REPUBLIC OF KENYA

COUNTY GOVERNMENT OF HOMA BAY

DEPARTMENT OF FINANCE AND ECONOMIC PLANNING

Medium-Term Debt Management Strategy

2024/2025-2026/27

Meeting the Financing Needs of the County Government at the Lowest Possible Cost Over Time

February 2024

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FOREWORD

This Medium-Term Debt Management Strategy 2024 has been prepared in compliance with the various provisions (Sections 123, 124, 140, 141, 142, 143, and 144) of the Public Finance Management Act (2012) as read together with the PFM County Regulations (Sections 41,177,178,179,180 and 187) of 2015. It covers the period of 2024/25 to 2026/27 and it sets out the county strategy for both actual and potential liabilities over the next three years.

This is the County Government of Homa Bay's tenth debt strategy paper since its inception, but only the second under the new administration led by Her Excellency Gladys Wanga. The paper outlines guidelines for managing debt, including the process of issuing debt, managing the debt portfolio, and adhering to laws and regulations governing debt contracting and management. By following this strategy, the County Government of Homa Bay can make and implement better decisions regarding the structure and horizons of debt, ensuring that their strategy for financing any fiscal deficit is feasible and at reasonable costs, while maintaining an acceptable level of risk.

There is a well-defined set of objectives for managing debt in this MTDS, and a framework to achieve them. The strategies proposed align with the global debt management community's best practices for responsible debt management. These practices aim to reduce exposure to financial shocks and contagion and include: (a) clearly defining debt management objectives; (b) weighing risks against costs; (c) establishing a coordinating office; (d) setting limits on debt expansion; (e) defining mechanisms for managing refinancing, market risks, and interest costs associated with debt burdens; (f) establishing sound institutional structures and policies to minimize operational risks, including defining roles and responsibilities among government agencies involved in debt management; and (g) having a reliable way to identify and manage risks related to contingent liabilities.

The County has experienced debts arising from bank overdrafts and payment arrears to staff and suppliers of goods and services resulting into pending bills of **KSh. 567,683,611** up to February 2024.There is a further **Ksh.188,934,228** for liabilities inherited from the defunct Local Authorities which was largely unpaid salaries, unremitted statutory deductions and accounts payables. The onus is now on the County Government to ensure these liabilities remain within sustainable levels such that the burden of and benefit from public debt is shared equitably between the current and future generations as stipulated under Article 201 of the Constitution.

Already, it is evident that the county government must have a vibrant debt management unit within the County Treasury to handle all matters relating to borrowing and servicing of debts. Measures geared towards the reduction of county debt have to be reinforced and additional strategies formulated to deal with current and future debts. Meanwhile, the county government will continue strengthening the capacity of existing staff and linkages with the National Treasury to help with financing inherited debts and guaranteeing of future borrowing especially to fund unavoidable budget deficits.

During the process of preparing this paper, an analysis of the existing level of debt, associated risks, and strategies to address management of the debt was undertaken. Existing payment obligations will have to be met at the lowest possible cost and with a reasonable degree of risk, while ensuring that the overall level of public debt is sustainable.

Providing the same level of public services while retiring the ever-increasing liabilities may remain a challenge in the medium term what with the ever-enlarging financing gap for critical services such as health. However, with this MTDS that has been prepared by the national best practice, several options will be evaluated from time to time under the specific macroeconomic assumptions, economic outlook and risk scenarios to ensure that the selected option is feasible. In that regard, all anticipated borrowings by type and attendant risks that may impact the county government's ability to meet its debt obligations, taking into account national and local economic and financial developments, will be considered.

Going forward, the County Government of Homa Bay will operate within a determined internal rate of return that is consistent with its Gross County Product. To show seriousness and shore up creditworthiness besides due diligence, the County Treasury will be part of the County Creditworthiness Initiative (CCI) which is a collaboration between the Commission on Revenue Allocation, the World Bank Group (WBG) and other stakeholders so that it is able to benefit from technical assistance and other measures instituted to help counties bridge their creditworthiness gaps and access finance for infrastructure and other development projects.

Hon. Solomon Obiero.
CEC Member – Finance and Economic Planning.
Homa Bay County Government.

ACKNOWLEDGEMENT

The Second Medium Term Debt Management Strategy (MTDS) 2024 prepared under the GENOWA Agenda is anchored on the requirements of various sections of the Public Finance Management Act, 2012 (PFMA).

The MTDS defines the debt management strategy of the County Government of Homa Bay over the medium term detailing actual and potential liabilities. The strategy impacts decision-making and provides vital information on 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, and an in depth look at the sustainability of the amount of debt, whether actual or potential.

The Public Finance Management Act, 2012, provides that the MTDS will be formally tabled in the County Assembly, submitted to the Intergovernmental Relations Office, and will be published and publicized. To ensure wide circulation of the MTDS, will be available on the Homa Bay County Website: http://www.homabay.go.ke / finance-economic-planning

May I take this earliest opportunity to acknowledge the CEC Member for Finance and Economic Planning for his overall leadership, the Director of Budget and Planning for overseeing the preparation of the MTDS, and all technical staff within the Directorate of Budget and Economic Affairs involved in the preparation of this MTDS, specifically, the core team comprising of Harriet Onyango, Simon Oyindo, Ken Oluoch, Amos and Ashton.

Mr. Alphonce Werah
Chief Officer – Finance and Economic Planning

LEGAL BASIS FOR PUBLICATION OF THE DEBT MANAGEMENT STRATEGY

The Public Finance Management Act, 2012 in Section 104 gives the mandate to the County Treasury to lead in monitoring, evaluation, and overseeing the management of public finances and economic affairs of the County Government, including managing the county government's public debt and other obligations and developing a framework of debt control for the county. Specifically, Section 123 of the Public Finance Management (PFM) Act, 2012 requires that:

1) On or before the 28th of February in each year, the County Treasury shall submit to the county assembly a statement setting out the debt management strategy of the county government over the medium term about its actual liability and potential liability in respect of loans and its plans for dealing with those liabilities.

2) The County Treasury shall ensure that the following information is included in the statement—

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

3) As soon as practicable after the statement has been submitted to the county assembly under this section, the County Executive Committee member for finance shall publish and publicize the statement and submit a copy to the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council.

Other relevant sections that define the management of the county debt in the Act include:

- Section 140 on authority for borrowing by county governments, requires that borrowing by county governments is undertaken by the debt management strategy of the county government over the medium term;
- Section 141 on obligations and restrictions to county borrowing, requires that a county government shall ensure that it's financing needs and payment obligations are met at the lowest possible cost in the market that is consistent with a prudent degree of risk while ensuring that the overall level of public debt is sustainable;
- Section 142 deals with borrowing by county government entities;
- Section 143 deals with persons who are authorized to execute loan documents at the county government level;
- Section 144 deals with the issuance of county government securities As such maintaining a sustainable level of debt as approved by the county assembly is highlighted as one of the fiscal responsibility principles, under Section 107 of the Act;

LIST OF ABBREVIATIONS

ADB: African Development Bank

CDMAC: County Debt Management Advisory Committee

CDMU: County Debt Management Unit

CEC: County Executive Committee

CFSP: County Fiscal Strategy Paper

FSP: Fiscal Strategy Paper

CIDP: County Integrated Development Plan

DSA: Debt Sustainability Analysis

GDP: Gross Domestic Product

IMF: International Monetary Funds

KNBS: Kenya National Bureau of Statistics

LIC: Lower Income Countries

SDGs: Sustainable Development Goals

MTDSP: Medium-Term Debt Management Strategy Paper

NAS: National Accounts Statistics

NPV: Net Present Value

PFM: Public Finance Management

SSA: Sub-Saharan Africa

EXECUTIVE SUMMARY

This Medium-Term Debt Management Strategy 2024 has been prepared in line with the various provisions of the Public Finance Management Act (2012) as read together with the PFM County Regulations of 2015. It covers the period of 2024/25 to 2026/27 and it sets out the county strategy for both actual and potential liabilities over the next three years.

This is the tenth debt strategy paper to be prepared since the inception of the County Government of Homa Bay but the second under the new administration of Her Excellency Governor Gladys Wanga. It provides guidelines for debt management including the issuance process, management of the debt portfolio, and adherence to various laws and regulations governing debt contracting and management. With this strategy, there is reasonable assurance that the County government of Homa Bay will make and implement better decisions concerning structure and horizons of debt such that County Government's strategy for financing any fiscal deficit is feasible and at reasonable costs with a predictable level of risks.

Whereas the County Government has so far not taken any outright or long–term loans, the County has experienced debts arising from pending bills, accounts payables and contingent liabilities. For pending bills, the **KSh. 567,683,611** being captured includes amounts owing to contractors up to February 2024.Liabilities inherited from the defunct local authorities is **KSh. 188,934,228.** The debt obligations inherited from those 7 defunct local authorities were domestic and were made up of 3 distinct components, namely; statutory deductions, unpaid emoluments, and pending bills from other creditors.

The MTDSP outlines clear objectives for debt management over the next three years as well as a framework for achieving those objectives. The objectives can be summarized into two: to ensure that the servicing and management of the county'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; and. to support the development of a vibrant domestic financial market.

This MTDSP has been formulated to ensure that both the level and rate of growth in public debt are fundamentally sustainable and can be serviced under the changing circumstances while meeting cost and risk objectives. The paper provides policy advice on an appropriate mix of financing from different sources with the spirit of upholding the integrity of the Public Finance Management (PFM) Act, 2012.

The County Government will utilize existing communication channels to publish public debt information regularly to enhance transparency on debt management in line with existing international best practices. This will be useful in winning and retaining investors' confidence with regard to risk assessment and the cost of debt. The county treasury will continue to strengthen the debt management department in terms of training and staffing to ensure that it is in a position to handle matters relating to borrowing and management of county debt. The county treasury will also continue to work closely with the national treasury to enhance the capacity building of staff and also offer technical expertise in issues relating to borrowing.

1.2 Rationale of the Medium-Term Debt Strategy

The MTDSP provides direction and benchmark for managing the county's debt portfolio. This will lead to the 'preferred debt composition', taking into account constraints posed by the economic and market environment.

The following are the main objectives of debt management in the county;

a) To ensure the financial needs and payment obligations of the county government are met at the lowest possible cost in the market and are consistent with a prudent degree of risk. Specifically;

- To establish a sustainable debt service profile consistent with the County Government's medium-term payment capacity;
- To promote the maintenance and further development of efficient primary and secondary markets for domestic Government securities;
- To broaden the County Government's investor base and diversify funding sources.

b) To ensure that the overall level of public debt is sustainable and shall never exceed twenty (20%) percent of the county government's total revenue at any one time as stipulated in the Public Finance Management (County Government) Regulations section 25 (1)(d).

c) To ensure that both the burden of and benefit from public borrowing is shared equitably between the current and future generation as stipulated under Article 201 of the constitution.

1.3 Scope of Medium-Term Debt Management Strategy

This Debt Management Strategy (MTDMSP) covers both actual and potential liability of the County government. It covers all loans and other payables, whether inherited or accumulated by the county government, that require payment of principal with or without interest by the county government to the creditor at the due date or a future date. The debt could be domestic or external provided it is incurred by legal entities of the County Government of Homa Bay. including the portfolio of government guarantees and contingent liabilities.

The MTDS will guide the county government's debt management operations in the medium term. However, debt analysis covers the total debt including debt inherited from the defunct local authorities at the advent of devolution and pending bills in February 2024.

The MTDS may not explicitly prescribe the correct amount to be borrowed as these are typically determined in the County Fiscal Strategy Paper and prescribed in an annual Borrowing Plan.

II. REVIEW OF HOMA BAY COUNTY DEPT PORTFOLIO

2.1 Introduction

This section aims at determining the levels of existing debt that will provide a basis for the type of strategies to be adopted for the purpose of proper management of public debt by the County Government of Homa Bay. The section also analyses the sustainability of the debts and the risks associated with the debts.

2.2. Stock of Debt

The total stock of debt as at 28th February 2024 stands at **KSh 567,683,61.** The debt is basically for contracts awarded but not paid in time due to delays in project implementation. There is another stock of **Ksh.188,934,228** from the defunct Local Authorities which is yet to be verified for settlement.

2.3 Sources of Liability

2.3.1 Explicit Contingent Liabilities

Contingent liabilities are potential liabilities that may occur depending on the outcome of uncertain future events. They are not reflected in the CFSP financial position but are adequately disclosed. However, a contingent liability is only recorded in the financial statements if the contingency is probable and the amount of the liability can reasonably be predicted.

2.3.2 Eligible Pending Bills

Eligible pending bills are unsettled financial obligations that occur at the end of a financial year as a result of failure to pay for goods and services that have been properly procured. Pending bills have been arising when county government entities fail to settle invoiced amounts for goods and services properly procured and delivered, or rendered as at the end of a financial year.

For the County Government of Homa Bay, the pending bills have been accumulating during the financial years 2019/20, 2020//21 and 2021/22 onwards. As at 23rd February 2024, the County government has pending bills amounting to **KSh. 567,683,611.** The breakdown of the debt per department is indicated in table 1 below.

Table 1. Pending Bills as at 23rd February 2024

NO.	DEPARTMENT	CONTRACT AMT KSH.	AMOUNT PAID KSH.	OUTSTANDING BALANCE KSH.
1.	Agriculture & Livestock Devt	11,062,325	2,569,919	8,494,406
2.	Gender, Culture & Sports	17,514,231	694,200	16,820,031
3.	Transport & infrastructure	667,675,430	505,990,679	161,684,751
4.	Blue Economy, Fisheries	40,381,179	7,860,208	32,520,971
5.	Education & ICT	12,033,379	12,033,379	0
6.	Health Services	284,267,498	162,667,877	121,599,621
7.	Trade & Industrialization	106,545,222	50,986,944	55,558,278
8.	Lands & Housing	40,183,199	30,751,199	9,432,000
9.	Water & Environment	224,686,682	90,641,389	134,045,293
10.	Finance & Economic Planning	6,676,082	0	6,676,085
11.	Executive Services	14,069,435	1,235,739	12,933,696
12.	Public Service Board	13,476,708	5,658,230	7,818,478
13.	Municipal Board of Homa Bay	11,438,672	11,238,672	200,000
	TOTAL	**1,450,012,048**	**882,328,436**	**567,683,611**

Source: Homa Bay County Treasury

From time to time, the County Government of Homa Bay has not been able to honor payments according to the contract terms as a result of myriad factors such as delayed transfers from the national government, own source revenue shortages, disputed payments and delayed legislations. Some of the pending bills were inherited from the defunct local authorities and the previous administration, many of which are under dispute.

2.3.3 Short-Term Credit Facilities

Section 46(3) of the Central Bank Act allows the National Treasury to have access to overdraft facilities at the central bank. However, the National Treasury is only allowed to use the facility to fund shortfalls in the domestic borrowing program and when it has cash flow problems. Lately, the facility has been opened to county governments even though county governments have been enjoying the same facility from local commercial banks in line with Section 142 of the PFM Act 2012 which allows for up to 5% of borrowing for cash management purposes. It also provides that such short-term borrowing shall be repaid within one year from the date of borrowing.

(i) Pending Gratuity Payments

Gratuity is a monetary gift from an employer to an employee especially for services rendered continuously for five years or more. It is a lump sum amount that an employer pays an employee if he or she retires or resigns from employment. after completion of a certain period of employment at one organization.

For the County Government of Homa Bay, 22 employees are eligible to receive a total of KSh. 31,982,096.83 in gratuity payments.

(ii) Actual Compensatory Damages

Compensatory damages represent the money awarded to a plaintiff in a lawsuit. This type of compensation is awarded in civil court cases where funds are provided to only replace what was lost such as employees whose employments were wrongfully terminated.

Several rulings have been made that favour county government employees and for which compensatory damages have been awarded.

2.3.5 Liabilities Inherited from Defunct Local Authorities

The Constitution of Kenya (2010) under SIXTH SCHEDULE (*Article* 262) TRANSITIONAL AND CONSEQUENTIAL PROVISIONS in part IV subsection 33, provides that an office or institution established under this Constitution is the legal successor of the corresponding office or institution, established under the former Constitution or by an Act of Parliament in force immediately before the effective date, whether known by the same or a new name. The county governments were thus by the very law that created them expected to take over the assets, liabilities, and every other contractual obligation that were in existence within the structures of the local authorities they were succeeding.

The same Constitution of Kenya 2010 gave the Transition Authority (TA) a lifetime of three years for which they were required to have completed the process of devolving all functions to county government including the verification of assets and liabilities as stipulated in section 7 (e) of Transition to Devolved Government Act 2012. However, by the end of its tenure the TA was not able to finalize the process of liability verification and handing over to the county government. Thus, the role of verification of county assets and liabilities was taken over from the T.A. by the IGTRC, who formed the County Assets and Liabilities Committees (CALC). These committees have already forwarded their findings to the IGTRC, and the body is in the process of report validation, which will form a basis for the implementation of their recommendations by counties.

For the 7 defunct local authorities that were handed over to the county government (Homa Bay County Council, Homa Bay Town Council, Kendu Bay Town Council, Mbita Town Council, Oyugis Town Council, Rachuonyo County Council, and Suba County Council), the debt totaled **KSh. 188,934,228.** The debts were made up of 3 distinct components, namely; statutory deductions, unpaid emoluments, and pending payments to other creditors. Table 2 (below) provides a breakdown of the debt.

Table 2: Debts from Defunct Local Authorities

Name of Local Authority	Unpaid Emoluments (Ksh)	Statutory Deductions (Ksh)	Other Creditors (Ksh)	Total Liabilities (Ksh)
Homa Bay County Council	10,005,175	5,201,175	8,145,791	23,352,141
Homa Bay Municipal Council	18,154,543	35,181,078	24,854,915	78,190,536
Kendu Bay Town Council	6,562,309	1,686,093	2,595,979	10,844,381
Mbita Town Council		7,038,702	5,569,703	12,608,405
Oyugis Town Council	24,550,042	7,556,216	3,905,453	36,011,711
Rachuonyo County Council		6,332,167	2,118,114	8,450,281
Suba County Council	7,040,578	5,814,399	6,621,796	19,476,773
Total Liabilities	**66,312,647**	**68,809,830**	**53,811,751**	**188,934,228**

Source: Transition Authority

2.3. Macroeconomic Assumptions and Key Risks to the County

2.3.1. Macroeconomic Assumptions

The Medium-Term Debt Strategy is based on the medium-term macroeconomic framework as provided in the 2024 Budget Policy Statement (BPS) and the Homa Bay County FSP 2024. According to the 2024 BPS, the Kenyan economy will rebound to 6.1 percent growth in 2024 up from 5.5 percent in 2022, reinforced by the National Government's Bottom – Up Economic Transformation Agenda geared towards economic turnaround and inclusive growth. In that national plan, priorities will be implemented under five core pillars of Agricultural Transformation; Micro, Small and Medium Enterprise (MSME) Economy; Housing and Settlement; Healthcare; and Digital Superhighway and Creative Industry.

Within the established macroeconomic framework, effective coordination between monetary and fiscal policies will continue to support macroeconomic stability with interest rates remaining relatively stable. The year-on-year overall inflation rate is expected to decline due to a decline in food prices following favorable rains in some areas and declining international prices of edible oils. However, the inflation rate in early 2024 may remain higher than was recorded in early 2023.

The Kenyan economy in 2023 demonstrated resilience in the face of severe multiple shocks that included the adverse impact of climate change, the lingering effects of COVID-19, global supply chain disruption, and the impact of the Russia- Ukraine conflict. As such, the economic growth slowed down to 4.8 percent in 2023 from 7.6 percent in 2022 but broadly aligned with the pre-pandemic decade average of 5.0 percent of GDP on account of improved receipts from service exports and resilient diaspora remittances. The official foreign exchange reserves at 4.2 months of import cover in November 2023 will continue to provide adequate buffer against short-term shocks in the foreign exchange market.

In the context of Homa Bay, the County Government will continue implementing fiscal consolidation measures aimed at having a balanced budget, stabilizing public debt, prioritizing development expenditures, and protecting social spending and investments, in addition to implementing various measures to boost revenue mobilization.

Over the medium term, the county government will continue to maintain a balanced budget where total revenue equals total expenditure i.e. the preparation of MTDS does not envisage borrowing to finance the budget and over the medium term the focus will be on ensuring the sustainability of current debt through debt servicing.

This MTDS 2024 is prepared based on the assumptions that:

i. The macroeconomic framework underpinning the strategy will remain stable during the medium-term period. Forecasted GDP growth rates will be realized and variables such as inflation rates, and interest rates amongst others will remain stable to minimize the cost of debt.
ii. The macroeconomic framework underpinning the MTDS 2024 is consistent with projections included in the 2024 BPS and the Homa Bay County FSP 2024.
iii. The political, social, and economic environment will remain favorable during the implementation of this strategy paper.
iv. As per the constitution, the National government will guarantee county government loans.
v. Homa Bay County Government will adhere to the strategies contained in the debt management policy document while the CFSP 2024 will guide the borrowing requirements. Appropriate borrowing Plans will be put in place before any borrowing.
vi. There will be an adequate legal and institutional framework for debt management.

2.3.2. Key Risks to the Debt Portfolio

The major risks to the county debt portfolio are highlighted in the CFSP 2024. Public expenditure pressures combined with revenue underperformance may make it difficult for the County Government to actualize and sustain macroeconomic policies detailed in the CFSP 2024. Other fiscal risks include shocks in the external which could impact the cost of debt servicing, the terms of trade, and inflation.

The sustainability of Homa Bay County Government public debt depends on macroeconomic performance, especially stability in general price levels (exchange rate, inflation, and interest rates). External financing on both concessional and non-concessional terms poses foreign exchange risk which could undermine the capacity of the national government to secure new debt and finance the full cost of borrowing. Contracting of new debt on short-term maturities could also increase the refinancing risk.

A stifled economy could slow down revenue mobilization, and create pressure on the county government's resources through increased transfer payments, thereby widening the fiscal deficits. An increasing fiscal deficit could also increase a county's borrowing requirements, thereby raising the public debt which would translate into higher debt servicing. Moreover, inefficient Public Sector Entities could further expose the economy to rising contingent liabilities carrying the impediment to such liabilities being consolidated into the public debt stock.

Some of the specific risks as highlighted in the CFSP 2024 include:

- **Contingent Liabilities.** The County Government of Homa Bay has an explicit contingent liability amounting to **KSh. 188,934,228** being liabilities inherited from the 7 defunct Local Authorities
- **Natural Disasters and Man-made Hazards** to which the county has been exposed ranging from floods, lake accidents, the COVID-19 pandemic, and drought. The compounding effects of these disasters could have a severe impact on lives, livelihoods, and the economy.
- **Climate Change Related Fiscal Risks are** the ravaging impacts of which the Homa Bay County's economy is vulnerable e.g El Nino and prolonged drought
- **The County's high wage bill**. The new administration inherited a very large workforce from the previous administration most of whom are deemed to be "ghost" workers as they fail to show up at work while minting huge salaries from the county coffers. There has also been increased pressure from workers' unions for higher pay especially by the health workers.
- **Overreliance on national government transfers** is another risk that also undermines the County's fiscal autonomy. Coupled with the unpredictability on account of the delays in the release of the resources, it poses another risk to the proper implementation of the county's budget.
- **High public expectations** against the resources available to the County;
- **Staff shortages** where staffing levels at some technical areas are wanting and this exacerbates poor performance at the County.

Ultimately, the County Government will have to ensure proper debt management. The build-up of payment arrears could cause unsustainable fiscal deficits, unnecessary deadlocks with OCOB, and a collapse in investor confidence, which will also impact the private sector, leading to a decline in GCP growth and a further increase in debt-to-GCP ratios. Donors could also withdraw funding and technical assistance if the county government goes into unsustainable debt arrears.

2.3.3 Risk of Existing Debt

The extent of the risk will depend on *risk factors* and *risk exposure*. The main risk factors, together with the extent of County Government exposure, are discussed below.

Repayment (Debt Service Cost) Risk

Servicing debt is the primary concern for debt management. The County Government must make sure that total expenditure including debt service costs do not exceed revenue collected. The main risk for the debt portfolio for the County Government of Homa Bay is the government's inability to make repayments or 'repayment risk'. This risk can be expressed as the cost of debt repayments compared with funds available. This risk is currently mitigated by setting aside ten percent of domestically sourced revenue to service debt. The risk is that revenue could decrease so much that ten percent is less than the debt servicing cost. If this happens, there will be insufficient funds available to make debt payments.

Foreign Exchange Rate Risk

Foreign exchange rate risk relates to the vulnerability of the debt portfolio, and therefore the government's debt servicing cost, to a depreciation or devaluation in the external value of the domestic currency. Debt servicing costs fluctuate from month to month according to exchange rate changes. Foreign exchange movements will also change the value of debt outstanding and therefore the ratio of debt to GDP.

Interest Rate Risk

Interest rate risk is the risk associated with interest rate changes. All external debt is at a fixed interest rate, and about half of the domestic debt portfolio is subject to interest rate changes.

Rollover Risk

Rollover risk is the risk that maturing debt cannot be replaced or refinanced, or that the replacement debt will be more expensive. Except Treasury Bills, County Government debt is legacy debt (maturing debt is for projects that have been completed) with an amortizing principal. Rollover risk is limited to Treasury Bills. Treasury Bills are essentially funded on a rolling system, with new issuance funding maturities. Therefore, rollover risk is the risk that auctions will be undersubscribed or that new issuance will be at higher yields than for maturing Bills. A mechanism will be put in place to mitigate this risk by allowing the use of the Debt Servicing Account at the County Treasury to pay off maturing County Treasury Bills if funding from new issuance is insufficient.

Creditor Concentration Risk

Creditor concentration risk refers to risks associated with most of the debt portfolio being held by one or two creditors. Creditors who hold a large proportion of debt could have a vested interest in the course of a county's affairs. Large creditors could potentially have an undue influence on government policy development.

Inflation Risk

The impact of inflation on debt affordability and sustainability can be mediated through currency valuation, GDP, and government revenues and is difficult to predict.

Legal risk

Legal risk is the risk that the CDMU and, by extension, the County Government do not execute their legal obligations as stated in the deed documents, loan agreement contracts, or in the legislation dealing with debt. Possible examples are failure to make payments on time or for the correct amount.

Strategic risk

Strategic risk is the risk that decisions made about the management of the debt portfolio have a high opportunity cost. For example, if the Homa Bay County Government decides not to borrow, then it could miss out on grant funding (if grant funding for these projects is not available from other sources). If the county government decides to borrow for particular projects that do not match expectations, then this money could have been better spent elsewhere on other, more beneficial projects. Money spent on servicing debt might be better spent on providing essential services, for example. Alternatively, it is better to pay down debt (which saves the County Government future interest payments and increases borrowing opportunities in the future) rather than spend funds unwisely.

Financial risk

Financial risk is the risk that the government's portfolio management is a source of instability for the private sector. The risk for the Homa Bay County Government is that a poorly managed debt portfolio will mean that less money is available for servicing the county's basic needs. A burgeoning debt portfolio or a build-up of debt arrears will cause a collapse in investor confidence, which will also impact the private sector, leading to a withdrawal of investment in the county, a decline in GDP growth, and a further increase in debt to GDP ratios.

2.4. Debt Sustainability

County public debt sustainability is the ability of a county to service its debt obligations as they fall due without disrupting its budget implementation. The sustainability of debt is guided by PFM Act Section 107 (2) (e) and Section 107 (4). As per Section 107 (2) (e), the county debt shall be maintained at a sustainable level as approved by the county assembly. Section 107 (4) further states that Every County Government shall ensure that its level of debt at any particular time does not exceed a percentage of its annual revenue specified in respect of each financial year by resolution of the County Assembly.

The County Government recognizes the importance of managing debt prudently to avoid unwarranted debt burdens for future generations and reduce the risk of macroeconomic instability. Significant efforts have been made to improve institutional debt management as well as the capacity to assess risks. The county treasury acknowledges the need to maintain debt at sustainable levels and is closely monitoring spending by County Government Entities and working with all of them to cut on pending bills.

According to the Institute of Economic Affairs (IEA) Budget Focus Report for 2021/2022, Kenya may not take long before it breaches its public debt-to-GDP threshold of 74 percent, which was at 63.4 percent in 2021. By the end of the Financial Year 2020/2021, the Kenyan government had a debt-to-revenue ratio of 356 percent and debt service to revenue ratio of 68 percent which according to the World Bank threshold is unsustainable. As of June 2021, the external debt from Kenya had accumulated to roughly four trillion Kenyan shillings, approximately 35.3 billion U.S. dollars. The value was equivalent to 52 percent of the country's total debt. Kenya's external debt increased by over 370 billion KSh (some 3.3 billion U.S. dollars) from July 2020.

The ceiling for loans to the County Government of Homa Bay will stand at KSh. 2 billion for the financial 2024/2025. For purposes of short-term borrowing, the limit will be KSh. 500 million. This is consistent with the provision of PFM Regulations 25(d) which requires that the county public debt shall never exceed twenty percent (20%) of the total government revenue at any given time.

III. POTENTIAL SOURCES OF COUNTY DEBT FINANCING

3.1. Introduction

This section outlines the potential sources of deficit financing for the Homa Bay County Government including domestic and external sources. The County Government will carry out a debt sustainability analysis (DSA) before raising funds from any of the sources. As stipulated in the PFM Act, such funds will only be used to finance capital projects. All funds borrowed by the County Government will be used only for funding priority core infrastructure and development interventions.

3.2 Potential Financing Sources

The preferred source of financing remains the county's own source revenues given the cost and risk of other sources of financing. However, to raise additional finance for development, the county will explore other alternative sources of financing including:

(i) **Borrowing from commercial banks**: The County will pursue short-term borrowing from commercial banks or central bank. Borrowing from the CBK attracts low-interest rates but requires the National Treasury to formulate guidelines. Further, borrowing from commercial banks leaves the county exposed to high interest rate fluctuations. However, overdrafts, will be maintained at 5% of the County's Total revenue at any given time for cash management purposes and be repayable within one year as per the PFM act 2012.

The County Government of Homa Bay will continue to pursue additional revenue enhancement strategies to raise more resources for financing the county's development. Specifically, the county will review the valuation roll and enhance collections of other underperforming revenue streams. The cost involved is minimal and only requires improving county revenue collection efficiency by improving the county's operations.

(ii) **External borrowing**: This financing is usually at concessional rates for longer periods than commercial banks. This may mean floating international bonds or borrowing from foreign banks. However, this is subject to volatility of the international money market and specifically fluctuation of the exchange rate since the bonds is denominated in dollars.

Foreign currency debt generally poses particular risks, and excessive reliance on foreign currency debt can lead to exchange rate or monetary pressures or both if investors bid to refinance the government's foreign currency debt. Since this reduces the risk of crowding out the local private sector, prudent debt management, along with sound policies for managing contingent liabilities, can make the County Government less susceptible to contagion and financial risk.

(iii) **Borrowing from the money and capital market**: The County may borrow from the money market and Capital Market through the issuance of County bonds. Borrowing from the capital and money market is subject to very strict conditions by the capital market authority. Whereas money markets are for trading in short-term debt, capital markets are long term and are used for trading securities including corporate and government bonds.

Money markets ensure a constant flow of cash between governments, corporations, banks, and financial institutions, borrowing and lending for a term as short as overnight and no longer than a year. Capital markets may include trading in bonds, derivatives, and commodities in addition to stocks. Ultimately, money markets provide short-term liquidity to an economy while capital markets channel the savings of the economy in a meaningful way to aid growth and development.

(iv) **Public-Private Partnership**: This requires engaging in public-private partnerships to finance projects. However, the process is very lengthy and rigorous and requires approval from the National Treasury.

According to the National Treasury definition, a PPP involves a contract between a public-sector institution and a private party, where the private party performs a function that is usually provided by the public sector and/or uses state property in terms of the PPP agreement. In terms of projects, the contract is prepared for the delivery of an infrastructure service on the payment of respective charges. Here, the main goal of PPP construction projects is to combine and involve the capabilities of both the private and public sectors for mutual benefit.

The main features of PPP construction projects are not only that it will assume planning. Design, financing, construction, and maintenance of the facilities performed but also that can be employed to bring new facilities and upgrade existing facilities

3.2.1 Domestic Sources

The Kenyan domestic debt market is vibrant and dominated by commercial banks as the main investors in government securities. The domestic market sources available for the County Government include overdrafts and term loans from financial institutions including banks and other credit-giving institutions. Domestic borrowing can also be realized through the placement of County Government securities, including short, medium, and long-term securities. Lately, the Central Bank of Kenya has also opened a short-term credit line for counties thereby enlarging the pool of financial institutions at the service of county governments.

For purposes of domestic borrowing, the County Government of Homa Bay will carry out debt sustainability analyses and consider the most attractive interest rates, the financial institution's strength, the sustainability of the facility, and the duration of interest advantage.

As stipulated in the PFM Act, conditions to be met for domestic borrowing include:

- **Authority of the County Assembly**. The Assembly must authorize borrowing by county government entities.
- **Purpose of Borrowing**: A county government may borrow only for cash management purposes only.
- **Compliance with Debt Ceilings**. Short term borrowings may not exceed five percent of the most recent audited revenues of the entity.

- **Payment within Established Term**. The county government entity that borrows shall ensure that the money borrowed is repaid within a year from the date on which it was borrowed.

Whenever there is a need for domestic borrowing, the County Government of Homa Bay will strive to provide the requisite information to the market regularly by issuing the borrowing calendar and supporting an electronic trading platform of County Government securities to promote efficiency and transparency in securities trading. The County Government will also promote financial inclusion and saving culture for its people to enhance uptake by Homa Bay residents.

Apart from the Central Bank of Kenya and local commercial banks, other potential domestic market debt funding players include pension funds, the insurance sector, and nonresidents' holdings. Reliance on domestic debt can help mitigate County Government exposure to foreign currency risk.

3.2.2 External Sources

The main sources of external debt financing include loans and grants from multilateral and bilateral organizations which must get approval and guarantee from the National Treasury. The PFM Act stipulates that the Cabinet Secretary may guarantee a loan of a county government or any other borrower on behalf of the national government and that loan shall be approved by Parliament. These sources include friendly nations, bilateral donors, and other credit-giving institutions including the IMF, Multilateral Agencies like the ADB and the World Bank amongst others. In seeking external sources of funding, the county government shall consider the following terms of the facility, interest rates, concessions offered, and conditions of the facility.

The conditions to be met for external borrowing include:

- The loan must be for a capital project.
- The County Government must be capable of repaying the loan and paying any interest or other amount payable in respect of it.
- The financial position of the County Government over the medium term must be satisfactory;
- The terms of the guarantee must comply with the fiscal responsibility principles and financial objectives of the county and national governments.
- The loan limit shall be subject to limits set out by the PFM Act.
- The loan must be approved by the County Assembly and Parliament.

Securing external financing from the international financial markets may reduce pressure on domestic liquidity thus spurring economic growth.

Table 3 provides information on related potential Creditors and briefly describes some cost and risk indicators on the various types of financing.

Table 3: Creditors Cost and Risk Indicators

	Creditors		Cost indicators	Risk Indicators:
Multilateral				
	Concessional			
	IDA, ADB, IFAD, EI	Highly Concessional	Very low interest rates	Fixed Interest rates Long amortization profile Foreign currency, risk mitigated by the long amortization profile
Potential	Japan	Highly Concessional	Very low interest rates	Fixed Interest rates Long amortization profile Foreign currency, risk mitigated by the long amortization profile
Bilateral				
Potential				
	China	Semi-ConcessionaL	Low interest rates	Foreign currency indicators Fixed interest rates
	Rep. of Korea	Focusing on rural development and ICT		Depending on the source of financing
	India	Focusing on agricultural projects		Depending on the source of financing
	Indonesia	Focusing on social transformation		Depending on the source of financing
	Africa Development Bank	Focusing on infrastructure development		Foreign currency indicators Fixed interest rates
Theme Funds				
Potential				
	Climate Change Funds	Grants/Loans		Depending on the source of financing
Domestic				
Bonds	Domestic		Market – will reflect market development	Depends on tenors achieved, there maybe some re-fixing, indexation creates other risk exposures
Loans	Commercial loans		Respond to changes in interest rates	Interest rates Interest fluctuations create risk exposures

Under the non-traditional sources of financing, such as Climate Change 'Theme Funds', the WB manages 6 climate change funds, which could provide important amounts of financing for the county.

For consideration in future periods, some semi or concessional financing may also be available from other sources such as Brazil, Russia, India, Indonesia, China, South Africa (BRICS), and from the European Union (EU) and the Organization of the Petroleum Exporting Counties (OPEC).

IV. MEDIUM-TERM DEBT MANAGEMENT STRATEGY

4.1. Introduction

This section outlines debt management strategies envisaged when the County Government of Homa Bay contracts a debt. There are four components to the Homa Bay County Government MTDS:

i. Maintenance of debt at sustainable and affordable levels.
ii. Ensuring that any new borrowing follows fiscal responsibility guidelines for a fit purpose; from an allowable source; and with acceptable terms and conditions.
iii. Development of the domestic debt market.
iv. Introduction and consolidation of fiscal, legal, institutional, and operational measures that ensure that the above three objectives are met.

4.2 Dealing with Risks Associated with Each Source

4.2.1 Dealing with External financing (semi and concessional) and some domestic bond financing

External financing is raised through foreign lenders, such as foreign commercial banks, foreign governments, and international financial institutions. Here, all repayments must be made in the currency in which the debt was issued. There are several risks associated with this:

a. Affected economic growth: Economic growth occurs when governments and companies incur capital expenditures that boost production and increase output and income levels. If large amounts of external debt need to be repaid, then there is less money left for investment purposes. It hampers future economic growth.

b. Long gestation period: The gestation period is the interim period between the initial investment in a project and the time the project becomes productive. When external debt is used to fund infrastructure projects, it takes a few years for the project to start giving a return on the investment. It will take time for the investment to become functional, start production, and earn money or value. However, the debt will need to be repaid, along with interest, within the provided time of receiving the loan. Thus, the government will face the pressure of repaying the loan even before the project starts yielding a stable return.

c. Unexpected devaluation of domestic currency: If the currency of the borrowing country depreciates concerning that of the lending country, then the real value of interest (as denominated in the domestic currency) will rise.

d. The Vicious Cycle of Debt The most crucial disadvantage of external debt is that it often leads to a vicious cycle of debt. The debt cycle refers to the cycle of continuous borrowing, accumulating payment burden, and eventual default. When a government's expenditure exceeds how much it earns in a year, it faces a fiscal deficit. To finance the adverse gap, the government borrows money from another country. In the next year, with the additional expense of interest payment and loan repayment, the government might face a deficit again and be forced to take another external loan. In subsequent years, there might be a situation where it borrows money to repay its previous loans.

4.2.2 Dealing with Negotiated Domestic Borrowing and Utilization of Securities Market

Domestic Borrowing involves borrowing in the local market. It is done through the issuance of securities like treasury bills, which are short-term debt instruments with tenures ranging from 91, 182, and 364 days, and treasury bonds with a maturity period of more than a year Risks associated with domestic borrowing include:

a) Domestic borrowing could lead to pressure on institutional investors and banks to absorb "too much" government debt and this may hurt financial stability.

b) Expanding the market for domestic government bonds may have the risk that the public sector may crowd out private issuers.

c) Finally, there are political economic reasons that may make domestic debt more difficult to restructure. A few highly indebted countries that were able to use debt relief initiatives to address their external debt problems are still burdened with high levels of domestic debt.

Given that the county government operates within the wider Kenyan economy, the aforementioned may not impact heavily on the Homa Bay county economy.

4.2.3 Dealing with a Mix of External financing and some domestic bond financing

This is where the county combines both external and domestic financing to take advantage of the medium to high risk mainly due to the foreign exchange factor and low to medium cost about County revenues.

With gradual development of the domestic market, this would provide a more balanced composition of public debt with less external debt and more domestic debt.

This is the model that the county government of Homa Bay would consider so that can source funding from both external and internal sources but with an emphasis on domestic borrowing to minimize the risks associated with external borrowing.

4.2.4 Way Forward on Debt Financing

From the analysis of the potential financing strategies, borrowing from 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.

Consistent with and within the provisions of the fiscal responsibility principles highlighted in section 107 of the PFM Act and PFM regulation no. 25, the debt shall be a productive debt geared towards increasing the productive power of the county. The level of this debt at any particular time shall not exceed twenty percent (20%) of the county's total revenue.

Ultimately, the National Treasury remains empowered with direct control over the borrowing of county governments. This control takes the form of review and authorization of county borrowing operations (including approval of the terms and conditions of the operation). The controlled borrowing serves the purpose of centralizing all government borrowing, with on-lending to county governments for approved purposes (generally investment projects). Control powers generally encompass not only the ex-ante authorization of proposed borrowing but also ex-post monitoring, on a more or less detailed and timely basis, of the county governments' financial operations.

By exercising direct controls on the capital spending of county governments this way, the National Treasury has been able to influence the level of county governments' capital spending through the amount of financial support (grants or loan approvals) provided to them, and through a requirement that localities set aside a part of their receipts from asset sales to fund new investment. This also means that can be approved only for investment purposes, paying regard to both the projected debt service ratio and the overall financing needs of the county. Generally, the national government controls on borrowing have been tightened in recent years, in an attempt to stem the rapid growth of deficits at the county level. Presently, all bond placements by the county governments (as well as most borrowing by county governments) need prior approval by the National treasury.

With up to 88% of the County Government of Homa Bay's total budget coming from the national government support through grants and loans, the national government has created, through portfolio coefficients on financial intermediation, a substantial captive market for the placement of county debt at below-market interest rates. Whereas a unified approach to foreign markets for sovereign borrowing is likely to result in better terms and conditions than a fragmented one. Again, many foreign lenders require an explicit national government guarantee for subnational borrowing. At a minimum, they are likely to count on an implicit guarantee. Thus, the central government is likely, de facto, to bear ultimate responsibility for the subnational governments' foreign debt.

4.3 Debt Management Strategies

4.3.1 Maintaining Ddebt at Ssustainable and Affordable Levels

This will require the County Government to:

i. Pursue grant funding and budget support;
ii. Where grants are unavailable, or where a loan element of grant funding for priority development projects is mandatory, limited concessional borrowing may be sought;
iii. Borrowing must be limited to concessional loans from multi- or bilateral donors or development partners, as defined by the IMF;

iv. The criteria for considering concessional financing shall be a grant element of 35 percent or more. This is in line with international debt management practice and as recommended by the IMF and World Bank. It is also a requirement under the IMF Standby Credit Facility Agreement and is also likely to be a requirement in any replacement agreement with the IMF. The IMF definition of the grant element is the difference between the face value and the market value of a loan expressed as a percentage of the face value of the loan. The grant element must be independently verified by the County Debt Management Unit (CDMU);

v. 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;

vi. Currency exposure should be diversified, but consideration will also be taken of the potential volatility of the currencies relative to the Kenya Shilling;

vii. Projected debt servicing cost, not allowing for grace periods, must be less than 8 percent of forecast domestic sourced revenues, assuming no growth in revenue;

viii. Debt servicing shall be sequenced to avoid large peaks in repayment expenses at certain times of the year. Where semi-annual payments are to be made, the payments should target the months during which revenues tend to peak.

ix. Debt levels must be lower than any thresholds stipulated in the PFM Act (2012) and any other land legislation governing matters of debt;

x. As part of the budget process, an annual borrowing limit will be set such that debt levels will not exceed the minimum set thresholds (50 percent of Internal revenue).

xi. As a general rule, and to maintain any debt to be incurred at its affordable and sustainable levels or below, the cumulative new issuance should not exceed the cumulative principal repayments to be made once interest to incur debts are floated;

xii. Debt levels used in monitoring and analysis will be total public debt;

xiii. Any additional fiscal surplus arising from buoyant county revenues will be used to retire domestic debt.

xiv. Ensure that any new borrowing follows legal and fiscal responsibility guidelines for a fit purpose; from an allowable source; and with acceptable terms and conditions.

xv. New borrowing must be recommended by a CDMU to the Debt Management Advisory Committee (CDMAC) and approved through the proper legal and institutional channels. It must comply with the conditions contained within the MOU signed by the county and the entity issuing the debt.

4.3.2 Following Legal and Fiscal Responsibility Guidelines

Borrowing by the County Government must comply with legislative requirements in sections 58 and 142 of the *Public Finance and Management Act 2012* and article 212 of the Kenya Constitution 2010, the fiscal responsibility principles and financial objectives in the Homa Bay County Fiscal Strategy Paper and the Homa Bay County MTDS. New borrowing must be recommended by the County Debt Management Advisory Committee and approved through the proper legal channels.

The borrowing must be:

i. For a fit purpose;
ii. From an acceptable source; and
iii. With favourable terms and conditions.

Concepts such as intergenerational equity are also important. Future county citizens should not pay the bills for living citizens. These requirements and standards are included in fiscal responsibility provisions proposed for amendments to the PFM Act (2012).

4.3.2.1. Borrowing for a fit purpose

Borrowing must be for the following types of projects

i. Investing in the productive capacity of Homa Bay County;
ii. Funding priority core infrastructure and development initiatives;
iii. Specific purposes (projects) identified as high priority in the CIDP;
iv. Preference should be given to projects with high rates of return or projects such as investing in hospitals that generate a high 'social rate of return' that will help Homa Bay County Government reach its aspirations as per the CIDP.
v. Borrowing proposals be submitted and incorporated as part of the budget approval and appropriation process to allow for adequate budgeting for repayment.

With investment projects cash flows need to be clearly identified as sufficient to make debt repayments and the cost of any contingent liabilities and obligations such as tied procurement must be factored into the cost and risk of debt.

Borrowing must not be used for:

i. Funding shortfalls in recurrent expenditure. The County Government is committed to delivering fiscally responsible, and fully funded, budgets.
ii. Funding losses of County Government Agencies.

4.3.2.2 Borrowing from an acceptable source

Acceptable and unacceptable funding sources should be prescribed in the Financial Regulations issued by the County treasury. For the duration of this Debt Strategy (three years) borrowing should target 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 (including various EXIM banks around the world). The County Government must independently verify that any proposed loan is concessional.

Loan amounts will depend on the specific projects to be funded and donors' funding allocations. 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.

Terms of potential multilateral sources of finance and their financial characteristics vary. Lending from bilateral partners is linked to specific projects and terms and conditions depend on the project. 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 country). Loan disbursement may also be highly dependent on the progress of the project. A third potential source of funding is through domestic securities as discussed in 4.1 1nd 4.2 above. The PFM Act (2012) section 144 envisages that the CEC Member for finance may issue securities on behalf of the county government for money borrowed by the county government.

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.

4.3.2.3. Ensuring terms and Cconditions are acceptable

The terms and conditions associated with any debt proposals must be examined carefully. Loans will be subject to a cost risk analysis by the CDMU.

The following factors will be examined:

i. **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.
ii. **Debt sustainability and affordability:** The volume and cost of debt must not have a negative impact on debt sustainability and affordability. All economic indicators must be below the thresholds when subject to stress tests and using conservative estimates of economic variables. Hidden costs, such as fees (transaction, commitment, agency or underwriting), requirements for the county Government to fund maintenance or project management expenses beyond the current year must be included in the analysis.
iii. **Currency and exchange rate risk:** Despite offering very low interest rates, concessional loans still carry foreign exchange risk. The benefit of very low or even zero interest rates could be negated by depreciation of the Kenya shilling against the loan currencies. Stress tests used in the above analysis must assess the impact on affordability and sustainability of foreign exchange movements.
iv. **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.
v. **Tenure:** Concessional loans have a standard long time to maturity. 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 borrowed 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.

vi. **Grace period**: Debt sustainability analysis must extend beyond grace periods. 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.

vii. **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.

viii. **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.

ix. **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.

x. **Legal risk:** Borrowing proposals must be examined for potential legal risks. They must not contravene any National and County Government legislation. In addition, the county government 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.

4.3.3 Developing 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. This market may be limited if the county has a history of default and poor investor confidence, as well as limited systems for issuing and recording debt. However, in the future, Treasury Bonds may be a cheaper or at least less risky source of financing, since they are not subject to foreign exchange risk.

Homa Bay County Government will aim to have a liquid market in government securities because they:

- offer flexibility in funding;
- are denominated in domestic currencies and are therefore not exposed to exchange rate movements (and are therefore potentially a lower cost funding source;
- allow diversification of the County Government's debt financing base;
- improve the functioning of the finance sector by enabling the creation and transfer of liquidity via interbank trading; and
- serve as a price benchmark by providing a risk-free reference rate.

4.4 Implementation Framework

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

4.4.1 Fiscal Measures

Homa Bay 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.

4.4.2 Legal Measures

Essential aspects of debt management contain these elements:

- Definition of debt to include loans, borrowings, guarantees and on-lending;
- Clear authorization by Parliament to the Cabinet Secretary for Finance to approve borrowings and loan guarantees on behalf of the County government;
- A requirement that all borrowing proposals (including guarantees) are reviewed by a CDMAC and recommendations submitted to the CEC Member for Finance and Economic Planning before borrowing and loan guarantees can be approved on behalf of the county 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;
- There may be special circumstances when the Government needs to raise funds for the recurrent budget such as in a genuine emergency or crisis.
- Clear authorization from the CEC Member for Finance and Economic Planning 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 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.

4.4.3 Institutional Framework

(i) Process for recommending borrowing proposals to the County Executive Committee

As outlined above, there needs to be clear delegation of responsibilities for recommending and approving debt, where debt includes loans, borrowings, guarantees and on lending by the County Government. The proposed process for approving debt to be incorporated into the county Financial Regulations is as follows:

a) Borrowing proposals are recommended by the Department of Finance, Economic Planning and Service Delivery are first forwarded to the DMAC for consideration. The projects identified for debt financing shall be consistent with the Development Strategy and limited to those projects that add to capital formation, contribute to foreign exchange earnings, job creation and/or GDP growth, or are investments in essential social infrastructure (hospitals or roads for example). New borrowing will be prioritized projects with high rates of return or key infrastructure for achieving the county objectives as outlined in the CIDP, the Kenya Vision 2030 and the Sustainable Development Goals. 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.
b) Borrowing proposals are assessed by the 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.
c) The DMAC will recommend and rank acceptable proposals;
d) Proposals that have been recommended by the DMAC can then be submitted and incorporated as part of the budget approval and appropriation process.
e) The CEC member for Finance and Economic Planning has sole authority to approve loans. Therefore, borrowing will not be legal unless it has been signed off by the CEC Member for Finance and Economic Planning.

(ii) Functions and responsibilities of the County Debt Management Unit (DMU)

The functions and responsibilities of the CDMU will be incorporated into legislation through the financial regulations and will include:

a) Make debt payments on time and for the correct amount;
b) Keep timely, comprehensive and accurate records of outstanding government debt, guarantees, contingent liabilities and new borrowing in a single debt database;
c) Publish, in a timely manner, monthly (and quarterly) reports showing the status of
d) outstanding debt, debt payments, and projected debt payment obligations;
e) Prepare, review and update the Debt Strategy;
f) If required, prepare an annual borrowing plan;
g) Prepare and publish auction calendars for issuance of domestic securities (Treasury Bills and Treasury Bonds);

The County Debt Management Advisory Committee (CDMAC) will assess the volume and risk characteristics of debt to ensure that:

a) Debt is sustainable and affordable;
b) Debt is below the thresholds established by the Debt Strategy and annual Borrowing Plan;
c) Debt is from an acceptable source;
d) Debt is within legislative guidelines (including Public Finance and Audit Act) and other legal obligations (such as IMF Facility);
e) Debt is for a good purpose and the project is a high priority in the CIDP;
f) Debt is not for funding recurrent expenditure;
g) Project has a positive NPV or helps achieve SDGs;
h) The cost of any contingent liabilities and obligations such as tied procurement are factored into the cost and risk of debt;
i) Cash flows from project can be identified that will be able to be used for repaying the loan.
j) Loan terms and conditions are acceptable and achieve the best cost and risk outcome.
k) Borrowing aligns with the County Medium Term Fiscal Strategy Paper.
l) Monitor and advise on all debt servicing obligations of the government;
m) Prepare forecasts on government debt servicing and disbursements as part of cash management and the yearly budget preparation;

(iii) County Debt Management Advisory Committee (CDMAC)

The County Debt Management Advisory Committee will evaluate borrowing proposals. The DMAC will be chaired by the Chief Officer for Finance and Economic Planning, with other members including the Legal and Economic Advisors to the Governor, the County Directors of Finance and Budget and a member of the CDMU. The CDMU will act as Secretariat for the Committee. The Committee will make recommendations to the CEC Member for Finance and Economic Planning as to whether borrowing should or should not proceed.

(iv) Liaison with the County treasury

The CDMU will maintain a close working relationship with the county treasury, including quarterly liaison meetings. The areas of cooperation include, but are not limited to:

a) Debt recording and maintaining a Debt Recording and Management System database;
b) Issuance of debt securities;
c) Co-ordination concerning early repayment or retirement of domestic debt to ensure that liquidity injections do not lead to excessive credit growth;
d) Debt payments from the County Government's account;
e) Publishing debt data;
f) Ensuring that County reserves are adequate for debt repayments;

4.4.4 Operational Framework

Accurate records and reports are necessary for maintaining and building HBCG's 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 Debt Monthly Monitoring and Management Meeting Strategy. An outline of what is required will be incorporated into the Financial Instructions. Operational guidelines, procedures and approval processes for domestic and external borrowing also need to be documented.

(i) Debt recording

The CDMU 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. CDMU also needs to keep records on liabilities of County Government Units and Agencies. Records and information on the details of holders of government securities will be maintained by the county treasury.

(ii) Debt reporting

DMU will publish monthly reports on the status of county government total debt including loans, guarantees, contingent liabilities and payment arears. 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 both the county government and county department of Finance and Economic Planning 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.

The Debt Strategy and reports will be published on the Department of Finance and Economic Planning or county government website. Reports will be published in a timely manner, so that stakeholders have access to up-to-date information.

The results of auctions of domestic securities (Treasury Bill and Treasury Bonds) will be published on the county government website before the end of each week. A monthly calendar indicating issuance volumes and target maturities of domestic debt securities will be published on the same website in a timely manner.

(iii) Debt Strategy

Every year the CDMU will review and update the Debt Strategy. 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. The MTDS will be reviewed by the Debt

Management Advisory Committee. The key elements of the Debt Strategy will be incorporated into the CFSP and approved by the County Assembly as part of the annual budget process.

(iv) Borrowing Plan

When required, CDMU will prepare a borrowing plan.

(v) Debt Sustainability Analysis

CDMU will prepare a debt sustainability analysis, using data from the Department of Finance and Economic Planning in addition to using the Joint World Bank/IMF Debt Sustainability Framework, as appropriate.

(vi) Integration with Cash Management

The CDMU will continue to work with the county treasury to integrate cash and debt management. Cash management ensures that the County has sufficient funds to meet its obligations as and when they fall due. Use of cash management tools depend on reliable cash forecasting. For example, County 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.

(viii) Capacity Building

Capacity building will continue at all levels, with assistance from the National Government and other organizations such as donors and learning institutions. CDMU will update its capacity development plan annually in line with the Department of Finance and Economic Planning Corporate Plan.

4.4.5 Other Operational Strategies

a) 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 financial year is enhanced.

b) Strengthening commitment controls - Commitment controls are part of the internal control system, which should prevent the County from initiating expenditures 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. The verification of debts inherited from the defunct local authorities is yet to be finalized.

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.

V. IMPLEMENTING THE 2024 MEDIUM TERM DEBT STRATEGY

5.1 Introduction

The County Government of Homa Bay will prepare a borrowing plan to accompany the 2024 MTDS should need arise to meet financing requirement for the financial year 2024/24. The borrowing composition assumed in the MTDS analysis together with the County Government cash flow plan provides the basis for the projected annual borrowing plan. The County Government will communicate the domestic borrowing plan to the market participants through Daily newspapers and public Forums.

5.2 Authority to borrow

The authority to borrow in this instance shall rest with the County Executive Committee member responsible for Finance. That CEC member will be responsible for liability management operations or other debt-related transactions (such as debt restructuring and potential swaps) and will seek loan guarantees from the National Treasury. Ultimately, the County Assembly and Parliament will have approval powers as provided for in the Constitution and PFM Act of 2012. However, debt management operations will be the domain of the County Treasury. The CEC member may exercise some delegation but the power to authorize shall be exclusive so that there is a single borrowing authority not multiple authority. The CEC member shall therefore be the sole borrowing agent for the County Government of Homa Bay.

5.3 Borrowing purposes

To guard against the risk of abuse, the delegation of the borrowing power shall be restricted by this statement of the purposes for which the County Government can borrow or by the limit on annual net borrowing (5%) or the outstanding debt (20% or both). Article 212 (1) of the Constitution of Kenya provides that borrowing shall happen only when such borrowing is guaranteed by the National Government and approved by the County Assembly. Section 58 (2) of the PFM Act also provides that the Cabinet Secretary guarantees a loan only if such a loan is for financing capital projects. Consequently, borrowing shall be only for the purposes of financing a deficit on the capital accounts; refinancing, prepaying or buying back an outstanding capital debt; financing an investment programme; fostering development of local financial markets; and/or pre-financing or temporary financing of liquidity connected with cash flows (i.e. as part of cash management.

5.4 Debt Management Objectives

For accountability purposes, it is always important that there is a formal objective against which the county government's performance can be assessed.

5.5 Audit, reporting and accountability requirements

The proposed borrowing shall strictly comply with governance, audit, reporting and accountability processes. These would include a requirement to publish a debt management strategy; and to report on debt management activities (as well as publish data), at least annually to the County Assembly.

To the greatest extent possible, the terms and conditions of the proposed borrowing shall be reported to the County Assembly quarterly. However, if constraints of commercial confidentiality in relation to commercial borrowing must apply, where the lender will not want terms revealed to market competitors, this may not be done.

The County Debt Committee will be required to produce quarterly reports that would be backed by an annual public debt management report, which would include a discussion of policy and market developments as well as the latest comprehensive data. The bulletin or annual report should also include an evaluation of outcomes against stated objectives as set out in the strategy.

5.6 Estimated Loan Request or Borrowing Limit

For cash management purposes, the County Government of Homa Bay will be restricted to borrowing not more than KSh.500 million (being the 5% of the projected estimates for the FY 2024/25 revenue, excluding any balances carried forward from 2023/2024). However, because such borrowing has become common at the beginning of the year when the first exchequer releases usually arrive at least two months late, the County Treasury may request the County Assembly to consider the equivalents of two months' worth of compensation to employees and contingency amounting to approximately **KSh. 750 million** in a year.

The borrowing will be done to pay outstanding salaries or settle contingent liabilities including those inherited from the defunct local authorities as well as eligible pending bills of a capital nature verified for payment by the Kenya National Audit Office. This is consistent with provisions of Section 142 of the PFM Act, 2012 provides that (1) the County Assembly may authorize short-term borrowing by county government entities for cash management purposes only and that (2) any borrowing under subsection (1) may not exceed five percent of the most recent audited revenues of the entity. It further provides in (3) that a county government entity that has any such borrowing shall ensure that the money borrowed is repaid within a year from the date on which it was borrowed.

In line with the PFM Act 2012 Regulation 25(d) provisions the County Government of Homa Bay will be able to **raise only a maximum of KSh. 1.96 billion** being approximately 20% of the projected total revenue for the financial year 2024/25.

Debt Management Entity

The County Treasury shall rely on the capacity and expertise of the National Debt Office by supplying the Public Debt Management Office with any information that shall enable it to execute this mandate efficiently. This is consistent with the provisions of Section 65 (2) of the PFM Act, 2012.

However, the County Government of Homa Bay shall establish a County Debt Management Office. Equally, the County Government shall constitute a County Debt Advisory Committee (CDAC) consisting of the Chief Officer responsible for finance and economic planning (Chair); the Economic Policy Advisor; the Directors responsible for planning, budget, audit and finance, and; the Principal Finance Officer.

Once constituted, the CDAC shall be an advisory body to the CECM Finance on all matters relating to debt management. The functions of the Committee shall be:

i. to advise the CEC member on matters relating to external and domestic borrowing, issuing of government guarantees, and acceptance of grants on behalf of the Government.
ii. to monitor the implementation of the Annual Debt Strategy and borrowing plan approved by the Government for the ensuing quarter.
iii. to prepare quarterly debt and budget execution reports.
iv. to advise on the formulation of an Annual Debt Strategy and borrowing plan.
v. to monitor, coordinate, and direct the activities of all government departments and institutions involved in the management of debt, grants, and guarantees.
vi. to advise on the measures to be taken against any person for non-compliance with the provisions of the Act.

VI. Other Issues

6.2 Cash management

Provisions for the Treasury Single Account and cash flow forecasting (including the powers to require budget units and revenue departments to supply forecast information) shall normally apply as covered regulations relating to the budget or financial administration.

6.3 Expenses

Unless otherwise stated, all expenses in relation to borrowing shall constitute a proper charge on the budget. These expenses shall be provided for in the official estimates of the FY 2017/18, and not simply be netted off receipts. These shall include payments to those advising on a securities issue as well as other administrative costs.

VII. CONCLUSION

Homa Bay County Government is committed to ensuring that public debt is managed prudently and remains within sustainable levels. This MTDS 2024 provides a medium-term framework to guide in decision making on the desired mix of domestic and external borrowing to finance County Government debt in the financial year 2024/24, taking into account the evaluated cost and risk.

This MTDS has considered the current macro-economic environment and the related vulnerabilities. The recommended strategy is one that seeks a move in the composition of debt towards medium-term domestic debt over the medium term, and more uptake of external concessional debt. The successful implementation of this 2024 MTDS will not only improve the sustainability of debt but will also lay the ground for future borrowing.