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Downgrade of South Africa's credit rating further into junk

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The impact of the National Credit Act on contracts of suretyship

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A notable feature of credit transactions is the inherent commercial risk to credit providers. Our law, however, makes provision for the alleviation of such risks through, among others, the laws relating to security. In order to mitigate these risks, creditors have the option to require their debtors to provide them with security for the fulfilment of their obligations.

A creditor who requires security for the fulfilment of an obligation may obtain such security in various forms. For instance, the creditor may require the debtor to provide real security in the form of a pledge of its movable property, or a cession *in securitatem debiti* of the debtor's assets, in favour of the creditor. Alternatively, the debtor may provide personal security by procuring that a third party be bound to the creditor, such that if the debtor fails to fulfil its obligations to the creditor, such third party will be liable for the fulfilment of the debtor's obligations. That personal security may be provided in a number of ways including *inter alia*, the provision of a guarantee and/or indemnity by the third party in favour the creditor, or the conclusion of a contract of suretyship between the creditor and the third party. In either case, the third party binds itself to the creditor and holds itself liable for the obligations of the debtor.

A contract of suretyship is an agreement in terms of which one assumes liability for the obligations of another, which obligations have arisen pursuant to a lawful underlying causa. Put differently, it is an agreement, which is ancillary to a valid primary obligation, in terms of which one (the surety) secures the obligations of another (the principal debtor), by binding themselves to the creditor. In consequence, if the principal debtor fails, without lawful reason, to fulfil its obligations to the creditor, the surety will fulfil such obligations. The accessory nature of the contract of suretyship was emphasised by the Constitutional Court in *Shabangu v Land and Agricultural Development Bank of South Africa and Others* 2020 (1) SA 305 (CC), which held that a suretyship cannot survive where the underlying obligation is invalid. It has become the practice for sureties to bind

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themselves to creditors as both surety and co-principal debtor. In such cases, although the surety will have bound themselves as a co-principal debtor, their liability still emanates from the contract of suretyship. The effect of entering into the contract as a co-principal debtor is that the surety renounces the common law benefits of excussion and division, and they become jointly and severally liable for the obligations of the principal debtor. Moreover, notwithstanding that their obligation remains ancillary, the surety becomes entitled to the defences attaching to the principal obligation itself and defences available to the principal debtor, save for those personal to the principal debtor.

In light of the nature of contracts of suretyship, they have become an important means by which credit providers manage the risks presented by credit transactions. It is therefore, necessary to determine whether or not the National Credit Act (Act) applies to contracts of suretyship and, if so, the consequences thereof. Although the Act has been in force for a number of years, there are still uncertainties regarding its effect on certain types of contracts, one of which is the contract of suretyship. The Act provides that, subject to certain exceptions, it applies generally to all credit agreements between parties dealing at arm's-length, which are concluded or have an effect in South Africa. In terms of the Act, an agreement constitutes a credit agreement if it is a credit facility, a credit transaction or a credit guarantee as defined therein, or any combination thereof. However, the Act specifically excludes insurance policies or credits extended by insurers only for maintaining premiums on insurance policies, leases of immovable property and stokvel transactions from the definition of credit agreements.

The court in *Firstrand Bank Ltd v Carl Beck Estates (Pty) Ltd and Another* 2009 (3) SA 384 (T) provided that "*there is no doubt*" that the obligations of a surety constitute a credit agreement, including a credit guarantee pursuant to which one undertakes the obligations of another pursuant to a credit facility or credit transaction. The court further held that although a contract of suretyship constitutes a credit guarantee for purposes of the Act, it is only regarded as such if it is provided pursuant to a credit facility or transaction. In addition, the court provided that the contract of suretyship does not create an independent obligation on the part of the surety nor does it transform the surety into a principal debtor. Moreover the contract of suretyship does not constitute a credit provided to the surety, neither does it make the surety a party to the underlying agreement in respect of which the suretyship contract is provided as security. This is so, even where the surety has concluded the contract as both surety and co-principal debtor.

Given that the definition of credit guarantees provided in the Act requires such agreements to have been concluded pursuant to a credit facility or credit transaction which is subject to the Act, it follows that for a contract of suretyship to be governed by the Act, the underlying transaction must similarly be governed by the Act.

The impact of the National Credit Act on contracts of suretyship*...continued*

In light of the fact that under common law, a surety is entitled to the defences available to the principal debtor, save for those personal to the principal debtor, it would follow that a surety would be entitled to the protections which the Act avails to consumers. This would include, without limitation, the defence of reckless credit lending by the creditor, or unlawfulness of the underlying credit agreement. Moreover, before being able to hold the surety to its contractual obligations, the creditor would have to follow the process set out in the Act for enforcing a credit agreement, including the prescribed notices set out in the Act. The creditor would have to follow the debt collection processes set out in the Act, and if the surety were over indebted, it would be entitled to rely on the provisions of section 79 of the Act. All of the above implications render a contract of suretyship governed by the Act, weaker security than it was under common law. It is also more onerous on credit providers.

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Having regard of the aforegoing discussion, it is clear that the provisions of the Act have had a significant impact on contracts of suretyship. As outlined above, the Act categorises suretyship agreements concluded pursuant to a credit agreement, as credit guarantees and accordingly renders the Act applicable to them. It is apparent that the effect of the Act on contracts of suretyship is that enforcing security granted under such contract has become more onerous on the creditor. Accordingly, it may have the consequence of alienating contracts of suretyship when it comes to securing credit facilities or transactions.

Kuda Chimedza and Mashudu Mphafudi

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Downgrade of South Africa's credit rating further into junk

The rating agency downgraded South Africa's long-term foreign currency credit rating from BB to BB-, being three notches below investment-grade and its long-term local currency credit rating from BB+ to BB, being two notches below investment-grade.

On 29 April 2020, Standard & Poor's Global Ratings (S&P) lowered South Africa's sovereign credit rating further into non-investment grade, otherwise known as junk status, citing the impact of COVID-19 on South Africa's public finances and economic growth as one of the reasons for its ratings action.

The rating agency downgraded South Africa's long-term foreign currency credit rating from BB to BB-, being three notches below investment-grade and its long-term local currency credit rating from BB+ to BB, being two notches below investment-grade. This decision comes weeks after Fitch Ratings downgraded South Africa's ratings deeper into junk as a result of the lack of *"a clear path towards government debt stabilisation"*, which was preceded by Moody's decision to downgrade South Africa's sovereign investment-grade credit rating in March 2020.

S&P further said South Africa's cost of servicing public debt will climb to about 6.5% of GDP by 2023. S&P also predicts that South Africa's GDP will shrink by 4.5% this year – better than the South African Reserve Bank's forecast of 6.1%.

Despite S&P's decision to downgrade the country's sovereign credit rating during these challenging times, government welcomes S&P's revised outlook from *"negative"* to *"stable"*, and in the very least considers this as an indication that the rating agency *"recognises some of government's fiscal and monetary policy measures as strong points"*.

The downgrade casts further gloom on South Africa, however, what impact does the downgrade of the country's sovereign credit rating have on clients and investors in the near future?

Clients need to know that there is a direct correlation between the level of long-term interest rates and the depth of junk status. This means the further South Africa falls into junk status, the more long-term interest rates will tend to rise. Simply put, investors will most likely demand a higher rate of interest for lending, which will raise borrowing costs. It should, however, be noted that in a recent briefing by National Treasury held on 30 April 2020, it was stated that the monetary policy implemented is helping to support the cost of borrowing by providing liquidity in the bond market, and ultimately is reducing bond yields.

Generally speaking, clients should also carefully consider provisions in facilities insofar as the rating of South African banks and other financial institutions' long-term unsecured and non-credit enhanced debt obligations are concerned.

Some other impacts expected from the downgrade, include the deterioration of South Africa's credit reputation, less access to conventional credit markets; deterioration in consumer and business confidence leading to a potential contraction in private investment and consumption demand; South Africa losing its status in various bond indices whereby some bond investors with mandate limitations are prohibited from buying the country's bonds; and a large forex outflow as foreign investors dump South African debt.

The future of the South African economy is faced with a lot of uncertainty, however, it seems that government is committed to implementing structural reforms to move South Africa onto a higher growth path and to forge a new economy in light of this global reality.

Pierre Swart and Stephanie Goncalves

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