Local Government Finance in Europe - Trends to Create Local Government Funding Agencies

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Local Government Finance in Europe

This paper explores the recent developments concerning local government finance in western Europe. It especially concentrates around the trend to create local government funding agencies. What are the reasons for this trend? Why do we see this trend now? Why is this development important for growth?

In this paper I will also present the existing local government funding agencies in Europe. Furthermore, I will give an overview of local finance in the United Kingdom, Germany and Italy and refer to ongoing discussions and projects to create local government agencies.

Public investments and growth

Local government plays a crucial role for our society. Not only do local authorities provide much of the basic public services, but the sub-national level is also the most important investor in infrastructure. In the European Union, regional and local authorities are responsible for more than two thirds of all public investments. The five countries leading that list are:

1.	Italy	80.9 %
2.	Czech Republic	77.3 %
3.	France	73.1 %
4.	Finland	71.1 %
5.	Denmark	66.8 %[1]

The fact that infrastructure investments are important for growth was underlined by the Nobel laureate Paul Krugman in an article in the New York Times. He wrote: ”Everything we know about economic growth says that a well-educated population and high-quality infrastructure are crucial.”[2]

In this respect it is alarming that local government investments had dropped substantially during the last few years. OECD reports that, between 2007 and 2012, sub-national government “directs investments contracted sharply (-7% in real terms between 2007-2012 and -15% in the three most recent years) in particular in Ireland, Iceland, Spain, Italy and Portugal.” The conclusion is that “If this drop in investment were to continue, it could have negative long-term consequences for national economic growth and societal well-being.”[3]

Local authorities in many European countries have refrained from starting new projects as austerity measures have resulted in lower state grants to local authorities. But, since infrastructure investments, to a big part, are reliant on borrowing, a changing credit market has also hampered investments activities.

A large part of the local authorities borrowing have been provided by banks, both commercial

[1] CEMR (2013), Factsheets: A figure-based portrait of local and regional Europe, CEMR, Brussels
[2] Paul Krugman (2010), “America goes dark”, *New York Times*, Aug. 8.
[3] OECD (2013), *Regions at a glance*, OECD, Paris.

and development banks. This situation is now changing. The cause for this is twofold:

1. As a result of the financial crisis from 2008, banks have seen their credit rating falling. Not one single commercial bank can show an AAA-rating and very few AA-ratings. The result is, of course, higher refinancing costs and a need to raise margins.

2. The Basel III accord, which is planned to be implemented gradually until 2018, includes higher capital requirements and a new demand for liquidity. This will limit the scope of bank lending and will give priority to lenders that will accept high margins. Banks are already adjusting to these new rules, with the result that lending to local authorities have decreased substantially. The lending that is still done has higher margins and shorter maturities. In some cases, the margins of bank loans to local authorities have tripled over the last few years.

This development indicates that banks will play a minor role in lending to local authorities in the future.

In response to this development, local authorities many countries have started to look closely at the example of the Nordic countries and the Netherlands.

Existing local government funding agencies in Europe

In Denmark, a local government funding agency was created as early as 1898. Kommunekredit is a cooperative society and all Danish local authorities have voluntarily joined. The agency is now dominating the market of local government credits in Denmark. Kommunekredit issue bonds in various capital markets, with the support of a joint and several guarantee signed by the members, and then on-lends the proceeds to the local authorities. The guarantee has been in force since the creation of Kommunekredit, but has never been used.

The Norwegian agency has a different background and set-up. Kommunalbanken was established in 1926 by the Norwegian State, at a time when the local authorities were under great pressure. During its history, the agency has had some changes in the ownership structure, but it is now back in the hands of the central government of Norway.

Kommuninvest in Sweden was created in 1986. At that time, the Swedish local authorities were heavily reliant on bank loans for their investments. The competition among the banks were not optimal and the showed signs of oligopoly. Local authorities were charged with interest rates that in no way reflected their creditworthiness. This made a group of local authorities in a region in central Sweden, take the initiative to create Kommuninvest. Over the years more and more local authorities have joined the cooperative society of Kommuninvest and now over 90 % of all regional and local authorities in Sweden are members. The Swedish agency has radically changed the market for loans to local authorities. Kommuninvest operates, in the financial markets, with a joint and several guarantee from its members. This guarantee, as in the case of Denmark, has never been used.

The Finnish agency Municipality Finance (Munifin) was created in 1990. Munifin is a joint-stock company in which municipalities, municipal federations and companies owned by municipalities hold the majority of the ownership. Additional shareholders are the Local Government Pensions Institution (31 %) and the Republic of Finland (16 %). Munifin is guaranteed by the Municipal Guarantee Board (MGB), which is a public law body established by the 487/1996 Act on the Municipal Guarantee Board. The membership of the MGB consists of 303 (as of 1 January 2013)

Finnish municipalities, representing 99.95 % of the population of Finland.

In the Netherlands, the Bank Nederlandse Gemeenten (BNG) was established in 1914 as a specialised financial institution for the public sector. BNG is a statutory two-tier company under Dutch law (*structuurvennootschap*) and is owned by the Dutch State (50 %), 11 provinces (3,6 %) and 406 municipalities (46,4 %). BNG has a market share of around 60 % of the Dutch municipal sector.

Also in the Netherlands, Nederlandse Waterschapsbank (NWB) was established in 1954 as a specialised lending institution to provide Dutch local governments and water boards with funding at cost-efficient levels. All of the bank's funding was government-guaranteed until July 1989. The explicit support was subsequently withdrawn as part of a wider government policy of reducing public participation and guarantees.

All the existing local government funding agencies in Europe are AAA-rated. During 2012 these agencies issued bonds in various capital of a total amount of over € 70 billion.

New local government funding agencies are born

In a number of European countries, the establishment of local agencies is now discussed. These projects have reached different stages in different countries. France was the first country to follow the example of the existing agencies.

France

In France there are over 36 681 *communes*, 101 *départements* and 26 *régions*. Among the communes, 35 734 has less than 10 000 inhabitant, but together they represent over half of the French population. Due to the large numbers of local authorities, cooperation bodies have been created, such as the *metropole, communauté urbaine, communauté d'agglomeration* and *communauté de communes*.

French local authorities play a very important role as investors in local infrastructure. Local governments carry out over 73 % of all public investments. Investments have traditionally by a large part been financed by the state, which in 1987 created Credit Local de France. This entity was during the 1990s partly privatized and in 1996 it merged with Credit Communal de Belgique and formed Dexia. Through acquisitions Dexia expanded their business to many parts of the world, but was hit hard in the financial crises of 2008. This was due to losses in subsidiaries, short term borrowing – long term lending and investment in securities issued by the financially weakest countries in Europe. All this has lead to the dismantling of Dexia. The remains of Dexia has been included an entity created by Banque Postale and Caisse de depot, named La Société de Financement Local (SFIL).

During the last ten years commercial banks have played a big role in financing local authorities. These have also been largely affected by the crises, which from time to time have created great difficulties for local authorities to obtain financing of the investments.

A possible French Municipal Bond Agency started to be discussed as early as at the turn of the century. In the period from 2004 to 2008 a number of so-called ”club- deals” were successfully carried through. A ”club-deal” is a bond-issue where a number of local authorities participate, each with a clearly defined part of the bond-issue. These exercises showed the need for an agency, since “club-deals” are cumbersome to coordinate. Furthermore, an agency can produce better interest rates than a group of local authorities with different financial standings.

In 2010 three of the local authorities’ organisations, Association de Maires de France (AMF), Association de Communautés Urbaines de France (ACUF) and Association des Maires des Grandes Villes de France (AMGVF), formed an association: Association d’Etude pour l’Agence de Financement des Collectivités Locales (AEAFCL). This association have had the role to coordinate the work with the goal to create a local government funding agency. Apart from the founding associations, around 50 local authorities joined the AEAFCL from start. Over the following year another 30 local authorities joined together with six other local authority organisations: Fédération des Villes Moyennes, Assemblée des Communautés de France, Association des Maires Ruraux de France, Assemblée des Départements de France, Association des Régions de France, Association des Petites Villes de France. Among the local authorities that are members of the AEAFCL, one can find the cities of Lyon, Lille, Bordeaux, Grenoble and Strasbourg. The memberships fees were differentiated by type of local authority and size.
The AEAFCL appointed a working group mainly with financial directors from its members. Then, a group of advisors were procured, with the role to assist the working group in the work to outline a comprehensive report, containing all major elements that are needed in order to create an agency.

The group of advisors that were commissioned consisted of Natixis (Yves Millardet), AB Mårten Andersson Productions (Lars M Andersson), HSBC, Willkie Farr & Gallagher (law firm) and Ernst & Young. On the basis of discussions with the working group within the AEAFCL, the advisors submitted a final report (FR) in July 2011.

The FR was approved by the general assembly of the AEAFCL September 20, 2011. From this date the lobbying towards central government and other entities was intensified. The president of France, François Hollande, gave a green light for the creation of the agency during Congrès des maires (the mayors’ annual conference) in November 2012. The law that was required for the creation of the agency, successfully passed the Senate and the National Assembly in the spring of 2013.

Agence France Locale was created October 22, 2013 and the first bond issue is planned for the end of 2014.

United Kingdom

Local government in England operates under either a one-tier system - unitary authorities, or a two-tier system - county and district councils. There are five types of local authority in England: county councils, district councils, unitary authorities, metropolitan districts and London boroughs. In total, there are 353 principal authorities in England. Birmingham has the largest council population with over a million inhabitants.

Local government in Scotland is organised through 32 unitary authorities. In Wales there are 22 unitary authorities. Northern Ireland is divided into 26 districts for local government purposes.
UK local government are responsible for 53,5 % of all public investments. These investments are in part financed by loans. The main provider of loans to local government is the Public Works Loan Board (PWLB), which is a government agency within the Treasury.
Distribution of local borrowing (March 2013):

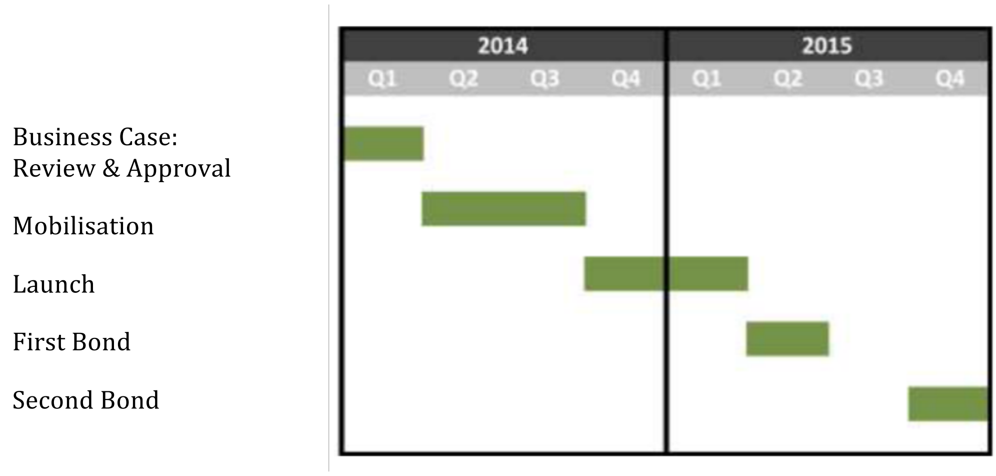
PWLB	75 %
Banks & financial inst.	13 %
Issues in the capital markets	5 %
Others	7 %[4]

In October 2010 the PWLB raised their margin over Gilts to 100 bp. This margin was lowered, in November 2012, to 80 bp for those local authorities, which could supply details of funding requirements in advance. In November 2013, the rates were lowered to 60 bp, but only for infrastructure projects nominated by a Local Enterprise Partnership.

The English Local Government Association (LGA), together with the Welch Local Government Association (WLGA), started to explore the possibilities of creating a Municipal Bond Agency in 2011. This project was carried out in cooperation with Local Partnerships, an entity jointly owned by the LGA and the Treasury (50/50). In January 2012 an outline business case was presented. This action probably triggered the PWLB to lower their rate the same year, which in its turn was one of the reasons why the Municipal Bond Agency project did not gain momentum at that time.

The question of creating a Municipal Bond Agency was raised again by the LGA in 2013, which commissioned three advisors to review the Outline Business Case of 2012 and to suggest a way forward. Aidan Brady (ex. Deutsche bank) was the lead advisor with Francis Breedon (Professor of Economics and Finance at Queen Mary University, London) and Lars M Andersson as strategic advisors. Their report was delivered in March 2014, presenting evidence why a Municipal Bond Agency should be created. The report was approved by the LGA and this is now followed by talks with local governments, but already in November 2013 around twenty local authorities agreed to work with the LGA on creating the agency. Among those local authorities one can find Birmingham City Council, Cambridgeshire County Council, City of London Corporation and Newcastle City Council.

The report delivered by the advisors envisage the following timeline for the continuation of the project:



[4] CLG statistical datasets https://www.gov.uk/government/statistical-data-sets/live-tables-on-local-government-finance

Germany

Germany, being a federal state, has a different set-up of local government compared to France or the UK. The states (*länder*) within the federation play an important role for local government and local infrastructure investments. The *länder* are responsible for around 25 % for all public investments, while this figure for the local level reaches almost 50 %.

In a report from Deutsche Bank, "Einer für alle, alle für Einen?" (One for all, all for one?), from 2012, it is suggested that the German local authorities should consider an agency similar to the existing Nordic agencies.[5] The background that this report paints is about the changing market for loans to local authorities in Germany. The local authorities are reliant on bank loans for their infrastructure investments. A large proportion of these loans, almost 50 %, are submitted by the public banks (*landesbanks, sparkassen*). The author, of the Deutsche Bank report, focuses on the fact that structure and volume of municipal credits have changed. Shorter and medium-term maturities have increased greatly. Loans with short maturities, intended for short-term liquidity constrains, have evolved for many municipalities as a permanent means to finance current expenditure.

The report, from Deutsche Bank, argues that the dominant role of banks in the future is open to doubt. In view of the changing regulatory environment (especially increased capital requirements and new liquidity requirements under Basel III) and the impact of the sovereign debt crisis on the risk assessment of the municipalities by the banks, it is likely that local authorities will see changes in loan condition or even find that they longer can be provided with the credits that are required.

The report concludes with the following statement:

Municipal financial agencies are in principle well suited to provide the local authorities new and advantageous financing alternatives through the capital market - this is shown by the Scandinavian examples. The pooling the demand for capital can give a number of advantages (in particular: economies of scale, higher volumes and liquidity, and diversified products), which can lead to significant cost benefits for local government and make a transition to the capital market possible. At the same time, the bonds issued by an agency may be of interest to many international investors.

The report, cited above, has been followed-up by an article by the same author, written in October 2013, with the headline "France establishes sub-sovereign finance agency: A model for Germany?"[6]

So far, no official project have been launched with the aim of establishing a local government funding agency in Germany, but there are some examples of efforts to issue so-called "club-deals" (a bond issue by a group of local authorities).

Italy

Italian regional and local authorities are responsible for over 80 % of total public investment, but these investments have decreased with 25 % from 2009 to 2013. This is specifically worrying since

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[5] Frank Zipfel, DB research (2012), "Einer für alle, alle für Einen? Kommunale Finanzagentur - ein Überblick".
[6] Frank Zipfel, DB research (2013), "Talking Point; France establishes sub-sovereign finance agency: A model for Germany?"

it is stated in an OECD-report, that "Italy suffers from a large infrastructural gap with respect to other European countries, thus massive investments in those key strategic sectors have become of paramount importance."[7]

The Centro Studi sul Federalismo, reports that "the most striking effect of the reduction of transfers joined to the limitations of the DSP (Domestic Stability Pact) has been the strong reduction of local administrations' final investments, more or less evenly distributed across the country. That had a significant impact upon the performance of the whole economy because sub-national governments, in particular the communes, are the most important public investors in Italy, like in other EU countries."[8]

The Internal Stability Pact had led to a situation in which Italian local authorities can only finance investments with loans up to an amount that corresponds to 8 % of the turnover of their balance sheet. The dominant lender is the Cassa Depositi e Prestiti, which have a market share of 60 % in lending to local authorities.

The restrain on local authority borrowing has lead to an increase of the use of Public Private Partnerships (PPP). This is also the conclusion of the OECD-report "Hearing on Public-Private Partnerships": "…PPP subscriptions may be eventually connected to the attempt of local authorities to bypass certain financial constrains…irrespective of the extent of the infrastructure gap".[9]

PPP is used for around a third of all local government investments, with new projects reaching as high as 44,2 % of the total contract starting amounts. The vast majority of local authority projects are below € 15 millions, with a relevant financial involvement of the public sector.

The OECD-report arrives at the conclusion that "…the correct implementation of PPPs would require the public sector to be endowed with higher levels of skills…" and "Scale matters: small projects should be carried out by local authorities through a more traditional approach (= traditional procurement procedures must be considered)".[10]

In a few of the regions in Italy you can find agencies that finance local authorities. The internationally best known is Cassa del Trentino (CdT). CdT is wholly owned by the Autonomous Province of Trento, which have a population of around 500.000. There are around 230 local authorities in the province.

CdT mission is to pursue any activity relating to the management and the granting of funds and contributions provided to it by the province to above mentioned local authorities. In general, CdT disburses capital subsidies, on behalf of the province, to these entities. It can also acquire share in public companies within its area of operation. In the area of PPP, CdT support the Province of Trento with analysis related to the planned projects.

CdT funds part of its operation by issuing bond in the European capital market. A Euro-Medium-Term-Note (EMTN) Programme was established in 2010 and then updated. The Province of Trento guarantees all borrowing of CdT, which has been assigned an A3 rating from Moody's and

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[7] F. Antellini Russo and R. Zampino, (2014), "Hearing on Public-Private Partnerships", OECD, Paris.
[8] Stefano Piperno (2012), "Implementing fiscal decentralization in Italy between crises and austerity. Challenges ahead", Centro Studi sul Federalismo.
[9] Antellini Russo and Zampino.
[10] Ibid.

A from Fitch.

Conclusion

Local government investments are crucial for our societies. The mayor part of public investments in infrastructure is carried out by local authorities. These investments give opportunities for the private sector to grow, while, at the same time, they improve the living conditions for the general public.

The access to funds to finance local infrastructure investments is a key element in the economical development. Decentralisation and reduced central government grants means that local authorities have to take control over questions regarding investment financing. An investment for the future needs to be financed with a mixture of current income (this generations money) and loans (next generations money). So, where do local authorities get low-cost, risk-free loans? The last few years shows that it is more and more difficult to get it from commercial banks. And, it will not be easier with the upcoming Basel III regulations. Only the very large local authorities can manage to borrow in the capital markets and, even they, don't have the volume in their borrowing to be able to frequently come to the market and diversify in terms of markets, instruments, investors etc.

Sometimes PPP is brought forward as a solution for local authorities. One feature of PPP-project is that the private side of the cooperation finance the project. This is always more expensive (at least in Europe) compared to if the local authority would have borrowed the required funds themselves. This means that other efficiencies in the project have to out-weigh the higher costs of funds. Many of the studies made in the UK shows that this is rarely the case. One of these report are from the Treasury Committee in the House of Commons.[11]

The quest for low-cost, low-risk financing has led to the trend that more and more countries explore the possibilities to set up Local Government Funding Agencies. The existing agencies work in a self-controlling way: in order for the agency to be successful in the capital markets, the local authorities (members or shareholders in the agency) must have good creditworthiness. The agencies have controls in place to supervise their members and take action as soon as any deterioration is detected in one of the member's financial situation. These routines are crucial for the agency's rating and, hence, for their success in the capital markets. This is also an efficient brake mechanism against excessive borrowing on the side of the local authorities. Actually, a Local Government Funding Agency relieves central government from many aspects of the monitoring of local government.

Finally, a market-based approach, with the checks and controls of an agency, tends to be more efficient than a system where central government controls local financing through borrowing restrictions. In order for local authorities to be able to contribute to growth, they should be in control of the financing of their own investments.

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[11] House of Commons, Treasury Committee (2011), Private Finance initiative

Lars M Andersson initiated the creation of Kommuninvest, the Swedish Local Government Funding Agency in 1986, and became the agency's first president. He developed its operations until 2001.

During the last 20 years, he has worked as an advisor to local authorities in many parts of the world; recently, in projects to create Municipal Bond Agencies in France and the UK.

Lars M Andersson is a member of the Supervisory Board of Agence France Locale and chairman of the Strategy Committee within the agency's board. He is also a member of the Board of Fonds mondial pour le développement des villes (FMDV, *Global Fund for Cities Development*) and chairman of Kommuninvest's Research Fund Committee.

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