NAIROBI CITY COUNTY

Medium Term
Debt Management Strategy

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FOREWORD

The importance of counties to pay serious attention to management of debts cannot be underscored particularly in respect of the huge stock of debts inherited from the former councils. Particularly the Nairobi City County inherited substantial debts from the former City Council of Nairobi that has continued to pose serious liquidity problems.

The constitution and the Public Finance Management Act, 2012 provides the requisite framework to ensure the country continue with prudent debt management. The PFMA has laid strict procedures, accountability and reporting requirements for counties.

The Medium Term Debt Management Strategy (MTDS) is one of the important deliverables of the County Treasury as provided for under the PFMA. It provides the guidance to the Counties on the amount, type of borrowing to undertake over the medium term. It evaluates the costs and risks of various scenarios and recommends an optimal strategy for implementation. The 2016 MTDS is aligned to the broad strategic priorities and policy goals set out in the County Fiscal Strategy Paper 2016 tabled in the County Assembly in February 2016.

As Nairobi county government becomes more established caution is required before considering borrowing to finance development expenditure. This is because the amounts inherited from the former Council are huge in consideration of the revenue potential.

The National Treasury has developed guidelines for country domestic and external borrowing to guide engagement between the GOK and development partners, counties and National Government to ensure proper coordination not only in the area of loans but also grants and on other forms of aid. The DMOs has undertaken to train Counties on preparation of debt strategies.

Gregory S. Mwakanongo
CEC MEMBER FOR FINANCE

ACKNOWLEDGEMENT

This is the third MTDS to be tabled in the County Assembly since the onset of devolution under the PFM Act 2012.

The MTDS sets out the debt management strategy of the County over the medium term with respect to actual and potential debts liabilities for both loans and other payables.

As required by the PFMA the MTDS will be formally tabled to County Assembly ,submitted to the Intergovernmental Relations office and will be published and publicized.

To ensure circulation of the MTDS, it is available in the County website. www.nairobi.go.ke.

Let me take this opportunity to acknowledge the staff of the County Treasury who were involved in the preparation of the 2016 MTDS. Specifically, I wish to thank Kefa Omanga, James Ngunjiri, Peterson Njiru, Alice Mundia, Peris Githinji, and Theresia Makau

Luke M Gatimu
Chief Officer Finance and Economic planning

LEGAL BASIS FOR THE PUBLICATION OF THE DEBT MANAGEMENT STRATEGY

The Debt Management Strategy is published in accordance with Section 123 of the Public Finance Management Act, 2012. The law states that:

- **The County treasury shall submit to the county assembly on or before 28th February in each year ,a statement setting out the debt management strategy of the county government over the medium term with regard to its actual liability and potential liability in respect of loans and its plans for dealing with those loans.**
- **The information to be included in the DMS includes:**

  a) **The total stock of debt as at the statement date**
  b) **Sources of the loans made to the county government**
  c) **Principal risks associated with those loans.**
  d) **The assumptions underlying the debt management strategy**
  e) **An analysis of the sustainability of the amount of debt, both actual and potential**

- **As soon as practicable after the debt management strategy has been submitted to the assembly the County Executive Member for Finance shall publish the statement and submit a copy to commission for revenue allocation and the Intergovernmental Budget and Economic Council.**

List of Abbreviations

CBK	Central Bank of Kenya
CBR	Central Bank Rate
DMO	Debt Management Office
DMD	Debt Management Department
FY	Financial Year
PFMA/PFM	Public Finance Management Act, 2012
MTDS	Medium Term Debt Strategy
CBA	Collective Bargaining Agreement
MTEF	Medium Term Expenditure Framework
GOK	Government of Kenya

EXECUTIVE SUMMARY

The accumulation of government expenditure arrears is one of the most common problems in public financial management (PFM). Government debts are financial obligations incurred by any level of the public sector for which payments have not been made by the due date. Payments may be overdue based on a particular legal obligation (such as payment of social security benefits, or salaries), a specific contractual commitment (such as payment for construction of a road), or a continuing service arrangement (such as payment for electricity supply).

Debt remains one of the major economic policy issues facing County Governments. Nairobi County Government (and its predecessor the defunct City Council) has been heavily in debt for more than a decade.

The County Government debt portfolio comprises of both short and long-term debts. These include loan from commercial banks, overdrafts unremitted staff statutory deductions and other creditors, which include unpaid staff arrears and suppliers for goods and services.

Further, the County's debt portfolio has been worsened by implementation of the CBA thereby increasing the wage bill while revenues remain almost the same as before. This has made servicing of the debts quite a challenge and the result is an ever-growing debt portfolio.

I. OUTLINE OF THE 2016 MTDS

Objective of Debt Management in Nairobi City County

Section II outlines the basis on which the 2016 MTDS is prepared. It provides the intention of the Government for the year 2016/2017.

Recent Developments

Section III provides an overview of the recent economic developments in both domestic and external front**.**

Characteristics of Kenya's Public Debt

Section V describes the salient features of the County Debts .It also establishes the starting point and provides guidance on the direction in which the county should move with regard to the cost and risk of the debt portfolio.

2016 MTDS: Key Assumptions

Section V Outlines the fiscal framework that aims at supporting rapid growth while at the same time ensuring that debts remain sustainable

Outcomes of analysis of Strategies

Section VI gives the performance of the alternative strategies in terms of their relative cost and risk.

Debt Sustainability

Section VII provides the debt sustainability thresholds for the County.

Implementing the 2016 MTDS

Section VIII outlines the commitment of the County Government in implementing the 2016 MTDS and provides the engagements the county government intends to take.

Conclusion

Section IX concludes

II. OBJECTIVE OF DEBT MANAGEMENT IN NAIROBI CITY COUNTY

The principal objective of the County Government debt management is to meet the County Governments financing requirements at the least cost possible with a prudent degree of risk.

The secondary objective is to enable the government to deal with the existing debt portfolio in order to release resources to service delivery.

The 2016 MTDS will guide the County Government operations in 2016/2017 and 2017/2018. The strategy seeks to balance cost and risk of public debt while taking into account the financing needs of the county and to develop initiatives for new funding sources.

III. RECENT DEVELOPMENTS

a) Developments in the Domestic Debt Market

Interest rates

Short-term interest rates have declined following improved monetary conditions that led to increased liquidity in the money market. The interbank rate was at 6.2 percent as of 21st January 2016. Liquidity conditions remained tight between September and October 2015, with short-term interest rates remaining above the Central Bank Rate (CBR) and the rates on treasury bills rising substantially. This tight liquidity situation improved beginning November 2015 resulting in reduction in all the money market interest rates.

The interbank rate averaged 6.2 percent as of 21st January 2016 compared to 7.3 percent in December 2015 and 8.8 percent in November 2015. The 91-day Treasury bill rate declined to 11.4 percent as of 22nd January 2016 from 21.7 percent in October 2015. The 182-day Treasury bill also declined to 13.7 percent as of 22nd January 2016 from 21.5 percent in October 2015 while the 364-day Treasury bill rate averaged at 14.3 percent from 21.6 percent over the same period.

The Kenya Banks Reference Rate (KBRR) was reviewed upwards from 8.5 percent in January 2015 to 9.87 percent in July 2015 as a result of the upward revision of CBR. The increase of the KBRR resulted to the increase of the average lending rates to 17.4 percent in December 2015 compared to 16.0 percent in December 2014 while the deposit rate increased to 7.9 percent from 6.8 percent over the same period. As a result, interest rate spread was at 9.5 percent in December 2015 from 9.2 percent in December 2014, a reflection of the increase in both the lending rate and deposit rate

Inflation

Macroeconomic stability has been preserved with inflation remaining on a single digit level. Overall month on month inflation was at 8.0 percent in December 2015 from 6.0 percent in December 2014 and 7.3 percent in November 2015. This was attributed to the Food and Non-Alcoholic Drink's Index which increased by 1.23 percent following increases in prices of several food items; the Alcoholic Beverages, Tobacco & Narcotics index increased by 11.46 per cent from November 2015.

B) External Domestic Debt Market

The Kenya shilling Exchange Rate

The Kenya Shilling exchange rate has stabilized following increased foreign exchange inflows in the money market. The current level of foreign exchange reserves, backstopped by the precautionary program with the IMF, continues to provide an adequate cushion against exogenous shocks. Furthermore, the current account deficit narrowed, mainly due to a lower oil import bill, and a slowdown in consumer imports.

The Kenya Shilling exchange rate, which had weakened against major international currencies, for most of the year, strengthened following foreign exchange inflows into the money market. The currency stabilized at Kshs. 102.2 against the US dollar as of 21st January 2016 compared to Kshs. 102.8 in October 2015. The depreciation of the currency was mainly due to the global strengthening of the US Dollar on the international market, and high dollar demand by importers in the domestic market.

Against the Sterling Pound, the shilling strengthened to Ksh 145.2 as of 21st January 2016 from Kshs. 153.3 in December 2015 and against the Euro, the exchange rate also strengthened to Kshs. 110.8 from Kshs. 111.1 over the same period. The Kenya shilling has continued to display relatively less volatility compared with the major regional currencies due to Diaspora remittances, increased foreign investor participation in the NSE.

Inflation

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IV. CHARACTERISTICS OF NAIROBI CITY COUNTY'S DEBTS

Stock of Debts

Table I: Summary of Outstanding Debts as at 31st December 2015 in billions

Type	**Outstanding As at 30th June 2015**	**Outstanding As at 31st December, 2015**
Statutory Creditors	12.9	15.01
Merchants and Litigations	2.1	2.3
Utilities	0.3	0.3
Loans	3.6	4.3
Contingent Liabilities		
Pensions	4.0	4.0
Government Guaranteed loans	19.1	19.1
Total	**42.3**	**45.2**

The total debt portfolio stood at Kshs45.2 billion as at 31st December 2015 from Kshs 42.3 billion as at 30th June 2015. The stock of debts is mainly composed of unpaid statutory deductions Kshs 15.1 billion, unpaid supplies Kshs 2.3 billion and utilities Kshs 0.3 billion owed to Kenya power, and bank loans and overdrafts kshs 4.3 billion.

In addition the County inherited debts amounting to kshs 19.1 billion .Though the details are available are scanty, the debts were loans taken from development partners for the development of water infrastructure in the 70s by the former city council of Nairobi and guaranteed by the Treasury. The debts remained in the books of the former City Council of Nairobi until the 2013 when the County Government took over.

Further, the County also inherited an amount of kshs 4.0 billion owed to Lap trust and Lap fund. These are amounts that were disputed by the former City Council of Nairobi and the issues remained unresolved.

Sources of loans

The County inherited bank loan from the defunct City Council of Nairobi. The City Council of Nairobi had taken a Kshs 5 billion loan from Equity bank to finance payment of statutory creditors. The County has occasionally obtained short-term loans from commercial banks to address shorter cash flow liquidity issues.

Cost /risk characteristics of public debt

Due to the short term nature of debts the County is faced with many risks in terms of high interest rates on commercial loans and overdrafts and undue pressure to pay these short term creditors. This in effect has a bearing on our liquidity and ultimately affecting service delivery especially where the funds must be channeled to paying these debts. In addition, the amount owed to pension schemes continues to earn interest on unpaid dues channeled to paying these debts. In addition, the amount owed to pension schemes continues to earn interest on a monthly basis.

Increased cost of service provision - Government suppliers try to mitigate the risks and opportunity cost of delayed payments by adjusting their initial prices upward.

Reduced or interrupted public service delivery - As the cost of supplies rise, the county with its limited resources may be forced to reduce the amount of supplies purchased and/or the volume of service provided to the residents of Nairobi paid dues.

Strategies to deal with the existing debt

The current debt portfolio shows that all the debts have already overdue as most are owed to suppliers, pension schemes and government of Kenya inform of guarantees. Strategies to deal with the existing debt portfolio include:

Strategy 1 – Debt rescheduling/renegotiation: *The County will seek to reschedule the current bank loans with a view to obtaining favorable terms and for a longer period. This will ease the pressure on the cash flows and thereby release the scarce resource to service delivery. This will in turn lead to increased confidence in the County management and further this is likely to improve on our cash flows.*

Strategy 2- Debts /Asset Swops: *Where the County owes various statutory creditors/utility firms who also owes us various debts in terms of rate ,the County will enter into negotiations with various creditors with a view to effect debts/assets swops.*

Strategy 3 - Debt Write offs: *In order to clean our balance sheet and improve our creditworthiness ,the County shall enter into negotiations with the GOK with a view to write off debts that were guaranteed by the central Government to the former City Council of Nairobi.*

Strategy 4:Enhancing revenue collection: *Further the County shall also explore ways of enhancing revenue collection in order to liquidate these debts to improve liquidity*

V. 2016 MTDS: KEY ASSUMPTIONS

a) Objectives and scope

In the 2016 MTDS , Nairobi County will continue pursuing broad objectives of funding the County Government Budget while maintaining a prudent level of risk taking account of costs. This will be achieved through diversifications of sources of financing and lengthening the average time to maturity of the domestic debt.

The scope of the analysis of the 2016 MTDS is based on the combined county government debts. The debt currently stands at Kshs 45.2 billion including contingent liabilities.

b) Macroeconomic Environment and Risks

The Macroeconomic framework underpinning the MTDS is consistent with the projections included in the 2016/17 County Fiscal Strategy (CFSP). It is hoped that fiscal policy will continue to support economic activity within the context of a sustainable public financing. From the year 2016/2017 the County has reoriented expenditure towards priority programs such as health, education, infrastructure under the Medium Term Expenditure Framework(MTEF).This process will be strengthened with a revamped legislative framework to enable accommodation of critical programs that will accelerate socio-economic development.

The medium outlook for 2016/2017-2018/2019 assumes a balanced budget with no deficits. In order to realize the budget objectives, the County needs to realize all the potential revenues both from the GOK and internally generated revenues to finance all our budget activities. Overall growth of the economy will depend on the pace of global economic growth, weather patterns and fuel prices will impact negatively on revenues of both the National and County Governments and hike expenditure demands.

Increased investment in infrastructure may necessitate the County Government to take in more debt to finance these additional expenditures. The crystallization of contingent liabilities would represent a significant increase in risk to the current debt burden. The transfer of functions from the national government with the implementation of devolution will has an impact on the pension scheme s of the officers transferred to the counties and will have an impact on the liabilities.

c) Potential Financing Sources

The preferred source of financing remains our own revenues in view of the cost and risk of other sources of financing. However to raise additional finance for development the county the other alternative sources of financing are:

i. **Borrowing from commercial banks*:*** The County will pursue borrowing from commercial banks or central bank. Borrowing from the CBK attracts low interest rate but requires the National Treasury to formulate guidelines. Further borrowing from the commercial banks leaves the county exposed to interest rate Fluctuations.The County will pursue revenue enhancement strategies in order to raise more resources for financing development. Specifically the county will review the valuation roll and enhancing collections of single business permits. The cost involved is minimal and only requires improving our revenue collection efficiency by improving our operations.

ii. **External borrowing:** External financing is usually at concessional rates at longer periods than commercial banks .The County may float international bonds or borrow from foreign banks. This is subject to volatility of the international money market and specifically fluctuation of the exchange rate since the bonds is denominated in dollars.

iii. **Borrowing from the money and capital market:** The County may borrow from the money market and Capital Market through issuance of County bonds. Borrowing from the capital and money market is subject to very strict conditions by the capital market authority.

iv. **Public Private Partnership Projects:** The County will pursue to engage in public- private partnerships to finance projects. The process is very lengthy and rigorous and requires approval from the National Treasury.

v. **Engineering Procurement and Construction:** This is where the contractor finances the projects and the contributes in kind for things like land. The County will pursue revenue enhancement strategies in order to raise more resources for financing development. Specifically the county will review the valuation roll and enhancing collections of single business permits. The cost involved is minimal and only requires improving our revenue collection efficiency by improving our operations.

VI. OUTCOMES OF ANALYSIS OF POTENTIAL FINANCING STRATEGIES

From the analysis of the potential financing strategies, borrowing from the commercial banks remains the only viable option in the medium term. However due to the volatility of the interest rates the County will need to negotiate with banks for fixed interest rates for the duration of the loan.

The borrowing should be capped at 15% of total revenues realized in the previous year subject to approval by the county assembly in accordance with section 141(2) of the PFMA.

VII. DEBT SUSTAINABILITY

The County Government recognizes the importance of managing debt prudently to avoid unwarranted debt burden to the future generation and reduce risk of macroeconomic instability. Significant efforts have been made to improve the institutional debt management as well as capacity to assess risks.

From Table 1,the total debt excluding contingent liabilities stands at Kshs 22.0 billion as at 31st December 2015.The total budgeted revenues for 2015/2016 stands at Kshs 30.9 billion. This implies that our debts stand about 71% of our total revenues. Considering that apart from the bank loan to Kenya Commercial Bank inherited from the defunct council all the other debts are current debts payable to utility firm KPLC, Pension schemes and PAYE ,this leaves the County exposed to these creditors.

The total debt including contingencies stood at Kshs 45.2 billion as at 31st December 2015. However, most of the contingent liabilities are owed to the national government on account of guaranteed loans to former local authorities.

As the county embraces strong fiscal responsibility measures such as paying current and part arrears of statutory deductions, the debts are expected to significantly reduce by 30th June 2016 to about Kshs 21billion.

The projected borrowing is set at a maximum of 15% of total revenues. The projected revenue for 2016/2017 stands at Kshs 34 billion. In case the County borrows the maximum of Kshs 8 billion this will push the total debts to about Kshs 29billion excluding contingent liabilities. This will translate to about 85% of the total revenues.

From the analysis above the results is that the County debts remains sustainable over the medium term since the loans are long term with fixed interest terms.

Other Operational Strategies

Enhancing the credibility and realism of the budget- One of the first steps in addressing a persistent arrears problem is to strengthen the realism of the annual budget. This will depend on robust assumptions and forecasts in the fiscal framework on which the budget is based. Internal revenues should be realistic and should be matched against expenditure. The County should set up realistic revenue targets and ensure the actual collection in a FY is enhanced.

b) Strengthening commitment controls - Commitment controls are part of the internal control system, which should prevent the County from initiating expenditure without available budget and cash. IFMIS will be used to enforce commitment control to ensure that expenditure incurred in a financial year has been budgeted for.

c) Improving cash and debt management - Reliable cash forecasting should ensure that liquidity is available to meet payment obligations as they arise. For effective cash management, the county treasury needs to develop accurate and timely short-term estimates of cash inflows and outflows. Spending Sector's should be required to prepare financial plans both a schedule of commitments and likely cash outflows.

d) Verification of Arrears - Once data on the outstanding debts has been collected, the data should be verified to ensure that such payments are genuine claims to avoid payment of fraudulent claims. This activity can be undertaken by the internal audit function of the County, or private audit firms, depending on the legal and institutional arrangements and capacity available.

e) Strengthening the legal and regulatory framework- The legal framework or related regulations should define payment terms (and when a payment is in arrears); reporting requirements; controls at the budget authorization, commitment, and payment stages; and the sanctions associated with any breach of those provisions. A clear credit policy should be put in place to enhance reporting, prioritization and timely payment of debt.

VIII. IMPLEMENTING THE 2016 MTDS

The County Government will prepare a borrowing plan to accompany the cash flow plan after approval of the budget. The Government has enacted legislation governing both external and internal borrowing under the PFMA with provisions that are in line with the requirements of the Constitution of Kenya, 2010 and best international practices. The total debt including contingencies stood at Kshs 45.2 billion as at 31st December 2015.However most of the contigent liabilities are owed to the national government on account guaranteed loans to former local authorities.

The County will also establish a debt management office to strengthen the institutional arrangement for management of debts. Comprehensive, accurate and timely information on public debt is critical in managing of debts. Public debt information will be published more regularly to enhance transparency on debt management in accordance with other best practices in the world.

The County will also continuously engage the Debt Management Office (DMO) at the National Treasury in order to manage to improve on debt management and especially concerning the debts guaranteed by the National Treasury.

Specifically and in-order to clear already outstanding debts the County proposes the following implementation plan and way forward**.**

Kenya Revenue Authority and NSSF

To settle the outstanding amounts the County will approach the National Government and negotiate a debt swap against the amounts owed by the National Government in outstanding rates.

Lap-trust

To settle this amount the County is entering into negotiations to transfer to the scheme one of our prime asset/ Estate. The agreed estate will be valued by three professional valuer's including the government in order to establish the correct value.

Lap-fund

Lap-Fund had taken the County to Court but was approached to reach an out of court settlement. If this is achieved, the County will negotiate with the Fund with a view to regularize the earlier transfer of Mariakani Estate (LR/209/6612 IR No.20935/1) ; by having, the estate re-valued a fresh and then credit the new value of the property/ deducted from the outstanding debt. Further, any outstanding balance will be addressed by collaborating with Lap-fund in the Urban Renewal project and cede part of our interest to the extent of the balance.

KCB Loan-3,031,414,761 and IPF loans & overdrafts-1,266,594,099

The Loan is to be re-paid over 9 years at 13%.The loan is repayable on a quarterly basis at Kshs. 141 Million per quarter. The same is appropriated from our revenues. The equity loan was repayable at an average Kshs 100million per month including interest thereby affecting operations.

Other Creditors & Utilities

In the meantime, the County has procured a Debt Collector tasked with collection of all outstanding rates. The proceeds from the exercise should be used to retire pending bills and Litigation amounts.

The County has to free itself from this debt burden in order to focus on service delivery.

GOK Guaranteed Loans

The loans were obtained many years back by the defunct City Council of Nairobi for the development of water infrastructure. The loans were obtained from the World Bank, USAID, and Local Government Loans Authority (LGLA).The loans were guaranteed by the National Government and in view of lack of documentation for the loans the County has approached the National Debt Management Office with a view to write off these loans from our books.

IX. CONCLUSION

The 2016 MTDS is a robust framework for prudent debt management. It provides a systematic approach to decision making on the appropriate financing of development projects. The 2016 MTDS has considered the current macroeconomic environment both at the local and external environment and other the related vulnerabilities. The recommended strategy is one that seeks to borrow from the commercial banks and enhancing our revenues.

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