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## PRINCIPLES OF GIVING LOANS TO MUNICIPALITIES

The basis of the financing of a municipality (*gmina* in Polish) formed by the statutory principles of financing municipal activities, specifies the basic conditions of their relationship with financial institutions, which is on a different basis than relationships of such institutions with, for example, business entities. Municipalities cannot go bankrupt, have a relatively stable income base, and their financial economy is public by nature. All this makes municipalities a potential area of interest for financial operators who, as research indicates, are showing growing interest by their commercial presence on this market.

Reactivation of municipalities as basic units of territorial self-government has opened new possibilities for dynamic development of the financial services market, in the broad meaning of this phrase, which must be provided to about 2,500 entities. Thus, the establishment of units of territorial self-government raised the following question to institutions of the financial market, which operate according to commercial principles, and especially for banks: How should this fact be treated in market strategies?

Individual types of municipalities differ with respect to their economic potential, population, income level and structure, as well as demand for financial services. Moreover, we deal with a vast diversity in many respects within the scope of each separate category of municipality, including, among other things, economic potential. This diversity is especially noticeable in the field of budget size.

Budgetary income of all municipalities in 1999 [Karpiński, 2000] totalled PLN 52.7 billion, which corresponds to 8.5% of the Polish gross do-

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mestic product (GDP). The income of municipal organizations without a corporate identity (mainly budgetary), not included in municipal budgets, was around PLN 8.8 billion. This means that municipalities had in total a sum of about PLN 60.5 billion, *i.e.* almost 10% of GDP, to their disposal. In comparison with European Union countries, this indicator places Poland in a group of countries with a strongly centralised system of public finances. A special position on the economic map is occupied by urban municipalities [Karpiński, 2000]. Although they make up about 13% of all municipalities, their economic potential is much bigger; for example, the share of their budgets in total municipal budgets is over 60%.

The income of urban municipalities per inhabitant was diverse in 1999 and was, on average, 1,500 PLN in urban municipalities and about 1,100 PLN in urban-rural and in rural municipalities. But the affluence of municipalities valued in this way is also very diverse within individual groups; *e.g.* in the case of rural municipalities it ranges from about 840 PLN to 4,580 PLN. This is an important observation, as research confirms the existence of a close relationship between the economic potential of a municipality and the size and structure of their demand for financial services, including bank services. Identification of these relationships is of crucial importance to banks with regard to forming a market strategy in relation to municipalities, because it allows for adaptation to the expectations and preferences of concrete groups of entities. This is especially relevant in the case of credit policy.

Banks give loans to municipalities for:

- covering seasonal budgetary shortfall,
- financing investment expenditure which cannot be covered by the annual budget of a municipality.

Credit which covers seasonal budgetary shortfall within an annual budget can be granted up to the amount specified in a budgetary resolution to be the limit on short-term loans and credit taken during a given budgetary year. The repayment of this credit (maturity date) falls in the budgetary year in which the loan was taken. Credit for financing investment expenditure which cannot be covered by the annual budget of a municipality be granted up to the amount specified in a budgetary resolution to be the amount required to cover the deficit.

The maturity dates for such credit may fall in later years than in which the loan was taken. The total sum of the credit instalments due in a given year, together with the interest due in that year, cannot exceed 15% of the municipal budget. The total amount of liabilities to banks at the end of a calendar year cannot exceed 60% of municipal income in that budgetary year.

In order to obtain a loan, the municipal council files a credit application to a bank, which is prepared according to the banks model. Depending on the designated goal of credit funds, the following documents should be supplied with the application:

**1) when a municipality applies for credit covering a seasonal budgetary gap which occurs during a year:**

- the budgetary resolution for the current year (which includes the authorisation for the council to obtain the credit),
- the resolution of the council on obtaining and securing credit and the resolution of the council which indicates which members of the council are entitled to obtain and secure the loan.
- the last Rb - 49 report (annual balance),
- all reports regarding the implementation of the budget (prepared according to the model specified in the current Ordinance of the Minister of Finance concerning the principles of preparing municipal budget reports) prepared in the current year and the last report from the previous year.

**2) when a territorial self-government unit applies for credit for financing expenditures which cannot be covered by its annual budget:**

- a filled in cash flow form,
- information about the investment to be realized, the budgetary resolution which specifies the amount needed to cover the deficit (which includes the authorisation of the council to incur the debt),
- the municipal council resolution on obtaining and securing credit and the council resolution indicating which members of the council are entitled to incurring the debt,
- reports on the implementation of the budget from the previous year,
- the current municipal investment plan,
- the council forecast regarding the financial situation of the unit of territorial self-government during the credit period,
- the last two Rb - 49 reports,
- all reports on the implementation of the budget of the territorial self-government unit (prepared according to the model specified in the Ordinance of the Minister of Finance) prepared in the current year and the last report from the previous year.
- Current, comprehensive balance sheets of all budgetary units,
- legal documents regarding the self-government unit: its statutes, REGON (registry) certification and NIP (tax identification) numbers,
- the opinion of the regional clearing house,
- specimen signatures from the bank which handles the major account.

The list of documents attached to a given application is established by a bank employee together with a representative of the municipal government. The current and future creditworthiness of the municipality is established on the basis of such a credit application, appendices and, if required, some other documents that are of informative value to the bank.

While appraising the creditworthiness of a municipality, a bank takes the following factors into consideration:

1. Municipal activity is non-commercial by nature, which excludes assessment of the profitability of the activity to be realized in the classic meaning of the word. This also applies to most investments, which after their realization can become a source of income intended for credit repayment.

2. Appraisal of the credit risk of a municipality does not include the same extent of risks which are characteristic to business, *i.e.* bankruptcy risk, competition risk, demand risk, etc.

3. Appraisal of credit risk should include the economic situation in the country, which has an influence on municipal budgets with regard to both subsidies for specific purposes, as well as proceeds from taxes which are a source of budgetary income.

4. Financial activity of a municipality is based on its budget passed by the council, which specifies its relatively large feasibility and stability. Budgetary income is shaped, above all, by proceeds from taxes, and the tax brackets for a given year are already known at the time the budget is passed.

Banks have established the following parameters for appraising the creditworthiness of a municipality:

1. credit service to income ratio:

$$\frac{\text{instalments} + \text{interest} + \text{guarantees and securities}}{\text{total income}} \times 100$$

The value of this indicator cannot exceed 10% and the smaller it is, the smaller the credit risk.

2. the share of tax proceeds and subsidies in the income of a municipality:

$$\frac{\text{taxes} + \text{subsidies}}{\text{total income}} \times 100$$

The bigger this indicator is, the more stable income is and the smaller the credit risk is.

3. the credit service to free resources ratio:

$$\frac{\text{instalment and interest payments}}{\text{free resources}^*} \times 100$$

The value of this indicator cannot exceed 25% and the smaller it is, the smaller the credit risk is.

4. the share of remuneration expenditure in total budgetary expenditure:

$$\frac{\text{remuneration}}{\text{budgetary expenditures}} \times 100$$

The smaller this indicator is, the smaller the credit risk is.

5. the share of free resources in municipal income

$$\frac{\text{free resources}}{\text{total income}} \times 100$$

The bigger this share is, the more favourable the municipality's financial situation is.

6. investment as a percentage of income:

$$\frac{\text{investment expenditures}}{\text{total income}} \times 100$$

This indicator specifies investment activity. Such appraisal should take liabilities stemming from earlier investment credit into consideration.

To fully appraise the creditworthiness of the municipality, a bank may also take other factors into consideration:

- the state of the municipality's financial resources (surplus from the previous year),
- the state of municipal assets,
- the financial condition of companies that operate within the territory of the municipality,

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\* "Free resources" - the difference between income which includes proceeds from fees, taxes, subsidies and grants for set tasks and expenditure which includes personal related expenditure, material and asset related expenditure, current expenditure and expenses incurred on assigned tasks (without repayment of interest and investment expenditure).

- assessments of the municipality formed by the Regional Clearing House,

- stability of the council and the quality of budgetary management.

Appraisal of the creditworthiness of municipalities, carried out according to the above principles, constitutes the basis of a credit decision made by the management of a bank. After a favourable decision is made, a credit agreement is prepared. A credit agreement (according to the common and valid model) should:

- be signed by authorized bank representatives and two members of the municipal council, indicated by the council resolution on incurring debt,

- have the counter-signature of the municipal treasurer.

An inherent element of any activity, including the activity of municipalities, is risk. In the case of economic activity such risk cannot be avoided, since during decision making:

- the subject which makes a decision cannot foresee the development of a given situation,

- the subject which makes a decision does not have full information,

- there exists a probability that information contains mistakes, etc.

Thus, risk is defined as the danger that a set goal will not be realized.

The concept of risk is used by various authors with various meanings. Kreim proposes the following definition of risk: "Risk means that, due to incomplete information, decisions are made which are not optimal from the point of view of reaching the set goal." Holscher defines the concept of risk in the following way: "Risk is the danger that in current conditions the intended profit will not be realized." Zawadzka defines risk as: "Risk is the danger that the intended goal will not be realized. For banks this means decreasing ownership capital, financial problems, and, finally, bankruptcy."

The risk involved in granting loans is the danger related to credit repayment with interest and maturity dates, caused by problems connected with the fulfilment of the credit agreement. Risk be inconsiderable or considerable. Credit risk is always present, but it can be characterised by intensities of various degrees. Its level specifies a bank's possible financial loss in relation to the foreseen income. Credit risk is specified by factors that directly or indirectly influence the economic and financial situation of the borrower, including municipalities. Direct factors include:

- the borrower's financial situation,

- the effectiveness of investment ventures undertaken by the borrower,

- the financial structure of such ventures.

The factors that indirectly influence credit related risk include:

- the economic situation of the local market,
- the degree of engagement of the credit bank with respect to individual customers (so called credit concentration),
- the period of time for which credit is given,
- the economic, political and social situation in Poland,
- the overall world economic and political situation.

Credit risk is, above all, related with the danger that the debtor will not repay the debt incurred (as a whole, or partially), together with interest and other fees. Credit risk (also called subject risk, address risk or bank risk) is a basic part of risk of the transaction partner not meeting the obligations [Zawadzka, 1996].

A question arises as to whether credit risk occurs when a bank finances a territorial self-government unit such as a municipality. In looking for answer to this question one should notice that there is a risk of not paying a part or all the debt incurred by municipalities by the maturity date. This is caused by differing levels of creditworthiness of municipalities, which can be expressed, among other things, by the scale of the budgetary deficit, or by the level of income and expenses. As information supplied by 22 of the biggest cities in Poland confirms, the budgetary deficit of the biggest cities in Poland was 10% of their income in 2001 [Myczkowska, 2002]. Self-governments most often financed this by means of credit and loans.

These Polish cities planned at the beginning of the year that at the end of 2001 these deficits would be in total over 2 billion PLN. Although the value of deficits grows year after year, plans are usually more pessimistic than real life. Finally, at the end of 2001, among these cities only 2, namely, Koszalin and Opole, had a budget surplus. The total deficit of the other units reached a value of over 1.5 billion PLN.

The income of self-governments is still dependent on resources which originate from the state budget. Transfers from the treasury make up on average 64% of the total amount of the income of the biggest cities. By far the largest amount of resources originates from subsidies – 28% on average, grants – 19%, and a share in receipts from the income tax on individuals – 15%.

A new act on the income of territorial self-government units, which is being prepared, should change the structure of the income of self-governments. Their share in receipts from income tax on individuals and corporations will be greater. Self-governments are also to receive revenue from a share in indirect taxes, such as VAT, excise tax, and gambling tax. Their proceeds from grants, however, will be lower.

Credit is becoming more and more popular. A few years ago a town, a city, or a municipality only occasionally decided to incur a debt. Now among the biggest cities, only a few do not take advantage of this form of obtaining additional resources. Credit and loans are the most crucial source of financing deficits. In 2001 only every tenth zloty intended for covering budgetary shortfall originated from other sources. The popularity of issuing communal bonds is also growing among big cities. In 2001 proceeds from their sale covered expenditure to the amount of 416 million PLN. Currently nothing indicates that the situation will change in this regard.

In 2002 the 22 biggest cities in Poland will have, on average, an income lower by 0.2 percent than in the previous year. Although expenditure will be lower in comparison with plans from the previous year by 1.7 percent, almost all the biggest municipalities will end the year with a deficit.

Only 2 out of these cities did not plan to finish the year with a deficit. In other cities the value of budgetary shortfall is, on average, 12 percent of the income planned for 2002. Self-governments intend to cover this shortfall in a similar manner to previous years, above all, with credit and loan resources, and then, with money received from the privatisation of communal assets. A few cities plan issuing communal bonds.

Banks estimate the credit risk of municipalities according to a method of risk scoring which includes quantity and quality assessment. Quantity assessment is assigned maximum 70 points, and quality assessment, 30 points. The method of assessing the credit risks of a municipality is presented below.

A credit risk assessment form for territorial self-government units

Assessment criterion	Possible score
<b>Quantity assessment</b>	<b>maximum 70 points</b>
Investment potential to income ratio:	
up to 10%	5 points
11-20%	10 points
21-30%	15 points
31-50%	25 points
over 50%	35 points
Credit service to income ratio:	
over 15%	0 points
15%	5 points
13-14%	10 points
12-10%	15 points
9-5%	20 points



Assessment criterion	Possible score
Credit service as a percentage of free resources	
over 25%	0 points
25%	1 point
24–20%	2 points
19–15%	3 points
14–10%	4 points
10 and lower	5 points
Share of tax proceeds and subsidies in budgetary income:	
up to 49%	1 point
50–59%	2 points
60–69%	3 points
70–79%	4 points
80–85%	5 points
Share of remuneration expenditure in budgetary expenditures:	
over 60%	0 points
46–60%	1 point
36–45%	2 points
31–35%	3 points
26–30%	4 points
0–25%	5 points
Quality assessment	<b>maximum 30 points</b>
Size and nature of the territorial self-government unit	maximum 10 points
Financial situation in the territorial self-government unit	maximum 10 points
Economic situation in the territorial self-government unit	maximum 6 points
Stability of governing body and quality of budgetary management	maximum 4 points
Maximum total	<b>100 points</b>

On the basis of the assessment of credit risk, it is possible to define the following classes of creditworthiness:

#### Classes of creditworthiness\*

Class of creditworthiness	Score
1. very good	100–81
2. satisfactory	80–61
3. average	60–21
4. bad	20–0

\* Assessment of creditworthiness is made on the basis of the number of received points

On the basis of the considerations presented above the following conclusions can be drawn:

1. The economic situation of municipalities within individual groups is very diverse, thus the demand for financial services, including those related to credit, is also diverse.
2. The number of municipalities that finance budgetary deficit by means of bank credit is on the increase.
3. In the face of decreasing income, the creditworthiness of municipalities is becoming weaker and symptoms of real credit risk occur.
4. Most indebted municipalities can be included in class 2 of creditworthiness (satisfactory) or class 3 (average).
5. The risk which occurs in giving credit is not great, because of the specifics of the functioning of a municipality and the inconsiderable level of credit risk.
6. Banks, securing against risk in giving credit to municipalities, take advantage of legal forms of protection, using mainly collateral security.

**Literature**

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 Myczkowska, A., „Deficyt finansowany kredytami” („Financing deficits by credit”), *Rzeczpospolita*, March 6, 2002.  
 Zawadzka, A., *Zarządzanie ryzykiem w banku komercyjnym* (Risk management in commercial banks), Poltex, Warszawa, 1996.

Score	Class of creditworthiness
100-80	1. very good
80-60	2. satisfactory
60-40	3. average
40-0	4. bad