Ákos Aczél and Dániel Homolya: Risks of the indebtedness of the local government sector from the point of view of financial stability*,[1]

This article explores the risks that arise as local governments become indebted. The article is based on interviews conducted with the heads of the local government business branches of the most important credit institutions in terms of local government financing, as well as related data, such as data from the Hungarian State Treasury on the financial management of local governments and data from banks. Until 2011, of the outstanding bonds issued during the boom in the local government sector in 2007–2008, payment began on only one third. By the end of the year, however, nearly 50 per cent (and by the end of 2013, 90 per cent) of total bonds outstanding will enter the principal repayment period. Due to the considerable foreign exchange exposure of total loans and bonds outstanding (60 per cent, with 80 per cent of those having Swiss franc exposure), as well as the declining revenues of local governments and deteriorating economic prospects, it is doubtful that local governments will be able to repay their debts to the banking sector in line with the original maturities. Our analysis establishes that local government debt-related risks have increased significantly in the recent period, but the banking sector is willing and able to manage these risks. Future comprehensive restructuring of the local government system and a change in debt settlement procedures by the Government may determine the financial position of the local government system. In parallel with a reorganisation of responsibilities, the possible transfer of a portion of local government debt (primarily from local county governments) to the central budget may result in a clearer picture.

INDEBTEDNESS OF LOCAL GOVERNMENTS

During 2007 and 2008, the liabilities of local governments to the banking sector approximately doubled. Total exposures of the banking sector have not increased significantly since the end of 2008. At end-June 2011, total bonds and total loans outstanding amounted to HUF 550 billion and HUF 450 billion, respectively. Foreign exchange exposure within the accumulated total loans and bonds outstanding is significant (approximately 60%), 80% of which is Swiss franc denominated. The increase in total liabilities outstanding was driven by both supply and demand factors. It is important to emphasise that this article basically analyses the risks to the banking sector, and therefore, it does not contain a thorough examination of the risks related to other debts (mainly commercial credit) of local governments, which have been fluctuating around HUF 200 billion for years.

In addition to cross-selling opportunities (EU applications, counselling, payment services, etc.), the banks' increasing **supply** experienced in the local government segment may have been driven by their attitude, typical among creditors, towards the continuous operation of local governments: due to their responsibilities being required by law, local governments may not become completely insolvent; nor may total dissolution occur, as they are obliged to ensure the performance of certain basic duties, and related revenues may cover repayments as well. There is a concentration on the supply side, as the seven banks that are the most active in local government financing have a market share of approximately 97 per cent.

The demand of local governments **strengthened** due to three main factors. First, the support programmes announced by the European Union basically require own funds; many of these provide the awarded funding only after the completion of the given project. Therefore, it may

* The views expressed in this article are those of the author(s) and do not necessarily reflect the offical view ot the Magyar Nemzeti Bank.

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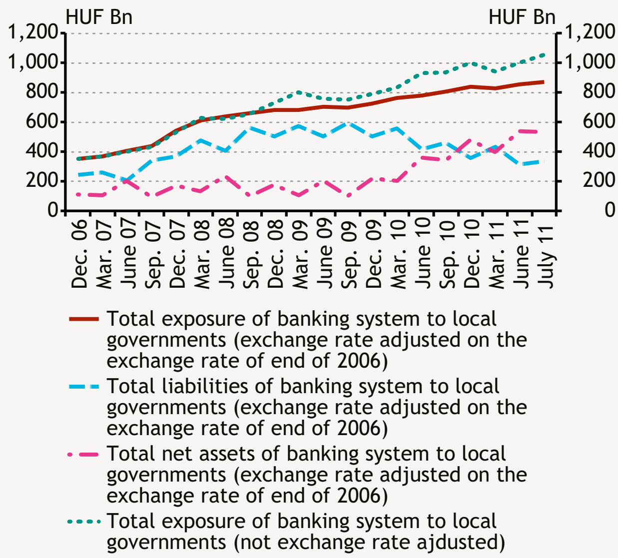
have become necessary for applicants to advance funds. Secondly, precautionary considerations stemming from regulatory uncertainty may also have played a role in the considerable magnitude of indebtedness. As a result of bills[2] outlining restrictions in lending to local governments, local governments took this last opportunity – presumably in order to accumulate reserves – to expand resources, even in economic situations where concrete investment objectives were not yet specified. The hypothesis that governments prepared applications and accumulated reserves in advance is confirmed by the fact that, at a system level, the amount of deposits accumulated following the issuing of bonds did not change for years, and the operating costs and accumulated expenditures of local governments did not increase until the end of 2009 (i.e. the resources were not used for several years). Moreover, foreign exchange funds were available at a favourable price, which may have provided an interest advantage over the entire maturity, allowing until disbursement of funds the realisation of the difference between the interest to be paid on foreign exchange loans and the interest received on forint deposits.

As the funds – mostly originating from bond issues – were placed as (forint-based) bank deposits, the position of the sector vis-à-vis the banking sector only slightly deteriorated until end-2009 (i.e. until local governments began reducing their deposits). However, in the period between early 2010 and the publication of this article, net accounts receivable of the banking sector vis-à-vis the local government sector increased by HUF 444 billion (Chart 1). This worsening of the position is attributable to three main processes. The withdrawal of deposits was typical on the asset side of local governments. The decline in total deposits by around HUF 220 billion occurred in parallel with an increase in expenditures with an accumulation purpose (accumulated expenditures presumably related to EU applications increased from HUF 574 billion in 2009 to HUF 721 billion in 2010). In addition, operating costs in 2010 also exceeded the 2009 level by approximately HUF 84 billion.

On the liability side of local governments – in parallel with the stagnation of long-term loans – the surge in overdraft credit impaired the position of the local government sector vis-à-vis the banking sector. Since January 2010, the total overdraft credit to local governments has nearly doubled, increasing from HUF 62 billion to HUF 116 billion. Local governments may have been encouraged to increase the amount of overdraft credit by the fact that – as is the case with bond issues – using this form of loan, available as part

Chart 1
Position of the local government sector vis-à-vis the domestic banking sector



Source: MNB.

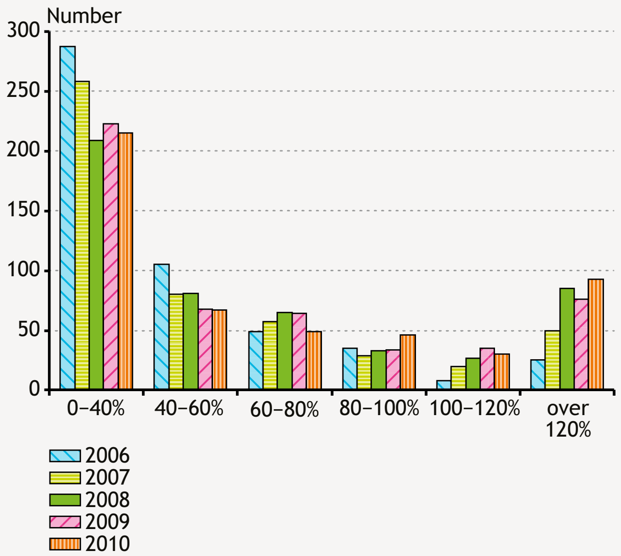
of the payment service, does not require a public procurement procedure. On the other hand, the increase in short-term loans outstanding also indicates strengthening liquidity problems, which may stem from the stretched financial management of local governments. Changes in depositing and borrowing are also reflected in the fact that in 2010, in parallel with a slight increase in outstanding debt, the cash-flow based deficit of local governments grew considerably.

The weakening of the forint against the Swiss franc also resulted in the worsening of the net position. Due to the change in the exchange rate, accounts payable of the local government sector to the banking sector increased by some HUF 110 billion since 2010 Q1, which underlines the significant exchange rate risk surrounding the outstanding debt.

In addition to the aforementioned exchange rate risk, other default risks are also related to the accumulated debt stock. It is uncertain whether local governments will be able to cover the costs of their investment implemented (i.e. their own funds for the application and the cost of interest to be paid in the case of subsequent financing). There is indication of a slight development of efficiency, in that the sector spent nearly three quarters of its investment on real estate purchases and barely one fifth on real property renewal (i.e. operating costs may presumably decline to a lesser extent).

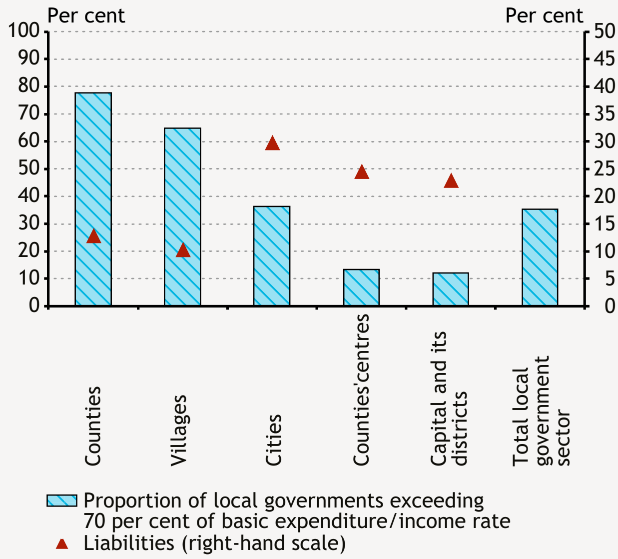
[2] In November 2007, the Ministry of Finance prepared a proposal to amend the Act on Local Governments. Inter alia, this aimed at changing the existing borrowing limit. (The content of the proposal is outlined in Vígvári, 2007).

Chart 2
Changes in liabilities to own revenues of the five hundred largest local governments that have revenues of their own between 2006 and 2010



Sources: Hungarian State Treasury, authors' own calculations.

Chart 3
Liabilities of local governments and the proportion of those with a high basic expenditure/revenue ratio according to types of settlements



Note: Basic expenditures mean operating costs, including the value of instalments coming due, whereas revenues contain all revenues except for those related to securities and loans.
Sources: Hungarian State Treasury and authors' own calculations.

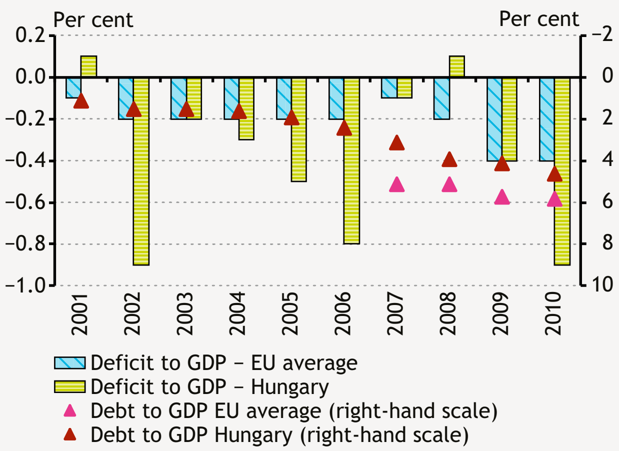
On the other hand, it is questionable whether the budgets of local governments were well-founded and based on forward-looking financial planning for the long-term. As repayment of the principal of bonds usually only begins three or four years following their issue, short-term objectives may have overshadowed prudent financial planning. An indication of this can be seen by the following: while in 2006 liabilities exceeded revenues for only thirty-three of the largest five hundred local governments that have their own revenues, the number increased to one hundred and twenty-three in 2010 (Chart 2). This increase in liabilities played an even more dominant role in the worsening of the liabilities-to-own-revenues indicator observed in recent years than the decline in own revenues.

For the sake of complete analysis, on the basis of data from the Hungarian State Treasury we also reviewed profit and loss accounts, balance sheet statements and other reports from local governments. Examinations at an individual level reveal that indebtedness is strongly concentrated among larger local governments. The breakdown according to types of settlements shows 23 per cent of the total debt is concentrated in the municipality of the capital and its surrounding districts. Their financial situation may be considered relatively stable. Based on our data, these local governments have sufficient flexibility to afford the instalments coming due. An examination of revenues (apart from revenues related to securities and borrowing) and basic expenditures (operating costs, including the repayment burden coming due) of local governments reveals that basic expenditures exceed 70 per cent of revenues only in the case of one tenth of the capital and district municipalities.[3] Local governments of counties and small settlements are the most overextended: for both of these, the ratio of local governments (value weighted with expenditures) where basic expenditures exceed 70 per cent of revenues is significant at 60–80 per cent (Chart 3). Moreover, among villages, around 23 per cent of settlements (value weighted with expenditures) exceed the 100 per cent basic expenditure/revenue ratio. Within own revenues that determine repayment ability, business tax plays an important role. If the revenues originating from business taxes were deducted from total revenues, the amount of basic expenditures would exceed 70 per cent of revenues in the case of nearly three quarters of the two hundred local governments (typically larger settlements), where 90 per cent of the sector-level business tax revenue is realised. As a result, risks related to solvency would dramatically increase. Accordingly, any redistribution of revenues originating from the business tax would result in a decline in the solvency of local governments previously considered creditworthy.

Although the system of tasks and financing of local governments varies across countries, it is worth also looking

[3] Value weighted with expenditures means five or six municipalities.

Chart 4
Debt-to-GDP ratio of the local government sector compared to the EU average



Note: In countries where Eurostat differentiates between separate local government and federal levels (Germany, Austria, Spain and Belgium), the federal level was not taken into account in our data.
Source: Eurostat.

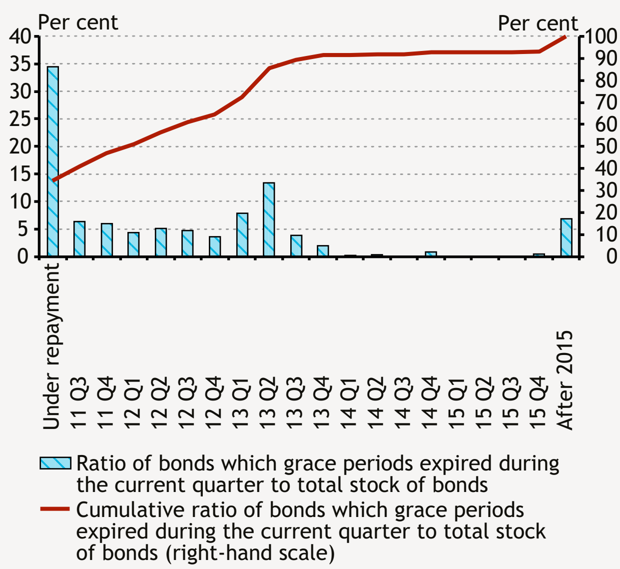
at the indebtedness of the Hungarian local government sector from an international perspective. A comparison of local government sectors in other European Union countries shows that the domestic local government sector is clearly susceptible to the accumulation of high deficits, although, for the time being, debt as a proportion of GDP cannot be considered extreme. Nevertheless, it may be a reason for concern that, as a result of high deficits, debt as a proportion of GDP increased from the 1.1 per cent level typical at the beginning of the millennium to 4.6 per cent by 2010. This also shows that stricter regulation of the financial management of local governments and ensuring adequate financing are necessary.

RISKS FROM THE ASPECT OF THE BANKING SECTOR

Bonds outstanding, which exceed half of the total exposure of local governments, were typically issued between 2006 and 2008. As a result of intense competition among banks, the premium levels that evolved were advantageous for local governments. Approximately 90 per cent of the Swiss franc-based bonds, which account for the greater part of bonds outstanding, were issued with a premium between 0 and 150 basis points above CHF LIBOR. It is worth mentioning that these premium levels are even below the premia of the bonds issued by Swiss local governments, in spite of the fact that in their case the risk stemming from the uncovered foreign exchange position does not exist. As deposit and lending rate statistics for the local government segment are not available to us, we can rely only on the 'general opinion' reinforced during multiple interviews with banks, according to which income appears in the local government segment through cross-selling opportunities. In addition to credit and bond products, banks offer a wide range of products to local governments, from maintaining accounts to options transactions, which may generate commission income for banks. The typically three- to five-year principal repayment grace periods of bonds issued (totalling approximately HUF 550 billion) started to expire at the end of 2010. Based on our estimates, by end-2011 nearly half of all the bonds outstanding will reach the repayment period, and this ratio may even amount to 90 per cent by end-2013 (Chart 5). Thus, although until now interest rates have been low, and the fact that they are tied to a variable rate (between mid-2008 and August 2011, the 3-month CHF LIBOR interest rate declined by approximately 2.5 percentage points to a level of 0–0.2 percentage points) has offset the effect of the strengthening of the Swiss franc on the repayment burden, the commencement of principal repayments imposes an increasing burden on local governments.

Calculated in terms of the end-2010 exchange rate, with the commencement of principal repayment periods in 2011 the repayment burden related to total long-term liabilities may exceed HUF 60 billion. The increase of HUF 8 billion to the bond repayment burden plays a determining role in the HUF 10 billion increase in the repayment burden, compared to 2010. According to our estimate, based on forward-looking reports of local governments, by 2012–2013 the total

Chart 5
Timing of the start of principal repayment within local government bonds outstanding



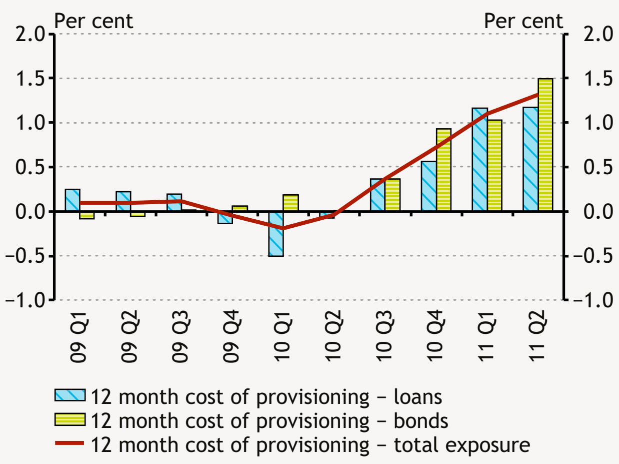
Source: MNB.

repayment obligation may grow to HUF 80 billion. Accordingly, the repayment burden related to long-term debt will increase from 0.2 per cent in 2010 to 0.3 per cent as a proportion of GDP.

Based on portfolio indicators at the end of the second quarter of 2011, the exposure of banks to local governments cannot be considered problematic, although observable changes project an increase in risks. Risks related to bonds outstanding have especially increased. At the end of the second quarter of 2011, the proportion of non-performing loans was 1.2 per cent in the case of *loans to local governments*. According to our estimates, at end-June 2011 the 90+ day delinquency rate within *total bonds outstanding* was nearly 3 per cent, reflecting a gradual increase compared to the level of 2.1 per cent at end-March 2011. Accordingly, within total local government exposures the ratio of non-performing loans reached 2.1 per cent, while the loan loss provision coverage of this stock grew to 14 per cent, which is below the approximately 40 per cent coverage of the total non-performing bank loan portfolio.

The increase in the ratio of the amount of new loan loss provisioning to exposure points also to portfolio deterioration. The cost of provisioning as a proportion of total loans outstanding increased from the level of around 0 observed until mid-2010 to 1.3 per cent by mid-2011 (Chart 6), while other data show that the banking sector practically started provisioning for the exposure to local governments only from mid-2010 on. The 1.5 per cent level of loan loss provisioning as a proportion of total loans outstanding at end-June 2011 is far below the approximately 5 per cent exposure-proportionate amount of provisioning for all credit type (loan-based and debt security-based) receivables in the banking sector. Looking ahead, however, we consider it important that banks should apply prudent loan loss provisioning methods for the local government exposure, and that they should keep adequate records of restructured transactions, reflecting the risks related to such exposures.

Chart 6
Cost of provisioning in the local government portfolio

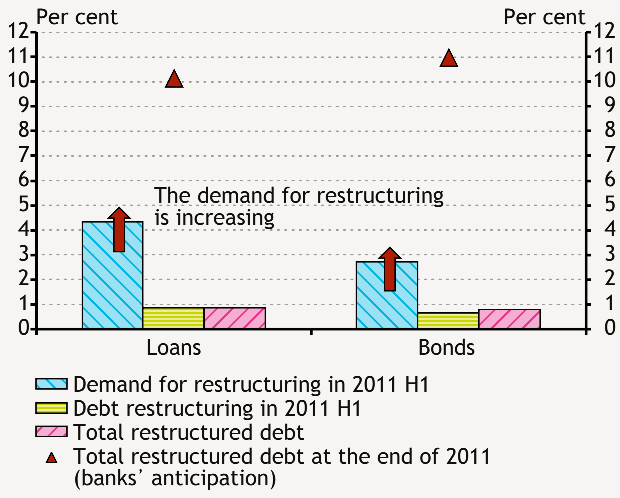


Source: MNB.

The start of restructurings related to the local government segment during 2011 also foreshadows a worsening in risk indicators. At end-June 2011, restructured exposure fluctuated around the level of a mere 1 per cent. However, demand for restructuring from the borrowers' side was already appearing, in relation to 3–4 per cent of the portfolio. Based on data from the Senior Loan Officer Survey on Bank Lending Practices[4] conducted by the MNB in July 2011, banks expect approximately 10 per cent restructuring as a proportion of total loans outstanding by end-2011 (Chart 7). According to a survey conducted among banks by the central bank, from the demand side (i.e. local government side), restructuring is mainly driven by declines in revenues, expenditure structure problems, unsuccessful investments and exchange rate changes. Meanwhile, the management of solvency problems and the smoothing of loan losses are determining factors for banks.

Banks usually apply maturity extensions and temporary moratoriums on complete or partial principal repayment as means of restructuring. Restructurings allow the payment burdens of local governments and the scheduling of

Chart 7
Restructuring expectations in the local government portfolio



Source: MNB.

[4] http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Penzugyi_stabilitas/hitelezesi_felmeres/mnben-hitelezesi-felmeres-20110825/Senior_loan_officer_survey_on_bank_lending_practice_2011_Q2.pdf.

payment to be adjusted in relation to an environment, different from the previously expected. At the same time, restructuring allows banks to apply pricing that better reflects risk costs and costs of funds. Recently, some local government organisations proposed a further general principal repayment moratorium of one or three years for all bonds. However, in our opinion, due to the uniqueness of local government transactions, the optimum solution may be to individually treat the cases of local governments with payment difficulties.

Restructurings indicate that the banking sector is willing to manage the risks related to the local government portfolio. However, aside from this willingness, another important issue is whether the banking sector is able to manage payment difficulties that may arise. Examining the local government bonds outstanding that are considered to be the riskiest, the ratio of total local government bonds outstanding to the capital buffer (until end-June 2011) does not significantly exceed 50 per cent. In the event that – in addition to the already existing loan loss provisions – a significant 10 per cent aggregate loss[5] appeared on the total bonds outstanding, only 7 per cent of the capital buffer of the banks active in the local government segment would be used up. In this scenario, there would not be a single bank where the potential loss would exceed half of the available buffer. In line with concentration of exposure, risks also affect the participants of the banking sector in a concentrated manner. A database of relationships with banks is available for total bonds outstanding. Based on this, it can be established that the various settlement segments basically reflect a share that is typical of total local government exposure. The related risks may be increased by the approximately HUF 200 billion exposure to local government companies, as seen in our survey conducted during the summer of 2011, as well as the financing of PPP projects. Manageability may be limited by the addition of other possible risks.

It may occur that risks related to the local government sector will be further increased by derivative transactions that they conclude. We assume that customer payments vis-à-vis the non-financial sector, concluded with others than non-financial corporations and private persons, may provide a rough estimate of derivative positions taken against local governments. Based on end-June 2011 data, the market value of these positions was around minus HUF 6 billion. This does not entail an effect on the profits of the banking sector, due to its covered position (commission revenue related to transactions is counted as income), but it may mean a potential profit for the local government segment. Information that allows the analysis of these derivatives has been available since early 2010. It can be established that, compared to 2010 Q1, there has not been any material change in the market value of these positions. There has been a decline in the contract value of transactions, however, which indicates some kind of adjustment. The number of partners has remained between 60–70.

REGULATORY ISSUES

In addition to the risks that already exist with the debt of local governments, the future situation may significantly be influenced by a restructuring of the whole system of local governments. Together with a narrowing of the basic responsibilities and the assignment of important institutions to the central government, it may be the case that, together with the reorganising of the duties of certain local government segments (local county governments), their debts would also be assumed by the state, resulting in a clearer picture. It is important to emphasise that this would not an entail an increase in government debt, as the debt of local governments is also presently included as a part of government debt.

The proposed change in government concept published in May 2011 raises several possibilities, including central management of local government debt, reorganisation of responsibilities and a possible transfer of the current accounts of local governments to the Hungarian State Treasury. According to prevailing regulations and practice, the current accounts of local governments are held at credit institutions, and they are allowed to change account-holding credit institutions only as of the first day of each month. Moreover, the Hungarian State Treasury has to be notified of any changes in writing 30 days in advance.[6] The transfer of accounts to the Hungarian State Treasury would result in lost revenues for banks. At the same time, it would lead to an increase in credit risk, which may be reflected in an increase in financing costs. However, in the case of such a change like this, recent information regarding the financial situation of the local government sector as a whole would be available in a more up-to-date manner, and the increased possibility of controlling financial management would entail an important advantage from the national economy aspect.

[5] This assumption means that 20 per cent of the local governments involved in the total bonds outstanding would get into trouble, and a 50 per cent loss would develop for each of them.

[6] It is worth mentioning that the Heves County Local Government, which is under debt settlement proceedings, transferred its current account to the Hungarian State Treasury, which reduces the chances of intervention by the credit institutions concerned (mainly those of the OTP Bank). The prompt timing of this step taken by the Heves County Local Government raises the issue of conflict with prevailing Hungarian legislation.

From the perspective of financial stability, it is important that repayment by local governments should remain an acknowledged obligation and, looking ahead, local government borrowing constraints move in the direction of 'effectiveness'. The latter is especially important, given that current debt constraints are too loose and thus not effective at a system level. According to our estimates, 8 per cent of the approximately 3,200 local governments may hit the statutory borrowing limit, whereas this ratio is a mere 3 per cent as a proportion of total own income in the sector. In terms of significant foreign exchange-based exposure, it may be worth considering an imposition of limits on foreign exchange-based indebtedness in order to prevent the development of future risks. It is a positive shift that pursuant to the change in legislation effective as of early 2011, if a local government borrows with a maturity of over one year or issues bonds, the body of representatives is obliged to entrust an auditor in advance. The auditor is obliged to let the body of representatives know about his professional opinion on the planned assumption of an obligation. The body of representatives is obliged to inform the financial institution providing the financial service about the opinion of the accountant.

The amendment to the Constitution also created a possibility of strengthening central control over borrowing: 'An Act may define conditions for, or the Government's consent to, any borrowing to a statutory extent or to any other commitment of local governments with the aim of preserving their budget balance.' (The Constitution of Hungary, effective as of 1 January 2012). The intention to impose stronger control over borrowing also appears in connection with the local government concept, discussed by the Government in August 2011 but not disclosed in full.

From the perspective of credit risk, procedures that help resolve situations related to insolvency are of key importance. It is important to emphasise that there is no state guarantee on local government debt, and in the event of any payment problems, liabilities may be settled in a debt settlement procedure. Nevertheless, in the current turbulent environment, uncertainties related to the ability and willingness of local governments to pay may also add to the sensitivity of risk related to the Hungarian sovereign.

The settlement of local government debt is regulated in Act XXV of 1996, which sets up a clear framework for cases of insolvency and can be considered a good statutory regulation, even internationally speaking. The purpose of the Act is for bankruptcy proceedings to provide for the restoration of the solvency of local governments, in addition to performing their mandatory duties and satisfying creditor claims in proportion to disposable assets. The debt settlement procedure of local governments is different from corporate bankruptcy law procedure in two main ways: first, because local governments have to also provide basic public services during the debt settlement procedure; and secondly, because the available collateral is special. Prior to 2010, debt settlement procedures were usually initiated in the case of smaller local governments. In 2010, they began in the case of larger local governments as well (Szigetvár, Esztergom, and Heves County in 2011).

In the summer of 2011, somewhat independently of the restructuring of the local government system as a whole, local government debt settlement procedures were changed. In view of that, while the definition of assets that may be involved in the debt settlement remained unchanged, but the legislation provided a more precise definition of elements that cannot be included in the debt settlement (Table 1). Accordingly, the scope of collateral that can be involved in the debt settlement is practically narrowed to assets that do not serve the purpose of public duties or ones not yet secured for the purpose of another institution.

Table 1
Change in the scope of assets that cannot be involved in local government debt procedures

Assets excluded from debt settlement (before the change in July 2011)	Assets excluded from debt settlement (after the change in July 2011)
Residential real estates and other real estates that were transferred from state ownership to local government ownership	Residential real estates and other real estates that were transferred from state ownership to local government ownership
	Assets for which the state provides support and contribution
	Assets of local government partnerships and local minority self-government(s) appearing in the budget of the local government
	The own fund and support parts of development and operating resources won by the local government or its budgetary body through an application exclusively for a given purpose, related to the performance of a mandatory task stipulated by law
	Separately managed sum allocated to the local government in order to settle the ownership situation of church-owned real estate

At the same time, the amendment to the law also defined what revenue can be involved in debt settlement (the amount of own revenues collected in a given year or outstanding as receivables, as well as revenue from assigned central taxes, from the commencement of the debt settlement procedure until the recovery of the declared creditor claims). A so-called reorganisation loan was defined, which may help in the repayment of earlier outstanding debt with an interest subsidy that can be imposed by ministerial decision. In addition, the scope of mandatory duties that have to be performed during debt settlement was narrowed by certain social benefits and expanded with certain responsibilities.

Based on the amendment, the power of the mayor is narrowed during the whole process. The power of the bodies of representatives has been increased, which may facilitate the adoption of measures related to debt settlements. This amendment to the law also allows the restructuring of budgetary bodies and public education institutions belonging to local governments during the debt settlement, even the immediate effect is contrary to regulations regarding their normal operation.[7]

Overall, from the perspective of the banks, the inclusion of the experience of earlier debt settlement procedures in the regulation is a favourable development. The narrowing of the scope of collateral that may be involved in debt settlement could pose a problem, but the use of significant real estate collateral for local government exposures was not typical before the amendment (only a mere 4 per cent of total debt outstanding was covered by real estate); the amount of other collateral (mainly guarantees) is nearly 11 per cent of total debt outstanding. The practice of requesting collateral is in line with the aforementioned assumption, presented in the article by Homolya and Szigel (2008), that banks base their financing decisions on the continuous operation of local governments. Namely, in spite of the uncertainties explored here, credit institutions are not afraid of suffering significant losses on local government portfolios because local governments cannot be liquidated, even in the case of a bankruptcy, and their sources of revenue may not be completely exhausted. Also, credit institutions expect insolvent institutions to meet their obligations sooner or later, even without state intervention, by rescheduling loans and limiting expenditures, using their own revenues. Looking ahead, however, increasing risks in the local government segment signal continued strict lending conditions.

SUMMARY

Until 2011, of the outstanding bonds issued during the boom in the local government sector in 2007–2008, payment began on only one third. By the end of the year, however, nearly 50 per cent (and by end of 2013, 90 per cent) of total bonds outstanding will enter the repayment period. As a result of significant exchange rate exposure, the declining revenues of local governments and deteriorating economic prospects, solvency problems may arise. In order to prevent disturbances in the operation of the financial system, appropriate management of risks related to the portfolio is important; at the same time, opinions formed abroad about the Hungarian state may also be negatively influenced by risks related to the local government sector. Our analysis suggests that the banking sector is willing and able to manage these risks. Looking ahead, however, from this point of view the Government's future comprehensive restructuring of the local government sector as a whole may be essential.

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[7] For example, it must normally be decided before the end of May whether a school's operating rights will be transferred to another organisation.