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## Local financing through capital markets

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### **Abstract**

*In this paper are presented results of research conducted to identify sources of financing alternatives for local community. The study includes an analysis of the present situation on the financing of investments by local municipal bonds. The paper ends with the presentation of the benefits of municipal bonds and proposals on the development of this market.*

**Keywords:** *municipal bonds, local financing, bond interest rates*

**JEL:** G10, G12

### **1. HISTORICAL AND THEORETICAL CONSIDERATIONS**

In 2007, turns 101 years from the first issue of municipal bonds in Romania. The issue was conducted by the city of Craiova, in 1906, for water supply, amounting to 5,149,000 lei (in gold) was offered to local and foreign investors with an interest rate of 5% per year.

Recent history of the exchange recorded 6 years from the first issue of municipal bonds after the reestablishment of the Bucharest Stock Exchange (in 2001 city of Mangalia and town of Predeal have launched the first issues of municipal bonds).

The emergence of private pension funds and issue of bonds with terms of maturity over 10 years may lead to an increased dynamic market of debt securities at the Bucharest Stock Exchange. In comparison with other countries in the region, Romania has made a delay in starting the issuance of municipal bonds. In the U.S., most of the 40,000 villages launched issues bonds for the network of utilities, schools, universities and even highways.

At the Bucharest Stock Exchange, the municipalities have actively contributed to the development of capital market in recent years, the issue of bonds performed for the purpose of funding projects at the local administration. Also to be noted that this type of bonds are almost the only types of debt incurred in the trading of Romania, because the state has not issued securities through the stock exchange and corporate bonds are very few.

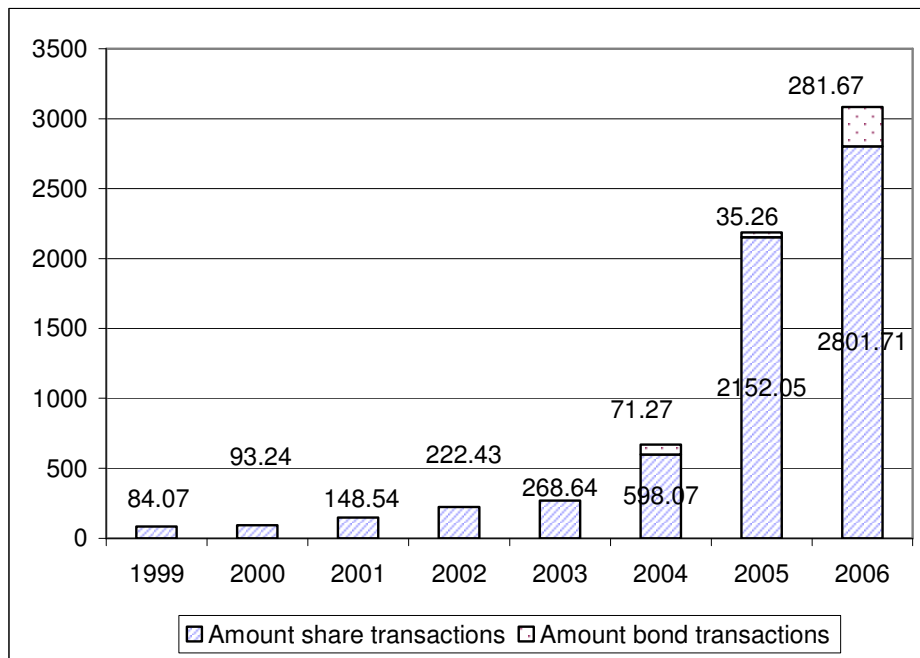
By the year 2004 can not talk about a market bonds by stock exchange, because the amounts traded were insignificant. The year 2006 was a very good year for corporate bonds segment. These favorable results contributed categorically International Bank for Reconstruction and Development (IBRD), by launching a public issue of bonds, in September 2006, worth 525 million lei. Operation is of the greater, as it is the first issue of international financial institutions through the capital market in Romania and more, is the first of such scale. Because the credibility of the issuer, the operation was a success and was listed in October with the AAA rate. The success is by far greater number of bonds underwritten, 635,948 bonds, 21% more than the 525,000 allocated.

Among issues of local bonds are carried out by the Romanian Commercial Bank, important by the total value of 200 million lei and overwritten by about 21.5%.

The number of issues of bonds was increased by those made by banks ProCredit Bank and Commercial Bank Carpathian, worth 35 million lei, or 40 million U.S. dollars.

The amount and number of these issues puts 2006 on first place in the trading of bonds, since the establishment of stock exchange so far. The total value of transactions in bonds, to 281.67 million, was close to the threshold of 10% of the value of transactions made with shares (Figure 1).

**Figure 1 Evolution of share vs. bonds transactions in BSE, in the period 1999-2006**



Source: *CNVM Report, year 2006*

At the end of 2006 by the BSE is dealt seven issues of corporate bonds versus six in 2005, issues: BIRD (IBRD09) in the category of international securities, BRD (BRD07A) in category II of bonds, the Bank Carpathian (BCC09 ) in category III of the bonds and those of BCR Leasing (BCL07), Finansbank (FBR07A), Hexol Lubricants (HXL07) and Raiffeisen Bank (RZB07A) per share unlisted segment. Those from 2006 are added International Leasing bonds issued in 2005 and listed in category II of bonds in December 2006.

## 2. ANALYSIS OF BONDS MUNICIPAL MARKET IN ROMANIA

Municipal bonds are bonds issued by local authorities to finance capital investment in the form of schools, bridges, sewers, airports, transport underground.

Acquisition of these securities is made, usually by investment banks, which sell again to commercial banks, insurance companies and individual investors with very high incomes. Such securities market is insignificant, due to limited number of participants.

The credits obtained through the issuance of municipal bonds are part of local public debt. Depending on the source of payment of debt, are four types of bonds:

1. *general taxes* – are the source of most used until now in Romania, but as the local development programs will be used and diversify forms of financing described below;
2. *special taxes* – to cover some funds intended targets local contracts loans to be repaid on a particular tax. Examples: taxes on tourism - to develop the ski runs, charging the use of public places such as parks for certain events, and from the collected money are building places to play;
3. *profits from the provision of services* – electricity, sewerage, water, transport, health - amounts advanced by the local loan and then paid from the profits earned by these companies;
4. *special revenue* – such as the rents collected from the following development supported by local authorities through the construction of industrial, commercial or housing.

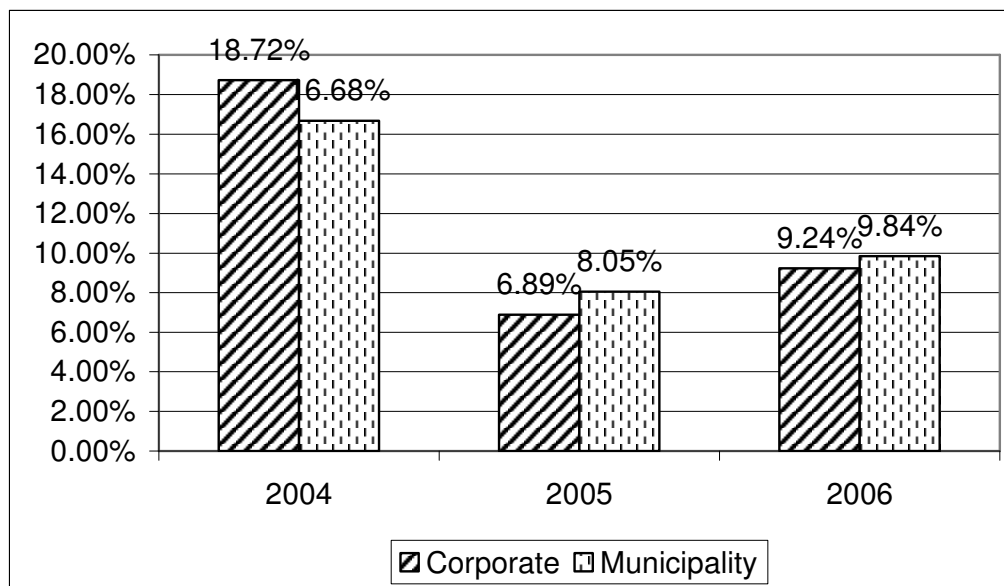
Of all the tools available credit on the capital market in Romania municipal bond market is most active.

However, the existence of issuance of municipal bonds has not provided a market liquidity, due to two factors: the value of reduced schedules and deadlines reduced due behavior led investors to retain securities to maturity.

In Romania investors get a higher yield of investments in municipal bonds, compared with the monetary investments, with the highest yield can be obtained from financial instruments with fixed income.

The issuance of municipal bonds traded on the BSE at the end of 2006 was 11 (compared with 15 in 2005). The average interest rate corporate bonds in lei, was at the end of 2006 to 9.24%, up versus 6.89% at the end of 2005. The average interest rate municipal bonds were at the end of 2006 of the 9.84% growth compared to the 8.05% in 2005 (Figure 2). It may notice an unusual situation to the capital markets developed by higher interest granted to municipal bonds to those corporate, although a lower risk than the latter.

**Figure 2 Average interest rates on corporate and municipal bonds, in the period 2004-2006**



Source: [www.intercapital.ro](http://www.intercapital.ro) (amount December)

In the month of March 2007, the amount transacted bonds rose from 16.2 million lei, the amount recorded in March 2006, to 112.3 million lei. Thus, the share value of transactions in bonds in the total value of securities traded on the market rose by 0.5 percentage points to 3.2%.

Main technical data on the issue municipal bonds are:

- Deadlines due: 1-2 years, 5-6 years, just one issue with 20 years deadline.

- Interest:

\* variable, calculated using the formula:

$$(BUBID\ 3M+BUBOR\ 3M)/2 + \text{risk premium};$$

\* fixed interest rate on Euro;

\* deadlines for payment of interest, in order of preference of investors: quarterly, half-yearly and annual basis. (eg upgrading roads Lugoj, in October 2006: quarterly payment,  $(BUBID\ 3M+BUBOR\ 3M)/2 + 0,95\% = 9,68\%$  per year)

In the year 2006 were approved a number of nine bids for the sale of municipal bonds (Table 1) and there is a tendency to increase the maturities.

**Table 1 Offers for the sale of bonds in 2006**

Nr. crt.	Issuer	Bonds issued	Price (lei)	Bonds subscribed	Value (Thousands lei)	Maturity (years)
1.	Băile Herculane city	31.500	100	31.500	3.150	14
2.	Predeal city	40.000	100	40.000	4.000	20
3.	Eforie city	60.000	100	60.000	6.000	11,5
4.	Teiuş city	15.000	100	15.000	1.500	14
5.	Hunedoara County Council	150.000	100	150.000	15.000	20
6.	Lugoj Municipality	35.000	100	35.000	3.500	8
7.	Timișoara Municipality	300.000	100	300.000	30.000	10
8.	Hunedoara County Council	135.000	100	135.000	13.500	20
9.	Alba Iulia Municipality	80.000	100	80.000	8.000	19
TOTAL		846.500		846.500	84.650	

Source: *Annual Report 2006, CNVM*

In the period 2004-2006 are recorded a decrease in the number of new bond issues, but an increase in the amount of issuance (Table 2).

**Table 2 Evolution bond market indicators in the period 2004-2006**

Indicators	2004	2005	2006
Number of issues bonds	22	29	19
Number of new bond issues listed	16	6	5
Transacted value (mil. lei)	289,79	127,44	949,08
Number of transactions	1.116	362	529

Source: *Annual Reports, BSE*

The destination of financial resources attracted by municipalities:

- ensuring water supply;
- sewage;
- development and operation of networks of gas supply;
- heating;
- maintenance of public areas;
- development of tourist areas (cliff from Mangalia, ski runs in Predeal);
- realization of irrigation systems or a system Hydroenergetic at regional level;
- ecological cesspool;
- strengthening buildings or historic building rehabilitation;
- parking;
- investment of any public utility that requires large financial resources.

*The advantages and disadvantages of municipal bonds:*

- to obtain cheaper financing than those in the banking system (with numbers ranging between 10% and 30% of the total cost of financing);
- lack of credit guarantee;
- through bond issue on a long-term, 20-30 years old, can access larger amounts, and by their lower collectivities;
- the main flaw lies in increasing the indebtedness of the local community;
- there is the risk of inability to repay the amounts and the interest;
- realization of local investment which generate resources:
  - \* construction of commercial buildings and industrial areas - and the loan repayment from rents or sales rate;
  - \* arrangement of municipal land with utilities (sewer, water, electricity, gas) for the purpose of building private housing - and hire-purchase or concession;
  - \* construction of sports stadiums or bases;
  - \* creation of facilities of transport;
  - \* construction of production facilities that can be leased or granted;
  - \* arrangement of land with the municipal utilities (sewer, water, electricity, gas) for the purpose of building private housing - and hire-purchase or leased.

### **3. CONCLUSIONS AND PROPOSALS**

The correlation between stock-market indicators and the savings of population is not very clear, but may be a clue to lower interest individuals for stocks in 2006, during which there has been a slight increase in May of savings and sales to the public and increase investment in housing.

Concluding both companies and people, still prefer bank deposits as a form of savings or retain sums of money temporarily available, although interest in the banking system are in continuous decline in recent years.

The banking system is perceived as less risky than investments made in the stock market, even if the increases are higher net on the capital market over the bank.

Increased interest for bonds issued in 2006 may give some hope for a slight improvement in confidence in the debt stock investments.

*The main proposals are made from the analysis are:*

- raising the threshold level of indebtedness of local, only for long-term loans at 30-40%, by changing the legal framework;
- financing investment projects from the small towns through the support of county councils on the issue bonds;
- financing projects of construction of social housing, and not only, through the issuance of municipal bonds or long-term mortgage of 20-30 years and partial reimbursement of amounts, by paying in installments housing.

The study will be continued by exploring other municipal securities, encountered on the capital markets developed in order to the proposal to be introduced in Romania (tickets, certificates of participation, the effects of trade non-taxable).

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