Are cross-guarantees dangerous?

Posted by **Lars M. Andersson** on February 8th, 2012

In France the local authorities are well on their way to forming a local government funding agency. I am one of the advisors in this process. Now this is also being discussed in the UK and cross-guarantees are a frequent topic in this debate.

When forming a Local Government Funding Agency the question about credit enhancement of the entity is of crucial importance. In order for the agency to be able to supply cost-efficient financing to local authorities it needs to be perceived to have the same creditworthiness as the local authorities or, preferably, better. There are some alternative ways in which this could be achieved, but there is a long track record (see below) proving that local government guarantees are among the best ways to assure the agency of a high creditworthiness and a high credit rating.

Kommunekredit of Denmark has worked with a joint and several guarantee signed by its members since it started its operations in 1898. The guarantee has never been used. Still the Danish local governments are guaranteeing each other, which might feel like an unattractive risk taking for local governments that are forming a local government funding agency today. How could this be mitigated?

One way would of course be to use single guarantees from each local authority that covers their own borrowing from the agency. A major disadvantage of this is that the rating agencies and the financial markets when assessing the agency's creditworthiness will focus on "the weakest link of the chain". That will result in higher cost of borrowing.

Kommuninvest of Sweden has formed a system that combines cross-guarantees with final responsibility for the local government's own borrowing from the agency. All members of Kommuninvest Cooperative Society signs a joint and several guarantee covering all commitments of the agency. Furthermore they sign an agreement between the guarantors (the local authorities that are members of Kommuninvest) that says that if a claim were raised with reference to the guarantee, the guarantors would cover this claim with an amount that equals the proportion of their own borrowing from the agency. The result of this is that each local authority is liable for their borrowing, unless one of the guarantors was unable to fulfill its obligations under the agreement. In that case the missing part will be spread out over the other guarantors and will be treated as a loan to the troubled local authority. The interest rates for these "loans" are stipulated in the agreement between the guarantors.

The guarantee system of Kommuninvest has never been tested since no one has put forward a claim with reference to the joint and several guarantee.

Finally, Kommuninvest's existing members have the full power to set the criteria for joining the agency, which assures that every new member has an acceptable creditworthiness. This is then surveyed every year with the possibility to expel members with a deteriorated economy.

The conclusion is that cross guarantees are an efficient way to assure a good credit rating for the agency and that it could be done without excessive risk taking.

Explore More

Innovation Blog »

Making central government irrelevant?

NLGN's big focus this year is on making central government irrelevant. Ministers have already created huge pressure for change and another wave of central policy change now would be a distraction. Instead, we need to focus on supporting councils… *Simon Parker, NLGN*

Forthcoming NLGN Events »

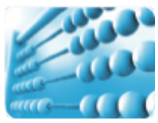
Report Launch – The Future of Local Economic Growth
(Monday, 16th April 2012)

Current Research »

Understanding the future citizen

The future of public health and local government

The future of local economic growth



Capital Finance and the Retail Bond Market