Overview of local entities´ debt: Evolution and expectations

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The level of local entities´ debt has evolved quite differently relative to other levels of government. Nevertheless, regulatory restrictions on borrowing requirements have led to an increase in financing through the government´s newly created supplier financing mechanism. Economic recovery is expected to continue improving local entities´ solvency, although city councils have become even more polarized, with some entities likely to need financial assistance to remain viable.

In contrast to the nearly daily scrutiny over the fiscal and debt dynamics of the central government, the autonomous regions and social security, local entities are quite possibly the least well-known public sector entities. However, in view of their fiscal consolidation efforts, as the sole administrative level to register a surplus in their accounts (from 2012), and with the lowest pace of debt growth (41% between 2007 and 2013, as against 163% at the central government level and nearly 240% at the autonomous regions level) they now merit a more in-depth analysis. Due to their heterogeneity and atomization, it is hard to draw conclusions about local entities in general. However, in this article, we provide an overview of the evolution of Spain´s local entities´ debt, based on individual data from year-end 2013, provided by the Ministry of Treasury and Public Administrations (MINHAP).

How is debt distributed across local entities?

At present, there are 8,685 local entities – mainly city councils – representing 84.6% of local debt, along with 52 provincial governments, councils and boards, which hold 14.4% of the outstanding debt. There is also a group of territorial entities below the municipal level, in local regions or other entities, that group together several municipalities, whose relative weight is quite small (less than 1%).

The limited information available –outstanding balances only – constrains the ability to analyze

Refinancing of trade debt with financial instruments has significantly increased outstanding debt levels of local entities that had previously not registered notably high debt levels.

the local sector's financing portfolio, although we estimate that it is mainly long-term (average

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term of 4-5 years) and virtually comprised by euro-denominated loans with high exposure to interest rate risk. In absolute terms, the published information allows for identifying municipalities with the largest volume of debt. Due to the varying sizes of local entities, a discriminatory range must be established on the basis of population, and our analysis will therefore focus on entities with a population greater than 75,000 inhabitants.[2]

Within this aggregate, the following are the local entities with the largest and smallest debt levels at year-end 2013:

Table 1

Local entities´ debt levels at December 2013: Largest to smallest

Local Government	Debt (thousand €)
Madrid	7,035,765
Vizcaya	1,255,857
Barcelona	1,110,000
Valencia	872,000
Zaragoza	860,755
Malaga	701,305
Jerez de la Frontera	563,614
Guipuzcoa	544,731
Alava	533,028
Seville	439,000

Local Government	Debt (thousand €)
Council of El Hierro	5,765
Bilbao	7,319
Soria	11,807
Barakaldo	14,377
San Sebastian de los Reyes	14,756
La Gomera	15,332
Ciudad Real	15,464
Arona	16,212
Alcobendas	18,001
Pontevedra	19,135

Source: MINHAP.

However, the same classification will yield different municipalities if it is based on year-on-year changes in the outstanding balance. This difference is due to borrowing from the Fund for the Financing of Payments to Suppliers (FFPP), the impact of which will be seen throughout the

Table 2

Local entities´ debt level increases in yoy terms at December 2013: Largest to smallest

Greatest yoy increase

Local Government	Debt (thousand €)	YoY (%)
Parla	125,634	813.9
Cornella de Llobregat	86,687	788.2
Bilbao	349,356	240.3
Leganes	186,995	107.0
Rivas-Vaciamadrid	78,133	72.3
Terrassa	215,055	70.8
Arona	80,987	57.6
Chiclana de la Frontera	82,212	57.2
Santa Coloma de Gramenet	120,029	54.0
Reus	106,790	46.9

Greatest yoy reduction

Local Government	Debt (thousand €)	YoY (%)
Salamanca	30,868	-45.7
Barcelona	133,812	-38.1
A Coruña	43,345	-36.0
Council of El Hierro	5,765	-28.9
Vigo	297,355	-28.3
Lugo	98,457	-27.2
Alcobendas	111,040	-27.0
Tenerife	315,183	-26.5
Pontevedra	67,546	-25.9
Caceres	33,732	-25.3

Source: MINHAP.

[2] Municipalities with more than 75,000 inhabitants are used because, under the Revised Text of the Law Regulating Local Treasuries (TRLRHL), they must submit for final approval – following the approval of the plenum – their Economic and Financial Plan to the financial oversight body (the autonomous region or the Ministry of Treasury, depending on whether the region has assumed financial oversight power over its municipalities).

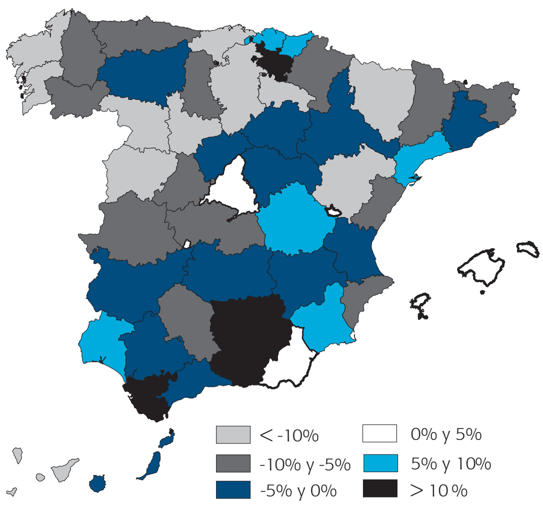
analysis herein. The use of financial instruments to refinance trade debt has resulted in steeper increases in the outstanding debt balance under the Excessive Debt Procedure (EDP) for local entities that did not register the largest volumes of debt.

How is local debt distributed across Spanish territory?

The distribution of changes in the debt balance by provinces, aggregating the debt balances of provincial authorities and the municipal bodies located therein, would situate the largest year-on-year increases in the south of the country, mainly coastal areas. Notable increases were also recorded in Basque municipalities and provincial councils[3] in 2013, with net indebtedness increasing in the provincial councils of the three Basque provinces. Nevertheless, only one fourth of the provinces overall registered an increase in debt, where the majority saw a decrease of between 0% and 5% in 2012.

Exhibit 1

2013 *vs.* 2012 change of local debt by province



Source: MINHAP.

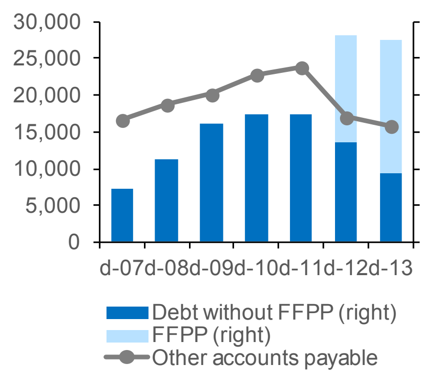
Sustainability of debt

Absolute values and changes in the period provide information on the strategy employed during the year, but a comparison with other figures allows for an analysis of the more significant issue: the weight and sustainability of the financial debt, and the impact of assistance for the financing of the trade debt, where the government´s new supplier funding mechanism – the FFPP – has granted some 11 billion euros to local entities to date (i.e., more than one fourth of their total debt).

The FFPP has made a very significant impact: not because of its large relative weight, or because it is currently the second largest source of funding for local entities, but because it provides a solution to address the shortfall of funds, which was translating into delays in supplier payments.

Exhibit 2

Outstanding accounts *vs.* financial debt (mill.€)



Source: Bank of Spain.

[3] The basque provincial authorities and Navarre (the so called foral territories) have authority over nearly all the taxes that are collected in the territory, giving to the central government a portion of them in order to compensate for the expenses incurred in providing non transfered services.This amount is set every five years and updated annually by applying an index. This index is the increase in net revenue obtained by the central government in taxes agreed from the base year to each year.

Accordingly – and with regard to city councils – it becomes particularly important to weigh the outstanding debt balance in terms of population and current revenue.

City councils´ solvency positions have become more polarized due to the FFPP's implicit financing mechanism in the form of trade debt.

Historically, the distribution of solvency among city councils has been sharply polarized: a majority of councils register low debt levels, while a smaller, although noticeable number, carry elevated outstanding balances.

A comparison of the distribution of debt per capita and against current revenue in the last three years clearly demonstrates this result. At year-end 2013, the number of city councils with debt levels at less than 50% of current revenue declined, whereas there are more municipalities with a higher ratio of debt per inhabitant and of relative weight over current revenue, exceeding the threshold of 110%.[4] The refinancing of trade debt with financial debt has become an implicit financing mechanism and brought about an impairment of city councils' solvency, especially in relation to current revenue.

In accordance with the limits of 75%[5] and 110% of debt to current revenue, and based on a distribution by provinces, the following map identifies the relative weight in the total of municipalities that are unable to immediately borrow, i.e., municipalities with a ratio above 75%.

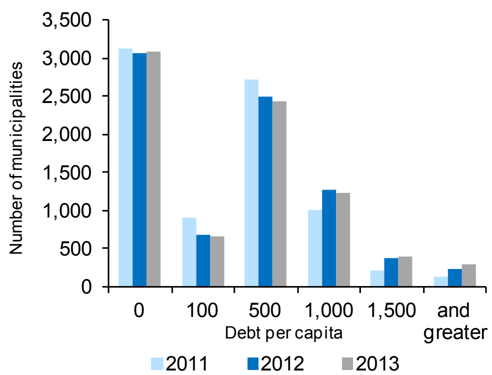
A comparison between the map for 2008 and that for year-end 2013 illustrates the worsening position of local entities. At the outset of the financial crisis, the majority of municipalities were in a solvent position, with a debt-to-current revenue ratio below 75%.

This profile contrasts with the situation five years later. The breakdown shows that the Mediterranean provinces have been most severely affected by the economic and financial

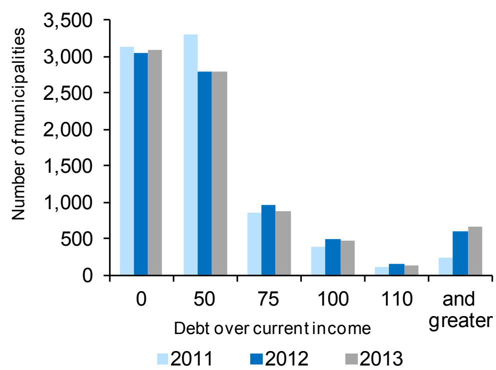
Exhibit 3

City councils' debt ratios

Debt per capita



Debt to current revenue



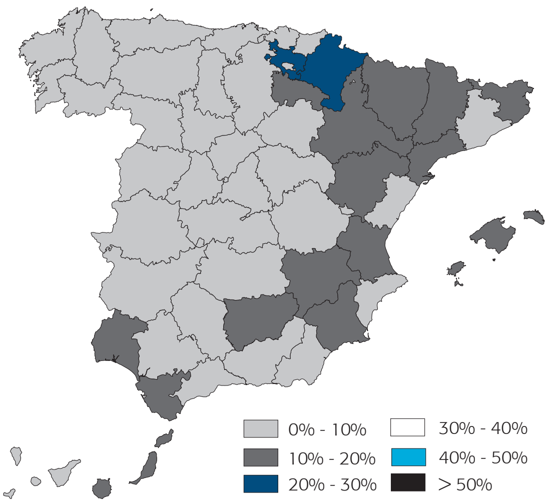
Sources: MINHAP, INE.

[4] Legal limit set out in Article 43 of the TRLRHL.

[5] On the basis of this ratio of debt to current revenue, local entities must draw up an adjustment plan prior to any new borrowing, under Additional Provision Fourteen of Royal Decree-Law 20/2011, of March 3rd, on urgent budgetary, tax and financial measures to correct the public deficit, modified by Final Provision Thirty-One of Law 17/2012, of December 27th of General State Budgets for 2013.

Exhibit 4

Percentage of city councils with a debt-to-current revenue ratio above 75% in 2008

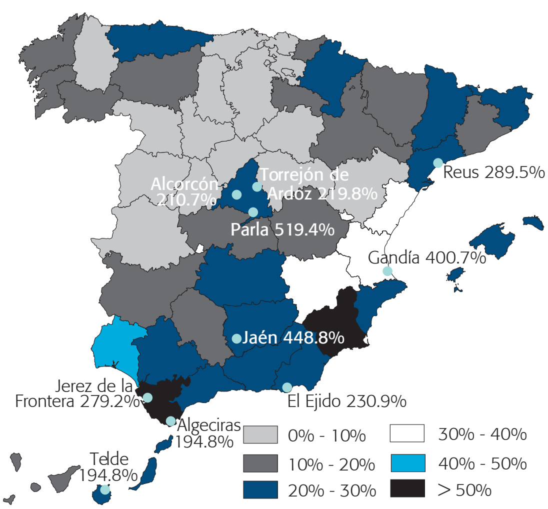


Source: MINHAP.

crisis (all Mediterranean regions have enrolled in the regional liquidity fund, and three failed to meet the 2013 deficit target), where the weight

Exhibit 5

Percentage of city councils with debt-to-current revenue ratio* above 75% in 2013



*Note: * Ratios calculated on the basis of 2012 budgets, latest available figures.*

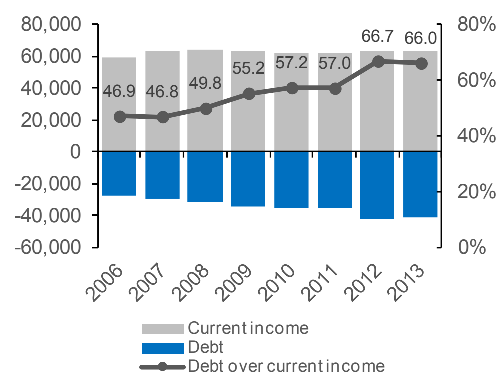
Source: MINHAP.

of city councils with high relative debt levels is greater. The map also shows the ten municipalities with a population of more than 75,000 inhabitants that have the largest relative weight of debt to current revenue.

This worsening was foreseeable, given aggregate trends in both debt and current revenue. Local entities have increased their aggregate debt levels by nearly one third, while revenues have fallen by 1.5% relative to 2008. This map merely reflects that trend and the variation among local entities, demonstrating that entities already in a more weakened position were more greatly affected.

Exhibit 6

Debt to current revenue (mill. € and %)



Sources: MINHAP, Bank of Spain.

The impact of regulation on the evolution and composition of local debt

Unlike the autonomous regions and the central government, local entities have had to cope with regulatory changes aimed essentially at limiting their ability to borrow, in addition to an extremely tight financial environment. Accordingly, the control and rigidity to which local entities have been subject has, undoubtedly, been more stringent.

The initial framework defined by the Revised Text of the Law Regulating Local Treasuries (TRLRHL) in 2010 tried to prevent local entites[6] from undertaking new borrowing, while the limitation was eased in 2011,[7] as entities with a final balance of net savings and level of debt below 75% of current revenue were again allowed to borrow. These conditions were extended in 2012,[8] and made open-ended in 2013.[9]

Regulation for 2014, therefore, allows local entities with positive net savings to undertake new long-term borrowing provided the total amount of outstanding debt does not exceed 75% of current revenues. If they exceed this level, but fall short of 110%, they may borrow subject to the authorization of the competent body responsible for financial oversight. Any entity with net negative savings or a debt level above 110% cannot borrow.

However, as an exception, long-term refinancing is authorized if arranged prior to the entry into force of the Royal Decree-Law regulating the FFPP mechanism,[10] provided the purpose is to reduce the financial burden and/or to extend the repayment period. Local entities with negative net savings or debt levels above 75% of current revenue must approve, in their respective plenums, a financial repair or debt reduction plan to correct the imbalance within a maximum of five years.

Moreover, borrowing undertaken through the FFPP mechanism carries the second largest weight in the portfolio of local debt, as the FFPP is the largest lender to local entities. Consequently, decisions implemented relating to the mechanism are of special significance to the performance of the outstanding balance of local debt.

Unlike the autonomous regions and the central government, the local entities have had to cope with stricter regulatory requirements, in addition to a highly restrictive financing environment, resulting in smaller debt increases.

In principle, an extension of the mechanism is not to be expected, as per the announcements made by the Spanish government. But the government has unveiled a series of measures, approved in 2013, to assist the local sector through the FFPP, aiming to supplement aid to local entities in financial difficulties.[11] The reduction of the Treasury's current cost of funding has encouraged interest in compensating public entities that have made greater progress in fiscal consolidation and have had to face a more restrictive regulatory framework.

The recently-approved measures apply to the first of the phases developed by the FFPP, to loans formalized in 2012, for a total volume of 8.75 billion euros and that represent the bulk of the outstanding balance of local entities with

[6] Article 14.2 of Royal Decree-Law 8/2010, of May 20th, adopting extraordinary measures for reduction of the public deficit.

[7] Final Provision Fifteen of Law 39/2010, of December 22nd, of the General State Budget for 2011.

[8] Additional Provision Fourteen of Royal Decree-Law 20/2011, of December 30th, of urgent budgetary, tax and financial measures for the correction of the public deficit.

[9] Final Provision Thirty-One of Law 17/2012, of December 27th, 2012, of the General State Budget for 2013.

[10] Recently, the Council of Ministers approved the possibility of refinancing local entities´ operations with the FFPP, provided that this implies, among other things, a savings for the entity.

[11] Title II of Royal Decree-Law 8/2013, of June 28th, of urgent measures against late payment of the public administration and in support of local entities with financial problems. Local entities with financial problems are defined as those which meet one of the following conditions, *inter alia:* negative net savings and cash surplus in the two previous years, a debt to public creditors ratio above 30% of non-financial revenue, a debt balance of more than a million euros with the FFPP and non-compliance with periodic quotas, or a combination of the foregoing. Assistance is based on the possibility of consolidating short-term debt into long-term debt, bridge loans, financing a cash surplus or extending the repayment period of negative cash positions.

the mechanism. They involve reductions in the credit spreads, extensions of the grace period with a smaller reduction in the spread, or in some extreme cases, the latter with an extension of financing terms to 20 years.[12]

All these possibilities have an impact on both the level of debt and its future evolution. The extension of the grace period and of the repayment period slow the pace of reduction of the outstanding balance of debt from the FFPP. Meanwhile, the application of a lower spread relieves the financial burden and financnial expenditure. This increases municipalities' capacity for fiscal consolidation and reduces the risk of slippage on budgetary objectives.

It must also be borne in mind that there may be yet another factor that affects the pace of repayment. As noted above, local entities are the only level of public entities to register a surplus. The allocation of the surplus is regulated by the Organic Law on Budget Stability and Financial Sustainability (LOEPSF). Under Additional Provision Six, local entities that comply with or do not exceed their borrowing authorization limits and that have a surplus and positive cash surplus for expenditure in 2014 must allocate the surplus or, if lower, the cash surplus,[13] in this order, to meet outstanding budget obligations, to repay outstanding borrowings and to finance investments, provided that the latter are financially sustainable over the useful life of the investment.

Therefore, entities with a surplus and liquidity can reduce their debt levels. Allocation of the surplus is one of the reasons underlying the 16% reduction of the ex-FFPP aggregate debt of local entities from their peak in 2010, along with limitations in borrowing in past years that made it impossible to refinance maturities.

Conclusion

The analysis herein shows that, given the inelasticity of local expenditure, the legal limits placed on local entities funding resulted in financing that involved an extension of payment periods to suppliers. Given the rapid growth of average payment periods to enterprises and self-employed that provided services to the public sector, it became necessary to deal with non-payment through extraordinary measures, namely through the FFPP. The secondary effects of this extraordinary measure facilitated the determination of local entities' total debt and real solvency levels, however, fostered greater polarization among them.

Unlike the central government and the autonomous regions, which are able to incur deficits up to a specific target in the 2014-2016 period, local entities as a whole are expected to maintain the downward trend in their outstanding debt balance for the coming years. The budgetary stability targets set for the medium term, the obligation to maintain a lower debt-to-current revenue ratio than the aggregate of regional governments (156.6%, individually within a range of 67.5% to 288.2%) and the obligation – albeit eased to a certain extent – to allocate surpluses to the early repayment of commitments leave very little margin for new debt increases.

Again, regulation will play an important role. The LOEPSF and its regulatory implementation are especially strict with regard to local budgetary policy. Hence, the expenditure rule, combined with the budgetary stability demanded of local entities, will generate fresh surpluses allowing the early repayment of loans, where FFPP debt is among the most likely to be repaid. Its wide credit spread and the lack of an obligation to pay compensation for early repayment make this option financially attractive. This is the view

12 Order PRE/966/2014, of June 10th, publishing the principal characteristics of borrowing operations charged against the mechanism for financing of payments of suppliers to local entities.

13 The unaffected cash surplus.

taken by a number of regions and local entities which, to date, have refinanced their outstanding FFPP debts, adjusting terms to current market conditions. Thus, a new contrast arises among local entities – those able to prepay their debts and those which need an extension. This lends great importance to the financial assistance measures implemented by the central government for local entities in a situation of distress, as the measures have become a method for injecting viability into city councils currently facing the most difficult conditions.

Solvency indicators will improve along with the economic recovery, but the polarization of local entities will continue to worsen, as in previous years. Therefore, extraordinary financial assistance measures will be necessary for the most distressed city councils to remain viable.

As the economic recovery begins to take shape, solvency indicators will improve, albeit not uniformly. As in recent years, the polarization of the local sector will intensify, and divergences among local entities will widen, as they move towards the extremes in the distribution: local entites with better solvency levels and entities with worse levels.