

UNITED NATIONS
ECONOMIC
AND
SOCIAL COUNCIL



49639
Distr.: LIMITED
E/CN.14/UAP/51(o)

7 September 1966
Original: ENGLISH



ECONOMIC COMMISSION FOR AFRICA
Seminar on Local Government Finance
Addis Ababa, 5 - 17 September, 1966

CREDIT FACILITIES FOR LOCAL AUTHORITIES
IN INDUSTRIALISED COUNTRIES - A SURVEY

by

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M66-1283

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Introduction and some general aspects

When approaching to the subject "Credit Facilities for Local Authorities" it is essential to see and to know that there are some basic aspects and general principles, which do in fact apply to industrialised countries as well as to emerging countries:

Above all, for any borrowing operations in favour of local authorities there must be in existence a well working and well organised banking system which is able to meet the various borrowing and other financial requirements of local authorities. This important precondition cannot be waived or omitted because in the absence of adequate banking facilities there will hardly be adequate or sufficient credit facilities. At this stage of our considerations, it does not matter yet in which way such a banking system should be organised or be established, (e.g. for instance on a decentralised or on a centralised basis). Those problems should be dealt with at a later stage.

1. Banking and credit

There is an important and inseparable connection between the following facts: in its ultimate origin or source all banking institutions, (e.g. more or less all banks) do in fact depend to a most vital degree on the "credit" (which means confidence or trust) in a bank's standing and in its good reputation. Nobody throughout the world would ever entrust his money or his savings to a bank if he is to fear that the bank might become insolvent and thus should fail to meet its obligations, which means the impossibility of repaying deposits received. Therefore in the absence of such "credit" in depositor's or in the public opinion, nobody will be prepared to put any funds in a bank. In consequence, a bank will not be able to effect any borrowing operations, for instance in favour of local authorities.

2. Safety for depositors

In order to create such confidence or credit in their standing, and thus to obtain the funds required for borrowing operations, banks have to offer appropriate protection for their depositors' funds. This indispensable protection or safety for depositors' funds may be obtained for instance by means of:

- (a) a guarantee granted by a local or central authority which guarantee is to cover all of the bank's liabilities including the balances of depositors;
- (b) certain limitations as to the bank's loan transactions which limitations are to be imposed on the bank by means of its statutes, regulations and bye-laws;
- (c) a sound business policy on the part of the bank;
- (d) the building-up of adequate reserves for meeting any possible losses or contingencies on the part of the bank. These reserves are to be allocated out of the bank's earnings or profit;
- (e) the provisions of the national banking law;
- (f) the customary supervisions and controls exercised by the National Bank and other bodies;
- (g) the examinations exercised by independent auditors;
- (h) other measures.

Provided that these preconditions and conditions as outlined before are given or being met (e.g. a well working banking organisation which enjoys a doubtless reputation in public opinion and sufficient protection in favour of depositors' funds) then there can and will be sufficient borrowing facilities in favour of local authorities.

This is what tradition, science and experience in an industrialised country as Germany show and these are some principles which to my personal opinion do apply to a very great extent also to the financial problems in emerging countries and especially to local authorities borrowing requirements.

3. Local authorities and financial institutions -- the German Savings Banks model

In order to meet their financial and borrowing requirements and to fulfill their various tasks, local authorities need the assistance and services of a banking system or organisation. Thanks to the outstanding considerations of Dr. Werner Schmidt, I am able to confine my contribution to this point to a few remarks. As you certainly have noted from Dr. Schmidt's statements, in Germany there exists the Savings Bank Organisation which in this connection may be described as the "classical bankers to local authorities". Classical means that:

- (a) their experience in more than 150 years of German banking history;
- (b) their good co-operation with local authorities for many years and generations;
- (c) their excellent organisation of 863 savings banks with more than 13.000 branch offices and a staff of about 100.000 people throughout Western Germany;
- (d) their powerful financial resources which comprise for instance of about Deutsche Marks 70.000.000.000,— alone in savings deposits entrusted to them to which may be added many further milliards of own funds and reserves;
- (e) their co-operation with the "Girozentralen" which act as bankers to the savings banks resulting in a further strengthening of this Organisation. The 14 Girozentralen dispose of assets of about Deutsche Marks 60.000.000.000,— and have themselves some thousands of employees;

made this banking organisation the ideal bankers and financiers serving the financial requirements of local authorities in manifold ways. To my personal opinion, there are absolutely no reasons to be seen why this Organisations' tradition and experience should not be mobilized for and adapted to the requirements of emerging countries, provided that there is a desire or interest on part of these countries. Furthermore, I am fully convinced, that such an adapted organisation can play an important role in the progress, growth and wealth of for instance African countries. To fully understand and to share this opinion, one must bear in mind that Savings Banks in Germany started working when per capita incomes have been extremely low, capital formation insufficient and the bulk of Germany's National Product was mainly derived from agriculture and only to a small degree from industrial production.

Thus, there were many parallels to an emerging country. Perhaps the most important point is that such a banking organisation may be used as an "instrument of self Aid" by means of which the monetary and credit reserves and resources of an emerging economy may be mobilized to the best possible extent. It is further important to see that such "Self Aid" or "Development from within" which depends on own initiative does in any event avoid the taking up of external loans in foreign countries. This means that there will be a true improvement in a country's international balance of payment because no payment in foreign currency must be effected and no loss of urgently needed foreign exchange such as for instance Pound Sterling or US Dollars, etc. is incurred.

4. Local Budgeting and Local Credit facilities

It is obvious that there are very close relations between the local budgeting and borrowing process. May I here again draw your attention to Dr. Werner Schmidt's excellent survey as to this subject which permits me once more to confine myself to a few remarks and for

which method of procedure I am grateful indeed, because this enables me to deal more intensively with specific borrowing problems.

We may, therefore, take it for granted that in accordance with the German model of an industrialised country's local borrowing procedures, all borrowings of a local authority must have been sanctioned or approved in the local authority's budget, e.g. approved in the budget prior to the actual taking-up of a loan. In other words, the local budget empowers a local authority to enter into and finally to conclude loan negotiations in accordance with the local authority's financial requirements. This method implies the necessary and desirable flexibility which local authorities require in order to fulfill their tasks and in order to determine the best possible time and extent of their indebtedness. The budget contains, of course, a detailed plan as to the redemption or repayment of loans taken up. Furthermore, the budget and thus the extent of borrowing transactions has to be sanctioned by a supervision authority the decisions of which authority being of a binding effect on the local authority's borrowing plans.

As a special case may be, the supervision authority may well decline such borrowing plans and may therefore restrict the extent of local credit facilities. However, as experience shows, this happens only in very rare cases. It might be of interest to know that on the other hand a lending Savings Bank or a Girozentrale (a Girozentrale as we know is the banker to the savings bank) may have any objections to a local authorities borrowing plans. The reason for such objections might be that in the lending bank's opinion the borrowing local authority's extent of indebtedness has already reached too high a volume. In this case, the lending bank may and will contact the supervision authority and request them for a comment on the local authority's indebtedness or its debt repaying capacity. At this stage the supervision authority will, for instance, inform the inquiring bank that the supervision authority are fully aware of the local authority's

high indebtedness and expressedly stating that the project which is to be financed by means of borrowing is of such great importance or urgency that a temporary high indebtedness of a local authority is indispensable. After such a confirmation from the supervision authority and after other steps a lending savings bank has fulfilled its legal obligation of examining the credit-worthiness of the borrowing local authority and the loan applied for may be granted.

By the way, the supervision authority may in this special case assist the borrowing local authority by granting special aid for instance by means of the allocation of a special grant, an equalisation payment or other special financial assistance. To sum up: as set forth before, by means of an excellent co-operation between borrowing local authority, lending savings bank and the supervision authority the problems of budgeting, borrowing and control of local authority's indebtedness can be solved and have been solved in Germany already for many years and generations. Personally, I could well imagine that this procedure as outlined in its broad principles and methods, could be adapted to the requirements of local authorities in emerging countries. I have, however, to stress, that such an undertaking should be carefully studied and prepared before starting, because economic conditions, experience and financial requirements will in fact differ from country to country to an often very remarkable extent.

5. Sources of credit facilities for local authorities

When examining the financial possibilities, (e.g. when to answer the question from which sources funds may be borrowed) it is that in principle and fairly broadly speaking there are in the main two borrowing possibilities:

- (a) Firstly, as borrowing requirements of local authorities are fairly different as to their volume or their timing, and as there are some authorities working with at least temporary surpluses of funds whilst other authorities are

in a temporary deficit situation requiring temporary borrowing, a solution to the various requirements could perhaps be seen in an "inter-authority-pooling and subsequent lending policy" out of own funds. This method of "financing each other" may perhaps turn out as a workable system in theory. Practical experience over many years, however, has shown the highly limited practical value of such a policy or system. For instance, just one unforeseen or sudden additional financial requirement or the delay in an expected repayment may turn the whole system into a great muddle. Although such a system may perhaps work on a tiny scale with low sums involved, it is nevertheless no workable financial instrument.

(b) Secondly, as experience teaches, the far better working system or instrument for obtaining funds for reinvestment in local authorities requirements is that by means of which the financial sources and resources of a banking e.g. savings banking organisation will be mobilized. This system will imply the following important advantages:

(b a) For example, all of the various local authorities' funds and balances may be deposited with and pooled into such a banking organisation. Practically spoken, for instance, Provident Funds, Gratuity Reserves or Pension Funds are thus pooled into one agency on which local authorities can draw for their borrowing requirements. This method will already in itself result in a quite considerable strength and lending power of such an agency or bank.

- (bb) Furthermore, to a remarkable extent the lending power may be enlarged by attracting deposits or funds, for instance, from private individuals, or from private enterprises, or from other public institutions and after all from public enterprises run by local authorities. This will naturally result in a further increased lending or capital power.
- (bc) This remarkable financial strength will in the course of time be expanded by such an organisation's growing own funds, own reserves and own means. The latter - as seen from a banker's point of view - provided of course that no substantial losses will incur and that at least a moderate profit is achieved after expenses, salaries taxes and the like have been met.
- (c) Finally, a further source of borrowing facilities may be opened by means of money market or capital market transactions. Time permitting, we shall revert to this subject at a later stage as this point deserves fairly normally through experience, specially trained staff and a substantial financial backing, to my personal mind and experience such transactions should deliberately be exercised exclusively by financial or banking organisations for instance such as savings banks and should not directly be exercised by any local authorities. Furthermore, if exercised by financial institutions, local authorities can avoid certain risks and responsibilities involved in such transactions, which risks certainly are not part of their tasks or functions.

6. Deeds of indebtedness

For our purposes it will be sufficient to summarize these problems as far as possible, because they are of mainly technical interest and they furthermore depend on the type of borrowings made available for local authorities.

- (a) The customary deed or instrument of indebtedness is a written loan contract, signed by the lender and by the borrower containing the essential elements of a loan granted, e.g. principal or loan amount, rate of interest, method and time of repayment, receipt that the amount was paid to the borrower, the promise to pay interest and repayment instalments on the loan granted and other such details. Normally, the lending institution does not insist upon a specific security (which means cover or collateral), provided of course, that the loan taken is contained in the local authority's budget and had been approved by the supervision authority. We have, as you certainly remember, dealt with this point at an earlier stage. It is common financial custom among lending savings banks in Germany that the "taxation power" or the property of a local authority is regarded as a sufficient cover, which means in practice, that no special security must be furnished or prepared by the borrowing local authority.
- (b) Bills of Exchange as instruments or deeds for financing local authorities are used in Germany to a very rare extent. The reason for this may be seen in the fact that bills represent a special legal security or cover which is dispensable when financing local authorities. However, the use of this sometimes valuable instrument cannot be waived or excluded in any event, because this depends on a country's or district's financial customs or background.

I can well imagine that for instance such bills of exchange might be of great interest in the case of a lending bank in an emerging country. For such bills may eventually be rediscounted with the nation's central bank or State bank thus enabling a lending bank to refinance a certain part its own borrowing activities in case of need or if liquidity requirements should demand such a refinancing procedure.

- (c) The final instrument of indebtedness, municipal bonds, may be dealt with very quickly, because in Germany the issuing of such bonds is normally entrusted to financial institutions and not to local authorities.

7. Periods of loans granted

The period of a loan granted depends in general on the purpose for which funds are required or taken up. The customary schedule consists of three types of periods:

- (a) short-term loans which usually cover a period of up to one year. Such loans are mainly granted in order to bridge a gap between a local authority's current revenue and its current expenditure. Such loans, for example, are taken in order to conduct a local authority's normal business and tasks in an properly and orderly way. Given that revenue from taxation will be due on the fifteenth day of a certain month, the salaries etc. to be paid however will be due on the first day of a month, then there exists the indispensable necessity of bridging this gap by means of short-term borrowing. It is a good and well established custom that German Local Authorities' budgets do regularly contain the precautionary approval or sanctioning of such short-term borrowing operations, e.g. as a precautionary measure which means that in case of need no lengthy or

difficult negotiations for short-term borrowings are involved. On the contrary, such loan requirements can be met within a few days, sometimes even within a few hours.

(b) medium-term loans cover a period from one year up to about ten years, whereas

(c) long-term borrowings cover all loan transactions exceeding a period of ten years.

8. A general principle of local authorities borrowing policy

Generally speaking, the period of a non-short-term loan should not exceed the corresponding period during which the project financed by a loan may be properly used by a local authority or a community. For instance, in the case of a road which may be expected to be renewed, say, within five years, the term of the corresponding loan should not exceed five years. In the case of a school building which may reasonably be expected to stand some 15 or perhaps 20 years, the term of the corresponding loan may and should be extended accordingly.

Among lending German banks there exists a borrowing principle which in this connection may be described as the "Golden Rule of Financing Local Authorities".

According to this principle long-term projects should be financed by means of long-term borrowings and in no event by means of medium-term or even - which is of course the worst of all - by means of short-term borrowings. A brief look on the history and experience exercised in 1931 shows, that many a local authority in Germany entered into more or less severe difficulties when at that time disregarding this general and important principle.

9. Methods of repayments

The method by which a loan granted is to be repaid or redeemed depends in many cases on the period for while the loan has been granted.

- (a) short-term borrowings are mainly granted on an overdraft basis or at a fixed repayment date. In this case, as revenue flows or as repayment dates are agreed upon, the redemption will be effected and the loan thus extinguished. As there are no specific problems, this point needs no further consideration.
- (b) medium-term and long-term borrowings running up to or exceeding a ten years' period need special agreement or provisions regarding redemption methods and periods.
- (ba) Compulsary repayments are those, where fixed dates and fixed amounts of repayments have expressly been agreed upon between borrower and lender. It is obvious, that these agreements must properly be fulfilled at maturity.
- (bb) Voluntary repayments may be agreed upon additionally to compulsory payments in order to provide for additional redemption facilities in the interest of the borrower.
- (bc) Block repayments mean that the total of a loan granted is to be repaid in one single amount at maturity. This method of repayment looks very easy to be handled. However, it is being used very rarely and should be avoided whenever possible, because lending institutions do normally insist upon a gradual redemption of loans, which is effected by means of
- (bd) the annuity method of repayments. Here, the amount borrowed for, say ten years totalling for DM 1.000.000,--- will be divided into 10 equal instalments of DM 100.000,--- each and are to be repaid annually. This method offers good advantages for the borrower as well as for the lender and is, therefore, in common

use in Germany. Personally, I would recommend this method as a good scheme how repayments should be arranged.

If desired, we can go through the methods of repayments perhaps more thoroughly during the discussions.

10. Taxation versus borrowing?

There is an old and even in our time now and then renewing dispute among some people concerning the question whether local authorities' projects or undertakings should be financed by means of taxation or by means of borrowing.

The one party maintains that taxation may put the financial burden on the shoulders of the living generation which they regard as just or justified because in their opinion the living generation will be the beneficiaries of such a project and therefore one should make them pay for this benefit.

The other party maintains that the future generation would participate to an unjustified extent if the expenditure for a certain project is being met by the living generation. Therefore, the second party regards borrowing - e.g. long-term borrowing - as a specific and welcome measure to shift some of the present generation's financial burdens to the shoulder of future generations, which procedure they regard as justified and adequate. Personally, I feel that this way problems are being dealt with, seem to be purely academic and which apparently is not suited to produce a workable answer to the problem in question. As experience shows, local authorities may and should avail themselves of both methods of financing, always depending on the nature or volume of a certain project.

Therefore, to my mind the question cannot be taxation only versus "borrowing only" but a solid and sound combination of either methods. However, it should not be overlooked that borrowing - and in

our case this means long-term borrowing - may in fact shift some of the financial burdens into the future. This is, however, not a question of moral or justice but a question of economy and calculation. Borrowing transactions are always to be paid for by means of interest. It is, therefore the question, what in the interest of a whole community is going to be reasonably and economic. A general and all-time answer can therefore, neither be given nor be expected.

11. Final remarks and summary

The German answer to the question how local authorities can be financed in an industrialised economy is: "Savings Bank Organisation". This powerful banking organisation with its outstanding history and tradition, its long experience and considerable financial strength is pleased to share its experience with those nations interested in participating in our efforts and achievements if there is such a desire. Nobody is compelled or urged to accept this system or its ideas which in the main are:

- (a) Self administration for local authorities regarding the fulfilment of their local tasks combined with own and full responsibilities in all financial affairs on local level;
- (b) assistance and help for the socially weak part of our population by means of "self aid" or "development from within" depending on own initiative and mobilizing our funds and means for the benefit of the whole community by promoting the idea of saving.

This organisation has played an important role during the centuries of our country's development from small beginnings and therefore its experiences might be used to the benefit of those countries which might be interested in doing so.