South Africa's Sub-National Debt legal framework, implementation and reforms

Intergovernmental Relations – October 2018

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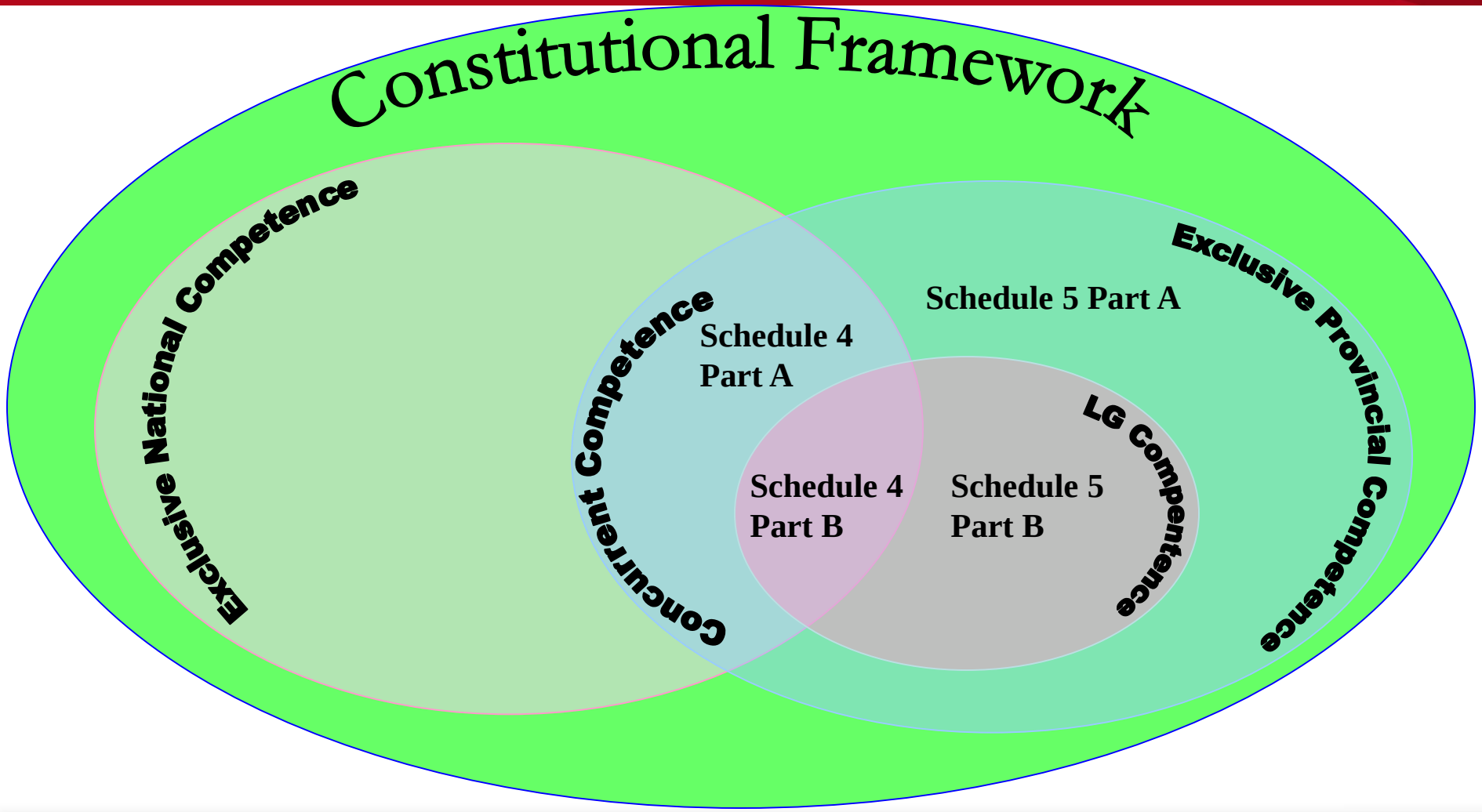
Intergovernmental context

- South Africa has an intergovernmental system that is based on the principle of cooperation between the three spheres of government –
  - ***National government***
  - ***Provincial government (9 provinces); and***
  - ***Local government (254 municipalities)***
- Constitution describes the three spheres as being 'distinctive, interdependent and interrelated' and enjoins them to 'cooperate with one another in mutual trust and good faith
- In addition to the Constitution, various legislation governs or organises the system of intergovernmental relations, some of the keys legislation are:
- **Intergovernmental Fiscal Relations Act (1997)-** provides a framework for the establishment of intergovernmental forums and mechanisms to facilitate the settlement of intergovernmental disputes.
- **Intergovernmental Fiscal Relations Act (IGFR),** 1997- sets out the process for the division of nationally raised revenues between the three spheres of government
- **Municipal Structures Act (1998)** – This Act provides for the establishment of different types of municipalities (metros, districts and local) and the division of powers and functions between local and district municipalities
- **The Municipal Finance Management Act** –provides the foundation for sound financial management principles and practices in the local sphere of government

Principles that underpin the intergovernmental system

- **Accountability:** Each sphere has specific constitutionally defined powers and responsibilities, is accountable to its legislature or council, and is empowered to set its own priorities.
- **Transparency and good governance:** Accountability of political representatives to the electorate and transparent reporting arrangements within and between spheres is at the heart of the intergovernmental system.
- **Mutual support:** National and provincial governments have a duty to strengthen the capacity of municipalities.
- **Revenue-sharing:** The fiscal system takes into account the fiscal capacity and functions assigned to each sphere (Provinces and municipalities are funded from own revenues, equitable share allocations, and conditional and unconditional grants).
- **Broadened access to services:** The Constitution and current government policy prioritises broadening access to services.
- **Responsibility over budgets:** Each sphere of government has the right to determine its own budget and the responsibility to comply with it. To reduce moral hazard and ensure fairness, national government does not bail out provinces or municipalities that mismanage their funds, nor provide guarantees for loans.

Allocation of functions to the different spheres of government



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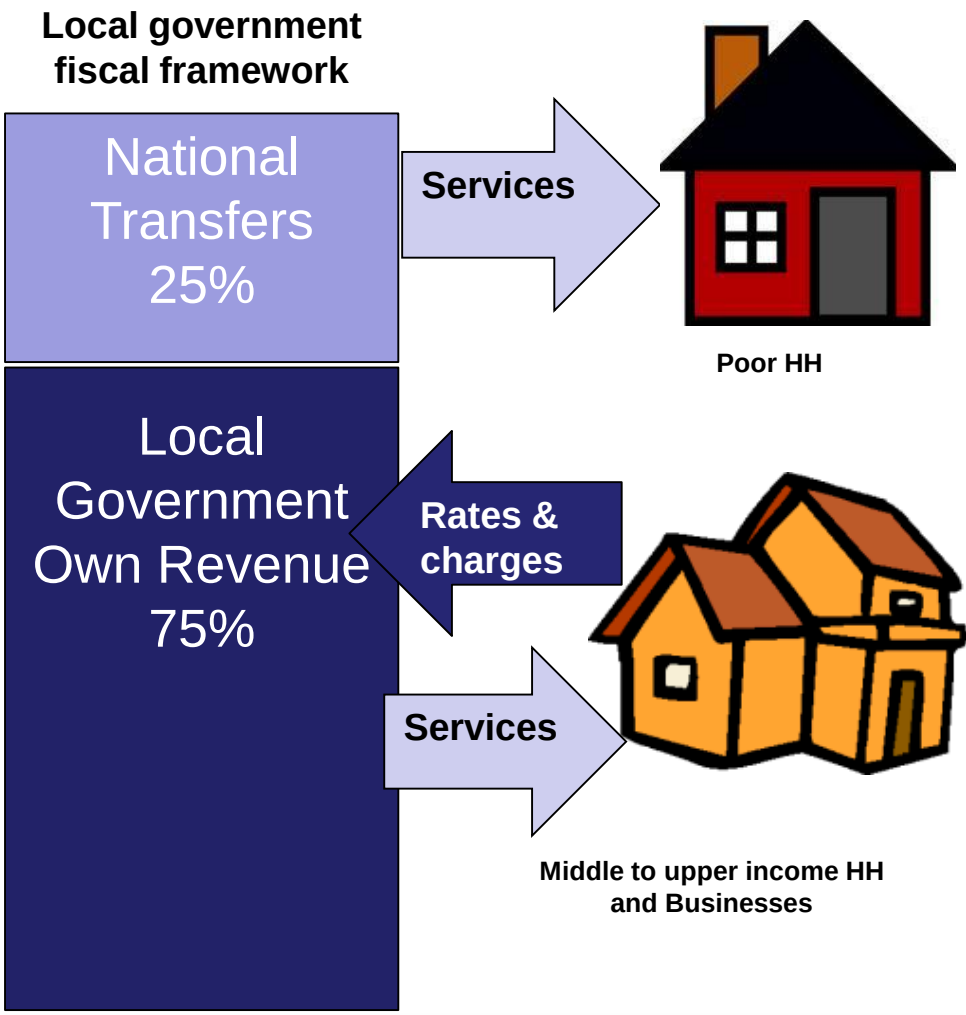
Concurrent functions are shared among different spheres and exclusive functions are performed by one sphere only

Capacity support and interventions

- Constitution places on national and provincial government to support and strengthen the capacity of municipalities to manage their own affairs.
- There are various national and provincial support initiatives, some of which are described in Chapter 5 Municipal Financial Management Act
- Section 139 of the Constitution provides that the provincial executive can intervene in a municipality when it fails to fulfil an executive obligation.
- The same section provides that the provincial executive, or the national executive, must intervene in a municipality when it fails to approve a budget or any revenue raising measures necessary to give effect to the budget, or when there is a crisis in its financial affairs.
- Interventions may include instructing the municipal council to take certain actions, taking over responsibility for particular functions and dissolving the municipal council and appointing an administrator.

Local Government Fiscal Framework

- Services for poor households are mainly funded through transfers from national government (some cross-subsidisation within municipalities is also expected)
- Services for non-poor households and businesses are paid for from own revenues
- For the whole of local government, own revenues fund 75% of budgets, but in rural areas (with higher poverty rates) transfers can fund up to 80% of budgets
  - Size of own revenues determined in part by high volumes consumed by non-poor HHs and businesses



Municipal Borrowing

- Section 230 of the Constitution- a municipality may raise loans for capital or current expenditure in accordance with reasonable conditions determined by national legislation.
- The borrowing policy framework- developed in 1998/1999:
- Intended to reinvigorate the capital market and help creditworthy municipalities to access capital
- This was to be done in a competitive market which is appropriately priced and reflects their creditworthiness (no guarantees)
- Policy served as a guide for legislation- Municipal Finance Management Act (chapter 6 and 13)- the most important piece of legislation for financial management in the local sphere of government
- The borrowing policy has generally been successful- private lenders are significantly investing in municipal loans and bonds
- To maximise accountability, transparency and sound management- municipalities are also required to develop their general borrowing policies which are used to consider their borrowing

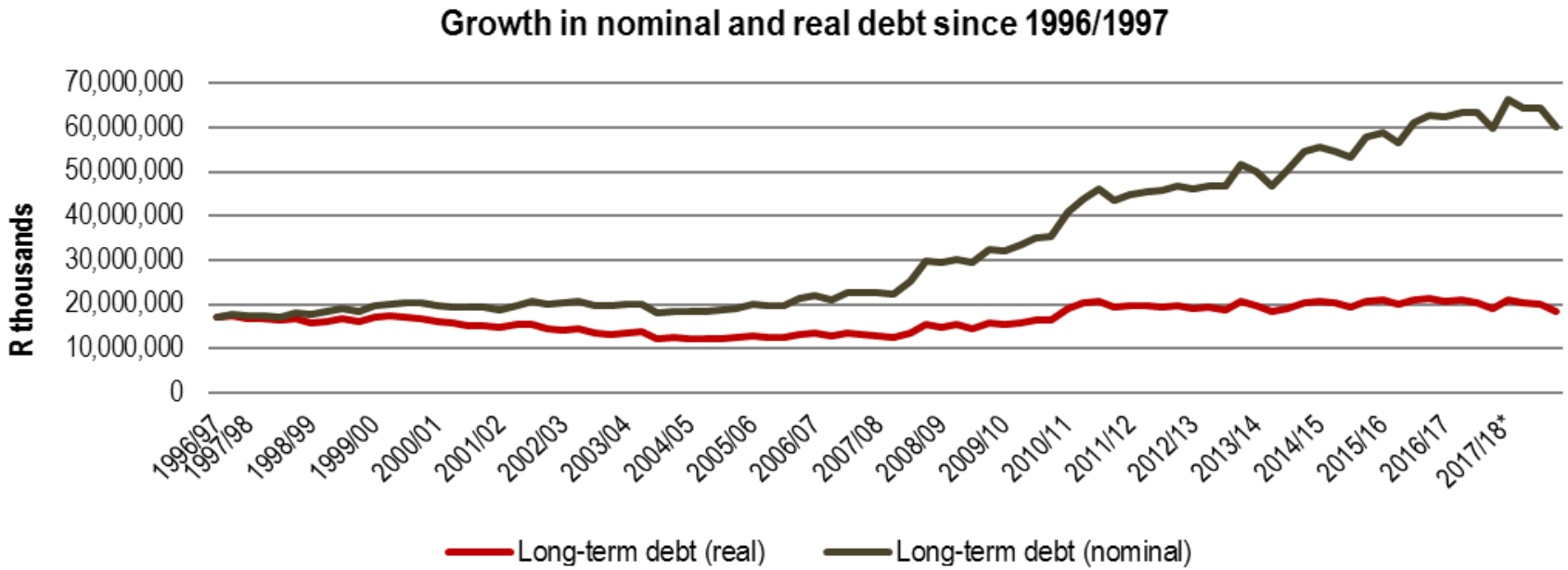
National and provincial governments do not guarantee municipal borrowing
The extent of the borrowing remains a decision of the municipality itself

Municipalities are authorised to engage in two types of borrowing

- **Short-term borrowing-** used to support cash-flow management-bridging purposes during fiscal year
  - *Municipality must repay short-term debt before the end of financial year*
  - *Such debt can only be incurred when a municipality point specific revenue to be used to repay the debt*
- **Long-term borrowing-** finance strategic infrastructure which unlock growth and providing essential services
  - *In limited circumstances it is also permitted for refinancing existing long-term debt*
  - *Municipal council is authorised to bind the municipality (and future council) to repay long-term debt*
  - *Municipality must issue notice to the public, provincial and National Treasuries to provide comments*
  - *Disclosure requirements- ensure that prospective lenders and investors have access to information material to investment decisions*

There are no fixed ratios or limits on municipal borrowing
National Treasury only monitors key indicators and ratios

Growth in long term municipal borrowing

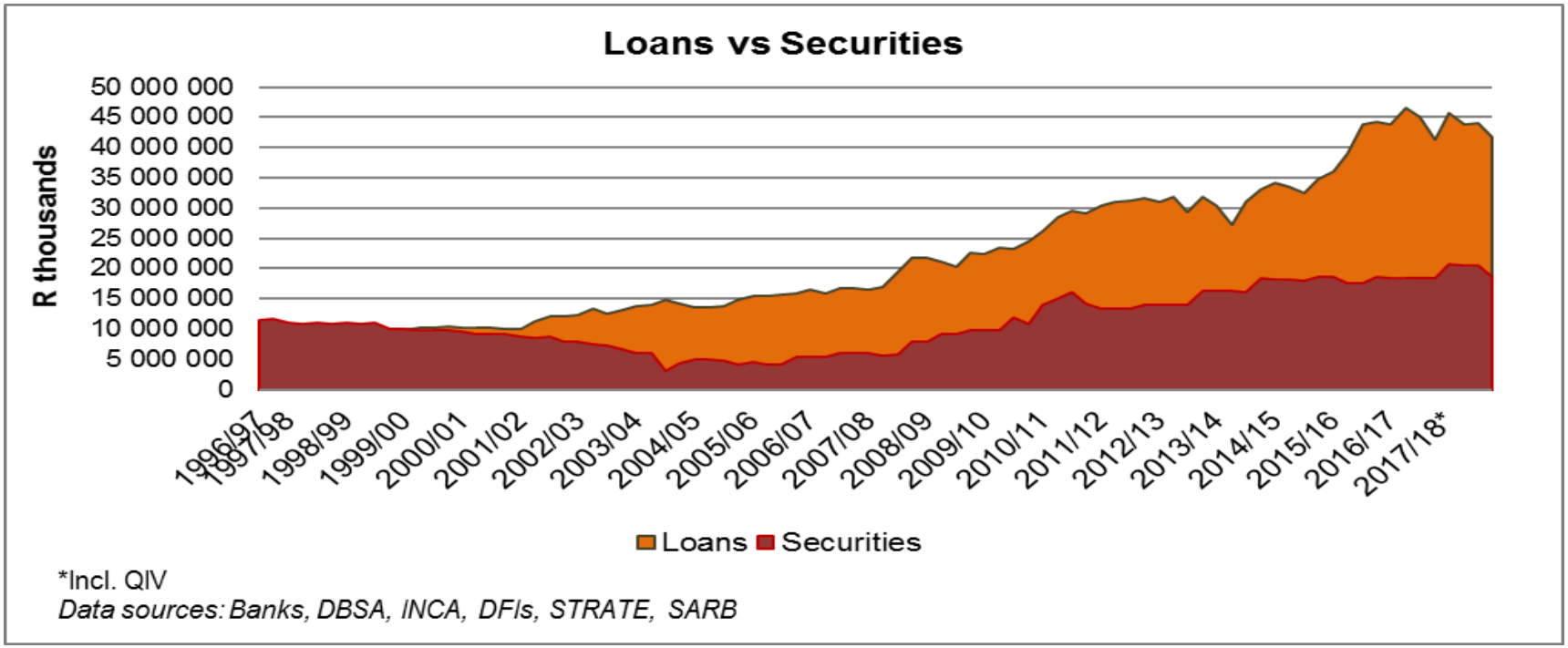


*Incl QIV

Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

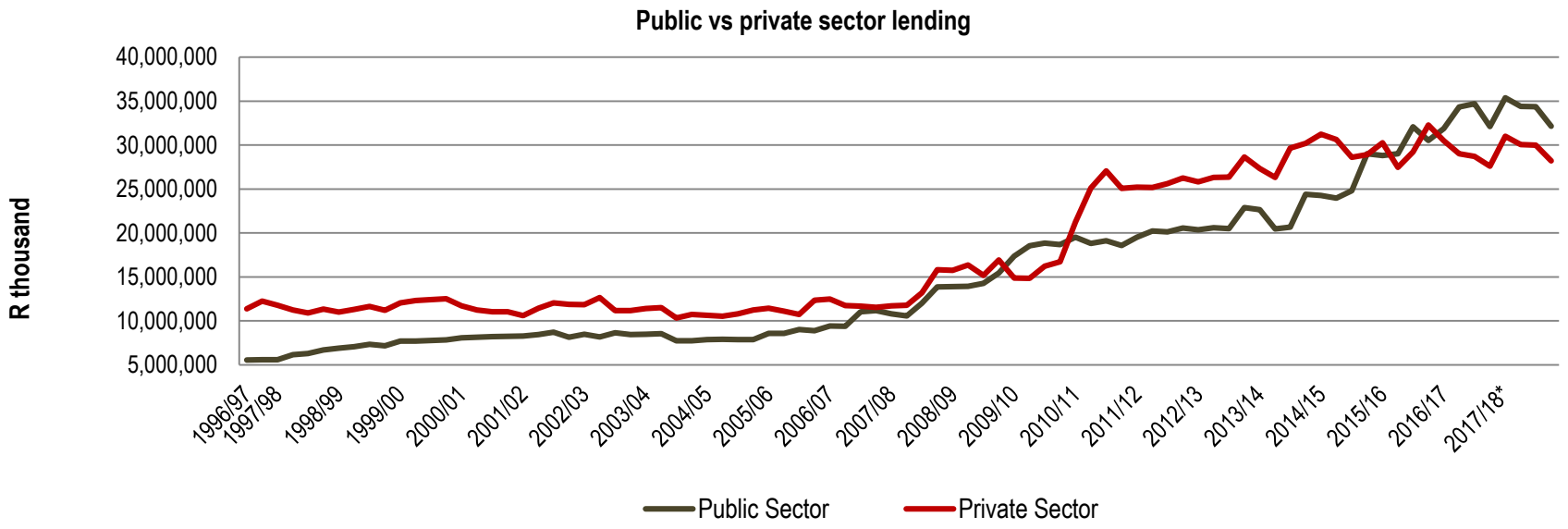
Municipal long term debt (nominal) has grown more than threefold over the years from R16.9 billion in March 1996/97 to R60.3 billion at the end of FY2017/18

Split between debt instruments



Loans continue to form the larger share of municipalities' long term borrowing
Only four out of eight metros are issuing bonds

Public and private sector lending to municipalities



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The private sector had been, for most of the past 21 years, the biggest source of capital finance for municipalities.

However, during the FY2015/16, the public sector overtook the private sector to become the bigger holder of long term debt

Some challenges still exist……..

- Despite the successful implementation- there are still some limitations:
  - Borrowing is not long term as initially intended (it does not relate to the useful life of assets)
  - Secondary markets have developed but not vibrant as anticipated
  - The role of DFIs need to be defined to avoid crowding out private sector
- To address these challenges-National Treasury is updating the borrowing policy framework
- The updates confirms core principle that creditworthy municipalities should borrow responsibly, without central guarantees

Borrowing policy update…

- **For lenders / investors:**
  - Emphasizes the importance of reliable information & disclosure for efficient price setting
  - **Quarterly Borrowing Bulletin**: a publication used to share information on developments in the municipal borrowing market
  - **Municipal Money** (www.MunicipalMoney.gov.za): web tool designed to inform citizens and interested parties on municipal financial performance
    - Financial statements (audit outcomes, liquidity position; current ratio etc)
    - Income/budgets: capital budgets, operating budget etc.
    - Expenditure (how money is spent and on what): capital expenditure; operating expenditure; repairs and maintenance

MUNICIPAL BORROWING BULLETIN ISSUE 9 June 2018 KEY HIGHLIGHTS DATA ANALYSIS

Mbombela: Rimers Creek Water Treatment

PURPOSE

The purpose of the Municipal Borrowing Bulletin (MBB) is to advance transparency, responsibility, prudent and responsible utilisation of municipal borrowing to finance infrastructure.

The MBB achieves this purpose by informing partners and invested individuals on developments in the municipal borrowing market. The MBB aim to add to a better understanding of developments and patterns in municipal borrowing through information sharing, analysis, and exchange of topical relating to municipal borrowing.

CONTEXT

The MBB is issued by the National Treasury on a quarterly basis. This issue covers long term borrowing information up to 31 March 2018, corresponding to the third quarter of the 2017/18 municipal financial year.

Sources used for this MBB include data submitted by municipalities to National Treasury as required by Sections 71 and 74 of the Municipal Finance Management Act of 2003; data acquired from lenders; information published by the South African Reserve Bank (SARB); and data from the Johannesburg Stock Exchange (JSE) sourced from STRATE.

HIGHLIGHTS

- The aggregate of municipal borrowing budgets was adjusted upwards from R13.3 billion to R13.9 billion.
- Only R4.7 billion or 34 percent of the budgeted amount has been borrowed to date.
- The total aggregate outstanding long-term debt reported by municipalities amounted to R65.6 billion against R64.3 billion reported by lenders – a variance of R1.3 billion or 2 percent.
- Long term debt owed by metros accounts for 87 percent of all long term municipal borrowing.
- Results of a recent long term municipal borrowing data verification exercise revealed that there are numerous other institutions which have finance lease contracts with municipalities which have not so far been included in lender-side reporting.

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Borrowing policy update…

For lenders / investors:

- Encourages public and private efforts to support a liquid secondary market
  - As opposed to corporate and municipal bonds, there is active secondary market in RSA bonds
  - Explore how municipalities can position municipal bonds to be like sovereign bonds than corporate bonds
  - Like national govt, municipalities have permanent existence and taxing powers as compared to corporate issuers which can become bankrupt
- Explicitly addresses pooled finance arrangements
  - In recent years some municipalities and potential lenders have been interested in pooled finance mechanism
  - The update to policy outline various models of pooled finance mechanisms and their "pros" and "cons". Some models discussed include; joint local government bond issued by large group of municipalities; establishment of intermediary/special purpose vehicle to borrow (using the balance sheet of the entity)

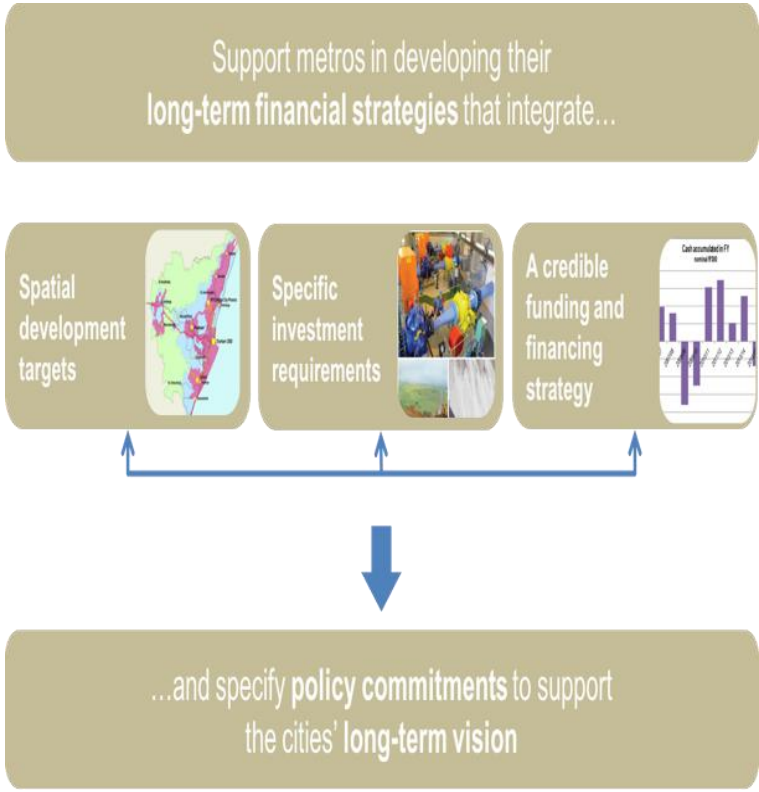
Borrowing policy update…

For lenders / investors:

- Clarifies the role which DFIs have to play to develop a healthy municipal credit market through-
- (i) increasing stock of bonds issued,
- (ii) securitising loan portfolios;
- (iii) partnerships between originators and investors across tenors

Borrowing policy update……

- **For borrowers:**
  - Emphasizes importance of more effective demand for financing through:
    - **Long Term municipal financing strategies** (building on BEPPs)
    - **Disciplined portfolio management & project prep**
    - **Importance of revenue enhancement**
  - Clarifies scope of **security interests,** including grant pledging (DoRA limitations removed)
  - Notes significant scope for **innovation in financing instruments**
    - Project finance, revenue bonds and tax increment financing are all explicitly authorized.
    - Complementary reforms to Devt Charges & grants



Thank you