POLICY FRAMEWORK FOR MUNICIPAL BORROWING

2017 UPDATE

Table of Contents

Executive Summary **3**
The context has evolved *3*
Core principles remain *4*
What is new *4*
Introduction **6**
Background *7*
The legal environment 7
The state of urban infrastructure finance 8
Gathering evidence for policy-making *10*
Overall Policy Goals **11**
Prudent borrowers and prudent lenders *11*
The intergovernmental fiscal framework *13*
Policies related to borrowers **14**
Borrowing based on creditworthiness *14*
Local policies and strategies *15*
Short- and long-term borrowing *15*
Short-term borrowing: 16
Long-term borrowing: 16
Amount of borrowing *17*
Security for debt obligations *17*
Borrowing by municipal entities *19*
Project finance, revenue bonds, and tax increment financing *19*
Policies related to lenders and investors **20**
Markets *21*
Extending the term of municipal borrowing *24*
Development Finance Institutions *25*
Pooled finance and intermediary arrangements *27*
Policies related to financial emergencies **29**
Section 139 of the Constitution *30*
Chapter 13 of the Municipal Finance Management Act *31*
Conclusions **33**
Appendix: Selected borrowing issues in focus **34**
Development Charges: Capital Recovery Fees and Impact Fees *34*
Borrowing through special purpose vehicles *35*
Borrowing for infrastructure beyond the municipal boundary *36*
Project finance, revenue bonds, and tax increment financing *37*
Special instruments for specific priorities: *39*
Listed vs. unlisted debt instruments: *40*
The role of public private partnerships *41*

Executive Summary

The purpose of this Update is to review and update the borrowing policies set forth in the *Policy Framework for Municipal Borrowing and Financial Emergencies,* which was adopted by Cabinet in December of 2000. The policies related to financial emergencies may also need to be reviewed and updated, based on evidence now being collected on the strengths and weaknesses of provincial and national interventions in municipalities.

The context has evolved

A robust legal framework is now in place. One goal of the original *Policy Framework* was to articulate a vision for legislation that would enable prudent borrowing from the private sector. This legislation included two Constitutional Amendments, and a suite of ordinary legislation, including the *Municipal Finance Management Act (MFMA)*, the *Municipal Systems Act* and the *Municipal Property Rates Act*. Financial management in most municipalities has significantly strengthened with the implementation of this foundational legislation.

Municipal authority over land use decisions has strengthened. In 2013, the National Assembly adopted the 2013 *Spatial Planning and Land Use Management Act* (*SPLUMA)*, which clarified municipalities' authority over, and responsibility for land use processes. With the financial and planning legislation in place, municipalities have the critical tools needed to coherently shape their built environment.

Additional investment priorities have emerged. While cities have made significant progress in extending services to all citizens, additional investment needs have become apparent over the seventeen years since the original *Policy Framework*. These include:

- (i) Expanding infrastructure to support economic and population growth;
- (ii) Rehabilitating and replacing aging infrastructure;
- (iii) Promoting densification and spatial transformation to improve access to jobs, education, services and opportunities.

The identified need for investment in local infrastructure has grown significantly. A study by the National Treasury indicated that the required investment for a 10-year period beginning in 2015 would be in the neighbourhood of R430 billion in the metropolitan municipalities (metros) alone. Actual investment remains far below that level.

Public sector lending has grown faster than private sector lending. The focus of the original *Policy Framework* was to enable municipal access to private sector credit. While private sector lending has grown significantly since the *MFMA* was implemented, public sector lending has grown even faster.

National resources are under stress. Low economic growth rates are putting strain on the intergovernmental fiscal framework. National Treasury is re-evaluating the size

and role of capital transfers to Metros. Going forward, Metros will be expected to rely more on their own resources for infrastructure investment.

Core principles remain

Government remains committed to the principles underlying the original *Policy Framework.* These include the following:

- Creditworthy municipalities should borrow responsibly to finance capital investment and fulfil their constitutional responsibilities.
- Municipal access to private capital, based on investors' evaluation of municipal creditworthiness, is a key to efficient local government and fiscal discipline.
- Municipalities should borrow in the context of long-term financial strategies, which reflect clear priorities and the useful life of assets.
- A sustainable municipal credit market includes the proper pricing of risk. Government does not support "soft" or subsidized loans to municipalities.
- Investors whose funds are at risk have both the incentive and the means to limit or deny credit if there is doubt about the sustainability of proposed borrowing.
- Neither national nor provincial government will underwrite or guarantee municipal borrowing. There will be no bailouts by national or provincial government.

What is new

To address questions that that have arisen since the original *Policy Framework* was developed, this *Update* reflects the following policy decisions and clarifications;

Government will remove DORA limitations on municipal pledges. In recent years, the Division of Revenue Act (DORA) has contained language requiring the approval of the National Treasury to pledge conditional transfers for the purpose of securing a loan. This provision will be removed, so that municipalities may pledge grant streams, subject to the specific conditions of these grants.

Project finance, revenue bonds and tax increment financing are all explicitly permitted, subject to the terms of the *MFMA.* A municipality may find that it is useful or appropriate to pledge specific revenue streams to repay debt obligations, either to improve the creditworthiness of a particular debt issue, or to mitigate risks associated with general obligation borrowing. A municipal council considering ring-fenced financing or spatially targeted investments should solicit public input on the potential impacts, including impacts related to inclusiveness.

Government encourages public and private efforts to support a liquid secondary market. Approaches that may have merit include the following:

- Metros may want to position their bonds as similar to sovereign bonds, given that municipalities have permanent existence and taxing powers. In these respects, municipalities differ to corporate issuers. Debt payment structures that replicate RSA bond issues may be most attractive to investment managers.

- Financial institutions may want to explore standardization of municipal debt instruments and supporting documentation. This could reduce transaction costs and increase liquidity.
- All lenders, including commercial institutions and DFIs should consider originating new municipal lending in the form of bonds. These bonds can be held or sold as capital and liquidity needs evolve.

The role of DFIs is clarified. Public-sector lenders, both domestic and foreign, should be guided by a social and developmental investment approach, in which demonstrable social outcomes are considered alongside potential financial returns. One or more development objectives, and appropriate indicators, must be agreed in advance of DFI lending, with National Treasury and any proposed municipal borrower. This can be done on an annual or programmatic basis. Credible metrics and independent annual reviews will be required throughout the term of any loan.

Pooled finance arrangements are explicitly addressed. Any pooled financing mechanism must be structured to avoid assumption of credit risk by one municipality on behalf of another. Correctly structured, pooled finance and intermediation can help small creditworthy municipalities access affordable credit. Poorly structured, pooling can create inappropriate risks. Two principles should therefore guide any proposals for pooled finance: first, the mechanism must not be used to make credit available to municipalities that are not creditworthy; and second, no municipality should be at risk of becoming responsible for any debts of another entity.

Introduction

South Africa's existing *Policy Framework for Municipal Borrowing and Financial Emergencies* was adopted in December 2000. [1] It was grounded in the 1998 *White Paper on Local Government*.[2] The *White Paper* set forth a new vision for local infrastructure finance within a developmental system of local government in the new South Africa. The goals were to leverage in private-sector infrastructure investment and to expand municipal powers to borrow for infrastructure. Cabinet adopted the *Policy Framework* to further these *White Paper* goals, to clarify and restrict the use of short-term borrowing by municipalities,[3] and to describe the legislation that would be needed to implement the policy vision. The intention was to set forth clear rules and, in line with the fiscally decentralized orientation of the Constitution, to rely on market relationships between borrowers and lenders to mobilize capital for infrastructure investment and to support disciplined financial management.

The purpose of this *Update* is to re-examine the original *Policy Framework*, along with the legislation that was adopted to implement it, in light of the experience with municipal borrowing that has accumulated since 2000. This *Update* is informed by dialogue and discussion that began during the August 2015 *Urban Investment Partnership Conference*, and that continued through the 2016 and 2017 meetings of the *Urban Finance Working Group.*

Government remains committed to a competitive market in which creditworthy municipalities can borrow responsible and sustainably to finance long term infrastructure investments. This implies that the price of financing will reflect the creditworthiness of the borrower, and that well-managed and fiscally disciplined municipalities will be able to access long term capital to meet their infrastructure investment needs. South Africa's municipalities, and especially our urban centres, require significant infrastructure investment. These investments will support our economy and deliver services to our citizens and enterprises for many decades. It is therefore appropriate that they should be financed with debt instruments that increasingly correspond to the useful life of the assets being created.

Municipalities which do not have the resources or capacity to repay debt should not borrow. Borrowing, at an appropriate scale, is reasonable for any well-managed municipality, including a poor municipality that relies primarily on intergovernmental transfers to fulfil its constitutional responsibilities. While most municipal borrowing will remain concentrated in larger municipalities with significant own-source revenues, smaller municipalities are also encouraged to pursue the path of fiscal discipline that makes them creditworthy.

---

[1] Notice 2739 of 2000

[2] Available at http://mfma.treasury.gov.za/MFMA/Guidelines/whitepaper.pdf

[3] At the time, several municipalities were experiencing chronic problems with debt that was originally incurred as short-term, but was being rolled over from year to year.

Background

South Africa's ongoing urbanisation is of critical national importance. The 2012 *National Development Plan* recognizes that by 2030 about 70 percent of South Africans will live in urban areas. Government's 2016 *Integrated Urban Development Framework* envisions how this urbanisation can be managed to ensure inclusive economic development, job creation and improved living conditions for our people. As more people live and work in urban areas, they need and expect adequate infrastructure and reliable services. The same is true of the firms and entrepreneurs that drive our nation's economic growth.

New investment priorities have emerged. At the beginning of our democratic era, the imperative of urban investment was to extend services to those who were previously unserved or underserved. While some backlogs remain, our major cities have made big strides in this regard. And new investment priorities have emerged, including:

- (i) Expanding urban infrastructure so that it can support economic and population growth;
- (ii) Rehabilitating and replacing aging infrastructure that is at or past its design life;
- (iii) Promoting densification and spatial transformation so that our people have ready access to jobs, education, services and opportunities.

National finances are under stress. While urban infrastructure investment needs are pressing, the low growth rates in South Africa's economy are putting strain on the intergovernmental fiscal framework. The global financial crisis that began in 2008 has come and gone, but our economic growth rates have not returned to pre-crisis levels, and the national trend of economic growth has been slowing for the past several years. As a result, Metros will be expected to rely more on their own resources for infrastructure investment.

The legal environment

A robust legal framework is in place. One goal of the original *Policy Framework* was to articulate a vision for legislation that would enable prudent borrowing from the private sector. Following Cabinet's December 2000 approval of the *Policy Framework,* Parliament enacted important legislation to implement the policies announced therein. All of the legislation anticipated by the *Policy Framework* was put in place by the end of 2004, including two Constitutional Amendments, the *Municipal Finance Management Act (MFMA),*[4] the *Municipal Systems Act* and the *Municipal Property Rates Act*. Financial management in most municipalities has significantly strengthened with the implementation of this foundational legislation.

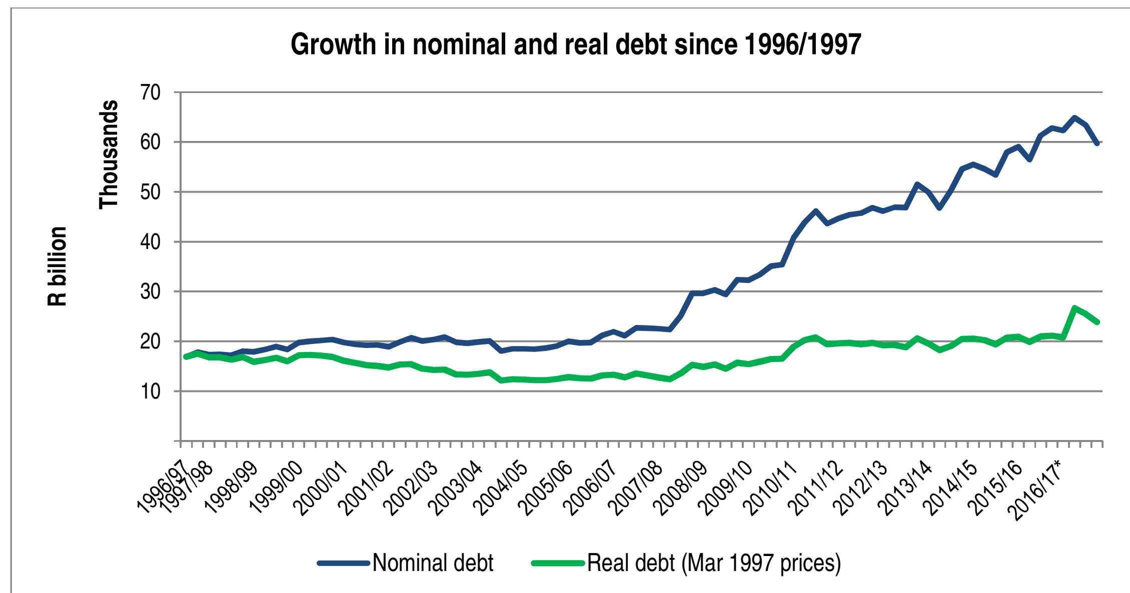
[4] Act No. 56 of 2003: Local Government: Municipal Finance Management Act

Legislation regarding urban land use: In 2010, the Constitutional Court invalidated key provisions of the *Development Facilitation Act*.[5] In response, the National Assembly adopted the 2013 *Spatial Planning and Land Use Management Act* (*SPLUMA)*,[6] which clarified municipalities' authority over, and responsibility for land use approval processes.

With these legislative changes, South Africa's municipalities now have both the financial and planning tools to shape their built environment.

The state of urban infrastructure finance

South Africa successfully relies on market relationships to mobilize capital and support financial discipline. The legislation that has been enacted lays a strong foundation for private sector lending to municipalities without central government guarantees. Lenders are accountable for investigating the financial capacity of borrowers and making wise lending decisions. Municipalities are responsible for managing their finances, including sustainable levels of debt. There have been no reported instances of municipal over-borrowing, and no financial crises caused by excessive levels of municipal debt. In this, South Africa is a global leader. Many other countries have experienced chronic and severe problems with excessive levels of subnational borrowing.



In terms of mobilizing finance for municipal infrastructure, the *Policy Framework* has been a qualified success. In early 1998, when the *White Paper* was written, the

[5] City of Johannesburg Metropolitan Municipality vs Gauteng Development Tribunal, (CCT89/09) [2010] ZACC 11; 2010 (6) SA 182 (CC); 2010 (9) BCLR 859 (CC) (18 June 2010). The Court noted that "*the Constitution envisages a degree of autonomy for the municipal sphere, in which municipalities exercise their original constitutional powers free from undue interference from the other spheres of government.*"
[6] Act No. 16 of 2013: Spatial Planning and Land Use Management Act

total outstanding long-term borrowing for infrastructure was around R17 billion. By the end of 2016, this number had risen to more than R64 billion, a 277% increase. However, if we adjust for inflation, the increase in outstanding long term municipal borrowing is a more modest 51%. Note that these borrowing levels reflect the net increase, subtracting old municipal debt that has been retired, and adding new debt obligations that have been incurred. In all, more than R150 billion in new infrastructure has been financed with borrowed funds since the original *Policy Framework* was adopted.

Metros have become dependent on intergovernmental transfers for half of their infrastructure investment. Most long-term borrowing is done by the Metros - close to 90% of aggregate municipal borrowing. Even so, as a group the Metros have financed only about one quarter of their infrastructure investment through borrowing. An additional one quarter is financed with current revenues. Both the borrowed funds and current revenues represent self-financed municipal infrastructure investment. The remaining one half of local infrastructure investment is now financed by the national government through transfers. The amount of these transfers has increased dramatically over the last decade. This shift toward reliance on intergovernmental transfers in our biggest cities is a substantial deviation from the principles set out in the 1998 *White Paper*,[7] which anticipated more reliance on private capital by large cities with strong local revenue bases. Such cities have the potential to finance the bulk of their own infrastructure investment needs.

National Treasury is re-evaluating the size and role of capital transfers to metros. The past decade's rapid growth in national transfers to metros was intended 1) to boost overall levels of investment and 2) to encourage investments reflecting national priorities (such as housing, BRT systems and stadiums) as they were understood at the time. Inevitably, the capital spending funded by these transfers has also increased pressure on metros' operating budgets, due to the need for additional expenditure to operate and maintain what has been built. Moreover, the sizze of these transfers has enabled dependency on grant financing, so that some metros have focused on implementing national grant programmes more than on identifying their own investment priorities, and taking responsibility for funding them. The National Treasury is in the process of evaluating the systemic impacts of these capital grant programs, and is likely to reconsider the size and role of transfers to metropolitan municipalities.

Public sector lending to municipalities has grown faster than private sector lending. A key objective of the original *Policy Framework* was to build the confidence of the private sector and thus increase the use of private capital in building local infrastructure. In the intervening years, private sector lending has indeed increased. On the other hand, public sector lending has grown faster over the period. An important lesson is that policies and legislation related to municipal borrowing do not operate in isolation. They will inevitably be less effective at achieving their objectives if other policies are not coordinated.

[7] The White Paper was grounded in a strategy to leave a larger share of nationally generated revenues for redistribution to smaller and poorer communities.

The identified need for investment in local infrastructure is even larger than it was twenty years ago. In 1997, the Municipal Infrastructure Investment Framework estimated that municipalities across the country would need to invest between 67bn and R114bn (1996 prices) over a 10-year period, to meet their constitutional service delivery obligations. More recently, a study by the National Treasury indicates that the required investment for a 10-year period beginning in 2015 would be in the neighbourhood of R430 billion in the metros alone.

The potential for more impactful municipal borrowing is significant. Many municipal borrowing maturities are relatively short: recent borrowings by major metropolitan municipalities reflected average maturities under six years.[8] When compared to the useful life of assets being financed, this kind of borrowing represents missed opportunities. If they are willing and able to extend their average debt maturities, municipalities can greatly increase the quantum of their infrastructure investment. By strategically increasing investment levels, with a view to unlocking structural economic constraints, cities can unlock dynamic growth and improve South Africa's global competitiveness.

It is not just quantum of investment that matters: the productivity and inclusiveness of our cities depend on what infrastructure is built, where it is built, and how those choices are made. The embedded inequality of South African cities has been reinforced over the past two decades by spatially short-sighted investments. To generate more inclusive and productive outcomes, municipal councils need to be clear about their objectives and metrics of success. This puts them in a position to identify the investments they need, to establish priorities, to procure engineering and construction services efficiently, and to operate and maintain infrastructure sustainably.

Gathering evidence for policy-making

Learning from experience: Fourteen years after the *MFMA* was adopted, significant experience with operationalising the legislation has accumulated, and it important to learn what we can, in order to make appropriate adjustments to the *Policy Framework*. National Treasury seeks to reinforce what has worked well, and adjust where there are areas for improvement.

Research projects: The National Treasury commissioned research into how two Metros have used the proceeds of long term borrowing. Both borrow infrastructure essential for municipal service provision, and to a lesser extent for assets that support the provision of municipal services (such as buildings, office equipment, software, and vehicles). A second study is now underway to examine provincial and national experiences with financial emergencies in municipalities, to unpack the root causes of such emergencies, and to evaluate the outcomes of interventions. A third study is also ongoing, to develop and analyse options for encouraging the growth of a broader and deeper secondary market in municipal debt securities.

[8] July 2017 bond auctions by Ekurhuleni and Cape Town

Overall Policy Goals

The original *Policy Framework* set out five main reasons for pursuing a capital market-based approach to municipal borrowing. These were:

- Access to capital: Local government is responsible for infrastructure that requires large, "lumpy" capital investments on a periodic basis. Particularly where the need for capital greatly exceeds what is available in the form of grants from the central fiscus, access to capital markets can provide municipalities with the resources necessary to finance infrastructure investments efficiently.

- Inter-temporal equity. The benefits of infrastructure investments often extend for long periods and accrue to future generations of taxpayers and consumers. It is equitable for such generations to bear some of the costs of these investments. Financing infrastructure over time with funds accessed from capital markets allows for this.

- Efficiency. Because capital markets allocate capital resources on a commercial basis, capital tends to be allocated efficiently. Moreover, allocating costs to local government provides incentives to ensure efficiency and discourage "overbuilding" and wasteful investment, which are more likely with grant-funded programs.

- Accountability. Markets tend to punish poor fiscal and management performance through pricing (pushing up interest rates or making capital increasingly scarce.) This can promote accountability and fiscal discipline at the local level. It may also provide other stakeholders (national government, provinces, aid agencies and the public) with a convenient means to assess the relative performance of municipal governments.

- Short-term matching of revenues and expenditures. In the short term – for example within a given financial year – municipal revenues and expenditures are seldom completely congruent in time. Short-term borrowing allows municipalities to deal with this lack of synchronicity.

Prudent borrowers and prudent lenders

Creditworthy municipalities should be able to borrow private sector capital for infrastructure investment. Government's strategy for local infrastructure finance, as expressed in the original *Policy Framework* and implementing legislation, is to enable municipalities to borrow private sector capital to finance local infrastructure investment. To accomplish this, that *Policy Framework* noted that cities should borrow long-term investment resources from capital markets. This engagement with at-risk private investors has helped to keep cities fiscally disciplined. Investors whose capital is at risk have both the incentive and the means to limit or deny credit if they doubt the sustainability of a proposed borrowing. This strategy remains sound, especially in an era of fiscal consolidation that will constrain national transfers.

Municipalities should borrow in the context of long-term financial strategies. While the availability of financing is critical, it is also essential that municipalities develop long-term, participatory strategic and financial planning processes. Municipal borrowing must be strategic and prudent. If South Africa's cities are to be sustainable and successful, they must identify and prioritize investment projects which support inclusive growth of the local and national economy, which accommodate a growing urban population, and which efficiently deliver essential services. If cities are to use debt finance wisely, they must be clear about the long-term costs and benefits of the investments they make and the financing instruments they use.

Direct access to private capital allows creditworthy municipalities to invest in support of their constitutionally mandated roles. With improved financial management, accounting and information systems, investor confidence in the municipal sector has increased over the past two decades. The availability of capital is no longer the binding constraint it once was. It therefore continues to be Government policy that:

1. Access by municipalities to private investment capital, based on investors' evaluation of their creditworthiness, is a key to efficient local government.

2. Neither national nor provincial government will underwrite or guarantee municipal borrowing.

3. The development of a healthy, sustainable market for municipal debt includes the proper pricing of risk.

4. Government does not support "soft" or subsidized loans to municipalities. It rather seeks to develop a sustainable market for municipal debt where risk is properly priced.

Affordable infrastructure finance depends on well-managed municipalities and on a regulatory and institutional framework that encourages prudent behaviour on the part of both borrowers and lenders.

Limiting risks and expanding resources: The original *Policy Framework* laid out three reasons why government supports arms-length, long-term municipal borrowing from the private sector. These remain valid:

1) <u>Limiting implicit or contingent liabilities.</u>

It is important to protect central government from responsibility for the debts of local government. This is important both for prudent fiscal management at the national level and to ensure that municipalities are incentivised to improve their own management and creditworthiness. Therefore, neither national nor provincial government will underwrite or guarantee municipal borrowing. There will be no bailouts by national or provincial government.

2) Systemic discipline.

Direct borrowing from the private sector helps ensure that capital flows to the most productive uses, rather than to role-players that may be politically connected. Incentives for inefficient and wasteful decision-making must not be allowed to replace those that encourage the productive use of capital and disciplined financial management.

3) Expanding investment resources.

Decentralised borrowing increases the nation's overall resource base for public investment. When national government finances local infrastructure with transfers, funding for these transfers competes with other national priorities. When local government accesses investment capital directly, more investments in the nation's future are possible.

The intergovernmental fiscal framework

Municipal borrowing policies work hand-in-glove with intergovernmental fiscal policy. The Constitution, in Section 227, guarantees the local sphere of government an "equitable share" of nationally raised revenue in order that it may "provide basic services and perform the functions allocated to it". As expected by the *White Paper on Local Government,* this "equitable share" of national revenue has been directed by cities primarily to subsidizing the provision of basic services through targeted subsidies to poor households. On average, targeted subsidies for the poor, funded through the equitable share, are a small fraction of local government expenditure in larger and more urban municipalities, and a more significant share of expenditure in poor and rural municipalities. Equitable share transfers have been supplemented by conditional national transfers from the national share of revenues in order to support national policy priorities.

The intergovernmental fiscal architecture relies on the financial strength and autonomy of cities. The overwhelming majority of municipal revenues, especially in large cities, come through own source revenue instruments, such as property rates, water tariffs, and electric tariffs, at levels determined by each municipality. As noted in the *White Paper*, "on average, municipalities have sufficient revenue raising powers to fund the bulk of their expenditure, and finance 90% of their recurrent expenditure out of own revenues." This revenue structure guarantees the financial autonomy of South Africa's large urban centres. With that autonomy and financial strength comes the responsibility to manage their finances responsibly, and to finance the bulk of their local infrastructure using their own resources. Where the revenue base is adequate, services must be funded primarily through own source revenues. Moreover, Metros with significant tax bases and relatively affluent customers are expected to use a portion of their own revenues to contribute to cross-subsidies for the poor living within their boundaries.

The intergovernmental fiscal system provides resources for poor municipalities. In some municipalities, there is relatively little valuable property to tax, and few affluent customers for trading services. In such places, fiscal sustainability must rely on transfers, in the form of an equitable share of nationally collected revenues. Where the

local revenue potential is inadequate, basic services must be funded primarily through the equitable share and other transfers. While both rich and poor municipalities have the legal power to borrow for infrastructure, the scale of their borrowing will inevitably differ according to their means. There is no legal requirement that would impede municipalities from borrowing against their equitable share, but both the municipality and its lender must consider the sustainability and scale of such borrowing.

Policies related to borrowers

When the original *Policy Framework* was adopted by Cabinet, the legislation to implement those policies had yet to be drafted or considered by Parliament. Today, the *Municipal Finance Management Act* (*MFMA),* together with regulations thereunder prescribed by the Minister of Finance, constitute the most comprehensive statement of national policy on municipal borrowing. It is therefore useful to call attention to the key policies that underpin the *MFMA*.

Borrowing based on creditworthiness

A fundamental policy, protected by the Constitution, is that all municipalities have the legal power to borrow. The *MFMA* makes no distinction between municipalities when it comes to borrowing. This represents an intentional break with the apartheid-era practice of classifying or grading municipalities. Any municipality, large or small, rich or poor, that manages its finances well can be creditworthy, and can borrow at an appropriate scale. The intergovernmental fiscal framework, including redistributional transfers such as the equitable share, is intended to ensure that all municipalities have the resources to provide basic services and finance essential infrastructure.

The legal power to borrow must be distinguished from the financial and management capacity to borrow sustainably, which determines creditworthiness. The policies of the *White Paper,* the original *Policy Framework,* and the *MFMA* are based on market interactions involving responsible borrowers and responsible lenders.

The National Treasury does not guarantee or assume liability for any municipal borrowing. At the time of the original *Policy Framework,* Government considered and rejected the possibility of national government guarantees for municipal borrowing. That rejection of guarantee instruments remains fundamental to Government policy. While guarantees would be an easy shortcut to mobilizing investment in local infrastructure, they would eliminate the healthy market discipline that Government relies on to prevent municipalities from becoming overly-indebted. Lenders must lend or invest at their own risk, based on their evaluations of the creditworthiness of municipal borrowers.

The goal of Government policy, and of the *MFMA*, is not undisciplined access to credit, but rather self-disciplined borrowing and lending. Government policy is to ensure that loose lending does not swamp local government with debt it cannot repay. As stated in the original *Policy Framework,* "investors – whose funds are at risk when lent … are much better placed, and have much stronger incentives, to assess whether

any municipality is capable of borrowing than is any organ of government." Since lenders and bond buyers are putting their capital at risk, they must understand the risks involved, and they must satisfy themselves as to the willingness and ability of the municipality to repay the debt on time and in full. This reliance on disciplined lending decisions by investors whose capital is at risk is an intentional change from apartheid-era policies of directed investment.

Local policies and strategies

To maximise accountability, transparency and sound management, a municipality should consider borrowing only in accordance with a general borrowing policy. There are many good examples in South African municipalities. They typically include matters such as acceptable levels of borrowing, purposes for which borrowing will be considered (within those allowed by law), factors to be taken into account when Council considers borrowing, acceptable forms of security, risk management, and other matters.

To ensure that capital, including borrowed funds, is used strategically, investment should follow a long-term capital improvement plan. This plan may be reflected in a municipality's integrated Development Plan (IDP) and/or in a Metro's Built Environment Performance Plan (BEPP). Such strategic planning ensures that a municipality's borrowing capacity is not exhausted on investments that are not critical priorities for inclusive growth and service delivery.

To ensure sustainability, rehabilitation and replacement needs, as well as operation and maintenance costs, must be considered. Strategic financial planning not only prioritizes new capital investments. Council and local officials must also must plan, well in advance of system failure, to finance the eventual rehabilitation or replacement of existing infrastructure which is nearing the end of its design life. And, when they do plan for new infrastructure, councillors and officials must have a clear picture of the impact that operation and maintenance associated with each new investment will have on future annual budgets.

Short- and long-term borrowing

Municipalities are authorized to engage in both short- and long-term borrowing. However, the purposes for which funds may be borrowed; and the rules and procedures to be followed, are different for each type of debt. In both cases, the decision to borrow is taken by the municipal council, without any national or provincial approval; and the obligation to repay is that of the municipality, without any national or provincial liability. In all cases, only Rand-denominated borrowing is permitted,[9] so that municipalities (whose revenues are in Rands) are protected from exchange rate fluctuations.

[9] *MFMA,* Subsection 47(a).

Short-term borrowing:

If used to support cash-flow management, short-term borrowing can be useful. A municipal council should assure itself that the advantages outweigh the costs. In terms of the Constitution, short-term borrowing can be used for current expenditure, but only for bridging purposes during a fiscal year.[10] This means that a municipality must repay any short-term debt before the end of the financial year. The *MFMA* further requires that such debt only be incurred when the municipality can point to specific sources of anticipated revenue that will be used to repay the borrowed funds.[11] One example is property rates, some of which may be collected annually or semi-annually by the municipality. Another example is equitable share transfers from the national government. Knowing that those funds will be received by a certain date, a municipality might decide to borrow against the expected revenue, in order to stabilize operational expenditure.

Short-term borrowing must not become an indirect way of paying for operating deficits. When the *MFMA* was adopted, several municipalities were experiencing chronic problems with debt that was originally incurred as a short-term obligation, but was in practice being rolled over from year to year. This was a serious burden, resulting from a combination of poor financial management and undisciplined lending. From the municipal side, such rollovers are now clearly prohibited. Moreover, lenders are prohibited from rolling over short-term obligations, and are on notice that a municipality is not obligated to repay short-term debt if a lender wilfully extends short-term credit beyond the financial year.[12] This policy is seen as a significant success – although some problems with short term borrowing do still occur, systemic risk has abated substantially.

Long-term borrowing:

Long-term borrowing is an important tool, empowering municipalities to finance infrastructure without relying on the national government. Long-term borrowing can be used to finance strategically important infrastructure, unlocking economic growth and providing essential services. On the other hand, debt repayment over time limits the municipality's future spending flexibility, and should not be undertaken without serious reflection.

Committing to long-term borrowing is a significant decision, and a municipal council is expected to give serious consideration to the advantages and disadvantages of any proposed borrowing, taking on board public comments, and those of the national and relevant provincial treasury. Key policies regarding long-term municipal borrowing are reflected in the *MFMA* and the Constitution:

1) Long-term borrowing is only permitted for financing capital investment, and in limited circumstances for refinancing existing long-term debt;[13]

---

[10] Constitution of the Republic of South Africa, *as amended*, Subsection 230A(1)
[11] *MFMA,* Subsection 45(1)
[12] *MFMA,* Subsection 45(5)
[13] *MFMA,* Subsection 46(1)

2) A municipal council is authorised to bind the municipality (and future councils) to repay long-term debt;[14]

3) Notice to the public and other spheres of government is required, to provide an opportunity to comment, and to ensure the municipal council has the benefit of any views that may be submitted related to the proposed borrowing,[15]

4) Disclosure requirements ensure that prospective lenders and investors have access to information material to their investment decisions.[16]

Amount of borrowing

Local government has the right, and the responsibility to take prudent borrowing decisions. There are no fixed ratios or limits on municipal borrowing. As noted in the original *Policy Framework*, consideration was given to a "rules-based" limit on the amount of municipal borrowing, including various ratios of debt to annual revenues. After careful consideration, Government decided not to pursue this approach for a number of reasons, including that the municipal borrower and the prospective lender are better positioned than national government to judge what is reasonable in particular circumstances. One municipality may be experiencing rapid growth in its local economy, in which case it is both necessary and prudent to take on higher debt levels in order to be able to serve the booming demand. Another municipality may be experiencing little or negative population growth, and its future revenue prospects suggest that it would be risky to take on any significant amount of debt. What is appropriate depends on more than a mechanical ratio – wise borrowing choices are informed by an analysis of growth trends, the quality of management, the credibility of strategic planning, and many other factors. National Treasury monitors key indicators and ratios, but such ratios should not be construed as an indication that any notional level of borrowing is appropriate for any particular municipality.

Lenders and investors are responsible for the lending decisions they make. Investors whose funds are at risk have both the incentive and the means to limit the availability of credit if there is doubt about the sustainability of a proposed borrowing. There will be no bailouts by national or provincial government. This approach has served South Africa and its municipalities well. We have not seen the high debt levels that have plagued local government in some other countries.

Security for debt obligations

Municipalities may provide lenders and investors any kind of lien, pledge, hypothecation, mortgage or other security interest. This includes the pledging of real or personal property, revenue streams, bank accounts, or other assets. The municipal council can also agree to maintain tariffs at a particular level, to restrictive

[14] Constitution, Paragraph (1)(b) of Section 230A
[15] *MFMA,* Subsection 46(3)
[16] *MFMA,* Section 49

covenants on future debt, and to other arrangements as it deems necessary and appropriate. The question of what security is provided is a matter to be agreed between the municipality and the lender or investor. As envisioned by the original *Policy Framework*, the Constitution was amended in 2001 to provide that a municipal council can bind itself and a future council in the exercise of its legislative and executive authority, in order to secure loans or investments.[17] The revised Constitutional language now appears in Section 230A. Because the pledging of public assets is a serious and consequential matter, the *MFMA* requires that any security arrangements must be approved by a resolution of the municipal council.[18]

Municipal councils must carefully evaluate the costs and risks associated with proposed security arrangements. Lenders sometimes over-reach in terms of security interests. For example, they have been known to ask for pledges of real property worth many times the amount of a loan. A council must assure itself that it is not encumbering assets that are necessary to provide municipal services, in a way that could interfere with their availability for that purpose. When approving a security arrangement, a municipal council is required to make a specific finding as to whether the asset or right it is pledging is "necessary for providing the minimum level of basic municipal services."

When the pledge involves something necessary to provide basic municipal services, a council resolution must specify how these services would be provided in the event of municipal default. So, for example, a council could pledge a municipal water treatment plant as security for financing, but if the municipality defaults, the security arrangements should be crafted to ensure that the investor could not take that plant, dismantle it and sell the components to recover his investment. On the other hand, the municipality could agree that if it does not pay its debt, the investor or its agent could take over operations, and run the plant in a way that both provides municipal services and also generates revenue to repay the debt.

Removing limitations on municipal pledges of certain revenues: In recent years, the Division of Revenue Act (DORA) has contained language along the following lines:

> *A municipality may only, after obtaining the approval of the National Treasury, pledge, offer as security or commit to a person or institution future conditional allocation transfers due to the municipality for the next financial year and the (following) financial year, for the purpose of securing a loan or any other form of financial or other support from that person or institution.*

While some lenders may have believed that this provision authorized municipalities to pledge conditional transfers, it actually *limited* municipalities' previously broad authority, in terms of section 48 of the *MFMA*, which authorizes the pledging, mortgaging, or hypothecating of various assets, including the cession of *any* category of revenue or rights to future revenue. In essence, these DORA provisions curtailed the municipal power to pledge by requiring approval of the National Treasury in the case of a conditional transfer from national government.

---

[17] Act No. 34 of 2001: Constitution of the Republic of South Africa Amendment Act, section 17.

[18] *MFMA,* Section 48

There is moral hazard in this approach, as lenders or borrowers may see approval by the National Treasury as an implicit guarantee that the anticipated transfers will be made in the out-years. To this extent, the DORA provision has created ambiguity, which is the enemy of effective risk allocation.

Going forward, Government will eliminate the National Treasury approval process for municipal pledging of conditional grants. Treasury may comment in terms of section 46 of the *MFMA,* but the borrowing decision is entirely that of the municipal council. Municipalities may pledge grant streams, and lenders may ask for such pledges. Although neither can bind the Parliament in the exercise of its legislative authority and budget responsibilities, the historic record of such transfers being timely and predictably made may give lenders comfort.

Borrowing by municipal entities

In addition to municipalities, a municipal entity may borrow for infrastructure, in accordance with its business plan and the provisions of Chapter 6, which apply *mutatis mutandis*.[19] The definition of a municipal entity is drawn from the *Municipal Systems Act*,[20] and includes companies under the ownership or control of one or more municipalities.

Municipal entities can borrow on the strength of their own creditworthiness. Lenders and investors must satisfy themselves as to the willingness and ability of the municipal entity to repay the debt on time and in full. Entity borrowing allows for ring-fencing, so that repayment obligations can be limited e.g. to the revenues of a water supply company or an electric company, without recourse to the general revenues of a municipality, such as property rates. This would be an example of "project finance," which is dealt with below.

Alternatively, a municipality may choose to guarantee the debt of a municipal entity. At council's option, it may guarantee the debt of an entity under its sole control. In this case, the municipal council must approve such a guarantee in the same way that it would a direct municipal debt.[21] Additionally, although it is difficult to conceive of a case where it would make sense to do so, the *MFMA* permits a municipality, with the approval of National Treasury, and with adequate cash or insurance coverage, to guarantee the debt of a municipal entity under shared control.[22]

Project finance, revenue bonds, and tax increment financing

Project finance, revenue bonds, and tax increment financing are potentially useful instruments. These are potentially useful types of municipal borrowing, and are

[19] *MFMA,* Section 108.
[20] Act No. 32 of 2000: Local Government: Municipal Systems Act. See definition of "municipal entity" in section 1.
[21] *MFMA,* Subsection 50(b)
[22] *MFMA,* Subsection 50(c)

explained in some detail in the Appendix. Such arrangements can have political and distributional consequences. The costs, benefits, and risks associated with any specific use of these tools should be carefully considered by the municipal council before they are implemented.

Tax increment financing can be controversial. One political/equity tension that can arise with tax increment financing has to do with differing narratives about what might have happened in the affected area without public investment. If the area would, in any event, have seen property values rise (perhaps as a result of private decisions and investments), then there was no need for the public contribution, and the public money might have been better spent elsewhere. If the area was doomed to remain blighted and unproductive in the absence of public sector intervention, then it can be said that investments made possible through the use of tax increment financing unlocked the potential of the area. Because it is always difficult to know what *might* have happened, such tensions are difficult to resolve. It is strongly recommended that, when a municipal council considers ring-fenced financing or spatially targeted investments, the council solicit public input on the potential impacts of the financing arrangements and infrastructure plans, including impacts related to inclusiveness and economic productivity.

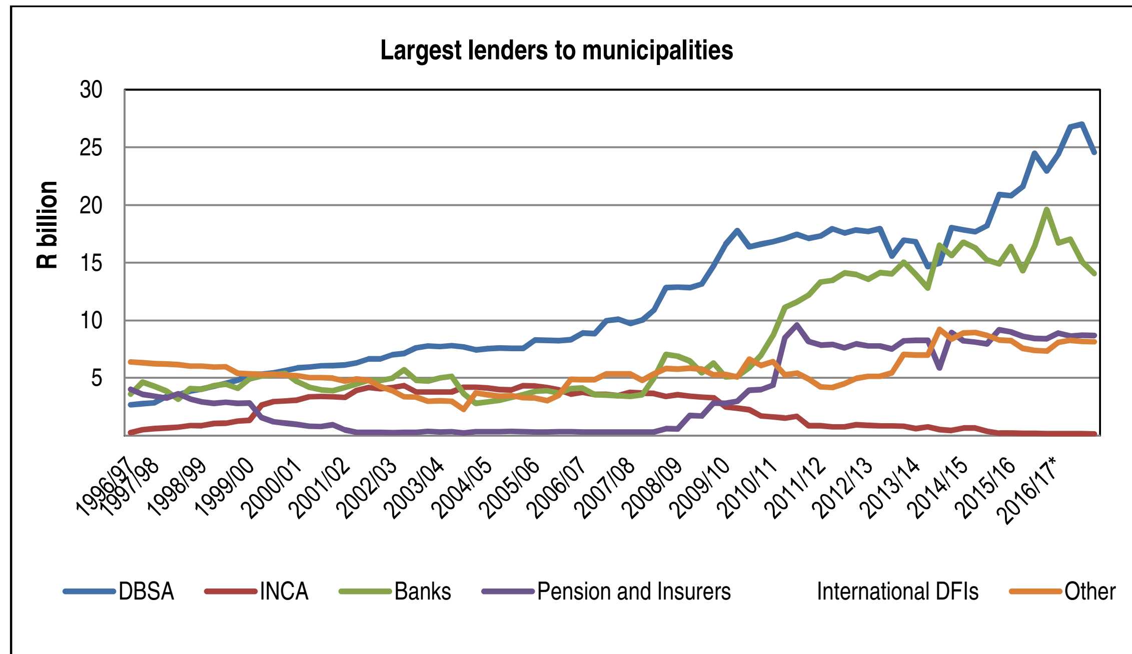
Project finance, revenue bonds, and tax increment financing are all permitted. As noted above, section 48 of the *MFMA* authorizes a municipal council to engage in a wide variety of security interests, pledges, and hypothecation in order to secure investment. Consistent with these provisions, project finance, revenue bonds, and tax increment financing are permitted, subject to the restrictions and requirements contained in the *MFMA.* A municipality may find that it is useful or appropriate to pledge specific revenue streams to repay debt obligations, either to improve the creditworthiness of a particular debt issue, or to mitigate risks associated with general obligation borrowing. In the former case, the council might expect a better interest rate that would be obtained without the pledge. In the latter case, the council might expect to pay a higher rate to compensate investors for the limited recourse available to them in the event of a default.

Policies related to lenders and investors

South Africa has an open market for municipal borrowers and lenders. To limit currency risk, municipalities may only borrow in South African currency, but there is no limitation on the types of lenders or investors from whom municipalities may borrow. And indeed, municipalities do source funds widely, borrowing from commercial banks, institutional investors, development finance institutions, and other sources.

The Development Bank of South Africa dominates the market. As can be seen from the chart below, the DBSA has been the most active lender to municipalities. In only one quarter since the *MFMA*, at the beginning of calendar year 2014, did the loan books of South Africa's commercial banks, taken as a group, outweigh the DBSA's. This quarter was followed by a sharp and sustained uptick in DBSA lending, and the DBSA continues to dominate the market. The 2009-2011 period saw an encouraging surge of new

investment from institutional investors, but investment from this group has since levelled off.



Markets

Interest rates depend on market interactions between borrowers and lenders/investors. The interest rate that a borrower must pay depends on investors' changing expectations about inflation, evolving perceptions of the riskiness associated with a given borrower or debt issue, the current availability and attractiveness of alternative investments, and the extent of competition between lenders.

Interest rates also vary with the term of the investment: as the term of a loan increases, lenders usually demand a higher interest rate to compensate for the increased risk associated with longer maturities. As a result, the yield curve is typically upward sloping. Liquid markets can help mitigate term risk – investors are more likely to buy and hold long-maturity municipal bonds if they are confident of finding a buyer, should the need arise. In the absence of a liquid market, the holder of a municipal bond takes the risk that it may have to hold it to maturity, or sell it at a deep discount, if it needs cash.

Reliable information is foundational to correct pricing. To help lenders and investors to price credit appropriately, the *MFMA* and regulations prescribed thereunder require municipalities to report periodically on their finances, and require that their financial statements be audited. National Treasury provides a web-based tool, *Municipal Money,* which contains extensive municipal financial data over several years.[23] This data is freely available and promotes transparency, civic oversight and accountability. In addition, the *MFMA* requires full disclosure of all information

[23] https://municipalmoney.gov.za/

material to an investment decision, at the time a municipality engages in borrowing activities.[24] Deliberate or grossly negligent failure to do so can result in imprisonment for up to five years.

Primary markets determine the price of municipalities' debt instruments. The primary market for municipal debt instruments operates in two ways: some municipalities take on loans for a specified term and amount, in which case they seek tender offers from prospective lenders and enter into a loan agreement with the successful lender; other municipalities sell municipal bonds or long-term notes, which they can do either at auction or through private placement. Both loan agreements and bond sales are transactions in the primary market, i.e. between the issuer and the lender or investor. Nothing in the *MFMA* favours one method over the other – the choice of instruments is determined by the municipal council. Because a bond issue can entail significant transaction costs, small scale borrowing will rarely take the form of municipal bonds. To date, only metropolitan municipalities have issued bonds.

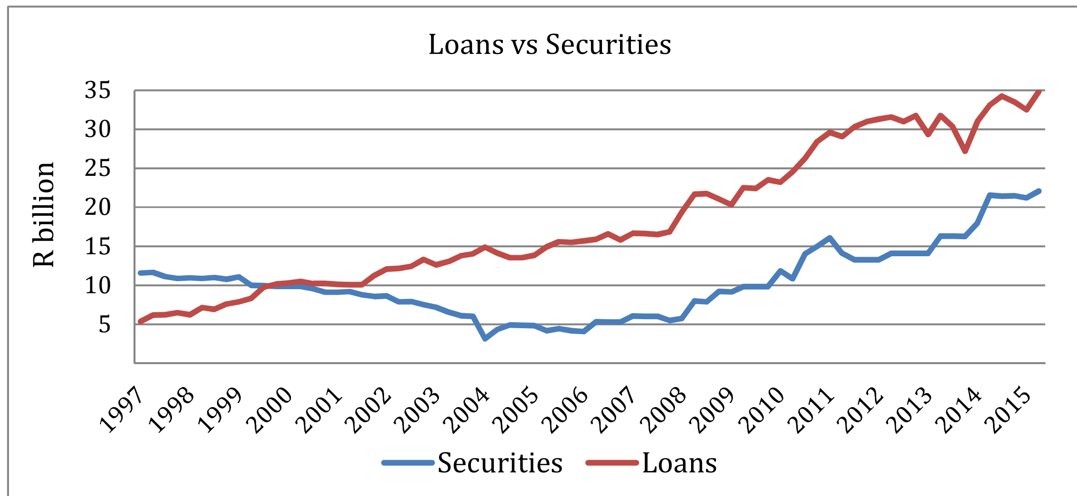
Distinguishing primary and secondary markets: In the secondary market, investors trade debt instruments with one another rather than buying bonds from the issuer. Loans may be bought and sold, but this is relatively rare. Bonds, on the other hand, are intended as tradable debt securities. They are sold to investors, with the understanding and intention that they may be resold, potentially many times, to subsequent investors. Such re-sales make up the secondary market. The debtor municipality is not a party to these subsequent transactions because it has already received its capital when the securities were sold to the original investors. However, the municipality has an interest in ensuring that its bonds are tradable in the secondary markets, because liquidity makes its bonds more valuable, and the interest rate at origin consequently lower.

Secondary markets can improve financial efficiency: A liquid secondary market helps municipalities borrow more cheaply and efficiently for two reasons: 1) a freely tradeable municipal bond is less risky for any bondholder, large or small - the bondholder can sell at any point that the investment no longer meets the investor's needs; and 2) liquidity broadens the pool of potential investors, because individual bonds can be bought by smaller investors who would not be willing or able to provide the total amount of capital required by the municipality.

A vibrant secondary market has yet to emerge. The critical mass of municipal debt stock which would be required for an active secondary market in South Africa has not yet been achieved. Three factors constrain the quantity of tradeable securities: 1) municipalities are not borrowing as much as had been anticipated at the time of the original *Policy Framework*; 2) municipalities are not borrowing for the long tenors that would be needed; and 3) more borrowing continues to be done through illiquid loans, as opposed to tradeable debt instruments. There is a weak secondary market, but trading is infrequent and volumes are quite low.

---

[24] Section 49 of the MFMA provides that any person involved in municipal borrowing must disclose all material information in that person's possession or within that person's knowledge.



More could be done to promote a secondary market in municipal bonds. Some approaches under consideration by National Treasury include the following:

1. <u>Encouraging collaboration between sovereign and municipal issuers.</u>

As opposed to corporate and municipal bonds, there is an active secondary market in RSA bonds. It would be useful to explore how municipalities can position municipal bonds as being more like sovereign bonds than corporate bonds. Like the national government, municipalities have permanent existence and taxing powers. In this, both spheres of government are different to corporate issuers, which can become bankrupt or be dissolved.

It would be possible for one or more metropolitan municipalities to consider parallel issuances with RSA bonds, e.g. auctioning both national and local obligations with the same maturities simultaneously, and co-marketing them with a combined road show and investor relations strategy. This is not primarily a policy issue, but rather a practical issue of collaboration. So called "replica bonds" would reveal with precision how investors see the credit quality of a participating metro relative to the credit quality of the sovereign.

2. <u>Researching the perspectives of different investor groups</u>

Different investors, and different groups of investors, have different needs. Treasury has begun detailed research, including focus groups and interviews, to better understand and forecast what can be expected of each investor group, in terms of appetite for municipal debt, preferences regarding general obligation or revenue debt, tenors, interest rate spreads, and other parameters. Groups with differentiated appetites and requirements include banks, insurers, public and private pension funds, unit trusts, institutional investors and fund managers, and large investment funds.

3. Increasing the stock of municipal bonds

The most critical part of the secondary market challenge is that an effective and efficient market requires a significant stock of securities of varying maturity profiles and credit quality. To increase the stock of municipal bonds, at least two options are possible:

- The DBSA, commercial banks and DFIs could all be encouraged to originate loans in the form of bonds. The DBSA is reportedly doing this to some extent. These bonds can be held in the institutions' treasuries for some period, and then sold into the market as the institutions require liquidity, and/or as part of a coordinated strategy to boost the secondary market.
- Existing loans held by public or private financial institutions could be securitized, e.g. by creating a special purpose vehicle which would acquire those existing loans and issue securities backed by the portfolio of loans. The costs and benefits of such approaches should be analysed.

Government encourages public and private actors to pursue these and other approaches to support the development and growth of an efficient and liquid market for municipal debt obligations.

Extending the term of municipal borrowing

Because most municipal infrastructure has a long useful life, it is appropriate to finance it with long-term debt. "Borrowing is arguably the most efficient way to pay for public assets that have a long life. By matching payment for the infrastructure with the time when benefits received, governments can provide the benefits of infrastructure investments while deferring the payment."[25] The importance of matching the term of financing to the useful life of the asset was recognized in the *White Paper* and in the original *Policy Framework.* Both before and after the *MFMA,* there have been examples of 20-year lending, mostly but not exclusively from the DBSA. This is good, but municipal infrastructure typically has an even longer life. More infrastructure could be provided sooner if municipal maturities could be extended reliably into the 20-30 year range.

Moving toward longer maturities: Mobilizing more long-term borrowing options is likely to require one or more of the following:

1) A liquid secondary market can evolve, so that holders of long-dated instruments can reliably sell the bond if their liquidity needs so require;

The question of liquid markets and market size are discussed above.

2) Institutional investors, including pension funds and insurance companies that have long maturity needs, can become more active lenders, as they appreciate the stability and creditworthiness of today's major metropolitan municipalities;

[25] Bahl, Linn and Wetzel, Financing Metropolitan Governments in Developing Countries, Lincoln Institute of Land Policy (2013)

Institutional investors largely exited the municipal market with the uncertainties of the democratic transition in the 1990s, but began returning to the market in 2009-10. Nevertheless, they still account for less than 20% of outstanding municipal borrowing. National Treasury is now engaged in a long-term study to help understand how different institutional investors view long term municipal bonds. Hybrid arrangements, in which commercial banks (which manage municipal accounts and have long experience of municipalities) specialize in loan origination, and finance the shorter maturities, partner with institutional investors who can finance the longer maturities, would seem to have merit. National Treasury has not uncovered any evidence yet of such arrangements in South Africa.[26]

3) intervention by development finance institutions, to take on longer maturities, to support a liquid secondary market, or both.

Possible interventions by development finance institutions are discussed below.

Development Finance Institutions

There has been no clear policy regarding the role of development finance institutions (DFIs) in municipal lending. The primary goal of the original *Policy Framework* was to leverage in private sector investment in local infrastructure. The availability of national government funds for local infrastructure was considered to be extremely limited. The publicly owned Development Bank of Southern Africa (DBSA) was seen as a mechanism for municipalities to indirectly access capital markets, and it was anticipated that the relationship between indirect mechanisms and direct access to private capital would "require further attention once the policy framework …[was] established in legislation."[27]

DFI lending to municipalities, and especially to metros, has grown significantly. Although the National Treasury has repeatedly signalled that the DBSA should not be lending in competition with the private sector, the metros remain the largest borrowers from the DBSA. At the end of the fourth quarter of 2016/17, approximately 33 % of metros' debt obligations are DBSA loans. Moreover, international development finance institutions (DFIs) are now also lending directly to some municipalities. In aggregate, public sector lending accounts for approximately 40% of metros' outstanding long term debt obligations, as of the end of the fourth quarter of 2016/17.

DFI lending to creditworthy metropolitan municipalities carries risks. The aim of the original *Policy Framework* was to encourage creditworthy municipalities to engage directly with private investors. Mobilizing private sector capital that would be at risk was seen as essential in order to allocate and price capital efficiently; to keep municipalities fiscally disciplined, avoiding the risk of over-lending; and to free up national resources to support poor and rural municipalities. Over the years, those goals

[26] In 2012, the International Project Finance Association adopted standards for PEBBLE ("Pan European Bank to Bond Loan Equitisation"), a vehicle which combines longer term notes, intended for institutional investors, with first-loss loans funded by commercial banks.
[27] *Policy Framework for Municipal Borrowing and Financial Emergencies* (2000), p. 23

have been undermined as public-sector lenders have lent ever larger amounts to creditworthy metros. The risks of continuing along this path include the following:

1) pricing will continue to be distorted by DFI lending;
2) the size and number of municipal bond issues will be limited;
3) contingent risk and moral hazard will increase;[28] and
4) the financing needs of poor and rural municipalities, where the DFIs have a comparative advantage and constructive role to play, will remain on the back burner.

Municipal lending by public institutions carries responsibilities. Publicly held financial institutions should pursue developmental goals, rather than lending in direct competition with profit-oriented private sector lenders. Public-sector lenders, both domestic and foreign, should be guided by a social and developmental investment approach, in which demonstrable social outcomes are considered alongside potential financial returns. Developmental and social goals include the following:

- Financing basic infrastructure and services in rural areas;
- Supporting the development of long term financial strategies in municipalities of any size;
- Extending the tenor of borrowing for municipal infrastructure beyond 20 years, to better match the useful life of the assets being financed;
- Supporting the development of a liquid secondary market for municipal debt securities;
- Supporting spatially transformative development within South Africa's cities, so as to increase access to opportunities for all citizens;
- Ensuring 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; and
- Supporting municipalities to assess their own creditworthiness, and supporting efforts to improve their creditworthiness.

It is important to define and measure how DFI responsibilities are met. One or more development objectives, and appropriate indicators must be agreed, in advance of any DFI lending, with National Treasury and any proposed municipal borrower. This can be done on an annual or programmatic basis.

- If a development finance institution proposes lending to a **metropolitan municipality**, clear and measurable developmental outcomes might include extending the weighted average maturity of a municipality's borrowing beyond 20 years; substantially increasing the volume of municipal bonds listed on the JSE; establishing or supporting market-makers in municipal securities, to ensure liquidity; enabling or accelerating otherwise unaffordable investment in spatially transformative development; and supporting the development of long term financial strategies aligned with long term physical and engineering planning.

---

[28] It is one thing for national government to tell a private bank they should have done a better credit analysis, and they must bear the loss if they have over-lent. It is politically much harder to tell the DBSA or a foreign government the same.

- If a development finance institution proposes lending to a **creditworthy secondary city** with smaller borrowing needs, clear and measurable developmental outcomes might include making long term credit available with a weighted average maturity of at least 20 years; establishing or supporting pooled borrowing mechanisms which limit each municipality's risk to its own capital investment needs; and supporting the development of long term financial strategies aligned with long term physical and engineering planning.

- If a development finance institution proposes lending to one or more **poor or rural municipalities**, clear and measurable outcomes might include the sustainable use of borrowing to fund appropriately scaled infrastructure investments; sustainable financing for basic infrastructure and services; and supporting the development of long term financial strategies aligned with long term physical and engineering planning.

Credible metrics will be required throughout the term of any loan, including measurements before a DFI loan is contracted, in order to establish baseline values for the targeted indicators. Independent annual reviews on progress in achieving the agreed developmental outcomes will be required, and will be submitted to the municipality and the National Treasury within 60 days of the anniversary date of each loan.

The role of public sector development finance institutions is not to extend credit to risky borrowers, but rather to assist borrowers to become creditworthy. Neither public nor private lenders should extend credit to a municipality that is unlikely to be able to repay. And neither public nor private lenders should price their credit below its true cost in pursuit of market share.

Subsidies and concessions that reduce the cost of borrowing for creditworthy municipalities are distortionary. Such subsidies benefit a particular municipality in the short run, but thwart the development of a healthy municipal credit market in the long run. Market priced credit is important because it rewards good financial fundamentals and good management with lower interest rates.

Pooled finance and intermediary arrangements

In recent years, some municipalities and potential lenders have been interested in pooled finance and intermediary mechanisms. These are proposed as a way for municipalities to collectively raise finance for infrastructure investments. While most metropolitan municipalities have access to private sector capital, smaller municipalities have had less success in finding affordable credit to address their infrastructure needs. In this context, pooled financing has been proposed as a way to aggregate the borrowing needs of a group of municipalities and attract investors to meet these needs through a collective loan or bond issue. This could be done by creating a special purpose entity, or by using an existing institutional structure.

Understanding why the DBSA is not an effective market intermediary. As noted above, the original *Policy Framework* described the DBSA as a mechanism for municipalities to indirectly access capital markets. This is essentially the same role as a

municipal bond pool would play. In this context, it would be useful and important to analyse why the DBSA is not seen as an effective channel for smaller municipalities. If the governance, operations or incentives of the DBSA are barriers to effective pooling of municipal needs, it may be wise to address these problems directly, rather than creating new institutions. In considering options, it should be borne in mind that the DBSA currently lends to many non-municipal borrowers, and to borrowers outside of South Africa.

There are various models of pooled finance mechanisms from other countries. Globally, a number of structures have evolved that fall under the general rubric of pooled finance. These are useful benchmarks as stakeholders explore what might be appropriate in the South African context. For example, a Japanese model that was discussed by National Treasury involves a joint local government bond that is issued by a large group of subnational governments. In this model, all of the subnational governments are jointly liable for the total debt, so that in the event of a default, an investor could look to any of the participating local government units to pay the debt of any other. A French example that was discussed involves a recently established intermediary, the Agence France Locale (AFL), which was created following the collapse of a previous French-Belgian intermediary, Dexia. Member municipalities jointly own the new AFL, and only those meeting minimum financial criteria may join and borrow. There are also long-standing examples of bond banks from several US states (e.g. Virginia, Maine, and New Hampshire).[29]

Managing the risk of pooled financing. With a pure pooled finance arrangement, such as the Japanese model. each municipal borrower would be jointly and severally liable for the full cost of the aggregate funds borrowed. This presents a moral hazard risk, and is not appropriate for municipalities with different financial and managerial capacity. Well-managed municipalities could easily become the guarantors of poorly managed municipalities. This would undermine market discipline, and could endanger the creditworthiness and sustainability of well-managed municipalities, if they participated in the pool.

Intermediation can limit the risks of a pure pool. With an intermediary, as in the French model, the DBSA model, or the former INCA model, the intermediary agency issues debt in its own name, and uses the proceeds to lend to municipalities. The intermediary agency could be government owned (the DBSA model), municipally owned (the French model), or privately owned (the INCA model). Whatever the ownership structure, such an intermediary would need to be initially capitalized. The amount of required capitalization depends on the amount of lending the intermediary would do, as well as market judgements about the structure and risk management capacity of the institution. To the extent that the intermediary has sufficient capital and creditworthiness to borrow on the strength of its own finances, the borrowing municipalities would have no exposure beyond the amount of the loans that they take

[29] Models from developing countries, such as Colombia's FINDETER or India's Tamil Nadu Urban Development fund would seem to be of less use in the South African context, given South Africa's strong financial institutions and functioning capital markets.

from the intermediary. There would be no risk of becoming liable for another municipality's debt, as in the Japanese model.

Operational costs depend on functions. In addition to initial capitalization, operational costs of the intermediary would need to be met from some source. The size of the operational budget would depend on the functions the intermediary agency would perform. A pass-through entity that does nothing but borrow from the markets and lend to the municipalities could be quite lean. To the extent that the agency would also provide financial advice, project preparation support, or other technical assistance, the operational costs would naturally increase.

Any pooled financing mechanism must be structured to avoid assumption of credit risk by one municipality on behalf of another. Correctly structured, pooled finance and intermediation can help small but creditworthy municipalities access affordable credit. Poorly structured, pooling can create risks that would not be appropriate for national or local government. Two principles should therefore guide any further proposals for pooled finance: first, the mechanism must not be used to make credit available to municipalities that are not creditworthy; and second, no municipality should be at risk of becoming responsible for any debts of another entity. Government's policies are based on the principle that well-managed municipalities should have access to appropriate levels of credit, and that financially challenged municipalities must not borrow until and unless their finances are in good shape.

Policies related to financial emergencies

Municipalities experience financial difficulties for different reasons. The question of how the various spheres of Government would respond to financial emergencies in municipalities was first addressed in the original *Policy Framework* and the *MFMA* because of the linkage to municipal borrowing. At the time, banks and other financial institutions had largely stopped lending to municipalities. The goal of the financial emergencies provisions was to clarify the "end game" for a financially troubled municipality. Without such clarity, argued the financial sector, lending to municipalities is too risky for lenders and too expensive for borrowers. To support the development of appropriate policies, research was undertaken in 2000-2001 to better understand the causes of financial crisis in municipalities. That research found that municipalities can experience financial crisis for at least three different reasons, and each requires a different solution:

a. Structural financial capacity limitations: municipalities in areas with poor economies cannot be expected to generate adequate own-source revenues to meet the needs of the population. The ultimate solution for such problems lies in redistribution. The equitable share provisions of the Constitution, and the policies in the *White Paper on Local Government*, support redistribution to benefit municipalities without an adequate economic base.

b. Management and political problems: most financial problems are related to bad management. The problems can be on the revenue side (failure to impose or collect adequate taxes, fees, and charges), or on the expenditure side (failure to budget and

control expenditure in line with available resources). Sometimes municipalities are badly managed because the CFO or other key staff is not competent, and sometimes the issue is political dysfunction. Improving financial management requires sustained attention to revenue collection and expenditure control. If a council cannot take the necessary decisions to ensure financial balance, the ultimate solution, in terms of the Constitution, is to dissolve the council and call a new election.

c. Economic factors: even a well-managed municipality can be hit by economic factors, whether related to specific local conditions (such as the closing of a mine or factory), or broader national or global financial crises. Resolution of such problems can take a number of years. If the potential for own source revenue collection is reduced, then expenditure levels must be reduced. Eventually, the equitable share can be adjusted to reflect the new realities. The transition period can be very difficult for a municipality and its citizens, and it may be necessary for the state or national government to consider temporary assistance, if their resources permit.

There is clear and explicit legislation providing for resolution of financial problems in municipalities. The original *Policy Framework* anticipated that Government would establish statutory procedures to deal with municipalities in financial crisis, and to facilitate an appropriate resolution, depending on the cause(s) leading to the crisis. That was done, and the relevant provisions are to be found in section 139 of the Constitution, and in Chapter 13 of the *MFMA*.

Section 139 of the Constitution

Section 139 of the Constitution establishes overall framework. The original *Policy Framework* recognized that the Constitution, as it then existed, would need amendment so that legislation could be enacted which would (a) establish structures and procedures to deal with financial emergencies in municipalities and (b) provide for these structures to exercise executive and legislative powers on behalf of the municipality to the extent necessary to deal effectively with the emergency. This recognition led to the financial emergency provisions (Chapter 13) of the *MFMA*, and the enabling amendments to Section 139 of the Constitution. The amendments to Section 139[30] were extensive and became a rather detailed roadmap for intervention in a failing municipality. The following features of Section 139, as amended, are notable:

- It distinguishes between **executive obligations** of council, which are dealt with in subsections (1) through (3) of Section 139, and obligations related to the budget and revenue measures (which are **legislative functions**). The latter are dealt with in subsection (4) of section 139.

- In terms of section 139(1), if an executive obligation is not fulfilled, the province has three options: first, it may issue a directive to Council requiring it to take action; second, it may assume responsibility for the obligation itself to the extent necessary;

[30] The former section 139 of the Constitution was replaced in its entirety, under the terms of the Constitution Eleventh Amendment Act, No. 3 of 2003. The current provisions are set forth in the Appendix to this memorandum.

and third, it may dissolve the Council, in exceptional circumstances, and appoint an administrator until a new election can be held.

- In terms of section 139(4), if a budget or revenue-raising measures are not approved, the province must intervene to ensure that such measures are approved. The province may dissolve the Council, appoint an administrator until a new Council is elected, and approve the necessary measures on a temporary basis.

- In terms of section 139(5), if financial problems have led to a serious or persistent breach of the municipality's obligations to provide basic services or meet financial commitments, the provincial executive must impose a binding recovery plan and must dissolve the Council if it does not approve legislative measures necessary to give effect to the plan.

- Finally, in terms of section 139(7), if the province does not adequately intervene, the national executive must intervene in the place of the provincial executive.

Mandatory intervention by provincial or national government may sometimes be required. Subsections 139(4) and 139(5) provide the predictability that was required in order to open the door to municipal borrowing from the private sector. In terms of these sections, where the problems are financial, the province has no choice – it must intervene. The corollary is that an affected party could bring a mandamus action to compel the province to act. And if the province does not act adequately, it is mandatory that the national government intervene. This also can be enforced by court order, if necessary. Constitutionally, the appointment of an administrator is only possible in "exceptional circumstances" in the case of a subsection 139(1) discretionary intervention, but can be mandatory in terms of subsections 139(4) or 139(5), when financial and basic services issues are involved. As reflected in subsection 139(5), the financial and service delivery obligations are given equal weight. In practice, these are usually intertwined. It does not make a difference whether the municipality is failing to meet its financial commitments or failing to meet its obligation to provide basic services- the mandatory process laid out in subsection 139(5) is the same.

Chapter 13 of the Municipal Finance Management Act

Chapter 13 of the MFMA contains a detailed roadmap for resolving financial problems in municipalities. This chapter has four parts:

- Part 1 is a single section requiring municipalities to avoid, identify and resolve financial problems, and to notify the province and SALGA if they encounter a serious financial problem or anticipate problems in meeting financial commitments.

- Part 2 describes the processes for interventions by the provincial and national governments, including the requirements for financial recovery plans.

- Part 3 sets forth a quasi-bankruptcy procedure, which allows a high court to temporarily protect a municipality from legal process so that a recovery plan can be implemented, and in certain narrow circumstances, allows the suspension or termination of a municipality's financial obligations.

- Part 4 establishes a Municipal Financial Recovery Service within the National Treasury, and sets out its powers and functions.

Responses to municipal financial problems depend on the type and seriousness of the problems. It is useful to summarize the key provisions of Part 2 here, which are intended to regulate the processes established by Section 139 of the Constitution:

- The legislation parallels the amended Section 139 of the Constitution in distinguishing between executive and legislative obligations[31] and in mandating intervention when a municipality is in serious or persistent breach of its obligations to provide basic services or meet financial commitments.[32]

- Section 137 describes how the province <u>may</u> intervene at its discretion, and is paired with Section 138, which lists eight factors that must be taken into account in deciding if there is a serious financial problem.

- Section 139 describes what the province <u>must</u> do in a mandatory intervention, including a request for a recovery plan from the Municipal Financial Recovery Service (as opposed to any "suitably qualified person" in the case of a discretionary intervention). This is paired with Section 140, which lists another four factors to be considered, along with others, to determine if there is a serious material breach of financial obligations.

- Sections 141 through 144 lay out the processes, and substantive requirements, for a financial recovery plan. Under section 145, in a discretionary intervention the Council must implement and report, but the plan is only binding in terms of executive actions. Under section 146, in a mandatory intervention, the municipality must also implement, and in this case with respect to both executive and legislative issues; and the province must dissolve the Council and appoint an administrator if the Council does not approve necessary legislative measures.

- Section 150 of the MFMA provides that if a mandatory intervention is required by the Constitution, and the province does not adequately intervene, then the national government must.

The National Treasury has initiated research into provincial interventions in terms of Section 139 of the Constitution. This research is intended to shed light on the nature of the failures that lead to intervention, the contributing factors underlying these failures, and the nature and extent of provincial and national responses to financial problems in municipalities. We hope to learn what has worked well, and what has not. This is likely to lead to operational improvements, and may suggest legislative reforms.

A clear and effective end-game for resolution of financial emergencies remains critical for financial stability in the local government sector. It is important that

---

[31] See MFMA Section 136, subsections (2) and (3).
[32] See MFMA Section 136, subsection (4).

investors know what will happen in a financial crisis. Government must ensure that the national and provincial institutions that monitor and oversee municipal financial health are appropriately used and empowered.

Conclusions

The legislative and regulatory framework established by the Constitution, as amended, appropriately allocates responsibility and risk for borrowing by municipalities and lending to municipalities.

Substantial work remains to improve the creditworthiness of many municipalities, and to ensure that they have the resources for strategic planning of capital investments, and the capacity to design, procure, and manage infrastructure.

Government encourages the following as the most productive approaches to continuing to develop the market for municipal infrastructure finance:

1. Demand-side issues:

- Day to day municipal finance management continues to need attention in many municipalities;
- Municipalities must develop long-term financial strategies that reflect expectations about future population and economic growth, that are linked to land use and infrastructure planning, and that identify priority investments and their timing; and
- Municipalities should clearly articulate to prospective investors the financial strategy underpinning any borrowing, including the intended use of proceeds and the revenue streams that will support repayment of borrowed capital.

2. Supply-side issues:

- Measures to expand the term of years for which creditworthy municipalities may borrow for long term infrastructure investment are encouraged; and
- Measures to develop a liquid secondary market for municipal bonds are encouraged.

Appendix: Selected borrowing issues in focus

Development Charges: Capital Recovery Fees and Impact Fees

Development charges are a revenue source that can be used either to enhance the municipal fiscus generally, or as security for revenue bonds issued to finance infrastructure that generates new capacity, such as a water treatment plant, a highway interchange, or a storm water facility.

The burden of paying for infrastructure shifts, depending what source of funds is used to finance the infrastructure and service the debt:

a. When funded from a municipality's general revenues and accumulated surpluses, the cost is borne by local taxpayers and consumers.

b. When funded from national transfers, the cost is borne by all South African taxpayers.

c. When funded from specific user charges or impact fees, the cost is borne by those who use the infrastructure, or create the need for it.

Each of these approaches carries its own social and political dynamic, and has its own economic and financial implications. Capital recovery fees can be collected when a developer connects new structures to the city's electric, water or sanitary sewer lines. Impact fees can be collected when a developer builds facilities that generate traffic requiring public parking or upgrades to off-site streets, or paves over a formerly pervious surface, causing more run-off and the need for storm drainage improvements downstream.

Development charges have the potential to allocate costs more equitably: if we accept that affluent households, industrial and commercial users, and others that can afford to, should pay at least in proportion to what they use, or to the impacts they cause, then we would want to encourage greater reliance on development charges.

There are two main types of development charges:

a. **Capital connection/ capital recovery fees:**

A municipality imposes these fees when a new user or development connects to its utility networks. Such fees recover the cost of capital investments previously made by the municipality, so that they would be able to serve new customers. For example, when a municipality creates capacity, by way of investments in physical plant and equipment, to deliver electricity or water to new users, and incurs financing costs associated with the investment, it can recover a *pro rata* portion of those costs when a new user connects. This approach allocates investment costs to the beneficiaries, and ensures that a city has the funds it needs to meet the challenges of urban growth.

Without capital cost recovery fees, the municipality is left to cover the costs of investment for future users by increasing the tariffs it charges for current users. Even

low-income users pay more, as they help cover the capital cost of future development, including high-end gated communities, shopping centres and other commercial development. The resulting misallocation of costs penalizes the poor and middle class, and subsidizes developers.

Moreover, raising tariffs can be politically difficult, so the municipality's investment costs may never be fully recovered. In this case, investment in new capacity will be less likely, and the municipal finance system will face unnecessary financial challenges as it tries to balance its capital and operating requirements.

b. **Impact fees:**

Impact fees are a type of development charge related to off-site impacts. For example, they may reflect the need for future traffic or storm water improvements. These impacts tend to be incremental and cumulative. It would not make sense for each new developer to expand downstream storm drainage facilities or build parts of highways. But in the aggregate, the lack of effective impact fees eventually imposes serious off-site physical, financial and economic consequences.

Borrowing through special purpose vehicles

This issue has arisen in the context of a proposed tax increment financing structure in Johannesburg. Tax increment financing is described below. Although tax increment financing in no way requires the use of a special purpose vehicle (SPV), the City of Johannesburg proposed to use such a structure in order to make it crystal clear that TIF bonds would not obligate the City in the event that the revenue stream (increased tax revenues from the proposed district) are not sufficient to pay the bonds.

If the proposed SPV were created by the City of Johannesburg, it would likely be a municipal entity in terms of the relevant legislation.[33] It appears that the *MFMA* would require that the debt of an SPV that is a municipal entity be included in the consolidated financial reports of the municipality. Section 122(2) of the *MFMA* provides as follows:

> (2) A municipality which has sole control of a municipal entity, or which has effective control within the meaning of the Municipal Systems Act of a municipal entity which is a private company, must in addition to complying with subsection (1), prepare consolidated annual financial statements incorporating the annual financial statements of the municipality and of such entity. Such consolidated annual financial statements must comply with any requirements as may be prescribed.

Including a controlled entity with the municipality's financial statements is good public policy – this means that accountability for financial disclosure of the condition of a municipal entity rests with the elected city council. The specific method through which entity debt is consolidated is subject to regulation. It does not appear possible to keep

[33] See section 1 of the Municipal Finance Management Act, and section 1 of the Municipal Systems Act.

the debt of a municipal entity "off" the balance sheet, though it is possible and may be desirable to keep ring-fenced, non-recourse debt from being treated as though it were general obligation debt.

The *MFMA* has slightly different rules for municipal entities under shared control, and it does not appear that the financial reports of such municipalities would be consolidated with those of the parent municipalities.

If the SPV were not created and controlled by the City of Johannesburg, but rather by a private entity that would contract with the municipality, then the *MFMA* provisions on municipal entities would not apply. The National Treasury has not taken a position on what circumstances might make it possible for an autonomous entity to collect or distribute revenues collected on behalf of the city. However, it would seem possible for the municipality to contract for services from a private entity, within a geographically bounded area, and limit the municipality's contractual obligation for payments to the amount of the tax increment after a base year.

The financial reports of any municipal entity created as part of a TIF arrangement should be consolidated with those of the parent municipality. Whether or not there is a municipal entity involved the financial statements should note that the municipality's or entity's liability for the debt is limited to specified revenues.

Borrowing for infrastructure beyond the municipal boundary

Extraterritorial service by a municipality: The *MFMA* in Section 46, allows borrowing for "capital expenditure on property, plant or equipment to be used for the purpose of achieving the objects of local government as set out in section 152 of the Constitution…" *This formulation does not limit capital expenditure to any municipal boundaries*, so it is legally possible for any municipality to borrow funds and finance infrastructure that is located in, or which provides services to, any other municipality. Such an arrangement would require the consent of the recipient municipality, in terms of *MFMA* section 164(1)(b), which says that no municipality may "provide a municipal service in an area outside its jurisdiction except with the approval of the council of the municipality having jurisdiction in that area." In this extra-territorial scenario, the service-providing municipality might be the borrower, and the service-receiving municipality might commit to buy services from the provider over a long-term, creating a revenue stream that helps support the borrowing.

Multi-jurisdictional utilities: Going one step further, it is possible to create an entity that covers multiple municipalities. When legislation to implement the *Policy Framework for Municipal Borrowing and Financial Emergencies* was developed, consideration was given to providing for the establishment of special districts on the American model,[34] which could borrow, build infrastructure, and provide municipal services and impose taxes, or fees and charges, but would not be municipalities *per se.* This idea was rejected as inconsistent with the democratic South African local government paradigm, as set forth in the Constitution. The approach that was taken

[34] In 2012, the Census Bureau found 37,203 special districts in the United States. https://www.census.gov/newsroom/releases/archives/governments/cb12-161.html

instead was the "multi-jurisdictional municipal service utility" model described in Part 4, Chapter 8A of the *Municipal Systems Act (MSA)*. The *MSA* provides that a multi-jurisdictional service utility is accountable to the parent municipalities; and must comply with the *MFMA.*

These provisions of the *MSA* and the *MFMA* provide a foundation for intergovernmental cooperation, including infrastructure and services that cross municipal boundaries. The issue of responsibility for any long-term debt incurred in pursuit of such arrangements would be established in agreements between the municipalities involved, and their investor(s). It is easy to imagine how such an arrangement could resemble a pooled finance structure, with the risk that the most creditworthy municipality would act as surety for less creditworthy municipalities.

Consistent with the pooled finance policy described above, it is therefore the policy of National Treasury that any multi-jurisdictional arrangements must:

- Clearly specify how financial risks will be allocated and mitigated; and
- Cover the costs of establishment and operation of the arrangements.

Project finance, revenue bonds, and tax increment financing

"Project finance" refers to the practice of financing investment in reliance on the projected cash flows of a project. Project finance can be arranged through a municipal entity, as described above, and it can also be arranged through the municipality itself. The key is that a lender or investor agrees that it will be repaid only to the extent that specified revenues from a project are sufficient. Sometimes project finance is colloquially referred to as "off balance sheet" financing (though in accordance with South African accounting practice, a project finance obligation would be reflected on municipal balance sheets with a notation that there is no recourse to the general funds of the municipality).[35] For example, if a city plans to build a convention centre, recreational facility, or light rail system, it will collect charges from users. With the right market conditions, projected user charges may be enough to cover the debt service on a loan to pay for the project's construction or acquisition costs. If the city can establish to the satisfaction of a lender or investor that there would be strong customer demand, the parties might agree that the lender would be paid only from the revenue to be generated by the facility, without looking to the municipality to use other funds to repay the loan.

There are at least four reasons why a municipality might issue revenue bonds or pursue project finance arrangements:

1) If the municipality's finances or management may be such that it is not creditworthy, it may nevertheless be able to borrow for specific revenue-generating projects, provided that it agrees to ring-fence the revenues and/or management in a way that gives investors the confidence to lend;

[35] Note that "project finance" debt need not be issued by a municipality. Project debt instruments could also be issued by a creditworthy private entity, which would build and operate a facility, such as a water or electric plant, and sell the output to a municipality. The JSE is preparing listing requirements for such instruments.

2) If the municipality wants to support a “nice-to-have” project like an aquarium or waterfront redevelopment, but does not want to guarantee the success of the venture, it may choose to ring-fence the project, so that the risk of financial failure would be limited, and would not put the city’s overall fiscal health at risk; and

3) A municipality may feel it has reached the limit it considers prudent for general obligation debt, and wants to more directly allocate costs of some new project to beneficial users rather than ratepayers as a whole.

4) If the municipality wants the project to “pay for itself” and not impose costs on ratepayers as a whole.

Revenue bonds can be issued to finance projects. Investors in revenue bonds understand that they will look only to a specifically described revenue stream for repayment. For example, the revenues generated by selling water from the city’s water system, or the rental revenues realized from leasing out a city-owned structure to a private management group, could be pledged to repay bondholders. For cities that need to build large infrastructure projects, such as water treatment plants or electrical generation stations, the revenues realised by selling a portion of that capacity, through development charges (specifically the type of charge that is sometimes referred to as a capital recovery fee or capital connection fee), can be pledged as a revenue stream to repay loans or bonds. Revenue bonds are distinguished from the more typical general obligation bonds that have, until now, been issued by South African municipalities.

Revenue bonds can be backed by development charges. Development charges are described in some detail earlier in this Appendix. From a borrowing perspective, development charges are a revenue source that municipalities can offer as security for revenue bonds (or other debt instruments). Such bonds are appropriate to finance infrastructure that generates new capacity, such as a water treatment plant, a highway interchange, or a storm water facility; provided that the municipality has a development charge scheme in place that ensures that future developers will pay when their developments connect to the water system, when they develop land served by the interchange, or when impervious surfaces create storm water impacts downstream.

Tax increment financing is a type of project finance. Tax increment financing (“TIF”) originated in the USA as a way to finance the redevelopment of blighted urban areas. Because property values in such areas are typically low, but can be expected to rise significantly if transformative public and private investment can be mobilized, the expected differential in property tax collections can be used to finance the cost of public investment. The sequence is as follows:

- The property rates collected from a specific geographic area in a base year, before investment occurs, are documented.

- Tax increment bonds (or other debt instruments) are issued, payable from whatever property rates are collected in future years, over and above those collected in the base year.

- As public investment (in infrastructure) and private investment (in real estate development) occur, the assessed valuation of property in the area rises.

- The incremental increase in tax revenue is used to retire the bonds, and once this is done, the future yield of property rates in the area is available as part of the general funds of the city.

Tax increment financing is sometimes promoted as a "land based financing instrument" or a "land value capture tool." And there are additional land based financing approaches that ring-fence specified revenues for investment in a specified area. These instruments can include;

- Special improvement districts,
- Business improvement districts, and
- Special rating areas.

The general notion behind such tools is that when a city invests public funds in infrastructure or services which result in specific private property increasing in value, disproportionately to other similarly situated properties, then the city should be able to recover a portion of the increased value to help pay for the investment it has made. In other words, these structures allow a municipality to more directly allocate costs of a project to beneficiaries, as opposed to all ratepayers.

These tools carry political and other risks. As noted in the body of this *Update, it* is strongly recommended that, when a municipal council considers ring-fenced financing or spatially targeted investments, the council solicit public input on the potential impacts of the financing arrangements and infrastructure plans, including impacts related to inclusiveness and economic productivity.

Special instruments for specific priorities:

A question has arisen as to whether any special policies should be considered for specific priorities. For example, one suggested target is "green finance." There is no universally accepted definition of this term,[36] though it can be read broadly to include any form of financing that takes into account the environmental impact and sustainability of what is being financed.

The attractiveness of green investments is often in the eye of the beholder. An investor who is interested only in the financial return of his or her investment may not care whether the invested funds will be invested in a "green" project. But even such an investor needs to consider the risk to his or her investment if the project being financed turns out to be environmentally unsustainable. And the investor who wants to do good may be willing to take a slightly smaller financial return if he or she is convinced that the funds invested will be used to reduce global warming or other environmental problems.

---

[36] See Nannette Lindenberg, Definition of Green Finance, DIE (2014) at https://www.die-gdi.de/uploads/media/Lindenberg_Definition_green_finance.pdf

The global market for green bonds is undoubtedly growing, and it may make sense for South Africa's larger metros to issue such bonds. However, no adjustments to the municipal borrowing policy framework are needed to enable such efforts – it is largely a matter of packaging and marketing. To the extent that there are international or national standards for certifying or validating the "greenness" of the investments being financed, municipalities would be expected to comply with such standards.

It is not recommended that any special incentives for particular sectors or types of projects be built into the policy framework for municipal borrowing. That does not mean that a municipality cannot raise funds, pledging to use the proceeds for green investments or other specific priorities (e.g. slum upgrading, or labour-intensive capital projects).

Each elected municipal council must determine its own capital investment priorities. One municipality might be interested in reducing its carbon footprint, while another might be primarily interested in promoting economic growth, or providing clean drinking water for those otherwise without reliable access. If the national government establishes incentives for particular types of investment, a municipality can and should consider such incentives in weighing the financial viability of debt issuance.

Listed vs. unlisted debt instruments:

There is nothing in the *MFMA* or other legislation that requires municipal bonds to be listed. And in many countries, including the US, municipal bonds are not listed on an exchange.

One reason for listing securities (debt or equity instruments) on an exchange is for disclosure purposes - so that buyers have authoritative information about the offerings.

In the case of municipal bonds, disclosure is provided in any event as required by the *MFMA* and the disclosure regulations promulgated thereunder. One could argue that JSE listing, and compliance with JSE listing requirements, is therefore unnecessary.

Notwithstanding that argument, National Treasury is not aware of any municipal bonds since the JSE bought BESA, which have not been listed.

The *Financial Markets Act*, No. 19 of 2012 has some provisions worth noting:

In Section 1 of the Act, "securities" are defined as listed or unlisted …bonds issues by public companies, public state-owned enterprises, the South African Reserve Bank and the Government of the Republic of South Africa…

Note that municipal bonds are not covered by the definition, and thus largely not subject to the Act. This makes some sense, since they have their own disclosure regime, as mentioned.

In Sections 24 and 25 of the Act, it is provided that one can only carry on the business of buying and selling **listed securities** if that person does so through the exchange; and

that transactions in listed securities must be reported to the Registrar.

Note that municipal bonds are again not covered by this provision, since they are not within the statutory definition of "securities." Even if they were included in the definition of securities, they could be unlisted securities, and thus not covered.

The role of public private partnerships

A municipal public-private partnership (PPP) is a contractual agreement whereby a private service provider agrees to provide a service and/or infrastructure on behalf of the municipality. The private party provides the service or infrastructure in exchange for financial commitments by the municipality over a period of time, such as a take-or-pay service agreement. The financial implications of an infrastructure PPP can be similar to those of municipal borrowing, as both involve payments over time. In addition to their potential for financing infrastructure, PPPs involve design, management, rehabilitation, or other services to be provided by the private party.[37]

This *Policy Framework* is limited to policies related to municipal borrowing. There are separate national policies and legislation related to municipal PPPs, which are beyond the scope of this document. PPPs can be complex, and can involve detailed analysis and planning. The successful procurement and ongoing management of a PPP can require significant expertise and capacity. The National Treasury's GTAC unit provides technical assistance to municipalities interested in pursuing PPPs.

[37] A less common PPP structure involves the use of public land for private commercial purposes.