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NOVELTIES OF LAW "ON CORPORATE AND MUNICIPAL BONDS" ON LOCAL BORROWING

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Abstract
Financing the needs of local borrowing through issuing municipal bonds is one of the methods, used by local government bodies, which recently is regulated and well equipped with the law "On corporate and municipal bonds" enacted by the end of 2009 by the Albanian Parliament. This law aims at expanding the local autonomy of local government units by raising funds other than funds granted by central government bodies. The local borrowing of municipal bonds was originally regulated by the law "On local borrowing" enacted in 2008 and later, with the approval of the law "On corporate and municipal bonds" the methods of borrowing were enriched with borrowing from public and investors. Such way of raising capital is not practiced in Albania; therefore we will give a general picture of provisions of law on municipal bonds and procedures of issuing them. These securities are used by the local government unit to raise money for a variety of reasons for examples; to cover irregular cash flows or to raise immediate capital for projects for long-term financing. Bonds are usually sold to finance capital projects over the longer term. Local Governments may issue Short-term and Long-term debt in the form of Bond loans. This paper will be focused on municipal bonds, their characteristics and the way the bondholders' rights are guaranteed by our legislation.
Key words: municipal bonds, local government, local government borrowing, bonds

Introduction

The law "On Securities" regulates the types of securities, the conditions for their issuance, trading and registration procedures, requirements for brokers, the conditions for the organization of the public trading of securities, rules on protection of investors and the securities holders, the organization and functioning of securities registries and stock exchange.

The securities market is supervised by Financial Supervisory Authority (hereinafter referred to as FSA). FSA was established by law no. 9572 dated 3.7.2006 the Albanian and it replaced the Securities Commission.

The financial system is at an early stage of development and while the core legal and regulatory framework are enacted generally under foreign assistance. Our financial system has two main characteristics which should be taken into consideration during this paper: a) the stock exchange, albeit existing is not functioning and b) the financial sector in Albania is bank driven.

What are bonds, and why are they issued? Bonds are often considered simply as loans that investors grant to issuers. Companies, government and local government bodies need money to grow the business expand to new location or upgrade equipment or any other use of capital. In cases of capital needs the aforementioned subjects have the following choices:

a) They can issue shares/stocks; (companies only)
b) They can borrow money from the bank;
c) They can borrow money from investors.

If the choice of the aforementioned subject is borrowing money from investors through bonds issuance, they are obliged to pay the bondholders a regular income from the interest until the loan is repaid.

As provided by the definition given by the law, bonds are a category of securities which can take different names based on certain criteria of classification. Therefore, our legislation acknowledges a variety of bonds such as: corporate bonds, treasury bills, and Albanian government bonds and municipal bonds.

Bonds are often considered simply as loans that investors grant to issuers. Companies and government need money to grow the business expand to new location or upgrade equipment or any other use of capital. In such situation there are three choices:

d) They can issue shares/stocks
e) They can borrow money from the bank;
f) They can borrow money from investors.

If the choice of the aforementioned issuer is the issuance of bonds, they are obliged to pay the bondholders a regular income from the interest until the loan is repaid.

Based on the definition given by the law:

"A bond is a long-term debt security binding the issuer to pay the bond owner, on a determined date, the nominal value and the interest of the bond, in one or in more installments."[1]

Another definition of bonds which is in line with the abovementioned legal definition may be:

"Bonds are debt instruments denoting the obligation of an issuer to satisfy a holder's claim to capital repayment and interest (and/or any other commitments entered into by the issuer). The basic features of each bond are – apart from the zero-coupon bonds mentioned hereafter - the par value (which will normally be the redemption value), the coupon/interest rate and the maturity period".

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But, when it boils to its essential, a bond is simply a contract between a lender and a borrower by which the borrower promises to repay a loan with interest. Therefore, there exist an obligation relationship between the issuer and the bond holder, within which the issuer promises to repay the debt to the bondholder at maturity. The purpose of issuing bond is to raise long-term finance from the investment community as an alternative of borrowing a loan to the bank.[2]

1 Article 16 of Law "On securities".
2 Corporate Bonds and Commercial Paper, Financial World Publishing, 2.

However, bonds can take on many additional features and/or options that can complicate the way in which prices and yields are calculated. Based on the characteristics of bonds, they are considered as investments that provide a fix periodic income and the eventual return of the principal at maturity. Unlike a variable income security, where payments change based on some underlying measures such as short-term interest rate, the payment of a fixed-income security are known in advance.[3]These methods of gaining capital from investors can be used by corporate, government and local government bodies. The latter, will be the main focus of this paper. The local borrowing was firstly regulated with the law No. 9869, dated 04.02.2008 and then further detailed with the law on corporate and local borrowing No. 10 158, dated 15.10.2009. These laws provide for expansion of local autonomy and for the first time the possibility of local government bodies to issue bonds and consequently fulfilling their needs for capital. Unfortunately, the law on corporate and municipal bonds has not been put into practice yet, and the following analyses will be a theoretical one.

1. Municipal Bonds

1.1. Introduction to Munis

Municipal bonds are bonds, like the other types of securities provided by the law; they have the same features and characteristics like corporate bonds. The only differential feature consists in the issuer; municipal bonds are issued only by local government bodies under the law regulation. Local government bodies, have some characteristics as subject issuing debt in order to fulfill their needs for capital. First, municipalities are semi-sovereign or self-governed. That is, they may not go bankrupt or even if they go bankrupt, they do not undergo liquidation or any change in ownership. Second, municipal bond market has very little trade price transparency[4] especially because of asymmetric information.[5]

The law on securities foresees a variety of bonds types which can be issued by local government bodies.

Bonds may be classified:

1- by the method of securing the rights:
   a) secured; and
   b) unsecured.

2- by the method of exercising the right on interests:
   a) zero-coupon bonds, which are bonds that pay interest immediately, and
   b) bonds with coupons, which are bonds that pay interest in installments;

3- by interest:
   a) bonds with no interest rate,
   b) fixed-interest bonds, and
   c) bonds with floating interest rates;

4- by the method of exercising the right to redeeming the nominal value:
   a) bonds redeemable in one installment, and
   b) bonds redeemable in several installments;

5- by special rights:
   a) participating bonds, which are bonds conferring their holders the right to also receive dividends,
   b) bonds that are convertible to shares, or
   c) convertible bonds conferring their holders preemption rights to purchasing shares.

1.2. Issuing municipal bonds as a means of local government financing

Municipal bonds constitute one of several ways by which cities and districts may issue debt in order to raise funds. Classic fiscal federalism theory suggests that in certain cases it is preferable to finance investment projects from borrowing rather than from current local revenues.[6]

Besides benefits, there are also potential risks in borrowing, both of a microeconomic and a macroeconomic nature. The microeconomic danger lies in the potential for excessive indebtedness of some local governments, which may lead to difficulties in repayment of loans and may jeopardize the provision of vital public services. At the macroeconomic level, local governments contribute to the overall level of public debt. Local government indebtedness may thus have a negative effect on inflation and other important parameters of the national economy.[7]

Local governments may issue short-term bonds in order to temporarily finance cash flow deficit and also issue long-term debt for capital investment that is to be utilized for public purposes, such as for infrastructure projects etc.[8]

Investors usually do have guarantees that their loan will be returned on time, because local government bodies are generally serious and reliable issuers. Own revenues constitute the most used form of guarantee when referring to the local government borrowing. Overall the most usual forms of guarantee for the issued debt comprise: a) intercept financing, b) additional revenue security, c) physical property security, d) reserve funds, and e) private guarantees. The payment of debt may sometimes be guaranteed by the central government, so the investors are assured of receiving full and timely payment of scheduled

3 Fixed Income Securities – Bonds, Dipen Chatterjee, pg 3.
4 Municipal Bond Liquidity, Lawrence E. Harris Michael S. Piwowar, pg 1
5 The law sets forth the obligation to provide the following information:
The issuance of municipal debt is made by the mayor of the municipality in accordance with the decision of the council of the municipality. The issuance of debts by the municipality should contain the following data:
issuer name, head office, the NRC registration number;
type, guaranty if any, place and date of issuance of bonds and their registration in NRC;
nominal value of each bond;
the total nominal value of all bonds;
the name of the bondholder;
place, time and method of redemption of bonds;
signature of legal representative of issuer;
necessary data for the definition of the rights of bondholder and guaranties, the conversion rights or the right to participate in dividends;
the series number of bonds;
the interest rate, in case of coupon bonds and time and manner of its payment;
any call option of the issuer;
the amount of registered capital of the issuer and the amount resulting in the date of issuance if the issuer is a joint stock company.

6 EBRD legal technical assistance project, Advisory support to the Albanian financial authority on drafting the new law on bonds, page 18.
7 EBRD legal technical assistance project, Advisory support to the Albanian financial authority on drafting the new law on bonds, page 18.
8 Article 64 of Law "On corporate and municipal bonds" reads: Local government can issue short-term and long-term bonds in accordance with the provisions of the law on Local Government borrowing.

interest and principal for the life of the bond issue.[9] Due to the guarantees offered with the municipal bonds, they are often categorized as a safe investment.
One of the key features related to municipal bonds is their special ability to provide tax-exempt income. Because of the special tax-exempt status of most municipal bonds, investors usually accept lower interest payments than on other types of borrowing (assuming comparable risk). This makes the issuance of bonds an attractive source of financing to many municipal entities, as the borrowing rate available in the open market is frequently lower than what is available through other borrowing channels.[10]

1.3. The legal framework on municipal bonds in Albania

The law on municipal bonds was approved approximately two years ago. The issuance of this category of bonds is now regulated by law No. 10 158, dated 15.10.2009. The draft of this law was prepared with the assistance of World Bank.
According to the Law on corporate and municipal bonds, local governments may issue short-term debt, payable within the fiscal year, issued to temporarily finance cash flow deficits.[11] Short term debt, is used by the local government only after a negative reply by the Ministry of Finance for covering the needs (of the local unit) for liquid assets through loans with or without interest by the State budget.[12]
Local governments may also issue long-term debt in the following cases:
(a) for capital investment that is to be used for a public purpose and
(b) to refinance outstanding long-term indebtedness issued pursuant to (a) above.[13]
Interest on local government debt is subject to taxation in the same manner as securities issued by the Republic of Albania.
All local government debt is secured as a general obligation of the local government payable as a first claim from all of the local government's lawfully available funds, which have not been otherwise pledged to other lenders.
The general obligation of the local government may be secured by all or portion of any revenues over which the local government has spending discretion. However, any such pledge cannot in any way oblige the central government to make any such payments to the local government.
In order to provide for additional securing of the payment of their issued debt upon an event of default, local governments may receive unconditional transfers from the Ministry of Finance. The general obligation of the local government may also be secured by physical property under the terms of the Albanian Civil Code.

9 EBRD legal technical assistance project, Advisory support to the Albanian financial authority on drafting the new law on bonds, page 19.
10 EBRD legal technical assistance project, Advisory support to the Albanian financial authority on drafting the new law on bonds, page 19.
11 Article 4 (1) of Law "On local borrowing", No. 9869, dated 4.2.2008
12 Article 6 (2) of Law "On local borrowing", No. 9869, dated 4.2.2008
13 Article 4 (2) of Law "On local borrowing", No. 9869, dated 4.2.2008

The issuance of local government debt does not represent a direct or indirect obligation of the Republic of Albania, unless the Ministry of Finance has expressly issued a guarantee in connection with it. Additionally, unless the Ministry of Finance has issued an express guarantee, the terms of issuance of the debt must contain the statement that the debt is payable solely from the sources described in its terms and is not an obligation of the Republic of Albania.
Based on the methods of securing the municipal bonds payment often the latter are classified as:
The first are called general obligation (GO for short), and are backed by the issuer's ability to impose tax. General obligation bonds are issued to pay for projects such schools and sewer systems. Most investors consider general obligation bonds safer than their revenue counterparts; this is a misconception.
Revenue munis, on the other hand, are issued by special state or local-government sanctioned entities (such as a utility company). The interest is serviced (i.e., paid) by the revenue generated from the business that backs the obligation. In the case of a water company, bondholders are paid out of the cash generated from customers paying their water bills.

1.3.1 Procedure on the issuance of municipal bonds

The decision to issue a bond loan is taken from the competent decision-making bodies of the local governments i.e. the Council of the local government unit.
The law on local government borrowing sets forth that:
"The unit of local government borrows a short-term loan, in accordance with the decision of the council on the budget of this unit for the current fiscal year"
And
"1. The local government unit borrows under the Decision of the Council approved with the majority of votes of the total members of the council members, in a meeting open to the public"[14]
Being under the obligation to transparency the notification for the meeting of the local council unit, which will decide upon the bonds issuance, shall be published in a newspaper not later than fifteen days prior to date of meeting. The local government unit, within 10 days as of the approval of the decision, shall notify the Ministry of Finance. The notification shall contain:

1. The decision authorizing the loan;
2. The revenues and operative expenses of the previous fiscal year;
3. The cost charged to the unit by the loan in the current fiscal year, including the cost of the new loan

Pursuant to the Law "On corporate and Municipal bonds", all local government debt must be secured as a general obligation of the local government, payable in principal from all of the local government's lawfully available funds, which have not otherwise been pledged to other lenders.[15]
There is principally no third party enhancement in the form

14 Article 7 of the law "On Local Borrowing", No. 9869, dated 04.02.2008
15 Article 9 and Article 12 of Law "On Local Borrowing", No. 9869, dated 4.2.2008

of a sovereign central government guarantee of local government debt[16]. However the Ministry of Finance has the option of an express a state guaranty of the debt[17] which is important in case local governments do not have tax revenues sufficient to pay back significant levels of debt, otherwise there is no obligation on the Republic of Albania on such obligation.
The guaranties for performing the obligation of municipality: Long term and short term debt constitute a general obligation of the municipality, which shall be payable by all the funds, legally available, of the municipality which were not put as guarantees for other lenders. In order to assure the redemption of the principal and interest, the law foresees a strict regime on guarantees and investment of any income resulting from the loan usage. The short-term or long-term debt constitutes a general obligation of local government body and should be payable by all funds of the unit therefore the followings means guarantee the redemption of bonds principal and interest in case of default.

1.4. Other guarantees used to redemption of bonds

1. The loan can be guaranteed by all or part of the revenues on which the municipality has full authority.
2. The revenues which serve as guaranty are used under the loan term and the lender has priority on such revenues.
3. The municipality may give additional guarantees with the lender, entering an agreement that in case of default, to allow the payment form unconditioned transfer or divided tax from the State Budget, on behalf of this municipality. These funds should be paid to the lender according to the conditions of the loan agreement.

1.4.1. Physical assets guaranty

The loan may be guarantees by physical, non-public assets owned by the municipality.
The council of municipality may offer other guarantees taking the commitment to:
a. Apply tax and tariffs at a certain level, permitted by the law, in order to create an amount of revenues;
b. Manage an enterprise or other property in accordance with the loan terms;
c. Make direct payments from funds or sources in order to guarantee the payment of loan;
d. Deposit funds or revenues set as guarantee on account of the lender;
e. Accept special payment procedures to guarantee the exclusive or dedicated payment to the lender, including the interception of revenues, payments in special accounts or other mechanisms or procedures on payments;
f. Accept other agreements which are considered necessary in taking the loan and offering the guarantee for its redemption.

2. Organization of bondholders

The Albanian legal framework lacked a piece of legislation guaranteeing the organization of bondholders. It was recommended for Albania that any future legislative framework in relation to bonds should impose the obligation to the issuer to appoint, though a written agreement, a bondholder representative who will be independent from the issuer and shall represent the bondholders against the latter and any third parties. The law "On corporate and Municipal Bonds" as the first law regulating bonds and their issuance procedure provides for the first time that: *"The terms of Bond loan contained in the Bond loan program being sold through public offer must provide for the appointment of a Bondholders' agent and his deputy. The Bondholders' agent and his deputy to be appointed shall be selected from a list of candidates (minimum of five persons) drafted by the issuer. The issuer shall convene a meeting of the group of Bondholders for the appointment of the Bondholders' agent within 30 days upon approval of the list of candidates by the Authority"*[18]

2.1. Bondholders' agent

The bondholders' agent responsibilities are defined exclusively in the provisions of the law "On corporate and municipal bonds", the terms of the bond loan contained in the bond loan program and the decisions of the group of bondholders. Additional competencies to the bondholders' agent can be attributed by decision of the group of bondholders with the consent of the issuer. The competencies granted by the law exclusively to the group of bondholders cannot be delegated to the bondholders' agent. The group of bondholders is legally represented in court and out of court actions versus the issuer and third parties by the bondholders' agent. The dismissal of the bondholders' agent and his deputy by the duty is made unilaterally by the issuer in cases the bond loan is distributed through private placement.

16 Article 9 (1) of Law "On Local Borrowing", No. 9869, dated 4.2.2008
17 Article 9 (4) of Law "On Local Borrowing", No. 9869, dated 4.2.2008

[18] Article 26 of law "On corporate and municipal bonds"

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