

4 January 2011

GREATER TZANEEN MUNICIPALITY

FINANCE DEPARTMENT

BORROWING FRAMEWORK POLICY AND GUIDELINES

1. PURPOSE

To establish a borrowing framework policy for the Municipality and set out the objectives, policies, statutory requirements and guidelines for the borrowing of funds.

2. OBJECTIVES

- Manage interest rate and credit risk exposure.
- Maintain debt within specified limits and ensure adequate provision for the repayment of debt.
- To ensure compliance with all Legislation and Council policy governing borrowing of funds.

3. SCOPE OF THE POLICY

The primary goal in the borrowing of funds is to ensure that the funds are obtained at the lowest possible interest rates at minimum risk, within the parameters of authorised borrowings.

Risk Management

The need to manage interest rate risk, credit risk exposure and to maintain debt within specified limits is the foremost objective of the borrowing policy. To attain this objective, diversification is required to ensure that the Chief Financial Officer prudently manages interest rate and credit risk exposure.

Cost of Borrowings

The borrowings should be structured to obtain the lowest possible interest rate, on the most advantageous terms and conditions, taking cognisance of borrowing risk constraints, infrastructure needs and the borrowing limits determined by Legislation.

Prudence

Borrowings shall be made with care, skill, prudence and diligence. The standard of prudence to be used shall be the “prudent person” standard and shall be applied in the context of managing overall debt.

Officials are required to adhere to:

- a) Written procedures and these guidelines
- b) Exercise due diligence
- c) Prepare all reports timeously
- d) Ensure strict compliance with all Legislation and Council Policy.

Ownership

All loans must be in the name of Greater Tzaneen Municipality.

4. LEGISLATIVE FRAMEWORK AND DELEGATION OF AUTHORITY

The relevant Legislation and Regulations in terms of which borrowing decisions are governed is Local Government Municipal Finance Management Act, No 56 of 2003.

5. TYPES OF LOANS

“VANILLA” LOANS

“Vanilla” Loans are straightforward and uncomplicated. The loan amount, interest rate and repayment period offered by the Financial Institution are fixed. The calculation of the instalment payable on an annuity basis is simple and straightforward. Normally with a “Vanilla” loan, the instalment of the loan will be repaid in equal six monthly instalments over the term of the loan. The capital portion of the instalment will increase over the duration of the loan and conversely, the interest charged will decrease over the loan period. Where the interest rate offered by the Financial Institution is on a variable basis, an interest rate swap (IRS) must be taken out. An IRS agreement will need to be signed with the party agreeing to accept the variable rate and offer the fixed rate to the Municipality. An Interest Rate Swap Agreement must comply with the terms set out by the International Swap Dealers Association (ISDA).

The fixing of debt repayments is an important consideration in meeting the legal requirement of the Municipality, that of annually producing a balanced budget.

STRUCTURED FINANCE LOANS

In its simplest form, a structured finance loan is one where the Lender, who is a tax payer, uses certain tax “claims” and effectively passes a portion of this benefit onto the Municipality by way of a reduced interest rate.

The advantage of this type of financing is that the benefits are utilised, giving the borrower a lower interest rate on the loan. The disadvantage is that any amendments in South African Tax Laws or the underlying assumptions in the financial model determining the structure of the loan will result in changes in the overall interest rate.

It must be appreciated that before entering into any structured finance contract the Municipality, being a Statutory body, will carefully scrutinise all aspects of the structured finance loan agreement including seeking legal advice from the Manager : Legal Services to ensure that the Municipality is not participating in a structure which the South African Revenue Service may deem to be one which leads to tax evasion. The Municipality will always adopt a prudent and carefully evaluated approach before entering into structured finance loan agreements.

The Municipality has not entered into any structured agreements recently, and in view of the tax implications under the present tax regime it is unlikely that it will enter into structured loan agreements in the future.

BONDS

A Bond is an instrument used by Government and Parastatals such as Telkom, Eskom, Transnet, Corporates and Municipalities to raise loan capital on the open market. Bond holders have the right to interest, usually paid on a semi annual basis, and the repayment of the capital amount reflected on the stock certificate held on maturity date. The coupon, maturity, principal value and market value are intrinsic features of a Bond.

The most critical variable factor in determining Bond rates is the expected long term trend in inflation, in order to provide a return that equals inflation plus a risk premium. The higher the risk attached to a borrower, the higher will be the risk premium investors will demand.

During its tenure the Bond will trade on the Bond market at prevailing interest levels. The price of a Bond trading at any given time on the market is a function of prevailing interest rates. Bond prices move inversely to movements in interest rates.

Advantages of a Municipal Bond issue are:

- A Municipal Bond issue may match the life of the asset being financed. This allows for pay-as-you-use, whereby the ratepayer pays for the use of the asset over the life of the asset.
- A Municipal Bond issue can take advantage of conditions in the interest rate market. The best example being when short-term rates are higher than long term rates – an inverted yield curve. If all preparations have been taken to enter the market quickly, then a Bond issue with a medium

to long term duration could take advantage of short term volatility in the market.

- If a Municipality establishes a position in the market, it can realize certain benefits. It gives the Issuer a benchmark for further issues. If there are several large maturities that are listed / quoted, it may be possible that a small add-on issue could be put into the market at a lower cost than a new issue.
- A Municipal Bond issue is an alternative to Bank loans or structured loans. Also because of the involvement of such parties as Financial Advisors and Underwriters, there would be better understanding and knowledge about interest rates and investor capacity for lending.

Disadvantages of a Municipal Bond issue are:

- The regulatory requirements which must be complied with prior to an issue will take more time to accomplish than the concluding of a Bank loan.
- The cost of an issue will be more expensive than a Bank loan.
- There will be more parties to a Bond issue and therefore organizing and implementing such an issue will require greater administration.
- Because of the public offer nature of a Bond issue, there will be a greater need for continuing information disclosure, and the accuracy of this information will be important in order not to mislead the Investors.
- There will be a number of Investors rather than one lender, payment of interest and principal will need to be made to many lenders, requiring greater administration.

The Greater Tzaneen Municipality has not issued any Bonds the last ten years.

USE OF INTERNAL FUNDS

The Municipality from time to time, will use certain of its surplus funds to fund its capital programme. The utilisation of surplus funds enables the Municipality to reduce its reliance on external debt financing.

6. OTHER CONSIDERATIONS

The Municipality has by the judicious use of surplus funds and external long term debt implemented its Integrated Development Plan which has facilitated the much needed service delivery program.

Factors to be considered when borrowing:

- The type and extent of benefits to be obtained from the borrowing.
- The length of time the benefits will be received.
- The beneficiaries of the acquisition or development.
- The impact of interest and redemption payments on both current and forecasted property tax income.
- The current and future capacity of the property tax base to pay for borrowings and the rate of growth of the property tax base.
- Likely movements in interest rates for variable rate borrowings.
- Other current and projected sources of funds.
- Competing demands for funds
- Timing of money market interest rate movements and the long term rates on the interest rate curve.

The Municipality may only borrow funds, in terms of the Municipal Finance Management Act, for the purpose of acquiring assets, improving facilities or infrastructure to provide service delivery.

Greater Tzaneen Municipality's external borrowings have been mainly sourced from the following Institutions:

- South African Registered Banks
- Development Bank of Southern Africa Limited

Greater Tzaneen Municipality may incur long term debt only for the purpose of Capital expenditure on infrastructure, property, plant or equipment to be used for the purpose of achieving the objects of Local Government as set out in Section 152 of the Constitution.

7. REFINANCING DEBT

Section 46 of the Municipal Finance Management Act provides that the Greater Tzaneen Municipality may refinance existing long term debt, if such refinancing is in accordance with the prescribed framework. The Municipality may borrow money for the purpose of refinancing existing long term debt, provided the existing long term debt was lawfully incurred and the refinancing will not extend the term of the debt beyond the useful life of the infrastructure, property, plant or equipment for which the money was originally borrowed.

No loans will be prematurely redeemed unless there is a financial benefit to the Municipality.

8. DEBT REPAYMENT PERIOD

Whilst the period for which loan debt may be received will vary from time to time according to the needs of the various Lenders, presently the typical debt repayment period for loans is between ten to twenty years, closely matching the underlying asset lives serviced by the loans.

Cognisance is taken of the useful lives of the underlying assets to be financed by the debt, and, moreover, careful consideration is taken of the interest rates on the interest yield curve. Should it be established that it is cost effective to borrow the funds on a shorter duration (as opposed to the life of the asset) as indicated by the interest yield curve, the loan will be negotiated to optimise the most favourable and cost effective benefit to the Municipality.

9. SECURITY

The Municipal Finance Management Act provides that the Municipality may provide security for any of its debt obligations, including the giving of a lien, pledging, mortgaging or ceding an asset, or giving any other form of collateral. It may cede as security and category of revenue or rights of future revenue. Some Lenders may require the Municipality to agree to restrictions on debt that the Municipality may incur in future until the secured debt is settled.

10. OVERDRAFT

Greater Tzaneen Municipality has a Bank overdraft facility, which is used from time to time.

11. SHORT TERM DEBT

The Municipal Finance Management Act provides that the Municipality may incur short term debt only when necessary to bridge shortfalls within a financial year during which the debt is incurred.

The Municipality must pay off short term debt within the same financial year and may not renew or refinance its short term debt.

The Municipality may, in terms of the Municipal Finance Management Act, incur short term debt only if the Chief Financial Officer has made a prior written finding that the debt is either within prudential limits on short term debt as previously approved by Municipality, or is necessary due to an emergency that could not reasonably have been foreseen and cannot await Council approval.

12. DISCLOSURE

Any Official involved in the securing of loans by the Municipality must, when interacting with a prospective Lender or when preparing documentation for consideration by a prospective Investor disclose all relevant information that may be requested or that may be material to the decision of the prospective Lender or Investor. Reasonable care must be taken to ensure the accuracy of any information disclosed.

Whilst this is a standard and acceptable business practice, it is also in compliance with Section 49 of the Municipal Finance Management Act.

13. GUARANTEES

The Municipal Finance Management Act provides that the Municipality may not guarantee any debt of any entity unless the entity is a Municipal entity under its sole ownership control. The debt must be reflected in the approved business plan of the entity. The guarantee must be authorised by the Municipality. This must be done in the same manner and subject to the same conditions applicable to any other borrowings. Neither the National nor Provincial government may guarantee the debt of any Municipality.

14. APPROVAL OF LOANS BY THE MUNICIPALITY

Section 46 of the Municipal Finance Management Act stipulates that the Municipality may incur long-term debt only if a resolution of the Council, signed by the mayor, has approved the debt agreement and the Accounting Officer has signed the agreement or other document which acknowledges the debt. At least 21 days prior to the meeting of the Council at which approval for the debt is to be

considered, the Municipality must make public an information statement setting out particulars of the proposed debt, including the amount of the proposed debt, the purposes for which the debt is to be incurred and particulars of any security to be provided. The Public, the National Treasury and Provincial Treasury must be invited to submit written comments or representations to the Council in respect of the proposed debt.

A copy of the information statement must be submitted to Council at least 21 days prior to the meeting to discuss the proposed loan, together with particulars of:-

- (i) the essential repayment terms, including the anticipated debt repayment schedule; and
- (ii) the anticipated total cost in connection with such debt over the repayment period.

15. PROVISION FOR REDEMPTION

Greater Tzaneen Municipality may borrow from Institutions and set up sinking funds to facilitate loan repayments, especially when the repayment is to be met by a bullet payment on the maturity date of the loan. These sinking funds may also be invested directly with the Lender's Bank. The maturity date and accumulated value of such investment must coincide with the maturity date and amount of the intended loan that is to be repaid.

16. NON-REPAYMENT OR NON-SERVICING OF LOAN

Greater Tzaneen Municipality must honour all its loan obligations timeously. Failure to effect prompt payment will adversely affect the raising of future loans at favourable costs of borrowing.

Failure to pay any loan instalment, even by one day and even if only through administrative oversight, will have severe repercussions, and may jeopardise the Municipality's credit rating.

17. PROHIBITED BORROWING PRACTICES

In the past some Municipalities have borrowed funds with the sole purpose of investing them to earn a return. The motive was clearly speculative. The cost of debt is almost always more expensive than the return that the Municipality can drive by investing in permitted investments. Consequently, as a principle, Greater Tzaneen Municipality does not borrow for investment purposes.

Foreign Borrowing is permitted in terms of Section 47 of the Municipal Finance Management Act, whereby the debt is denominated in Rand and is not indexed

to, or affected by, fluctuations in the value of the Rand against any foreign currency.

18. INTERNAL CONTROL

The internal control procedures involves Internal Audit and Performance Management, and the Auditor general reviewing and testing the systems of the Finance Department on a regular basis. In order to prevent losses arising from fraud, misrepresentations, error, conflict of interest or imprudent action, a system of internal controls governs the administration and management of the portfolio.

Controls deemed most important include:-

- Control of collusion, separation of duties
- Custodial safekeeping of loan agreements and contracts
- Clear delegation of duties
- Checking and verification by senior officials of all transactions
- Documentation of transactions and repayments
- Code of ethics and standards
- Procedure manuals
- Electronic Funds Transfer limits and a detailed procedure manual for the system.

19. NATIONAL TREASURY REPORTING AND MONITORING REQUIREMENTS

The Municipality submits numerous returns to National Treasury. It is mainly coordinated by the Finance department. One such report deals with the Municipality's external interest paid each month. Another return, prepared on a quarterly basis, requires the Municipality to itemise all its external borrowings for the quarter ended.

20. MUNICIPAL REGULATIONS ON DEBT DISCLOSURE

The Municipal Regulations on Debt disclosure has been promulgated (Government Gazette no. 29966, 15 June 2007) and has been effective from 1 July 2007 for a municipality or municipal entity. Municipal Finance Management Act: Municipal Regulations on Debt Disclosure.

The implementation of the regulations will help to strengthen the level of confidence in Municipal fiscal affairs and enable the capital markets to effectively participate by providing access to a range of competitive funding instruments for the provision of Municipal infrastructure and other capital development in accordance with Section 46 of the Municipal Finance Management Act.