

RISK FOR COMMERCIAL BANKS IN THE FIELD OF OPERATING THE LOCAL GOVERNMENTS: THE CASE OF POLAND

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Abstract: *The paper presents the risk for banks in operating the local governments. It was studied the case of Poland in this field. First and foremost, the author presents the concept of risk and its types. There are especially characterized some typical risks of the functioning of local governments, which can affect the financial situation of the banks. The article shows some findings in this field, which based on the research conducted by the author in 2011. As a result, there are analysed the risk of the each type of local government, its kinds as well as risk of main credits for these units.*

Keywords: *risk, local government, banks*

JEL Classification: *G21, G32, H70*

1. INTRODUCTION

Local governments should expand their relationships with the commercial banks. It results from the fact that, in many cases, they do not have enough money to meet all needs of the local community. Therefore, these units may take advantage from the credit activity of banks. Moreover, these financial institutions can provide local governments with some instruments, which could streamline the managerial processes within the organization and gain additional benefits. On the other hand, local public units are obliged to cooperate with the banks in order to operate their budgets. However, this cooperation may be threatened by some risks typical for the functioning of the local governments. In consequence, the aim of the paper is to study them. The author shows some findings in this field, which based on the research conducted among the group of leading commercial banks in Poland in 2011.

2. THE CONCEPT AND TYPES OF RISK IN LOCAL GOVERNMENTS

In the literature we can find a variety of terms of the risk concept. In many cases, risk is called as the uncertainty, associated with some events or actions, which may cause a deviation in previously scheduled issues. It is also defined as a possibility that something may happen and will influence on the previously defined objectives (the probability of benefits or risk of losses). Moreover, it is understood as a combination of the probability of the appearance of some events and their consequences. So, the risk is a hazard, danger, exposure to mischance or peril (Fragner, Sullivan 2007). K. Jajuga formulates two concepts of this term, such as (Jajuga 2007):

- 1) the possibility of not achieving the expected effect (risk as a threat);
- 2) the possibility of achieving different result than it was awaited (risk as a threat and an opportunity).

Some authors also point out that considering only the negative differences arising between the plan and its execution we speak about the pure risk. However, taking into account certain opportunities associated with the activity we can define the speculative nature of risk

(Kaczmarek 2005). This kind of risk may have a positive, neutral or detrimental impact on the unit. Hence, it involves some form of gamble. So, the purpose of certain legal regulations imposed on the local governments, especially involved in the public finance act (e.g. limits of indebtedness, possible investment securities etc.), is to decrease the negative consequences of excessive risk (Drennan, McConnell 2007). Furthermore, M. Kulesza claimed that local and regional authorities realizing a specific set of tasks incur a certain business risk, like other private entities. However, this risk must be distinguished from the incompetence, negligence, unlawful activities, or even criminal acts, because in a decision-making process in local governments is required to respect the law, procedures, transparency and professionalism. Thus, legal regulations reduce the likelihood of irrational actions, but do not prohibit from some business risks there (Kulesza 2008). As a result, risk is an inherent feature of the functioning of local governments. Sources of this risk can be divided into (Wojtasiak-Terech 2011):

- 1) Internal, caused by:
 - financial factors (related to the collection and disbursement of cash) - an important criterion for assessing the creditworthiness of local governments is the result of the budget execution in the past, including the assessment of revenues and expenditures in this field;
 - regulations, due to the fact that a certain unit does not comply with them (e.g. the implementations of illegal tax exemptions);
 - organizational factors, such as aspects of human resource management, implemented procedures of the process of decision-making or some technological solutions, including internal information technology);
 - political factors, mainly due to the inappropriate cooperation between politicians within the local governmental structures, especially on the line "making the law - executing the law".
- 2) external, derived from:

- the proximal environment (e.g. the relationships with the citizens, various institutions, customers, suppliers, financial institutions etc.);
- the further environment, in particular: a) economic, e.g. alterations in interest rates, b) legal, e.g. changes in the field of revenues or the scope of expenditures, c) social, e.g. demographic trends, d) environmental, e.g. weather catastrophes and other fortuitous events, e) political, e.g. the forcing of certain actions in parliament, that are inconsistent with local needs).

The main criterion of the division of risk into internal and external is the possibility of determining it. Thus, the internal risk derives from the strategic decisions or operational activities of the unit, whereas the external one is largely out of the control. Hence, for banks it is crucial to study the operational risk of the public body, which it operates. At the operational level, risk is present in the day-to-day functions and services there. It might result from the people, property or processes involved in delivering services to the local community.

In local governments operational risk takes many forms and may be described as: a) professional – associated with the particular nature of each functions (e.g. housing, social services, education services etc.), b) financial, especially concerning the condition of the local budget, c) legal – related to potential breaches of legislation or issuances of flawed regulations, d) physical – cause by fire, some accidents (or even the hazard of the employees), e) contractual – associated with the outsourcing of key services, f) technological – tied with information systems and other machinery, g) environmental – connected with the pollution, recycling, waste disposal, energy efficiency etc. (Drennan, A McConnell 2007). Therefore, during the process of estimating the operational risk of the local governments banks ought to include some qualitative information, such as: the property of the unit, the condition of infrastructure, the level of entrepreneurship, location etc. (Misterec 2008). In consequence, it may cause some problems to judge these issues properly. It concerns also the risk of the functioning of the overall local government sub-sector. It means that some regulations, which protect public sector as a whole or activity of the Ministry of Finance in this field, might be a threat for some local or regional units. Furthermore, bank should consider the whole system of finance of the public sector, mainly on the line: central government – local governments. Literature points out here risk of fiscal discipline. It means, that local governments may behave in fiscally imprudent ways (e.g. the excessive rise of expenditures, which are covered by a debt) if they have the central government's implicit assurance that they will be bailed out in the aftermath of financial problems (Fölscher 2007). On the other hand, commercial banks may exploit these promises in order to decrease potential financial risks of this sub-sector. However, banks mainly focus on the quantitative information gathered from the each operated unit. They are strongly tied with the financial situation of the units and involve different measures characterizing the indebtedness, financial independence or financial liquidity. As a result, banks carefully analyse the credit risk of the operated unit. It is defined as a danger of not paying off a debt. In practice, the assessment of the credit risk is the

most meaningful for the banks (Gwizdała 2011). To describe and manage it, banks use statistical tools: data collection, sampling and data analysis (Kendrick 2003).

The membership of Poland in the European Union and the possibility of using EU funds caused that banks implemented new services and products in this field. As a result, there appeared new types of risks associated with this banking support for local governments. Risks in this area can be considered on several levels. So, there might be distinguished:

- 1) risks arising from the organization and management of the project (drafting business plan, gathering the necessary documentation, filing the application, carrying out investment accounts, etc.), and
- 2) risks related to process of financing certain investment (granting the bridging credit or credit for the own contribution of the unit into the EU project).

The first group of the above risks, i.e. the organization and management of the project, result from the possible involvement of the bank into the process of applying for EU funds by a specific beneficiary and some activities related to the settlement of the investments. However, the second ones are strongly tied with the credit risk of the assisting EU projects of the local government (Galiński 2011).

3. THE RISK FOR BANKS IN OPERATING THE LOCAL GOVERNMENTS IN POLAND – RESEARCH FINDINGS

In Poland commercial banks provide many products for the local governments (communes, counties, cities of county status and voivodships), mainly in the field of operating their budgets, giving them credits or investing the cash. This offer is a part of services for corporate clients and is required in order to compete on the market. However, the local governments are very desirable business partners for the banks. It results from the fact that they are the units of the public finance sector. Although they need a lot of banking products, especially credits, they are trustworthy. In consequence in 2011 for 64% of the banks in Poland these units were estimated as very attractive clients (figure 1). Banks pointed out, that operating local governments, during the period of the crisis on the financial market, they could balance decreasing revenues from servicing private corporations.

In Poland the large significance of the credit products for local governments is caused by the financial shortages in this sector. Their revenues consist of own revenues, general subsidy that is divided into educational part, compensatory part and equalizing part (regional part in voivodships) as well as special purpose grants and are insufficient to meet local needs. It means, that on the expense side local governments in Poland have to finance current expenditures and capital expenditures (mainly investment ones) to realize their tasks properly. As a result, they do not possess enough revenues to cover expenditures connected with the modernization and development of the local infrastructure.

According to the commercial banks, within the group of local governments in Poland the communes and voivodships are characterized by the lowest level of risk, while the higher one is in the cities of county status and counties (figure 2). The higher, than other local government, risk assessment in the counties results from the lower revenue

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base, including the smaller capacity to generate their own revenues there. First and foremost, they do not possess, as communes and cities of county status do, such significant shares in the Personal Income Tax (it has a significant role as a own revenue) as well as they cannot impose the local taxes (mainly on properties; in Poland in counties and voivodships local taxes do not supply their budgets).

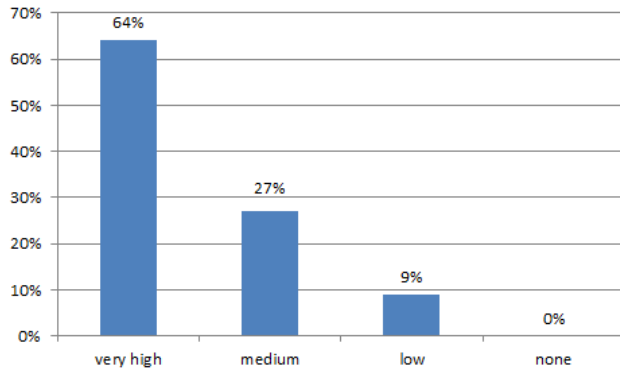


Figure 1 Attractiveness of operating the local governments in the opinion of banks in Poland in 2011 (% of the banks)

Source: own study based on the questionnaire from May 2011 (Galiński 2011)

Moreover, the greater risk of operating these units is caused by problems in (Galiński 2011):

- increasing its financial independence;
- generating and maintaining the stable operating surplus (positive difference between current revenues and current expenditures), which enables to finance additional investments or repay a debt;
- restructuring some local facilities, especially hospitals, that burden their budgets;

In turn, the higher level of risk in the cities of county status is determined by the potential possibilities of the appearance of financial problems in the field of their liquidity because of their large investment activity and indebtedness (Galiński 2011). In many cases, these units are engaged in many investment projects in the field of social and technical infrastructure in order to increase their competitiveness. However, these investments are crucial to meet the growing needs of the citizens. Therefore, local authorities of the large cities are afraid that people could move out into the other local governments, especially located on the suburbs, still using their local infrastructure for everyday needs (urban transport, schools, cultural and sports facilities etc.). In consequence, they have to develop and keep the infrastructure, but have no guarantees that their budgets will be supplied by the increasing shares of PIT. This also concerns the development of infrastructure required by the entrepreneurs (the share in Corporate Income Tax is also a component of own revenues in local governments in Poland). But, it should be underlined that for many banks in Poland local governments are devoid of risk, which is understood as a possibility of bankruptcy.

In 2011 in Poland in the process of risk appraisal of local governments by the banks the lowest level had risk of the fortuitous events as well as operational risk (figure 3). The size of these two types of risks, in particular their low level, may indicate certain dysfunctions in that evaluation. Since the risk assessment of local governments in commercial banks is made primarily on the basis of historical financial

data, less important are qualitative information, describing the local economy (e.g. the level of industrialization of the regions), environment (e.g. geographical location, access to raw materials) and society (e.g. education of the local population). However, these issues determine the possibilities of the appearance of some events (e.g. migration of the people affects the own revenues from the shares in the state taxes and then the financial independence of the unit). Therefore, some quantitative issues may influence the risk of the local governments, but are omitted by the banks.

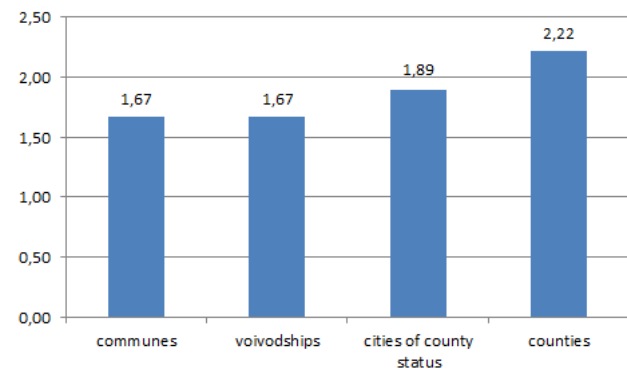


Figure 2 The risk (assessment ranging from 1 – low risk to 5 – very high risk) of operating the types of local governments for banks in Poland in 2011

Source: own study based on the questionnaire from May 2011 (Galiński 2011)

That is way in 2011 in Poland in banks the highest risk of operating the local governments was associated with the specificity of the functioning of this part of the public finance sector (figure 3). This was primarily due to the volatility of the law in this field, including mainly the possibilities of implementing additional restrictions concerning the level of indebtedness of these entities or imposing additional tasks by the state (Galiński 2011).

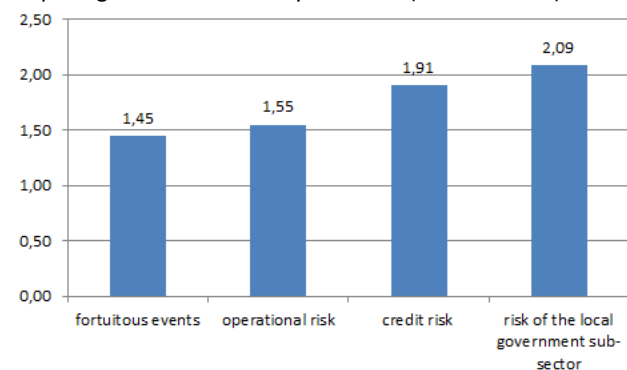


Figure 3 Chosen types of risk (assessment ranging from 1 – low risk to 5 – very high risk) in the field of operating the local governments by the banks in Poland in 2011

Source: own study based on the questionnaire from May 2011 (Galiński 2011)

Besides, the study shows that banks in Poland relatively lowly assess the risk of the main types of credits for local governments. In this group, the renewable credits are characterized by the lowest risk (Figure 4). This risk is determined by the fact that the unit does not have to include them during the budget preparation. So, they should be repaid within the year. Moreover, in many cases the renewable credit is a component of a long-term

agreement in the field of operating the budget of the unit. Hence, before this agreement will be signed the bank examines the financial situation of the unit accurately. On the other hand, in 2011 in Poland the credits for European Union projects of local governments were characterized by the highest level of risk. This especially concerned the credits financing the own contribution of these units into the EU projects. This results from the presence of additional sources of risk in the group of these credits, such as: the risk of difficulties in the settlement of the project, which may negatively influence on the refund of costs (problems to repay the EU bridging credit). Nevertheless, as it was mentioned, banks preferred to give them credits in comparison to different entities from the private sector.

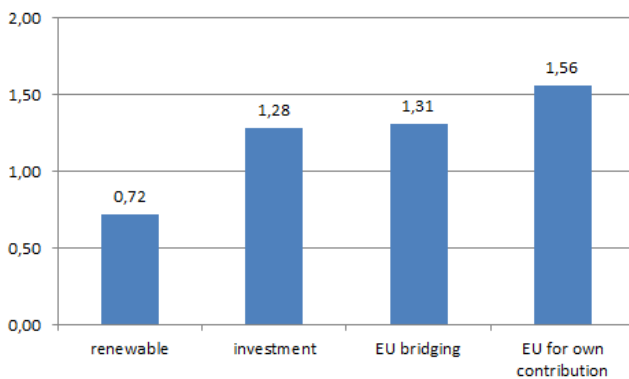


Figure 4 The level of risk (assessment ranging from 0 – very low risk to 5 – very high risk) of main types of banking credits and loans for local governments in Poland in 2011
Source: own study based on the questionnaire from May 2011 (Galiński 2011)

4. CONCLUSION

During the process of operating local governments, the commercial banks may encounter some risks, which are typical for this sub-sector of the public finance. Many of them are determined by the qualitative issues that are difficult to predict and estimate. That is way, in Poland lots of such constraints are assessed on the higher level in contrast to financial risks resulting from the economic condition of the unit. It especially concerns the credit risk that is relatively easy to appraise by the banks. Nevertheless, in Poland local governments are the key clients for these institutions. This cooperation enables to balance possible losses made on the private corporations. In particular, renewable credits for local governments are characterized by the low risk. Whereas the credits for the EU projects are treated with the addition caution there.

Taking into consideration all types of local governments in Poland, counties are described by the highest risk in the field of their banking operation. This results, inter alia, from the low financial independence of these public units and possibilities of increasing their own revenues. It means that banks value the economic autonomy of local governments. Therefore, implementing some constraints for this sub-sector by the state may influence on the growth of risk of their service. In consequence, it may contribute to the increase of payments of some banking products for local governments.

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