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forward for KCC and Local Governments
in Uganda**

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25 June 2007

Online at <https://mpra.ub.uni-muenchen.de/4585/>

MPRA Paper No. 4585, posted 23 Aug 2007 UTC

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Key words: Sub-National Finance, Municipal bonds, Public infrastructure development.

Acknowledgement

This study was completed with the help of funds from the African Capacity Building Foundation, and was started after his worship the Mayor of Kampala City: Al-Haji Nasser Ntege Sebagala commissioned it.

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1.0 INTRODUCTION

1.1 Background and rationale

The world over municipalities and cities often rely on capital markets for their long term financing needs. It is envisaged that such debt issues accelerate the development of cities. The rationale is that since the projects are supposed to benefit the public over time, the issuance of debt to spread the payments between generations is optimal (World Bank, 2004). Municipal¹ bonds are still unexplored as a mechanism of financing capital projects of municipalities in Uganda. Municipal bonds are securities or debt instruments issued by municipalities or city authorities to raise capital for public works and income generating projects. They usually carry a fixed rate of interest; a coupon that is the nominal yield a holder is entitled to annually. The fixed par/face value is repaid after a fixed period. The existence of a secondary market for bonds; make them suitable instruments for the public to hold, which encourages bond issues in the primary markets.

A typical municipal bond or debenture issue is used to provide funds for needed public works for which a major capital outlay is required. Such expenditures may be charged over a period of years against the tax revenues of those years since the projects is undertaken to provide a continuing benefit over those years. This study addresses the following questions:

- 1) Legal environment; does the Local Governments Act and the Capital Markets Act allow such instruments?
- 2) What incentives are needed to make them viable investments for the public?
- 3) The study should advise on what needs to be put in place to achieve this goal, and then discuss technically the aspects of the bonds in terms of face value, maturity and coupon rates.
- 4) The significance of municipal bond issuance to financial development, infrastructure and service delivery in local governments in general.
- 5) What has to be done to prepare Kampala City Council (KCC) and other local governments for such a brave move?

In this era of capitalism, decentralisation and the scrapping of poll tax. Municipalities have to be innovative in order to meet their financing needs. The poll tax revenue loss should be replaced by income generating projects. Vibrant capital markets lower the return investors require that keeps

¹ Municipal, City and local/sub-national government are used interchangeably, so they could be city bonds or local government bonds.

cost of capital low, the liquidity of such investments is the main incentive for investors. A recent example where a city has issued debt, to pay off more expensive debt is in Johannesburg. In April 2004, the first municipal bond was launched in south Africa, under new legislation and was oversubscribed, ever since then the city has issued four more bonds and has become a consultant for other cities that wish to do the same. Bonds are issued under the Municipal Finance Management Act No.56 of 2003 and the Municipal Systems Act No.32 of 2000.² If there is a fact finding trip this would be a good place to go.

The Government of Uganda (GoU) shed some of its responsibilities to local institutions, among which are municipalities and district administrations (Obwona *et al* 2000). This implies that local governments have to start thinking of how they can optimise their service delivery on limited revenue sources. Sometimes allocations from GoU may just manage to finance recurrent expenditures for; road maintenance, garbage collection and wages. As cities develop they require huge sums to build road networks and sometimes flyovers to ease traffic bottlenecks and to provide other necessary infrastructure like; airports, railway networks. Sometimes their may be efforts to beautify cities by getting rid of street vendors and slums. All these require capital to invest in product markets, new roads, stations parking lots, council housing projects that are aimed at the poor (low cost housing).

Local administrations have jurisdiction over revenues according to the Local government act, of a recurrent nature and must be divided between short term and long term projects; it may be foolhardy to wait say 60 years by putting away small sums to build a modern public transport terminal. In other developed cities such projects that can generate revenue are financed by loans. These loans often come in the form of municipal bonds that are paid off the revenue from the same projects. It is thus necessary to prepare our local governments for such remedies.

1.2 How bonds connect savers to borrowers

For the local government; it enables them to raise money to finance the necessary infrastructure to develop the localities, without relying heavily on the central government. The convenience of borrowing in local currency to the government is of great benefit. As it can always print money to pay off and then issue more bonds to mop up excess liquidity if it so happens that such prints

² <http://www.joburg.org.za/2004/bond.stm>

generate inflationary tendencies. It is generally a preferred mechanism to say borrowing in foreign currency from international markets.

Insurance companies and Social security funds that hold money in trust rely on such instruments that ensure long term savings or contingency funds for settling claims, are protected from loss of value by inflation. Thus a bond satisfies the needs of large non bank financial institutions, the financing needs of local governments and also provides avenues for the general public to invest excess funds; moreover for purposes that benefit them. A good transport network reduces transport costs, while provision of ample parking in the city ensures business success. Some ambitious cities may consider; airports, or finance railway stations and lines that link to the major line to increase their connection to the rest of the country. In order to attract tourists with convenience or to ease transportation of local produce and the procurement of needed consumption goods produced elsewhere.

1.3 Municipal bonds and financing development

When such projects take off they generally increase jobs available locally. Skilled staff like; engineers, architects and managers. Semi skilled staff like construction workers and unskilled staff like porters. In some areas where the only activity is seasonal agriculture, local government projects may ease on seasonal unemployment. In the long term good infrastructure attracts investment hence further improving local tax revenues and creating more employment. Local markets facilitate the sell of local produce that directly benefit the poor.

In this era, where the national agricultural policy is demand driven and farming considered to be a business rather than a way of life, building markets using bonds shall augment the GoU Plan for Modernisation of Agriculture, by easing marketing costs for produce in local areas. In areas where more produce moves than people, it may even be rational to think of public transport for produce, funded and managed by the local government, to ensure that even the poor can access markets. Through the issue of bonds local governments can accelerate their development and hence that of the country by making it easier to move people and produce around in an efficient system built on local debt, as well as building planned settlements that encourage organised urbanisation that is pro-

poor. Even strategic institutions may be built like; polytechnics, city Universities, entertainment and convention centres for events.³

These efforts in other emerging countries have attracted donor support⁴ The U.S. agency for International Development (USAID) motivated by the fact that; local government's ability to fund infrastructure development is limited by finance. Is helping Local governments in Mexico and South Africa; to finance municipal infrastructure by accessing domestic capital markets through municipal bonds. This support also encompasses identification of new financing needs as well as playing agent between municipal borrowers and lenders.

In Uganda's case this sort of help is highly needed to kick start the Municipal Bond market, as such it may be a good idea for KCC to approach USAID with its financing needs and express desire to finance the above through the issue of municipal bonds.. It is envisaged that Munipal bonds shall lower the cost of borrowing to sub national governments, enabling cities to finance development infrastructure at a lower cost relative to bank finance that is often short term and expensive.

³ Recently a famous preacher was in Kampala city; 50,000 people camped at Mandela national stadium. Press rumours claim he paid a whole 82 million Uganda Shillings (48,800 US\$) to rent the grounds. Imagine what would have happened if Mother Nature unleashed rain in the tropical form some of you know? A stampede, a wet sermon, and a possibility of not having the event at all! Utter shame for the city. How many preachers should worry about tropical rainfall instead of the scripture before the city builds a befitting convention centre? A possible contender target for the maiden Municipal bond is apparent.

⁴ <http://www.sdp.gov/sdp/initiative/c12882.htm>

2.0 RESEARCH ISSUE

2.1 Why Municipal Governments borrow money

Current tax revenue may not be sufficient to meet all expenditures; large sums are often required for capital and recurrent expenditures on; schools, hospitals, roads, and power plants. Local governments can levy taxes in the subsequent years to pay back interest and principal. These assets are expected to last a long time and hence benefit future residents of the community as well as the present ones. Therefore the cost is spread over the number of years that the assets are expected to last and shared by all those who will benefit from them during that time (CSI, 1990).

2.2 The evolution of Uganda's bond market

Bohnstedt, Hannig and Odendall (2000); note that there was hardly any mechanism for the intermediation of long term funds. The bond market had been tapped only by the East African Development Bank (EADB) and the Eastern and Southern Africa Trade and Development (PTA) Bank. They are predominantly of interest to a few institutional investors, individuals and corporations. It was difficult for bond issues to compete with treasury bills; they are predominantly used for monetary policy as opposed to raising long term funds, yet they absorbed most of Uganda's liquidity. The bond market took a turn for the good in 2004. The highlight was the introduction of the BOU Long Bond Series, a key monetary policy tool and benchmark (USE Annual Report, 2004).

Then there were further improvements in the amount outstanding and a secondary market that is helpful in encouraging holders emerged. Four bond issuances for a total of Ushs 105 billion and bond re-openings amounting to Ushs 260 billion, the total amount issued during the financial year; Ushs 365 billion, a 152% increase from the Ushs 145 billion level. There was increased secondary market activity with trades rising to Ushs 3,398.5 million from Ushs 321.4 million in financial year 2003/4, USE Annual Report 2005 .No trades were recorded in the corporate bond as market holders held onto their investments to reap from the attractive rates (USE Annual Report, 2005).

In addition; Uganda received a rating of grade B from the Fitch that is an indicator of risk.⁵ The report recognised the relative political and economic stability. However, weak public finances and high levels of external indebtedness remain a challenge in addition to; a seriously deficient revenue

⁵ <http://www.bou.or.ug/UgandaFitchRating170305.pdf>

base and a debt/revenue (grants inclusive) ratio of over 300%. The implication of this to local governments is that in an attempt for government to manage fiscal deficit, the allocations from the central government shall continue to dwindle, with damaging effects to the ability of local governments to fund infrastructure developments. Perhaps the recent introduction of a local government levy (Budget speech, 2007) that targeted income was a step by government to avert the crisis. The question remains as to whether these revenues shall be sufficient. It is thus prudent for local governments to start institutional changes that may enable them obtain credit by way of bonds, with a view of developing self financing projects that enhance private sector competitiveness.

In 2006 the bond market registered further improvements; the highlight being a more stable yield curve for the economy; the challenge to accelerate the structuring to benchmark instruments for the fastest growing sub sectors of the economy; energy and home ownership is noted (USE Annual Report, 2006). It would not be too ambitious for KCC to start its own low cost housing scheme to beautify the city in line with the greater Kampala metropolitan plan.

The USE report acknowledged GoU's macro economic fundamentals; especially the progressive construction of yield curve, a critical component for the successful conduct and development the bond market in Uganda. In Financial year 2005/6, eight new bonds were listed bringing the total number of listed bonds to 15. The total outstanding amount was up 30 percent from the previous year at Ushs 655 billion. In addition, a remarkable increase in secondary market government bond activity recording a total turnover of Ushs 38.37 billion, ten times more than the value of trade in financial year 2004/5.

2.3 The yield curve and its application to municipal bonds

“The Milestone Treasury Bond Signal, launched January, has over the past 6 month period successfully evolved in tenors ranging from the 2yr, 3yr, 5yr and 10yr. The first BOU Bond Series also signalled recognition of Uganda's continuously stable macroeconomic variables. It is hoped that the resulting Yield Curve-however inverted in some areas, will in time become the benchmark for pricing instruments in the financial sector. At any rate, the inversions can be straightened out by continuous re-openings on the 3, 5 and 10 year bonds” (USE Annual Report, 2004). What can be said is that the inversions have been straightened out; the 2006 yield curve can be used to price new bond issues of various maturities. Howawini and Ashok (1982) survey different methods of calculating yields. In particular the yield to maturity is of great interest to investors. By examining

yields to maturity investors can compare bonds with varying characteristics, such as different maturities, coupon rates or credit quality.

The yield curve plots the relationship between yield to maturity and time to maturity of bonds with similar risk. The relationship between yields and maturities is called the term structure of interest rates; a theoretical exposition of its characteristics is provided in Cox, Ingersoll and Ross (1981). Empirical tests of its validity were pioneered by Macaulay (1938) who rejected the expectations hypothesis alongside Nelson (1972) and McCulloch (1975). However, positive tests are provided by Culbertson (1957) and Fama (1976) who find evidence that the simple assertion that today's rate is a good predictor of tomorrow's interest rate in what they call the yield to maturity expectations hypothesis. Despite the mixed evidence most practitioners believe that the yield curve incorporates markets expectations concerning future interest rates, and thus fixed income security (bond) analysis revolves around this curve. Its existence is the key to pricing new issues.

The relevance of the yield curve formation in Uganda by the introduction of long term Government of Uganda bonds can be regarded as a milestone in the conduct of monetary policy in Uganda. It can be argued that the introduction of municipal bonds would certainly be made possible and easier by the existence of a yield curve of benchmark bonds. In this regard; BOU, GoU, USE and CMA have to be applauded. The existence of better bonds market allows for the use of interest rates as a stabilisation tool. It would be ideal to follow this up by encouraging local governments to follow suit and begin the formation of another curve for municipal bonds.

KCC is likely and well positioned to be the pioneer given that it's the capital city where 75 percent of the highest earners and by implication savers live (Buringuriza and Hyltensam 2002). In any case better service delivery and infrastructure would enhance the livelihoods of the same citizens. GoU may issue bonds for monetary policy reasons, for municipalities it is a question of service delivery and infrastructure development to cope with growth of the economy and population, these notions are complimentary.

2.4 Capital market development and macroeconomic policy

The privatization of former state enterprises formed the bedrock for the development of a domestic capital market by providing a critical mass of stock for trading. African stock markets are typically small and illiquid, with a limited volume of trade. Lack of a central depository and clearing system increases the risk of default on payment and delivery. Uncertain political and economic volatility render risk high. Donors support operations of formal capital markets like the Lusaka Stock exchange (LuSE) - was assisted by the World Bank, International Finance Corporation (IFC) and UNDP, (Bohnstedt, Hannig and Odendall, 2000) on the premise that a developed capital market is essential for economic development. In Uganda GTZ are helping the USE set up a central depository system to reduce systemic risk.

Political and general macroeconomic environment should be emphasized; fortunately GoU is committed to this through its Poverty Eradication Action Plan (PEAP) pillar 1. In order for municipalities to access markets they have to improve on financial and asset management and generally become more accountable leading to more efficient use of resources.

Municipal bonds are aids to existing macro policy; The Uganda macro environment is characterized by liberalism and tight fiscal policy to curb inflation, the state's role has changed to that of providing a competitive environment for the private sector. Private sector competitiveness in Uganda is hampered by the high costs of utilities and poor infrastructure that leads to rise in transport costs. This coupled with the land lockedness make the nation's output uncompetitive (Bohnstedt, Hannig and Odendall, 2000). Therefore a strategy of providing bond financed infrastructure, would be necessary, on the assumption that bond finance would cost less than bank finance in the long term.

It is feared that corruption is rampant in KCC and therefore this idea may not pass. However, the market knows how to price risk and that is why it exists. It can be argued that the desire for democratically elected leaders to perform would force institutional changes that would reduce corruption. Markets have stringent disclosure requirements: in an attempt to get better credit ratings to lower the cost of borrowing, local governments may become more efficient and accountable to the public. Such pragmatic steps have to be taken to avert a situation where the economy is slowed down by infrastructure bottlenecks that may work to undermine central efforts at prudent macro policy

3.0 LEGAL FRAMEWORK

3.1 Legislation

Local governments derive their authority from the Constitution of the Republic of Uganda, 1995 and the Local Governments Act Cap.243 Laws of Uganda (as amended). The aim was to engrain the decentralisation policy in the laws of Uganda. The policy was aimed at improving; accountability, efficiency, equity, effectiveness and sustainability in the provision of social services country wide. It was envisaged that this would strengthen local government's management and technical capacity (Obwona *et al*, 2000). Here we concentrate on highlights of the law that augment the issue of bonds, "there shall be established for each local government unit a sound financial base with reliable sources of revenue" and "appropriate measures shall be taken to enable local government units plan, initiate and execute policies in respect of all matters affecting the people within their jurisdiction" Article 176 (d) and (e) of the 1995 constitution.

The above legal quotes are useful in two ways, with respect to revenue; the reliable sources of revenue can be pledged to enable local governments to borrow through the issue of bonds. Quote two; empowers the local governments to initiate projects that are bound to address issues affecting their people. In Kampala city; there are a number of issues that are affecting people that can easily be addressed by bond issues like; building flyovers to ease traffic bottlenecks, building bus parks and an efficient public transport system, and the provision of organised low cost housing that should be an alternative to the slums that are the dwelling of less affluent individuals in the city, in fact a state exists to cater for these or to protect the interests of the less affluent.

It is legally possible and equitable for local governments to borrow especially in a case where the said projects are likely to improve on their revenue performance. It is often puzzling how the city lets out a market to a company that collects revenue on its behalf in product markets. It is evident that such people get the same revenue which sometime they fail to pass on to the city from the same markets. Would it not be better for the city to establish an asset management unit that runs and caters for the development of new markets as the city expands? Markets are inevitable and they are bound to be easy to develop through bond issues, with potential benefit to the city as the rent collections may be even higher than the debt service in the long term.

Relevant highlights of the Local Governments Act (Cap 243), can be found in the objectives of the act; “to give full effect to the decentralisation of functions, powers, responsibilities and services at all levels of local governments”, “to establish sources of revenue and financial accountability” These two objectives can simultaneously be met by bond issues that address infrastructure needs as desired by local governments. The developed projects can be used to enhance the revenues of municipalities; the desire to borrow from the public will force local governments to be mindful of their accountability in a desire to get good ratings on their bonds that reduce the cost of obtaining funds.

3.1.1 Accounting Regulations and Borrowing

Accountability of funds in municipalities is governed by the Local Governments Financial and Accounting Regulations statutory Instrument 243-15. In part II that guides the control of financial transactions; it is stated that “The financial transactions of local government and of a lower council shall be managed by the chief finance officer, the accountant, or the sub accountant, as the case may be, subject to the provisions of the Act and these Regulations under the general supervision and guidance of the accounting officer of the respective council.” The accounting officer is the chief executive that ensures appointment of qualified and competent staff among other duties: “In the exercise of his or her duties the chief finance officer, the accountant or the sub accountant shall prepare monthly receipts statements, monthly cash advances, salaries and allowances, monthly bank reconciliation statements, reimbursements and remittances by the council and ensure that such reports are made available to members of the standing committee responsible for finance within fifteen days after the end of each month” all this is reviewed by the standing finance committee that reports to the council where council; is a sitting of elected officers of local governments.

Under the same Regulations; compliance is monitored by; “The Auditor General, local government inspectors and any other state organs authorised by law shall ensure that local governments and the relevant officers of local governments comply with these Regulations and shall report to the Minister and any other relevant authority any failure of an administration to comply with these Regulations.” It is clear that the law on financial management and the provision for audit is clear, if well followed then the fears of corruption and loss are mitigated. This is particularly useful to lenders that may be worried about the financial conduct of local governments.

In Part VII section 57 of the Regulations; council revenues recognised are; “taxes, rates, fees, rents and other income” implying that local governments have several revenues that may make them credit worthy if the collection of them is good. The principal dealer of municipal bonds is required to assess these revenues thoroughly and the collection rates in order to come up with a view or a rating for the municipal bonds of a respective municipality. In Part VII named “other funds”- grants from the central government are recognised as other revenue, alongside donor funds that should be “spent solely on the objectives and activities specified in the agreements between the donor and the government or between the donor and the respective local governments”

In Part VII section 57 of the Regulations; the provision for local government borrowing is provided for clearly and is particularly interesting in as far as lender protection is concerned; we state it in full below with some remarks specific to bonds:

- 1) “A local government may raise funds by borrowing in accordance with the Act.” It is legal for KCC to issue municipal debt without legal encumbrances
- 2) “The loan shall be utilised for purposes for which it is intended and a separate loan account shall be opened.”
- 3) “The local government shall make progress reports on utilisation of the loan funds.”
- 4) “The provisions of the loan agreement relating to principal repayment and interest payments must be adhered to.” Earlier we discussed the possibility of default, these regulations clearly state that the indenture must be satisfied hence mitigating fears of lack of legal remedies in the case municipal debt goes bad.
- 5) “A local government shall borrow after the executive committee has assured the council that repayments shall be met without default and that salaries of employees, as well as other satisfactory obligations, shall not be affected by the loan repayments”. From this it is clear that a good place to start setting up a management unit dealing with bond related debt and the assets created is the executive committee of KCC or any other municipal that may issue bonds to develop its locale.

The law is clear on the issuance and repayment of bonds, the management of loan funds; there are provisions for internal audit in Part XVI of the Regulations. It can be said that most worries related to risk of default are addressed by the law; most importantly local governments can issue debt legally to finance specific projects.

3.2 Role of Capital Markets Authority

The Capital Markets Authority (CMA) acts as the regulator of the capital markets industry in Uganda. It is a legal administrative agency of the Government under the Bank of Uganda (BoU) it derives its authority from the Capital Market Authority Statute by Parliament of Uganda enacted in 1996. CMA is mandated to encourage and develop an orderly, fair and efficient capital market. It is empowered to supervise the Uganda Stock Exchange (USE), all dealers/brokers and to protect the interests of investors. It also operates a Compensation Fund for investors⁶ who incur losses due to failure of brokers or dealers to honour their contractual obligations (Bohnstedt, Hannig and Odendall, 2000). If any municipality is to issue bonds then all aspects of the indenture have to satisfy and be approved by the CMA in the interest of mitigating default risk.

The CMA regulates corporate bond issues;⁷ this terminology raises questions as to whether local government bond issues would be governed under the same regulations. However, The Local Governments Act (Cap 243) Part II section 6 sub-section 1; reads; “every local government shall be a body corporate with perpetual succession and a common seal, and may sue or be sued in its corporate name and may, subject to the provisions of the constitution, do enjoy or suffer anything that may be done, enjoyed or suffered by a body corporate.”

What is interesting; the regulations illuminate this research in a basic manner that readers may find interesting, for fear of distortion we quote “Corporate bonds and Commercial paper and are instruments issued for the purpose of raising funds directly from investors without intermediation by banks or other financial institutions. In the case of commercial paper, the purpose is primarily to raise working capital, while in the case of corporate bonds the issuer seeks to meet its long-term financing requirements” the rate at which Kampala city is expanding requires a lot of long term financing if it is to fulfill its service delivery and infrastructure needs. The city is still largely dominated by infrastructure that was meant to cater for only a few citizens “The issuance of these instruments is critical to the deepening of the capital markets, as they provide a number of financing options to corporate institutions and also serve to enhance market liquidity. The ultimate result is a reduction in the cost of borrowing and promotion of intermediation in the economy as well as a competitive financial sector”. The corporate bond regulations state conditions under which

⁶ The Capital Markets Act(Cap 485A) regulates foreign investors

⁷ Capital Markets Corporate Bonds Guidelines;

corporations may be allowed to issue bonds; including minimum capital revenue performance and the minimum issue as well as lot size.

3.3 USE listing rules

Bonds do not necessarily have to be listed on USE as they can be traded over the counter or by private placement. However, listing municipal bonds on USE, would lower the cost of capital, foster financial deepening and make the pricing of future issues easier. Appendix 3 of the USE listing rules details the disclosure requirements for the Fixed Income Securities Market Segment (FIMS), the same segment has seen the listing of Government bonds, with some considerable success.

4.0 MUNICIPAL BOND CHARACTERISTICS AND ISSUE STRATEGIES

4.1 Nature of bonds

A municipal bond when bought is equivalent to offering a loan to the municipal council that promises to pay back at maturity and pays interest at set amounts usually semi-annually. The term bonds is a term used by custom but sometimes the nature of the instruments issued by the municipalities are debentures (unsecured promises to pay), not backed up by pledged assets in case of default. Municipalities cannot pledge public property but can pledge certain revenues.

Bonds are normally issued with a fixed period to maturity, The year of maturity normally forms part of the bond's title, it is common to classify bonds by their residual maturity, bonds with lives up to five years are called 'shorts'; from five to fifteen are called mediums, over fifteen are called 'longs'. The coupon is normally made in two instalments at 6 monthly instalments each equal to half the rate specified; the coupon rate is the ratio between the coupon and the par or redemption value. Some are auctioned as is the case with government treasury bills to allow the market to price issues. Bond prices in the secondary market fluctuate inversely with interest rate. The yield on bonds is commonly expressed in two ways; the *redemption yield* and the *running* or *interest* yield. Bonds are supplied by municipalities, governments and corporations they are often demanded by; long term insurance funds, pension funds, discount houses. The attractiveness lies in their guaranteed rate of return if held to maturity, for some investors the tax treatment of bonds may be an attraction (Howells and Bain, 1994).

Suppose the par value for Ugandan bonds is Ushs 100,000. The small denomination is to make it easy for the public to hold; the convenience of the denomination makes it attractive to individuals as well as companies that may not have huge sums to invest. These points can be illustrated by a hypothetical Kampala City Council (KCC) bond, KCC 20% 2015; its title tells us that it will be redeemed in the year 2015 and that it will pay 10,000 Ushs every 6 months.

In some cases; bond issues are organised by financial institutions located in another country, usually in one of the three main financial capitals of the world; London, New York and Tokyo. They can also be issued in local or foreign currency; and the buyers or lenders do not necessarily have to be individuals or firms bonafide in the issuing country, which provides an opportunity to raise money from international investors. Prices in the secondary market are mainly driven by interest rates and

inflation. Also the credit rating of the borrower may be a factor in price determination. In an effort to make municipal bonds attractive some central governments guarantee them to reduce the risk and hence local governments are able to borrow at a lower cost (Vaitilingam, 2001).

4.2 Limitations of bonds⁸

4.2.1 Interest rate risk

The market price for bonds varies inversely with interest rates, an increase in interest rates leads to lower prices and hence a possibility of capital loss if they are not held to maturity, therefore interest rate fluctuations render them risky, that may discourage potential holders due to fear of loss. Interest rates are market determined, mainly driven by the inflation rate. Among the objectives of central bank is to control inflation. Since the government often relies on bonds for its financing, through the central bank, they keep a keen eye on inflation that partly drives interest rates; as a wild fluctuation of rates is undesirable. Bonds end up less risky than stocks; an alternative investment for potential lenders. Free lunches are rare in the financial markets; investors in stocks demand higher returns in order to hold on to riskier assets relative to bonds (Dimson, Marsh and Staunton, 2002).

4.2.2 Default risk

Bond issuers may fail to pay back the money borrowed; this risk is higher if the projects do not generate enough funds; this risk is highest towards the redemption date when a large sum has to be paid. Some strategies have been developed to reduce or eliminate this risk, in case of Municipal bonds this risk is virtually eliminated when they are guaranteed by the treasury, in years when there is a windfall in project earnings it is often prudent to redeem prior to the maturity date; that reduces both the coupon outgoings in subsequent periods and the risk of default at the redemption date. Instalment debentures have also been used as a remedy; where a part of the issue matures each year to prevent the risk of default at maturity, for example a debenture issue of Ushs 1bn may be designed in such a way that 100 million matures each year. This also favours the investors who have different maturity preferences in line with the preferred habitat theory (Modigliani and Sutch, 1966).

⁸ See McNish (2000) ch.7 pp.196-199, for a generic listing of issues affecting bonds. In designing the indenture it is prudent to address some of the perverse risks that may hinder wide participation from the public.

4.2.3 Liquidity risk

From the perspective of the issuer it may be hard to raise the money by selling off the bonds at their prevailing price that may lead to them being sold at a discount. This may be risky if the money raised is not enough to complete the desired project for which the bond was issued, it is possible to mitigate this by having issues slightly higher than the total project cost, or ensuring that they are sold wholesale to an investment bank or private placement that may resell them in the secondary market, bulk buyers are referred to by all sorts of names; market makers, discount houses; in Uganda; Bank of Uganda (BoU) refers to them as primary dealers.

From the perspective of the buyers, the ability to liquidate the bonds into cash is critical; bond holding becomes more attractive in the event that when individuals or firms feel the need to sell them, a ready market for them exists, much has been written about the liquidity of young markets, a subject that we do not go into here. Liquidity constraints on USE and possible remedies have been documented by Lutwama (2006). It may be a good policy to have the issues listed on USE to create a buoyant secondary market.

4.2.4 Agency type risk

These are mainly prevalent for corporate bonds, where the actions of the corporation may affect its risk profile or its ability to service the loan. A famous case is that of the Marriott Corporation, briefly described in (McInish, 2000). In case of municipal bonds that are project tied, the project management may take actions that may increase the risk profile of the project hence exposing holders to extra risk; a remedy is to write contracts (indentures) that limit the actions of municipal project managers.⁹

4.2.5 Sovereign risk

When municipal bonds are listed on foreign capital markets; they are guaranteed by the treasury; it is difficult to force countries to pay when they default. The remedy has normally been to have rating agencies that classify country bonds into mainly two broad categories investment-grade and speculative grade. The desire for better ratings that would ease future issues to fund future projects

⁹ The agreement between the bondholder and the issuer of a bond is called an indenture(Mcnish, 2001)

forces countries to honour their obligations. It is prudent to get rated when issuing bonds to encourage the international market to participate whether they are issued locally or not.¹⁰ Uganda currently has a B rating from Fitch.

4.2.6 Exchange rate risk

If bonds are issued in foreign currency then there is a risk of increased servicing costs when the local currency depreciates against the foreign currency in which they were issued, since the guarantor often the treasury has to rely on foreign exchange reserves to bail the issuer in case of shortfalls; its ability to do so is limited that increases the risk of default. To local holders; coupons may reduce if the exchange rate appreciates against the local currency. To foreign investors that hold Uganda shillings denominated bonds then the exchange rate will impact on there returns regardless of whether the coupon rate is fixed, hedging is used as a remedy to mitigate these types of risk.

4.3 Select categories of municipal bonds¹¹

In the USA these bonds are prevalent; commonly known as Munis or tax exempt because they do not attract federal taxes. They are issued by states, cities, towns, counties and their agencies. They are differentiated by the form of collateral used to back them to raise the revenue:

- General Obligation Bonds (GO Bonds); these are paid back from tax revenues; they are almost as secure as government securities.
- Revenue bonds; mainly used in the development of toll roads, bridges or tunnels, or any revenue generating projects, these bonds are paid off by the revenues arising out of those specific projects. They usually offer a higher rate of interest than GO Bonds, as payment is more narrowly backed.
- Industrial development bonds; These are issued by local governments to fund the establishment of new industrial parks or plants, or developments that might attract businesses and increase leasing revenue for the state, in Uganda's case; bus parks and markets for exchange of produce and manufactures may be categorised as such.

¹⁰ McInish (2001) pp. 214; lists several rating agencies "Moody's, <http://www.moodys.com/moodys/mdyinindex.htm>; S&P' <http://www.standardandpoors.com/ratings/corporates/index.htm>; Fitch IBCA, <http://fitchibca.com/home/frame.html>; Duff & Phelps, <http://www.dcrco.com/>; Thomson Bankwatch, <http://www.bankwatch.com/bankw.htm>; and A.M. Best, <http://www.ambest.com/ratings/preface/pc/contents.html>. The A.M. Best rating system is described at <http://www.ambest.com/ratings/preface/pc/contents.htm>."

¹¹ See <http://www.cftech.com/BrainBank/FINANCE/MuniBond.html>

- Redevelopment Agency Bonds for the construction of large commercial projects, they are secured by part of the property taxes levied on the development.
- Airport bonds Secured by general operations revenue and usage fees. Another riskier bond is tied specifically to facilities leased by individual airlines and is secured by the leasing contract itself.

4.4 Issuing strategy

Municipal bonds can be issued by competitive tender; the process currently used by BoU to sell treasury bills. The disadvantage is-through some tough bidding yields may be affected in a manner that constrains future issues of bonds. The alternative is to appoint an agent that buys them wholesale from the issuer depending on market conditions, a process known as underwriting.

4.4.1 Role of the investment dealer

The investment dealer underwrites and markets municipal bond issues; they have to assess the current credit position of the municipality before they finance the municipality. They study the municipal's financial position and other related factors.

4.4.2 Rating Municipal Credit

Dealers analyse among others: Trend of the population that bears the burden to pay back, value of taxable property and collection rates of city property rates, they also have to analyse the relation of debt charges to total revenue; "A rule of thumb ratio actual and estimated future debt charges should not exceed 10-15 percent of projected revenues" (Canadian Securities Institute (CSI), 1990).

The dealer also assesses the tax rates, tax collections and tax arrears per capita. They also look at the percentage of current tax collections to levy; these measure a community's ability to carry its tax load. They also have to verify outstanding recurring bank loans; that indicate poor tax collections or unwise spending on the municipality's capital account (CSI, 1990).

4.4.3 Bid submission and selling of the issue

After the assessment is considered satisfactory the dealer submits a bid to the issuing municipality, the bid is calculated to allow for profit and also cover cost of the due diligence described in the previous section as well as the marketing and selling costs.. If the bid is successful, the dealer goes a head to underwrite and sell the issue, in some cases dealers may widen the distribution by offloading off some of the debt to other dealers or simply sell the entire lot to its clientele.

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Is it possible to issue bonds?

It is legally possible for local governments to issue bonds; they can borrow up to 25 percent of their revenue. However, the conditionality in the law that requires them to maintain a balanced budget may be a limiting factor, the CMA seems to have laws for bond issues that are geared to corporations; whether these same laws apply to local governments is something that must be established by seeking the advice of CMA officially.

It is important to note that a yield curve exists for government bonds that can be used as a benchmark for pricing Municipal bonds (USE Annual Report, 2006). It is our view that the size of the bond market is already encouraging enough to be confident that the market may receive such issues favourably especially if they know that better infrastructure benefits all of them; most development banks and donors may be helpful in this noble attempt as they have done in other cities of emerging countries.

5.2 Recommendations

5.2.1 Responsibilities of the issuer

Obviously it must be legally possible for the municipality to issue a bond, and the term and size depend on the ability of the municipality to pay back, an assessment of internal revenue sources is critical, and the general rule is that the term of the loan should not exceed the useful economic life of the project.

5.2.2 Possible projects in Kampala

The main criterion for all projects to be funded by bonds should be their feasibility, in generating revenue to pay off the principal and periodic interest. Focus should be put on taxi parks of various levels, slum upgrading and markets because these have high potential market.

- Suitable and necessary flyovers; Bat Valley- Makerere Kivulu, Nsambya- Zana fly over avoiding the queens clock junction, Uganda railways head quarters over Mukwano Industries to Kibuli and to Nsambya road, fast railway service to the airport in the long run.
- Parking lots-underground and over ground, obviously as a means to ease traffic in the city, parking on road sides should be phased out after providing parking in the city. The city council should also develop and manage a modern bus terminal for taxis, with ample parking on levels and shopping centres upstairs.
- Entertainment facilities; on top of the list should be a national convention centre; an arena for conferences with many participants, concert performances and political party conventions that should be hired out to users. At the moment Mandela national stadium at Namboole is being used but is subject to the vagaries of nature. It is also necessary to build recreational facilities for the public to access that contain swimming pools, gyms and courts for games that should be accessed on pay per entry or membership.
- Markets almost generate instant cash as soon as they open; there would be plenty of tenants ready to occupy the premises.
- Council houses; decent but not very expensive. National Housing and Construction Corporation or Akright Projects may play a leading role here as the builder and supplier of houses to KCC.

5.3 Proposed way forward and areas for further study

More analysis has to be done on the current financial position of the council, and then we have to relate that position to establish parameters for issuing debt. ‘A rule of thumb ratio; actual and estimated future debt charges should not exceed 10-15 percent of projected revenues’ (CSI, 1990). The Local government act stipulates that all borrowing should not exceed 25% of revenue, projected plans have to be detailed enough to include projected cash flows to comply with these provisions.

More has to be done to improve on the image of council through credit enhancement strategies. Other areas that need further study are asset management techniques and the development of a bond market in general. Tremendous volume of literature is available on the Municipal Finance Task Force website.¹² Since this effort was meant to introduce the bonds as a possible remedy for the lack

¹² www.mftf.org; It covers all the topical issues and case studies of the problems other countries have faced in their efforts to establish bond markets for local government projects. It covers in detail: Credit Enhancement, Asset Management, Public-Private partnerships, Debt Market Development

of capital development funds in council at present. We have deflected from discussing this literature until a firm desire to move in this direction has been adopted by council.

In the event that council wishes to issue bonds; the services of an investment dealer become critical and it may be necessary to involve donors at that stage. They sometimes act as principal agents (technical support) to sell local government debt to investors or facilitate the dealer to become a specialist to maintain a secondary market in the stocks that is critical for future debt issues. It is also necessary to have the debt traded on the Uganda Stock Exchange. Areas that need attention and are viable for financing by bond issues are the bus parks, city parking lots, product markets and slum upgrading.

Municipal corporations can be kick started by convertible bonds; at maturity they can be converted into equity that would be an attractive way to achieve a public-private partnership. Similarly waiver of capital gains taxes and corporation taxes to municipal corporations and projects can enhance market participation and ensure that municipal debt is competitive relative to corporate issues. Donors may be called in to support market makers to ensure liquidity of bond issues.

The last recommendation is to take action and find viable projects and kick start the process with a pilot project probably not so big in one of the city's municipalities.

APPENDICES

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