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Marcin Kalinowski

The Gdańsk School of Banking
Faculty of Finance and Management
e-mail: mkalinowski@wsb.gda.pl
phone: 58 522 75 16

Municipal Bonds as a Financing Tool for Polish Local Government Units – The State of the Market and Development Prospects

Abstract. *Municipal bonds are an interesting alternative financing tool for local government units. These are a cheaper and more flexible tool than traditional capital acquisition forms out on the market. Between the years 2007-2015, the debt resulting from municipal bond issuance for local governments in Poland increased fivefold (from 4 to 20 billion PLN). This article presents a Polish municipal bond market assessment and outlines the market development prospects based on an analysis of opportunities and constraints.Analyses carried out in the article show that the municipal bond market in Poland should develop dynamically in the next few years. This market, among others, needs to develop to be able to secure local government unit contributions for the implementation of project that are co-financed by the European Union during the years 2016-2020.*

Keywords: *municipal bond, local government unit financing*

Introduction

Local government units are financing not only different ongoing activities, but also, an abundance of infrastructure investments. They are supporting regional development, as well as, enhancing the local economy's competitiveness; however this often leads to excessive expenses over the revenue in their budgets. Local government budgets being imbalanced force these units to use external financing sources.

When using external financing sources, local governments primarily perform infrastructure investments to allow local companies to develop business in other markets. This type of investment has become an important element of regional development [Kozak 2015: 87]. It is worthy to note that a significant source of financing infrastructure investments in Poland is EU funds. However, they require the local government units also have their own contribution to the project. The local government's own contribution is often financed by external sources. One of the external financing sources for local government units are municipal bonds. This is not currently the most important source of funding for local governments, but there is a continuous development in the Polish municipal bonds market. Still, the most important and most popular external source of financing local governments are loans, but municipal bonds have become an increasingly important financial tool in recent years [Szewczuk, Kogut-Jaworska & Ziołło 2011: 28]. Thus, municipal bonds may be an interesting alternative to traditional financing for municipalities in the future, instead of, for example, traditional financing in the form of loans.

The aim of the study is to assess the state of the Polish municipal bond market and to outline the development prospects pointing out the opportunities and limitations.

The research is conducted with the use of data from the Ministry of Finance (MF), the European Central Bank (ECB), the Eurostat, the securities exchange platform CATALYST, periodical reports of the National Bank of Poland (NBP), the National Council of Regional Chambers of Audit (KR RIO), Fitch Polish, and economic literature.

1. Financing sources for local government units

In order to meet the collective needs of the community, local government units receive funding guaranteed by law; this includes their own revenues, subsidies, and grants. Their own sources of revenue are often insufficient to finance local government tasks, in particular, investments. Among external sources, local governments may use financial instruments that are:

– non-refundable (like grants, subsidies, or funds from the European Union),
– refundable (like credits, loans, securities – municipal bonds) [Rosa 2011: 367].

According to Art. 89 § 1 of the Public Finance Act of August 27th 2009[1] the local authority can take out loans and issue securities in order to:

– cover the budget deficits occurring during the transitional year,
– finance planned budget deficits,

[1] Ustawa z dnia 27 sierpnia 2009 r. o fnansach publicznych, Dz.U. nr 157, poz. 1240 [Public Finance Act of 27th August 2009, i.e. Journal of Laws no. 157, item 1240].

– repay earlier obligations, such as repayment of securities, loans, and other borrowings,

– finance activities also financed by the European Union budget.

An important element for local government units in financing their deficit is the selection of appropriate financial tools. Factors determining the choice of the financial tool used by local governments can be classified in different ways. Among them are:

– internal factors – related to the conditions of the community, including its ability to incur liabilities, and the scale of the needs and nature of the planned investment projects,

– external factors – determined by the sources of financing themselves, including in particular, the availability and cost of capital acquisition [Zioło 2011: 294].

Among the criteria that guide local authorities in choosing an external financing source are:

– financial criterion,

– non-financial criterion (social, political, formal, legal, and organizational) [Rosa 2011: 367].

The financial criterion, which is one of the key factors determining the choice of financial instrument, can determine the source of capital return with minimal debt servicing costs. The cost of acquiring the funding raises capital costs and current debt service costs. An important factor is the flexibility of a debt instrument and the possibility to adapt it to the specific tasks. Moreover, this group of factors include: the availability of capital, the rate of capital, the payback period of the capital, the collateral required for its return, as well as, the risks associated with raising the capital [Zawora 2014: 207].

Selecting the sources of budget deficit financing should always be preceded by a comprehensive economic analysis. Also important, as an institution under public law, are the established local government specifics to meet local community needs, where economic calculation must go hand in hand with social benefits [Zawora 2014: 206-207]. The main source of deficit financing by Polish local governments, according to data at the end of 2015, are loans. They account for ap-

Table 1. The structure of liabilities for local government debt in 2015
(in billions of PLN)

Structure of liabilities	Billions of PLN	%
Issuing securities	4.15	5.9
Loans	67.3	94.0
Other liabilities	0.15	0.1
Total liabilities	71.6	100.0

Source: own elaboration based on *Sprawozdania z działalności...* 2009, 2010, 2011, 2012, 2013, 2014, 2015.

prox. 94% of debt. The issuing of securities (municipal bonds) represents almost 6% of liabilities (Table 1).

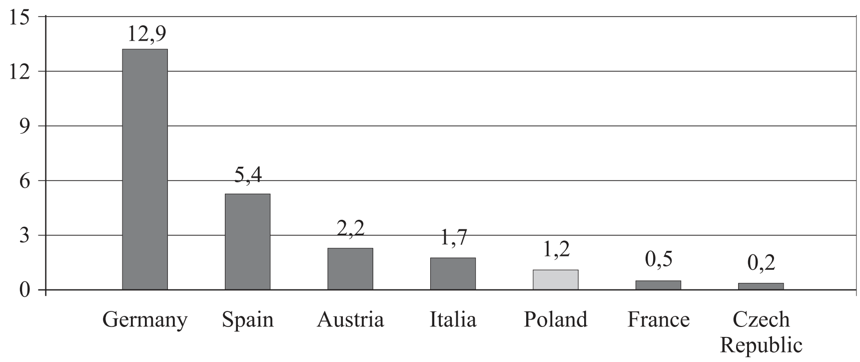
2. Municipal bonds as an example of a debt financial instrument

Municipal bonds are an instrument for balancing the budget and ensuring the liquidity of government in the long run. The Polish municipal bonds market analysis shows that governments issue bonds frequently to finance investment projects [Kozuń-Cieślak 2008: 111].

Legal issues related to the issuance of municipal bonds in Poland are regulated by the Bonds Act of January 15th 2015.[2] However, it neglects to introduce a definition of municipal bonds. This term is consistent with the general bonds term contained in Art. 4 § 1 of the Bonds Act.

Art. 4 indicates a bond as a security issued in series, in which the issuer states that they are indebted to the bond owner (bondholder) and is committed to him and the outlined performance. Moreover, Article 2 indicates that bonds can be issued by, among others, municipalities, districts, provinces, and the associations of these units and regional units or local authorities, other than the Republic of Poland, as long as it is an EU country. Typically municipal bonds have long-term maturities in the range of 1 to 15 years, with the average usually between 5 and 10 years. Final payment resulting from the bond contract is preceded by periodic coupon payments based on the interest rate dependent on the interbank rate.

Chart 1. The debt of local government units from the issuance of debt securities in relation to GDP in selected countries of the European Union selected in 2014



Source: own elaboration based on NBP 2015: 247, prepared on the basis of the ECB and Eurostat.

[2] Ustawa z dnia 15 stycznia 2015 r. o obligacjach, Dz.U. poz. 238 [Bonds Act of January 15th 2015, Journal of Laws item 238].

The municipal bond market is a minor part of the capital market in Poland. These instruments accounted for over 3% of the outstanding long-term debt securities of domestic entities at the end of 2014. The local government unit's (LGU's) debt from the issue of bonds in 2014, represents approximately 1.2% of the GDP. The municipal bonds market development level in other EU countries varied widely and, to a large extent, depend on the degree of autonomy of the administrative system of the state and territorial units (Chart 1). The biggest market for these instruments operates in Germany [NBP 2015].

3. Municipal bond market in Poland

Municipal bonds are in a dematerialized form and are payable to the bearer. Such legal characteristics allow them to be traded publicly. This increases the number of potential investors. A significant part of bonds issued are publicly offered through the electronic platforms operated by the stock exchange. Despite some advantages of these debt securities they are not in use very often in Poland.

Apart from a public offering, municipalities also issue bonds using a private engagement. A private offer may be addressed to a maximum of 149 people without the use of announcements in the media. This is a much simpler procedure than the public offering. Its main advantages are lower execution costs and a shorter period of the implementation process. The disadvantage is the limited number of investors, which reduces the potential of attracting external investment funds.

A large increase in the municipal bonds market value was observed after Poland's accession into the European Union in 2004.

Debt resulting from local government units increased fivefold from 2007 to 2015, from 4 to 20 billion PLN. There is an increase during the analysed period

Table 2. Municipal debt due to issue of municipal bonds and its share in total municipal debt in Poland during the years 2007-2015

Year	Municipal debt due to the issue of bonds (in billions of PLN)	The share of debt from the bonds issued in local government debt (in %)
2007	4.1	15.9
2008	4.5	15.4
2009	6.9	17.0
2010	10.9	19.6
2011	14.4	21.7
2012	15.6	22.9
2013	18.6	26.7
2014	19.1	26.4
2015	20.02	N/A

Source: own elaboration based on the Ministry of Finance, Fitch Polska, and NBP data.

of the issuance of municipal bonds by local government units resulting in debt. Currently, more than a quarter of debt stems from the issue of bonds.

Among the local government units, the issuing of bonds most often occurs in cities and towns. According to Ministry of Finance data at the end of 2014, the amount of debt instruments used by these units accounted for 85.3% of the outstanding value of municipal bonds.

The funds from the issue of local government bonds were basically spent to refinance other obligations, manage early repayments, and to finance infrastructure projects. According to Fitch Poland, local government unit debt securities amounted to 2.1 billion PLN during 2014 in the primary market, and this was less than in 2013, when the value was about 2.4 billion PLN. The reduction in the issue of municipal bonds is connected with the introduction of new debt limits. In addition, there was a decrease in demand for financial resources for the implementation of projects that were co-financed from EU funds resulting from the completion of applications for funding under the EU financial perspective for 2007-2013, and also failing to start new operational programs for new prospects for 2014-2020.

In 2014, municipal bonds were made exclusively private. The primary market was lacking in value security sales. In addition to the relatively low borrowing needs of small local government units, there was a problem of sharing bonds issued in a number of series. The average value of a single series issued was only 1.3 million PLN in 2014; this was about 0.5 million PLN less than in 2013.

More than 60% of municipal bonds issued by local governments in 2014 were instruments with an original maturity from 5 to 10 years. The ones with a greater value of issues mostly had a longer original maturity. Variable interest rates still dominate as a key debt security issue. The amount of municipal bond coupons basically depend on WIBOR reference rates. The only fixed-rate bond instruments were issues in Warsaw between 2009-2011.

The organizers of the issue of local government bonds were mainly banks. The brokerage houses had a very limited activity in this area. As a result, when PKO BP completed its acquisition of Nordea Bank Poland on October 31st 2014, it gained the largest market share of issued municipal bond.

Local government debt securities traded on the Over the Counter (OTC) market at the end of 2014 were approximately 83% of all municipal bonds. Domestic banks still dominated among the investors in the OTC market. Their share in the municipal bonds buyer structure was approximately 90%. It was an alternative tool to lending money. A small amount of municipal bonds trading on the secondary market OTC was also the result of strong market fragmentation resulting from the low borrowing needs of small local government units and dividing up the issue of a number of series. Low market liquidity was one of the main reasons for the minor interest in municipal bonds among other entities, like in particular,

Table 3. Municipal bonds quoted on the Catalyst platform between the years 2009-2015

Years	Electronic Order Booked Trades (daily)		Non-Electronic Order Booked Trades (daily)		Number of Series	Emission Value (in millions of PLN)
	Turvover Value (in millions of PLN)	Number of Trades	Turvover Value (in millions of PLN)	Number of Trades		
2009	62.68	181	14.00	1	9	930
2010	124.21	621	69.60	9	27	1753
2011	41.76	432	1.59	2	24	2222
2012	10.83	279	0.00	0	31	2374
2013	7.23	169	12.33	13	57	3088
2014	17.48	204	0.56	1	60	3187
2015	10.25	69	1.74	1	58	3189

Source: CATALYST Statistic Bulletin, Catalyst 2009, 2010, 2011, 2012, 2013, 2014, 2015.

non-bank financial institutions. Shares of investment funds and pension funds do not exceed 5% in the structure of buyers in this market.

Municipal bonds trading is present on the Catalyst platform – the regulated markets of the Warsaw Stock Exchange (WSE), BondSpot, and retail ASO organized by WSE. There were 65 municipal bond series traded, worth 3.2 billion PLN at the end of 2014; 65% of those were Warsaw bonds. In the analyzed period, the regulated market trading on the Warsaw Stock Exchange introduced municipal bonds with a total value of 113 million PLN (399.5 million PLN in 2013), which was issued by five local government units. At the same time, we observe a drop in interest for issuers on the alternative trading system and less active investors in this segment of the market (Table 3). There was a small liquidity on the secondary market Catalyst platform for municipal bonds in 2014. Approximately 90% of the net sales in this market were transactions for Warsaw bonds.

4. Polish municipal bond market development prospects

A local government's economic development depends on, among other things, on building sustainable competitive advantages within their own region or country. In the constant shortage of investment capital, municipal bonds seem to be the cheapest and most convenient external capital source. They are particularly important and valuable in a case when the value of necessary capital significantly exceeds the municipality's capacity in taking on a bank loan.

On the other hand, factors beyond local government control that determine the most efficient indebtedness level should be considered: current and projected national socio-economic developments, the market mechanism development level and privatization process, changes in GDP, inflation, unemployment, market interest rates, foreign exchange rates, the public finance state of the country and limits on municipal debt, state regulations on debt instruments available to municipalities on the domestic financial market, changes in domestic and global economic conditions, the risk aversion level among international investors and their attitude towards countries with emerging markets.

The fact that bonds are a much cheaper source of funding for regional development compared to bank loans is one of the most frequently emphasized advantages of municipal bonds. The cost of funding could even be reduced by purchasing a guarantee of repayment for the bonds, which lifts the issuer creditworthiness and, consequently, forces investors to accept bonds with lower interest rate coupons.

Another features, positive for the municipality market development, is the flexibility of selecting repayment terms, including coupon payment schedule, the term of capital repayment, or the rolling over bond issue possibility. The possibility of dividing total issues into many branches with varied values and maturities provide municipalities with the ability to match the incoming cash flow to the investment project's individual needs.

In addition, by issuing bonds municipalities obtain credit ratings from independent rating agencies and become more transparent and attractive to potential new investors. This increases their credibility, as well as, their chances for participation in projects co-financed with EU structural funds.

A new opportunity for the development of the municipal bond market are perpetual bonds. The new Bonds Law from January 15th 2015, introduces a new category of bonds called perpetual bonds. In this type of bond, there is no redemption date specified and the interest is only paid. If the maturity date is not specified, the debt ratio of the local count will only be interest. It will be very encouraging for many municipalities, because it will allow them to incur greater commitments for greater investments; this was probably the intention of the government. There is only one problem: the risk for investors will be higher – as in the case of revenue bonds – than ordinary bonds, which will mean higher interest rates. Increased costs due to higher interests rates can contribute to subsequent financial problems. Therefore, governments should be very cautious, making use of this instrument.

From July 2015, local government units in Poland can issue perpetual bonds. Through perpetual bond issuance, issuers of these securities receive a reliable and stable source of capital, which – as a rule – you do not have to pay. It is the duty of the issuer to ensure the timely payment of benefits from the bonds and to keep other commitments made by the issuer in terms of the bonds issued.

Perpetual bonds may be an interesting tool for potential investors. The purchase of such securities can be an excellent way to provide current and specific financial receipts for them and, in the future, for their heirs. In addition, the bondholder does not need to make a reinvestment of the funds received from the redemption of bonds, as is the case with the purchase of other bonds types.

The advantage of such funding tools like municipal bonds is that investment funds mostly come from domestic investors and do not generate foreign exchange risk. Additionally, municipal bonds provide a save and flexible tool for long-term domestic investments.

The matter of the use of municipal bonds in the funding regional development has been frequently discussed in economic literature. On one hand, researchers point to the numerous advantages for the bond issuers, including debt management flexibility, or the possibility of applying for EU structural funds. On the other hand, the development prospects for the municipal bond market in Poland is, very much, limited.

The limitation for the development of the municipal bond market in the coming years may be new regulations on local government debt limits. New debt limits determine the upper limit of the allowed expenses related to the redemption of local government and service obligations in relation to their income. According to regulations, having first applied to the resolutions of the budget of local government units for 2014, the ratio of the local government unit's repayment obligations annual value and service charges to the planned total income does not exceed the rate corresponding to the arithmetic average of the calculated value for the last three years, the relationship of current revenue plus proceeds from the sale of assets and the net current expenditures to total revenue.

For many local government units, primarily those with low-income, new debt limits may be more restrictive than those applied in the end of 2013. A possible decrease in the ability of local governments to assume new obligations in the coming years may translate into a slowdown in their municipal bonds debt growth.

Conclusion

Municipal bonds are an interesting financing tool for local government units. For municipalities, bonds are a convenient form for collecting investment funds. They are much cheaper than banking loans and provide a broad range of flexibility in the repayment schedule. Municipalities can effectively adjust bond repayment plans with payments stemming from the development projects they are used for.

At the end of 2014, these instruments accounted for over 3% of the outstanding long-term debt securities of domestic entities. The local government unit's (LGU's) debt represented approximately 1.2% of GDP from the issue of bonds in 2014. Debt resulting from the issue of bonds by local government units increased fivefold from 2007 to 2015, from 4 to 20 billion PLN. Larger cities are leaders in the issuance of municipal bonds.

The perspective of co-financing regional economic and infrastructural projects with EU structural funds and limits in indebtedness have the most impact on municipalities in organizing new issues of bonds. Recently, to limit the level of debt and to connect external capital with the profits from particular economic projects, local governments will probably force municipal enterprises to issue revenue bonds. Similarly like in developed countries, such bonds will help fund utility and infrastructure projects in large Polish cities.

From the municipal, national, and provincial point of view, municipal bonds are an advantage over traditional credit. This arguments shows that the municipal bond market should develop dynamically in the coming years.

It is important that the years 2015-2020 be a period of inflow of EU funds in the new financial perspective. Projects funded in part by the European Union require local government's own contribution; this means that they will need to start borrowing capital through, for example, the issue of municipal bonds.

In addition, since 2015 local governments can use a new type of bond – perpetual bonds. They can also become a popular tool for financing the deficit in local government units.

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Obligacje komunalne jako narzędzie finansowania jednostek samorządu terytorialnego w Polsce – stan rynku i perspektywy jego rozwoju

Streszczenie. *Obligacje komunalne stanowią w ostatnich latach interesującą alternatywę finansowania dla jednostek samorządu terytorialnego. Są to narzędzia tańsze i bardziej elastyczne od tradycyjnych form pozyskiwania kapitału na rynku. W latach 2007-2015 dług wynikający z emisji obligacji komunalnych przez jednostki samorządu terytorialnego w Polsce wzrósł pięciokrotnie (z 4 do 20 miliardów PLN). W artykule zostaje dokonana ocena rozwoju rynku obligacji komunalnych w Polsce i nakreślone zostają możliwości rozwoju tego rynku w oparciu o analizę szans i ograniczeń. Przeprowadzona w pracy analiza wskazuje, że rynek obligacji komunalnych w Polsce powinien się w kolejnych latach dynamicznie rozwijać. Wynika to m.in. z przyszłych potrzeb uzyskania przez jednostki samorządu terytorialnego wkładu własnego do realizacji projektów współfinansowanych w ramach środków Unii Europejskiej w latach 2016-2020.*

Słowa kluczowe: *obligacje komunalne, finansowanie jednostek samorządu terytorialnego*