Policy Insights
82
March 2020

Exploring Pooled Finance for South Africa

PALESA SHIPALANA

African perspectives
Global insights

SOUTH AFRICAN INSTITUTE OF INTERNATIONAL AFFAIRS

Executive summary

In response to the need for local authorities to have access to/receive resources that match their responsibilities, there has been a concerted effort to support the development of new local government (LG) financial tools and deepen financial innovation. Sub-national pooled financing mechanisms (SPFMs), also known as pooled bonds/finance, allow local and regional governments and other entities with similar interests and credit characteristics to access credit markets that would otherwise not have been available to them. Pooling different infrastructure projects increases the size of the transaction, making it attractive to capital market investors. It also substitutes the pooling entity's credit rating with that of the component sub-nationals, thereby meeting the criteria for accessing private funding. SPFMs are thus perceived as creditworthy. Although SPFMs require extensive upfront technical assistance to secure private finance, they have been successful in providing long-term cost-effective finance to local authorities and have also facilitated the development of an attractive asset class for local investors. In the main, the advantages of implementing SPFMs are that they allow greater access to capital markets, lower margins on loans, lower processing costs, lower risks through diversification and financial expertise, incentives to improve creditworthiness, and transfer of knowledge.

All LG entities and municipalities (irrespective of size) need long-term infrastructure financing at a reasonable cost to fulfil their constitutional mandate, which includes infrastructure service delivery. SPFMs have been identified as relevant mechanisms to be implemented in South African municipalities, both in diversifying capital financing sources and in helping to develop domestic capital markets through the provision of a new asset class for private investors. National Treasury (NT) supports South African municipalities' interest in pooled finance at a policy level, but with limiting conditions that require zero risk transfer between entities in a pooled finance arrangement, and that municipalities only borrow when they are creditworthy. Given the developmental role of municipalities, national government should help them to improve their capacity and diversify their sources of finance.

Introduction

To bridge the global infrastructure gap, including the $1–1.5 trillion annual gap in developing countries, there is a need to invest in sustainable, accessible, resilient and quality infrastructure in developing countries. This will help them to achieve the sustainable development goals (SDGs). Globally, investment needs are estimated at $5–7 trillion annually, signalling the importance of actively developing effective financing instruments serving LG where the need for sustainable infrastructure is dire.[1] In Africa alone there is

1 UN, "Report of the Intergovernmental Committee of Experts in Preparation for the 3rd International Conference on Financing for Development, Addis Ababa, 13-16 July 2015, United Nations, New York" (New York: UN, 2015), https://www.undocs.org/A/CONF.227/20.

an estimated $130 billion annual deficit in infrastructure investment, and inadequate institutional investment in infrastructure.[2] Infrastructure development in developing countries can be facilitated by ensuring access to market-based financing in the local currency, enhancing technical support, developing appropriate funding mechanisms and strengthening the capacities and finances of sub-national governments. In addition, there is a need for strong regulatory frameworks to ensure that blended finance (the strategic use of development finance to mobilise commercial capital at scale towards sustainable development in developing countries)[3] benefits local communities.

Many countries (eg, the US, India and Mexico) have started developing or authorising various financial solutions or instruments that allow local and regional authorities to meaningfully participate in resource mobilisation

It is against this backdrop that many countries (eg, the US, India and Mexico) have started developing or authorising various financial solutions or instruments that allow local and regional authorities to meaningfully participate in resource mobilisation to fund critical infrastructure and other service delivery needs at sub-national level. SPFMs have been identified as one of the financial solutions with the potential catalytic role of allowing local governments in developing and emerging countries to diversify their capital financing sources. Although there are different definitions of SPFMs, pooled bonds/finance is used broadly to define this mechanism of pooling the infrastructure investment needs of several LGs in one financing transaction. In simple terms, SPFMs are mechanisms facilitating pooled access (by local authorities) to bond markets and can also make access to large syndicated multi-bank loans more possible.[4]

SPFMs have been identified as one of the financial solutions with the potential catalytic role of allowing local governments in developing and emerging countries to diversify their capital financing sources

2 Gideon Oberholzer et al., "Infrastructure as an Asset Class in Africa" (Discussion Paper, GEGAfrica, November 2018), http://www.gegafrica.org/item/860-infrastructure-as-an-asset-class-in-africa.

3 Organisation for Economic Cooperation and Development, "5 Insights from OECD's Recent Blended Finance Report", Blog, February 12, 2018, https://www.convergence.finance/news-and-events/news/ee0fmoW5fqSow2GM0UyKW/view.

4 David Painter (independent development finance advisor), interview by P Shipalana, November 2019.

The Global Fund for Cities Development (FMDV), a financial engineering organisation, supported by the French Development Agency (AFD), has been advocating for and supporting the use of SPFMs to implement the new Agenda for Development and the New Urban Agenda (Habitat III),[5] and also published the first SPFM policy paper in 2015.[6] Local authorities are at the coalface of service delivery, tasked with responding to the modern world's key issues, including urbanisation, which intensifies the need for infrastructure investment. This raises the profile of local authorities in infrastructure development planning, designing and financing, as well as in overseeing the implementation of sustainable infrastructure.

This policy insight seeks to explore SPFMs as an innovative way of financing infrastructure development in LG in South Africa, drawing lessons from other countries that have used such pooled funding mechanisms. It also discusses South Africa's efforts to facilitate the adoption of SPFMs, as well as any hindrances to their take-up. It concludes with policy recommendations on how to fast-track the adoption of SPFMs in South Africa.

An overview: Sub-national pooled financing mechanisms

SPFMs give local and regional governments joint access to cost-effective private capital (bank finance and bonds) and public financing to fund infrastructure and other public services. Pooled financing is the cooperation between local and regional governments that share similar credit characteristics[7] and are interested in financing local infrastructure through investments from external debt sources, but that do not have the financial scope, scale, expertise and credit history to access credit markets individually. These local or regional governments either want to diversify their capital financing sources or cannot individually access credit markets owing to their limited project capital needs, expertise and credit history. To access private funding, small projects can be pooled by a specialised financing entity to mitigate repayment risk, diversify the investors' project portfolio and provide professional and technical management. Pooled finance may be viewed as the use of a 'blended finance' approach for government-owned and sponsored projects, but differs from public–private partnerships because SPFMs raise debt financing for projects from investors in the capital market without transferring ownership or control of the projects to the private sector.

5 UN, "Transforming Our World: The 2030 Agenda for Sustainable Development", https://sustainabledevelopment.un.org/content/documents/21252030%20Agenda%20for%20Sustainable%20Development%20web.pdf.

6 Global Fund for Cities Development, *Creating the Local Financing Framework for Sustainable Development Goals: The Potential Catalytic Role of Subnational Pooled Financing Mechanisms*, 2015, http://www.agence-france-locale.fr/sites/afl/files/base_documen taire/2017-09/FMDV_Policy-Paper_%20SPFM_ENG.pdf.

7 David Painter (an independent development finance advisor) in peer review notes to Palesa Shipalana dated February 4, 2020, asserts that the pool need not necessarily only include sub-nationals with 'similar' credit quality (although meeting a minimum threshold of creditworthiness is usually advisable). Some pooling entities in the US will accept unrated local governments in their pools if the pooling entity has a powerful means of assuring that LG must repay, eg, a revenue intercept.

There are two key determinants of the final SPFM structure. The first is the country's legal and institutional frameworks as they relate to the financial needs and current state of the domestic financial sector. The second is the perceived creditworthiness of local authorities, which raises the need for credit enhancements in SPFMs in order to get the quality credit assessment necessary to access private finance. However, the entities issuing SPFMs need careful supervision of and transparency in the accumulation of liabilities by LG, which also requires strong independent oversight by public sector finance experts to mitigate risks.

> To access private funding, small projects can be pooled by a specialised financing entity to mitigate repayment risk, diversify the investors' project portfolio and provide professional and technical management

SPFMs can be structured in three ways:

- LG funding agencies: these serve as the principal conduit for LGs' access to credit by issuing bonds in domestic capital markets and on-lending the proceeds to LGs and related entities. All lending to LGs occurs in the domestic currency in order to match the revenues generated by LGs and their projects. The agency converts foreign denominated bond issues into domestic currency using foreign currency swaps that are for the same term as the pooled financing. The counterparty must assume full responsibility for repayment of the hard currency debt over its life (note that such swaps can be difficult to obtain).[8] These agencies do not seek a priori to make a profit, and surpluses in their accounts are reinvested in their activities.
- Municipal bond banks: typically operated by state government agencies at a national level, these are broadly defined as entities that sell their own securities and re-lend bond proceeds to multiple local governments.
- Modified pooled financing funds: can be used to secure both bank loans and bond finance.[9]

SPFMs are constructed in three different ways:

- A group of local authorities working together on financial issues (ie, risk policies, procurement procedures, etc.) creates economies of scale but without borrowing together.
- A 'club deal' is made whereby two or more local authorities issue bonds without creating a special-purpose vehicle (SPV), meaning that each municipality is responsible

8 Painter, interview.

9 FMDV, *Creating the Local Financing Framework*.

for its own repayment. Although this medium-level approach offers small to medium municipalities access to capital markets, it is too complex legally and structurally and comes with higher costs that end up offsetting the low-cost pricing of the bond.

- An SPV acts as an intermediary between local authorities and capital markets, reaching sufficient volumes in its borrowing to diversify its funding operations and achieve cost-efficient pricing. By diversifying, the SPV will have more than one source of funding or market and so reduce its risk. Investors will be attracted to an SPV that is creditworthy with sufficient capitalisation and reinforced guarantees (participating LG entity, development partners, national government, pension fund, local guarantee agency or a mix of any of the latter).[10]

The first and last options require the setting up of separate legal credible entities or another entity acceptable to investors, with a government-owned SPV being the most common requirement. The SPVs must have transparent governance structures and processes, as guided by national legislation, in order to fulfil their role of contracting debt and making debt service repayments.[11] It is, however, possible for the SPV to be non-government owned (ie, by the private sector, development partners or non-governmental organisations).

To ensure the creditworthiness of SPFMs, several levels of credit enhancements can be used:

- In the reserve account model, annual capital grants are placed in a reserve account that is pledged as collateral in the event of the borrower's failure to meet debt service obligations.
- Transferring intercepts are used when an LG defaults on obligations to repay loans, and as an ongoing of debt service, if that is the structure that was used. This model works in jurisdictions where LG intercepts are allowed, and the market also views the model favourably if LG revenues are largely transfers from national government and when these transfers can be redirected from a pooled financing facility to investors.
- Partial credit guarantees can be used to achieve the needed market confidence.[12]

Other credit enhancements include first loss facilities and output-based aid to subsidise those that are unable to pay for services rendered by LGs.[13] By their very nature, credit enhancements are costly, so it is advisable to use them for pooled projects (rather than on small projects) in SPFMs to take advantage of the economies of scale. In developed countries there is more use of SPFM structures that leverage market perceptions of the high creditworthiness of LGs, while in developing countries the use of heavily structured credit-enhanced structures is most common.

---

10 FMDV, *Creating the Local Financing Framework*.

11 Sustainable Infrastructure Portal, "Subnational Pooled Financing Mechanisms for Funding Infrastructure Projects", March 21, 2018, https://infrastructure.iisd.org/research-and-reports/subnational-pooled-financing-mechanisms-funding-infrastructure-projects.

12 FMDV, *Creating the Local Financing Framework*.

13 Urbanet, "Interview with Jean François Habeau", August 2, 2016, https://www.urbanet.info/subnational-pooled-finance-mechanisms/.

In addition, these mechanisms have accountable management processes and lower transaction costs. As a result of all these characteristics, pooled financing facilities not only serve as efficient creditworthy links between infrastructure projects and sources of private capital but also diversify project risk, mitigate debt service payment risk and provide the technical professional management required to access private finance.[14] The resultant sub-national pooled financing facility is deemed creditworthy and able to meet investor requirements for debt service. Through shared mechanisms, local authorities can tap into long-term and competitive private financing in capital markets. However, the creditworthiness of SPFMs must be underpinned by revenues (either own source and transfers) that are predictable and timely, with adequate intergovernmental fiscal transfers as a core component.[15]

SPFMs have been successfully used in providing long-term cost-effective private finance for infrastructure development and public services at sub-national level in developed, emerging and developing countries (eg, Mexico, India, the US, the Netherlands, Sweden, Denmark and France). The Scandinavian and Dutch agencies issued bonds deemed to be a specific asset class in various capital markets in 2014, raising approximately EUR70 billion ($85.159 billion).[16] These mechanisms have been used in both developing and developed countries to secure funds for 40 000 local projects.[17] In developing countries, $3 billion in private finance has been mobilised in the past 15 years (compared to $1 trillion in developed countries) to fund essential public services in the water and sanitation, energy, transport, telecom and education sectors. A small part of the funds has also been used to develop a pooled finance mechanism structure and fund initial underwriting costs (eg, financial advisors, legal support, rating agency fees, etc.); assess and process enabling reforms in legal, regulatory and institutional frameworks; and build capacity in relevant government entities and project preparation.[18] Although SPFMs have proven to be viable financial structures, they have yet to be implemented in Africa.

Benefits of sub-national pooled financing mechanisms

In addition to providing long-term cost-effective finance, SPFMs act as catalysts for the rise of a developmentally oriented LG asset class in domestic capital markets, matching the long-term investment needs of domestic pension funds and other institutional investors with the availability of creditworthy pools of essential infrastructure projects. This is even more important in the context of African countries that are characterised by small, shallow, illiquid, relatively undeveloped and low market-capitalised capital markets. In SADC,

14 FMDV, *Creating the Local Financing Framework*.
15 Urbanet, "Interview with Jean François Habeau".
16 Currency code for the EU's euro.
17 FMDV, *Creating the Local Financing Framework*.
18 Urbanet, "Interview with Jean François Habeau".

the development of capital markets has been recognised as a crucial element in raising much-needed funding for the region's long-term infrastructure and social development programmes through stocks, bonds and other investment offerings.[19]

SPFMs have several benefits.[20]

- Given the lack of access to private markets, the limited availability of domestic long-term debt capital, challenges in project preparation and a limited fiscus, local governments face difficulties in accessing the funding required for essential public services. Furthermore, projects at the sub-national level do not have the scale needed to attract funding. Bonds usually need to be of a substantial size (eg, $25 million or more, depending on the country) to attract capital market investors. This tends to exclude LGs from participating in the market. But with SPFMs, a few municipalities can participate in the market through a pooled bond even though their individual infrastructure projects are below the market threshold. SPFMs therefore help local governments to **obtain finance for local infrastructure development and other essential public services**.
- Well-structured and managed SPFMs can **reduce the financial burden on national governments** by providing prudent financial instruments that enable the mobilisation of municipal capital project financing. They also reduce the financial burden that comes with LG monitoring conducted by national government because they already have built-in periodic financial audits required by private creditors and the technical SPFM management. In addition, LGs benefit from diversified sources of finance, as these allow them to tap into private finance and underutilised resources at local level by optimising user fees for services, tax payments and land. When the SPFM has an independent legal structure, it also provides limiting contingent liabilities for national government, as the shareholder's (local or national government) credit is not affected by a default.[21] In addition, loans from the SPFM are on the balance sheets of the local governments that receive them. An SPV created by an SPFM entity can be structured to be off the balance sheet of the SPFM itself.[22]
- **Through financial engineering and economies of scale, the costs of local infra-structure projects can be reduced in all aspects of the project cycle**. SPFMs successfully reduce transaction, development and management costs, which often impair the ability of small local infrastructure projects to secure funding. SPFMs reduce the perceived risk of the LG by creating a consolidated financial asset that is investible, and improves the latter's creditworthiness. When the risk is lower, interest costs are lower, thereby extending the time period of finance and providing access to lower-cost finance markets such as bonds. Furthermore, SPFMs standardise project

19 Palesa Shipalana and Mopeli Moshoeshoe, "Bridging the Divide: Integrating SADC's Capital Markets" (Occasional Paper 295, South African Institute of International Affairs, Johannesburg, April, 2019), https://saiia.org.za/research/bridging-the-divide-integrating-sadcs-capital-markets/.

20 Sustainable Infrastructure Portal, "Subnational Pooled Financing Mechanisms".

21 FMDV, *Creating the Local Financing Framework*.

22 Painter, interview.

development procedures and processes allowing for economies of scale, in addition to reducing the finance, development, management and monitoring costs.[23]

- SPFMs **act as 'market makers' that stimulate the development of domestic capital markets** by providing institutional investors, banks and other investors with creditworthy investments seen as a new asset class. At times, they ensure stability in the flow of funds and reduce uncertainty in the funding of infrastructure when banks reduce their lending to infrastructure projects. By introducing new competitive pressure in the market, SPFMs challenge existing LG credit providers, thereby helping to reduce interest rates and related fees in the market.[24]
- SPFMs **improve both the quality of projects and their creditworthiness**. Usually, LGs do not have the in-house technical expertise (project development, finance and management capacity) required to develop, finance and operate infrastructure projects. SPFMs serve as conduits for knowledge transfer and capacity building. Sometimes, user fees for SPFM projects are standardised, increasing the predictability and quality of revenues and so enhancing creditworthiness.
- SPFMs **act as a catalyst for the adoption of strict market standards by LGs**, because they require compliance with strict credit standards. They also enable **greater results and transparency** through comprehensive project monitoring.
- The adoption of SPFMs can **create a new 'hard credit culture' for LGs**, which can be contagious locally and regionally – new credit principles and techniques can spread through peer learning, exchange, emulation and collaboration.
- SPFMs **advance the implementation of the SDGs and national development goals by reducing costs to end users and improving operational efficiencies in the provision of local services**. They provide a technical framework to secure public support and private finance for service delivery, which is fundamental to advancing the achievement of the SDGs and national development goals. As such they expand the capacity of local and national government agencies to fulfil their constitutional obligations. More so, SPFMs enable sustainable financial planning and investment capacities at LG level.[25] Specifically, SPMFs are used to help integrate poor, marginalised and underserved secondary cities.
- SPFMs **facilitate development effectiveness**. Support from national, regional and local governments is absolutely essential to the successful development of SPFMs in developing countries, with the long-term and consistent support of development partners critical for securing private capital and catalysing the domestic reforms required (legal, regulatory and institutional frameworks).

23 Painter, interview.
24 Painter, interview.
25 Painter, interview.

Nonetheless, there are preconditions for having successful SPFMs, including, but not limited to, effective political leadership, competent leadership, and sufficient long-term committed funding for technical and consultation costs.[26]

Challenges associated with pooled financing

The Global Fund for Cities Development conducted a review[27] of SPFMs in developing countries that revealed the challenges and risks inherent in SPFMs, owing to the need to develop domestic capital markets, national and LG frameworks, credit enhancements, and the technical capacity for project implementation. To make SPFMs feasible and efficient, the following are needed:[28]

- sustained political support from local and national government, as well as development partners;
- reforms in institutional, regulatory and legal frameworks to enable the establishment of SPFMs, with fiscal decentralisation and devolution being a pre-condition;
- advocacy (for SPFMs to become an essential mainstream financial instrument using a 'blended finance' approach for government-owned and sponsored projects), stakeholder consultation and consensus, with buy-in from private sector investors (rating agencies needed for bond issuance);
- investment in high up-front costs for the development and structuring of SPFMs, and a prudent professional team that will independently supervise them to avoid over-indebtedness of the LG (ensure transparency in all liabilities incurred);
- experts that meet investor requirements (long-term track records in credit and risk management, so that the investment criteria and due diligence fiduciary requirements are satisfied) to manage SPFMs on a technical basis without political interference; and
- independent audits on a regular basis.

Is pooled finance a viable option for South African municipalities?

State of South African municipalities

LG is at the heart of both the government's service delivery system and poverty eradication initiatives. Despite the municipal sphere's budget of ZAR 376.49 billion ($28.42 billion) in

26 Sustainable Infrastructure Portal, "Subnational Pooled Financing Mechanisms".

27 FMDV, *Creating the Local Financing Framework*.

28 Sustainable Infrastructure Portal, "Subnational Pooled Financing Mechanisms".

2017/18,[29] extensive service delivery protests still engulf municipalities. This means more concentrated efforts should be directed at the local sphere of government by both the national and provincial governments, as informed by their constitutional obligations. The financial health of South African municipalities is deteriorating, with worsening audit outcomes (for the 2017/2018 fiscal year) indicating that accountability for financial and performance management continues to decline in most municipalities. The inability to collect overdue fees and taxes from municipal consumers is widespread, with 34% of municipalities in deficit amounting to ZAR 5.8 billion ($437.832 million). The financial troubles of LGs also weigh heavily on municipal creditors, evidenced by the non-payment of electricity and water to Eskom and the water boards. Because of problems like this, 18 municipalities are currently under provincial administration.[30]

Municipalities are constantly struggling to finance their infrastructure needs on their actual balance sheet, and are trying to improve their creditworthiness and gearing ratio. Their main revenue streams are an equitable share of the national tax income, several grants from national government (which in the main are being underspent), and their own revenues generated from their local fiscal basis. Municipalities borrow in the form of long-term loans and bonds – in 2016 their debt totalled ZAR 211 billion ($14.341 billion). With total assets worth ZAR 737 billion ($50.092 billion) in 2016, the debt ratio was 29% against a 45% set NT guideline. Thus, 29c of every rand used to finance municipal operations was borrowed.[31] Municipal debt included 10.9% in loans from the Development Bank of Southern Africa (DBSA), 5.8% in bank loans and 8.1% in bonds. The big four banks[32] are the major players. South Africa's eight metros together furnished almost two-thirds of municipal debt (amounting to ZAR 142.2 billion [$9.665 billion] in 2016/17), followed by local municipalities at 32% (ZAR 72.8 billion [$4.948 billion]). District municipalities accounted for the remaining 5% (ZAR 10.8 billion [$734.05 million]) because they are administrative in nature (ie, not involved in procuring services such as electricity, water and sanitation, or refuse removal). At the end of 2018, ZAR 250 billion ($18.872 billion) was required to develop new infrastructure in metros and secondary cities.[33]

The condition of municipal infrastructure in South Africa is a crucial element in government's ability to deliver services in the country. There is no comprehensive asset register or national data on the condition and age of existing infrastructure. In general, many municipalities do not conform to the requirements of the Municipal Finance Management Act (MFMA), Municipal Systems Act and other legislation that requires them to ensure that adequate provision is made for the long-term maintenance of their infrastructure assets. Given the amount of municipal infrastructure and the often-poor

29 Auditor-General South Africa, *MFMA 2017/18 Local Government Audit Outcome*, https://www.agsa.co.za/Portals/0/Reports/MFMA/2019.06.25/MFMA2017-18%20-%20Section%201%20-%20Executive%20summary.pdf.

30 AGSA, *MFMA 2017/18 Local Government Audit Outcome*.

31 StatsSA, "Financial Census of Municipalities for the Year Ended 30 June 2016", June 28, 2017, http://www.statssa.gov.za/publications/P9114/P9114June2016.pdf.

32 First National Bank, ABSA, Standard Bank and Nedbank.

33 National Treasury, "Legislation and Policy Environment – Infrastructure Financing", June 13, 2018, https://www.salga.org.za/dev/miif/Presentations/Session%20One%201%20National%20Treasury.pdf.

records that have been kept, local municipalities compare unfavourably in terms of strategic planning, asset accounting, planning and making financial provisions to improve infrastructure.[34] Municipalities should allocate sufficient budgetary funding to maintaining infrastructure, have the capacity and competence to carry out this maintenance, and retain skilled staff. The failure to draw up preventive budgets can result in municipalities' incurring significant expenditure in future to replace unmaintained assets. However, many of them do not have even the basics in place, and there are gross shortcomings in maintenance policies and practices.

> The condition of municipal infrastructure in South Africa is a crucial element in government's ability to deliver services in the country

The underlying systematic causes of the ongoing failure of many municipalities to address maintenance backlogs, run a preventive maintenance programme and deliver a reliable, sustainable service are: inadequate budgets (either because of the municipality's being in a distressed financial state or because infrastructure maintenance is not allocated a sufficient budget); and inadequate skills (especially technical skills) and experience to plan and implement the appropriate maintenance.[35] The financial predicament that many municipalities find themselves in is so dire and the operational debt of some municipalities so severe that, even if no further infrastructure were acquired, they cannot catch up with existing maintenance backlogs and restore sustainable operations without innovative external assistance. On the revenue side, municipalities face ongoing non-payment for services and loss of revenue where basic services must now be provided for free.[36]

Is the South African environment conducive to pooled finance?

There is market appetite for municipal finance for infrastructure development,[37] but both metros and intermediary municipalities need more solvability and bargaining capacities to lower the cost of debt and improve their access to funding. Of South Africa's 257 municipalities, only four metropolitan municipalities or metros (Johannesburg, Cape Town, Tshwane and Ekurhuleni) have issued bonds[38] – made possible by the enabling legislative environment created through the MFMA. The City of Joburg issued its first ZAR 1.46 billion

34 Council for Scientific and Industrial Research and Construction Industry Development Board, "The State of Municipal Infrastructure in South Africa and its Operation and Maintenance: An Overview", August 2006, http://www.cidb.org.za/publications/Documents/State%20of%20Municipal%20Iinfrastructure%20in%20South%20Africa.pdf.

35 CSIR and cidb, "The State of Municipal Infrastructure".

36 CSIR and cidb, "The State of Municipal Infrastructure".

37 Nedbank (officials), interview by P Shipalana, November 2019.

38 StatsSA, "Four Facts about Municipal Debt", http://www.statssa.gov.za/?p=11266.

($139 million) green bond in 2014, which was used to fund green initiatives.[39] The 10-year bond, underwritten by Standard Bank, was 1.5 times oversubscribed and followed World Bank guidelines.[40] The ability to successfully absorb credible bonds affirms the sophistication of the South African bond market. In addition, the ability of the four metros to successfully issue bonds means that the market is mature enough to consider pooled bonds, which is an alternative debt-funding avenue to source financing for infrastructure projects. Infrastructure bonds are riskier because they are linked to a single project and because of the public sector's reputation when it comes to project implementation. Infrastructure funds are an increasingly popular option for investors, as these enable them to invest in a range of diversified projects to spread their risk. General bond issuance is less risky because it offers a diversified set of revenue sources for debt service. In addition, by virtue of being a general bond, the risk of failure lessens. Institutional investors look for steady, predictable and inflation-adjusted income streams, which mainly involve mature and operating assets that generate income. This criterion is usually met by economic infrastructure, which investors consider to be an asset class – unlike social infrastructure, which is less likely to be considered an asset class.[41] This supports the case for pooled bonds and the development of an LG asset class in the country. In general, however, challenges such as municipalities' limited capacity to access banking and financial markets, and high interest rates remain barriers to access these resources.

> There is market appetite for municipal finance for infrastructure development, but both metros and intermediary municipalities need more solvability and bargaining capacities to lower the cost of debt and improve their access to funding

Municipalities are mandated to provide all types of infrastructure, which is why they need to attract pension funds and the private sector in general to help them develop social infrastructure where possible. According to the FMDV, which has not been active in South Africa since 2016, no pooled bonds have been issued in South Africa to date (there is also no information or data about funds raised using any of the SPFM mechanisms). There was an attempt by the City of Joburg to pilot a pooled bond in 2015 with secondary municipalities, and the City of Cape Town is exploring its first pooled bond.[42] In an effort to raise awareness about SPFMs, the FMDV engaged with local policymakers and stakeholders such as NT,

---

39 Johannesburg Stock Exchange, "City of Johannesburg Lists First Green Bond in South Africa", Press Release, June 20, 2014, https://www.jse.co.za/news/city-of-johannesburg-lists-first-green-bond-in-south-africa.

40 World Bank, "World Bank Green Bond Process Implementation Guidelines", http://pubdocs.worldbank.org/en/217301525116707964/Green-Bond-Implementation-Guidelines.pdf.

41 Oberholzer et al., "Infrastructure as an Asset Class in Africa".

42 FMDV (official), interview by P Shipalana, October 2019.

DBSA, the South African Local Government Association (SALGA), the AFD, the South African Cities Network, etc. This culminated in a local workshop on SPFMs in 2016, indicating that advocacy regarding SPFMs is now being recognised. The latter three institutions have been playing a key role in promoting the use of SPFMs in the country. On the continent, the FMDV is raising awareness of and helping initiate pooled finance in Uganda and Morocco.[43]

National and international institutional partners should also play a greater role in supporting municipalities through capacity building and technical cooperation, together with guarantee offers. Development finance institutions (DFIs) such as the DBSA, AFD, KfW, European Investment Bank, International Finance Corporation, USAID and the State Secretariat for Economic Affairs have introduced different tools dedicated to helping municipalities to improve their capacity to access borrowing, and foster the market's appetite for sub-national debt. Most of the financing tools are first addressed at central government, with a few DFIs having experienced direct loans to municipalities. Furthermore, commercial banks always proclaim their interest in better understanding municipalities' projects in order to offer loans that are more adapted to local needs for long-term and cheaper funding. Other investors such as local pension funds have also expressed interest in local infrastructure investments, provided that risk remains minimal. The South African pension fund industry is well established, being the eighth largest in dollar terms globally.[44] Pension funds can contribute to an investment-led economic recovery by voluntarily localising a small portion of their investment strategies. However, given the current controversy surrounding prescribed assets in the country, the government should initiate an open and transparent discussion with pension funds and the private sector to discuss how they can help develop social infrastructure where possible.

Impediments to the uptake of pooled finance in South Africa

South Africa is a good fit for SPFMs since it has a well-developed capital market. However, there are other prerequisites, including LG consensus, awareness of SPFMs, and the buy-in of the private sector. Even with well-developed capital markets in developing countries such as South Africa, Morocco, Uganda, Mexico and India (the latter two countries are considered to be advanced), it takes time to institute the necessary reforms. For example, after the introduction of SPFMs in France, it took 10 years for a pooled bond to be issued

South Africa is a good fit for SPFMs since it has a well-developed capital market. However, there are other prerequisites, including LG consensus, awareness of SPFMs, and the buy-in of the private sector

43 FMDV (official), interview.

44 Oberholzer et al., "Infrastructure as an Asset Class in Africa".

owing to the legal, institutional and regulatory reforms that had to be undertaken, and four years to get consensus among different entities and to structure the instrument.[45]

SPFMs cannot be developed without a local asset class that has been tried, tested and analysed by the marketplace. Investors and the local authority issuing the bond need to have confidence in that asset class. South Africa's ZAR 3.4 trillion ($235.187 billion) infrastructure programme needs investments from the public and private sector, including institutional investors, who have ZAR 3 trillion ($207.518 billion) worth of assets under management.[46] Pooled bonds would provide an additional source of funding for infrastructure projects and give institutional investors an opportunity to participate in infrastructure projects through listed, tradable securities with superior risk-adjusted returns. The need for infrastructure development is undisputed, but borrowers will have to learn to trust the local infrastructure bond market and the government will have to create an environment that encourages the issuance of infrastructure bonds. The South African government should consider a tax exemption for pooled bonds (as done in the US and in some cases in India), as well as specific exemptions for infrastructure bonds and/or funds to encourage their use as an alternative funding mechanism.

SPFMs cannot be developed without a local asset class that has been tried, tested and analysed by the marketplace. Investors and the local authority issuing the bond need to have confidence in that asset class

While there are serious challenges with local municipal governance systems, capacity to implement infrastructure projects, etc., pooled finance's failure to take off does not lie with the municipality or potential investors. It is the result of the limiting behaviour of the national government, SALGA and NT, which devolve substantial responsibilities to cities while issuing municipal finance regulations that limit their ability to raise funds. This is often driven by a disinclination on the part of national departments responsible for the country's sovereign rating and national revenues to allow cities to hold their own purse strings – and rightly so, given their past performance. NT has effected the necessary reforms to the related LG frameworks in order to create an enabling legislative environment to help municipalities raise funding. For example, the newly updated municipal finance borrowing framework that is going to Cabinet for approval – the MFMA and the Municipal Systems Act – currently allows for pooled finance.

45 FMDV (official), interview.

46 Deloitte, "Project Bonds: An Alternative Source of Financing Infrastructure Projects", https://www2.deloitte.com/za/en/pages/finance/articles/project-bonds-an-alternative-to-financing-infrastructure-projects.html.

The legislative framework for LG makes it clear that municipalities are autonomous, and NT's role in their borrowing decisions is only to comment on the risks associated with the impending borrowing decision, not to approve/refuse.[47] The municipal finance reforms set out clearly what financial activities can (eg, borrowing for long-term investments) and cannot (eg, borrowing for operational expenditures) be undertaken, giving the market sufficient room to stimulate financial innovation to promote alternative funding mechanisms. For example, the newly updated municipal finance borrowing framework is cautious about the broader risks around implementing SPFMs, and sets two conditions. First, pooled finance 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 the debts of another entity.[48] The transfer of risk between municipalities in a pooled bond is not necessary and not preferred, as it will draw down the risk of creditworthy municipalities in the scheme. It is this perceived transfer of risk between local entities that caused the lack of appetite from government when SPFMs were first introduced in South Africa. However, if structured correctly, pooled financing will not transfer risks between the parties.

The establishment of a sound structure for the SPFM is important – it will be credit rated and act as an issuing agency[49] that selects the municipalities that can participate in the pooled bond. It must ensure that the municipalities can repay the load (ie, municipalities must demonstrate that they can pay for the operational costs, current liabilities and the new loan from the pooled bond). The SPV should hold a debt service reserve fund for a specific period as a form of financial collateral held in trust to repay bondholders if there is a municipal default. In addition, allowing for a revenue intercept from the equitable share will create a mechanism whereby investors are guaranteed repayment of the debt. Intercept funds can be put in a separate account and linked to a specific bond issue, providing an institutional rating to strengthen and enhance the transaction rating of the specific bond issue.[50] That is to say, because they are autonomous, municipalities have their own institutional rating, but it is possible for an underlying municipality not to have a rating in a pooled bond if it is very small or poor (cannot afford to pay for a rating). In such a case, the SPFM would act as a credit quality reviewer hiring a third party to do the credit rating of the SPFM as an institution. In 2000 the City of Tshwane attempted a bond with a revenue intercept that NT did not approve.[51] The revenue intercept funds would be the Medium-Term Expenditure Framework budget allocation for a municipality. The bigger the revenue intercept fund, the bigger the bond that can be issued, the bigger the amount that can be borrowed by municipalities, the lower the interest and the longer the bond issue. Pooled bonds would be in local currency because LG only has local currency revenue, which would

47 National Treasury officials (Pretoria), interview by P Shipalana, November 2019.

48 NT, "Policy Framework for Municipal Borrowing" (Unpublished 2017 update).

49 Painter (peer review) points out that there is a difference between an institutional SPFM and a transactional SPV. 'Pooled financing entities', commonly known as SPFMs, over time enter into financing transactions (bonds or syndicated long-term loans) for numerous pools of LGs and SPVs, which are the specific structures of a specific financing transaction and the named source of repayment. However, an SPFM entity may create an SPV for the purpose of issuing bonds for a specific pool of LG projects. An SPFM entity may itself be created as an SPV, but if so, it can still create a series of subsidiary SPVs to finance each pool it creates.

50 Painter, interview.

51 Painter, interview.

negate the need for hedging given the rand's volatility (which increases the repayment risk). The SPV would have a loan agreement with each participating municipality. Municipalities with a good credit rating would get a good interest rate from the SPV, which may add a small margin to be used for its operational costs. Both national and local government could own the SPFM together with a DFI. Alternatively, another form of an SPFM such as an LG bond bank could be established with special powers to intercept.

While some DFIs active in this space locally are keen on supporting local municipalities with capacity and pooled financing mechanisms,[52] the DBSA's reluctance to fulfil its municipal finance mandate by facilitating pooled finance is undeniable. There seems to be scepticism around the rationale for pooled finance – why would a creditworthy metro want to do a pooled bond with a secondary municipality that is not creditworthy? SALGA and the City of Joburg tried (a few years ago) to put together a pooled bond for select Gauteng municipalities under the leadership of the Office of the Member of the Executive Council/ political office. Western Cape municipalities are also currently exploring a pooled bond. In order to overcome South Africa's development finance gap, there is a need for political will from both local and national leaders, complemented in equal measure by new ideas and innovations such as pooled finance. Developing countries have been marginalised in terms of global finance – so much so that not only do they need to secure greater participation in global finance, but they must also use global financial instruments for development more frequently and effectively. Furthermore, the dominance of the DBSA, which lends more to poorer municipalities than banks do, as well as the increasing presence of DFIs should encourage efforts to develop and support a vibrant LG debt market.

Pooled finance would take off in the local market if the DBSA were to provide de-risking mechanisms for LG infrastructure projects. De-risking mechanisms for pooled bonds work the same way as bond issuance, thus one needs a guarantee against transaction failure, fees, interest rates and currency fluctuations. Creditworthy or not, a guarantee is needed in case the market fails. The City of Joburg's first green bond issuance employed the same de-risking mechanism. DFIs see the DBSA as a partner in LG infrastructure development, not as a competitor (which is the case with banks). In the same vein, they should be working together towards de-risking LG infrastructure projects. The AFD has been active in the South African LG market, providing bond issuance guarantees and de-risking mechanisms that enhance the credit quality of municipalities, enable project bankability and extend the debt tenor to better meet project needs.[53]

Given the failure of pooled finance to take off, the DBSA is suspected of exploiting its 'near monopoly' position by undercutting competitors in the market since it has a lot of low-cost capital and a captured LG market.[54] The DBSA could have helped to develop an asset class for infrastructure in South Africa by now if it had been offering standard terms and

---

52 French Development Agency (official),interview by P Shipalana, November 2019.

53 Agence Française de Développement, "Innovative Financing Instruments", https://www.salga.org.za/dev/miif/Presentations/AFD%20innovative%20financing%20muni.pdf.

54 Painter, interview.

Pooled finance would take off in the local market if the DBSA were to provide de-risking mechanisms for LG infrastructure projects

conditions for all borrowers. National government can reform LG financing and prevent a monopoly in municipal lending. The creation of a bond bank is one solution, but it will require political will. Current reforms also need to be bolstered by diversified revenue sources for municipalities and technical capacity to implement infrastructure projects. One of the challenges is leadership/officials failing to develop, implement and monitor effective systems and processes of internal control, including corrective action.

Against the backdrop of LGs' crippled condition, regulatory heavy-handedness will not resolve the lack of LG creditworthiness and technical proficiency. At the same time, the financial market's lack of readiness to participate in municipal finance is another factor limiting the take-off of pooled finance in South Africa. The DBSA sources capital from across the world and has considerable technical skills that could be used to assist municipalities with infrastructure development and finance.[55] In addition, NT also has a Government Technical Advisory Centre that can help with technical capacity at LG level. By virtue of having a 'near monopoly' of municipal finance, the DBSA should play a leading role in finding innovative ways to finance LG infrastructure projects and develop an infrastructure asset class in the country to diversity municipal financing sources.

Against the backdrop of LGs' crippled condition, regulatory heavy-handedness will not resolve the lack of LG creditworthiness and technical proficiency. At the same time, the financial market's lack of readiness to participate in municipal finance is another factor limiting the take-off of pooled finance in South Africa

Conclusion and recommendations

Several pooled finance mechanisms have been explored, showing that the final financial arrangement should be made in accordance with the national legal framework,

55 Painter, interview.

municipalities' capabilities, and market interest. SPFMs require significant investment upfront, including sustained long-term effort and complicated processes, especially in developing countries. However, they also have the potential to deliver significant returns, including acting as catalysts for domestic capital markets and as levers for transforming enabling domestic frameworks. Notwithstanding the requirement for extensive upfront technical assistance, SPFMs are cost effective, with long-term low-cost finance, low operating costs, and low default rates. However, SPFMs can only be successful if LG has a culture of accountability and the full backing and endorsement of national government, which creates a conducive environment.

In South Africa, a culture of intergovernmental cooperation and mutual partnership is promoted between the three spheres of government, giving the implementation of pooled finance more impetus. Interventions have been made to improve the legal, regulatory and institutional frameworks for LG, yet the uptake of SPFMs has not occurred. LGs need support to enable them to achieve a stable financial status, which can be done if they improve their revenue collection capacity. Also, greater authority over all their sources of revenue – such as allowing revenue intercepts – would go a long way towards their credit-enhancement.

This policy insight makes the following recommendations:

- The DBSA should initiate de-risking mechanisms for LG infrastructure projects. This can be done by establishing a fund (for example) directly or in partnership with DFIs that are already active in the domestic market to facilitate the de-risking of opportunities/LG infrastructure projects to the extent that they become attractive to other funders in the market and leverage additional funding from other private or donor funding sources.
- NT should consider a tax exemption for pooled bonds, as well as specific exemptions for infrastructure bonds to encourage their use as alternative funding mechanisms for LG infrastructure.
- In spite of efforts by national and local government, middle-sized and smaller municipalities have not benefited from loans for investments and have not improved their solvency position, while their investment efforts have been constrained by the lack of tailored financial products. NT should work with interested DFIs to support the development of a pilot SPFM entity and its initial pooled financing transactions to introduce the concept in the South African capital market.

Author

Palesa Shipalana
is an economist specialising in development finance and is currently the head of SAIIA's Economic Diplomacy programme. She holds an MCom from the University of the Witwatersrand and an LLB from UNISA.

Acknowledgement

The author is grateful to David Painter, an independent development finance advisor based in the US, for his guidance and review of this policy insight.

SAIIA gratefully acknowledges the support of the Swedish International Development Cooperation Agency (SIDA) for this publication

About SAIIA

SAIIA is an independent, non-government think tank whose key strategic objectives are to make effective input into public policy, and to encourage wider and more informed debate on international affairs, with particular emphasis on African issues and concerns.

SAIIA's policy insights are situation analysis papers intended for policymakers, whether in government or business. They are designed to bridge the space between policy briefings and occasional papers.

Cover image

Building workers stand on scaffolding beneath the roof structure during the construction of the Mall of Africa retail space at the Waterfall City residential and commercial urban development (Waldo Swiegers/ Bloomberg via Getty Images)

SOUTH AFRICAN INSTITUTE OF INTERNATIONAL AFFAIRS

African perspectives. Global insights.

Jan Smuts House, East Campus, University of the Witwatersrand
PO Box 31596, Braamfontein 2017, Johannesburg, South Africa
Tel +27 (0)11 339–2021 • Fax +27 (0)11 339–2154
www.saiia.org.za • info@saiia.org.za