

MUNICIPAL BORROWING

BULLETIN

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Molepo Water Treatment Works POLOKWANE LOCAL MUNICIPALITY

PURPOSE

The purpose of the Municipal Borrowing Bulletin (MBB) is to advance transparency, prudence and responsible utilisation of municipal borrowing for infrastructure delivery. The MBB informs interested parties on developments in the municipal borrowing market. The MBB aims to add to a better understanding of developments and patterns in municipal borrowing through information sharing, analysis and exchange of topical content 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 2021, corresponding to the end of third quarter of the 2020/21 municipal financial year.

This MBB includes data submitted by municipalities to National Treasury as required in terms of Sections 71 and 72 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

- Moody's downgraded five South African cities and one municipal entity on 16 July 2021.

- Lenders reported a total of R67.1 billion in outstanding long-term borrowing by municipalities, while R67.4 billion was reported by municipalities.
- Municipal borrowing budgets aggregated for all municipalities had been revised down by 36 percent at the start of the third quarter of the current financial year.
- New borrowing incurred so far in the current year was reported at R3.16 billion which is about 43 percent of the adjustment budget borrowing amounts.
- A total of R1.75 billion of outstanding bonds issued by the cities of Johannesburg, Ekurhuleni and Cape Town were redeemed between December 2020 and March 2021.



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA



DATA AND ANALYSIS

1. Municipal borrowing budgets

Following a downgrade to Tshwane’s credit quality late in June, Moody’s further downgraded five South African cities and one municipal entity on 16 July 2021. uMhlathuze is the only secondary city included in the rating action, along with Johannesburg, Cape Town, Nelson Mandela Bay and Ekurhuleni which are all metros. The Ekurhuleni Water Care Company (ERWAT), a water services entity belonging to the city of Ekurhuleni, has also been downgraded. The report by Moody’s is a reminder that the way in which municipalities are managed matters to the markets. Rating agencies play an important function; they are a barometer of how the market perceives financial management in municipalities. Sound municipal finances are critical to municipalities’ ability to consistently provide services to people and businesses.

The impact of the downgrades will be different across all affected municipalities. The general expectation is that the downgrades will have an impact on investor appetite. From a municipal perspective, higher risk premiums on new debt may render municipalities less willing to borrow, causing them to rely even more on grant funding and internal sources of revenue to fund capital expenditure. Given

the pressures on the sources of funding, we expect to see a further slowdown in municipal infrastructure investment. Many municipalities rely on property taxes and service charges (for water and electricity services) as their main sources of revenue. Due to COVID-19 and the current economic stress, households and businesses have a more challenging time paying their municipal bills. Finances are also tight at the national level; the national fiscus is currently under pressure trying to simultaneously meet competing needs.

The current stressed global economic environment is equally weighing heavily on South Africa as well, whereby all spheres of government are feeling the strain, including the citizens. Municipalities are often the hardest hit under these conditions because of the role they have to play in cushioning the pressures whilst continuing to provide services to the consumers. The National Treasury has been working with municipalities and Provincial Treasuries to understand the impact of the pandemic and the economic landscape. Before the recent downgrade of some of the municipalities; most municipalities had been deferring their borrowing plans, aware of the need to conserve cash and meet their ongoing service delivery obligations. It is therefore not expected to see a significant impact on municipal borrowing plans from the downgrading. Instead, it is a sharp reminder to all concerned that we need to build resilience into our systems and plan for the unexpected in all spheres of government.

Table 1: Budgeted borrowings

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Original Budget	9 631 795	9 728 855	12 038 295	12 155 568	12 015 730	13 327 264	16 195 667	17 620 931	11 395 889
Adjusted Budget	9 273 438	9 747 836	12 033 281	11 674 332	11 602 644	13 572 036	12 241 682	16 017 275	7 280 462
Actuals	6 490 000	7 583 000	9 357 000	9 222 000	8 099 900	8 749 729	8 004 007	5 897 860	3 161 278
	70%	78%	78%	79%	70%	64%	65%	37%	43%

Source: National Treasury Database

Municipal borrowing budgets aggregated for all municipalities had been revised down by 36 percent going into the third quarter of FY 2020/21. Overall, municipalities adjusted their borrowing plans for the 2020/21 financial year from an initial R11.4 billion to about R7.3 billion. Long-term borrowing has become a permanent and essential feature of municipal budgets, especially for the metros and some secondary cities. At the start of the 2020/21 financial year, borrowing was planned to contribute about 16.4 percent towards aggregated municipal capital budgets. However, as a result of the adjustments, only 11 percent of the capital budgets is now expected to be financed through borrowings. And that assumes the adjusted borrowing plans will be implemented in full, which seems unlikely, based on historic performance. To date, only R3.1 billion has actually been borrowed, which equates to 43 percent of the adjustment budget borrowing projections.

Municipalities have to make difficult decisions as they are faced with slow revenue collections as well as shrinking government support through transfers against growing demands for service delivery. Also, the need to build and replace critical infrastructure is ever increasing, which calls for the exploration of alternative capital financing options other than capital grants and internally generated funds. Long-term borrowing remains the most available option for creditworthy municipalities. However, a troubled revenue base coupled with declining government transfers means that debt repayment capacity is also narrowing. This greatly limits the amount of long-term borrowing municipalities can undertake to support capital investment.

2. Analysis of long-term debt as reported by municipalities

Table 2: Outstanding long term debt as at 31 March 2021

Municipal Category	Municipality	"Total debt Q3 2020/21 R'000"	Share of total debt	"Forecast Revenue 2020/21* R'000"	Debt to revenue ratio
A	BUF	245 423	0,4%	7 507 552	3%
	NMA	1 140 232	2%	9 909 273	12%
	MAN	800 702	1%	7 412 427	11%
	EKU	7 815 820	12%	41 629 459	19%
	JHB	22 605 131	34%	69 142 819	33%
	TSH	10 819 952	16%	37 560 714	29%
	ETH	7 850 574	12%	40 534 246	19%
	CPT	7 132 329	11%	42 443 103	17%
		Total Metros	58 410 163	87%	256 139 593
B	B1 (19)	5 766 666	9%	59 819 336	10%
	Other Municipalities	2 745 466	4%	76 737 217	4%
C	Districts	486 217	1%	22 087 274	2%
	Total all municipalities	67 408 512		414 783 420	16%

*excluding capital transfers

Source: National Treasury Database

Since last year this time, there has only been a slight increase in total outstanding long-term debt for all municipalities.

Municipalities owed R66.9 billion as at the end of the third quarter of FY 2019/20. At the end of the third quarter of the 2020/21 financial year, that amount had risen to R67.4 billion. i.e. a net increase of almost R500 million. New long-term debt of R5 billion was incurred between 01 April 2020 and 31 March 2021 while outstanding long-term debt of around R4.5 billion was repaid. The cities of Johannesburg and Cape Town are the only metros that recorded an increase in outstanding long-term debt, with net increases of R1.1 billion and R824 million respectively. Long-term outstanding debt for the rest of the metros has declined and eThekweni has

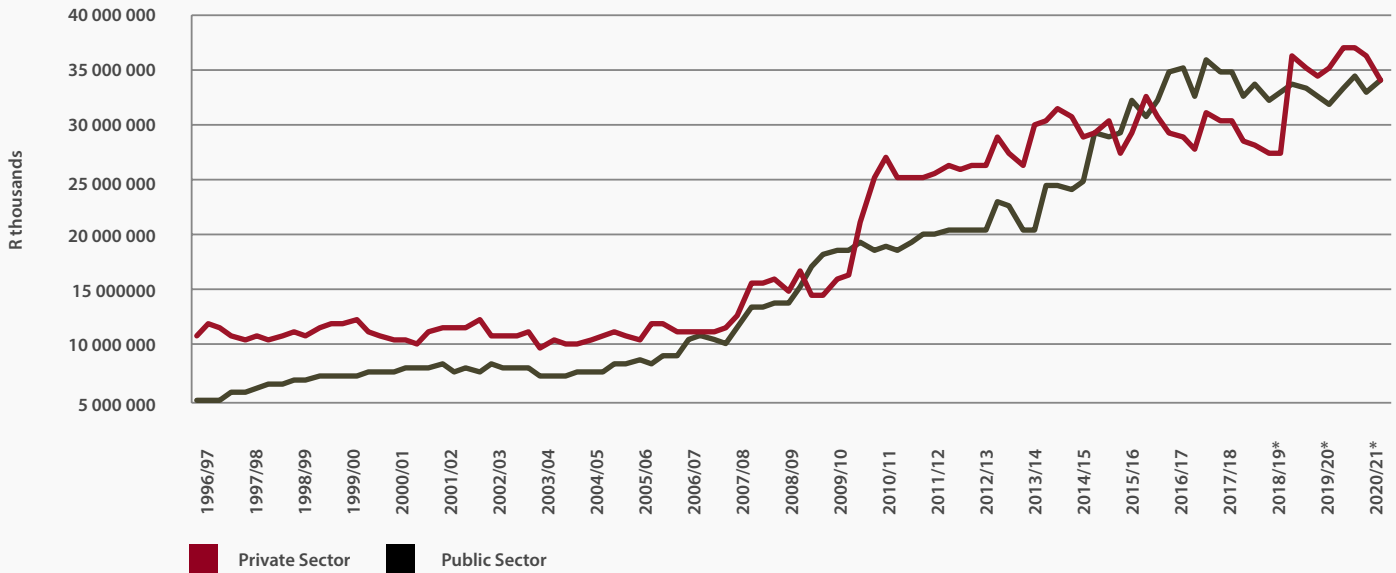
shown a decrease of R807 million. Outstanding long-term debt for the secondary cities has also marginally declined whereas long-term debt incurred by other local and district municipalities has grown slightly.

The debt to revenue ratio aggregated for all municipalities has remained at 16 percent for the past twelve months. To realise the maximum benefit of long-term borrowing, debt service schedules must be carefully fitted to projected operating surpluses. This is why "appropriately structured" long-term borrowing is one of the key fundamentals of the 2017 Update to the Policy Framework for Municipal Borrowing.

3. Analysis of long term debt as reported by lenders

Figure 1: Public and private sector lending to municipalities

Public vs private sector lending



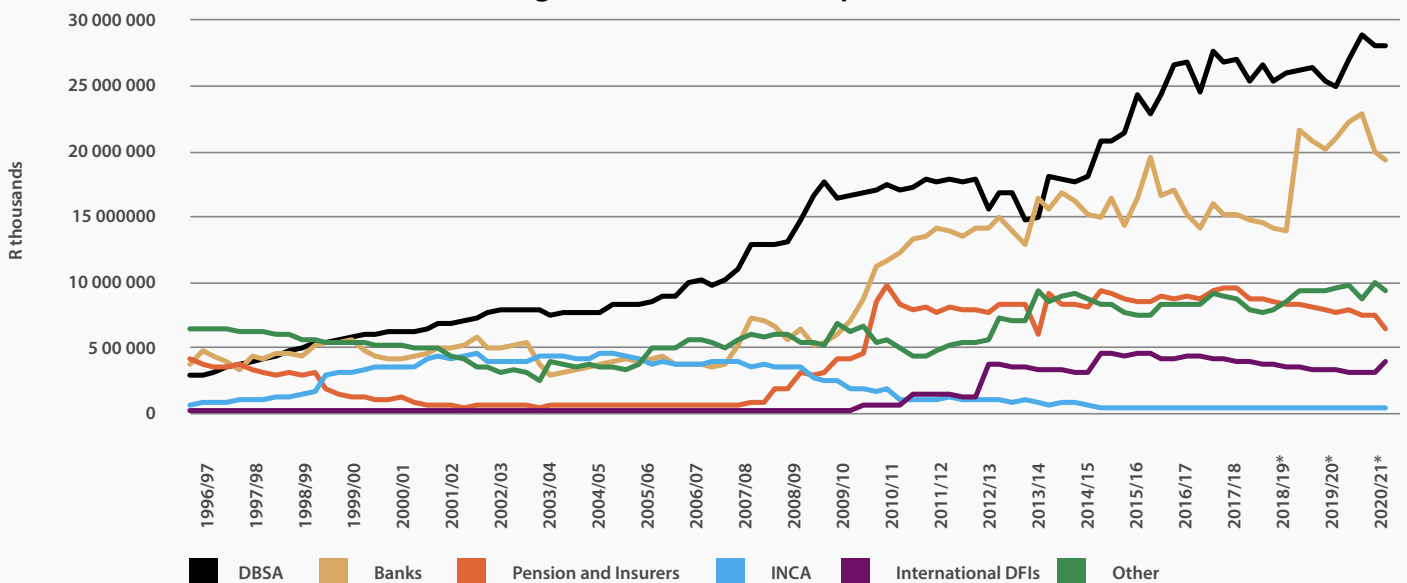
*Incl QIII
Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

Public sector investment in municipal debt obligations has surpassed investment by the private sector over the past twelve months. For the first time since the end of the 2018/19 financial year, municipal long-term debt held by public sector lenders is more than debt held by

private sector lenders. Private sector lenders and investors were owed R34.6 billion at the end of March 2020 and as of March 2021 were owed R33.5 billion. This compares to public sector lenders, who are now owed R33.6 billion, up from R31.5 billion this time last year.

Figure 2: Largest lenders to municipalities

Largest lenders to municipalities



*Incl QIII
Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

The DBSA's investment in municipal debt obligations substantially increased over the past twelve months. The DBSA is now owed R28.3 billion by municipalities compared to this time last year when it was owed only R25 billion. In contrast, the stake for commercial banks in municipal debt obligations fell by about R400 million over the past twelve months. Banks are responsible for about 61 percent of private sector lending to municipalities. Municipal debt held by pension funds and insurers is down by R1.2 billion since the end of March 2020. This follows bond redemptions that took place between December 2020 and March 2021, with both Johannesburg and Ekurhuleni redeeming outstanding bonds of R850 million each and Cape Town redeeming R50 million of its outstanding bonds. In total, the redemptions add up to around R1.75 billion. International DFIs are now owed R3.8 billion, up from R3 billion at the end of March 2020.

TOPICAL ISSUES

MUNICIPAL INDEPENDENT FINANCIAL ADVISORY

Since the adoption of the White Paper on Local Government (1998), the National Treasury has made numerous efforts to increase private sector lending to finance infrastructure in creditworthy municipalities. As a follow up to the White Paper, policies were adopted such as the Policy Framework for Municipal Borrowing and Financial Emergencies of 2000 which sought to facilitate increased private investment through articulating a vision for legislation that would enable prudent long-term municipal borrowing from the private sector. The envisioned, legislation (MFMA Chapter 6 and 13) was enacted, and the Constitution was twice amended to support the development of a deeper capital market for municipal infrastructure finance.

Notwithstanding these efforts, the amount of private sector investment in municipal debt obligations remains relatively modest. An updated study, "Infrastructure investment needs"¹ commissioned by National Treasury has revealed that municipalities need to invest R1.7 trillion (R1.7 billion p.a.) over the next 10 years in order to finance the infrastructure need.

Due to the growing need for local infrastructure investment, and the apparently low municipal appetite for long-term borrowing, National Treasury has been exploring whether independent financial advice could change the dynamic and assist municipalities to borrow in a way that is more suitable for their needs. Currently, large metros tend to use outsider advisors only for transactions and not for strategic planning. When advisors and arrangers for bond issues are hired, they tend to be associated with large banks, who often buy a significant portion of the bond issue. Some transactions have been structured in a way that is attractive to lenders, but difficult for municipalities, using up their near-term borrowing capacity, while neglecting longer term possibilities and consequently limiting the amount of capital investment municipalities can make. This suggested the possible usefulness of independent financial advisors not associated with lending institutions, to assist municipalities and narrow the information gap.

The US municipal market was once similarly asymmetric - municipalities often relied on financial advice from investment bankers who also acted as underwriters and made significant profits from each municipal bond issue. Over the past three decades, a profession of independent financial advisors has emerged in the US. These advisors help municipalities plan for and structure bond issues; and generally, assist municipalities in managing relations with investors and ratings agencies. The use of independent advisors has given American municipalities greater bargaining power and significantly reduced the cost of borrowing. The question is whether this would be a useful innovation in the South African context.

To begin answering this question, a team within National Treasury undertook research to find appropriate ways to build a stronger, healthier and more sustainable market for municipal borrowing. This began with a series of interviews with a variety of stakeholders: banks, institutional investors, rating agencies, ASISA, SALGA, CIGFARO, and several municipalities to determine whether the development of a similarly independent profession would be useful and of interest to municipalities in South Africa. This was done with the assistance of an American financial advisor, David Paul, who has been part of the evolution of the profession in the US over the decades, and also works with municipalities internationally.

The objective of the National Treasury is to ensure that municipalities have access to strong financial analytic and structuring capacity, in order to engage on a level playing field with financial institutions. Our research sought to understand where and how municipalities take financial advice when considering borrowing for infrastructure, and the scope of the advice received. The interviews revealed mixed feelings as to the utility of an independent advisor function. Ultimately, the success of such services would depend on municipal demand.

THE FOLLOWING ISSUES WERE IDENTIFIED:

Accountability: Investors urged National Treasury to focus on improving financial management in municipalities as there seem to be minimal consequences for mismanagement and ballooning irregular expenditures. Investors urged National Treasury to ensure better implementation of, and compliance with, the MFMA in order for municipalities to better position themselves to receive capital flows.

Political Risk: Concerns were raised in respect to political uncertainty given that municipal councils can change every five years. The degree to which a political change impacts on professional management of the municipality was a concern. Since creditworthiness is affected by management stability, in addition to the obvious need for clean audits and good financial ratios, there is a need for political astuteness whereby councils understand that healthy finances are of long-term importance.

Investor relations: Investors highlighted the insufficiency of efforts by municipalities in maintaining relations with the investor community. Municipalities that intend to issue bonds should be holding annual

¹ Kim Walsh and Brendon van Niekerk, Infrastructure investment needs update, 31 October 2019

road shows, irrespective of the timing of borrowings. In addition, the frequent change in CFOs and staff erodes the opportunity for municipalities to build trust and long-term relationships with the investment community.

Long term investors' views: Investors had mixed reactions as to whether the independent advisory function would be useful. Investors suggested that if such a profession were to develop, complete independence from government and other official institutions would be key. Retirees from DBSA and INCA were suggested as possible advisors. Some investors raised a concern with outsourcing the advisory function and believed that the skills should be built within the municipality.

Banks' views: As with institutional investors, banks expressed concerns about credit quality in a growing number of municipalities. Systemic issues within municipalities which tend to dampen investor enthusiasm included financial metrics and the governance problems.

Bank arrangers and advisory teams: Growing nervousness about municipalities was reported by bank arrangers and advisory teams. This is seen by the absence of substantial new investment in municipalities by institutional investors. Furthermore, even the big metro borrowers would need to re-introduce themselves to investors at this stage.

Banks' municipal relations: It was indicated that banks can generally rely on CFOs in large metros, however it may be necessary to build the capacity of some CFOs. Due to a skills gap, bankers have observed that it is easier for a municipality to deal with a single bank, as opposed to a group of potential bond investors, or the market in general.

Metropolitan municipalities: Metros that have issued bonds tend to have a coherent, if not aggressive financial strategy. They understand how to procure and use transaction advisors in structuring specific deals. Mixed views were found on the value of independent advice.

Secondary cities: Some secondary cities interviewed welcomed the idea of independent and strategic advice. However, they emphasised the need for advisors to thoroughly understand the municipal environment in order to offer useful advice.

Municipalities' relations with banks: Both metros and secondary cities tend to have close relations with commercial banks, especially those handling their accounts. Some municipalities are aware that commercial banks sometimes do not offer the best financing options, and hoped this could be rectified by receiving strategic financial advice.

WHERE WE ARE

In September 2020, preliminary findings were presented in an Urban Finance Working Group meeting (involving metros, banks, institutional investors, rating agencies, DFIs and others). The presentation was well received and sparked considerable debate. In June 2021, a workshop was hosted for municipalities on **"how to make municipal borrowing more efficient."** This was an opportunity to provide feedback on the overall findings of the research and to discuss the issues raised. It was well attended and received.

National Treasury is not proposing or committing to anything at this stage, as the fundamental question remains one of municipal appetite for independent financial advice. If there are interested municipalities, we hope to find a way to begin working with them, and the following issues/questions will be looked at in that regard:

- (a) Which institution could facilitate such services?
- (b) Should independent financial advisors be certified by some professional body?
- (c) Should National Treasury or others subsidise the cost of such services?
- (d) What would be the scope of such services? and
- (e) Should independent advice include all infrastructure finance options, e.g. loans, bonds, structured financing, and PPPs?

One outcome from the June workshop was the decision to form a working group to more fully develop the options; identify sources of funding; identify potential advisors; and explore training for those identified. If you are interested in participating in this working group, please contact **Noxolo Mlambo** Noxolo.Mlambo@treasury.gov.za and **Sandra Sekgetle** Sandra.Sekgetle@treasury.gov.za