transparency and accountability.

The way financial data is aggregated and presented in local budgets, financial statements or other finance-related documents is mostly determined by the **accounting system** in place. Accounting standards and their applications vary greatly among countries, but there are two basic accounting systems: cash accounting and accrual (or commercial) accounting.

- **Cash accounting** is generally regarded as the more simple accounting system. Traditional cash accounting is focused on the actual cash flow in a predetermined period of time (the budget year), and captures incoming payments and outgoing payments. Transactions are only recognized when there is an exchange of cash. This leads to credits being regarded as incoming payments. Traditional cash accounting (if not modified) does however not require registering asset values, nor does it account for depreciation. Critics therefore argue that the information it provides does not support sound decision-making because the real financial situation is disguised and there is little or no information about the actual consumption of wealth and resources.
- **Accrual accounting** records revenues and expenses as they occur, regardless of whether or not cash has actually been transferred. Accrual accounting therefore tries to measure the actual financial performance and thus accounts not only for profits and losses, but also for assets and liabilities. The system allows for depreciations, and if all fixed and mobile assets are registered, which

[4] More detailed information on the local government competencies, revenues and intergovernmental relations in the analyzed countries is available on www.nalas.eu as additional material to this guide (only in English).

is normally required, the yearly balance sheet gives decision-makers an accurate picture of the actual consumption of wealth and resources, and the real financial situation. Since accrual accounting generates information essential to potential investors, it is regarded as the more favourable accounting system for sub-sovereign lending.

Table 1: Accounting systems and standards, reporting procedures[5] [6]

Cashed based accounting system	Modified accrual accounting system	Accrual accounting system	International public sector accounting standard (IPSAS)
Cash based accounting system recognizes revenues and expenditures only when cash is received or spent[5].	Modified accrual accounting system recognizes the revenues in the period they become available and measurable, and the expenditures are recognized in the period the associated liability is incurred.	Accrual accounting system recognizes the financial effect of transactions when they occur, regardless of the timing of related cash flows.	IPSAS are accounting standards for use by public sector entities around the world in the preparation of financial statements
▶ Albania ▶ Kosovo ▶ Macedonia ▶ Moldova ▶ Serbia ▶ Slovenia	▶ Bulgaria ▶ Croatia ▶ Montenegro ▶ Republika Srpska, BIH ▶ Turkey	▶ Romania	▶ Croatia ▶ Macedonia ▶ Moldova ▶ Montenegro ▶ Romania ▶ Serbia[6]

As shown above some countries are applying cash accounting, some the modified accrual accounting system and in the case of Croatia the long-term goal is to completely switch to accounting on an accrual basis and comply fully with international public sector accounting standards.

5 Managing Government Expenditure, Asian Development Bank, 1999
6 In practice these standards are not used at local level

Regardless of the system in use - which should at least fulfill internationally recognized minimum standards[7] - the most important and necessary condition for local borrowing in this respect is that local governments adhere to the national accounting standards in place. This determines whether financial documents and reports are readable, transparent and comparable for potential investors, as they need this information in order to assess the creditworthiness and credit risk.

The economic and financial crisis has raised several public sector accounting issues. Many governments have extended credit to banks, guaranteed the liabilities of banks, purchased impaired debt instruments and in some instances have assumed control of banks. The unique nature of the crisis and the unprecedented response by governments around the world has reinforced the importance of high-quality standards for financial reporting by governments. The crisis has increased the need for accountability in the public sector and for transparency in its financial dealings.

Financial reporting and the disclosure of local budgeting are **essential for credit risk assessment**, (as well as for local accountability). Potential investors will always need detailed information from financial statements and audits as input in their risk analysis. In all of the countries participating in this project, the State Audit Office is established. Additionally, control is carried out by internal and sometimes also by external auditors. Banks or other financial intermediaries are not always familiar with the structures, processes and the financial management of local governments. The opinions of supervisory bodies and especially of external independent audit courts help to reduce this uncertainty of potential investors (which is ultimately reflected in higher interest rates). Audit statements provide primary evidence of the soundness of local governments financial operations since they deal with bookkeeping quality, accounting methods, and adherence to other budgetary rules and legal requirements. They thereby help potential investors to assess the financial capacities and performance of local governments. Potential investors are also interested in whether local governments have met any correctives recommended by auditors or supervisory bodies. If local governments do not make reports available, or submit reports that are outdated, their creditworthiness decreases. Poor reporting may also be a strong indicator of low levels of accountability and deficits in financial management. Additionally, external independent audits can help to improve local government creditworthiness also in other ways, as they provide local governments with recommendations on where and how to improve their financial management capacities. Usually, external independent audits of local governments contain:

[7] Public sector accounting standards based on International Public Sector Accounting Standards (IPSAS) or Generally Accepted Accounting Principles (GAAP) require information to be reliable, understandable, timely, relevant, and comparable across governments. For further information see: www.imf.org/external/standards/agency.htm

- Objective assessment of important municipal financial operations of critical concern to mayors, municipal councils and citizens;
- Confirmation that internal control and procedures are satisfactory (or substantive recommendations for remediation);
- Recommendations for improvement of internal controls to prevent and/or detect various kinds of problems in the area of financial management and of very specific identification of controls (internal and other) that need improvement;
- Identification of substantial deviations from compliance with statutes, rules, municipal polices or citizen's specifically expressed expectations;
- Discovery and remediation of any possible frauds, dishonesty or other irregularities;
- Recommendation of improvements to accounting controls and procedures and written documentation thereof needed to detect and/or prevent problems;
- Recommendations to eliminate redundant, burdensome or excessively expensive internal controls and other excessively centralized or otherwise archaic control systems;.

2.2. Municipal Authority to Borrow

2.2.1. Procedures for Subnational Borrowing in NALAS Countries

The authorization of local governments to undertake external financing can be done at several administrative levels: (i) local government executive (mayor), (ii) local elected body, (iii) regional authorities or (iv) national authorities. The authorization can also be the result of the decision of the local community, through a referendum.

Usually the decision to borrow large amounts of debt should be the responsibility of the local elected body. Authorization of local borrowing by executives should be limited to relatively small amounts of debt, which do not pose any significant risks to the financial stability of the local government.

Best practice from other countries suggests that the decision of a local government to borrow should be approved by a local council. Otherwise the probability of future debt repudiation or refusal to enact necessary tax increases in order to meet debt service increases significantly. Additionally, the public debate, from within a local council, on debt policies help keep the process open and visible.

2.2.2. Higher level Approval and Control, State guarantee

The involvement of central government in the authorization process of local borrowing should be limited to the control of a clear and objective set of rules. Usually, central government looks at the following criteria in approving a local government's loan: (i) debt threshold imposed by national legislation, (ii) other legal indebtedness restrictions (i.e. foreign currency borrowing, purpose and form of borrowing) or (iii) consistency of local debt policy with national policy on public debt. Such oversight and review might prevent irresponsible borrowing at the local level. Moreover, if the state or national authorities could certify the procedures used in the borrowing process, this can help build investor confidence and relieves individual investors of some of the "due diligence" that would otherwise be required.

Table 2: Central government approval procedures

Country	Central Government Approval for local debt issue
Albania	YES Municipal loan must be approved by the Ministry of Finance. There are two different procedures for loan authorization 1) when municipality borrows domestically and 2) on the international credit market. The MoF verifies the procedural compliance with the law as well as reevaluates the increased risk of borrowing.
Bulgaria	NO No approval of central government required, but (according to Municipal Debt Act) a Central Municipal Debt Register must be established at the MoF with individual records for each local government. The register is reported to the MoF every month. The register has three sub-registers on for loans, bonds and guarantees features (lender, principal, interest rate, fees, and maturity).
Croatia	YES According to the Budget Law the local governments can take on debt pursuant to the decision of the representative body of the LGU with the prior consent of the Government of the Republic of Croatia.
Kosovo	YES After approval by the Municipal Assembly for the requested loan should be approved by the Minister of MFE, if the Minister of MFE within 60 days does not answers then this loan is considered as approved by the Minister of MEF
Macedonia	YES Municipalities may borrow from the country and abroad only upon prior consent by the Government of Macedonia, on the basis of an opinion by the Ministry of Finance (MoF). Any initiative, pursuant to the Public Debt Law on beginning negotiations for conclusion of loan agreement should be started upon prior consent by the Government of Macedonia. This initiative should mandatorily contain positive opinion by the MoF.

Country	Central Government Approval for local debt issue
Moldova	NO No approval of central government required. According to the Law on public debt local authorities only report to MoF the level of debt and the guarantees issued
Montenegro	YES According to the Law on Local Government Finance municipalities need Central Government approval for borrowing
Republika Srpska - BiH	YES The National Assembly of Republika Srpska gives an approval for municipal borrowing based on Central Government proposal. Ministry of Finance is responsible for implementation of the respective activities in case proposal for local debt issue is approved.
Romania	YES Commission on local government debt authorization (MoF based committee)
Slovenia	YES Municipality must receive an approval for borrowing from the Ministry of Finance and the decision for borrowing has to be included in the annual budget.
Serbia	Ministry of Finance provides opinion on the local government request for borrowing - proposals for new draft of Law on public debt are that Ministry of Finance, Public debt department should give approval for local government borrowing and not just opinion. This approval should consider several different criteria before being issued.
Turkey	NO Local governments do not need approval from the national government. For local debt issuance local governments must stay within the borrowing limits only. Regarding external (foreign) borrowing, the Treasury permission must be obtained by submitting related documents.

Although central government's approval is required for municipal borrowing in a majority of the analyzed countries, it does not imply any state guarantees or liabilities.

Public consultation prior to local debt issuance is foreseen in the legislation of some countries (Albania, Bulgaria, and Republika Srpska-BiH[8]). Even without specific provi-

[8] Pending the issue and amount of potential borrowing it is possible Government may decide to organize referendum on the subject.

sions in the laws, sometimes the local government may organize a public consultation process on the opportunity to undertake external financing in order to build trust and obtain the citizens commitment.

One of the most important issues facing regulators and potential investors is how to deal with default or insolvency of local government. There is no clear answer as to whether or not regulations should prescribe for central government bailouts in cases of local government default.

One point of view is that national regulations should not contain prescriptions for bailouts in order to avoid that this might lead to moral hazard (i.e. less fiscal discipline and prudence in local governments). But then the question remains what can be done when local governments are "too big to fail" (as seen with banks in the financial crisis)? This suggests that a greater responsibility of states exists and that a bailout or state guarantee in these cases is likely necessary. One can also observe that state guarantees can encourage lenders to skip a thorough project review altogether and to even ignore local financial conditions. As long as a loan is adequately covered by central government commitments, the lender has no strong incentive to limit its lending to economically feasible projects.

The other point of view is that prescribing for central government bailouts or state guarantees in national regulations can lead to better credit ratings and interest rates, and thus better access to financial markets. In some countries there are such regulations, but state guarantees and central government bailouts for defaulting or insolvent local governments are then mostly accompanied by severe sanctions, such as the (part) loss of financial and/or administrative autonomy and submission to central government control.

The state cannot be invoked as a guarantor of local debt in Albania, Bulgaria, Moldova and Romania. In the rest part of the analyzed countries, the majority provides state guarantees and has legal provisions regarding this issue as follows:

- In **Croatia**, based on the proposal of the Ministry of Finance, the Central Government can issue a guarantee;
- In **Macedonia,** the Government of the Republic of Macedonia may guarantee and take liabilities which may derive from the long-term debts of the municipality, including also the municipal public services founded by the municipality, only in cases when liabilities are undertaken according to law on issuance of a sovereign guarantee; The Minister of Finance signs the agreement on issuance of a sovereign guarantee on behalf of the Republic of Macedonia;

- In Montenegro, the government can make decision with regard to borrowings and issue guarantees in accordance with the annual budget law. End-user of guarantee shall pay risk fee, in the amount of 0.5% of the amount of the guarantee; for the time being9, the government hasn't issued any guarantees for local governments;
- In **Serbia,** the central government has the right to issue guarantee and to refund principle, interest and other expenditures occurred if the requirements are not met by the local government; central government recover these funds by suspension of the rights of local government on share of taxes/transfers;
- In **Turkey**, the under-secretariat of Treasury is authorized to issue state guarantees for specific projects and they are mostly concentrated on basic infrastructure projects, i.e. subway projects, solid waste management projects.
- In **Republika Srpska**, the National Assembly approves issuing of guarantees, as per proposal of the central government; minister of finances is authorized to sign guaranties upon the approval by the Assembly; Guarantees of Republika Srpska can be issued to the creditor of borrower only to guaranty obligations of local communities, funds for social security and some other public institutions, for the purpose of financing capital investment of public interest.

2.3. Borrowing provisions

2.3.1. Short-Term Borrowing provisions

Short term financing should be pursued by local governments only as an instrument to manage temporary liquidity shortages. Examples of situations when short term borrowing should be permitted include: (i) paying operating expenses in anticipation of cash-in-flows from tax revenues, (ii) financing of current or capital investment using short term debt in anticipation of nonrecurring revenue, such as from the sale of assets, receipt of a grant, or issuance of long-term debt (bridge-loans).

Legal limits should be in place to control local governments' short term borrowing, in order to prevent structural cash-flow deficits:

- Threshold for maximum short term indebtedness as a percentage of the municipal operating revenues,
- Short term borrowing should be restricted (i) to the financing of anticipated cash needs for a certain number of months including debt-repayment within the ongoing fiscal year, or (ii) to revenues or receipts to be received within a period of time.

[9] June, 2010.

2.3.2. Long-Term Borrowing provisions

Long term borrowing commits local governments' budget to fixed expenditures (debt service) in the future and therefore it may limit its financial flexibility. Poor debt management decisions from today may lead to inability of a local government to service its debt obligations in the future with major financial and economic implications for the local community (e.g. increase in local taxes). As a general rule, long term debt should be used only to finance capital expenditures.

Provisions for long term indebtedness of local governments should be provided in the national legislation. Table 4 summarizes the main limits and restrictions placed on long term borrowing in NALAS countries.

Table 3: Provisions for Long-Term Borrowing regarding purposes and terms of borrowing

Country	Provisions for Long-Term Borrowing regarding purposes and terms of borrowing
Albania	Since February 2008 Local Governments in Albania can borrow from the domestic and/or international financial markets to satisfy their capital investments needs. The ratio of the debt stock to the total recurrent revenues (own source revenues, shared taxes and unconditional transfers) must be less than 1.3:1 The LGs must respect the following limitations when consider borrowing: • The ratio between the operative surplus of the previous year (calculated as the difference between the operative revenues, from its own sources, the divided taxes and unconditional Transfers and the LGs unconditional operational expenditures) and the debt service due in any year of all the long term, must be no less than 1.4: 1. • The amount of debt service due in each year of the long term loan cannot exceed 20% of the average total actual revenues of the local government from the unconditional transfer, shared taxes, and local taxes and fees of the previous three fiscal years.

Country	Provisions for Long-Term Borrowing regarding purposes and terms of borrowing
Bulgaria	Long term borrowing may be carried out to finance capital investment projects, debt refinancing, and to meet payments made under municipal guarantees that have become due. The municipal council makes decision on borrowing. The decision of the Municipal Council requests the mayor to carry out the procedure for choosing a financial institution to provide the necessary funding for the project or the financial intermediary in the issuance of municipal securities. Municipal debt comprises: 1) issues of municipal bonds, 2) debt incurred by municipal loan contracts, 3) debt incurred by municipal owned enterprises, 4) issued municipal guarantees, 5) central government interest free loans including those for co-financing EU projects, and 6) obligations under commercial credit and financial leasing for a period exceeding two years
Croatia	All local government units (municipalities, cities and counties) can take long-term debt by taking out loans on the money and capital market, exclusively for a capital investment project, for reconstruction and development, financed from their budgets.
Macedonia	The loans of the municipalities from abroad need to have a prior agreement of the Government of Macedonia based on the Ministry of Finance positive opinion. LLGF stipulates that the Government of Macedonia cannot guarantee and undertake obligations that come from the debts of the municipalities, including the municipal public services, except in cases when the obligation has been undertaken by law. The municipality can have longer-term loans for financing capital means and investments only if the repayment of the debt is done in equal or decreasing annual installments. The decision for long-term borrowing is made by the Municipal Council. The total amount of the annual repayment of the debt for a long-term loan must not exceed 30% of the total revenue of the current operational budget of the municipality in the previous fiscal year.
Moldova	Local public authorities of level I (communes and municipalities) and level II (rayons) based on a decision of respective Councils, have the right to sign long-term loan agreements for capital investments with domestic and international financial institutions/lenders.
Montenegro	Law on Financing of Local Self-Government prescribes that a municipality may take long-term loans only for the purposes of financing infrastructure projects or for the purchasing of major capital assets, in compliance with approved Capital Investment Plan.
Republika Srpska - BiH	Local community can take long-term borrowing for following purposes: a) financing of capital investment b) refinancing of the unpaid debt as per paragraph

Country	Provisions for Long-Term Borrowing regarding purposes and terms of borrowing
Romania	Mid-term and long term borrowing may be carried out only for capital investment and debt refinancing.
Slovenia	The municipal council is authorized to approve long-term borrowing along with the Ministry of Finance approval and the amount of the debt should be included in the annual budget. According to the Public Finance Act each local government borrowing from the international credit market must be permitted by the law. Municipalities are also allowed to take long-term loans to co-finance EU funded projects and it doesn't affect municipal borrowing capacity.
Serbia	Local government cannot enter into long-term debt, except when it comes to financing or re-financing capital investment expenditures planed in the local budget.
Turkey	The Municipality may undertake obligations and issue debentures according to the following principles and procedures in order meet the expenses required to be made for performance of duties and services; • Within the frame of the provisions of the Law Nr. 4749 Related to Public Finance and Management of Debts, foreign borrowings may be provided only for financing of the projects defined in the investment program of the Municipality. • The Municipality using investment credit and cash credit from Iller Bank shall be obliged to present the payment plan to this bank. Iller bank shall be entitled to reject the loan request of the municipality where the re-payment plan is found insufficient. • Issuance of debentures may be considered only for the financing of the projects defined in the investment program and shall be realized according to the provisions of the relevant law. In order to finance a project; a few points must be taken into consideration: • The project can be aimed to be financed through foreign financial institutions (with foreign capital) only in case of its inability to be implemented via Turkish Technology. • The project must appear in the "Annual Bulletin" of State Planning Organization. • The approval of Under-secretariat of Treasury must be obtained.

2.3.3 Indebtedness limits

Virtually all legislation on local government debt establishes limits on the amount of local debt an individual local government can take on. There are two types of debt thresholds:

- Limit on outstanding debt level,
- Limit on maximum annual debt service (interest and principal repayment), that a local government can commit to.

Some countries apply only one of the two debt limitation criteria. There are also countries where both criteria are enforced (such as Albania, Macedonia, Serbia, aggregated national local debt in Romania). In recent years, there has been an increase in the number of countries using the second type of debt limitation - annual debt service - as it provides a more precise estimate of the local governments' effective debt burden.

Table 4: Legal framework provisions regarding long-term debt limitations

Country	Total outstanding Debt and Debt Service Capacity
Albania	Maximum level of the final stock of the long term debt must not exceed the ratio of 1.3:1 of the total recurrent revenues (own resources, the shared taxes and the unconditional transfers). The debt service capacity cannot exceed 20% of the average total actual revenues of the local government from unconditional transfers, shared taxes and local taxes and fees of the previous three fiscal years.
Bulgaria	The annual debt service capacity must not exceed 25% of the own-source revenues and equalization subsidy from the previous audited report and the nominal value of the municipal guarantees issued must not exceed 5% of the same amount. The Municipal Debt Act does not contain any provision on total outstanding debt but municipal debt is included in the central government debt which must not exceed 60% of GDP.
Croatia	The annual borrowing limit is 20% of the actual revenues from the previous year. It comprises the amount of the average annual annuities on loans, guarantees given from the previous years, and short-term outstanding liabilities. The additional limit introduced in 2003 is that overall LG's debt can't exceed 3% of the total recurrent revenues of all LGs in Croatia.
Macedonia	The total outstanding long-term borrowing of the municipality including all guarantees shall not exceed the total amount of revenues in the current operational budget of the municipality in the preceding year. The total amount of the annual debt-service capacity from the long-term borrowing in one fiscal year can amount up to 30% of the recurrent revenues of the municipality in the preceding fiscal year.

Country	Total outstanding Debt and Debt Service Capacity
Moldova	Short-term borrowing – 5% of total revenues Long-term borrowing for capital investments – 20% of total annual revenues
Montenegro	Debt service capacity must not exceed 10% of the actual recurrent revenues from the previous year
Republika Srpska – BiH	Local community can have borrowing not higher than 18% of regular income of that local community in the previous fiscal year. Overall debt of the local community as per issued guaranties cannot exceed 30% of regular income in previous fiscal year.
Romania	Annual debt service should not exceed 30% of own revenues (local taxes and fees and shared income tax). Debt threshold is calculated against the arithmetic mean of last three fiscal years' own revenues.
Slovenia	Debt service capacity is settled up to 8% of the own revenues of the previous year
Serbia	Outstanding debt - 50% of total recurrent revenues from the previous year and Debt service - 15% of total recurrent revenues from the previous year
Turkey	Domestic Borrowing is limited to an amount of 10% of previous year's realized revenues modified with the revaluation rate. Total outstanding debt stock (including external debt) cannot exceed the revaluated amount of the latest annual budget. (1.5 times for metropolitan municipalities). (Reevaluation rate is determined according to Tax Code Law No.213)

2.4. Local debt guarantees and pledges

Potential investors want, and need loan repayment pledges or guarantees. Depending on the type of guarantee, costs of borrowing can be lower or higher. Local governments can provide various types of loan repayment guarantees: they can pledge physical assets, such as land or buildings, or general revenues from taxes and transfers, or project-generated revenues from user fees or charges collected from the project's beneficiaries. Pledging physical assets rather than revenues has certain disadvantages:

- local governments may need to pledge physical assets that have a higher value than the debt being secured,
- a pledge on land or building is prone to corruption,
- municipalities might pledge assets that are needed for providing essential public services

- securing loans only with physical assets can lead to less concern with revenue streams and cash flows, and whether they are sound enough to allow borrowing,

Revenue interception is a special form of pledge. It is an instrument that is particularly credit enhancing since it is very effective in reducing credit risk.[10] If local governments are not able to meet their debt obligations, revenue interceptions authorize the creditor to collect debt repayments directly from higher levels of government. Revenue interceptions are therefore usually taken from intergovernmental transfers.

Local governments may also provide guarantees for third party debt repayments, such as those of local public enterprises. If allowed, such guarantees should be:

- Authorized in the same manner as sub-national debt,
- Restricted to projects in the public interest
- Limited to third parties created or controlled by the local government.

Table 5: Type of allowed guarantees and collaterals:

	Allowed	Not allowed
Own revenues	Albania, Bulgaria, Croatia, Kosovo, Macedonia, Moldova, Montenegro, Republika Srpska, Romania, Slovenia, Turkey	
Physical property	Albania, Bulgaria, Kosovo, Macedonia (partly), Montenegro, Slovenia, Turkey	Croatia, Moldova, Republika Srpska, Romania
Reserve funds	Albania, Croatia, Kosovo, Macedonia, Montenegro, Turkey	Bulgaria, Moldova, Republika Srpska, Romania, Slovenia
Private insurance	Slovenia	Bulgaria, Croatia, Kosovo, Moldova, Republika Srpska, Romania
Others	Macedonia: Credit enhancements (guarantees by USAID through Development Credit Authority)	

[10] There is empirical evidence that municipal development funds that use intercept arrangements have much fewer non-performing loans than funds that do not.

3. Which debt instrument is suitable?

There are two major types of debt instruments available to finance municipal capital expenditures: (i) loans and (ii) bonds. Loans are granted by a financial institution (e.g. commercial bank) directly to the local government. Applying for a loan is less complex than the procedures required for bond issuance. From this point of view, loans are more advantageous to small and medium size municipalities seeking external financing. Many international financial institutions have dedicated programs aimed at supporting and financing local governments' infrastructure projects, especially in the emerging markets. The financing occurs either directly or indirectly, via intermediated loans to local banks in target countries. The terms and conditions of such loans are more favorable to the local governments than in case of typical commercial banking loans. Bonds are the preferred form of financing for large capital investment projects which require long term financing. Bonds are issued by local governments either directly or via financial intermediaries (e.g. funds, banks) to institutional or individual investors. The cost of borrowing using bonds is usually lower than in case of a loan. There are two types of municipal bonds. A. General obligation bonds are secured by the local governments' revenues stream. Such bonds are used to finance investments in public goods (public safety, streets and bridges, public parks and open space, public buildings etc.). B. Revenue bonds are backed by the stream of revenues generated by the project, financed from the bond sale. Revenue bonds are not backed by the taxing power of the local government. Typical projects financed by revenue bonds include: municipally-owned airports, water and sewer systems, electric utilities, athletic and sport facilities and limited access highways

Debt instruments can be broadly classified in two categories: (i) loans and (ii) bonds.

In case of loans, debtors deal directly with lenders (e.g. banks, pension funds or insurance companies) – i.e. borrower negotiates terms of the loan directly with the lender. The due diligence process (risk assessment and monitoring) of the borrower is performed by the creditor.

Bonds represent a different kind of financial intermediation. They are sold directly or via financial intermediaries (e.g. funds, banks) to institutional or individual investors. In case of bonds, due diligence is the responsibility of credit rating agencies (or financial intermediaries). Based on their analysis, investors decide under what conditions (i.e. required yield) they are willing to buy the bonds.

Loans have been more popular as a debt financing instrument of local governments across Western Europe, where they financed municipal investment throughout the 20th century. Bonds are characteristic for the U.S. market, laying the foundation of municipal credit market development in North America.

In its early stages, local government credit markets may start with either of the two models but usually end up with both models serving different segments of the market. The same legal framework should be applied to all types of debt instruments without discrimination. Competition between banks, a bond market and other available financing instruments can help keep the costs of capital as low as possible for municipal borrowers and increase the flow of information about credit quality in between market stakeholders.

3.1. Bank Loans

Loans represent a common source of financing capital investments of local governments. Loans are granted by commercial or saving banks.

The terms of a bank loan will vary depending upon the local governments' individual financial position, the macroeconomic environment of the local economy as well as upon the willingness and capacity of a bank to finance local governments.

Administrative procedures that are required to take out a loan are less complex and costly than in case of a bond issue. On the other hand, large outlays for an investment project are more difficult to finance through loans from a single bank or even from a consortium of banks than through a bond issue. Moreover, bonds usually have longer maturities than loans, because some of the institutional investors (insurance companies, pension funds) buying these bonds rely on longer term resources (deposits) than banks. In some instances, banks can decide to rollover (i.e. refinance) an existing loan at maturity, thereby extending its maturity. However, structuring of a long term financing by means of short term loans, which are rolled over at maturity, exposes the local government to refinancing risk – i.e. lender might refuse at any time to renew such a loan. This could result in (i) liquidity or even insolvency issues for the local government and at the same time in a (ii) partially completed project that is of no value to anyone.

The cost of a loan is made up from the interest rate and other commissions and fees that banks usually charge. Banks set the interest rates based on current market interest rates, maturity and collateral of the loan and creditworthiness of the borrower. Rates can be fixed or floating. Floating interest rates are made up from a reference interest rate (e.g. EURIBOR) plus a fixed margin, which accounts for banks' profitability and borrower specific risk.

Bank Loans

Advantages

- Provides a readily available source of financing based on competing existing local banks
- Applying for a bank loan is a much simpler process than issuing a municipal bond (which makes them more suitable for smaller municipalities)
- Credit analysis is performed directly by the lender
- An additional credit rating from an external rating agency may not be required
- Loan terms and conditions are negotiable to some extent, but they are bounded by the borrower's credit quality

Disadvantages

- Interest rates tend to be higher than other types of debt (depending on economic cycle, maturity, ancillary services etc.)
- Higher loan to value requirements – i.e. collateral requirements are more conservative
- Less suitable for large investment projects requiring long term financing

3.2. National and international development program loans

In all of the analyzed countries some sort of local government development fund is established. These development funds act as a credit institution at sub-national level. International development banks (World Bank, KfW, EBRD etc.) are using these funds as a way to channel loans to local governments. The financing of local governments through such programs occurs either directly or indirectly (on-lending), via intermediated loans to local banks in target countries.

The terms and conditions of these loans tend to be less rigid than that of "normal" banks. Their objective is to assist local government long-term development needs rather than make a profit. The maturity of the loan is often tied to the life of the asset. Another characteristic of these loans is the existence of an initial grace period on principal repayment, which shifts the debt burden further into the future.

Interest rates on these loans are typically below commercial banks' "normal" lending rates. Fixed interest rates are common and are set based on a relationship to government's borrowing rates. But it has to be stated, that such interest rates below the market price bear the risk of crowding out the local financial credit market and hinder its development.

In addition to lending funds to local governments, the development programs use incentives in form of grants or technical assistance if borrowers meet some requirements.

The case of Macedonia, where the World Bank and the Ministry of Finance initiated EUR 18.9 million USD Municipal Services Improvement Project, is a very good experience, especially in the early stage of municipal credit market development. This on-lending program was launched in 2008 and its objective is to improve transparency, financial sustainability, and delivery of targeted municipal services such as water supply, sanitation, solid waste management, support for energy efficiency projects, urban transport and other services. Along with the loans the Project provides grants to local governments as an incentive and reward for implementation of reform initiatives aimed at performance improvements in service delivery. The awarded grant to an individual local government amounts to 20% of the investment loan.

Montenegro has a similar vehicle, the Investment Development Fund, which provides loans to local governments at lower interest rates compared to commercial banks. For example, the average interest in 2009 for local governments' loans originated by commercial banks was 10% while at the same time the Fund charged only 5%. The fund also controls the primary municipal bond market (i.e. buys bonds of issued by local governments). There is no secondary market for municipal bonds.

The banks participating in the on-lending programs perform all the due diligence of the potential borrowers and bear the entire credit risk of the related loan portfolio.

Example 1:

Istanbul Municipal Infrastructure Project financed by World Bank Development Program Loan of Environmental Projects

The objectives of the Istanbul Municipal Infrastructure Project (IMIP) in Turkey are to assist the Istanbul Metropolitan Municipality in: (i) improving its solid waste management; and (ii) improving its capacity to mitigate earthquakes by retrofitting key facilities and infrastructure and upgrading the institutions and their procedures to help them respond to emergencies.

Project Owner:	Istanbul Metropolitan Municipality
Name of the Project:	Istanbul Municipal Infrastructure Project
Project Amount :	USD 322,150,000
Lender/Creditor:	International Bank for Reconstruction and Development (IBRD), a member of the World Bank Group
Guarantor:	Under-secretariat of Treasury
Instrument Used:	Project Financing
Credit Amount:	USD 322,150,000
Maturity:	5 years of Grace Period + 10 years (20 equal installments)
Approval of the Bank:	28.06.2007
Credit Agreement:	25.07.2008 (between the Municipality and the Bank)
Guarantee Protocol:	13.09.2009 (between the Municipality and the Treasury)
Guarantee Agreement:	13.09.2009 (between the Treasury and the Bank)

The main point diverging from this example is that this loan agreement is under state guarantee. Therefore, Istanbul Metropolitan Municipality has signed a "Guarantee Protocol" with the Under-secretariat of Treasury in accordance with the requirements of the IBRD, a member of the World Bank Group; whereas, the Treasury has signed a "Guarantee Agreement" with the Bank. Moreover, with this protocol, the Municipality is obliged to transfer changing percentages of its various revenues into an official account in order to be facilitated during debt repayment periods. This account is named as "External Debt Repayment Account". These revenues are "Advertisement and Publicity Tax" and "Real Estate Tax"; which are collected by the Municipality. The transactions are audited and supervised by the Controllers of Treasury.

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Since a part of Municipality's own revenues (taxes), whose ratios are determined in its sole discretion, goes under cede. Nevertheless, this is a bilateral guarantee mechanism for both sides and the transferred amount constitute very small portion of Municipality's annual revenues since most are formed by the mechanism of shared tax revenues of the central government.

Another difference unique to state guaranteed agreements is that Turkey's Treasury, on behalf of borrower, conducts the negotiations with creditor. Hence, disproportionate consumption of time is a negative outcome in this sense.

Example 2

European Investment Bank's (EIB) intermediary loans in some Central and Eastern European countries (as of June 2010)

EIB finances small projects with total cost between EUR 40,000 and EUR 25 million indirectly through global loans (credit lines) to local financial institutions. EIB can fund up to 50% of total project cost. The financing aims to promote the building, upgrading or refurbishing of small municipal infrastructure via the Municipal Finance Facility.

Main local banks participating in the subsidiary financing agreement

- Hungary: OTP Bank, Erste Bank Hungary, UniCredit Bank Hungary
- Czech Republic: Ceská sporitelna, a.s., Komercní banka, a.s.,
- Bulgaria: UniCredit Bulbank AD, Société Générale Expressbank, DSK Bank EAD, OTP Group, Raiffeisenbank (Bulgaria) EAD
- Romania: Banca Comerciala Romana S.A., Bancpost S.A., BRD – Groupe Société Générale S.A.

The final financing decision on the local governments' projects rests with the local banks, thus EIB effectively leveraging on local market expertise. Usually the local banks participating in the MFF are also amongst most active in the local government credit markets.

3.3. Municipal Bonds

Local governments can obtain long term funds, by issuing municipal bonds on domestic or international capital markets.

A bond is an interest bearing certificate issued by an organization in order to borrow money. A bond is a debt-agreement between the borrower or *issuer*, and the lender or *investor*. The issuer usually pays on borrowed funds a fixed (pre-determined) periodic interest (coupon). Principal repayment can occur either in one tranche at maturity (bullet) or in multiple tranches throughout the life of the bond (e.g. linear amortization or progressively increasing or decreasing amortization).

Local government bond issues are intermediated by investment and/or commercial banks in case of private placements or by brokerage houses in case of public placement. One advantage of bond issues over bank loans is that they may open local government access to longer term funds. Also the repayment schedule of a bond can be more attractive (e.g. bullet bonds).

One of the main arguments in favor of municipal bonds is that they can accommodate longer maturities than bank loans. Also, the costs of borrowed funds by issuing bonds is usually lower than the cost of a long-term loan. However, issuing a bond is more complicated than taking a loan and requires a more developed financial market.

Types of municipal bonds

General obligation bonds

The type of bond, which the local governments choose to issue, depends upon the benefit the investment produces. If the investment generates a facility or service that benefits the entire or at least a bigger part of the local community, the investment is said to be a "public good," and should be paid for by all taxpayers. Thus a general obligation bond is appropriate. Typical examples of these investments include: public safety, streets and bridges, public parks and open space, as well as public buildings. General obligation bonds are secured by the local governments' revenues stream.

Table 7: Example of Local Government Bonds Issue in Croatia[11]

Local Government	Issuance date	Maturity (years)	Currency	Amount (EUR)	Coupon rate	Purpose
Koprivnica	2004	7	HRK	8.000.000	6.5%	Communal infrastructure and sport facilities
Zadar	2004	7	HRK	18.500.000	5.5%	Sport hall building with swimming pool
Rijeka	2006	10	EUR	24.600.000	4.125%	Sport center with swimming pool

11 See also the case of Koprivnoca/Rijeka presented at the case studies section

Split	2006	7	EUR	4.000.000	4.5625%	Cultural and athletic facilities and communal infrastructure
Zagreb Holding (International issuance)	2007	10	EUR	300.000.000	5.5	Capital projects within Zagreb Holding
Vinkovci	2007	10	HRK	5.600.000	5.5%	Cultural-business center with swimming pool
Osijek	2007	10	HRK	3.333.333	5.5%	Revitalization of the city square
Split	2007	8	EUR	8.100.000	4.75%	Various capital projects
Split	2008	7	EUR	8.200.000	6%	Various capital projects

Source: Zagreb Stock Exchange Report, March 2009

The case of Croatia is very interesting for analysis purposes. Significant progress of local government bond market development happened since 2004. All bonds that have been issued by local governments are general obligation bonds which are secured only by local government's budget.

Prior to the bond issuance, the Croatian Securities and Exchange Commission defined disclosure standards for securities. These standards define the type of information of the investment projects and the financial standing of the issuer, that the issuer must present in the bond prospectus (sale document) but also periodically once the bond has been sold.

Revenue bonds

Often referred to as "limited liability" bonds, these rely solely upon a city's pledge of restricted revenues or user fees (such as service charges, tolls, admission fees, leases and rents) to guarantee repayment. Revenues that back the repayment are usually generated by the project which is financed from such bonds. Revenue bonds are not backed by the taxing power of the local government. Failure to raise sufficient revenues to make payments will result in default of the revenue bonds. In some limited situations, local governments have backed revenue bonds with a tax pledge to add strength to the creditworthiness of the revenue bond. These are referred to as "tax-supported revenue bonds" or "indirect general obligation bonds." This approach may work when the revenues are not strong or where there is a limited credit history associated with the project. Rating of revenue bonds may differ from creditworthiness of the city and is strongly dependent on the cash-flows generated by the project but also on other factors (e.g. willingness and capacity of a municipality to provide financial support in case of default).

Capital investments that directly benefit a specific group of users that pay for the investment through user charges are considered to be a "private" good, and appropriate for revenue bond financing. Examples include: municipally-owned airports, water and sewer systems, electric utilities, athletic and sport facilities and limited access highways.

Eurobonds

Eurobonds are international bonds denominated in a currency different from that of the country in which they were issued (so not only in EUR). Eurobonds are tradable and transferable securities, as defined in the EU Prospectus Directive (89/298). Eurobonds are usually launched through a public offering and are listed on a stock exchange.

Example

City of Bucharest on its municipal €500M Eurobond issue- the largest Eurobond offering by a regional or local entity in CEE and the first Romanian municipal Eurobond.

The Eurobond issue launched by the Bucharest City Hall in June 2005 on the London market was fully underwritten, to EUR 500M, with a 4.277% annual interest rate. The interest to be paid by the municipality is approx. one per cent lower than the one paid for Romania's latest Eurobond issue.

The bonds have ten-year maturity, and the bond issue was brokered by investment banks ABN Amro and JP Morgan.

The funds are used to finance infrastructure projects such as the Basarab overpass, acquisition of public transportation means (buses and trams), rehabilitation of streets and tramlines.

4. Local Government's Creditworthiness Assessment

Prior to establishing the terms and conditions of a financing agreement (be it loans or bonds), investors evaluate local governments' creditworthiness. The creditworthiness of a local government measures both quantitatively and qualitatively its ability to repay debt. This is a rather complex process and covers (i) a thorough analysis of the local governments' financial position, (ii) an assessment of the local economy in which the municipality operates (e.g. economic and political context) and (iii) an evaluation of the national macroeconomic environment. The depth of such analysis differs across financial institutions, depending on the degree of specialization and knowledge on/ of the local governments' segment. Local governments should perform a self-assessment of their creditworthiness prior to approaching financial institutions. Thus they will be able to determine roughly how much money they can borrow without impairing their financial stability. Moreover, this self-assessment prepares local governments for the discussions with financial institutions which will take place at the time when they want to issue debt. It can also be used as a diagnostic tool by local governments to better understand the factors which may affect their financial stability as well as to perform certain scenario analysis.

In general, the creditworthiness assessment of a local government is based on the following three broad factors:

- Economic Risk,
- Political Risk, and
- Financial Risk

In this chapter, we identify a series of economic and financial indicators essential for understanding the past performance, projecting future financial position and consequently assessing the creditworthiness of the local governments. While many of the parameters are quantifiable, subjective judgments are also employed to assess qualitative factors such as government's policies.

4.1. Economic Risk

The ability of municipalities to repay debt is sensitive to economic conditions. Local governments that raise most of their funds from local taxes are especially vulnerable to local economic conditions. Local governments that rely primarily upon intergovernmental transfers are more exposed to the national macroeconomic conditions. One task of credit analysis is to identify the economic events which would impair the most a local government's ability to repay debt and come up with solutions to mitigate such risks.

The strength of the local economy is one of the most important factors influencing creditworthiness. Own revenues and shared-taxes of local government, as the main source to repay financial debt, are dependent on the performance of the local economy. Demographic trends, economic diversification and growth perspectives are key aspects which influence local government medium and long term revenues. Economic diversification is an important feature for a local economy. A highly diversified economic activity means that economic downturns will have a smaller impact on local output than compared to a concentrated local economy, where a few economic sectors hold a large share of total activity.

Key in the analysis of the strength of the economic structure are the following factors:

- Economic and Social Infrastructure and socioeconomic trends underpinning the demand for public services provided by the Local Government
- Per Capita Income and its volatility
- Real Annual Local GDP Growth
- Composition of Local GDP
- Natural Resources
- Employment Growth & Quality of Workforce
- Economic Policies

Furthermore, the assessment should focus on the availability of basic economic infrastructure, relevant to the quality of life. This includes reliable electricity supply, transport system, health, water and wastewater treatment facilities, telecommunication system etc.

Demographic indicators such as per-capita income, poverty levels, degree of urbanization, employment rate etc. are also very important. Favorable demographics significantly improve a local government growth potential while at the same time relaxing budgetary constraints related to high social expenditure allocations.

4.2. Political Risk

The objective of political risk assessment is to provide a means of evaluating the political stability of local governments on a comparable basis. Political stability is vital to continuity in economic decision making and growth as political consensus enables economic reforms. Political risk is a judgmental factor. It should be quantified by considering the (political) stability of the local government in the past and the attitudes of major political parties towards important issues for the local community.

The political relationship between the central and local governments has to be also taken into account as this may have an impact on transfers (grants) from the central government and direction of investments in new projects. Therefore it may have an impact on the local economic development.

4.3. Financial Risk12

The financial situation of a local government is crucial for its creditworthiness, as it determines the ability to meet current obligations and debt service. Factors that have an impact on the financial position of local governments include:

- revenue and expenditure structure and dynamics
- net operating result
- ongoing liquidity and cash flow management
- financial flexibility – autonomy to raise taxes and fees,
- the ability to balance financial operations over the economic cycle
- willingness and ability to control expenses
- indebtedness – both on and off-balance sheet debt

Municipal senior management must be well prepared to identify, evaluate and mitigate the main sources of risk for the financial situation of the local government (currency, interest rate, maturity mismatch risk). The materialization of such risks would negatively impact cash flows: consequently, municipalities may be exposed to insolvency or default scenarios.

When assessing financial risk of a local government, each of the above mentioned factors have to be compared with relevant benchmark values established for a group of similar local governments. Such an approach must be supported by adequate techni-

[12] Annex 3 contains the main factors that are taken into account by Standard & Poor's credit rating methodology in assessing the financial risk profile of a local government as well as a comprehensive set of financial indicators that are typically used to assess a local government's creditworthiness.

cal and accounting expertise as well as by the establishment of reliable local statistics database.

4.4. Determining Local Government Borrowing Capacity

Local governments should be aware of their maximum borrowing capacity (i.e. how much money they can borrow) in order to be able to set and prioritize capital investment objectives.

Projecting the future financial position (revenues and expenditures) of a local government is key in determining the financial resources available to repay debt. The forecasting framework of local revenues and expenditures should incorporate the economic, political and financial risk factors that were described in the previous section.

Local governments usually repay debt (principal plus interest) from the operating surplus, which is the difference between operating revenues and expenditures. Maximum borrowing capacity of a local government can be estimated as the present value of its future net operating surpluses (operating surplus minus debt service on outstanding debt). The discount rate used in the present value calculation should be the interest rate charged by banks for m loans.

Local governments should be able to demonstrate that they are able to generate persistent positive net operating results in the future, as a precondition for borrowing. If a local government has a temporary structural deficit (negative net operating result) in the future, it can still take on new debt, provided that the financing agreement foresees a grace period at the time the deficit is recorded. Alternatively it can use capital revenues to finance the operating deficit. However, if a local government runs on persistent structural deficits, serious efforts must be made to rationalize operating expenditures and increase revenues before borrowing should even be considered[13].

The ratio of expected net operating result to expected debt service is probably one of the most important indicators of local governments' debt carrying capacity. If the ratio is close to one, then any major fluctuation in a local government's operating revenues or expenditures could result in serious problems in meeting the debt service obligation. A ratio significantly higher than one indicates that the local government has a comfortable financial position relative to its debt obligations.

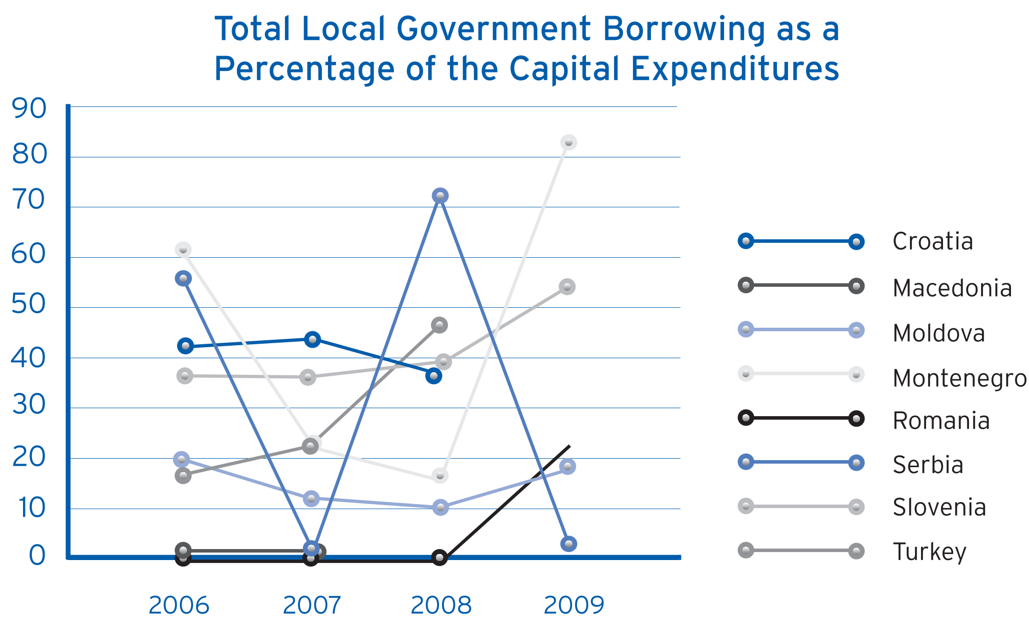
[13] USAID/SLGRP; "Introduction to Municipal Borrowing in Serbia; Tony Levitas; p.15

4.5. Local Government Debt Statistics in NALAS Countries

Total Local Government Borrowing as a Percentage of the Capital Expenditures

Debt financing of capital expenditures varies across local governments from different NALAS countries (Figure 1). For example, in Montenegro debt financed 80% of local governments' capital expenditures, while in Moldova only 10% (2008). On average, between 2006 and 2009 debt has financed around 37% of local governments' capital expenditures from all NALAS countries, excluding Turkey. The share of debt in the overall financing sources of capital expenditures presents large deviations from one year to another in almost all of the analyzed countries.

Figure 1: Local government borrowing as percentage of capital expenditures

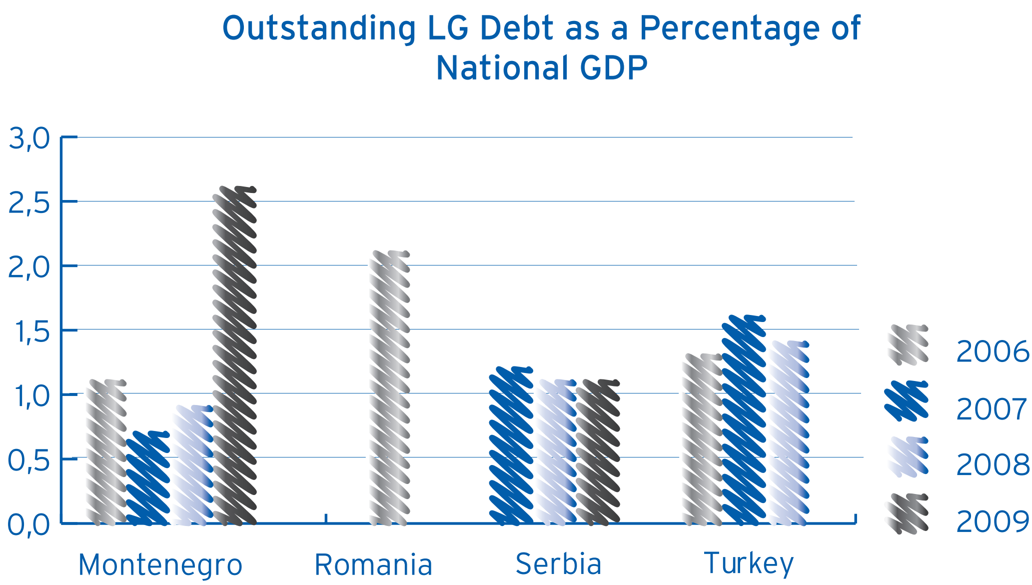


Source: Calculation based on the questionnaires answered by local experts

Outstanding Local Government Debt as a Percentage of GDP

In all NALAS countries, local credit markets are still in their infancy. In most of the analyzed countries (Albania, Bulgaria, Croatia, Macedonia, Moldova), local debt accounts for less than 0.5% of GDP and less than 5% of local governments total expenditures. In Serbia and Turkey the dynamics of local debt has been in line with economic growth, resulting in relatively stable debt ratios during the past years (Figure 2).

Figure 2 : Outstanding debt as percentage of GDP

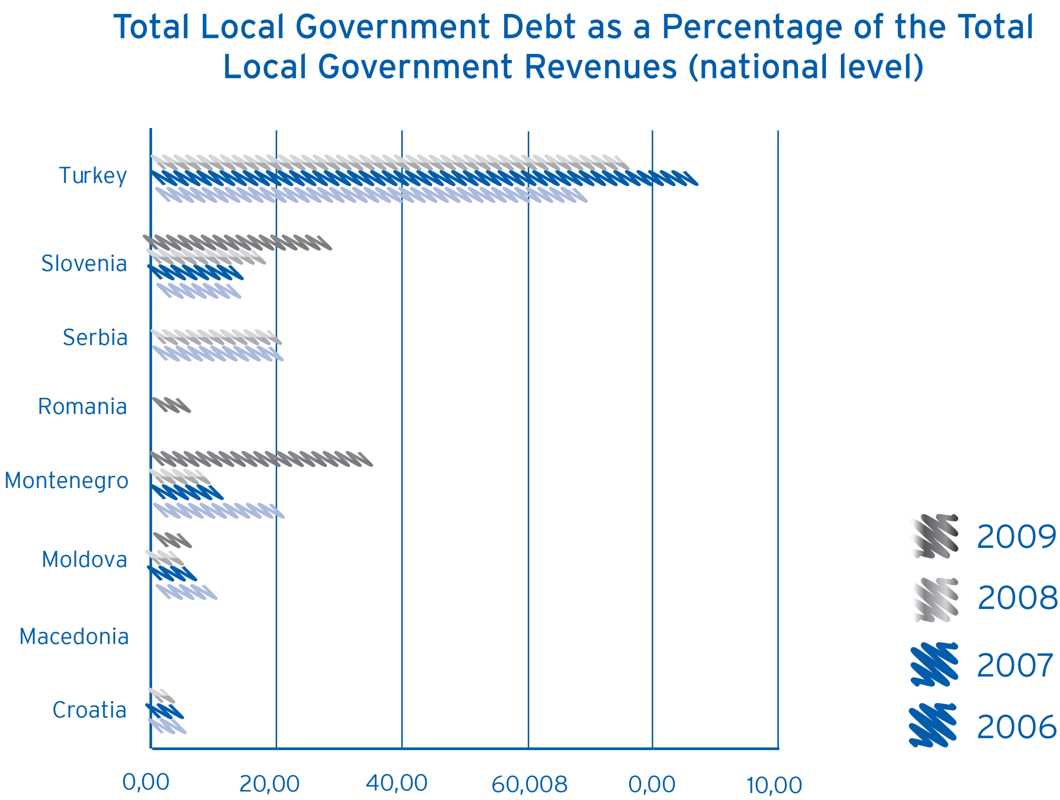


Source: Calculation based on the questionnaires answered by local experts

Total Local Government Debt as a Percentage of the Local Government Revenues

Local governments' indebtedness varies across analyzed countries. In Croatia, Macedonia, Moldova and Romania local debt represents less than 5% of local governments' total revenues. Slovenia, Serbia and Montenegro have an indebtedness level ranging between 20-30%. Turkey stands out as the country with the highest indebtedness level (75% in 2008).

Figure 3: Total Local Government Debt as a Percentage of the Local Government Revenues



Source: Calculation based on the questionnaires answered by local experts

5. Improving Financial Management Performance

Adequate, accurate and timely financial information on local governments' operations benefits both investors and local governments. A uniform financial reporting format, which suites both local/ central governments' and investors' requirements, should be a top priority for national regulators, as a precondition for improved financial management performance. Local governments' annual reports should include at least an administrative report, a balance-sheet and income statement as well as a cash-flow analysis (if accounting system is accrual based). Public disclosure of financial reports should be mandatory. Independent audits should be conducted on a regularly basis. Local governments could also improve their financial management performance by applying for an external credit rating. By obtaining the credit rating, the local government will better understand what the main determinants of its creditworthiness are and can decide what changes are needed to improve its credit risk profile and thereby reduce its borrowing costs.

5.1. Sound Financial Management for Improving Creditworthiness

Both local government officials and investors need adequate, accurate and timely financial information to be able to take optimal decisions.

Financial analysis assists officials to better understand the local government's fiscal situation and identify emerging trends of which they may be unaware. Financial analysis can also be used to present the local government's strengths and weaknesses to the local council, citizens, central government and investors. This promotes budget transparency and enhances the local government's ability to borrow. Moreover, financial analysis guides the financial planning and fiscal policy.

Investors need relevant and reliable financial information in their credit risk assessment analyses. The financial reports that local governments prepare rarely present financial information in the form that credit market participants need. A uniform financial reporting format, which suites both local/ central governments' and investors' requirements, should be a top priority for national regulators.

Local governments' annual reports should include at least an administrative report, a balance-sheet and income statement as well as a cash-flow analysis (if accounting system is accrual based). In some countries, the local governments are required to consolidate their financial statements with those of the subordinated local public institutions.

Steps to Improve Systemic Creditworthiness
1. Standardize the financial reporting format of local governments to include information that is important to credit markets 2. Public disclosure of local governments' financial reports should be mandatory 3. Periodic independent audits 4. Central government should monitor local debt service and financial ratios to ensure financial stability

Table 9: Using Financial Data To Improve Creditworthiness[14]

Besides the steps aimed at improving the quality of financial reporting, additional actions should be taken in the areas presented in Table 10.

Table 10: Steps to be taken for improvement of local government creditworthiness[15]

Steps to be taken for improvement of local government creditworthiness	
Area	Actions
Fiscal System 1. Intergovernmental Transfers 2. Local Revenues	1a. Establish clear legislative or constitutional basis for revenue sharing and grants 1b. Maintain stable revenue-sharing formulas 2a. Provide for local control over local tax rates on some significant revenue sources

[14] WB, "Measuring Local Government Credit Risk", George Petersen, 1998, p.19
[15] WB, Measuring Local Government Credit Risk and Improving Creditworthiness, George Petersen, 1998, p.11

Municipal Development Funds 1. Problem Loans 2. Credit Assessment 3. Loan Policy	1a. Set explicit targets for maximum acceptable problem loan rates; monitor actual experience 2a. Assign explicit risk rating to each municipal loan 2b. Separate department or external credit-rating institution performs risk assessment. 2c. Compare ex post default or problem-loan experience with ex ante credit ratings; revise risk assessment methodology if necessary 3a. No new loans to borrowers who have problem loans outstanding 3b. No capital grants by Government to borrowers with problem loans outstanding
Legal System 1. Default Procedures; Collateral Foreclosure	1a. Establish clear legal rules governing default procedures that are followed in practice, and enforceable by courts
Loan Defaults 1. Local Budget Intervention	1a. Establish automatic procedures for local budget intervention by Government at time of default 1b. Give intervention team power to restore budgetary balance by mandatory spending cuts and/or tax increases

5.2. Credit Rating

Local governments could improve their financial management performance by applying for an external credit rating. A credit rating is an opinion assigned by Credit Rating Agency on the ability and willingness of an issuer to make timely payments on a debt instrument over the life of that instrument. By obtaining the credit rating, the local government will better understand what the main determinants of its creditworthiness are and can decide what changes are needed to improve its credit risk profile and thereby reduce its borrowing costs.

Three major firms now provide this service for regional and local governments in South East Europe: Moody's Investors Service, Standard and Poor's and Fitch. Long-term bonds of the highest quality are rated "Aaa" by Moody's and "AAA" by Standard and Poor's and Fitch. Issues rated below "Baa" by Moody's and below "BBB" by Standard and Poor's are considered below investment grade. A separate set of ratings are used for short-term notes.

Table 11: Moody's Long-term Debt Ratings (maturities of one year or greater)

Investment Grade	**Aaa** - "gilt edged" **Aa1, Aa2, Aa3** - high-grade **Baa1, Baa2, Baa3** - medium grade
Speculative Grade	**Ba1, Ba2, Ba3** - speculative elements **B1, B2, B3** - lack of characteristics of a desirable investments **Caa1, Caa2, Caa3** - bonds of poor standing **Ca** - highly speculative **C** - lowest rating, extremely poor prospects of attaining any real investment standing

Moody's Short-term Debt Ratings (maturities of less than one year)
Prime-1 (highest quality)
Prime-2
Prime-3
Not Prime (can be thought of as speculative grade)

The rating process:

- Local governments approach Credit Rating Agency
- Application with specific financial information related to the local governments' activity is sent out to the Credit Rating Agency.
- Credit Rating Agency analyses the local governments' application along with the local and national economic conditions and assigns a credit rating to the local government. As a rule, the credit rating of a local government cannot exceed the country's sovereign rating.
- After the initial rating, the Credit Rating Agency reviews periodically the rating to take into account the latest financial and economic information related to the local governments' position.

Important definitions pertaining to the rating process[16]:

- Rating outlooks: These are opinions regarding the likely direction of an issuer's rating over the medium term, generally 18 months. Outlooks fall into 4 categories: positive, negative, stable, developing;
- Rating review: A credit is placed on the watch list when it is on review for pos-

16 Moody's Investor Service – Rating Methodology

sible upgrade, or on review for possible downgrade, or (more rarely) on review with direction uncertain. A formal review is normally concluded within 90 days;

- Confirmation of a rating: If after a formal review a rating committee decides not to change a rating, the rating is said to be confirmed.

Benefits of a credit rating for a local government:

- Access to a broad number of potential investors, thereby reducing the local government's borrowing costs as competition will increase;
- Independent opinion on the future ability and legal obligation of an issuer to make timely payments on its financial commitments;
- Independent estimation of the current municipal credit condition and future revenue and expenditure scenarios based on budget trends and budget projections;
- Diagnosis of the basic risk factors that contribute to the creditworthiness condition and identification of the critical risk areas that may threaten the ability of the local government to make timely principal and interest payments on their debt obligations;
- Objective assessment of important municipal financial operations of critical concern to mayors, municipal councils and citizens;
- Increased transparency and accountability of municipal operations.

6. How to find and select the lender?

Depending on which type of debt instrument (loans or bonds) a local government wants to issue, there are different specialized financial institutions which should be approached. Local government loans are originated by: (i) municipal banks, (ii) commercial banks, (iii) international financial institutions and (iv) municipal development funds. Bonds are intermediated by commercial/ investment banks or brokerage houses. The existence and availability of these financial institutions to finance local governments depends on the architecture (bank lending model or bond model) and development of the local credit market. Central and local authorities should promote specific measures aimed at supporting the development of sustainable credit markets by minimizing the risk of market failures.

Meeting lender's expectations will increase local governments' chances to borrow under good conditions. Local economic conditions, budgetary performance, financial and political flexibility, project management capacity, transparency and disclosure, the quality of the budgeting process, the existence of a debt management and capital investment strategy, available guarantees are all important aspects that influence a local government's borrowing capacity.

In the process of contracting new loans or issuing bonds local governments have to undergo tender procedures in order to select the lending/ underwriting financial institution. Thus it is essential for local governments to draft the tender documentation in a way which ensures (i) that eligible bidders have the adequate level of knowledge and experience for the project to be financed and (ii) that selection criteria used to assess lenders' offers enables local governments to obtain the most competitive loan structure in a transparent way.

Besides financial institutions, local governments in EU member and accession countries can tap on financial resources from grants offered by the European Union (EU). In member states such local government projects may frequently exceed 15 million EURO. The value of the projects put forward by local governments in accession countries is smaller, but the benefits of financing local capital investment through EU grants are unquestionable nevertheless.

6.1. Financial institutions specialized in lending to local governments

6.1.1. Lending institutions, the rules they are operating with, markets they are thriving in and markets they avoid

The development of local government credit markets represents an important pillar for the expansion of local public goods and services (both quantitatively and qualitatively). In Chapter 3 we identified two models that underpinned the development of local credit markets: (i) bank lending model and (ii) municipal bond model

In the bank lending model, financial institutions that lend to local governments can be largely divided into those specialized in 'niche' banking, targeting only local business (municipal banks) and those involved in a large spectrum of banking activities – retail, corporate, investment banking.

The main differences between municipal banks and large commercial banks that lend also to other sectors consist in (i) the types of available lending products and characteristics (pricing, maturity etc), (ii) the way they build their relationship with local governments, (iii) the range of support services they provide to local governments besides the lending activity or (iv) the monitoring and analysis capacity. One characteristic of municipal banks is their ability to provide longer-term lending to local governments as compared to other commercial banks, as they are most of the time state-owned and thus have access to long-term resources. For example, Credit Locale de France used to have access to long term funds accumulated through the postal system's savings plan for small savers. Municipal banks aim at developing a permanent relationship with local governments, whereby, besides the lending activity, they also provide a range of complementary support services, such as advising on the preparation and structuring of budgets or designing of investment projects.

Initially municipal banks' special status was protected by law; they effectively enjoyed legal monopoly (e.g. Municipal Bank of Netherlands). However, financial sector deregulation put under pressure municipal banks, as it opened the ground for competition on local government segment from other financial institutions (commercial banks). Today, most of the municipal banks lost the preferential access to long term resources and had to enter competition with other banks for (short-term) funds. Dexia, is one example of large municipal bank which survived this process. Formerly government owned, Dexia is now fully privatized and competes throughout European market with other commercial banks as an alternative supplier of capital for local governments. The state owned

National Economy Bank from Poland is another example of specialty municipal bank. It specializes in assisting to the public sector through provision of support to the state's social and economic programs and local governments regional development programs.

In developing countries where municipal banks have little or no history, the process of financial deregulation brought municipal lending under the umbrella of standard commercial banking. The short term savings horizon which is characteristic for commercial banks translated into loans to local governments with shorter maturities as compared to those offered by specialty municipal banks. Also, as lending to local governments for a commercial bank represents only a fraction of its portfolio, the resources allocated to acquire and build expertise on local finance mechanics are scarce. This results in a more narrow range of lending products and higher borrowing costs. OTP Bank in Hungary or Erste Bank's Banca Comerciala Romana are two examples of large commercial banks that dominate the local governments' credit market, in the absence of municipal banks[17].

A special category of lenders to local governments are the international financial institutions (IFI) – e.g. World Bank, European Bank for Reconstruction and Development, European Investment Bank, European Council Development Bank – which are running dedicated programs aimed at supporting and financing local governments' infrastructure projects, especially in the emerging markets (see Chapter 3).

The municipal bond model, as an alternative/ complementary way to develop local government credit markets differs from the bank lending model in the following aspects:

- it is based on competition and not relationship banking,
- monitoring is public and not proprietary, and
- support services are unbundled.

Competition is the essence of local capital financing; neither institutional nor individual bond investors need to have a long term relationship with the issuer as it happens in the bank lending model. Whereas in case of bank lending model, the monitoring and analysis of local government financial position is done by the lending bank, in case of the municipal bond model, the financial information is disclosed by the issuer to the market in a standardized format; based on this information, each investor makes its own assessment of the opportunity to invest in a particular municipal bond issue. Furthermore, in a municipal bond market a local government can make its own decision on where to seek financial advisory services or technical assistance on project design as compared to the bank lending model where such services may be bundled.

[17] Dexia Bank used to have a subsidiary in Romania and was an important player on the Romanian local credit market, but it recently closed its operations on the Romanian market due to a restructuring at group level

Emerging markets are an attractive target for foreign financial institutions as they can offer superior risk adjusted returns. Low development of infrastructure (of all kinds) along with the perspective of a stable and predictive macroeconomic environment and coupled with credible economic policies are key ingredients for a developing economy to attract foreign financing. Moreover the status of member to international organizations (such as EU, NATO, WTO), which underscores a country's commitment to adhere to certain sustainable development landmarks, brings additional guarantees to foreign investors. Geographical and geopolitical position of a country also matters.

In this context, lending to local governments in eligible emerging markets may represent a viable and productive business opportunity for foreign financial institutions. Creditworthiness is usually better than that of private sector borrowers given their permanent revenue generation capacity, but below sovereign creditworthiness, thus ensuring attractive returns at relatively lower risk. During the current financial and economic crisis, some banks from emerging countries found it more profitable to finance local governments rather than the private sector, as the latter's debt servicing capacity had been severely impaired by the economic downturn. One such example is Banca Comerciala Romana, the market leader in the Romanian banking sector in terms of total assets, which managed in 2009 to partially compensate for the deleveraging that occurred in its portfolio of private debtors by expanding into the local governments segment. The willingness and capacity of financial institutions to finance local governments varies across target emerging countries due to a number of specific factors which characterize the degree of development of local public finances in general, such as (i) transparency, (ii) access to financial data, (iii) administrative capacity, (iv) revenue stability and predictability, (v) regulation of local public debt, (vi) existence of bankruptcy procedures or (vii)

Type of bank Country	Private commercial bank	State owned commercial bank	State-funded-development bank	Donor-funded-development bank	International financial institutions	Other
Albania	National Commercial Bank, Intesa Sanpaolo Bank, Raiffeisen Bank,		Albanian Development Fund, Highland Areas' Development Fund		KFW, World Bank (WB) ,EBRD, CEB	
Bulgaria	Municipal Bank plc				EBRD, EIB	
Croatia		Croatian Bank for Reconstruction and Development		United States Agency for International Development	EBRD, EIB	
Kosovo	Pro Credit Bank, Raiffeisen Bank,NLB Prishtina, Banka Kombetare Tregtare (National Trade Bank)					

Macedonia	Uni Bank, NLB Leasing - DCA partners and all the otherdomestic commercial banks			USAID DCA fund	WB, EBRD, KfW	
Moldova	Victoriabank, Ex-imbanc, Moldova-Agroindbank, Moldindconbank.	Savings Bank (Banca De Economii)	Fund of Social Investments from Moldova,			Interna-tional Associa-tion for Develop-ment
Montenegro	Crnogorska komer-cijalna banka, NLB Montenegrobanka, Hypo Alpe-Adria Bank, Podgoricka banka, Komerci-jalna banka AD Budva		Investment Development Fund of Montenegro		EIB, KFW bank, EBRD, IBRD	
Republika Srpska	Hypo Alpe Adria, Unicredit, Raiff-heisen, Komerci-jalna Banka	Investment-Development Bank of Republika Srpska	Incentive funds for employment and agriculture and economy de-velopment		EBRD, MMF, WB	
Romania	Banca Comer-ciala Romana S.A., Bancpost S.A., BRD - Groupe Société Générale S.A.				EBRD, EIB, WB	
Serbia	Intesa Sanpaolo, Unicredit, Hypo Alpe Adria, Com-mercial bank, AIK bank, Raiffeisen-bank, Erste bank, NLB Vojvodjanska bank, Credit, Agri-cole bank		State Develop-ment Fund		EBRD, EIB, KfW, WB, Coun-cil of Europe Develop-ment Bank	
Turkey	BNP Paribas Fortis, WestLB AG, Credit Agricole, HSBC, RBS	Vakifbank, Ziraat Bank	KFW, AFD		WB , EIB, EBRD	

6.1.2. Market failures and possible solutions

Both the bank lending and the bond model bear drawbacks that may limit the develop-ment of functional credit markets and lead to inefficiencies. As outlined earlier, commer-cial banks usually lack the capacity to understand local public finances and consequently the propensity to lend to local governments may be lower. Also, due to the fact that they attract resources on the short term, their ability to lend on longer terms is impaired. In case of bond issues, the lack of adequate financial disclosure may deter investors from purchasing municipal bonds. Moreover, past experience shows that in its early stages, local government bond markets do not necessarily provide longer-term capital than compared to bank lending.

In this context, there are several options available to central governments from emerging economies that can enhance the development of sustainable local credit markets:

a) General

- Promote economic policies that lay the grounds for a stable and predictive macroeconomic environment (e.g. anti-cyclical monetary and fiscal policy);
- Ensure the development of a sound and financially stable banking sector; prevent through adequate regulation the build-up of large imbalances in banks' portfolios (e.g. excessive lending towards specific sectors, large share of foreign currency loans), that could impair banks' future lending capacity;
- Increase transparency of local governments (e.g. standardized disclosure formats on financial position, investment projects, audited financials);
- Promote and support the establishment of an authorized local credit rating agency specialized on local governments' credit risk assessment;
- Increase the incentives for local governments to have credit rating from a rating agency (local or international) – e.g. increasing risk weight for unrated local governments and variable risk-weight for rated ones in calculation of regulatory capital for banks → this would result in higher borrowing costs for unrated local governments; And
- Define clear legislation and procedures for local government bankruptcy – remove implicit central government guarantee of local debt.

b) Specific

- The existence of municipal guarantee funds can stimulate the development of local government credit markets in its early stages. However, it is important to use such an institution only for a limited period of time, as it can result in moral hazard behavior (see examples below);
- The establishment of state-owned banks specialized in municipal lending can enhance the access of local governments to credit markets. Such banks can usually tap longer term resources, which can be channeled into local government long-term infrastructure projects.

Municipal development funds established and operated at a level above that of individual local governments represent also a potential solution to enhance local credit markets and support the investment in urban infrastructure, services and enterprise (see examples below.)

Examples

Enhancement mechanisms that support the development of LG credit markets

a. Guarantee funds

Bulgaria - the USAID Guarantee Mechanism - Development Credit Authority (DCA) provides guarantees for municipalities as borrowers to United Bulgarian Bank guaranteeing 50% of the loans. 13 municipalities have used this instrument so far.

Macedonia – similar mechanism to Bulgaria

Romania – there are two guarantee funds (Rural Credit Guarantee Fund and Small and Medium Enterprise Guarantee Fund) which provide letters of guarantee and loan guarantees in the name of local government beneficiaries of EU-grants.

6.1.3. The situation in the target countries

Past experience has shown that lack of discipline of decentralized local governments related to local public indebtedness may cause financial distress at macroeconomic level. In the past 20-30 years the state budgets had to intervene and bail out local governments in 19 out of the 44 countries analyzed in a 2005 study by Singh and Plekhanov[18]. For example, in Argentina and Brazil local government difficulties caused a serious burden for the national budget contributing to the emergence of financial crises.

In case of EU member states, indebtedness of local governments has not raised worries so far; however periods of financial distress can be traced back in the recent history (Germany and Sweden in the 1990s).

Such a situation clearly calls for some controlling mechanisms aimed at ensuring financial stability of local governments. The literature identifies four regulation mechanisms of local public indebtedness (Ter-Minassian-Craig, 1997[19]):

[18] Singh, Raju-Plekhanov, Alexnder (2005): How should local government borrowing be regulated? Some cross-country empirical evidence. IMF Working Paper, WP/05/54.

[19] TER-MINASSIAN, TERESA-CRAIG, JOHN (1997): Control of local government borrowing in Fiscal Federalism in Theory and Practice (Chapter 7). IMF.

- Market discipline – in this regime there is no restriction regarding local government indebtedness; financial institutions will lend based on their own risk appetite and limits. Free markets regimes are usually characteristic for developed markets;
- Direct controls – lending is subject to approval by the central government. Such a mechanism clearly impedes on local government autonomy, however it may compensate the lack of discipline and administrative capacity at local level;
- Rule-based approach – limits on indebtedness level are set out in legislation on local debt, either as a cap on total outstanding debt or on maximum debt service;
- Co-operative approach – local governments decide together with central government on maximum debt levels.

Figure 6: Controlling mechanisms across CEE countries

LG from emerging markets exhibit usually at least one form of controlling mechanisms through direct controls and/or legal rules

Industrial countries*				
Country	Market discipline	Co-operative control	Rule based	Direct controls
Australia		●		
Austria				●
Belgium		●		
Canada	●			
Denmark		●		
Finland	●			
France	●			
Germany			●	
Greece				●
Ireland				●
Italy			●	
Japan				●
Netherlands			●	
Norway				●
Portugal	●			
Spain				●
Sweden	●			
Switzerland			●	
United Kingdom				●
United States			●	

** Based on Ter-Minassian-Craig, 1997*

Developing countries**				
Country	Market discipline	Co-operative control	Rule based	Direct controls
Albania			●	
Bulgaria			●	
Croatia			●	●
Macedonia			●	●
Moldova			●	
Montenegro			●	●
Republika Srpska				●
Romania			●	●
Slovenia				●
Serbia			●	
Turkey			●	

*** Based on questionaire data*

6.2. How could local governments increase their chances to borrow

6.2.1 Lenders' expectations from local governments

Financial institutions approaching local governments operations usually pursue a detailed qualitative and quantitative analysis of a wide range of financial, economic and institutional factors in order to assess creditworthiness. The depth of such analysis varies across financial institutions, depending on degree of specialization on local government segment.

As shown in Chapter 4, the economic conditions in which a local government operates have an important influence on its creditworthiness. Although some financial institutions may not put too much emphasis on this factor in their credit analysis, it is important for local governments to understand its importance for their future revenues and indebtedness capacity and take proactive measures. Such measures may include various tax facilities offered by the local governments to large local companies of systemic importance[20] for the local economy aimed at stimulating investment and employment; local governments can also increase investment attractiveness of the region by providing large investors with real estate assets (land, buildings).

[20] Companies which hold a large share of local economic activity in terms of turnover, value added and employees.

Example

Romanian experience in supporting the development of local economy

The Metropolitan Area of Oradea (MAO), which gathers the municipality of Oradea along with 11 neighboring communes, is in the process of creating a marketing strategy aimed at increasing attractiveness of the local economy among foreign investors.

In a first step MAO identifies from the pool of real estate assets (land, buildings) that belong to its members the ones which could be used to support new investments. Based on a detailed analysis of the local economy structure and growth perspectives, MAO selects the economic sectors which have the greatest development potential by taking into consideration the key strengths of the local economy. It then combines the results of the analysis with the available real estate assets for new investments into territorial sectoral offers, which are subsequently marketed to foreign investors.

For example, one of the identified investable assets is a piece of land owned by one commune in a touristic area. As tourism has been identified among one of the key industries with potential to drive the local economy forward, the territorial offer in this case would be addressed to potential investors interested in developing a tourist resort. MAO would provide the land and access to public infrastructure to the investors which are committed to build a resort in the area.

As previously explained (Chapter 4) when assessing budgetary performance of local governments, financial institutions also analyze the trend of the **net operating result** (balance).

The **degree of financial flexibility,** which local governments have at their disposal to adjust the budget in periods of financial and economic distress, is also important from the point of view of debt servicing capacity. If a local government has high financial flexibility, it will be able to effectively adjust its revenues or expenditures in the face of external shocks, so as to maintain its financial stability.

Related to the financial flexibility is the **political flexibility** – i.e. willingness to rationalize expenditures – to pursue austerity measures in case of financial distress. Thus, even if a local government has financial flexibility it may lack the readiness to implement adjustment measures to balance the budget due to political reasons.

Project management capacity of local governments represents another area of focus in banks' credit risk analysis. It emphasizes the sophistication of local government structures and practices and it evaluates the capacity to observe legal procedures for procurement and financial management. In this context banks may be interested to see how the implementation of previous investment projects succeeded, what were the main problems encountered and how the local officials dealt with them.

A high degree of **transparency and disclosure** is a key characteristic of good financial management. It is an important aspect of the relationship between local governments and financial institutions as it provides banks with the necessary information in their due diligence procedures and helps them to build an unbiased representation of the former's true financial position. In this context local leadership should be willing and able to communicate all required information to lending institutions.

The quality of the **budgeting process** belongs also to financial management capabilities. Budgeting should be accrual and program based. A consolidated approach to budget planning is desirable; budget should include all operations of local governments and subordinated related entities.

The existence of a **debt management strategy** at local government level with clear and strict indebtedness policies, besides those available at national level has a positive impact on creditworthiness. The debt policy should be explicitly formulated and observed. It should be stable and predictable across time, adequately disclosed, with no unplanned or sudden debt issues and correlated with the capital investment strategy. Debt limits imposed by national legislation should be respected at all times. Moreover, the local government should ensure an indebtedness level which can be sustained without putting too much burden on revenue streams.

Political changes in the local governments may determine in some cases a shift in the local development strategy which may have negative consequences on **willingness and commitment to service debt** contracted during the previous term. Local managers need to understand the importance of having a good track record in repaying financial debt and ensure continuity of investment projects, as they both represent preconditions for accessing future loans at reasonable costs. Lenders learn about non-compliant or distressed local governments from their peers or from national debt registers. Such behavior sheds a lasting negative light on the local governments, which results in difficulties in contracting new loans or higher risk-associated costs.

A clear and coherent **capital investment strategy** represents the starting point of any investment project and provides the lender with a long-term perspective over any local government's investment plans and future financial position. To this end it is important for the local government to have multi-year financial planning with corresponding appropriations that enables them to roll out the planned investment projects. The strategy should include a prioritization of the major projects according to their importance and funding needs.

Financial institutions require borrowers to bring a form of eligible **guarantees** in order to secure debt repayment. In case of decentralized local governments, borrowing is usually guaranteed by own revenues. Theoretically revenue streams would be intercepted by lenders in compensation for overdue debt service. Other forms of guarantees such as physical assets may be also accepted by law in some countries. In many cases, where legislation on local public debt is not clear enough, financial institutions may consider own revenues guarantees offered by local governments as good as government guarantees. Thus, it is important for local governments to ensure that financial institutions understand the nature of guarantees and conditions under which they become exercisable. Guarantees from central governments are also practiced in some credit markets, but they are usually characteristic for the early stages of development, when financial institutions knowledge about local governments and willingness to lend them is low.

6.2.2. Characteristics of the south-eastern European countries

All lenders would like to work in ideal conditions: stable legislation, open and correct financial statements and accounts, stable flow of revenues, well developed investment plans, sufficient administrative capacity and political commitment to service debt regardless of the leadership changes. In many countries today such conditions are not present. Thus lenders operate in volatile environments fraught with risks; during recessions such risks are even greater. Chief among them are: unstable allocation of revenues as a consequence of changes in the national legislation, volatile tax revenues, poor revenue planning and management at local level, lack of transparency and administrative capacity.

In the countries surveyed for this paper the lending conditions are not perfect either. During this subchapter, we will go through the related findings on the local credit market conditions.

Although the majority of local governments are required to adopt debt management policies and multiannual capital investment plans, many others do not have to observe such a prerequisite. In the latter cases lenders cannot get the big picture of the local governments future actions nor can they find lasting political commitment for the projects they are financing.

Revenue stability has been largely achieved over the last years. However, there are cases when governments or parliaments suddenly changed regulations to the disadvantage of local governments. Moldova, Serbia and Romania can be cited in this respect[21]. Local governments must be aware that lenders, like any other investors, are driven by confidence; revenue fluctuations inhibit confidence in the borrower's ability to service debt.

Any lender requires guarantees. Local governments in most of the surveyed countries are providing such pledges. The most frequent is revenue interception. Unless the debtor pays its dues, the bank is entitled to takeover part of its revenues in exchange. However, a lender should know that local government accounts with the State Treasuries are usually very difficult to execute. Some countries allow local governments to provide assets as collateral for incurred debt. Such instruments are allowed in Albania, Bulgaria, Kosovo, Macedonia, Montenegro, Slovenia and Turkey. Even in such cases, foreclosures can be very difficult and procedure-laden when it comes to public assets. A special case can be found in Serbia, where local governments are forbidden to issue any guarantees in favor of their lenders.

Example

Forced execution of local government accounts held in State Treasury in Romania

In Romania a court has to confirm the existence of an unpaid debt and approve the interception of the debtor's revenues within the Treasury. To pay the debt, the debtor has to have cash in his accounts. Else, it has a respite of six months to find resources and clear off the debt. The main credit officers play a decisive role in securing the cash to repay the debt. Unless he (she) is well-intentioned the lender could spend many months trying in vain. Eventually, after the six-month term expires the lender can resort to the foreclosure of the debtor's assets. To this end, the applicable procedures are laid by the Fiscal Procedures Code.

State guarantees are also to the liking of lenders despite the moral hazard they induce to local governments. Some countries make explicit to local governments and lenders that state guarantees are not available in any circumstances. Albania, Bulgaria, Moldova, Romania and Slovenia fall into this category. There are countries which leave the door open for state guarantees in special cases: Croatia, Kosovo, Macedonia, Republika Srp-

[21] In Romania, the governments eliminated the local governments' 40% share from the real estate transaction tax and took all the proceeds to the state budget. In Moldova, the government has decided to exempt the reinvested profit from profit tax which had been a major source of revenue for local governments.

ska, Serbia and Turkey. The state guarantees are usually approved by Parliament (Undersecretariat of Treasury in Turkey's case), but the government plays a central role through the Ministry of Finance. Moldova is a special case in this respect; the central government does not issue state guarantees, but county governments may do it in favor of local governments.

Example

Loan guarantees to local governments in Moldova

In Moldova there is a hierarchical relationship between county governments (rayons) and local governments (communes and towns) stemming from the role of the former in providing intergovernmental transfers to the latter. As such, public authorities of level II (i.e. rayons) are entitled to grant local public authorities of level I, as well as municipal enterprises, guarantees for loans for capital expenditure from financial institutions and from other national or foreign lenders. The guarantees have been granted for full or partial coverage of expenditure regarding repair works (Rayon council of Orhei); repair and maintenance of local roads (Rayon council Ungheni); construction of water wells (Rayon Council Hînce ti) etc. The loans are guaranteed with the rayon transfers for financial support to town and commune budgets.

In most cases lenders perform their own due-diligence, with the notable exception of bond issues where due diligence is carried out by independent auditors. With a view to evaluation, as a general practice, lenders require financial statements over a number of years, books of accounts, debt balance and commitments, lists of assets, investment plans and project technical documentation.

Credit ratings are rather rare, given their cost and local lenders' reliance on legal provisions. However, there are notable exceptions; a credit rating by a major independent agency is a prerequisite for a local government borrowing directly from an International Financial Institution (e.g. the European Investment Bank); moreover, bond-issues have to be backed by credit ratings to gain investors' confidence. In Bulgaria there is an Agency for Credit Ratings and Analyses which provides ratings to interested entities, including local governments. The agency was formed in 2010 from the merger of two existing credit rating agencies of which one was a Moody's affiliate. Also, Macedonia provides an interesting example of a national program to carry out local government credits rating by international credit rating agencies. In Turkey, the three main credit rating agencies are active in analyzing and assigning credit ratings for local governments. Fitch Ratings even has a regional office in Istanbul.

Example

Macedonian local governments' credit rating assistance program

In 2009, USAID Macedonia Local Government Activity (MLGA), in cooperation with Macedonian Financial Excellence Center (MFEC) and Moody's Investor Service, launched an external financial audit in six municipalities whose findings would be in compliance with international public accounting standards. Since then three local governments have been rated, namely Skopje, Strumica and Veles.

On 11 February 2010 Moody's Investor Service published the municipal credit ratings of Veles and Strumica, reflecting solid overall budgetary performances and lack of any direct-debt exposure.

The costs of credit rating vary between EUR 14,000 to EUR 19,000 depending of the size of the local government and the rating agency.

Examples

Local governments with rating across central and eastern European countries

Bulgaria – there is a locally established Credit Rating Agency which assigns ratings to LG. International rating agencies are also present. In 1999 Standard&Poor's rated Sofia and in 2000 Moody's rated Varna.

Croatia - Only City of Zagreb obtained a credit rating so far from Moody's.

Macedonia - Two municipalities Strumica and Veles as well as the City of Skopje have been rated.

Romania - on IFIs demand or prior to international bond issues - Bucharest 2005 – Standard&Poor's, Oradea 2009 – Fitch

Serbia - Three cities have been assigned with credit ratings in June 2010 by Moody's; Valjevo and Kraljevo obtained B1 and the City of Novi Sad Ba3.

Turkey - Most metropolitan municipalities are being rated by S&P, Moody's and Fitch. Istanbul, Ankara, Izmir and Bursa are some examples in Turkey. These municipalities are generally rated parallel to the sovereign grade. Istanbul, for instance, is rated as BB+ (Fitch Ratings), BB (S&P) and Ba2 (Moody's).

Annual fees show slight variations, changing between $30,000 and $36,000.

In the countries where State-funded banks and investment funds are present the interest rates and fees they charge to local governments tend to be lower than those of private lenders. As a rule, such market enhancing mechanisms may be welcome in less developed credit markets, but they must be temporary. Examples of this sort can be found in Montenegro (the State Development Investment Fund) and Turkey (the Bank of Provinces).

Last but not least, all lenders will be careful about the local governments' capacity to manage debt. In most countries in south-eastern Europe, rural and small local governments' financial departments are not staffed with adequately qualified personnel. In such cases lenders will keep close monitoring on the debt implementation.

6.3. How to develop the tender documentation for a loan

In the process of contracting a new loans or issuing bonds, in almost all the surveyed countries, local governments have to undergo tender procedures in order to select the lending/ underwriting financial institution. Thus it is essential for local governments to draft the tender documentation in a way which ensures (i) that eligible bidders have the adequate level of knowledge and experience for the project to be financed and (ii) that selection criteria used to assess lenders' offers enables local governments to obtain the most competitive loan structure.

6.3.1. Eligibility criteria for financial institutions

Local governments have to impose certain eligibility criteria to potential lenders in order to receive offers only from financial institutions which can prove similar experiences to that of the project to be financed. Such criteria may include:

- Minimum threshold for bank's revenues from ongoing operations (interest revenues and fees and commissions);
- Proof of similar projects – at least 3 – financed in the past years;
- Minimum threshold for loans granted by the bank in the past to local governments;

- Experience in complementary consultancy services, such as project design and implementation, if necessary.

In setting the eligibility criteria care has to be taken in order not to set the limits too restrictive for fear the competitiveness of the offers may be reduced.

6.3.2. Planning the loan and its components

The first step in drafting the tender documentation is for the local government to establish the criteria based on which it will assess the banks' offers. Usually the following parameters are included in a credit facility contract and should be considered by the local government in the evaluation process: (i) amount, (ii) currency (iii) interest rate, (iv) fees, (v) repayment schedule, (vi) grace period, (vii) refinancing options and (viii) restructuring possibilities.

Borrowing amount – can be imposed or subject to banks' offers. In normal market conditions it is imposed. However if liquidity on the market is low (such as during the recent financial crisis) and the chances of finding the whole amount of money for the project to be financed are reduced, then it is advisable to impose only a minimum threshold on the borrowing amount. In this way, chances are high that the local government will find partial financing, which may enable it to start the project. When market conditions resume, the local government could attract the additional amount of financing through another tender.

Currency – usually the currency in which local governments wish to borrow is specified. Otherwise it would be difficult to compare and discriminate across different offers which are denominated in different currencies. Local governments should be aware of the fact that when contracting foreign currency loans, they expose themselves to currency risk (exchange rate volatility), which can offset the benefits of lower foreign currency interest rates and even generate losses. In countries where exchange rate volatility is high, it is advisable for local governments seeking to borrow in foreign currency to consider hedging their currency exposure.

Interest rate – is one of the key assessment criteria. The local government has specify in the tender documentation the type of interest rate at which they wish to borrow: fixed or variable (e.g. Euribor 6 month). If the interest rate is variable, then banks tender only the margin over the reference rate. Usually lending to local governments occurs at variable rates, as the table below indicates.

Table 13: – Local government borrowing interest rates across target countries (as of Dec 2009)

Country	Domestic currency interest rates	Foreign currency interest rates
Albania	6 months prime rate of treasury bonds (7%) +0.5-3%	
Bulgaria	Basic interest rate +1.4% BGN	
Croatia	4.20%	
Macedonia	7,25-9%	6 months LIBOR+margin
Moldova	20%	5-6%
Montenegro	10%; 5%-Investment Development Fund	
Romania	ROBOR 3M + 2,75%-5,5%	EURIBOR 3M + 5,5%
Slovenia	EURIBOR +2-3.5%	
Serbia		EUR, Fixed: 6.75%, EUR, Floating: EURIBOR 3M+5%
Turkey	TR-LIBOR Apprx.9%	EURIBOR +2%, LIBOR +2.5%

Fees – have also to be considered when evaluating the offers. The number and type of fees - 1) Up-front Front Fee; 2) Front-end Fee; 3) Prepayment Fee; 4) Commitment Fee; 5) Management Fee; 6) Arrangement Fee; 7) Structuring Fee; 8) Agency Fee - charged differ across banks and financial markets, depending on banks' individual pricing strategy and markets' competition and development. It is advisable for local governments to impose a maximum limit on early repayment fees, in order to maintain flexibility to refinance if market conditions improve. Table below contains some indicative values on fees and commissions charged by Romanian banks for loans granted in 2009.

Table 14– Average fees and commissions charged by Romanian banks for local government loans in 2009 (%)

Lg type	Fees to be paid at contract's initiation	Drawdown fee per drawdown	Fee for not drawing down on the credit facility per year	Monthly fees	Annual fees	Early repayment fees	Refinancing fees
Overall	0.69	0.38	1.19	0.07	0.57	1.64	2.87
County council	0.76	0.25			1.00	1.25	2.00
Municipality	0.60	0.43	0.50	0.05	0.62	1.75	3.00
Town	0.66	0.25	1.18	0.08	1.00	1.67	3.00
Commune	0.75	0.43	1.25	0.07	0.46	1.58	3.00
Village	0.38					3.00	

Repayment schedule – usually it should be specified by the local government, depending on the future liquidity needs, debt service of outstanding loans or projected revenues and expenditures. Debt repayment can occur in equal tranches, with progressively increasing/ decreasing amortization or based on a customized schedule. Most often repayment schedule is based on equal tranches. Bullet repayments[22] can also be considered as an option. However given the fact that local governments in most countries have limits placed on their maximum debt service, bullet repayment will result in loans of lower values than compared to a plain vanilla loan (amortizing). Frequency of payments can be monthly, quarterly, semiannual or annual; local governments should tailor the frequency of payments based on its projected cash-inflows (revenues), in order to avoid shortages.

Grace period - represents a period of time at the beginning of the loan contract (usually 1-3 years) when the local government pays only the interest on the outstanding loans (i.e. no principal payments). Grace period should also be determined by the tender; however a minimum accepted grace period should be specified in the tender documentation. It is important for the local government to understand that, although grace period eases down debt burden in the first years, it increases the overall cost of the loan.

Maturity – Infrastructure projects usually require large initial outlays compared to the local government budget. Long term-loans result in lower debt service burden for the local budget, which is easier to sustain from own revenues. Thus maturity should also be among the criteria used to assess banks' offers.

Refinancing possibilities – local governments have to ensure that they have the flexibility to refinance the loans if market conditions improve in the future. To this end, local governments should avoid entering a loan agreement which contains restrictive refinancing conditions, such as high refinancing commissions or constraints on where to refinance from.

Restructuring options – can also be foreseen in the tender documentation as criteria to evaluate banks' offers. Such options usually stipulate the conditions and fees under which a loan is restructured by extending its maturity or rearranging the debt service payments.

22 Debt repayment which occurs in one tranche at maturity.

6.3.3. Assessing the loan to identify the most competitive offer

To compare and discriminate across banks offers, the local government has to aggregate the loan components in a transparent and objective way. In this context, we present a comprehensive methodology by means of which a local government could sum up the assessment criteria:

a) Financial pressure of the loan on the local government budget: three aspects are important here, namely, grace period, maturity and debt repayment schedule. For each factor a score is assigned based on the following table:

Factor	Minimum score	Maximum score
Grace period	0 - Bank with the lowest grace period	10 - Bank with the highest grace period
Maturity	0 - Bank with the lowest maturity	10 - Bank that offers the highest maturity
Repayment schedule	0 - Bank for which the repayment schedule results in the highest debt burden* as a percentage of local government revenues	10 - Bank for which the repayment schedule results in the lowest debt burden as a percentage of local government revenues

** debt burden – calculated as the maximum debt service incurred in any period over the life of the loan*

Each factor should receive a weight, based on its importance for the local government. In general total weight of financial pressure on the aggregate score should not exceed 20-30%.

b) Overall effective cost incorporates besides interest costs all other fees and commissions that are due. It is calculated as the yield which discounts future cash-flows related to debt repayment (principal, interest and commissions) to the present value of the loan:

$$C = \sum_{k=0}^{m \cdot N} \frac{x_k + y_k + z_k}{(1 + \frac{r}{m})^k}$$

where: r – represents the overall effective cost of the loan

C – loan facility amount

N – maturity of the loan (years)

m – periodicity of debt repayments (m=12 for monthly payments, m=3 for quarterly payments etc)

xk, yk and zk – represent the fees and commissions, principal and interest payments paid at time k

If interest rate is variable, in order to be able to calculate a repayment schedule, the local government should specify a unique value for the reference rate, which will be used by all the banks when making the offer.

The Bank with the highest overall effective cost should receive a score of 0 whereas the bank offering the lowest overall effective cost would receive 10 points. The weight of this factor in the aggregate score should be high, around 40-50%.

c) Refinancing and early repayment fees: a similar evaluation grid can be used in order to assess the degree of flexibility which a bank offers in terms of refinancing options.

Factor	Minimum score	Maximum score
Early repayment fee	0 – Bank with the highest early repayment fee	10 – Bank with the lowest repayment fee
Restructuring fees	0 – Bank with the highest restructuring fees	10 – Bank that offers lowest restructuring fees

Each factor from this section should be weighted, so as to ensure an overall weight of around 20-40%.

The aggregate score is calculated from the weighted average score of individual factors described at points a, b and c. The Bank with the highest score should win the tender.

Figure 4: Example of identifying the best offer in a tender procedure

Local government "L" wants to borrow EUR 10 million for a local infrastructure project, with a maturity of minimum 10 years, repayment in semi-annual installments and a grace period of minimum 1 year. Following a short tender procedure, L receives offers from three banks:

Criteria	Bank A	Bank B	Bank C
Interest rate	Euribor 6M+3.5%	Euribor 6M+2.7%	Euribor 6M + 4%
Fees at loan disbursement	1% flat	1.5% flat	0.25% flat
Annual fees	0.30%	0.50%	0.20%
Maturity	12 years	15 years	20 years
Grace period	2 years	1 years	3 years
Early repayment fee	1.50%	2%	0.75%
Restructuring fee	1%	1.50%	0.80%

In terms financial pressure Bank C has the highest grace period, the longest maturity and the lowest maximum debt service burden over the life of the loan. Bank A has the lowest score in this respect.

Financial pressure

Factor	Bank A	Bank B	Bank C	Weight
Grace period	5	0	10	5%
Maturity	0	3.75	10	7%
Repayment schedule	0	8.2	10	8%

In terms of overall effective cost, Bank B has the lowest cost with an internal rate of return of 4.4%, followed by Bank A with 4.9% and Bank C with 5.2%. This results in the following score:

Factor	Bank A	Bank B	Bank C	Weight
Overall effective cost	7	10	0	50%

From the point of view of **refinancing and restructuring options** the best offer is from Bank C

Factor	Bank A	Bank B	Bank C	Weight
Early repayment fee	2	0	10	20%
Restructuring fee	5.7	0	10	10%

6.4. Securing liquidity for EU-funded projects' implementation

6.4.1. Borrowing for implementation of EU-funded projects

Grants offered by the European Union (EU) to both member and accession countries are a valuable contribution to the development of local infrastructure, services or administrative capacity. In member states such local government projects may frequently exceed 15 million EURO; indeed, they may come close to 100 million EURO as in the case of regional water and sewerage infrastructure. The value of the projects put forward by local governments in accession countries is smaller, but the benefits of financing local capital investment through EU grants are unquestionable nevertheless.

However, securing and spending EU financing are no easy tasks. While project preparation and contracting is not the realm of this paper, we will touch upon the instruments available to local governments to ensure liquidity for project implementation. The EU regulations and procedures require grant beneficiaries to contribute from their own resources to the project's eligible (up to 50% in revenue-generating projects) and ineligible expenditure. In addition, as a rule, the grant money is provided to the beneficiary local government as reimbursement of legal eligible expenditure, which means that local budgets have to cover fully the initial sets of invoices from local resources. Such requirements may have a negative impact on the cash available for recurrent operations of local governments and may cripple their capacity to provide other services. Hence, the need to make use of credit to pay for all or part of local contribution to EU funded projects without disturbing the other recurrent operations. Such a solution makes sense since much of the principal repayment is secured from the reimbursed grant; interest and fees will always be serviced by the borrower from its own resources.

Even traditional loans may undergo adjustments, usually under more favorable conditions than in case of loans for investment projects financed from the local government own resources. The existence of a Guarantee Fund, which can provide additional guarantees, would provide further support to this type of lending. For instance, in Romania numerous local governments, including rural ones, borrowed from banks to pre-finance[23] or/and co-finance[24] local capital projects with maturities ranging from 8 months to 2 years. Such practice is of course at variance with the recommendations of medium and long-term borrowing for capital investments, but it is a rational behavior given the reimbursement procedures and the scarcity of local budget cash at any given moment.

The actual pre-financing and co-financing needs may not be accurately estimated for a variety of reasons; the reimbursement process is likely to be delayed by lengthy clearance procedures or shortage of state budget resources; on the contrary, the payment of invoices may coincide with an influx of tax collections which provides the local government with enough cash in hand to meet all incurring commitments; or, the public procurement can result in a lower price than the initial estimations. Hence, a creditworthy local government may only want a credit line. The EU-funding for the project increases likelihood to obtain the financing. Also, subsequent to project implementation the operation of the investment can be financed by means of a working capital credit line.

[23] Pre-financing - full payment of initial invoices issued by project suppliers from the own resources of the beneficiary. The EU grant is subsequently pro-rata reimbursed on condition that all procurement and expenditure was legally processed.

[24] Co-financing - the contribution of the beneficiary to an EU-funded project. It includes part of the eligible expenditure and the ineligible expenditure. Variations in local contribution may occur as a result of national settlements; for instance, some countries cover from the state budget the contribution to eligible expenditure required from beneficiary local governments.

In other cases, local governments which are more confident in meeting all project commitments from local resources may still evaluate the need for a bank guarantee (or letter of guarantee) from a bank or a guarantee fund for fear of unexpected inability to pay invoices from suppliers at any given moment or as a prerequisite for advance payments. The costs of a bank guarantee include usually a fixed commission paid periodically to the issuing financial institution over the life of the guarantee and also additional guarantee fees paid to a Guarantee Fund if the letter of guarantee is secured.

Example

Bank guarantees for EU grant-funded projects in Romanian rural infrastructure

In Romania, the rural local governments which obtain financing from the EU-funded National Program for Rural Development (NPRD) may choose to receive advance payment before project inception (after public procurements is finalized and confirmed as legal) up to 50% of total eligible expenditure. The advance payment largely eliminates the need for a loan or a line of credit. However, the NPRD requires the receivers of advance payments to put forward a letter of guarantee from a bank or the state-owned National Guarantee Fund for Small and Medium Enterprises or the Guarantee Fund for Rural Credit. The letter of guarantee provides the management authority of the NPRD the option to call on the bank/ guarantee fund resources if the local government does not fulfill the requirement to repay the advance payment. The fee for the letter of guarantee issued by the two state-owned funds is set by order of the minister of agriculture. The guarantee may cover up to 110% of the advance payment. The collateral for the issuance of the bank guarantee is the local government's local budget revenue (i.e. revenue interception).

6.4.2. Legal incentives for debt aimed at local contribution to EU-funded projects

To encourage and support local government use of EU grants some countries conceive special provisions in the local public finance and debt legislation. Such provisions may have various objectives:

a) Simplify the debt approval process. Concrete measures could be:

- Eliminate the need for central government approval or
- Simplify the bureaucratic requirement for the approval process

b) Ensure all local governments which benefit from EU funding are permitted or able to take loans to ensure project liquidity. Specific tools could be:

- Make exemptions from existing conditions and limits to borrowing
- Provide state guarantees for loans taken to implement EU-funded projects by local governments or municipal enterprises which would otherwise not be deemed creditworthy.

c) Provide resources from national budgets to meet liquidity needs until disbursements are settled. To this end most obvious instrument is an advance payment of up to 30%-50% of total eligible expenditure upon the conclusion of the financing agreement. The advance payment allows the local government to pay the first invoices from suppliers, but there are no guarantees it would suffice until disbursements begin in earnest. Moreover, the disbursing authority will retain a certain amount of each disbursement to offset the advance payment.

As noted, there are various options available to governments willing and able to encourage local governments to meet EU-funded project liquidity needs through borrowing. The choices are obviously a matter of political and macroeconomic considerations at the same time. Countries seeking to cut budget deficits will not encourage borrowing, but might put more emphasis on advance payments. Countries with less developed local credit markets or with numerous small local governments may ponder the option of guaranteeing the latter's loans. Finally, countries trying to reduce the complexity and involvement of central government into EU-funded project implementation will allow local governments to borrow under privileged conditions.

6.4.3. Borrowing for EU-funded projects in south-eastern European countries

Out of the participating countries to this paper three are already members of the European Union, namely Bulgaria, Romania and Slovenia. Others are candidate countries and will one day be persuaded to take support measures for their local governments' absorption of EU funding. So far only the three member states adopted incentives for local governments to borrow for EU-funded project implementation. EU assistance for the other countries mostly takes the form of small projects wherein local contribution can be secured from own resources.

As stated above, countries have a wide range of support instruments to choose from. Bulgaria and Slovenia apparently chose a minimal approach, with only one type of incentive, while Romania has adopted a few.

Examples

Incentives to borrowing by local governments in European Union member states for the implementation of EU-funded projects

In **Romania** support to EU-funded local governments takes the following forms:

a. Debt taken to provide local contribution to EU-funded projects is exempt from the debt threshold and from the annual national threshold of contracting and disbursement. However, central government approval is still required.

b. Local government or regional water & sewerage company loans related to EU-funded road, water infrastructure, waste management, education and social assistance projects may guaranteed by the state through the National Fund for Loan Guarantees to Small and Medium Enterprises. The guarantees allow less creditworthy rural and town governments to borrow at lower costs or to attract lenders at all. In turn, the Ministry of Finance guarantees any lender the servicing of unpaid dues should any local government default. Subsequently, the MoF withholds general purpose transfers from the state budgets to the respective local government to recover the amounts it had paid to the lender. Loans guaranteed under this scheme benefit from the provisions at point a).

c. Advance payment to EU-grant beneficiaries is also available, up to 30%-50% of project eligible expenditure.

In **Bulgaria**, the central government provides local government with interest free loans for co-financing EU-funded projects (also called bridge financing). No state guarantees can be called upon.

Slovenian local government long-term loans secured to co-finance EU-funded projects are exempt from the debt threshold.

7. How to manage the credit?

Local governments can tap external resources using a wide range of borrowing instruments. However, each instrument is suited to finance only certain types of activities. Short term financing instruments include: (i) working capital credit line – local government draws funds from the credit line, on which they pay interest, to finance temporary revenue shortages; principal is usually rolled over, (ii) bridge loans are a special type of short term loan where financing for a capital investment project is provided for a transitory period until the main (long term) financing is obtained. Medium and long-term borrowing should be pursued by local governments when financing capital investment projects. Long-term borrowing to cover current expenditures is usually prohibited by law and must be avoided anyway.

Planning the structure of a financing package should be in line with a local government's debt management and capital investment strategy. When negotiating with the financial institution(s), local governments have to think at maturity, grace period, interest rates, fees, drawdown (loan disbursement), refinancing etc. After securing the financing package local governments have to generate enough revenues to pay for debt service and also allow for additional lending or direct investment. Unfortunately, when things do not go as planned, local communities must deal with loan restructuring and sometimes default.

Restructuring of a loan should be contemplated as an option when local governments enter a period of financial distress. Restructuring should be foreseen, whenever this is possible, from the beginning when the financing contract is signed with the bank. Restructuring of a bank loan usually involves the following elements: (i) refinancing, (ii) maturity extension, (iii) reshaping the debt service schedule to match the client's projected cash-flows, (iv) writing off a portion of the debt (haircut).

7.1. Types of loans and their recommended uses

As described in Chapter 3, local governments can tap external resources using a wide range of borrowing instruments. Each instrument is suited to finance certain types of activities and may be allowed or prohibited by national legislation.

National legislation in surveyed countries differentiates between **short term** and **long term borrowing.** Local governments can issue short term debt in most of the target countries to cover temporary shortages in revenues, in order to finance current expenditures (and ensure continuity in public services), refinance maturing loans, provide intermediary (bridge) financing for major investment projects, pre-financing loans for EU funded projects, or in some cases to fund capital expenditures (from within the fiscal year when the shortage is incurred). Short term loans have to be repaid by local governments usually before the year end from own funds or alternatively through a longer term credit facility.

The most frequent short term instrument is the *working capital credit line*. The local government can draw funds from the credit line based on their liquidity needs, on which they pay interest; depending on how the product is structured, local governments may be required to repay the utilized amount within one year or alternatively the drawn amount can be rolled over. Amortizing loans can also be used to finance short term deficits.

Bridge loans are a special type of short term loan where financing for a capital investment project is provided for a transitory period until the main (long term) financing is obtained.

Medium and long-term borrowing should be pursued by local governments when financing capital investment projects. Long-term borrowing to cover current expenditures is usually prohibited by law and must be avoided anyway. Loans for investment should be structured according to each project's characteristics and economic life. In this context, a local government can either apply for a *long term loan* or approach a *bond issue*. The loan should be structured to enable maximum financial flexibility for the local government at a competitive cost (long grace periods, customized debt repayment schedule to avoid overlapping peaks in debt service with previously contracted debt). Bonds can be more attractive than loans to finance long-term investments, as they have usually longer maturities than plain vanilla loans. However, bond issues should in general be structured with an amortizing repayment schedule; as a result of legal debt thresholds bullet bonds do not allow local governments to issue a significant amount of debt.

7.2. Debt management practices and recommendations

7.2.1. Planning the structure of the loan and its components

Local governments in former communist countries are facing many drawbacks in terms of planning. While planning was a mantra during communist rule, it was rejected as impossible or unnecessary afterwards. By late 1990s it became obvious that at least financial and investment planning were needed if local communities were to harness their development potential and the grants from European Union and other donors. By then the entire administrative context had changed and planning skills were no longer up-to-date. Planning in the new legislative, economic and political background was a totally different experience as compared to communist times.

Although it looks as a straightforward job, debt management is complex, especially in medium and large municipalities which can afford to take several loans at a time. Before taking a loan local officials must decide where to spend the money and over how long a period. When negotiating the loan, they have to think at maturity, grace period, interest rates, fees, drawdown (loan disbursement), refinancing etc. After securing the loan local governments have to generate enough revenues to pay for debt service and also allow for additional lending or direct investment. Unfortunately, when things do not go as planned, local communities must deal with loan restructuring and sometimes default.

Despite the importance of rational debt management most local governments do not have any specific strategies and therefore act on an ad-hoc manner. The conclusion holds true for the surveyed countries, too; the few examples of debt strategies that were put forward had mostly been developed by foreign technical assistance teams.

Taking all this into account, local officials must be familiar with some general practical recommendations regarding the debt they are contracting.

The data from the research in the target countries on South-Eastern Europe show that bonds, although considered as the best instrument for long-term capital investment, are rarely used. As a matter of fact, only Romania, Croatia and Montenegro have witnessed local government bond issues. Loans make for the vast majority of debt instruments. Hence, we will focus on loans in the next paragraphs.

It is important that local governments borrow in national currency especially in developing countries, where exchange rates fluctuate and inflation is considerable. Although national currency interest rates can be dissuasively high, debt service should be denominated in the same currency as budget revenues. If borrowing in foreign currency with low interest rates proves irresistible, then local governments should secure hedging provisions to shelter from national currency depreciation. Hedging agreements should be as detailed as possible about their nature (forward contracts or options[25]), the reference exchange rate, interest rate, fees etc.

Some countries, such as Kosovo, forbid borrowing in foreign currency altogether. From a different perspective, Slovenia, which is part of the EURO area, also forbids local government loans in foreign currency.

Ideally, the loan maturity should be equal to the investment's economic life. However, in volatile markets such as those in Southeastern Europe banks are reluctant to lend over long term in national currency. At the moment, in less developed markets maturities of local currency loans average 5-7 years while those in foreign currency may top 15-20 years. Inevitably the prospect of joining the European Union and adopting the EURO will increase the confidence of lenders in the macroeconomic policies so maturities for national currency loans will eventually grow. When that happens, local officials should aim for long-term maturities.

Grace periods are useful especially for loans given to revenue-generating activities, such as water, waste management, business parks, tourism etc. The grace period should last until the new revenues start flowing. This way the investments themselves will pay for the loan at least partly. Grace periods may also be used for infrastructure investment loans until the planned public works are completed. If needed, the local government may agree with the lender not to pay interest during the grace period.

Planning for debt service (both principal and interest) has to be correlated to revenue cycle, to the recurrence of other payment commitments and to the legal provisions for debt threshold. Local government must avoid the overlapping of multiple pay obligations at a time while lacking sufficient revenues. The revenue cycle of local taxes depends of the dates and number of pay deadlines. For instance, if property tax can be paid in two stages during the year, the local budgets will benefit from important flows of revenues around those dates. In the case of transfers from state budgets, including shared taxes, proceeds are generally transmitted monthly to local budgets. If such conditions hold true and taking into account the recurrent activities' pay commitments, it may be wise to structure debt service in correlation with periods when the most revenues are collected during the year.

Regarding the principal payment it is important to structure the amortization to fit existing debt service commitments and planned revenues. The objective is to avoid the overlapping of peak service for multiple debt instruments or other expenditure com-

[25] A forward contract will lock in an exchange rate at which the transaction will occur in the future. An option sets a rate at which the local government may choose to exchange currencies; if the current exchange rate is more favorable, then the company will not exercise this option.

mitments. Such a situation may endanger the recurrent service provision and also the observance of the legal debt threshold. Also, one must deal carefully with bullet debt instruments, which can break the threshold or deny room for additional borrowing at given times. As a conclusion, the amortization of the loan must be fine tuned. Local governments have the option of even, progressively increasing or progressively decreasing principal amortization. In the first case, the principal is repaid in equal amounts during the maturity period; in the second situation, debt service begins with smaller amounts which increase progressively until maturity; finally, progressively decreasing amortization starts with high values of principal payment and ends up with low ones.

As for the interest rate setting, in developing countries it should be weighed against a national of international reference rate, such as the interbank exchange rates determined by national banks (of European Central Bank). Fixed interest rates are useful in volatile markets, but also very hard to obtain for long-term loans.

Loan fees may often prove burdensome, but are inevitable. Lenders sometimes combine lower interest rates with higher or multiple fees to disguise the real cost of borrowing. Quite often low profile fees may eventually become additional interest rates. Examples of such recurrent fees are: management fee (paid regularly), drawdown fee, utilization fee, non-drawdown fee. In addition, there is a plethora of one-off fees: commitment fee, arrangement fee, agency fee, approval fee, analysis fee, insurance fee, originating fee, refinancing fee, early repayment fee etc. Local government specialized personnel must be very careful in measuring the cost of all fees in any loan offer. In many cases, they make the difference between a good and a bad transaction.

In the majority of the surveyed countries loan proceeds are held in accounts with commercial banks. Some banks may choose to open escrow accounts on behalf of the local governments and direct themselves the payments to suppliers. In a minority of cases, loan proceeds are held within the State Treasuries, along with the other local government resources (Kosovo, Macedonia, Serbia and Slovenia).

Drawdown (loan disbursement) depends on the type of debt. In the case of bonds all proceeds reach the borrower immediately. The respective local government should deposit the money to a commercial bank, if possible; until drawdown begins in earnest the interest from the deposit may cover part of the debt service. For example, in Romania, Bucharest municipality deposited 500 million EURO from its 2005 bond issue with a commercial bank; for two years, the gains from the deposit were enough to pay the interest rate of the bonds.

In the case of loans, banks usually refuse to put all loan proceeds at the client's disposal. In addition, they sometimes ask to verify the invoices from suppliers to ensure the payments are in keeping with the loan objectives. In such cases, drawdown takes place on demand from the local government. All loans have a drawdown plan; on the other hand, breaking the plan prompts some banks to charge non-compliant local governments a non-drawdown fee.

7.2.2. Keeping options open: budget planning during debt service

Debt servicing should not make use of all operational and capital surpluses. It is important that local governments preserve and plan for a resource-buffer for unexpected pay needs or costs incurred by additional borrowing. The budgetary indicator of such a buffer can be called net balance after existing debt service (or net result) and is determined with the following formula:

NBADS = [(recurrent revenues - recurrent expenditure) + (capital revenues - capital expenditure)] - (interest rate + principal)

where,
(recurrent revenues - recurrent expenditure) = operational balance
(capital revenues - capital expenditure) = capital balance

Net balance after existing debt service provides information on the capacity of a local government to take and service additional debt. It has to be estimated over the maturity period of the new debt instrument. The estimation can be calculated as follows:

- assume the three-year average structure and weight of operational and capital expenditure remain unchanged,
- add the planned debt service for existing debt (direct or guarantees).

If the results are significantly positive values, then the local governments may plan for another loan. However, the new debt service has to fit within the estimated values of the net balance. In the results are close to zero or turn negative, the local government has the following options:

- trim estimated revenues and/or expenditure,
- restructure existing debt instruments so as to reduce debt service,
- plan for a different structure of the new loan (e.g. longer maturity, customized debt service).

As far as revenues and expenditure are concerned the decisions lay with local elected officials. On the side of revenues, the options are to improve collection and/ or to increase tax rates, fees and charges. Unfortunately, many Southeast European countries limit the increase of tax rates. Local officials are inclined to use it as a last resort anyway. Collection improvements usually yield only marginal gains unless structural changes are undertaken (e.g. taxing properties at market value, full revision of tax inventory etc).

Hence, most savings can be made by trimming expenditure. As a rule, capital expenditure should not be significantly altered. Instead, local governments are set to save resources if they:

- cut administrative costs by merging separate entities and use resources jointly (car fleet, human resources, budget & accounting, legal services etc),
- cut the costs of purchasing goods and services by carrying out unified/ single public tenders for all local entities (e.g. for food, mobile phone subscription, replacement parts, consumables, fuels etc),
- close service provision in inefficient locations: schools, social assistance units, libraries, cultural centers,
- outsource services to private companies (e.g. waste collection, water & sewerage, public transportation, road works etc). Although some local officials and practitioners blame outsourcing for cost increases, they can be proven wrong provided public tenders are correctly carried out and service contracts allow for cost adjustments. The experience shows that determined local officials have managed to extract significant cost cuts from contractual suppliers.

7.2.3. What if debt restructuring is unavoidable?

Restructuring of a loan should be contemplated as an option when local governments enter a period of financial distress. Restructuring should be foreseen, whenever this is possible, from the beginning when the financing contract is signed with the bank.

Financial distress arises when a local government encounters serious difficulties in paying its obligations. This can be the result of a decrease in revenues following an economic downturn or an increase in current expenditures (due to increased responsibilities that are not matched by appropriate increases in revenues) or a rise in debt service obligations (due to a rise in interest rates or exchange rate depreciation) or a mixture of the above elements. Additionally, bad management capacity can also be responsible for such a situation.

Banks usually consider restructuring as a first option when clients enter into financial distress (especially in case of corporate clients). They regard foreclosure and seizure of clients' assets and/ or bankruptcy only as alternatives of last resort. It is advisable for local governments to communicate with the bank and design a restructuring plan before arrears on bank debt occur.

Restructuring of a bank loan usually involves the following elements: (i) refinancing, (ii) maturity extension, (iii) reshaping the debt service schedule to match the client's projected cash-flows, (iv) writing off a portion of the debt (haircut).

8. How local government associations can help improve the local debt legislation and credit market

Local government associations are voluntary membership organizations, which comprise local governments from within a country or region, acting as an effective and authoritative advocate on members' behalf in relation to central government, the parliament, potential investors and other stakeholders. With regard to local public debt local government associations should aim to (i) create and/or improve appropriate legislation, (ii) monitor the impact of relevant legislation, (iii) provide information and statistics to potential lenders, central government and other stakeholders and (iv) assist member local governments to develop and improve debt management plans and operations. To these ends, local government associations will concentrate their actions as follows:

A. In relation to lenders - mediating communication and information flows between local governments and potential investors

B. in relation to member local governments - providing assistance to members in structuring and financing investment; maintaining ongoing communication with member local governments to set/develop best practices in accordance with international standards

C. in relation to central governments and parliaments - to lobby and campaign for changes in policy, legislation and funding on behalf of its members.

8.1. In relation to lenders

As outlined in earlier chapters, local credit markets in emerging economies lack the functionality of developed economies; financial institutions' willingness and capacity to finance local governments is reduced by the low degree of knowledge and transparency of local finances. In this context, associations can play a crucial role in bridging this information gap and thus may contribute to a better understanding by lenders of local economics.

Local government associations should centralize and disclose publicly, if possible on a website, **information about member local governments**, which would help financial institutions identify potential lending targets based on their internal credit risk policy. Data should be updated regularly and presented in a standardized format that would enable comparison and benchmarking analysis across member local governments. Information should also be provided about important data that could be of interest to potential investors – e.g. statistics on local economy of each LG, list of projects to be financed, financial figures or political structure of the LG decision taking body.

Information about geographical positioning, natural resources demography as well as the **dynamics and structure of local economy** would enable potential investors/ lenders to have an accurate overview over a local government's medium and long term revenue generation potential and implicitly over its indebtedness capacity.

Detailed financial statements of individual local governments should be compiled and published regularly on the associations' website. They should include consolidated budgetary executions, balance-sheet data as well as information on arrears and off-balance sheet items (e.g. contingent liabilities). A historical outcome (at least 3-5 years) of each local government's financial position should also be made available. **Legislation on local public debt** has to be well understood by lenders. Legal provisions for the purpose and tenor of loans as well as limits on maximum indebtedness level should be clearly identified and outlined on the associations' website. Lenders could correlate such information with current indebtedness as well as other financial indicators to determine the additional indebtedness space for individual local governments.

Associations should centralize and market to potential lenders major **investment projects** for which member local governments seek external financing. To this end they should also collect and disclose the latters' capital investment strategies. A solution to increase accessibility and transparency could be the development of an electronic platform where members could upload a detailed description of their future investment projects over a longer time horizon (3-5 years), prioritized by their importance and financing requirements. Thus, interested investors/ credit institutions would find out about the local governments' investment plans in advance and would have time to analyze and decide when and where to allocate their resources. Eventually, the associations could bring together member local governments and financial institutions in discussion forums, where the former would present their capital investment strategy and outline/describe the most important projects.

Initiatives to increase awareness on local finances among lenders should also be priorities of local government associations in relationship with potential investors. Organizing seminars focused on issues related to the functioning of local public finances would increase investors' knowledge and could result in more willingness to finance this sector.

Local government associations may get involved in the **development of local credit markets** by lobbying at the central government level and international financial institutions for the creation of market enhancement mechanisms. As described in Chapter 5, the existence of municipal guarantee funds, the establishment of state-owned banks specialized in municipal lending or the founding of municipal development funds can stimulate the development of credit markets in their early stages.

8.2. In relation to member local governments

The perception about financial markets among inexperienced local governments is usually incomplete, which leads to inefficiencies in terms of structuring, contracting and servicing financial debt aimed at funding investment projects. In this context, local government associations should assume a proactive role, by helping members to better understand the mechanics of credit markets and thus to be able to make the right decisions when they access debt financing.

Setting up a database with loans contracted by member local governments – including transaction details such as interest rates, commissions and fees, grace period, maturity, amortization schedule or refinancing options – would enable associations to have an extensive overview of the market's activity. Moreover, they could carry out **regular market surveys** to collect lenders' offers for standardized financing products. The results of the monitoring analysis could be compiled into a periodical bulletin and sent out to members.

Depending on market conditions, associations should advise members when to pursue debt financing. For example, at times of financial market distress, with low liquidity and high risk premiums – as it was the case during the recent global financial and economic crisis –, debt financing can be difficult and expensive. In such cases, associations could work out with local governments to prioritize investment expenditures and postpone them, if possible, until market conditions resume to normal.

Local government associations should issue recommendations, based on identified best practices, on how members should structure tender documentation when contracting loans or issuing bonds. Depending on the type of investment project and the financial position of the contracting local government, different requirements can be included in the public procurement documentation. Designing the criteria for identifying and selecting the best suited offer is also an important aspect that needs to be addressed by associations.

8.3. In relation to central governments

General remarks

The relationship between local government associations and central governments in the design of legislation regarding local public finance and debt is decisive. Local governments should make every effort to develop and consolidate a cooperative relationship with central governments as a first necessary step in the pursuit of their aims.

The relationship may be institutionalized or ad-hoc. In the former case, a national regulation should provide that draft legislation influencing local governments must be separately discussed and debated with representative associations. The names of the associations should be clearly stated. In addition, a procedure should be laid out dealing with at least the following issues:

- the type of draft legislation to be consulted with local government associations (laws, government resolutions, emergency ordinances/ legislation, minister orders etc);
- the areas of legislation to be consulted separately with local government associations (anything that influences the operation of local governments or a limited number of areas - finance, allocation of expenditure responsibilities, human resources etc);
- the phase(s) when the consultation takes place (before the final approval decision, before or after the first draft is completed, before endorsement by the initiating central government institution etc);
- the forms of consultation (written communication, meetings, conferences etc);
- the deadlines for written communications (for instance, the line ministry would expect feedback from the associations in 10 days from communication and 3 days in emergency situations);
- the report on the consultation procedure and the associations' points of view should be included in the description documentation accompanying the draft legislation to the decision-makers;

- the sanctions for non-compliance with the consultation procedure (challenges to the administrative/ constitutional courts, fines etc).

The ad-hoc relationship does not require special consultation with local government associations. This can be carried out as part of the general public consultations. Special local government consultations take place only if the central government deems necessary. In certain situations, central governments may deliberately seek to avoid discussing to local government associations and stick to the minimum legal requirement for transparency. As a result of this approach the message of local government associations may dilute into a melting pot or may not be heard at all.

Consequently, it is wise for local governments to push for an institutionalized relationship with central governments as a prerequisite for successful influence on national legislation.

Example

Compulsory consultation of local government associations in Romania

In Romania the relationship between the four local government associations and the central governments has been institutionalized since 2005 when a Government Decision laying down a special procedure was passed (G.D. no. 521/2005). The procedure requires all central government entities to consult the associations on every draft piece of legislation with direct impact on local governments 15 days (5 days in emergencies) before the approval/endorsement by the heads of the respective institutions. To this end, central government entities must assign contact persons and departments with specific responsibilities. Local government associations must send feed-back within 5 days from the reception of the draft (3 days in emergency cases). The associations' opinions and the conduct of the procedures are included in a report attached to the draft piece of legislation and also conveyed to the Ministry of Administration and Interior (MoAI). The associations should inform quarterly the MoAI about the pieces of legislation which have been approved without consultation, their impact and related proposals for improvement. In turn, the ministry is required to present a quarterly general report to the government on the application of the consultation procedure.

In practice the procedure has been fairly well observed, but it does not compel the central government to accept the associations' proposals. At times, the consultation is not conducted at all, but such cases are rare. Local governments have challenged to the administrative court government decisions approved without consultations, but to no avail. Finally, the quarterly reporting requirement from the associations and to the government on the conduct of consultations is not met by any stakeholder. As a conclusion, the consultation procedure has improved considerably the relationship and the influence of local government associations over central government legislation. Currently, whenever draft pieces of legislation are developed the ministries approach the associations by default. However, there are still situations when the consultation is not properly carried out. Also, sometimes the associations are overwhelmed by the multitude of feedback requests and fail to answer appropriately if at all.

Central governments may not always know the demands and grievances of local communities. Hence, the heads of the associations should seek to meet the members of the government and other decision-makers as often as possible. Also, local government associations should develop the habit of regularly informing the government and line ministries about their status and most pressing problems. Such reports should be send regularly and include tangible and reasonable solutions; the associations should be aware that no ministry gives attention to radical or unrealistic proposals. Finally, local governments could invite central government experts to visit their premises and experience firsthand how the legislation is implemented and what problems are encountered.

8.4. In relation to Parliaments

Local government lobbying for better regulation on local public debt must not stop once the draft piece of legislation is developed and endorsed. In the case of laws, local government associations should continue to their work within the parliaments. Although parliaments do not practically draft much of the legislation they approve all laws and emergency ordinances put forward by central governments. In effect, members of parliament (MPs) have the last word on any draft which is set to become law. Hence, local governments associations must devote time and appropriate expertise in lobbying parliaments to ensure that approved legislation meets their objective.

Parliaments work in special committees and general assemblies. Most debates take place in committees; in this context, stakeholders can be invited to take part. Committee debates do not usually have a detailed technical content; MPs are more concerned with political objectives of the draft laws and particular situations arising from their constituencies. The central government representatives take part in the committee hearings by default. Local governments should also make sure their voice is heard especially if they are seeking specific aims. If invited, the associations should not send only technical staff, but also local elected officials wielding political influence in their parties, such as mayors of big municipalities. They are more likely than central governments to convince the MPs because they are credible representatives of local communities.

In parallel, local government associations must seek to develop a permanent relationship with the MPs and technical staff from specialist parliamentary committees in a similar way to that with central government experts and decision-makers. Such a relationship greatly enhances the associations' powers of persuasion and also allows them to by-pass the central government if needed.

As regards the legislation on local public debt, local government associations should pursue the same specific goals outlined above making sure the content of draft laws is not altered against their wishes.

8.5. In relation to donors and international financial institutions

The scarcity of resources which the local government associations can draw from their members should prompt them to look for alternative funding. To this end, donors represent the the most likely source of funds. The European Union, the United States Agency for International Development and the likes may provide much needed technical assistance and funding to the associations' projects. Donor aid can materialize in direct support to member local governments. In the case of local public debt, the associations could draw technical assistance for development of analyses, handbooks, draft legislation, local debt strategies and even carrying out credit ratings.

As regards international financial institutions, the associations could play a role in facilitating contact to member local governments and promoting local credit market enhancement mechanisms, such as development funds or guarantee funds. Such examples are already present in South-Eastern Europe, as already described through the paper.

Annex 1 – Case studies

CASE STUDY

Serbia – Uzice regional solid waste treatment facility/EBRD loan - City of Uzice, Serbia, (83.022 inhabitants, last official census in 2002)

Short description of the experience:

The nine local government units from the region around city of Uzice have agreed on the construction of an EU-standard sanitary landfill called "Duboko" for solid waste to serve their residents. The project further includes a waste separation line at the landfill site, the construction of waste transfer stations in each of the local government units, and closure of existing dumpsites in each of them.

The Duboko region comprises the cities of Uzice and Cacak and municipalities of Cajetina, Pozega, Kosjeric, Lucani, Arilje, Ivanjica and Bajina Basta and is located in the western part of Serbia. Population in these LGs is estimated at around 371,000. The region is not a separate legal entity but has been defined exclusively for the implementation and operation of the "Duboko" Regional Landfill Project. For the purpose of the Project, participating municipalities have established the inter-municipal company called "Public Utility Company Duboko". Duboko will be the first Regional waste management plan in Serbia and because of that it will also be comparative project for other regions in Serbia. Goals of the Project are improvement of services quality and operational effectiveness.

The main component of the project financed by EBRD loan is construction of landfill for 500.000 m3 of waste. Additionally, preparation of location and access roads will be completed as well as sewerage for waste water and natural gas installations. Also, separation line for recycling organic waste will be constructed, than construction of waste transfer stations in 8 municipalities together with trucks for waste transportation and costs for consultant supporting the project implementation are financed by EBRD loan.

The whole process was done through rather innovative arrangement between nine municipalities, joint public utility company and the EBRD as financing bank. The whole arrangement includes 5 separate contracts signed by these parties: loan contract between EBRD and joint utility company Duboko, contract on inter-municipal support between joint utility company and 9 municipalities and EBRD, contract on pledge on joint public company bank accounts between EBRD and joint utility company, contract on waste disposal between Public Utility Company Duboko and Public Utility Bioktos Uzice and contract on waste disposal between Public Utility Company Duboko and Public Utility Komunalac-Moravac Cacak (this means that joint public company has contracts with public utilities for waste collection from two biggest cities out of total 9).

Borrowing instrument used for financing this project was bank loan provided by EBRD, total amount of 5 million euro. On the top of this grants were provided by European Agency for Reconstruction (2.9 million euro) and Serbian Government Ecology Fund (1.1 million euro). Finally, participation of municipalities themselves will be 3.1 million euro. Total project investment finance is 12.1 million euro. For purposes of this example, only EBRD loan is relevant and will be elaborated.

Total amount of EBRD loan is 5 million euro and will be disbursed in total or by installments not less than 100.000 euro each . The loan is euro denominated. Front payment bank fee is 1% of the loan (50.000 euro) and assessment fee is additional 30.000 euro. Also, loan user will be obliged to pay 0.5% annually for total outstanding loan amount which hasn't been used by the loan user on initially agreed periods. The loan will be repaid in 10 equal semi-annual payments (on 10^{th} of June and 10^{th} of December each year) starting from June 10^{th}, 2011. The date of the loan agreement is March 20^{th}, 2008. For premature loan repayment, loan user will pay fee to the bank equal to 3% of the principal which is prematurely repaid. The interest rate is Euribor plus margin equal to 3%.

Strong points/critical factors of the experience and what were lessons learned and/or solutions found?

The whole project is still in implementation phase and under construction so it is too early for lessons learned. Regarding the loan itself, it is still in the grace period since repayment of the loan will start from June 2011.

However, some solutions found or critical factors can be pointed out:

1) this was the first time that group of municipalities on regional basis are entering rather complexed financing arrangement including the bank loan, specifially since the loan is coming from international financial institution like EBRD

2) this arrangement has one additional unique feature which is related to collateral or guarantee; according to Law on public debt local governments in Serbia can not issue guarantees for their public utilities so this was overcome by sophisticated contracts arrangement between municipalities, public utility and the bank itself in a way which is giving the bank enough confort to enter the investment

3) this example shows that municipalities grouped together can attract bigger investors like EBRD and can get more attractive borrowing conditions than ones existing on local market

4) this kind of inter-municipal cooperation was able to attract additional support in the form of grants coming both from EU funds but also from Serbian Government funds

5) potential negative feature of this loan agreement is contract provision which is regulating bank fee for funds not withdrawed as planned (bank fee for committed and not used funds); this can prove to be significant having in mind usual practice of delayed implementation of specific phases regarding construction projects in Serbia.

Information available on this experience and its context and background

Official website of Public Utility Company Duboko, Uzice -
http://www.duboko.co.rs

Officail website of European Bank for Reconstruction and Development (EBRD)

http://www.ebrd.com/pages/project/psd/2006/37033.shtml

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CASE STUDY

Croatia – Municipal Bond aissue, examples of City of Koprivnica/Rijeka

Short description of the case:

This example of selecting the agent and procedure of issuing of municipal bonds reveals how the process in Republic of Croatia. Municipal bonds are debt securities that the local government as the issuer agrees to return within a specified period borrowed funds to a particular interest. Collected funds are invested in projects of local and regional significance. Municipal bonds are one of the safest securities because of their guaranteed payment of county, city or municipality and shall be properly traded on the securities market.

General information on the amount involved:

The amount of money involved in the borrowing experience:

City of Koprivnica:	HRK 60 mln = cca. EUR 8.2 mln (in June 2004.)
City of Rijeka:	HRK 180 mln = cca. EUR 24.5 mln (in May 2006.)

Period of the project: June 2006- June 2008

General aim of the experience and specific objectives:

Croatian market debt securities consisting of long-term and short-term securities. Long-term securities are bonds or bonds with a state guarantee, as well as corporate and municipal bonds, while short-term securities are Treasury bills issued by the Ministry of Finance and commercial records company. On the Croatian market are traded Eurobond issuers of Croatian. Development of the domestic corporate bond market started the beginning of 2002. Corporate bonds recorded significant expansion in the domestic market during 2004. Three homemade books (EUR 117 mil.) and a parallel version in the domestic and international markets contributed to the promotion of this way of external financing of enterprises in the domestic market. Most domestic editions of corporate bonds are bonds with indexed or denominated in euros, were issued with fixed coupons and principal payment at maturity with semi-annual payment of interest.

At the Zagreb Stock Exchange in late 2005, there were a total of 20 listed bonds in the first quotation (Official Market) of which is 10 bond issues of Croatian

State is associated institutions (HBOR), 8 corporate edition (Agrokor, Atlantic Group, Beliš e, Bina-Istra, Hypo Alpe-Adria- Bank, Medika, Pliva and Podravka) and 2 issues municipal bonds (City of Koprivnica and the City of Zadar).

In Croatia, the two editions were issued municipal bonds. Bonds City of Koprivnica has been issued in three tranches in 2004, the total nominal amount of EUR 60 million, with the deadline expiry Juny 29, 2011 .

Bonds of City of Koprivnica is amortization bonds. That means the principal of the bonds shall be payable in 14 semi-annual installments to be paid on the due date and 1 / 14 of the principal. Bonds is included in the first quotation (Official Market) of the Zagreb Stock Exchange and the first quotation Varaždin Stock Exchange. Since its listing on the Zagreb Stock Exchange by mid-June 2007. total turnover of this bonds was amount HRK 49.6 mln..

The first tranche of bonds issued to the City of Rijeka on July18 th, 2006th in the amount of EUR 8.191.504,00, and the second tranche of the May 17th, 2007th in the amount of EUR 8.191.504,00. Also in 2008th was released the third tranche of bonds the City of Rijeka in the amount of EUR 8.191.505.00 and the total amount of bonds the City of Rijeka in circulation in 2008. amount to EUR 24.574.513,00. Finally the principal portion of the bonds is July 18th, 2016th. Bonds of City of Rijeka is also amortization bonds. Since its listing on the Zagreb Stock Exchange by mid-June 2007. total turnover of this bonds was amount HRK 7.1 mln.

City of Koprivnica edition of municipal bonds has financed the building of city swimming pool, high school and communal infrastructure.

Brief overall, narrative, description of the experience:

In Republic of Croatia, in accordance with the provisions of Article 5 of the *Public Procurement Act* (Official Gazette No. 110/07) and Article 4 *Law on Amendments to the Law on Public Procurement* (Official Gazette No. 125/08) it is not necessary to organize a public tender for selection of agent and underwriter of municipal bonds.

First of all, before applying for borrowing the Croatian Government and the terms in which these procedures should be implemented, the procedure (in Republic of Croatia) goes:

- selecting the bank which will transact business underwriter of municipal bonds
- a decision on choosing the bank sponsor brings city or municipality council,

- decisions about the city borrowing by issuing municipal bonds to qualify for the domestic market which will in accordance with the *Rules of Procedure of borrowing* will be determined by purpose of borrowing (clearly defined projects for borrowing) the name of the bank underwriter of bonds, the amount of bond issues, bond maturities and other characteristics bonds as the best bid is selected bank - underwriter - a decision made by the city or municipality council,

- decision on accepting capital projects with a clear purpose brings city or municipality council.

After making these decisions about borrowing and acceptance of capital projects, city or municipality council sends Croatian Government *the Application* for issuing approval for borrowing. Application with the aforesaid decision, submitted documentation prescribed in Article 10 *Rules of Procedure of borrowing of local (regional) governments* (Official Gazette No. 55/09) and providing guarantees for borrowing by district (regional) governments. Application for approval for borrowing and issuing guarantees submitted mayor or Mayor (of the city) or prefect.

With the application municipalities, cities and counties submitted the required attachments and documentation, as follows:

- adopted the budget plan for the year in which the borrowing. General part of the plan budget, the revenue account and expenditure account includes funding from the planned receipts from financial assets and borrowing and expenditure for the financial assets and repayment of loans. In a separate part of the budget plan should be transparent expenditure for procurement of fixed assets for which the county, city or municipality borrowing.

- coordinated plan for development programs in which the listed investment by borrowing from sources of revenue for the overall performance of the investment and display all expenses related to investment, which will be charged to the budgets next year,

- decisions regarding the execution of the budgets of local or regional government for the budget year in which the specified amount of new debt and / or guarantees during the budget year and the expected amount of total debt at the end of fiscal year,

- decisions of the representative body of the acceptance of investment with a clear purpose. If an investment is financed more subjects, it is necessary to submit a draft agreement on co-financing,

- decisions of the representative body of the assignment, giving assurances and approvals. The decision contains the purpose of investment and the name of the creditor / donor of the loan in accordance with section 7th this article - that means proposed contract or letter of intent lenders / service the loan with loan terms and repayment schedule with all the listed conditions (amount of credit

/ loan repayment period, interest rate, grace period, assets of insurance and other costs),

Of *the Application* for borrowing Croatian government decision within 40 days after *the Application*. After receiving approval follows the process of making bond prospectus and application to the *Committee for the Croatian securities* for approval of the prospectus. After receiving the decision by the *Committee for the Croatian securities* approval of the prospectus following bond issues and the primary sales of bonds. The time period in which the prospect of making bond and term bond issues shall be determined after the procedure and the selection of the bank - municipal bond underwriter.

After the procedure of collecting bids for conducting underwriter of municipal bonds, the city or municipality council hired an authorized brokerage company for business consulting and development of the *Information Memorandum*. Now follows the selection of the bank will transact business underwriter of bonds. Underwriter of bonds guaranteed by the registration of the total bond amount, regardless of the investor interest for the registration of bonds in the primary market and the bond issuer pays the full amount of funds on behalf of registration of bonds. As I wrote before, to select the bank underwriter is not necessary to conduct public procurement procedures with regard to the fact that the acquisition of financial services in connection with the issuance, sale, purchase or transfer of securities or other financial instruments, brokerage services, and services central bank does not apply the provisions of the *Public Procurement Act*. In accordance with the recommendation of consultants, the bank underwriter has selected in a way that large banks in Croatia and who are authorized to trade securities, make a call for tenders for conducting underwriter of bonds. The text calls on all essential elements on which banks may be submitting a proposal, drawn up earlier selected consultant.

With the invitation, *Committee for conducting municipal bond underwriter* (appointed by the municipality or city) deliver to the potencial banks and *Information Memorandum*. Information Memorandum is designed in a way that the bank, interested in business sponsorship of bond issues, provides a comprehensive economic picture of the economic and social environment interested municipality or city, information on strategic projects and asset management, a review of revenues and expenditures of local budget, legal framework for borrowing, a description of projects which will be financed from funds generated from issuing bonds to financial and schedule of investments and the proposal of the basic elements of bond issues under which the bank gives its offer.

Committee evaluates the submitted bank *bids*, and two best bid has been selected for the second round of negotiations and establishing the final conditions of bond issues, after which the *Committee* proposes to the city or municipality council the making decisions about choosing of the bank - municipal bond underwriter.

After selected bidders - bank underwriter is going to make *prospectus*. Prospectus for the issuance of municipal bonds must be approved by *HANFA (Croatian Agency for Supervision of Financial Services)*. Before an issuing municpal bonds, city or municipality must join to *SKDD (Central Depository Company)*. After that bonds is going to issue, in this case, in dematerialized form, the name and denomination of 1 HRK. Interest will be calculated at a constant annual rate, in this case of 5.50%. Interest will be paid semi-annually in equal amounts. Repayment of principal on bonds is amortizated, in a way that will repay the principal on bonds over the past five years to maturity of bonds in the amount of 20% per annum.

Information available on this experience and its context and background:

Maybe you can provide here links to documents available on websites.
Here are some links of *prospectus* for the issuing of municipal bonds:

www.rijeka.hr/fgs.axd?id=11298
www.rijeka.hr/lgs.axd?t=16&id=19013
www.zse.hr/userdocsimages/**prospekt**i/GRVI-O-17AA-**Prospekt**.pdf

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CASE STUDY

Albania - Improving secondary and local roads –an initiative of Albania Government supported from World Bank and implemented from Albania Development Funds.

Main Objectives:

- Improvement of the transport conditions in the rural areas;
- Facility in access to marketplaces;
- Improvement in access to administrative, educational and health services;
- Contribution to the economic development via employment and creation of conditions for the rural development.

Goal:

This program aims at improving the access to basic services and at increasing the opportunities of economic, agricultural and tourist development for the beneficiary population via the provision of asphalted roads for the inhabitants in the hinterlands of the project roads.

Expected results:

- Reduction in vehicle journey time and relevant expenses.
- Reduction of expenses on vehicle maintenance by road users.
- Increase in access to health, educational and administrative facilities as well as the increase in access to regional markets;
- Increase in traffic volumes on project roads.
- Increase in positive expectations by road users regarding quality of roads.

Short description of the project implementation

This project has as objective to improve the access in the basic services and to increase the possibility for economic, agriculture, touristic development for the rural population profitable in the improving roads areas. The project it is expected to achieve this objective through: (i) improve priority segments of the secondary network and local roads in all the Albania; (ii) using maintenance contracts by contracting private sector for the local roads network; (iii) empowerment of responsible organism for managing local roads network and (iv) consolidating institutions responsibility for managing and planning the maintenance and the investments in secondary roads.

This program includes about 1,500 km secondary and local roads, with an amount of 400 million USD for the entire program. The project has started the implementation in December 2007 and actually includes the most important regional axis in 12 counties in the country. Actually the following projects are in implementation in total: 100 million USD; World Bank (20 million $), OPEC Fund (15 million $), Albania Government (5 million $), CEB (56 million $ or 40 million Euros) and IPA program 2008 (11 million $ or 8 million Euros)}. Also, are being draft financial agreements with 40 million USD with IDB, 50 million Euros with BERZH and BEI and 70 million USD with Japan Government.

The main component of the project:

Component 1: includes infrastructure works to improve the segments of secondary road network (regional). Due to the amortization of the road, the interventions of this component are the rehabilitation and reconstruction of the road. The entire pavement is done through new asphalt and with the necessary under floors. The rehabilitation works includes the construction of new podium and paving the new asphalt.

Component 2: includes civil works accompanied with improvement in the local road network (roads in the commune or in the municipality). This local road network was in very bad conditions, that's why it was intervene in the rehabilitation and reconstruction. The pavement of the new asphalt in the secondary roads projects, as well as the rehabilitation works includes the construction of the new basement and the pavement of the new asphalt. Attention was pain also to the roads safety and the environment protection, protecting and using the contemporary parameters and standards.

Component 3 – Implementation and Institutional Support

This component finance giving technical support, buying merchandise as well as financing operational expenses which facilitate the project implementation, especially capacity building of ADF and local government.

Feasibility Analyze.

The evaluations of primary and secondary works are done through using a process of two phases with multi-criteria analyzes. The first phase includes local government units in the identification and delivering of their own projects to be financed from the project, which latter on were evaluated and listed from ADF according to several criteria (used in the program of competitive grants).

These criteria include:

- The impact in the social and economic development, the approach of the project with the local/ regional strategy.
- The impact in reduction of poverty and increasing the access in the basis services;
- The direct beneficiaries;
- The physical roads condition that will be reconstructed;

The projects that will be selected are evaluated according to a contemporary method of cost-benefits or cost-efficiency, following the World Bank models.

The second phase the analysis costs-benefits which is been undertaken (CBA) consists in the comparison of two alternatives one of the given example (or doing the minimum) and the proposed alternative of reconstruction in the project (scenario of the project). The result of this analyze gives the percentage of economic return (ERR) of 16%.

The selection of the priority roads segments is done through an open and transparent method. In the first phase of the project ADF has included the local government in identifying and presenting the priority projects toward to several criteria sent to the local governments units and published in the web-page of ADF. These priorities are ranked by ADF according to others criteria published as well. The final criterion includes the socio and economic impact such as: influence in agriculture production, promoting natural and cultural tourism, the impact in reducing the poverty and community participation in the decision-making process.

The local government is requested to introduce a yearlong plan for the contraction of the maintenance, as a precondition for the project on going and in ensuring its sustainability. The evaluation process and the lists with the project ranking are being published in the web-page.

The progress of the project. The project has started in December **2007** with these activities developed until today:

Selecting the implementer agency, ADF. In accordance with the World Bank Mission in June 2007, Albanian authority confirmed the Albania Development Fund as the implementer agency of the project. The Albanian Development Fund has a large experience with the implementation of the World Bank projects starting from its foundation in 1993, including here the latest project on going, Works in the Community II.

The goal of this project is to: Improve the living conditions of the rural population by drafting the local development plans for the communes which possess potentials for the economic development especially in tourism.

Objectives:

-To encourage sustainable socio-economic development.
-To improve communal infrastructure.
-To strengthen government at local level.
- To increase community role at governance via participative approaches.

Expected results:

- Drafting of narrow sectoral plans for 16 Communes,
- Drafting of Spatial Plans (Petrele, Ulez, Velipoje),
- Drafting of Tourism Development Plans (Ishem, Petran, Qender-Vlore).

Preparing phase of the project. During February the British company "Roughton International" has started working as a consultant in drafting the project. As part of the contract the company is finalizing technical projects and tenders documents for the first phase of the work. This plan includes the selected areas in 12 counties of the country. In the end of 2008 the company in collaboration with the ADF has prepared or reviewed technical projects ready for procurement 400 km of regional and local roads.

The first phase of the plan. The first phase of the plan has started during 2008 and consists in the reconstruction of 12 important regional areas in 12 counties with the financing of WB, OPEC, and Albania Government including designing, supervising and technical assistance. The selection of the segments for the financing has been realized with a large participation of the beneficiaries. ADF in collaboration with the international consultancy (ROUGHTON International) has realized a full analyze of the traffic, the transport and economic profit. The four other segments are financing from IPA 2008, respectively in the Counties: Gjirokaster, Durres, Lezhe and Shkodër.

The list of priorities and the financing segments. During this period ADF has collaborated with an international consultant Roughton International (RI) for the inventory of 3500 km of secondary and local roads based in their functionality. ADF has a database of the economic transport evaluation for 1500 km, or approximately 525 roads segments, which are evaluated as the main rural network. To accomplish this duty has been undertaken many activities such as: measuring the difficulties of walking on the road, measuring the traffic and its intensity for any category of vehicles etc. All these database are analyzed from a software, which prepare the feasibility of each road, by offering in a real time a prioritizing of investments and the respectively costs.

Supervising infrastructure work. ADF has a considerable experience in supervising the infrastructure work. By having the need of high level standard in this project, ADF collaborated with an international supervising company with a high reputation level. In collaboration with this company, ADF is supervising the implementing object, in total will include 1500 km.

Project sustainability. ADF, expect of the investments in the roads, has ensured the right technical support in capacity building through trainings for the Local Government, aiming the maintenance of the investments. ADF has the right means and programs to help in predicting costs and time to interfere for the maintenance.

Strengths/critical factors of the experience, lessons learnt and findings.

Ensuring and a sustainable financing as a result of Albania Government and foreign donors commitment.

- Feasibility analyze in two phases including local government units in identifying the primary roads segments and delivering the projects as well as the costs-benefits analyze.
- Including local government units (municipality, commune) in defining the priorities as well as in assuring the maintenance after the project (as a helpful factor of the investments).
- Including city council for studying the project-proposal has increased the effectively in assuring a beneficial with local and regional values.
- Using the standards which are applying by the donors and the support from an international and specialized company.
- Supervising the works from ADF, which now has a large experience in the investments field in local government, ensure a guaranty in implementing the projects as well as in influencing the local governments to create a good work tradition in this direction, especially in the local government units with small capacity.

Useful information on this experience, content and background

Albania Development Fund was created with a special law in 1993, as a necessary way in adding financial sources for investments in the local government. In the beginning they used funds from different donors mainly the World Bank, as well as 5-10% the contribution of the local governments' funds, in order to increase and develop the community interest for the implemented projects.

Gradually, the government participation became more visible, and the donors have been increased. ADF is directed from a board chaired by the deputy Prime minister or another person from the Ministry Council, with other Ministry participation and representatives from the local governments.

During these years of application, ADF has realized many investments in local public objects, has helped local governments units in increasing their capacities, in drafting projects, in implementing standards for realizing investments, in the commitment of the maintenance of the financed objects, in the field of procurement and of purchased materials etc.

The previous year some additional and improvement was made to the law which gives to ADF the possibility and the power to lend money to local governments, but it didn't started yet to be implemented.

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CASE STUDY

Macedonia – Karposh Energy Efficiency through Loan – Saving for the Future

Short description of the experience:

The Municipality of Karpos has applied to access the USAID Development Credit Authority (DCA) loan guaranty facility through the USAID/Macedonia Local Government Activity (MLGA) and its Municipal Investment Program.

The USAID MLGA has provided extensive technical assistance to the Municipality of Karpos to assess its creditworthiness and its current financial health, the credit condition and future projections. Based on this analysis it was estimated that the Municipality of Karpos is creditworthy and has the financial capacity to borrow.

The project proposed by the Municipality met the DCA requirements in terms of the municipal capability to implement energy efficiency project as well as to improve municipal services.

Type of the borrowing instrument used – Loan; The total proposed Municipal Investment Project is in the amount of $635,000 USD

Period of the project – July – October 2008

General aim of the experience and specific objectives - Municipality of Karpos has applied to access the USAID Development Credit Authority (DCA) credit guaranty facility through the USAID/Macedonia Local Government Activity (MLGA) and its Municipal Investment Program. The application is directed at completion of a primary school project. This primary school "J.A.Komenski" is one of the first in the history of independent Macedonia to be constructed by a municipality with decentralized authority over education (as opposed to a central government).

By utilization of municipal credit via the DCA the Municipality of Karpos will complete the construction of the primary school focusing on the energy efficiency and especially installation of energy efficient heating system, electricity and lighting, and roof construction.

As one of the main priorities of the DCA supporting work in the municipality of Karposh is the energy efficiency. The Council of the municipality of Karposh has adopted a program for energy efficiency (MEEP) 2008-2012. Installation of appropriate high efficiency heating and lighting equipment in the new primary school "Jan Amos Komenski" will enable much more efficient use of energy and significant reduction of operating costs.

The impact of the equipment to be DCA financed is as follows:

a. *Heating* - Assessment of the savings (compared to typical existing school infrastructure) was between 10 and 20%

b. *Electricity* - The type of lights and other electrical equipment which are installed in the new building is fully compliant with the prescribed standards for an educational facility, and fluorescent lights are used, i.e. mostly luminous pipes with parabolic raster. Assessment of the energy savings with the new lights was estimated at around 30%, and the amount of lighting, in comparison with the older type fixture will be increased by approximately 50%

c. *Roof construction* - It was estimated that with the improvement in thermal efficiency of the roof construction insulation there will be less loss of thermal energy by about 20%.

Macedonian municipalities and municipal utilities that are creditworthy, authorized by Macedonian law to borrow money, and capable of implementing energy efficiency or renewable energy projects to improve municipal infrastructure or operations are qualified to apply for DCA guarantee support. Prior to the borrowing procedure, the USAID MLGA has provided a technical assistance to the Municipality of Karpos as a cooperating municipality. The creditworthiness self-assessment tool was installed and applied there to assess the current municipal financial health, the credit condition and future projections based on historical budget trends and future revenue and expenditure scenarios. This tool used by the financial officers helped them to better understand the influences of financial stability or instability in relation to the revenues and expenditures in the recurrent and capital budgets. It also gave the finance officers a diagnostic tool to analyze the factors that may improve the collection of revenues and cost savings, as well as to perform certain scenario analysis. The analysis outlined a strong municipal financial standing and net operating result substantially higher than the debt service capacity.

Before the borrowing procedure started, as required by the Law, the Municipality of Karpos contacted several financial institutions to obtain draft terms and conditions for borrowing. The obtained draft terms and conditions were submitted to the Ministry of Finance along with the Request for obtaining an opinion for borrowing.

After the Government of the Republic of Macedonia, on the basis of the positive opinion from the Ministry of Finance issued a consent for borrowing, the Municipality of Karpos was obliged to procure the financial service pursuant to the provision of the Public Procurement Law. The Municipality of Karpos has published a tender and UNI Bank, a DCA partner, has offered most competitive conditions for loan and therefore it won the tender. This was the first USAID/DCA guaranteed municipal loan.

This was also the first approval that the Government of the Republic of Macedonia has issued to any municipality since municipal borrowing has been enabled by the newly enacted legislation.

On July 2008 the Municipality of Karpos and UNI Bank signed the Loan Agreement for the amount of $635,000.00 USD, of which 50% is guaranteed by the USAID Development Credit Authority (DCA), five (5) years term of the loan and 7.5% interest rate.

Results of the experience: The total energy operating cost savings in the first year was approximately $13,681 USD. Note that this savings estimate is conservative since it assumes constant electrical and heating costs. Given that heating and electricity costs increased 12% and 10% respectively, the total adjusted savings in closer to $19,500 USD.

Municipal Energy Efficiency Program Results – "J.A.Komenski" School, Municipality of Karpos					
	Before Capital Improvements (2008)	After Capital Improvements (2009)	Total Reduction	% Reduction	
	MKD/m2	MKD/m2	MKD/m2		
Heating	430.85	386.80	44.05	-10.22%	
Electricity	245.30	156.70	88.60	-36.12%	
Renovated Building size equals 4,280 m2		Total savings	132.65	MKD/m2	
			567,742	MKD Total Annual Savings	
			$13,681	USD Total Annual Savings	

Strong points/critical factors of the experience and what were lessons learned and/or solutions found:

1) This new way of municipal financing will have a very significant influence for the local community, the media and the general public, and especially for other municipalities considering whether to apply to the DCA for their projects.

2) Access to capital is a major issue for Local Governments in Macedonia, especially now once they are allowed to borrow from the private credit market to stimulate growth. Many have not had the opportunity to develop a credit history or to be recognized by banks as "clients in good standing".

3) This is a model of cooperation, involving diverse participants: USAID, the DCA participating bank, ZELS, the municipality, energy service companies and the Ministry of Finance, all cooperating in this program and providing a model for public-private partnerships in the future.

4) This very first DCA successful project implementation is seen as incentive to other mayors, for now they have the tools and resources to be able to implement energy efficiency projects or to improve municipal infrastructure.

Information available on this experience and its context and background:

Official website of the Municppality of Karposh - http://www.karpos.gov.mk

Officail website of the USAID Local Government Project http://www.mlga.com.mk/success_stories_more.php?id=49

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Turkey – The Supply and Commissioning of 120 Subway Vehicles in Metropolitan Municipality of Istanbul

Short description of the experience: Istanbul is a city with a dynamic population of 12,9 million. It is a tough job to fulfill the needs of its residents regarding transportation problems dating back to tens of years. Istanbul Metropolitan Municipality, which has an annual consolidated budget of approximately USD 10 billion, has taken an initiative to ease the transportation stress in the city. The most practical solution obviously is the application of underground mass transportation, which is the metro construction, in order to surpass the traffic above.

In this regard, the Project of Kadikoy-Kartal Metro Line has been launched with a deal of EUR751 million. The financing of this project, which was accomplished through a syndication loan of 10 commercial banks, covered only the construction and electromechanical works.

Our interest will now focus on the procurement of rolling stocks to be utilized in this project and its financing process. The bureaucratic steps taken during this financing process will be presented in detail. Furthermore, the problems and/or obstacles the Municipality had been exposed to will also be discussed in this case study

12.9 million people will benefit from this project financing. (The Whole Province)

The reasoning is that Turkish Grand National Assembly passed a law in 2005 that the area served by Istanbul Metropolitan Municipality had been enlarged; therefore, the border of the whole province has been turned out to be the service area of the Metropolitan Municipality

Features of the Financing Practice:

Project Owner: Istanbul Metropolitan Municipality
Name of the Project: The Supply and Commissioning of 120 Metro Vehicles to be utilized in Kadıkoy-Kartal Metro Line
Project Amount: EUR 138,739,027
Contractor: Construcciones y Auxiliar de Ferrocarriles S.A. (CAF)
Lender/Creditor: BNP Paribas Corporate & Investment Banking
Export Credit Agency: Compañia Española de Seguros de Crédito a la Export-

ación S.A. (CESCE)

Instrument Used: Project Financing

Export/Buyer Credit: EUR 117,928,172.95 (plus EUR 9,875,733.94 Insurance Premium)
Maturity: 31 months of Grace Period + 10 years (20 equal installments)
Commercial Credit: EUR 20,810,854.05
Maturity: 6 months of Grace Period + 7 years (14 equal installments)

Period of the project: October 2009 – May 2012

The signing date of the procurement agreement is 09.09.2009
The starting point of the project is 28.10.2009
The end of the project is 28.05.2012 (31 months from the starting point)
The signing date of the loan agreements is 10.03.2010

General aim of the experience and specific objectives:

The goal of the project is to purchase 120 Subway Vehicles to be utilized in Kadikoy-Kartal Metro Line. The tender was put out; and finally a Spanish contractor won the deal with an offer of EUR 138,739,027.

In order to finance a project; a few points must be taken into consideration:

- The project can be aimed to be financed through foreign financial institutions (with foreign capital) only in case of its inability to be implemented via Turkish Technology.
- The project must appear in the "Annual Bulletin" of State Planning Organization;
- The approval of Under-secretariat of Treasury must be obtained.

As known, state guarantee is a choice for all credible local governments. To this extent, Istanbul Metropolitan Municipality, which has the best creditworthiness among all Turkish Local Authorities, followed a way without state guarantee in order to avoid wasting time.

After these steps had been taken; Istanbul Metropolitan Municipality pursued a policy to involve several financial institutions in the deal to succeed in getting the best financial offer. Therefore, around 100 financial institutions were informed about the project and its financing process via Request for Proposals (RFP).

Steps taken:

The steps are listed below in accordance with chronological order:

- Preparation of feasibility reports of investment projects within the municipal structure
- Selection of projects to be implemented in the upcoming budgetary year and their existence in the following year's forecasted budget
- Preparation of qualified projects and involvement of these projects in the Municipality's Annual Investment Program (Law No. 5393, Clause 18-a)
- Approving "Investment Program" in the Municipal Council after regular discussions (Law No. 5393, Clause 18-a)
- Project's appearance in "Government Investment Program" (Notification Clause 3 for Procedures and Principles for providing external debt that is stated in the Annual Investment Program, Law No. 4749 Clause 8)
- Receipt of official document from the Directorate of Rail System about requesting of financing the Project
- Requesting "prior permission" from Under-secretariat of Treasury for the financing of the Project (Notification Clause 3 for Procedures and Principles for providing external debt that stated in the Annual Investment Program, Law No. 4749 Clause 8-Article 10)
- Carrying out "Municipal Council Resolution" for external borrowing for the Project (Law No. 5393 Clause 68)
- Completing the Tender Period with the framework of No. 4734 Public Tender Law
- Sending RPFs (Request for Proposal) to all financial institutions in the database for indicative proposals
- Analyzing the indicative proposals and short listing banks/proposals (In the analyses, we use different methods and software.)
- Informing the shortlisted banks/group of banks in order to modify their offers
- Mandating BNP Paribas as presenting the best offer regarding financial costs
- Starting negotiations with BNP Paribas on the wording side of the drafted agreements

- Implementation of Tender with Finalized Loan Agreements
- Sending the Signed Loan Agreements to the Head Office of External Economic Relations of Under-secretariat of Treasury (Notification of Procedures and Principles for providing external debt that stated in the Annual Investment Program, Subject 3)
- Appointing a Process Agent in the Turkish Embassy located in London since English Law was chosen as the Governing Law in the Loan Agreements
- Registering the Loan Agreements in the "External Financial Information System" (External Debt Log) at the Under-secretariat of Treasury (the Head Office of Public Finance: Notification regarding T.P.K.K.H. 32 Clause 42, Decision T.P.K.K.H. 32 B.H and D.T.M.' 91-32/5 I-M Circular regarding Republic of Turkey Central Bank)
- Mailing the documents required for disbursements, which are called as "Conditions Precedent", to BNP Paribas Bank in 30 days after signing agreements.
- Transferring the insurance fee to Spanish Export Credit Agency (CESCE); and commission fees to Mandated Lead Arranger
- Transferring the Advance Payments and Progress Payments to the supplier (Construcciones y Auxiliar de Ferrocarriles S.A.- CAF) by making first disbursement from Loan Agreements
- Informing the Head Office of Public Finance of Under-secretariat of Treasury via sending related documents within 10 days after disbursement (T.P.K.K.H 32 Notification No: 91-32/5 Clause 42)

Results of the experience

Since this financing process was going to focus mainly on export financing, we were aware that financial institutions would be highly enthusiastic about our project. Hence, we determined our own/unique strategy and implemented it till the end.

In the first indicative proposal phase, we were slightly concerned that the costs were a bit higher than we had anticipated due to global financial turmoil. On the other hand, we were surprised that offers and costs varied in a broader range. Our expectation was in a manner that banks would submit quite similar proposals.

Actually, this helped us to easily eliminate the banks at the worst end, and to shortlist 5 banks/group of banks in the end.

As the due date for submitting the final proposals of shortlisted banks arrived, almost all banks waited till the very last minute.

BNP Paribas's offer was quite good since the bank's overall financial condition in the crisis was sound. They even acquired Fortis Bank in the meantime.

In conclusion, our expectations were met and a successful agreement was signed between two parties.

Strong points/critical factors of the experience and what were lessons learned and/or solutions found:

Borrower should be very concise and precise in negotiations. The costs of the proposal may seem to be very suitable; however, the wording of the agreement may force you to get exposed to pay more in different ways.

Borrower should be careful about extra demands of the creditor about documentation. Sometimes documentation may be frustrating. Creditors would always be willing to supervise financial statements periodically.

Fees depicted in the agreement should be negotiated. Disbursements should be made in accordance with the project, and the opportunity cost of commitment fee should be calculated before disbursements.

Extra expenses/Out-of pocket expenses should be capped. If not, then it may cause you to incur disproportionate amount of costs when the creditor is malicious.

Creditors should be well reviewed and past experiences should be considered as assets.

Borrower should force creditors to put a binding clause that states "any right/ and or obligation cannot be transferred to a third party or an affiliate, which is located in a country that Borrower's country does not recognize".

Disbursement requests should be in the authority of only Borrower, not Supplier.

Documents designed to fulfill conditions precedent are usually submitted in 30 days after signing agreements. So, Borrower should be quick and practical in documentation; otherwise, agreements may be canceled.

Information available on this experience and its context and background:

http://tradefinancemagazine.com/Article/2347000/Regions/22997/Banks-win-mandate-for-Istanbul-metro-deal.html
http://www.ibb.gov.tr/tr-TR/Pages/Haber.aspx?NewsID=18185
http://www.ibb.gov.tr/en-US/Haberler/Pages/Haber.aspx?NewsID=324

http://www.stargazete.com/ekonomi/istanbul-belediyesine-138-milyon-avro-kredi-haber-249017.htm

http://www.sabah.com.tr/Yasam/2010/03/11/kartal_metrosuna_kredi_destegi

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CASE STUDY

Bulgaria – Bridge financing from "FLAG" Fund in support for the project implementation for the municipality of Mezdra

Short description of the experience: Since its operation in January 2009, "Fund for local authorities in Bulgaria- FLAG" STC (FLAG) has managed to become a partner of the municipalities in the preparation and implementation of projects financed by EU funds.

According data to July 2010, concluded is a total number of 105 credit agreement amounting at 119.09 million BGL / approximately 60 million EURO/ for support to the implementation of municipal investment at the value of 339.83 million BGL/ approximately 170 million EURO/.

FLAG does not finance projects; it just assists the municipalities for their successful implementation through the provision of bridge financing- i.e. providing necessary resources for payments to the contractors, which ease the timely submission of interim and final payments to the relevant Managing Authority.

One of the municipalities whose projects are being implemented with financial support from FLAG is Mezdra municipality. Municipality of Mezdra receives bridge credit for implementation of the project for reconstruction of 6.7 km municipal road, financed entirely by grants under the Operational Programme " Regional Development" 2007- 2013.

The municipality applied for resource from FLAG relatively at the late stage of the project implementation - two months before its completion. The amount of the loan, compared to the actual cost of the project (after the public procurements and contracts signed with contractors) is approximately 85%.

The credit from FLAG at the amount of 2.8 million BGL/ approximately 1.4 million EURO/ provides a resource for final payment to the contractors also for refinance of the part of the costs incurred to date by the municipality, paid with its own resources.

The credit is short term- 7 months, and its repayment is in two installments with the funds received from the interim and final payments by the Managing Authority of OP. The project was completed successfully and the loan is repaid within the fixed deadlines.

1.591 habitants will benefit from this project financing. (The whole municipality)

Strong points/critical factors of the experience and what were lessons learned and/or solutions found:

One of the problems in the absorption of the funds under the Operational Programs is the delaying in payments to the municipality (beneficiary) from MA, this is leading to non-implementation of the time schedule for completion of the relevant project activities- FLAG maintains intensive communication with the Managing Authorities of Operational Programs on the implementation of projects for which funding requests for credit are deposited.

As information about the project, the Managing Authority of Operational Program provides to FLAG, is the status of requests for payment from the municipality to the MA and the possible reasons for the delay (need for corrections to the payment request, suspected irregularity established irregularity, etc.). There have been detected some weaknesses in project management, showing a lack of sufficient administrative capacity at local level- through consultations provided by the experts from FLAG, for the purpose aiming to minimize mistakes, especially at the stage of actual implementation of the project and submitting of the requests for payment to the Managing Authority of the OP.

Information available on this experience and its context and background:

Information for FLAG – http://www.flag-bg.com/?id=6 ;

http://www.flag-bg.com/?id=47&l=2 (EN)

Loan conditions for project implementation - http://www.flag-bg.com/?id=16

Report for company activities for 2009- http://www.flag-bg.com/docs/Annual%20Report%202009.pdf

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Romania – 500 million euro for traffic improvement in Bucharest

Short description of the experience:

In 2005 Bucharest municipality carried out a 500 million EURO bond issue in London. The bond issue had been chosen as the best instrument available to finance many priority investments simultaneously. The central government publicly supported the initiative and also exempted the city from the legal debt threshold.

Before the issue, the city hired an international rating agency and an investment bank. Both prepared the way for what became the most successful local debt project in Romania.

The proceeds were used to finance numerous public works aimed at upgrading the road infrastructure and public transportation of a rapidly developing city.

Period of the project: June 2005 – June 2015

General aim of the experience and specific objectives:

The bond issue was chosen in 2004 as the best solution for financing the investment needs in the public infrastructure of Bucharest.

In 2000 the city had approved the conclusions of a comprehensive transport study made by foreign consultants which presented the mayor with a list of investment in the city's ageing road infrastructure, parking facilities and public transportation fleet. In addition, in 1999 the city had concessioned the water& sewerage services to a private operator, while retaining some of the major investment commitments. Moreover, the investment needs in the district heating infrastructure were also badly needed as the main transport and distribution network had been built in the 1960s.

Consequently, the city hall has put together a priority list of investments, decided the bond issue as the best instrument for financing and started due diligence and preparations.

The city did not put forward to investors a comprehensive detailed list of investments, but mentioned the rehabilitation and upgrading of the city infrastructure. Indeed, the city did not have all technical documentation prepared, nor had it secured the land rights for some of the planned investment. All these aspects were bound to take time and were sometimes uncertain.

However, the city hall publicly said the money would be use to build the two-kilometer Basarab overpass completing the main ring-road, build an underground parking at the main railway station, buy new tramcars, build parking spaces in residential areas and other capital spending on urban infrastructure.

Spending the money begun in earnest in 2007. Eventually, the Basarab overpass was financed from the bond issue. However the parking projects and the new tramcars did not materialize. In turn, much of the bus and fleet of the local transportation company was revamped (1.000 buses). In addition, major road works were carried out on the main city roads.

During the 1990s few of the investments needs of Bucharest, the 2 million inhabitants capital of Romania, were met. During 2000-2004 the elected mayor, Traian Basescu, put forward a bold investment plan in the city road, water and district heating infrastructure. Securing the financing has proved to be un uphill struggle for several reasons:

- the legislation regulating the city revenues was amended repeatedly to divert revenues from the city hall to the six district halls

- the internal local credit marked was in its inception

- the city hall and central government were at odds politically and strategically: central government sought to weaken the city mayor and council in favor of the district mayors and councils.

In 2004, the mayor was re-elected and used his new legitimacy to push for the badly needs investments. A priority list was assembled. An analysis of financing opportunities was carried out. The conclusion was that neither local credit market and nor the international financial institutions (ERBD, EIB, IFC etc) were able to meet the city demands. Hence, the only option left was the private international markets, namely a bond issue.

Then the city hired Standard&Poor's to undertake a rating analysis. In 2004 it gave Bucharest municipality the same rating as the central government (BB-stable). Just before the bond issue it upgraded the rating to BB+ stable.

In parallel, the city carried out an public procurement for the investment bank. A consortium made of JP Morgan&ABN Amro was selected. It carried out all the preparation of the bond issue, including the much needed advertising and investor awareness. To this end, a city hall delegation took a roadshow in several major European financial cities, Athens, Vienna, Paris, Frankfurt, Münich, Amsterdam i London. It also developed the structure of the issue, namely a 150 million EURO 10 year bullet repayment instrument.

By then, the city had a new mayor. Traian Basescu had been elected president and the new government and the new mayor were political allies. Hence, the government passed an emergency ordinance exempting the city from the 20% debt threshold (of own revenues) which was in forced at that time. The exemption was passed just a month before the bond issue.

The issue took place in mid-June 2005 at London Stock Exchange. Initially, the issue was valued at 150 million EURO, but it was quickly apparent that demand largely exceeded that amount. Finally, the city sold bonds worth 500 million EURO, although the demand exceeded 700 million. The interest rate was 4,12% per year, better than the initial estimate. The bond underwriters were mainly major European banks.

The municipality deposited the money in a local bank until the public works would begin. The deposit yielded just enough interest to service the bond issue interest rates for two years.

Most of the bond issue proceeds have been spent to this day. Less that 10% is still left to finish the works at Basarab overpass.

Results of the experience

The bond issue ended up more than three times bigger than planned. It saved the city hall from looking for more financing in the coming years.

In terms of money usage, not all of the initial investment came to materialize. However, the city infrastructure and transport got much needed upgrades.

The city had not borrowed ever since. It is trying to do so, but the bullet repayment makes if exceed the debt threshold in 2015. The Ministry of Finance claims that the 2005 exemption did not include the repayment, only the approval for the issuance.

Strong points/critical factors of the experience and what were lessons learned and/or solutions found:

The main strong point is the city itself. As the largest in Romania, Bucharest is set to grow faster than the country as a whole and is the likeliest source of investment, jobs and high wages. Most of the city hall budget depends on income tax.

Secondly, the central government publicly backed the city and exempted it from the debt threshold. However, no hint of an eventual bailout was given.

The city officials were flexible enough to increase the issue as demand proved high.

The deposits from bond proceeds yielded enough interest to service the debt for two years.

The bullet repayment structure causes problems to the city nowadays. It's plan to take a new loan to build kindergartens is stalled because the debt threshold is set to be broken in 2015 when the bond issue is repaid.

The interest rate of 4,12% is lower than that of central government bonds. The Ministry of Finance pays 5% interest for bonds issued in 2010. It is also lower than most interest rates of current municipal loans in Romania.

Information available on this experience and its context and background:
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Annex 2 - General financial framework of local governments

	Country	Local Government Revenues			Expenditures Assignment		
		Most important local taxes/fees and average share in the annual budget	*Shared Taxes*	*Central Government Transfers*	*Exclusive to Local Governments*	*Shared Local with Central Governments*	*Shared Region with Central Governments*
1	Albania	1. Local tax on small business – 20,47% 2. Real estate transfer tax including tax on buildings and agricultural land - 12,4% 3. Vehicles registration tax - 5,45%	1. Personal income tax 2.Profit tax (Have not been applied yet))	1. Unconditional transfers (grants and competitive funds) 2. Conditional transfers 3. Transfers from the Regional Development Fund	1. Management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Public lighting 5. Sanitation/waste collection 6. Local public transportation 7. Social housing, houses for youth and social welfare 8. Urban planning 9. LED	1. Urban planning 2. Social services 3. Environmental protection	

2	Bulgaria	1. Waste taxes - 11,79% 2. Property tax - 9,53% 3. Property revenues - 4,64%	1. Personal income tax - 50%	1. General complementary subsidies (for financing delegated state competences) 2. General adjustment subsidies - equalization subsidy (for financing local activities) 3. Target subsidies (for financing capital investments)	1. Management of the local road infrastructure 2. Sewage, waste and pluvial water treatment 3. Public lighting 4. Sanitation/waste collection 5. Local public transportation	1. Water supply 2. Social housing as well as houses for youth	*1. District heating supply* *2. Management of local interest airports*
3	*Croatia*	*1. Income tax and surtax on income tax* *2. Income from non-financial asset* *3. Property tax*	*1. Income tax (34% until 2006; 52% as of 2007)* *2. Profit tax (20% until 2006; 0% as of 2007)* *3. Tax on real estate (60%)*	*1. Transfers for decentralized functions - primary education; secondary education; health care; social welfare and fire protection* *2. Equalization grants - for general purposes and for capital purposes*	*1. Management of the local road infrastructure* *2. Water supply* *3. Sewage, waste and pluvial water treatment* *4. Public lighting* *5. Sanitation/waste collection* *6. Local public transportation* *7. District heating supply*	*1. Energy saving projects*	*1. Social housing and houses for youth (exclusive competence of regional government)* *2. Management of local interest airports (exclusive competence of regional government)*

	Country	*Local Government Revenues*			*Expenditures Assignment*		
		Most important local taxes/fees and average share in the annual budget	*Shared Taxes*	*Central Government Transfers*	*Exclusive to Local Governments*	*Shared Local with Central Governments*	*Shared Region with Central Governments*
4	Macedonia	1. Property tax – 6% 2. Real estate transfer tax - 17% 3. Communal fee – 29%	1. Local governments receive 3% of personal income tax (PIT)	1. a general purpose transfer from VAT 2. earmarked/block grants for the areas of education, culture, social policy and child protection 3. capital grants, and 4) funds received for delegated competencies.	1. Management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Public lighting 5. Sanitation/waste collection 6. Local public transportation	1. Social housing as well as houses for youth	

5	Moldova	1. Real estate transfer tax 2. Tax on territory planning 3. Tax on natural resources	For communes and municipalities established by rayon councils in the frame of 0-100% 1. Tax on income of legal entities 2. Tax on income of physical persons		1. The management of the local road infrastructure 2. Water supply 3. Public lighting 4. Sanitation/waste collection 5. Local public transportation 6. District heating supply (Only for Chisinau and Balti) 7. Social housing 8. Management of local interest airports (Only for Chisinau and Balti)	1. Social housing and houses for youth	*1. The management of the local road infrastructure*
6	*Montenegro*	*1. Utility fees – 23%* *2. Real estate tax (property tax) – 7.5%* *3. Surtax on income tax – 5.5%*	*1. Personal income tax – 10%* *2. Real estate transfer tax – 50%* *3. Concessions and fees for using natural resources – 30%*	*1. Equalization grants (comprise 11% of personal income tax and 20% of real estate transfer tax)* *2. Conditional grants – for financing investment projects*	*1. Management of the local road infrastructure* *2. Water supply* *3. Sewage, waste and pluvial water treatment* *4. Public lighting* *5. Sanitation/waste collection* *6. Local public transportation* *7. Social housing – social welfare*		

	Country	*Local Government Revenues*			*Expenditures Assignment*		
		Most important local taxes/fees and average share in the annual budget	*Shared Taxes*	*Central Government Transfers*	*Exclusive to Local Governments*	*Shared Local with Central Governments*	*Shared Region with Central Governments*
7	Republika Srpska - BiH,	1. Property tax – up to 35% 2. Turnover tax – up to 20% 3.Rent – up to 15%			1. Management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Sanitation/waste collection 5. Local public transportation	1. Sewage, waste and pluvial treatment 2. Public lighting 3. District heating supply 4. Building of social houses as well as houses for youth	
8	Romania	1. Property tax (building and land) 2. Motor Tax 3. Royalties and rents (In all, local taxes and fees make for 16%-18% of local budgets' revenues)	1. Income Tax (shared up to 77% in various degrees; and accounts for a third of all LG revenues)	1. Earmarked recurrent transfers 2. Earmarked capital transfers 3. Block grants 4. General purpose grants (equalization) (Transferred to both counties and municipalities. Make for about half of all LGs)	1. The management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Public lighting 5. Sanitation/waste collection 6. Local public transportation 7. Social housing	1. District heating supply – thermal retrofitting 2. Education (LGs maintain the infrastructure)	*1. Education (LGs maintain the infrastructure)*

9	*Slovenia*	*1. Fee on the use of construction land* *2. Real estate transfer tax* *3. Fee on the use of public space*	*1. Personal Income Tax – 50% assigned for municipalities from which 70% to each municipality and 30% shared through the solidarity fund for poorer LGs.*	*1. General grants – assigned to municipalities by formula as the equalization grant* *2. Earmarked grants – assigned for co-financing investment projects* *3. Special grants – for co-financing minority rights*	*1. The management of the local road infrastructure* *2. Water supply* *3. Sewage, waste and pluvial water treatment* *4. Public lighting* *5. Sanitation/waste collection* *6. Building of social houses* *7. Management of local interest airports* *8. Tourism* *9. Primary healthcare and pharmacy services* *10. Social care* *11. Management of cultural and sport facilities* *12. Fire protection* *13. Public order and peace*	*1. Local public transportation* *2. Subsidies to the economic and agriculture sector, primary schools*	

	Country	*Local Government Revenues*			*Expenditures Assignment*		
		Most important local taxes/fees and average share in the annual budget	*Shared Taxes*	*Central Government Transfers*	*Exclusive to Local Governments*	*Shared Local with Central Governments*	*Shared Region with Central Governments*
10	Serbia	1. Construction land development charge - 8% 2. Construction land use charge - 6% 3. Property tax - 5%	1. Income tax - 40% share 2. Tax on inheritance and gift - 100% share 3. Property transfer tax - 100% share	1. Non-Earmarked transfers (equalization transfers; compensation transfers; transitional transfer[3]; general transfers) 2. Earmarked transfers (block transfers; categorical transfers in a narrow sense)	1. The management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Public lighting 5. Sanitation/waste collection 6. Local public transportation 7. District heating supply 8. Pre-school education (all costs related) 9. Investment costs of primary schools and primary health care centres	1. Management of local interest airports 2. Building of social houses and houses for the youth	*N/A*

11	Turkey	1. Advertisement and Publicity tax 1-5% 2. Entertainment tax 1-5% 3. Fire insurance tax 1-5%	5% of all nation-wide taxes are allocated to Local Governments. The main taxes stem from VAT and Special Consumption Taxes. Shared taxes account approximately 50% of annual average income of municipalities.	All shares allocated from the tax income of the general budget are considered as Central Government Transfers. They are placed in the budgets of both Ministry of Finance and other ministries in purpose of Grants to Local Governments.	1. The management of the local road infrastructure 2. Water supply 3. Sewage, waste and pluvial water treatment 4. Public lighting 5. Sanitation/waste collection 6. Local public transportation 7. Geographical urban data systems	1. District heating supply 2. Building of social houses and houses for the youth 3. Disaster management expenses (i.e. earthquakes, floods)	1. Management of local interest airports

Source: authors analysis based on the questionnaire provided by local experts

Annex 3 – Local governments' creditworthiness indicators

Financial Risk Profile Analysis according to Standard and Poor's credit rating methodology

Financial Risk Analysis			
Surplus Generation and Debt Servicing Ability	**Cash Flow Adequacy**	**Capital Structure**	**Liquidity and Financial Flexibility**
▶ Source of revenue ▶ Importance of asset sale income ▶ Analysis of margin growth and interest coverage	▶ Focus on debt service capability ▶ Analytical distinctions with profitability ▶ Analysis cash flow coverage and cash generation abulity	▶ Leverage ▶ Type and structure of debt ▶ Hedging arrangements ▶ Off-balance sheet obligations ▶ Asset values	▶ Sources of liquidity ▶ Potential calls on liquidity ▶ Short term debt maturity ▶ Bank credit facilities ▶ Unencumbered assets and debt capacity

Overview of typical financial ratios used in assessing local governments' financial position

Ratios	Definitions	Interpretation
Recurrent Revenues / Total Revenues	Measures the degree to which a local government relies on recurrent revenues.	A ratio of 100% or close to 100% may be inappropriate for a local government that is funding the acquisition of significant nonfinancial assets.
Recurrent Revenues per Capita	Measures the relative burden of taxes and user charges on local taxpayers and service users.	A higher level of operating revenues per capita indicates a relatively high burden of taxes and charges.
Own-Source Revenues / Total Revenues	Measures a local government's own-source revenues compared to its total revenues.	A relatively high percentage of own-source revenues (max indicator 100%) indicate that the local government is more reliant on recurrent, predictable revenues to fund its activities.
Own-Source Revenues / Operating Expenditures	Measures a local government's own-source revenues compared to its operating expenditures.	A ratio of 100% or more indicates that the local government has surplus own-source revenues available to apply to non-operating expenses. A ratio of less than 100% indicates that a local government that is dependent on non-own source revenues.
Key Own-Source Revenues / Total Revenues	Measures the reliance by a local government on each of the principal own-source revenues for local governments generally.	The relative reliance on each of the own-source revenues by a local government can be indicator of creditworthiness.
Actual to budget	Measures the ratio of initial and final budget projections to actual results.	Show the degree of accuracy in budgeting. It represents how well a local government can plan and manage its finances over time
Relative growth	Shows how changes in revenue compare to changes in expenditures over time.	Faster growing expenditures will eventually lead to a deficit, if revenue growth decreases. Conversely, faster revenue growth will produce or maintain a future operating surplus.
Long-Term Debt Service / Recurrent Revenues	Measure of the ability of a local government to service debt.	Rely on revenues that are, to some extent, under LGs' control and derived from revenue sources within its jurisdiction.

Ratios	Definitions	Interpretation
Liquid Short-Term Assets / Short-Term Liabilities	Measures a local government's liquidity position.	The higher a local government's liquid short-term assets compared to its short term liabilities, the greater its liquidity and the greater its ability to cover its short-term liabilities during periods of unexpected revenue shortfalls.
Outstanding debt	This indicator looks at the structure and amount of long-term debt liabilities.	These are basic indicators and therefore the data must be consistently available from balance sheets to be a reliable indicator.
Net Financial Balance and Debt Service Coverage Ratios	Provides a margin of financial safety in case of unanticipated expenses or revenue shortfalls.	A portion of a net financial surplus can be used to support additional debt and/or to pay the cost of acquiring non-financial assets to the extent that revenues from non-financial assets and the planned issuance of debt don't fully cover that cost.
Debt Service Coverage Ratios	It is a measure of the financial margin of safety provided in the local government's budget to ensure lenders that the local government will have sufficient funds available to service its debt.	A debt service coverage ratio of 1.0 indicates that the borrower will have funds available in exactly the same amount as the required debt service. A debt service ratio of less than 1.0 implies that that the borrower will have insufficient funds available to service the debt. Lenders typically require debt service coverage greater than 1.0 when they consider making a loan.

Glossary

Accrual Accounting System – A method of accounting that recognizes the financial effect of transactions when they occur, regardless of the timing of related cash flows. The revenues are recorded when earned, and expenditures are recognized when incurred.

Cash Basis Accounting System – Accounting method in which revenues are recorded when cash is received, and expenditures are recorded when cash is paid out.

Modified Accrual Basis Accounting – A method under which revenues are recognized in the period they become available and measurable, and the expenditures are recognized in the period the associated liability is incurred.

Credit Enhancement – Use of property as a collateral, or a third-party guaranties to enhance local government's qualification as a borrower.

Municipal Credit Market – The market for all types of loans and bonds offered/issued to/by local governments.

Due Diligence – Evaluation conducted by Lenders / Underwriters to determine actual or potential associated risks involved in an investment. It is a duty of lenders to gather necessary information in connection with the Debt Issuer.

Debt Limitation – The maximum amount of debt that a local government may authorize for qualified purposes under the law.

Debt Policy – Part of an overall capital debt financing policy that provides evidence of a commitment to meet infrastructure needs through a planned program of future debt financing.

Debt Restructuring - is a process that allows a sub-sovereign entity (local government) - facing cash flow problems and financial distress, to reduce and renegotiate its debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations.

Debt Service Capacity – Assessment of the amount of debt a local government can repay in a timely manner usually stated in annual terms of the principal and interest (from available means or resources) without jeopardizing its financial viability.

Escrow - Legal arrangement in which an asset (property or money) is delivered to a third party (called an escrow agent) to be held in trust pending a contingency or the fulfillment of a condition or conditions in a contract such as payment of a purchase price. Upon that event occurring, the escrow agent will deliver the asset to the proper recipient, otherwise the escrow agent is bound by his or her fiduciary duty to maintain the escrow account.

Financial distress – It is a tight cash situation in which a local government cannot pay the owed amounts on the due date. If prolonged, this situation can force the owing entity into bankruptcy or forced liquidation.

Insolvency - means the inability of a local government to pay off its debts.

Cash flow insolvency - unable to pay debts as they fall due.

Balance sheet insolvency - Having negative net assets or in other words, liabilities exceed assets.

Lending institutions – Financial Institutions or Commercial Banks that provide loans to local governments.

Local Taxes – Taxes that are due in addition to state taxes. These can be in the form of property, sales, water... and occasionally income taxes. Funds generated from this cover some local government services.

Long-term debt – An obligation having a maturity of more than one year from the date it was issued.

Shared tax – A tax the State creates and collects and then share with local governments under defined regulations. The rules of revenue sharing are set by law and local governments are autonomous in spending the shared revenues.

Short-term debt – An obligation having a maturity of one year or less.

Supplier Credit – Goods or services received on deferred payment terms. It is also called supplier financing.

Outstanding Debt – Unpaid portion of a debt that may include interest accumulated on the balance.

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funded by
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Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (BMZ) **Internet:** www.bmz.de

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CIP - Каталогизација во публикација
Национална и универзитетска библиотека "Св. Климент Охридски", Скопје

352.073.527(4-12)(036)

GUIDELINES on local government borrowing and recent developments in NALAS countries. - Skopje : Network of Associations of Local Authorities of South East Europe - NALAS, 2011. - 154 стр. : граф. прикази ; 21 см

Glossary: str. 141-143. - Библиографија: 114-148

ISBN 978-9989-2928-7-3

а) Локална самоуправа - Задолжување - Југоисточна Европа - Водичи
COBISS.MK-ID 87091978

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