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The Role of Commercial Banks in Financing Debt of Local Government Units

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***Abstract*— The authors of the paper present the results of their research in the structure of resources used to cover financial deficit of institutions of public finance sector on central and local level. The authors also evaluate the consequences triggered by application of different methods of financing. The aim of the paper is to analyse the reasons of low activity of local government units in obtaining financial resources directly from the capital market as compared to the State Treasury and commercial enterprises. By means of tools used in comparative analysis the authors juxtapose the most important parameters of primary and secondary markets of long-term debt securities issued by local government units, the State Treasury and commercial enterprises.**

Index Terms— budget deficit, bank credit, bank loan, municipal bonds.

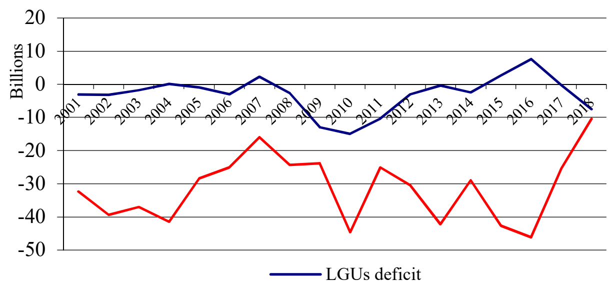
I. INTRODUCTION

Deficit is a phenomenon which invariably accompanies budgets on central level but also many budgets of local government units. The deficits of LGUs are incomparably lower than the deficits of budgets on central level, still they are significant enough not to be ignored. The ratio between deficit of the state budget and deficit of local government budgets is presented in Chart 1.

The analysis of data presented in Chart 1 allows to formulate a conclusion, that the deficit in the budgets of local government units is not a permanent phenomenon as increased deficit can be observed only in the period of 2009-2012 and in the latest available reporting period. It should be remembered however, that this is an accumulated outturn of all units of local government i.e. about 3000 units. The outturn embraces units with budget surplus as well as with budget deficit.

One may also not neglect the phenomenon of public debt understood as accumulated and unpaid deficits from previous years.

CHART 1. RATIO BETWEEN DEFICIT OF THE STATE BUDGET AND THE DEFICIT OF LOCAL GOVERNMENT UNITS.



Source: Own work based reports on execution of the state budget.

In such a case, despite the surplus in the current period, it is necessary to enter into commitments in order to settle current liabilities within their maturity date, this mechanism is called debt roll over. This debt, according to the latest available data, amounts to more than 77 billion PLN. The evolution of indebtedness of the local government sector is presented in Chart 2.

The indebtedness of local government units is constantly rising and it becomes more and more necessary to manage this debt rationally. A vital element of this process is the choice of external sources of financing. The sources should be chosen taking into account the criteria of costs of obtaining funds and rational instalment arrangement in order to meet the statutory criteria regarding limits on outflow of resources for this purpose as well as economic premises related to the management of financial resources at the disposal of LGUs.

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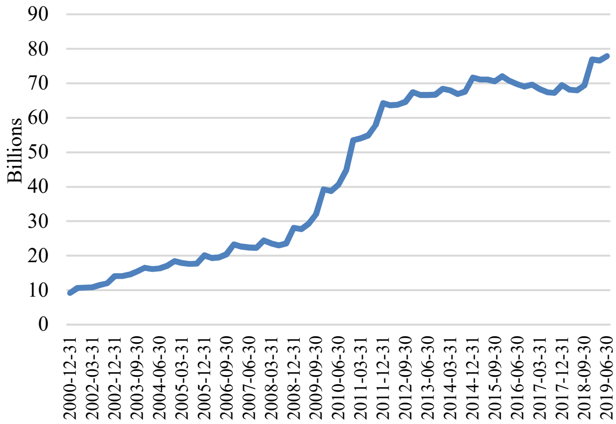
CHART 2. INDEBTEDNESS OF LOCAL GOVERNMENT SECTOR IN THE PERIOD 2001-2019.



Source: Own work based on date provided by the Ministry of Finance and available at www.gov.pl

II. EXTERNAL SOURCES OF FINANCING

Budget deficit of local government units may be fed from a number of sources. In the Act on Public Finance (Journal of Laws 2009 No 157 item 1240) there are eight sources listed, in reality however, only two are in active use: bank credit and issue of securities. The analysis of literature on the subject points to numerous advantages of financing budget deficits through emissions of securities because this enables LGUs to enter into commitments with a number of creditors at the same time and for longer periods of time than in case of bank investment credits (Główka, 2010). In majority of cases securities are a much cheaper and much more flexible instrument of external financing most of all due to lower costs of debt servicing and lower frequency of interest payments (quarterly, half yearly, yearly) than when it comes to credits (monthly), which results from inclusion of the principle of value of money in time. The most important thing, however, is that the issuer is able to arrange the issue in specific time-frames and decide about the volumes of particular issues thanks to which he may activate resources for specific invoices what considerably eliminates the costs of unspent funds (Markowski, 2002). The superiority of issuance of municipal bonds over credits and loans have been presented in Table 1.

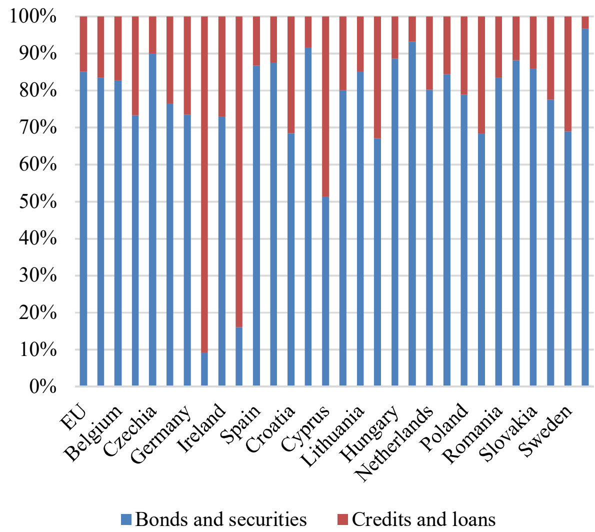
TABLE 1. MUNICIPAL BONDS VERSUS CREDITS AND LOANS

Municipal bonds	**Credits and loans**
- legal basis - Polish Bonds Legislation, - no need for own contribution, - more attractive for investors (creditors), - lower interest rates, - less documentation necessary, - faster preparation phase and completion of transaction, - resources can be utilised in a flexible way, - repayment scheme adjusted to the capacity of the budget, - coverage of the reimbursement not necessary, - public procurement procedure not required, - possibility to promote the issuer, - faster to obtain in case of higher sums of money, - long maturity periods of the bonds, - more flexibility in terms of debt limits.	- legal basis – Banking Law (credits), and civil code (loans), - one creditor, in case of a bank consortium a few creditors, - own contribution required, - small flexibility in negotiating conditions of credits and loans, - creditworthiness necessary, - legal security necessary, - public procurement procedure necessary while choosing a bank and when the credit exceeds 30.000 Euro, - tight monitoring from the bank during the credit utilisation period.

Source: (Brzozowska, 2018)

The advantages of issuing bonds and securities presented above point to the obvious superiority of this method above other forms of external sources of financing tasks executed by LGUs. It is particularly vital in periods of economic downturns and times of higher volatility of the economy when there is a more rigorous assessment of potential borrowers (Kaya and Meyer, 2013). The analysis of the public sector has generally confirmed this thesis. The structure of financing debt in the Member States of the European Union is shown in Chart 3.

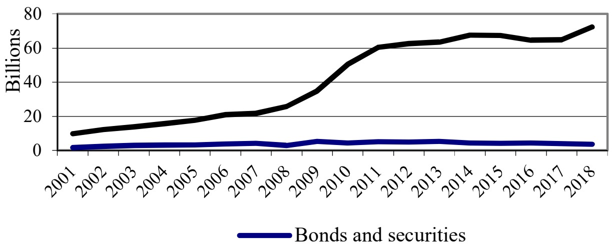
CHART 3. STRUCTURE OF FINANCING PUBLIC DEBT IN THE PUBLIC SECTOR IN THE EU IN 2018.



Source: Own work based on data provided by Eurostat.

The overwhelming majority of the European Union members relies on bonds and securities in financing its debt. There are two exceptions to this rule: Estonia and Greece. In Cyprus debt financing is evenly distributed between bonds, securities and credits and loans. However, when it comes to debt on local level in Poland the situation is quite different. The dominating instruments are credits and loans. In 2018, the proportion of indebtedness of Polish LGUs for issuing bonds and securities amounted to 1.1% GDP, while in Germany such debt reached 10.8% of GDP (Rozwój, 2018). The structure of LGUs debt by instrument is presented in Chart 4.

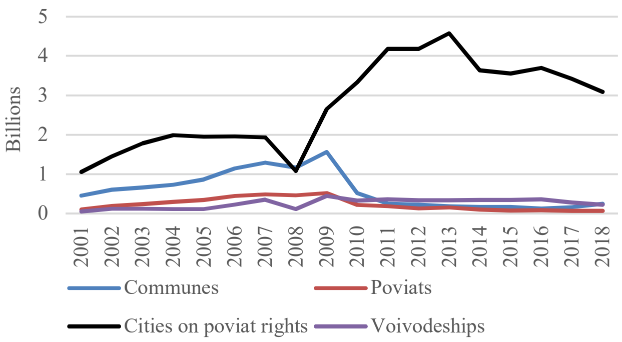
CHART 4. STRUCTURE OF LGUS DEBT BY INSTRUMENT.



Source: Own work based on data provided by the Ministry of Finance and available at www.gov.pl

The analysis of the Chart shows that credits and loans are dominating instruments in the structure of external financing of LGUs and this domination shows rising tendencies as of 2010. In 2018 the share of credits and loans in the overall structure was 95.2%. However, it should be brought to the reader's attention that according to the methodology of statistics of public debt which relies on definitions of public statistics which are in line with the *European System of National* and Regional *Accounts* (ESA2010), debt securities for which a liquid secondary market does not exist, are classified as credits or loans (Michalski, 2010) because from the economic point of view their form is similar to a credit. This definition embraces all issuances of bonds which were bought in private offer by one bank (the organiser of the issue) and which remained in non-public turnover (Michalski, 2014). The best year as regards the issues of bonds and securities was the year 2003 when the proportion of bonds and securities in the entirety of instruments reached the level of 17%. The analysis of debt structure by instruments observed in respective units of local government shows that cities on poviat rights are the most numerous local government units who issue bonds and securities in order to acquire financial resources. Indebtedness of local government units related to issuances of bonds and securities is presented in Chart 5.

CHART 5. INDEBTEDNESS FOR ISSUANCE OF BONDS AND SECURITIES OF POLISH LGUS IN THE PERIOD 2001-2018.



Source: Own work based on date provided by the Ministry of Finance and available at www.gov.pl

Issues of bonds and securities despite the advantages discussed above are also burdened with flaws. The biggest drawback form the point of view of the issuer, is the necessity to find buyers for the issued shares. In case of small communes this task is certainly much harder due to smaller recognition and not numerous population of potential buyers. However, big cities and cities with poviat rights dispose of a considerable potential in the form of a widely recognised brand as well as bigger populations who identify themselves with their local government unit. These two premises make the issue of municipal bonds an option which is more easily accessible for bigger units which, in turn, translates into better conditions of acquiring financial resources offered to them. The basis for determination of municipal bonds value was WIBOR 6M reference rate. This interest rate embraced 90% of issuances remaining in the turnover at the end of 2018 and almost all bonds issued in 2019 [Rozwój 2018]. However, it does not eliminate the chances of smaller units to successfully utilise this instrument while entering into financial obligations. There is a number of Polish communes which decided to issue municipal bonds in public offering in 2019 and are listed on the CATALYST market (Bestwina, Biała Rawska, Bobrowniki, Chełmża, Kęty, Koluszki, Opole Lubelskie and many more).

III. THE MARKET OF MUNICIPAL BONDS IN POLAND

Great expectations regarding development of the sector of corporate and local government debt in Poland were put in the Catalyst market which was established by the Warsaw Stock Exchange at the end of 2009. Before that time, issues of corporate and local government bonds took place outside the public market and were addressed mainly to banks and other financial institutions (Nawrocki and Żabka, 2013). Public offer, within the meaning of the Act on Public Offer and the Conditions of Introduction of *Financial Instruments* to Organised *Trading* System and on Public Companies (Journal of laws of 2005 No 184 item 1539) constitutes a proposal which is addressed to at least 150 people in the territory of one Member State or to the unmarked state recipient. This proposal contains such information regarding bonds or securities and conditions for their purchase which is sufficient to constitute a basis for taking a decision about purchase of these bonds and securities. This information can be communicated in any form and in any manner

When it comes to the issue of municipal bonds by Polish units of local government, the majority of issues were of non-public character and the issues made use of the so called investment sub-issue in which the entity who organises the issue (sub-issuer) purchases the bonds on his own account without the necessity for subsequent resale (Haładaj, 2014). It is confirmed in the statistics of Fitch Ratings (Rating&Rynek, 2019), according to which portfolios of various banks contained bonds worth 20.2 billion PLN, while reports from execution of budgets of local government units indicated that liability of local governments for bonds and securities did not exceed 4 billion PLN. It means that around 16 billion PLN was acquired as the result of bond issues in non-public offer. Statistics from the same source indicate that banks were the main buyers of

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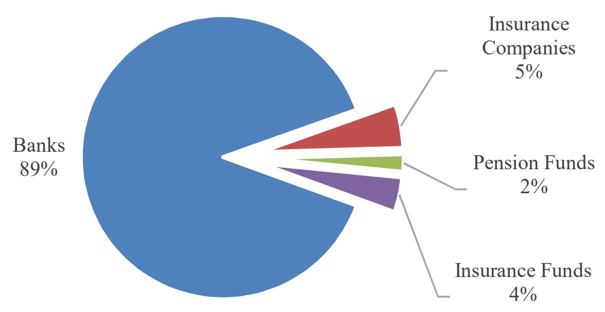
these bonds. The structure of buyers of municipal bonds is presented in Chart 6.

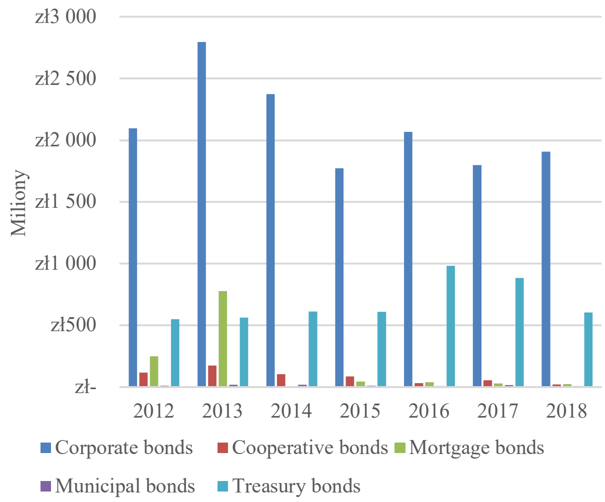
CHART 6: STRUCTURE OF MUNICIPAL BONDS BUYERS FOR 2019



Source: Own work based on (Rating&rynek, 2019)

The structure is fundamentally different than the structure of buyers of other long-term debt securities. The main buyers of commercial bonds issued by commercial enterprises in 2019 were investment funds (41,69%), pension funds (21,20%) and insurance companies (14,79%). Such dilution of the structure of buyers offers in consequence higher supply potential on the secondary market, and hence provides liquidity of turnover. This thesis finds confirmation in Chart 7 which shows the value of turnover on the CATALYST market with respect to debt securities of various entities.

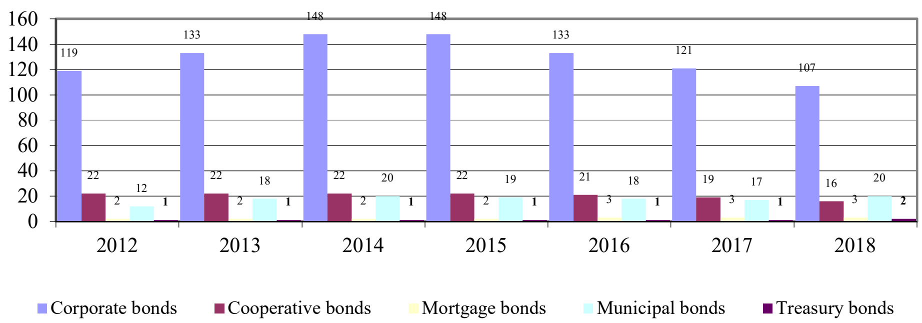
CHART 7. VALUE OF DEBT SECURITIES TURNOVER ON THE CATALYST MARKET BY ISSUERS.



Source: Own work based on data obtained from the Warsaw Stock Exchange.

Low volumes of turnover on the market of municipal bonds is a consequence of a negligent number of issues of securities by LGUs and low values of these issuances. The number of issues in public offer on the Catalyst market does not exceed 20 per year, while the number of corporate issuances amounts to more than 100 per year. The number of issuers of respective issues of bonds and securities on the Catalyst market is presented in Chart 8.

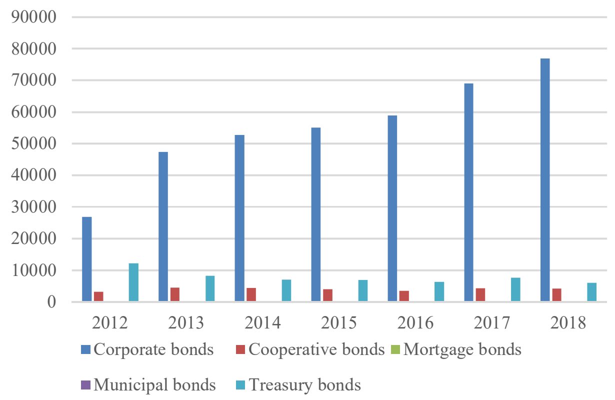
CHART 8. NUMBER OF LONG-TERM ISSUES OF DEBT SECURITIES ON THE CATALYST MARKET BETWEEN 2012 AND 2018.



Source: Own work based on data obtained from the Warsaw Stock Exchange.

A small number of issues of municipal bonds in public offer as well as rather low values of these issuances seem to be the biggest barriers for the development of the municipal bonds market in Poland. Also, the group of potential traders dealing with these instruments on the secondary market is very narrow. Debt securities were issued by almost 550 local government units in Poland but none of the units managed to acquire more than 9 million PLN on average (Rozwój, 2018). Commercial banks are able to embrace the entirety of securities issued by the units of local government. Additionally, commercial banks very often treat municipal bonds as a part of their investment portfolio, thus they are reluctant to introduce them into secondary turnover. These factors and low value of issues dedicated for the secondary turnover mean that the secondary market of municipal bonds operates in a very low liquidity environment with only 70 transactions annually. The number of transactions with debt instruments issued by issuers representing respective sectors of the CATALYST market is presented in Chart 9.

CHART 9. NUMBER OF TRANSACTIONS WITH DEBT INSTRUMENTS ON CATALYST MARKET BY ISSUERS.



Source: Own work based on data obtained from the Warsaw Stock Exchange.

Lack of liquidity of the market obviously means that these investments have time horizon measured until the maturity date of the bonds or they have to be resold at considerable loss. This explains low demand for municipal bonds among investors.

IV. CONCLUSIONS

Issue of municipal bonds may be an attractive form of financing expenses which are uncovered by revenues of local government units. To boost this attractiveness, however, the liquidity of this particular segment of the market must considerably improve. It can be achieved through increase in the number of bond issuances available in public offer. Due to the fact that issues of municipal bonds as a rule do not reach high volumes of sums to obtain, this instrument must be used widely by the LGUs because only then there will be enough shares in the secondary turnover to secure its liquidity and, as the result, the secondary market will become more attractive for a wider group of investors.

Unlike the majority of enterprises whose debt securities are listed on the CATALYST market, instruments of LGUs are guaranteed by the state who in case of their insolvency takes over their debts. Therefore, the investment risk of LGUs is rather low. What is more, local governments dispose of other resources which are unavailable to commercial companies i.e. enormous wealth which may serve as a collateral for issues of bonds, marketing potential which facilitates the search for potential buyers of bonds in public offer, but the most important asset of LGUs are, of course, the local residents. Strong identification of local communities with their authorities offers solid foundations for fruitful mutual collaboration in the area of financing local debt by means of municipal bonds and for members of the community it offers an opportunity to invest their savings in low risk instruments with interest rates higher than a bank deposit. For local government units acquisition of resources with lower interest rates than these offered by a bank credit and dilution of the structure of creditors will considerably facilitate the management of public debt.

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