
Impact of the financial crisis on the Public Finance specialized banks and their regional and local partners

ICLC survey
October 2008 to July 2009



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ICLC objectives are to promote local public sector investment financing. The association was founded in October 1958 in Oslo by Crédit Communal de Belgique, Bank Nederlandse Gemeenten and Kommunalbanken Norge. Since then it has grown to become a truly global organisation, with to date 23 members from Europe, North America, Africa and Asia.

Survey Background (1)



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- Initiated by the ICLC General Assembly 2008
 - Launched by the ICLC general secretariat in October the same year
 - Given the evolution of the crisis, the survey was adapted in order to better reflect the new situation
 - 18 of 23 members answered during a nine month period providing an overview on 20 countries

Survey Background (2)



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- The answers were full of information but they required some interpretation
 - A challenge has been to highlight specific examples without disclosing sensitive information the Members provided
 - Hope the results will stimulate the following discussion...

I - Impact on the banking sector



I-1 Have you noticed a loss of confidence towards the banking sector?

- Loss of confidence towards the banking sector is closely:
 - Tied to individual countries' exposure to the financial crisis
 - Related to the size of banks: larger banks appear to have suffered from mistrust (Germany, Iceland, Switzerland)
- In exposed countries where a loss of confidence is reported, the main concerns are
 - "sophisticated" financial products
 - banks' solvency

I-2 When do you believe we will start to see a recovery?

- Most of the respondents agree that the recovery should start during 2010
- Most respondents expect that the recovery of the American will precede that of the Euro zone
- A new member of the European Union mentions its reliance on the recovery of the Euro zone
- Participants believe that the worst of the crisis has passed
- Economic recovery is expected to lag far behind financial stabilization

I-3 Have you observed any structural change in the banking industry?

- Considerable turmoil reported for large German, Swiss and Icelandic banks
- Withdrawal of foreign banks is observed in several countries
- Generally speaking, banks have reduced capital available for (market) risk taking
- Overall lending has reduced
- Banks are more likely to focus on public sector lending rather than on private

Other observed structural changes

Fundraising shifts (ex: from bank loans to equity issuance)

High level of liquidity requirements

Information disclosure

Public recapitalization

I-4 How has the financial crisis affected the competitive environment?

- The financial crisis has considerably impacted the competitive environment in almost every country, except Canada, Israel and Morocco
- Four types of impact:
 - Temporary withdrawal of competitors
 - Reduced activities and focus on core business
 - State guarantee
 - Reorganization of banks (mergers)

*The case of northern
European municipality banks*

In northern Europe, several commercial banks have scaled down their municipal activities so that some members became the only actor in that market

I-5 Do you believe that the financial crisis will modify the current generic banking industry regulatory environment?

- Out of 17 answers, 14 observe that the crisis will imply an important change of the regulatory environment, which may include:
 - Focus on regulation and transparency
 - New reporting requirements, especially in risk management
 - Improvement in accountability
 - Capital requirements
- The crisis stressed the importance of Basel II
- Respondents agree that these measures would require international coordination and commitment

I-6 Do you expect more stringent rules of the game, in particular concerning the sale of sophisticated financial solutions? Will it significantly impact the profitability of Public Finance activities?



- The majority of respondents indicated that new, more stringent rules and requirements would mostly affect sophisticated financial products
 - More scrutiny by financial authorities
 - Greater cautiousness by clients
- However, they are not forecasted to impact significantly on profitability
- Countries with conservative tools to finance local authorities do not expect changes

I-7 How do you feel that the financial crisis has affected your competitors' pricing policy?



- All respondents report that credit margins have sharply increased in the aftermath of the financial crisis
- Main reason: funding margins for banks have increased
- Spreads have also considerably increased

Margin range

Since the crisis, margins are from +40 to +120 bps and especially in the range +80 to 100 bps.

I-8 Will banks revise their services and products?

- Some banks do not forecast any changes, notably those only active in the public sector
- The other respondents indicate that new services and products should be created but are not yet clearly defined
- New offers and products will focus more on:
 - Transparency
 - Simplicity

Strategy reorientation:

Focus on plain vanilla offers

Diversification of offers

Consulting

Conclusions



- A confidence crisis is more apparent where the financial crisis hit the hardest
- State guarantees have in many cases enabled banks to avoid a “credit crunch”
- Short term lending has been one immediate result of new financing conditions
- The crisis stressed the importance of Basel II and international regulation
- Major structural changes have hit the banking industry
 - Turmoil of large banks
 - Withdrawal of competitors
 - “Non banking” specialized financial institutions have taken advantage of banking sector weaknesses
- Sharp increase of margins and spreads and return to simpler financial products

II - Impact on your entity

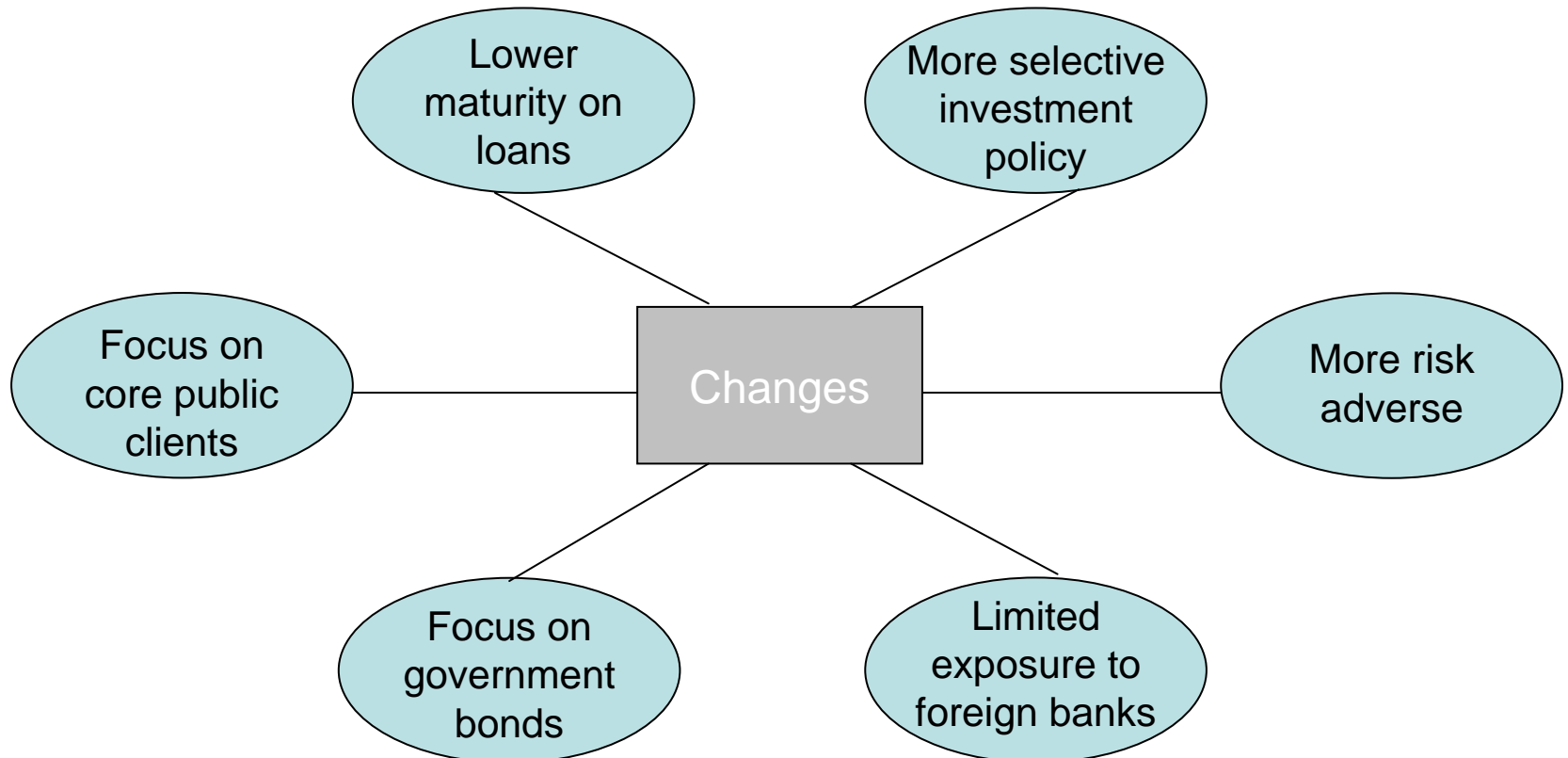


II-1 Have you taken any action to restore your clients' confidence?

- More than half of the banks assert that confidence has been maintained and sometimes even reinforced
- Among banks which report a confidence loss, efforts have been made to:
 - Maintain a systematic presence to respond customers' needs
 - Strengthen relationship with core clients
 - Reduce other public relation actions viewed as superfluous

II-2 Have you changed your financial portfolio philosophy since the beginning of the crisis?

- 12 banks report changes whereas 7 do not



II-3 Have you adapted your funding strategy?

- 10 banks assert that they did not change their funding strategy because they:
 - Already had a solid liquid base
 - Rely on diversification and flexibility
 - Enjoy an important competitive advantage - investors prefer highly rated issuers
 - Want to maintain a reasonable match between assets and liabilities
 - Focus on the local financial market
- Among those adapting their strategy some key directions were:
 - Increase disintermediation financing to decrease balance assets
 - Transform assets in AAA vehicles in order to obtain cheaper funding
 - Seek longer-term funding via state guarantee
 - Pursue funding from multilateral banks

II-4 Have you changed your own pricing policy?



- A few banks which preserved stable funding costs did not increase their prices
One bank has even decreased its prices →

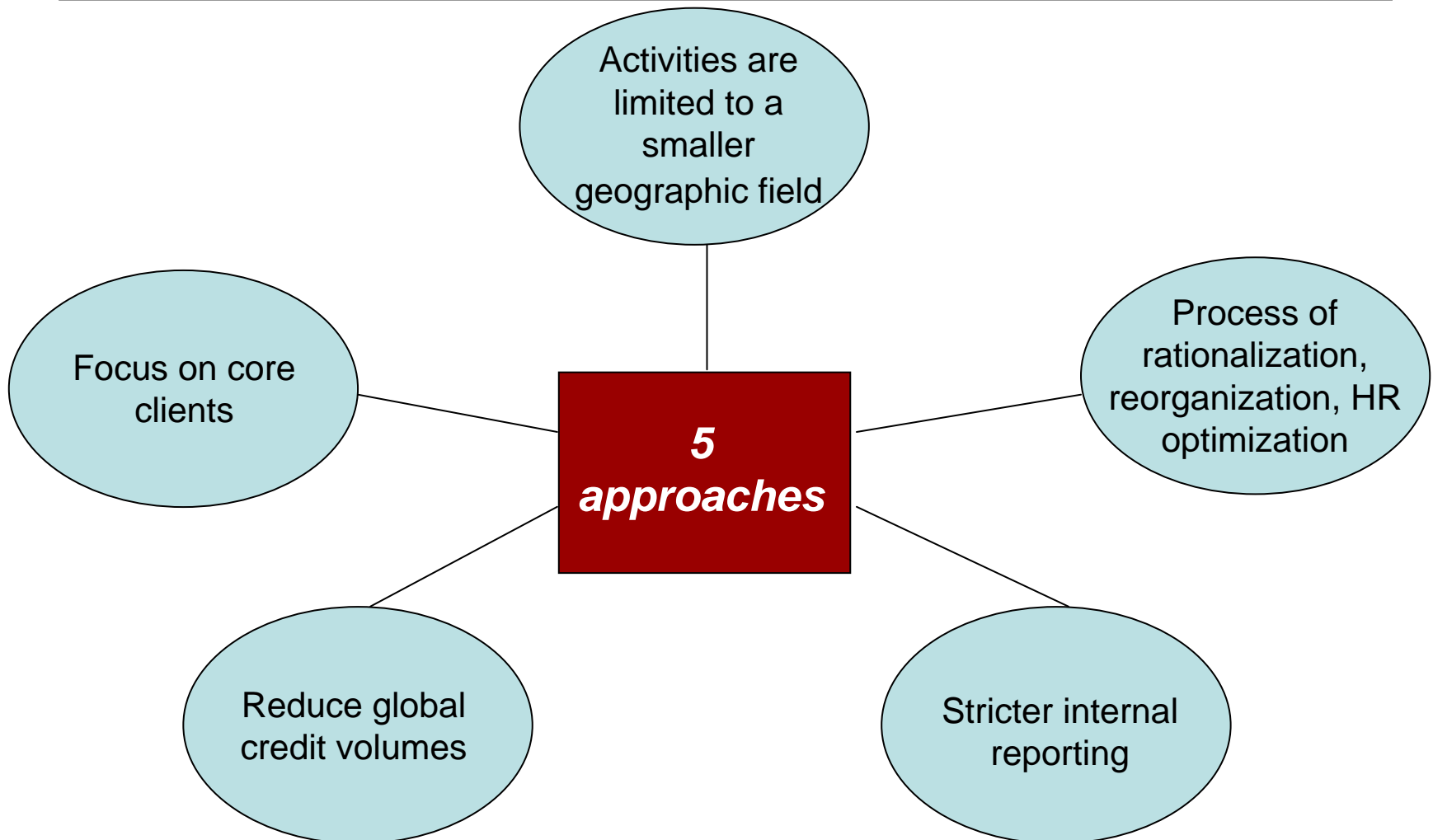
Danish KommuneKredit reports that as its funding costs have decreased, it has also decreased its pricing

- Most of the banks have increased their prices in line with market trends
 - Higher risk margins
 - More attention to all the aspects of each deal (ex: underlying options)
- The price increase appears a problem for the core business of public finance

II-5 As far as project finance is concerned, do you impose more stringent covenants?

- All respondents do not have a project finance activity
- Among the banks continuing their project finance activity:
 - In Northern countries, project finance already only 100% local authority guarantee and lending at a very minimal level of risk
 - In other countries, banks are more cautious about :
 - Existing and new covenants
 - Due diligence
 - Debt service and income ratios
 - Contract duration

II-6 What is the general impact of the financial crisis on your own organization and development strategy?



Conclusions



- Northern and Swiss banks tend to be the sole provider of funding to local authorities
- In the mainstream, responses reveal that banks have focused on their core clients and limited their activities to some countries / on some products
- Given the increased lending rates, and more stringent lending conditions, banks are also making efforts to inform and reassure their core client base
- Banks report their concern about a good match between funding and lending

III - Impact on sub-national governments



III-1 How has the Q4 2008 financial crisis affected sub-national governments?



- Some respondents did not report a “credit crunch” in the short term
- Some specific impacts are reported, including:
 - credit spreads have sharply increased
 - lending durations are shorter
 - tenders / new borrowing have been postponed
- Exceptions are found in countries with lower exposure to the financial crisis, e.g. Morocco and Israel

Early leader of pain

The Icelandic member reported the strong difficulties of its banking sector and local authorities

III-2 Did the resulting economic downturn have a major impact on sub-national entities?



Lower tax revenues

Income tax

Property tax

VAT

Gas and oil royalties

Higher expenses

*Financial expenses
(higher spreads)*

*Social expenses due to
unemployment and
social housing*

III-3 Has the national government taken any action towards the local government sector in the framework of national rescue plan?

- In 12 countries national measures have been taken to support local authorities
- Direct assistance through subsidies:
 - Social housing
 - Education (in Germany, accounting for 54% of short term measures for the municipal level)
 - Foster employment in the construction industry (Spain)
- Investment stimulation through rescue plans and loan packages
- Exceptional allowed deficit for local authorities
- Redefinition of tax distribution, notably through an anticipated VAT refund (France, Spain)
- Specific support mechanisms (EU grants for Slovakia, IMF for Iceland, IEB for Sweden...)

A different approach in Israel

The national budget for 2009-2010 includes cost cutting to address the challenges created by the crisis.

Assistance to weak local authorities is planned, via credit package.

III-4 Did sub-national governments take any particular initiatives in response to the crisis?



- One third of respondents report that regional / federated authorities planned measures to face the crisis
 - Counter cyclical measures by maintaining and stimulating investments via local recovery plans (ex: employment programs, public work projects)
 - Cost cutting
 - Rationalisation and prioritisation programmes
 - Reinforced partnership between the central State and local authorities

Counter cyclical measures

France: local plans in Bourgogne (EUR 23M), Languedoc-Roussillon (EUR 250M), Midi-Pyrénées (EUR 801M)

Spain (Valencia): direct financial help to SMEs for permanent contracts created, up to EUR 400M in guarantees for liquidity lines to SMEs

III-5 Do you forecast an increase of financing needs?

Austria, Canada, Denmark, Finland, France, Iceland, Israel, Japan, Morocco, the Netherlands, Norway and Spain expect new financial needs

Social support /social housing

New infrastructure: hospitals, schools, roads...

Upcoming loan repayment

Reorientation towards green energy

Belgium, Iceland, South Africa, Slovakia, Switzerland and Sweden do not believe that financing needs will increase

Investments are held back

Cost cutting

Debt divestment

III-6 Have adjustments to the current local finance regulatory framework been made?



- 10 countries report no changes in the current local finance regulatory framework
- 3 countries report immediate temporary adjustments:
 - Exceptional short term treasury lines
 - Permitted higher deficit
 - Allowed to finance recurrent spending with capital income / financial sources

Germany, Canada, Finland, Netherlands, Norway, Switzerland, RSA, Sweden, France, Israel

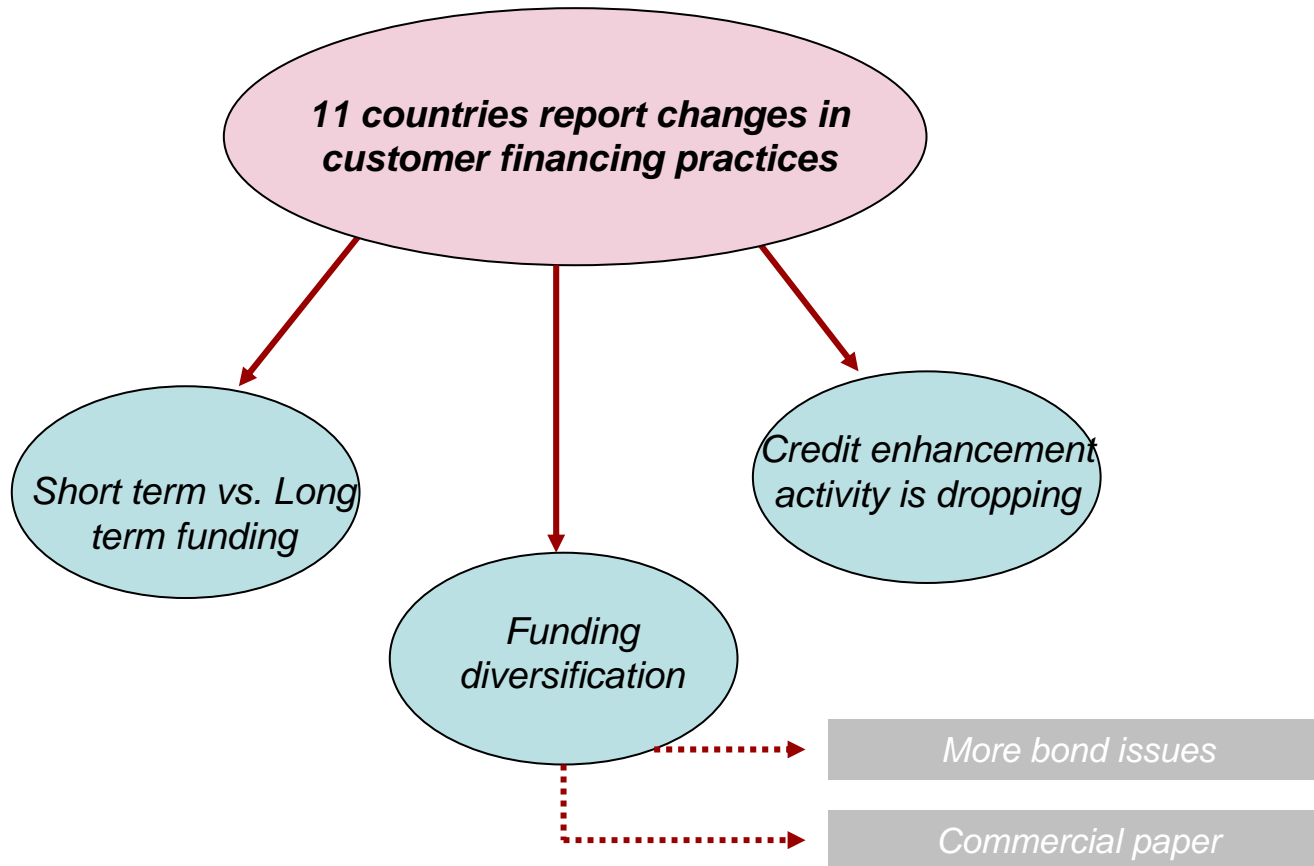
Germany, Slovakia, Spain

Spain and Germany:

In 2009, Spanish regions are exceptionally allowed to raise funds to finance a part of their deficit (1% of regional GDP). Deficit limits are increased to 2.5% of regional GDP in 2010; 1.5% in 2011 and 1.3% in 2012.

German municipalities are allowed to raise additional funds via short term credits (approx. 20%).

III-7 How has the dislocation of certain financial market segments affected customer financing practices?



Conclusions



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- The effects of the crisis are diverse
 - 3 countries do not observe an immediate impact of the crisis on sub-national governments:
 - Morocco: low exposure to the international financial market
 - Israel: local authorities are marginally affected
 - South Africa: no immediate effects but expected difficulties
 - Scandinavian countries (except Iceland) were less affected
 - Countries which were largely exposed to the crisis do report - or at least forecast - difficulties for sub-national entities to find funding or meet their engagements.
 - Local and regional authorities are playing a counter-cyclical role thanks to central governmental measures as well as actions taken on their own
 - In that respect, facing the economic crisis has particularly involved:
 - Cost cutting and rationalization programs
 - Programs to foster employment