

# Dániel Homolya–Gábor Szigel: Lending to local governments: Risks and behaviour of Hungarian banks<sup>1</sup>

Over the past one and a half years, the amount of credit granted by banks to Hungarian local governments has doubled, and the gap between their cash deficit and net additional indebtedness has increased. This borrowing boom is not the result of a drastic change in the financial management of local governments, but stems primarily of the fear of statutory tightening of borrowing conditions and their propensity to hold reserves. As the current statutory regulation does not represent an effective restriction on debt, indebtedness in the sector is limited only by the market – i.e. banks' lending propensity. Although it is not unprecedented in international practice that this kind of market coordination may – with minor fluctuations – be able to keep indebtedness at an acceptable level, the uncertainties in the financial management of local governments and the weak transparency related to their long-term or contingent liabilities mean that the conditions for this kind of coordination are not fully in place in Hungary. Our survey of banks underpins this assumption, revealing that due to the sharp competition between banks, local governments are in a strong bargaining position vis-à-vis credit institutions, as – due to the lack of information and a high level of uncertainty – credit institutions are limited in the use of more sophisticated risk assessment techniques generally used in the corporate sector, and thus their lending is based on the expected continuity of local government operations.

## INTRODUCTION: THE BOOM IN LOCAL GOVERNMENT DEBT IN 2007

The development that led to this article is the recent sudden increase in the indebtedness of Hungarian local governments: over the past one and a half years, borrowing has almost doubled in the sector, and net debt formation has deviated from the cash deficit to a considerable extent (Chart 1). In previous years, net borrowing by local governments was roughly equal to their annual deficit, i.e. the amount borrowed was used for financing the deficit. In 2007, however, local governments borrowed some HUF 140 billion (0.5% of GDP) on aggregate, which is more than sufficient to cover their cash deficit.

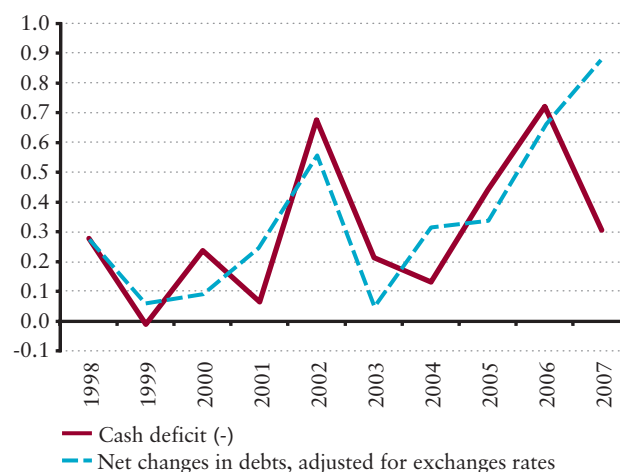
This strong boom in debt continued in 2008 Q1, and although the disbursement of new loans dropped significantly, it did not stop in Q2: thus in the course of 2008 H1, banks granted more than HUF 100 billion in new loans to local governments (exchange rate adjusted, Chart 2). As a result, the debt-to-GDP ratio in the sector (including outstanding debts in loans and bonds) rose from 2.3% at the end of 2006 to 3.2% in March 2008.

This borrowing boom was presumably due partly to the uncertainty of the *future* financing position of local

Chart 1

### Cash deficit and net borrowing by local governments as a percentage of GDP

(excluding privatisation revenues)



Source: MNB.

governments, and partly to their fear of an eventual statutory tightening of their borrowing, rather than a drastic change in their *current* financial management.<sup>2</sup> This is confirmed by the fact that for the time being, the additional amount borrowed by local governments has been deposited in the banking

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<sup>2</sup> In November 2007, the Ministry of Finance prepared a proposal for amending the Act on Local Governments, recommending, amongst others, amendment of the current borrowing limit. The proposal, which is still on the agenda of Parliament, can be adopted by two thirds of the votes. The content of the proposal is outlined in: (Vígvári, 2007).

system. The amount of ‘excess deposits’ is in the range of HUF 200 billion (0.8% of GDP), which means that current deposits of local governments exceed the ‘usual’ deposits by this amount (Chart 2).

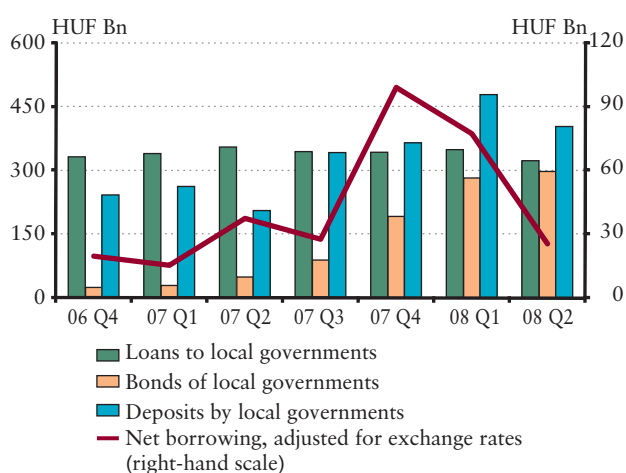
Debt was contracted mainly in the form of long-term bonds issued by local governments and subscribed by banks (Chart 2). The choice of bond-based financing merely had a technical significance: bonds are accounted in the banks’ own books, and the management of these transactions does not essentially differ from that of regular loan transactions. (For this reason, unless specifically noted otherwise, the issuing of bonds will henceforth be included in borrowing.) The attractiveness of bonds lies in the fact that they allow local governments to circumvent announcing public procurement tenders.

The borrowing boom increased the accounts receivable by the bank sector from local governments not only in terms of absolute value, but also relative to their total exposure and regulatory capital. The share of local governments in bank lending and securities exposure rose from 2.7% in late 2006 to 3.3% in June 2008, while in the same period the aggregate local government exposure increased from 22.8% to 32.7%.

This sudden outflow of loans raises the following questions in terms of financial stability:

## Chart 2

### Local government loans, bonds and deposits in the Hungarian bank sector<sup>3</sup>



Source: MNB.

- Regarding local governments: What risks are involved in the indebtedness of local governments? Is the appropriate use of the loans ensured?
- Regarding regulatory issues: Do the mechanisms designed to ensure the soundness of local government indebtedness either on the demand or on the supply side (statutory and regulatory conditions as well as market trends) function properly?
- Regarding banks: What risk is involved for the system of credit institutions in the increased exposure of local governments? To what extent can banks’ practice (i.e. the fact that they hurried to satisfy the burgeoning borrowing demand by local governments) be considered as a practice of responsible lenders?

In the following, we attempt to answer these questions.

## DEMAND: LOCAL GOVERNMENTS WHICH BORROW AND THEIR FINANCIAL MANAGEMENT

Presenting an overall assessment of financial management in the local government sector is beyond the purpose and scope of this study and, as noted above, another reason for dropping the idea of a comprehensive survey is that the 2007-2008 borrowing boom was for the most part not directed at deficit financing. For this reason, only the most significant features and risks of financial management are discussed in this chapter.

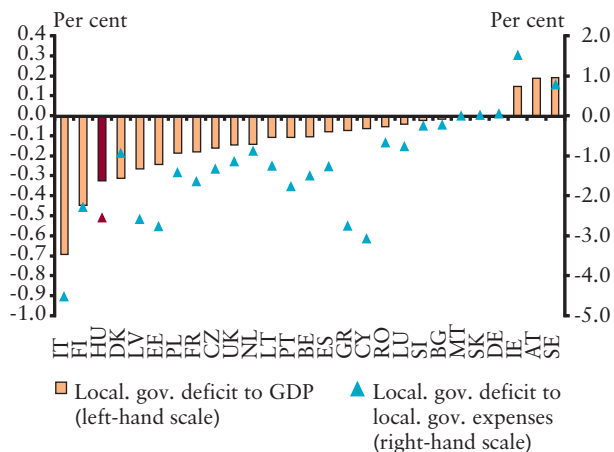
The first of these issues is the fact that in a European comparison the deficit of Hungarian local governments seems to be high (Chart 3) not only relative to GDP, but also compared to the expenditures of the sector. An adequate comparison should, of course, consider the differences between the state administration systems of the individual countries, as well as the fact that the current indebtedness of Hungarian local governments is relatively low (3.1% of GDP at the end of 2007), especially in comparison to certain Western European countries. If, however, the current deficit level is maintained, debt may gradually rise and the sustainability of the local government sector would require further investigation.

In financial terms, Hungarian local governments are characterised by substantial concentration. In 2007, 85% of

<sup>3</sup> In interpreting this chart, it must be taken into account that due to the significant strengthening of the forint in 2008 H2, increase in loans and bonds was less in the accounts than in reality. Expressed in the original currencies, the rise is faster. In turn, net borrowing is adjusted for exchange rates, thus providing a realistic picture of actual borrowing.

**Chart 3**

**Business deficit of local governments<sup>4</sup> as a proportion of GDP and their own expenditures; average; 2003-2007**



Source: Eurostat.

the total revenues of the sector<sup>5</sup> were raised and 93% of the balance-sheet liabilities owed by the five hundred local governments with the largest proprietary income (and the local government of Budapest alone accounted for 10.5% of the proprietary revenues and 22.3% of the liabilities). This means that a few hundred of the 3200 local governments comprise the segment capable of resourceful business management and investment, and that these local governments are of sufficient weight to be considered as potential clients for credit institutions. In addition, there is a ‘periphery’ of a large number of local governments with extremely small budgets, which can expect funds only from government support (local governments in a disadvantaged position for reasons beyond their control and inoperable local governments). Although their situation may be worrying from other perspectives, in terms of financial stability their systemic significance is negligible.

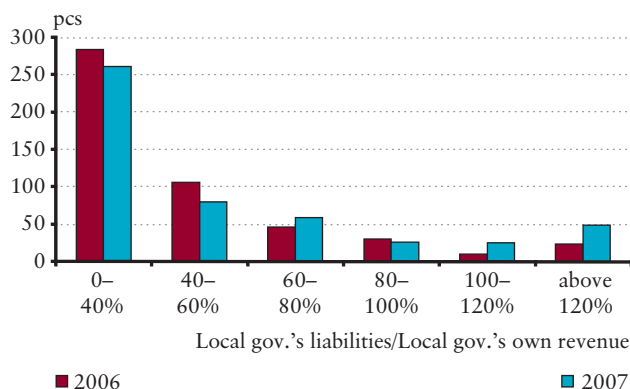
Although the debt of the five hundred largest income local governments varies greatly, the number of more indebted local governments clearly increased last year. Whereas in 2006 liabilities exceeded proprietary revenues only in the case of 34 local governments, in 2007 this number more than doubled, rising to 74 (Chart 4).<sup>6</sup> These 74 institutions – including the local

government of Budapest – owed more than half of all liabilities, while they shared only 25% of the proprietary revenues in the local government sector. This means that local government debt arises from a relatively small number of entities.

Generally speaking, the local governments which borrowed in 2007 and 2008 were those that were less indebted at the end of 2006, and changes in indebtedness had no correlation with the rise in the operating costs of the individual local governments. This again supports the assumption that the 2007 borrowing boom was primarily motivated by reserve accumulation and did not relate to actual financing needs. One fact suggesting that there is some degree of controlling power exercised by the market is that local governments with higher debts at the end of 2006 were granted far fewer loans compared to the sector average.

**Chart 4**

**Liabilities compared to annual proprietary revenues of the 500 largest income local governments**



Source: Hungarian State Treasury (MÁK).

Another unavoidable problem of local government debt is the high level of uncertainty and limited transparency which characterises the future state of financial management in the sector:

1. On the one hand, a significant part of local government incomes – 70% in 2007 (even in the case of the largest institutions) – depends directly or indirectly on the central government budget.

<sup>4</sup> In countries where Eurostat differentiates separate local government and federal levels (Germany, Austria, Spain and Belgium), the federal level was not considered in the data published by us.

<sup>5</sup> For the purposes of this study local governments’ own or proprietary revenues mean their current and assigned (tax) revenues, excluding cumulative revenues (e.g. income from privatisation), normative support from the state and other subsidies, or even the funds granted by the European Union. This is a wider-than-usual definition of proprietary income, which differs from the one applied in the Act on Local Governments (the latter is used in Chapter II). The reason why we considered the wider sense of the term here is that – with certain limitations – this is perhaps the best to grasp the essence of the freely disposable earnings of local governments from the data available.

<sup>6</sup> In this segment, average indebtedness compared to proprietary revenues increased from 62.9% in late 2006 to 73.0% (projected for the entire sector, this indicator deteriorated from 59.2% to 66.4%).

2. On the other hand, the financial management of local governments is also characterised by low transparency. There are numerous signs suggesting that certain local governments realise investment projects – for example, using PPP constructions – in such a manner that the local government budget is only debited at a later point in time, or the costs are spread over time and thus imposing a burden on the local government budget for a long period. These cases can be considered as concealed borrowings (Hegedűs–Tönkő, 2006). Although local governments complete forms on the time schedule of debts, exhaustive data on all future commitments (including PPP schemes) are unavailable. Another clear example of the postponement of liabilities can be found in bond issues with deferred principal redemption, which is expected to cause approximately HUF 10-13 billion of additional cash expenditure to local governments from 2010-2012, when the grace period granted for principal repayment ends.<sup>7</sup> This amounts to 13%-17% of their deficit. Due to the lack of information on such future and contingent liabilities, it is difficult to judge the actual financial state of the sector.
3. Thirdly, local governments can also become indebted via companies which they own, without debiting the current budgets. As these companies are primarily engaged in the provision of public services, sooner or later the owners (local governments) will have to meet the liabilities incurred by these companies (furthermore, according to information provided by banks, the loans granted to such companies are frequently covered by local government guarantees). The amount of loans granted to local government companies is significant: according to the following estimate, it amounts to 25%-30% of the total debt of the local government sector, or roughly 0.6%-0.8% of GDP.

We tried to estimate the debts of local governments on the basis of data available from the court of registration. The data show that 1,551 companies were registered with at least 50% local government ownership in 2006. The total amount of loans granted to these companies amounted to HUF 164.5 billion (excluding supplier credit and liabilities to owners). The strong financial concentration which is characteristic of local governments can also be observed in case of these companies: in respect of the aforementioned total amount of debt the first ten companies with the largest debts accounted

for approximately 60% of this sum, and first one hundred companies accounted for 90% of this total debt. In 2006, more than one-third of these one hundred companies closed the year with a loss.

On the basis of the information currently available,<sup>8</sup> the borrowing boom observed in the case of company owners is likely not to have taken place via local government-owned companies. Therefore, based on data for 2006, the total amount of debt owed by these companies is estimated at HUF 170-200 billion. This estimate has essentially been confirmed by our bank survey, which revealed that the loans granted to companies in local government ownership amounted to around 3%-4% of the banks' corporate loan portfolio and approximately 20% of local government exposure.

In addition to indebtedness, loans for reserve maintenance purposes also involve risks:

1. On the one hand, because the currency of new loans and bonds was the CHF in most cases while the deposits are usually denominated in HUF, a considerable open position has been generated in the local government sector, even though the affected local governments realise gains on the difference between the HUF and FX interest rates (in some cases, this may be an important incentive for borrowing).
2. On the other hand, as these funds have not yet been spent, for the time being they have increased the general government debt without affecting the balance (deficit). Thus one risk associated with these funds is that they may be spent *all at once*, triggering a considerable *one-off* rise in the general government deficit (amounting to 0.5% of GDP). If, however, these funds are spent gradually – a more likely scenario – the effect will be spread over time.
3. Thirdly, based on our bank survey detailed below, in many cases the purposes of these funds were stated in rather vague terms, and thus there is also risk of them being used for projects which are not thought through carefully enough.

As for the use of these funds, numerous experts cite preparation for funding from the European Union as a motive for the recent borrowing by local governments. This argument is based on the fact that in the planning period between 2007-2013 more funds from EU sources will be

<sup>7</sup> This estimation was based on the fact that since mid-2007 local governments have issued long-term (20-25 year) bonds with principal repayment deferred by 3-5 years in excess of HUF 200 billion. Thus, the principal instalments of these bonds must be repaid after 2010-2012. Repayment in equal amounts and 15-20 years to maturity were presumed with the estimated HUF 10-13 billion.

<sup>8</sup> This was confirmed by the information provided to us by banks as well as the most recent data on the indebtedness of certain high priority companies in local government ownership and monitored by MNB, which were granted approximately half of the loans allocated in 2006, revealing a mere 9% increase in 2007.

made available than in the previous periods: in a working paper prepared in early 2007,<sup>9</sup> the National Development Agency estimated the allocation of HUF 1,470 billion from the Structural Funds and HUF 717 billion from the Cohesion Fund to local governments in this period. According to these calculations, these projects require HUF 219 billion of own contribution (approximately 0.9% of GDP), and non-eligible costs – estimated at 30% of the project costs – are also required for the projects (a total amount of approximately HUF 656 billion, or 2.6% of GDP).

This is substantially more than the own contribution required for the total amount of HUF 279 billion in support granted from the Structural Fund and the Cohesion Fund to local governments in the planning period between 2004-2007, which amounted to a total of HUF 72.2 billion according to the project documents (although non-eligible costs were disregarded in this case).<sup>10</sup> The latter amount is roughly one-third of the net total borrowed from the banking sector in the period 2004 to 2007.

Thus, the EU transfers scheduled for local governments has increased fourfold on an annual basis, while the required minimum own contribution doubled relative to the previous planning period. Based on the above, the approximately HUF 200-250 billion in ‘excess credit’ granted to local governments during the current borrowing boom does not appear to be a high amount. Nevertheless, the crowding-out effect of EU transfers on local government projects financed solely from own funds must also be taken into consideration. This trend was already detected in the 2004-2007 period. Despite the fact that considerable EU transfers were already received by local governments during that period, the sector’s projects compared to GDP – after adjustment for the election years – remained at the previous 1.6%-1.8% (thus, as a result of the support granted by the European Union, no upturn was seen in local government projects). Consequently, part of the projects supported by the European Union are likely not to generate additional financing requirement for local governments in comparison to the previous periods.

## APPROACH TO LOCAL GOVERNMENT DEBT AND ITS REGULATION IN AN INTERNATIONAL CONTEXT

One concern frequently cited in relation to decentralised state administration systems is the fact that the lack of fiscal discipline at the lower levels of administration may cause

serious macro-economic imbalances. Over the past 20-30 years the central budget has had to intervene due to the insolvency of lower level public administration units in 19 of 44 countries analysed in a study (Singh-Plekhanov, 2005). In certain countries, such as Argentina and Brazil, the financial difficulties of local (federal) governments created serious costs for the national economy and contributed to the emergence of financial crises. Although in the current Member States of the European Union, local government debt has not resulted in major problems recently, examples of central assistance to certain local governments can be recalled from the 1990s (e.g. in Germany and Sweden).

Similar worries have been expressed in connection with Hungarian local governments for two reasons. On the one hand, the Hungarian local governments sector is rather sizeable: its aggregate expenses amount to about 12% of GDP – ranking it among medium-sized local government sectors in the European Union – and, for this reason, imbalances in this sector could be felt at a macro-economic level. On the other hand, Hungarian local governments are fairly independent in respect of their financial management, with enough freedom to potentially mismanage their assets. (It must also be noted that so far, fiscal shocks have primarily been caused by the central government in Hungary.)

The authoritative literature in this field (Ter-Minassian-Craig, 1997) distinguishes four fundamental systems in the regulation of local government indebtedness:

- *market discipline* (no limits are set, and satisfaction of the credit requirements of local governments depends solely on market participants’ lending propensity);
- *direct controls* (lending is subject to approval by the central government);
- *rules-based approaches* (rules set out in statutory acts regulate debt);
- *co-operative approach* (the heads of local governments decide on debt in agreement with a central body in co-operation).

Theoretically, from among these alternative methods the Hungarian system is rule-based, as the Act on Local Governments (Act LXV of 1990) determines an annual maximum debt service for local governments. The essence of

<sup>9</sup> Despite the fact that the referenced decision-preparation material was compiled approximately one and a half years ago, no other recent analysis is known to us.

<sup>10</sup> Data were provided by the National Development Agency. The support disbursed by the Cohesion Fund was taken into consideration without the projects transferred from the pre-accession programmes to the Cohesion Fund, supported by the European Union in the amount of HUF 80.1 billion. In the case of financing requirements it must be taken into consideration that local governments can also rely on the own contribution fund established by the Ministry of Local Government, with a limit of about HUF 15 billion in 2008.

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.

For the time being, however, this legislation is incapable of limitation for three reasons. One of them is that local government debt is still far below the maximum level set forth in the act (see the box below). The other is that – due

to the abovementioned uncertainties in financial management and the lack of transparency – it is difficult to keep in mind the limits required for *future* compliance with the statutory maximum when assuming *current* liabilities. In other words: as the management of local governments will not be responsible for compliance 5-10 years on, in most cases it does not constrain the representative bodies from borrowing *at present*. The third reason is that there is no penalty for exceeding the borrowing limit.

### Possible level of local government indebtedness allowed by statutory regulation

Based on 2007 data on the financial management of local governments, we attempted to estimate their maximum indebtedness allowed by the effective statutory regulation, relying on the budget reports and balance sheets of local governments.<sup>11</sup> The 440 local governments with short-term liabilities exceeding proprietary income, i.e. those which violated the statutory indebtedness limit in 2007, were excluded from the data. Most of these are small villages, however, there are two larger towns and two county governments as well. (These local governments share approximately 3% of the total amount of proprietary revenues generated in the sector, thus this segment is insignificant for the time being.)

The data thus adjusted suggest that the local governments raised proprietary revenues required by law of HUF 663.4 billion, while their short-term liabilities amounted to HUF 137.7 billion. 70% of the difference between the two is HUF 368 billion, which is the cap on their

debt. However, this is only an annual maximum set for liabilities (i.e. one year's 'repayment instalment'). Presuming repayment in equal amounts, but with various maturities and interest rates, according to our estimation (Table 1), local governments could borrow an additional HUF 2,000-4,000 billion (approximately 8%-16% of GDP) before they reach the statutory maximum, about 2.5-5 times the HUF 800 billion credit liabilities they currently have.<sup>12</sup>

However, in this estimate one must remember that the statutory limit may automatically decrease if future amendments of the act are taken into consideration and certain contingent or future liabilities are included in the balance sheet, while no new loans are granted. In the case of local government bonds issued with deferred principal repayment, the end of the 'grace period' alone increases short-term expenses in the current year.

**Table 1**

#### Possible additional borrowing by local governments, assuming annual 'repayment' of HUF 368 billion

(HUF billion)

Average term to presumed interest	4%	6%	8%
Average 10-year loan term	2,620	2,300	2,040
Average 20-year loan term	4,080	3,340	2,820

Source: Authors' calculation.

For this reason, the current regulation fails to set penalties and remains a theoretical rather than an effective limit, and the Hungarian system operates in a quasi-market controlled way. According to the literature (e.g. Ter-Minassian–Craig, 1997), regimes based on such market co-ordination can function more or less satisfactorily if the markets are open

and free, *sufficient* and *satisfactory quality* information is available on the financial situation of the debtors, and there have been no previous cases requiring central government bailout. A good example for the successful application of such solutions is Canada, where each federal state has an external credit rating. Nevertheless, even the Canadian

<sup>11</sup> As these items of the financial management of local governments fail to fully comply with the provisions of Section 88 of the Act on Local Governments, we may have slightly underestimated their proprietary income and overestimated their short-term liabilities – primarily liquid credit. Therefore, we may have underestimated the total debt limit. This is supported by the fact that based on the consolidated data of form 25 of the borrowing limit of local governments, the borrowing limit of the sector was HUF 409.8 billion in 2007 (for lack of any available data, we could not adjust this value for the local governments exceeding the borrowing limit).

<sup>12</sup> When the parameters used for the estimation were set, we relied on the assumption that the term of loans granted to local governments generally does not exceed 10 years, however, the bonds they issue mature over 20 years in general. Possible interest rates were set on the basis of the nominal CHF interest rates of local government bonds registered by KELER (Central Clearing House and Depository) and MNB (central bank of Hungary) (for the most part below 6%). For the purposes of calculation, we disregarded the product attributes provided with local government lending products such as grace period for principal repayment, which may add to the borrowing possibilities of local governments.

system was unable to prevent ‘excessive indebtedness’ of the federal states in the early 1990s, which had to be offset by painful austerity measures later on. (The efficiency of market control is uncertain in general, as well as on the level of the central budget: this is exactly the reason why, among others, the Maastricht criteria were adopted in the European Union, and in the example of Canada above, the individual federal states also adopted self-regulatory provisions.)

Thus the question is whether the conditions of market control apply in the Hungarian local government system, at least with more or less efficiency. In our opinion, this is highly doubtful. Although the central government has not been required to assist in debt settlement proceedings so far,<sup>13</sup> due to the uncertainties in financial management and the lack of transparency mentioned in the previous section, even professional lenders can enforce the criterion regarding adequate information to a limited extent only. This is substantiated by the following discussion of banking practices.

### SUPPLY: LENDING TO LOCAL GOVERNMENTS IN COMMERCIAL BANKING PRACTICE

The recent boom in borrowing by local governments was carried out for the most part through the Hungarian banking system. Although the local government sector also owes approximately HUF 118 billion to foreign banks through the European Investment Bank (granted for the underground project in Budapest and the European cultural capital project of Pécs), HUF 621 billion of the HUF 670 billion domestic loans and bonds were financed by Hungarian banks (end-June 2008 data).

In order to get a better understanding of lender considerations, we conducted a survey in June 2008 based on

interviews with the six market leader credit institutions in the local government sector. Based on their closing stocks on 30 June 2008, these institutions constitute 94% of the Hungarian bank sector’s exposure (loans and bonds) to Hungarian local governments.<sup>14</sup> In the course of our survey the banks’ experts were asked questions regarding business as well as risk developments.

According to the respondents, market competition has clearly become more intense among local governments over the past 12 months, and this resulted in a deterioration in their bargaining positions. Some of the local governments consciously capitalised on this situation and announced public procurement procedures and bond issue tenders with short deadlines, and margins are just as low in this sector – especially in the case of larger local governments – as in the sector of large companies. In addition, lending conditions – such as maturity, the specification of loan purposes and collateral – are also set by the local governments (at least in the case of local governments with relatively low levels of debt, as such transactions are considered more desirable for banks). Furthermore, last year the following business trends emerged:

- The fact that bonds gained ground – although initially they were probably meant to avoid public procurement procedures – affected product structure. While earlier loans were generally granted to local governments with 10-year maturity, bonds usually mature in 20-25 years (based on data from KELER, nearly 60% of the bonds issued in 2007-2008 mature after 20 years, and 8%-9% of them have maturities exceeding 20 years). Consequently, the average term of liabilities undertaken by local governments has considerably been extended (Table 2). Moreover, due to deferred principal repayment opportunities, repayment costs are lower for the transitional 3-5 years. In comparison: in corporate

**Table 2**

#### Maturity composition of the local government portfolios of the surveyed banks

Maturity distribution of exposures	31 Dec. 2006	31 Dec. 2007	31 Dec. 2008
Less than a year	47.4%	17.7%	13.2%
Between 1 and 5 years	12.9%	11.4%	7.5%
Between 5 and 10 years	14.2%	19.7%	13.9%
Between 10 and 15 years	11.3%	16.5%	14.3%
Over 15 years	14.2%	34.6%	51.0%
Total	100.0%	100.0%	100.0%

Source: MNB, on the basis of data provided by the credit institutions participating in the survey.

<sup>13</sup> Local governments in disadvantaged situation for reasons beyond their control cannot be considered in this scope.

<sup>14</sup> The interviewed banks accounted for 88% of the gross portfolio increase that took place between June 2007 and June 2008.

lending and project financing, loans granted for more than 7-8 years are extremely rare.

- Although the overwhelming majority of bank loans were granted credit for the purpose of investment projects, the emergence of bonds has made the determination of loan purposes uncertain. While in the past banks made clear efforts to lend on the condition of clearly defined purposes (although this could not be enforced by every bank and in every case), in the case of bonds, accurate specification of the purpose of financing is problematic, partly because of the long term. Despite this fact, some banks attempt to supervise the use of the disbursed amounts (e.g. the transfer is subject to the submission of a signed main contracting agreement), while others disregard this question. Based on the data of the interviewed credit institutions, approximately 10% of the financing granted to local governments is used for operating, and about 40% for unspecified or unknown purposes. Based on one credit institution's estimation, about 30% of the issued local government bonds are used for operating purposes.
- In the case of subsidised loans with preferential refinancing facilities, more detailed documentation and more specific investment goals are required in general. In subsidised refinancing, the Hungarian Development Bank plays a pivotal role, along with a few foreign banks, mainly the EIB. The essence of this facility is that with access to preferential refinancing, commercial banks can grant project loans or subscribe to bonds issued for development purposes for local governments under more favourable terms, while keeping the lending risk in their own portfolios. Subsidised facilities amount to nearly 20% of the exposure to local governments of those participating in the survey.
- Similarly to other fields, mediating agents have a considerable role in lending to local governments. Both in public procurement procedures and in closed tenders based on invitation, agents frequently participate as consultants in preparing documentation and assisting evaluation. In consideration for their contribution, they are paid commissions by the banks. Access to clients through agents is an established banking practice in the retail segment. However, in relation to local governments, this method seems to be less obvious path, due to the tenders announced on a competitive basis. The responding bank experts did indeed doubt the value that such consultants/mediating agents could provide added value to the deal.
- Few banks use proactive sales strategies. Credit institutions basically react to the announced public procurement and

bond tenders, and therefore borrowing is essentially initiated by local governments.

In addition to these aspects, bank experts identified the following risk management problems:

- Lack of transparency, a high level of uncertainty in future and contingent liabilities as well as commitments not included in the debt portfolio. Due to these problems mentioned above, the future cash-flow of local governments is difficult to plan. For this reason, most banks make projections based on the past management data and attempt at planning future flows on the basis of any available customised data, although they are aware of the shortcomings of this method (if the loan is granted for the purposes of a specific project goal, they also analyse return on the project).
- In the case of loans, public procurement procedures are often too short, while in the case of bonds, the tender deadlines are short, therefore banks are not given sufficient time for prudent client and deal rating.
- The applied rating schemes are based on expert judgement based estimates or foreign parent bank models, as the client data available for most banks are insufficient for developing their own models based on statistics (non-performance is also rare in the local government sector). Thus, for the time being, the reliability of these ratings is doubtful.
- At present, banks have very little experience in local government bankruptcy, as the number of such cases has been extremely low in the past decade. The settlement of local government debt is regulated in Act XXV of 1996, which sets out a clear framework for cases of insolvency and can be considered an excellent statutory regulation even by international standards. The purpose of the act is to provide for the recovery of the solvency of local governments in bankruptcy proceedings in addition to performing their mandatory duties and satisfying creditor claims in proportion to the disposable assets. Since the adoption of the act in 1996, debt settlement proceedings have been started in no more than 28 cases altogether (Jókay, 2007; IGE, 2008), and only in the case of small villages, excluded from the circle of institutions having key significance – and characteristically borrowing from banks – as mentioned in Chapter 1 above. Thus in these cases, bankruptcy proceedings were basically initiated in the interest of meeting liabilities to suppliers, and the banks involved in our survey were not affected.
- The repayment of local government loans is guaranteed primarily by their cash-flows, and although there are deals



**Table 3****Features of collateral for the local government portfolios of the banks surveyed**

<b>Collateral ratio and distribution by collateral types</b>	<b>30 June 2008</b>
Credit to collateral ratio (%)	16.88%
<i>of which: Guarantee and unconditional payment guarantee</i>	5.97%
<i>Real estate</i>	5.12%
<i>Other</i>	5.79%
<b>Total</b>	<b>16.88%</b>

Source: MNB, on the basis of data provided by the credit institutions participating in the survey.

collateralised with real estate and unconditional payment guarantees (in most cases provided by Garantiqa Hitelgarancia Zrt.), they cannot be considered typical in this sector (Table 3). Local governments usually do not offer real estate as collateral, and banks do not encourage it either, as the legal procedure of obtaining the title to real estate is complex. Most local governments consider the costs of unconditional payment guarantees too expensive, and they are also subject to a requirement for more accurate specification of the loan objectives. For this reason, in this field banks typically take the initiative to include Garantiqa in the lending transaction, if they are unable to assume the risks involved. Some of the unconditional payment guarantees provided by Garantiqa to local governments are secured by the re-guarantees of EIB. Changes related to collateral are well illustrated in a survey conducted in 2000: at that time, nearly 40% of the loans granted to local governments were covered by real estate, and revenues from fees or taxes were offered for approximately 35% (Barati, 2000).

Despite these problems, in absolute terms banks consider the risks involved lending to local governments as low for the reasons of the continuity in their operation. In other words, despite the uncertainties, credit institutions are not afraid of suffering major losses in their local government portfolios because local governments – in contrast to corporations – cannot be liquidated or wound up even if they go bankrupt, and – in contrast to retail clients – their sources of income cannot dry up completely. Interestingly, the majority of bank experts do not expect assistance from the central budget even in the case of local government bankruptcy, but they do expect that even insolvent local governments will sooner or later repay their liabilities from their own revenues – by rescheduling their loans and cutting their expenses.

In addition, banks consider the cross-selling opportunities opened up to the clients of local governments through lending to be important, which is actually another incentive for lending. In addition to credit and bond issues, credit

institutions offer a wide range of products ranging from current account management to option deals to their local government clients. Banks expect that if they can develop favourable co-operation with the local governments through their financing facilities, they may be more likely to be commissioned with the provision of liabilities-side products, investment and ‘treasury’ transactions and gain advantage at subsequent public procurement procedures and other tenders.

Not only were the risks of lending to local governments lower than those of lending to companies, but their capital requirements as well, as their risk weighting was only 50%, instead of 100%. Simultaneously, with the adoption of the European capital requirement directive (Basel II), the use of a simpler standard method might have resulted in the increase of the capital requirement. The reason for this is that pursuant to the new regulation, exposures to local governments are assigned weights identical with credit institutions and investment businesses, i.e. one category worse than the risk rating of the Hungarian central government. Depending on which rating agency’s classification is used, this may have increased the risk weight of exposures to local governments from 50% to as much as 100%. However, banks did not report cases in which the business activities of a local government would have been affected by the eventual change in the capital requirement (just as previously the attraction of this market segment had not been its lower capital requirement).

## CONCLUSIONS

The underlying reason for the major ‘credit boom’ of Hungarian local governments in late 2007 and early 2008 was basically reserve maintenance, rather than a drastic increase in the operational deficit. For the time being, the indebtedness of local governments does not represent a substantial risk for the financial system, as banks’ exposure to this sector is low. If, however, these portfolios are further extended, significant risks might arise.

Although the Hungarian system of local governments is rather fragmented, concern over debt only affects a small group of a few hundred larger institutions in this sector. The sustainability of their indebtedness requires further investigation, which, however, is primarily prevented by the high uncertainty and lack of transparency characteristic of local governments.

At present, the statutory regulation of local governments' indebtedness does not impose an effective limitation on debt, and borrowing in this sector is currently (and for the foreseeable future) controlled by the market – in other words, by the lending propensity of the creditor banks. This practice is not unknown in other countries, and despite its weaknesses, there are examples of its fairly successful application. Nonetheless, the efficiency of market control in Hungary is impaired by the shortage of information resulting from the uncertainties of local government management, which is a challenge for credit institutions as well. Thus the question arises: to what extent are banks capable of gauging the likelihood that a local government will actually become insolvent and its consequences (and act as appropriate market controllers). Our survey of banks show that credit institutions have confidence in the continuity of local governments' operation.

As the problem of indebtedness affects only in a small group of local governments (as mentioned above), the creation of a regulatory environment channelling the debt of this group towards a framework, perhaps by the adoption of administrative measures or the promotion of market mechanisms could be an approach worth considering. In both cases, the transparency of financial management would need to be increased, a requirement which is not unrealistic vis-à-vis local governments, which are in principle more sophisticated than the sector average.

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