

Comments to the Basel Committee re the New Basel Capital Accord

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Comments

to the Basel Committee re the New Basel Capital Accord,
and to the Auditors of the Swedish Parliament re their Report 2000/01:9 "Akut eller långvård? statens stöd till kommuner med ekonomiska problem".

The international Basel Committee on banking supervision submitted in January 2001 for comments their Second Consultative Package with a proposal for a New Basel Capital Accord. They want comments at the latest on May 31st 2001 in order to publish the new Accord at the end of 2001 and to be implemented during 2004.

Due to the present unclear regulations and the present structure of incentives regarding the finances of the Swedish local authorities (*kommuns*) the Swedish government has during the last few years been forced to introduce two expensive (so called "acute") solutions for local authorities with financial problems. The Auditors of the Swedish Parliament have in a thorough and critical report from April 2001 scrutinized the function of these acute solutions. They want comments on their report during May in order to deliver a writ to the Swedish Parliament before the summer of 2001 with their proposals for action.

As both the problems with local authority loans and their efficient solutions are due to the issues in the two studies above, the comments are here presented in one joint paper. Svensk KommunRating is one of the very few institutions that follow the development of the credit worthiness of all Swedish *kommuns* and how the creditors interact with the *kommuns*. Svensk KommunRating AB was formed in connection with the emergence of the 1992 new Local Authority Act, in order to respond to the new demands for information, that the *financial deregulation* of the local authorities constituted. Being independent from all parties¹, Svensk KommunRating has as a private evaluation and assessment company been able to submit information and training services to creditors and Swedish *kommuns* since 1992 trying to contribute to the avoidance of the local authority sector from being the next financial crash sector in Sweden

To avoid problems with local authorities being unable to within their financial obligations, regulations are needed that affect:

1. the actions of the creditors,
2. the actions of the *kommuns*,
3. the system for monitoring from the regulating authorities.

To deal with problems connected with financial defaults from *kommuns*, regulations are needed for:

4. how creditors are repaid,
5. how the economy of the defaulted *kommun* will be monitored.

The above five points are commented upon below in regard to how the connections are to the proposal from the Basel Committee as well as to the proposals from the Swedish Parliament Auditors.

¹ That is creditors, local authorities and others connected with local authority credits and with the trust that the local authorities have on the market.

1. Regulation of the actions of the creditors

Kommuns that overspend can continue their services due to the presence of at least one creditor, who continues to give loans to the *kommun*. There are several explanations for this, the most important of which are commented upon below, together with how the proposals in the two reports may counteract the problems.

1.1. The capital requirements are improved in the proposed New Capital Accord

The Swedish local authorities most likely became the most financially deregulated local authorities in the world due to the 1992 new Local Authority Act. That reform, however, did not affect the rest of the legal regulations system. Thus, the capital requirements continued to be zero percent. As a consequence of that, the banks and other credit institutions have been enticed to lend as much as possible to the *kommuns*, as the capital requirements are not hampering the loan volumes and the competition for market shares.

One reason for the creditors to “park loans” to Swedish *kommuns* is that they are free from capital requirements, and the creditors thereby can increase their turnover and market shares, without decreasing their other business opportunities.

The problem in Sweden was that the deregulation of the local authorities took place at about the same time as the introduction of the preset capital requirements. The connection was not observed by the government, or possibly the government at that time did not want to risk the increase of costs to the local authorities by introducing more logical capital requirements.

The new capital requirements regulations as proposed by the Basel Committee give freedom of choice between different methods. Banks who will be allowed to use the Internal Rating Method (IRR) are expected to use that, even if the Standardised Approach is said to be of the same value. Svensk KommunRating thinks this is good. For banks using the proposed Standardised Approach the Basel Committee proposes the following risk weights for loans to *kommuns* (= **PSEs**, Non-Central Public Sector Entities) :

Counterpart rating according to the scale of Standard & Poor's	Risk weight in percent if the counterpart is		
	a state	a PSE or bank	other companies
AAA to AA-	0	20	20
A+ to A-	20	50	50
BBB+ to BBB-	50	50	100
BB+ to BB-	100	100	100
B+ to B-	100	100	150
Worse than B-	150	150	150
No rating	100	50 or 100	100

Svensk KommunRating thinks that this system will be good for *kommuns* with an international rating. However, very few Swedish *kommuns* have that today. And the number is expected to increase only marginally by the year 2004 due to the high cost to receive such a rating.

The Basel Committee suggests that the finance inspection authority in each country may apply other risk weights than the above table, which is a good proposal. The national finance inspection will, according to the Basel Committee, also confirm which rating scales and rating institutes that may be used in each country. This means that the Swedish

Finansinspektion may propose the following risk weights for Swedish *kommuns*, as a function of Svensk KommunRating's scales for Swedish *kommuns*.

The rating according to Svensk KommunRating's eight degree scale	The rating according to Svensk KommunRating's four degree scale	Risk weight if the counterpart is a Swedish <i>kommun</i> or other Swedish PSE
A1 or A2	A	20 %
B1 or B2	B	40 %
C1 or C2	C	70 %
D1 or D2	D	100 %
No rating	No rating	100 %

That would mean that more *kommuns*, being handled according to the Standardised Approach, may receive risk weights that correspond to their credit worthiness. This is regarded as a system advantage as compared with the present system.

It may be noted, that these eight and four degree scales began to be used by Svensk KommunRating from March 1st 2001² (after several years of development work). The rating scales, the rating method and the latest rating documentations are always published on Svensk KommunRating's web page www.kommunrating.se and the number of Swedish *kommuns* that are being rated according to this system is expected to increase substantially during the next few years. (The web page is at present only in Swedish.) It is expected that in the year 2004 many Swedish *kommuns* without an international rating will have this rating instead. As may be seen on the web page, several small *kommuns* already have such a rating.

There also exists a three degree rating scale, now used for over 100 Swedish *kommuns*. The Swedish *Finansinspektion* may (for example during spring 2003) evaluate if that scale also shall be included in the system – for example according to the following relations:

The rating according to Svensk KommunRating's three degree scale	Risk weight if the counterpart is a Swedish <i>kommun</i> or other Swedish PSE
b	50 %
c	80 %
d	100 %
No rating	100 %

Several small Swedish *kommuns* have found that the Svensk KommunRating's rating is cost effective, as may be seen on the web page www.kommunrating.se

1.2. The credit investigation requirement will be achieved more efficiently according to the proposal from the Basel Committee

Banks are according to the Swedish Bank Business Law (*bankrörelselagen*) obliged to investigate if a *kommun* is credit worthy and can be expected to repay its loans in time. But this obligation to investigate *kommuns* has not been tested in court. Therefore, due to the interpretation uncertainty, many banks seem to have a very low profile in regard to the application of this rule. As a consequence of this there are *kommuns* that can continue to borrow for their running costs, as long as a creditor keeps the *kommun* financially alive.

² Previously, the web page www.kommunrating.se has not given ratings for the *kommuns*, but for several years key factor scores for several key factors for all Swedish *kommuns*. Those key factor scores are still presented and are updated annually for all Swedish *kommuns*.

This can hardly continue for long. Loan expansion has contributed to the explanation that the system has not yet failed.

The Swedish Bank Business Law (*Bankrörelselagen*, SFS 1987:617) says in paragraph 13 that a loan may only be given *if the borrower on sound grounds may be expected to fulfil his loan obligations*. There are no sanctions connected to this paragraph.

Paragraph 13 could mean two things:

- That a bank makes an error, if it can not show sound grounds. The bank must thus have some evidence that shows how a borrowing *kommun* can repay the loan in due time. (In many cases today, the banks do not have any specific evidence, but give loans to the *kommun* based on a general view that the local authority sector is expected to be stable and secure.)
- That a bank makes an error when it gives a loan to a *kommun*, in spite of knowing that the *kommun* for a long period of time has been financing its running costs through loans, and has projections showing a deteriorating financial development. (This case is less common, but has occurred many times for several *kommuns* during the last years, especially when a VIP in the board of the bank is at the same time a local politician or connected in other ways to the administration of the borrowing *kommun*. That person has conflicting loyalties and is probably feeling a strong responsibility for the regional development, and he may feel forced to disregard the financial circumstances and give priority to the reality of counting potential votes.)

Paragraph 13 was established in 1984³, partly as a result of the findings of the bank inspection that there were banks that only performed the credit investigation in the form of an assessment of the offered securities. For local authorities the law says that no security is necessary, but there is no exception from the requirement that the borrower on good grounds shall be expected to fulfil his financial obligations connected with the loan. And in order to avoid having a specific security, the bank has to positively find facts that makes the fulfilment of the loan obligations secure.

It may be noted, that the Swedish Government Committee on banking legislation (*Banklagskommittén*) in 1999 proposed⁴ to skip the existing regulations that loans may only be given if the borrower is expected on sound grounds to fulfil its loan obligations. The committee wished that the regulations should not regulate each loan, but instead aim at limiting the risks of the total loan portfolio. The idea of the committee was that by stressing the risk of each loan the result could be higher total risks – and that the main problems with the loan investigations of Swedish banks during the time up to the bank crises was the inability to set correct prices on risk. The committee does not omit the cause, that this partly was due to the basic division of loans into ‘secure’ and ‘not secure’ loans, where only ‘secure’ loans may be given.

(It may be noted that this Swedish Government Committee on banking legislation in an earlier report⁵ in 1998 had presented similar thoughts. There they wanted to cancel general soundness principles and instead look into the total ability of the bank to fulfil its obligations. Therefore they had ideas to propose improved translucency and overviews for the financial positions of banks.)

Svensk KommunRating believes that these proposals from the Swedish Government Committee on banking legislation now are irrelevant and mean that the Basel Committee’s proposed New Basel Capital Accord has many advantages in reducing the risk for financial

³ Swedish Government proposition 1983/84:146.

⁴ See page 28 i SOU1999:82 ”Vårdslös kreditgivning” (Careless credits)

⁵ See page 112-115 in SOU 1998:160 ”Reglering och tillsyn av banker och kreditmarknadsföretag”

crises in banks and *kommuns*. The proposals should substantially increase the probability that creditors will follow the paragraph 13 of the Swedish Banking Business Law (*bankrörelselagen*) in regards to loans to *kommuns*. This is good. It would also reduce the problems that now exist with local authority politicians, who have divided loyalties, sitting on local saving banks boards and feeling obliged to give their own *kommun* loans, in spite of the fact that this is loan financing of running costs – thereby contributing to a conscious or unconscious lack of professional loan investigation.

1.3. The pricing of risk will be improved with the Basel Committee proposal

Banks in Sweden do not price risk satisfactory, especially not in regards to loans to Swedish *kommuns*. This is partly due to the habit, that banks apply a *total customer perspective*, that is: the bank looks at the yield of the total relations with a customer. It is thus common to have the low price of a loan making that loan unprofitable, as long as the loss is compensated by other profit generating services to the customer. Another explanation for the bad pricing is that banks do not apply sufficiently sophisticated routines in order to assess credit risks – and that the banks are not looking into the possible co-variation of the credit risks. A third reason may be unfortunate and diffuse statements from members of the Swedish government during the last decade, stating that *kommuns* are safe borrowers, without having neither factual grounds for that, nor any legal basis. The culture among the Swedish creditors and possibly also among politicians has probably remained in the time before the financial deregulation of the local authorities. Many loan decisions are made as binary decisions: either the *kommun* will receive the loan, or the bank is not even acknowledging the loan question from the *kommun*. The price difference thereby is only marginal, as the general price on the risk part is too low. When the price of risk is too low, it may result in consequences far outside of the banking sector, as the price of financial services has an important information value to the rest of the economy.

All these weaknesses may be corrected if and when The New Basel Capital Accord is implemented. But it may be noted that the Swedish Government investigation of the credit market (*Kreditmarknadsutredningen*) is emphasising⁶ that loan training ought to be one of the most important components of the internal education and training programs of banks. That is not the least valid for loans to *kommuns*. The habit according to the Swedish banking culture, to have a total customer perspective is contrary to what the *Kreditmarknadsutredningen* is demanding for each banking product: they should as far as possible carry their own costs and banks should avoid offering under-priced loans in order to try to sell other more profitable products. They also emphasise⁷ that continued under-pricing (as related to risk and liquidity costs) may cause serious structural problems, so called ‘bubbles’ in the system, and that the anatomy of the granting of loans therefore ought to be well known.

Also, it is no advantage from a customer perspective to keep outdated legal capital requirements that are not coinciding with the economic risks. Therefore correct pricing on properly measured risks ought to give the banks the possibility to improve their assessment of risk profiles and also to perform conscious risk judgements. The result is of greater informative value to the inhabitants of the *kommuns* and is expected to vitalise the local democracy. The credit market for *kommuns* becomes more rational and the focus in the local political debate may deal more with long term strategic issues instead of short term populist issues.

⁶ See Volym B, page 126 in SOU2000:11.

⁷ See Volym B, page 125 in SOU2000:11.

1.4. The proposal gives the effect that the lack of sanctions becomes less important

A bank that does not obey paragraph 13 in the Swedish Bank Business Law (*bankrörelselagen*) does not seem to risk any legal punishment. It is thought that primarily it is the bank that suffers economic loss. The Swedish Government Committee on banking legislation (*Banklagskommittén*)⁸ discussed thoroughly the possibility to introduce legal consequences for banks that do not obey paragraph 13. They found five arguments to criminalize irresponsible and neglectful lending:

- Deter people from the unwanted behaviour
- The risk of punishment could form a norm and create better morals and customs
- Give a more stable compliance of the finance sector
- Increase the trust that the public has for the banking system
- Increase the possibilities to sue careless banks and increase the possibilities of the state to receive compensation for the losses caused by a bank crises.

In spite of this, the committee came to the conclusion that they *not would propose punishments* for neglectful banks. Also, it does not seem to be tested in the Swedish court system where the boundaries are to be set for when a bank is neglectful in their lending considerations or when they are lacking in their investigation obligations of the credit matters for *kommuns*. (One reason for the lack of court cases may be the lack of punishment possibilities.)

On the other hand a bank employee who has handled the credit matter may be legally punished. The prerequisites for such sanctions are summarized in **Appendix 1**⁹ in order to show how unclear the regulations are and how the lack of precedents, that deal with neglectful lending to *kommuns*, still causes creditors to often look on their business as secure.

Svensk KommunRating judges that if the proposals of the Basel Committee are implemented, the problems with lack of sanctions becomes less important in order to reach a reasonably low probability for a financial crash in the local authority sector in Sweden – and that *kommuns* are not causing a bank crisis.

1.5. Conclusions on the proposed New Basel Capital Accord – concerning local authority loans

The New Basel Capital Accord is expected to work well, if and when it is introduced, provided that the creditors educate and train their personnel in risk handling for *kommuns*, and that the Swedish *Finansinspektion* receives the resources¹⁰ that the new regulation system requires.

The effect is expected to be a price differentiation of loans to *kommuns* with different risks. Also, it ought to be a good signal to the *kommuns* and their voters.

It may however be many years before the creditors have educated and trained their personnel in the new system, and until the Swedish *Finansinspektion* have the required resources. It may – as a rough estimate – take until the year 2007 or 2008. Meanwhile many *kommuns* are expected to behave to a great extent as they are doing now, that is trying to borrow in order to finance their operating costs, and trying to persuade the state of Sweden to solve acute payment problems.

⁸ Fi 1995:09

⁹ The appendix is not translated from Swedish, due to the technical contents, and not attached here. It can be viewed at www.kommunrating.se/Artiklar

¹⁰ See additional comments on resource requirements under point 3.1 below!

2. Regulation of the actions of the *kommuns*

As the regulations give weak incentives for the Swedish *kommuns* to consolidate their finances, the state of Sweden has been forced to implement several successive and disjointed minor legal adjustments in order to try to stabilize the actions of the *kommuns*. It remains a patch work, that most likely will continue to cause similar intrusions from the government for many years to come.

Generally, the regulations of the *kommuns* lack force and sanctions. Therefore it is not unusual that *kommuns* are borrowing and selling fixed assets in order to cover their operating or running costs. The book keeping is not according to sound practice, as, for instance, huge volumes of short term loans are booked as long term loans. This increases the financial risk.

The requirement of sound economic management – shall stop overspending

The Swedish Local Authority Act (*Kommunallagen*¹¹) states in Chapter 8, paragraph 1, that *kommuns* shall have sound economic management in their activities and in all activities carried out thorough other organisations. There is however no good guidance regarding the interpretation of the concept of sound economic management. There are no rules or sanctions, when paragraph 1 is not obeyed. The government offered in its legislation papers¹² examples of what should be sound economic management, but did not see it as meaningful enough to regulate that concept in detail.

In April 2000 the Swedish Ministry of Finance started a one person investigation¹³ in order to review the economic achievements of the *kommuns* and to report on October 31, 2001. This investigation shall among other things review the regulations about sound economic management and how these regulations are obeyed. Most likely the investigation will present several examples of sound and poor economic management. But no change of the law text is expected and no introduction of sanctions.

As the Swedish Parliament's Auditors conclude¹⁴, it must be regarded as unfortunate, that this investigation is **not** to cover suggestions about how the state shall act if and when similar situations occur, that caused the mentioned two 'acute' solutions in 2000.

The balance requirement – does not guarantee long term consolidated finances

As requirements of sound economic management are not legally operationalized, the state has felt forced to use temporary solutions and introduced what is called a balance requirement in the Local authority accounting law (*Kommunal redovisningslag*¹⁵) Chapter 4, paragraph 4, and the Local authority law (*Kommunallag*¹⁶) Chapter 8, paragraph 5. This introduction of the balance requirement has probably changed the focus of the local politicians from the requirement of sound economic management to the minimum level of the balance requirement. No long term financial consolidation is thereby guaranteed.

It is unfortunate that it is not until the year 2003 when it can be observed as to what extent the balance requirements for year 2000 have been obeyed. It is also unfortunate, that the balance

¹¹ SFS 1991:900.

¹² Proposition 1990/1991:117.

¹³ Former minister of the interior, Mr Jörgen Andersson, Direktiv 2000:30.

¹⁴ in their Report 2000/01:9.

¹⁵ SFS 1997:614. According to a transition rule from year 1997 (SFS 1997:614) the balance requirement shall be implemented for the first time for the accounting year 2000 and the entire law be valid from January 1st 1998. But according to a later law (SFS 2000:890) the entire law shall be implemented on January 1st 2001 and be applied for the first time in the accounting year 2001.

¹⁶ SFS 1991:900.

requirement will most likely be diluted and thereby delay necessary actions in order to have improved finances in the problematic *kommuns*. The afore mentioned investigation ending the 31st of October 2001 shall review the economic management in the *kommuns*, shall clarify and possibly also modify the balance requirement. It is expected that new transitional rules will be introduced according to this, meaning that discussions about how the problems should be solved will be postponed until the general elections during the fall of year 2002. According to what the investigator Jörgen Andersson reported on the 10th of May 2001, he will not propose any legal sanctions, but only changed technical solutions in the law.

Thus, it is unlikely that there will be any decisive change in the regulations system concerning the requirement of sound economic management and the balance requirement, that will improve the incentives to the *kommuns* to obtain sustainable finances. It is however good that the investigation will be reported during the fall of year 2001 at about the same time as The New Basel Capital Accord is presented. That ought to improve the possibilities for an efficient integrated discussion on how to regulate the *kommunal* borrowing in order to reduce the risks for sector crises in both the *kommun* and the creditor sectors.

The accounting requirement – has no sanction possibilities

The accounting in Swedish *kommuns* has for many years hardly been regulated. According to the Swedish law 1997:614 on local authority accounting (and also according to *Kommunallagen*) improved rules have however been implemented from the year 2000.. Therefore there is a hope that the local authorities to a great extent will obey these new rules. There is however no guarantee, due to the lack of legal sanctions in that legislation. According to an inquiry, performed by the Swedish Association of Local Authority Economists (*KEF, Sveriges Kommunalekonomers Förening*) among its members, many local authority economists and accountants reported that they had been subject to troublesome pressure from their politicians in order to deviate from sound accounting principles¹⁷. Thus the accounting in the *kommuns* is a problem, that is expected to remain as long as sanctions are lacking. – This especially as the auditors in the local authorities do not risk any sanctions when they avoid to comment upon their political party allies in the ruling majority of the *kommuns*.

Conclusions on regulations of the actions of the *kommuns*

The regulating system to affect the actions of the *kommuns* is not satisfactory in order to stop with a reasonable degree of probability that the requirement of sound economic management is bypassed. If The New Basel Capital Accord is not implemented, it will be only a matter of time until the situation will be unbearable for the *kommun* sector. But if the proposal is implemented according to the present time plan, the chance is great that there will not be any financial crises in the *kommun* sector. Correctly applied by the creditors to the Swedish *kommuns*, The New Basel Capital Accord will have a favourable influence of the actions on the *kommuns*.

Compared with the hitherto existing acute solutions it ought to be more efficient to use differentiated prices. Also, this will lead to a more open attitude regarding credit matter. The local self-government will be considerably strengthened. The risk for state interventions will be reduced. The proposal from the Basel Committee ought to strengthen the self-government of the Swedish *kommuns*, when it is implemented.

¹⁷ According to SFS 1997:614, Chapter 1, paragraph 3.

3. Regulating the system for monitoring from the regulating authorities

There exists a system for monitoring of the creditors, but hardly any system for the *kommuns*. The main problem today as regards credits to *kommuns*, is the weak obedience of the Bank business law (*Bankrörelselag*), the Local authority law (*Kommunallag*) and the Law on local authority accounting (*Lag om kommunal redovisning*). An additional problem is that the well formulated counsel from the Swedish *Finansinspektionen* are not used by the creditors, so that the interest rates for credits to Swedish local authorities are differentiated.

3.1. The system for creditors may become acceptable

The monitoring system for creditors has to do with the Swedish *Finansinspektion*. There exists counsel, but no punishments. That means that there are no sanctions when the counsel is not followed.

The general counsel from the Swedish *Finansinspektion* (FFFS 1995:49) on credit risks in credit institutes etc are formulated in *ought to* terms and do not deal with the responsibility distribution within banks when there has been a default.

The general counsel from the Swedish *Finansinspektion* (FFFS 2000:10) on dealing with market and liquidity risks in credit institutes etc are more adapted to The New Basel Capital Accord - but has very little to do with credits to *kommuns*, as the above counsel on credit risks. This counsel is also *ought to* formulated and no sanctions are indicated if the counsel is not followed.

The present system did not stop the Swedish bank crises in the beginning of the 1990's, even if the *kommuns* were not involved. The New Basel Capital Accord requires substantially more resources for the Swedish *Finansinspektion*. It is doubtful if those resources will be implemented to the extent that is sufficient in order to comprise the actions of the creditors towards the *kommuns*.

The Swedish *Finansinspektion* received an increased budget from the fiscal year 2000 and is reorganised in order to refocus the activities and use the available resources in a more efficient way. The *Finansinspektion* has notified the Swedish government that more resources are necessary in order to comply with the new requirements according to The New Basel Capital Accord. It is unclear if those resources will be available. It is difficult to judge in advance, but probably the new system will be an improvement, even if the *Finansinspektion* is not allowed to expand its resources as much as is needed in order to have a fully implemented system.

The Auditors of the Parliament ought now in their writ to the Swedish Parliament to observe the following possibilities: for the long term finances of the *kommuns* it could be more efficient to follow up how the creditor's loans to the *kommuns* are complying to the Law of banking business (*Bankrörelselagen*) and the Counsel of the *Finansinspektion* (*Finansinspektionens råd*), than that the government tries to monitor how the *kommuns* are to fulfil the economic requirements. If the Parliament states that it is the creditors and not the state (or rather all other *kommuns*, according to the redistribution system) that stands the primary risk, the managers of the *kommuns* will very quickly be given clear incentives to obtain sound finances.

If nothing is done soon, the loans to Swedish *kommuns* will soon be very expensive, after a financial crash has occurred. But if a price adaptation takes place now, the short term effect could possibly be more expensive loans for all Swedish *kommuns*. That would be unfortunate, as it will also affect the well managed *kommuns*, if they are not yet rated. These *kommuns* are harmed also according to the present system, as they pay for the misrule of poorly managed

kommuns. This system is regarded unfair due to the system for state grants and local authority readjustments of the finances. In the long run practically all local authorities will gain from lower interest rates due to more sustainable finances. And even for the poorly managed *kommuns*, that now have become foresighted and start an adoption of their thinking into rating terms, the credits may have time to become less expensive due to the proposals from the Basel Committee on capital requirement rules – as compared with what the costs otherwise would have been.

3.2. The ‘system’ for *kommuns*

There is no well organized system for monitoring the finances of the Swedish *kommuns*. The following aspects may however be commented upon.

The temporary system with acute solutions adopted during year 2000

Two so called ‘acutes’ were introduced¹⁸ for *kommuns* for the year 2000. This system has been strongly criticized by the Auditors of the Swedish Parliament. Their criticism¹⁹ includes the following summarizing points:

- Substantial parts of the appropriation from where the ‘acutes’ have been financed (Budget Area 25 “General grants to *kommuns*”) lack goals and seem to lack strategy. That appropriation should only comprise the grants 91:1 “General state grant to local authorities”, 91:3 “State grant for equalization to local authorities”, and 91:4 “Grants to the Council for local authority accounting”. The grant 91:2 “Grants to special requirements for some local authorities” should therefore be phased out from year 2004.
- “From acute to long term care”: The Swedish Government asked the Parliament in 1995 for resources at the government’s disposition and the appropriation was introduced in order to help some local authorities with an especially difficult financial situation, when the new equalisation system was introduced. Now after more than five years, the Auditors find that this temporary support still exists, and that it only partly has been used for its original purpose. The appropriation has received the character of a permanent appropriation.
- These ‘acute’ financial supports may influence the incentive structure in a negative way, and the knowledge that there exists acute financial resources may increase the risk taking in the *kommuns* in an unfortunate way. Instead a new regulation system should be introduced, that may increase the incentives for sound long term economics in the *kommuns*.
- The profit or loss statement for the appropriation is not satisfactory. The appropriation was handled by a committee and is therefore not covered by the requirements that state authorities have to obey. The government formulates the goals and does the assessment of the outcomes itself, and the role distribution is thereby not adequate between the parliament, the government and the authorities. The appropriated “Grant to special support to some local authorities” is thus lacking goals, results and analysis of goal fulfilment in the existing documents to the Parliament! And the National Audit Bureau (*Riksrevisionsverket, RRV*) is not allowed to audit the use of resources at the disposition of the government. (The internal audit within the government office is supposed to audit, but this has not been done for this grant.)
- The temporary form of organisation makes the role distribution unclear and hides the decision structure, which is a serious problem.
- The decision criteria are not fully utilizing the available bases for decision.

¹⁸ Kommundelelegationen (dir1999:65) and Bostadsdelegationen (Prop 1997:98:119).

¹⁹ Rapport 2000/01:09.

Temporary system for follow up of certain kommuner until the year 2004

For *kommuner* that have made agreements with the state of Sweden through the two acute systems, a special investigator has been appointed to follow the agreements up to the year 2004. This has also been heavily criticized by the Auditors of the Parliament. The Auditors criticism²⁰ includes the following points:

- Grants at the disposition of the Government do not follow the desired pattern, that the system with goals and profit monitoring shall have a clear role distribution. The requirements for result statements are unclear, and rules and regulations are partly lacking. The government has been dealing with matters that should be dealt with by some authority. And the government does not follow the same regulation and control system that normal authorities do.
- Unfortunate agreements have been made with *kommuner*, where no action plans are included in the unclear agreements. The government took away the proposed action plans from the formal agreements. This creates a risk to support a structure, that is lacking long term sustainability, if the government continues to give grants to *kommuner* when the proposed actions are not implemented.
- It is unclear how the follow up of the agreements shall be made. It should be made by an authority. It ought not be made by an investigator without measurable responsibility.

A negotiation system that invites criticism on the buying of votes

The system of grants to problem *kommuner* as decided by the government has been heavily criticized by the Auditors of the Parliament. Their critic includes the following points:

- Vote buying: Analyses of how the matters have been dealt with show that the government has taken advantage of its power over the grants from the budget Area 25 (that is 6.77 billion SEK for so called local investments programs) in a tactical way. There is support for accusing the government of buying votes by giving more grants to *kommuner* with easily influenced voters, and that this happened in March-April 1988, only few months before the general elections to the Parliament and the local governments in the *kommuner*. For the two 'acutes' the Auditors do not draw such clear conclusions on vote buying, but point at statistics that possibly could be interpreted in the similar direction, even if this not is shown in the same way as for the investment programs.
- The *kommuner* that have their applications for extra grants accepted have a considerably higher level of grants than other *kommuner* from the cost redistribution system within the equalization system.
- *Kommuner* that already have implemented similar cost cuts have not received corresponding state grants. These fore runners in the ambition to cut costs and be more efficient in their production are now suffering from increased fees and decreased grants in the cost redistribution system..

A centralized follow up system under construction

The government is constructing a monitoring system for *kommuner*. The project has just started. It will probably take many years to construct. It seems to a large extent to be focused on detailed monitoring of politically interesting activity areas. It is unclear if it will be fully implemented, as there is political uncertainty on how it should be planned and implemented. It is judged to contain great constitutional risks through the possibility of reducing the local self-government. (It suits the central power, that wants to rule the *kommuner* in detail as a compensation for power lost to EU, including some possibilities to buy votes.)

²⁰ Rapport 2000/01:09.

A follow up system ought to be based on a sound view of the reality

Obviously the Auditors of the Parliament are pointing at very troublesome circumstances, as the Minister of *kommuns* immediately felt obligated to try to diminish the importance of their report. Thus he said in a short press comment on April 6th 2001 that the report “gives an unrealistic impression”. It is serious, as the Minister’s view of the reality obviously differs completely from the fact based arguments from the Auditors. The description of their reality, as documented by the Auditors, coincides well with what Svensk KommunRating finds daily in contacts with *kommuns* and creditors.

The mass media functions poorly and could be improved

It is unfortunate that the weak state and credit market system for following up of the finances of the *kommuns* is also supplemented by weakness in the mass media. Journalists that know anything about local authority finances are scarce. The national newspapers and broadcasting media lack personnel that are competent in local authority finances. For the regional and local media the problem is even larger. Even the specialized magazines in local economics have problems finding journalists who can describe or comment on the system. The system for education in economics in Sweden is more focused on business and national economics than on regional and local (*kommunal*) economics. And the education in local authority economics is more focused on accounting than on planning and analysis.

Scrutinizing the contents of the journal *Ekonomisk Debatt* for the years 1972-2000 gives a very low proportion of the articles, comments or editorial pages, that have dealt with local finances or *kommuns*. The frequency has increased somewhat during the second part on the 1990’s, but is still on a notably low (quantitative) level, as compared with the importance of the local authority economy for the development of the welfare and economy of Sweden.

Preferably, the Auditors of the Parliament could in this connection make the Parliament pay more attention to this problem.

3.3. Conclusions on indirect follow up of the *kommuns* via the banking system

For the local authority sector in Sweden there is today no acceptable regulating system or acceptable appointed agents. It may however turnout well, if the The New Basel Capital Accord is fully implemented.

4. How creditors are repaid from a *kommun* who does not pay in due time

A Swedish *kommun* can not go bankrupt, as the Swedish bankruptcy law (*Konskurslagen*) is not applicable to *kommuns*. It is a problem that there are no rules for how to deal with a *kommun*, who does not pay in due time. This means that it is not regulated how a creditor could act if he wants money from a *kommun* who can not or will not pay in due time. Probably a creditor may try to apply the Law of distraint (*Utsökningsbalken*²¹) against a *kommun*, but in practice it is not expected that it is possible to distraint any asset of interest in a *kommun* in order to cover the financial obligations that the *kommun* is not paying.

The present situation as regards to the (lack of) regulations of financially defaulted *kommuns* – and the probably non-existing possibilities for practical distraint – are summarised in **Appendix 2**. That appendix is not translated from Swedish²².

It is sometimes said that no one has yet lost any money on loans to a Swedish *kommun*, as if only ten years of financial deregulation should be sufficient to create financial junk *kommuns* (using a vocabulary of the financial market). On the contrary, there are now ominous trends that point towards increased differences between the financial development in well and poorly managed *kommuns*. (Those trends are to a great extent a consequence of the behaviour of the creditors and of the unclear regulation system.)

Svensk KommunRating estimates that the proposal from the Basel Committee gives good incentives to change the actions of the creditors so that the probability is reduced for payment problems in the *kommuns*. If a Swedish *kommun* runs into a financial default, it may primarily affect a local savings bank. (The effect on the Swedish economy may however be substantial, as the financial system often is so sensitive to disturbances – not the least in the probably complicated situation that is causing the fallacy.)

²¹ SFS 1981:774.

²² The appendix is not translated from Swedish, due to the technical contents, and not attached here. It can be viewed at www.kommunrating.se/Artiklar

5. Dealing with legally unregulated issues when they have occurred

There are no regulations of what will happen when a Swedish *kommun* has a financial default. There is no good precedence giving support for how the present regulation system shall be interpreted when a creditor has given loans to a over spending *kommun* – and the *kommun* is not repaying in due time. There are more questions than answers concerning the legislation of local authority defaults. Some scenarios and comments are given in **Appendix 3** on what may happen, when a Swedish *kommun* not is paying its interests or amortizations. That appendix is not translated from Swedish²³.

The central power in the state of Sweden seems today to try to balance between two poor scenarios:

- One is that some banks are not paid in due time and that consequently the interest level is increased for the entire *kommun* sector. It is very unclear how many interest points the interest level may increase and thereby how many million SEK more expensive the local authority loans may become.
- The other is an increased risk for bad management in several *kommuns*, that try for as many state grants as possible. The price tag in the short run is here more clear, or billions of SEK for the two ‘acutes’. It is unclear how soon the next need for state “acute” support may occur. (With the present regulation system it is only a matter of time. The Auditors of the Parliament have a good view of the reality in their report.) The risk is that the costs the next time will be higher than in the year 2000, especially if the timing with the general economy and the development of costs in the *kommuns* is more unfavourable.

Thus the government tries to tell the creditors that *kommuns* are safe borrowers, in order to not increase the level of the interest rates. At the same time the government tries to tell the *kommuns* that they must have their finances in sound shape, otherwise different punishments may be introduced in the future. This means that the government gives good grounds for a very expensive game: the *kommun* that misrule may hope for help, if most other *kommuns* do well. As the Auditors of the Parliament clearly states²⁴, this gives totally wrong incentives to the *kommuns* for fulfilling the requirement of sound economic management.

In order to reduce the potential risks the government tries to construct a new system for follow-up of *kommuns*. It is unclear if that system will be implemented and if it will function as intended.

The government does not seem to choose between two other scenarios:

- Credits to *kommuns* priced according to the credit risk as suggested in The New Basel Capital Accord - possibly with an additional statement from the state, that *kommuns* have to manage their own finances at their own responsibility and that the state has no intention to give “acute” financing to the *kommun* that can not repay its loans.
- A political discussion to what extent the *kommunal* cost readjustment system shall introduce factors to compensate for different interest rate levels due to different degrees of poor management of the finances. (That discussion is expected to show up, in spite of **that the cost redistribution only** shall comprise factors that the *kommuns* can not influence.)

A system that gives incentives to price also loans to *kommuns* with respect to risk, would probably be more sustainable and economically efficient. That system would support economic growth. It would vitalize the local politics.

²³ The appendix is not translated from Swedish, due to the technical contents, and not attached here. It can be viewed at www.kommunrating.se/Artiklar

²⁴ Rapport 2000/01:09.

Concluding statements

With the above background it is possible for Svensk KommunRating to state as follows:

- The proposed New Basel Capital Accord has a good chance to make the market function in a more rational way as compared with the present situation, if the system should be implemented from the year 2004. The proposal is good and will speed up the achievement of a market for loans to *kommuns*, that is based on fundamental facts.
- The proposals from the Auditors of the Parliament in their report are based on a good description of the reality. The statement from the Swedish *Kommunminister* on April 6th 2001, that “the report from the auditors gives an unrealistic impression” may mean that the actions of the government are monitored by a world **view that is based on a wish to buy votes, and this view** differs considerably from the financial reality, that we note daily when we observe how creditors and *kommuns* act in matters of credit worthiness. If this view of the reality differs between the government and the Auditors of the Parliament, it seem that the proposals from the Auditors should be taken seriously and be implemented. Otherwise the government’s view of the reality will contaminate the local authority level and cause the *kommuns* to act so that their financial fundamental facts will deteriorate..

If the Basel Capital Accord is implemented in the year 2004, the parties on the market for credits to *kommuns* should have good use of the services that Svensk KommunRating is offering from March 2001 and that is expected to be fully expanded in the beginning of year 2003. The new rating approach and the ratings for Swedish *kommuns* that from March 1st 2001 are published at www.kommunrating.se (under *Analyser: ”Finansiella betyg”* and *”Vägen till betygen”*) correspond well to the Standardised Approach according to the proposed New Basel Capital Approach.

If that proposal is implemented and if the proposals from the Auditors of the Swedish parliament are implemented, the points 1, 2 and 3 above will have an acceptable set of regulations. That would with good certainty mean that the present problems with weak regulations around the above points 4 and 5 could become considerably less acute. The Swedish *kommuns* would receive much stronger incentives to obey the required sound economic management according to the Law of local management.

Uppsala, 25 May 2001
Svensk KommunRating AB

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Appendices (only in Swedish):

1. Receiving money from the *kommun* who has none.
2. Possible legal punishments for acting employee who gives credit with careless assessment.
3. Scenarios for how defaults in *kommuns* will be handled.

The appendices are not translated from Swedish, due to the technical contents, and not attached here. They can be viewed at www.kommunrating.se/Artiklar where the above comments are presented in Swedish for the Swedish *Finansinspektion*.