Sub-national authorities, such as local governments and their local public service enterprises are playing an increasingly crucial role in providing services that are essential to the health, safety, wellbeing and development of their communities. Keeping up with the demand for local services is a challenge that requires significant investment in local infrastructure development.

In turn, an adequate level of infrastructure development requires long-term financing in local currency (See SNTA Brief No.2). More and more sub-national authorities are finding that they need to turn to banks and capital markets in order to find enough long-term financing to meet their needs.

In many countries, banks and capital market investors are not yet familiar with the risks related to providing long-term financing to sub-national authorities. In some cases this lack of knowledge about risk makes long-term infrastructure financing very difficult to find. In other cases, financing transactions are successfully completed only because lenders and investors think that the debts of sub-national authorities carry an implicit guaranty from higher levels of government based on the assumption that the sub-national borrower will not be allowed to fail and cease operations. While this is a logical viewpoint, global experience shows that the presumption of an implicit guarantee ultimately destabilizes domestic financial markets. The resulting financial crises have constrained long-term financing for local infrastructure in country after country. So, implicit guarantees need to be avoided.

There are two ways that the assumption of an implicit guarantee may find its way into a local infrastructure financing transaction. First, if the borrower is a general purpose local government (such as a state/province, district, metropolitan government or municipality), lenders may inaccurately assume that the local government debt is implicitly guaranteed by the national government. Such implicit sovereign guarantees can create unexpected problems for the national government when lenders seek payment from them after a local government default. Second, if the borrower is a local public service enterprise (such as a municipal water utility or municipal bus company), lenders may inaccurately assume that the general purpose local government that is served by the local public service enterprise implicitly guarantees the debt of the enterprise. Such implicit sub-national government guarantees to the enterprise may lead lenders to make claims on the general purpose local government (which may ultimately have to turn to the national government for financial support if those claims are upheld in the courts).
IMPLICIT GUARANTEES AND MORAL HAZARD

Worldwide experience shows that when lenders assume that an implicit guarantee exists, they offer financing to sub-national authorities without carefully assessing the risk of default. Their attitude is: Why worry about the risk of providing financing if repayment is guaranteed? In this environment, local governments and local public service enterprises can become over-indebted by borrowing without carefully assessing their own ability to repay the debt. After all: Why worry about borrowing too much if a financial bailout is guaranteed? (See Until Debt Do Us Part: Sub-national Debt, Insolvency, and Markets, Octavio Canuto and Lili Liu editors, World Bank, 2013.) These scenarios are examples of “moral hazard”: a situation where there is a tendency to take undue risk because those taking the risk do not expect to feel the consequences that could result.

Moral hazard permits risky behavior by both lenders (banks and capital market investors) and borrowers (local governments and their local public service enterprises). The problem arises when risky long-term infrastructure financing goes bad; i.e., when the funds needed for debt service payments are not available. At that point, the lenders will turn to the national or local government that was assumed to be providing a repayment guarantee. Since local governments and local public utilities provide essential services to their communities, lenders cannot simply take legal action to seize and sell their assets as would be done with a defaulting private enterprise. This puts the supposed guarantor in a difficult situation. They are not legally obliged to make the debt service payments, but refusing to make the payment will have serious consequences for both the lender and the borrower. Ultimately, a default can also affect peoples’ access to adequate local services; directly affecting their health and safety.

CONSEQUENCES

If there is no bailout by the supposed guarantor, lenders suffer an immediate financial loss. Accounting and auditing rules require lenders that are unable to collect debt service payments to write-off the debt as a zero value asset. This reduces the value of the lenders’ investment portfolio and may even endanger their overall financial viability. In countries such as Argentina in 2001, Brazil in 1989/1993/1997, Mexico in 1995, and Russia in 1998 implicit guaranties made moral hazard commonplace and led to widespread sub-national bad debt that destabilized the entire financial sector into a debt crisis.2 Regardless of how many lenders are affected by sub-national debt write-offs, the unexpected failure of implicit guarantees leads to an immediate reassessment of the risk of sub-national debt and a rapid reduction in the supply of financing for local infrastructure. In those circumstances, even sub-national authorities that have been conscientious financial managers and prudent borrowers find that additional financing for needed infrastructure is much more expensive and harder to access.

If there is no bailout by the supposed guarantor, the borrower suffers an immediate and long-lasting loss of its reputation for creditworthiness. Once a local government or local public service enterprise fails to pay its debts on time and in full, private sector lenders and investors will classify it as an unacceptable credit risk. Access to long-term financing from banks and the domestic capital market is cut off. Financial institutions can have long memories, and it may be extremely difficult for a defaulting sub-national authority to regain access to long-term domestic financing to build infrastructure. The impact on the supply of long-term financing produced by defaults is illustrated by the 2008–2009 defaults that became the global financial crisis. World Bank research found that: “The economic downturn is likely to have a lasting impact on the fund management industry and on long-term asset allocation strategies of institutional investors by promoting more cautious investment strategies... Investors have sought refuge in bills and bonds from governments with strong creditworthiness. The financial crisis has effectively accelerated a long-term trend increase of bond allocation that started at the beginning of the last decade.”

Because the consequences of debt defaults by sub-national authorities are so serious for lenders and borrowers alike, there is enormous pressure on the national or local government that is the implicit guarantor to provide a bailout that prevents the default. These bailouts are unwelcome at any time and at any level of government, but they can be especially harmful to local governments that typically lack the financial reserves to cover the bad debts of a local public service enterprise. In many cases, local governments that attempt to fulfill their implicit guarantees fall into a financial crisis of their own. How this can happen is illustrated by the now famous U.S. debt default by the Washington Public Power Supply System (WPPSS) that affected the City of Seattle, Washington (See box).

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Guarantees can be a legitimate and useful tool for making long-term financing more affordable for sub-national authorities (see SNTA Brief No. 5). It is the implicit character of some guarantees that causes the problems described above. Guarantees that are explicit and clearly defined in legal documents can avoid many of the problems caused by implicit guarantees. An explicit guarantee is a form of insurance (a legally-binding commitment of the guarantor provided in writing to the lender) that protects the lender and the borrower according to the terms of the guarantee.

Explicit guarantees can cover some or all of the default risk for a specific sub-national financing transaction, but they always make it clear to lenders what risks they will continue to carry after they deliver the financing. With an explicit guarantee there should be no surprises for a lender in the event that a sub-national borrower finds itself unable to repay its debt. For an explicit guarantee to be acceptable to lenders, the guarantor must be able to demonstrate their ability to make the necessary payments in the event of a default. In some countries, highly specialized financial guarantee insurers (‘mono-line’ insurance companies) guarantee sub-national bonds. In other countries, national governments, multilateral development banks and international development agencies may provide explicit guarantees.

Regardless of the source, in virtually every case, guarantors charge the sub-national authority a fee (or insurance premium) for their explicit guarantee. Local governments may want to explicitly guarantee the debts of their local public service enterprises, but they should only do so to the extent that they have established cash or other financial reserves sufficient to cover the debt. Since this is a very difficult and expensive thing for local governments to do, explicit guarantees covering local public utility debt are typically provided by an external source for a fee.

In order to prevent lenders and borrowers from making the assumption that a particular sub-national debt carries an implicit guarantee, the actual process for resolving a default needs to be clearly established in a legal framework. This can be done in two ways. The first way is to give lenders a legal document providing an explicit guarantee that spells out the requirements for claiming payment from the guarantor and the administrative process for resolving the lenders’ claim (including the amount of loss the lenders have to absorb by themselves). The second way is to establish laws and regulations that create an insolvency framework for sub-national authorities equivalent to a bankruptcy law for private enterprises. The existence of a credible insolvency framework creates a viable alternative to a bailout. By requiring bad debts to be resolved through a legal insolvency process, the framework makes it clear to all that there are unpleasant financial consequences for lenders and borrowers that create bad debts, and that a bailout cannot be expected. It is useful to view these two approaches from the perspective of national government and local government to understand the steps that should be taken.

National governments can take a series of steps to minimize the presumption of an implicit sovereign guarantee for sub-national debts. First, the individual debts of all sub-national authorities need to be identified by whatever means is most practical and thorough. Once the entire list of sub-national debts has been established, those that cannot be expected to be fully repaid by the borrower need to be identified. This requires an analytic effort by national government auditors. The sub-national bad debts identified then can be cleaned up by applying a one-time explicit national government guarantee to each one. The national government guarantee can be either for 100 percent of the debt service payments (a complete one-time bailout of the sub-national authorities and their lenders), or for only a partial percentage of the debt service (thereby sharing the pain with the borrowers and lenders as well).

In January 1982, the Washington Public Power Supply System board stopped construction on two power plants when total cost for the plants vastly exceeded available resources. Because these plants generated no power and brought in no money, WPPSS was forced to default on $2.25 billion in bonds. This meant that the member utilities, including the City of Seattle, and ultimately the city’s tax payers, were obligated to pay back the borrowed money. In some small towns where unemployment due to the recession was already high, this amounted to more than $12,000 per customer.
However, national governments should never simply end their efforts with a bailout. For current and future sub-national debts not covered by the one-time bailout, a sub-national insolvency framework needs to be enacted. The framework of laws and regulations may involve the use of the courts and/or special administrative tribunals to resolve all future sub-national bad debts, while maintaining the delivery of essential services. There are a variety of models that can be researched and adapted to the particular circumstances of every country (See Until Debt Do Us Part: Sub-national Debt, Insolvency, and Markets, Octavio Canuto and Lili Liu editors, World Bank, 2013.). The most important objective to be achieved is that the insolvency framework must be credible to lenders and investors so that they can no longer assume that the national government will ultimately make good on sub-national debts to prevent outright default.

At the local government level, there are also steps that can be taken to avoid implicit local government guarantees for any debts of a local public service enterprise. First, the local government can develop and maintain a comprehensive registry of all debts contracted by local public service enterprises associated with the local government but not funded directly by the local government budget; e.g., water and sewer utilities, solid waste management companies, public transport authorities, airports, hospitals, etc. Next, the local government can determine if any of those debts are a legitimate contingent liability of the government that need an explicit guarantee in order to remain viable, and then work with the public enterprise and external guarantors to arrange the necessary coverage. For current and future local public enterprise debt, the local government can pass legislation that officially renounces any responsibility for the debts of local public enterprises unless a specific explicit guarantee is provided in writing. If the national government establishes a sub-national insolvency framework, then the combination of local legislation and the national framework can protect the local government from having to provide a budget busting bailout to a local public service enterprise or deal with the loss of an essential public service.

**ADDITIONAL RESOURCES**