

Local governments and the financial markets

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Summary

- Problem definition, problem relevance
- Local governments' financial needs
- Financial markets' information needs
- LGs' financial reports: trends, usefulness
- A new relation between LGs and the financial market

Local governments asking for money

- LGs are continuously borrowing money, both short and long term
- Long term borrowing is the typical financial source for investments, so it is crucial for LGs
- Moreover, borrowing engenders political capital
- The markets offer a wide range of financing tools, so to better fit the borrower's needs and possibilities

Municipal bonds

- Municipal securities are structured in terms of maturity, denomination, interest (coupon) rate and other features to attract particular investor groups
- Debt offerings are timed to meet market opportunities, not just the local financing agenda

Some European Union 2009 data

- Subnational public sector expenditure: 2023,6 bn €, i.e. 33,8% of public expenditure
- Subnational public sector capital expenditure: 221,6 bn €, i.e. 64,9% of public expenditure
- Subnational public sector budget unbalance: 84 bn €, i.e. 0,7% of GDP
- Subnational public sector debt: 1368,2 bn €, i.e. 11,6% of GDP and 15,7% of public debt
- (Source : CEMR-Dexia)

Reaction to global financial crisis

- The global financial crisis increases the need of public intervention (both for bailouts and for typical public service production), so more borrowings may be needed
- On the other side, financial markets look with increased attention to the public sector, both for its size and for its relatively low risk rate (crisis did not origin in the public sector!)

But there is no free lunch!

- Capital markets insist that an increased transparency is needed and more accurate information has to be available, in order to allow them to make better decisions
- And this (reasonable) request is endorsed by many relevant institutions and agencies
- Thus, we could ask ourselves whether the public sector (in general) and LGs (more specifically) comply with this request

Accounting change

- The answer is positive
- Nearly everywhere the public sector is engaged in a great effort, aimed at improving its efficiency, effectiveness and economy
- And the accounting reform is a part of this effort
- This happens in OECD countries ; but not only (I personally could teach and consult in Peru and the West Bank)

But this is not enough

- So, accountability, information, disclosure are all musts: no entity can nowadays claim to be acceptably managed without them
- Nevertheless, I see some problems of correct targeting and emphasis
- So let's look to some hints of a different, although complementary, viewpoint

What causes investor action?

- Despite the general belief that financial reports should be the most critical piece of information to make a decision, there are findings that there is no mechanical relationship between financial information and investment action (Hellman, 1996)
- Nor can significant market reaction be observed to the release of governmental annual reports (Apostolou et al, 1992)

Investor action (cont.)

- decisions regarding equity trades are continuous processes ... where the main use of accounting information seems to be when there is already some idea of action that needs to be quantitatively evaluated
- The factors that seemed to affect the initiation of these decision processes were mainly macro-economic information, private information and different investor conditions (Hellman, 1996, referring to both private and public borrowing)

Rating

- This is confirmed by rating agencies' behaviour, which consider 4 main aspects:
- National political-administrative system
- Local political-administrative system
- Local and regional socio-economic structure
- The single government's current and expected financial flows and its level of indebtedness

The reasons behind this

- On one side, rating agencies are fully aware of the poor quality of some public sector financial reports, so they look for other information (but this does not mean that this quality has not to improved)
- On the other side, they also know that the real guarantees for a debt repayment stay in a country's macro-economic situation, in the quality of its administrative system (e.g. NYC 1975 decision to give priority to debt repayment), in its tradition of fiscal responsibility

Under this light ...

- ... the fact that many legislations are introducing accrual accounting for local governments may be a relevant element
- ... but does not change the whole picture
- LGs should concentrate on the accrual's implementation problems
- and try to get the best of its information potential
- without expecting it to ensure “per se” a sounder management
- And capital markets should not overestimate the usefulness of (accrual) financial reports

Some notes on accrual

- Despite IPSASB's big efforts, accrual reports continue not to offer a clear and comprehensive view of an entity's financial position. Some open issues are:
- assets evaluation
- (un)funded pension schemes
- future commitments not always clearly stated
- lack of risk recognition and disclosure
- reports poorly (if ever) audited
- cash budget (and reports) prevailing over accrual reports

Some notes on accrual (cont.)

- Moreover, financial reports do not normally offer a clear picture of the macro-economic and demographic trends
- Consequently one should be very cautious in making decisions based on current accrual reports
- We shall remember that financial reports are based on past events, while perfectly informed decisions would need to be based on the knowledge of future events

Some notes on accrual (final)

- Thus, accrual accounting is a tool, it may help, but:
- it does not give all the information the markets are in search of
- nor does it exclude the possibility that LGs be managed irresponsibly
- so, in the end, it does not automatically ensures against repayment risks

Suggestions for better B-G relations

- Notwithstanding the crucial role of the accounting reform (as the current CIGAR Chair I would never do!) , I believe that a different perspective may be helpful both for financial institutions and LGs
- So, let us see what financial institutions and LGs could do

Financial institutions

- The financial institutions could try to change their (real? perceived?) attitude, and act more credibly as financial partners
- This has not always happened (e.g.: the use of derivatives, and the consequent losses, litigations, court cases)
- But financial institutions have the knowledge to move along that line

Expected benefits

- LGs are helped to borrow money only when needed
- They are offered advice on the best fitting solution for their financial needs
- Financial institutions' short term profits may decline, but this behaviour would contribute to have healthier LGs
- And these would have the chance to raise new capital for new investments (i.e.: more business opportunities for lenders)

Local governments

- LGs, on their side, have also to change their attitude towards the markets
- Having said that financial reports are not the only instrument for the markets to decide, LGs have nevertheless to invest on their information accuracy, timeliness, reliability, transparency
- At the same time, they need to invest on the quality of their financial management
- Surely this also one aim of CIPFA in this conference

Any examples?

- What I said is mainly a proposal, I do not have many examples
- One of them is a network, established in Italy in the Emilia-Romagna region, between a dozen of municipalities and provinces, which decided to coordinate their requests to the capital markets
- This made this network interesting for the capital market: while the size of borrowing is growing, it is also clear that LGs are becoming a qualified and knowledgeable partner

Conclusions- some gaps must be filled

- A cultural gap: long term partnerships instead of short term business opportunities
- A (double) knowledge gap:
- LGs must be aware of financial institutions' needs
- these must invest more to fully understand the peculiar aspects of public sector management & accounting, which, like it or not, are both different from business ones

Some TO DOs for academics, governments, practitioners

- Public management & public sector accounting crucial topics in business schools
- Public management orientation relevant in auditing firms, consultancy firms, financial institutions: the public sector deserves to be treated appropriately
- Governments and oversight bodies need to better know the market's needs, rules, aims