

MUNICIPAL BORROWING

BULLETIN

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Sol Plaatjie, Bulk Water augmentation

Richie, 31 January 2018

PURPOSE

The purpose of the Municipal Borrowing Bulletin (MBB) is to advance transparency, and the prudent and responsible utilization of municipal borrowing to finance infrastructure. The MBB shares information on developments in the municipal borrowing market, and aims to add to understanding of developments and patterns in municipal borrowing.

CONTEXT

The MBB is issued by the National Treasury on a quarterly basis. This issue covers long term borrowing information up to 30 June 2018 and corresponds to the fourth quarter

of the 2017/18 municipal financial year. Sources of data 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.

Commemorating the 10th Issue of the Municipal Borrowing Bulletin

This marks the tenth issue of the Municipal Borrowing Bulletin since the first publication in June 2015. The publications have helped

interested parties to engage in municipal borrowing topics and has improved the general understanding of municipal borrowing statistics and dynamics.

Over the last three years, there has been an improvement in data collection; cross-checking and analysis. Contact with potential investors has also improved, thereby broadening and stimulating the municipal debt market. The Urban Finance Working Group has also been established as a forum where municipal borrowers, lenders and other stakeholders engage with the information.

The policy framework for municipal borrowing has been updated and is soon to be formally adopted by Cabinet.



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA



HIGHLIGHTS

- Actual new borrowings for the financial year stood at R8.7 billion, representing only 64 percent of municipalities' aggregate adjusted budgets for borrowing.
- Municipalities reported aggregate long term debt of R62.5 billion while lenders reported an aggregate of R60.3 billion, reflecting a variance of about R2.2 billion between municipality and lender reported data.¹
- Municipalities continue to under-utilise their borrowing capacity.
- Although long term municipal debt has grown more than threefold over the past 21 years, the growth in real terms has not been as significant (only 9.2 percent).
- There has been no further municipal bond issuance since the July 2017 issues by Ekurhuleni Metropolitan Municipality and the City of Cape Town. A number of municipalities have, however, recently indicated their intentions to issue bonds.
- The provinces of Gauteng, Western Cape and Kwa-Zulu Natal, home to the five largest municipalities in the country account for 93 percent of outstanding long term municipal debt.

DATA AND ANALYSIS

1. Aggregate municipal borrowing budgets

Table 1: Budgeted borrowings

R'000	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Original Budget	9 631 795	9 728 855	12 038 295	12 155 568	12 015 730	13 327 264
Adjusted Budget	9 273 438	9 747 836	12 033 281	11 674 332	11 602 644	13 572 036
Actuals	6 490 000	7 583 000	9 357 000	9 222 000	8 099 900	8 749 729
	70%	78%	78%	79%	70%	64%

Source: National Treasury Database

Actual municipal borrowing in FY2017/18 amounted to only 64 percent of municipalities' adjusted budget projections for the year. This is a relative decline from 70 percent in the fourth quarter of FY2016/17. Municipalities had initially budgeted to incur a total of R13.3 billion in new borrowings in FY2017/18, which would have been an increase of about 11 percent from the previous year's aggregated budgets. These budget projections were adjusted upwards to R13.9 billion in the third

quarter and subsequently revised down to R13.5 billion in the fourth quarter of the 2017/18 financial year. As shown in table 1 above, only R8.7 billion in new borrowings had been incurred by the end of the fourth quarter of FY2017/18. The growth in actual borrowings from 34 percent in the third quarter, to 64 percent at the end of the fourth quarter, reaffirms the observation in the previous bulletin that municipalities tend to borrow most during the last quarter of a financial year.

2. Analysis of long term debt as reported by municipalities

Table 2: Capital expenditure, new borrowing and outstanding debt

R million	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual
Capital expenditure	39 577	39 625	30 945	33 239	41 679	47 932	53 241	54 682	54 411	58 756
New Borrowing	9 463	8 226	6 401	6 211	6 490	7 583	9 357	9 222	8 099	8 750
New borrowing as a % of CAPEX	24%	21%	21%	19%	16%	16%	18%	17%	15%	15%
Outstanding debt	32 366	35 388	43 190	45 640	48 078	51 431	53 493	60 903	62 043	62 512

Source: National Treasury Database

¹ We have yet to receive data from the newly identified lenders as indicated in the previous bulletin. Once in hand, this data should substantially narrow the gap. Letters to the lending institutions whose information was identified as missing during the data verification exercise have been issued in order to formally request municipal borrowing data

Capital expenditure, new borrowings and total outstanding long term debt as reported by municipalities are shown in table 2 above. The adjusted total capital budgets for FY2017/18 were R71.3 billion, against an aggregate capital expenditure at the end of the fourth quarter of R58.8 billion. Again, the inclination of municipalities to spend most of their capital budgets towards the end of the financial year is shown by the movement from R31.9 billion in capital expenditure at the end of the third quarter to R58.7 billion by the fourth quarter of FY2017/18. The underutilised borrowing budget is one of the contributing factors to the underperformance of the capital budget. Notwithstanding, actual capital expenditures surpassed the R54.4 billion recorded for the 2016/17 financial year by 8 percent.

Similarly, FY2017/18 saw an increase in new borrowings of 8 percent from R8.1 billion in the previous financial year. Considering the effects of inflation at 4.6 percent for the year, this is a very modest increase. It is clear that most South African municipalities are taking a cautious approach when it comes to long term borrowing. New borrowings as a percentage of capital expenditure remain at only 15 percent as in the previous financial year. Compared to the previous years, the year-on-year increase in long term outstanding debt from FY2016/17 to FY2017/18 is not significant as shown in table 2 above. Although the nominal long term debt is increasing, it is declining as a percentage of capital expenditure because grant transfers have been growing at a higher rate than borrowing.

Table 3: Outstanding long term debt as at 30 June 2018

Municipal Category	Municipality	Total debt Q4 2017/18 R'000	Share of total debt	Actual Revenue 2017/18* R'000	Debt to revenue ratio
A	BUF	398 126	1%	5 381 630	7%
	NMA	1 231 625	2%	9 827 182	13%
	MAN	1 064 077	2%	4 844 571	22%
	EKU	5 917 681	9%	32 331 029	18%
	JHB	19 887 948	32%	45 279 731	44%
	TSH	10 793 547	17%	30 130 257	36%
	ETH	8 042 455	13%	32 405 050	25%
	CPT	6 913 288	11%	37 592 871	18%
	Total Metros	54 248 747	87%	197 792 321	27%
B	B1 (19)	4 770 882	8%	52 159 357	9%
	Other Municipalities	2 808 863	4%	72 553 680	4%
C	Districts	683 727	1%	25 090 123	3%
	Total all municipalities	62 512 219		347 595 481	18%

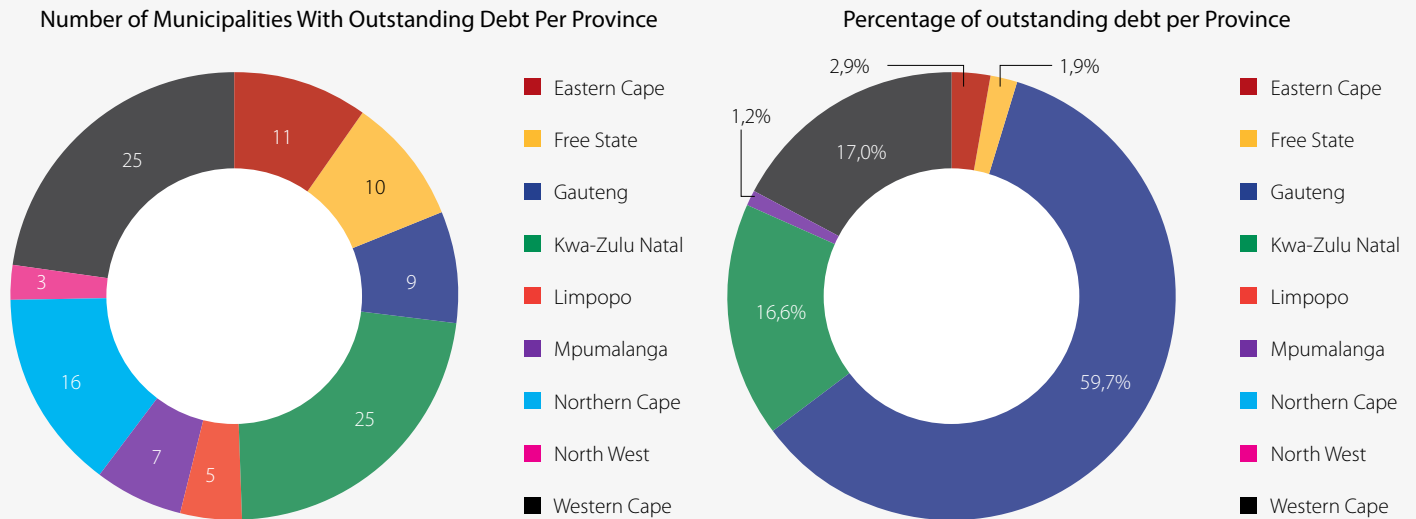
**excluding capital transfers*

Source: National Treasury Database

As observed in table 3 above, 87 percent of the total outstanding long term debt is owed by metropolitan municipalities, while secondary cities and other municipalities account for 8 and 4 percent respectively, with the remaining 1 percent attributable to district municipalities. Understandably, the greater revenue capacity of metros enables them to access more credit compared to the other municipalities. Many secondary cities with reasonably sound revenue levels are not taking advantage of long term debt finance to enhance their infrastructure investments. Also, not all smaller municipalities are doing enough to improve their access to long term debt finance. There are opportunities through the pledging of grant transfers for smaller municipalities to leverage their capital budgets through small scale borrowing.

The largest borrowers remain the City of Johannesburg, City of Tshwane and eThekweni with 32, 17 and 13 percent respectively of total outstanding long term debt. The aggregate outstanding debt to annual revenue ratio for all municipalities is at 18 percent (a decline from 20 percent from the previous year). The City of Johannesburg is borrowing aggressively with a debt to revenue ratio that is 1 percentage point away from the recommended 45 percent. It should be noted, however, that this 45 percent is purely a recommendation to safe-guard that borrowings remain prudential. It does not limit municipalities to explore higher borrowing levels if their financial management and local economy are sound.

Figure 1: Outstanding debt per province



National Treasury

In figure 1, outstanding long term municipal debt is shown per province. Municipalities in Gauteng have R37.3 billion in long term debt, or almost 60 percent of total municipal long term debt in the country. This is driven by the borrowing programmes of the Cities of Johannesburg, Tshwane and Ekurhuleni. Although the Eastern Cape has two metropolitan municipalities, Nelson Mandela Bay and Buffalo City, these cities have significantly lower levels of long term debt, largely correlated with their lower revenue bases. Nelson Mandela Bay, Mangaung and Buffalo City are three of the lowest borrowing metro municipalities as can be seen in table 3 above.

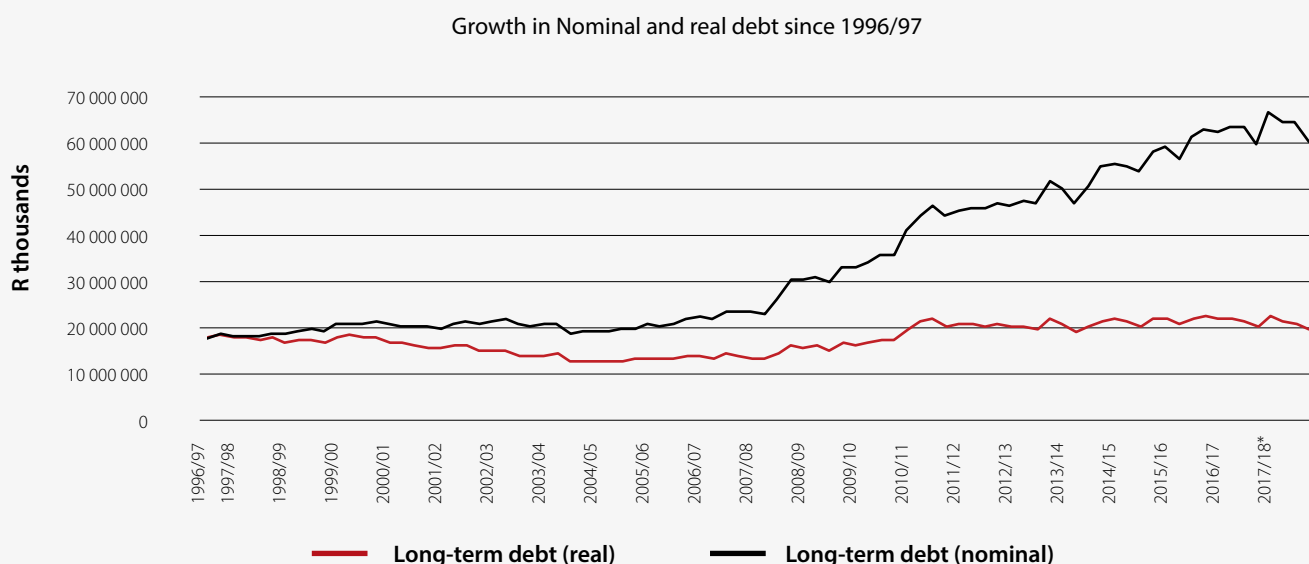
The Western Cape and KwaZulu-Natal provinces each have 25 municipalities that engage in long term borrowing, and their share of

outstanding debt is at 17 percent and 16.6 percent respectively. The provinces of North West, Northern Cape, Limpopo and Mpumalanga, have the lowest share of outstanding long term debt.

3. Analysis of long term debt as reported by lenders

This section looks at long term debt as reported by lenders. This data, however, does not so far include data from additional municipal lenders identified as a result of the data verification exercise conducted earlier this year. Letters requesting these institutions to provide quarterly municipal borrowing data have been issued and the data will likely be featured in the next bulletin.

Figure 2: Growth in long term municipal borrowing



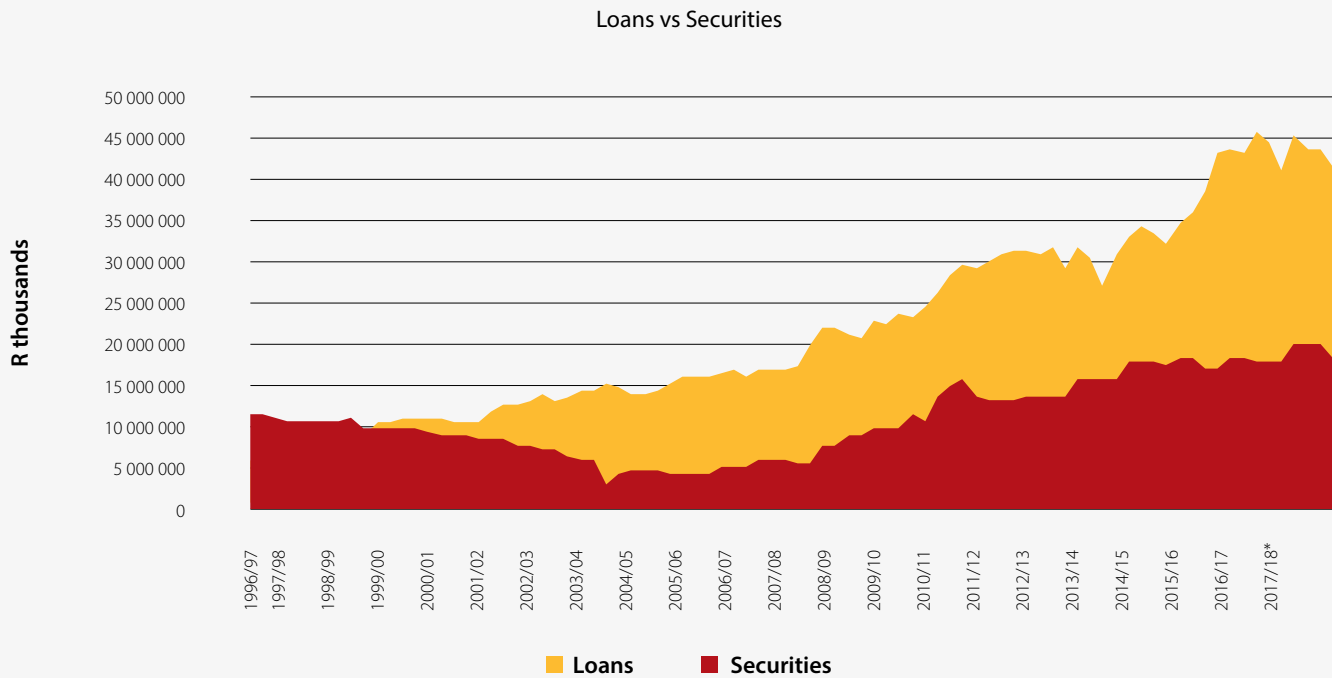
*Incl QIV

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

The red line in Figure 2 shows how much municipal borrowing has grown over the years in real terms, after adjusting for the effects of inflation. Inflation is adjusted for using March 1996/97 prices. 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. Over the 21-year period between March 1996/97 and the end of FY2017/18, municipal long term debt has only grown by 9.2 percent in real terms from R16.9 billion to R18.5 billion.

Figure 3: Split between debt instruments



**Incl QIV*

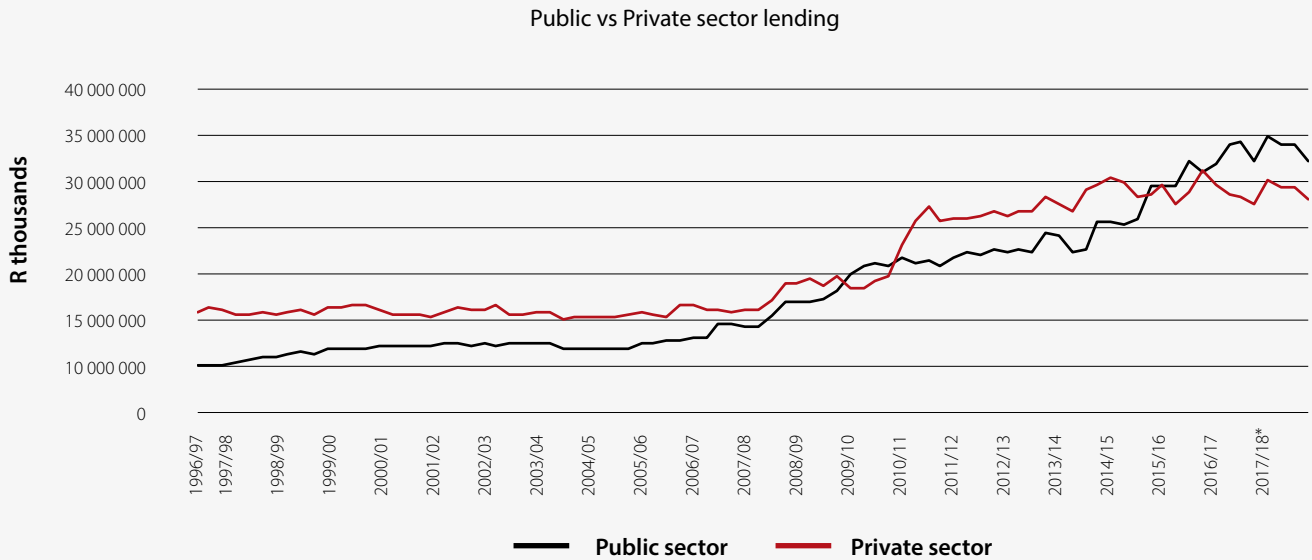
Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

Figure 3 shows that as at the end of FY2017/18, loans continue to form the larger share of municipalities' long term debt at 69 percent compared to 31 percent for bonds. This has not always been the case. Securities were dominant prior to the 1999/2000 financial year. The 21st century has seen a sharp rise in loans as the dominant form of debt. The only new bond issues in the 2017/18 financial year were the July 2017 issuances by Ekurhuleni and the City of Cape Town.

There is a study underway by the National Treasury aiming at determining what the barriers are to a more vibrant and liquid secondary market for municipal bonds. One obvious challenge is that currently, there are not enough securities in the market to allow for the necessary liquidity.

4. Holders of municipal loans and bonds

Figure 4: Public and private sector lending to municipalities



*Incl QIV

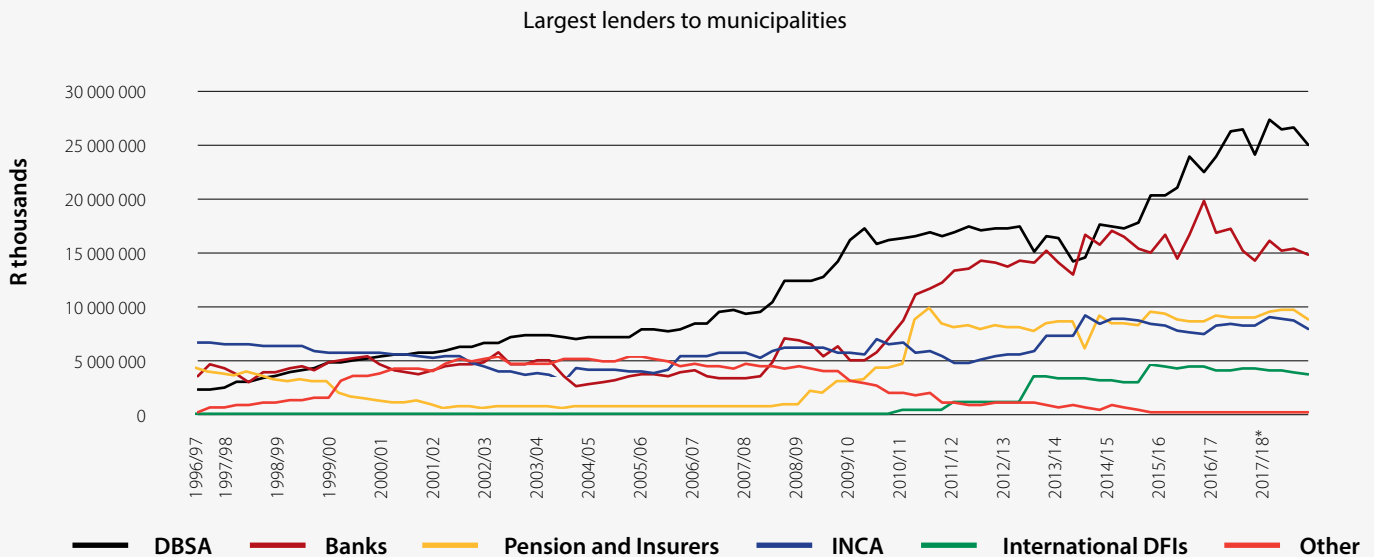
Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

The mix between private and public-sector lending in municipal long-term debt is shown in figure 4. The private sector has 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. As at the fourth quarter of FY2017/18, the public sector accounts for 53 percent of total long term debt compared to 47 percent for the

private sector, a position that has not changed since the end of the first quarter of the year under review.

It should be noted that the proposed policy updates require the public sector lenders to start focusing on developmental objectives and not to compete with the private sector lenders.

Figure 5: Largest lenders lending to municipalities



*Incl QIV

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

The composition of municipal long term lenders is shown in figure 5. The DBSA has consistently been the largest single lender to municipalities since December 1999 and as of end June 2018 accounts for 42 percent of total long term municipal debt. DBSA's holdings have fallen by approximately R1.7 billion from the third quarter due to some of the loans reaching maturity. While the DBSA plays an important role in broadening municipal access to private capital markets, particularly in acclimatising municipalities to requirements for market participation, this over-dependence on one public institution is not

ideal in terms of developing a deep and liquid capital market for municipalities.

The banking sector collectively accounts for the second largest amount of long term municipal debt with about R14.7 billion (24% of total long term debt). This figure has decreased by R466 million since the third quarter of FY2017/18. Pension funds and Insurers are the third largest source of long term borrowing by municipalities. International DFIs' share of long term debt amounts to R3.6 billion as at 2017/18 financial year end.

DISCUSSION

Development Finance Institutions (DFIs) and local government borrowing

South Africa is different to many developing countries in that it has a sophisticated and generally well-managed financial sector. There is a great deal of privately managed capital available to invest in productive infrastructure in well managed municipalities. Because of this, the National Treasury continues to call on DFIs to play a different role in South Africa than they do in many other developing countries. We seek to ensure that DFIs do not compete with the private sector in lending to creditworthy municipalities. We must ensure that the availability of DFI financing does not discourage private interest and capital investment in municipalities.

National Treasury is seeking a better alignment between DFIs' lending strategies and Government's policy objectives. After 18 years of experience with informally encouraging DFIs to play a more constructive role, National Treasury determined that the role of DFIs must be addressed explicitly and formally. Otherwise, there is a substantial risk that DFIs will continue to lend mostly to high quality, low risk borrowers. Accordingly, the 2017 Update to the Policy Framework for Municipal Borrowing specifies that DFIs' lending to municipalities, both domestic and foreign, should be guided by one or more developmental objectives with appropriate indicators which must be agreed in advance with National Treasury. This does not mean that Treasury wants to have any involvement in specific lending transactions. It is envisaged that framework agreements with any DFI interested in lending to municipalities will be reached on an annual or programmatic basis, ideally well in advance of any proposed lending. We have begun reaching out to DFIs that we know are interested in the municipal sector to initiate discussions on such framework agreements.

It is anticipated that the framework agreements to be reached with each DFI will be different as each one operates on an overall, often global, development mandate from its sponsors. The goal of the municipal lending framework agreements envisioned by the Update is to specify, for South African municipalities, what development impact the DFI ought to achieve and how the DFI will measure and report on impacts.

WHAT IS A DEVELOPMENT FINANCE INSTITUTION?

DFIs, sometimes called development banks, are financial institutions created and supported by one or more governments which provide credit to developing countries and in some cases to local government and private firms in developing countries. They can leverage their impact by providing credit guarantees and other enhancements to encourage third parties to provide credit. Three types of DFIs operate in South Africa:

- **Multilateral DFIs** include the World Bank and its private sector arm, the International Finance Corporation (IFC), the African Development Bank, European Investment Bank (EIB), the New Development Bank (formerly known as the BRICS Bank), and others.
- **Bilateral DFIs** include the Agence Française de Développement (AFD), the German Development Bank (KfW), the Swiss Investment Fund for Emerging Markets (SIFEM), etc.
- **South African DFIs** include the Development Bank of Southern Africa (DBSA), the Industrial Development Corporation (IDC), the National Urban Reconstruction and Housing Agency (NURCHA), and others.

The rationale for DFIs is that they can invest in countries or sectors that would not otherwise be able to attract private sector investment capital. Most DFIs have systems for measuring their "development impact" – i.e. evaluating what value or "additionality" is being provided by DFI involvement, that would not otherwise be available.

During the consultation process that led to the 2017 Update to the Policy Framework for Municipal Borrowing, National Treasury was often asked the kind of development impacts it thought DFIs could usefully pursue. Without wanting to limit the possibilities, here are some examples that would be consistent with the policy on deepening and broadening the private capital markets to support responsible borrowing by creditworthy municipal borrowers:

1) EFFORTS RELATED TO CREDITWORTHY MUNICIPALITIES

Term: Even creditworthy metros face term limits. Recent municipal borrowing has often been for 15 years or less. If large, fast growing metros were able to borrow affordably for 20 to 30 years, they could significantly increase their borrowing and investment capacity. It would therefore be useful to explore ways to affordably lengthen the term of municipal borrowing, especially in the context of municipal infrastructure with a useful life of 30-50 years. A DFI might use partial credit risk guarantees, interest rate buy-downs, or take-out arrangements to mitigate investor risks associated with term extension.

Quantum: The South African municipal bond market is thin. Most DFI credit to municipalities has been extended in the form of illiquid loans, rather than tradeable bonds. We would be interested in DFI programmes that result in a more significant volume of municipal bonds listed on the JSE. Depending on the DFI, the original bonds could be quickly re-sold on the market, or they could be held in for some period, and then sold into the market as the DFI requires liquidity, and/or as part of a coordinated strategy to boost the secondary market.

Strategy: Many municipalities are borrowing for relatively routine investments which, while important, will not guarantee that they have the systems and capacity to support anticipated population and economic growth. DFIs could be useful in supporting municipalities

to analyse what systems will reach or exceed capacity limits and reasonable life expectancy over the next 20-30 years which will in turn help municipalities to develop investment and operations programmes that avoid crises.

Intermediation: Smaller municipalities, even if they are well managed and creditworthy, may have trouble attracting the attention of the capital markets. We would like to see DFIs develop programmes to ensure that appropriately priced credit is available to creditworthy municipalities whose borrowing needs are too small to attract the interest of the capital markets or commercial lenders. Such programmes must be designed to ensure there is no contingent risk to other municipalities and to the National Treasury.

2) EFFORTS RELATED TO NON-CREDITWORTHY MUNICIPALITIES

Human and institutional capacity: With the backing of the equitable share and other intergovernmental transfer programmes, all municipalities should be able to access credit, if they are well-managed. Unfortunately, services and infrastructure in many poor and rural municipalities continue to lag behind national goals. This is often correlated with poor capacity to plan and implement sustainable programmes for building and operating basic infrastructure and services. National Treasury would like to see DFIs working with these municipalities to develop such programmes. This does not mean simply providing capital – it also means supporting the institutional and human resource development that is foundational to good governance and financial sustainability.

Creditworthiness assessments: It would be appropriate for DFIs to support municipalities to assess and work towards improving the creditworthiness of those municipalities.