

Helping De-Risk South Africa

Supporting local currency financing for state-owned enterprises

OVERVIEW

The World Bank is supporting South African clients diversify their sources of funding and mitigate their foreign exchange (FX) risk by making local currency financing available. Eskom, largest of the country's 13 state-owned enterprises, accounting for 95 percent of the nation's energy generation, transmission and distribution, as well as Land and Agricultural Bank of South Africa (Land Bank), with 29 percent market share in the agricultural sector, have high financing requirements. Any mismatch between their revenues, which are in local currency, and debt obligations exacerbates their FX risk.

Background

South Africa's smooth and peaceful political transition to constitutional democracy, along with a sustained record of macroeconomic prudence leading to steady GDP growth, has been one of the most remarkable political achievements of our time. After the 2008 global economic crisis however, growth has decelerated, slowing to an estimated 0.28% in 2016; and unemployment, poverty, and inequality remain a challenge.

To address these challenges, the South African government is promoting infrastructure investments and inclusive agricultural development, among other national priorities. Borrowing is one of the options to finance government programs and state-owned enterprises (SOEs).

South African SOEs, which are highly-leveraged and with approximately 40 percent of their total debt denominated in FX¹, run the risk of foreign exchange rate exposure. Their revenues are in domestic



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currency, the South African rand (ZAR), but their debt exposure is partly in hard currencies.

Financing Objectives

- Diversify the range of funding sources available to South African borrowers for longer maturities in ZAR, either via a US\$ to ZAR swap offered by IBRD, or via Automatic Conversion to Local Currency (ACLC) upon disbursement of any non-ZAR denominated IBRD loan
- Mitigate foreign exchange rate risk for South Africa, by making South African rand financing available at competitive rates
- Eskom: (i) enable Eskom to access the market for long-term currency swaps at competitive rates; (ii) maintain the variable spread component of the IBRD loan vs. the fixed spread, which is over 40 bps higher
- Land Bank: provide long-term financing for Land Bank, in South African rand, to sustainably scale-up Land Bank's financing in agriculture to benefit emerging farmers

¹ IMF Country Report No. 16/218

Financial Solution

In South Africa, where the US\$/ZAR swap market is highly liquid for relatively longer maturities, the solution was customized in line with client demand.

Eskom: IBRD is using currency swap transactions to convert tranches of the disbursed IBRD loan, transforming the loan obligation from US\$ to ZAR. The loan is converted into a fixed rate in ZAR, with a residual variable spread that is adjusted every six months depending on movements in IBRD's borrowing costs and the FX rate. The World Bank was able to access longer maturities in the US\$/ZAR market at competitive rates and pass these on to Eskom. The loan was initially committed in US\$ and subsequently converted to ZAR using the loan's embedded conversion options. Between 2013 and 2017, IBRD executed 14 swap transactions with tenors ranging from 21 to 25 years and notional amounts ranging from US\$ 100 to 300 million.

Land Bank: IBRD is using currency swaps to convert the loan amount to ZAR at the time of each disbursement. Using the loan's Automatic Conversion to Local Currency feature agreed with the borrower, each amount withdrawn from the loan account is automatically converted by IBRD upon withdrawal from US\$ to ZAR for the longest maturity available for such amount. The applicable interest rate following the conversion is determined by converting a Variable Rate comprising 6-month US\$ LIBOR plus a spread into a Variable Rate comprising the 3-month ZAR-JIBAR-SAFEX Rate for each Interest Period plus a spread (including the residual variable spread), as well as a transaction fee. IBRD will execute US\$ to ZAR swaps with the market every time there is a request for disbursement. Thus, the client will not be exposed to foreign currency, as it will receive and repay the loan always in ZAR.

Benefits for the Client

By having the World Bank intermediate the swaps that accompany each conversion, South African borrowers benefit from:

Hassle-free transactions

- No FX mismatch between borrowing and debt servicing obligations, as these are all in ZAR
- No need for negotiating and signing legal documents, such as the ISDA Master Agreement, designed to document over-the-counter derivatives transactions.
- The ACLC feature can already be embedded in the loan (Land Bank example)

- No need to post collateral, for entering into swaps with market counterparties

Market access through WB Treasury's relationships with major financial institutions, which give it access to market intelligence on the US\$/ZAR swap market and experts with extensive foreign exchange-linked derivatives and capital markets knowledge. An additional benefit for the client is to gain access to long-dated cross currency swaps at competitive price (due to IBRD's AAA counterparty credit risk).

Advisory work with the client on the mechanics of structuring the transaction.

Outcome

IBRD supported South Africa by making local currency financing available for longer maturities at competitive terms. Since 2013, approximately US\$ three billion local currency (ZAR) financing has been made available to South African SOEs so far, such as Eskom (USD eq. 2.9 billion, out of the US\$3.75 billion loan) and Land Bank (USD eq. 6.6, out of the US\$93 million loan).

Mitigating FX risk and diversifying South Africa's funding sources in ZAR will promote investments in much needed infrastructure and support ambitious plans to scale-up agricultural financing, which has potential to benefit the larger region.

As South Africa is the economic power house of Sub-Saharan Africa (SSA), economic conditions in the country have important spillover effects on its neighbors, and indeed, on the SSA region as a whole. The local currency financing through IBRD has the potential of influencing SSA markets, as the rand circulates freely in the Common Monetary Area (CMA) formed by South Africa, Lesotho, Namibia, and Swaziland whose currencies are pegged to the rand. Through interest rate and exchange rate movements, policy actions in South Africa immediately affect economic conditions in the CMA.

Local currency financing is one of the many ways the World Bank Group helps member countries become more resilient to economic shocks. IBRD's triple-A credit rating, market presence and convening power allow the World Bank Treasury Financial Products team to develop innovative new products to help clients maximize financing and mitigate risk.

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