Risks of the indebtedness of the Hungarian local government sector from a financial stability point of view

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Our paper explores the risks that arise due to indebtedness of Hungarian local governments. Our analysis relies on interviews conducted with the heads of the local government business branches of the credit institutions most important in terms of local government financing and on the related data collections, as well as on data from the Hungarian State Treasury regarding the financial management of local governments and on data from banks. Until 2011, the repayment of the bonds issued during the bond issue boom experienced in the local government sector in 2007–2008 started only in the case of one third of the bonds outstanding. However, by the end of 2011 year nearly 50 per cent and by end-2013 90 per cent of total bonds outstanding will reach the principal repayment period. Due to the considerable foreign exchange exposure of total loans and bonds outstanding (60 per cent, 80 per cent of which is Swiss franc exposure) as well as to the declining revenues of local governments and the 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. Therefore local governments financing may have an effect not only on the fiscal position but on the whole financial system as well. Nevertheless, our partial analysis establishes that the risks related to the debt of the local government sector have increased significantly in the recent period, but these risks could be managed by the banks. The comprehensive restructuring of the local government system as a whole and a further changing of debt settlement procedures by the government may influence the financial position of the local government system. In parallel with the regrouping of tasks, transferring of a portion of local government debt (primarily from the county local governments) to the central budget may result in a clear picture.

Keywords: banks, state and local borrowing, bankruptcy, liquidation

1. 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 end-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; therefore, it does not contain a thorough examination of the risks that surround other debts (mainly commercial credit) of local governments, which have been fluctuating around HUF 200 billion for years.

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* Earlier version of this paper was published in October 2011 Issue of MNB Bulletin. (http://english.mnb.hu/Kiadvanyok/mnben_mnbszemle/mnben_mnb-bulletin-october-2011). This paper contains the views of the authors, and does not necessarily reflect the official position of the Magyar Nemzeti Bank (central bank of Hungary). Many pieces of news have arisen in connection with the restructuring of the local government system since mid-2011; this article is based on information that became known until end-August 2011. However we made some preliminary comments on the changes executed at the end of 2011 regarding regulation of local governments. Responsibility for any mistakes lies with the authors alone.

In addition to cross-selling opportunities (EU applications, counselling, payment services etc.), banks' increasing *supply* experienced in the local government segment may have been fed by the approach built upon the continuous operation of local governments, which is typical among creditors: resulting from their tasks declared by law, local governments may not become completely insolvent, and total dissolution may not take place either, as they are obliged to ensure the performance of certain basic tasks, and the related revenues may cover repayments as well. There is some kind of concentratedness on the supply side, as the 7 banks that are the most active in local government financing have a market share of approximately 97 per cent.

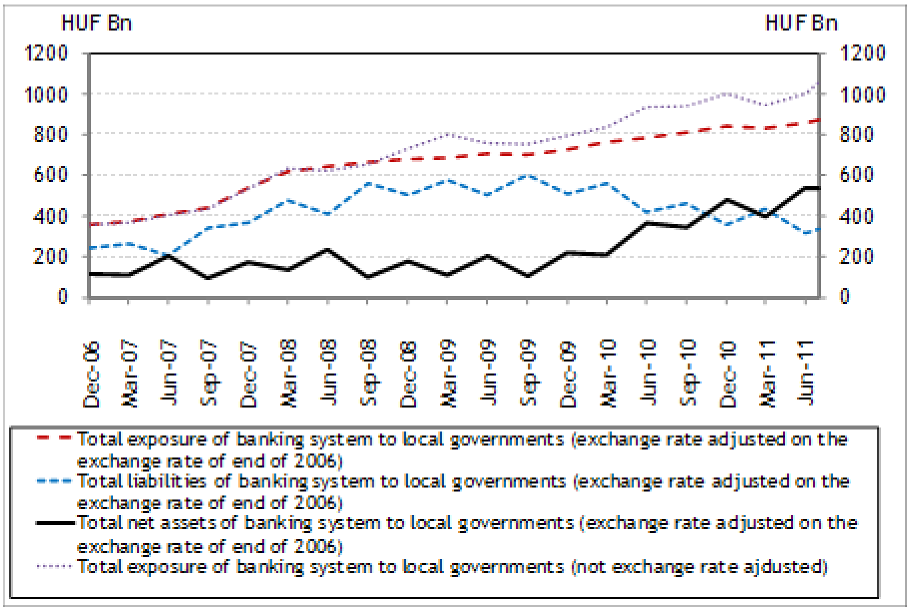
The demand of local governments *strengthened* due to three main factors. Firstly, the support programmes announced by the European Union basically require own funds and many of them provide the awarded funding only after the completion of the given project; therefore, it may have become necessary for applicants to advance the funds. Secondly, precautionary considerations stemming from the regulatory uncertainty may also have played a role in the considerable magnitude of indebtedness. As a result of the bills[1] pointing to restrictions in lending to local governments, as a kind of last opportunity – presumably in order to accumulate reserves – local governments expanded their resources even in economic situations when concrete investment objectives were not yet specified. The hypotheses of preparing for applications and of accumulating reserves in advance are confirmed by the fact that at system level the amount of deposits built up following the issue of bonds did not change for years, and the operating costs and accumulation expenditures of local governments did not increase until end-2009, i.e. the resources were not used for several years. Moreover, foreign exchange funds were available at a favourable price, which may provide an interest advantage attainable over the entire maturity, and allows, until the spending of the funds, the realisation of the difference between the interests to be paid after the foreign exchange loans and the interests received for the forint deposits.

As Homolya and Szigel (2008) analysed Hungarian regulatory limits to obtaining financing by the local governments were not effective, the realised local government financing was determined by interaction of supply and demand limited by risk management concepts of banks. As it is refered in Homolya and Szigel (2008) (p. 24.). The literature (Ter-Minassian and Craig, 1997) distinguishes four fundamental systems in the regulation of local government indebtedness: market discipline, direct controls by the centralgovernment; rules-based approaches; co-operative approach (decision of local governments in agreement with a central authority). Theoretically, from among these alternative methods the Hungarian system was rule-based before 2012, as the relevant act determined an annual maximum debt service for local governments, this regulation is that the annual liabilities undertaken by local governments (including all financing costs, primarily loan repayment, debiting the particular year) may not exceed 70% of their own proprietary revenues minus short-term liabilities. However this rule was incapable of limitation because of not reach of this preset limit by almost any local government, uncertainties about future compliance with these limits, and no predefined penalty for exceeding the borrowing limit. Thus the Hungarian system was a quasi market controlled system, however the control power of market players was limited by intransparency of financial positions of individual local governments (see Homolya and Szigel (2008) for more details). It is worh mentioning, that issue of limiting indebtedness of local governments is not only Hungarian specific question, in the last couple of years in case of different countries concerns about subgovernmental level public debt have been emerged (e.g. autonomous communities/ provinces in case of Spain, some states in the

[1] In November 2007, the Ministry of Finance prepared a proposal for amending the Act on Local Governments aiming at, inter alia, changing the existing borrowing limit. (The content of the proposal is outlined in Vigvári, 2007).

US).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 deteriorated only slightly until end-2009, i.e. until local governments started to reduce 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). The 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 moved together with the increase in expenditures with an accumulation purpose (accumulation expenditures that are presumably related to EU applications increased from HUF 574 billion in 2009 to HUF 721 billion in 2010). In addition, operating costs also exceeded the 2009 level by some HUF 84 billion in 2010.

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



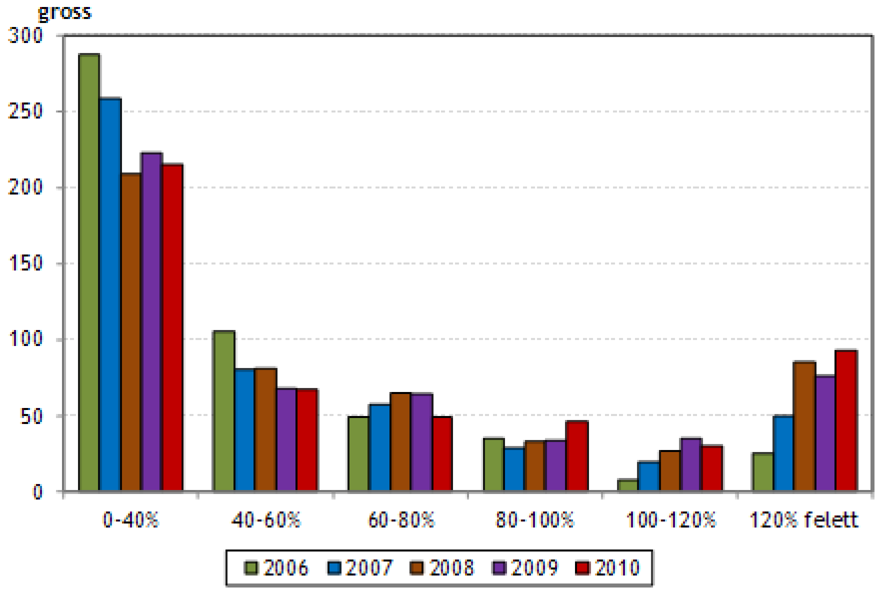
Source: MNB data.

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 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 – similarly to bond issues – using this form of loan does not require a public procurement procedure, as this loan is available as part of the payment service. 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. The developments 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 sector to the banking sector increased by some HUF 110 billion since 2010 Q1, which calls attention to 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 carries an uncertainty whether local governments are able to produce the costs of their investment implemented, i.e. own funds for the application and the interest cost to be paid in the case of subsequent financing. It indicates a slight development of efficiency that the participants of the sector spent nearly three quarters of the investment on real estate purchases and barely one fifth on real property renewal, i.e. operating costs may presumably decline only to a lesser extent. On the other hand, it is questionable whether the budgets of local governments were well-founded and based on forward-looking financial planning for a longer period of time as well. As the repayment of the principal part of the bonds issued usually has to be started only 3–4 years following the issue, short-term objectives may have overwritten the aspects of prudent financial planning. An indication of this is that while in 2006 the liabilities of only thirty-three of the largest five hundred local governments that have own revenues exceeded their own revenues, the number of such local governments already reached one hundred and twenty-three in 2010 (Chart 2). The increase in liabilities played a more essential role in the worsening of the liabilities-to-own revenues indicator observed in recent years than the decline in own revenues.

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



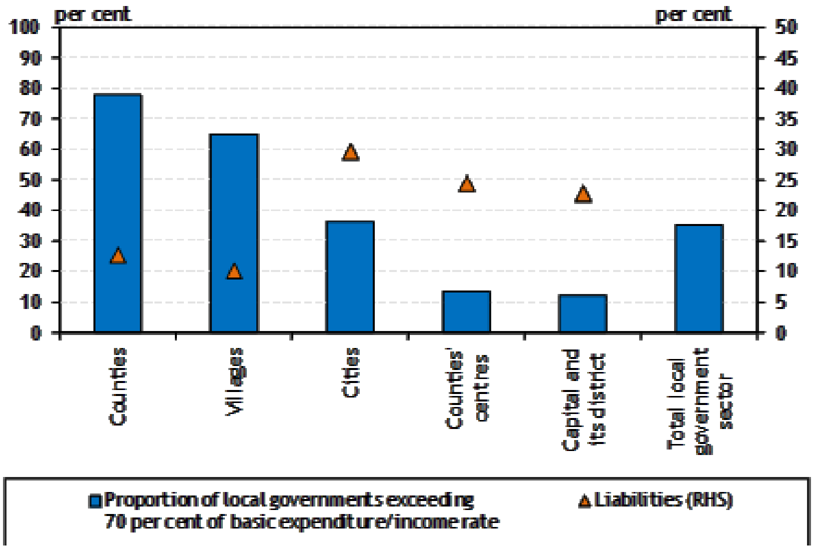
Sources: Hungarian State Treasury, the authors' own calculations.

For the sake of a complete analysis, on the basis of the data of the Hungarian State Treasury we also reviewed the profit and loss accounts, balance sheet statements and other reports of local governments. Individual level examinations reveal that indebtedness is strongly concentrated among larger local governments. The breakdown according to types of settlements shows that 23 per cent of the total debt accumulated at the municipality of the capital and at the districts of the capital. Their financial situation may be considered relatively stable; based on our data, these local governments have enough room for manoeuvre to afford the instalments due. The examination of the revenues (apart from the revenues related to securities and borrowing) and the basic expenditures (operating costs including the repayment burden 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.[2] Local governments of counties and small settlements are in the most stretched situation: in the case of both types, the ratio of local governments (value weighted with expenditures) where basic expenditures exceed 70 per cent of their revenues is significant, 60–80 per cent (Chart 3). Moreover, among the villages, around 23 per cent of the settlements (value weighted with expenditures) exceed the 100 per cent basic

[2] Value weighted with expenditures, means 5–6 municipalities.

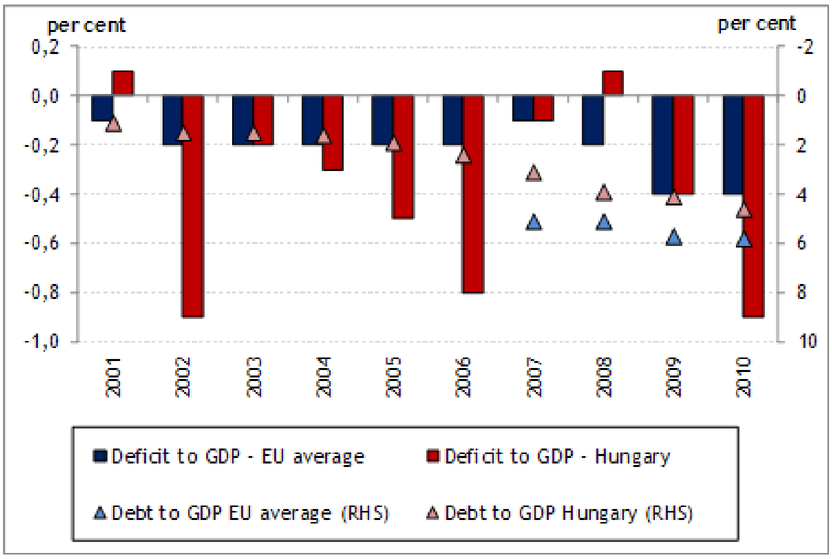
expenditure/revenue ratio. Within own revenues that are determining in terms of the repayment ability, the business tax plays an important role. If the revenues originating from the business tax were deducted from total revenues, the amount of basic expenditures would exceed 70 per cent of revenues in 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, the risks related to solvency would increase strongly. Accordingly, any redistribution of the revenues originating from the business tax would result in a decline in the solvency of local governments that were considered creditworthy earlier.

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



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

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



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

Although the system of tasks and financing of local governments varies across countries, it is worth having a look at the indebtedness of the Hungarian local government sector in an international comparison as well. The comparison with the local government sectors of the countries of the European Union shows that the domestic local government sector is clearly among the ones that have accumulated high deficits, although its debt as a proportion of GDP cannot be considered extreme for the time being. Nevertheless, it may be a reason for concern that as a result of the 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 a stricter regulation of the financial management of local governments and ensuring adequate financing are necessary.

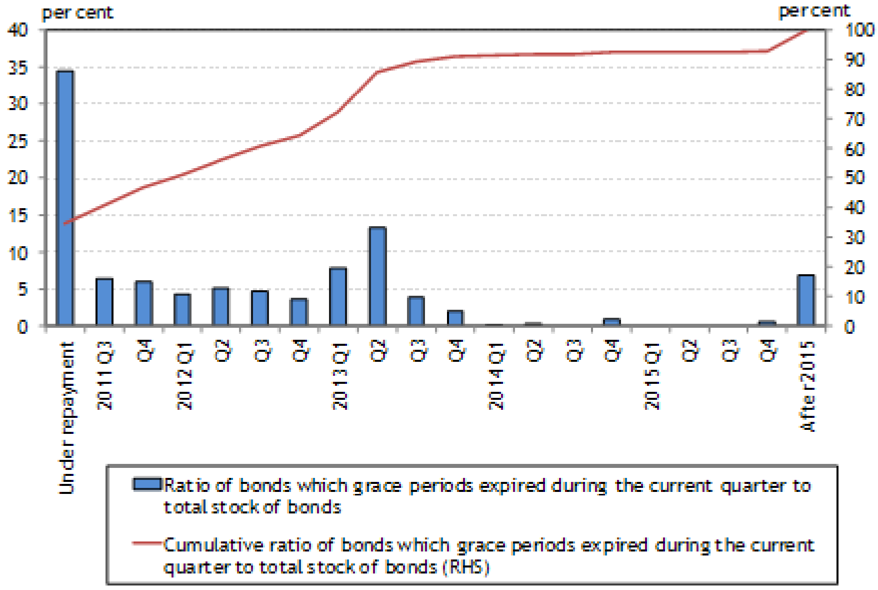
2. Risks from the aspect of the banking sector

Bonds outstanding, which exceed half of the total exposure of local governments, were typically issued between 2006 and 2008. As a result of the intense competition among banks, the premium levels that evolved were advantageous for local governments. 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 premiums 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 for us, we can only rely on the 'public opinion' revealed repeatedly during interviews with banks, according to which income appears in the local government segment through the cross-selling opportunities. In addition to credit and bond products, banks offer a wide range of products to local governments, starting from keeping an account to option dealing, which may generate commission income for banks. The typically 3–5-year principal repayment grace periods of the bonds issued (in a total value of approximately HUF 550 billion) started to expire at end-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 the low interest rate level and the fact that it is tied to a variable rate (between mid-2008 and August 2011, the 3-month CHF LIBOR interest rate declined by some 2.5 percentage points to a level of 0–0.2 percentage points) offset the effect of the strengthening of the Swiss franc on the repayment burden, the starting of principal repayments imposes an increasing burden on local governments.

Calculating with the end-2010 exchange rate, with the start of the 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 in 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 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. Especially the risks related to bonds outstanding have 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 estimate, at end-June 2011 the 90+ day delinquency rate within *total bonds outstanding* was nearly 3 per cent, which means 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.

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



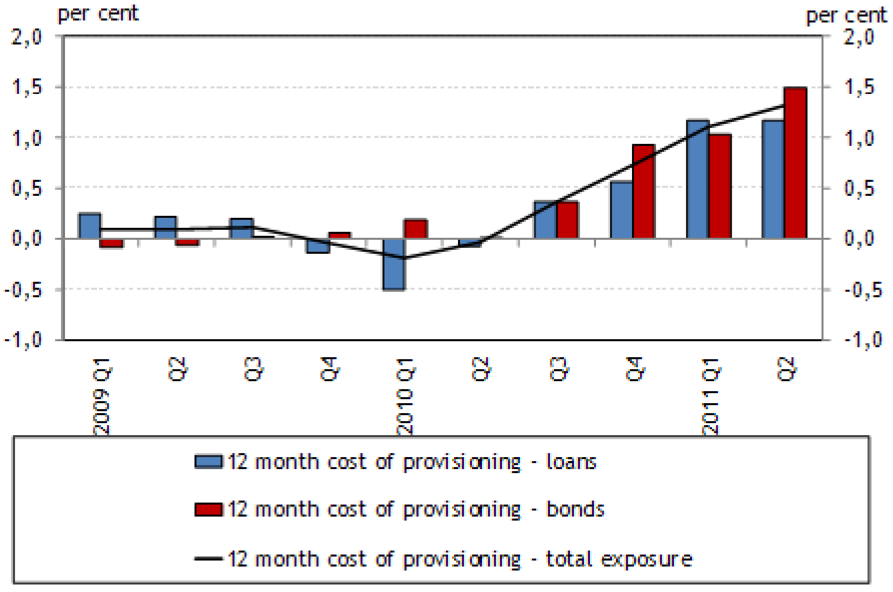
Source: MNB data.

The increase in the ratio of the amount of new loan loss provisioning to exposure also points 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), and 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 the credit type (loan-based and debt security-based) receivables of 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 should keep adequate records of the restructured transactions, reflecting the risks related to the exposures.

The start of restructurings related to the local government segment during 2011 also projects 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 appeared already concerning the 3–4 per cent of the portfolio, and based on the data of the Senior Loan Officer Survey on Bank Lending Practices[3] conducted by the MNB in July 2011, banks expect an around 10 per cent restructuring as a proportion of total loans outstanding by end-2011 (Chart 7). According to the survey conducted among banks by the Central Bank, from the demand side, i.e. local government side, the demands related to restructuring are mainly driven by the decline in revenues, expenditure structure problems, unsuccessful investment and exchange rate changes. Meanwhile, the management of solvency problems and the smoothing of loan losses are the determining aspects on the side of the banks.

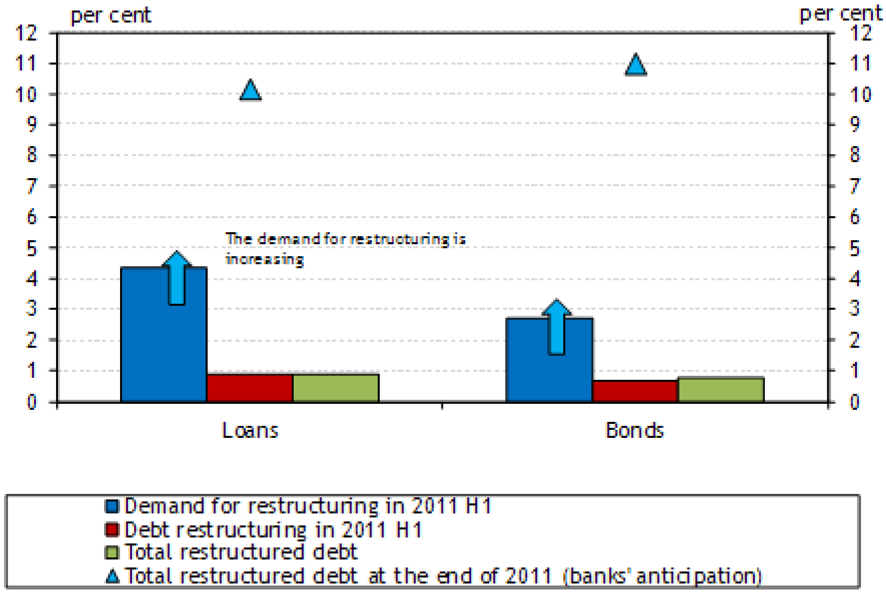
[3] http://english.mnb.hu/Root/Dokumentumtar/ENMNB/Penzugyi_stabilitas/hitelezesi_felmeres/mnben-hitelezesi-felmeres-20110825/Senior_loan_officer_survey_on_bank_lending_practice_2011_Q2.pdf

Chart 6: Cost of provisioning in the local government portfolio



Source: MNB data.

Chart 7: Restructuring expectations in the local government portfolio



Source: MNB data.

Banks usually apply extension of maturity and temporary complete or partial principal repayment moratorium as means of restructuring. Restructurings allow the payment burdens of the local governments concerned and their scheduling to be adjusted to a different environment compared to the situation expected earlier. 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 1 or 3 years covering all bonds. However, in our opinion, due to the uniqueness of local government transactions, the optimum solution may be to treat the cases of local governments that have payment difficulties individually.

Restructurings indicate that the banking sector is willing to manage the risks related to the local government portfolio. However, in addition to willingness, another important issue is whether the banking sector is able to manage the payment difficulties that arise. Examining local government bonds outstanding that are considered to be the riskiest, the ratio of total local government bonds outstanding to the end-June 2011 capital buffer 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[4] appeared on the total bonds outstanding, only 7 per cent of the capital buffer of the banks that active in the local government segment would be used up, and there would not be any bank where the potential loss would exceed half of the buffer available. In line with the concentration of exposure, risks also affect the participants of the banking sector in a concentrated manner. Database about relationship with banks is available for total bonds outstanding. Based on this, it can be established that in the various settlement segments basically the share typical of the total local government exposure is reflected. The related risks may be increased by the approximately HUF 200 billion exposure to local government companies found in our survey conducted during the summer of 2011 as well as the financing of PPP projects, and manageability may be limited by the culmination of possible other risks.

It may happen that the risks related to the local government sector will further be increased by the derivative transactions concluded by them. We assume that customer payments vis-à-vis the non-financial sector concluded with those other than non-financial corporations and private persons may provide a rough estimate of the 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 profit of the banking sector due to its covered position (the commission revenue related to transactions means 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, but there has been a decline in the contract value of transactions, which indicates some kind of adjustment. The number of partners has remained between 60–70.

3. Regulatory issues[5]

In addition to the risks accumulated to date in connection with the debt of local governments, the future situation of local governments may significantly be influenced by the restructuring of the whole system. Together with a narrowing of the basic tasks and the assignment of important institutions to the central government it may arise that together with the reorganising of the tasks of certain local government segments (local governments of counties) their debt are to also be assumed by the state, resulting in a clear picture. It is important to emphasise that by this step government debt would not increase, as the debt of local governments is a part of government debt at present as well.

The concept of the government published in May 2011 raises several possibilities, including the central management of local government debt, the reorganisation of tasks and a possible moving of the current accounts of local governments to the Hungarian State Treasury. Until end of 2011 such a legal change were not executed. According to the prevailing regulation and practice, the current accounts of local governments are held at credit institutions, and they are allowed to change account-holding credit

[4] 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 on each of them.
[5] As the cut-off date for the overall research was August 2011, we do not analyse in more details the news law on local governments of Hungary accepted at the end of 2011. However this does not imply irrelevance of our analysis.

institutions only as of the first day of each month. Moreover, the Hungarian State Treasury has to be notified of the change in writing 30 days in advance.[6] The transfer of account-holding to the Hungarian State Treasury would result in lost revenues for banks, and at the same time it would be a credit risk increasing factor, which may be reflected in an increase in financing costs. However, in the case of a change like this, the more recent information base 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 a national economy aspect.

From the aspect 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'. This latter is especially important because the current debt constraints are too loose, and thus they are not effective at system level. According to our estimate, the statutory borrowing limit may effectively arise at 8 per cent of the approximately 3,200 local governments, whereas this ratio is a mere 3 per cent as a proportion of own income. Reacting to the significant foreign exchange based exposure it may be worth considering that impose limits to 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, and 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 the 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 of a stronger control of borrowing also appears in connection with the local government concept discussed by the Government in August 2011. The Law on economic stability of Hungary (Act CXCIV of 2011) accepted at the end of 2011 defined limits stricter than earlier and central government controls on newly disbursed indebtedness by local governments, which might be a significant step to direct Hungarian local government system from a quasi market based system to a control/rule based system.

The procedures that help in arranging situations related to insolvency are of key importance from the aspect of credit risks. 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 the uncertainties related to local governments' ability and willingness to pay may add to the sensitivity to risk related to the Hungarian sovereign as well.

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 in international comparison. The purpose of the act is that bankruptcy proceedings provide for the restoration of the solvency of local governments, in addition to performing their mandatory duties and satisfying creditor claims in proportion to the disposable assets. The debt settlement procedure of local

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

governments is different from the corporate bankruptcy law procedure due to two main reasons: firstly, because local governments have to provide the basic public services during the debt settlement procedure as well; secondly, because the available collateral is special. Prior to 2010, debt settlement procedures usually started in the case of smaller local governments, but during 2010 already in the case of larger local governments as well (Szigetvár, Esztergom; and Heves County in 2011).

In the summer of 2011, to some extent independently of the restructuring of the local government system as a whole, local government debt settlement procedures were changed. Within that, the definition of the assets that may be involved in the debt settlement remained unchanged, but the legislation gives a more precise definition of the elements that cannot be involved 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 tasks or the 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

Source: authors's own construction

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

Based on the amendment, the power of the mayor is narrowed during the whole procedure, while the power of the bodies of representatives has increased, which may facilitate the adoption of measures related to the debt settlement. The amendment to the regulation allows the restructuring of budgetary bodies and public education institutions belonging to local governments during the debt settlement even with immediate effect, contrary to the rules regarding normal operation.[7]

Overall, from the aspect of 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 be a problem, but the use of significant real estate collateral behind local government exposures was not typical earlier either (only a mere 4 per cent of the total debt outstanding is covered by real estate), and the magnitude of other collateral (mainly guarantee) is nearly 11 per cent as a proportion of the total debt outstanding. The practice of the request of collateral is in line with the already mentioned 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, credit institutions are not afraid of suffering significant losses on their local government portfolios because local governments cannot be liquidated even in the case of a bankruptcy, and their sources of revenue may not dry out completely either. Also, credit institutions expect the insolvent institutions to meet their obligations sooner or later anyway, even without state intervention, by rescheduling the loans and restraining their expenditures, using their own revenues. Looking ahead, however, the increasing risks in the local government segment point to the remaining of the strict lending conditions.

4. Summary

Until 2011, the repayment of the bonds subscribed during the bond issue boom experienced in the local government sector in 2007–2008 started only in the case of one third of the bonds outstanding.However, by the end of the year nearly 50 per cent and by end-2013 90 per cent of total bonds outstanding will reach the repayment period. As a result of the significant exchange rate exposure, the declining revenues of local governments and the deteriorating economic prospects, solvency problems may arise. Appropriate management of the risks related to the portfolio is important from the aspect of the undisturbed operation of the financial system; at the same time, the opinion formed of the Hungarian state abroad may also be negatively influenced by the 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 aspect the future comprehensive restructuring of the local government sector as a whole by the Government may be essential.

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[7] For example, normally it has to be decided before the end of May whether the operating right of a school will be transferred to another organisation or not.

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