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Western European Local And Regional Government Borrowing Is Rising Sharply In 2012

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Western European Local And Regional Government Borrowing Is Rising Sharply In 2012

Western European local and regional government (LRG) borrowing is set to increase sharply in 2012, effectively erasing the slowdown observed last year and continuing the rising trend of 2009 and 2010. This is according to Standard & Poor's Ratings Services' eighth annual borrowing survey, which consolidates data and estimates of LRG borrowings in 12 Western European countries.

We estimate the region's LRGs will borrow a total of €268 billion in 2012, a significant increase of 27% on 2011. As a consequence, we expect the total debt stock of the LRG sectors monitored in this study to have surpassed €1.5 trillion by year-end 2012, a significant 6% increase on 2011.

Overview:

- We estimate Western European LRGs will borrow €268 billion in 2012, 27% more than last year.
- This will bring the total debt stock of the LRGs in the 12 countries covered in our survey to just over €1.5 trillion by year-end.
- Weak regional finances and large refinancing needs in Spain, as well as the one-off effect of a housing reform in the U.K., are among the main reasons for this sharp increase in debt issuance.

We believe this hike in debt issuance mainly reflects heavier borrowing in Spain and the U.K., where we forecast significant LRG borrowing needs for 2012. In Spain, weak regional finances, large refinancing needs, and a central government initiative to convert the sector's commercial debt to suppliers into financial debt are combining to almost double the LRG sector's borrowings in 2012 compared with 2011, according to our projections. In the U.K., we expect the Housing Revenue Account reform to lead to a significant increase in LRG borrowings in 2012, with gross borrowing set to increase more than twofold from 2011.

Elsewhere in the region, we expect LRG borrowings to be relatively stable compared with 2011. We believe that robust tax revenues will help limit borrowing needs in Germany, although it has by far the highest subnational borrowing in the region as a result of huge refinancing needs. Similarly, refinancing needs will remain large and will be a key impetus for gross borrowings in Switzerland and Sweden. Moreover, in several countries, particularly in the Nordics, substantial LRG investment continues to be a major component of LRG borrowings.

We note that borrowing in the region is still highly concentrated in five countries (see table 1). We estimate that German LRGs will continue to account for the largest proportion (34%) of total gross borrowings in 2012. Nevertheless, we expect that German LRGs' relative share of the region's LRG borrowing will decline significantly from 44% in 2011, while the share of borrowing in Spain and the U.K. will rise from 17% to 27% and from 5% to 9%, respectively, in 2012. The region's fourth and fifth largest borrowers, at some distance, are Switzerland and France (both with a 6% share).

This survey on Western European LRG borrowing encompasses 12 countries where Standard & Poor's has rating coverage, which we believe offers a sound proxy for the region's LRG debt. We base our survey on data collected from statistical offices as well as on our assessment of the sector's borrowing requirements and debt outstanding, such as bonds and bank loans. The reported figures are our estimates and do not necessarily reflect the issuers' own projections. For our data on issuers outside the European Economic and Monetary Union (EMU or eurozone), exchange rate movements can affect the euro amount of debt held by LRGs. Consequently, euro amounts sometimes don't properly reflect actual underlying local currency movements. For comparison, we present our aggregated data in euros, but comment on possible exchange rate-related inconsistencies in our detailed country sections.

We rate 102 LRGs in the countries surveyed in this report, including almost all the large European borrowers and particularly those active in the capital markets. For a full list, see "Local And Regional Government Ratings In Europe, The Middle East, And Africa," published on April 12, 2012.

Table 1

Western European Local And Regional Governments Gross Borrowing

	-- 2012e --			-- 2011 --			-- 2010 --			-- 2009 --		
	Ranking	(mil. €)	As % of total	Ranking	(mil. €)	As % of total	Ranking	(mil. €)	As % of total	Ranking	(mil. €)	As % of total
Germany	1	90,000	34	1	92,300	44	1	113,086	47	1	107,133	48
Spain	2	71,340	27	2	35,256	17	2	39,455	17	2	29,386	13
U.K.	3	25,371	9	7	10,308	5	7	7,974	3	8	8,291	4
Switzerland	4	16,364	6	3	15,484	7	4	13,744	6	4	12,151	5
France	5	15,500	6	4	13,900	7	3	17,500	7	3	17,600	8
Sweden	6	12,358	5	5	11,765	6	6	10,732	4	5	9,183	4
Norway	7	10,846	4	6	11,202	5	5	11,181	5	9	7,277	3
Denmark	8	6,424	2	8	6,744	3	8	6,839	3	10	5,926	3
Italy	9	6,417	2	12	2,483	1	10	4,650	2	7	8,415	4
Austria	10	4,787	2	9	5,016	2	12	4,464	2	11	5,180	2
Belgium	11	4,258	2	11	2,791	1	9	4,753	2	6	9,040	4
Finland	12	3,900	1	10	3,659	2	11	4,638	2	12	4,059	2
Total Western Europe		267,565	100		210,908	100		239,016	100		223,642	100

e--Estimate. Based on Standard & Poor's data.

Total Debt Will Surpass €1.5 Trillion By The End Of 2012

Our previous LRG debt survey forecast that Western European LRG debt would approach €1.42 trillion by year-end 2011 (see "Western European Local And Regional Government Borrowing Is High But Likely To Stabilize In 2011," published on July 13, 2011). This year's survey indicates that gross borrowing is rebounding in 2012, leading in turn to an increase in the total stock of debt.

Total gross borrowing slowed to €211 billion in 2011, down from €240 billion the year before. However, we anticipate it will resume its growth in 2012 to an estimated €268 billion by year-end.

We believe the refinancing of maturing debt will account for the bulk of gross borrowing in 2012. Nevertheless, the issuance of new debt to finance capital expenditures and in some cases to balance budget deficits is again putting the region's LRG indebtedness on an increasing trend. Based on our current estimates, Western European LRGs' debt stock should increase by about 6% in 2012, leading to our estimate that total debt will surpass €1.5 trillion by the end of 2012 (see table 2).

Table 2

European Local And Regional Governments Debt Stock By Country

	-- 2012e --			-- 2011 --						
	Ranking	**(mil. €)**	**As % of total**	**Ranking**	**(mil. €)**	**As % of total**	**(mil. €)**	**As % of total**	**(mil. €)**	**As % of total**
Germany	1	653,921	43	1	638,921	45	626,621	46	595,321	47
Spain	2	222,251	15	2	175,503	12	154,890	11	125,662	10
France	3	128,000	8	3	125,000	9	124,100	9	118,800	9
Italy	4	111,213	7	4	112,282	8	116,571	9	119,265	9
U.K.	5	104,117	7	5	84,044	6	81,088	6	73,106	6
Switzerland	6	77,317	5	6	77,971	5	77,213	6	64,654	5
Norway	7	58,330	4	7	55,493	4	48,369	4	38,081	3
Sweden	8	43,333	3	8	43,605	3	39,951	3	33,649	3
Belgium	9	41,838	3	9	41,108	3	40,275	3	37,143	3
Austria	10	31,014	2	10	29,427	2	25,467	2	24,103	2
Denmark	11	23,409	2	11	22,572	2	20,878	2	19,976	2
Finland	12	14,772	1	12	13,772	1	12,811	1	10,834	1
Total Western Europe		1,509,514	100		1,419,697	1	1,368,234	100	1,260,594	100

e--Estimate. Based on Standard & Poor's data.

Debt issued by German LRGs accounts for about 43% of total European LRG debt, according to our data. The German states ("Länder") have large debt stocks but their relative share of total debt has been steadily declining as LRGs in neighboring countries, grappling with fiscal imbalances, increase their indebtedness at a quicker pace. In particular, we have observed a sharp increase in the total debt of Spanish LRGs over the past three years, a trend that we expect will be further accentuated in 2012.

According to our estimates, bonds make up about 60% of Western European LRGs' total debt stock. German states dominate European LRG capital markets, accounting for about 70% of the region's issuance. Some way behind Germany is Spain in the euro market, and the Swiss cantons in the Swiss franc market (the latter targeting primarily domestic investors). In the Nordic countries, we note that a substantial part of LRG borrowing is conducted through municipal funding vehicles. In most other Western European countries, LRGs tend to rely heavily on bank loans to cover their financing needs, although bond issuance is gaining momentum in France as a result of a sector-wide banking credit crunch.

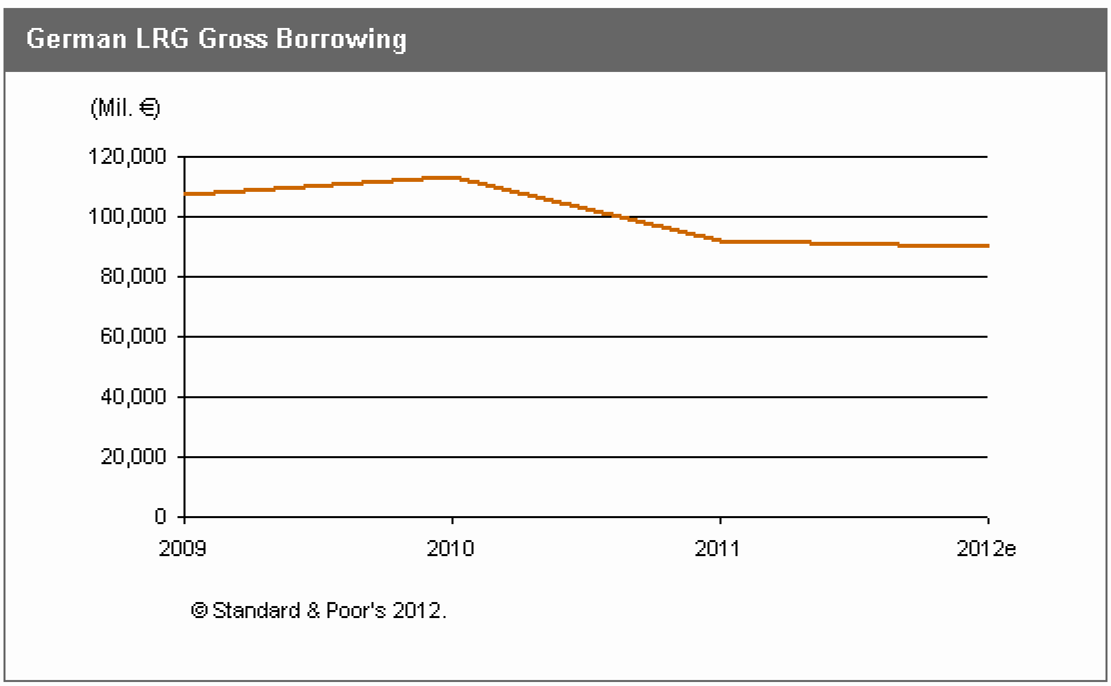
Below, we summarize the borrowing trends in a selection of countries covered in our borrowing survey. We have also published more detailed analyses on the financial, borrowing, and rating trends of the LRG sectors in these countries (see Related Research below).

Strong Tax Revenues Contain New Borrowing For German States, But Municipalities' Financing Needs Are Growing

Helped by robust growth in tax revenues, we expect that German LRG gross borrowing will decrease slightly in 2012 compared with 2011 and stand significantly below the amount recorded in 2010 (see chart 1). Still, we expect that significant refinancing of maturing debt will continue to keep the gross borrowing needs of German LRGs well above those of their Western European counterparts.

In view of Germany's comparably resilient economic development, we expect LRG tax revenues will post an estimated year-on-year increase of 4.6% in 2012, which should help contain net new borrowing increases. Still, according to our projections, German LRGS' net borrowing will increase to €15 billion in 2012 from €12.3 billion in 2011, primarily driven by increased borrowing needs in the municipal sector while the states on aggregate are making efforts to consolidate their budgets.

Chart 1



German states account for about two-thirds of LRG Eurobond issuance, and the states depend on refinancing for their large debt stocks. While we observe that all rated German states have ready access to the market, we note that investors are becoming increasingly hesitant toward nonrated issuers.

Moreover, the persistent budgetary crisis in several German municipalities is increasingly drawing the attention of market participants to the underlying credit risks in the German municipal sector. We note that some market participants are withdrawing from the municipal finance sector, owing to credit risk considerations and also because of new banking regulations, which make lending to public service entities less attractive than in the past. This process bears the risk that German municipalities, particularly those with weaker financial profiles, might face deteriorating access to funding opportunities.

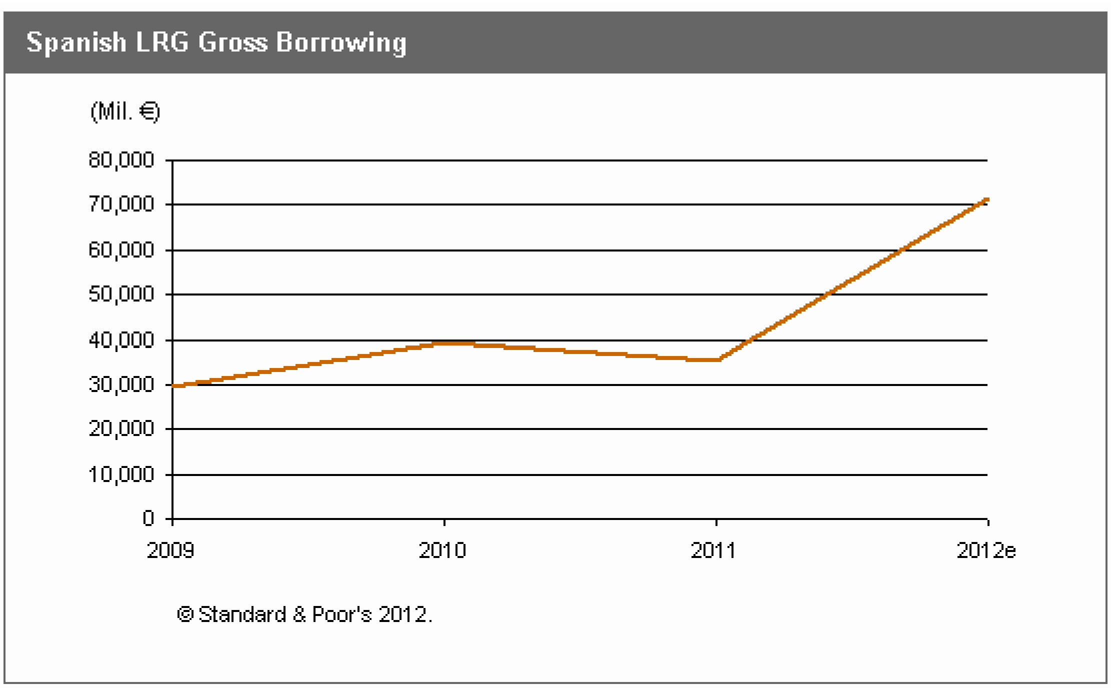
For more information see "German And Swiss Local And Regional Governments Rein In New Borrowing But Gross Debt Will Stay High," published on July 30, 2012.

Spanish LRGs Face Surging Borrowing Needs Despite Fiscal Consolidation

Persistent large regional and municipal deficits continued to increase Spanish LRG borrowings in 2011, despite fiscal consolidation measures initiated by the central government. We estimate that the total debt stock for Spanish LRGs stood at €176 billion at year-end 2011, equivalent to a year-on-year increase of 13%. In our forecast for 2012 and beyond, we expect deficits to start to reduce progressively, following the introduction of what we consider to be strong fiscal conditionality clauses to obtain financial support from the central government. Furthermore, the government has strengthened legal instruments to detect, correct, and sanction budgetary deviations.

Nonetheless, we expect the sector's gross borrowing will remain sizable. This is because high refinancing needs, substantial—albeit decreasing--deficits after capital expenditure, as well as the conversion of LRGs' commercial debt to suppliers into financial debt should combine to cause a surge in Spanish LRG borrowings in 2012. Based on our current estimates, Spain's LRGs' total debt stock should increase by about 27% in 2012 to reach €222 billion by the end of 2012.

Chart 2

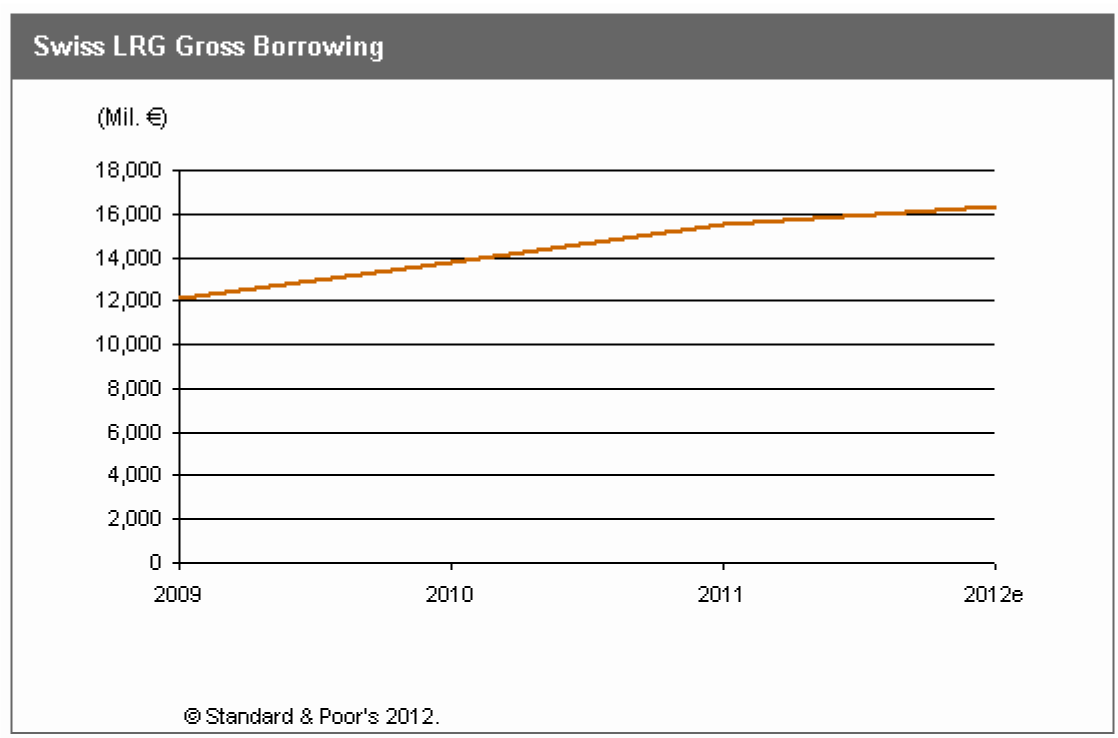


We project LRGs' gross borrowing to total €71 billion in 2012, double that of 2011 (see chart 2). This increase has three significant components. First, the refinancing of maturities of about €24.6 billion is set to remain substantial throughout the year. Second, we forecast that deficits after capital accounts of about €19.3 billion will require loan financing. Third, the conversion of LRGs' commercial debt to suppliers into financial debt under a mechanism approved by the central government adds a significant €27.4 billion to our projections of gross borrowings. For more information see "Local And Regional Government Borrowing Is Rising Sharply In Spain, But Not In France And Italy," published on July 30, 2012

Swiss Cantons' Debt Issuance Is Likely To Increase On Refinancing Needs

In Switzerland, we forecast gross debt issuance by LRGs will increase slightly in 2012 from 2011 (see chart 3). While the cantons would have reached surpluses in 2011 absent one-off effects, in 2012 they are facing new challenges, such as the national hospital reform and the effects of the strong Swiss franc. Nevertheless, we expect Swiss LRGs on aggregate to weather these potentially adverse factors and to exhibit zero net new borrowing in 2012. As with other non-euro issuers, currency movements can affect the euro equivalent amount of debt issued.

Chart 3



After Switzerland's strong economic rebound in 2010 and 2011, illustrated by annual real GDP growth rates of 2.7% and 1.8%, respectively, we envisage a significant slowdown ahead in Switzerland. Nevertheless, we forecast that the debt accumulation of Swiss LRGs will remain moderate in the medium term. This is based on our assumption of real economic growth of 0.2% in 2012 and 1.2% in 2013 and that Swiss LRGs will weather the expected slowdown of economic growth and budgetary challenges.

For more information see "German And Swiss Local And Regional Governments Rein In New Borrowing But Gross

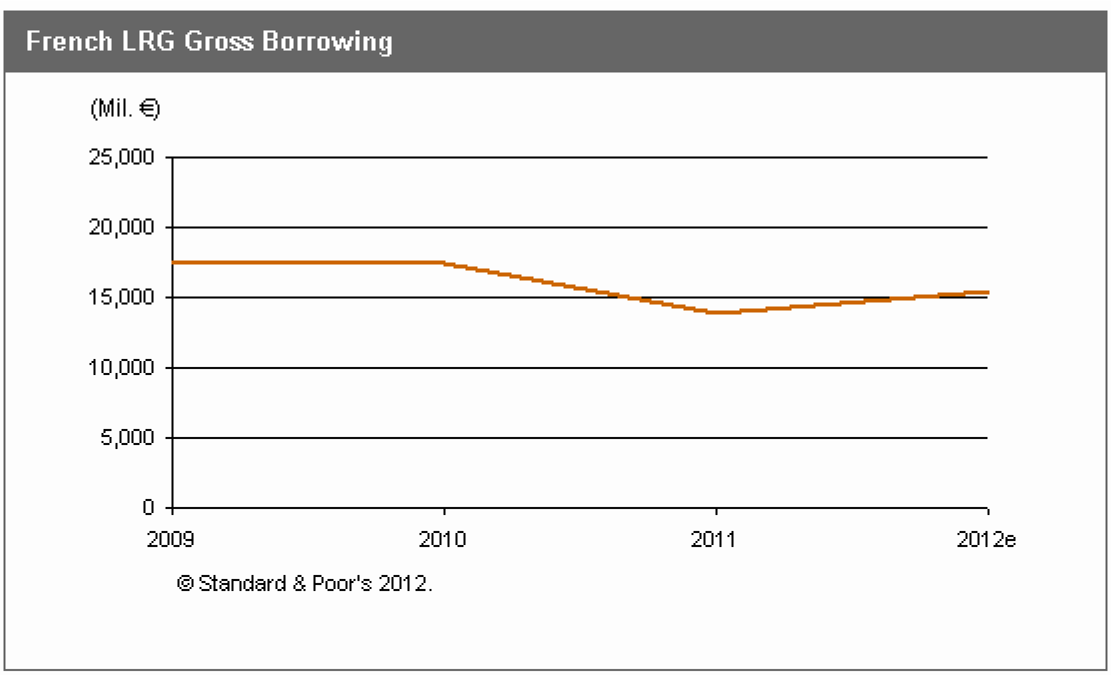
Debt Will Stay High," published July 30, 2012.

French LRGs Increasingly Tap The Financial Markets In 2012 As Access to Bank Loans Tightens

French LRGs face a tougher environment in 2012 than last year. In 2011, improved operating margins in combination with a stabilization of capital expenditures allowed LRGs to reduce their deficit after capital accounts to a low 0.2% of total adjusted revenues in 2011. The improved budgetary performance led to gross borrowing of €16 billion for the sector, below our expectation of €18 billion in our 2011 survey.

In 2012, however, we believe that French LRGs will face more constraints on the revenue side. We anticipate that operating revenues will increase by a modest 0.7% due primarily to a decrease of about 15% in property transfer duties (PTDs), while state transfers are set to remain stable. While we expect the sector's operating performance to weaken in 2012, capital expenditures should remain at a similar level to 2011. Consequently, we anticipate deficits after capital accounts to expand somewhat compared with 2011, but to remain low in an international context at about 1.5% of total revenues. This, in turn, should trigger an increased recourse to gross borrowings of approximately €15 billion-€16 billion for the sector (see chart 4).

Chart 4



In 2011, we observed that several commercial banks significantly cut their funding to French LRGs, some of which consequently turned to publicly owned banks and the capital markets. Given that French LRGs continued to have restricted and much more costly access to private bank loans, owing notably to the new Basel III arrangements, we anticipate a further increase in bond issuances in 2012. By illustration, as of end-April 2012, new bond issuances among LRGs had already exceeded €1 billion, a far higher level than that observed for the whole of 2011 (about €700 million).

For more information see "Local And Regional Government Borrowing Is Rising Sharply In Spain, But Not In France And Italy," published July 30, 2012

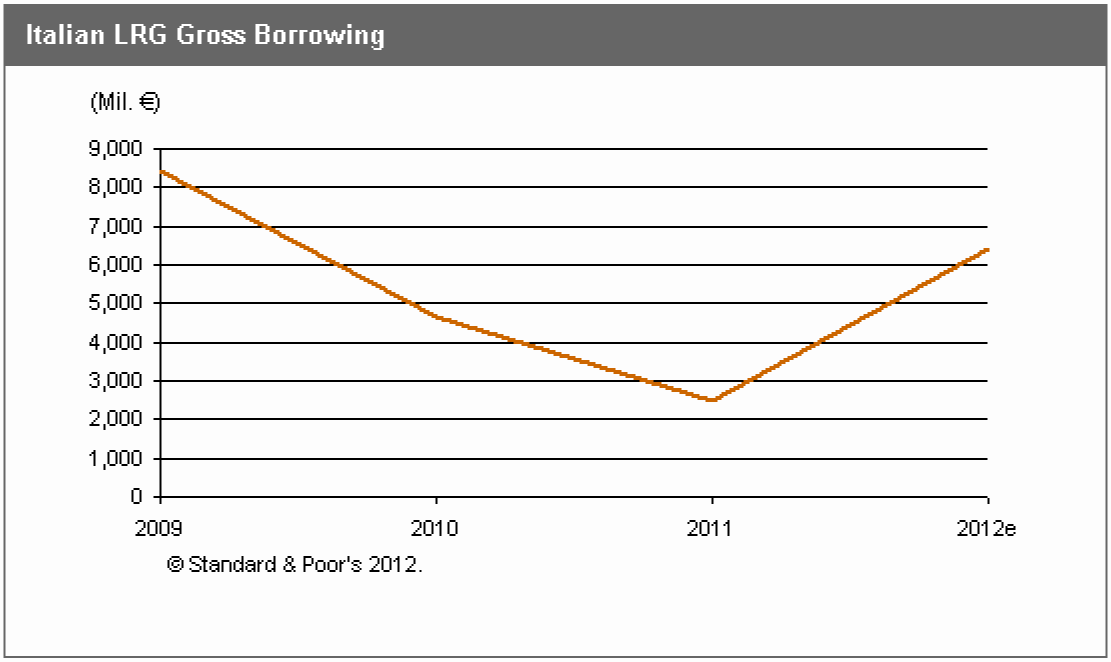
Fiscal Discipline Reins In Italian LRG Borrowings

Stricter fiscal rules in place in Italy since 2008 have dampened Italian LRG borrowing, and we expect that this will continue. Most significant among these rules was the internal stability pact, introduced in 2009, which has established more stringent expenditure limits for regions and generally shaped up the budget discipline for cities and provinces by requiring balanced after capital accounts. In addition, a variety of new enforcement mechanisms have in our view spawned a fiscally more disciplined LRG sector.

For 2012-2013, we believe budgetary surpluses on average will remain similar to 2011 in the sector, enabling the stock of LRG debt to further decrease for a third consecutive year to €111 billion by year-end 2012. We nevertheless assume that regions will not make use of cash holdings to amortize debt to the extent they were able to in 2009-2011. We therefore forecast that the overall stock of debt will shrink at a slower pace in 2012 and 2013 than over the past two years.

Contrary to the regions, Italian cities did not reduce their debt stock over the period 2009-2011. The compound annual growth rate of municipal debt over 2009-2011 increased slightly by 0.1% in 2011, compared with a 5.9% reduction for the regions. We don't believe the cities' stock of debt will expand over 2012 and 2013. We base this assumption on the strong constraints posed by fiscal rules for municipalities, which are stronger than for regions. In particular, cities must abide by the same debt-per-capita ratios as regions, or otherwise reduce debt. In addition, they must comply with limits set for interest-to-operating revenue ratios, or else debt issuance is not allowed.

Chart 5



In general, LRGs' debt issuance will continue to be hindered by the internal stability pact that limits their expenditures and reduces funding needs. In the past, LRGs have met the overall fiscal targets by reining in capital expenditure. We now believe they will likely comply with the fiscal target by achieving larger operating surpluses rather than reducing capital spending.

For more information see "Local And Regional Government Borrowing Is Rising Sharply In Spain, But Not In France And Italy," published July 30, 2012.

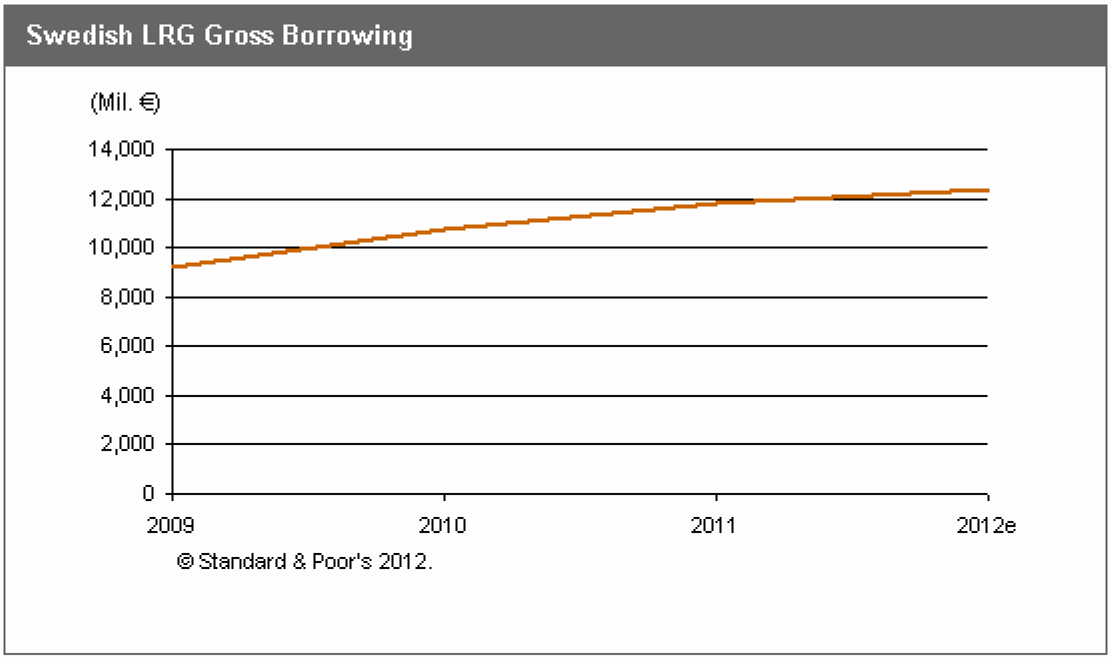
Capital Expenditures Propel Nordic LRG Borrowing

Because of the high proportion of short-term debt maturities in Scandinavia, refinancing of maturing debt has been a key component of total gross borrowings. We expect this to remain the case in 2012, even though we have seen a lengthening of the term structure of the LRGs' loan portfolios.

In Denmark, debt issuance is stable and any potential new borrowing needs are connected to capital expenditure financing, which we expect will remain modest in 2012. This is likely to lead to a small increase in the country's LRG indebtedness.

Following two years of strong economic growth, we expect the Swedish economy to lose growth momentum in 2012. As such, we expect that the evolution of the growth in income tax revenues will be uncertain in the coming years. Faced with declining growth in operating revenues but continuing ambitious capital spending, Swedish LRGs are likely to increasingly resort to debt financing of capital expenditures. Even though we expect operating balances to weaken from 2010 and 2011 levels, we anticipate that they will remain sound over 2012-2013. This should help curb the net financing need of capital expenditures, in our view. Still, the comprehensive sector-wide capital expenditures in 2012-2013 will translate into a moderate borrowing need. All in all, in net terms we expect the debt stock of Swedish LRGs to expand by a manageable 4% in 2012 in Swedish krona terms.

Chart 6



In Norway, by contrast, we have observed over the past two years that heightened political ambitions have led to investments increasing across the sector. A significant part of these investments have been debt-financed, leading to a 10% year-on-year increase in the sector's indebtedness (in Norwegian kroner) in recent years. We expect this evolution to continue for 2012, with gross borrowing and overall debt stock rising at rates similar to those in 2011. However, we also observe that the Norwegian government has increased its grants to the LRG sector to provide it with adequate means to handle rising debt service expenses. This mitigates risks associated with increasing debt.

In Finland, we expect municipal capital expenditures to remain high in 2012, related primarily to infrastructure, utilities, and public housing. While, the current municipal reforms may postpone some local government investment decisions in the coming years, ongoing investment projects are set to require the bulk of municipal loan financing. As a result, we expect the Finnish LRG sector's gross borrowing to remain largely stable in 2012 compared with 2011. Borrowings will continue to relate to debt-financing investments. We expect this level of borrowing to translate into an increase of the sector's debt stock by 7%-8% in net terms in 2012.

For more information see "High Investments Fuel Nordic LRG Borrowings, With Debt Stocks In Norway And Finland Rising The Most," published on July 30, 2012

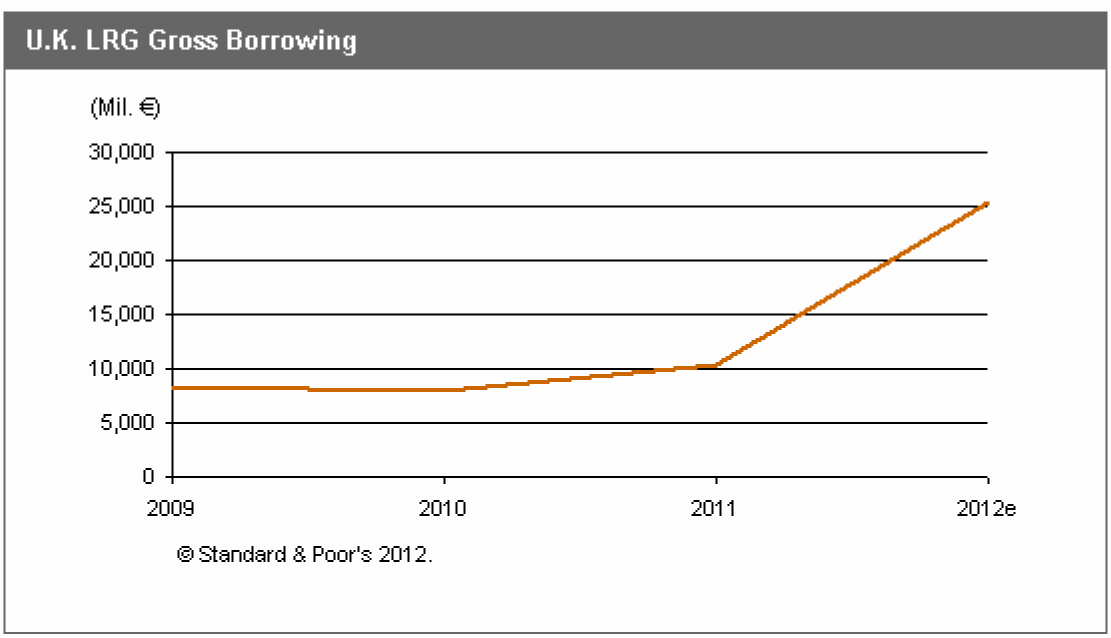
Housing Reform Sharply Increase U.K. LRG Borrowings

In the U.K., we forecast that gross borrowing by LRGs will increase steeply to £21.3 billion (about €25 billion) in 2012 (see chart 7) as a result of the Housing Revenue Account (HRA) reform that transferred a substantial one-off amount of debt to local authorities in exchange for increased autonomy in the management of council housing. We estimate that HRA-related gross borrowing will amount to £13.4 billion this year.

LRG debt has already increased moderately over the past two years. The 2010 Comprehensive Spending Review carried out by the Treasury reduced funding to LRGs by 28% in nominal terms over four years. This led to deteriorating operating performance for most LRGs in 2011, and to an overall reduction in investments, with the exception of strategically important local authorities, such as the Greater London Authority (GLA, AA+/Stable/--), Transport for London (TFL, AA+/Stable/A-1+), and Birmingham City Council (AA+/Stable/--). Overall debt increased moderately in 2010, by £2.8 billion to £69.2 billion. For 2011, U.K. LRG net debt increased by a similar amount, to £2.9 billion. However, gross borrowing from both commercial and public sector sources increased to about £8.5 billion from £6.8 billion in 2010. Part of this was due to £600 million of commercial bond issuance, which is unusual in a sector that typically meets its capital needs through loans.

Estimated commercial gross borrowing for 2011 increased to £3.2 billion, up from £1.8 billion in 2010, in part because of the £600 million bond issuance from GLA to fund the construction of Crossrail, a rail project for the London metropolitan area with an overall investment of about £15 billion. However, the Public Works Loan Board (PWLB) remains the main source of funding for U.K. LRGs, with £5.3 billion gross borrowing, up from £5.1 billion in 2010 (source: Public Works Loan Board Report and Accounts 2010-2011).

Chart 7



Total outstanding debt for U.K. LRGs was about £72 billion as of Dec. 31, 2011, of which the PWLB accounted for about 76%. The remaining 24% represented commercial funding sources, namely bank loans for 90% and bond issuances for 10%.

The steep increase in gross borrowing that we forecast for 2012 related to HRA reform is likely to be funded by PWLB loans, which will be provided at a discounted rate.

The 2011 increase of PWLB rates by an average of 87 basis points (bps) may in our view strengthen the attractiveness of commercial funding. On the other hand, we believe that this effect will be at least partially offset by the recent introduction, announced within the central government budget for 2012, of a 20 bps discount on PWLB loans for local authorities that provide improved information on their investment plans. We therefore expect the remaining £4 billion gross borrowing to be raised through a mix of PWLB and commercial funding, including bonds of strategically important local authorities, such as the GLA or TFL, which have large investment plans.

Besides the HRA-related funding requirements, we expect smaller LRGs to limit net borrowing needs in 2012, due to investment programs being downsized in the current funding environment.

HRA-related lending will take PWLB's outstanding balance close to its statutory limit of £70 billion, potentially reducing its headroom for lending to about £3 billion this year after the HRA debt drawdown. However, we expect the central government to increase this limit in 2012.

Debt Refinancing Will Remain Substantial

These country snapshots suggest to us that while LRG borrowings are set to increase sharply in 2012, considerably different factors are causing the increased loan financing. We note that central government initiatives can have a heavy impact on their LRG sectors' borrowing. The HRA reform of local authority housing financing in the U.K., for example, is leading to a one-off borrowing hike in 2012. In Spain, the underlying ailing national economy is proving to be a significant challenge for the country's LRGs and has driven large, repeated increases in debt since 2009. Over the coming years, we think that LRG borrowings in Spain will depend on how currently ailing national economic conditions develop. It will also depend on how effectively the central government is able to redress regional public finances and stop the spiral of indebtedness through consolidation measures and through its capacity to step in if regions are noncompliant.

By contrast, the German states appear in relatively good shape to contain debt growth, owing to robust tax revenue growth. Still, their historically very large debt stocks and consequent refinancing needs affect the region's total LRG borrowings. Similarly, while LRG sectors in Scandinavia continue to show resilience to the stressed conditions elsewhere in Europe, their large and ambitious investments plans are still driving buoyant funding requirements.

Overall, we consider that existing debt refinancing will remain a substantial and constant funding need, and we do not expect Western European LRGs' funding strategies to change materially in 2013 and beyond. European bond issuance will likely be concentrated in the German states, with French LRGs increasing their direct capital market activity. We believe the majority of municipalities and provinces in Western Europe will continue to rely on more traditional bank loans together with loans from special municipal funding agencies. This form of municipal financing has been common in the Nordic countries, but is increasingly gaining attention in other parts of Europe.

Related Criteria And Research

- Local And Regional Government Borrowing Is Rising Sharply In Spain, But Not In France And Italy, July 30, 2012
- German And Swiss Local And Regional Governments Rein In New Borrowing But Gross Debt Will Stay High, July 30, 2012
- High Investments Fuel Nordic LRG Borrowings, With Debt Stocks In Norway And Finland Rising The Most, July 30, 2012
- Local And Regional Government Ratings In Europe, The Middle East, And Africa, April 12, 2012
- Western European Local And Regional Government Borrowing Is High But Likely To Stabilize In 2011, July 13, 2011

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