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PUBLIC FINANCE CONSIDERATIONS FOR ISRAELI MUNICIPALITIES

Leon J. Bijou

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Since the reforms of the 1980s, Israel's economy has undergone rapid and dramatic transformation. The sustained growth of 1990-1996, a gross domestic product per capita that exceeds that of some European countries and the emergence of its robust high-tech industry are only three of Israel's very impressive economic achievements. Israel's development as an economic power reflects a coming of age which could not have been imagined ten years ago.

Establishing a Municipal Debt Program

There are several concrete benefits that can be derived by establishing a municipal debt program for Israeli municipalities, including relieving the general government's burden of funding the municipalities, creating fiscal autonomy for local authorities, and developing a domestic capital market. There can, however, be difficulties along the way to reaching these goals, depending on the relationship between the general government and the local government in creating such a program, and on the municipality's ability to adjust to the demands of the capital markets.

To highlight the two different ways that that relationship has been managed, let us first look at the history of public finance in the United States, together with some of the recent developments in public finance that have taken place in other parts of the world.

Historical Perspectives

One of the founders of the United States, Alexander Hamilton, once said that money is the lifeblood of government. Assuming the truth of that statement, then, in most cases, the power to raise money and spend it will be a source of tension between local governments (which have first-hand knowledge of their needs) and the general government (which may consider local governments unfit or not sufficiently responsible to administer their own financial affairs). In the United States, both the need to issue local governmental debt and the tension with the general government over the issuance of that debt began when it was a British colony in the late seventeenth century.

In 1690, Massachusetts was the first colony to

DANIEL J. ELAZAR, EDITOR AND PUBLISHER; ZVI R. MAROM, ASSOCIATE EDITOR; MARK AMI-EL, MANAGING EDITOR. 13 TEL-HAI ST., JERUSALEM, ISRAEL; TEL. 972-2-5619281, FAX. 972-2-5619112, INTERNET: ELAZAR@VMS.HUJI.AC.IL. IN U.S.A.: 1616 WALNUT ST., SUITE 507, PHILADELPHIA, PA 19103; TEL. (215) 204-1459, FAX. (215) 204-7784. © COPYRIGHT. ALL RIGHTS RESERVED. ISSN: 0334-4096.

issue debt, which was used to finance its military activities. In 1712, South Carolina was the first of the colonies to set up a state bank that loaned money to private borrowers. The purpose of these banks was to produce revenues, finance their militias and encourage economic development of the local areas. The need for issuing the debt was due to the unwillingness of the colonial government (Great Britain) to provide money to the colonies, except for purposes that it approved. This exercise of potential financial power did not go unnoticed or unchallenged by Great Britain. By 1764, the British Parliament prohibited the issuance of debt by all of the American colonies.

British domination over the colonies ended in 1776 and for the next 160 years, so did the tension between the local governments and the newly created federal government. During that time, the federal government did not meddle in the financing affairs of the states or the cities and there were three separate types of debt (federal, state and local). The vacuum created by the federal government's laissez-faire approach was filled by a public entrepreneurial spirit of state and local governments, which were responsible for developing transportation infrastructure (canals, turnpikes and railroads) during the nineteenth century.

The status quo was altered during the Great Depression of the 1930s when many cities were under severe financial stress and the federal government interceded to prevent a worsening of the crisis. As part of its plan of assistance, the federal government began an ambitious program of public building that would put people back to work. As a result, the federal government encouraged states to establish public authorities that would issue revenue bonds. Since then, the federal government's involvement in such matters has increased, largely through its control of the tax code.

This brief history illustrates that "there is nothing new under the sun." Each of the issues that the colonies faced in the eighteenth century must be confronted today by the many municipalities that are considering establishing a public finance program (sometimes referred to as subsovereign debt). But the global economy of the late twentieth century has created a new environment in which general governments recognize that the needs of their municipalities require the active involvement of local officials, and in which some of those municipalities have the ability to access cross-border capital markets on their own. The government of Israel and its municipalities should look to these recent developments as the more relevant model in developing a public finance program.

Current Global Trends

There are three separate but related trends regarding public finance that are currently taking place throughout the world: the globalization of municipal debt, the development of emerging local governments as issuers and the decentralization of governments. All of these trends are influenced by the strain on the budget and borrowing capacity of general governments worldwide and the increasing need for capital to build much-needed infrastructure. Consequently, there have also been some exciting innovations in the field of public finance.

The Globalization of Municipal Debt. Recently, some well-known municipalities have begun to access the international debt markets due to the lower costs of borrowing from those markets as compared with the banks. (As this trend increases, the disparity in perceived risk between domestic and international debt markets may be reduced.) By undertaking these transactions, these municipalities are acting as stand-alone financial entities with a global reach that transcends their sovereign borders. Some of these include:

- In February, 1995, the City of Barcelona, Spain, successfully issued an aggregate principal amount of \$200 million in Yankee bonds in the U.S. capital markets.
- In June, 1996, only three years after the City of Naples, Italy, effectively declared bankruptcy, it became the first major Italian city to access the international capital markets as it issued \$175 million in debt in the U.S. The proceeds of that issue were to be used to improve the city's transportation network.
- In December, 1996, the City of Milan issued the first *buoi obbligazionari comune* ("BOCs"), which are Italian municipal bonds. The issue consisted of 100 billion lire with a maturity of 15 years, and was placed with the private Italian bank, Banco Ambrosiano Veneto.
- The City of New York, one of the largest issuers of municipal debt, is no longer limited to issuing debt in the U.S. capital markets. In May, 1993, the city issued \$900 million in taxable municipal bonds that were denominated in yen and sold in Japan's capital markets. In June, 1996, the city issued \$180.5 million in general obligation, fixed-rate, taxable Euronotes, which was followed in January, 1997 by the issuance of \$300 million in variable rate Euronotes, which was used to refund previously outstanding debt.

The Development of Emerging Local Governments as Issuers. While the business world has been focused on the emerging markets (i.e., the Asian Tigers, Eastern Europe, South America), since 1996 local and

regional governments within those markets (i.e., Bogota, Columbia; the State of Ceara, Brazil; and Riga, Latvia) have applied for, and received, credit ratings. For those governments that want to issue debt, a credit rating from a reputable rating agency is essential because it can provide the issuer with ready access to the capital markets. While it is possible to issue debt without a rating, an issuer with a rating can move more quickly and borrow at lower rates. For those governments that will use the credit ratings to attract foreign investors, negotiate lines of liquidity, and dispense with the need for collateral when undertaking projects, the credit rating will be a recognized measure of its financial health.

What has made it possible for these governments to consider other funding sources is that global investors have developed an enormous appetite for debt and have adjusted to the risks of investing in paper issued by cross-border issuers.

One of these new municipal issuers is the City of Moscow. Despite the troubled transition of the former Soviet Union to a market-driven economy, in 1997 Moscow became the first local government of the Russian Federation to receive a rating from Standard & Poor's. In its announcement, S&P noted Moscow's diverse economy, prudent fiscal management, and low current and projected debt. On the negative side, S&P cited Moscow's high unemployment, weak tax collections, contingent liabilities, and low revenue flexibility.

In May, 1997, Western investors bought all of Moscow's first debt issuance, a \$500 million offering of three year notes with a 9.50 percent coupon (315 basis points over U.S. Treasury notes). The fact that the offering was oversubscribed by \$3 billion created some immediate and concrete benefits: only days later, the City of St. Petersburg issued a \$300 million offering in Eurobonds, with a five-year maturity and a 315 basis point spread over U.S. Treasury notes. Then Nizhinyi Novgorod, another Russian republic, announced that it would tap the Eurobond dollar market.

The Decentralization of Governments. Perhaps the most dramatic change in the global environment has been the wave of decentralization that has spread across Europe. Spain, France, Germany, Italy, Russia, and Ukraine have all granted regions under their control a greater voice in managing their own affairs, including fiscal autonomy. Because this new authority is being granted when municipal debt is becoming a global event, it will result in many new issuers coming to market.

To cite just two examples of decentralization, in

1997 the Spanish government announced a series of decentralization reforms designed to promote fiscal independence by its seventeen autonomous regions. Under the new plan, the regions have been granted the authority to collect a new income tax and, in 1998, are to be empowered to structure the tax and establish rates, exemptions, and deductions. To ease the transition to the plan, the Spanish government has established a series of funds that will guarantee that the revenues of the regions will keep pace with each other.

In the second example, Prime Minister Tony Blair of England has put into motion a plan that will reorganize the government of the United Kingdom. By signing the Council of Europe's charter of local self-government, Blair reversed a trend of centralization of responsibility and opened the door to greater input on the part of local officials. Both Scotland and Wales have voted in favor of establishing local legislatures that will have the power to tax, in Scotland, and the power to spend, in Wales. The government is also considering holding a public referendum on establishing a finance authority for the City of London.

Recent Innovations. Each of these trends is taking place at the end of the spectrum where public finance is just developing. At the same time, at the end of the spectrum where public finance concepts are already well developed, there have been some recent sophisticated innovations. Orrick, Herrington & Sutcliffe LLP has been involved in two of these innovative transactions.

The first transaction involves the application of structured finance principles to public finance. In 1994, we structured a transaction in which the City of New York issued \$208 million in tax collections-backed notes that were secured by delinquent real estate tax receivables. The sale of such debt was the first of its kind and was well received in the market. As a result, it has created a growing interest in the United States for similar transactions.

The second transaction involves the issuance of debt by a government issuer in the 144A market. (The 144A market consists of "qualified institutional buyers," such as insurance companies, investment advisors and trust funds, that own at least \$100 million in securities.) In April, 1997, we closed a transaction in which our client, PaineWebber Incorporated, underwrote \$63.9 million aggregate principal amount of bonds issued by the Aruba Airport Authority N.V. that were backed by revenues of the airport. The transaction consisted of two tranches, each with a 16-year maturity: the insured tranche priced at 7.74 percent per annum (90 basis points over U.S. Treasury bonds); while the second

priced at 8.09 percent per annum (125 basis points over U.S. Treasury bonds).

In this new global environment, the fiscal autonomy for local governments is no longer an aberration but a growing trend. As such, it creates exciting new opportunities for those municipalities that want to access the capital markets.

Accessing the Capital Markets

Capital Markets Debt. There are several advantages to issuing debt in the capital markets. Most of the differences between the terms of bank financing and capital markets debt make the latter more attractive to municipal issuers. Capital markets debt has a longer maturity than traditional bank financing. This distinction is crucial, especially for large-scale projects that will require 20-30 years to repay the debt. In addition, the fixed interest rate of such debt will allow an issuer to project its future debt service payments for the life of the issue. Capital markets debt is usually less expensive than debt offered by a bank because it offers a broader source of funds. Moreover, the covenants and warranties required by the capital markets are not as demanding as those of a bank (especially a bank that is aware that it represents one of the municipality's few funding sources).

Bank debt, however, does offer several advantages. It may be easier to work with a bank than it is to prepare a prospectus for selling debt in the capital markets. Also, if a borrower wants to restructure its debt it can do so by approaching the bank and renegotiating the terms of the loan. On the other hand, once the debt has been issued in the capital markets, it is much more difficult to renegotiate because the indenture or resolution authorizing the debt will require that debt holders consent to any changes in the structure. Obviously, the greater the number of debt holders, the more difficult it will be to obtain the necessary approvals. On balance, however, these disadvantages can be considered a small price to pay for accessing this less expensive market.

Considerations for the State Government. If a public finance program is created in Israel, some municipalities will become issuers and experience greater autonomy, but they will be operating within a framework that will be established by the state government.

The state government may approve each issuance on a case-by-case basis or it may adopt legislation granting municipalities a general authority to issue debt. In the latter case, the state government would probably

adopt a series of guidelines for such issuances (including debt limits) that a municipality could follow without having to return to the state government for its approval. In either case, the state government will have to decide if the projects that may be financed with municipal debt will be limited to those with governmental purposes (and define such purposes) or whether to include industrial development projects (in which a private developer uses the proceeds of the debt and is responsible for reimbursing the debt). Perhaps the most important decision in establishing such a program will be whether to permit the interest on municipal debt to be exempt from inclusion as income for tax purposes.

Issuer Concerns

To provide full disclosure regarding issuer concerns, let us recall the Irish writer George Bernard Shaw: "There are two tragedies in life. One is not to get your heart's desire. The other is to get it."

Initially, an issuer will have to identify a project and then undertake several important legal and business considerations. Thereafter, the issuer will become involved in a highly detailed and demanding process in which it will have to establish a partnership with the underwriters, credit providers, if any, rating agencies, and the debt holders. If an issuer can successfully negotiate all of these steps, it will reap the rewards for many years to come.

Issuer's Legal and Business Considerations. Of primary importance in a debt issuance will be the authority of the issuer to issue debt and to pledge the security for the debt. Each of these components must be well-documented under law as they form the core of the issue. The security for the debt can be a general obligation of the issuer (payable from any legally available funds), a specific revenue stream that can be pledged to repay the debt (such as real estate taxes or airport revenues), or both, depending on how the market perceives the credit risks associated with each type of security.

The issuer will have to establish its creditworthiness, which will be based on several considerations such as its budget process, sources of funds and revenues, outstanding debt, if any, history of budget deficits and surpluses, financial projections, and feasibility reports. Once this has been established, the issuer must decide whether to adopt a "pay-as-you-go" approach (in which current revenues are spent on capital projects) or issue long-term debt. The issuer will have to take into account any municipal debt limits and market perceptions regarding its debt.

Thereafter, the issuer will have to create a plan of finance that will describe the project in its entirety, the size of the debt issuance, the issuer's ability to repay the debt, whether credit enhancement will be available and/or necessary to guarantee the repayment of the debt (such as a letter of credit from a commercial bank, a governmental or corporate guaranty, bond insurance, or some combination of the foregoing), and whether to obtain a credit rating and, if so, from which rating agencies. Each of these options will have to be researched as to availability and relative cost and benefit.

In a cross-border transaction, the issuer must also consider the currency risk that exists in a transaction in which borrowed money is to be repaid in a foreign currency while the revenue stream to repay the debt will be generated in New Israeli Shekels. There are several alternatives to address this issue, including: (i) using a swap in the currency markets; (ii) permitting payments to be made in shekels but indexing those payments to the exchange rate; (iii) obtaining a guarantee of the central government that would be drawn upon in the event of a devaluation; and (iv) if a revenue stream is used, overcollateralizing the transaction by pledging an amount that exceeds the principal amount of debt issued.

The Debt Issuance Partnership. By becoming an issuer, a municipality will become more independent in its ability to address its needs and, at the same time, interdependent as the successful issuance of municipal debt requires creating a partnership with the underwriters, credit providers, if any, rating agencies, and debt holders. The two cornerstones of this partnership are disclosure by the issuer to each of its partners and cooperation by each member of the partnership to reach a consensus that will result in a financial closing.

Underwriters: From the outset, the issuer must realize that nearly every action that it takes in municipal debt is done on behalf of the investors who will purchase its debt. In undertaking each of the legal and business considerations noted above and all of the activities noted below, the issuer will be assisted by the underwriters whose first-hand knowledge of the capital markets will be essential. The underwriters' incentive to assess the markets correctly is that they will purchase the debt from the issuer and bear the risk of selling it to investors. The issuer's creditworthiness, its financial accounting and history, and its plan of finance will affect the marketing of the debt, which will be undertaken by the underwriters.

Credit Providers: While, currently, the municipalities have relationships with one of the banks as credit

providers, that relationship will change dramatically in an issuance of municipal debt. Today, due to the municipalities' lack of fiscal independence, the negotiations between municipalities and the banks that fund them are not an equal arm's length matter, but they are based on historic relationships in which the bank is a direct lender.

With municipal debt sold in the capital markets, however, the role of the banks may be limited to providing a letter of credit that will serve as an alternate funding source for repayment of the debt if the issuer cannot make those payments. A letter of credit can be a direct-pay (which will be drawn upon to make scheduled principal and interest payments directly to the debt holders) or a stand-by (that will be drawn upon only in the event of a payment default). If the security for the debt is sufficiently strong, a letter of credit may not be required.

Alternatively, the credit provider may be a municipal bond insurance company, which will issue a policy that will obligate it to make payments on the debt if the issuer fails to do so. If industrial development bonds are issued, the borrower of the debt (or its parent) may issue a corporate guarantee, which may also be called upon in the event of a payment default.

Regardless of the kind of credit provider that is used in a transaction, the issuer will have to make full disclosure to that provider, which will take the risk that the issuer will successfully complete the project and repay the debt. The credit provider will require the issuer to comply with certain representations and covenants as part of the negotiations, but as a provider of back-up credit rather than direct credit, these will be less rigorous than they would be in a direct bank loan.

Rating Agencies: Once a municipality has chosen a project, created a plan of finance, and decided to apply for a rating, it will prepare a presentation and tell its story to the rating agencies in a formal and well-rehearsed presentation. The story will consist of its creditworthiness (both present and future outlook), the need, schedule and budget for the project, and its ability to repay the debt it plans to issue. The rating agency will review every aspect of the proposed issuance with an eye toward revealing risks to purchasers of the debt. Based on that thorough analysis, the rating agency will propose amendments to the financing structure to mitigate those risks. After reaching an accord, the rating agency will issue a rating that will be made public to investors and be the most important factor in establishing the interest rate that will be borne by the debt.

Debt Holders: The partnership between the issuer and the debt holders is an unusual one: initially, it is a theoretical relationship, as the entire deal will be structured and negotiated without a single debt holder present. But, as previously noted, every aspect of the transaction will be structured with the investors in mind. Equally unusual is the fact that while the issuer's direct relationship with investors exists only after the investors have purchased the debt, in all likelihood, that relationship will never be exercised.

Except for making the scheduled principal and interest payments, there are only a limited number of instances when the municipality will have contact with the debt holders. If the issuer wants to change the terms of the transaction, it will have to obtain their approval. If the issuer defaults on the payment of principal or interest on the debt, the issuer will have to negotiate with (and answer directly to) the debt holders regarding such payments.

Conclusion

Despite the many changes that a municipality must undertake to become an issuer, there are many benefits to be gained. By making the transformation, a municipality can put its finances in order in a way that re-

sponds to the demands of the discipline of the capital markets. Thereafter, a local government can use its new ability to raise and spend money to increase investment and build infrastructure that will directly improve life for its citizens. Finally, a municipality that is well run and that provides for its citizens will become a more attractive place to live.

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Leon J. Bijou is a municipal bond attorney with the New York office of Orrick, Herrington & Sutcliffe LLP, in charge of business development in the Middle East, and specializing in debt financing and project financing for infrastructure. He is currently serving as a consultant to the governments of Israel and Jordan in connection with the creation of a binational airport authority for the Aqaba-Eilat Peace Airport. A version of this *Jerusalem Letter* was originally prepared for a seminar on "Issuing Municipal Bonds" held in Jerusalem in September 1997, and was later distributed at the JCPA - Milken Institute conference on "Practical Privatization: Lessons from Cities and Markets," held in Jerusalem on 18 June 1998.

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