THE ISSUE OF MUNICIPAL BONDS, A CHALLENGE FOR THE ROMANIAN LOCAL PUBLIC ADMINISTRATIONS

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ABSTRACT: This paperwork studies the municipal bond loan issue situation on the Romanian financial market and its relation with the local financial decentralization. We discussed also about the opportunity of the municipal rating in selling local bonds and the advantages gave by this kind of financial instruments, both for the issuers and the investors.

Key words: municipal bonds, local public administration, decentralization, rating;

JEL codes: G11, H72, H74;

Introduction

The last 10 years, Romania registered great changes in local public administration. The regional economic development and the law improvement made possible the local decentralization level to increase. This context gave to the local public administrations the possibility to gain their local financial independence, that meaning the free decision to choose the financial sources for local objectives. This way, the local authorities chose the bond loan to sustain some of their investment expenses. The problem is that how many of the local public administrations can issue the municipal bonds and how many can face that responsibility. This paper work porpose is to present the Romanian municipal bond market situation in the context of the local financial decentralisation and to reflect its importance for the local development and for the safety of the investors portfolio. Also we touched the subject of local rating, discussing about its opportunity on a very volatile and with high costs market.

Literature Review

The Romanian municipal bond market and its importance for local economy and the financial market have not been profound studied yet and this researching area has still a lots of gaps. The explanation is that the local bond area is not completely developed, as issue bond number and their atractivity for the investors. The economical litterature only tackled the local financial decentralisation subject. The last 6 years marked a positive evolution for the Romanian local decentralisation, especially after the Tax Code was passed. The municipalities are more and more interested to gain their financial independence (Bolos, 2006), many of them already having a remarcable financial situation. This fact made possible the financing from the capital market, as an issuer of bonds. Their offer is very attractive, both for the remuneration and for the risk, very close to zero. The buyers of this kind of assets enjoy a better interest rate than bank deposits give and the safety of their investment. On top of this, the costs of the operation for the municipality is lower than to access a bank credit (Mosteanu, Lacatus, 2008).

Starting the financial decentralization expansion, the responsibilities of the local public administrations increased proportionally with the taxes/benefits ratio and also with the level of external effects and the scale economies for the public assets (Mosteanu, Iacob, 2007). To increase

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efficiency for local public expenses, these should be orientated for those programs with a few external effects and low scale economies, that meaning to consider only particular communities' objectives. This way, the social welfare reaches maximum, only if the public services are managed at the closer administration level to the citizen (Dascalu, 2006) and it's evident that "financial decentralization begins to work beyond the limit area of using national public services and commodities start to restrict and the comparative cost of making decisions at the central level becomes very high" (Vacarel, 2003).

The terms of the bond issues and the necessity of the towns to gain the investors' trust made them to pay attention to the way they collect and manage the resources, to the objectives they are looking for and the amount of the expenditures. So the municipalities give now a lot of importance to the efficiency and efficacy of their activity. This way, the local financial decentralization and the issue of municipal bonds become interdependent (Mosteanu, Lacatus, 2009).

Research Methodology

Our study is based on statistical data seeing the municipal bonds listed on Bucharest Stock Exchange and the financial data for the issuing towns. We computed indexes that reflect the local incomes and debts and on this base we could conclude about their capacity to manage a bond loan. Also, relaying on the data we obtained we could discuss the opportunity for the municipalities to list their issue as to make it all known and more attractive. The end of this work paper put the municipal bond issue in the context of the financial crise and show the changes in the investors interest about this kind of secure investment.

The Local Financial Independence and the Opportunity of Issuing Bonds

The Local Autonomy Charta[3] stipulates that, within the national economical policies, the local public administrations have the right to own sufficient and proportional resources, established in accordance with the state law, from which freely to dispose, for exerting their tasks. The tax bracket collecting system, on which local administrative authorities are relaying for its own resources, has to be of a sufficient, diversified and evolutional nature. Only this way they can face the evolution cost of exerting competences. In this way, the local decisions in any area that concerns community can be taken under restrictive conditions with consulting local people thru voting cast or any other form of direct participation of the citizens to local affaires[4], obeying the law and respecting requests of efficiency and readiness.

In the period of 2000-2008, the local revenues grew exponentially, as a sign that local public administrations had to their disposal larger and larger amounts of money, till 12%-13% of the Gross Domestic Product. That was a result of the local financial decentralization development. Therefore, we noticed a process of reorientation of the added value in the economy, with a special attention to the amounts distributed to local communities. More money to the community disposal, disregarding their sources (regular funds, amount readjustments, transfers with special destinations or loans obtained from the capital market) will allow regional development sustaining and the social wealth growth, answering to the particular needs of the localities.

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[3] Law No. 199/1997 for the ratification of the European Local Autonomy Charta , adopted on Strasbourg, on the 15th of October 1985, and published in the Monitorul Oficial No. 331/1997;

[4] Law No.215 of the local public administration, published in the Monitorul Oficial No. 204/23.04.2001, and modified by the Law No.286/2006;

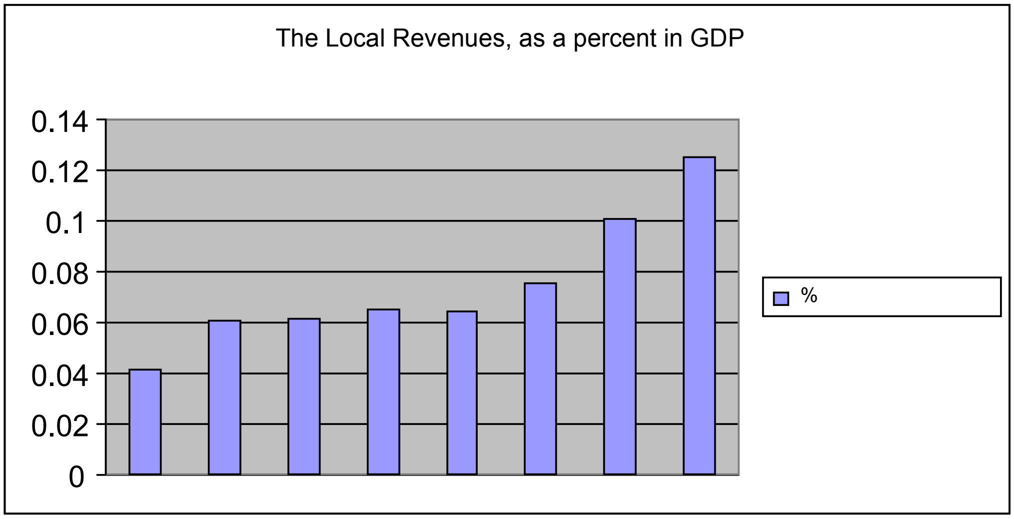

Fig. no.1 - The local revenues, as a percent of GDP, in the period 2000-2007
Source: data from the National Institute of Statistics and the National Romanian Bank

But the level of the funds that local public administrations dispose is still low. The impossibility to raise the tax level, to obtain in this way bigger amounts of money for the local budgets, imposed to find some alternative sources to finance the local projects. Completing their financial resources, local public administrations, have the right by law to collect other kinds of revenues, beside the usual ones (the ones from taxes and fees), which sometimes may be insufficient. One of these complementary resources is the internal or the external loans, used just for reaching investments purposes of local interest or refinancing local public debt. The Local Finances Law stipulates that the municipalities may use to sustain their objectives with instruments of the local public debt as the titles of value or credits from bank or other credit institutions (Moşteanu et al, 2008). This way, it was possible the appearance of the municipal bonds on the Romanian financial market, which contributed both to the local development and decentralization and to the capital market growing. Therefore we may say, relaying on historical data, the credit using bonds has more advantages as costs and period of reimbursement compared with the bank credits.

Even starting with the year of 2001, an important period of the development of the Romanian capital market, the local authorities identified the bond loans as an important new financing source. The first issue was realized by the municipality of Predeal, having as objective to finance a ski resort upgrade[5].

There have been placed by now 55 issues of municipal bonds, listed on the Bucharest Stock Exchange, and 23 of them didn't reach their maturity yet[6]. Many municipalities used this kind of additional resources repeatedly (Bacau, Alba Iulia, Lugoj, Timisoara, Oradea, Deva, Predeal, Sebes), as a sign of their success and opportunity (Moşteanu, Lăcătuş, 2009). The main objectives of the local projects relaying on this kind of loan instruments are: municipal roads, cleaning stations, water net extensions, the modernization of the roads to the touristy areas, the modernization of the districts, etc...

[5]http://www.kmarket.ro/emisiuni/afisare_obligatiune.php?nume=Predeal%20I&id=60;
[6] http://www.kmarket.ro/emisiuni/emisiuni.php;

Table No.1

The municipal bonds issues number evolution on the Bucharest Stock Exchange

The year of the issue	Number of issues
2001	2
2002	8
2003	12
2004	8
2005	6
2006	5
2007	7
2008	5
2009	2

Source: Monthly Statistics from Romanian National Bank

For the towns which issued and listed municipal bonds on the Stock Exchange (only for these ones we could find data) we computed the weight that the loans have on the total local financing resources. On the period 1991-present we remarked some modest results, varying between 0% and 13%. The most of the municipalities registered about 4% or 5% as loans amount percent in the total resources[7]. We observed that, for a very large number of towns, the bond issuing was the first time when they borrowed money. Municipalities as Sebes, Slobozia, Campulung Muscel, Timisoara, Arad, Targu Ocna, Cluj Napoca, Oradea, and Sacele had no loans contracts before the municipal bonds issuing.

Analyzing the local loans amounts realized by the localities which issued bonds, we could not find a specific trend. The nationally cumulated data show that the local loans increased more after the year 2003, when the local collectivities started to enjoy a bigger local financial independence by the rights gained on some income categories. That was possible because of the new fiscal legislation. Starting with the year of 2005, as a sign that the local public administrations become surer about their financial and managerial capacity, we noticed an exponential growth of the Romanian local public debt. It increased from 0.10% of the GDP, the result registered in the year of 2003, to 0.90% in 2005 and up to 1% of the GDP after 2005[8]. In the same time, the other local financing resources like the self revenues or the transferred incomes increased, as percent of the Gross Domestic Product. This fact underlines that we face a real development of the local public finances, in the context that the localities gain a bigger and bigger financial independence.

Table No.2

The local public debt analysis, between 2000 and 2007

Year	2000	2001	2002	2003	2004	2005	2006	2007
Local public debt, as a percent from GDP (%)	0	0	0	0.10%	0.10%	0.90%	1%	1.30%

Source: www.bnr.ro

The bond loan, the new kind of the local financial resource, could be tackled in the context of a favorable evolution of the financial decentralization in Romania (Moşteanu, T., Lăcătuş, C., 2008). The improvement of the legislation sustains the local autonomy, the financial independence[9]

[7] Computations made by the authors banking on the data offered by the issuing prospects offered by www.kmarket.ro;
[8] Computations made by the authors, banking on the Romanian National Bank statistical data;
[9] Law No.215 of the local public administration, published in the Monitorul Oficial No. 204/23.04.2001, and modified by the Law No.286/2006

and the increasing level of the own financial local sources but also of the balanced amounts used for local objectives, with no central administration intervention. The local public authorities begun to borrow money in 1995 and they directed them to their budgetary deficit financing or to make possible the existence of different local projects. The improvements and the supplements of the public finance legislation but also the legislation seeing the development of the capital market, all these gave a favorable context to the municipal bonds issues (Mosteanu, T.; Lacatus, C., 2009). The transactions with this kind of instrument on the Romanian financial market generated numerous advantages for the municipalities. Many of them put away the classic bank credit, making this way a costs and means saving.

The financial power that towns enjoy is reflected by the level of their revenues. So, the loans which can be attracted will be proportionally with these ones. Instead, our studies showed that the villages benefit of important amounts as special destination transfers from the central budget and balanced amounts. So, it's obvious the effort that the central public administration does to help the smallest local communities which own revenues are not very rich because of small fiscal capacity of tax payers and the impossibility to follow the fiscal debtors known as bad payers. So, the villages still do not have access to the issue of bonds in local interest, as an effect of their weak level of local decentralization (Mosteanu, T., Lacatus, C., 2008).

Normally, these kinds of bond issues could be realized only by those localities which demonstrated their reimbursement capacity based on financial strength. The budgetary revenues and expenses of the cities which issued bonds reflect a decentralization level over the country medium level. We have to remark the municipalities of Predeal, Bacau, Alba Iulia, Timisoara, Oradea, Cluj Napoca, and Navodari, which decentralization level surpasses 60% and grew constantly all over our study period. We obtained an exceptionally result for Predeal, a 90% decentralization (Moşteanu, T., Lăcătuş, C., 2009).

Is it Suitable to Rate or to List a Municipal Bond?

We have to recognize that there are a few of issuing localities that did not manage exceptionally the reimbursement of the public credit but in the end they faced the payments by selling some assets. These phenomena, really rare, still should admonish the law device body to look deeply into the risks assumed through this type of bond loan and into the capacity of the town to dispose the cash needed to pay back the credit at the proper moment. So, we really need a rating for the issuing localities, to reflect synthetically the types of risk assumed by the investors and their dimensions. In Romania, the bond department of the capital market is not so developed yet (even though we said there is a progress) to assume necessary to classify the local collectivities by their financial credibility. In the same time, they do not gather all the conditions, as the greatest rating agencies ask for to study them. So, the potential investors have very few information seeing the liquidity risk, the insolvability risk or the market risk they assume. The only possibility to create for their own need an image about the bond issue they are interested in is to study the basic information gave by the issue folder. On top of this, listing a bond loan to the Bucharest Stock Exchange comes as a guarantee for the credibility of the issuing municipality.

We noticed the recent years the activity of the first Romanian Rating Agency, whose objective represents the rating of the Romanian local bonds. Unfortunately, the qualifiers gained by the municipal bond issuers do not represent public information. At the International Conference "Rating for Romania and the Black Sea Countries", the Society for Investment Consultancy Bucharest Equity Research Group (BERG) launched on the Romanian capital market the rating service CR.DM Credit Risk Datorii Municipale which evaluates the probability of the non payment risk or the delay of paying for the bonds issued by the Romanian towns.. The rating is based on public information and is build to serve also the municipalities and the investors from the capital market, those ones interested to buy municipal bonds. There are two directions of the study which base the rating qualifier, an economical one and a financial one. The relevant indexes for the financial component were obtained by analyzing the local budgetary accounts execution and the financial data of the local employers, registered by the Ministry of Public Finances. That also includes their arrear to the local budget. The economical component of the rating involves the analyzing the social and demographical data (as population aging, the salaries level, education, unemployment) with their dynamics in time and analyzing the economical activity structure and of the risks involved by an unfavorable or mono industrial area. In the same time the economical component take too in account the stability and the political structure of the local public administration and its capacity to increase the percentage of the own incomes into the full revenues.

From the studies realized by Bucharest Equity Research Group, we could pick up some qualifiers. So, Predeal bonds gained the best mark, BB+. This one is based on the fact that the municipality has bigger own revenues than the ones it obtains from the central budget, as the annalist from BERG says. That shows that the municipality „ tries to have a financial independence from the state budget”[10]. At the opposite pole are situated Zalau bonds, which obtained only the mark 2C. This qualifier is describing the vulnerability of the municipality in revenue administration, most part of these ones being samplings from the public general budget. So, we may put a question mark on its capacity to be financial independent.

The economical literature points out the importance of the rating for the towns that issue bonds. Generally, the rating agencies consider the next criteria for grounding the rating mark: the economical foundation of the community, financial factors, the collectivities debts and the administrative factors, all of these to judge the town as its worthiness. So, we may say the rating represents a signal of the credibility and as the score obtained is better, the town can be remarked by its financial stability and integrity (Cluff, G.., Farnham, P., 1985). In the end, the rating represents a label.

But, is this a rational choice to list a municipal bond issue (Reeve, J., Herring, H., 1986)? This decisional process supposes the evaluation of the cost and benefits attached, for a rating mark receiving. Self selection of some municipalities in the unlisted class is the result of two phenomena: in the first case they choose not to list because the issue has very weak characteristics and in the second case, the rating cost (the municipalities are frequently accepted to list in function of their rating) is much too big comparing the possible benefits. So, when we find that an issue is not listed, we should not conclude that the bonds are not qualitative. But the rating appears as an extra hypothesis seeing the credibility of the town, because, generally, investors prefer the listed municipal bonds. The rating represents a quality sign. The market penalizes the unrated municipal bonds because there it is considered that the lack of listing and the absence of a rating are generated by the weak credibility and financial power of the issuers. So, this kind of bonds cannot be appreciated at their true value because of the absence of the synthesized information contained by the rating qualifier. Generally, we may expect that unlisted municipal bonds have higher costs that the listed ones because they are not so performant and their demand does not usually get very high. We observed that small cities do not list their bond issues taking in account both the costs involved and the possibility to receive a negative rating, which would create a negative perspective to the investors.

The municipal bond market issued by big towns is clearly different than the one of the small cities issues. First of all, there are differences in demand and supply. The small towns have small amount issues and they address to the local investors, without using the national market and be forced to be listed. This way they avoid a listing cost that surely would make their issuing financial effort bigger. In exchange, the big cities realize very larges amount issues and prefer to be listed to attract this way the national and international investors. So being said, depending of their size, even though they have the credibility levels identically, the issuing towns register different cost for their bond issuing actions (Rivers, M.; Yates, B., 1997). Instead of assuming very high costs to be

[10] http://www.capital.ro/articol/note-bune-pentru-obligatiunile-municipale-9437.html;

analyzed and to receive a rating mark, a possible launching pad for their success at the Stock Exchange, the small towns prefer better to offer directly demographical, economical and financial information to the potential buyers. In this way they substitute the rating, making important costs savings. The cities prefer to make this cost saving instead of a lower rating which may generate o negative image. Investors would avoid the investment and the municipality's registered costs would be doubled: there are some resources lost (the bonds cannot be sold of in time) and also there are unjustified expenses done (with the rating analysis). These kinds of towns, which prefer not to be listed on Stock Exchange, are relaying on the local investors and their affinity to the local development. So they prefer to use a social, cultural and psychical strategy beside the financial one. Suceava town is a very good example here, with the 50 million lei borrowed in 2007, to sustain the city's infrastructure modernization and some historical buildings restoration.

The Municipal Bonds and the Local Decentralization

The issuing of municipal bonds represented an extra step for the local financial independence, the success of this kind of events, mostly on the principal capital market, giving an important impulse to the local authorities. The fact that these loans are reimbursed exclusively from the local resources made the local public administrations more careful to the way of collecting their own revenues, to their amount and how judicious money is spent. So, the issuing of municipal bonds becomes a cause of the increasing financial decentralization, even initially it represented an effect (Mosteanu, T.; Lacatus, C., 2009). As a consequence, the municipal bonds are sustained by a sufficient level of financial decentralization and force the local administrations, by the financial responsibilities assumed, to make an extra effort being extremely prudent and responsible in allocating the resources they dispose on. This way, there is obtained an effect of increasing level for the financial decentralization.

Many of the municipalities made more than one loan on the capital market, using even higher maturities, about 25 years old. Analyzing the municipal bond loans from Romania, we noticed that as the maturity is higher, the extra remuneration offered by the medium inter banking interest rate for credit and deposit[11] decrease, sign of the precaution of the local administration in assuming too high future financial duties which may affect the solvability. The development of the decentralization level gave to the local authorities the chance to enlarge the maturity of the loan in financial safety conditions. In the same time, the investments are more attractive by the surplus of interest produced over the medium market interest, even this fact means an increasing risk, both for investors (which will recuperate later their investment because of the higher maturity fixed term and may register opportunity cost) and for municipality (because the rate of remuneration is based on a variable interest rate). The volatility of the coupons of the municipal bonds offers important information about the solvency level of the municipality, because it has to face a probable increase of the interest, generating a bigger financial effort for bonds remuneration.

Municipal Bonds on the Romanian Capital Market

The appearance of the municipal bonds on the Romanian capital market gave to the investors a new instrument they can use to diminish the investment portfolio risk, a viable alternative to the bank deposits with a lower risk attached to. In the last period, more exactly starting with November 2008, the transactions with municipal bonds at the Bucharest Stock Exchange are not as rare as they used to be. The investors' preference, in this volatile and uncertain market period, are certain assets, which do not offer a special return rate but insure about all the payments to the creditor.

We noticed also that, even the National Bank decreased the rate of interest for the monetary policy to 8.5% from 10.5%, and so the expected potential gain brought from this kind of assets is

[11] The coupon rate, generally, is based on the medium interbanking debit and credit interest rate, plus a spread, subjective chose by the municipality: (ROBID+ROBOR)/2+spread%;

diminishing substantially, there are almost daily transactions with municipal bonds at the Stock Exchange, facts that did not happened till this year.

The municipal bonds started to have success, not so much as shares do, but comparatively with last years, the frequency of transactions and their values and volumes really increased[12]. So, the municipalities represent a guarantee of reimbursement, even though financial and economic crisis forced the government to take some measures seeing the local decentralization level, affecting their financial power and generating financing lack of balance.

Seeing the secondary market of the municipal bonds, it doesn't have a proper development yet, because the investors still prefer to buy this kind of assets from the primary market and to keep them in the portfolio till their maturity. The transactions on the secondary market don't give important gains and so the municipal creditor keeps the bonds protecting his savings from the current volatility of the financial market.

We have to underline that the municipalities are not to transparent seeing their bond issues, because the issuing prospect is the only kind of document that investors may use to conclude about the opportunity of their investment. Sometimes, if the bond is listed on Stock Exchange, this is a good signal for the financial strength of the issuer. When we need to follow the financial situation of a public administration during the maturity of the loan, the execution budget may give also some information about the solvency of the municipality, but the study of this kind of document needs knowledge which many investors do not have. Also, it may be lost a lot of time to come to a conclusion.

So, we recommend legislative initiatives to increase transparency in this area, for constant local financial and rating studies. The effects are good also for the municipalities, for the governments and also for the investors. So, it will be easier to follow and to enforce the local debts initiatives for different kinds of projects and the flux of the payments. Also, the local authorities will be more responsible with spending the collected amounts and that should have as a result the simplification of the budgetary evidence. This way, the investors may verify anytime the situation of the local budget, types and amounts of incomes and expenditures, their sources or objectives, the financial power of the community and its capacity to pay back the debts.

Conclusions

The Romanian public administrations registered great success in issuing bonds, even though they still cannot afford a powerful launch in the market. But we have the proof that there is a specific decentralization level which allows independence in collecting incomes but also to use them according with the freely fixed objectives. For sure, these kinds of issues are not too many because there still are discrepancies seeing the regional development level in Romania and there are just a few cities which can afford to sustain a loan from the capital market, to be solvable and attractive as remuneration.

The municipal bond issue represents in the end a provocation, but their listing is a bigger one. This kind of value titles are more important than we think, playing a double role, both in the Romanian financial market and into the local financial autonomy growing.

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