

Municipal Pooled Financing in South Africa

A pre-feasibility study
prepared for IFC

Executive summary

Municipal Pooled Financing Mechanisms (PFMs) can be broadly defined as a cooperation between local authorities with a focus on local infrastructure investments financing through marked-based borrowing. PFM can be an efficient tool to address financing challenges at municipal level in developing/emerging countries, where financial markets and municipalities are sufficiently sophisticated. A wide international experience validates that pooled financing has been very successful in enabling markets-based funding of local infrastructure investments, reducing costs of borrowing and supporting decentralisation. Implementation of PFM been adjusted to political and public sector circumstances in many developed countries and some developing countries. It can range from execution of a single bond issue (club-deal) by several municipalities to the creation of a platform for repeated club-deals and a municipal funding agency, which would be created by municipalities and be aggregating their borrowing needs and issue bonds in the capital market on a regular basis.

This study investigated possibilities to implement PFM for South African municipalities, taking into account their financial situation, legal issues and the state of the local capital market.

Since 1994 the local government system of South Africa has been subject to a number of reforms, including a new division into provinces and municipalities of different categories, administrative and fiscal decentralisation. Introduction of the Municipal Finance Management Act created a basis for integrated development planning and sophisticated financial practices.

South African municipalities face significant infrastructure investment needs, which arise from essential public services delivery backlogs and rapid urbanisation.

Many of the small and medium size municipalities have issues with poor creditworthiness and lack of capacity, which prevent public investments in local infrastructure. Financing of local infrastructure is to a large extent reliant on transfers from central government, but the National Treasury has stated its intention to lower these grants and to incentivise municipalities to use other sources of funding.

Metropolitan areas (metros) and some secondary cities have a reasonably good financial standing and can finance its investments through banks loans and, in some cases, through bond issues.

The Southern Africa Development Bank (DBSA) is the dominant lender to municipalities, but is now seeking other ways to support infrastructure development, for example as an arranger of borrowing in the capital market complementing its own lending.

Municipal bonds have been issued by some of the metros in a domestic capital market, which is considered to be well developed.

PFM could be a way forward to further expand the activities on the capital market and add increased flexibility and diversification in the funding operations for creditworthy municipalities such as metros and some secondary cities. For other municipalities to become a part of PFM intense efforts must be made to increase their creditworthiness and management capacity.

In conclusion, many of important prerequisites of PFM exist today in South Africa. It is recommended to:

1. **Start a process;** a core group of municipalities should take a lead in identifying an appropriate PFM structure, such as club-deals or PFM agency.
2. **Organise the process;** appoint a steering group with local politicians, preferably from more than one political party, and a working group with city managers and CFOs from the involved municipalities.
3. **Procure experts;** internationally experienced experts, alongside with experts with extensive knowledge of the legal system in South Africa.
4. **Produce a roadmap for the process;** this includes detailed organisation, budget, workload, deliverables and time-line.
5. **Conduct a creditworthiness study;** the aim is to answer the question about the level of creditworthiness, which would be sufficient for applying PFM and to what extent the involved municipalities reach this level. It should also recommend a plan to improve municipal creditworthiness.
6. **Conduct a legal study;** this includes the legal framework for municipalities as well as the regulation of the capital market. The study should answer if it is legally possible to introduce PFM in South Africa and what legal set-up is required for such a platform.
7. **Conduct a benchmark study;** this includes the study of PFM business models that are applied in other countries and an assessment of what elements could be used in the South African context.
8. **Structure a first club-deal;** the primary aim is to gain real experience of cities working together and how the capital market receives a PFM bond issue.
9. **Build a stable platform for future club-deals;** using the experience of the first club deal, a stable platform should be built taking into consideration questions related to governance, creditworthiness, credit enhancement etc.

If, after the steps recommended above, the creation of a PFM agency is deemed suitable and possible detailed studies should be made into questions of legal set-up, ownership/stakeholders, capital structure, governance, creditworthiness requirements, internal policies, asset liability management, IT, HR etc.

As an overarching methodology it is suggested that the municipalities themselves are the leaders of this project. They should among themselves organise the process and set the targets. PFM is by definition by and for local authorities. When the basic structure of the process is established discussion with the National Treasury should take place to agree on legal and other features of the process. Subsequently, consultations can be held with other stakeholders, like DBSA, DFIs, pension funds and other that can play a role in applying PFM in South Africa.

IFC could play a very important role in supporting a PFM project. A project like this needs resources to build the platform. For this there will probably be a need for credits that could possibly be supplied by IFC.

IFC could also play an important role in the structuring of club-deals that hopefully will be a first result of the project. Furthermore, the first bond issue will need support, which IFC could supply either through guarantees or through investing in the issued bonds.

If a PFM-vehicle is created, IFC could channel credits directly to this vehicle, which in its turn on-lends the proceeds to municipalities for infrastructure investments.

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During the last 20 years, he has worked as an advisor to local authorities in many parts of the world; recently, in projects to create Municipal Bond Agencies in France and the UK.

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