

# Sub-National Debt Management: What Have We Learned from the Global Financial Crisis?

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# Pressures on Local Debt Management

- Local Revenue Decline and Reduced Capacity to Service Debt
- Diminished Liquidity of Credit Suppliers
- Breakdown of Traditional Lending Structures

# Overview

- Jefferson County, US Municipal Market
- Dexia, European and Developing Country Market
- What Has Not Happened: Financial Contagion from the Subnational Sector ...Why?
- Lessons for Bank Policy
- Other Pressures from Global Financial Crisis

# Jefferson County, Alabama

- Potentially biggest subnational default in US history: \$3.2 billion in sewer system debt.
- County had fixed-rate 30 year bond. Financed (barely) from sewer fee.
- Insurer provided guarantee to upgrade to AAA.
- To reduce interest rate: County re-financed into LIBOR-based floating rate, then swapped into adjustable rate demand notes.
- For this, the Financial Advisor charged \$100 million.

# Jefferson County, II

- When insurer providing guarantee was downgraded, sewer system debt was downgraded. Interest rate on swaps rose to 10%. Gave holders the right to accelerate payment. \$636 million now past due.
- County commissioners voted 3-2 against filing for bankruptcy, but also will not raise sewer system charges to pay debt service.
- As a result, County's General Obligation debt was accelerated, \$255 million due in March.
- County owes \$608 million to unwind swaps.

# Traditional Lending Structure: US

- For infrastructure: 20-30 year municipal bonds
- Fixed interest rate (tax-exempt)
- Rated for underlying revenue stream (e.g, A)
- Enhanced by guarantee from specialized insurance company (becomes AAA)
- Until Dec 2007, some 55% of subnational bonds issues were enhanced by guarantee

# Breakdown of US System

- Each part of this system has failed to some degree.
- Monoline insurers ventured into other products: CMOs, CDS etc. With high default rates, insurers were downgraded to below underlying municipal credit. Municipal insurance has now all but disappeared.
- Credit Rating Agencies have been challenged. They failed ratings test on new products. 80% default rates on some AAA-rated CMOs.
- Meanwhile, large number of subnational issuers converted from fixed-rate to adjustable rate securities. Long-term debt, but interest rate is set weekly or monthly through re-sale. Increases rate risk. Increases liquidity risk.

# Europe: Dexia

- Dexia—Largest subnational lender in world.
- US subsidiary, FSA, entered market for guaranteeing securitized mortgages etc. Suffered high default rates.
- Dexia injects capital into FSA: \$500 million (Feb), \$5 billion credit line (June), \$300 million capital (Aug), more...
- Dexia's municipal bank subsidiaries in Austria, Slovak Rep. venture into FX mortgages, structured finance throughout E. Europe. High losses.
- Dexia at risk: France, Belgium step in with rescue package, invest 6.4 billion euro of public funds. Reverses much of Dexia's privatization. Public shareholding back to 75%.

# Breakdown of European System

- System has relied on municipal banks like Dexia, originally a public institution, Credit Local de France, as financial partners of municipalities. Typical structure: long-term, fixed-rate loans.
- But starting in 2005, Dexia and others rapidly converted to variable rate loans tied to exotic indices beyond borrowers' control or understanding.
- Offered long grace periods upfront. Similar to teaser mortgage loans.
- It is estimated that 20-25 billion euro of these “toxic” municipal loans were made.

# Examples of “Toxic” Loans

- Saint-Etienne—35 year loan, 13 years of grace (zero interest), thereafter catch-up surcharge tied to exchange rate between Swiss franc and Euro.
- Representative 30-year loan: at a time when fixed rate was 4.06% and Euro= \$1.30: Dexia offered loan at 3.18% as long as Euro was less than US\$1.44. If Euro moved higher, interest rate to be re-set. Under this formula, interest rate reached 10.87% in June 2008. If Euro should reach US\$2.00 at any time in 30 year period, interest rate would exceed 31%.
- Other loans tied to even more exotic indices. Lyon had loan tied to price of a barrel of oil, discussed loan tied to price of barrel of champagne.

# Impact on Developing Countries

- Dexia announced last month that it is withdrawing from all local lending activities in developing countries: Eastern Europe, Mexico, South America, Turkey, South Africa... Part of slowdown in cross-boundary capital flows.
- Role of Credit Rating Agencies. Ratings are built into the regulatory structure sanctioned by Basel II, determine risk-adjusted capital ratios for banking system. Does recent performance justify this? Is it appropriate to out-source regulatory risk assessment to agencies paid by issuer?

# What Has Not Happened

- Unlike 1998-99, subnational sector of developing world has not been a significant source of world financial stress.
- Why? Better Regulatory Rules
  - \* Limits on Local Borrowing
  - \* Limits or prohibitions on FX Borrowing
  - \* Better risk assessment by market and regulators

# Lessons for Future Risk Management and Regulation

- Lesson 1: Simplicity of Loan Structure. Sub-national lending should be low risk activity. Advantages of fixed-rate, long-term loans or variable-rate loans tied to meaningful indices with caps. The new instruments created huge risks and placed them with the entities least equipped to handle such risk, local governments.

# Lessons...

- Lesson Two: Advantages of a specialized municipal credit market. This should be a low risk/low return market, best served by institutions, or separately organized divisions of institutions, that specialize in dealing with local governments.
- This is the model that US & Europe are returning to—separating low-risk municipal insurance, low-risk municipal credit rating, specialized municipal banks or divisions of commercial banks.

# Lessons...

- Lesson Three: Importance of developing domestic credit market:
  - \* Not dependent on external capital
  - \* Not subject to FX risk
  - \* Competitive market, with both banks and bonds
  - \* Public intermediary for local governments not ready to access private market.  
Can blend public capital with market capital.

# Land Markets and Financial Crisis

- Extent of Infrastructure Finance from Land Sales and Charges:
  - Cairo (2007): \$3.12 billion land auction for new town infrastructure, 117 times total annual property tax in country
  - Mumbai (2007): \$1.2 billion land sales to finance regional transportation, trans-harbour bridge
  - Istanbul (2007): \$1.5 billion land auctions for infrastructure vs. \$97 million in borrowing (2005)
- Land market has been hit hard by financial crisis.
- Priority: to construct long-term infrastructure financing strategy that efficiently taps future growth in land values from urban development

# Implications of Using Subnational Governments for Stimulus

- Potential to transform domestic credit markets:
- China: announced that local governments will be authorized to issue 200 billion yuan of bonds in 2009. Opening of local bond market?
- India, Brazil: Pressure on state governments, cities for counter-cyclical debt finance. Will this undo the reduction in subnational debt, under Fiscal Responsibility Laws, that has been critical to macroeconomic stability and growth?