The Risks of Municipalities in Case of Free Financial Fund Investments

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Abstract
Municipalities, as they work with public funds, should act as a "good farmer": the local municipality has to use its available resources properly, with an efficient and economical management. Municipalities are in a difficult situation when they have to decide on the temporary use or "storage" of their temporarily free funds.

Keywords
local municipalities; free financial funds; investments; national assets

1 Introduction

In the last few years, especially in 2015–2016 the management of the local municipalities and their lawfulness and efficiency became a daily topic in Hungary due to the fact that several municipalities were affected by the bankruptcy of financial service companies such as Quaestor, Hungária, Buda Cash etc.

In addition to the loss of billions of private individuals and private companies, the public sector and, in particular, the local governments got involved in the process, because they have lost (or temporarily failed) the fixed assets, which is public money and that is why in principle it has to be used under stricter rules.

During the years 2015–2016, the State Audit Office, the Office of the Prosecutor General and other public bodies conducted investigations at the local authorities in which it was established that there were local governments that were doing their job properly and carefully and there were those that did not.

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A professional debate has emerged beyond the political debate, whether the actors in the public sector can invest with their temporarily free financial funds or whether they are obliged to do so?

2 Legal Background

Act CXCVI of 2011 on national assets (hereinafter: Act on National Assets) regulates the preservation and protection of the wealth of local municipalities, as well as the requirements of the responsible management of the national assets [Art. 1 (1) of the Act on National Assets]. The provisions of the Act on National Assets are not applied to the financial funds of the bodies and persons at the level of the central government and local communities (Art. 2 a) of the Act on National Assets). The regulations of the Act on National Assets cannot be applied to the financial funds of municipalities, although in the case of purchase of stock or securities, the fulfilment of the consideration comes therefrom.

Municipalities, as they work with public funds, should act as a "good farmer": the local municipality has to use its available resources properly, with an efficient and economical management. Art. 61 (1) of Act CXCV of 2011 on the national budget said that *"the purpose of public finance controls is to ensure regular, economical, efficient and effective management of public finances and national assets, to ensure the proper fulfilment of the reporting and information obligations"*. Successfulness means that farming should have fruits and a yield. Moreover, if the subject of the study is the result of success, it means that it is also the goal of achieving profitability, so the yield and the fruits. It can also mean that it is necessary to invest free resources, because if this does not happen, the value of the money will reduce, so the purchasing power of the available resource is less (it is lost, if only nominally), namely it has lost its property, so the owner of the temporary free money did not take proper care.

Regarding Art. 5 (1) of the Act on the national budget, the amount of budget revenues and budget expenditures that are fulfilled in the budget year (a budget year is the same as the calendar year at budgetary institutions in Hungary) is determined by the municipality's budget regulation for the local government subsystem. Also in point h) of Art. 23 (2) of the Act on the national budget, the powers related to the implementation of the budget, in particular the revenue and the expenditure in financing, must be included in the municipal budget regulation. The financing revenues and expenditures are defined in Art. 6 (7) of the Act on the national budget. According to the subpoints aa) of point a) of this paragraph, financing revenues and expenditures are the revenues and expenditures arising from the purchase and sale of debt securities. Also regarding Art. 4/A (3) of the Act on the national budget, the use of the budget surplus is realised through financing revenues and expenditures.

3 The Practice

Usually, local governments define their rules and powers in their budget regulation in force at any time, these are the bases of the local government's financing expenditures and revenues. Consequently, local governments may allocate their temporarily free funds – which are at a given moment in their budget, but are intended to finance for the obligatory and voluntary commitments later – as fixed-term deposits, state-guaranteed securities or risky (riskier) securities with a possible higher yield. The latter solution is not illegal under any law.

There are other investment methods with which it is possible to use temporarily free money, but they are usually not used in the shorter term (for example real estate investments). However, there may be special situations, when such an investment cannot be unthinkable in the short term. Although, some of these investments already leads to the asset management area from financial investments.

There are usually three periods of the municipal management within a calendar year when a budget surplus may appear at local governments, not including the income which is accidental and single, unforeseen property utilisation (mainly from property sales). These three periods are fundamentally linked to the local taxation system and it can appear in March, September and December because of the local tax payments by taxpayers. These incomes are used to finance the entire annual tasks of local governments, but they are relatively evenly distributed over a calendar year.

Municipalities are primarily responsible for fulfilling their public tasks, including the provision of public services to the public, and they should act with due diligence. According to this, they can do two things: either they are not using their temporarily free money (for example by placing deposits, purchasing state-guaranteed government bonds, etc.) and in taking on the inflation, they suffer the consequences of a purchasing value decrease measured in the purchasing power parity; or they try to reduce and mitigate the inflation of the money, maybe gain profits, namely manage efficiently, thus keeping the value of their resources for later municipal performance.

Most of the local governments choose and usually chose the latter one during their management. And it must not be forgotten that if they decide to invest and buy a government bond, they will contribute to the financing of public debt, thus ensuring a source of funds to manage the deficit of the central government within the system of public finances.

4 Overview of the Investment Methods

What is the difference between the bank deposit, holding funds on the payment account (i.e. when the money is still not tied up) and the investment in a state-guaranteed security or other investments? The bank deposit or the payment account can no longer be considered safer in terms of investment or custody than state-guaranteed securities, namely government bonds. Moreover, government bonds are the safest form of investment, since the State is responsible for the purchased government securities. In case of local governments, there are no guarantees for the bank deposit and the payment account: it is not covered by the National Deposit Insurance Fund and the Investor Protection Fund, which means if the financial service provider goes bankrupt, there is no guarantee for the local governments. All other investment instruments are riskier than these solutions, such as paying accounts, deposit or government bonds, since there is no guarantee for the investment, and also without an extraordinary situation, it is questionable whether the capital invested may be refunded at the end of the investment, which is ensured by the former three solutions.

It should also be noted that point b) of Art. 136 (1) of Act CXXXVIII of 2007 on investment firms and commodity exchange service providers and their activities states that "during the liquidation of investment firms, financial assets and cash [...] entitled to or owned by the client are not part of the liquidation assets [...]". Therefore, if an investment firm goes bankrupt, clients' customer accounts (assets managed on their bank accounts or securities accounts) will not be part of liquidation assets, because they are subject to the deposit account rules governed by Art. 147 of Act CXX of 2001 on capital markets. Namely, they must be given to their owners immediately after the proper procedure has been carried out. Another question is that in such a situation, the matter of urgency can be a multi-year procedure, since this can happen when the liquidator checks the claims, examines those belonging to the same rank, and whether the coverage actually exists. If everything is cleared, then the expenditure can be fulfilled. This can cause the investor a temporary problem, especially if he has a liquidity problem. At the same time, it may also lead to higher yields (mainly in repo transactions), as in case of secondary government securities, the yield is usually the amount that the distributor waives, which is less than the one on the day of the conversion. So, on the day of the conversion, the government bond may be owned by the investor, so it will get higher returns than originally planned.

It is also important how to judge whether a government buys a government bond with the Hungarian State Treasury. The government securities are issued by the Hungarian State Treasury as the primary securities distributor, which may be purchased through it.

As a primary and non-secondary distributor, he holds no government bonds, he is only acting on behalf of the Hungarian State, and therefore his financial transactions are also limited. If the local government wants to maintain its liquidity, it also has to buy from others, since at the Hungarian State Treasury the local government has to expect that the maturity would expire, or the purchaser of the government securities and then the person wishing to sell it would have to look for a person who bought his government securities on the secondary government securities market. Alternatively, using a limited repurchase option, the State Treasury may sell the government bond at a daily rate which results in a non-predictable return, and the exchange rate does not often support the intention to repurchase. On the other hand, at the Hungarian State

Treasury, only government bonds whose subscription is in progress, may be purchased, given that it is a primary distributor, thus the government bonds issued earlier (up to ten years) with a substantially higher yield cannot be obtained. Finally, it is worth noting that secondary distributors are usually institutional investors who usually have access to government bonds with a higher yield on government bond auctions than non-institutional investors, such as those who directly buy government bonds through the Hungarian State Treasury.

It should be noted that, in case of a securities purchase, and if it was the investor's request, the purchased securities are kept by Keler Zrt. in a sub-account of a financial investor under the name of the investor, which is opened under its account. The legal nature of the deposit is an account, and not the property of a financial service provider. Otherwise, the register will not be named, but the financial service provider will separate the securities under its own name on an operating account which makes it much more difficult or even impossible to obtain access, as is the case of some local governments in recent years.

The practice of local governments is the repo transaction, which is one of the safest forms of securities purchasing. This means that at a given time, securities (e.g. shares, bonds, government bonds) will be received and, at the same moment, they will make a transaction on their sale at a later date. The difference between them is an exchange difference; this exchange difference is the yield profit of the buyer. The repo transaction is a secure form of investment, given that the securities being subject of the purchase until they are repurchased are the property of the buyer. In the event that a subsequent repurchase price is not paid to the former buyer, namely to the later seller, the securities remain the property of the buyer.

Of course, it is imaginable that a local government may not buy government securities, but other types of riskier but more promising securities (such as shares), as well as it may not enter into repo transactions, but pass the securities in another way (eventually finding a buyer later), losing the certainty that you know at the time of purchase that you have the buyer and also at what price. Thus, there may be a risk of holding securities (for example shares) for a long period of time or risking if you do not find a buyer, you may have a liquidity problem or you may be in a bad condition due to constraint to sell it. In case of higher returns, however, the local government can expand its financial scope to achieve goals and tasks that would not otherwise be possible in the absence of resources.

5 Decision about Investments

It should also not be ignored in case of money market operations that financial investment is a quick decision-making operation, which typically takes decisions for up to several days, but more often only for hours. This implies that if a body (a representative body or a committee) has to make a decision on an offer, and the board's decision will be properly taken (e.g. because of the rules of reconvene), it is almost certain that the offer will not be available. Thus it is worth taking the decision-making competence in the direction of personal decision (mayor or clerk), which raises the question of whether or not it may be allowed or can be referred the decision on hundreds of millions or billions to a person's decision-making competence or whether that person will assume this responsibility politically, professionally and legally.

Professional competence can be assumed either at the professional committee (e.g. financial committee) or at the office apparatus, which is capable of carrying out a risk analysis or impact assessment in preparing or taking the decision.

It is necessary to find the balance between quick decision-making, well-founded decision-making, professional competence, and responsibility, and expectations of the responsibility. The impact assessment cannot be missed by a prudently operating manager before any public spending. In case of attribution of powers, the decision must be taken, and the most viable solution shall be chosen, at the same time, with greatest expertise and security.

6 Other Risks

The possibilities outlined above concerns the case when the concerned persons acted properly. In this case, there is a business risk that may threaten temporarily free funds and it may be that the negative return on capital will have the investment. However, it is not possible to account for the risk when one party acts unfairly from the beginning, namely when the party intends to deceive the other party. There are some bodies for checking whether a financial service provider has sufficient capital, whether the coverage is available during the issuance of securities, and whether it issues and distributes the proper securities and in the quantity for which it is licensed, and so on. In such a case, as any natural person or legal entity, all public-sector entities may legitimately trust that the competent bodies perform their duties properly and have the authority to operate and perform certain financial market activities within the legal framework. It cannot be prepared for someone who behaves deliberately, either directly or by chance, in a way that it hurts another. This may be the case when a financial service provider sells securities that they do not have a license or issued in a much larger amount than the authorised amount. In such cases, the investor cannot do anything, since apparently everything is appropriate, a bond was given to him, while in reality it is not under his name. At the same time, there are legal institutions that have tried and are trying to reduce this risk, such as the fact that the establishment of a commitment or the execution of a payment in public funds is only possible with a transparent body. However, there is no guarantee that a transparent organisation will not do so.

7 Conclusion

Based on the abovementioned topic, it must be stated that municipalities are in a difficult situation when they have to decide on the temporary use or "storage" of their temporarily free funds.

They can be interested in buying a government bond, depositing it as a bank deposit, choosing investments with a higher return, or leaving it on the payment account without making a deposit.

They must act with utmost care and with due regard for the laws and the effectiveness aspects; it is questionable whether they can choose a solution that would be not risky either legally, professionally or politically; still the government bond investment seems to be the safest form for local governments.

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