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ACHIEVING A VIBRANT SOUTH AFRICAN

MUNICIPAL SECURITIES MARKET

By
Thomas H. Cochran
Michael Schaeffer
Kenneth R. Von Der Heiden
George E. Peterson

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A NOTE ABOUT THE AUTHORS

Thomas H. Cochran heads MBIA & Associates - International Consulting. Mr. Cochran is a former public official, investment banker and regional policy researcher now working principally in the field of infrastructure capital market development internationally. He has served in the Office of the Mayor of New York, the New York City Board of Education and the Office of the Governor of New Jersey. He has also founded and directed a non-profit regional economic policy research organization still active in Washington, DC and worked for almost a decade as a senior municipal finance investment banker for Lehman Brothers, in charge of the North Atlantic Region. He has directed the International Public Finance Program since its inception in 1992 as part of the Resources Development Foundation, and presently as an activity of the Institute of Public Administration. He holds an B.A. in Psychology from Beloit College, and an M.P.A. from the Woodrow Wilson School of Public and International Affairs of Princeton University.

Michael Schaeffer is a Director of RMS International a small financial consultancy based in Paris, France and Washington, D. C. His background includes professional management experience in municipal and corporate finance, privatization of municipal and corporate assets, developing joint ventures in emerging markets, credit analysis, appraisal and evaluation. Before joining RMS International Mr. Schaeffer served as a Country Risk/Project Finance Economist with a Canadian Bank; as a Strategic Management Consultant with a large International Management Consultancy, and as a Merger and Acquisitions Specialist with a U.S. Fortune 500 company. Mr. Schaeffer's consulting experience has taken him to Eastern Europe and the CIS, Latin America, Africa and South East Asia.

Kenneth R. Von der Heiden has enjoyed a forty year career in the municipal securities markets. His background includes professional management experience in several aspects of the marketplace including President, The Guaranty Risk Services subsidiary of Enhance Financial Services Group, where he also served as Executive Vice President of Enhance, and Executive Vice President, Board Member and Chairman, New Products Committee of its major credit enhancement subsidiaries. Prior to that, he spent several years at John Nuveen & Co., and Kidder, Peabody & Co. as manager of their respective Municipal Departments. His industry affairs activities include Treasurer and Board Member, Public Securities Association; Vice President, Municipal Forum of New York; Board Member, Municipal Bond Club of New York, and Member of the Professional Qualifications Committee of the Municipal Securities Rulemaking Board.

George E. Peterson is a public finance economist and Senior Fellow at the Urban Institute. He is the author of several books on infrastructure financing in the United States, and served as Chairperson of the National Research Council of the National Academy of Science's task force on urban infrastructure development. Dr. Peterson has completed a comparative study of municipal credit intermediaries to be published by the Urban Management Porgramme of the World Bank and United Nations (Habitat), and has directed projects designed to help build local credit markets in the Czech Republic and Romania (for USAID), in the Philippines (for the World Bank) and in Colombia (for the Inter-American Development Bank). He received his Ph.D. in economics from Harvard University, his M.A. in philosophy and politics from Oxford University where he was a Rhodes Scholar, and his B.A. in history from Amherst College.

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Acronyms

ABSA	ABSA Bank
BA	Bankers Acceptances
BESA	Bond Exchange of South Africa
BIS	Bank of International Settlements
BMA	Bond Market Association
CDE	The Center For Development and Enterprise
CEM	Credit Evaluation Model (INCA)
CGIC	Credit Guarantee Insurance Corporation of Africa Ltd.
CIP	Capital Investment Plan
COSAB	Council of South African Banks
DBSA	Development Bank of South Africa
DC	District Council
DCD	Department of Constitutional Development
EPIQ	Environmental Policy and Institutional Indefinite Quantity Contract
Eskom	Electric Energy Company of South Africa (Parastatal)
FFC	Financial and Fiscal Commission
FMCA	Financial Markets Control Act
FNB	First National Bank
GJMC	Greater Johannesburg Metropolitan Council
ICG	Intergovernmental Grants
IFC	International Finance Corporation (World Bank)
INCA	Infrastructure Finance Corporation Limited (South Africa)
IRG	International Resources Group
JSE	Johannesburg Stock Exchange
LALF	Local Authorities Loan Fund
LAC	Local Area Councils
LGTA	Local Government Transition Act
LC	Local Councils
MC	Metropolitan Councils
MEC	Member of Executive Council (Provincial Dep't. Head)
MIP	Municipal Infrastructure Program
MLC	Metropolitan Local Councils
OTC	Over the Counter (form of securities trading)
R	Rand(s)
RC	Regional Council
RDP	Reconstruction and Development Program
REPC	Representative Councils
RFP	Request for Proposals
RSA	Republic of South Africa
RSC	Regional Services Council
SA	South Africa
SARB	South African Reserve Bank
UI	Urban Institute
UNEXcor	Universal Exchange Corporation
USAID	United States Agency for International Development
YTM	Yield to Maturity

Executive Summary

A recent analysis undertaken by the Urban Institute (UI) for the Republic of South Africa (RSA) and the United States Agency for International Development (USAID) identified a number of constraints on attracting private investment into the South African local authorities. According to figures provided by the South African Reserve Bank (SARB), approximately R9 billion of local authority bonds is held by South African investors. Much of this debt was issued prior to 1989 when prescribed asset allocations were still in force, and institutional investors were mandated to purchase this debt. Furthermore, the central government of South Africa provided implicit guarantees of local authority debt.

Over the past decade, local municipal governments experienced some significant degree of financial stress. However, the amalgamation process has placed sharply increased financial stress on local authorities during the past two years. This has resulted in strained municipal budgets and a small but increasing rate of local government defaults and near-defaults. Subsequent to South African elections in 1994, the central government made an official determination that it does not guarantee local authority bonded debt.

Presently, there are few new local authority bonded issues being originated and little of the already issued local authority bond issues are being traded. A more robust primary market for local authority short-term debt remains, although there is no evidence of trading in such instruments. In contrast, private sector short term debt instruments such as bankers acceptances do trade actively.

INCA is one exception to the prevailing pattern of stagnation in the long term local authority debt market. INCA has successfully floated its own senior debt and originated loans to localities (transactions executed as local authority bond issues purchased by INCA). INCA's own debt does trade albeit infrequently.

In view of the magnitude of local government debt outstanding, and the estimated medium term future infrastructure financing requirements estimated at R170 billion, there is an urgent need to stimulate the primary and secondary municipal credit market(s). This report presents the main findings of the Urban Institute's examination of the South African primary and secondary debt markets. At the request of INCA, and with the sponsorship of USAID and its contractual relationship with The International Resources Group, the Urban Institute under the direction of George Peterson organized the team of Thomas Cochran, Michael Schaeffer, and Kenneth Von der Heiden to assess the current state of the South African municipal debt markets and recommend actions which could be taken by INCA or others to stimulate a more active market. The team was asked to give particular emphasis to providing "assistance to INCA in the creation of a Secondary Municipal Bond Market." This report examines current obstacles to primary and secondary market municipal credit activity and presents recommendations to stimulate additional activity in these markets over the short, medium, and long terms.

Sub-sovereign governance and finance issues are by their nature diffuse and typically do not capture or consistently hold the attention of powerful decision makers. Nonetheless, a great deal is at stake in improving South African sub-sovereign governance and finance. The South African Constitution vests such substantial power and responsibility at the local level that the ability of the public sector to deliver on the promises of the post-apartheid era rests heavily on the shoulders of local government. Failure to perform at the local level would prove disastrous to the new South Africa.

Principal Findings

Our principal findings and recommendations can be summarized in four broad categories, as follows.

First, there is some objective evidence that at least certain sub-sovereign credit characteristics (e.g., local tax and fee collection rates, need for short-term borrowing to smooth cash flows, etc.) are continuing to deteriorate in much of South Africa, despite sustained central government attention and increasingly rigorous collection efforts encouraged by the RSA. For example, nonpayment rates for taxes and user fees have steadily increased over the last year for all large, medium and small municipal categories. As of June 1997, small municipalities have the largest percentage of tax and user fee arrearage. These non-payment rates now stand at 38.2%, followed by medium and large cities at 31.7% and 28.7%, respectively. Due to the general increase in total customer billings and increases in service price levels, total collected revenues have increased. In general, the incremental increase in user fee receivables has expanded at a faster rate than the incremental increase in revenues. However, it should be noted that these are aggregate data and there are municipalities which have substantially lower non-payment rates than the averages.

Most of the investor community remains anxious and skeptical about the willingness and/or ability of most local public borrowers or prospective borrowers to pay debt service on long term obligations. Hence, there can be only modest improvements in the primary and secondary markets for local authority debt until the fundamental building blocks of a sound and stable sub-sovereign public finance system have not only been conceived but put effectively into place. The conceptualization and design process is well-advanced, but implementation is still at an early stage. The fundamental skepticism currently characterizing the investor community responsible for the near grid-lock in the primary and secondary markets is not likely to subside until this process is far more advanced.

Second, in South Africa as in most places around the world, primary and secondary markets are so mutually interdependent that any action which helps or hurts one will almost certainly help or hurt the other. Key government decision-makers seem keenly aware of the relationship between the heath and stability of the overall system of local public finance and the ability of primary and secondary capital markets to finance much of the infrastructure investment required by a citizenry with high expectations. Dramatic indications of the government's understanding of this and related issues include the national and provincial governments' forceful and initially successful intervention in the Johannesburg debt crisis. This strategy may have avoided the appearance of a sovereign guarantee and thus strengthened the developing hard credit culture among local authorities throughout the country.

Equally significant, but not as well understood among investors and others are 30 other interventions of the National Intervention Program which have resulted in corrective instructions being issued by provincial Members of the Executive Council (MECs) responsible for local government to local authorities which were found by Project Viability or through other means to be in some degree of financial distress due to mismanagement and/or other problems. The National Intervention Program, an RSA initiative developed over the last two years, has reportedly completed an additional 70 management audits and assisted MECs in drafting instructions which are to be finalized and sent to local authorities by the end of 1997. The team views this record of monitoring, problem identification and initial steps back toward sound management as being very favorable signals about the future of South Africa's local debt markets.

Third, it is likely to take up to two years before the critical elements of a sound sub-sovereign public finance system can be put fully into place and shown to function properly. Current plans call for some vital components to take even longer, e.g., a multi-year phase-in of the critical intergovernmental transfer formula. The need for this new formula to be fully implemented as speedily as possible is urgent.

During this transition period, certain steps can be taken by INCA and/or third parties to increase the liquidity of INCA's own senior debt obligations. This, in itself, is important because INCA is already both a primary and secondary market participant; increased liquidity in INCA bonds is itself increased market liquidity. INCA can swiftly build its portfolio of investments through improved primary transaction origination, secondary market purchase and/or swaps, and potentially other means. Improved marketing and application procedures, a more predictive credit evaluation modeling capacity, use of new forms of structural and legal risk mitigation, increased use of revenue bonds, and use of serial bond structures for both INCA's and the borrowers' debt structures are among the methods INCA can employ as it builds and maintains the credit strength of its portfolio.

Fourth, other steps can be taken which may improve the activity and liquidity of the broader sub-sovereign market in the near term. These include such actions as requirements that the valuation of securities held in portfolios be done on a current market basis (usually referred to as "mark-to-market" requirements), improved disclosure of holdings by all classes of institutional investors, and improved information flows to all sub-sovereign market participants. These improvements are likely to assist INCA's own liquidity as they increase the level of activity and liquidity of the broader market. Perhaps more importantly, they will help prepare the way for a far more vibrant market once the building blocks have all been put into place and are functioning effectively.

Introduction

South Africa's parastatal and private infrastructure capital markets are sophisticated, demonstrating relatively active primary and secondary market characteristics[1]. However, the same level of sophistication and liquidity is not evidenced in the municipal bond market.

According to figures provided by the South African Reserve Bank (SARB), approximately R9 billion of local authority mid- to long-term bonds are held by private South African institutional investors. Much of this debt was issued prior to 1989 when prescribed asset allocations were still in force, with institutional investors mandated to buy this or other government debt. Furthermore, the central government of South Africa provided implicit guarantees on the local authority (sub-sovereign) debt. Approximately, one-third of the R9 billion in local authority bonded debt is held by South African banking institutions with the remaining two-thirds held by pension funds and insurance companies.

Recent analysis undertaken for the RSA by USAID, The Urban Institute, and the International Finance Corporation (IFC-World Bank) among others have identified a number of constraints in attracting private investment to local authority debt. As local governments amalgamate and reorganize into newly democratic entities which strive to extend services to a much larger constituency, they have experienced sharply increased financial pressure. This has resulted in strained municipal budgets and a small but increasing rate of local government defaults or near-defaults. Subsequent to South African elections in 1994, the central government determined and communicated to the investor community that it will not guarantee local authority bonded debt. For these and other reasons, most of the local authority bonded debt is not traded, and little primary market activity is occurring. A more robust primary market for local authority short-term debt continues in the form of overdrafts, bankers acceptances and other instruments. This primary market is growing, although there is no evidence of trading in such instruments.

The Infrastructure Finance Corporation Ltd. (INCA) is one exception to the pattern of stagnation in the local authority long term debt market. INCA is a unique institution in the team's experience in that it is a wholly private entity established to on-lend to local authorities to finance municipal infrastructure projects. INCA has successfully floated its own senior debt and originated loans to localities (transactions executed as local authority bond issues purchased by INCA). Finally, INCA's own debt does trade, albeit not in as great a volume as many market participants would prefer. Still, according to BESA, INCA stock was the 6th most active institutional stock on the exchange.

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[1] Parastatals include Eskom, Telkom, and Transnet.

A number of strategies are currently underway to assist in the development of the local bond market including the efforts of INCA. At the request of INCA, and with the sponsorship of USAID and its contractual relationship with The International Resources Group, the Urban Institute organized the team of Thomas Cochran, Michael Schaeffer, and Kenneth Von der Heiden to "provide assistance to INCA in the creation of a Secondary Municipal Bond Market."

Specifically, the team:

- Reviewed the existing municipal capital finance system;
- Analyzed the risks and rewards of stimulating the secondary market;
- Identified the key market mechanisms;
- Provided suggestions for overcoming municipal debt market stagnation; and,
- Provided suggestions for INCA in improving the sub-sovereign bond market.

The report examines the primary obstacles to expanding municipal credit market activity (primary and secondary) in South Africa and explores options for INCA, capital market regulators, and other parties to strengthen the local authority debt market. An expanded version of this report, including specific business recommendations to INCA, was prepared and submitted on a restricted basis to INCA.

1 Local Authority Fiscal and Debt Finance Overview

The amalgamation of previously separated areas over the past two years has increased the geographic area and population which many local authorities must serve. There has, however, been little corresponding increase in the tax base of the newly amalgamated local authorities due to the impoverished and previously under-served nature of most of the people brought into the expanded jurisdictions. Service backlogs, deteriorating infrastructure, administrative inefficiencies, and escalating accounts receivable have combined to place many local government authorities under sharply increased financial stress. Perceived credit worthiness has fallen and access to mid- to long-term debt has been sharply reduced. Nonetheless, INCA and The Development Bank of Southern Africa (DBSA, (the government's development finance agency now focused principally on infrastructure development) still provide some capital market access for some local municipalities.

The difficulties in municipal government finances have transcended the primary and secondary municipal debt bond market. The following sections serve as a brief overview of the current state of the municipal government finance system.

1.1 Structure of Local Government

South African local governments are currently undergoing profound transitions. The 843 local authorities are experiencing a range of parallel changes to their political and socioeconomic bases. In addition to substantial changes in municipal government personnel, the structures, functions and operational and financial responsibilities of municipal governments are continually and rapidly evolving.

South African local governments can be divided into two broad categories: urban, and rural. Table I below, defines the various levels of local governments within these categories. The two tier system consisting of a metropolitan council and metropolitan local councils has been established for six metropolitan areas, including: Greater Johannesburg Metropolitan Council (GJMC), Vaal/Lekoa Metropolitan Council, Pretoria Metropolitan Council, Khayalami Metropolitan Council, the Durban Metropolitan Council, and the Cape Metropolitan Council.

Table I
Structure of Local Government

URBAN	RURAL
Metropolitan Councils (MC)	District Councils (DC)
Metropolitan Local Councils (MLC)	Rural Councils (RC)
Local Councils (LC)	Representative Councils (REPC)
	Local Councils/Local Area Councils (LAC)

Source: Green Paper on Local Government, October 1997.

The former local government categorization scheme also remains in effect using a number of factors to define local authorities including population, tax base, and water hook-ups. Grades 10 -15 represent the largest cities in South Africa. Grades 6-9 and 0-5 represent medium size and small cities, respectively.

Despite the increasing fiscal difficulty under which local authorities now operate, it is clear that the financial position of local government(s) contrasts sharply with that of the provincial governments, specifically:

- the revenue/expenditure gap in 1996/97 was much smaller at the municipal level (minus R 4 billion) than at the provincial level (minus R78 billion); and,
- provinces were able to finance only 4% of their expenditures with their own revenues, whereas local municipalities were able to finance 90% of expenditures from their own revenues.

Table II
Revenues, Expenditures and Fiscal Gaps (1996/97)

	REVENUE (R BILLION)	EXPENDITURE (R BILLION)	GAP (REV-EXP)	OWN REV % OWN EXP
Local	43.0	48.0	-5	90%
Provincial	3.2	80.8	-78	4%
National	147.0	96.7	50	152%
Total	193.2	225.5	-33	

Source: FFC, July 25, 1997.

The figures presented in Table II lead to a number of observations, including:

1. the vertical imbalance between different spheres of government is considerably greater between the national and provincial governments than between the national and local governments;

2. in the case of the local government, the financial gap cannot currently be filled by the provincial governments because of inadequate own-source provincial revenues; and,

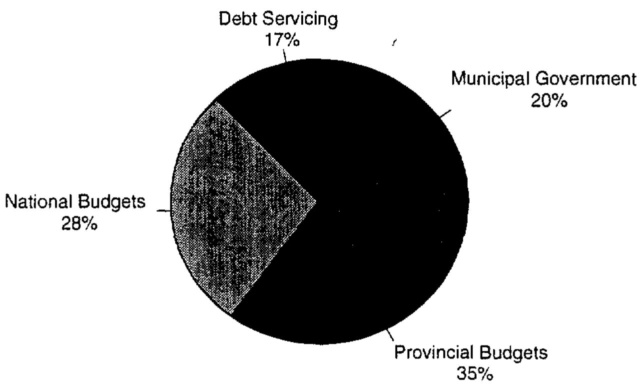
3. the relative fiscal independence of the local municipal sector implies that the local governments currently do not receive large predictable revenue sharing transfers which can be used to secure municipal borrowing[2]. Nonetheless, the revenue streams may be substantial enough in some cases to provide a source of risk mitigation (e.g. interception in the event of defaults).

1.2 Financial Status of the Municipal Sector

Chart 1 below illustrates the composition of the total public sector budget. According to the recently released Green Paper on Local Government, the national, provincial and local municipal budgets, exclusive of debt servicing, represent 28%, 35%, and 20% respectively of the country's total 1996/97 public sector R193.2 billion budget.

Chart 1

Total Public Sector Budget - (1996/97)



Source Department of Constitutional Development, November 1997.

Approximately 90% of municipal revenues consist of "own-source" revenues, taxes and users fees raised at the local level. The major revenue sources are property taxes, and user fees services for electricity, water, sewerage, and solid waste removal. Chart 2 on the next page, illustrates the principal income categories[3]. The largest amount of most local governments' income is generated by "trading services", including: electricity (41%), water (12%), and sanitation (8%). This is due in large part to the historical role of municipalities as direct deliverers of services. The surplus derived from the sale of electricity and water is an important source of local municipal income. Property taxes provide about 20% of local government own revenues. The payroll and turnover taxes levied by district and metropolitan councils are an additional source of revenue, generating over R2 billion annually.

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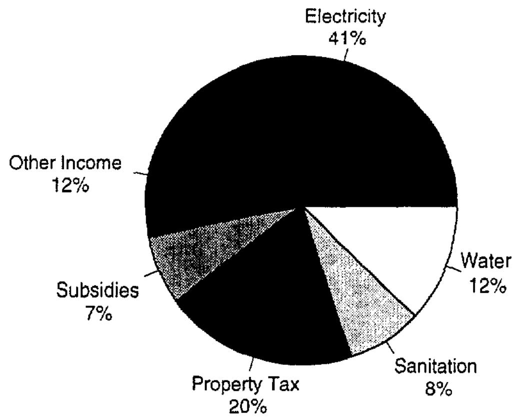
[2] Potential future loan repayments will be tied far more closely to municipal own-source revenues than in many other countries. This raises the importance of stable and transparent local tax and fee collection and sound local budgetary management, as well as a stable intergovernmental operating and capital grant system.

[3] Chart 2 excludes capital funding, regional services and district council income.

Chart 2

Estimated Local Government 1996/97 Income - R31.6 billion



Two kinds of fundamental change now underway have serious implications for the way that municipalities finance future operating and capital expenditures. The amalgamation process has extended the application of utility rates and property taxes into areas formerly excluded[4] for all practical purposes.

Further, new electricity institutional polices imply that the utility "trading account" surpluses enjoyed by general purpose local governments must be replaced with some other form of revenue (e.g., utility excise taxes). For example, if municipalities are no longer responsible for electricity distribution and thus unable to charge user fees, local governments may find that 41% of their revenues are in jeopardy.

1.3 Outstanding Arrears

Project Viability (formerly Project Liquidity), operated by the Department of Constitutional Development has monitored payment of rates and service charges to local authorities since 1995. Project Viability mails questionnaires to 843 municipalities on a quarterly basis. The questionnaire's response rate is on average between 75% and 85%. Table III provides Project Viability data on all outstanding customer and taxpayer arrears, as a percentage of total scheduled annual service charges and rates income. The table shows that for the local authorities providing information over the entire period, average total outstanding arrears (or non-payments) are approximately 27%. Non-payment of rates and service charges has gradually increased over the past year.

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[4] Property tax administration issues which appear to require additional local municipal government attention include but are not limited to: the basis of property valuation; the regularity of valuations; valuations in informal townships; and property taxes in rural areas. Collections systems and their improvement – the most urgent administrative issue readily visible to decision makers at all levels and to investors -- are inextricably bound up with these less visible but equally vital administrative issues.

Table III

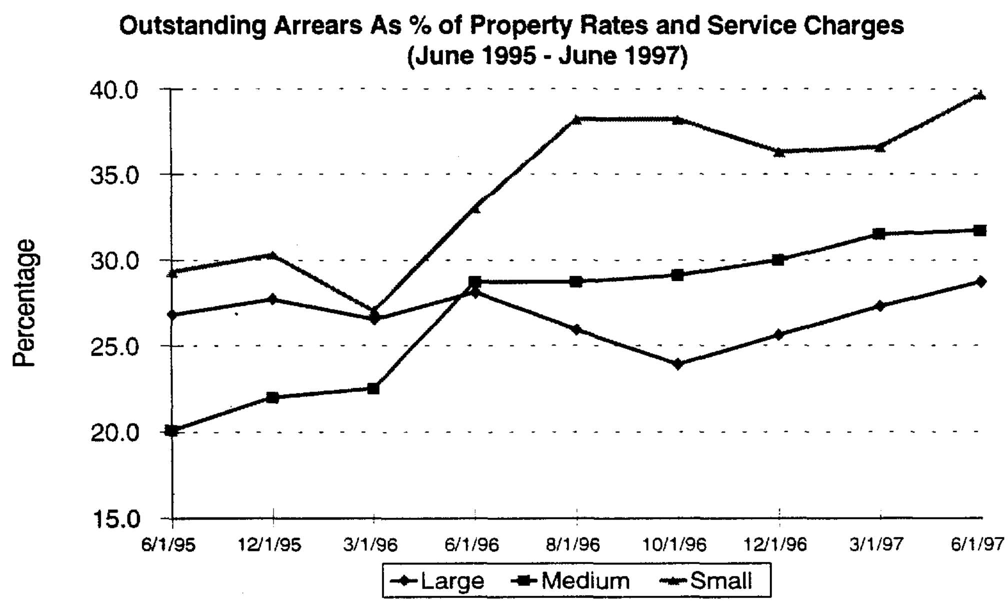
Outstanding Arrears as Percent of Property Rates and Service Charges

DATE	ALL MUNICIPALITIES	LARGE[5]	MEDIUM[6]	SMALL[7]
June 1995	25.7%	26.8%	20.1%	29.3%
December 1995	26.8	27.7	22.0	30.3
March 1996	25.8	26.5	22.5	27.0
June 1996	28.3	28.1	28.7	33.0
August 1996	26.6	25.9	28.7	38.2
October 1996	25.1	23.9	29.1	38.2
December 1996	26.5	25.6	30.0	36.3
March 1997	28.2	27.3	31.5	36.6
June 1997	29.4	28.7	31.7	39.7
Average	26.9	26.7	27.1	34.3

Source: Department of Constitutional Development, Project Viability October, 1996; and, June 1997.

Chart 3 below, shows steadily increasing arrearage rates for all three municipal categories. As of June 1997, small municipalities have the largest percentage of arrearages 38.2%, followed by medium and large cities at 31.7% and 28.7%, respectively. Interestingly enough, after a brief dip in October 1996 arrearages for large municipalities have shown a steadily increasing trend.

Chart 3



[5] Grades 10-15.
[6] Grades 6-9.
[7] Grades 0-5.

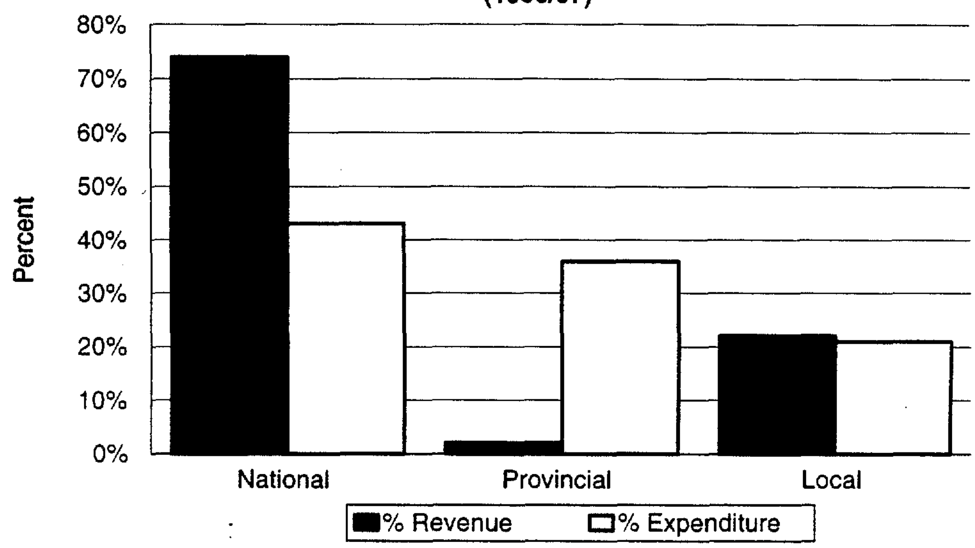
The figures presented in Table III probably understate the non-payment problem for the nation as a whole, given the imperfect response rate for Project Viability's questionnaire.

1.4 Intergovernmental Operating Transfers

In fiscal year 1996/97 approximately 76% of all government revenues were raised at the national level. The remaining 24% of all government revenues were raised at provincial and local levels. During the same period, the share of government expenditures was approximately 43% national, 36% provincial , and 21% local (see Chart 4, below)[8]. The disjunction between tax assignment and expenditure responsibilities has clearly defined the opportunity for a rational system of intergovernmental transfers.

Chart 4

Percent Own Revenue and Expenditure By Level of Government (1996/97)



According to the Ministry of Finance, the funds allocated from the national government to the provincial government are easy to identify. Many of the funds allocated to the provincial government come in the form of untied revenue sharing. The funds allocated to municipalities by the national government are less transparent to identify, especially when they are transferred through provincial governments. As a result, national government transfers to local governments are not easy to quantify nor are they predictable. Until very recently, the earmarking of intergovernmental funds through provincial governments was not a common

[8] Department of Finance, Budget Review, 1997/98.

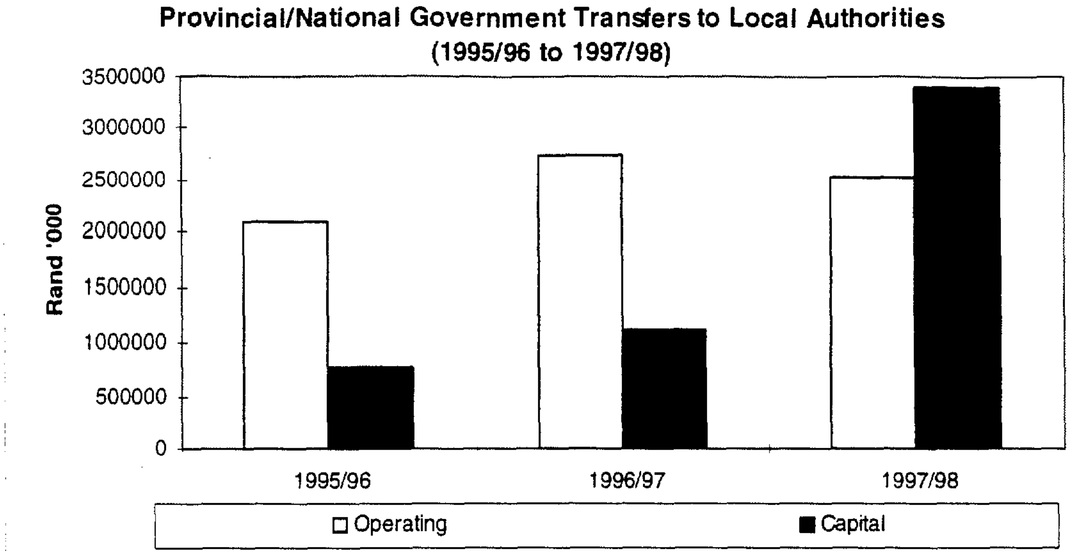
occurrence. In terms of the interim period outlined by the LGTA and the Constitution, there are virtually no obstacles to earmarking funds for local municipal governments. However, it has been difficult to obtain reliable information on the flow of funds to localities through the provincial level.[9]

In the new budget system defined in the Constitution of 1996, funds to be allocated to provincial governments are divided into "investigated" and "non-investigated" functions by the Department of State Expenditure. Investigated funds are more commonly known as "purpose" funds, directed toward health, education and welfare. All other funds made available to provincial governments by the Central Government are defined as non-investigated funds. These funds are made available to the provincial government in lump sum form without any preconditions of use. The non-investigated funds provided to Provincial governments includes funds to be provided to municipalities for certain functions that the local authorities must perform as agents of the Provincial government as well as for general financial assistance to municipalities. The total level of non-investigated funds distributed to municipalities depends on the Provincial government concerned.

Chart 5 below illustrates the total level of capital and operating subsidies given to local government over the past three years. The figures supplied in Chart 5 exclude "agency payments" made to local governments for the performance of contractually specified services, as well as bad debt provisions made by Eskom. Intergovernmental transfer payments reached R5.9 billion in 1997/98, a 110% increase from 1995/96 levels of R2.8 billion. Total subsidies for current local authority expenditures have increased by an average annual nominal rate of about 6.6% over the past three years reaching R2.5 billion in 1997/98. Intergovernmental capital spending transfers to local authorities increased by more than 4.5 times over the three year period, climbing from R779 million in 1995/96 reaching R3.4 billion in 1997/98. Briefly stated, intergovernmental operating budget transfers have been declining in real terms, whereas intergovernmental capital spending transfers have been accelerating over the past three years.

[9] "Investigation Into the Flow of Funds to Local Government", Ministry of Finance, July 1997.

Chart 5



The current state of intergovernmental transfers can be described as follows:

- The national and provincial governments are prioritizing intergovernmental transfers towards capital spending rather than operating budget subsidies.
- Of the operating budget subsidies, fully 30% are directed toward health, transport and social services.

1. 5 Intergovernmental Capital Transfers

A system of intergovernmental transfers providing funds for meeting the capital costs of infrastructure for basic services, the Municipal Infrastructure Program (MIP), has been designed by the Department of Constitutional Development. For the 1997/98 fiscal year, R500 million has been earmarked for the MIP. These grants are expected to remain constant in real terms over the medium term. The team was unable to determine whether these funds could be "leveraged" by using them for debt servicing. This option deserves consideration.

1.6 Current Debt Market Overview

South Africa provides a relatively wide variety of public sector institutions and debt opportunities. In comparison with other developing countries (Poland, Hungary), South Africa has a relatively liquid and well-capitalized stock exchange, a substantial domestic government bond market, a relatively liquid bond market for parastatal companies (e.g. Eskom), and a substantial number of competing institutional investment vehicles. However, its government debt sector is remarkably limited for the size and nature of the South African economy.

Within the public sector, the National Government is the largest issuer of debt estimated at approximately R350 billion. The other primary issuers of debt are Eskom, Telkom, and Transnet. The RSA is used to benchmark all other parastatal issues. The benchmark long government bond is the "R150". The R150 is the consolidation of several RSA issues with the same fixed rate coupon of 12% with similar maturities. Trading in the R150 alone represents about 30% of all trading done on the Bond Exchange of South Africa (BESA). Table IV, below, illustrates how much each issuer represents as a portion of the South African *listed* debt market.

Table IV
South African Bond Market as of June, 1997

ISSUER	NOMINAL ISSUE AMOUNT (IN RAND BILLIONS)	% OF TOTAL SOUTH AFRICAN DEBT MARKET
RSA	276.1	80.0%
Eskom	23.7	6.9
Telkom	6.5	1.9
Transnet	18.1	5.2
Other[10]	20.7	6.0
Total	345.1	100.0%

Source: Bond Exchange of South Africa, Annual Report 1997. June, 1997.

Directly under the Government debt in perceived credit quality come the parastatals (i.e. Eskom, Telkom, Transnet). The Republic of South Africa is widely understood to directly or implicitly guarantee the outstanding debt of these parastatals under a variety of different agreements. However, the central government has made it clear that new parastatal debt will not carry a direct or implicit sovereign guarantee.

The third, and most thinly traded, tier of debt is the municipal or local government authority sector. The amount of local municipal mid- to long-term debt stock in private sector portfolios is estimated at R9 billion. There has been a serious deterioration in the perceived credit quality of much of this outstanding local municipal debt arising from the recent amalgamation of the outlying townships, informal communities and other areas with the old established white municipalities. Local authority bonds are held in institutional portfolios (insurance companies, pension funds) and are rarely traded.[11]

According to BESA, from July 1, 1996 through June 30, 1997 there were 11 new listed bond issues introduced to the South Africa market through the exchange including 5 by the RSA, 3 separate maturities in one issuance by INCA, 1 by the

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[10] The R20.7 billion figure includes an estimated R 9 billion in local authority debt as well as corporate debt.
[11] The actual holdings of all institutional investors is difficult to determine. There is a substantial level of secretiveness (or "non-transparency") and reluctance to divulge holdings by the South African institutional investor community.

Landbank and 2 by Lesotho Highlands Development Authority. These issues totaled R13 billion.

Within the commercial sector, there are apparently only two corporate bonds currently outstanding, an issue by S.A. Breweries and the relatively small issue 3 maturity issue for INCA.

1.7 Local Authority Borrowing

The LGTA (1996) includes some specific rules with respect to local authority borrowing. Section 10G(8)(a)(i) states "that a municipality may obtain money and raise loans for capital expenditures...provided that the Minister of Finance determine reasonable conditions and criteria to the raising of loans". This section also requires that a resolution authorizing borrowings be supported by a majority of all members of the local council. Specific debt conditions found in the LGTA include:

- Loans for cash flow management purposes ("bridging finance") normally taking the form of overdrafts or Banker's Acceptances (BAs) may only be raised by a municipality in order to finance current expenditure in anticipation of receipt of revenue in that particular financial year. The bridging loan may not be used as a continuous or revolving credit.

- A municipality may not raise funds in a foreign currency or incur any liability in a foreign currency.

1.7.a. Short Term Municipal Borrowing For Capital Purposes[12] South Africa does not currently have a matching grant structure under which local authorities of limited fiscal capacity can have their own-source revenues (or borrowing) matched by intergovernmental capital grants. As stated above, the current practice is to finance capital projects either through government grants or through the local authorities' own-source revenues supplemented by near market-rate borrowing. Given the stagnation of mid- to long-term municipal borrowing, many municipalities are now reportedly financing investment from short-term lines of credit from local banks (generally at rates of between 16-20%).[13]

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[12] In terms of section 10G(8)(a) a municipality may obtain money and raise loans for capital expenditure. Such resolution requires a majority of all members of the local council. The Minister of Finance may determine reasonable conditions and criteria with regard to the raising of loans by municipalities and as part of that process may limit or disallow such loans.

[13] Section 10G(8)(a) also echoes the provisions of Section 230(1) of the Constitution of the Republic of South Africa, Act 108 of 1996, in that loans for bridging finance which includes bank overdrafts may only be raised by the municipality during a financial year in order to finance expenditure in anticipation of revenue in that particular financial year and not as a continuous and revolving credit.

Local authority short term debt to banks stood at almost R3.6 billion in September 1997. This level of short term "overdraft" debt has increased by 193% since September 1996. The peak of the short term borrowing occurred in June 1997 when local authority overdrafts hit R4 billion. The rise in local overdrafts is further evidence that local authorities are finding it increasingly difficult to manage their cash flows within their prescribed budgets or that they are using their short-term debt to finance capital projects (or, some combination of both). Discussions held with the Department of Constitutional Development indicate that many municipalities are failing to comply with the annual requirement that short term borrowing for cash flow management be "cleaned up" by the end of each fiscal year.

1.7.b. Collateral The only form of collateral that the LGTA expressly forbids is described in Section 10G(12), "No claim of any creditor or any municipality may attach to or be paid out of the national revenue fund or attach to or be paid by the national provincial government unless specifically and duly authorized by such government." This clause appears to the team to be self explanatory. But many local advisors have implied that this statement means that intergovernmental transfer payments as a form of collateral--i.e., voluntary intercept mechanism--are completely prohibited, as are bonds backed by nationally collected revenues. The possibility of governmental approval of the use of such mechanisms seems to be overlooked by many observers and decision-makers.

It does not appear however, that a municipality is expressly forbidden from using any other form of collateral (or revenue stream). Nonetheless, the team was informed that it is not common practice to pledge specific property or such other assets as user fee revenue streams as collateral. Any pledge of specific collateral would likely reduce municipal credit risk because it would eliminate the uncertainty in settling general obligation claims. Furthermore, most lenders are including negative pledge provisions in their debt agreements to prevent any future "double pledging" of specified assets.

1.7.c. Voluntary Intercept Arrangements The LGTA does not expressly forbid the use of voluntary intercept arrangements by local authorities and their creditors. It is not clear whether current local authority loan contracts contain provisions requiring the municipality to establish special account(s) for receiving revenues transferred to the municipality by the central government. Under normal voluntary intercept arrangements, as long as any debt service payments are still owed, the loan provisions would grant the lending institution exclusive access to this account.[14]

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[14] Any loan agreement should be encapsulated in contract form stipulating repayment schedules and clearly define each party's contractual obligations. It follows that the party whose rights have been breached may enforce its ordinary contractual rights. This implies that the party would notify a defaulting municipality that it

1.7.d. Debt Service Ratios An important measure of municipal indebtedness is the debt service ratio, defined as the ratio of annual interest and principal payments on debt to total municipal recurring revenue. A high ratio suggests that a municipality has relatively little financial flexibility. The LGTA does not place a hard ceiling on any local authority debt ratio. However, in light of the fiscal deterioration of Johannesburg, there is a heightened level of concern that some municipalities have placed themselves at risk by taking on excessive debt (including overdrafts).[15] The Departments of Constitutional Development and Finance are currently developing a draft document outlining potential municipal debt service caps (or restrictions).

1.7.e. Revenue Bonds[16] The "ring-fencing" of utility revenues and dedicating future revenues as bond security, has not been used at the local level in South Africa until very recently. However, interest in the general idea of utility ring fencing has recently increased because of the widespread attention given to the concept of municipal utility privatization (i.e. Nelspruit's water system). Municipal revenue bonds have not generally been employed in South Africa although INCA is beginning to use the technique.

In many instances, there is a misunderstanding as to what is meant by municipal revenue bond obligations. We define this form of municipal borrowing as bonds secured by the revenue stream of a specific service such as solid waste collection. The service itself remains within the general sphere of the local municipal government. The credit quality of a specific revenue stream can be reinforced by a general obligation pledge (double barrel) of all other revenues and assets.

Opinions vary regarding the legal status of revenue bond financing. Our discussions with numerous capital market, central bank, and government officials indicate that there is a considerable amount of ambiguity about whether municipalities can "ring-fence" the revenues from a particular function within the municipal budget and dedicate future revenues for debt service. The arguments regarding the legal foundation for revenue bond obligations center on whether local authority councils have the legal right to dedicate future revenue streams. Some of those interviewed felt that municipal councils would always be free to tap the future (ring-fenced) revenues for general budgetary purposes. The team found no provision in

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is in breach of one of the conditions of the contract, and that a court order could be obtained to enforce the obligation.

[15] Data on South African municipal debt obligations and municipal debt service are not readily available. There is no mandatory reporting of the information to the Department of Finance or the SARB.

[16] See George Peterson and Priscilla M. Phelps, "Municipal Credit Enhancement in South Africa: Strategic Opportunities for USAID" April 1997.

the LGTA (1996) that explicitly overrides the general authority of the municipal council. Others interviewed stated that the local municipal councils could contractually bind itself and future councils to pledging future revenue streams.

The consensus is that it would be prudent to clarify legislation and regulations authorizing ring fencing of project revenues and the issuance of revenue bonds, and specify the procedures that the local authority, council and private investor must follow in doing so.

1.7.f. Privatization and "Asset Stripping" Among investors and others there is considerable anxiety about the financial consequences of transferring a local authority's assets (and their attendant cash flows) to the private sector. The term "asset stripping" is often used to encapsulate this concern. South African examples include the privatization and concomitant transfer of water utilities and, to a lesser extent, retail electric power distribution systems. At the present time, privatization is not prevalent and hence has no perceived immediate impact on municipal balance sheets or income statements. However, due to energetic advocacy of privatization by some leaders in government and elsewhere there is a marked concern expressed at all levels that financial asset stripping will negatively impact the future financial stability of local municipalities.

Because some South African municipal general purpose budgets have been heavily reliant on surpluses produced by municipal utilities, the issue of "asset stripping" does pose a major challenge. The problem can be mitigated only if municipal general purpose budgets end their reliance on surpluses produced by municipal utilities. To do this, they must find new sources of revenue and/or do a better job of collecting property taxes and other existing revenues.

One practice regarded by many in the investor community as a form of asset stripping – the sale and lease-back of physical assets – has now been prohibited by specific legislative action.

One prudent measure which local authorities could take to clarify the status of physical assets would be to clearly state in their financial statements and budget which future revenue streams have been ring-fenced.

1.8 Securitization

According to a section of a study provided by USAID[17], the South African market has completed just two asset backed securities to date: a mortgage backed security issue in 1991 by the United Building Society[18] called MS101; and, a small commercial company Sasfin (Asset Securitization Limited) - which did a modest receivables securitization involving leases. In brief,

- **MS101** was issued by the United Building Society (currently, ABSA Group) in 1990. The size of the issue was R250 million. The maturity is 2009. The debentures were issued in two classes: Class A - R225 million was senior in order of preference of payment of capital and interest; and, Class B - R25 million. Both classes carry floating interest rates. The United Building Society undertook this issue in order to test the South African capital market's appetite for securitization. The primary investors were Sanlam Liberty Life and Old Mutual.

- **Asset Securitization Limited (Sasfin)** Sasfin Asset Securitization Limited issued a 20 -year R30 million debenture in 1991 backed by lease agreements which had been held on the books of a company known as Sasfin Limited. The interest rate on the debenture is floating and is paid quarterly. The rate is adjusted once per quarter. Sasfin Limited is a lease company providing credits to small and medium sized businesses for the purchases of machinery and other equipment. The debentures had the benefit of credit enhancement from the Credit Guarantee Insurance Corporation of Africa Limited (CGIC). CGIC's cover in this securitization was to underwrite the full risk of failure of the end-users of the lease agreements to pay on the installment agreements up to R12.5 million of the R30 million issue amount. Based on the quality of the collateral and credit enhancement, the debentures earned a South African in-country rating of "AA" from Republic Ratings. Since 1991, Sasfin has issued additional securitizations for R30 Million in 1992 and R8 million in 1997.

These two issues "tested the waters" to determine the SA capital market's understanding and appetite for securitizations. Several lessons were drawn from the these two issues that resonate through SA financial community. These lessons include:

- The investors that purchased these bonds did not have a good understanding of the underlying structure of the securities that they purchased. The securities were purchased on the basis of the reputation of the underwriter and on the underlying yield of the offering.

[17] Abt Associates study examining mortgage securitization done in conjunction with the National Housing Finance Corporation

[18] The United Building Society is currently known as the United Bank and is part of the ABSA Group.

- Investors found that that both debentures were relatively illiquid due to their small size.

- In the case of MS101, transaction costs were high as the mortgages had to be registered, and thus incurred stamp and other transfer duties. The transfer costs were significantly lower for the Sasfin securitization: by the time of the offering, transfer duties were not payable on these assets. (Transfer duties continue to be payable on mortgages, however.)

- With respect to the Sasfin offering, the "AA" rating had little impact in stimulating investor demand. Investors were not willing to rely on the rating agencies' assessments. Although the debentures were initially listed on the Johannesburg Stock Exchange (JSE) they were de-listed in early 1997. The issuer found that there was little additional value in listing on the JSE (lack of liquidity). De-listing the debenture eliminated the listing fees and associated administrative costs.

- The insurance provided by CGIC for the Sasfin debenture was replaced by "over-collateralization". The lesson to be drawn from this is that investors are willing to accept over-collateralization as a replacement for credit enhancement.

2 The Role of INCA, DBSA and others in the Municipal Market

The South African municipal bond market is largely inactive with the exception of INCA's work. Most new issue activity ceased with the end of a prescribed investment regime and the realization that the central government would no longer provide an implicit or explicit guarantee of municipal debt. As noted in the introduction, INCA's involvement in new municipal issues over the past year is the first visible sign of non-government sponsored activity. Most institutional and other investors have not re-entered the municipal credit market because they remain uncertain about the new legislative and financial environment and local authority management capacity.

Secondary market activity such as purchases, sales and swaps have never been a major factor in the SA municipal bonded debt market because municipal bonds represented a very small percentage of institutional portfolio holdings and were basically set aside as low risk securities to be held to maturity. From the portfolio managers' perspective, it makes little sense to sell something that is scarce; filled specific structural investment needs (e.g. maturity matching); and, offered significant yield spreads over sovereign debt.

Primary and secondary debt markets are interdependent in a number of respects. First, when there is a primary market activity, there is some supply of paper which could trade in the secondary market. Second, primary market issuances may cause portfolio managers to change their mix of existing holdings, thus creating the possibility of secondary market activity. Third, uncertainties about the general credit environment which prevent primary market activity are also likely to prevent secondary market activity.

2.1 The Primary Market

Interviews with a cross section of the investment community indicate that most or all of the institutional components necessary for a vibrant municipal bond market exist but are not necessarily operating effectively. Such existing institutional components include: The Bond Exchange of South Africa (BESA); broker/dealers; clearing systems; commercial banks; DBSA; financial planners; institutional investors; issuers; jobbers; market makers; merchant banks; paying agents, and trustees.

The Bond Exchange of South Africa (BESA) is a licensed financial exchange and is charged with the responsibility of regulating the bond market. The Exchange -- formerly, The Bond Market Association (BMA) -- was licensed in 1996, and operates within the framework of the Financial Markets Control Act (FMCA) and a set of Rules and Directives approved by the Registrar of Financial Markets.

There are over 75 members of the Exchange including broker/dealers, issuers, insurance companies and banks. In time, members with investor profiles may have to form separate dealer subsidiaries if they wish to continue to hold membership. The BESA market is designed for institutional investors or very wealthy individuals, because the minimum round lot is R1.0 million. Disclosure and other rules governing formal listing designation are still in draft form at present.

The BESA reports that as of June 30, 1997, it has granted formal listing status to 268 bonds issued by 21 different borrowers. The exchange concludes more than 750,000 trades per annum. However, RSA bonds constitute 80% of all listed securities.

BESA publishes a monthly "Valuation of Bonds", referred to as the "Yellow Book". According to the October, 1997 issue, there were 45,047 trades in September 1997. The October issue contains over 1,000 separate line items of listed and unlisted bond issues. Each line item describes: stock code; whether listed or unlisted; issuer name; coupon rate; redemption date; loan number; interest payment dates; yield to maturity or price, and bond value converted from YTM to Rand price. The Yellow Book also prints a 0-30 year yield curve. Evaluations of individual line item securities are assigned using actual transactions; or in relation to the yield curve and the perceptions of differences in risk on items that have not actually traded.

Market makers in SA frequently refer to securities issued by sovereigns and a few well founded sub-sovereigns as "gilts". SA market makers refer to municipal bonds as "semi-gilts". According to BESA , gilts are called bonds or bond-edged. Semi-gilts are called semi bonds or "stock". Equity investments in INCA are called "shares" and INCA bonds are called "stock". INCA stock is traded on the BESA.

Only four issuers of municipal bonds are now formally listed: Beacon Bay (now part of East London); Durban; East London, and Johannesburg. According to a BESA spokesperson there were no municipal bond trades in October, two in September, none in August, and six or seven in July. Most of these trades were in unlisted names, such as Cape Town. BESA members did report them to the Exchange even though the transactions were in effect executed "over the counter" (direct broker to broker trading not executed through an exchange). Listed or not, there is still a transaction fee that must be paid to Universal Exchange Corporation (UNEXcor) which is the approved clearing house.

Municipalities are not currently required to list their bond issues on the Exchange. The most recent draft of BESA's "Listing Disclosure and Requirements" is dated October 28, 1997. Requirements contemplated in the application process include the name of the issuer and financial instrument; the issue date, coupon rate, payment periods, payment dates and maturity date; a copy of the resolution by the governing authority of the issuer authorizing the issue of financial instruments; a copy of the provisions of the Act under which such financial instruments are to be issued and listed; a copy of any applicable government guarantee in respect of the financial instruments; a copy of the placing document or prospectus; and copies of all marketing material used in connection with the original issue of the financial instruments. The draft contains several other requirements and procedural suggestions

Secondary market municipal bond transactions are legally required to be executed ("crossed") through the Bond Exchange[19]. However, the team was told that many trades are completed without the use of BESA. In the long run, a formal bond exchange may not be the most efficient medium for an efficient and actively traded secondary municipal bond market. There may well be a lot of daily activity but rarely in the same name. Such trading may ultimately prove to be more suited to the over the counter (OTC) markets as in the U. S. experience.

Serial debt structures ("annuity bonds" in South African parlance) which use annual maturity of principal avoid the problem of sinking funds left unfunded by irresponsible local decision-makers. In South Africa, we would expect serial bond issues to be used as a mitigant for principal risk as interest rates decline, competitive pressures increase and the sophistication of issuers rises.

Serial bond issues also fulfill the requirements of investors with predictable redemption patterns. Examples are actuarial requirements of pension and insurance funds as well as INCA debt matching. When sellers and buyers both benefit from structure, then greater activity in the secondary market is a predictable result. However, BESA rules that define minimum round lots of R1million will not accommodate serial bond issues. In the U.S., the OTC markets have proven to be very effective in accommodating the unique requirements of municipality debt issuance, as well as the needs of investors and dealers, in all shapes and sizes of transactions. Concerns about suitability of investment for different investor groups (e.g., individuals with small investment requirements) are valid in any market and can be addressed by appropriate oversight of dealer/client activities. Self-regulation is just as effective in OTC markets as it is in exchange-base markets. Dealer activities regarding suitability and price need to be the subject of vigilant regulation and enforcement, no matter what institutional form the market takes.

The BESA maintains a Guarantee Fund as required by the FMCA to protect members and clients against price movement losses that may occur in unwinding trades with a defaulting member. The *Guarantee Fund* has been established at R30 million. The exchange is reportedly exploring the possibility of increasing it to R100 million via an insurance policy.

We have not found any previous history of reliance on qualified legal opinions as to the validity of bond issuance and subsequent enforceability of bond indentures.

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[19] A possible exception may be a swap between INCA and institutions using bonds in their portfolios in exchange for INCA stock that has been registered but not yet distributed

Trustees are sometimes used but not by municipal issuers. No such structures were deemed necessary as long as there was an implied central government guaranty.

The financial market institutions are undergoing a rapid and profound transition. The Johannesburg Stock Exchange is the world's eleventh largest. Nonetheless, the Central Depository is only two years old. BESA settlement date moved on November 17, 1997 from 14 days to 3 days and electronic settlement is replacing the former manual physical system. SARB is recommending the further relaxation of exchange controls to coincide with other sweeping reforms to the financial sector including the introduction of a repurchase agreement system in the money market[20], the appointment of primary dealers in government stock. Primary dealers in government stock are scheduled in April 1998 to take over the SARB's function of selling debt to fund the budget deficit.

2.2 Broad Ranking of Municipal Credit Quality.

There are 847 local authorities in SA that could conceivably issue debt. It is now common practice for the municipal finance community to group local authorities into three principal tiers of potential investment quality:

- Tier 1 - Communities or other entities capable of achieving stand-alone investment quality, ideally suited for INCA portfolio;

- Tier 2 - Communities with some of the characteristics of investment quality, but requiring at least some technical assistance and/or direct subsidy to achieve that level of quality; and,

- Tier 3 - Communities so impoverished as to be the responsibility of the provincial or national government.

2.3 The Secondary Market

As noted above, the primary (new issue) and secondary (trading) markets are two inter-linked components of the municipal bond market. One cannot flourish without the other. This section will address two different types of secondary markets,

- the secondary market for individual municipal bonds; and,

- the secondary market for INCA's senior lien bonds.

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[20] A repurchase agreement consists of two simultaneous transactions whereby one party purchases securities from a second party and the second party agrees to repurchase the securities on a certain future date (sometimes as soon as the next day) at a price that produces an agreed-upon rate of return.

These are two somewhat different markets, although both are traded on the bond exchange. The typical SA institutional municipal bond investor has tended to place municipal bonds in the static part of the portfolio. These are investments that will probably be held to maturity and are ideally suited to match schedules of maturing pay-out obligations.

There are numerous impediments to the development of an active secondary market for existing municipal bonds, including:

- **Lack of Transparency in Institutional Investments**. Only unit trusts are required to disclose their investments. Unit trusts must publish quarterly reports identifying the amount and full descriptions of their investments. Insurance companies, banks and pension funds have no such requirement and therefore do not disclose anything specific enough about their holdings to help potential trading partners recognize opportunities for mutually advantageous transactions.

- **Unwillingness to Book Accounting Losses.** Institutional investors are unwilling to book losses in static portfolios even if that were to result in improved performance. A requirement for all investors to "mark to market" would help eliminate this problem. If holdings must be marked to market, and published at least quarterly, then there is nothing to hide. Market professionals can then devote time and effort to portfolio improvement suggestions.

An argument is made that one cannot mark to market if there is no market. However, the team believes that this can be dealt with in a similar manner to U.S. municipal bond market practice where well over one million different bond descriptions exist. Since few bonds relative to the total quantity outstanding actually trade in the U.S., it has become necessary to develop theoretical market values based on the relative quality of the bonds in comparison with highest grade securities, and to the relevant high grade yield curve. There already exists a SA base yield curve for high grades published in the BESA monthly "Yellow Book". Municipal securities' issuers are already tiered into three distinct groups of quality. Additionally, the use of objective ratings by increasingly credible independent bond rating agencies is likely to grow over time and assist in marking-to-market.

3 General Findings and Recommendations

This section makes a series of general observations and recommendations regarding both the conditions in which the municipal debt market can best develop and specific municipal debt market mechanisms.

3.1 Improving the Conditions Necessary for Municipal Credit Market Development

Neither primary nor secondary municipal credit market(s) are likely to flourish until basic public finance building blocks are in place and have reached a reasonable level of stability. At present, "the rules of the municipal borrowing/lending game" are not readily understood by the all-too-reticent participants in the South African municipal capital market. Having been raised on a "diet of soft credits", South African municipalities must learn how to exist in a hard credit financial environment.

A basic set of easily understood principles is the foundation of a sound municipal credit market. Reforms to put these principles in place are already rapidly evolving in the South African market as indicated by the publication of "The Green Paper on Local Government" in July, 1997 and the promulgation of new financial reporting requirements for local CEO's by the DCD, as well as such prior initiatives as Project Viability and the National Intervention Program. The initiatives already implemented and the reforms prefigured by the Green Paper and other planned reforms should bring greater clarity to municipal finances, increase the number of credit worthy projects, and make it easier for any potential municipal credit suppliers to enter the municipal market.

Elements of the municipal credit market's permanent foundation that are still not in place or adequately functioning that require reforms, include:

- **Accounting, Auditing and Full (Transparent) Disclosure of Municipal Financial Condition** Of great concern to potential municipal credit market investors is the non-transparency and non-comparability of municipal financial statements and budgets. South African national policy should establish a clear, comprehensive municipal chart of accounts to be uniformly applied across the country. At present, many municipal accounts are audited by the Auditor General. Many investors would find independently audited accounts to be more credible, particularly if such independent audits were accompanied by management letters. Without reliable financial data, meaningful credit analysis cannot take place and municipalities will continue to find it difficult to access private capital.

- **Increasing the Availability of Municipal Financial Information** The current level of uncertainty is exacerbated by the limited flow of municipal (and even national government) financial information available to the private financial sector. Even given the difficulties associated with accurate and reliable local government reporting, municipal financial reports are often released too late and are too infrequent to be of much use to private investors in assessing risk, given the rapidity of change sweeping through the South African municipal sector.

The national government has sought to address this problem with Project Viability, formerly known as Project Liquidity. Project Viability requests cash flow information not normally reported by municipalities in standard financial reporting documents. The publicly reported data in Project Viability are in many instances highly aggregated, and too limited in focus to be of use to private investors. Project Viability analysis appears to be concentrated on gathering information on nonpayment of taxes and service fees. The questionnaire should at least be expanded to include information on local authority short and long term borrowing and arrears in paying debt service. Furthermore, Project Viability reports are not delivered on a regular quarterly basis. The fact that Project Viability information is not shared with the financial community is a major impediment to well-informed investor decision-making.

The SARB has, over the past year, started collecting short-term municipal "overdraft" data from banks. This data is very useful in determining whether a municipality has breached sustainable debt service levels. This short-term overdraft data has not been released to private investors via the normal Reserve Bank publications. Confidentiality restrictions also limit information from other sources. DBSA, for example, treats the financial information from its local project appraisals and technical assistance as proprietary.

Disclosure in the Financial Markets Full disclosure of institutional investor holdings facilitates trading and other market activity. In South Africa, confidentiality and the lack of financial transparency in normal financial reporting requirements constitute a major impediment to the successful stimulation of the municipal credit market. Only Unit Trusts (mutual funds) currently disclose what is held in their portfolios. The absence of requirements for full disclosure creates a market that is opaque and relatively immobile. (For example, in the U.S. insurance industry, full disclosure takes the form of a Schedule D filing, part of the normal documentation that insurance companies must annually file with their respective state Insurance Commissioners. The Schedule D discloses on a line item basis all holdings of the insurance company at calendar year-end.)

Full disclosure of institutional investor holdings can also bolster the credibility of rating agency judgments as these holdings are subject to increased scrutiny by all market participants. As the credibility of rating agency judgments increases, so will the market interest rate spread effects of these ratings.

- **Assessing Municipal Credit Risk** The capacity to accurately identify the credit risk of different local authorities is a pre-requisite for making the primary and secondary municipal credit market operate successfully. Effective credit risk assessment is essential in boosting private capital investment to the municipal credit market. Unfortunately, local financial risks are still difficult to appraise. Pro-active credit analysis and vigorous financial monitoring of local municipal financial conditions by lenders is imperative to the successful evolution of a municipal credit market. Many South African institutional investors do not actively monitor their current portfolio. Most investors exercise a "buy and long-term hold" philosophy. Moreover, their involvement in the municipal market has been limited as a percentage of total holdings, that they see little need to establish active surveillance capacity at each institution.

- **Stabilizing Intergovernmental Transfers and Shared Taxes** The future revenue structure of local authorities has not been fully clarified yet. Nor has the sector's complete range of expenditure obligations. The central government has been working over the past year on a well-defined, transparent and predictable intergovernmental and shared taxation formula. It is projected that the intergovernmental transfer formulas will be finalized by the end of 1997 and gradually implemented over the medium term. A transparent and predictable intergovernmental transfer and shared taxation formula will provide some measure of security to investors.

  Equally important, the rapid stabilization of intergovernmental transfer and shared tax flows will open more practical possibilities for the use of intergovernmental aid intercept mechanisms to enhance credit quality in some situations.

- **Change in South African Bank Loan Loss Reserve Requirements** Actual South African local government default experience remains relatively low. Local authority loans carried a 10 percent additional risk weighting over loans to the central government over the 1994-1996 period. (Additional risk weighting percentages are calculated against a basic 8% capital adequacy standard.) SARB raised the capital adequacy requirement to 20 percent in late 1996 (early 1997). However, the capital adequacy ratio has recently been raised by SARB in November 1997 to 100 per cent for local authority debt. This places municipal debt capital adequacy ratios on par with local corporate adequacy ratios. The result of increasing the South African banks' local authority capital adequacy ratio is likely to make municipal borrowing from institutions affected by the change either more expensive or less available (or both). However, the capital adequacy requirement for investors holding INCA bonds has always been 100%. INCA bond pricing in the South African capital market already reflects this fact.[21] Thus, the playing field between INCA and traditional lenders such as commercial banks has been leveled, effectively increasing the opportunities for INCA. For example, the change in reserve requirements may induce some current municipal debt holders to trade their holdings for cash or INCA bonds. As a result, a secondary market for municipal bond debt may be gradually, albeit slowly emerging.

- **Rapid Development of Local Government Public Management Skills** The local authority infrastructure financing challenge will require public management skills to be rapidly upgraded. Virtually every interviewee stated that the primary problem at the municipal level is "inadequate public management skills." Clearly the municipal finance investment community has the perception that local municipal governments are not run in an effective manner. Some of those interviewed believe the problem is associated with the turnover of key personnel and affirmative action, while others see it as a more general challenge facing a level of government confronted with new fiscal and management responsibilities.

  Local government staff should be trained in skills to improve public management efficiency. As efficiencies improve, local staffing levels may be reduced. Local government officials should be required to develop performance indicators to determine whether their efficiency gains have been realized.

  To generate the operating surpluses necessary to finance borrowing, local governments will have to extract significant surpluses from upper- and middle-income service users and from property tax payers. Further, local authority accounts receivables due to non-payment of service fees and local taxes are continuing to rise. Cash flow management and increasing (and making more transparent) local reporting requirements is an area where local authority management skills should be raised.

- **Defining Municipal Capital Asset Inventories** The amalgamation of local government authorities has created ambiguous capital asset inventories. Given the nature of some credit structures (e.g. revenue bonds), it will be necessary for local municipalities to develop a clear legal understanding of the assets that are under their jurisdiction.

- **Developing Multi-Year Capital Investment Plans (CIP)** Most local government authorities currently prepare some form of capital investment and infrastructure

[21] INCA's internal capital adequacy risk weighting policies and practices both differ with respect to the municipal credits to which they are exposed. Its policy is to assign weightings of 1.6% (20% of 8%) to Category 1 credits, 3.2% (40% of 8%) to Category 2 credits, and 4.8% (60% of 8%) to Category 3 credits. Its current practice is to hold all credits at 4.8% to provide a "buffer" in the case of re-ratings and for other reasons.

maintenance plan. However, a brief review of several local municipal budgets indicate that the CIPs are more comparable to capital project "wish lists" rather than documents which clearly define future project and financial spending priorities. Local authorities should be required to prepare multi-year capital investment and infrastructure maintenance plans integrated with a separate municipal capital budget. The plan should include some details as to how many of the priority projects will be financed.

3.2 Improving Primary and Secondary Markets - Key Mechanisms

Key capital market participants and systems are already in place or could rapidly be put into place during the next two years. These resources can be mobilized to bring about a degree of improvement in the liquidity and other characteristics of the present market environment. Moreover, they can prepare the way for more substantial market improvement once all the public finance building blocks have been put into place. The following section identifies the existing and future risks to the municipal securities market and reviews risk mitigation systems for the municipal securities market as a whole and for INCA.

3.3.a Identifying Existing and Future Risk

Debt market participants need the most reliable possible methods of identifying existing and future risks so that they can price and allocate their capital in a risk-adjusted manner. Most emerging markets share the problem of little or no risk-differentiation among a variety of issuers or potential issuers. In South Africa's case, this lingering problem appears to be a legacy of the nation's past use of both a prescribed investment regime and implicit or explicit sovereign guarantees of sub-sovereign public purpose debt. The accurate identification and estimation of risk is also constrained by the quality of information supplied by the entities being evaluated. As noted earlier, this is an area that needs substantial improvement in South Africa as it does in virtually every developing sub-sovereign debt market.

As with any other evaluative model, the "garbage in/garbage out" principle places absolute constraints on the quality of sub-sovereign risk assessment. However, it is important to note that there will never be perfect information available in even the most sophisticated and transparent capital markets. Imperfect market information and the ability of different market participants to make the most of what information exists typically provide an important impetus to market activity, particularly secondary market activity. Thus, the need for improvement in South Africa's basic sub-sovereign information and reporting systems is not a valid reason for market participants to avoid using whatever information is available to make the best informed credit judgments possible.

3.2.b Rating Agencies, Project Viability and DBSA Credit Analysis

Independent, objective and un-regulated ratings of high quality are an essential component to the development of a vibrant hard credit marketplace.

The rating agency CA Rating has affiliated with Standard and Poor's ("S&P"), and has already scanned financial characteristics of approximately 100 municipalities. While this process reportedly did not go into the depth necessary for either published or shadow ratings, it is nonetheless an important step. CA Rating's affiliation with S&P should substantially enhance the credibility of this agency within the South African issuer and investor communities. S&P also has a highly regarded bond evaluation affiliate (Kenny Information Service).

IBCA recently announced its acquisition of Fitch, the widely respected New York based rating agency specializing in sub-sovereign and other debt issuers. This acquisition should substantially increase the credibility of IBCA in the sub-sovereign community. Project Viability is clearly another important means by which existing and future municipal and other sub-sovereign risks could be identified, if its findings were made available to the investor community. The team recommends that as much aggregate Project Viability data as possible be published on a regular and timely basis and that, once the accuracy of data has been confirmed by individual local authorities, the data be published in disaggregated form as well.

DBSA has also developed an internal rating system for its existing book of outstanding loans, analogous to that employed by the surveillance departments of banks and financial guarantors in fully developed markets. This information is not made available to other market participants or potential market participants. Because this data is used directly in making credit decisions by a banking institution, it should not be published. However, consideration should be given to finding ways that DBSA information could be used in studies and analytic work without compromising the confidentiality of the credit decision-making process.

3.3.c "In-house" Investor Credit Assessment Capability

In fully developed debt markets, neither institutional investors nor guarantors would rely solely on such third parties as rating agencies or government-sponsored monitoring programs to assess existing or future risk. However, in South Africa, only INCA and DBSA appear to be taking an active investor's approach to this crucial issue and developing their own systems for estimating and tracking changes in risk in the sub-sovereign sector. Most other investors continue to take what appears to the team to be a passive approach to these credits.

In addition to the lingering legacy of the prescribed investment regime and implicit sovereign guarantee, there probably is a more practical reason why even the largest institutional investors have not developed their own in-house systems for sub-sovereign risk assessment. Sub-sovereign securities typically constitute a very small portion of each investor's holdings and the institutional investors can be expected to allocate scarce research resources to sectors in which their exposure is relatively greater.

3.4 Risk Mitigation Systems

Once accurately identified, risks embedded in new debt financings can often be mitigated through the use of special structural techniques and/or legal covenants. There appears to be little experience with these techniques to date in South Africa. This is probably due to the nation's history of prescribed investments and implicit sovereign guarantees. However, DBSA's risk management staff director informed the team that it is beginning to seek structural and/or legal provisions to reduce its risk exposure in certain new transactions. DBSA could assist in developing the South African sub-sovereign debt market at large by sharing information regarding these techniques and how well they are accepted by issuers as its staff gains experience with their use.

While INCA's or any other lender's ability to use legal and structural risk mitigation techniques might appear to be limited to new borrowings, this may not always be the case. There may be instances in which an existing loan or bond issue can be restructured with the consent of the borrower, (e.g., a current or advance refunding undertaken to "stretch out" the final maturity of the debt or in some other way provide relief to the issuer). In such instances, INCA could seek new provisions that effectively mitigate its risks in the restructured existing transaction.

Examples of techniques which the team's U. S. and international experience suggest can be explored and possibly applied in some South African transactions include:

3.4.a. Debt Structure Provisions

- Secure means of "carving out" and dedicating specified revenue streams for payment of principal and interest;
- maximum feasible use of fixed rate debt, minimum possible use of floating rate debt (particularly floating rate debt with put features) in order to eliminate interest rate risk (and potentially put risk) for issuers;
- "Shirt-tail" periods in concession agreements which allow substantially longer periods of time for operating revenues to continue to flow to the concessionaire after the final maturity of the debt, allowing time for adjustments of final maturities in cases where that is a useful way of curing a problem (e.g., slower-

than-anticipated growth in traffic on a toll facility);

- Gross revenue pledges, "super liens" and similar devices which provide bond-holders with superior position to those of any other claimants on an entity's tax and/or fee revenue – devices such as these will be particularly crucial in structuring transactions used in working out troubled or defaulted credits;

- Frequency of loan payments (i.e., riskier borrowers required to make principal and interest (P&I) payments to the trustee as frequently as monthly) – increasing the frequency of P&I payments to a payment fund allows the investor or trustee to track the borrower's repayment performance more closely and provides an earlier warning of possible debt service payment problems;

- "Double barreled structures" that provide effective backing to the primary source of revenue being depended upon and provide investors with the substantially increased comfort of a "backstop" to the primary source of credit;

- Letters of credit from banks of acceptable credit quality or financial insurance from an insurance company of acceptable credit quality, used as a form of credit enhancement;

- Interest rate swaps to hedge against interest rate risk and/or currency swaps to hedge against foreign exchange risk, with conservative guidelines for their use (e.g., credit quality requirements for counter-parties, etc.);

- Amortizing debt structures (mandatory sinking fund requirements for term bonds) to better match debt requirements with the useful lives of assets and avoid unaffordable "balloon" payments at maturity;

- Debt service structures coinciding with "known" increases in future revenue flows (e.g., an approved rate plan calling for annual increases in instances where regulatory risk has been effectively mitigated);

- Use of senior/subordinated lien structures to enhance the quality of the senior debt; and,

- Over-collateralization in structured transactions (e.g., pools of municipal credits, publicly sponsored residential mortgage-backed transactions, receivables-backed transactions by utilities, etc.).

3.4.b Legal covenants

- Methods of ensuring regulatory support for fee rate increases necessary for borrowers to remain in compliance with all provisions of a financing during its life – these could include guarantees by rate regulators, two or three party performance agreements among regulators, utilities and general purpose local governments, etc.;

- Cash-on-hand requirements (e.g., 30 or 45 days of cash flow) included in the basic financing documents, particularly for hospitals, and similar institutions heavily dependent on a regular flow of transactions;

- Enforceable debt service coverage tests and additional bonds tests – key elements in any limited tax or revenue bond transaction that ensure rate increases necessary for a "cushion" of cash flow over the bare minimum necessary for 1:1 coverage of debt service;

- Debt service reserve funds or similar liquidity devices to "buy time" for borrowers to cure defaults;

- Major maintenance and replacement reserves as required elements to assure investors that the assets producing the streams of revenue to which they must look for payment of P & I continue to be capable of efficient production for the life of the bond issue;

- Requirements that independent experts be used at intervals over the life of the transaction for both financial and technical operating opinions to provide professional second opinions on key economic and other issues central to the continued success of a financing or the operation of the asset producing the revenue stream that makes the transaction possible;

- Construction completion guarantees by rated entities, particularly important for project financings;

- Requirements that facilities being financed carry appropriate levels of insurance during construction and operation;

- Requirements that appropriate levels of environmental performance be maintained by facilities during operation – as environmental regulation becomes an increasingly important consideration in public as well as private enterprise operations, these requirements become more and more essential to a successful transaction;

- Rate stabilization funds which act as "savings accounts" that can be drawn upon by public enterprises during periods of lower-than-normal rates of operation and delay or avoid rate increases;

- Permitted investment requirements, including restrictions on the use of derivative products to avoid losses of bond proceeds before expenditure and/or losses of interest payment funds before bondholders have been paid;

- Take or pay contracting (this can be either a risk mitigant or a risk factor depending on which part of the municipal system is being enhanced);

- Requirements that excess cash flow be captured to retire debt ahead of schedule to reduce the maturity risk of securities with nominally long lives;

- Trustee-administered "lock-box" mechanisms for sequestering revenue for the exclusive purpose of principal and interest payments, including "off shore" versions of such mechanisms to reduce possible convertibility and transfer problems;

- Security interests (e.g., mortgages) in property which has value, liquidity and importance to the borrower, but which is not so essential to the borrower that enforcement of the security interest in the event of default would be politically or practically impossible;

- Restrictions on liens which can be granted to other creditors to avoid dilution of security interests;

- Limitations on asset transfers to reduce the risk that assets producing revenues to which investors are looking for P & I repayment will be removed from the control of the issuer during the life of the issue;

- Restrictions on mergers to reduce the risk of credit quality down-grading caused by a new partner;

- Guarantees by stronger, more senior levels of sub-sovereign government;

- Limitations on guarantees that can be made by the entity receiving the benefit of the credit enhancement to avoid increased risk exposure to both the guarantor and the recipient of the guarantee;

- Central government aid interception in the event of a default; and

- Investor or guarantor consent requirements in the event of any changes in financing documents to avoid the unilateral addition of new sources of credit risk by the borrower.

3.4.c Revenue Bonds Structures and Risk Mitigation

It is important to note that some of the risk mitigation strategies outlined above have tended in the well developed U.S. municipal bond market to be most useful in the context of revenue bond or limited tax bond financing structures. However, in a market such as South Africa's in which the general tax backed ("full faith and credit" or "general obligation") credits must do everything possible to reestablish credibility and provide as much comfort as possible to investors. Therefore, the team believes that virtually all of these techniques can be used to good effect in some situations with all types of bond structures However, a few are likely to be difficult or impossible to use when structuring debt. These are likely to include use of carved out dedicated revenue streams (by definition) and over-collateralization.

This point underlines the importance to the development of a vibrant sub-sovereign debt market of:

- establishing full clarification of the legal "rules of the road" for sub-sovereign use of revenue bond structures; and

- introducing locally-issued revenue bonds into the market as soon as possible.

3.5 Central Bank - Monetary Policy

The principal ways in which SARB can help mitigate risk is through stabilization and, to the extent prudent, reduction of interest rates. The South African Rand has depreciated by more than 6% since early 1997 due to fears of rising global interest rates and weak gold prices. SARB has, however, resisted pressures for early cuts in interest rates. With the SARB itself not reducing liquidity in the market, the Central Reserve Bank decided that the circumstances were right for an interest rate cut[22]. Based on lower than expected producer price inflation for August and the fact that monetary aggregates had moved closer toward the SARB's guidelines over the June to August period, the central bank reduced lending rates from 17% to 16% in August. Commercial banks followed by cutting their prime mortgages rates by one percentage point to about 19%.

In addition, SARB can and does monitor local debt levels of local government and play a useful role in providing data of this kind to other government decision-makers and to the market. As noted elsewhere in this report, SARB has played this role with respect to the use of short-term debt by municipalities. Also, as discussed elsewhere, the SARB sets reserve requirements for institutional investors in various classes of securities and recently made a substantial change with respect to municipal securities.

The risk-mitigating effects of these roles are indirect and general, but nonetheless real.

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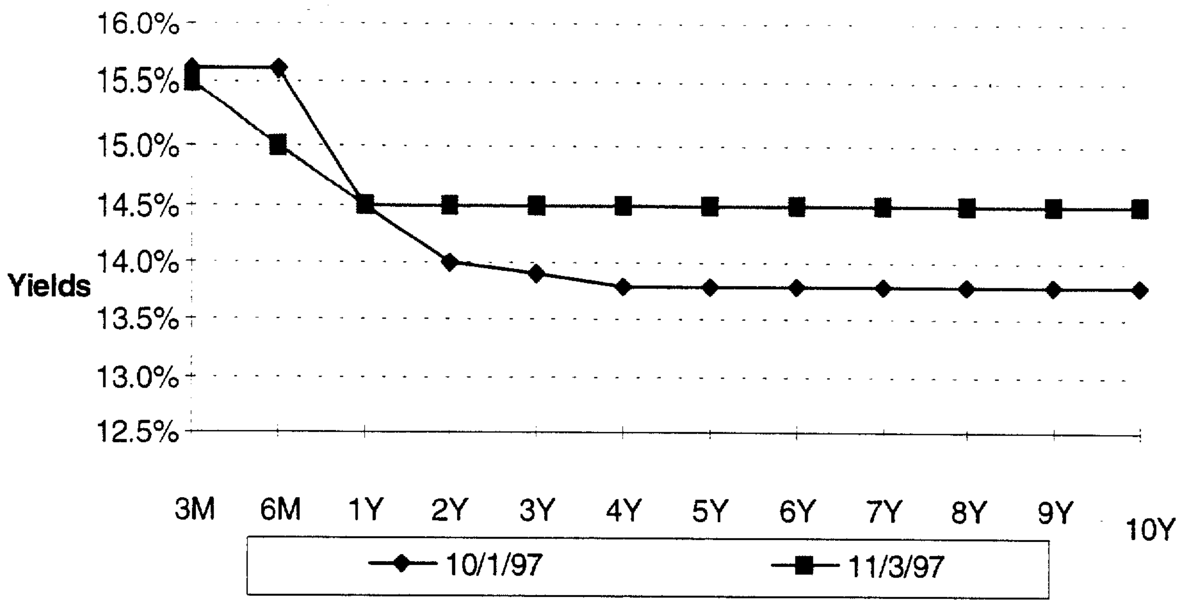
[22] First National Bank, South African Economic Indicators: 3 November, 1997.

Chart 6

RSA Sovereign Yields
(11/3/1997 versus 10/1/1997)



In November, the Central Bank raised capital adequacy ratios to 100 percent for local authority debt, representing a fivefold increase from the previous level. This places municipal debt capital adequacy on par with local corporate adequacy ratios. The result of increasing the South African banks' local authority capital adequacy ratio is likely to make municipal borrowing either more expensive or less available.

Chart 6 compares the yield curves for two recent periods and demonstrates the impact of Central Bank action taken to influence domestic credit policies. The inverted SA yield curve is an indication of the commitment to control inflation. Note the change in an already inverted yield curve. Municipal borrowers have relied heavily on short term borrowing. Borrowing costs under tighter bank reserve requirements will inevitably be impacted. Bankers acceptances are an alternative to bank overdrafts for short term borrowing. The advantages of BA's in recent months have been lower cost money.

3.6 Concentrated Default Experience

The team has been able to identify two areas of local debt finance that experienced substantial defaults. The first is debt incurred by local authorities from the national government for housing. It is the team's understanding that most local authorities which took on such debt are in default on such obligations. However the team also understands that this debt is likely to be written off by the government in the near future, thereby eliminating it from the local authorities' books. It would be helpful in clarifying the financial position of the municipalities which are currently carrying these debts if this write-off takes place as swiftly as possible.

As noted by Peterson and Phelps in their April/May, 1997 report, a substantial number of loans made prior to amalgamation by the Local Authorities Loans Fund (LALF) have experienced defaults. The most recent data reported by Peterson and Phelps showed 425 borrowers with 48 in default and a total of R9.1 million in arrears. As of November 14, 1997, the number of borrowers had been reduced apparently through full loan repayment to 399. The number of borrowers in default has been reduced to 31. The amount in arrears has increased to R13.0 million.[23] The LALF portfolio is now administered by DBSA and will soon be fully integrated into DBSA's own debt portfolio. DBSA's own portfolio contains 80 other loans to localities, which are experiencing no defaults[24].

DBSA has sought to cure defaults through aggressive use of actions available to all creditors. Although first impressions suggested to DBSA's LALF administrators that many of the communities were too destitute to pay debt service, close inspection revealed that, at least some are capable of paying in a timely fashion. Some LALF defaults may even have been part of a strategy to protest reductions and obtain restorations in central government fiscal assistance. Accordingly, DBSA has taken a tough stance on arrears and reports progress in curing defaults. The next major test of the LALF portfolio is expected to come in December, 1997 when the next semi-annual debt service payments from many borrowers are due. DBSA staff express guarded optimism that the default rate will be substantially lower at that time.

In discussions with investors holding significant amounts of sub-sovereign debt, neither the Urban Institute team nor the Deloitte and Touche team could detect more than a handful of defaults. When defaults did occur the existing legal mechanisms (e.g., court summons procedures and asset attachment) were of substantial assistance in curing such defaults.

There continues to be general apprehension in the investor community that the current estimated default rate of 1% will rise dramatically in the near future. This apprehension seems based on the investors' generally dim view of local government management capabilities, increased financial stress on local operating and capital budgets since amalgamation and on press reports of aggregate Project Viability findings.

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[23] The increase in arrears may be an artifact of difference in reporting dates. Many local authorities try to cure arrears by the end of a reporting period.

[24] There is one technical default which has arisen between a small locality that merged with the borrower. The technical default is a result of a dispute over which community owes DBSA.

3.7.a The Greater Johannesburg Metropolitan Council (GJMC) Experience[25]

The recent, highly publicized case of the Greater Johannesburg Metropolitan Council (GJMC) financial crisis and the government's response to that crisis has important implications for the sub-sovereign debt markets on several levels. This financial crisis occurred when the GJMC began spending money transferred from operating accounts for capital projects in the belief that long term debt would soon be successfully issued in the domestic and international markets to pay for the capital program. The national government enforced a provision of the Transitional Local Government Act prohibiting the international transaction. GJMC had been negotiating with Sumitomo Bank. It also raised questions about the quality of GJMC's budgeting and other financial management procedures, in particular, GJMC's practice of budgeting revenues as if it would achieve 100% rates and fees collection when its current collection rate had declined to 88%. As a result, GJMC's capital market access effectively ended and it was unable to pay back the inter-fund transfers, throwing the operating budget into serious imbalance in the current fiscal year.

The response from higher levels of government was swift. Financial and management discipline was mandated through a set of "Instructions" issued October 10, 1997 by the Gauteng Minister of Development Planning and Local Government to the GJMC and its Substructures pursuant to the Local government Transition Act. These instructions were apparently drafted with substantial central government involvement. A bulk infrastructure loan of R585 million was negotiated with the DBSA to provide an immediate solution to the problem of market access for the GJMC's capital program. The precise terms of the loan were not made available to the team, but we were assured that the interest rate was non-concessional, an amortizing structure was used (normal DBSA practice) and that at least two risk mitigating provisions were included in the loan's structure. Those cited to the team were:

- use of R85 million of the loan proceeds for the required purchase of a "sinking fund" zero coupon security to mitigate principal risk; and
- a requirement that, if the loan falls into arrears, part of a specified local revenue stream sufficient to amply cover debt service be diverted to a "lock-box"

[25] The Constitution of the Republic of South Africa, Act 108 of 1996 states, "When a municipality cannot or does not fulfill an executive obligation in terms of legislation, the relevant provincial executive may intervene by taking appropriate steps to ensure fulfillment of the obligation, including: a) issuing a directive to the municipal council describing the extent of the failure to fulfill its obligations, and stating any steps required to meet its obligation; b) assuming responsibility for the relevant obligation in that municipality to the extent necessary, which includes i) maintaining essential national standards or meeting established minimum standards for the rendering of a service; and, ii) preventing a municipal council from taking unreasonable action that is prejudicial to the interest of another municipality of to the province as a whole or to maintain economic unity."

mechanism from which the arrears would be made up and future debt service payments made.

3.7.b Impact of GJMC on the Municipal Securities Market

The crisis and its initial resolution appear to the team to have had at least two significant market impacts. First, there is no question that this crisis heightened the anxieties of many existing and potential investors in the sub-sovereign debt markets. The case was cited numerous times to the team by investors already concerned by the results of the Project Viability report and other anecdotal indicators of financial difficulty being experienced by local authorities.

Second, more sophisticated specialists in the municipal market perceive the crisis and the governmental intervention as a positive development with respect to municipal credit-worthiness in general as well as a demonstration that GJMC in particular would never be permitted by higher authorities to default on outstanding debt. However it also is clear to the team that there is a need for the investment community at large (particularly the less sophisticated "passive" investors) to be informed fully about the steps that were taken by higher levels of government and the GJMC's response to date.

For example, the team understands that the Instructions were drafted with substantial involvement of central government players concerned with local and provincial government. Pursuant to the Instructions, the swift appointment of the ten person commission to oversee the implementation of these reforms and a "technical task team" to advise the Committee on the detailed design of the reforms, and several initial reforms have all taken place. These reforms include a reduction in the revenue estimate to include a collection rate assumption of just over 90% and a concomitant reduction in the operating budget large enough to create a substantial working capital reserve.

The Instructions themselves and the local compliance with the Instructions are all positive developments in the credit quality of the GJMC and set important precedents for other similar situations around South Africa. Additional, comfort can be taken by investors in the coordinated conditionality of future disbursements of the GJMC's bulk infrastructure loan from the DBSA. Future draw-downs of this loan are tied to the achievement of financial management improvement "mile-stones" by the Johannesburg government. There is lingering skepticism about how thoroughly the Johannesburg intervention and the DBSA's loan conditionality and risk mitigation features will change the management behavior of those in charge of the GJMC. If we can be guided by the analogous experiences of other major cities, including those of a number of U.S. cities, the process of designing and implementing the far-reaching management reforms that are needed will be a long, painful process, with each stage fraught with political and technical complexity. However, if the central and provincial authorities persevere with the highest possible expectations, the necessary changes are likely to be made and to become part of the fabric of Johannesburg municipal government.

Another case of intervention by higher authority occurred in Ladysmyth, a relatively small municipality in Cape Province which was reportedly experiencing severe operational and financial mismanagement. Here the provincial government did take the leading public role in an intervention which saw the virtual suspension of local powers, including financial management responsibility.

Equally significant, but not as well understood among investors and others, are 30 other interventions of the National Intervention Program which have resulted in corrective instructions being issued by provincial Members of the Executive Council (MECs) responsible for local government to local authorities which were found by Project Viability or through other means to be in some degree of financial distress due to mismanagement and/or other problems. The National Intervention Program has reportedly completed an additional 70 management audits and assisted MECs in drafting instructions which are to be finalized and sent to local authorities by the end of 1997. The team views this record of monitoring, problem identification and initial steps back toward sound management as being very favorable signals about the future of South Africa's local debt markets.

The team believes that the interventions by higher levels of government and DBSA the Johannesburg and Ladysmyth crises -- as well as the DBSA's continuing recovery efforts in the LALF defaults -- are potentially watershed events in the development of a hard credit culture among sub-sovereign issuers in South Africa. Some investors appear to share this view, but many seem too poorly informed to take appropriate levels of comfort from these events. Hence, the establishment of means by which INCA and other parties can quickly inform the sub-sovereign investor community about the swiftly changing landscape of South African sub-sovereign public finance is vitally important.

Fortunately, this is beginning to happen. Examples include INCA's planned quarterly newsletter and the recent establishment of a forum on municipal finance under the leadership of the Council of South African Banks (COSAB). Such efforts should have a directly positive impact on liquidity and other characteristics of the sub-sovereign debt markets.

3.8 Policy Issues Affecting Municipal Borrowing

While higher level government intervention in both the Johannesburg and Ladysmyth situations have positive implications for the municipal finance market, further well-publicized efforts ensuring that swift, consistent central and provincial reaction to possible default situations will continue to comfort market participants. For example:

- The Department of Constitutional Affairs introduced new regulations on November 14, 1997 requiring municipal Chief Executive Officers to submit regular and detailed reports to councilors on the state of council finances and making it possible for provincial and national governments to intervene in cases where municipalities appeared to be headed for a financial crisis. Specifically, the new regulations,

  a) require the CEO of the local authority to age all current debts and debts outstanding for 30 days, 60 days, 90 days, 120 days, and more than 120 days;

  b) require the CEO to complete an age (aging of accounts) analysis for the 20 highest monthly paid creditors including the reasons for all amounts outstanding for more than 30 days;

  c) require the CEO to reconcile the cash book with the bank statement and provide more detail of all reconciling items which have been outstanding for more than three months;

  d) require the CEO to provide information with respect to the type of investment, interest rates, period of investment and a summary of the local authorities exposures to particular financial institutions; and,

  e) require the CEO to provide a six month local authority cash flow projection which should include detailed plans to finance any shortfall.

- Failure to comply with the regulations would be a breach of the law and would leave CEO's exposed to possible court and disciplinary action by their councilors. These new regulations clear up, to some extent, the current uncertainty among capital market participants and government decision makers alike about the degree to which provisions of the Local Government Transition Act can be used to deter Mayors and Councilors from taking actions leading to debt defaults.

- It would be helpful for all market participants to understand that "structural adjustment" or similar "bailout" loans will only be made in extremes and only with partial or full higher level government takeover of local fiscal and possibly operating responsibility.

- Lenders to sub-sovereign borrowers can currently obtain court intervention in the event of default (e.g., use of the "summons" procedure and attachment of physical assets) and some holders of municipal bonds in default appear to have used these powers to assist in curing defaults. Nonetheless, it would be helpful in strengthening the sub-sovereign debt markets for the national and provincial governments to make clear their strong support of such legal actions.

- In addition, it would be useful for model default or pre-default work-out mechanisms to be prepared, and made ready for swift use by national and provincial decision-makers in financial crises. For example, clear state aid interception mechanisms can be legally authorized and the circumstances under which they may be used in transaction structuring clearly spelled out. Furthermore, such provisions could be fleshed out with detailed standard operating procedures (e.g., early warning "trip wire" triggers) that ensure they will actually work in the event they must be called upon. Similarly, trustee'd "lockbox" mechanisms for sequestering revenues and "super lien" structures to provide debt holders unquestioned senior positions before all other claimants (e.g., operating costs, employee compensation, etc. should be authorized for possible use in the work-out of default or near-default situations.

- The government can strictly enforce the Local Government Transition Act, Second Amendment Act 1996 provisions on budget submission and review, paying particular attention to the budgets' provisions for paying all debt service known to be due in the upcoming budget year and for paying debt service on any new debt planned for issuance in the up-coming budget year.

- Further elaboration of regulations in this area may be useful. For example, the government could require that payments for debt service be made to a trustee in equal monthly installments so that investors are further assured that the amounts needed for semi-annual debt service payments will actually be on hand for debt service when they are needed. Such a provision could be applied to all local authorities or only those that have been in arrears on any debt obligation in the past few years.

- It is useful in the development of a hard credit culture for national and/or provincial government to prevent sub-sovereign issuers in default from access to new subsidized debt or capital grants, unless such access is conditioned on imposition of rigorous fiscal control from a higher level of government.

- It will also be important for the government to continue the National Intervention Project and further develop local government fiscal crisis intervention team capabilities at the provincial level. While the Constitution makes clear that provinces have the leading role in conducting the kinds of interventions already carried out in Johannesburg and Ladysmyth, there is a legitimate national interest in making sure that these capabilities are of consistently high quality. Hence, national level policy leadership, technical assistance and coordination will continue to be desirable. Making these national and provincial crisis intervention capabilities highly visible will be useful in restoring investor confidence in the sub-sovereign sector.

All the policy initiatives outlined above should not be confused with an implicit sovereign guarantee. In some instances, financial default cannot and should not be cured by higher levels of government. In a hard credit culture investors must understand that no implicit guarantee exists that higher levels of Government will bail out insolvent local borrowers, regardless of the cause of excessive debt or the cost of remedying it. Credit risk will always exist to some degree or other in the new hard credit culture of South African sub-sovereign public finance.

4. Conclusions

Sub-sovereign governance and finance issues are by their nature diffuse and typically do not capture or consistently hold the attention of powerful decision makers. Nonetheless, a great deal is at stake in swiftly improving South African sub-sovereign governance and finance. The South African Constitution vests such power and responsibility at the local level that the ability of the entire public sector to deliver on the promises of the post-apartheid era rest heavily on the shoulders of local government. Failure to perform at the local level would prove disastrous to the new South Africa.

The team has reached a number of general conclusions from its exploration of the present state of South Africa's sub-sovereign debt market and of INCA's current ability to participate effectively in that market.

1. Primary and secondary markets are so mutually interdependent that any action which helps or hurts one will almost certainly help or hurt the other.

2. There is some evidence that at least certain sub-sovereign credit characteristics (e.g., local tax and fee collection rates, need for short-term borrowing to smooth cash flows, etc.) are continuing to deteriorate.

3. Most of the investor community remains anxious and skeptical about the willingness and/or ability of local authorities to pay debt service on long term obligations. Hence, there can be only marginal improvements in the primary and secondary markets until the fundamental building blocks of a sound and stable sub-sovereign public finance system have been put into place and broadly publicized.

4. It will likely take one or two years before the fundamental building blocks of a sound sub-sovereign public finance system can be put into place. During this transition period, certain steps can be taken by INCA and/or third parties to increase the liquidity of INCA's own senior debt obligations. This, in itself, is important, because INCA is already both a primary and secondary market participant; increased liquidity in INCA bonds is itself increased market liquidity.

5. Other steps which can be taken which may improve the activity and liquidity of the broader sub-sovereign market in the near term include mark-to-market requirements, improved disclosure of holdings by all classes of institutional investors, and improved information flows to all sub-sovereign market participants. These improvements are likely to increase INCA's own liquidity as well as the level of activity and liquidity of the broader market.

Appendix A

Schedule of Completed Interviews / Contacts

[illegible]	Title	Corporate Affiliation
Arend Adriaanse	Senior Dealer Fixed Income	ABN AMRO Bank Tel: (011) 784-9026 Fax: (011) 269-8401
Tim Marsland	Chief Dealer Fixed Income	ABN AMRO Bank Tel: (011) 784-9026 Fax: (011) 269-8401
Rudi Bam		Bond Exchange of South Africa Tel: (011) 482-2605 Fax: (011) 482-6699
Allen M. Jones	Market Operations	Bond Exchange of South Africa Tel: (011) 482-2605 Fax: (011) 482-6699
Chris Kapp		C J Kapp and Associates cc Tel: (041) 38-4009 Fax: (041) 38-4008 Cell: 082-655-1222
Bob Tucker		C.O.S.A.B Tel: (011) 838-4978
Barry Jackson		D.B.S.A Tel: (011) 313-3686
Mandla Gantsho	Executive Manager	D.B.S.A Tel: (011) 313-3319 Fax: (011) 313-3151 Cell: 083-275-2824
Oscar Somers		D.B.S.A Tel: (011) 313-3740 Fax: (011) 313-3086
Trevor De Kock	Treasury	D.B.S.A Tel: (011) 313-3744 Fax: (011) 313-3401
Pieter Van Der Gryp	Money and Capital Market	De Witt, Morgan and Co. Tel: (011) 838-6413 Fax: (011) 838-1499
Gavin Fennell	Director and Partner	Deloitte and Touche Tel: (011) 806-5614 Fax: (011) 806-5666
James Veitch		Deloitte and Touche Cell: 083-610-0534

Jackie B. Manche	Chief Director: Local Government Finance	Department of Constitutional Development Tel: (012) 334-3700 Fax: (012) 320-8026 Cell: 082-459-6749
Moeketsi Mosola	Director: Municipal Planning and Partnerships	Department of Constitutional Development Tel: (012) 334-3700 Fax: (012) 320-8024 Cell: 082-459-6750
Roland White	Senior Manager: Municipal Finance Policy	Department of Finance Tel: (012) 315-5346 Fax: (012) 323-1585
Andy D. Stuart	Senior Legal Adviser	First National Bank Tel: (011) 371-2111 Fax: (011) 371-2744
Belinda Dryer	Assistant Legal Adviser	First National Bank Tel: (011) 371-2111 Fax: (011) 371-2744
Willem A. Van Zyl	Head - Bond Trading	First National Bank Tel: (011) 371-0770 Fax: (011) 371-8400
Willem Wiggett	Director	HSBC Simpson McKie (Pty) Limited Tel: (011) 836-9642/3/4/5 Fax: (011) 836-9646 Cell: 082-821-1571
Attie Van Zyl	Executive Director	I N C A Tel: (011) 352-3465 Fax: (011) 352-9678
Dirkje Bouma	Credit Manager	I N C A Tel: (011) 371-8615 Fax: (011) 352-9678
Hylton Mathews	General Manager of Finance	I N C A Tel: (011) 532-4410 Fax: (011) 352-9678
Joanne Quinn	Secretary	I N C A Tel: (011) 371-2247 Fax: (011) 352-9678
Johan Kruger	Managing Director	I N C A Tel: (011) 352-3455 Fax: (011) 352-9678

Name	Title	Corporate Affiliation
Philip Van Den Heever	Executive Director	I N C A Tel: (011) 371-8604
Sonja Van Der Walt	Secretary	I N C A Tel: (011) 352-4399 Fax: (011) 352-9678
Ismael Ayob		Ismael Ayob and Partners
Ronald T. Gault	Managing Director	J P Morgan Tel: (011) 302-1620 Fax: (011) 302-1678
Doug Drysdale	Assistant General Manager-Fixed Interest	Liberty Asset Management Limited Tel: (011) 408-3054 Fax: (011) 403-1777
Henk Viljoen	Assistant General Manager-Fixed Interest	Liberty Asset Management Limited Tel: (011) 408-302/3/4/5 Fax: (011) 403-1777
Neill Maree	Portfolio Manager	Public Investment Commissioners Tel: (012) 328-3766 Fax: (012) 325-6778
Philip M. Chen	Managing Director	South Africa Infrastructure Fund Tel: (011) 636-0434 Fax: (011) 636-1517 Cell: 083-300-2579
Thenjiwe Sibanda	Senior Manager Project Development	South Africa Infrastructure Fund Tel: (011) 636-0522 Fax: (011) 636-1517 Cell: 083-307-5022
Andre Bezuidenhout	Deputy Registrar of Banks Deputy Head:Bank Supervision Department	South African Reserve Bank Tel: (012) 313-3401 Fax: (012) 313-3758
Christo F. Wiese	Registrar of Banks Head: Bank Supervision Department	South African Reserve Bank Tel: (012) 313-3770 Fax: (012) 313-4135 Cell: 082-451-8404
A H Arnott	Executive Director (Employee Benefits)	Southern Life Tel: (011) 491-6417 Fax: (011) 838-7335 Cell: 083-700-2297

Lauren Nolan	Logistic Coordinator and Research Assistant	Tel: (011) 942-3543 Cell: 082-924-6688
Sharon Manfred Trail	Secretary General	The African Union for Housing Finance Tel: (011) 326-0183 Fax: (011) 326-0073 Cell: 083-290-1070
Daan Wandrag	Executive Director	Theta Securities Tel: (011) 447-1253 Fax: (011) 788-8113
Joel E. Kolker	Housing and Urban Development Division	U.S.A.I.D Tel: (012) 323-8869 Fax: (012) 323-6443 Cell: 083-600-9709

Appendix B

Selected Data Sources

Data Sources (Publications)

Bank of America	South Africa - Financial Markets Review, April 25, 1997.
Bond Exchange of South Africa	Annual Report 1997
Bond Exchange of South Africa	Electronic Settlement in the South African Bond Market
Bond Exchange of South Africa	Listing Disclosure and Requirements, October 28, 1997.
Bond Exchange of South Africa	Publications Various
Bond Exchange of South Africa	Valuation Bonds, September 30, 1997.
Business Day	Article "Funding Corporation Inca to Receive R110 m loan" August 27, 1997.
CDE	CDE Publications Various, including: "Durban-South Africa's Global Competitor?" October 1996.
DBSA	Development Bank of South Africa, Annual Report (1997).
DBSA Proposal	Rationale of IDB and Guarantee Structure (Overhead Slides)
Department of Constitutional Development	Overhead Slides (Public Sector Budget et al.)
Department of Public Works	Asset Procurement and Operating Partnerships - Macro-economic Issues, August, 1996.
Economist Intelligence Unit	South Africa Country Report, First/Second Quarter, 1997.
Financial and Fiscal Commission	Local Government in a System of Intergovernmental Fiscal Relations in South Africa, July 25, 1997.
Foreign Investment Advisory Service	"Foreign Direct Investment in Infrastructure - The Challenge of Southern and Eastern Africa," February, 1997.
Future Bank Corporation	FBC - Future Bank Corporation, Annual Report, 1997.
Gauteng Provincial Government	Instructions in Terms of Section 10G of the Local Government Transition Act, 1993: Greater Johannesburg Metropolitan Council and its Substructures (Revised October 1997)
George Peterson	"Building Local Credit Systems," May 1997.
George Peterson, Priscilla M. Phelps	"Municipal Credit Enhancement in South Africa: Strategic Opportunities for USAID", April 1997.

IBCA	"Default Procedures" IFCL - 8/96 p3-6
IFC - World Bank	Investigation into Possible Establishment of a Financial Guarantee Insurance Program for Municipal Bond Financing, April 1997.
INCA	Deloitte-Touche Interview Notes (Various) August-September 1997.
The Liberty Group Life	The Liberty Life Group, Annual Report, 1996, 1997
Inca	Inca Interim Report, June 30, 1997
Local Government Transition Act	Statute of the Republic of South Africa - Local Government Issue, No. 31. Supplementary.
Ministry of Provincial Affairs and Constitutional Development	Green Paper on Local Government, October 1997.
One Mutual	Quarterly Report, June 30, 1997.
Project Viability	June, 1997 Quarterly Report.
RDP Infrastructure Investment Conference	Towards A National Infrastructure Investment Framework, March 28-29, 1996.
Report to the Gauteng Provincial Government	Mobilizing Municipal Bond Finance in South Africa, August 1997.
RTI	Financing Municipal Infrastructure in South Africa, March 1996.
South African Ministry of Finance	Investigation Into the Flow of Funds to Local Government, July 1997.
South African Reserve Bank	Annual Economic Report, 1997.
Southern Life	1996 Annual Report
Syfrets	Quarterly Report, September 30, 1997.

Appendix C

Vermont Municipal Bond Bank Application Form

Vermont Municipal Bond Bank
174 Elm Street, Post Office Box 1219
Montpelier, Vermont 05601-1219

Tel #: (802) 223-2717
Toll Free: (800) 894-2717 (In Vt.)
Fax #: (802) 229-4709

1997 Municipal Application

See Attached Instructions

A. General Information

Name of Applicant: ______________
Local Bond Counsel: ______________
Applicant's Bank: ______________ Bank Account #: ______________
Bank Location (*Town/City*) : ______________ *Account to wire transfer bond proceeds at closing*

Amount of bonds requested must be in increments of $5,000

Date of approving vote(s): ______ ______
Number of voters voting: ______ ______
Percentage of eligible voters: ______% ______%
P tage for project: ______% ______%
Percentage against project: ______% ______%

Total bonds requested in this application: $______
1. Purpose ______ $______
2. Purpose ______ $______
3. Purpose ______ $______

ALL APPLICATIONS MUST BE ACCOMPANIED BY THE FOLLOWING:

1. Annual reports for the last three years (2 copies of each)
2. An independent (CPA or RPA) audit of your financial statements for the most recent year (2 copies)
3. A preliminary legal opinion from your bond counsel

The application should be as complete as possible. It will be reviewed by the Bond Bank Board of Directors, the underwriters, insurance company, and rating agencies. You may get a call directly from them during their review of the application, if they have questions.

Contact Person/Title: ______ ______ Date: ______
Name of Official for Signature: ______ Tel #: ______
Address: ______ Fax #: ______

B. Project Summary

1. Project description:

a. Purpose:(*attach other information, if necessary*)

b. Describe who the users of the project will be:

c. Will the debt service be paid by taxes, fees or both?

2. Project(s) start and completion date(s):

Start Dates: *Month/Year* 1. ______ 2. ______ 3. ______

Estimated completion dates: *Month/Year* 1. ______ 2. ______ 3. ______

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3. Required permits

Have you obtained all the required permits for this project(s)? Yes [ ] or No [ ]

If NO, please describe the status and expected date of approval for each in the comment section on page 11

4. Sources and uses of funds for project(s)

A. $Sources of Funds		B. $Uses of Funds	
This Bond Issue:		Project Costs:	
Federal:		Refinancing Debt:	
State:		Costs of issuance:	
Local:		Other (Describe):	
Other:			
$Total Sources:		$Total Uses:	

Total sources must equal uses

5. Spending schedule of bond proceeds:

Qtr/Year	$ Amount:	Qtr/Year:	$ Amount:

Estimate the amount of bond proceeds spent by quarter assuming a receipt of the funds in July 1997

Total $:

Total must equal the bond issue

6. Payment schedule of bond issue *Annual payments must be in increments of $5,000*

(2.) See below for statutory payment schedule requirements

# Years	Dec 1st Year(1)	Principal $ Amount	# Years	Dec 1st Year	Principal $ Amount
1	1998		16	2013	
2	1999		17	2014	
3	2000		18	2015	
4	2001		19	2016	
5	2002		20	2017	
6	2003		21	2018	
7	2004		22	2019	
8	2005		23	2020	
9	2006		24	2021	
10	2007		25	2022	
11	2008		26	2023	
12	2009		27	2024	
13	2010		28	2025	
14	2011		29	2026	
15	2012		30	2027	

Total $:

Must equal the amount of the bond issue

(1) Principal payments start December 1998 unless you request otherwise

(2.) School & general municipal projects can bond for up to 20 years with level or declining principal payments

Water and sewer projects can bond for up to 30 years with either level principal payments or level debt service

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C. Tax Information

1. Total municipal tax effort:

This should include the total tax rate information including portions for the city/town, school and all other

Year	Tax Rate	Equalized Tax Rate*	Total $ Taxes Billed	% Change	% of Delinquent taxes at FY End
1996					
1995					
1994					
1993					
1992					

*From State Property Valuation & Review Division

Total amount of delinquent taxes at year end as a % of taxes billed

2. Tax rate change because of this bond issue

What will be the estimated effect of this bond issue on the overall tax rate? *(using the first full year of debt service)*

	Before:	After	% Change
Tax Rate:			

3. Tax filing information:

a. Tax Due Dates: ________ ________ ________

b. Penalties charged for late payments: ________

c. Interest charged on late payments: ________

D. Property Valuations

1. Listed property values:

Year	Local Listed Values (List full value)	Annual % Change	State Equalized Values	Annual % Change	% Level Of Appraisal
1996					
1995					
1994					
1993					
1992					

2. Year of last reappraisal: ________

3. Composition of the tax base: (State Form 411)

Residential & mobile homes	____%	Vacation	____%
Commercial	____%	Farm & Woodland	____%
Industrial	____%	Govt & Miscellaneous	____%
Utility	____%	Owned by non-state residents	____%

4. Tax stabilization contracts:

Describe any major contracts in the comment section on page 11

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E. Financial Statements

1. Basis of Accounting: Cash [ ]*. Modified Accrual [ ] or Full Accrual [ ]

2. BALANCE SHEET (General Fund only)

	__/__/94	__/__/95	__/__/96
Assets			
Cash			
Investments			
Accounts Receivable (less uncollectables)			
Taxes Receivable (less uncollectables)			
Due from Other Funds			
Due from Other Governments			
Other			
Total Assets:			
Liabilities			
Tax Notes Payable			
Other Notes Payable			
Accounts Payable			
Due to Other Funds			
Due to Other Governments			
Revenues Collected in Advance			
Other			
Other			
Total Liabilities:			
Fund Balance			
Reserved			
Unreserved			
Total Fund Balance:			
Total Liabilities & Fund Balance:			

Total liabilities & fund balance must equal total assets

* If basis of accounting is cash, complete the following:

Accounts Receivable	Start of FY			
	End of FY			
Accounts Payable	Start of FY			
	End of FY			
Taxes Receivable	Start of FY			
	End of FY			

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3. REVENUE AND EXPENDITURES (General Fund only)

	__/__/94	__/__/95	__/__/96	Projected __/__/97
Revenues				
Local taxes				
Licenses & Permits				
Federal				
State				
Charges for Service				
Interest				
Other				
Other				
Total Revenues:				
Expenditures				
Operations				
Debt Service				
Other				
Other				
Total Expenditures:				
Budgeted Expenditures*:				

* *Amount budgeted prior to the start of the year*

Balance				
Annual Surplus/(deficit):				
Transfers In:				
Transfers Out:				
Adjustments:				
Beginning Balance:				
Ending Balance:				

Beginning and ending balances must track from year to year

If you have had annual deficits in more than two years or in the most recent year please describe reasons for the deficit and plans to retire the deficit in the comment section on page 11

4. Has anything occurred since the date of your last annual report or financial statements that would significantly affect your revenues, expenditures or your ability to pay future debt service?

Yes [ ], or No [ ] *If YES, please describe in the comment section on page 11*

5. Which of the following retirement systems do you participate in?

Municipal [ ], Teachers [ ], Your Own* [ ], or None [ ]

* If you have your own retirement system please provide an estimate of any unfunded liability:

$__________ or none [ ] *If YES describe unfunded liability in the comment section on page 11*

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F. Debt Information

1. Debt statement as of: *Month/Year* ____________

List amount of principal only, do not include interest

	Current Bonds Outstanding	Bonds Requested
A. General obligation bonds		
1. Outstanding with the Bond Bank:	______	
2. Outstanding with other lenders:	______	
3. Bonds requested in this application:		______
Total Outstanding General Obligation Bonds:	______	
B. General obligation notes		
1. Bond anticipation notes (BANS):	______	
2. Tax anticipation notes (TANS) outstanding at FY end:	______	
3. Other:	______	
Total Outstanding General Obligation Notes:	______	
C. Less Self-supporting debt		
1. Bond anticipation notes retired from this issue:	______	
2. Self-supporting bonds: *bonds repaid with project revenues not general taxes*	______	______
3 Other:	______	
Total Self-supporting Debt:	______	
Total DIRECT Debt: *Bonds (A) plus notes (B) less self-supporting debt (C)*	______	
OVERLAPPING Debt: *From table 2 below*	______	
Total EXISTING DIRECT Debt: *Total direct debt plus overlapping debt*	______	
Total EXISTING DIRECT DEBT plus new REQUESTED DIRECT Debt:	______	

2. Overlapping direct debt:

See definition in attached instructions

Name of Govt Unit	Outstanding $Debt	Your % Share	Your $ Share *Debt X %share*
______	______	______	______
______	______	______	______
______	______	______	______
______	______	______	______
	Total Overlapping $Debt		______ *<-Enter above*

Self-supporting overlapping debt: *(for information only, not included above)*

______	______	______	______
______	______	______	______
______	______	______	______

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. Description of existing debt

.. General obligation bonds

Purpose	Direct or Self-supporting	Year of Issue	Year of Maturity	$ Original Amount	$ Amount Outstanding

This should agree with previous page A. total > Total:

b. Short term debt

Purpose	Direct or Self-supporting	Year of Issue	Year of Maturity	$ Original Amount	$ Amount Outstanding

This should agree with previous page B. total > Total:

4. Tax anticipation notes

FY		Issued During FY	Outstanding At FY End
1992			
1993			
1994	*Describe reasons for TANS*		
1995	*outstanding at the end of FY 1996*		
1996	*in comment section on page 11*		

5. Do you have any authorized unissued direct debt: Yes [ ] or No [ ] *If YES, list below*

Purpose: $ Amount

6. Do you have any authorized unissued overlapping debt: Yes [ ] or No [ ] *If YES, list below*

Purpose: $ Amount:

6

7. Schedule of long term direct debt service

Assumed Interest Rate:

A. Existing Debt: *List only existing direct debt, in whole $*

B. Proposed Debt: *This will be completed by the Bond Bank*

FY	A. Existing Debt: Principal	A. Existing Debt: Interest	B. Proposed Debt: Principal	B. Proposed Debt: Interest	Total
1997					
1998					
1999					
2000					
2001					
2002					
2003					
2004					
2005					
2006					
2007					
2008					
2009					
2010					
2011					
2012					
2013					
2014					
2015					
2016					
2017					
2018					
2019					
2020					
2021					
2022					
2023					
2024					
2025					
2026					
2027					
2028					
Total:					

% of New Debt paid off in 10 years:

% of Total Debt paid off in 10 years:

This will be completed by the Bond Bank

8. Future Borrowing Plans:

Attach 5 year capital plan, if available, or explain in comment section on page 11

9. Pending Litigation:

Do you have any pending litigation in excess of $10,000? Yes [ ] or No [ ]

If YES, please describe the cases including amounts covered by insurance and also any affecting the project funded by this issue in the comment section on page 11

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G. Economic Data

1. Geographic Data:

a. Located in county. ____________ b. Square miles: ____

2. Population:

This section will be completed by the Bond Bank

	Population	% Change	State	County
1995				
1994				
1993				
1990				
1980				
1970				

3. Income & Employment Data:

This section will be completed by the Bond Bank

	1993	1994	1995	1996
a. Unemployment Rate				
County or local area				
State rate				
b. Median Adjusted Gross Income				
District Median Income				
State Median				
Index				
c. Adjusted Gross Income per exemption				
District income per exemption				
State Average				
Index				
d. School District Total Adjusted Gross Income for 1995				

4. School Information:

a. ENROLLMENT Data

Include all school students including union schools

	High School	Junior High	Elementary	Total	% Change
1992	____	____	____	____	
1993	____	____	____	____	
1994	____	____	____	____	
1995	____	____	____	____	
1996	____	____	____	____	
Projected:					
1997	____	____	____	____	
1998	____	____	____	____	

b. Do you have any OVERCROWDING problems or are any anticipated? Yes [ ] or No [ ]

If YES, please explain in comment section on page 11

c. Number of BUDGET DEFEATS in the last three years: 1994: ____ 1995: ____ 1996: ____

If more than two (2) per year please explain in comment section on page 11

d. Do you have any ASBESTOS problems that have not been addressed? Yes [ ] or No [ ]

If YES, please explain in comment section on page 11

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5. Building Permits (If available)

	Number of Permits	% Change	$ Values Residential	$Commercial Industrial	$Other	Total $ Values
1992						
1993						
1994						
1995						
1996						

6. Ten Largest Taxpayers *Please provide the requested information for all of the ten largest taxpayers*

	Name of Taxpayer	Type of business or Use of Property	$ Taxes Paid in 19___	$Assessed Value
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
		Total		
		% of Total		

7. Largest Employers *list only employers with a minimum of 10 full time employees*

	Name of Employer	Type of Business	Estimated # of Full Time Employees
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			

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H. Comment Section

You may use separate or additional pages

1. General Economic Comments: *(This section must be completed)*

Please furnish brief comments relating to general economic development trends evident in your community or surrounding area. Be sure to include a brief discussion of the nature of your economic base together with information relating to current or contemplated private development projects, changes in employment opportunities and population changes.

2. Investment guidelines and Controls: *Describe your policies regarding the investment of your funds*

3. Additional application information: *Use this area to explain or expand upon information in the application, if necessary, including, but not limited to the following:*

a. Required permits;
b. Major stabilization contracts;
c. General fund deficits;
d. Revenue and/or expenditure problems;
e. Unfunded retirement liability;
f. TANS outstanding at year end;
g. Future borrowing plans;
h. Pending litigation;
i. School overcrowding problems;
j. Budget defeats;
k. School asbestos problems

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Vermont Municipal Bond Bank

MUNICIPAL APPLICATION INSTRUCTIONS

Municipalities must have a **favorable bond vote**, an **independent financial audit** of the most recently completed fiscal year and a **preliminary legal opinion** from bond counsel. The application may be submitted in draft form before the audit is complete, but the application will not be considered for final approval until the audit is finished.

The applicant must complete all sections of the application **except those shaded**. The application **does not have to be typed.** The Bond Bank will enter the draft application on our computer and return the final draft for your review. ***When you have completed the application please send it with the necessary supporting documents to:***

Ruth Sabol
RD #1, Box 1602
Northfield, VT 05663
Tel#: 485-8096

If you have any questions or need more information contact Ruth at the number listed above or call the Bond Bank at either of the following numbers:

(800) 894-2717 (Toll free in VT) or (802) 223-2717

A. General Information

Bond Counsel: This must be one of three Vermont firms approved by the Bond Bank. For a list of the eligible firms contact the Bond Bank office.

Bank Account#: We need to know your Bank, location and account number to be able to wire the bond proceeds at closing.

B. Project Summary

Permits: If you do not have all your required permits please describe the ones you do not have and when you expect to obtain them.

Sources and Uses: The sources represent the income for the project(s) and the uses are the expenditures. When completed the totals of the two columns should agree.

Spending schedule of the bond proceeds: This is an estimate by quarter of when the bond proceeds will be spent on the project. The total should agree with the amount of the bond issue.

Payment schedule: This must be in increments of $5,000 and can generally be for any number of years you want subject to the restrictions listed below the schedule.

C. Tax information

Total Tax Effort: **Data for this section** should represent the total tax effort for the entire municipality including both the town/city and schools and should be found in the Town Reports. The **% delinquent** represents the amount turned over to the tax collector divided by the total taxes billed.

Bond issue effect on the tax rate: This is an estimate of the total tax rate before this bond and then what it would be after factoring in the first full year of principal and interest.

D. Property Valuations

Local Listed Values: List total local values for the municipality from Town Reports or lister's appraisals. If **State Equalized Values** are available, list here, if not the Bond Bank will complete this section.

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Date of Last Reappraisal: From listers; **Composition of Tax Base**: from State Form #411, listers should have this information; **Owned by non-state residents**: from ownership ratios report.

E. Financial Statements

Which Financial Statements to include: If the applicant is a Town, City or Village then only include the General Fund of the municipal entity, excluding school income and expenses. If the applicant is a School District then only include the general fund of the school district.

Basis of accounting: If cash, the only figures in the Asset section will be the ending cash for the year involved. No liabilities will be listed and the Fund Balance will be the same as the cash balance. Also the bottom section will have to be completed.

Balance Sheet: The totals of the Liabilities and the Fund Balance must agree with the total Assets each year. In addition the Fund Balances must agree with the Revenue and Expenditure Statement ending balances found on the next page.

Revenue and Expenditure Statement: Be sure to enter the expenditures budgeted at the beginning of the fiscal year. If this is for a Town/City Application do not include the school district data. Also do not include Tax Anticipation Notes as income and expense items except for TANS outstanding at year end. The Beginning and Ending Balances should track from year to year and agree with the Fund Balances shown on the Balance Sheet (unless adjusted by audit). If you have had ending balance deficits you will need to explain the reasons for the deficit and what your plans are to retire it (comment area, page 11).

F. Debt Information

Self-Supporting Debt: debt paid by user fees or revenues, not taxes. Examples are sewer and water department debt. If the bond application is for self-supporting debt then a separate **<u>Enterprise Application</u>** will also have to be completed.

Overlapping debt: This represents the debt that is shared with another political entity. Information for these balances should be in Town Reports and the reports of the Union School, Village or Town, Solid Waste, Water, Sewer or Fire District, etc.

Schedule of Long Term Debt: Consolidate the annual debt service of all long term direct debt. The total principal should agree with the General Obligation Bonds Total listed on page 6 (Section A).

G. Economic Data

School Information: This should include the school enrollment data of all grades. This will be found in the Town Report (School District Section) or from the office of the Superintendent of Schools.

Building Permits: The total number of permits should be found in the Town Report, if not check with the Zoning Administrator. The $values of permits should be included, if available.

Largest Taxpayers: Information for the largest taxpayers can be found in the Grand List book and the tax book. Multiple ownership of properties under the same name or names should be totaled for a single listing.

Largest Employers: Estimated employment numbers are usually available at the local Chamber of Commerce. If not, call local employers. The total should be for the average annual full time number of employees.

H. Comment Section

<u>This section must be completed</u>. Please use this area for general economic comments and to explain or expand on information in the application.

UNITED STATES OF AMERICA

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EPIQ's Purpose: EPIQ—an environmental policy and institutional strengthening Indefinite Quantity Contract (IQC)—helps decisionmakers in transitioning and developing countries analyze, develop, and implement policy options that balance economic growth with environmentally sustainable development, thereby reducing the long-term threats to the global environment. EPIQ services strengthen environmental capacity, institutions, and policies as well as assist in the development and implementation of environmentally sound strategic planning.

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EPIQ

1211 Connecticut Ave. NW, Suite 700
Washington DC 20036

(202) 289-0100
(202) 289-7601
E-mail: epiq@irgltd.com

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