REPUBLIC OF KENYA

COUNTY GOVERNMENT OF LAIKIPIA

MEDIUM TERM DEBT MANAGEMENT STRATEGY

2013/14-2017/18

COUNTY EXECUTIVE MEMBER, FINANCE, PLANNING AND COUNTY DEVELOPMENT

LAIKIPIA COUNTY

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EXECUTIVE SUMMARY

This debt management strategy is the first to be developed by the County Government of Laikipia (CGL). The county governments is required to prepare a strategy for managing their debt – this fact is recognized by the Public Finance Management Act (2012) section 123 which requires them to submit a debt management strategy over the medium term to the County Assembly on or before 28th February in each year.

The debt strategy provides clear objectives for debt management as well as a framework for achieving these objectives. There are two key objectives. The first is to ensure that the servicing and management of CGL's financing requirements and payment obligations are met on a timely basis, and at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. The second objective is to support the development of the domestic securities market. In practical terms, CGL must not go into arrears when it resumes borrowing, decisions must not be made on an ad hoc basis, debt levels must be sustainable and affordable, and borrowed funds must be used to increase the wellbeing of Laikipia County.

This document lays out plans for CGL's debt management for the next five years. It targets three different ways to help SIG achieve its objectives. Firstly, it sets out the analysis required for a debt strategy and to determine annual borrowing limits, secondly it puts in place a borrowing framework that is intended to be incorporated into Fiscal Responsibility Legislation and lastly, clarifies the responsibilities of the Debt Management Unit (DMU) of the docket of finance and Planning.

Prudent levels of borrowing that are below the thresholds will be calculated each year, as part of the budget process, to establish an annual borrowing limit and borrowing plan. Controlling and centralizing the approval process for all borrowing proposals (including borrowing by CGL issuing guarantees and on-lending) will ensure that the Government knows what its total liabilities are and that debt remains at affordable and sustainable levels. A Debt Management Advisory Committee (DMAC) will assess borrowing proposals to make sure that projects increase government revenue and GDP, or fund essential infrastructure that can benefit all citizens. Borrowing must be from an allowable source and with acceptable terms and conditions. Assessment of borrowing proposals will be part of the budget process to make sure that projects can be compared and only the best projects are funded. Borrowing also needs to be consistent

with the County Fiscal Strategy Paper and other legislations. The DMAC will make recommendations to the County Executive Committee Member for finance in relation to borrowing proposals. Based on recommendations from CECM for Finance will have sole authority for approving loans and guarantees.

List of Abbreviations

CECM	County Executive Committee Member
CFSP	County Fiscal Strategy Paper
CGL	County Government of Laikipia
CIDP	County Integrated Development Plan
DMAC	Debt Management Advisory Committee
DMU	Debt Management Unit
MDGs	Millennium development Goals
PFMA	Public Finance Management Act

Contents

EXECUTIVE SUMMARY ii

List of Abbreviations iv

1.0 Introduction 1

1.1 Definition of Debt 1

1.2 Definition of a Medium-Term Debt Management Strategy 1

1.3 Overall Objectives for Public Debt Management 2

1.4 Scope 2

2. The Current Status of the Debt Portfolio 2

3.0 Components of Debt Management Strategy 2

3.1. Maintain debt at sustainable and affordable levels 2

3.2 Ensure that any new borrowing follows legal and fiscal responsibility guidelines 3

3.3 Develop the domestic debt market 6

3.4 Introduce and consolidate fiscal, legal, institutional and operational measures that ensure that the above three objectives are met 7

3.4.1. Fiscal measures 7

3.4.2. Legal measures 7

3.4.3. Institutional framework 8

3.4.4. Operational framework 10

4.0 Conclusion 12

1.0 Introduction

The county governments is required to prepare a strategy for managing their debt – this fact is recognized by the Public Finance Management Act (2012) section 123 which requires them to submit a debt management strategy over the medium term to the County Assembly on or before 28th February in each year. This is in regard to its actual and potential liabilities in respect of loans and its plans of dealing with those liabilities.

The following information should be included in the strategy:

- The total stock of debt as at the date of the statement
- The sources of the loans made to the county government
- The principal risks associated with those loans
- The assumptions underlying the debt management strategy
- An analysis of the sustainability of the amount of debt , both actual and potential

After the statement has been submitted to the county assembly, the county Executive Committee member for Finance is required to publish and publicize the statement and also submit a copy to the Commission of Revenue Allocation and the Intergovernmental Budget and Economic Council. Developing sound debt management strategies has been identified as an important factor in avoiding debt and financial crises, and the hardship that such crises bring to citizens.

1.1 Definition of Debt

Government debt, or borrowing, includes the contracting or guaranteeing of domestic and external (foreign) debt through loans, financial leasing, on-lending and any other type of borrowing, including concessional and non-concessional borrowing, whatever the source.

Borrowing and debt of county corporations would be included in the definition of total county government debt.

1.2 Definition of a Medium-Term Debt Management Strategy

This Medium-Term Debt Management Strategy (Debt Strategy) is a *framework* that the County government intends to use over the medium-term (five years) to ensure that debt levels stay affordable and sustainable, that any new borrowing is for a good purpose and that the costs and risks of borrowing are minimized

1.3 Overall Objectives for Public Debt Management

Public debt management is more than making debt payments. There are two overall objectives

- Ensure that the servicing and management of the County government's financing requirements and payment obligations are met on a timely basis, and at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk;
- Support the development of a domestic debt market.

1.4 Scope

This Debt Strategy covers both domestic and external debts of the county government or its agencies as may be authorized by the county assembly. External debt is defined as debt denominated in currencies other than Kenyan shillings. Domestic debt is defined as debt denominated in Kenyan shillings, even when the creditor is a foreign entity.

Note that the scope of a debt strategy does not prescribe borrowing amounts. These are typically determined in a County Fiscal Strategy Paper. For the county government, borrowing is not to fund recurrent expenditure, but only for development expenditure. The key elements of the Debt Strategy will be incorporated into the CFSP and updated every year as part of the budget process.

2. The Current Status of the Debt Portfolio

3.0 Components of Debt Management Strategy

There are four components to the Debt Strategy

- Maintain debt at sustainable and affordable levels.
- Ensure that any new borrowing follows fiscal responsibility guidelines for a fit purpose; from an allowable source; and with acceptable terms and conditions.
- Develop the domestic debt market.
- Introduce and consolidate fiscal, legal, institutional and operational measures that ensure that the above three objectives are met.

3.1. Maintain debt at sustainable and affordable levels

a) Pursue grant funding and budget support;

b) Where grants are unavailable, or where a loan element of grant funding for priority development projects is mandatory, limited concessional borrowing may be sought;

c) Borrowing must be limited to concessional loans from multi- or bilateral donors or development partners.

d) The criteria for considering concessional financing shall be a grant element of 35 per cent or more. This is in line with international debt management practice and as recommended by the IMF and World Bank.

e) Concessional debt terms and conditions must be appropriate for the project being financed. These terms are suitable for long-term infrastructure projects, but projects with a shorter life must have loans with a comparably shorter time to maturity. Also, a 10 year grace period could be too long for projects where a revenue stream is forecast to commence in less than 10 years;

g) Projected debt servicing cost, not allowing for grace periods, must be less than 8 per cent of forecast domestic sourced revenues, assuming no growth in revenue;

h) Debt servicing shall be sequenced to avoid large peaks in repayment expenses at certain times of year. Revenues tend to peak in July and December, so where semi-annual payments are to be made, these months should be targeted.

i) As part of the budget process, an annual borrowing limit will be set such that debt levels will not cause thresholds to be exceeded

j) Debt levels must be lower than any thresholds stipulated in the Public Finance Management Act (2012);

3.2 Ensure that any new borrowing follows legal and fiscal responsibility guidelines

New borrowing must comply with legislative requirements in sections 58 and 142 of the *Public Finance and Management Act 2012* and article 212 of the Constitution 2010, the fiscal responsibility principles and financial objectives in the CFSP and the county debt management strategy over the medium term. New borrowing must be authorized by the County Assembly and approved by the National Treasury. The new borrowing must be:

- for a fit purpose;
- from an acceptable source; and
- with favourable terms and conditions.

Concepts such as intergenerational equity are also important. Future citizens should not pay the bills for living citizens. These requirements and standards are included in fiscal responsibility provisions proposed for amendments to the Public Finance Act.

1. Ensure that any new borrowing is for a fit purpose

(i) Borrowing must be for the following types of projects

- investing in the productive capacity of the county government;
- Funding priority core infrastructure and development initiatives;
- Specific purposes (projects) identified as a high priority in Laikipia County Integrated Development Plan (CIDP)

(ii) Borrowing must not be used for:

- Funding shortfalls in the county's recurrent expenditure.
- Funding losses of county entities

2. Ensure that any new borrowing is from an acceptable source

For the duration of this Debt Strategy (five years) borrowing should be restricted to concessional sources of finance from multilateral or bilateral donors. Such financing generally comes with greater scrutiny and oversight, making sure that funding is used for the purposes it was provided and decreasing reputational risk. Concessional lending is available through multilateral agencies like the ADB and World Bank and bilateral donors.

Loan amounts will depend on the specific projects to be funded and donors' funding allocations for the county. The denomination of the loan currency will also influence the acceptability of the source. Acceptability of source will also depend on the individual characteristics of the loan, limitations and conditions on the loan.

Lending from bilateral partners is linked to specific projects and terms and conditions depend on the project. Interest rates are at or below LIBOR. There is usually limited flexibility on the choice of terms. There may be hidden costs, such as various transaction charges and conditions attached to the loan including disbursement penalties, tied procurement (requiring recipients to use or procure goods and services exported by the creditor county). Loan disbursement may also be highly dependent on the progress of the project.

In the future, a third potential source of funding is through domestic securities. The PFMA 2012 section 144 envisages that the CECM for finance may issue securities on behalf of the county government for money borrowed by the county government. At the moment, the county governments are not authorized to issue securities.

Borrowing from private sources such as commercial banks is prohibited for the following reasons:

- Cost – interest rates are high;
- Interest rate risk – with variable interest rates, costs can increase;
- Rollover risk – loans tend to be short-term;
- Requires assets to be offered as collateral;
- Lack of transparency.

3. Ensure that terms and conditions are acceptable

The terms and conditions associated with any debt proposals must be examined carefully. The following factors will be examined:

1. *Grant/ concessional element:* Preference should be given to debt with a large grant component. However, the project still needs to be for a fit purpose.

2. Debt sustainability and affordability: The volume and cost of debt must not have a negative impact on debt sustainability and affordability. Hidden costs, such as fees (transaction, commitment, agency or underwriting), requirements for the Laikipia County Government to fund maintenance or project management expenses beyond the current year must be included in the analysis.

3. *Currency and exchange rate risk*: Despite offering very low interest rates, concessional loans still carry foreign exchange risk. Preference should be given to debt denominated in SDR.

4. *Interest rate:* Debt with a lower interest rate will have a lower cost. Fixed interest rates have a lower risk than variable interest rates where the future cost of debt is not known.

5. *Tenor*: Concessional loans have a standard long time to maturity (32 or 40 years). However, the term of the loan should be more closely aligned to the cash flows of the project. The advantages of very long term loans (such as the impact of inflation on the value of the loan) and very low repayment amounts can be outweighed by accumulating large amounts of debt over many generations. Very long term loans may encourage fiscal irresponsibility, because if the project fails, it is future generations that must bear the cost. By using up the borrowing envelope

now, it might restrict the ability of future generations to borrow, and they will be servicing debt for projects that were completed before they were born and for which they receive no tangible benefit.

6. *Grace period*: Debt sustainability analysis must extend beyond grace periods. The standard long grace periods of eight or ten years offered by multilaterals such as the World Bank and ADB may not be appropriate. The length of the grace period should be assessed in terms of factors such as the revenue stream from the project, its duration, inter-generational equity and the time value of money.

7. *Repayment risk:* The county government must be able to afford the debt repayments over the life of the loan and repayments must be timed for months with lower repayment volumes or where the County Government has peaks in cash collection.

8. *Conditions*: Preference should be given to debt with positive characteristics such as project administration or management and advisory services. Negative characteristics such as tied procurement, the requirement to use particular companies or nationalities for project implementation, future expense commitments (such as auditing expenses or maintaining equipment) need to be factored into assessments of the cost of debt.

9. *Concentration risk:* If the volume of the loan is large, it may contribute to concentration risk.

If an institution or bilateral partner has a large concentration of debt it could use this as a means of exerting undue political influence or bargaining for favours (for example tax concessions, access to resources). The behaviour of the lender needs to be assessed.

10. *Legal risk*: Borrowing proposals must be examined for potential legal risks. They must not contravene any national or county legislation. In addition, CGL must be certain that it is able to comply with all legal requirements such as conditions attached to the loan and including ability to repay. All loan contracts must first be cleared with the legal Office before signing.

3.3 Develop the domestic debt market

A domestic government securities market is made up of tradable debt instruments with a time to maturity up to one year (Treasury Bills, which are discount instruments) and Treasury Bonds which have a time to maturity of more than one year. Currently, the primary market is limited to Treasury Bills with a time to maturity of up to 182 days. The current market is limited in that counties have no securities of their own because of legal restrictions.

3.4 Introduce and consolidate fiscal, legal, institutional and operational measures that ensure that the above three objectives are met

Fiscal, legal, institutional and operational measures are needed to strengthen debt management and establish a borrowing framework. These measures also need to increase transparency and accountability so as to restore credit worthiness through rebuilding reputation. The PFMA 2012 provides an effective borrowing framework.

3.4.1. Fiscal measures

The Laikipia County Government must continue its commitment to balanced recurrent budgets and debt should not be used for recurrent spending.

Annual borrowing limits will be set as part of the budget process to keep debt at sustainable and affordable levels, based on conservative forecasts of macro-economic factors, and in line with the County Fiscal Strategy Paper.

3.4.2. Legal measures

Essential aspects of debt management contain these elements:

- Definition of debt to include loans, borrowings, guarantees and on-lending;
- Clear authorization by county assembly to approve borrowings and loan guarantees on behalf of the county government;
- A requirement that all borrowing proposals (including guarantees) are reviewed by a Debt Management Advisory Committee and recommendations submitted to the CECM for finance before borrowing and loan guarantees can be approved on behalf of the government;
- Decisions surrounding borrowing made as part of the budget process so that projects can be compared on merit, and appropriations are made for borrowed funds;
- Clear authorization from the CECM for Finance to the debt management entities to undertake borrowing and debt-related transactions and to manage loan guarantees;

- Clear debt management objectives, including that the cost of the debt is minimized from a medium/long-term perspective, the risks in the debt portfolio are kept at acceptable levels, and that development of the domestic debt market is promoted;
- A requirement to review and update the Debt Strategy annually which will serve as an operational strategy and will provide a framework for how the county government will achieve its debt management objectives; and
- As part of the annual update of the Debt Strategy, mandatory reporting on progress since the last review, covering an evaluation of outcomes against stated objectives.

3.4.3. Institutional framework

(i) Process for recommending borrowing proposals to County Executive

There is needed to be clear delegation of responsibilities for recommending and approving debt, where debt includes loans, borrowings, and guarantees and on lending by the county government. The proposed process for approving debt is as follows:

1. Borrowing proposals are recommended by the finance and Planning docket and forwarded to the Debt Management Advisory Committee for consideration. The projects identified for debt financing shall be consistent with the CFSP and limited to those projects that add to capital formation, job creation or are investments in essential social infrastructure (hospitals or schools for example). New borrowing will be for prioritized projects with high rates of return or key infrastructure for achieving Millennium Development Goals (MDGs). Cash flows from investment proposals need to be clearly identified and be sufficient to make debt repayments. The cost of any contingent liabilities and obligations such as tied procurement are factored into the cost and risk of debt. The implications for the recurrent budget should also be quantified, for example, maintenance of buildings or other assets acquired through the proposal.

2. Borrowing proposals are assessed by the Debt Management Advisory Committee (DMAC). The Committee shall propose a methodology for evaluating projects for debt financing consideration. This methodology will include evaluating the cost /risk tradeoffs of the proposal.

3. The DMAC will recommend and rank acceptable proposals;
4. Proposals that have been recommended by the DMAC can then be submitted and incorporated as part of the budget approval and appropriation process.
5. The CECM for finance has sole authority to approve loans. Therefore borrowing will not be legal unless it has been signed off by CECM for finance.

(ii) Functions and responsibilities of the Debt Management Unit

The functions and responsibilities of the DMU will be incorporated will include:

- Make debt payments on time and for the correct amount;
- Keep timely, comprehensive and accurate records of outstanding government debt, guarantees, contingent liabilities and new borrowing in a single debt database;
- Publish, in a timely manner, monthly (and quarterly) reports showing the status of outstanding debt, debt payments, and projected debt payment obligations;
- Prepare, review and update the Debt Strategy;
- If required, prepare an annual borrowing plan;
- Prepare and publish auction calendars for issuance of domestic securities (Treasury Bills and Treasury Bonds);
- Assess the risks in issuing any guarantees, and prepare reports on the method used for each assessment and the results thereof for the attention of the Finance Minister;

Debt Management Advisory Committee will assess the volume and risk characteristics of debt to ensure that:

- Debt is sustainable and affordable;
- Debt is below the thresholds established;
- Debt is from an acceptable source;
- Debt is for a good purpose and the project is a high priority in the CIDP;
- Debt is not for funding recurrent expenditure;
- Project has a positive Net Present Value or helps achieve MDGs;
- The cost of any contingent liabilities and obligations such as tied procurement are factored into the cost and risk of debt;
- Cash flows from project can be identified that will be able to be used for repaying the loan.

- Loan terms and conditions are acceptable and achieve the best cost and risk outcome.
- Borrowing aligns with the CFSP

(iii) Debt Management Advisory Committee

The Debt Management Advisory Committee will evaluate borrowing proposals. The Debt Management Advisory Committee will be chaired by the chief officer in charge of finance with membership from Planning, Infrastructure and water dockets. The county treasury will act as secretariat for the Committee. The Committee will make recommendations to the CECM for finance as to whether borrowing should or should not proceed.

3.4.4. Operational framework

Accurate records and reports are necessary for maintaining and building Laikipia County Government accountability and transparency, and thus credibility. These are all important factors in improving investor confidence which will reduce the cost of borrowing in the future. Accurate records are needed for analysis, for example cost and risk analysis and for assessing performance against the Strategy. Operational guidelines, procedures and approval processes for domestic and external borrowing also need to be documented.

(i) Debt recording

The DMU will maintain accurate and up-to-date records of all debt (including guarantees, on-lending and contingent liabilities) and investments, which can then be reported. DMU also needs to keep records on liabilities of county entities.

(ii) Debt reporting

DMU will publish monthly reports on the status of County's total debt including loans, guarantees, contingent liabilities and payment arrears. The report will include details of new borrowing and issuance of Government guarantees, as well as debt repayments, rescheduling, write-offs, and retirements.

Quarterly debt bulletins indicating debt levels and cost, debt sustainability and affordability and actual and projected debt service costs over the medium term will be published on county's websites. An Annual Report will be produced showing changes in the debt status over the year,

details of any new borrowing and debt repayments, key events in the management of debt and the DMU, and a review of progress and performance against the Debt Strategy. Reports will be published in a timely manner, so that stakeholders have access to up-to-date information.

(iii) Debt Strategy

Every year the DMU will review, update the debt management strategy and present to the county assembly. The Debt Strategy will provide a framework for ensuring debt financing decisions are consistent with County government's broader fiscal and development strategies and that the level of borrowing fits within the debt sustainability/affordability thresholds defined in legislation or any other official documents and with achieving macroeconomic objectives.

(iv) Borrowing Plan

When required, DMU will prepare a borrowing plan.

(v) Debt Sustainability Analysis:

DMU will prepare a debt sustainability analysis.

(vi) Integration with Cash Management

The DMU will continue to work with county treasury to integrate cash and debt management. Cash management ensures that County government has sufficient funds to meet its obligations as an when they fall due. Use of cash management tools depends on reliable cash forecasting. For example, Treasury Bills can be issued to fund forecast cash shortfalls, with maturity timed to coincide with periods of forecast cash surplus. Similarly, excess cash can be invested in term deposits or similar instruments to earn the county government reasonable rates of return, with term deposits maturing at times of forecast cash shortfall.

(vii) Compliance

Where staffing levels permit, the DMU will move toward an office organization with separation of back, middle and front office duties so that work can be monitored and verified. DMU will also work with Treasury toward greater integration of the cash management task.

(viii) Capacity Building

Capacity building will continue at all levels and the DMU will update its capacity development plan annually.

(ix) Business Continuity and Disaster Recovery

Business continuity will be strengthened by documenting procedures for all key processes.

A register will be kept of key spreadsheets and documents, and these will be backed up regularly.

4.0 Conclusion

The 2013/14-2017/18 Medium Term Debt Management Strategy is a framework for prudent debt management. It provides a systematic approach to decision making on borrowing to finance the budget taking into account the risks and the costs. It's imperative that the county government continues to ensure that they implement prudent debt management practices and policies for a sustainable debt position.