



Section 164(1)(c) – Forbidden Loans

A number of municipalities have sought greater clarification on section 164(1)(c) of the Municipal Finance Management Act (MFMA), relating to forbidden activities. This states:

No municipality or municipal entity may make loans to councillors or officials of the municipality, directors or officials of the entity or members of the public.

In response to this, the National Treasury prepared this circular to assist municipalities in legally interpreting section 164(1)(c) of the MFMA and to provide guidance on some specific questions raised by municipalities.

1. What are the implications of section 164(1)(c)?

- 1.1 Section 164 commenced on 1 July 2004.
- 1.2 No loans may be granted to or taken up by persons mentioned in section 164(1)(c) after 1 July 2004.
- 1.3 Loans granted to or taken up by persons mentioned in section 164(1)(c) before 1 July 2004 remain valid (legal) until the expiry, settlement or termination of such loans.
- 1.4 Policies, practices, agreements or other arrangements, including employment contracts, conditions of employment and collective bargaining agreements, allowing for the granting of loans to or taking up of loans by persons mentioned in section 164(1)(c) after 1 July 2004 contravene the MFMA and are therefore illegal.
- 1.5 Vested Rights: No person mentioned in section 164(1)(c) has a vested right in respect of the granting or taking up of loans after 1 July 2004 notwithstanding the application of such practices, agreements or other arrangements immediately prior to 1 July 2004. Specifically, an official does not have a vested right to a loan by virtue of his or her conditions of employment. No term or condition of employment can violate an Act of Parliament.

2. To whom does section 164(1)(c) apply?

- 2.1 Section 164(1)(c) prohibits a municipality or a municipal entity from making loans to three categories of borrowers:
 - councillors or officials of the municipality;
 - directors or officials of the municipal entity; and
 - members of the public.
- 2.2 The term “councillor” and the term “official” are defined in section 1 of the MFMA. The MFMA does not differentiate between categories of officials and therefore applies to all officials.
- 2.3 Directors of municipal entities refer to the directors of the board of a municipal entity.

- 2.4 In the context of section 164(1)(c), “member of the public” refers to all persons in the community as a whole. This includes both individual members of the public (natural persons) and organisations, associations, bodies corporate or the like (juristic persons). Therefore a loan to a resident, business, company, non-governmental organisation, sport clubs and the like is not permitted.

3. What constitutes a loan?

- 3.1 The MFMA does not define the term “loan”.

A loan, in terms of law, has certain essential elements or characteristics. In essence a loan is the act of making something available to another for a limited period on the understanding that it or its equivalent will be returned.

- 3.2 Two types of loans are possible:

3.2.1 Type 1: in this instance the subject of the loan, such as money, is made available and the ownership passes to the borrower. On expiry or termination of the loan an equivalent object must be returned to the lender. The borrower may be required to return the equivalent or more to the lender. In the case of money, the borrower may be required to pay interest on the money borrowed.

3.2.2 Type 2: in this instance the subject of the loan is made available free of charge and ownership remains with the lender. On expiry or termination of the loan the exact same object, such as a vehicle, must be returned to the lender. If there is a charge it is not considered a loan and may constitute a lease or hire purchase arrangement.

- 3.3 It is important to note that the MFMA distinguishes between the granting of loans on the one hand, and allowances, advances, instalment sales, hire purchase, leases and benefits such as a bursary donation on the other hand.

- 3.4 Municipalities and municipal entities are advised not to disguise the true nature of agreements in order to avoid or circumvent the prohibitions contained in section 164(1)(c). The courts will consider the true nature and substance of agreements and may regard them as “*in fraud of the law*”, resulting in the agreement being declared null and void. In addition, National Treasury will request the Auditor-General to audit compliance with this provision as non-compliance may constitute grounds for a charge of irregular expenditure against the accounting officer.

4. What is the position where the granting or taking up of a loan is part of a broader agreement?

- 4.1 If prior to 1 July 2004, the municipality or municipal entity entered into an agreement that, amongst other matters provided for the granting of a loan by the municipality on a future date (after 1 July 2004) or the taking up of a loan by a person mentioned in section 164(1)(c) on a future date, the loan portion of the agreement will be contrary to the MFMA and therefore *illegal*. Whether or not the entire agreement is illegal or only the loan portion thereof depends on whether the loan portion can be severed (see 4.2 below) from the agreement or not. It will therefore require careful consideration of the entire agreement and may require renegotiation between all parties to resolve corrective action in relation to the offending provision(s).

- 4.2 The basic test for determining whether the loan provision is severable from the agreement is whether the parties intended it to be severable. This will normally require the following to be satisfied:
- the loan provision must be distinct from the rest of the agreement;
 - the loan provision must be subsidiary to the main purpose of the agreement such that its elimination would leave the substantial character of the agreement unchanged; and
 - the parties would have entered into the agreement even without the loan provision.

5. Do the following kinds of arrangements constitute loans?

Please note that the examples contained below in 5.1 to 5.7 do not represent an exhaustive list of all possible arrangements that may constitute loans. Only specific matters raised by municipalities in respect of section 164(1)(c) have been addressed.

5.1 Allowances

Allowances are not loans. They are usually part of an employee's remuneration and are paid to:

- enable an employee to perform his or her work;
- compensate an employee for working after hours or away from home; or
- to compensate an employee for expense incurred in performing his or her work.

Examples of such allowances are –

- Cell phone allowance: The employer may need an official to have a cell phone to be contactable when performing work away from his or her normal place of work or after normal working hours. In cases where the official agrees to utilise his or her personal cell phone for this purpose the employer may reimburse the official for work related calls and pay the official a set amount of money as a contribution to the other costs of the phone.
- Subsistence allowance: This is intended to cover the cost of meals, accommodation, taxi fares and the like where the official or councillor is expected to work away from home or attend a conference or similar authorised engagement. This may be paid either as a fixed amount per day or paid in arrears on proof of expenditure. When paid in advance the official may be required to furnish proof of expenditure and refund the unspent portion to the employer. This is not a loan.
- Travel allowance: Where an official uses his or her personal vehicle for work related purposes, an employer may elect to reimburse the official.

5.2 Study Schemes

Normally bursaries do not constitute a loan. Usually a bursary is a *donation* in terms of which the bursar undertakes to pay to the student, or on behalf of the student, certain monies associated with the expense of studying.

In situations where the municipality or municipal entity requires the student to refund a bursary under certain circumstances then it may be viewed as a *conditional* donation. Examples of such conditions include failing to remain in the employment of the municipality or failing to pass a subject.

However, an arrangement in terms of which the municipality or municipal entity undertakes to pay an official or his or her children's studying expenses or pay such expenses on their behalf on the understanding that the full expenses are to be repaid on a future date, would constitute a loan and is no longer allowed.

Consideration should be given to pay bursaries in arrears upon completion of subjects and on proof of expenses.

5.3 Housing Schemes

A municipality that lends money for securing housing is clearly providing a loan and therefore in contravention of section 164(1)(c). However, not all housing benefits or schemes constitute loans.

For example, a housing subsidy will not constitute a loan because the employee is not expected to repay the subsidy.

A separate circular will be issued in respect of loan guarantees.

5.4 Transport Schemes

Where a municipality assists an employee to purchase a motor vehicle by granting the employee a loan of a certain amount of that employee's annual remuneration, it clearly constitutes a loan. Loans of this kind made before 1 July 2004 remain in force but loans made after 1 July 2004 will be *invalid* and of no force and effect.

Existing employment contracts that grant motor vehicle loans will require the loan provision to be severed from the employment contracts once the current loans expire or terminate and alternative arrangements should be negotiated.

The accounting officer must ensure that any new arrangements are appropriately researched and are the most efficient and cost effective means to providing vehicles to officials for work purposes. Future arrangements may involve leasing arrangements or greater use of "pool" vehicles. Independent financial advice may be required to ensure that taxation and salary implications are correctly addressed in any new arrangements.

5.5 Advances on salary

In general an advance on a salary is the payment of remuneration prior to the date upon which it becomes due and payable. It is simply a payment of a debt before it comes due and not a loan. Although not a loan, this practice must be discouraged and proposed regulations will deal with such activities.

5.6 Loans to members of the public - provision of infrastructure

The settlement over time of fees and charges associated with connecting consumers to water and electricity services (including pre-paid meters and measuring equipment) do not constitute loans.

5.7 Staggered payments for the purchase of immovable property

In some areas municipalities have entered into agreements with members of the public to buy immovable property from the municipality and pay the purchase price over a number of years. The agreement requires portions of the purchase price to be paid at various intervals in the future.

In these circumstances the municipality acts as a financial institution. Such arrangements are, in the view of the National Treasury, loan agreements.

Financing agreements of this nature in place prior to 1 July 2004 remain legal and will need to run their course.

From 1 July 2004 these arrangements are, in the view of the National Treasury contrary to section 164(1)(c) of the MFMA.

6. Reporting Requirements

Attention is drawn to the requirements of sections 66(f) and 89(b)(vi) of the MFMA which require the accounting officer to report to the municipal council expenditure on staff benefits (salaries, benefits, and allowances) and entities to report to their parent municipalities on remuneration packages paid to board members and staff. Furthermore, this information must be disclosed in the Annual Report (starting 2003/04) and the Annual Financial Statements (starting 2004/05). In all cases, this will require the reporting of new *and* existing loans.

7. Penalties

The accounting officer of a municipality or municipal entity commits an act of financial misconduct if that person deliberately or negligently contravenes the MFMA. The provision of a loan in contravention of section 164(1)(c) would constitute grounds for financial misconduct. A municipality or entity is required to investigate allegations of financial misconduct and, where warranted, institute disciplinary proceedings in accordance with the systems and procedures referred to in section 67 and schedules 2 and 3 of the Municipal Systems Act.

Where appropriate, criminal proceedings may be instituted where a conviction can lead to a fine or imprisonment for a period not exceeding five years.

Next steps

The accounting officer is required to take all reasonable steps to ensure that the municipality and municipal entity does not engage in forbidden activities from 1 July 2004.

Policies, practices, agreements or other arrangements, including employment contracts, conditions of employment and collective bargaining agreements, allowing for the granting of loans to or taking up of loans by persons mentioned in section 164(1)(c) after 1 July 2004 contravene the MFMA and are therefore illegal. Such policies, practices, agreements or other arrangements should be reviewed, renegotiated where necessary and amended as soon as possible to ensure alignment with the MFMA.

In respect of existing policies, practices, agreements and other arrangements within the municipality prior to 1 July 2004, municipalities are encouraged to apply the spirit of the legislation and to review all existing loans, which if entered into after 1 July 2004 would have constituted a forbidden activity. Where possible, these loans should be phased-out in an efficient and economical way.

Conclusion

Whilst this circular is issued to provide some clarification on section 164(1)(c) relating to forbidden activities, municipalities are encouraged to obtain independent legal and financial advice when reviewing existing policies, practices, agreements and other arrangements that may constitute a loan in contravention of section 164(1)(c) of the MFMA.

During the course of preparing this circular, National Treasury became aware of many and varied agreements that were entered into by municipalities. Due to the complex nature of these arrangements, each should be considered on a case-by-case basis.

Requests for further information are to be directed to the dedicated MFMA email address or to the facsimile number as listed below.

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DISCLAIMER

This Circular is a guideline designed to assist National Government in meeting its constitutional responsibilities in respect of supporting municipalities in exercising their rights and performing their functions. In using the Circular regard must be had to the provisions of the Municipal Finance Management Act No. 56 of 2003, the Municipal Systems Act No. 32 of 2000, the Municipal Structures Act No. 117 of 1998 and labour legislation. The National Treasury is not liable for damages of any nature arising from reliance on this Circular.