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IHS INSTITUTE FOR HOUSING AND URBAN DEVELOPMENT STUDIES
DELOITTE&TOUCHE CENTRAL EUROPE

Sector Review Paper:
Local Credit Market for Municipal Infrastructure

European Agency for Reconstruction (EAR)

23 August 2007

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ABBREVIATIONS

EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EU	European Union
EURIBOR	Euro Interbank Offered Rate
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession
KfW	German Development Bank
NDS	National Development Strategy
SCTM	Standing Conference of Towns and Municipalities
USAID	United States Agency for International Development

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ANNEXES

EXECUTIVE SUMMARY

The final goal of the reform of the local self government in Serbia should be **the creation of strong, influential and independent local governments with solid transparent public finances and adequate communal services** with a citizens' oriented approach. This objective can be achieved only if adequate decentralization of responsibilities is in place with instruments available - local government borrowing being one of them. Consequently, it is expected that local governments will take charge of all local matters, designing and implementing policies and projects that will further stimulate local development.

Still, local governments in Serbia have a long way to go. Presently local self governments are faced with:

1. **Large investment backlogs as a result of underinvestment in the construction of new and maintenance of the old infrastructure projects for more than 15 years**. Investment needs in municipal water supply and sewage, environmental and district heating infrastructure are estimated at some Euro 3.8 billion whereas also sizable funds will be needed for municipal roads, economic and social municipal infrastructure. Currently, municipalities are spending Euro 500 million or on average 30 percent of their budgets on capital investments for all sectors and uses.
2. **Limited financial funds in comparison with the infrastructure needs**. Traditional sources of investment, on pay-as-you-go basis, such as transfers from the central government and municipal budget revenues are not enough to bridge the investment gap.
3. **Limited but improving (human) capacities**, with significant regional disparities, in municipal budget and debt management and infrastructure project management.
4. **Inefficient public utility companies** with a weak financial and operation performance partly due to central government control of utility pricing.

Development of municipal borrowing, providing a means of investing in essential infrastructure at the local level, is one of the instruments that will allow local governments to address these problems.

In Serbia, market acceptance of municipal debt and the associated risks started to improve as of early 2005. This was the time at which municipalities started to realize that they would have to turn to the credit market in order to address their infrastructure needs. Concurrently, the banking sector was reformed with foreign banks coming in. Furthermore, the development of the municipal credit market was stimulated by the following: (1) The legal framework was put in place by adopting the Public Debt Law; (2) donor agencies were working to strengthen municipal capacities in financial management and provide co-financing for some of the projects.

This combination of factors led to an increase in municipal borrowing. At the end of June 2007, the stock of credits taken was Euro 359 million, while **outstanding credits were Euro 331 million (1.5 percent of GDP).**
At the current point of time, 14 commercial banks are actively participating in the municipal credit market, with seven of them cover more than 90 percent of the market, while just one of them has more than 50 percent of the total market share. Banks are

offering long-term credits of up to 15 year maturity and interest rates between 6 to 8.5 percent (EURIBOR plus margin).

International financial institutions such as the European Bank for Reconstruction and Development, the European Investment Bank and the German Development Bank KfW are actively participating in the market through direct lending to cities and larger municipalities or on-lending through partner commercial banks.

Municipalities have begun to realize the benefits of credit financing and currently out of 167 municipalities and 4 cities in Serbia, 82 municipalities and all cities have taken loans for infrastructure projects. The total volume of loans that municipalities in Serbia are allowed to take in accordance with current legislation amounts to some Euro 960 million. So far, cities and municipalities have utilized 34 percent of their borrowing capacity. Still, if credits to Belgrade and other cities are excluded, municipalities outstanding stock of debt is Euro 81 million implying that municipalities have free borrowing capacity of Euro 328 million or 80 percent. Municipal borrowing capacity will increase with the increase of their GDP and volume of the municipal budgets.

The municipal credit market therefore still has significant potential to grow. Commercial banks and international financial institutions show a keen interest in this market and will continue to compete for the remaining market share amounting to Euro 631 million at this point of time.

In order to facilitate the development of the municipal credit market, increase investments in the municipal infrastructure and stimulate the overall development of the economy at the local level, **central government and local authorities would have to**:

1. **Facilitate municipalities to identify development goals, investment priorities, prepare adequate feasibility studies and bring projects to mature phase.** Premature borrowing is likely to drain local budget resources and add risk to the fiscal system.
2. **Facilitate the development and preparation of regional projects that provide smaller and underdeveloped municipalities with essential infrastructure in a cost-effective manner.** This would also had the added benefit of allowing such municipalities to access the credit market in the form of pooled financing.
3. **Increase the transparency of the municipal financial performance by:** initiating the budget auditing, standardizing municipal financial reporting to separate current from capital revenues; requiring public disclosure of all municipal budgets and financial reports that present municipal assets and liabilities.
4. **Allow municipalities to issue guarantees for the public utility companies they founded.** The guarantees should be counted against municipal credit limits.
5. **Facilitate local governments to adopt Debt Management Strategies.** The success of the overall local government financial management requires a more proactive attitude in which local policymakers adjust their investment policies to the actual debt capacity of the local government, assessing the short, medium and long-term costs and benefits of each investment project within the municipal development agenda.
6. **Facilitate local government to adopt programmatic budgets** for the period of 3 to 5 years based on the municipalities' development strategies and capital investment plans.
7. **Establish clear legal rules governing municipal default procedures** that are enforceable by the courts.

8. **Corporatize public utility companies** and strengthen their financial and operational efficiency in order to make them to provide better services and become more viable borrowers.
9. **Redefine the formulas for setting up utility prices** based on a cost-recovery system.
10.

It is estimated that municipal loans will only be able to cover some 15% - 20% of the required investments in municipal infrastructure. Apart from the municipal revenues and central government transfers, other sources of funds may include: conditional grants by the EU through the IPA instrument, funds from the National Investment Plan that will be depleted with the end of privatization and public-private partnerships especially in the area of solid waste management.

The Serbian municipal credit market has successfully passed through the basic stages of development and is now entering a more mature phase with more mature risks such as municipal default and insolvency. The existence of demand and supply is not in question however, the question remains how effectively they will be managed in order to achieve municipal development goals and sustain fiscal and financial stability in the longer term.

The Paper will be presented at the Round Table on Municipal Credit Market on September 17, 2007 at the Standing Conference of Towns and Municipalities. The Paper and Presentation can be downloaded at the web pages www.skgo.com and www.miasp.com.

1 INTRODUCTION

This report represents the findings and recommendations for functioning of the municipal credit market in Serbia. The Municipal Infrastructure Agency Support Program, managed by the European Agency for Reconstruction and implemented by the Consortium of Royal Haskoning, IHS Institute and Deloitte, prepared this Study with the goal to analyze the present economic and legal practices and policy framework that currently exist in this area and develop recommendations as to how it can be improved.

During the preparation of the Study, in the period June to August 2007, more than 25 interviews have been performed with the main stakeholders from both private and public sectors:

1. Ten (10) municipalities – Subotica, Apatin, Smederevo, Kruševac, Čačak, Užice, Inđija, Vršac, Varvarin, Žitište and one (1) public utility company Duboko.
2. International financial institutions: European Bank for Reconstruction and Development, European Investment Bank and KfW;
3. Seven (7) commercial banks – Intesa Bank, Raiffeisen Bank, Unicredit Bank, AIK Bank, Komercijalna Bank, Vojvodjanska bank, Hypo Alpe Adria Group;
4. Government Institutions – Ministry of Finance of the Republic of Serbia (Public Debt Management Division), Ministry of the Government and Local Self-Government, Ministry of Economy and Regional Development, Municipal Infrastructure Agency, Public Procurement Office.
5. Association of municipalities – Standing Conference of Towns and Municipalities,
6. The USAID funded Programs MEGA and SEGA.

The Study was prepared under auspices and active involvement of the European Agency for Reconstruction.

The purpose of this Study is to describe the existing linkages and relationship between local government infrastructure financing needs and the capital and financial markets in Serbia and to compare it with regional practices. The Study aims to analyze the demand and supply side of the market, namely:

1. Acquaint municipalities[1] with the present supply of infrastructure development credits provided by commercial banks and international financial institutions.
2. Present to the banks and international financial institutions the problems faced by municipalities when applying for credits for infrastructure projects.
3. To present policy recommendations on the improvement of the municipal credit market.

The report assesses the most feasible options for enhancing the municipal credit market in the context of the current move to fiscal decentralization, infrastructure improvement policies, development of financial markets and the pre-accession talks with the European Union (EU).

The process of the preparation of the Study involved the following steps:

1. Collection of data and information in a questionnaire format from municipalities, IFIs and commercial banks. This questionnaires are presented in the original form in the annexes;

[1] *In this Study term local government, local authority and municipality are used interchangeably.*

2. Analysis of the data and information collected and a comparison with the experiences of countries that recently accessed the EU.
3. Development of policy and practice recommendations.

It is anticipated that this Study will serve as a guideline for further discussions amongst the stakeholders in this market. The Study will be presented at the Round Table on Municipal Credit Market on September 10, 2007 at the Standing Conference of Towns and Municipalities.

2 MACROECONOMIC ENVIRONMENT AND PUBLIC DEBT

As of the end of 2000, Serbia has been making continuing progress in economic development and growth. Since 2003, the average annual increase in GDP has been 6.5 percent,. In 2006, GDP growth was 5.7 percent, while inflation was cut to 6.6 percent. The projections are that the growth trends will be continued with GDP growth over 5.5 percent and inflation projected to be at about 6-7 percent in the following 5 years.

The key challenges for the new Serbian government will be to continue with the strong economic growth and to sustain low inflation. These challenges will be difficult to achieve as the growth was high but unbalanced, resulting in a current account deficit of over 13 percent of GDP[2] and an unemployment rate of over 21 percent[3] in 2006. This is the result of non-reformed public enterprises, still significant presence of socially-owned companies and rising public spending (Public sector wages rose almost 30 percent in real terms in the period June 2006 to June 2007). In its report from April 2007, the International Monetary Fund (IMF) warned that the biggest challenge Serbia is currently facing is growing public consumption, which from the consolidated budget deficit of over 2 percent of GDP has to generate surplus of 2.75 percent.

The rise of demand, which influenced the surge of current account deficit, was also generated by rise of retail lending by banks that were borrowing abroad from their mother banks. This contributed to an increase of foreign debt to USD 20.2 billion or 62 percent of GDP, out of which USD 11.8 billion (58%) is foreign private sector debt, while USD 8.4 billion (42%) is foreign public sector debt.
At the end of 2006, Serbia's public sector debt (domestic and foreign) was EUR 9.3 billion or 35.6 percent of GDP[4]. This debt does not include the debt of local self governments, which was Euro 359 million (about 1.5 percent of GDP)[5].

This methodology for calculation of public debt is not in accordance with the European Protocol on the Excessive Deficit Procedure, which states the rules for the calculation of government deficit and debt. According to this Protocol, public sector debt should include the central government, regional government, local governments and social security funds debts. At the same time it is important to point out that the general government sector does not include public enterprises and their debts.

On the other hand, the Serbian Public Debt Law defines the public debt as being the debt of the central government plus the debts of local self-governments that have been guaranteed by the central government. Even if the debt of the local governments and social funds are included, Serbia's public debt is still well bellow 60 percent of GDP and thus meets the Maastricht criteria[6] . Still, it is necessary to reconcile the Serbian Public Debt Law with European legislation and consequently publish the debt figures, which include total debts of local governments, regional governments (Vojvodina) and public social funds.

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[2] *National Bank of Serbia Statistical Book*
[3] *Source: Republican Bureau of Statistics web page*
[4] *Source: Budget Memorandum for 2007, with projections for 2008-2009*
[5] *Also, public debt figures do not include debts of social funds.*
[6] *One of the Maastrich criteria to access the EU is that the country's public debt must not exceed 60 percent of GDP.*

It is also important to mention that 94 percent of public debt in Serbia is denominated in foreign currency (73 percent Euro denominated), which creates huge foreign exchange risk, especially in the light of the high current account deficit.

In July 2007, the rating agency Standard & Poor's assigned to Serbia long term sovereign credit rating BB- and short term sovereign credit rating B. In its statement Standard & Poor's downgraded Serbia from "positive" to a "stable" outlook mainly due to the relaxed fiscal policy, high current account deficit and political risks concerning Kosovo and cooperation with the Hague Tribunal. This rating implies a warning to investors and thus increases the overall risk pricing of credits to Serbia.

International financial institutions and commercial banks interviewed for this Study perceive macroeconomic risk as medium in the mid-term, including inflation risk, GDP growth, monetary and fiscal policies.

Recommendations:

1. The Ministry of Finance is recommended to reconcile the Public Debt Law with the relevant EU legislation. Meaning that the Public Debt Law should include all of the following: central government, regional government debt and local governments.

3 LOCAL GOVERNMENT FINANCE

Local government administration in Serbia is managing approximately 7.3 percent of GDP[7] (4 percent in Romania in 2002). If we exclude the four cities, that total is reduced to 3.7 percent of GDP[8]. In Serbia, local self government accounted for 16.5 percent of consolidated public expenditures in 2006. In the first quarter of 2007 this level remained the same (in Romania, in 2002, local public expenditures were 35 percent of total public expenditures).[5]

Local self-government financing is regulated by the new Law on Local Self-Government Financing[9], which came into force as of January 2007 and the Organic Budget Law[10] from 2002. The Organic Budget Law defines, inter alia, the procedures for adopting, executing and auditing the municipal budget. The Law on Financing of Local Self Government defines the sources of revenues. In addition to the latter, on an annual basis, municipalities receive a Budget Memorandum from the Ministry of Finance, which defines the macroeconomic framework for municipal budgets and transfers from central to local governments.

The Law defines that local self-governments sources of revenues are own revenues, transfers (different types) and shared revenues.

1. Own revenues *inter alia* include property tax, local administrative and communal fees, construction land use charges, construction land development charges. Rates for original revenues as well as the method and measures used for setting the amount of local fees and charges are set by the municipal assembly.
2. Revenues allocated by the central government are shared revenues and transfers. Shared revenues and transfers are formula-based and defined by the Law and may be considered as stable and fully-respected.

The key characteristic of the Law is strengthening of the local fiscal autonomy, while clarifying and expanding local control over revenues. The main goal of the new Law was (1) fiscal decentralization; (2) more equal distribution of revenues between the four big cities and municipalities; and (3) predictability of local government revenues.

1. As a part of the process of fiscal decentralization, the responsibility for setting and collecting of the Property Tax was devolved to local governments (previously, central government was defining the tax level and central Tax Administration Office was collecting it). The Law also defines the maximum rate of up to 5 percent, but municipalities are allowed to prescribe lower rates; municipalities are free to define local fees and their level; they also received the authority to start collecting some taxes and fees on their own.
2. The new Law aimed to correct the fiscal capacity disparities among municipalities/towns/cities, which benefited 99 poorest municipalities in Serbia. Still the share of municipalities in total local self-government revenues comparing to four cities has not been changed. This is to a degree explained by the faster development of the four main cities in comparation with the rest of the country.

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[7] *Ministry of Finance of the Republic of Serbia web page*
[8] *Local Government Borrowing: Regulation and Practice, Country Report – Romania, 2002, Gabriela Calusery, Anca Ghinea, Iordan Nicola, Stela Stratean*
[9] *Official Gazette of the Republic of Serbia No. 62/06*
[10] *Official Gazette of the Republic of Serbia No.9/02*

3. Predictability of local government revenues is assured by defining that central government will transfer to each municipality 1.7 percent of that municipality's GDP annually. In the past 45 percent of municipal revenues originated from central government transfers that were defined by a law passed on an annual basis and without any transparent criteria.

Underpinning all credit analysis is the availability of pertinent, reliable data. The Law does not envisage the mandatory auditing of municipal budgets but mandatory information disclosure to the Ministry of Finance, which has to submit those reports to the Commission for Intergovernmental Finance and to the Standing Conference of Towns and Municipalities. Still the other Law on State Auditing Institution[11] defines that this is the institution to be performing auditing. This Institution should be performing annual audits of a number of municipalities selected on a random basis. The Organic Budget Law defines that municipalities are obliged to have their own internal control and internal auditing. None of these institutions has started functioning so far, although the State Auditing Institution should have started operating in 2006 according the Law. (In Romania, the Audit Court is the institution responsible for auditing local government expenditures and control at the central level.)

Since no on-sight performance audit is executed and local government reports do not include explanations for any deviations from approved budgetary targets, both budget execution and formulation is still a top-down process at the local level (only municipal council oversees budget formulation although approval does come from the assembly).

Another positive change was the Amendment of the Organic Budget Law in 2007. The changes made it possible to have programmatic part of the budget, which should facilitate medium and long term budget planning that is closely correlated with the necessary capital investments and development plans of a municipality.

However, municipalities are still faced with problems when presenting their financial statements to credit institutions. Key issues here are as follows:

1. <u>Adequate recording of one-time revenues</u>: according to the Charter of Accounts, one-time exceptional revenues are recorded together with recurring revenues, i.e. capital budgets are not distinguished from operating budgets. This is especially true for construction land development charges and targeted grants. These one-off revenues should there for be recorded as capital and not operating revenues and should not be included in the operating surplus. The USAID MEGA Program prepared a software for the appropriate classification and analyses of the municipal budgets. Since a single set of municipal financial reporting documents should serve the needs of both the credit market and government oversight, the Ministry of Finance should consider the possibility of changing the accounting rules.
2. <u>Municipalities do not have reports on assets and liabilities</u>. From the data on budget execution, one cannot see debt stock or arrears.

Municipalities do not own property according to the present legislation. Still, the new Law on Local Self-Government Property is expected to be adopted by the end of 2007 or beginning of 2008 in order to meet the Constitutional requirements from June 2006 and transfers property to the local level.

[11] *Official Gazette of the Republic of Serbia No.101/05*

There is no (inter)national rating agency that is providing a rating of Serbian municipalities.

Recommendations:

1. It is recommended that the Law on State Auditing Institution adopted in 2005 to be put in practice as soon as possible. This Institution should be performing annual audits of a number of municipalities selected on a random basis.
2. The Ministry of Finance may consider implementing the practice of external independent auditing for municipalities with revenues above certain threshold values.
3. The Ministry of Finance to standardize municipal financial reporting to separate current from capital (one-off) inflows. This is especially important for construction land development charges.
4. The Ministry of Finance should require public disclosure of all municipal financial budgets and reports that show municipal assets and liabilities (short-term and long-term).
5. The Ministry of Finance together with other relevant institutions should work to establish sub-sovereign credit ratings.

4 LOCAL GOVERNMENT INFRASTRUCTURE FINANCING

4.1 Infrastructure Investment Needs

Municipalities in Serbia are faced with the following trends in respect to the infrastructure development and borrowing :

1. Absence of investment in local infrastructure during the period 1990-2000, with modest investment as of 2001 ;
2. The development of the credit market facilitating borrowing opportunities as of 2003;
3. Improving capacities, although still modest and with significant regional disparities, in municipal budget and project management.

The consequence of the infrastructure underinvestment has been presented by the EBRD transition indicators[12]. According to the EBRD Transition Report from 2006, Serbia's overall infrastructure reform indicator is 2, (3- for roads and 2- for water and waste water). The road indicator was upgraded for one point due to the privatization of 20 out of 25 road maintenance companies in 2005, as well as due to the presence of road charges above-cost-recovery levels. The water and waste water sector was downgraded due to the government control over tariffs to control inflation from 2005. Table 4-1 shows that Serbia is significantly lagging behind their transition neighbours in terms of infrastructure development.

Table 4-1 Infrastructure Transition Scores

Country	Roads	Water and Waste Water	Overall Infrastructure
Serbia	**3-↑**	**2- ↓**	**2**
Bulgaria	3-	3	3
Croatia	3	3+	3
Romania	3	3+	3+
Hungary	4-	4	4-

Source: EBRD Transition report, 2006

Serbian authorities are fully aware that if Serbia wants to reach the development level of other transition countries that are already in the EU, it has to invest more in infrastructure. For that reason, the National Development Strategy (NDS) adopted by the Serbian Government at the beginning of 2007, defined that in order to maintain the annual GDP growth of 7 percent, it is necessary to increase the share of fixed investments in the GDP from 17.3 percent in 2005 to up to 25 percent in 2012. This would be possible if the fixed investment growth rate would be between 8 and 11 percent,

The NDS envisages that in the period 2006-2012 it is necessary to invest EUR 53 billion in the Serbian economy, out of which one third or EUR 18 billion should be invested in infrastructure (traffic, energy, telecommunications, water supply, etc). The rest should be invested by the corporate sector.

[12] *Transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialized market economy. ↑ and ↓ indicate change from the previous year. One arrow indicates a movement of one point (from 4 to 4+ for example), two arrows the movement of two points. Arrows pointing up indicate upgrades, and down indicate downgrades.*

Out of the total investments of EUR 53 billion, 1.9 percent or EUR 1 billion should be invested in the water sector and 4 percent or EUR 2.1 billion in environmental projects. These figures are especially important having in mind that 77 percent of the population in Serbia have water supply, while just 46 percent have sewage and 20 percent of waste water is treated in accordance with the international standards. Another EUR 0.7 million should be invested in district heating infrastructure.

Infrastructure expenditures for local development will be financed through: own revenues, central government transfers, credit or issuing bonds, foreign grants and public private partnerships.

4.2 Legal Framework for Municipal Infrastructure Investments

Serbian legislation provides a framework for municipal government to borrow. The Law on Public Debt[13], which provides the necessary framework, stipulates the following:

- Municipalities are granted the permission to borrow under Article 33 of the Law;
- Municipalities can take credits up to the limit of 50 percent of operating revenues collected in the previous year[14], while the annual installments for repayment cannot exceed 15 percent of collected operating revenues in the previous year ;
- The Decision on borrowing should be passed by the municipal assembly, after the approval of the Ministry of Finance has been granted;
- Municipalities can take long-term credits (tenor over 1 year) just for financing infrastructure projects;
- Municipalities can borrow on domestic and foreign financial markets by taking credits or issuing bonds (refer to Section 6.5);
- Municipality cannot issue guarantees for public utility companies founded by them. Central government can guarantee for municipalities;
- Central government is approving and monitoring the level of municipal debts. Namely, the Law prescribes that every six months municipalities have to report to the Ministry of Finance total amount of the credit, the value of credit repayments and the interest rates. The Organic Budget Law defines that if a municipality exceeds the credit limit, the minister of finance has the right to cease transfers from central government to that municipality.
- Municipalities can take short term credits for liquidity purposes up to 5 percent of operating revenues and these credits should be repaid within the same budget year.
- The Law also defines that if a municipality cannot service its obligations and the central government has to repay that municipality's debt than the central government will reduce the amount of transfers it is providing to that municipality in an amount equal to the credit repayments plus penalty interest rate.

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[13] *Official Gazette of the Republic of Serbia No. 61/05*

[14] *In the ratio stock of debt to operating revenues, the numerator is the stock of debt, while denominator is operating revenues (total revenues minus one-off revenues). In the ratio debt service to operating revenues, the numerator is equal to repayment of principal plus interest, while denominator is operating revenues (total revenues minus one-off revenues).*

The legal framework does not define the characteristics of municipal debt (interest rates, collateral), they are defined by the contract between the municipality and bank/financial institution.

It is recommended that debt management is a constitutive part of municipal financial management. A model for this purpose at central level has been prepared and this could be used as a model for preparing municipal debt management strategies. Furthermore, the USAID funded project MEGA prepared a Manual for Municipal debt management, which is available from the Standing Conference of Towns and Municipalities (SCTM).

Box 1. presents the example of Poland in regard to the legal limits for municipal borrowing, while Table 4-2 illustrates the legal framework for municipal borrowing in other transition countries.

Box 1: Restrictions and Monitoring of Public Sector Debt in Relation to GDP: The Case of Poland

In preparation for accession to the EU and because of a need to monitor and control municipal debt Poland's Public Finance Law of 1998 introduced new cautionary limits on local government borrowing:
The first measure was to introduce a limit of on the total debt stock of being no more than 60 percent of annual revenues.
The second measure set "cautionary limits" on local government borrowing. This legislation stated that if consolidated public sector debt exceeds 50 percent of GDP, then the following will apply: the maximum borrowing of each local government cannot exceed the ratio between planned state revenues and planned state deficit for the fiscal year. Thus, if the state limits its borrowing to 10 percent of its current revenues no local government can borrow more than 10 percent of its planned revenues. In the case that public debt exceeds 50 percent of GDP and the government decides to balance its budget, than no local government will be able to borrow anything at all.

Source: Building the Municipal Credit Market for Infrastructure Finance: The Legal Framework – Michael DeAngelis, Ronald Johnson, Christopher Kaczmarski, 2002, The Local Government Initiative implemented by RTI under USAID

Table 4-2 Local Public Debt Limits in Different Countries

Country	Debt Limit	Other
Poland	Annual debt service should not exceed 15 percent of budgeted revenues and stock of debt cannot exceed 60 percent of budgeted revenues.	- Short-term loans must be repaid within the fiscal year ; - No state guarantees unless explicitly stated; - Long-term credits only for investments; - Debt service includes potential liability under guarantee commitments.
Czech	No limit on the amount of debt.	
Romania	Annual debt service should not exceed 20 percent of budgeted revenues.	- No state guarantee, debt registration documents must include a clause to this effect; - Short-term cash deficit limited to 5 percent of total revenues; - Debt service includes potential liability under guarantee commitments.
Hungary	Annual debt service should not exceed 70 percent of own current revenues. Debt service includes potential liability under guarantee commitments.	- Local governments that extend certain limits of outstanding loans must have external independent audits; - Loans cannot be secured with primary assets[15], general transfers from the state or shared taxes;
Macedonia	Annual debt service should not exceed 15 percent of budgeted revenues. The total outstanding long-term borrowing of the municipality including all guarantees shall not exceed the total amount of revenues in the current operational budget of the municipality in the preceding year.	Municipalities can guarantee for the long-term debts of the public companies they founded.

Source: different policy papers

In monitoring municipal debt and ensuring that legally mandated limits and procedures are in place, central government has two critical objectives. The first being to ensure compliance with the EU recommended upper limit of public debt which is 60 percent of GDP. The second one being to preserve financial and overall macroeconomic stability. This is particularly important in the case of Serbia bearing in mind the recent history of hyperinflation and the confiscation of savings that took place during the 1990s.

[15] *Primary assets is defined as the infrastructure necessary in the provisioning of certain services. For example, in the case of water supply the primary asset would be the pumps and pipes transferring water to the end users.*

Recommendations:

1. Local government to be obliged by the Ministry of Finance to adopt Debt Management Strategies.
2. The level of approved municipal borrowing to be reassessed within the next 5 years in light of further accumulated experience in the following directions:
   More severe limits could be imposed for: (a) debt issued in foreign currency or indexed in foreign currency; (b) debt issued by municipalities that have a default history; (c) debt that is secured by sovereign guarantee.
   Increase the debt limit for municipalities that: (a) have been audited and have received a credit rating; (b) municipalities that have no default history; (c) for municipal infrastructure projects that can be co-funded by foreign grants (EU pre-accession funds).

Guarantees and Collaterals

Presently, the following are employed as securities for municipal borrowing : (1) revenue pledges: bills of exchange, contractual authorization, joint warranty by public companies founded by municipalities; (2) pledges on physical assets: collaterals on buildings and land. The central government is legally allowed to issue sovereign guarantees for municipal borrowing but it has done so in very few cases.

1. Three years ago, when the municipal credit market begun to develop, banks were in general seeking physical collaterals for securing loans. Nowadays however, banks are seeking secured debt. This change in policy reflects a realization by the banks that municipalities have secure revenue sources and that the history of repayments on municipal short-term loans has been positive. The other point that banks considered is that municipalities lack enough pledgable assets that can be used as collateral (buildings, land). Furthermore even if such assets do exist the approval of the approval from the Property Directorate of the Republic of Serbia is required. This is one more step in the process that usually takes about 30 days.

   In case municipalities do not service the debt in accordance with the signed credit agreement, the financial institution (bank) will present the bills of exchange to the Public Payment Agency of the Republic of Serbia, which should transfer the due credit installment(s) from municipality's to the banks' account. The Ministry of Finance (Treasury Public Debt Management Division) recommends that municipalities and banks when negotiating a loan as security use the Contractual Authorization document, which is similar to a bill of exchange but better defined and can be obtained from the Public Debt Management Division.

   The situation in regard central government responsibility to municipal debt is not clear from the relevant legislation. Obviously where a sovereign guarantee is issued the central government guarantees that debt. The Law on Public Debt defines that if a municipality is not able to service its debts and the central government has to make those payments, the central government will deduct those funds from the transfers to municipality with an interest rate charge made. It is unclear whether this applies to cases where no sovereign guarantee has been issued. If however it does apply to such cases, this "intercept" will provide a strong incentive to the credit market development.

2. The general principles of Serbian legislation do not prohibit securing municipal debt with a mortgage on local government property, although the Law on Public Debt does not include any provision related to securing municipal debt through physical assets. However, according to present legislation in Serbia, local governments do not own any property, but they do have user rights. As stated above, in order to use this property as collateral, permission is required from the Property Directorate of the Republic of Serbia. According to the new Constitution adopted in 2006, property will be transferred to the local self governments. In that respect, a new Law on the Property of Local Self-Governments will be adopted resulting in municipalities having all the associated benefits related to owning the property. Therefore property can be used as collateral on loans with a municipal decision. The Law is expected to be adopted by the end of 2007 or beginning of 2008. Still, local government will have a limited number of pledgable assets, especially non-primary assets.

Another form of security is special appropriations in the budget, internationally recognized as a “reserve funds”. The mechanism is that in annual budgets the amount equal to credit instalment is set in the special appropriation. It represents a financing device that sets aside an amount of funds, held separate from other funds of the local government and it is available only for debt payments. An example of this in Serbia is where the City of Belgrade employed this instrument with the EBRD loan.

In some other countries, insurance of municipal debt has been widely used to reduce creditors’ risk and enhance municipal debt creditworthiness. In such cases the bank providing the borrowing would take out insurance guaranteeing the loan reimbursements. This practice does not exist in Serbia, where the insurance market is still in early stage of development.

Recommendations:

1. It is recommended that the Ministry of Finance initiate the change of the Public Debt Law to enable municipalities to issue credit guarantees for public utility companies that they have founded. These guarantees where issued should be counted against municipal debt limits.
2. It is recommended that the Ministry of Finance to put in place necessary legislation that prevents primary assets being used as collateral.
3. Clarification of the obligation of the central government to cover municipal debt defaults where no sovereign guarantee has been issued.

Central Bank Regulations on Municipal Borrowing

Municipal loans are affected by two types of National Bank of Serbia (NBS) regulations: 1required reserve; 2 loans risk classification. Both regulations, monetary and prudent, are influencing the level of interest rates charged on municipal credits. In these regulations, the NBS is treating local governments lending in the same manner as it treats corporate lending.

1. The required reserve[16] is used as a monetary instrument with the aim of decreasing overall lending by increasing interest rates. In practice if a bank is receiving funds for municipal credits by borrowing from abroad, it must deposit 40 percent of these funds with the National Bank. Direct lending of the IFIs to municipalities and commercial banks cross border lending is not affected by this instrument, which allows them to offer lower interest rates and be more competitive.
2. The risk classification of credits associated with municipal lending is performed based on the National Bank of Serbia Decision on Classification of the Balance Sheet Assets and Off-Balance Sheet Items[17]. Dependent on the level of risk, credits are classified in one of the five groups A, B, C, D or E and respectively reservations of 1-2% of the value of the loan are needed for credits classified in the group A, 5-15% for the group B, 20-35% for the group C, 40-75% for the group D and 100% for the group E. The criterion used for assessing risk is overdue payments of the credit (principal and interest). For example, municipal loan will be classified as being in group A if the municipality has no overdue payments or is occasionally is late up to 30 days. Whereas, the municipal loan will be classified as being in group E if the municipal payments are overdue by more than 181 days. If municipality provides collateral, than the base for calculation of reservations is decreased by 50 percent of the value of the collateral provided.

Banks face no restrictions on the portions of their portfolios that they can allocate to municipal loans.

Recommendations:
In the medium-term, with the development of the municipal capacities to manage their finances, the National Bank of Serbia to consider providing municipalities with more favourable conditions concerning the level of provisions based on credit risk classification and required reserves.

Municipal Default – Insolvency
At the current point in time, the legal framework in Serbia has no provisions to cater for instances of municipal insolvency. The existing Law on Bankruptcies limits itself to the corporate sector. To date there have been no cases of municipal insolvency. This is explained by the following factors: (1) legal regulations limiting the level of borrowing; (2) in relation to the potential a relatively low overall municipal indebtedness; (3) municipal credit market started developing 3-4 years ago, meaning that a majority of loans are still in a grade period. As the municipal credit market develops and the level of indebtedness increases a certain level of loan default can be expected. In such cases, under the current legislation, it is unclear what the outcome would be.

Following on from the above, a clear definition of insolvency procedures must be defined. When this is in place, lenders will feel more secured and fiscal stability will not be jeopardized. The following issues have to be clarified: (1) priority of claims between lenders, municipal employees, vendors and other creditors during defaults; (2) role of

[16] Due to the high level of euroization of the economy (more than 70 percent of deposits are Euro denominated), the required reserve is used as the main instrument of monetary policy. The National Bank is pursuing high reserve requirements and tight monetary policy as a response to the banks' high borrowing from abroad and fiscal expansion.

[17] Official Gazette of the Republic of Serbia No. 57/2006 and 116/2006

the state as often it is perceived that municipal debt carries an implicit guarantee and the state should be clear regarding this issue .

Box 2: Municipal Insolvency Procedures: The Case of Hungary
Hungary is one of the rare transition countries that has defined legal procedures in case of municipal credit default. The legislation defines that in such cases the State is temporarily assuming debt service obligations. At the same time a fiscal intervention team is sent to the municipality with the aim of restoring the municipality's budget operations and resuming municipal debt service. A municipality remains under "forced management" until its budgetary situation is resolved. The municipality is prohibited from issuing new debt except as part of a refinancing package recommended by the intervention team and approved by a higher level of government.

Source: Peterson George: Measuring Local Government Credit Risk and Improving Creditworthiness, 1998, World Bank

Recommendations:

- Ministry of Finance to establish clear legal rules governing default procedures that are enforced by the courts.
- The regulations should forbid new loans and capital transfers by government to borrowers who have outstanding bad loans;
- A Ministry of Finance intervention team be given the power to restore budgetary balance by mandatory spending cuts:
- Default notification should be an obligation of both lender and borrower and be recorded in the public registry at the Ministry of Finance and available as public information.

4.3 Municipal Borrowing Capacities

Creditworthiness of municipalities is defined by their ability to generate enough operating revenue surplus, which can than be used for repayment of long-term capital debt obligations. The other definition is that the municipality is creditworthy when it meets the risk standard of the lender. Refer to Table 5 for the risks borrowers (municipalities) and lenders (banks/IFIs) are faced with during the process of municipal borrowing.

The promotion of more borrowing by municipalities should not be a goal in itself. Premature borrowing before a municipality has identified its development goals, investment priorities and prepared adequate feasibility studies is likely to drain local budgetary resources and increase risk to the fiscal system.

Although the supply side of the municipal credit market in Serbia appears to have sufficient liquidity and capacity to actively enter municipal credit market, the demand side of the market is currently dominated by municipalities with relatively strong economies. Disparities among municipalities in Serbia are significant. According to the Republican Bureau of Statistics, the richest municipalities in Serbia (mostly in the north of the country) have a GDP per capital 4 to 5 times above the average, while the poorest municipalities have between 30 to 40 percent of the average GDP per capita.

The National Bank of Serbia figures on municipal borrowing differ significantly from the Ministry of Finance figures. According to the consolidated balance sheet of the banking system in Serbia, total borrowing to local governments was Euro 663 million at the end of June 2007. National Bank of Serbia data include short-term borrowing, but do not include EBRD loans and cross border financing by commercial banks. These data differ as municipalities report credits to the Ministry of Finance while commercial banks report to the National Bank of Serbia. Although the coverage of the data is different, it may imply that municipalities do not register their credits with the Ministry of Finance on a regular and accurate basis. This report is based on the Ministry of Finance data.

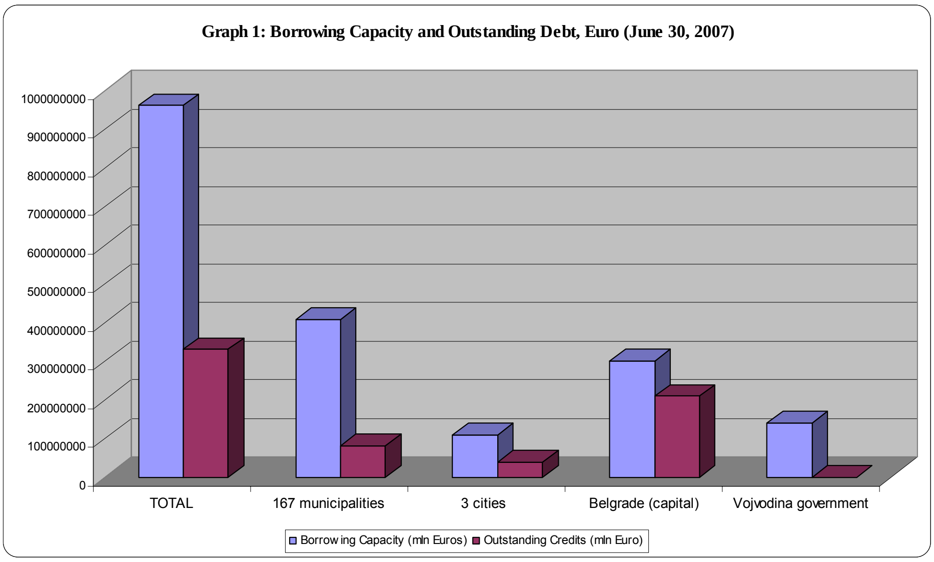
Once the Public Debt Law was adopted in 2005, the Ministry of Finance (Treasury Public Debt Management Department) began compiling data on municipal indebtedness. As of June 30, 2007 the amount of municipal debt was Euro 331 million which is 1.5 percent of GDP. This figure is well below the average of the EU developed countries, which is approximately 5 percent of GDP, but it is closer to the average for the new member states which is 2 percent of GDP [18].

As of June 30 2007, local government entities in Serbia (that includes 167 municipalities[19] and 4 cities) had the total borrowing capacity of Euro 820 million , according to the present legislation. The 167 municipalities had a borrowing capacity of Euro 409 million, the three cities (Niš, Kragujevac, Novi Sad) had a capacity of Euro 110 million, while Belgrade the capital city had a borrowing capacity of Euro 301 million. As of the same date, the total outstanding credits taken were Euro 331 million. This breaks down as follows: Municipalities had credits of Euro 82 million, three cities Euro 40 million and Belgrade Euro 210 million. In total, 34 percent of the overall borrowing capacity has been utilized. The breakdown is as follows: municipalities 20 percent, three cities 36 percent and Belgrade 70 percent. For more detailed information on remaining borrowing capacity by municipality refer to Annex 1.

The conclusion one can draw from these figures is the four cities and Belgrade in particular are making far more use of their borrowing capacities than the other municipalities in Serbia. This is linked to the size of their budgets thus increasing their attractiveness to lenders. Furthermore, it is likely there is an issue of capacity of human resources. The cities inevitably will have better qualified personnel and thus be better able to meet the demands set by lenders. The challenge is to ensure that poorer less developed municipalities with less qualified staff are enabled to access credit market and manage their subsequent debts in a responsible manner.

[18] *Toth Krizstina, Dafflon Bernard: "Managing Local Public Debt in Transition Countries: An Issue of Self-Control?"*

[19] *Excluding Kosovo municipalities*



Source: Ministry of Finance Database

The average value of individual credits is relatively small – Euro 1.88 million and even smaller if cities are excluded – Euro 0.5 million. Table 4-3 illustrates that the smaller credits of up to Euro 200,000 are most prevalent with there being few if any large scale credits (greater than Euro 5 million). If cities are excluded, one can see that just 4 municipalities (Užice, Kikinda, Leskovac and Vranje) took credits greater than Euro 2 million.

Table 4-3 Credit Structure by Volume[20]

The amount of the credit	Number of credits taken	Name of city/municipality that taken a credit (with number of credits taken)
Up to 200,000	22.00	
Between 200,000 and 499,999	35.00	
Between 500,000 and 999,999	25.00	
Between 1,000,000 and 1,999,999	17.00	
Between 2,000,000 and 2,999,999	3.00	Užice (1), Kikinda (1)
Between 3,000,000 and 3,999,999	2.00	Leskovac (1), Vranje (1)
Between 4,000,000 and 4,999,999	5.00	Belgrade (3), Kragujevac (1), Leskovac (1)
Over 5,000,000	7.00	Belgrade (3), Niš (2), Novi Sad (1), Subotica (1)

Source: Compiled from the data from the Ministry of Finance database

[20] *These data are for December 31, 2006 as Ministry of Finance did not classify data by credits for June 30, 2007*

Table 4-3 presents the remaining borrowing capacity of municipalities, divided into groups. One can see that there is still a significant amount of municipalities that have considerable credit potential, especially municipalities that can borrow between Euro 500,000 and Euro 2,500,000. More detailed presentations of the remaining borrowing capacities of municipalities is given in the Table 4-4.

For further information refer to Annex 1 that presents credit potential, outstanding credits and remaining borrowing capacity by municipality, based on the data from the Ministry of Finance (Treasury, Public Debt Management Division).

Table 4-4 Remaining Borrowing Capacity of the Municipalities in Serbia on June 30, 2007[21]

Amount	Names of Municipalities	No. of municipalities
Borrowing capacity between 1 and Euro 199,000	Golubac, Stragari, Kovacica, Opovo, Senta, Petrovaradin	6
Borrowing capacity between Euro 200,000 and 499,999	Batočina, Bela Palanka, Grocka, Bojnik, Crna Trava, Cicevac, Gadzin Han, Krupanj, Kucevo, Majdanpek, Raca, Razanj, Rekovac, Svilajnac, Trgoviste, Varvarin, Zabari, Niška Banja, Pantelej, Crveni Krst, Palilula, Mediana, Kanjiza, Nova Crnja, Secanj, Titel	26
Borrowing capacity between Euro 500,000 and 999,999	Aleksandrovac, Babušnica, Blace, Boljevac, Bosilegrad, Brus, Despotovac, Dimitrovgrad, Doljevac, Knić, Koceljeva, Kosjerić, Kuršumlija, Lebane, Lučani, Ljubovija, Mali Zvornik, Malo Crniće, Merosina, Osečina, Sokobanja, Tutin, Velika Plana, Vladičin Han, Vladimirci, Žagubica, Zitoradja, Lapovo, Bač, Bački Petrovac, Bečej, Čoka, Irig, Mali Iđoš, Novi Kneževac, Odjaci, Plandište, Žitište	38
Borrowing capacity between Euro 1,000,000 and 2,499,999	Aleksinac, Arilje, Bajina Bašta, Barajevo, Novi Beograd, Palilula, Savski Venac, Sopot, Voždovac, Vračar, Zemun, Zvezdara, Bogatić, Ćuprija, Gornji Milanovac, Ivanjica, Kladovo, Knjaževac, Leskovac, Ljig, Medveđa, Mionica, Negotin, Nova Varoš, Novi Pazar, Paraćin, Petrovac na Mlavi, Požega, Priboj na Limu, Prijepolje, Prokuplje, Raška, Sjenica, Smederevska Palanka, Surdulica, Svrljig, Topola, Trstenik, Vlasotince, Vranje, Vrnjačka Banja, Zaječar, Rakovica, Surčin, Ada, Alibunar, Apatin, Bačka Topola, Bela Crkva, Beočin, Kikinda, Kovin, Novi Bečej, Pećinci, Srbobran, Šid, Temerin, Vrbas, Vršac, Žabalj, Sremski Karlovci	61
Borrowing capacity between Euro 2,500,000 and 3,999,999	Aranđelovac, Čukarica, Bor, Bujanovac, Čajetina, Lajkovac, Mladenovac, Preševo, Jagodina, Ub, Veliko Gradište, Bačka Palanka, Kula, Ruma, Novi Sad Municipality	16
Borrowing capacity between Euro 4,000,000 and 5,499,999	Loznica, Pirot, Užice, Valjevo, Inđija, Sremska Mitrovica	7
Borrowing capacity	Stari Grad, Lazarevac, Sombor, Stara Pazova, Subotica	5

[21] *Outstanding borrowing capacity equals to the total credit potential defined by the Law minus outstanding debts*

between Euro 5,500,000 and 6,999,999		
Borrowing capacity between Euro 7,000,000 and 8,499,999	Čačak, Požarevac, Smederevo, Šabac,	4
Borrowing capacity between Euro 8,500,000 and 9,999,999	Obrenovac, Kraljevo, Kruševac,	3
Borrowing capacity between Euro 10,000,000 and 12,500,000	Pančevo, Zrenjanin, Kragujevac Municipality	3

In the Ministry's database on municipal borrowing most of the credits included are for infrastructure projects. This is in line with the Public Debt Law, which states that municipalities can take long-term credits just for infrastructure projects. More recently, an issue has arisen as whether to include leasing of vehicles under long-term credit or not. Currently, as a means of preventing overexposure to this type of borrowing leasing is included within the municipal borrowing limit and thus it could be argued is looked upon as long-term borrowing. The appropriateness of such a solution is disputable and one would argue that the levels of borrowing that could be employed for leasing should be defined separately with the limits being significantly lower than those for infrastructure.

It is important to point out that the borrowing capacity is different from creditworthiness. While borrowing capacity is defined by the Law, creditworthiness is dependant on the fiscal capacity and financial acumen of the municipality in question. These two factors, which relate to ability and willingness to pay, largely govern which units are candidates for borrowing. They are not always correlated with the size, but in general larger jurisdictions typically are of greater interest to private providers of credit for a number of reasons, including greater sophistication, the ability to draw upon more resources and the ability to spread the fixed cost of debt transaction over larger volumes of borrowing.

Recommendation:

1. Ministry of Finance and the National Bank of Serbia to compare and reconcile the data on municipal borrowing.

4.4 The Ability of Public Utility Companies to Borrow

Public Utility Companies (PUCs) in Serbia, at the local level, were founded by municipalities. The municipalities are participating in the management of the PUCs by having their representatives present on the management boards. Most of the 400 public utility companies, at the municipal level, are characterized by the following traitss:

1. poor operational and management practices;
2. a level of tariffs that barely covers the operating costs;
3. lack of investments funds for improvement and extension of utilities;

4. often low rates of tariff collection ;
5. all PUCs have a monopoly on the services they are providing within the municipality;
6. the absence of customer-orientated attitude.
7. the exists a large number of small PUCs that are financially and operationally inefficient.

PUCs are independent legal entities whose function is the provision of communal services. In theory PUCs are financed via fees paid on the services they provide. They are also responsible for the collection of these fees. The actual level of tariffs are proposed by the PUC to the municipal assembly for approval, however the municipal assembly is limited by the central government regulation. Tariff levels are different across Serbia.

As of the end of 2005, the control of setting tariffs of services provided at the local level has been regulated by the central government. This was a reintroduction of control that had been devolved four years previously. The rational for this change in policy was that at that time significant increases in tarriffs were impacting upon inflation. It was claimed that this was one of the factors contributing to the 17.7 percent inflation in 2005. The additional revenues generated from the price increases were not used for the investments, but for the payroll increases.

Central government regulates tariffs by issuing Instructions to local government and PUCs defining the rate by which they can increase tariffs and wages of the PUC employees on an annual basis. For 2007, the permissible cumulative nominal growth of tariffs was 7.5 percent, while for the wage bill it was 9 percent for wage bill. Since projected inflation for 2007 is 7 percent, there will be no real increase of tariffs and there will be slight increase of wages. This decision is an administrative measure that undermines the PUCs' abilities to invest as the wage bill is growing faster than tariffs. The growth of tariffs in real terms should be equal to growth in municipal GDP plus inflation. This will not be the case in 2007 as inflation is likely to exceed 7 percent. This implies that in most of cases, the wage growth will be again financed by a reduction in investments or municipal subsidies to PUCs.

To sum up a combination of following factors (1) below market level tariffs; (2) poor collection rates, and (3) high wage bill[22] are reducing the ability of PUCs to invest. Consequently, municipalities are forced to provide capital subsidies to PUCs or directly finance specific investment projects. Also, occasionally, where PUCs face problems with operational financing, municipalities are providing them operational subsidies.

As a result of limited municipal budgets and defined limits for municipal borrowing, this practice will have to change. PUCs will have to begin borrowing directly from banks for the projects that are feasible and in accordance with the municipal development plans.

The problem with PUCs financing infrastructure investments are:
1. In order to finance it from the revenue stream, either on pay-as-you go basis or pay-as-you-use basis, PUCs would require a sufficient net cash flow. In order to raise their revenues to the required levels PUCs would have to be able to set their tariff rates close to market rates. On the expenditure side, PUCs would have to become

[22] *Wage bill equals number of employees times gross salaries.*

more efficient and address the issue of operational restructuring (especially redundant employees) and general cost cutting.

2. PUCs cannot use physical assets as collateral. This is for two reasons – they are not the owners but users of water supply networks, heating networks, etc. At the same time they should not be allowed to use the primary assets, they are reliant upon for providing their services, as collateral.
3. Following on the last point the Serbian Public Debt Law, forbids municipalities to issue guarantees for PUCs which they founded

Serbian legislation does not limit PUCs borrowing in any respect. According to the EU criteria, public companies are “commercial enterprises”, whose debts are not public debts. This means that if IFIs/banks perceive PUC financially viable, the PUC can borrow with no legislative limits.

Despite the constraints discussed above, there are examples where PUCs have taken credits from financial institutions/banks. A good example of this is the case of the PUC for district heating in Kruševac, which took a long-term loan of Euro 1.7 million from Raiffeisen bank for purchasing new heating boilers and extending heating network.

Although they consider them more risky, commercial banks are willing to lend to PUCs and are already doing so. In the majority of the cases these are not credits for infrastructure projects but for the purchase of equipment. IFIs are also willing to provide credits to PUCs. The main difference between the financing provided by the IFIs and commercial banks is that the IFIs have broader mandate and are insisting upon full operational restructuring of the PUCs. Furthermore they are closely monitoring PUCs operational performance (see Box 3) The commercial banks, on the other hand, are more focused on the cash-flow of the PUCs and the subsequent repayment rates.

Box 3: Regional Communal Waste Management Project DUBOKO

Nine municipalities in Central Serbia (2 big municipalities Čačak and Užice and 7 smaller municipalities Pozega, Lucani, Cajetina, Ivanjica, Arilje, Bajina Basta, Kosjeric) decided to resolve their problem with solid waste by construction of a sanitary landfill for solid waste disposal.

The municipalities approached the European Agency for Reconstruction, the European Bank for Reconstruction and Development and the Swedish International Development Agency (SIDA). They all together developed a Project with a value of Euro 12.2 million. Municipalities will participate with Euro 2.7 million (21 percent), EAR will donate Euro 3 million (25 percent), EBRD will approve credit of Euro 5 million (41 percent) and the central government through its Eko Fund will participate with Euro 1.5 million (12 percent).

These nine municipalities formed a new public utility company Duboko, which will implement the Project and operate the landfill. The PUC Duboko will be financed from guaranteed municipal transfers, while municipalities will set tariffs that will be collected from the end users. The PUC Duboko will be the borrower from the EBRD. The types of securities and interest rate are currently under negotiations.

This is a regional project and the first of that kind in Serbia, which could be used as a pilot-projects for other municipalities and regional cooperation.

Source: Feasibility Study and information received during interviews

As discussed earlier, the municipalities are legally forbidden from issuing guarantees for PUC borrowing. However, for example, it is difficult to imagine a situation where a water supply company, even insolvent, can be bankrupt. The reason is that most of the PUCs are natural monopolies providing basic services like water supply and sewage and if they default it is likely that the municipality would have to intervene. The question remains what would be the insolvency procedure.

Recommendations:

1. It is recommended tha the central government changes the formula for defining public utility tariffs, based on cost-recovery principle;
2. The central government is recommended to adopt legislation obliging PUCs to inform them about their borrowing activities and that should be the information of the public domain;
3. The central government is recommended to define and adopt overall operational and restructuring programs with clear performance criteria for public utility companies. Municipalities that founded companies should be liable for the programs' implementation. As one of the possible instruments for enforcement, municipalities could use subsidies and their participation in the management board of the PUC. The central government could use their transfers from the republican budgets to municipalities.

5 LOCAL GOVERNMENT ATTITUDE TOWARDS BORROWING

Until a few years ago, infrastructure projects were financed on a pay-as-you-go basis (from current revenues), instead of a pay-as-you-use basis (borrowing). The reason was that infrastructure investments were financed either by direct subsidies from the central government or from the municipality's current revenues. However, following the underinvestment of the 1990s and the decentralization of various responsibilities to local governments it is no longer possible to finance the necessary infrastructure investments on a pay-as-you-go basis. Therefore, local governments are increasingly forced to raise revenues from their own resources and to access domestic and international financial markets.

It is encouraging that the local authorities' attitude towards borrowing has evolved, from 5 years ago, where it was one of fear of risk and mistrust to more positive perception at a current moment of time. This is reflected by the increase in municipal borrowing of 300 percent between the end of 2003 and mid 2007 according to the data from the National Bank of Serbia[23].

Compliance with the legal norms and a favorable rating at a bank are necessary but not sufficient conditions for a municipality to incur debt. Success in the overall financial management requires a more proactive attitude in which local policy makers adjust their investment policies to the actual debt capacity of the local government by assessing the short, medium and long-term costs and benefits of each investment project. In Serbia, the municipal credit market is characterized by:

- A lack of adequately prepared municipal development strategies and medium- and long-term investment plans;
- Lack of and poorly prepared projects. Often projects are oversized as a result of poor assessment of the costs and benefits of the investment program.
- Furthermore there is a reluctance for cooperation in-between municipalities for financing and operating projects which in many cases would result in economies of scale.
- Lack of technical and administrative capacity to access credits and manage debt, especially with smaller and underdeveloped municipalities;
- Increased intergovernmental transfers through so called National Investment Plan, financed by the proceeds of privatization.

Municipalities should be fully aware of the risks they are faced with when taking a credit. Table 5 provides a summary of the risks faced by both the borrower (municipalities) and lender (IFIs/banks) with regard to the municipal credit market. Since lenders are financial institutions more accustomed to risk management, it is the borrowers -

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[23] *National Bank of Serbia Statistical Book, June 2007. This is National Bank figure that is not precise and is used just to present the magnitude of increase. It is not precise as it does not include EBRD loans and cross border financing by commercial banks. Also, the Ministry of Finance figures on municipal borrowing differ from the National Bank figures as municipalities are registering their borrowing activities with the Ministry of Finance, while banks are registering with the National Bank of Serbia. The Ministry of Finance started compiling municipal borrowing database as of end of 2005 when the Law on Public Debt was adopted.*

municipalities who should pay more attention to the risks and eventual consequences on their future finances.

In the longer term the NIP funds will be depleted as the proceeds of privatization are depleted. This trend may be compensated by conditional grants provided by the European Union that may become increasingly important in the light of an increased demand for infrastructure investments in connection with the EU accession.

Table 5-1 Credit Risks

Risk	Definition	Party bearing the risk	Consequences	Risk Management
Credit risk	The risk that a borrower will not make full and timely payment of debt service.	Lender (Bank/International financial institution)	The lender has the most obvious interest in determining whether a loan is creditworthy since its money is in stake. Still a borrower-municipality should have an equal interest in understanding the risks it is faced with. In countries with developed financial markets, credit-rating agencies and bond-insurance firms perform the credit risk analyses and give the rating. In Serbia there is no rating of municipal debt, but banks use their own internal risk evaluations. Central government should also have interest in assessing the credit risk ensuring the prudent borrowing and financial and macroeconomic stability.	All parties should perform proper risk analyses. Ministry of Finance should oblige municipalities with budgets over certain limits that are taking the loans to do the independent audit. Finance Ministry should also maintain the credit default database, which will be available to public. Insolvency procedures should be clearly defined in case of default.
Interest rate risk	The risk that the interest rate will raise.	Borrower (Municipality)	Contracted loans as a rule have the floating interest rate (EURIBOR, LIBOR) plus margin depending on risk. This implies that the interest rates of municipal credits will float following the move of general interest rates.	Donor agencies and central government should help municipalities in developing proper debt management techniques. Banks, supported by the National Bank, should develop hedging instruments at domestic financial markets.
Foreign exchange risk	Inability of municipalities to service debts due to risk of domestic currency (dinar) depreciation.	Borrower (Municipality)	Loans are either indexed in foreign exchange (commercial banks) or are nominated and serviced in Euros (international financial institutions) , while municipalities do not have foreign exchange revenues.	Ministry of Finance and the National Bank of Serbia should create macroeconomic stability, restrain fiscal policy and support the development of dinar.

Risk	Definition	Party bearing the risk	Consequences	Risk Management
Liquidity risk	Lenders cannot realize the value of the loan before the maturity as there is no secondary market	Lender (Bank-International financial institution)	Banks cannot use municipal loans to manage their liquidity position and share of municipal loans in their portfolios.	Banks, supported by the National Bank of Serbia, should develop the secondary market for loans.
Ballooned maturities	Balloon maturities or large amounts of debt with prolonged initial grace period tend to postpone and obscure principal payments creating the risk when payments come due.	Borrower (Municipality)	Inability of municipalities to service ballooned maturities. Credits with long grace periods are more expensive for municipalities (if interest is paid during grace period).	Municipalities and banks/IFIs to avoid longer grace periods and balloon maturities.
Sovereign risk	Under sovereign risk, countries political and economic risk may be included. Also, in this case, sovereign risk derives from central government policy towards municipal sector.	Borrower (Municipality) Lender (Bank-International financial institution)	(1) Countries macroeconomic policy, especially inflation rate and foreign exchange policy in case of Serbian municipalities, may significantly influence municipality ability to service the loan. (2) central government policy towards local government sector and its changes make municipal lending more risky. (3) Serbia's credit rating is influencing interest rates municipalities are offered for credits.	(1) Government's fiscal, monetary and foreign exchange policies; (2) New Law on Public Financing reduced central government influence and increase the predictability of municipalities' revenues.

The question should be raised on the appropriateness of the projects that are financed by municipal borrowing. Not many municipalities in Serbia have long term development plans and plans of capital investments based on long term budget planning. Furthermore, in few or any cases do feasibility studies exist. This leads one to question the basis on which priority investment projects are selected. Certainly the anecdotal evidence illustrates there is a preference for high profile project such as road restructuring over lower profile but often far more necessary infrastructure associated with sewage, water supply and solid waste management. The concern is that municipal borrowing could be used in irresponsible manner to finance high profile infrastructure linked with the election campaigns.

The politization of local public administration in Serbia has significant influence on the way the local government is administered. It affects the majority of decisions made at the local level including important issues such as establishment of investment priorities, preparation of the budget and its execution and recruitment of key personnel. One key step that could immediately be taken would be the introduction of programmatic budgets with a 3 to 5 year horizon.

In order to take a credit, municipalities must apply the Public Procurement Law[24] and initiate an open tender procedure, according to the Public Procurement Office of the Republic of Serbia. Out of eight interviewed municipalities, six used an open tender procedure, one was collecting bids and the other negotiated directly. USAID funded MEGA project prepared a Model of the Tender Documentation for municipalities getting a credit which can be obtained through Standing Conference of Towns and Municipalities.

Commercial banks noticed that municipalities often prefer credit offers with longer grace periods and longer maturity. This practice should be changed as in effect longer grace periods are increasing the total cost of credit, while maturity would have to be matching project life time.

The type of borrowing that is not registered in the Ministry of Finance database is where credits are approved to municipalities by construction companies in a form of payments of works by multi-year instalments. Since, municipalities do not have balance sheets, this indebtedness is not transparent and does not impact upon the municipality's borrowing limit.

The poor access of the smallest and underdeveloped municipalities to borrowing is a persisting problem. These municipalities do not have enough funds to finance the infrastructure projects they need, their creditworthiness is poor and they lack capacity to obtain and manage the debt and projects themselves. For these reasons, these local governments should consider pooled financing at the regional level. The financing and operation of many projects are often more efficiently accomplished on a scale that is larger or more regional than an individual municipality can accomplish. Government policies regarding intragovernmental finance and governing technical and credit assistance to small and underdeveloped municipalities will affect how the market assesses their creditworthiness. The realty is that the parochial nature of many municipalities inhibits effective cooperation. Central government, donor institutions and IFIs have mandate and capacity to facilitate such cooperation through the combination

[24] *Official Gazettes of the Republic of Serbia No.39/02 and 55/04*

of transfers, donor funds and credits conditioned by feasibility and operational efficiency of such projects. Project Duboko (see Box 4) could serve as a good example of an inter municipal project.

For this Study, 10 municipalities were interviewed. Apart from municipalities listed in the Table 6, municipality of Užice and Čačak were interviewed as they are do-founders of the PUC Duboko (see Box.3) .

Table 5-2 Borrowing Information on Municipalities Interviewed for the Study

Name of the Municipality	Borrowing Capacity (Euro million)	Credits Taken (Euro million)	Type of Project	PUCs that took credits
Larger Municipalities				
Vršac	5.2	4.2	Roads	
Smederevo	9	2	Roads and water supply	
Kruševac	8.3			PUC for heating took a credit of Euro 1.7 million
Medium Municipalities				
Subotica		9	Waste water treatment	
Apatin	2.9	1.48	Water supply	
Inđija	4.5			
Small Municipalities				
Varvarin	0.82	0.49	Water supply	
Žitište	1.1	0.55	Roads	

These municipalities cited the following problems in dealing with the commercial banks and international financial institutions:

- The municipality cannot issue guarantees for the public utility companies it founded;
- The local government is still not the owner of the property at the local level ;
- The requirement that each credit should be approved by the Ministry of Finance;
- The low level of direct municipal revenues (Property Tax, Tax on the Transfer of Absolute Rights, other taxes;
- Euro-indexed credits;
- Limited number of pled able assets, especially non-vital properties;
- Extensive documentation requested by banks;
- A lack of experience of dealing with credit issues;
- Templates and forms required by the banks are not adapted to reflect the municipal operations;
- High interest rates;
- The small budgets of undeveloped municipalities.

Refer to Annex 2 to see a presentation of the detailed information collected from municipalities.

Recommendations:

1. It is recommended the Ministry of Finance regulate the practice of provision of credits to municipalities by construction companies.
2. That Municipal budgets Ministry of Finance should stimulate municipalities to adopt programmatic budgets for the period of 3 to 5 years.
3. The Public Procurement Office more closely monitor the procedures employed when municipalities access credit and ensure they are in line with the Law on Public Procurement.
4. The Ministry for Economic and Regional Development and the Ministry of Finance to stimulate smaller and underdeveloped municipalities to develop inter municipal projects through linking them to central government transfers and grant funding.
5. The Ministry of Finance together with the other relevant authorities (Ministry of Infrastructure, Standing Conference of Towns and Municipalities) to regulate what kind of projects are to be classified as infrastructure projects and allowed to be financed by borrowing.
6. Municipalities to adjust grace periods and maturities of projects with project life time.
7. Municipalities to increase their capacity to budget for and manage debt. In certain cases, when the credit arrangement is complex, the process of credit preparation and negotiations could be outsourced to a consultancy company that specializes in this field.

6 FINANCIAL OPERATIONS AT THE MUNICIPAL CREDIT MARKET

6.1 Role of the European Agency for Reconstruction

In the Republic of Serbia, the European Agency for Reconstruction (EAR) manages a cumulative portfolio of some €1.1 billion worth of European Union funds, 86% of which has already been contracted. Under the future Instrument for Pre-Accession (IPA) financing, the EU will focus on the development of municipal projects in the fields of: environmental, social and economical infrastructure. For the years 2007, 2008 and 2009 budgets of Euro 180 million per year are available, out of which approximately 30-40% could be available for municipal infrastructure.

The EAR is currently running 7 programs engaged with the reform of local self government in Serbia. One of these, the Municipal Infrastructure Agency Support Program that began in 2003 has the specific purpose of supporting the development of municipal infrastructure. The Program provided for a financial contribution to priority projects in 10 selected municipalities across Serbia (town streets in Smederevo and Žitište municipalities, and a district heating project is ongoing in Kruševac, while works on water supply networks and water treatment are dominant – in Apatin, Mionica, Varvarin, Smederevo, Zemun, Žitoradja, and now Inđija). The total value of these projects is Euro 34 million. Municipalities contributed with their own funds with Euro 6 million (18 percent) and they also took credits from commercial banks and IFIs of Euro 15 million (44 percent), while the EAR contributed with a grant money of Euro 11.3 million (33 percent), another 5 percent came from different sources.

Also, in June 2007, the EAR, through its Energy Program in Serbia, signed with mayors and district heating managers of Valjevo, Čačak, Užice, Subotica and Pančevo agreement on reconstruction, improvement and expanding of district heating systems in these towns. The value of the works will be Euro 18 million plus Euro 1 million for supervision of construction, fully financed by the EAR.

In future, the EU will continue to finance infrastructure improvement at the local level. The mechanism for this investment will be via IPA funding that will operate on a basis where selected projects will be financed by 75 percent of EU funds and 25 percent of local government contribution.

In order to apply for the EU funds for the infrastructure development, municipalities will be required to address the Ministry of Finance of the Republic of Serbia (Department for Grant and Development) as well as the Standing Conference of Towns and Municipalities for advice and support. For more information on the EAR project selection criteria and policies in the field of municipal infrastructure development please refer to Annex 3.

<u>How Can The EAR And Other Donor Institution Facilitate Development Of Municipal Credit Market</u>

Interviewed banks and financial institutions consider municipal projects co-financed by donors less risky. Some of them pointed out that co-financing by donor institution increases municipality capability for loan repayment as part of the project is financed by donor, while donors' analysis and co-funding contributes to increasing project viability.

The biggest commercial lender Intesa bank emphasized that municipalities are currently investing mostly in small-scale projects without clear vision of future development needs or investment priorities and suggested that donors could assist in this area. Most of the banks interviewed would like donors to play a role in reducing the risk of lending and one bank even suggested that donors could fully or partially guarantee municipal credits. USAID employed the risk-sharing instrument but with limited success as qualified banks were not interested due to the complicated procedures involved and the availability of other more flexible instruments.

The EBRD suggested that donors can help municipalities enhance their capacities for budget planning, debt monitoring, operational and financial improvements, commercialisation of municipal services and improvement of institutional capacities of the utility companies. KfW had similar suggestions and confirmed that municipalities require institutional support to strengthen their own capacity as well as that of the PUCs towards economic sustainability and service orientation. KfW stressed that donors should continue the support of the decentralization process and emphasized the need for the clear division of tasks and responsibilities between local and central government. The EIB suggested that donor agencies could assist in the project preparation and implementation monitoring, with support to project implementation units.

Recommendations:

1. Donor agencies, through their implementing partners, are recommended to facilitate the further decentralization of responsibilities to the local government level. While at the same time ensuring the necessary capacity exists at the local level to take on these new functions.
2. Donor grant funding at the municipal level should be linked to the following areas: develop municipal capacities in terms of long-term planning of development strategies and investment priorities; preparation of feasibility studies and project implementation; budgetary and debt management.
3. For donor agencies, through their implementing partners, to assist central government in preparing and implementing an adequate strategy for operational and financial restructuring and eventual privatization of the public utility companies.

6.2 Role of International Financial Institutions at Municipal Credit Market

In Serbia, the most important international financial institutions (IFIs) that are financing municipal infrastructure development are the European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB) and German development bank (KfW).

European Bank for Reconstruction and Development (EBRD) is the largest institutional investor in Serbia. Between April 2001, when the Bank signed its first contract in Serbia, and 31 December 2006, the Bank achieved a cumulative business volume of €1,108 million. The portfolio consisted of 69 projects at the end of 2006, with the highest concentration being in infrastructure and financial sectors. In the Serbia country Strategy, EBRD pointed out that “In the municipal sector the Bank expects to continue its successful cooperation with the city of Belgrade and work on completing signed projects. It will also seek to diversify its financing to medium-sized cities and regions, provided that their financial strength is adequate, in order to provide the substantial funds needed to improve local infrastructure in areas such as water and waste water management, landfills and waste management, district heating and urban transport." In the EBRD portfolio in Serbia, 16 percent belongs to municipal infrastructure.

In the field of municipal infrastructure EBRD granted credits to three projects:

1. The rehabilitation and modernization of the wastewater treatment plant in the City of Subotica with a total project value of Euro 12 million and total borrowing of nine million Euro (2004). A Sovereign guaranteed has been granted for the total value of the loan.
2. Sava river crossing project with an estimated total value of Euro 161 million. A municipal loan of up to EUR 69.6 million was extended directly to the City of Belgrade, of which EUR 20 million will be syndicated. There will be no sovereign guarantee (2005).
3. Solid Waste Regional Landfill (Čačak , Užice and another 7 small municipalities) with an estimated Project value of Euro 12.2 million. A loan of EUR 5 million will be granted to the public utility company that was founded by the nine municipalities to manage the landfill.

The minimum loan amount the EBRD is offering is Euro 5 million. The repayment period is up to 10 years, with a grace period of up to three years. The . interest rate is equivalent of EURIBOR plus a margin. If the credit has a state sovereign guarantee, then that margin is equal to 1 percentage point.

Based on its extensive experience in the municipal financing sector in transition countries, the EBRD named the following limitations with regard to the further development of this market in Serbia:

1. Caps on tariff increases imposed from the central government. The view of EBRD is that central government should trust local authorities to make the political trade offs;
2. The Public Debt Law which should be amended to allow municipalities to guarantee the debt of PUCs they have founded;
3. Clear but more relaxed debt ceilings on municipalities, which should be based on debt service "flows" rather than total outstanding debt "stock".

The difference between the EBRD and commercial banks is that the EBRD is more interested in the municipalities'/PUCs' operational and financial operations and is closely following it through operational and financial performance improvement programs.

For detailed information on the terms and conditions offered by EBRD please refer to the Annex 4.1.

European Investment Bank (EIB) has approved Euro 1.1 billion of credits for projects in Serbia, mainly for infrastructure in the period 2001 to 2007. Up to June 2007, the EIB was approving credits to government institutions with sovereign guarantees or was dealing through partner commercial banks for smaller-scale lending.

The EIB has 7 partner banks in Serbia and up to April 2007 11 banks got credits from commercial banks that were using the EIB funds. Partner banks were bearing all the risks and doing the assessment of the borrowers-municipalities. The interest rates for these credits were 8 percent fixed or 7.8 percent variable, grace period was up to 5 years and maturity up to 15 years. At the moment, the EIB is considering starting direct lending to bigger municipalities without sovereign guarantees.

The EIB is willing to lend for all infrastructure projects. The only limitation is that the EIB must finance physical assets for up to 50 % of overall project cost .

The EIB named the following areas where donors can help the development of the municipal credit market: Donor agencies can help in assisting with the project preparation, Project Implementation Units and projects implementation monitoring.

For detailed information on the terms and conditions that the KfW offers refer to Annex 4-2.

The German Development Bank KfW, on behalf of the German Government, has implemented financial cooperation between Germany and Serbia, since 2000. As of the beginning of 2007, Euro 410 million had been committed to projects in Serbia, out of which Euro 235 million was for the energy sector, Euro 55 million for the water supply sector, Euro 40 million for district heating and Euro 80 million to support the financial sector.

KfW began financing municipal infrastructure projects in 2001 with the rehabilitation of the district heating systems in three Serbian towns (Belgrade, Niš, Novi Sad) and has to date invested Euro 18 million on this program. As a continuation of this Program, KfW has already signed soft credit agreements for financing district heating in 2 cities (Niš and Kragujevac) and 4 municipalities (Sombor, Kraljevo, Pirot, Zrenjanin), with a total investment value of Euro 12 million.

The German government, via KfW, has upgraded the water supply and sanitation systems in Belgrade, Niš, Novi Sad and Kragujevac. The value of this Project was Euro 25 million. A further Euro 30 million have been committed for water-supply systems in the medium sized municipalities.

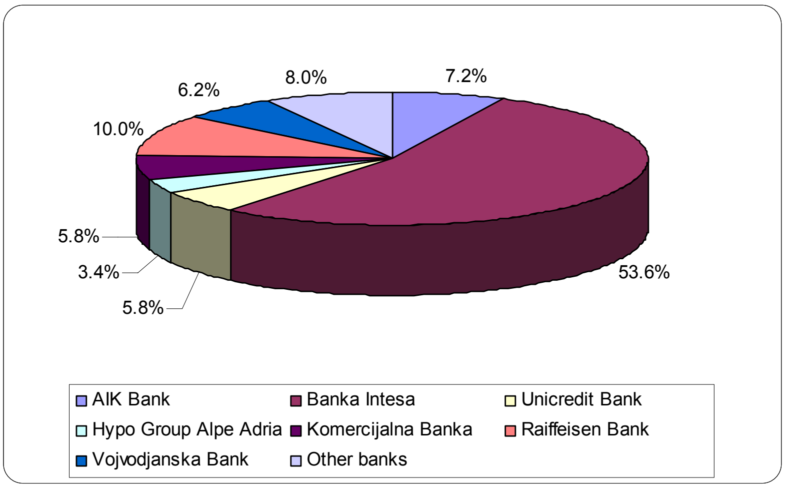
KfW is currently preparing a program for financing small municipal infrastructure projects with credits of up to Euro 400,000. This financing will be performed through partner banks, where partner banks will be responsible for the risk assessment of the applicants and thus cover the overall project risk. The repayment period will be up to 10 years, with a maximum grace period of two years. This credit line should be favorable for smaller and less developed municipalities that presently cannot access the credit market.

For detailed information on the terms and conditions that the KfW offers refer to Annex 4.3.

6.3 Role of the Commercial Banks at the Municipal Credit Market

In Serbia there are 36 banks. For this Study, the seven banks, that hold 55 percent of the total assets of the banking system in Serbia, were interviewed. These seven banks are covering over 90 percent of the municipal credit market (excluding EIB direct lending to cities and EBRD lending). Intesa Bank[25] (former Delta bank), that has 10 percent of total assets of the banking system in Serbia, covers over 50 percent of the municipal credit market. Graph 1 presents the figures on market share

Figure 6-1 Commercial Banks' Share at the Municipal Credit Market (excluding EBRD and EIB direct lending), June 2007



Source: Ministry of Finance Database

Presently, remaining credit potential of municipalities/cities in Serbia is Euro 600 million and will be rising with the growth of GDP and municipal budgets. Banks and the IFIs have enough funds to meet this demand.

Five banks (Bank Intesa, Unicredit Bank, Raiffeisen bank, Hypo Group Alpe Adria) out of these seven banks are owned by foreign banks, while two of them (Komercijalna banka and AIK Bank) are banks with majority local ownership although with minority foreign shareholders.

The commercial banks that were interviewed are offering the following credit conditions:

1. Maturity between 5 to 15 years;
2. Grace period of 1 to 3 years;
3. EURIBOR interest rates plus up to 4 percentage points;
4. Banks are looking for different sorts of securities from municipalities: bills of exchange, contractual authorization, joint warranty by public companies founded by municipalities and physical collaterals on buildings and land.

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[25] *Banca Intesa Beograd is a bank that operates in Serbia, majority owned (90%) by Italian Banca Intesa since August 2005. It was founded as Delta banka in 1991 by local businessman Miroslav Mišković's Delta Holding company. In February 2005, Banca Intesa acquired 75% stake in the bank for Euro 278 million. By August of same year its stake was increased to 90%. Following the majority takeover, Delta banka officially changed its name to Banca Intesa Beograd during the fall of 2005.*

Foreign banks are receiving funds for municipal credits either from funds from their mother companies abroad or by loans from the EIB and other international institutions (Council of Europe Bank, etc.). AIK Bank is using exclusively banks' own funds gained through share issuance on the Belgrade Stock Exchange, while the other local bank Komercijalna bank is using the bank's own funds and EIB funds (Komercijalna Bank was recapitalized by the EBRD in 2006). The on-lending of the EIB funds is regulated by contracts between the EIB and its partner banks (see Annex 4-2).
Due to the tight monetary policy and high reserve requirements, more and more banks are opting for cross-border financing. The mechanism is that the domestic commercial banks founded by foreign mother banks are performing the market research, tender applications and risk assessment of municipal credits, while formally their foreign mother banks are lending to municipalities. This prevents the need to put set aside required reserves and lowers the interest rates.

The improvement in the overall macroeconomic situation together with the increased competition in the reformed banking sector has begun to bring down interest rates in this part of the credit market. However this mainly applies to credits for larger creditworthy municipalities.

The terms and conditions these banks are offering are presented in Annex 5 (1-7). Table 7 provides a summary of this information.

Recommendations:

1. Banks and IFIs are recommended to develop clear documentation and transparent procedures needed for approving municipal credits.
2. Banks and IFIs are recommended to present their terms and conditions in a clear manner with all costs included and annual payment plan (principal and interest) presented.
3. Banks are recommended to develop hedging instruments for managing municipalities foreign exchange exposure.
4. Ministry of Finance is recommended to support the development of dinar market through issuance of dinar long-term government bonds as a repo rate for dinar credits and financial instruments.
5. Banks are recommended to develop secondary market of municipal credits in order to enhance liquidity risk management..

Table 6-1 Commercial Banks' Terms and Conditions for Municipal Credits

	Name of the Bank	Minimum Loan Amount	Minimum size of the municipality's budget p.a.	Maturity	Grace period	Interest rate	Preparation fee	Administration fee	Prepayment penalty	Security	Time for approving/rejecting credit	Note
1	**Intesa Bank**	Euro 40,000 for the loans financed by the funds from CEB	no limits	Conditions differ depending on loan amount, size of municipality and project structure.						Bill of exchange, mortgage.	7-10 days for bid preparation; if win few days for disbursement after contract signing	
2	**Raiffeisen Bank**	no limits	no limits	average 10 years	average 3 years	6.3 – 8.4%, depending on other loan conditions	Case by case according to the bank's policy	Case by case according to the bank's policy	Case by case according to the bank's policy	Physical collaterals case by case and bills of exchange and authorization to debit budget account	15 days	
3	**UniCredit Bank Serbia**	Euro 500,000	Euro 1,500,000	max 10 years	min 6 months, max 18 months	n.a.	n.a.	n.a.	n.a.	Bills of exchange of the municipality Contractual authorization	1 week	

	Name of the Bank	Minimum Loan Amount	Minimum size of the municipality's budget p.a.	Maturity	Grace period	Interest rate	Preparation fee	Administration fee	Prepayment penalty	Security	Time for approving/rejecting credit	Note
4	**AIK Bank**	no limits	no limits	max 5 years	max 1 years	EURIBOR + 4 percentage points	0.5 percent, one-off during withdrawal of funds	n.a.	/	Joint warranty by public companies	2 days	
5	**Vojvodjanska bank**	no limits	no limits	max 10 years	max 2 years	n.a.	0.5% one-off payment	/	/	Bills of exchange of the municipality; joint warranty by public companies, state guarantees and other.	Variable	Business plan evaluation fee and other fees defined by Bank's internal policy
6	**Komercijalna bank**	no limits	no limits	max 15 years	max 5 years	3m EURIBOR + 3,90% or fixed EURIBOR + 3,50%	1%	n.a.	/	Bills of exchange of the municipality; mortgage over building or land	Variable	
7	**HYPO Alpe-Adria-Bank**	no limits	no limits	5 to 15 years	max 3 years	3 m EURIBOR + fixed margin 6 m LIBOR + fixed margin	0.5% - 1.00%	n.a.	1%	Bills of exchange	7-10 days	

6.4 Perspectives for the Development of the Municipal Bond Market

The municipal bond market is an alternative method of raising financing for investment in municipal infrastructure. This method is more common and well developed in the United States, whereas in Europe it is less significant with the majority of municipal infrastructure still being financed by commercial credit. The main difference between municipal bonds and bank loans is that publicly sold municipal bond requires a greater level of disclosure of financial and other information that is not required in the case of bank loans.

In Serbia, currently this market does not exist, although the legal framework is in place. Thus, Law on Public Debt allows municipalities to issue bonds (either Euro or Dinar denominated) in order to finance long-term capital investments. The Securities Law envisages this possibility as well. This market does not exist as currently there is no enough demand or supply for this instrument.

On the demand side, there is a sufficient supply of municipal credits as a result of the reformed banking sector where about 90 percent of banking assets comes from foreign banks,. Since the tax authorities and the NBS are treating municipal bonds and credits equally, banks would not be stimulated to buy municipal bonds.

Banks are offering municipal credits with the interest rates of between 6 to 8 percent. At the same time, Government Euro denominated bonds yield about 5.5%. If we take into account the underwriting costs, this leaves little room for municipalities to benefit from bond issuance, as they would have to offer yields over 6 percent, plus they would have the larger associated costs (underwriting costs) than when obtaining a credit.

Dinar denominated bonds would be beneficial for the Serbian financial market due to the excess dinar liquidity and lack of long-term dinar instruments. But the problem is the lack of confidence in dinar due to the history of high inflation. If inflation proves to be stable in the the years to come, dinar-denominated bonds could become an attractive instrument.

At the moment, institutions in Serbia, especially municipalities, are not ready for bond issuance for the following reasons:

1. Municipalities do not have audited budgets and transparent financial statements. They also lack the capacity necessary for preparing a bond issuance.
2. The Securities Commission does not have disclosure standards neither for public offering or private placements of municipal bonds. Clear, fair and enforceable disclosure standards are crucial for the development of a municipal bond market.
3. Private pension funds that began operating at the end of 2006 are limited in their participation in the purchase of bonds to cases where the total value of bonds issued is a minimum of Euro 15 million. The implication being that just bonds issued by the four cities would qualify. Private pension funds regulations are also envisaging that municipalities have to have rating A- (according to the Standard & Poors methodology), while there is no rating of municipalities at all (except banks internal rating). This limits pension funds to investing in bonds issued by the four cities, which can all access relatively cheap funds.
4. Investment funds started operating in Serbia as of 2007 and, among other assets, could be interested in municipal bonds depending on their structure and yield. Still, some of local investment funds are presently yielding over 20 percent annually, which does not make municipal bonds very attractive.

5. The insurance industry is still in the early stage of development with mostly short-term assets. Development of life insurance could increase interest in municipal bonds. Still, currently, insurance companies are depositing the majority of their assets in banks, where they receive over 5 percent interest for time deposits.
6. According to the Law on Public Debt, general public (citizens) are not allowed to buy municipal bonds, just professional investors.

At the same time, municipalities are receiving grant funding from the National Investment Plan, as well as from donor institutions such as European Agency for Reconstruction.

Although, the development of municipal bond market would be beneficial for the development of Serbian financial markets at this moment of time it would not imply cheaper funding for municipal infrastructure projects. This possibility could be explored further in the medium term dependent on the development of the market..

7 CONCLUSIONS AND RECOMMENDATIONS

In order to facilitate the development of the municipal credit market, increase investments in the municipal infrastructure and stimulate the overall development of the economy at the local level, it would be necessary to:

1. Facilitate municipalities to identify **development goals, investment priorities and prepare adequate feasibility studies.** Premature borrowing is likely to drain local budget resources and add risk to the fiscal system.
2. **Facilitate local government to adopt programmatic budgets for the period of 3 to 5 years** based on the municipalities' development strategies and capital investment plans.
3. **Increase the transparency of the municipal financial performance** by: initiating the budget auditing, standardizing municipal financial reporting to separate current from capital (one-off) revenues; requiring public disclosure of all municipal financial budgets and reports that show municipal assets and liabilities.
4. **Facilitate local governments to adopt Debt Management Strategies**. The success of the overall local government financial management requires a more proactive attitude in which local policymakers adjust their investment policies to the actual debt capacity of the local government, assessing the short, medium and long-term costs and benefits of each investment project within the municipal development agenda.
5. **Facilitate the development and preparation of regional projects** that provide smaller and underdeveloped municipalities with essential infrastructure in a cost-effective manner. This will also had the added benefit of allowing such municipalities to access the credit market in the form of pooled financing.
6. **Corporative public utility companies and strengthen their financial and operational efficiency** in order to make them to provide better services and become more viable borrowers.
7. **Establish clear legal rules governing municipal default procedures** that are enforceable by the courts.

The Serbian municipal credit market has successfully passed through the basic stages of development and is now entering a more mature phase with more mature risks such as municipal default and insolvency. The existence of demand and supply is not in question however, the question remains how effectively they will be managed in order to achieve municipal development goals and sustain fiscal and financial stability in the longer term.

Table 7-1 presents a summary of the recommendations that have been made throughout the report for different stakeholders who are engaged with the municipal credit market.

Table 7-1 Recommendations

	Recommendations	**Authority in-charge**	**Donors Role**
1	Develop/improve municipal capacities in terms of long-term planning of development strategies and investment priorities; preparation of feasibility studies and project implementation; budgetary and debt management.	Standing Conference of Towns and Municipalities, municipalities	Capacity building of municipalities.
2	Reconcile the Public Debt Law with the relevant EU legislation.	Ministry of Finance	/
3	Compare and reconcile the data on municipal borrowing.	Ministry of Finance and the National Bank of Serbia	
4	Change of the Public Debt Law to unable municipalities to issue credit guarantees for the public utility companies founded by them.	Ministry of Finance	/
5	The Law on State Auditing Institution adopted in 2005 to be put in practice as soon as possible.	Government of the Republic of Serbia	/
6	Initiate external independent auditing for municipalities with revenues above certain threshold values.	Ministry of Finance to regulate, Municipalities to implement	/
7	Standardize municipal financial reporting to separate current from capital (one-off) inflows.	Ministry of Finance to regulate, Municipalities to implement	Capacity building of municipalities.
8	Municipalities to adopt programmatic budgets for the period of 3 to 5 years.	Ministry of Finance to regulate, Municipalities to implement	Capacity building of municipalities.
9	Require public disclosure of all municipal financial budgets and reports that show municipal assets and liabilities (short-term and long-term).	Ministry of Finance to regulate, Municipalities to implement	/

	Recommendations	Authority in-charge	Donors Role
10	Municipalities to adopt Debt Management Strategies.	Ministry of Finance to regulate, Municipalities to implement	Capacity building of municipalities.
11	Prevent primary assets being used as collateral	Ministry of Finance to regulate, Municipalities and PUCs to implement	/
12	Establish clear legal rules governing municipal default procedures	Ministry of Finance to regulate, Municipalities to implement	/
13	Regulate the practice of provision of credits to municipalities by construction companies.	Ministry of Finance to regulate, Municipalities to implement	/
14	Monitor the procedures employed when municipalities access credit and ensure they are in line with the Law on Public Procurement.	Public Procurement Office	
15	Work to establish sub-sovereign credit ratings.	Ministry of Finance	Consultancy support.
16	Reassess the level of approved municipal borrowing within the next 5 years in light of further accumulated experience	Ministry of Finance	/
17	Regulate what kind of projects are to be classified as infrastructure projects and allowed to be financed by long-term borrowing.	Ministry of Finance together with the other relevant authorities (Ministry of Infrastructure, Standing Conference of Towns and Municipalities)	/
18	Improve municipalities' capacities (human, IT, etc) for budget and debt management.	Municipalities, Standing Conference of Towns and Municipalities,	Capacity building of municipalities.
19	To adopt legislation obliging PUCs to inform them about their borrowing activities	Ministry of Finance, municipalities, PUCs	

	Recommendations	Authority in-charge	Donors Role
20	Facilitate the further decentralization of responsibilities to the local government level	Ministry of Governance and Local Self Government	Consultancy support.
21	Stimulate smaller and underdeveloped municipalities to develop inter municipal projects through linking them to central government transfers and grant funding.	Ministry for Finance and Ministry for Economic and Regional Development	Link grants to regional projects. Develop and co-fund regional projects.
22	Cease regulating utility prices	Central government	/
23	Define and adopt overall operational and restructuring programs with clear performance criteria for public utility companies.	Central government, Standing Conference of Towns and Municipalities	Consultancy support.
24	Formulate transparent and clear request for set of documents needed for the municipality credit assessment and credit file.	Commercial banks and international financial institutions	/
25	Develop clear documentation and transparent procedures needed for approving municipal credits. Present credit terms and conditions in a clear manner with all costs included and annual payment plan (principal and interest) presented.	Commercial banks and international financial institutions	/
26	Develop secondary market of municipal credits in order to reduce liquidity risk for banks	National Bank and commercial banks	/
27	Support the development of dinar market through issuance of dinar long-term government bonds as a reference rate for dinar credits and financial instruments.	Ministry of Finance and National Bank of Serbia	/
28	Development of hedging instruments for managing municipal foreign exchange risk.	Commercial banks.	Capacity building of municipalities.

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