



EU for Stronger Public Finance Systems of Local Governments



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Ukraine

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# A Review Of The Existing Practice In Local Authority Borrowing And Provision Of Local Guarantees

Component 3: Stronger supervision of local debt management

Activity 3.1. Assess the current practice and needs in strengthening the capacity of the Ministry of Finance to control  
the management of local debt

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## 1. Introduction

The need of local governments to seek additional financial resources has become particularly relevant in recent years. The growing economic autonomy of regions amid decentralization not only enables local governments to stimulate the initiative, but also makes them co-responsible for the implementation of the national economic policy. Hence, they bear the burden of not only ensuring uninterrupted operation of municipal infrastructure facilities, but also of enabling the conditions for further development. Insufficient budget funding of Ukrainian cities and regions makes the challenge of attracting the necessary resources from other sources particularly acute. In this context, local budgets must use the stock market opportunities to issue local bonds and regional loans. Local borrowings and local guarantees are an important source of funding for local government development and a powerful financial tool that helps effectively solve current and long-term issues in budget expenditure financing. While local borrowing market began taking its shape in 1995, the first local guarantees were issued only in 2008 or quite recently compared with foreign countries. This makes it necessary to review the progress in the development of local borrowings and local guarantees since 1995 and identify trends. In this context, it is crucial to compare the international practice in local authority borrowing and provision of local guarantees with the practice existing in Ukraine and prepare findings and recommendations.

## 2. Review of the existing practice in local authority borrowing and provision of local guarantees

### 2.1. Analysis of borrowings across Ukrainian regions following the Budget Code passage

Ukraine's Budget Code passage in 2001 marked the second stage in the local borrowing market development.

It was stipulated that the Supreme Council of the Autonomous Republic of Crimea and city councils may borrow money from domestic sources.

At that, those eligible for external borrowings were only councils of cities with a population greater than 800,000.

The debt threshold was set by resolution on local budget.

Local budget borrowings were made for the purpose set out by respective council.

Local budget annual debt service charges could not exceed 10% of respective local budget's general fund expenses.

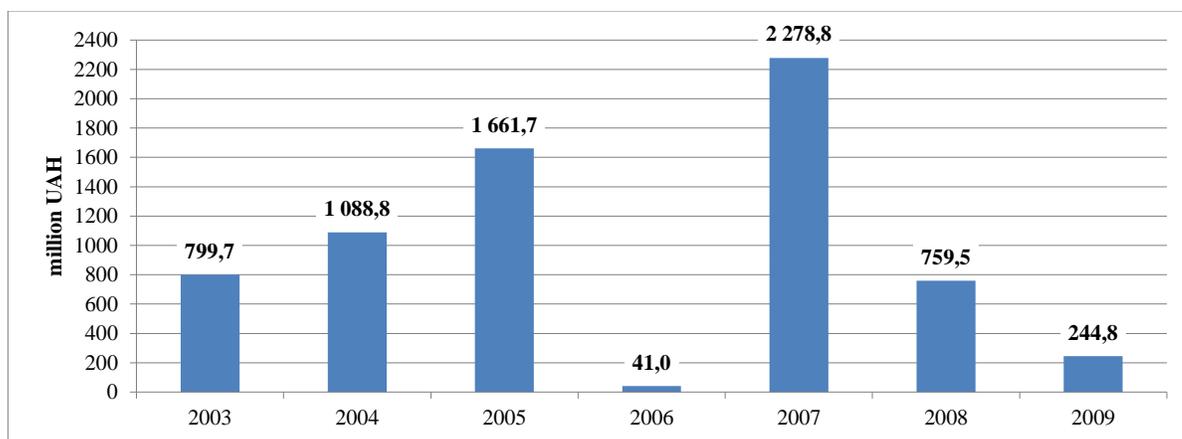
A breach of repayment schedule through borrower's fault during repayment of the principal amount of debt and debt service charges set out in the agreement between the lender and the borrower deprived a respective council of the power to make any new borrowings for the next five successive years.

Kyiv City Council was the first to make local borrowings. In 2003, it issued external loan bonds worth USD 150 million and internal loan bonds worth UAH 100 million. In 2004, Kyiv City Council was joined by Zaporizhia City Council, which issued internal loan bonds. The year 2005 saw more cities involved in local authority bond issuing.

There can be distinguished three phases in local authority bond issuing. The first phase was between 2003 and 2009 (see Table 1).

Table 1

Volume of the registered issues of local authority bonds from 2003 to 2009



During that period, the registered issues of local authority bonds totalled UAH 6,874.3 million (from this point onward the volume of registered local authority bond issues is specified exclusive of debt restructuring).

The year 2007 saw the largest issue worth UAH 2,278.8 million.

As is well known, the year 2008 marked the onset of the global financial crisis. However, Ukraine managed to issue bonds worth a total of UAH 759.5 million.

In October 2008, Kyiv cancelled the issue of local authority external bonds.

The financial crisis took its heaviest toll in 2009, when registered local authority bond issues totalled a mere UAH 244.8 million.

The second phase in local authority bond issuing fell between 2010 and 2014 (Table 2).

Table 2

Volume of the registered issues of local authority bonds from 2010 to 2014



The year 2010 saw material amendments to the local borrowing procedure resulting from the re-enactment of the Budget Code. If before 2010 the debt threshold was set by city council resolution, after that year it was set by the

Budget Code of Ukraine at 200% (400% for the city of Kyiv) of the average annual projected development budget revenue based on projected local budget targets for the next two successive local budget periods following the planned one.

In addition, a register of local borrowings was put in place to ensure compliance with local debt threshold.

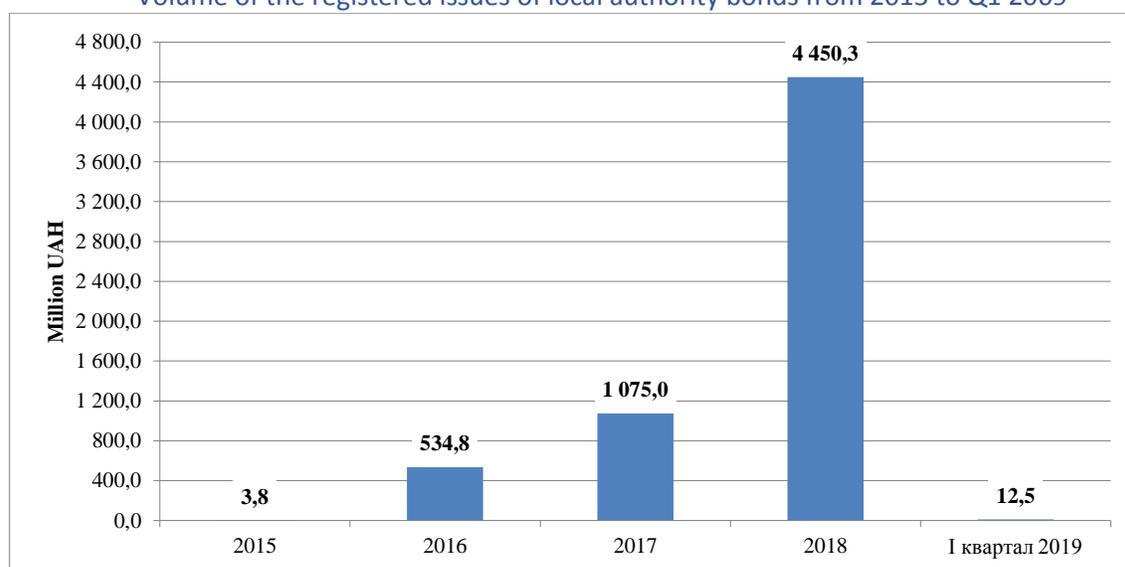
Article 74 of the Budget Code set forth the purpose of local borrowings.

The second phase saw a total of UAH 12,568.9 million in the registered issues of local authority bonds, with the year 2012 alone seeing a record high figure of UAH 6,854.1 million.

The third phase began in 2015 (see Table 3) when the Budget Code of Ukraine was amended to enhance the financial capacity of local governments. These amendments became known as the Budget Reform or Fiscal Decentralization.

Table 3

Volume of the registered issues of local authority bonds from 2015 to Q1 2019



The registered issues peaked in 2018 at UAH 4,450 million. In 2019 regional councils were also granted some bond-issue powers.

Having analysed the local borrowing market for the period between 2003 and Q1 2019, it is fair to say the Kyiv, Odesa and Lviv city councils are major issuers of local authority bonds and that local governments have been showing considerable interest in using this effective source of finance to tackle social problems in their regions (see Table 4).

Table 4

Cities with the largest registered volume of local authority bonds issued from 2003 to Q1 2019

City	Local authority bonds issued (in millions of UAH)	Percentage of total local authority bonds issued
Kyiv	14,937.5	58.5%

Odesa	3,223.5	12.6%
Lviv	1,221	4.8%
<b>Total</b>	<b>19,382</b>	<b>75.9%</b>

As can be seen from the table above, Kyiv alone issued local authority bonds worth UAH 14,937.5 million or 58.5% of the country's total.

Worthy of note is also a trend towards borrowing from international financial institutions that emerged in 2012.

However, the lack of positive dynamics in the growth of registered issues and sizeable time gaps between them only go to prove that the local borrowing market, as part of Ukraine's stock market, is at the initial stage of its development.

It should be noted that only 61 or slightly greater than 5 percent out of 442 cities of regional or rayon significance issued local authority bonds (see Table 5).

Table 5

Number of cities that issued local authority bonds from 2003 to Q1 2019

Region	Number of cities that issued local authority bonds (excluding the ARC and Sevastopol)	Total number of cities (excluding the ARC and Sevastopol)
Vinnytsia Region	1	18
Volyn Region	2	11
Dnipropetrovsk Region	6	20
Donetsk Region	5	52
Zhytomyr Region	4	12
Zakarpattia Region	1	11
Zaporizhia Region	2	14
Ivano-Frankivsk Region	3	15
Kyiv Region	6	26
Kropyvnytskyi Region	1	12
Luhansk Region	2	37
Lviv Region	1	44
Mykolaiv Region	-	9
Odesa Region	2	19
Poltava Region	4	15

Rivne Region	2	11
Sumy Region	3	15
Ternopil Region	2	18
Kharkiv Region	3	17
Kherson Region	-	9
Khmelnyskyi Region	4	13
Cherkasy Region	2	16
Chernivtsi Region	1	11
Chernihiv Region	3	16
City of Kyiv	1	1
<b>Total</b>	<b>61</b>	<b>442</b>

As can be seen from Table 5, the cities of Mykolaiv and Kherson regions did not address this matter at all.

Compared with European countries, in Ukraine the amount of local borrowings per capita is rather small.

In 2012, the year in which Ukraine saw the largest issue of local authority bonds in the period from 2003 through Q1 2019, the amount of local borrowings per capita stood at EUR 12.5 compared with EUR 261.7 in Germany, EUR 172.6 in Belgium, EUR 503.7 in Austria or even the EU average of EUR 49.7.

A significant indicator of the local borrowing market development is the share of local borrowings in local budget revenue. However, it has been within a mere 2% in recent years.

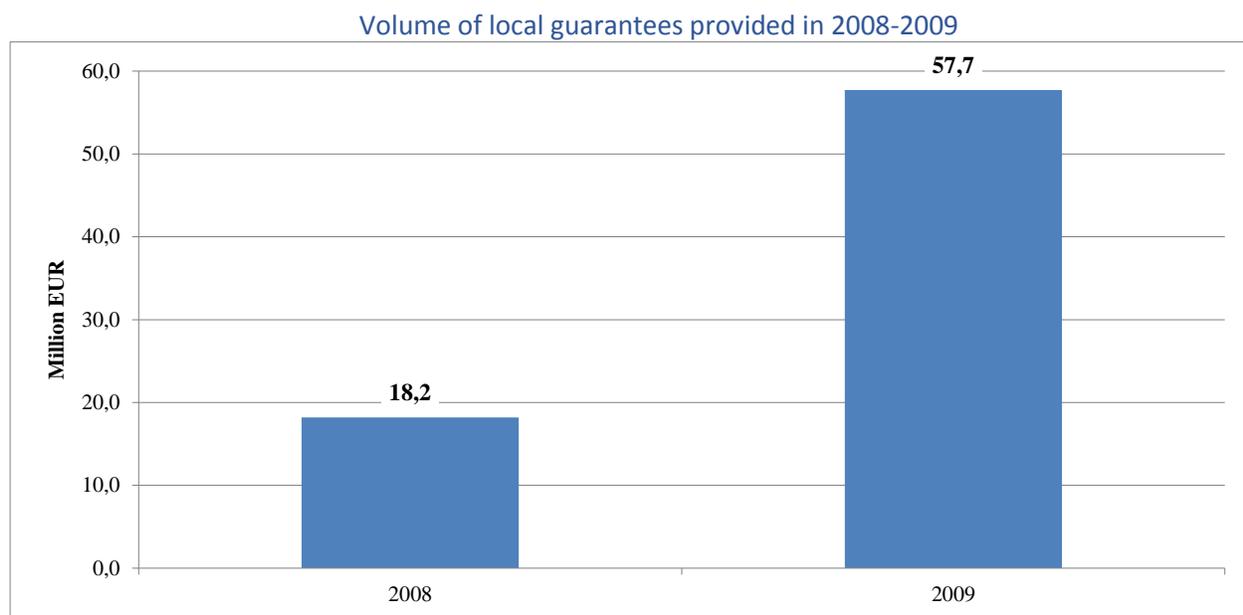
At the same time, the average for the EU countries is more than 80%.

Examples include Czech Republic – 21%, Lithuania – 24%, Poland – 32%, Latvia – 62%, France – 79%, Germany – 125%, Spain – 134%.

## 2.2. Analysis of the provision of local guarantees across Ukrainian regions

There can be distinguished two phases in the history of the system for the provision of local guarantees. The first phase was between 2008 and 2009 (see Table 6).

Table 6

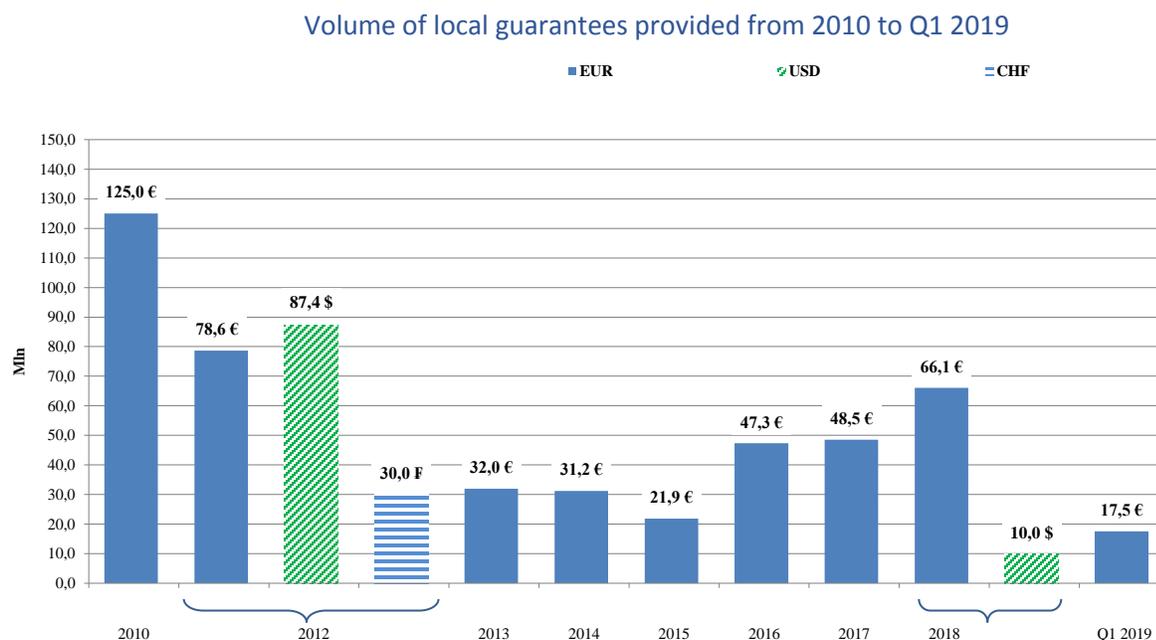


Under Ukraine's Budget Code 2001, the Supreme Council of the Autonomous Republic of Crimea and city councils, represented by heads of their executive authorities, could provide guarantees for debt obligations within the remit approved by local budget resolution.

The guarantee threshold was set by resolution on local budget. The volume of guarantees issued in 2008 reached only EUR 18.2 million. In 2009 this figure was already EUR 57.7 million.

Ukraine's Budget Code re-enactment in 2010 marked the second phase in the development of the local guarantee system (see Table 7).

Table 7



The Budget Code 2010 set forth a change in powers, designated which business entities would receive guarantees, and provided for inclusion of their volume into debt threshold.

Under the re-enacted Budget Code, the Supreme Council of the Autonomous Republic of Crimea or city council may, by their resolution, provide local guarantees to secure full or partial performance of debt obligations of business entities operating in the municipal sector of the Autonomous Republic of Crimea or respective city, located in a respective area and conducting investment projects aimed at municipal infrastructure development or resource-saving technology implementation within such area.

In addition, total local debt and debt guaranteed by the Autonomous Republic of Crimea or a city territorial community (net of guarantee obligations under loans from international financial institutions) as at the end of the budget period may not exceed 200% (400% for the city of Kyiv) of the average annual projected development budget revenue (net of local borrowings and capital transfers (subventions) from other budgets) based on projected local budget targets for the next two successive local budget periods following the planned one. In 2019 regional councils were also granted some powers to provide guarantees.

The largest volume of guarantees totalling EUR 78.6 million, USD 87.4 million and CHF 30 million was provided in 2012. A somewhat less volume of guarantees totalling EUR 125 million was issued in 2010. Then followed the slump, and only EUR 66.1 million and USD 10 million were provided in local guarantees in 2018.

All in all, only 23 cities (or 14% of their total number) provided local guarantees between 2008 and Q1 2019 (see Table 8).

Table 8

## Number of cities that provided local guarantees from 2008 to Q1 2019

Region	Number of cities that provided local guarantees (excluding the ARC and Sevastopol)	Total number of cities (excluding the ARC and Sevastopol)
Vinnytsia Region	1	18
Volyn Region	1	11
Dnipropetrovsk Region	2	20
Donetsk Region	-	52
Zhytomyr Region	1	12
Zakarpattia Region	-	11
Zaporizhia Region	2	14
Ivano-Frankivsk Region	1	15
Kyiv Region	-	26
Kropyvnytskyi Region	1	12
Luhansk Region	1	37
Lviv Region	1	44
Mykolaiv Region	-	9
Odesa Region	1	19
Poltava Region	4	15
Rivne Region	-	11
Sumy Region	1	15
Ternopil Region	1	18
Kharkiv Region	1	17
Kherson Region	-	9
Khmelnyskyi Region	1	13
Cherkasy Region	1	16
Chernivtsi Region	1	11
Chernihiv Region	-	16
City of Kyiv	1	1

<b>Total</b>	<b>23</b>	<b>442</b>
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At that, cities of Donetsk, Kyiv, Mykolaiv, Rivne, Kherson and Chernihiv regions were not involved in the provision of local guarantees. Lviv, Kyiv and Dnipro city councils were most active in granting local guarantees (see Table 9).

Table 9

#### Cities that provided the largest volume of local guarantees from 2008 and Q1 2019

City	Euros		US dollars		Swiss francs	
	Volume (mln)	Percentage of total volume	Volume (mln)	Percentage of total volume	Volume (mln)	Percentage of total volume
Lviv	204.2	37.5	23.7	24.3	30	100
Kyiv	123	22.6	-	-	-	-
Dnipro	48.6	8.9	-	-	-	-

Guarantees were mostly provided in such sectors as thermal energy, transport, and water supply and sewage (see Table 10).

Table 10

#### Volume of local guarantees granted from 2008 to Q1 2019 broken down by municipal economic sectors

Sector	Million Euros	Million US dollars	Million Swiss francs
Thermal energy	172.6	-	-
Transport	211.5	10	30
Water supply and sewage	40.5	51.9	-
Roads	28	-	-
Road traffic management	15	-	-
Greenery planting	25	-	-
Lighting	18.6	-	-
Energy saving	25.5	-	-
Other	8.1	35.5	-
<b>Total</b>	<b>544.8</b>	<b>97.4</b>	<b>30</b>

### 2.3. Analysis of compliance of Ukraine's existing practice in local authority borrowing and provision of local guarantees with international practice

In foreign countries, regional and local councils may make borrowings and provide local guarantees. At that, in some countries, foreign currency denominated borrowings may only be made subject to central government approval. In Ukraine, the Supreme Council of the Autonomous Republic of Crimea, regional and city councils may make local domestic borrowings. The Supreme Council of the Autonomous Republic of Crimea, regional councils and all city councils may take local external borrowings in the form of loans from international financial institutions. Other local external borrowings may only be made by the Supreme Council of the Autonomous Republic of Crimea, Kyiv and Sevastopol City Councils and councils of cities of regional significance. Local guarantees may be provided by resolution of the Supreme Council of the Autonomous Republic of Crimea as well as regional and city councils.

In most foreign countries, operating activities may not be financed out of long-term loans, as maturity loans for a period of more than year may only be taken to fund capital investments (the so-called "golden rule"). In Ukraine, borrowings may also be channelled solely to finance development budget expenditure.

In most foreign countries, total debt may not exceed a certain percent (from 60% to 100%) of current budget revenue. There are also specific limitations relating to an appraised value of property within a municipality's jurisdiction or investment in particular sectors. Ukraine also has a "specific limitation" of 200% (400% for the city of Kyiv) of the average annual projected development budget revenue.

Debt service charges in most foreign countries must not exceed a certain percent (usually 15-20%) of current budget revenue. In Ukraine they must not exceed 10% of the budget's general fund expenses.

In many foreign countries borrowings must be approved by central government departments, agencies or regulators. In Ukraine, all types of borrowings and guarantees are subject to the Ministry of Finance's approval.

Along with unsecured local borrowings, foreign countries use different types of collateral as security for local borrowings, which may be collateralized by government guarantees, municipal property and assets, transfers from the state budget or local budget revenue. In Ukraine, local borrowings may be either unsecured or secured by property and other collateral.

Many foreign countries have statutory procedures to deal with an insolvent local budget.

Ukrainian legislation clearly regulates the procedure for mandatory direct debiting of funds from the budget, and creditors may apply to court for the recovery of arrears in the event of borrower's insolvency. The procedure for the recovery of funds from local councils' budgets has its specifics due to the targeted use of budget funds.

In some foreign countries provisions are made that debts arising from contractual obligations (interest and principal repayment) constitute mandatory budget expenditure. In Ukraine, they are not only mandatory, but also top-priority. In foreign countries, an issuer (in some countries an issuer and underwriter) is liable for the adequacy and accuracy of an issue prospectus. However, in contrast to Ukraine, a prospectus does not have to be registered with regulatory authorities.

In foreign countries, guarantee obligations may be provided by a municipal enterprise, an entity governed by private law or a citizen. In Ukraine this may only be done by municipal enterprises for targeted use.

In Ukraine and foreign countries provisions are made for disclosure of financial information by municipalities.

In many foreign countries, borrowings are made by special financial institutions such as municipal funds or debt management agencies. There is no such practice in Ukraine.

Commercial bank loans and municipal bonds are among the most popular debt instruments in both Ukraine and abroad.

All in all, it may be concluded that for the most part Ukrainian practice in local authority borrowing and provision of local guarantees is consistent with foreign practice.

## 2.4. Analysis of the maintenance of the Register of Local Borrowings and Local Guarantees

Under the 2011 amendments to Article 18 of the Budget Code introduced to ensure compliance with local debt and local guarantee thresholds, the Ministry of Finance of Ukraine is responsible for keeping the Register of Local Borrowings and Local Guarantees, an information system containing details of local borrowings made and local guarantees granted.

A data form about local borrowings made and local guarantees provided in 2013-2014 available on the Ministry of Finance's website has columns about the thresholds of local debt and debt guaranteed by a city territorial community, and expected total local debt and debt guaranteed by a city territorial community as at the end of the budget period. However, these columns were not completed.

In 2015, the Ministry of Finance amended its Order On Approval of the Procedure for Keeping the Register of Local Borrowings and Local Guarantees No. 866 of 25 July 2012, and approved the data forms about local borrowings and local guarantees. The said data forms already have no columns about debt volumes, but have "Date of application for the Ministry of Finance's approval" and "Date of approval by the Ministry of Finance" columns instead.

A part of local borrowing or local guarantee process, the information in these columns is not necessary for further analysis as at the time of its inclusion into the register. In addition, it takes time to fill in these columns.

In fact, the Register is currently a mere information system with details of local borrowings made and local guarantees issued.

It is used by local governments, NGOs and researchers.

However, the Register is not sufficient to sustain a full analysis of local borrowings and local guarantees.

Although authorities use restructuring and refinancing to manage local debt, these instruments are reflected in the register as additional local borrowings. For example, the data form for the city of Kyiv for 2016 reflects UAH 1,915.253 million as a borrowing although it was, in fact, refinancing. The data form for 2018 reflects USD 115.072 million as a borrowing although it was, in fact, restructuring.

This also has to be reflected in the Register.

It is also necessary to improve the way information is presented.

The Ministry of Finance's website contains information on approval of local borrowings in 2011 and from the beginning of 2012. It also contains data on local borrowings and local guarantees without reference to a year. This is especially so with respect to 2011-2012, as information for 2013 is available.

However, the data without reference to a year includes the ARC's UAH 133 million borrowing, which had already been included in the data for 2011. At the same time, there is no data about Kyiv, which also approved a borrowing in 2011.

The data form about local guarantees for 2015 contains approval of Chernivtsi City Council's and Vinnytsya City Council's guarantees worth EUR 10 million and EUR 8 million respectively, with the year 2016 specified in the "Date of application for the Ministry of Finance's approval" and "Date of approval by the Ministry of Finance" columns. Data forms about local guarantees for 2016 also contain these approvals.

In addition, some data forms specify total volume of local borrowings and local guarantees, while others don't.

## 3. Findings and recommendations

The applicable legislation (acts and regulations passed by the Ukrainian Cabinet of Ministers, departments and agencies) is consistent with international practice and sufficient to sustain control over local debt, and it would be inappropriate to strengthen it further.

At the same time, the applicable legislation significantly slows down local borrowing and local guarantee issuance processes.

Only a little more than 5 percent of the total number of cities (excluding the ARC and Sevastopol) made local borrowings between 2003 and Q1 2019. At that, the cities of Mykolaiv and Kherson regions did not borrow at all. Only 14 percent of the total number of cities granted local guarantees, while cities of Donetsk, Kyiv, Mykolaiv, Rivne, Kherson and Chernihiv regions have no relevant practice at all. Local guarantees were mostly issued to international financial institutions.

Compared with European countries, the amount of local borrowings per capita in Ukraine is rather small.

In 2012, the year in which Ukraine saw the largest issue of local authority bonds in the period from 2003 through Q1 2019, it stood at EUR 12.5, which is almost fourfold lower the EU average, twenty times lower than in Germany and forty times lower than in Austria.

A significant indicator of the local borrowing market development is the share of local borrowings in local budget revenue.

In Ukraine it has been within a mere 2% in recent years. At the same time, the average for the EU countries is more than 80%. Examples include Czech Republic and Lithuania, where the respective figure is around 24%, Poland – more than 30%, Latvia – more than 60%, France – around 80%, Germany and Spain – more than 130%.

Ukraine's local debt principal amount threshold restricts local governments in their ability to increase, properly plan and manage local debt, and give rise to subjectivism in its assessment by both local governments and the Ministry of Finance. This, along with threshold on debt service charges at 10% of the budget's general fund expenses, does not bode well for attracting additional financial resources for socio-economic development.

The Budget Code of Ukraine stipulates that during the term of local guarantee agreement the Supreme Council of the Autonomous Republic of Crimea, regional and city councils earmark, by respective local budget resolution, funds for the performance of their guarantee obligations out of payments that fall due in a respective budget period. This means freezing development budget's financial resources that are, in fact, not quite well enough sufficient for socio-economic development of territories.

Entering a local borrowing market requires knowledge and expertise. Western economies set up municipal funds and debt management agencies, which, in addition to providing assistance, also deal with borrowings and providing loans to municipalities. The year 2016 saw a project for setting up a regional debt management agency drafted at the request of Ukrainian government, which, unfortunately, had failed to be turned into reality.

Taking the above into account, it is necessary to amend the applicable legislation of Ukraine.

It is proposed to amend Order On Approval of the Procedure for Keeping the Register of Local Borrowings and Local Guarantees No. 866 of 25 July 2012 (as amended) by removing "Date of application for the Ministry of Finance's approval" and "Date of approval by the Ministry of Finance" columns from data forms and introducing "Notes" or "Additional information" column to reflect restructuring, full or partial refinancing, changes to material terms and conditions of agreements, etc.

Information about Chernivtsi City Council's and Vinnytsya City Council has to be removed from data form about local guarantees for 2015. In addition, it is necessary to specify total local borrowings and local guarantees for each period.