

Ewa Gubernat

Wrocław University of Economics
e-mail: ewa.gubernat@ue.wroc.pl

**THE FINANCIAL RISK OF LOCAL GOVERNMENT
UNITS FROM THE PERSPECTIVE
OF COMMERCIAL BANKS**

**RYZIKO FINANSOWANIA
JEDNOSTEK SAMORZĄDU TERYTORIALNEGO
W OCENIE BANKÓW KOMERCYJNYCH**

DOI: 10.15611/nof.2016.4.03

JEL Classification: G21

Summary: Local government units carry out tasks aimed at meeting the needs of the local community. The implementation of these tasks necessitates the collection and disbursement of funds. As practice shows, rarely is a balance reached between revenue and expenditure. The shortage of the necessary funds to cover all planned expenditures in a given year causing the budget deficit, which in turn causes the need for borrowing. On this specific issue, this article presents the current scope of local government co-operation with banks. The article presents a catalogue of loan products and their availability to local governments. In this respect, the author has paid particular attention to the range of analyzed banks' risks, and the availability of information about the risks. This in the fullest possible way supports the implementation of the lending process, especially in terms of long-term financing. The primary purpose of the considerations made in this study was to find answers to the questions: what kind of risks are analyzed by banks in the lending process and how relevant are they? The conclusions were based on a literature review and survey research concerning the co-operation between commercial banks with local government units.

Keywords: risk, local government, bank.

Streszczenie: Samorządy w Polsce realizują zadania publiczne, często nie dysponując wystarczającymi zasobami finansowymi. Jako podmiot publiczny, posiadają osobowość prawną oraz mają prawo korzystać ze zwrotnych źródeł finansowania. Oznacza to, że przy ograniczonych dochodach oraz wykonywaniu zadań publicznych na oczekiwanym poziomie, samorządy aktywnie wykorzystują przywilej za zadłużanie się i zgłaszają popyt na pieniądź. Zatem instytucje finansujące dokonują analizy ryzyk, determinujących szeroko pojętą wiarygodność kredytową, wykorzystując informacje dotyczące ich sytuacji finansowej, ekonomicznej i społecznej. Uwzględniają przy tym pozostałe czynniki specyficzne dla podsektora samorządowego. Analiza ryzyk pozwala ustalić, jaka jest determinacja samorządów do spłaty długu, oraz ocenić, które czynniki i w jakim wymiarze mogą zakłócić tę spłatę.

Słowa kluczowe: ryzyko, samorząd, bank.

*Knowledge is not enough, you still
need to know how to use it.*

Goethe

1. Introduction

The market of banking services for local government sector units is one of the most dynamic areas of the expansion of commercial banks, as evidenced by the extensive product range reported by financial institutions. Given the number of local government units, they represent more than 2 800 entities and their respective financial potential. Commercial banks regard them as an attractive a target group of business partners. They confirm that the local government units are characterized by greater stability in comparison to other sectors of the economy, compared to other market participants they are far less prone to certain types of risk. They draw attention to the fact that the functioning of the local government sector is structured by many acts of law, particularly in the area of financial management in both the short and long term.

Local governments executing their assigned tasks, as with other organisations similarly engaged, often use external sources of financing. This is the result of the non-compliance level of income generation and their main sources to the scale of the spending, especially investment. Naturally the issue of returnable revenues also includes the issue of repayment.

The purpose of this article is therefore to analyze and identify the main risks associated with the financing of local government units from the perspective of the activities of commercial banks in Poland, with an indication of the potential product catalogue financing local governments. The author, based on a critical review of the literature and survey research, indicates the fundamental factors determining the use of borrowing by local governments and will attempt a classification of the main categories of risk factors that determine them and suggest possible mitigating factors.

2. Local government units as commercial bank customer

The activities of local government belong to the realm of public finances, and the basis of their financial economy is the annual budget. These set out defined standards, principles and rules for disposing of financial resources. In this sense, the budget is planned for expenditure of the sum identified for debt service units, while the expenditures amount to the attributable repayments of loans and advances as well as those redeemed in a given year's securities. The same happens on the revenue side. Although government units generally have no problem with access to feedback sources of financial supply, being entities that in the opinion of lenders are characterized by reliability and high liquidity – however they are internally very

Table 1. Factors determining the use of borrowing by local governments

	Characteristic	Cause-effect consequences
Use by local governments units with feedback funding	An important reason for use by local governments with feedback funding is the insufficient level of non-repayable funds from the sources through which the tasks imposed on local governments can be financed. This means that there is still a shortage of public funds.	<ul style="list-style-type: none"> • decentralization of public finances, • transfer revenue as grants, subsidies are not a sufficient source of financing for the needs of local government units, • using external repayable funds allows coverage of planned and current deficits, as well as guarantees flexibility of funding sources.
The consequences resulting from the use by local governments with feedback funding	The possibility of the use of returnable sources of financing facilitates the implementation of municipal investments.	<ul style="list-style-type: none"> • risk of decreased spending on the implementation of current tasks or investment, • the risk of excessive debt, loss of liquidity, • timely debt service, • increase the cost of debt servicing (interest).
Limiting the use by local governments with feedback funding	The ability to use external sources of financing and feedback is limited by these criteria: I. <ul style="list-style-type: none"> • legal – taking into account the level of debt and its servicing costs, • economic – due to the availability of financial market instruments and the rating of financial statements of self-government, i.e. external constraints. II. <ul style="list-style-type: none"> • political – determined by the current political agenda, defining the scale of municipal projects • organizational – lack of awareness of the level of debt and ability of effective debt management i.e. internal limits. 	<ul style="list-style-type: none"> • defined limits on the use by local governments with feedback funding sources prevent uncontrolled debt i.e. the debt trap, • debt limits protect lenders and investors that provide capital for a defined period from their own financial resources.
Factors concerning choice of feedback funding instruments	Choice of instruments feedback funding is determined by these factors: <ul style="list-style-type: none"> • economic – being the manner of determining interest rates, and responsiveness of the instrument on the financial market volatility, • legal – characteristics of the instrument of financing, the risks associated with the use of the instrument, regulatory restrictions on the maximum level of debt, • organizational – the customary mechanisms and risk aversion related to selected financial instruments. 	The choice of a particular instrument is determined with repayable financing by its own characteristics and risks associated with its use.

Source: own study based on [Gonet 2006, pp. 86-92].

diverse groups in many respects such as size or level of affluence. In Table 1, factors were presented determining their use by local governments with feedback funding sources.

Banks offer a catalogue of products and services bearing the credit risk for local governments, which are an integral part of the institutional client market (see Table 2), which is an important factor determining their competitiveness.

Table 2. The main source of financing of local government units

Public funds	<ul style="list-style-type: none"> • local taxes • charges • income from local government units, subordinated units and subsidiaries • income from municipal property • other own revenues • recommended statutory tax revenues owed to local governments • grants • subsidies • EU funds
Private funds	<ul style="list-style-type: none"> • credits • loans • municipal bonds • mortgages • liabilities • leasing • factoring • other securities
Hybrid funding	<ul style="list-style-type: none"> • public-private partnership • project finance • venture capital • securitisation • conversion of debt • guarantees • outsourcing
Other instruments	<ul style="list-style-type: none"> • methods to determine the total cost of debt service for the entire portfolio of instruments used • hedging transactions (hedging) • other derivative financial instruments • insurance and guarantees

Source: [Filipiak 2008].

The security of financial transactions, and therefore of entrusted funds of potential lenders, makes the following features being mainly of local governments [Gonet 2004, p. 78]:

- they are bodies of public law created by the state – the activities of local governments are non-profit,
- conduct a public financial management,

- their business is based on an annual budget which is passed – the revenue and expenditure of local government units are mostly predictable and cyclical, which favors estimating future cash flows and inhibits flexibility and freedom to manage the unit,
- have legally guaranteed sources of non-repayable income set annually – most of the revenue and expenditure of local governments depends on current legislation and of the parent entity,
- revenues of local governments are dependent on the condition of the main constituent parts concerned,
- expenditure of local government units depends on the condition of the utilities operating in its territory and the state of infrastructure (property unit),
- there is no possibility of declaring bankruptcy in local government units,
- have legally defined maximum limits of debt,
- regional audit chambers exercise financial control overseeing proper use and management of public funds,
- credit risk relatively lower than in the rest of the business sector borrowers.

Every time, prior to the award of financing, banks are required to verify the credit-worthiness of potential borrowers. This also applies to local government units. This step is part of the process of credit risk management at the bank, in which a specific credit exposure is viewed as a single engagement and as a component of total loans. In this case, the standards of the law define the minimum requirements for the lending process, although each bank sets its own internal procedures applicable to the credit of individual groups of borrowers. Common practice is to use separate procedures in relation to local government units, not least, however, in the testing process of the credit-worthiness assessment that is made of the organisation in terms of formal (i.e. having legal capacity) and substantive (i.e. having economic viability). The process of testing the credit-worthiness of local government units, in the context of the content, is made on the basis of a diversified number of elements including qualitative, which means that it is assessed by an expert. Therefore, the proper assessment of the credit-worthiness of local government units is one of the key elements in maintaining the financial security of both the bank and the borrower. The question of debt management, for both parties to the transaction, applies itself to choosing the right instruments, the repayment of liabilities and how to use them. The consequences of wrong decisions can cause adverse financial effects for both parties.

3. Identification and analysis of risks in the financing of local government

The activities of local government units involves risk, especially since they have public funds [Poniatowicz 2010, p. 326] through which they implement defined tasks and investment. It is therefore necessary to take into account the risks in their business, because risk is an integral part of social life [Pluskota 2008, p. 19]. Given

the specificity of the organization and the functioning of local government units, it is absolutely essential to recognize and identify all relevant risks and adapt to them by applying the appropriate risk management methods in order to minimize their effects. B. Filipiak [Dylewski, Filipiak 2012/2013, p. 29] says that local governments have the resources of public money, while society refers specifically to the issues of waste and the mismanagement of funds. Hence it is crucial to promote a specific approach to the problem of risk in local government units. In this context, it should be distinguished from mismanagement, negligence, unlawful activity or abuse, as in the decision making process in local governments they are required to comply with the law, procedures, and transparency of action [Czudec, Kata 2013, p. 15]. Hence legislation on the one hand reduces the likelihood of irrational actions but on the other hand does not prohibit taking some of the economic risk by governments and their agencies.

Funding agencies in co-operation with local governments attach the greatest importance to credit risk because it has the biggest impact on the finances of the bank. The risk is also due to the possibility of default by local authorities of a particular type of funding. In relation to local government credit risk, this is determined by assessing the credit-worthiness of the unit mainly in the aspects of testing for compliance with the regulations of debt contracting law and analysis of its financial situation [Poniatowicz 2005, p. 254]. To this end, commercial banks use individually designed methods such as an analysis, taking into account the quantitative conditions, which is based on the financial situation of the individual and qualitative factors. The basis of such a test represents a variety of financial statements of the organisation and the resulting budget. Such an analysis, however, is partly determined by the legal conditions of the debt borrowing by local governments. It should be noted, however, that the time horizon of the funding for the credit process is also important, since it is much easier to assess the risk for short-term transactions than for transactions in the long-term, given the uncertainty about future mishaps. As a result the risk analysis carried out by the banks is based on diversified economic aspects of the functioning of local government units. Assessed [Bogacka-Kisiel, Korenik 1998, pp. 216-219] was the financial situation resulting among other things from the structure and size of the income range of tasks performed and the amount of money borrowed. Additionally, it takes into account the other factors which have a direct impact on the functioning of these units. These factors tend to be associated with the local government unit as a constant, but that can also be shaped by the area in which they occur, and regardless of the area or that cannot be influenced as they come from the outside and are associated with the development of the total national economy [Wojtasiak-Terech 2011, p. 21]. The identification of individual risks that can occur when assessing the credit-worthiness of local government units is not an easy task. This is due to the diversity of activities carried out by the unit and the catalogue of risks and sources of their origins are presented in Table 3.

Table 3. Classification of risk in the financing of local government units

The risk of the exogenous	Financial risk	Economic factors	They determine the so-called market risk associated with the presence of local government in the financial markets, volatility of interest rates, exchange rates, commodity prices.	<ul style="list-style-type: none"> market risk (liquidity, currency, interest rate), inflation risk, interest rate risk, risk of unstable income, risk guarantees granted, the risk of default, reinvestment risk.
		Absorption of EU funds factors	Related to the use of EU funds by local governments relating primarily to the concept of self-government of the beneficiary's own contribution, acquisition and operation of interim financing and ineligible costs.	<ul style="list-style-type: none"> the risk of project organization and management of the EU, the risk financing of investment projects, the risk of non-repayment of the short-term financing, risk of non-reimbursement of costs, risk of financial engineering investment.
	Non-financial risk	Legal factors	Determine the factors associated with the change of the current legislative solutions.	<ul style="list-style-type: none"> risk in procurement procedures, risk of changes in the law (the risk that additional borrowing limits), risk of additional tasks assigned.
		Political factors	Caused by political factors, cooperation authorities acting with the authorities to adopt resolutions.	<ul style="list-style-type: none"> the risk of the term of office of local government, the risk of national investment priorities, the risk of political promises and their implementation.
		Environmental factors	Mostly negative changes in weather, political: forcing certain activities compatible with local needs, by a particular political option. Natural resources, location in the system of culture and education and communication of the country, the exposure to natural disasters.	<ul style="list-style-type: none"> the risk of random events
		Social factors	Derived from the environment such as relations with the community, different institutions, customers, suppliers, banks, the possibility of local conflicts between local government authorities society.	<ul style="list-style-type: none"> communication risk
The risk of the endogenous	Non-financial risk	Legislative factors	Caused by agents of a legislative nature mainly by taking action against illegal acts.	<ul style="list-style-type: none"> risks associated with the current legal order
		Organizational factors	Caused by organizational aspects.	<ul style="list-style-type: none"> operational risk, reputational risk, IT risk, bad management decisions risk, personal risk.
	Financial risk	Economic factors	Determined financial factors related to the collection and disbursement of cash – an important criterion for assessing the reliability of the entity's financial performance is a result of analysis of the implementation of the budget of the unit in previous years, including in particular the assessment of the implementation of its revenue and expenditure.	<ul style="list-style-type: none"> the revenue risk, the expenditure risk, risk regarding the management of cash, risks associated with the management of deficit and debt, risks relating to asset management.

Source: own study.

Table 4. Hierarchy of local government units financing risk in the evaluation of commercial bank

Rank risk	Character	Risk factor	Mitigants
COUNTRY RISK - POLAND	Potential form of a general deterioration of the Polish economy, resulting in the need to impose excessive control by the government to local government units. This may consequently limit by far the timely debt service.	<ul style="list-style-type: none"> • the degree of socio-economic development of the country, • the level of development of market mechanisms, • business cycles in the country and the world, • the inflation rate, • unemployment rate, • changes in GDP, • changes in market interest rates, • changes in market exchange rates, • public finances. 	<ul style="list-style-type: none"> • internal assessment of the commercial bank and a positive rating of the borrower determined based on: assessment of country risk, macro-economic country risk assessment, risk assessment of the government, • concentration risk of local government units through reduced exposure limit set for the total portfolio of these units.
The risk of the borrower – local government units and rating its creditworthiness	<p>Consisting in the absence of reliable information reporting and lack of criteria that might help in determining levels of risk categories by independent rating institutions, which in turn limits the credit rating:</p> <ul style="list-style-type: none"> • dynamics and variability of income levels, especially for the share in taxes constituting State budget income, determined by the current economic situation of the country, • increasing the level of debt of local government units. 	<p>BUDGET:</p> <ul style="list-style-type: none"> • the scope of the power to tax, • the scope of the power to make the expense, • the freedom to dispose of surpluses in financial sector, • local government debt limits and levels of use, • level of income transfer from the state budget and coverage of the expenditure for tasks, • catalogue of available debt instruments, which are available to local governments and their conditions. <p>SOCIAL AND ENVIRONMENTAL:</p> <ul style="list-style-type: none"> • nature of the local market, • demographic structure of the local community and long-term trends, • investment attractiveness of a given municipality, • income potential, • investment potential, • ownership structure, factual, economic. <p>GEOGRAPHIC:</p> <ul style="list-style-type: none"> • the size of LGU, • geographical location, • available resources and natural assets, • manufacturing potential of the LGU. 	<ul style="list-style-type: none"> • the maximum level of debt of local government units, • the maximum level of debt servicing costs, • individual control rate debt, • control and supervision over financial activities of local government units exercised by the Regional Chambers of Audit, • the central budget is not liable for the debt and its timely service of local government units, and has the tools with which may affect the level of cost reduction in local government, • qualitative and quantitative assessment of credit worthiness should be concentrated on applying the concept of operating surplus, based on cash flows.

<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Object financing risk</p>	<p>The main aim of financing local government is to finance the budget deficit, which in the tender procedure involves long-term and short-term financing. – They dominate the credit commitments of a general nature, repaid with funds generated internally, which means that they depend mainly on planned capital expenditure and current and planned debt profile.</p>	<ul style="list-style-type: none"> • correct diagnosis to finance, • discrepancy in finance in relation to the reported needs. 	<ul style="list-style-type: none"> • concept of operating surplus cash flow based on local governments to restrict the level and nature of risks associated with financing the deficit and reducing the risk of non-repayment. • analysis of the structure and profile of the current and planned debt in order to avoid problems with the flow of cash in local government units, due to overinvestment or attributable to the repayment of high capital installments. • implementation of the so-called golden rule of financing, according to which the level of investment expenditure should be higher than external sources of finance, i.e. the grants for investments and obtained commercial financing.
<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Structure of the transaction risk</p>	<p>Commonly used practices and procedures specified in the terms of reference, usually prevent the introduction of additional clauses, the structure of financing, or security, in order to improve the bank's position.</p>	<ul style="list-style-type: none"> • the ability to accumulate funds by local governments, • ability to determine resources to service the debt of local government, • ability to reschedule the debt in subsequent periods. 	<ul style="list-style-type: none"> • credit risk and the ability to pay particular local government unit operating is determined on the basis of existing legislation, taking into account the limits and financial constraints.

Source: own study.

As indicated in the table of risks, in many cases they coincide with the risk of financing other institutional clients of the bank. The strengths and also benefits with local governments, however, are that in some cases the level of risk involved will be significantly constrained by the control exercised over local governments by the national supervisory authorities and regional chambers of accounts [Galbarczyk 2007, p. 115].

To analyse and estimate the scale of the potential financial risks and their measurable effects is one of the basic elements in the credit process. Banks, taking into account that the local government units dealing with the disposal of public resources assume a precautionary approach and conduct a broad analysis of the risks, so as not to miss anything significant, which may have negative consequences, including financial ones [Korenik, Korenik 2007, p. 68]. Therefore, from the perspective of commercial banks, this requires the careful assessment of the risk knowledge and experience of the financial, economic and legal aspects of local government units.

Credit risk relating to the financing of local government is determined not only on individual characteristics, but also the specifics of the sector of the economy that it represents [Wiśniewski 2011, p. 156]. Therefore in the process of assessing the credit-worthiness of local government units, it should take into account elements specific to this sector, which are assigned the appropriate rank below in Table 4.

These factors are, however, very diverse and their weight is also not the same. An examination of each factor separately will determine its importance in the background of all the factors and this task is arduous, long and debatable because of their self-qualitative character. Nevertheless a risk assessment is carried out on the basis of historical data characterizing the financial position of local government units associated with: the analysis of the level of implementation of budgets; management of cash as an essential factor in maintaining the liquidity of units; an analysis of how to manage the budget deficit and debt in determining the size and structure of financing; and an analysis of the level of the efficiency of the property. This important role also provides information of a qualitative nature, showing the structure of the local economy, production potential, access to raw materials or education level of the local community and demographic trends. This group of factors determines the future ability to generate income in the local economy, and therefore also affects the level of operating surplus. As described in Table 4, these are the determinants defining the conditions for the functioning of local government units in which they operate and make decisions, but which also alone cannot change. These factors determine the potential therefore that governments have, that is to their advantage or to which they must adapt.

Despite the identified significant areas of risk, banks create systems for assessing the credit-worthiness of local government units based on their own experiences. These systems, however, are characterized by a strong expert approach rather than

derived directly from an estimation carried out on the basis of historical data. In particular, banks studied in the credit assessment focused on the important factors that could prove the ability of local governments to service the debt in the long term. But the most important link in the reliability of the credit is to assess the financial health of the individual considered as a measure that is objective and measurable. Whereas the assessment of qualitative characteristics: social, political, and geographic, complements the risk analysis process.

4. Conclusion

Local government units in Poland carry out public tasks, often having a sufficient financial envelope. As a public entity, on the basis of legislation, they have a legal personality and shall have the right to use the feedback funding sources. This means in consequence that with limited incomes and carrying out public tasks at the expected level, they actively use the privilege for borrowing.

The process of obtaining repayable funds by local governments is associated with their appearance as the demand side of the financial market. In connection with the capital providers, financial institutions are the supply side, maximising the security of transactions, analysing risks, and determining the capability of these units for the timely repayment of debt together with accrued interest, which is widely understood to be credit-worthiness. For the risk assessment process in financing local government, banks not only use information regarding their financial situation, but also economic and social. In addition, they take into account other factors specific to the local government sector. The concept of risk assessment and analysis allows us to determine the ability of the organisation to repay its liabilities and to assess which factors and to what extent, in the environment of local government, may disrupt their repayment.

References

- Bogacka-Kisiel E., Korenik D., 1998, *Badanie zdolności kredytowej samorządu terytorialnego przez bank*, [in:] Dolata S. (ed.), *Funkcjonowanie samorządu terytorialnego – doświadczenia i perspektywy*, Wydawnictwo Uniwersytetu Opolskiego, Opole.
- Czudec A., Kata R., 2013, *Zadłużenie a sytuacja ekonomiczna i ryzyko finansowe jednostek samorządu terytorialnego*, *Finanse komunalne*, nr 5.
- Dylewski M., Filipiak B., 2012/2013, *Ryzyko w działalności jednostek samorządu terytorialnego w nowych uwarunkowaniach prawnych*, *Rocznik Bezpieczeństwa Międzynarodowego*.
- Filiipiak B., 2008, *Strategie finansowe jednostek samorządu terytorialnego*, PWE, Warszawa.
- Galbarczyk T.A., 2007, *Zarządzanie ryzykiem banku w procesach kredytowania jednostek samorządu terytorialnego*, [in:] Węclawski J., Kicia M. (ed.), *Analiza zdolności kredytowej gmin w województwie lubelskim*, Wydawnictwo Uniwersytetu Marii Curie-Skłodowskiej, Lublin.

- Gonet W., 2006, *Kredyty, pożyczki, obligacje w gospodarce finansowej samorządu terytorialnego*, Monografie i opracowania, SGH, Warszawa.
- Gonet W., 2004, *Ocena zdolności kredytowej samorządów*, Bank i Kredyt, nr 7.
- Korenik D., Korenik S., 2007, *Stosunki samorządowo-bankowe a rozwój społeczno-ekonomiczny w przestrzeni*, CeDeWu, Warszawa.
- Pluskota P., 2008, *Rola i zadania JST w sferze zaspokajania potrzeb społecznych*, [in:] Filipiak B., Flejterski S. (ed.), *Bankowo-finansowa obsługa jednostek samorządu terytorialnego*, CeDeWu, Warszawa.
- Poniatowicz M., 2005, *Dług publiczny w systemie finansowym jednostek samorządu terytorialnego (na przykładzie miast na prawach powiatu)*, Wydawnictwo Uniwersytetu w Białymstoku, Białystok.
- Poniatowicz M., 2010, *Transfer ryzyka jako instrument zarządzania ryzykiem w jednostkach samorządu terytorialnego*, Zeszyty Naukowe Uniwersytetu Szczecińskiego, nr 620.
- Wiśniewski M., 2011, *Ocena zdolności kredytowej jednostek samorządu terytorialnego w Polsce*, Studia BAS, nr 4(28).
- Wojtasiak-Terech A., 2011, *Ryzyko w działalności jednostek samorządu terytorialnego*, Finanse Komunalne, nr 5.