MUNICIPAL ECONOMIC GROWTH ACTIVITY

Republic of Serbia

Municipal Credit Market Development Report

2005 - 2010

Author

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USAID's Municipal Economic Growth Activity

The Urban Institute

Notes from the author

Data presented in this report have been obtained from the Public Debt Administration of the Ministry of Finance and the webpage of the National Bank of Serbia. Data processor shall not be responsible for the accuracy and validity of data. Data are to be used solely for informational purposes as they were not verified in official reports.

ACRONYMS AND ABBREVIATIONS:

BELIBOR	Belgrade Interbank Offered Rate
CEB	Council of Europe Development Bank
DCA	Development Credit Authority
IPA	Instrument for Pre-Accession Assistance
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
EU	European Union
EUR	Euro, the official currency of EU
EURIBOR	Euro Interbank Offered Rate
HNB	National Bank of Croatia
HRK	Croatian Kuna
KfW	Kreditanstalt für Wiederaufbau
LIBOR	London Interbank Offered Rate
MEGA	USAID Municipal Economic Growth Activity
MoF	Ministry of Finance
NBS	National Bank of Serbia
RSD	Serbian dinars
SEGA	USAID Serbia Economic Growth Activity

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1 Legal and Institutional Framework for Local Government Borrowing in Serbia

Capital investment decisions are among the most important decisions a local government can make. These decisions usually concern large investments in the present with revenues coming of the investments, market prices and their trends, and project implementation risks.

Municipal Economic Growth Activity (MEGA), which is financed by the United States Agency for International Development (USAID) and implemented by The Urban Institute (UI), started cooperation with 10 local government units in Serbia in March 2006[1]. In early 2007, 11 additional municipalities[2] were included in the program implementation. Another 11 municipalities[3] were also included in the fall of 2008 to make total number of 32 municipalities covered by the Program.

Principal goal of the program is to build capacity of the local government and local business community to foster economic development and create jobs in order to create business friendly environment where significant private sector development may occur.

Start of MEGA Program implementation was characterized by newly created legal and institutional framework which has regulated the financing of the local government unit from the budget revenues, as well as from proceeds generated on the capital market. Method of financing projects aimed at fostering local community development has been regulated by a combination of laws adopted as of 2002:

- ***Law on Public Procurement*** [4] (2002), regulated the procurement procedure for financial services by the public sector entities in the Republic of Serbia
- ***The Budgetary System Law***[5] (2002), which, among other, set the procedures of local government budget adoption, implementation and audit
- ***Law on Public Debt***[6] (2005), permitted local government borrowing on the financial market and regulated the method and limits of borrowing
- ***Law on the Market of Securities and Other Financial Instruments***[7] (2006), which regulated the issuance and marketing of securities on the domestic financial markets
- ***Law on Local Government Financing***[8](2006), which regulated provision of funds for local government units to exercise original and delegated powers
- ***New Law on Public Procurement***[9] (2008), which regulated special procedure of loan procurement as a financial service by the public sector entity

[1] Cohort 1: Novi Beograd, Kragujevac, Subotica, Zrenjanin, Krusevac, Vranje, Loznica, Uzice, Indjija, Prokuplje
[2] Cohort 2: Leskovac, Pančevo, Šabac, Kraljevo, Čačak, Smederevo, Paraćin, Vršac, Prijepolje, Pećinci, Arilje
[3] Cohort 3: Novi Sad, Niš, Sombor, Valjevo, Novi Pazar, Sremska Mitrovica, Zaječar, Pirot, Bujanovac, Preševo, Medvedja
[4] "Official Gazette of RS" no. 39/2002
[5] "Official Gazette of RS" no. 9/2002
[6] "Official Gazette of RS" no. 61/2005
[7] "Official Gazette of RS" no. 47/2006
[8] "Official Gazette of RS" no. 62/2006
[9] "Official Gazette of RS" no. 116/2008

- ***New Budgetary System Law*** [10] (2009), which, among other novelties, regulated establishment of the Public Debt Authority in charge of monitoring the borrowing activities of local authorities.

In addition to the combination of adopted laws, the Government of the Republic of Serbia annually adopts ***the Budget Memorandum***[11], which defines the macroeconomic framework for the budgets of local authorities and transfers from the central to local level.

Combination of laws permitted and regulated the method local authorities will use to access financial markets in order to collect additional funds for financing of the local community accelerated development in contrast to traditional financing solely from the budget revenues. All financial market players may take on the role of the potential investor and financier of the local infrastructure. Investment method for local investment projects depends of their legal status, level of accumulation they posses, and the project financing method the local government has chosen. Adoption of the law, however, has not resulted in prompt activation of all potential financiers and investors on the market due to the time required to pass the by-laws, form new regulatory institutions, as well as to harmonization and amendments to the adopted laws. Experts from MEGA Program have actively participated in building and improvement of the legal and institutional framework both at the central and local level. Between 2005 and 2010, the process involved cooperation with the Ministry of Finance, main players on the Serbian credit market, Standing Conference of Towns and Municipalities and other donor programs and international institutions (EBRD, KfW, GTZ, USAID/SEGA, etc.).

According to the existing legal and institutional framework, local authorities can borrow in the country and abroad, in domestic and foreign currency, for long-term financing or refinancing of the capital expenditures planned in the budgets of local authorities. They can borrow from financial institutions (by means of open public procurement procedure for loans and financial leasing) or from the investors on the capital market (bond issuance). Decision on borrowing is to be adopted by the line entity of local authorities upon previous observation of the Ministry of Finance on observance of the long-term borrowing limitations, in accordance with the Law on Public Debt.

Limitation of municipal long-term borrowing by the Law on Public Debt

- **The total amount of long-term debts** may not exceed 50% of the total current revenues of municipal budget realized in the previous year
- **The total yearly annuity** may not exceed 15% of the total current revenues of municipal budget realized in the previous year

Aim of using the mentioned local government borrowing methods is to procure funds on the financial market under the best available terms. Therefore, during the implementation of

[10] "Official Gazette of RS" no. 54/2009

[11] „Memorandum on Budget, Economic and Fiscal Policy for the Following Year, with Projections for the Following Two Years" is adopted by the Government of the Republic of Serbia upon the proposal of the Ministry of Finance.

MEGA Program, 32 local government units have participated in numerous financial, debt and capital project management trainings. They were provided with the manuals on: debt management, loan procurement and financing of the capital investment projects. They were also given a local government creditworthiness analysis tool. Manuals and the mentioned tool help local government units to:

- prepare and present capital investment projects in a way acceptable by the financiers, i.e. financial institutions and investors
- create tender documents required in the open loan public procurement procedure
- examine possibility of borrowing on the financial market
- present their creditworthiness for the purpose of bond issuance or borrowing from financial institutions
- prepare the capital investment plans based on reconciliation of project cost-efficiency and the price of their financing.

Result of creation of the legal and institutional framework and development of modern financial management methods in cities and municipalities in the Republic of Serbia was development of a separate segment of financial market with active participation of MEGA Program. It is the municipal credit market, which is the first phase of debt market development in the country and the region.

Local government borrowing in the countries of the region started with the development of the bank loans market for municipalities. Only after the development of this segment of the market, and parallel with the development of the contemporary local government financial management methods and creation of financially strong institutional investors, the process of municipal bonds issuance has started. Main incentive to municipal bond market development was borrowing under the lower interest rates and with longer maturity in comparison to bank loans.

Further development of the Serbian local government debt market will depend on improvements of legal and institutional framework, which regulates the process of financing and borrowing of cities and municipalities and the way financial markets operate. In order to allow Serbian local governments to borrow from the investors through the bond issuance, the following is required: local governments should become the owners of the property they use, local government external audit and financial reports disclosure methods should be regulated, and all investors should be allowed to buy municipal bonds through public placements.

2 Players on the Municipal Credit Market

Start of the municipal credit market development concurs with the adoption of the Law on Public Debt in mid 2005 and the emergence of the first banks which were ready to assume the local government unit credit risks. Development of the bank loans for municipalities was also under the impact of international donors and financial institutions that provided financial support to local investment projects.

2.1. Role of the Foreign Donors in Market Development

Foreign donors (USAID, EAR, IPA Fund, etc.) use the funds for: support to implementation of public and private sector projects, support to domestic banks to engage in project lending, and covering of the consulting cost for project design. Majority of local commercial banks expressed their interest in project lending, which are to be co-financed by the donors, as well as in assuming a part of municipal credit risk.

USAID provided support to credit market development by means of the contract, signed with the Raiffeisenbank in 2005, on partial credit risk cover for loans to local authorities. DCA guarantee covered 50% of the credit risk and it was used by the bank during 2005 and 2006.

2.2. Role of the International Financial Institutions on the Credit Market

Funds of the international financial institutions are used for: direct public sector project lending, refinancing of the selected domestic partner banks or partial covering of the credit risk for projects financed by domestic partner banks. International financial institutions and development banks of other countries exercising lending activity in the Republic of Serbia are: European Bank for Reconstruction and Development, European Investment Bank and German Development Bank.

European Bank for Reconstruction and Development (EBRD) invests in the region and apart from own funds it collects the funds of foreign investors. Funds provided as mentioned are used for lending and investments in: financial institutions, private and public sector (states, regions, local government units, public enterprises, etc.).

Table 2.2.1. EBRD Lending Terms

DESCRIPTION	CONDITION
Type of project	Local infrastructure projects
Project sponsor	Public and Private Sector
Amount	Minimum 5 million Euros, and maximum 35% of total project cost
Maturity	8 to 10 years
Grace period	3 to 4 years
Currency	Euro
Interest Rate	Euribor + margin (1% margin for loans with government guarantees)
Fees:	
- to grant a loan	1% one-time payment to grant a loan
- to employ funds	0.5% semi-annual payment for unused amount of the granted loan
- for early repayment	0.125% of the principle amount subject to early repayment

EBRD financing may require project sponsor, based on comprehensive feasibility study for projects worth more than 5 million Euros. EBRD has not yet developed lending for low value infrastructure projects through domestic banks in Serbia.

European Investment Bank (EIB) is the financial institution of the European Union granting loans provided through borrowing activities on the market, reserves and deposited capital of EU members. Financing operations outside EU are primarily funded from own funds. Loans are contracted with the governments of the countries where the projects are to be implemented. Loans exceeding 25 million Euros may be directly contracted with the user of the loan. EIB loan users may be the owners of the project, both in public and private sector, and banks.

Table 2.2.2. EIB Lending Terms

DESCRIPTION	CONDITION
Type of project	Infrastructure and energy efficiency projects
Project sponsor	Public and private sector
Amount	Up to 50% of the project's investment cost
Maturity	Up to 20 years for infrastructure projects
Grace period	Equal to the project construction phase
Currency	Euro, American Dollar, Japanese Yen, Swiss Franc and other
Interest Rate	Fixed or variable (close to EIB borrowing cost paid on the market)
Fees	No charging

In addition to loans for individual projects, EIB offers global loans. **Global loans** are actually credit lines granted to intermediary banks that are using them to grant loans to local governments and small and medium enterprises. EIB has 10 intermediary banks in Serbia, 6 of which banks are active on the municipal credit market: Komercijalna Banka, Raiffeisenbank, UniCredit Bank, Hypo Alpe-Adria-Bank, Banca Intesa and KBC Banka. Partner banks assume the risk of the loan and they assess the credit risk of local government as the loan users.

German Development Bank (Kreditanstalt für Wiederaufbau – **KfW**) is the implementer of financial cooperation between Germany and Serbia on behalf of the German Government. As of 2008, KfW has been implementing the program of small utility infrastructure project financing, which suits small and underdeveloped municipalities. Lending is conducted through Banca Intesa, which is refinanced by KfW. Domestic bank is in charge of project risk and project implementer assessment, and it assumes the placement risk.

Table 2.2.3. KfW Lending Terms

DESCRIPTION	CONDITION
Type of project	Utility infrastructure project
Project sponsor	Local government unit and PUC
Amount	Up to 1.2 million Euros
Maturity	Up to 7 years
Grace period	Up to 1 year
Currency	Euro
Interest Rate	Euribor + 4.5% or fixed 6.5% annual rate

2.3. Role of Domestic Commercial Banks on the Credit Market

Borrowing from the domestic commercial banks is the traditional method of financing the capital project implemented by local authorities that was used sporadically before 2005 and more intensively during 2006. Availability of commercial bank loans improved gradually through the growth on the number of banks that were ready to analyze and assume local government credit risk, as well as to participate in public procurements of loans. The first banks that were ready to offer loans to local authorities on the basis of their fiscal capacity, with or without mortgage, were: Banca Intesa, Raiffeisenbank, Komercijalna Banka and AIK Banka.

Leading bank in the number of loans granted is Banca Intesa, the bank with long-term experience of cooperation with local government units in Serbia even before the establishment of new budget system and legislation on local government borrowing.

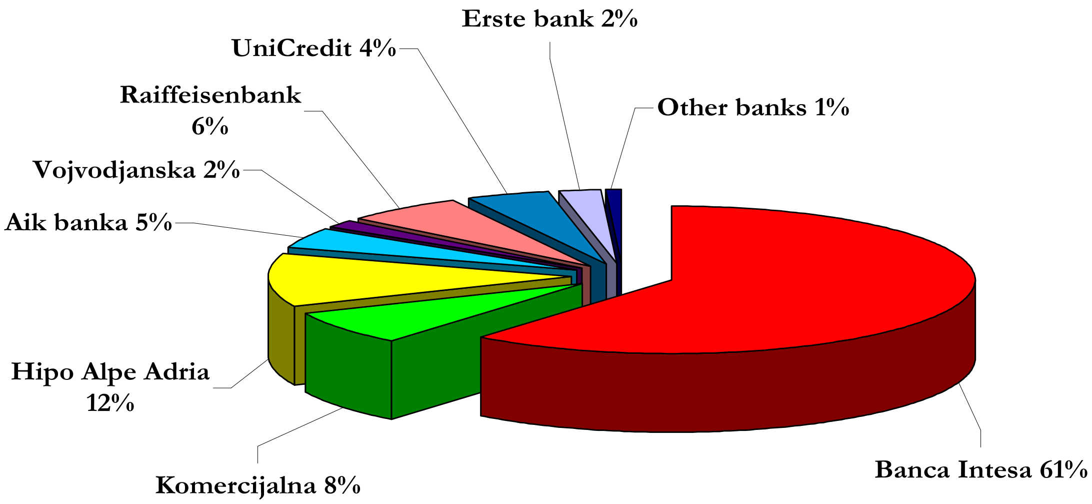
Table 2.3.1. Summary of Loans by Banks

Name of local commercial bank	Number of loans approved per year						Total
	before 2005	2005	2006	2007	2008	2009*	
1. Banca Intesa a.d.Beograd	2	13	33	18	16	3	**85**
2. Komercijalna banka a.d.Beograd	1	0	9	3	3	0	**16**
3. Aik banka ad Nis	0	3	5	2	1	0	**11**
4. Hypo Alpe Adria Bank ad Beograd	0	0	3	5	2	1	**11**
5. Vojvodjanska banka a.d. Novi Sad	1	1	4	1	2	1	**10**
6. Raiffeisenbank a.d.Beograd	0	3	3	1	1	0	**8**
7. UniCredit Bank Srbija ad Beograd	0	0	3	1	1	0	**5**
8. Erste bank AD Novi Sad	0	1	0	1	1	0	**3**
Other banks	1	2	1	2	0	0	**6**
Total per year	**5**	**23**	**61**	**34**	**27**	**5***	**155**
***Note: This report does not contain complete data for loans approved in 2009**							

Source: Ministry of Finance Database about municipal debts on December 31, 2009

Today, 34 banks operate in Serbia, out of which 8 banks are active on the municipal credit market. These eight banks manage 43% of the total balance sheet sum of all banks, and they cover 99% of loans placed to local authorities (without the international financial institutions).

Diagram 2.3.1. Market participation of the banks



Banca Intesa covered 60.9% of municipal placements in late 2009, with around 14% share of total assets of banks. Second place is held by Hypo Alpe Adria Bank, covering 11.6% of municipal placements. They are followed by Komercijalna Banka with 7.5% and Raiffeisenbank with 6.3% of market share. Other four banks cover 13.7% of total municipal debt to commercial banks.

Out of the mentioned eight banks, only two (Komercijalna Banka and AIK Banka) are with majority domestic capital, and the remaining six are owned by foreign banks. Domestic AIK Banka is using own funds collected on domestic market to finance local government loans, while Komercijalna Banka (in addition to own funds) is using the EIB credit line. Banks owned by foreign entities are providing loans mainly from own funds acquired outside Serbia from their founders or through refinancing by the international financial institutions (EIB, CEB or KfW).

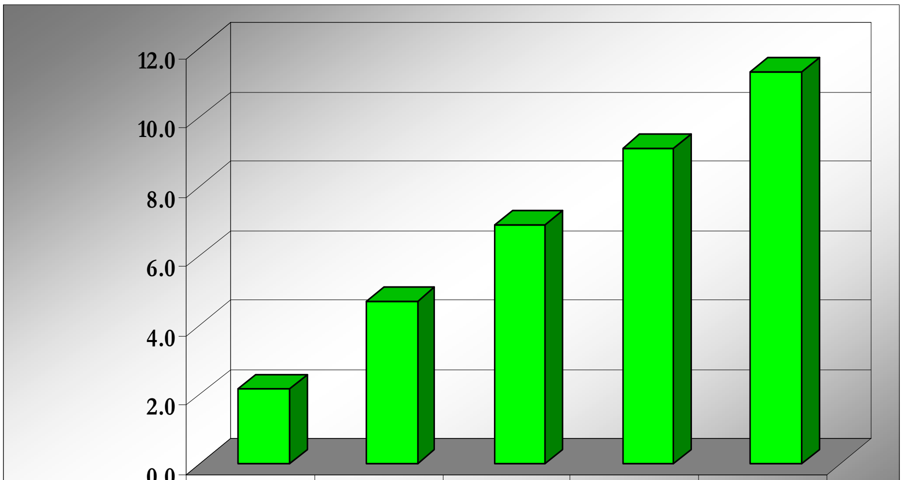
Commercial banks grant loans for all types of infrastructure projects. Lending terms depend on the method mentioned banks used to collect funds, refinancing terms for loans acquired from the international financial institutions (EIB, CEB, KfW, etc) and the municipal credit risk analysis. The table provided below shows commonly offered terms of commercial banks for loans to local authorities.

Table 2.3.2. Lending Terms of Domestic Banks

DESCRIPTION	CONDITION	
Maturity	5 to 15 years	
Grace period	1 to 3 years	
Interest Rate	for RSD: Belibor + 1,50% average	for EUR: Euribor + margin 3.5% to 7%
Collateral	Budget revenues (issuing order for debiting the budget sub-account of municipal treasury consolidated account with the central bank)	
	Bill of exchange issued by the Municipality	
	Guarantee (Pledge) of another legal entity	
	Mortgage on real estate (building and land)	

From data publicized by NBS on lending activities of the banks, we can see that the bank placements to local authorities grew between 2005 and 2009 at the average rate of 56%. They grew from 2.1 billion to 11.3 billion dinars, which is 528% growth. However, placements to local authorities are still at low levels as their share in total bank placements is only 0.9%.

Diagram 2.3.2. Bank Outstanding Loans to Local Governments



	2005	2006	2007	2008	2009
mld RSD	2.1	4.7	6.9	9.1	11.3

Source: NBS Report on Bank Control, December 2009

From NBS report we can learn what is the risk of bank placements to local authorities. If we take a look to the report for the first quarter of 2010, we will see that in total default loans, public sector loans[12] share is only 0.1%, while the share of loans granted to business entities is as much as 77% in total default loans.

[12] Loans to public sector include loans to the Republic of Serbia and local authorities. At the end of first quarter, they were worth 131 billion dinars, i.e. 10% of total bank placements.

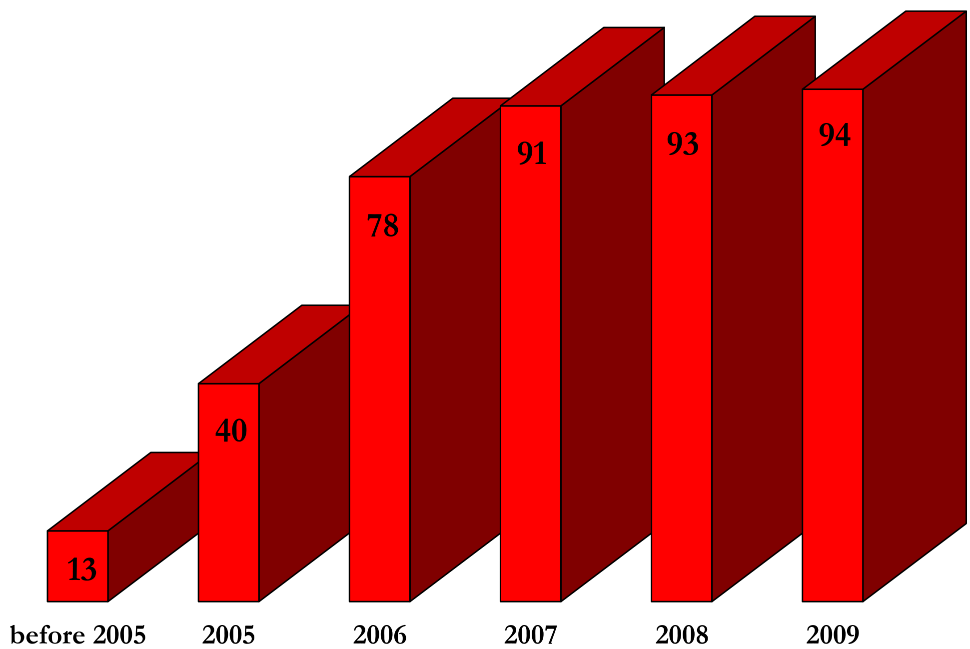
3 Activities of Local Authorities on the Financial Market in Serbia

Local authorities in the Republic of Serbia report to the Ministry of Finance on the level of their debt in the middle and the end of each year. Thanks to good cooperation between MEGA Program and the Public Debt Administration of the Ministry of Finance, reported data were available for Serbian local government debt analysis. Mentioned data are available to other players on the financial market if they request so from the Public Debt Administration. Processing of the reported data on level of city and municipal debts on December 31, 2009, analysis of local government activities on the financial market has been prepared.

3.1. Local Government Access to Financial Market

Intensive appearance of local authorities on the financial market, aimed at collecting additional funds for capital investment expenses financing, started after the adoption of the Law on Public Debt in mid 2005. Before the adoption of the Law, between 2001 and 2005, small number of local governments (only 13) have borrowed from the banks (see diagram below). Those were mainly the biggest cities (sometimes with the national government support) which accessed the loans of the international financial institutions (EBRD, EIB and KfW) or they were in position to borrow from domestic banks due to long-term cooperation.

Diagram 3.1.1. Number of Local Governments with Loans by Years



As much as 65 cities and municipalities borrowed in 2005 and 2006. More borrowing activities of local governments in that period were encouraged by the Local Infrastructure Agency. The Agency assisted municipalities in the preparation of feasibility studies for capital investment projects, which were financed from foreign donations (mainly EU), bank loans and budget funds.

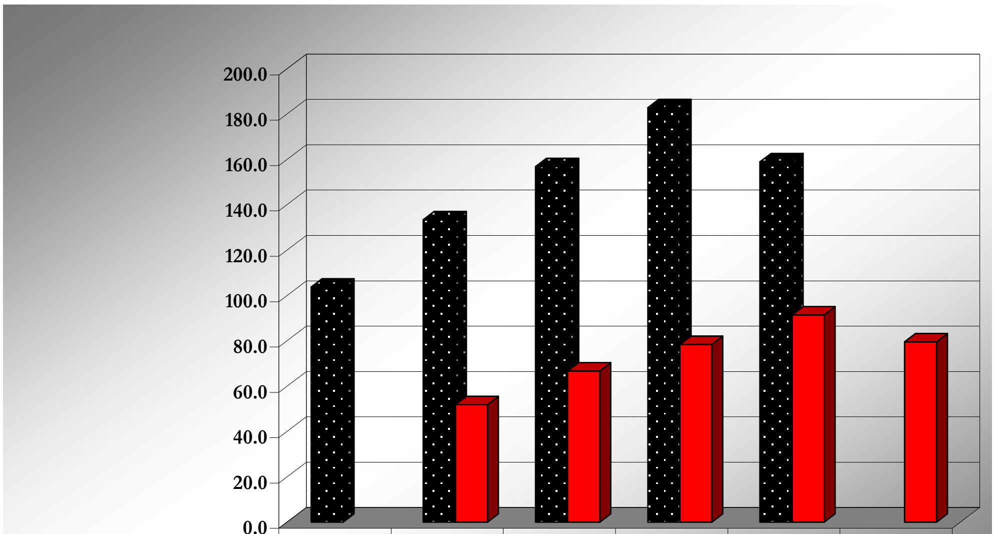
In 2007 and 2008, borrowing activities of local governments on the financial market slowed down for two reasons. One of the reasons is that they were given capital transfers from the National Investment Plan during that period. The second were local elections during 2008.

In 2009, borrowing activities of local authorities grew due to reduction of funds in the local budgets for financing of both already started and new capital investment projects due to macro economic instability in Serbia and reduction of general and capital transfers from the Republic budget. Further increase in borrowing is expected during 2010 and in the following years due to reduction of funds in the general and functional transfers from the national budget.

3.2. Borrowing Capacity and the Level of Local Government Debt

Borrowing capacity of local authorities, according to the Law on Public Debt, depends on the level of operating revenues of the local budget. Total outstanding debt of local government must not exceed 50% of operating revenues generated in the previous budget year. Diagram below shows the change of maximum permitted total debt of all Serbian local governments[13], by years, computed based on the revenues generated in the previous budget year.

Diagram 3.2.1. Borrowing Capacity of Local Governments (billions of RSD)



	2005	2006	2007	2008	2009	2010
Realised Current Revenues	103.6	133.3	156.8	182.8	158.9	
Borrowing Capacity		51.8	66.7	78.4	91.4	79.5

Source: Ministry of Finance, Public Finance Bulletin, December 2009

From the diagram, one can conclude that local government debt grew as of 2005 until 2008 as the result of increase in operating revenues of local budgets at the average rate of 21%. They grew from 103.6 to 182.8 billion dinars, or by 76%.

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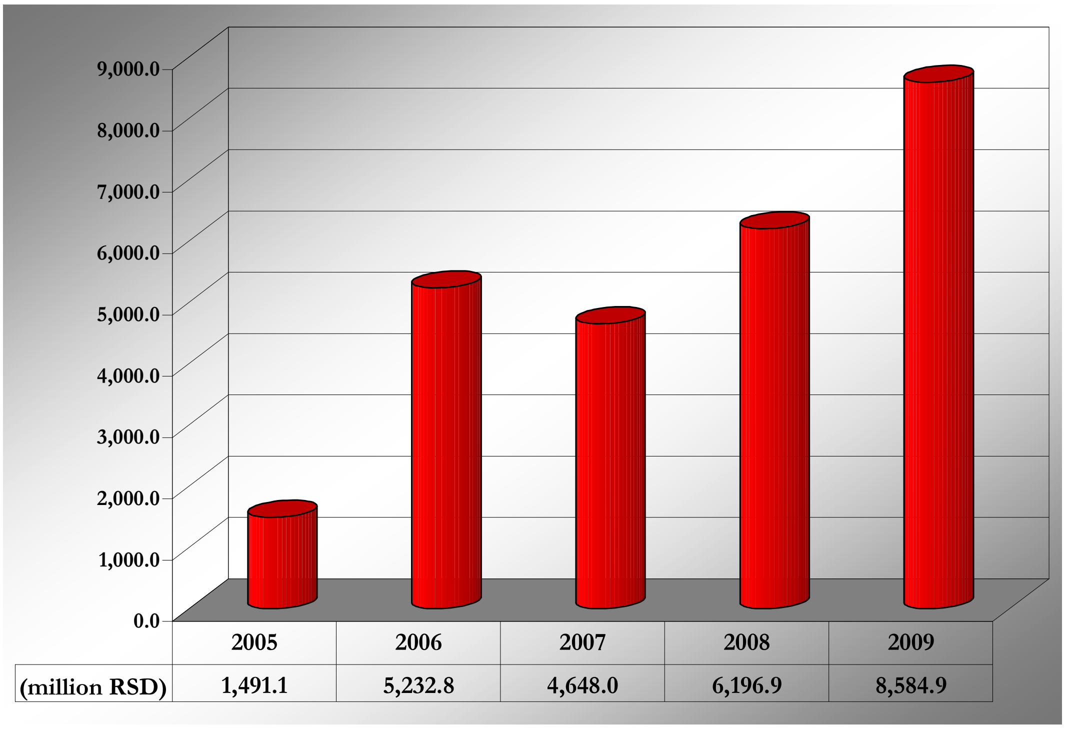
[13] MoF report includes 167 local governments, without local governments in Kosovo. For the purpose of conducting the analysis, exclusion of urban municipalities has not been done on the basis of whether the city charter permits or not the urban municipality to borrow on the financial market. Undoubtedly, urban municipalities of the City of Belgrade must be included in the analysis since, according to the Charter of the City of Belgrade, they are entitled to borrow with the approval of the Mayor.

Growth of operating revenues is the result of major change in the Serbian intergovernmental finance system. The most significant change was introduced with the adoption of the Law on Local Government Finance[14], which regulated provision of funds for local government units to exercise original and delegated powers. The Law prescribed that the local government unit is entitled to: original public revenues generated on its territory, shared public revenues (taxes and fees) pertaining to the republic and transfers from the Republic budget for financial equalization (non-functional and functional transfers).

During 2009, local budgets experienced reduction of operating revenues due to the recession and government transfer cuts. At the same time, permitted maximum level of debt was also decreased compared to the previous 2009. Mentioned decrease, calculated in dinars, is 13%, or 20% if calculated in Euros. Decrease in operating revenues increases the risk of debt repayment for debts contracted in previous years, with the higher level of operating revenues, as well as the risk that certain local authorities may be indebted above the legal limit.

In addition to the analysis of creditworthiness, it is also important to comprehend to which extent have local authorities used the ability to collect additional funds through borrowing. Following diagram shows the proceeds from borrowing by years. Proceeds from borrowing experienced the biggest growth in 2006, when they were 5.2 billion dinars (66.2 billion Euros) and in 2009, when they reached 8.6 billion dinars (96.9 billion Euros).

Diagram 3.2.2. Local Government Proceeds from Borrowing by Years

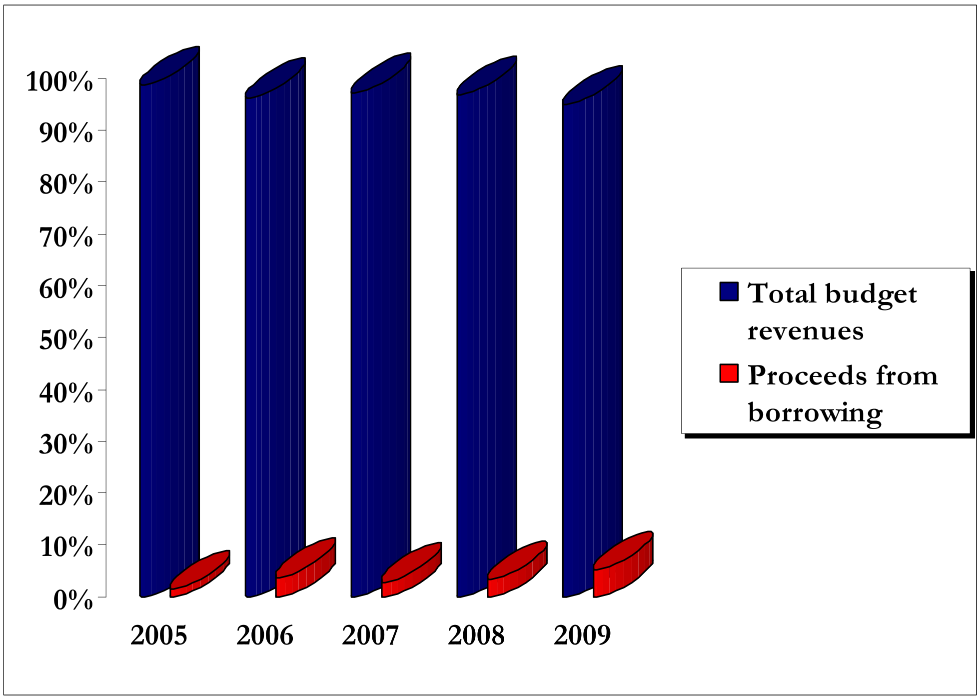


Source: Ministry of Finance, Public Finance Bulletin, December 2009

Diagram below shows the share of proceeds from borrowing in total revenues and proceeds of the local government budget. Proceeds from borrowing have increased total local government budgets by 1% to 5%, by years.

[14] "Official Gazette of RS" no. 62/2006

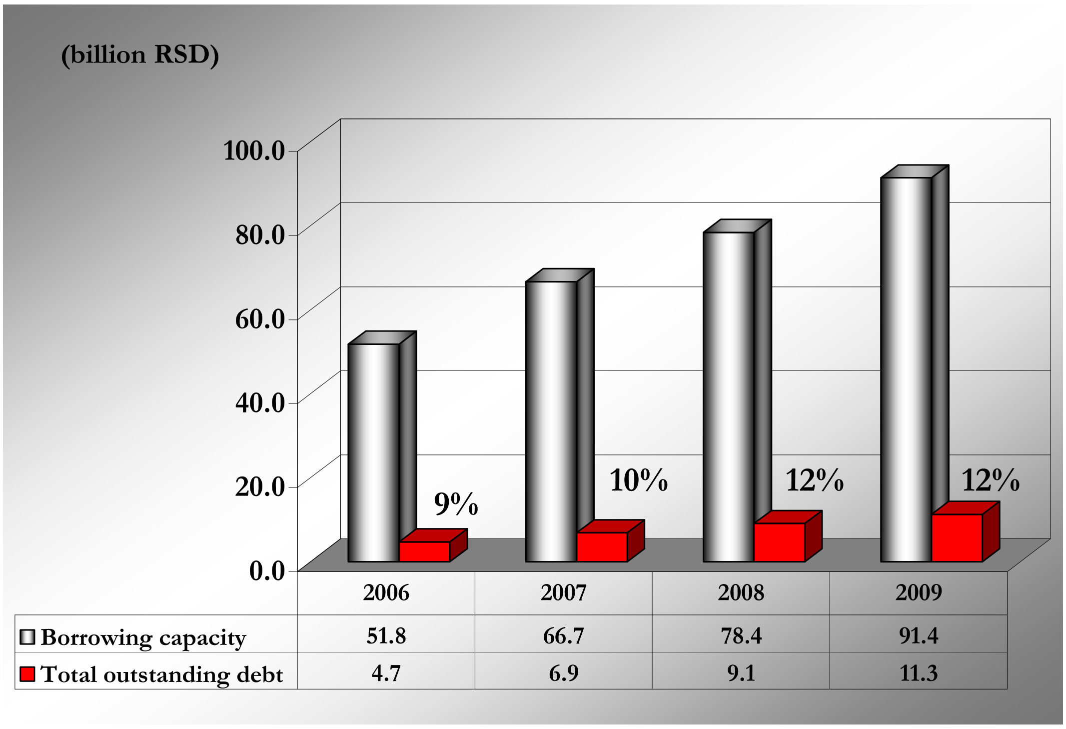
Diagram 3.2.3. Share of proceeds from borrowing in local government budgets



Source: Ministry of Finance, Public Finance Bulletin, December 2009

If we were to look at official statistics from the NBS and MoF, we could see to what extent local authorities used their municipal borrowing capacity on the domestic market. In the graph shown below, the maximum borrowing capacity was calculated based on current municipal revenues, which were published in the Ministry of Finance's Public Finance Bulletin. The graph also illustrates total local government outstanding debts as published in the NBS report.

Diagram 3.2.4. Share of domestic bank loans in municipal borrowing capacity



The graph shows that domestic bank claims from local governments since 2006 have been between 9% and 12% of the total permitted level of borrowing allowed under the law. This confirms the fact that there is significant room for domestic banks to increase their activities on the municipal debt market. If we were to include in this calculation loans approved by international financial institutions of about 20.2 billion dinars (22% of the borrowing limit), domestic banks would still have significant room to finance local investment projects.

3.3. Models of Borrowing on the Financial Market

Cities and municipalities borrow solely from financial institutions. Direct borrowing from the investor, through bond issuance, has not yet taken its roots in Serbia. Based on the reports cities and municipalities submitted to MoF in late 2009, total debt of local governments to creditors and trustees was 18.6 billion dinars (199.4 billion Euros) or 48% of total indebtedness, and the debt to international financial institutions was 20.2 billion dinars (216.2 billion Euros), i.e. 52% of total debt.

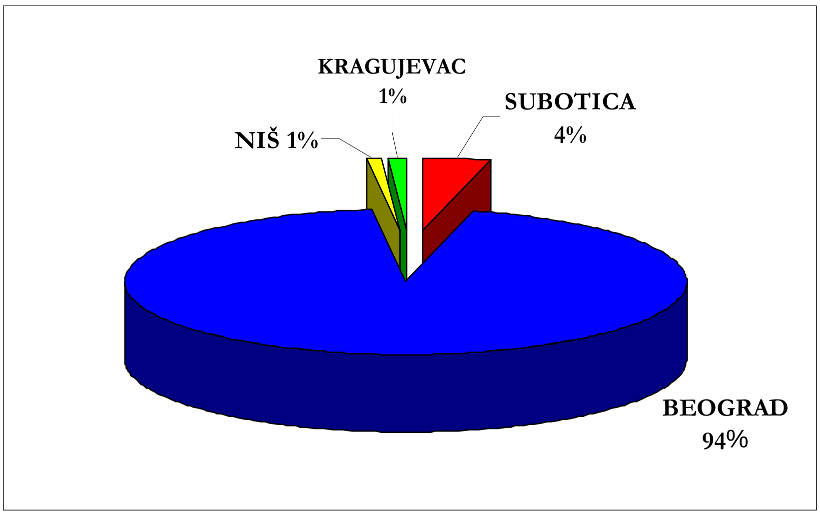
Table 3.3.1. Structure of Local Government Debt

Way of borrowing	Number of contracts	Outstanding debt (RSD)	Outstanding debt (EUR)	Debt structure
Loans from local commercial banks	149	9,564,707,464	102,360,380	51.3%
Borrowing from leasing companies	19	46,923,621	502,171	0.3%
Borrowing from suppliers	5	165,630,686	1,772,560	1.9%
Unreported debt per lenders		8,858,478,037	94,802,395	47.5%
Total domestic debt	**173**	**18,635,739,808**	**199,437,507**	**48.0%**
Foreign debt (EBRD & EIB)	**9**	**20,203,853,788**	**216,219,279**	**52.0%**
TOTAL DEBT	**182**	**38,839,593,596**	**415,656,786**	**100%**

Source: Ministry of Finance, Public Debt Administration, *Overview of Local Government Debt on December 31, 2009*

In total foreign debt of local governments, the City of Belgrade foreign debts take the biggest share of 94%, while remaining 6% are the debts of the cities of Niš, Kragujevac and Subotica.

Diagram 3.3.1. Structure of Local Government Foreign Debts



Source: MoF, Public Debt Administration, *Overview of Local Government Debt on December 31, 2009*

3.4. Lending Terms on the Domestic Financial Market

Lending terms for local governments on the domestic market between 2005 and 2010 have changed for various reasons:

- NBS monetary policy
- availability of long-term finances in the banking sector for municipal lending
- financing model and cost-efficiency of capital investment projects
- treatment of the local government credit risk
- interest of domestic banks to participate in public procurements of loans.

We will analyze lending terms for local authorities such as maturity, currency, type of collateral and interest rate.

Maturity for local government lending is greatly dependent on the currency. Foreign currency loans and loans with the currency clause were granted for maturity periods of 5 to 15 years from the very beginning of the domestic credit market development. Loans were often granted by the domestic banks that contracted their refinancing with the international financial institutions. An average maturity period of 8 years has been calculated from the sample made of 35 loans granted by the domestic banks.

Table 3.4.1. Overview of Loan Maturity Periods for the Selected Sample

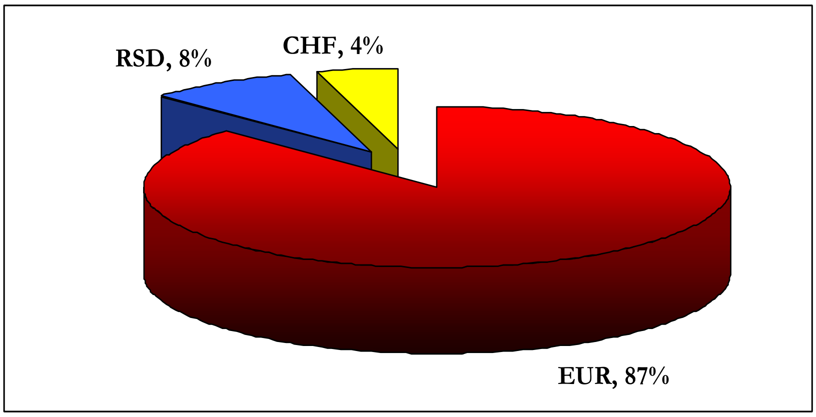
MATURITY	NUMBER OF LOANS	LOAN AMOUNT (EUR)
LOANS WITH CURRENCY CLAUSE		
less than 5 years	5	1,200,000
5 years	7	17,400,000
7 years	4	1,800,000
8 years	2	300,000
10 years	13	14,100,000
15 years	4	5,500,000
AVERAGE MATURITY IS 8 YEARS		
		(RSD)
LOANS IN DINARS		
1 year	2	10,000,000
3 years	6	90,500,000
4 years	2	81,810,000
5 years	6	213,130,000
7 years	1	12,720,000
10 years	2	88,000,000
AVERAGE MATURITY IS 4 YEARS		

Source: Standing Conference of Towns and Municipalities, Credit Market Research, April 2007.

Maturity periods for loans in dinars are shorter (due to the currency risk assumed by the banks) and they range from 2 to 10 years. Sample of 19 dinar loans was used to calculate the average maturity period for dinar loans, and it is 4 years.

Lending currency indicates high exposure of local authorities to the currency risk. Majority of loans, as many as 91%, were contracted with the currency clause. Only 9% of total loans in late 2009 was contracted in dinars. If we include the local government borrowing from international financial institutions (EBRD and EIB), exposure to currency risk is as high as 97%.

Diagram 3.4.1. Currency Structure of the Local Government Domestic Debt



Source: MoF, Public Debt Administration, *Overview of Local Government Debt on December 31, 2009*

Until 2010, banks refused to assume the currency risk for loans to local authorities. Since the funds for these loans were provided from abroad (from trans-border loans or by refinancing), domestic banks were offering mainly the loans with the currency clause. As late as during 2010, local government borrowing in dinars started to grow. Share of dinar loans increased during current year to 15%. Reason for that is the readiness of banks to assume the currency risk due to more competition in this market segment and more local government requests to borrow solely in dinars.

Debt security instruments of local authorities have changed and become relaxed with the municipal credit market development. Banks have initially granted loans collateralized with property used by the municipalities with the consent of the Republic Property Directorate to mortgage the subject property. As the banks were gaining trust and experience in work with local governments, they started granting unsecured loans. Banks started granting loans with no mortgage based on the local government credit risk assessment, which was the assessment of the fiscal capacity and debt repayment from the surplus of the operating budget. Loans were secured only by the general revenues of the local government budgets by means of authorizing the bank to debit the budget subaccount or by the local government promissory note.

NBS Report on the Bank Placement Risk

Total placements to public sector made **10%** of total bank placements in Serbia on March 31, 2010. Share of public sector loans in total default loans of banks was only **0.1%.** Since the placements to public sector include loans to the state and loans to local authorities, one can draw a conclusion that the local government credit risk in Serbia is low as in other market based economies.

Source: www.nbs.rs

Level of the interest rate, cities and municipalities were paying on the domestic market from 2005 until 2009, changed as a result of macro-economic trends, NBS monetary policy, market price of the capital and price of the bank funds. Level of the interest rate was also under the impact of the banks' readiness to assume the local government credit risk, as well as of the improvement of the municipal debt management skills.

Interest rate for dinar loans and loans with the currency clause was fluctuating between 2005 and 2009. It was based mainly on the reference market interest rate, which was increased by the rate margin, on the basis of municipal credit risk assessment done by the banks. Quarterly (3m) or semi-annual (6m) EURIBOR was used usually for loans with the currency clause in Euros, and quarterly (3m) or semi-annual (6m) LIBOR for loans in Swiss Francs. Quarterly (3m) or semi-annual (6m) BELIBOR was used for loans in dinars, which is formed on the Serbian financial market.

As of the second half of 2009, banks started to offer fixed interest rates for loans with the currency clause. That was the result of the growth of the number of banks offering loans to municipalities, as well as more rigid requirements of the local authorities in regard to credit prices in the public procurements of loans. Local authorities have contracted loans with fixed interest rate to protect themselves from the reference rate growth risk (Euribor), which is at it historic low.

Local governments were avoiding currency risk when borrowing in dinars, but they had no other option but to accept higher credit price the banks have formed on the basis of the high reference rate BELIBOR. Reason for that is the inverse yield curve of the Serbian financial market and lack of long-term sources of dinar funding in the banks.

Table below shows how the level of interest rate for loans with the currency clause in Euros have changed throughout years. Data should be taken with reserve as the cities and municipalities have not uniformly and reliably reported on the method they used to contract nominal and interest rates for their loans. Anyhow, one can get a view of the change of interest rate during the period of analysis.

Table 3.4.2. Interest Rates for Loans with Currency Clause in Euros

Year of approval	Average Interest Rate	Mandatory reserve rate of NBS
2005	**7.050%**	from 29% to 38%
2006	**6.601%**	from 38% to 40%
2007	**7.213%**	45%
2008	**7.829%**	45%
2009	**8.666%**	45%

Major changes of interest rates throughout years were primarily the result of the NBS monetary policy and the number of banks competing in the public procurements of loans. Main instrument of the monetary policy, which had a major impact on the price of municipal loans, was the level of mandatory reserve the banks had to set aside without interest (in the NBS) for foreign assets used to finance and refinance municipal loans. Mandatory reserve rate ranged from 29% to 45%. The highest level was reached between 2007 and 2010, and the result was a major growth of interest rates for municipal loans. In 2010, NBS eliminated mandatory reserve for credit lines of foreign governments and international financial organizations, and that led to drop of the credit prices for loans financed from these sources. However, drop of bank loan prices is still not sufficient due to present effects of economic crisis and insufficient credit price elasticity to decrease.

Table 3.4.3. Interest Rates for Loans in Dinars

Year of approval	Average Interest Rate
2007	**11.696%**
2008	**12.805%**
2009	**12.592%**

Change of the interest rate for loans in dinars is presented only for three years. Interest rates should be taken with reserve due to inexistence of complete data on the method of nominal rate contracting, as well as due to lack of information on possible revaluation of the dinar loan principle as a result of inflation.

4 Serbian Financial Market vs. the Region

Role of the financial system of a country is to provide undisturbed functioning and development of the national economy and overall prosperity of the society. Financial system performs this function by ensuring free circulation of monetary assets between the saving and investment units in the economy sector, public sector, household sector and international sector. Important participant on the financial market of a country is the public sector reflected through the central authorities, local government units, public enterprises and institutions.

European Charter of Local Self-Government envisaged possibility of local government borrowing on the financial market for the purpose of financing development. Management bodies of the local government unit decide on borrowing in accordance with the law. Central authorities set the limits on local government borrowing in order to avoid the risk of insolvency and provide undisturbed exercise of its powers. Limits must not be overly strict because they would reduce the flexibility and success of intergovernmental finance system. Exclusion of the capital market from the structure of the sources of financing would slow down the local community development.

As we have seen, local authorities in the Republic of Serbia do not use bonds to finance capital investment expenses for two reasons. The first reason is poorly developed legal and institutional framework for local government bond issuance. The second reason is a shallow and inefficient domestic financial market where the central and dominant position is held by the banking sector. Institutional investors (currently under development) have no opportunities to diversify their investment portfolio. Individual investors do not have opportunity to buy municipal bonds.

This part will provide a review of experiences of other countries in terms of local government debt market development.

4.1. Local Government Bonds in the Central and East Europe Countries

Countries of the Central and East Europe have accessed international capital market thorough local government bond issuance. Purpose of accessing the international market was to reduce the cost of bond issuance and to collect more capital. Local government units, which were not in position to access this market as their fiscal capacity was limited, have issued bonds on the domestic capital market. Level of local government bond market fluctuated from one country to another.

In **Czech Republic,** short supply of state bonds and rich offer of financial instruments by the institutional investors contributed to the development of the local government bond market. There were no statutory limitations for local government bond issuance on domestic and foreign capital markets, except for issuance permitting procedure purpose of which was harmonization of fiscal and monetary policies. Local government borrowing was under control of central authorities and support of the investors and bond issuance sponsor.

In **Poland and Hungary,** investor demand for securities led to development of the solvent market of state securities. The first bonds of local authorities were issued on the foreign capital market. They served as the reference securities for valuation of municipal bond issuances on the domestic market. Further development of local government bonds in Hungary was decelerated due to lengthy procedures of permitting and registering issuances, together with the domination of the private placement (banks kept bonds until the maturity date). In Poland, development of solvent market and local government bond trading has never happened. Reason for that was that major portion of bonds were issued through the private placements (without the issuance prospectus) and the banks were buying complete bond issuance to keep them in their portfolios until the maturity date.

4.2. Local Government Bond Issuance in the Republic of Croatia

Significant progress in the development of state and municipal bond market was recorded between 2004 and 2008. There were no new issuances of these securities in the last two years, which can be explained by negative tendencies on the capital market due to economic crisis.

Total of 19 public sector bonds are listed on the Zagreb Stock Exchange: 11 state and 8 local government bonds. All municipal bonds are issued through public placement on the basis of the bond issuance prospectus. All investors on the credit market were in position to purchase municipal bonds with no limitations, including citizens. Below we present an overview of local government bonds issued in Croatia.

Table 4.2.1. Local Government Bonds Issued in Croatia

Local government	Issuance date	Maturity (years)	Currency	Amount (EUR)	Coupon rate	Purpose
Domestic issuance						
Koprivnica	29.6.2004.	**7**	HRK	8,000,000	**6.5%**	Academic and athletic facilities and communal infrastructure
Zadar	1.9.2004.	**7**	EUR	18,500,000	**5.5%**	Building a sports center with swimming pool
Rijeka	18.7.2006.	**10**	EUR	24,600,000	**4.125%**	Building a sports center with swimming pool
Split	24.7.2006.	**7**	EUR	4,000,000	**4.5625%**	Cultural and athletic facilities and communal infrastructure
Vinkovci	23.10.2007.	**10**	HRK	5,600,000	**5.5%**	Cultural-business center with swimming pool
Osijek	30.10.2007.	**10**	HRK	3,333,333	**5.5%**	Revitalization of city square
Split	27.11.2007.	**8**	EUR	8,100,000	**4.75%**	More capital projects
Split	8.7.2008.	**7**	EUR	8,200,000	**6%**	More capital projects
International issuance						
Zagreb, holding	4.7.2007.	**10**	EUR	300,000,000	**5.5%**	PUC capital projects in Zagreb holding

Source: Zagreb Stock Exchange Report, March 2009, and the information on “Zagreb holding“ bond issuance

All bonds were issued as general obligations bonds, that is, secured by the budget revenues of local authorities. They were issued with the maturity period of 7 to 10 years. Funds collected through bond issuance were used to finance capital investment projects in the field of utility infrastructure, education, cultural and sports structures. Three bond issuances were in local currency, value of which in Euros was 3.3 to 8.0 million Euros. Five bond issuances were Euro denominated, and the value was between 4.0 and 24.6 million Euros. **Coupon interest**

rate of the bonds **in local currency** was between **5.5%** and **6%**, while the coupon interest rate of the bonds **in Euros** was between **4.125%** and **4.75%**. All coupon interest rates are fixed and they are not significantly higher than those of the state bonds[15].

One **foreign bond** was issued by "Zagreb holding", worth 300.00 million Euros, for the financing of the investment projects implemented by the city enterprises, founders of the holding. The bond was issued on the London Stock Exchange with the coupon interest rate of 5.5% and 10 years maturity period.

Table below shows the comparative overview of interest rates for local government bonds and average interest rates of the bank loans to legal entities in Croatia.

Table 4.2.2. Lending Terms in Croatia between 2004 and 2008

Way of borrowing	Interest rate
BORROWING IN LOCAL CURRENCY	
BANK LOANS TO LEGAL ENTITIES	**9.16%**
MUNICIPAL BONDS	from **5.5%** to **6.5%**
BORROWING IN FOREIGN CURRENCY	
BANK LOANS TO LEGAL ENTITIES	**7.15%**
MUNICIPAL BONDS	from **4.125%** to **5.5%**

Source: www.hnb.hr

One can conclude from the table that the coupon rates of the bonds are lower than the interest rates of the bank loans; hence, local government bond issuance was justified. In addition to better debt management capacity, local government direct borrowing from the investors, i.e. bond issuance, enabled debt repayment under lower interest rates comparing to bank loans.

Table 4.2.3. Bank Margins in Croatia (December 2008 - July 2009)

Interest rate	Local currency	Foreign currency
AWERAGE ACTIVE INTEREST RATES	11.41%	7.97%
AWERAGE PASSIVE INTEREST RATES	3.44%	4.00%
MARGIN	**7.97%**	**3.97%**

Source: www.hnb.hr

For the purpose of better understanding of the Croatian financial system, calculation of the bank margins has been prepared and it represents the difference between the average interest rate charged by the banks to the entities using the loan and the average interest rate banks pay to their clients deposits.

[15] Coupon rate of the state bonds is between 4.25% and 6.875% for Euro denominated and between 4.5% and 6.75% for local currency denominated.

Margin charged by the Croatian banks can not be compared to the margin charged by the Serbian banks because data on bank interest rates publicized by NBS are not classified by currencies.

4.3. Road to Local Government Bond Issue in the Republic of Serbia

From the experience of the countries in the region we can learn that local government financing through bond issuance depends on the political and legal environment, and the level of financial system development, on one hand, as well as on the financial management quality and creditworthiness of local government units, on the other.

Creation of the legal and institutional framework in Serbia started in 2000 through fiscal decentralization, regulation of the local government financing and borrowing, and development of the legislation and institutions of the financial system.

Financial system improvement process, initiated by the Ministry of Finance in 2008, needs to be continued. This process includes development of three important financial aspects: (1) financial markets and institutions, (2) initial public offerings serving to development of the capital market, and (3) development of the debt securities market in Serbia. Partial **amendment of the legal framework**[16] and **activation of key regulatory institutions** of financial markets[17] are expected within the continuation of this process and the goal is successful development of municipal bonds. It is also required to secure **political will** among those structures of the society that create legal and macro-economic environment to support:

- local authorities to improve their fiscal capacity through diversification of original local revenues and reduction of financial dependency from shared revenues and government transfers
- external audit of financial reports and local government financial data disclosure
- introduction of obligation for local authorities to issue debt securities on the basis of bond issuance prospectus
- regulation and price reduction for the approval and registration procedures for local government bonds.

All investors are present on the Serbian financial market, the same as on the markets of developed countries: banks, institutional investors, companies and natural entities – all entities having major saving and accumulation capacity that can be used for investments in local government bonds. Total balance sheet sum of the banking sector in mid 2010 was 2,343.1 billion dinars or 22.4 billion Euros. Total assets of the institutional investors (investment funds, insurance companies and pension funds) reached the value of 1.1 billion Euros and the citizens' saving deposits in banks exceeded 6.8 billion Euros. Institutional and private investors have no opportunity to invest their savings and assets in the long-term financial assets with the risk which would not be significantly higher than the one for bank deposits.

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[16] Passing of the Law on Public Debt and the Law on Securities

[17] Passing of the by-laws on the local government bond issuance and trade by the Securities and Exchange Commission, Central Securities Depot and Belgrade Stock Exchange.

Observing the local authorities as potential bond issuers, Serbia has seen significant progress of the management quality in cities and municipalities, including financial management and debt management. Another fact that speaks in favor of the previous statement is that in February 2010, USAID's Municipal Economic Growth Activity (MEGA) has organized a public competition of cities and municipalities in financial and creditworthiness analysis and presentation skills. In the competition, 16 cities and municipalities proved that they have realized the importance of transparent presentation of their financial capacity, results and plans before the potential investors, lenders and donors. They have displayed a readiness to use market models of capital investment model financing through the bond issuance and public-private partnerships for the purpose of improvement of public services and business environment.

16 partner cities of USAID/MEGA Program ready to access capital market in order to attract investments to be used for development financing: Novi Sad, Niš, Leskovac, Subotica, Zrenjanin, Kruševac, Pančevo, Šabac, Kraljevo, Čačak, Smederevo, Sombor, Valjevo, Sremska Mitrovica, Užice and Inđija

Commission comprised of independent investment and financial experts has selected 3 cities that stood out in terms of their financial results and capacities, management quality and the way they present their capacities to potential investors. Three cities were Novi Sad, Valjevo and Kraljevo. Their reward, which was financed by USAID, was the international credit rating assignment. Credit rating of the three cities was assigned and published by “Moody’s Investor Service” in June 2010.

Milan, June 24, 2010

Moody's Investors Service has today assigned a first-time issuer rating of Ba3 to the Serbian City of Novi Sad as well as B1 ratings to the Cities of Kraljevo and Valjevo. The ratings have a stable outlook.

"**The City of Novi Sad's** prudent budgetary management, which underpins its **Ba3 rating**, is evidenced by stable operating margins, particularly in 2009, when it managed to impose notable cost-cutting measures to mitigate a fall in operating revenue of 8%, driven by economic recession," says Katerina Hanzlova, Moody's lead analyst for Novi Sad and Valjevo. The rating also takes into account the lack of direct debt as well as the city's good cash reserves, which helped to cover the financial deficit it posted in 2009. The deficit was caused by a significant drop in the cyclically sensitive land development fee (a key source of capital revenue), which decreased the city's investment-financing capacity in 2009; this is unlikely to fully recover until 2011. "If investment plans are not scaled down accordingly, the city might be forced to finance them with debt. However, this is not anticipated, at least in 2010," adds Mrs. Hanzlova.

"**The City of Kraljevo's rating of B1** reflects its flexible capex implementation strategy, which has enabled it to maintain a balanced budgetary performance and to preserve its direct debt-free status over the past three years," says Miroslav Knazko, a Moody's Assistant Vice President and lead analyst for Kraljevo. "However, Moody's notes that the contraction in the local economy, together with severe cuts in central government transfers have weighed on the city's already volatile operating performance since 2009. Kraljevo will have to tighten expenditures in order to maintain a positive operating performance as key tax revenues are expected to remain constrained by a slow economic recovery," continues Mr.Knazko. Nevertheless, the rating agency does not expect any material changes in Kraljevo's budgetary performances, as the management's cautious capex implementation strategy, which relies heavily on the city's own-source revenue, remains in place and the involvement of debt is still in the early stages. Moreover, these borrowings are not expected to exceed 12% of the city's operating revenue in the foreseeable future, thus the potential debt burden appears to be manageable.

The City of Valjevo's rating of B1 reflects the city's responsible budget and debt management policies over the past four years, which have helped to maintain a balanced financial performance, contained debt levels and manageable debt service. However, the rating remains constrained by the city's dramatically declining, albeit still solid, operating margins, which are influenced by the city's limited revenue and expenditure flexibility. "If the city is able to implement cuts to its operating expenditure in 2010, GOB could stabilise around 20% of operating revenue in 2010, sustained largely by sound tax proceeds," says Mrs. Hanzlova. Moody's notes that it will become increasingly necessary for Valjevo to stabilise its operating margins in the future in order to ensure sufficient debt repayment capacity for its newly planned loan and to finance its investment requirements.

Prague

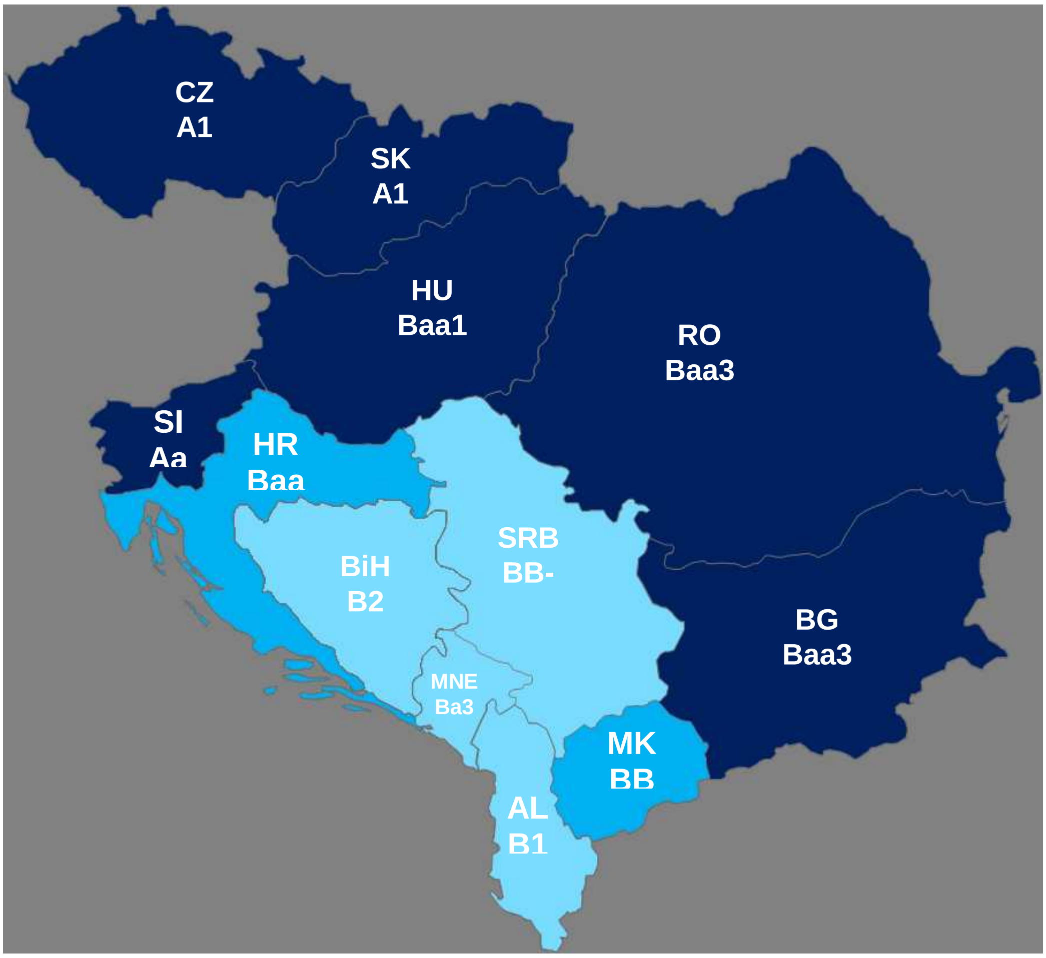
Miroslav Knazko

Asst Vice President - Analyst

Assignment and publishing of the credit ratings for the three selected cities is a message for the potential domestic and foreign investors about the risk of investments in the north, west and central parts of the Republic of Serbia.

Assignment of the credit ratings was the first appearance of Serbian local governments on the map of international investors as a new destination for their capital.

Figure 4.2.1. Republic of Serbia on the Map of International Investors



Credit ratings of the Republic of Serbia and other countries of the region are presented on the figure above. Below is presented the comparison of the credit ratings of surrounding countries and their local authorities assigned by the leading international rating agencies.

COUNTRY	RATING AGENCY & RATING		LOCAL AUTHORITY
	S & P	Moody's	
	AAA	Aaa	
	AA	Aa	
	A	A	
	BBB+	Baa1	
	BBB	Baa2	
CROATIA, BULGARIA	BBB-	Baa3	Zagreb
	BB+	Ba1	
MACEDONIA	BB	Ba2	
SERBIA	BB-	Ba3	Novi Sad
	B+	B1	Valjevo, Kraljevo, Strumica, Veles
	B	B2	
	B-	B3	
	CCC	Caa	
	CC	Ca	
	C	C	

The table shows that Serbian cities were assigned a credit rating of the Republic of Serbia – **B-** -confirmed by the Standard&Poor's in August 2010. City of Novi Sad was assigned Ba3 rating from Moody's, which is the same as the state credit rating. Cities of Valjevo and Kraljevo were assigned B1 due to lower capacity of local economy and lower fiscal capacity, which is immediately below the state credit rating.

Assignment of credit ratings for three Serbian cities was the prerequisite for them to prepare for the capital market and bond issuance. This would be a new asset on the capital market, an asset that is demanded by the financial institutions, institutional investors and the citizens of Serbia.

Benefits to be generated for local authorities in Serbia through bond issuance:

◊ bigger amounts of financial assets due to placement risk sharing between numerous investors

◊ possibility of long-term fixed rate borrowing

◊ public evaluation of the local government creditworthiness

◊ reduction of the local government borrowing cost

◊ more possibilities in regard to risk management of borrowing

◊ opportunities to attract foreign capital through bond issuance on international markets

Based on the results achieved at the local level we can conclude that conditions for examining the possibility of local government bond issuance on the domestic financial market have been created.