

The debt policy of the City of Warsaw for 2013-2020

The principal aim of the financial policy, including the debt policy, in the years 2013-2020, will be to ensure the stability of the fundamental financial indicators. This will be done by reducing the deficit and the debt, while maintaining the potential for development and investment. The current strategy for the debt policy of Warsaw is built on the previous one, developed for 2008-2012¹, as far as the borrowing needs and the debt management rules are concerned. The debt policy introduced as part of the 2008-2012 strategy, and also the internal debt limits which were set for that period, proved to be effective tools for the financial management of the City. Despite a number of negative developments caused by the economic crisis, the City's methodical implementation of the debt policy successfully helped reduce the materialised financial risks.

The current status

The debt level and the debt breakdown, and also the "debt quality" indicators, are monitored on an ongoing basis, and reported to the management of the City.

The City's Debt Breakdown at the end of Q3 2012 (in %)

Interest rate		Debt		
Fixed rate	Floating rate	in PLN	in foreign currency	bonds
54.6	45.4	85.4	14.6	52.5

The average debt maturity, used as a yardstick for the risk of a debt rollover (ATM ratio²), was 7.9 years at the end of Q3. The foreign debt maturity was slightly shorter (7.8 years) compared to the domestic one (8.1 years).

Duration³ is a popular measure used to assess the interest-rate exposure of financial instruments. In Q III, the bonds issued by the City of Warsaw achieved a duration of 5.0

¹ "The 2008-2012 debt policy outline for the City of Warsaw," September 2007, drawn up by the City of Warsaw authorities and approved by the Coordination Group on 20.11.2007

² Average time to maturity – a measure of the debt-rollover risk. This indicator is the average number of years until the repayment of the debt. The longer the debt-maturity dates, the lower the rollover risk and the higher the average maturity.

³ Duration – a measure for interest-rate risk related to debt, i.e. the interest-rate exposure of the debt service costs, is the average period (measured in years) required to adjust the debt-service costs to the fluctuating interest rates. The higher the interest rates and the proportion of short-term and floating-rate instruments, the higher the interest-rate risk and the lower the duration.

years. A supplementary measure for the interest-rate risk-duration ratio is ATR⁴, which was 6.1 years in Q3 (in comparison, the bond duration and ATR of the State Treasury debt are currently 3.8 and 4.4 respectively, according to the 2013-2016 Debt Management Strategy for the public finance sector).

Assumptions for financing and co-financing

With the debt-funding possibilities used up due to the restricted fiscal environment, the next thing to do is to look for additional means to finance the investment plans set out in the multiannual financial framework. The City will extensively use EU subsidies, seek co-financing from the private sector or other public-sector players, and also utilise non-debt financial instruments. In this context, it may be particularly reasonable to delegate the financing of some of the communal tasks to the entities legally established within the City's structure.

Our current experience suggests that the financing and co-financing process should be separated from the investment process, which is often highly volatile (due to procedural and administrative difficulties). The process of securing funds (credits) from international finance institutions is extended (compared to the alternative option of bond financing), as it involves the need to take actions several months in advance, near the end of the year preceding the year for which the budget is to be financed.

The 2013-2020 forecast for deficits and financial needs (amount, structure, timeframe)

In view of the above-outlined macroeconomic conditions, as well as the amount of EU funding, we can make a preliminary estimate of the borrowing needs which will stay in sync. with the necessary financial regime. The budget restrictions will require us to

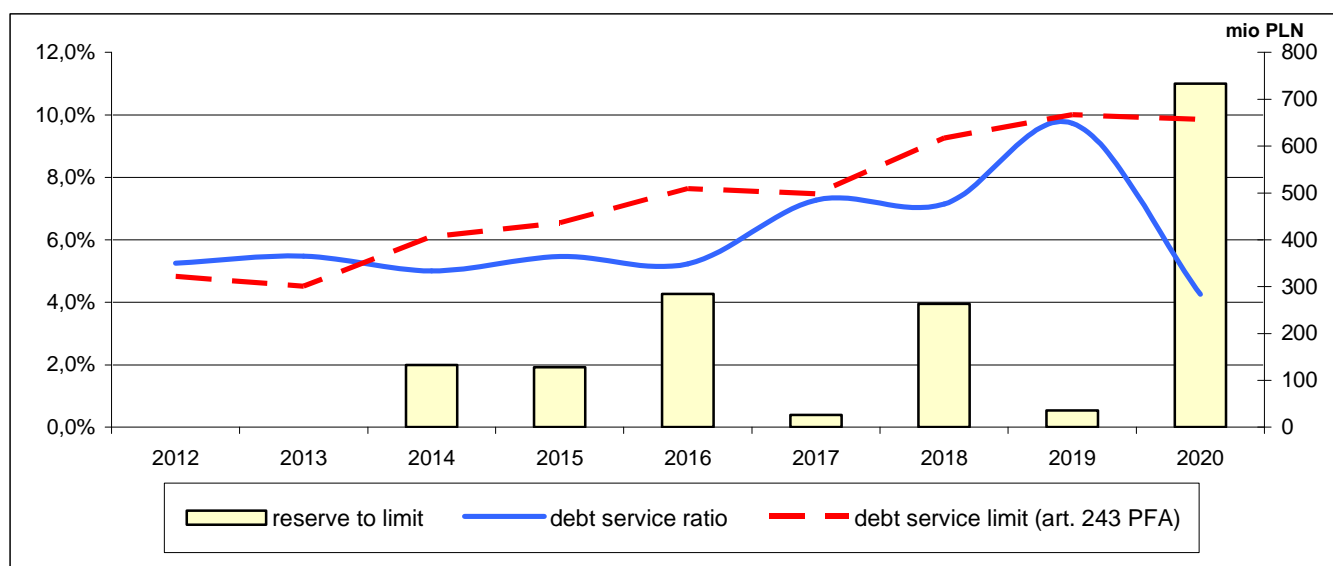
- work out the rules for extending sureties; if there is not enough space in the operating surplus of the City (as is the case when PPP agreements are signed)
- maintain a high level of financial security for the next dozen or so years to come, due to reductions in the deficit and the debt within the entire public sector and the increased restrictions in the financial sector introduced to ensure financial balance and risk stability,

⁴ Average time to refixing – a measure of the debt-related interest-rate risk. It is the average period (measured in years) for which the debt-service costs have been estimated. The higher the proportion of short-term and floating-rate instruments, the higher the interest-rate risk and the lower the ATR.

- adopt a target debt-to-revenue ratio within the range of 40–50% for the period by 2020 (similarly to the so-called public-sector benchmark) and to maintain the internal debt limit at 55%,
- introduce further limitations attributable to
 - the debt-rollover risk - to make sure that the amounts for the repayment of debt which matures in the respective years do exceed 10% of the existing debt, i.e. approx. PLN 600 million,
 - the interest-risk rate - to rely on the existing model, in which debt involves to the same extent fixed-rate and floating-rate interests, and to make adjustments if there are signs that national monetary policy is about to change,
 - the currency risk - to reduce this risk,
 - the operating risk, which needs to be monitored by the City on an ongoing basis (e.g. the risk related to the operating of computer systems),
 - the liquidity risk, which grows with the reduced reserve of available and carried-forward funds. To change the “buffer-stock behaviour” by guaranteeing higher limits for short-term borrowing when the available funds are reduced.

The chart below shows the development of debt-service costs against the limit set out in accordance with Article 243 of the Public Finance Act and effective from 2014.

Debt-service cost



The breakdown of the new liabilities will be correlated with the redemption period. Because the multiannual investment programme includes primarily infrastructural projects (with a long redemption period) or projects expected to last for significantly more than 20 years, the ideal solution will be to finance them through financial instruments with a maturity of 15–20 years. The City will constantly monitor and periodically assess the financial standing and debt level of its subsidiaries, despite their having separate legal personalities and being economically independent. Because when assessing the City's creditworthiness the rating agencies take into account the debt of these entities, it is necessary to maintain both ongoing and long-term supervision over their standing, allowing the assessment of the risks involved (the active assessment of the debt forecasts for the subsidiaries).

The results of financing simulation for 2012-2020 using the planned debt-policy restrictions – a sensitivity analysis

The statutory limits provide the maximum-possible margin for the negative changes in current revenue which might potentially occur while the proposed Multiannual Financial Framework is being implemented. The projected operating surplus for 2015-2020 directly affects the amount of funds earmarked to counteract negative scenarios, should they come into reality. The stress-test analysis reveals that the current-revenue risk, if realised, can be a substantial factor in the potential exceeding of the debt-service limit. As far as the plan is concerned, the assumed WIBOR rate is relatively safe in terms of interest rates and the level of foreign-exchange risk reserves is also fairly safe.

The assumptions for the benchmark portfolio of the City

The Multiannual Financial Framework forecast builds on the existing method for the financing of the budgetary borrowing needs, in that it employs two principal methods of financing:

- using the domestic market, through bonds or commercial loans
- using the foreign market, through loans from international finance institutions (IMF), and bonds

Debt timing and the principal instalment plan will ensure the necessary grace period for instalment payments in respect of loans raised to roll over the existing debt, and also help shift

forward the repayment of capital (depending on the type of bond). Also, they make it possible to keep the debt-service costs and risks at an acceptable level.

The fundamental component of the debt policy is the established acceptable level of risk and debt cost. Based on these factors, an appropriate set of instruments can be selected to finance borrowing needs. Consequently, the individual components of the debt portfolio are determined.

In line with the calculations, the target-liability breakdown should take the following into account:

- the market breakdown should reveal a preference for liabilities in the Polish currency⁵,
- the interest-rate breakdown should reveal a largely balanced choice of fixed-rate and floating-rate liabilities, though with slight preference for the fixed-rate situation,
- as far as financial instruments are concerned, they should employ the so-called financing mix, which is a method of diversifying the sources of funding and the maturity dates,
- in terms of the maturity and timing of liabilities, one should strive to achieve a debt duration exceeding that of the State Treasury debt (3.5–3.8 years in 2015), and ATR⁶ (5.3–5.9 years) respectively. This will help Warsaw maintain its existing, and favourable, financing structure, with a debt duration of 5.2 years and an ATR of 6.2 years,
- a reserve should be maintained in case there is a need to finance extraordinary expenditures by the City,
- an active policy should be initiated to reduce costs and risks by converting debt and changing its structure using the available solutions and taking account of the profitability factor.

The City's debt-management policy for 2013-2020 and the subsequent years

In line with the target model, the *active* strategy involves an active policy towards the restructuring of the existing and new debt. The proposed solutions for the measures to be pursued will be subject to economic analysis.

The aim of the City's debt management will be to

- Minimise the costs of debt service through by the optimum selection of debt-management instruments, their structure and the dates of issue.

⁵ Which means that the debt is incurred on foreign markets (The International Monetary Fund) based on domestic market parameters

⁶ ATR – a measure of debt-related interest-rate risk; the average period (measured in years) for which debt service costs are established. Higher interest-rate risk and a lower ATR result from the prevalence of short-term and floating-rate instruments in the debt structure

- Reduce the interest-rate risk by increasing the proportion of medium- and long-term fixed-rate bonds within the debt structure.
- Reduce the roll-over risk by making sure that the municipal securities and/or loans have the appropriate average maturity and that the redemption dates are evenly timed in the subsequent years.
 - The risk of roll-over in the domestic currency: the risk involves the possibility of redeeming the debt which has matured and the conditions under which it is rolled over (including the costs of servicing the new debt)⁷. The average maturity is the underlying measure of this risk
 - The foreign-exchange risk and the risk of roll-over in foreign currencies due to Poland's delayed accession into the Monetary Union will be reduced and taken into account only if it is necessary.
- Reduce the budgetary liquidity risk (the risk that the current liabilities and the planned budgetary expenditures cannot be settled/made on time) by constantly monitoring the liquidity management system (cash-flow application, the identification of the average liquidity budget for the upcoming planning periods, and also ensuring high level of overdraft on the current account).
- Gradually reduce the operating risk (involving mainly cash-flows) by applying appropriate procedures, and also through supervision and monitoring.
- Reduce the legal risk, where the lawmakers impose more restrictive limits or establish additional fiscal regulations for Local-Government units.

Summary and recommendations

The 2013-2020 debt policy of the City will include

- A downwards adjustment of the current assumptions for borrowing needs due to the stabilised level of investment
- The re-establishing of the priority for the fiscal criteria defined under the new debt-reduction rate (Article 243 PFA), which are directly responsible for the maintaining of the current surplus in the budget,
- A tight financial plan, a high budgetary risk for 2016-2018 and risk related to the fiscal ratio in 2014, 2015, 2017, 2019, which will require
 - an increase in the operating reserve of the budget,

⁷ In order for the costs to be spread evenly, one should ensure that debt maturity is timed evenly, and also adjust the rules of keeping the books of the debt-service costs (under the entire budget) to the actual economic costs of debt service (the so-called accrual-based accounting) –these were provided for in the public finance reform.

- the choice of transaction which will reduce the roll-over risk
- An elaborate system for monitoring directly-issued debt, and also the indebtedness of the legal entities established or owned by the City.