

## Chapter 4

# Lengthening Financial Contracts

### Introduction

Chapter 3 documents the scale of the problem of limited and costly access to finance. This chapter focuses on an area of finance in Africa that is particularly challenging in many countries across the continent: long-term finance. Long-term finance is crucial for Africa's economic development. The ability of financial systems to transform short-term claims into long-term assets is a key ingredient of Finance for Growth. It is this aspect of finance that transforms African economies: by supporting the expansion of the productive capacity of established firms, by financing productive investments such as equipment leases especially for farmers, and by financing infrastructure such as power, roads, and housing, financial deepening improves Africa's investment and business environment.

Despite recent encouraging innovations in banks, contractual savings institutions, and the capital market, the lengthening of financial contracts remains a challenge for financial systems across Africa. In areas where progress has been made, the progress is not yet at a rate at which it can significantly affect the scale of the financing deficit on the continent. The challenge for policy makers thus consists of scaling up current initiatives that are succeeding or showing promise; tapping new long-term funding sources, especially domestic sources; and working on long well understood constraints to long-term finance, namely, macroeconomic instability and weak institutions.

This chapter provides examples of long-term funding gaps in infrastructure, housing, and firms. It describes the current landscape of providers of long-term resources and offers policy options for expanding long-term finance. In discussing policies, we take a similar approach as in the previous chapter on expanding access: we distinguish between policies that help Africa optimize the current possibilities to expand long-term finance and policies that expand the frontier of long-term

finance. It is important to keep in mind that, as in expanding access, there is no silver bullet for enhancing long-term finance in Africa. The legislative and institution building agenda, including the establishment of reliable commercial courts, efficient property registries, and procedures for facilitating public-private partnerships (PPPs), is substantial and will take a long time to realize. It is therefore important to address this challenge through multiple initiatives and to pursue them consistently over time. Only with significant confidence in the financial system will investors and households seek longer-term savings instruments and financial institutions for longer periods. In this regard, this chapter is demonstrative and not exhaustive of the challenges and potential solutions for long-term finance in Africa.<sup>1</sup>

## Africa's Long-Term Financing Gap

There are various ways in which we could demonstrate the scale of Africa's long-term financing gap, but, for illustrative purposes, this chapter focuses only on three areas: infrastructure, housing, and firm finance.

### *The infrastructure finance gap*

The deficit in the availability of long-term financing is most evident in the state of infrastructure across the continent. Even if we take into account Africa's income level, the continent still lags behind other developing regions of the world and this holds back per capita GDP growth by 2 percentage points each year (see table 4.1). Electricity outages, deteriorating roads, and the poor provision of water and sanitation networks are too common in many countries. Africa's total installed power generating capacity is estimated at the equivalent of the capacity of Spain. Infrastructure services are twice as expensive in Africa as in other parts of the world because of diseconomies of scale and the lack of competition among providers. Transportation costs in Africa are more than twice the corresponding costs of the BRIC countries (Brazil, the Russian Federation, India, and China) in part because the relatively sparse road networks are poorly maintained (World Bank 2010a).

**Table 4.1 Infrastructure: Comparing Africa with Non-African Developing Countries**

Indicator	Africa	Non-African developing countries
Road density, kilometers per 100 square kilometers of arable land	7.22	127.11
Electricity production, megawatts per million population	398.00	2,475.00
Share of population with access to water, %	66.95	85.33
Share of population with access to improved sanitation facilities, %	34.67	70.14

Source: World Development Indicators Database, World Bank, Washington, DC, <http://data.worldbank.org/data-catalog/world-development-indicators/>.

The cost of addressing Africa's physical infrastructure needs is estimated at US\$93 billion per year, some 15 percent of Africa's gross domestic product (GDP).<sup>2</sup> About two-thirds of this amount is needed for greenfield and rehabilitation investments, and the other one-third is needed for the maintenance of existing infrastructure (Foster and Briceño-Garmendia 2010). This infrastructure gap, however, varies greatly by country type: it is greater in landlocked and sparsely populated countries. While there are substantial needs across sectors, more than 40 percent of the estimated spending is for power infrastructure. This reflects the particularly large physical deficits in this sector relative to other sectors such as transportation, telecommunications, and water. However, there remains a paucity of long-term resources available for investment in Africa's infrastructure to facilitate private investment in these key sectors.

Current spending on infrastructure is around US\$45 billion per year; two-thirds is sourced domestically, while one-third is financed externally through private, public-private, multilateral, or bilateral development partners, such as China and India (see elsewhere below). Because of the recent financial crisis, which resulted in limited fiscal space in Africa, but, even more so, in the developed world, the funding base for infrastructure has been reduced. There is thus a greater focus on finding new funding sources.

How can the sizable infrastructure gaps in Africa be filled? As this chapter shows, there is an increasing array of financing options for infrastructure. Most infrastructure financing has traditionally come from the public sector, either from national governments or multilateral or bilateral development partners. However, addressing Africa's chronic infrastructure shortfall is as much about improving efficiency as about raising more finance. Fiscal pressures have mounted because of the global financial crisis, and redressing the region's infrastructure shortfall has become more challenging than ever.

The main difficulty for many countries is often not the lack of financing, but rather the limited capacity to absorb infrastructure-related development aid and private investment. With a few exceptions, there is a serious lack of capacity to generate credible long-term strategies, policies, and programs for infrastructure finance. The lack of transparency and efficiency in bidding processes, the shortage of qualified financial skills for drafting and negotiating long-term financial contracts, and the absence of mechanisms for holding governments accountable for investment decisions limit the scale and pace of financing transactions for infrastructure. When public-private transactions have occurred, political constraints have often been an issue, especially for utilities such as water, where the sociopolitical resistance to staff reductions and to raising tariffs to cost-covering levels has often been underestimated. Not surprisingly, the overall balance of private participation in infrastructure finance has therefore fallen short of expectations (Jerome 2008). Overall, private participation in infrastructure finance has occurred mostly in transportation and telecommunications, while energy is a distant second.<sup>3</sup>

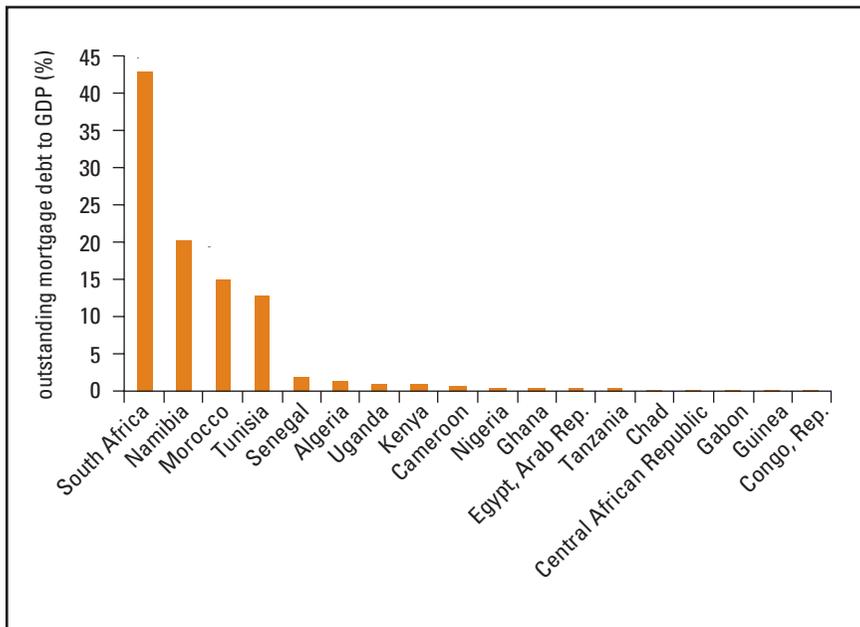
### ***The housing finance gap***

Demand for housing, especially in urban areas, continues to rise across the continent as Africa rapidly urbanizes.<sup>4</sup> Yet, the ratio of outstanding mortgage debt to GDP remains low, averaging around 10 percent, which compares with 50 percent for Europe and 70 percent for the United States (see figure 4.1). Excluding South Africa, the ratio for Africa falls to 8 percent. Excluding the North African countries reduces the ratio to only 1 percent for Sub-Saharan Africa. In those Sub-Saharan African countries in which formal mortgage markets exist, such as Burkina Faso, Ghana, Nigeria, Tanzania, and Uganda, the number of loans is rarely more than a few thousand, and these loans are often limited to the wealthiest segment of the population. External financing for housing thus eludes the vast majority of the African population.

Rapid urbanization and the lack of financing for private housing and public infrastructure impede any long-term planning processes, which, in turn, explains the lack of urban planning, the poor utility connections, and the poor transport links that can be observed across the continent. These factors also explain, in large measure, why over 50 percent of the urban population in Africa lives in slums.

The need for additional housing, however, varies significantly across Africa. Cross-country differences in population growth and internal migration point to

**Figure 4.1 The Size of Mortgage Markets in Africa**



Source: Walley (2010).

important variations in additional housing needs over the next 40 years. For example, in Nigeria, which is rapidly urbanizing, 550,000 new houses are required in cities, but only 144,000 in villages. Contrast this with Kenya, which requires, on an annual basis, only 65,000 new urban dwellings versus 136,000 new rural dwellings. Across the continent, almost the entire housing need will be urban by 2050. Even within the context of the current macroeconomic constraints and the demand and supply barriers, a growing, though still small segment of the African population could afford mortgage finance, as we discuss in box 4.1, in which we calculate an access possibilities frontier for housing finance.

Because of the low level of development of many housing finance markets in Africa, the direct impact of the financial crisis was limited. However, the conservative nature of much of the lending that resulted from the crisis meant that the longer-term development prospects of housing finance were negatively affected. Prior to the crisis, some banks had ambitious plans for expansion across Africa, as well as plans for raising the ratio of capital to debt. Subsequently, banks with a strong presence across the continent scaled back their expansion plans, although they still have a positive long-term outlook on Africa.<sup>5</sup> Alongside the expansion plans, there had been tentative signs that some banks would look to international capital markets such as the Eurobond market to fund some of their balance sheet growth. These plans, which would have provided banks with the longer-term funding required for products such as housing finance, were put on hold in the wake of the crisis (Walley 2010).

### ***Firms' long-term finance gap***

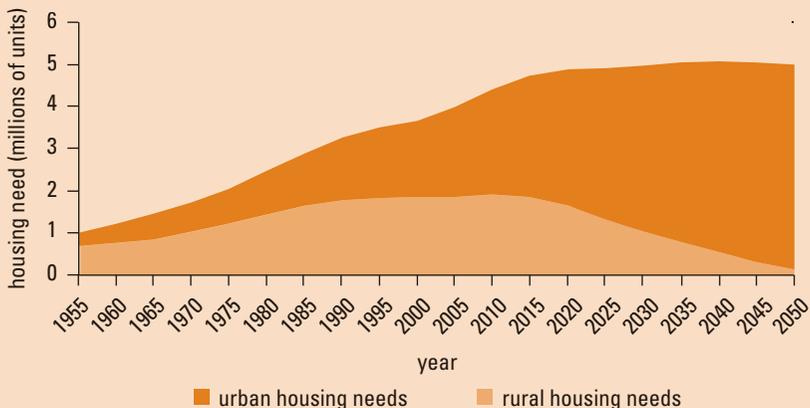
For firms, term finance is equally acute, especially for local small and medium enterprises (SMEs). Large multinational firms in Africa have access to finance from outside the continent, from parent companies, from domestic banks in local markets keen to keep large corporate entities on their books, or from foreign banks, often with mandates to accompany multinational firms outside their home countries. Local firms do not have these options, and, if funds become available, tenure is limited. In a survey of tenures in Cameroun, Côte d'Ivoire, Ghana, Kenya, Nigeria, and Senegal, Shendy, Kaplan, and Mousely (2011) find that, in most countries, 95 percent of loans are for five years or less. Similarly, available data suggest that, although firms in North African countries have made progress accessing longer financing contracts, mainly at the level of medium-term maturities, long-term financing remains limited in the region. Data from bank loans across five selected countries show that long-term credit is scarce (figure 4.2).

## **Optimizing the Current Possibilities for Expanding Long-Term Finance**

More recently, there has been an increase in the entry of new institutions, instruments, and products, which allows one to hope that Africa may be turning the

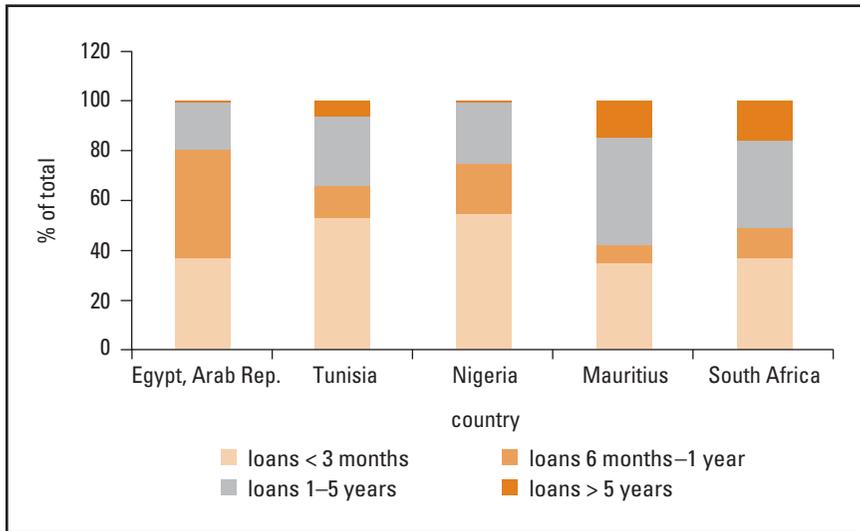
**Box 4.1 The Housing Finance Frontier: An Approximation for Africa**

Calculations can be made on future housing needs that can be supported by commercial finance for housing. There are two principal determinants over the long term that dictate housing need. These are the net population growth rate and the level of internal migration, which is, essentially, the urbanization process whereby villagers leave their homes in rural areas and move to the cities. This is a simplified model, but it also must take account of the average household size in rural and urban areas. The household size is used where data are available, and, where data are not available, the African average is used, which is 4.79 people per household in urban areas and 5.28 people per household in rural areas. This changes depending on cultures and relative levels of wealth and is also likely to change over time, but these factors are not accounted for in the model. This methodology can be put to use with United Nations population data to predict housing requirements over the next 50 years. The results for Africa as a whole are shown in figure a.

**Figure a. Annual Housing Needs in Africa, 1955–2050**

On the supply side, one has to take into account several factors. Based on the average interest rate, one can compute the most cost-effective maturity of a mortgage. Using the average price of a house, mortgage conditionality (based on interest and maturity), and a self-financing ratio of 20 percent, one can compute the average monthly mortgage costs. Assuming a maximum ratio of mortgage payment to income of 40 percent and using income distribution data, one may compute the share of the population that can afford commercially viable mortgages from formal financial institutions. On average, this provides one with a cut-off point for mortgage affordability among the richest 2.9 percent of the population across Africa (with large variations across countries). This translates into six million mortgage loans. Assuming an average loan of US\$50,000—half the average loan amount in South Africa—yields a total mortgage market across Africa of US\$300 billion, or 18 percent of GDP, almost twice the size of the current mortgage market. Behind these aggregate numbers are large variations across countries in the housing finance frontier.

*Sources:* Walley (2010) based on author calculations; STATcompiler (database), Measure DHS, ICF Macro, Calverton, MD, <http://www.statcompiler.com/>; World Urbanization Prospects: The 2009 Revision Population Database, UN Population Division, UN Department of Economic and Social Affairs, New York, <http://esa.un.org/wup2009/unup/index.asp>.

**Figure 4.2 Bank Loan Maturities in Selected Countries, 2008**

Source: Data of Bankscope.

corner on this challenge. In commercial banking, innovations in the use of specialized products and instruments are enabling banks and specialized lenders to extend the maturity of their long-term financing instruments. Also, the renewed interest in development banks has highlighted the need for appropriate governance structures that shield these banks from political interference. In the following, we offer a summary discussion of these trends.

### **Commercial banks**

Although commercial banks dominate the financial system in Africa, their participation in long-term finance remains limited. A number of reasons account for the limited tenor that banks are willing to provide. First, banks are plagued with a structural asset-liability mismatch. Although banks are highly liquid, their liquidity is largely financed by short-term deposits (discussed in chapter 2). Underdeveloped corporate bond markets are one factor inhibiting the ability of banks to cover their asset-liability mismatch. Second, an underdeveloped government bond market inhibits the development of the yield curve benchmarks necessary for commercial banks to price long-term debt in local currency.

Despite these constraints, Shendy, Kaplan, and Mously (2011) find that there are some exceptions: some local commercial banks find ways to overcome these challenges and provide long-term finance. For example, in Nigeria, the Lekki-Epe Express Toll Road, which reached financial close in 2008, was able to mobilize a 15-year loan from Stanbic's IBTC-Nigeria in local currency for ₦2 billion (US\$13.4 million) at a fixed interest rate of 13.9 percent and with a moratorium on principal

repayments for four years. The deal was also supported by other local banks, namely, Diamond Bank, Fidelity Bank, First Bank, United Bank for Africa, and Zenith Bank, which provided a total loan value of ₦9.4 billion (almost US\$63 million) for a tenor of 12 years.<sup>6</sup> In Senegal, the Dakar-Diamniadio Toll Road reached financial close in November 2010. The concessionaire Eiffage was able to tap into a local credit line at a Senegalese bank that provided approximately US\$10 million, with a 13.5-year tenor and a fixed interest rate of about 10 percent. This amounts to 10 percent of the total debt of the project. Similarly, the Kenyan Equity Bank has been the single largest financier in a syndicated loan to Rift Valley Railways.

### ***Development banks and specialized lenders***

State-owned financial institutions, particularly development banks, have returned to the spotlight of public debate. Concerned because of the lack of notable progress in increasing access to long-term finance, policy makers are discussing the efficacy of the role of development banks. African countries have had differing relationships with state financial institutions over the last couple of decades. In some, such as Malawi, there has been an active state-led interventionist approach to financial sector development until recently. In others, such as Mozambique and Zambia, there has been a more liberalized private sector-led model. In yet others, such as Ethiopia, the government continues to dominate the sector.

For decades, the debate on the rationale for state intervention in the financial sector has centered on market failures, such as lack of information, which are more prominent in some sectors, as discussed in chapter 3. In this case, direct state participation would be warranted to compensate for market imperfections that leave socially profitable (but sometimes financially unattractive) investments underfinanced.

Take the example of housing finance. Where commercial banks have feared to go in the past, state housing banks have often sought to bridge the gap. Many African countries have such banks, including Cameroon (Crédit Foncier du Cameroun), Gabon (Compte de Refinancement de l'Habitat du Gabon), Mali (Banque de l'Habitat), Rwanda (Caisse Hypothécaire du Rwanda), and Tanzania (Tanzania Housing Bank). Almost without exception, these institutions have failed in their mission to expand access to housing finance. Many have also required large bailouts from the government when they became insolvent. The reasons for the failures are repeated across the institutions and include poor management, political interference, and a perception by borrowers that they are receiving grants rather than loans, with little consequence if they do not repay. The concern related to state housing banks is the displacement effect they have on the private sector. There are certainly exceptions, as the case of the Banque de l'Habitat in Tunisia shows (box 4.2). There, the major difference with Sub-Saharan housing banks relates to the Tunisian bank's access to retail savings.

Some African countries have opted to establish specialized single-purpose non-bank mortgage lenders, or monoline lenders, most notably, the Arab Republic of

### Box 4.2 The Role of the Housing Bank in Mortgage Finance in Tunisia

In its social and economic policies, the Tunisian government has assigned a top priority to access to housing and has taken an activist stance. Banque de l'Habitat (BH) was established in 1989 as successor to a failed savings bank (Caisse Nationale d'Épargne Logement) to provide financial solutions in the housing sector. BH's mandate includes savings mobilization, prefinancing for real estate developers, and the provision of diversified mortgage loans to individuals through savings-based loans and direct loans. Unlike many housing banks in Sub-Saharan Africa, it is thus primarily a savings bank. In 1992, BH was authorized to extend its loans to all economic sectors and was listed on the Bourse de Tunis, though the government kept a majority shareholding of 58 percent. During the early 1990s, BH was the only bank authorized to offer mortgage loans in Tunisia, but, after the liberalization in 1998, private banks were allowed to enter, and, over time, BH's market share dropped significantly, to only 22 percent in 2008. Today, the bank is the major player in low-end housing finance, given that it is the only bank authorized to offer the classic housing savings plan, which pays the highest savings deposit rate, benefits from an exemption from the withholding tax on savings-for-housing accounts, and allows clients to enjoy subsidized interest rates on loans. In 2003, the financing of social housing projects represented almost 80 percent of BH interventions. This contrasts with private commercial banks, which mainly serve the upper part of the market. One of the success factors of BH is thus the more numerous subsidies and privileges it has received relative to private institutions in the housing segment.

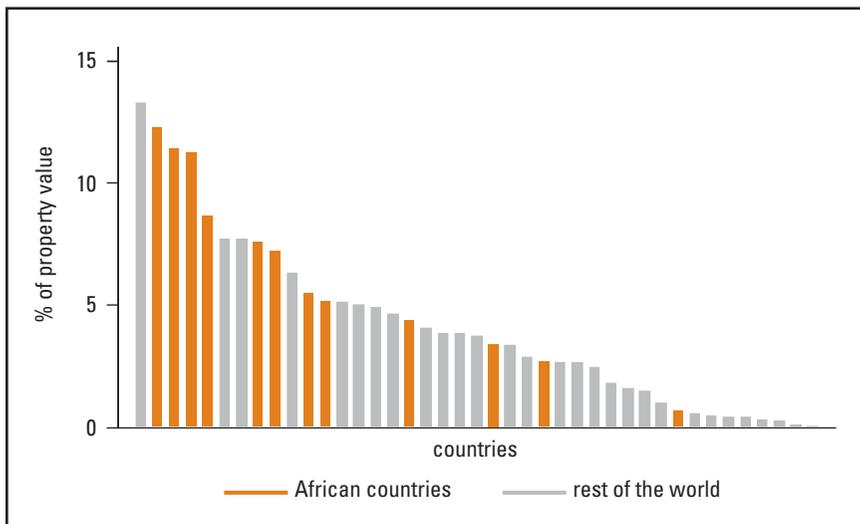
Despite the success of BH and the overall situation on the mortgage market in Tunisia, serious constraints remain. There is a large disparity in the quality of the housing stock between urban areas and rural areas, mainly in the northwest and center-west regions. While official statistics suggest that supply meets demand and significant progress has been made on the financing side, affordability remains an issue, mainly among low-income households. There seems to be an oversupply among upper-income and upper-middle-income groups and a shortage among lower-income groups. This is corroborated by the global property guide, which shows that demand for houses in Tunisia is mainly driven by the middle class and that house prices range from TD 450 (US\$320) to TD 1,700 (US\$1,215) per square meter. These prices are high relative to the minimum wage, which does not exceed TD 251 (US\$180). Relying mostly on retail saving accounts, BH faces funding constraints. Its loan-deposit ratio is above 1, plus it has maturity risks: deposit rates are fixed, while lending rates are tied to the interbank market rate. The current levels of interest rate risk exposure and maturity mismatch remain manageable, but the latter will need careful follow-up, especially in light of the political unrest that the country experienced recently and the potential negative effects of this on the real economy.

Egypt, which has mortgage finance companies; Kenya, which has housing finance companies; Nigeria, which has primary mortgage institutions; and South Africa, which has financial service providers specializing in mortgage lending. Typically, these institutions have a narrow banking license limiting their activities and, in particular, restricting deposit collection. This means that they are usually reliant on wholesale funding on the liability side of their balance sheets. This type of institu-

tion was especially vulnerable during the crisis because its funding costs rose to a much greater extent relative to lenders with a deposit base. One response has been a consolidation in the financial sector as banks acquired specialist mortgage businesses or started up their own. This is the case in Egypt (where a number of mortgage finance companies have been acquired by banks), Kenya (where Savings and Loan was acquired by Kenya Commercial Bank), and Nigeria (where banks have been setting up Project Management Institute subsidiaries to carry out their mortgage lending business). This bank-subsiidiary model allows specialization in mortgage lending and may attract some regulatory benefits, but it avoids the funding downside because banks can rely on a stable retail depositor base.

Meanwhile, for private and government financial institutions, the constraints to the development of mortgage markets are not restricted to problems within the financial sector. A major constraint for housing finance is the contractual framework, because high fees and difficult registration processes—that might involve additional informal fees—constitute a large hurdle to the formal recognition of property ownership (figure 4.3). Land laws in many countries still put restrictions on private ownership, and the infrastructure for property transfer is cumbersome, which makes the use of land as collateral difficult. Registries are often in a dismal state and are frequently based on handwritten records, which means the systems are open to abuse and corruption. Furthermore, government approval is often necessary before land can be transferred; this is the case, for example, in Malawi. Stamp duties and fees are another major hurdle. In Nigeria, for instance, the consent fee

**Figure 4.3 The Cost to Register a Mortgage or Transfer a Title**



Source: World Bank and IFC (2008).

Note: Sample size: 43 countries.

(the governor has to agree to a land transfer) amounts to at least 15 percent of the land valuation, and total stamp duties, registration fees, and other levies can add another 30 percent. Yet, there are many exceptions; thus, Rwanda and Zambia have continued to strengthen their already well-functioning property transfer systems.

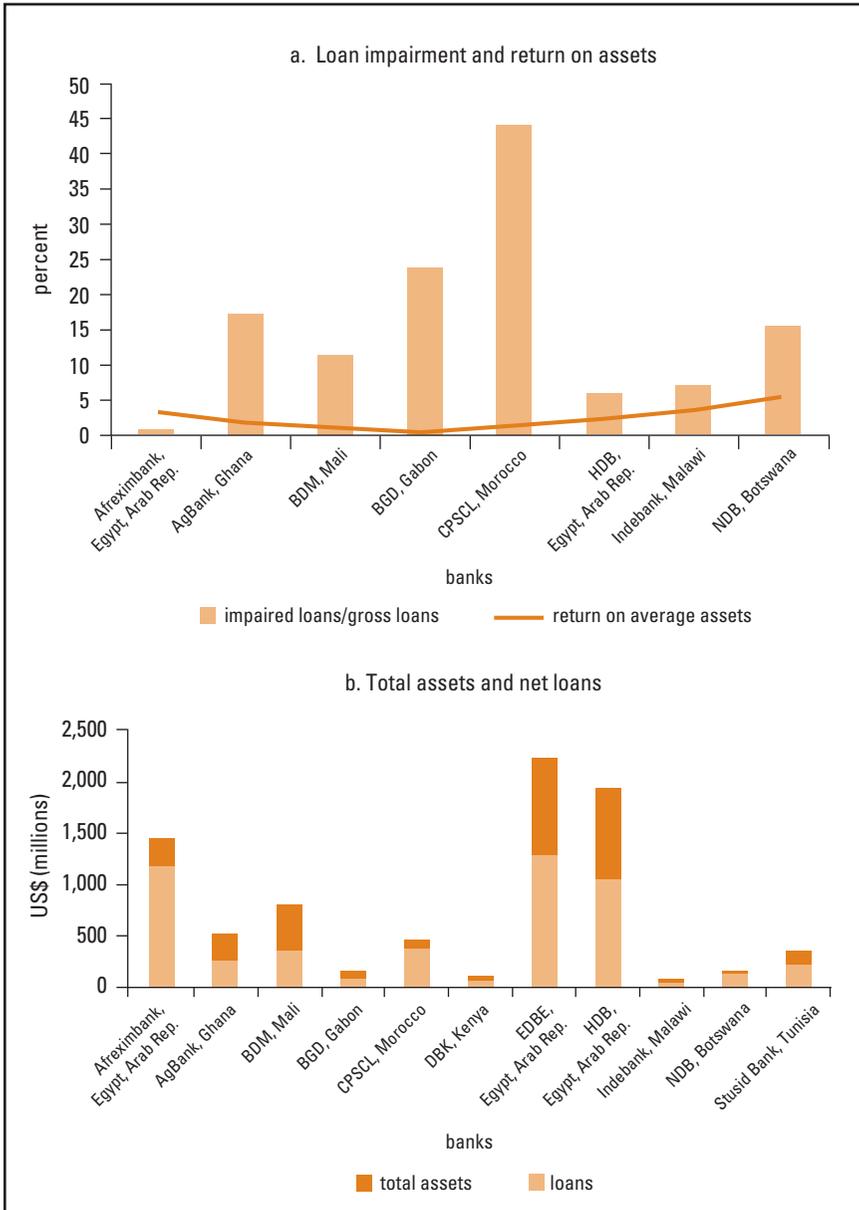
### ***Development finance institutions: continuing challenges and unclear mandates***

While many development finance institutions (DFIs) have been established and have good objectives, the activities of DFIs have often resulted in unintended consequences in terms of the credit culture of beneficiaries and the interest of the private sector in investment in the financial sector. Experience worldwide suggests that, despite the apparent advantages of government intervention in the effort to broaden access to credit, the public provision of banking services has generally not been successful in developing countries. La Porta, Lopez-de-Silanes, and Shleifer (2002) find a close association between government ownership and lower levels of financial development, less credit for the private sector, wider intermediation spreads, greater credit concentration, slower economic growth, and recurrent fiscal drains.

Even today, as governments revisit the role of development banks, the performance of these banks remains suboptimal. African DFIs, on average, perform poorly. They show low levels of profitability, with a 2.4 percent return on average assets, and high levels of loan impairment, with a 15.8 percent ratio of impaired loans to gross loans (figure 4.4). These are only some of the indicators of poor performance. For many of these banks, the problems of yesteryear persist, including political interference, the lack of capacity, and the lack of economies of scale.

This is not to say there are no success stories, but they are few and far between. In a survey by the International Monetary Fund covering 100 institutions in 25 countries, a third of these institutions reported losses over three years, and a third reported nonperforming loans greater than 10 percent, while capital injections were common as banking crises led to fiscal crises (Brooks 2006). Despite the limited number of success stories, DFIs, even poorly performing ones, have been tenacious survivors. There are more than 60 in Africa. Meanwhile, in Mali, Tanzania, Zambia, and many other countries, specialized state-owned banks have remained stagnant; they are largely illiquid and deliver few services, and their solvency is precarious and conditional on support from governments (Honohan and Beck 2007). Looking specifically at specialized DFIs that focus on the provision of housing, Hassler and Renaud (2009) distinguish among three types. Most of the funds for the first type are deposits, as in Algeria (Caisse Nationale d'Épargne et de Prévoyance) and Tunisia (Banque de l'Habitat). These banks, which are typically savings banks, have a strong funding foundation and the ability to offer a wide range of banking products. The second type typically consists of specialized banks without a large deposit-collection capacity that raise funds on bond markets, as in the case of Morocco (Crédit Immobilier et Hôtelier). The third type consists of

**Figure 4.4 The Profitability and Loan Impairment of African Development Banks, 2009**



Source: Author calculations.

Note: The data are valid as of December 31, 2009.

banks that are largely funded by public finance sources, such as mandatory savings or wage taxes, central bank facilities, or government grants and loans. This model is rare, but it has been used, for instance, in Cameroon (Crédit Foncier du Cameroun).

The limited success of DFIs—except where they can rely on a large retail savings base—calls into question the current business model of these entities. Rather than their current focus, policy-oriented and wholesale financing tasks seem more appropriate (see below). Such tasks could range from managing partial credit guarantee funds, discussed below in this chapter, to facilitating value chain finance arrangements in agriculture, managing investment funds that are provided by donors, and serving as conduits to private commercial banks acting as ultimate lenders. Caisse de Dépôt et de Gestion (CDG), in Morocco, is an example of a para-governmental entity that helps deepen the financial system. It collects funds from pension and provident funds, as well as insurance companies, and invests in listed and nonlisted companies. The CDG Group is the largest institutional investor in Morocco and a major player in funding development and social programs. It participates in private sector enterprises and investment on international stock markets (mainly France). CDG has also been supporting the private equity industry, including through its investment in Averroes Fund I, a €30 million (around US\$42 million) fund of funds targeting the Mediterranean region.

Many refer to the success of the Development Bank of South Africa (DBSA), which is one of the four state-owned development banks in the country. Its main objective is to facilitate financing and technical assistance among companies and municipalities, principally for infrastructure funding. It also provides financing to large infrastructure projects in neighboring countries. DBSA's taxable profits go to DBSA Development Fund, a subsidiary of DBSA, of which the main objective is to provide support to low-income municipalities through grants, the deployment of technical expertise, training, and the identification of projects. Rudolph (2009) concludes that DBSA's success can be primarily attributed to the bank's sound corporate governance structure. The presence of an independent and qualified board of directors, professional management, and the South African Treasury as an active shareholder have contributed to the bank's strong corporate governance practices. Furthermore, the lack of financial dependence on government funding has strengthened the asset-liability management functions of the bank.

Rudolph (2009) observes, however, that DBSA has faced challenges. Because its taxable profits go to DBSA Development Fund, DBSA has two conflicting objectives: financing infrastructure projects in middle-income municipalities and generating revenues to fund the operations of DBSA Development Fund. Although requiring a minimum return is a desirable objective, the goal of maximizing profits (with the purpose of funding DBSA Development Fund) may intensify the investments of the bank in commercially oriented projects that are not necessarily consistent with social objectives.

To help avoid a repetition of the disappointing performance of development banks in the 1970s and 1980s, Thorne and du Toit (2009) identify six dimensions of success, namely: an enabling environment; a mandate; regulation and supervision; governance and management; financial sustainability; and performance assessment. Development banks need a climate of macroeconomic stability without too many microeconomic distortions. They must be integrated into the financial system and operate along commercial lines, with a flexible mandate. They should do this without competing with the private sector, but, rather, they should aim to develop the private sector. They should also operate autonomously, while ensuring that they adhere to their mandate. Sound governance and management may be the single factor most likely to determine the success of a development bank. To align incentives, it might also be advisable for governments to capitalize new (or restructured) development banks adequately and then limit additional fiscal support to ring-fenced noncommercial activities undertaken on behalf of the state. Governments should also put in place arrangements for development banks to be assessed on a regular basis against an agreed set of financial and social or developmental objectives.

Guided by the principle that government intervention should support rather than distort incentives for the private sector provision of financial services, however, our preference remains for a reorientation and possible restructuring of existing state-owned financial institutions toward more wholesale long-term financing activities. Given the limited success of the direct provision of financial services by government-owned financial institutions and the promise that the use of technology and agent agreements holds for the expansion of access, government-owned financial institutions will be able to maximize more effectively their impact on financial sector broadening by providing assistance as second-tier rather than first-tier financial institutions.

For many countries, policy makers would be better served by refocusing the primary engagement of governments in the financial sector on policy formulation and wholesale lending activities, while leveraging the private sector to lead in the retail delivery of financial services, including long-term financial services. A holistic review and restructuring of current government institutions and programs could yield substantial economies of scale and reduce the current contamination of private sector-led efforts to increase access to financial services. Rather than establishing a new program each time a government prioritizes a particular sector, region, or activity, policy makers ought to consider focusing on using a single agency or institution to prepare and draft the eligibility criteria for the program and then tender the retail implementation of the program to interested institutions. All bank and nonbank financial institutions would be eligible to bid for the tender. By leveling the retail financial sector landscape in this manner, the government would increase the involvement of the private sector in the delivery of commercially sustainable long-term financing programs in the country.

### ***Contractual savings: pensions and insurance funds***

To the same extent that there is a renewed interest in development banks, there is also a persistent interest in unlocking the funds held by pensions and insurance firms and using them for long-term investments. Because of its long-run liabilities, this segment of the financial sector has the potential to play an important role. However, as discussed in chapter 2, the contractual savings sector in Africa is even more underdeveloped than the banking systems. Insurance sectors across the continent are mostly focused on non-life insurance business lines, with the notable exception of several southern African countries, where life insurance products are popular for, among other reasons, tax motives. Few countries on the continent have private pension funds; the majority rely almost exclusively on public funds in the form of pay-as-you-go funds or social security funds. An important feature of African pension funds is the limited coverage of the working population, though important variations exist across countries. While the coverage rate used to exceed 80 percent in Libya and Tunisia, it is 3 percent in Niger. We discuss below the insurance and pension industry in turn.

As shown in chapter 2, insurance sectors across Africa are small in depth and breadth, and most insurance sectors are dominated by the shorter-term non-life insurance business lines, while life insurance products such as mortality or savings products are less popular. In addition to the country factors discussed in chapter 2 that explain the limited financial sector development, demographic characteristics also play an important role. High mortality reduces the incentive to save through life insurance policies, but also makes the pricing of such products more difficult and less attractive for consumers. The small populations in most countries mean that the pooling and diversification of risks are more difficult. There are other important demand-side constraints, including low savings rates, the lack of awareness and financial literacy, and the lack of trust in insurance companies because of fraudulent practices and the shortage of consumer protections.

Many insurance sectors on the continent are characterized by a large number of small, locally owned, often undercapitalized companies with low levels of expertise and insufficient economies of scale that are unable to offer attractively priced products or professional levels of service. Consistent with the short-term nature of non-life insurance lines of business, insurance companies are mostly purchasers of short-term financial instruments. However, limited supply, lack of skills, and governance deficiencies would prevent the life insurance segment from maximizing its positive role even if there were demand for more long-term financial instruments.

The lack of long-term assets is particularly problematic for life insurance companies, which offer products with a payout many years after policy commencement, such as whole life or universal life contracts and long-term savings plans. Long-term investment assets offering attractive rates of return are seldom available, particularly because there are generally severe restrictions on investing assets outside a country. As a result, the returns from life insurance products are frequently unat-

tractive. Because of the short-term nature of their insurance contracts, such as automobile insurance and fire insurance, non-life property and casualty insurance companies are not as affected by the unavailability of long-term asset classes. Non-life insurers need to keep most of their funds, such as cash and fixed interest, in liquid form. However, even non-life insurers are not immune and are affected by the general lack of liquidity in government bonds, for which there is rarely a secondary market, and, hence, bonds need to be held to maturity. In addition, stock markets are frequently underdeveloped; stocks are thinly traded; and stockholdings are therefore generally illiquid. Thus, it is not uncommon for a smaller insurance company to advise its clients that valid insurance claims will not be paid for some months, until such time as the company sells a longer-term investment asset, after which it will have sufficient liquidity to pay the claim. This problem arises when an insurer invests in virtually any investment asset class other than cash, given that the illiquidity of stock markets, real estate investments, and even bond markets does not allow insurance companies to convert investment assets into cash in a timely fashion to pay insurance claims and policyholder benefits.

Similarly to the life insurance sector, the private pension industry in most African countries is small. With the exception of larger or middle-income common law countries, such as Botswana, Mauritius, and South Africa, but also Kenya, such funds are rare for the same reasons life insurance business is limited. In Kenya, over 1,000 occupational pension schemes are licensed and are required to outsource asset management to independent, registered fund managers and hire independent custodians to ensure the full segregation and safe custody of the assets of sponsors. Most of these schemes, however, are underfunded and suffer from risk concentration on both sides of the balance sheet. Botswana has seen impressive growth in occupational pension schemes only over the past 10 years or so, and the schemes now reach 40 percent of the formally employed population.

The pension sector in many African countries is still dominated by obligatory, state-owned pension schemes administered by national social security parastatals. Among pension funds, 7 percent are privately managed in Africa, compared with 16 percent worldwide.<sup>7</sup> Coverage is, however, mostly limited to the formally employed. There is a large variation in funding structures. In Uganda, the pension fund for civil servants is financed through the general budget, while, in Botswana, after the reforms around 2000, there is a fully funded, defined contribution scheme. Prefunding can have critical advantages, including an increase in the national savings rate and opportunities for international risk diversification.

Overall, the pension funds in Africa suffer from absent or weak investment guidelines, as well as limited capacity to implement investment strategies. Large parts of pension fund investments, whether private or public, are in real estate, short-term bank deposits, or government securities, while a limited, though increasing percentage is invested in equity (table 4.2). An even smaller share is held in corporate bonds. However, even if one wished to invest pension funds in corporate bonds, there might not be enough available in the domestic market, an issue to

**Table 4.2 Pension Fund Portfolios**  
*percent*

Country	Cash and deposits	Fixed income	Shares	Land and buildings	Other	
Egypt, Arab Rep. (2008)	26.82	69.28	2.07	0.39	1.44	
South Africa (2006)	5.01	8.70	23.32	0.49	62.48	
Zambia (2005)	15.00	27.85	17.83	23.57	15.75	
	<b>Fixed income</b>	<b>Equity</b>		<b>Real estate</b>		
Ghana (2008)	46.00	42.60		11.40		
	<b>Government debt</b>	<b>Listed equities</b>	<b>Government equities</b>	<b>Real estate</b>	<b>TPS<sup>a</sup></b>	<b>Other</b>
Kenya (2009)	13.00	50.00	1.00	29.00	5.00	2.00
	<b>Fixed income</b>	<b>Equity</b>		<b>Real estate</b>		
Uganda (2009)	70.00	10.00		20.00		

*Sources:* For Egypt, South Africa, and Zambia: data of the International Organization of Pension Supervisors; for Ghana: data of the Social Security and National Insurance Trust; for Kenya: data of the Retirement Benefits Authority; for Uganda: World Bank (2009b).

a. TPS = Tenant Purchase Scheme.

which we return below. The participation of some pension funds in African bond markets is also limited because of restrictions on the exposure of funds to this asset class or to investments outside the country; this is the case, for instance, in Egypt. In Nigeria, savings are managed by separately licensed private investment managers, who are also severely restricted in investment across asset classes and generally cannot invest outside the country. There may be macroeconomic reasons for restricting investments to the country of origin; however, this approach also restricts potential investment returns. The need to diversify away from government securities and real estate alone is reflected in the investment guidelines of the International Social Security Association (ISSA 2004).<sup>8</sup>

Recently, several countries have undertaken comprehensive pension reforms. These reforms might eventually result in a more important role for this sector in providing funding for long-term investment and growth. There is a significant trend toward greater autonomy among social security organizations, notably in Côte d'Ivoire, Gabon, Ghana, Kenya, Nigeria, Senegal, Tanzania, and Uganda. In many countries, the challenge lies in being able to tame the role of the government, even in the presence of a technically sound pension sector regulator. Autonomy is not the sole requirement for good governance. Moreover, it is sometimes associated with high administrative costs and excessive staffing levels. However, it helps in creating an environment for more accountability and a framework that can ensure proper governance.

In June 2008, the Social Security Regulatory Act was passed in Tanzania. It defines a framework to distribute the supervision of schemes between the Bank of Tanzania and a new social security regulatory authority. Ghana has also moved

forward by creating the National Pensions Regulatory Authority following passage of the National Pensions Authority Act in January 2010. For both agencies, it remains to be seen whether they will follow the widely accepted principles that supervision must be independent, money managers must be professional, and audits must be external, thereby enhancing their investment activities, but the potential is there.

In Kenya, the pension sector has experienced a significant improvement in performance since the establishment of the Retirement Benefits Authority, which resulted in the introduction of investment guidelines and a shift to private portfolio managers. The returns from privately managed pension funds have been strong since these reforms. In contrast, the government-controlled National Social Security Fund remains unreformed and has a long history of low returns. Moreover, it operates outside the Retirement Benefits Authority Act. (For example, it is not subject to the related investment guidelines, and it relies on internal portfolio management rather than outside professional money managers.) An argument could therefore be mounted that government-controlled pension managers, like all other managers, ought to be subject to the same enforcement measures associated with the stringent guidelines.

The lack of alternative domestic investment opportunities for insurance and pension funds raises the issue of how necessary it is that a portion of the funds be invested abroad. Many countries on which data are available show a bias toward domestic funds; Botswana is one notable exception. Yet, investing a proportion of their assets abroad allows pension funds to reap the benefits of diversification and offers greater investment opportunities, given the dearth of such instruments in most African markets. In addition, investment quality would be significantly improved. Few African assets are investment grade as defined by Standard & Poor's and Moody's; even the sovereign risk of many Sub-Saharan countries does not qualify as investment grade. This is particularly important for insurance companies: international requirements call for the use of more than 90 percent of available funds in investment grade assets. Investing a portion of funds outside the home country would thus present the management of insurance companies with an opportunity to upgrade investment quality, improve returns, and acquire the ability to match long-term liabilities with commensurate long-term assets.

However, permitting the management of insurance companies and pension funds to invest outside the home country has drawbacks. First, insurance company and pension fund management may not have sufficient expertise to make appropriate international investment decisions. Second, foreign investment could become a mechanism whereby funds are transferred outside the reach of policyholders.

Investing outside the country therefore requires safeguards. Rigorous checks and balances would need to be introduced through significantly stepped-up corporate governance requirements, supported by improved regulation. This would likely include criminal penalties for directors and managers who abuse their authority. Regulators would need to build their expertise in investment matters, im-

prove their market surveillance, act upon alerts from early warning systems, and rigorously enforce compliance with regulations. Investing abroad also introduces an additional element of volatility related to exchange rate movement and other possible sources of risk. Regional integration could help in this case, especially across countries with similar economic structures and stable, if not fixed exchange rates, such as in the currency unions of Central Africa and West Africa.

For pensions and insurance, there is an urgent need to undertake reforms in such areas as risk diversification, solvency, consumer protection, and taxation. Capacity building among regulators and financial literacy programs for policyholders are essential. Insurers are short on training and experience, and gaps in regulatory coverage persist. To ensure effective corporate governance, it is vital that insurance companies and pension funds have appropriate risk management processes in place. Insurance and pension regulators need to deploy risk-based supervision methodologies and thereby make use of sound oversight and supervision. In the case of the pensions industry, a separate implementation body and external evaluators for the overall process need to be considered (box 4.3).

### ***Capital markets: a limited role***

Long touted as essential to unlocking the long-term potential of finance by providing a trading platform for equities, stock exchanges have been the must-have institution of a modern national financial system. Yet, for decades, stock market capitalization has remained low in Africa and represents, as of 2009, only 2 percent of world market capitalization. As we discuss in chapter 2, markets in Africa have low levels of liquidity, with the exception of the Johannesburg Stock Exchange. As stated by a market practitioner, “an entire year’s worth of trading in the frontier African stock markets is done before lunch on the New York Stock Exchange.”<sup>9</sup>

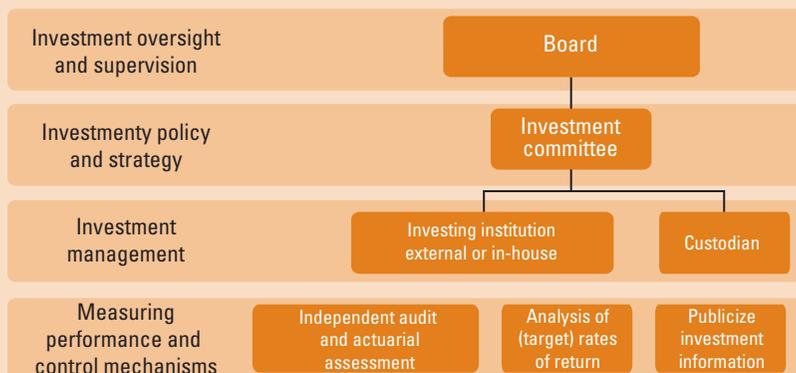
To revitalize, many stock markets in the region have undertaken regulatory and institutional reforms, such as a relaxation of the restrictions on foreign investors. All African stock exchanges now allow foreign participation (Allen, Otchere, and Senbet 2010). Governments have also tried to use tax incentives. In Tanzania, for example, equity-issuing companies face a reduced corporate tax rate for a period of three years if at least 35 percent of the equity is issued. Efforts have been made to reduce the transaction costs as well, including the taxation of capital gains. While tax incentives can increase the number of listed firms, it will not necessarily translate into enhanced liquidity in the market, as indicated by the example of Egypt, which recently abolished some tax subsidies.

However, the capital markets in the region still face severe challenges. Some capital markets are constrained by outdated practices and inefficient listing procedures and trading mechanisms, such as manual systems, the lack of a regulatory framework, and an inefficient market information dissemination process, though most African stock exchanges have now shifted to an electronic rather than manual trading system. Governments continue to try to make their markets more cost-effective by working with development partners on (1) market development strategies to

### Box 4.3 International Labour Organization Best Practice Guidelines for Board Members in Africa

An investment committee should be established concentrating on investment policy, strategy, monitoring, and evaluation (see figure a). Because the board needs to monitor investment policy and strategy on an ongoing basis, it is important that board members receive training to be able to evaluate and pass judgment on the investment committee's reports.

**Figure a. Administrative Bodies of a Social Security Scheme and Their Control Mechanisms**



Investment committees are different from investing institutions. The investing institution may be the administering body or a separate institution dealing only with investment management. It can be separate, but in-house, or it might be completely outsourced to professional money managers. Three more entities are necessary to contribute to achieving the best results from pension fund investments: a custodian, an external auditor, and an external actuarial assessment body. A custodian should be appointed for the assets, including to hold the documents and prove the ownership of the assets. This can be an independent firm, the central bank, or the ministry of finance. The renewal of an independent firm's contract should be based on performance. An external auditor who is free from political interference and independent of all internal bodies should be appointed by the board to carry out annual audits of the scheme. The same should be true of the actuarial assessment body. Its task will be to report findings to the board. In the extreme case that the future expenditures of a scheme are not covered by reserves and no remedial action is taken by the board, the actuary body should also make a report directly to parliament.

To improve performance, control mechanisms need to be employed on a regular basis as well, that is, performance assessment, compensation mechanisms, information systems and processes, risk management procedures, and regular reviews of expert advisers and any contractual arrangements. To help ensure accountability and good performance, a suggestion of the International Labour Organization is to publicize the relevant information on investments—such as the associated objectives, policies, and strategies and the performance of investments—in the annual report, but also throughout the year in press releases on the organization's website.

Source: ILO (2010).

increase listings, especially listings of upcoming medium-size enterprises; (2) capacity building among staff in the industry as a whole, including brokers and regulators; (3) education campaigns for relevant stakeholders and the general public that are aimed at informing the general public on long-term investment opportunities and risks and at informing firms about the benefits of listing on stock markets; and (4) reform in investor protection laws and corporate governance codes. The evidence of sustained success is still mixed at best, however.

Another option is secondary trading boards, such as exist in Botswana (introduced in 2001 as the Venture Capital Board and dedicated to helping firms that are looking for start-up capital), as well as in Egypt and South Africa. These make lower demands on issuers in terms of listing fees, track record, size, reporting requirements, and float, or the minimum number of shareholders. They thereby try to attract medium-size companies, for which the regular conditions are too burdensome. While these markets have facilitated the access of firms to stock markets, their limited success suggests they can only partly solve the problem of the access to finance. Box 4.4 describes the experience with a secondary board in Egypt. In Kenya, the introduction of a secondary trading board led to a switchover among companies from the main board to the secondary board to avoid the more onerous

#### **Box 4.4 The Experience with a Secondary Board in Egypt: Nilex**

Nilex is a second-tier market initiated by the government in 2007 to offer funding to SMEs. By offering relaxed listing rules, Nilex is meant to attract promising companies that cannot comply with the listing rules of the regular market. Nilex is currently functioning as a market segment of the Egyptian Exchange, but will be spun off once it reaches a critical size. So far, companies listing on Nilex cannot thereby benefit from any tax exemption.

While trading on Nilex started fairly recently (in June 2010), 16 companies were already listed on the market as of September 2010, and 4 are close to initial public offerings. On average, the listing process takes two months, but can be fast-tracked to two weeks if a company has a complete application. Candidates for listing operate in various sectors, including real estate, agribusiness, and manufacturing.

So far, companies have not been keen to list on Nilex for the following reasons: (1) fear of losing control by complying with enhanced disclosure requirements, (2) limited resources to pay listing fees, and (3) lack of understanding of the benefits of listing and of the need to pay listing fees. Nilex listing fees are set at LE 0.5 for every LE 1 million of paid capital, with a maximum of LE 25,000 per year. To tackle the listing fee problem, exchange authorities are working closely with several governmental and professional bodies to subsidize part of the listing costs. For example, the Industry Modernization Center bears at least 90 percent of the listing costs for industrial companies. Candidates must select a nominated advisor from a list prepared by the exchange. Nominated advisors are expected to help the company restructure its operations, comply with Nilex requirements, and assist in the listing process by playing the underwriter role.

*Source:* Feyen (2010).

listing and disclosure requirements on the main board. The switch therefore had only a limited overall effect on trading.

But even more cost-effective domestic stock exchanges will be constrained by the limited firm and investor universe of their respective host economies. Most small economies in Africa are too small to sustain a liquid stock exchange. Moving toward regional models or cross-listing arrangements are viable alternatives in this context. One route is toward regional stock exchanges, as in the case of the Abidjan Stock Exchange, which was expanded to become the Bourse Régionale des Valeurs Mobilières to allow enterprises from throughout francophone West Africa to list, or the Bourse des Valeurs Mobilières de l'Afrique Centrale, on which companies and states of the Economic and Monetary Community of Central Africa are encouraged to list. However, as of December 2010, of the 39 companies listed on the Bourse Régionale des Valeurs Mobilières, only six are not Ivorian and, of these, only Niger has more than one listed company. Similarly, with the exception of the International Finance Corporation bond issue, all issues on the Bourse des Valeurs Mobilières de l'Afrique Centrale were made by the government of Gabon or Gabonese firms (Banque de France 2009). The harmonization of regulations, trading systems, and tax regimes can be an important first step toward the regionalization of stock exchanges, but also in facilitating cross-listings.<sup>10</sup> The three stock exchanges in West Africa (Côte d'Ivoire, Ghana, and Nigeria) are in talks to establish uniform rules, regulations, and operational procedures. An alternative to regional stock exchanges is to allow cross-listing, which permits enterprises to tap additional investor communities and encourages more liquid trading of the shares of enterprises, thereby increasing the efficiency of the price-finding process (Pagano et al. 2001).

Yet, even under the best-case scenario, with the implementation of all the necessary regulatory reforms and all the cost problems solved, one has to be realistic about what to expect in terms of stock market development. The experience in Latin America, but even in Western Europe has shown that it is difficult to sustain liquid stock exchanges in smaller economies (box 4.5).

Given experiences in other regions, it is unrealistic to expect stock exchanges across Africa to flourish. The modernist approach would hold that financial services per se matter, not where or by whom they are delivered; this would mean that listing on foreign exchanges would be a good solution, for example, on the Johannesburg Stock Exchange. However, this would only help the largest enterprises in each country and might even increase the listing threshold, given the potential additional listing and transaction costs of listing abroad rather than at home. It might also pull liquidity away from small stock exchanges, exacerbating the small exchange curse (Levine and Schmukler 2006).

Corporate bond markets across Africa are also small and illiquid. They are limited in many countries by cumbersome regulatory structures. Rather than focusing on disclosure, most African countries impose a complex approval process. Rather than allowing the market to assess the financial viability of bond issuers and the risk of the securities, regulators feel compelled to undertake this assessment on

### Box 4.5 Capital Markets in Latin America

In Latin America at the beginning of the 1990s, high hopes for capital market development in emerging markets had catalyzed the debate about reform and action to address financial liberalization, the establishment of stock exchanges and bond markets, and the development of a regulatory and supervisory framework. The associated expectations that were thus built up were not met: Latin American countries, despite their reform efforts, greatly underperformed relative to East Asia and the G7 countries.

A couple of explanations can help shed light on what went wrong in the Latin American experience. One explanation ascribes the failure to a combination of impatience and the insufficient implementation of reform. Because reform efforts materialize only long after the initial steps, policy makers have to be patient in harvesting the fruits that they have planted. Instead, the claim has been put forth that some key reforms were not initiated, while other reforms were often implemented in an incomplete or inconsistent fashion. Appropriate laws and regulations were approved, but not duly implemented or adequately enforced. The policy advice that follows from this is to forge ahead persistently with reform and be patient. The reform efforts should seek to improve the enabling environment for capital markets, enhance market discipline through greater competition, upgrade the regulatory and supervisory framework for securities markets, and address problems in key areas, such as accounting and disclosure standards, corporate governance practices, and securities trading, custody, clearing, and settlement systems.

The second explanation ascribes the underperformance to mistakes in sequencing the reform. This view contends that, before the application of capital market reforms, other reforms are necessary, such as the achievement of a minimum threshold of institutional strength in the legal and regulatory framework, supervisory capacity, accounting and disclosure standards, and so forth. Hence, whether the Latin American countries will be successful in building capital markets will depend on their clarification of the sequencing issues.

A recent paper by de la Torre, Gozzi, and Schmukler (2007) finds that stock market development in the region is below what could be expected, given the economic and institutional fundamentals. There is a particular shortfall in market capitalization, trading, and capital raising. The authors believe the two explanations offered above are complementary to their gap analysis. A forward-looking reform agenda has to take into account the intrinsic characteristics of developing countries, in particular their small size, lack of diversification opportunities, weak currencies, and prevalence of systemic risk. The first point that should be considered is whether a given country can sustain an active domestic market for private sector securities. Furthermore, any reform agenda on capital markets should be part of a broader reform agenda that is embedded in an all-encompassing financial development agenda.

*Source:* Based on de la Torre, Gozzi, and Schmukler (2007).

behalf of market participants, which leads to inefficiency (because incentives are not aligned), but also opens the door to arbitrary decisions and corruption. Furthermore, some regulators require credit guarantees before issuing bonds, and this has also led enterprises to consider bonds unaffordable. For instance, the supervisory authority of the Bourse Régionale des Valeurs Mobilières, the West African

regional market, requires private companies to offer a guarantee equal to 100 percent of the issue value (interest, plus capital). This approach has been adopted to ensure that only companies with high-quality credit (or a guarantor) can issue debt. However, the result has been a *de facto* requirement for expensive guarantees, which add as much as 100–200 basis points to the cost for the issuer. The complex approval process for bond issuances also implies a long process of up to six months (in Kenya and in Senegal), which constitutes another hurdle for enterprises accessing corporate bond markets. In all these cases, there is a clear misalignment of objectives. The regulatory philosophy represented by the rules is appropriate in dealing with equities to protect small investors, but it is misplaced in dealing with institutions given that these can be expected to have access to professional investment advice and services.

High issuance costs are another impediment. In Kenya, issuance fees for corporate bonds have historically ranged from 3–4 percent compared with 1–2 percent for bank loans (World Bank 2003). In Nigeria, issuance fees in 2004 were over 6.0 percent, of which 1.8 percent went to regulatory authorities and the exchange, around 2.5 percent went to financial intermediaries, and another 1.5 percent went to fees for professionals and marketing. This turns a corporate bond issue into a financing tool of last resort. Costs are also high on the secondary market. Thus, in Nigeria, secondary market trading of corporate bonds involves fees of 3.75 percent, including 2.75 percent as a broker fee and 1.00 percent as a fee for the regulator and the exchange (World Bank 2007b).

In general, fixed income instruments are geared toward institutional investors, who have the capacity to operate in a disclosure-based framework. The requirement that corporate bonds need to be traded on exchanges shuts down a channel for introducing liquidity into the market. The one-off nature of the issuance of corporate bonds, combined with the small average size of issues, introduces a major liquidity constraint on this type of instrument. In this situation, the negotiation of the instrument by dealers and institutional investors in the over-the-counter market is the predominant practice around the world. Private placements can reduce the overall costs of a bond issuance because it shortens the time it takes companies to access the market.

The rather restrictive supervisory approach to issuers of stocks and bonds has been detrimental to the development of these markets in Africa. This observation is consistent with broader cross-country evidence that public enforcement contracts do not foster stock market development, but that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock market liquidity (La Porta, Lopez-de-Silanes, and Shleifer 2006).

## **Tapping International Markets**

As a source of finance, global investors have an important role to play in Africa. By investing through banks, contractual savings institutions, and capital markets in Africa, they not only provide finance for investment projects, but they also have

the potential to increase and improve the intermediation capacity of financial systems. In this section, we discuss the sources of long-term finance in Africa associated with international financial markets. One is private equity funds, and the other is sovereign wealth funds (SWFs). Both of these include African funds, as well as non-African funds that invest in Africa. Affecting both, but especially the latter, is the changing global environment and the increasing role of Brazil, China, India, and other emerging markets in Africa. A final opportunity is diaspora bonds, which we discuss in box 4.8 elsewhere below. While we see the possibilities for raising funds with such an instrument, we remain rather skeptical in the case of countries in Africa.

### ***Private equity funds***

Where organized exchanges are too expensive, more private structures might be helpful. While equity funds have acquired a somewhat bad reputation in Europe, especially in the aftermath of the global financial crisis, equity funds could be an important part of the corporate finance solution in Africa (box 4.6).

In Africa, private equity is becoming a growing part of the financial sector, especially for long-term finance. In the boom years of 2006 to 2008, private equity funds raised in Sub-Saharan Africa amounted to approximately US\$6.4 billion, while those invested reached US\$7.6 billion. Similarly, a survey shows that North African countries raised at least US\$1.6 billion in 2008 (ANIMA Investment Network 2008). Nonetheless, Africa still attracts only a small fraction of global equity funds, although there are promising trends (EMPEA and Collier Capital 2010). There is a growing number of seasoned and regionally experienced fund managers, an increasing number of investment opportunities (because of the improving macro-environment, sustained growth, and significant regulatory reforms), and, critically, improving exit opportunities.

Although the financial crisis dented the market, there are clear signs of recovery. Fund-raising in Sub-Saharan Africa through 2010 reached US\$1.5 billion, surpassing by far the 2009 total of US\$964 million (figure 4.5). Following the financial crisis, the recovery of fund-raising momentum was stronger in Sub-Saharan Africa than in many other emerging markets, including China, India, and Russia, and was comparable with the robust performance in Latin America. In contrast, private equity investment activity tells a modest tale: investments with known transaction values accounted for US\$631 million in 2010, the lowest level in emerging markets (EMPEA and Collier Capital 2010). This suggests that bullish fund-raising efforts are not being met with an equally bullish pipeline of transactions.

South Africa continues to be the main fund-raising hub and investment destination. Most funds operating in Sub-Saharan Africa have a panregional focus; these represent approximately 75 percent of the funds raised in both value and number from the beginning of 2009 through mid-2010 (figure 4.6). However, the market is slowly shifting away from generalist pan-African funds because fund managers are increasingly looking to specialize and develop a comparative advantage within an extremely diverse region. In terms of single-country focused funds,

**Box 4.6 Private Equity Funds: The Benefits and Experience in Africa**

The benefits of private equity funds can be assessed from different perspectives. At the macrolevel, private equity can catalyze structural changes through support for new economic sectors and by fostering industrial innovation (Kortum and Lerner 2000). It can help reduce unemployment rates, mainly among skilled workers, and spur overall employment growth (Fehn and Fuchs 2003; Belke, Fehn, and Foster 2003). Bernstein et al. (2009) show that industries with private equity investments grow more quickly in production, value added, and employment, while exhibiting more resilience to industry shocks. Conversely, opponents of private equity argue that these funds are return driven and that they reflect no hesitation to destroy jobs, ultimately jeopardizing global economic welfare in exchange for higher returns. According to this view, private equity funds are, at best, not value destroying, but certainly not value creating. In support of this view, Davis et al. (2008) report no differences in employment growth between their control group and manufacturing companies that are backed by private equity, and they report a higher level of job losses in businesses that are backed by private equity and that are operating in the services and finance sectors. Similarly, Lerner, Sørensen, and Strömberg (2008) find no significant difference in the quantity of patenting in the years following private equity investment. Most of this research, however, refers to cross-country samples or samples outside Africa, thus allowing few inferences on the expected effects of an increased role of private equity in Africa.

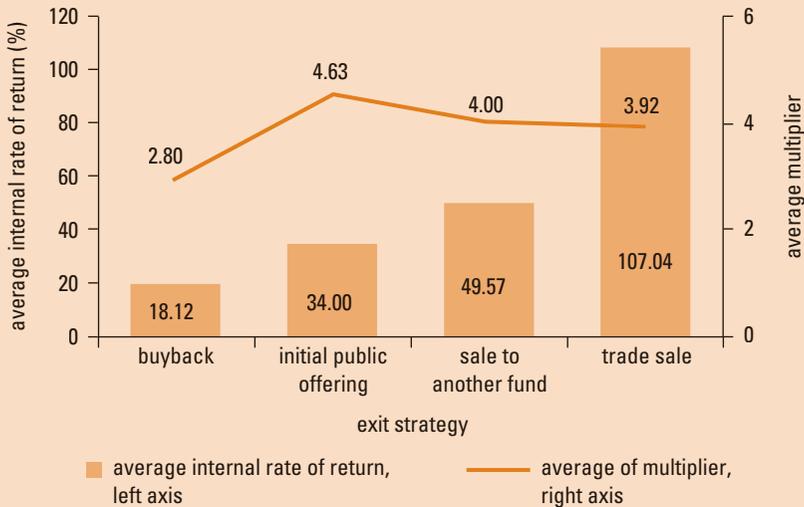
The employment and sales growth rates reported on random samples of exited deals in Morocco, South Africa, and Tunisia support the perception that businesses backed by private equity funds grow more rapidly and create more jobs than those without private equity fund support. South African businesses that were backed by private equity funds grew their sales by 20 percent, outperforming companies listed on the Johannesburg Stock Exchange and companies included in the all share index by 2 and 6 percent, respectively (SAVCA and DBSA 2009). Similarly, these companies backed by private equity funds reported employment growth rates significantly superior to the regional rates, which were estimated at almost 3 percent for North Africa and Sub-Saharan Africa. The involvement of private equity funds in African businesses seems to foster innovation as well. For instance, SAVCA and DBSA (2009) show that 69 percent of companies backed by private equity funds have introduced new products and services. According to the same report, the annual growth rate of research and development in these businesses was 7 percent, sevenfold the rate reported among companies listed on the Johannesburg Stock Exchange over the same period.

The value added of private equity funds can include more than the financing. A randomly selected sample of deals shows that private equity funds provided targeted businesses with valuable guidance that catalyzed improvements in their corporate governance structures and reporting standards. They also managed to strengthen management teams by leading to the replacement of entrenched managers, investment in training, or assistance in the recruitment of missing skills in the management team. This is consistent with the findings of Bloom, Sadun, and Van Reenen (2009) that businesses backed by private equity have superior management practices relative to family, private sector, and government ownership structures. The randomly selected sample also shows that private equity funds often introduce investee companies to strategic partners, including suppliers, clients, and acquisition targets which facilitate their expansion. Obviously, these simple comparisons cannot be interpreted in a causal sense because private equity funds will most likely invest in more promising industries and businesses, but the comparisons supply suggestive evidence that there is space for private equity in Africa to improve resource allocation and foster growth.

### Box 4.6 Private Equity Funds: The Benefits and Experience in Africa (continued)

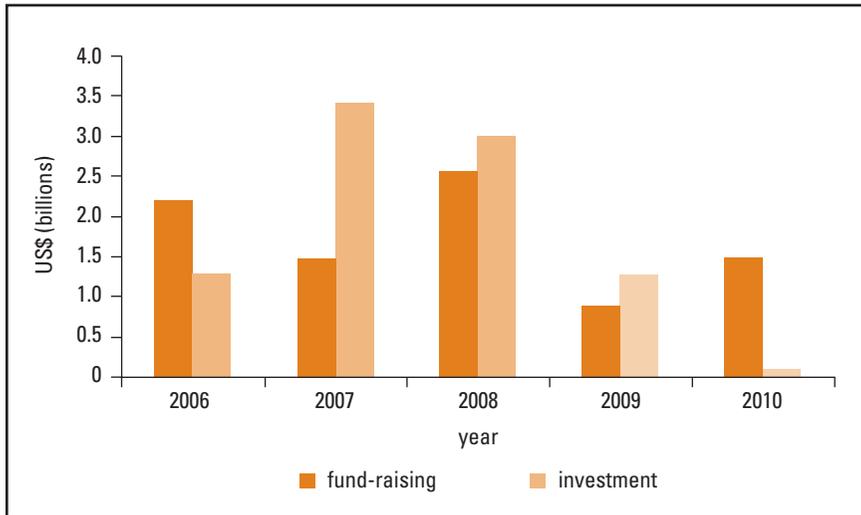
Private equity can generate benefits to the enterprises in which they invest, but this is also a profitable business proposal. As the head of one major global equity fund recently said, “the highest returns are in Africa.” Data on the realized returns from deals made by private equity funds are difficult to collect because funds are reluctant to disclose information about their gains. Nonetheless, the limited data available suggest that African businesses deliver attractive returns to private equity funds. For instance, a recent survey published by the Moroccan Private Equity and Venture Capital Association reports average internal rates of return of 26.9 percent for 26 deals of private equity investors in Morocco (AMIC and Grant Thornton 2010). The highest rate is reported for deals involving development capital investments (33.3 percent). Several reports by the Emerging Markets Private Equity Association include data about internal rates of return for 62 deals and the realized multiplier for 25 deals (EMPEA 2011; EMPEA and Collier Capital 2009, 2010). This information is schematized in figure a. The average internal rate of return for deals exited between 2005 and 2010 was 55.4 percent if the 972 percent internal return on resources is included that is reported by Citadel Capital on its investment in ASCOM Geology & Mining in Egypt, which appears as an outlier, and 40.16 percent if this return is excluded.

**Figure a. Average Internal Rate of Return and Multiplier by Exit Strategy**



South Africa is the market leader, accounting for 17 percent of funds by value, followed closely by Nigeria, at 10 percent. In North Africa, Egypt and Morocco are leading the markets. Most private equity markets in North Africa outside of these countries remain modest, but new funds are emerging. Over the last decade, the average size of deals among private equity funds in Africa increased significantly. For instance, the sale by Citadel of its ownership in Egypt Fertilizers Company was the first subregional private equity deal to break the billion-dollar mark.

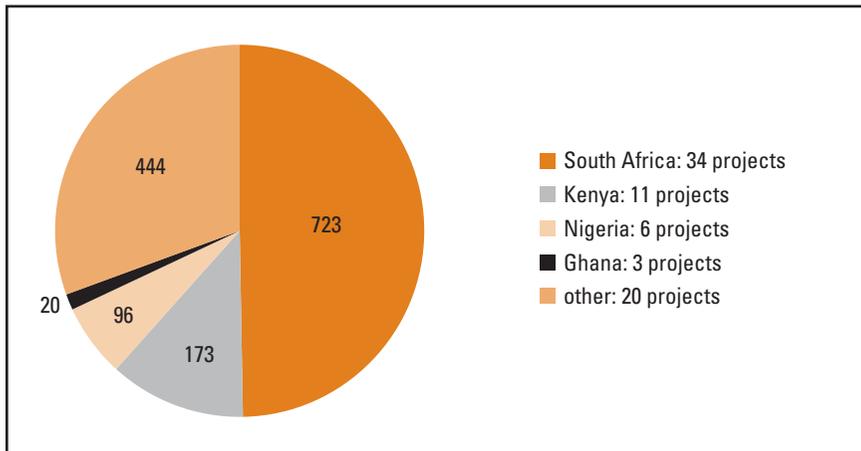
**Figure 4.5 Sub-Saharan Africa: Private Equity Fund-Raising and Investment, 2006–10**



Source: EMPEA and Collier Capital (2010).

Note: The data for 2010 are year to date.

**Figure 4.6 Private Equity Investment Activity, Sub-Saharan Africa, 2009–10**



Source: EMPEA and Collier Capital (2010).

Note: The data for 2010 are year to date. Values are US\$, millions.

The private equity model in Africa seems to target mainly well-established medium-size enterprises at the top end of the market. This is corroborated by survey data of ANIMA Investment Network (2008), which finds that there is a lack of seed and venture capital money compared with the equity investments in leveraged

**Table 4.3 Risk Premiums for Private Equity Funds Worldwide**  
percent

Emerging market country, region	2008	2009	Increase in risk premium
Brazil	6.9	6.4	-0.5
China	6.3	6.4	0.1
India	6.1	6.4	0.3
South Africa	6.4	7.0	0.6
Latin America, excluding Brazil	6.7	7.5	0.8
Middle East	6.5	7.3	0.8
North Africa	6.7	8.0	1.3
Central and Eastern Europe, including Turkey	5.0	6.4	1.4
Russian Federation, Commonwealth of Independent States	6.9	8.4	1.5
Sub-Saharan Africa, excluding South Africa	6.7	8.4	1.7
Other emerging Asia	—	7.3	—

Source: EMPEA and Collier Capital (2009).

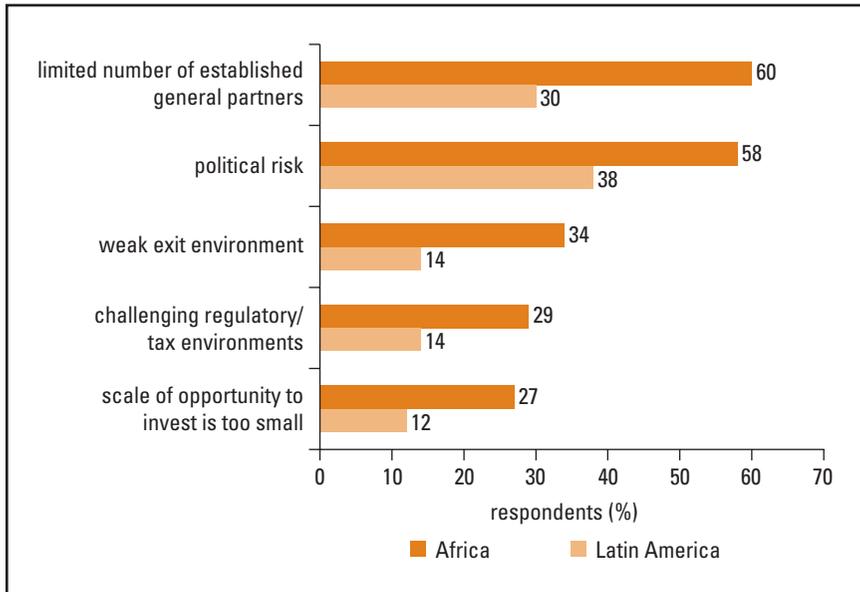
Note: The figure reflects the perceptions of limited partners (investors in private equity funds) of the risk premiums required for emerging market private equity funds relative to developed-market buyout funds.

— = not available.

buyouts and the expansion of investee companies in North Africa. Similar conclusions can be drawn from a study on Kenya (FSD Kenya 2008). The study found that, in 2008, US\$40 million of the US\$200 million of venture capital available in the country targeted early-stage SMEs. In addition, larger countries with a rising middle class, such as Egypt, Nigeria, and Tunisia, are more attractive to private equity funds given the potential for consumer goods industries.

Notwithstanding these positive trends, the main obstacles continue to be the limited interest of financiers in investment in private equity funds targeting Africa and the excessive risk aversion of investors toward Africa (table 4.3). Investors in Sub-Saharan Africa north of the Limpopo River demand some of the highest risk premiums, and risk premiums in the North African countries are only slightly lower. Investor behavior reflects the lack of an institutional track record because most of these funds are first-generation funds, as well as the perception that political risk remains high in Africa relative to other regions of the world (figure 4.7). For instance, well-publicized cases such as the tensions over the Jubilee oil field that pitted the government of Ghana against private equity-backed Komsos Energy are likely to damage the frail confidence of private equity investors in African markets. Furthermore, poor governance structures and inadequate research coverage make the identification and assessment of potential investment targets a challenge for private equity funds. Another key challenge for equity funds is the limited local access to debt coinvestment.

In addition to the perceptions of high risk, the industry suffers several specific challenges in Africa, most of them related to the institutional environment in which the industry operates.

**Figure 4.7 Factors Deterring Limited Partners from Investing in Africa and Latin America**

Source: EMPEA and Collier Capital (2010).

Note: Limited partners are investors in private equity funds. General partners are private equity fund managers.

First, the lack of scale affects private equity in three ways. Most private equity funds in Africa are small, which, by construction, excludes investments from several institutional investors, including SWFs. These funds usually have large investment tickets and strict exposure limits dictated by their risk management guidelines. For instance, if an SWF has an average investment ticket amounting to US\$80 million and an exposure limit to a single investment of 20 percent, only private equity funds larger than US\$400 million will be eligible. The size of investment opportunities also limits private participation. On any number of measures, the size of many firms is small; many are family owned and reluctant to bring in third-party management participation, which is essential for private equity. Finally, many of the markets make exit challenging. The highly illiquid stock exchanges and the limited availability of domestic funds severely limit the range of exit options for most private equity firms.

Second, there are many domestic regulatory constraints. For instance, current regulations in Morocco preclude insurance companies from using their regulated reserves instead of their equity to invest in risk capital entities that are not structured as *organismes de placement en capital risque* (OPCRs, venture capital investment funds). Insurance companies are also required to report their investments at accounting value rather than market value, which reduces their appetite to invest in

private equity structures.<sup>11</sup> Furthermore, Law 41–05 offers tax incentives to OPCRs, but requires such institutions to hold at least 50 percent of their resources in SMEs with annual turnover inferior to DH 75 million. The SME definition is being reviewed to reflect current market practices, and the 2011 Finance Act eliminated this minimum allocation rule, but the rule remains a problem because OPCR status is still conditional on compliance with it.<sup>12</sup> Additionally, current regulations on foreign exchange preclude private equity funds domiciled in Morocco with less than three years of operation from investing outside the country.<sup>13</sup> Similarly, Tunisia requires local private equity providers to invest at least 50 percent of their resources in priority sectors or regional development zones and upgrade programs, while investors in such vehicles are required to lock their investments for at least five years to benefit from tax exemptions.<sup>14</sup>

Third, there remains only a limited participation of contractual savings institutions. In Tunisia, domestic private equity markets are dominated by bank-controlled providers. These operators tend to favor applications made by the existing clients of banks and often adopt prudent investment strategies that are not always consistent with the purposes of banking. Financial institutions control 75 percent of the capital of fund managers in Morocco as well and slightly over 31 percent of the funds under management in South Africa (AMIC and Grant Thornton 2010; KPMG and SAVCA 2010). One of the investors in an equity fund may be contractual savings institutions, which have only a limited choice on organized capital markets. Yet, the contribution of pension funds and insurance companies seems to be small. For instance, they contribute less than 10 percent of the total venture capital funding in Kenya (FSD Kenya 2008). Most African countries restrain pension funds' and insurance companies' investment share in equity, which significantly reduces the potential resources available to African private equity funds. However, as noted elsewhere above, there is a trend toward the revision of investment guidelines. In September, Nigeria's National Pension Plan released draft regulations that would allow pensions to invest up to 5 percent of their portfolios in private equity funds targeting Nigeria.

Fourth, there are also ownership and foreign exchange barriers to foreign private equity funds. Some countries still restrict foreign ownership. Algeria imposes a 49 percent limit on foreign ownership, with the exception of importing companies, which must have a minimum of 30 percent of local participation (Deloitte 2011). The borrowing levels of foreign-controlled companies are restricted in South Africa (Bowman Gilfillan 2009). In Ethiopia, foreign investment is prohibited in the telecommunications, financial, transportation, and retail sectors. Even where there are no ownership restrictions, few African countries have fully convertible currencies, and a large number of them do not allow free profit repatriation for private equity and venture capital providers. In addition, several African countries have volatile currencies that cannot be properly hedged given the lack of instruments or the poor liquidity of the available instruments. Local currency volatility could result in a dramatic decline in a fund's performance.

Fifth, there are also taxation-related barriers across the continent. First, there is a double-taxation issue because investment revenue is taxed both at the fund and the ultimate investor level. Even if this may be addressed in individual countries, there is a lack of double-taxation treaties among African countries. Another issue related to some African tax regimes is the application of the value added tax on management fees or carried interest. Fund managers are subject to a 20 percent value added tax on management fees in Morocco. These taxes increase the cost of doing business significantly. Often, disparities in tax treatment make other asset classes more attractive. Today, most international private equity funds are based in Mauritius for tax purposes. Moreover, they also benefit from the fact that Mauritius offers both a common law framework and a civil law framework, a stable business environment, and a well-developed financial services industry.

Lastly, in the aftermath of the financial crisis, Europe and the United States are enacting new rules aimed at regulating nonbank financial institutions and enhancing the stability of their financial systems. These rules are expected to make fundraising for private equity funds targeting Africa more challenging and expensive. For instance, the European Union's Directive on Alternative Investment Fund Managers will make it more costly for non-European Union-based private equity funds to market their funds to European investors. Similarly, new registration requirements with the U.S. Securities and Exchange Commission will increase the cost of doing business for non-U.S. funds that have more than 15 United States-based investors, U.S. resources in excess of US\$25 million, and at least one office in the United States (PEI 2010). Thus, the Volcker Rule, which is expected to become effective in July 2012, precludes banking entities—both U.S. and non-U.S. banks with a U.S. branch or agency—from investing in or sponsoring private equity and hedge funds (Clifford Chance 2010). The increased burden resulting from this regulation will reduce the amount of resources available for investments in private equity in Africa and raise the cost of managing private equity funds targeting Africa, ultimately translating into lower returns to investors and new limits on their appetite to invest in Africa.

Despite these challenges, private equity funds in Africa are growing and are expected to play a more significant role in the future. Multilateral and regional DFIs are increasingly using them as a complementary way for more cost-effective investment and support for private sector firms in Africa. In 2009–10, the African Development Bank invested in 13 private equity funds targeting Africa; as of September 30, 2010, its investments in private equity funds represented 10 percent of its private sector active portfolio. Similarly, the International Finance Corporation launched the SME Ventures Program, which aims at establishing venture capital funds in several International Development Association countries, including the Central African Republic, the Democratic Republic of Congo, Liberia, and Sierra Leone. The Development Bank of Namibia has established a private equity fund focused on SMEs.

The performance of the public-led versus private-led model has not yet been explored in Africa. Nonetheless, recent evidence reported in Brander, Du, and Hell-

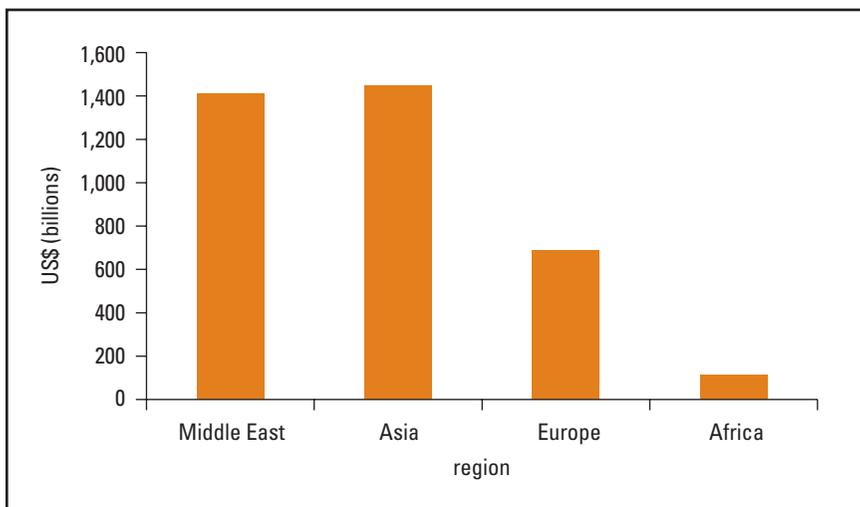
man (2010) based on a sample of 126 countries suggests that a PPP model, whereby the government invests in independently managed funds that also rely on private investors, leads to better results in terms of value creation and innovation compared with either a public-led model or a private-led model.

### ***Sovereign wealth funds***

Another potentially significant source of long-term funding is SWFs with strategic interests in Africa. These include funds in China, India, and the Middle East that have become important players in African infrastructure projects. The appetite of SWFs in Africa is growing for minerals and raw materials, as seen in China's successful efforts to lock up deals in the oil and gas sector, but they also provide substantial funding for transport infrastructure. SWFs from the Middle East are active in the physical and social infrastructure sectors. One can expect these trends to continue in the near future, though they may slow as some of the SWFs restructure portfolios and investment strategies damaged by the global financial crisis. SWFs experienced considerable losses as a result of the crisis, but remain active in the exploration of infrastructure opportunities in Africa. For instance, the 2008 annual report published by the Central Bank of Libya shows that revenues from the Libyan Investment Authority's long-term investment portfolio dropped from US\$687.3 million in 2007 to US\$63.5 million in 2008, mainly because of the financial crisis.

As of December 2009, African SWFs had US\$114.3 billion in assets under management. This was much less than their Middle East peers, which held assets amounting to US\$1.4 trillion (figure 4.8). The regional distribution of SWFs dis-

**Figure 4.8 The Size of Sovereign Wealth Funds, December 2009**



Source: Data of the Sovereign Wealth Fund Institute.

plays a predominance of the Middle East (43 percent), followed by Asia (36 percent) and Europe (18 percent).

Africa counts 15 SWFs. More can be expected, especially in countries with recently discovered oil (box 4.7).<sup>15</sup> Meanwhile, in 2006, Chad canceled its Fund for Future Generations. Among the five largest African SWFs, four are sourced from oil and gas revenues, and one from diamonds, minerals, and other natural resources. It must be noted, however, that the collection of data on the existence, holdings, and institutional arrangements of SWFs in Africa remains a challenge. This explains why there is also a limited literature on the activities of these funds.

In the case of Africa's development process, one has to make the important distinction between the role of domestic wealth funds—the task of which is mainly to manage a nation's natural wealth and stabilize the income stream from this wealth, thereby avoiding the well-documented Dutch Disease phenomenon—and the role of non-African SWFs.

Let us first discuss the role of domestic SWFs in managing Africa's natural wealth. Domestic SWFs can have a critical role in avoiding the Dutch Disease phenomenon that result from an appreciation of the real exchange rate, thus crowding out non-resource-related economic activities. They can prove to be efficient fiscal stabilization instruments by facilitating intergenerational transfers and creating higher risk-adjusted returns that allow savings in fiscal resources. For most African countries, such stabilization needs are twofold. In the short term, African countries need to smooth their expenditures in a context of volatile commodity prices to avoid the challenges in macroeconomic management resulting from revenue instability. In the long term, African countries need to protect themselves against the declines in revenues resulting from the depletion of nonrenewable commodities. This means that SWFs might still invest in financial markets and systems to pursue long-term stabilization objectives. They can also help avoid problematic privatizations and the looting of national wealth, as has happened so often already on the continent. Unlike the management of reserves by central banks, which is usually limited to investments in European and U.S. sovereign fixed income securities, SWF holdings are expected to be more diversified and could be structured to maximize the risk-adjusted investment returns that are not necessarily pegged to the dollar. Stabilization funds help insulate African economies from bullish and bearish cycles driven by commodity price swings and ensure fiscal stabilization. A final, less discussed, purpose of domestic SWFs can be to enhance overall transparency and governance throughout the economy.

However, the available data suggest that African countries have been regularly using their SWFs to close budget deficits rather than keeping resources to implement countercyclical macroeconomic policies or future long-term and intergenerational stabilization. For instance, Nigeria paid US\$6.8 billion out of the Excess Crude Account to state governors in 2008, while Sudan has almost wiped out its Oil Revenue Stabilization Fund to meet increased expenditure commitments (Ahmed 2010). Additional drawdowns of US\$12 billion in 2009 and US\$7 billion in 2010 almost entirely depleted the fund. Algeria has also been using its stabilization fund

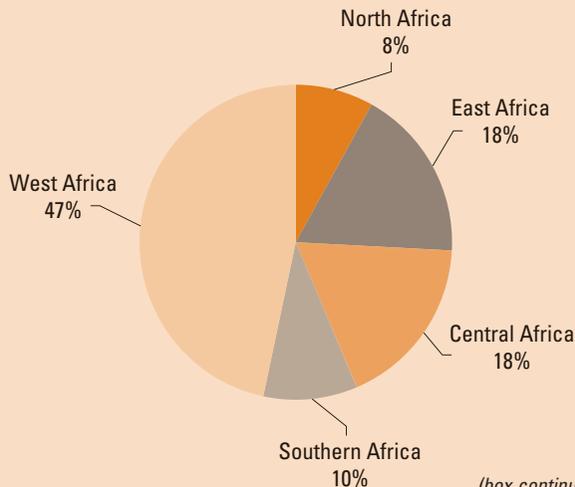
### Box 4.7 Sovereign Wealth Funds

SWFs are government-owned investment vehicles managed by a government entity or external managers on behalf of a sovereign state primarily to serve medium- to long-term economic and financial objectives. They have emerged as a potential solution for the active management of the large stocks of foreign reserves that several countries have accumulated by exporting commodities and other goods and services. There is considerable controversy about the relative merits of SWFs and their value added. Often citing the experience of Norway, the International Monetary Fund and the World Bank are increasingly advocating the creation of SWFs in resource-endowed economies, arguing that they can help foster economic growth and prosperity for current and future generations. Proponents of SWFs also point out that these vehicles can help stabilize the global financial system by providing crossborder liquidity in times of financial turmoil. Other observers, meanwhile, are expressing serious concerns that SWFs would endow governments with too much power, which could edge the global economy away from liberalism and impede market forces and competition. This argument is strengthened by empirical evidence suggesting that state-owned companies often operate less efficiently than private firms.

The first African SWFs were established in 1993 in Botswana (the Pula Fund) and Ghana (the Minerals Development Fund). Currently, Africa counts 15 active SWFs, which are, for the most part, relatively small compared with their peers in other regions of the world (such as Asia and the Middle East) in terms of the size of assets. The two exceptions are the Libyan Investment Authority (LIA) and the Algerian Revenue Regulation Fund, which rank among the largest 15 SWFs worldwide in size.

The LIA is the largest and most active Africa-based SWF, although the political unrest in Libya has created uncertainty about its future. It was created in December 2006 by a decree of the Comité Populaire Général and started its activity on June 2007 with US\$50 billion in assets under management. The aim of the LIA, which currently manages about US\$70 billion in assets, is to create a durable source of revenue and reduce Libya's dependence on oil

**Figure a. The Geographical Distribution of Libyan Investment Authority Investments in Africa by Region**



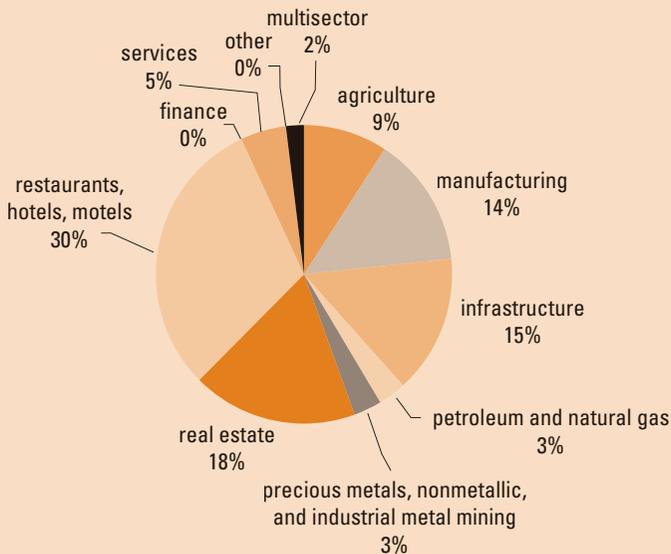
(box continues on next page)

**Box 4.7 Sovereign Wealth Funds** (continued)

exports. It invests both domestically and internationally either directly or via its subsidiaries. The bulk of LIA's investment in Africa, however, is undertaken by the Libyan African Investment Portfolio, which was created in February 2006 and has around US\$8 billion in assets under management. Its subsidiary, the Libyan African Investment Company, is present in 30 African countries, where it invests mainly in real estate and hotels (it owns 22 hotels in 15 African countries). The Libya Oil Holding Company (formerly Tamoil), another subsidiary of the LIA, runs gas stations in 16 African countries.

In terms of the regional allocation of LIA's investments in Africa, a sample of 98 deals shows that West Africa stands out as the largest beneficiary, with a share of 47 percent (figure a). East Africa and Central Africa each attract 18 percent of total investments. In terms of the sector allocation of these investments, the largest fraction is allocated to restaurants, hotels, and motels, followed by real estate and infrastructure (figure b).

**Figure b. The Sectoral Distribution of Libyan Investment Authority Investments in Africa**



Source: Author compilation.

to repay public debt and reduce fiscal deficits. Similarly, between November 2008 and March 2009, Mauritania withdrew US\$45 million from its *Fond National des Revenus des Hydrocarbures*, leaving a balance of US\$34 million as of March 2009. São Tomé and Príncipe withdrew US\$11.9 million in 2006, US\$1.7 million in 2008, and US\$1.2 million in 2009, leaving its fund with US\$9.9 million at the end of 2009. This represented 12 percent of the US\$77.8 million received by the country as an oil signature bonus. Such statistics suggest that African governments kept

spending, while also accumulating resources in their stabilization funds, which may potentially result in zero net savings. This raises concerns about intergenerational equity and long-term fiscal and macroeconomic sustainability, especially in a context of external shocks. The implication of such behavior is that African SWFs will have limited resources for long-term stabilization purposes and even less for savings for future generations. Accordingly, the role of SWFs as long-term investors in Africa can only be marginal if current practices are maintained.

Additionally, data suggest that most African SWFs are investing their resources mostly outside Africa. For instance, Asfaha (2007) reports that Chad invests the proceeds from its natural resources abroad, while article 6.6 of the Oil Revenue Management Law in São Tomé and Príncipe prohibits the use of the National Oil Account for investments in São Tomé and Príncipe or in companies controlled by São Tomé and Príncipe nationals (Albin-Lackey et al. 2004). According to the São Tomé and Príncipe oil revenue law, the National Oil Account is to be held at the U.S. Federal Reserve. Similarly, Belaïcha, Bouzidi, and Labaronne (2009) argue that half of Algeria's foreign currency reserves have been invested in U.S. sovereign bonds and deposits and tier-one banks. Botswana invests only in rated securities, which excludes all Sub-Saharan African countries except South Africa.

Over the past decade or so, Africa has also become the target of investment by non-African SWFs. Some governments are creating development funds (the China-Africa Development Fund established by the China Development Bank) or investment companies (Dubai World Africa) entirely dedicated to Africa.<sup>16</sup> Nonetheless, Africa's share in foreign SWF investments remains relatively negligible. Many SWFs, including African funds, are discouraged by the high risk of investment in Africa. According to recent research published by TheCityUK (2010), an independent membership body that promotes the financial and professional services industry based in the United Kingdom, Africa receives less than 5 percent of worldwide SWF investment flows. Similarly, as of December 2009, of 8,300 companies in which the Norway SWF held equity investments, only 144 (corresponding to 1.74 percent) were African, and these companies were concentrated in only three countries, namely, Egypt (32 companies), Morocco (8 companies), and South Africa (104 companies).

Such investment strategies are justified by the weak governance and significant volatility of African economies. Unfortunately, investment risk in Africa is still perceived as high, which hinders the continent's attractiveness as a target for African SWF money. This brings us back to the sequencing issue. African countries would have to reform governance structures and communicate more about the returns and risk profile of financial markets and institutions in Africa before SWF money would follow.

Foreign SWFs could have a striking effect on the amount of investment received by Africa. Statistics published by TheCityUK show that SWFs were managing US\$3.8 trillion in assets globally as of December 2009. The Organisation for Economic Co-operation and Development expects assets under SWF management to

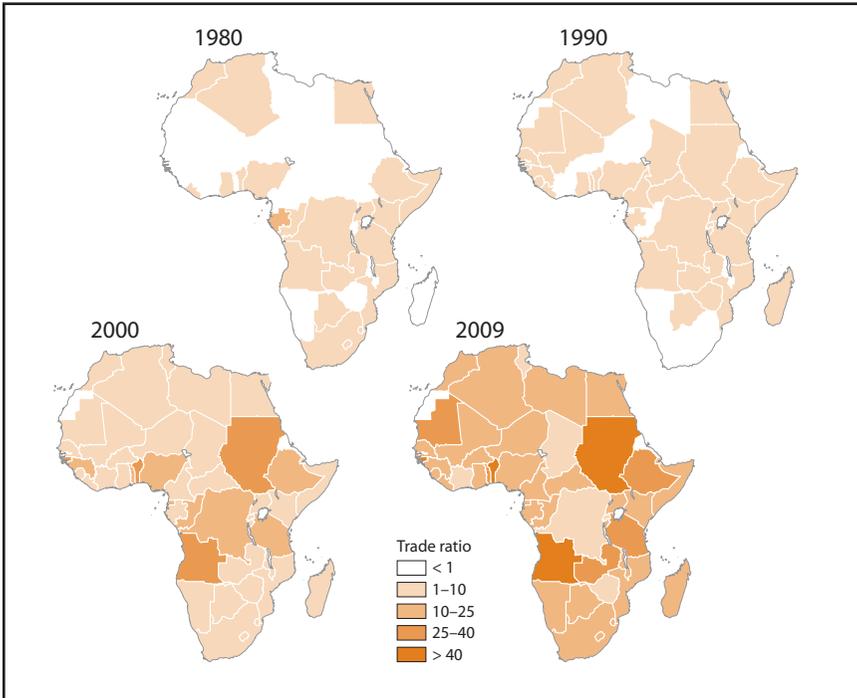
reach US\$5 trillion in 2010 and US\$10 trillion by 2015. Investing 1 percent of current SWF resources in Africa would channel up to US\$29.7 billion in foreign investment to the continent.

As with all foreign direct investment (FDI), however, there are also risks for receiving countries. First, high and volatile capital inflows, albeit with less volatility for SWFs, can lead to asset boom-and-bust cycles, especially in small countries with small and illiquid capital markets. Second, destabilization can result from SWF involvement in the banking sector, where these funds can distort the credit allocation process to favor home country businesses (Heyward 2008). Third, large reverses in SWF flows resulting from profit repatriation or asset reallocations also involve currency transactions that might affect the exchange rates of African countries, as was observed during the early stages of the financial crisis.

### **The Changing Global Environment: Tales of Dragons and Elephants**

Among the options available for tapping international finance, none is more noticeable than the BRIC countries, particularly China. China, India, and several Gulf states have been increasingly investing in Africa. This investment has come after a decade-long trend toward increased trade between middle-income emerging markets and Africa (map 4.1). This must also be seen in light of the increased demand for natural resources by emerging markets, notably the BRIC countries. There are other complementarities between these large emerging markets and Africa that likewise explain the increasing cooperation. China and India, for example, bring expertise from the construction sector and from their recent experience in building large infrastructure. Chinese construction firms are globally competitive, and they have won a large number of civil works contracts financed by the African Development Bank and the World Bank (Foster et al. 2008). Furthermore, both countries have a growing need for natural resources for their rapidly expanding manufacturing sectors and want to diversify their large financial resources away from U.S. Treasury Bonds. They have increasing food needs as well because of growing populations and increasingly scarce arable land. Chinese finance is often invested in large-scale infrastructure projects, with a particular focus on hydropower generation and railways. Currently, more than 35 African countries are engaging with China on infrastructure finance deals. The biggest recipients are Angola, Ethiopia, Nigeria, and Sudan.

The China-Africa economic ties experienced a great leap forward after the first triennial Forum on China-Africa Cooperation, held in Beijing in October 2000. Bilateral trade and Chinese FDI in Africa grew about fourfold between 2001 and 2005. This was accompanied by a major influx of Chinese enterprises and workers in the region. The natural resource exports of Sub-Saharan Africa to China grew exponentially, from slightly more than US\$3 billion in 2001 to US\$22 billion in 2006. Foster et al. (2008) estimate that Chinese financial commitments to African

**Map 4.1 Trade Links between the BRIC Countries and Africa, 1980–2009**

Source: Direction of Trade Statistics (database), International Monetary Fund, Washington, DC, <http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=170921> (assessed in 2010).

Note: The figure shows the ratio of the total BRIC trade with Africa to African trade with the world.

infrastructure projects rose from less than US\$1 billion per year in 2001–03 to around US\$1.5 billion per year in 2004–05 and reached at least US\$7 billion in 2006, China’s official “Year of Africa,” before trailing back to US\$4.5 billion in 2007. Chinese infrastructure finance has been widespread across sectors, from oil to hydropower and transportation. However, in the period through 2007, there was a geographical concentration. Over 70 percent of the finance went to only four countries: Angola, Ethiopia, Nigeria, and Sudan.

A typical arrangement is for the Chinese investment entity, whether private or state-owned, to form a joint venture with the local African state-owned enterprise. This has been the pattern set, for example, in the Democratic Republic of Congo, the Republic of Congo, Gabon, and Zambia. Chinese FDI flows typically involve investments by Chinese contractors that are funded through bilateral loans from the Export-Import Bank of China to the government of the beneficiary country. This accounted for 92 percent of recorded Chinese investment projects from 2001 to 2007. This leaves little room for African banks to become

involved in the funding of the projects. Increasingly, the China-Africa Development Fund has gained importance. While, previously, China Eximbank lent mostly to state-owned Chinese enterprises, it has recently also opened up its coffers to private Chinese enterprises. This has resulted in the Angola mode, or resources for infrastructure, whereby repayment of the loan for infrastructure development is made using natural resources.

What drives China's interest in Africa? According to Cheung et al. (2011), the determinants of China's engagement in Africa are similar to the determinants of traditional FDI: the search for new markets and follow-up on trade links, as well as natural resources, especially oil. Unlike Western countries, Chinese FDI is less influenced by concerns about the risk of political instability or corruption and therefore flows to countries where Western investors often do not dare to invest. China has also started creating special economic zones, such as in Mauritius and in the Chambishi copper belt region in Zambia. India has followed suit, using the Export-Import Bank of India. Similarly, several Arab countries have invested in African infrastructure projects. The finance from Arab donors is channeled through special funds or development agencies, such as the Islamic Development Bank, the Arab Bank for Economic Development in Africa, the Kuwait Fund for Arab Economic Development, the OPEC Fund, and the Saudi Fund.

Another possible option for raising international finance for the benefit of Africa is represented by diaspora bonds, which we analyze in box 4.8.

### **Pushing toward the Frontier and Beyond: A Long-Term Agenda with Tricky Shortcuts**

Lengthening financial contracts in Africa requires that policy makers address the structural bottlenecks that inhibit the issuance of longer-term contracts. To this end, there is a need to (1) increase the diversity of domestic sources of long-term finance and (2) promote an appropriately diverse range of long-term financial products and services. As in the case of expanding access, we can distinguish among several layers of policies for lengthening contracts. On the first level are market-developing policies, that is, policies that help create the necessary conditions for long-term funding flowing to and staying in Africa, as well for long-term financing tools and products to emerge. While far from sufficient, these policies are necessary. Most prominently among them are policies aimed at the contractual framework and macroeconomic conditions, including price stability and the development of long-term sovereign bond markets.

These policy reforms seek to unlock substantial additional sources of long-term finance through currently existing, but underdeveloped segments of financial systems, including pensions, insurance, and capital markets. While a boom in contractual savings cannot be expected in the short term (because of demographic and income factors), a stronger role for insurance companies, pension funds, and mutual funds should be fostered. Such reforms should also seek to encourage new

### Box 4.8 Diaspora Bonds

A diaspora bond is a debt instrument issued by a country or, potentially, by a subsovereign entity or by a private corporation to raise financing from its overseas diaspora. India and Israel have raised US\$11 billion and US\$25 billion, respectively, from their diaspora abroad (Ketkar and Ratha 2010). The people of the diaspora usually have more information about their country of origin than other foreign investors. These bonds are issued often in times of crisis and frequently at a “patriotic” discount. Unlike international investors, the people of the diaspora tend to be less averse to convertibility risk because they are likely to have current and contingent liabilities in their home countries. Furthermore, they usually have a strong desire to contribute to the development of their home countries and are therefore more likely to purchase diaspora bonds.

The stock of the Sub-Saharan African diaspora is estimated at about 16 million, with 5 million in high-income countries. Assuming that members of the Sub-Saharan African diaspora earn the average income of their host countries and save a fifth of their incomes, their annual savings would be more than US\$28 billion. Most of these savings would come from African migrants in the countries of the Organisation for Economic Co-operation and Development, where a third of the Sub-Saharan African diaspora is located, because of the larger income differentials. In an alternative scenario, if the Sub-Saharan African diaspora were assumed to earn only half the average per capita income in the host countries and save a fifth of their incomes, the annual savings of the African diaspora would still be over US\$10 billion. Presently, the bulk of this savings is invested outside Africa. African governments and private corporations can potentially tap into these resources by issuing diaspora bonds. Diaspora bonds can also provide an instrument for the repatriation of Africa’s flight capital, estimated at more than US\$170 billion (see chapter 2). Diaspora bonds could potentially raise US\$5 billion to US\$10 billion annually by tapping into this wealth.

While the size of the potential market for diaspora bonds is impressive, it may be difficult for most unrated Sub-Saharan African countries that are characterized by high risk to issue such bonds. Some of the constraints that Sub-Saharan African countries may face in issuing these bonds include weak and nontransparent legal systems for contract enforcement; a lack of national banks and other institutions in migrant destination countries, which can facilitate the marketing of these bonds; and a lack of clarity on regulations in the host countries that allow or constrain people in the diaspora in the investment in such bonds (Chander 2001; Ketkar and Ratha 2010). Finally, the diaspora of African countries is typically dispersed across various host countries, constituting small communities, which makes fund-raising more costly and more difficult.

*Source:* Based on Ratha, Mohapatra, and Plaza (2008).

providers and more competition, for example through equity funds. More urgent, however, is the need to explore alternative methods for intermediating pension resources transparently.

On a second level are market-enabling policies that take the current environment as a given and try to maximize the absorption and intermediation of existing resources in the financial system. These policies should be focused on competi-

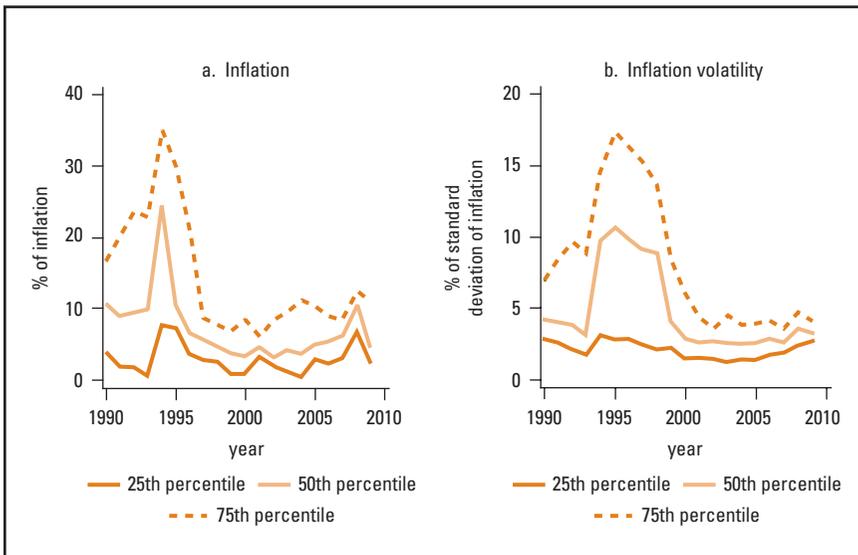
tion—encouraging the entry of new providers—and the removal of regulatory restrictions, as discussed in the case of equity funds above. However, they may also imply the application of market-friendly activist approaches that try to crowd in private providers. Most prominently among these have been partial credit guarantee funds as risk mitigation instruments.

### **Macroeconomic stability**

Most African countries have made enormous progress in macroeconomic stability over the past 20 years. Chart a in figure 4.9 shows the median inflation rate across African countries, while chart b in figure 4.9, shows the standard deviation of inflation, computed over five-year rolling averages. Behind these medians, however, are some rather large outliers, such as Zimbabwe.

External debt has been reduced substantially across Africa, often because of the heavily indebted poor countries initiative. In the case of commodity exporters, the reduction has also been caused by commodity price increases. The privatization of loss-making state-owned enterprises can also contribute to an easing of fiscal pressure and thus reduce the crowding out effect. However, many countries in Sub-Saharan Africa still depend heavily on donor flows. Although Mozambique, for example, benefited from debt relief under the heavily indebted poor countries initiative in 2001 and the multilateral debt relief initiative in 2006, the budget for 2008

**Figure 4.9 Inflation and Inflation Volatility, 1990–2009**



*Source:* International Financial Statistics (database), International Monetary Fund, Washington, DC, <http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=169393> (accessed in 2010).

*Note:* Sample size: chart a: 35 countries; chart b: 32 countries. The number of countries indicated represents the situation following the balancing of the data set.

projected external funding of 55 percent from various bilateral and multilateral donors. In large part because of Mozambique's success in implementing public financial management reforms, a substantial proportion of external assistance takes the form of direct budget support.

Despite the sustained macroeconomic stability in many African countries, the yield curve is still steep in most countries, if it exists at all. This can be explained by the high risk premium on long-term resources, which, in turn, is caused by political uncertainty and uncertainty about the willingness of governments to meet longer-term commitments, and which is also reflected in the illiquidity of long-term capital markets. The effective management of government debt—often seen as a purely technical area, but extensively discussed by Honohan and Beck (2007)—can make an important contribution to the creation of a yield curve and also help flatten it. As confidence in markets improves and issuing costs fall, the issuance of longer-term bonds, for example for infrastructure, can also help establish a yield curve. Interest rates might have to be adjustable, however, until confidence is created in long-term, stable macroeconomic management. A yield curve is a necessary, though far from sufficient condition for private market participants to lengthen their financial contracts. Having a benchmark curve allows easier pricing so that banks and other financial institutions may establish prices. Benchmark curves can also help reduce the risks in refinancing.

An important aspect of the management of macrostability is the challenge of tending to the Dutch Disease phenomena that arise from large inflows of capital through aid money, revenues related to commodity exports, or—least likely in the case of most African countries—portfolio inflows. If such inflows are mostly spent on import goods, a more relaxed approach can be considered, while an increase in the demand for domestic goods and services can easily result in inflationary pressures. For natural resources, there are SWFs, as we discuss above. Similar problems, however, can arise from aid surges if they are not absorbed properly in the domestic economy. Here, the domestic financial system has a critical role in terms of absorbing such funds.

### ***Institution building***

As discussed above, financial institutions in Africa, as in other parts of the developing world, face significant hurdles in the screening and monitoring of borrowers, that is, in choosing creditworthy borrowers and projects and in ensuring repayment, especially for long-term transactions. This points to the critical role of the contractual and informational framework, as well as appropriate corporate governance structures.

The informational framework, most importantly accounting and auditing standards, are critical to long-term transactions. This might enable banks to undertake what Berger and Udell (2006) refer to as financial statement lending, at least for medium-size and larger firms. The reliability of cash flows for a long-term investment can be a viable form of collateral if there is confidence in the financial statements that have been produced.

While many countries in Africa have taken the first step in advocating for the use of international financial reporting standards, at least for enterprises above a certain size, as well as for financial institutions, more work remains to be done. The emergence of a number of strong national accounting associations and professions on the continent is a welcome development for the industry.

Reforms in the contractual framework and corporate governance are another important item on the long-term agendas of policy makers throughout the region. There have been advances, though much slower than hoped by the modernists. These agendas comprise a large number of elements, ranging from changes in legal codes to changes in the court systems and building and reforming property and collateral registries. Recent reforms have been promising. In 2010, Ghana created a unified registry for movable property and now requires any secured credit agreement covering an amount of about US\$350 or above to be registered in the collateral registry. In recent years, Rwanda has significantly upgraded company law and related legislation, strengthening minority shareholder rights and disclosure requirements for companies. The 16 member countries of the Organization for the Harmonization of Business Law in Africa have started reviewing the Uniform Commercial Act (see World Bank and IFC, various).

### ***Regulatory and legal reforms***

Beyond the ongoing challenges of macroeconomic stability and the proper management of international capital flows, as well as the long-term tasks of building a contractual and informational framework, there is also an array of more immediate, short-term steps that governments can take to push financial systems toward the frontier of long-term finance.

One area is the regulatory framework for various segments of financial systems. As we discuss above, there are many regulations that, for the sake of stability, restrict the engagement of banks in long-term finance, but that, for the sake of usefulness for financial stability, might also be questioned. Loan concentration ratios—typically defined relative to capital—can be restrictive in terms of the scale of lending. In Africa, concentration ratios are defined at relatively high levels, at 20 percent or more in most countries. Exceptions are Ghana, where it is only 10 percent in the case of unsecured lending, and Tanzania, where it is only 5 percent for unsecured loans. Having to lend 60 percent of a portfolio to borrowers who are eligible for refinancing by central banks, as is still formally the case in West Africa, can also increase the cost of lending for banks and limit the borrower universe.

The legal and regulatory framework, including adjustments in tax codes, might be necessary if the leasing industry is to take off. Similarly, stamp duties and restrictions contained in legal codes concerning the sale of claims to third parties can limit the extent to which factoring is used as a financing instrument. Likewise, regulatory restrictions on the operations of domestic and international equity funds, as well as concerns about taxation, can limit the extent to which equity funds enter markets, as we discuss above.

An important and often overlooked challenge is the demand side. In chapter 3, we discuss the extent to which demand-side constraints can limit the expansion of the banked population; such constraints can also hold back the access to and use of credit services by enterprises, especially small and medium-size firms. Turning investment into bankable projects requires business planning and development skills that many entrepreneurs lack, but can be taught. Furthermore, even if the financing constraints are eliminated, enterprises across Africa face a plethora of constraints related to market and government failures that have to be addressed in the context of a broader reform of the business environment. African enterprises feel more constrained about various dimensions of the business environment relative to enterprises in other regions of the developing world. One should not downplay the importance of finance, but it is not necessarily always the binding constraint.

Beyond easing regulatory restrictions, addressing demand-side constraints, and fostering competition, governments across the continent have tended to favor more activist instruments in seeking to foster lending to underserved segments of the enterprise universe. Directed lending through commercial or development banks has not helped in most instances. A more indirect method is partial credit guarantees. Because these have become the intervention tool of choice among many donors and governments, we discuss the experience a bit more in depth below.

### ***Public-private partnerships***

We discuss the benefits, elsewhere above, that PPPs can create by closing infrastructure gaps. In most countries, however, the legislation on such partnerships remains confusing. How and with whom should one start negotiations? With the line ministry or the ministry of finance? Do the competitive clauses of national procurement laws apply to all PPP transactions? There is weak capacity in the public and private sectors in the management of such partnerships, and there is an opaque bidding process. PPPs in infrastructure have therefore not been used in Africa to their full potential or even to the same extent as they are used in other developing regions.

The donor community has initiated and invested in a number of funds aimed at attracting private financing for infrastructure projects in the form of PPPs. For their part, governments across Africa are making a concerted effort to harness this source of long-term finance by strengthening the legal and regulatory framework for PPP transactions. In Zambia, for example, the government has recognized that it has limited resources to embark on all the infrastructure development projects on its wish list and is actively working to improve the PPP environment. In December 2008, the government approved a policy framework for the implementation of PPPs. A central unit has been established at the Ministry of Finance and subunits in line ministries, including the Zambia Development Agency. The legal and regulatory framework has been approved by Parliament.

For countries such as Zambia to strengthen their pipelines for PPPs substantially, more work is required to ensure that the PPP legislation enacted by parliaments and the accompanying regulations issued by ministerial statutory instru-

ments are conducive to a wide variety of PPP transactions, support national PPP agencies in acquiring the relevant technical skills and financial resources to act as effective PPP transaction facilitators on behalf of the government, and ensure that all relevant public and private stakeholders in PPP transactions have a clear, established process for facilitating such transactions in a coordinated and complimentary manner.

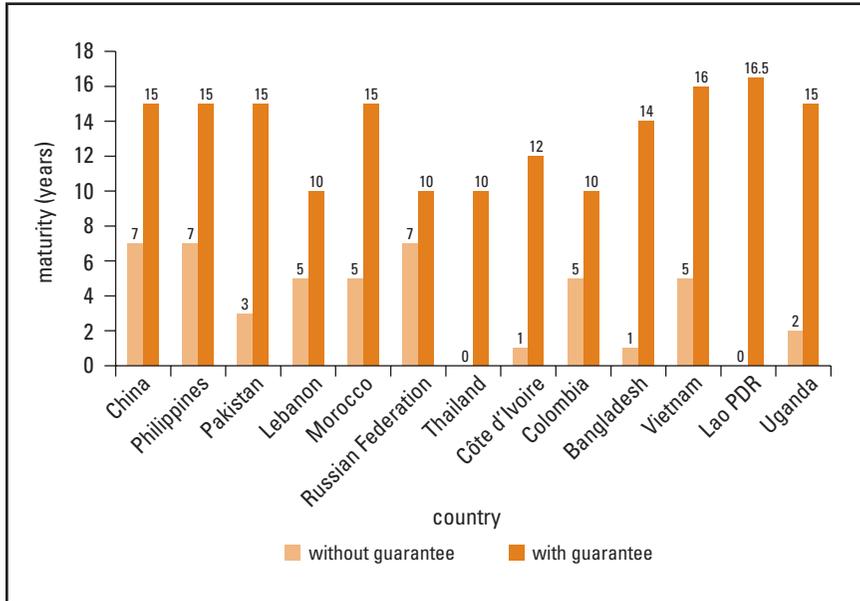
An important mechanism for increasing the appetite for PPPs for longer-term infrastructure projects is represented by risk mitigation instruments, to which we turn next.

### ***Risk mitigation instruments***

Over the years, some specialized instruments have been developed to mitigate the effects of specific risks. In housing, for example, mortgage liquidity facilities help lenders obtain long-term funds to finance their retail mortgage portfolios. This is a popular model that many francophone African countries have adopted in the form of *caisses de refinancement hypothécaire*, which is based on a similar institution in France. Such institutions exist, have existed, or are planned in Egypt, Gabon, Nigeria, Rwanda, South Africa, Tanzania, and the countries of the West African Economic and Monetary Union. The basic concept is simple: mortgage lenders are allowed to use their mortgage assets as collateral for loans from a centralized bond issuer. The bond issuer or liquidity facility is typically owned by the banks that use it for refinance purposes and is therefore a sort of mutual organization providing a service to members. The institution gains its strength from a strong capital base and careful lending, which is secured by mortgage assets as collateral.

Lenders can use a mortgage liquidity facility in two ways. First, it can be used as a direct source of long-term funds to help overcome the maturity mismatch, or, second, it can be used as a backup in the case of liquidity problems. Because the facility acts as a safety net, a lender is able to make better use of short-term deposits in the knowledge that any liquidity imbalances can quickly be overcome by presenting mortgage assets to the liquidity facility in exchange for long-term funds. Essentially, this allows banks to refinance their mortgage loans if they are in trouble. During the crisis, this was a function undertaken by a number of central banks to support mortgage markets in the absence of a mortgage liquidity facility.

Requiring borrowers to save for a period as part of the qualification for a mortgage as an alternative risk mitigation instrument is not a widely developed housing financing scheme in Africa. Such a scheme represents a significant opportunity, especially in markets where lenders are unable to obtain the credit histories of borrowers. The requirement allows lenders to verify the capacity of borrowers to save regularly and meet mortgage payments, and it helps borrowers build up a mortgage deposit and equity in the property. In Nigeria, the national housing fund mechanism requires a potential borrower to save for six months before becoming eligible to access a loan. This is a closed savings scheme, that is, the savings determine the eligibility of borrowers for loan disbursement. The six-month savings period qualifies many more potential borrowers than can be serviced by the

**Figure 4.10 The Effects of Guarantees on Loan Maturity**

Source: Fall (2010).

fund, which is therefore fundamentally unsustainable. In Kenya, meanwhile, investment in housing bonds allows borrowers to build up the necessary equity for home purchases. The government actively encourages this scheme by providing tax concessions to savers. A similar scheme exists in Uganda, although without the tax break.

One way to foster long-term financing is credit-enhancement through guarantees, such as an infrastructure guarantee facility (figure 4.10). Mitigating risk means protecting projects against arbitrary interference by regulatory agencies, including preventing tariff adjustments commensurate with cost increases caused by exchange rate movements. The partial risk guarantee against regulatory default that the World Bank granted for the concession of Uganda's electricity distribution company, for example, played a key part in attracting private investors (see Mazhar 2005; Nyirinkinda 2005). In the case of guarantee facilities, these are managed most effectively by independent private managers selected through a competitive process. DFIs can also use specific structures to mitigate the risks of commercial loans. This is the case, for instance, of the A/B loan structure that is offered by the African Development Bank and that extends the bank's privileges to commercial investors.<sup>17</sup>

African Trade Insurance (ATI), an initiative established by the Common Market for Eastern and Southern Africa in 2001 with financial support from the World Bank, is an example of a regional African institution that offers risk mitigation instruments.<sup>18</sup> The ATI offers political and credit insurance for transactions involv-

ing ATI-member countries. Participating states are liable for any loss triggered by violations of their commitments toward the ATI. Such violations would also trigger default with respect to the World Bank, thereby enhancing the deterrence effect of the ATI insurance. Given ATI's regional shareholding, ATI products have a stronger deterrent effect than the guarantees offered by national export credit agencies. The ATI has been providing political and credit insurance to facilitate the financing of several infrastructure projects. These projects have included mainly power plants and information and communication technology infrastructure. As of December 2009, only 10 percent of ATI exposure to political risk was represented by infrastructure projects.

An important policy tool to foster lending to the enterprise sector in general and, notably, to SMEs and other disadvantaged groups has been partial guarantee schemes. These schemes exist on a private basis, but governments and donors have been aggressively pushing to establish partial credit guarantees to overcome the limited access of SMEs to bank credit. Partial guarantees can help overcome the lack of collateral of most SMEs, but issues of appropriate pricing, funding, and institutional structure are important. Although such schemes could be run on a self-sustainable basis, they often involve significant subsidies and contingent fiscal liabilities to cover losses. While it is difficult to compute such costs *ex ante*, it is even more difficult to measure the benefits, which would be partially captured by additionality, that is, the share of borrowers that would not have gained access to finance if the partial credit guarantees had not been available. There are only a few rigorous impact assessments of such schemes, and evaluations are urgently needed given the popularity of this policy tool.<sup>19</sup>

As discussed by Honohan (2010), private credit guarantee schemes can emerge for three main reasons. First, if the guarantor has informational advantages over the lender, this can help overcome information asymmetries and improve access to borrowing or reduce the related costs of financing for certain borrower groups. Requiring guarantors for new borrowers was one of the pillars of the success of the cooperative banking movement in Germany and other European countries in the 19th century (Ghatak and Guinnane 1999). Second, guarantee schemes can help diversify risk across lenders with different sectoral or geographical specializations. As created in several European countries, cooperative central banks serve to insure individual cooperatives that are heavily invested in specific regions or sectors. Third, guarantee schemes can emerge to exploit regulatory arbitrage if the guarantor is not subject to the same regulatory requirements as the lender. The recent growth in guarantee schemes in China might derive from such regulatory arbitrage (Honohan 2010).

Coordination failure among private parties and first-mover disadvantage could prevent private providers from entering the market for credit guarantees or prevent lenders from pooling resources for such a scheme and thus justify government intervention (de la Torre, Gozzi, and Schmukler 2008). This can be seen as one major reason why most guarantee funds in Africa are, today, publicly financed and often even operated publicly. Another reason for the popularity of the schemes is the

limited resources that are needed up front, leaving potential liabilities to a much later stage.

The important assessment criteria are additionality and sustainability. How many creditworthy borrowers who previously did not have loans have been included because of the scheme? This requires not only an assessment of the additionality effect in itself, but also an assessment of the creditworthiness of the additional borrowers. The other important criterion is financial sustainability. The design of the scheme can be critical in reaching these two goals. While there has not been a rigorous research effort on the optimal design of such schemes, there has been quite a lot of discussion.

A first important design element is eligibility. Targeting the scheme on specific sectors, specific geographical areas, or firms of a specific size can help maximize the additionality effect. Targeting that is too specific, meanwhile, may increase the bureaucratic costs of running such a fund (for example, verification costs) thus limiting take-up. It might also limit the overall economic effect.

The coverage ratio is a second important design feature that can impact both additionality and sustainability. Retaining part of the risk with lenders can increase their incentives to assess and monitor borrowers properly and thus reduce loan losses. Too low a coverage ratio might reduce the value of the guarantee and dampen take-up. Too high a coverage ratio could incentivize lenders to excessive risk taking. Important to note is that the impact of the coverage ratio on lender incentives might vary with the informational advantage of the lenders. If guarantors have an informational advantage over lenders, then the coverage ratio that is sustainable might be higher than the coverage rate that would be sustainable under a scenario in which the informational advantage lies with the lenders. One interesting example in this context is the Small Businesses Credit Guarantee Fund of Chile, known as Fogape, which was launched to auction available guarantee amounts. In this case, lenders bid on the loan shares that are to be guaranteed. Bankers who bid for coverage of lower shares than the maximum allowable have their requests filled; others are rationed. In practice, the auctions have meant that primary lenders retain between 20 and 30 percent of the risk (Benavente, Galetovic, and Sanhueza 2006; Bennett, Doran, and Billington 2005).

The pricing structure is another important feature, especially for the sustainability of the fund both under the revenue aspect, that is, recovering the costs of the fund, but also in terms of providing proper incentives for lenders. If fees are too high, lenders might be reluctant to use the fund, and it can also cause good customers not to be included in the guarantee scheme that would have received funding otherwise. If fees are too low to maximize the additionality effect, the fund might not be sustainable. Critically, the fee structure should influence the incentives of lenders to screen and monitor properly.

The payment structure is a fourth important design feature. Prompt payments can increase trust in the system and, thus, the use by lenders. However, delays in payments until after a threshold of recovery efforts by the banks has been reached can be important in enticing lenders to monitor borrowers properly. Delaying pay-

ments until all legal recourse has been exhausted, however, might be too extreme, especially in countries with weak legal recovery processes. A staggered reimbursement schedule might be more appropriate, such as in Morocco and Tunisia, where 50 percent is paid once the claim is presented, followed by the remainder once the legal process has been exhausted.

Another item is the approach to operational management. Individual loan-level guarantees involve guarantee agencies in the screening stage to review eligibility (that is, whether potential borrowers are within the target group of the private credit guarantee), but also risk profiles (that is, whether the level of credit risk associated with specific borrowers is within adequate limits). In this approach, lenders will usually first approve the loans and then seek a guarantee approval on behalf of the borrowers. Alternatively, the portfolio model allows lenders, at their discretion, to assign guarantees to higher risk loans or targeted borrowers (that is, SMEs) and inform the guarantors after loans are approved or the loans default. While the loan-level approach might allow for more careful screening and risk management, it is also more costly for the credit guarantee fund. A hybrid approach would allow the guarantees to be extended to portfolios of loans up to a limit, after which additional loans would be screened by the guarantee fund.

Beyond the details of the design features, there is the more general issue of the relative roles of the private sector, the government, and donors. The assignment of responsibilities among government, the private sector, and donors might be important in creating the incentives so that lenders screen borrowers properly. Funding of the scheme through the proper pricing of the guarantees and by limiting government funding to setup costs might be important in giving lenders the proper incentives to monitor borrowers, avoid excessive risk taking, and, thus, minimize loan losses. Credit risk assessment by private parties rather than government bureaucrats can help improve the quality of the risk decisions and, again, minimize loan losses. Similarly, loan recovery by lenders rather than the government can maximize recovery because lenders typically have more information about the borrowers and potentially stronger incentives to recover loan resources.

## Conclusions

This chapter documents the enormous long-term resource needs of Africa, but also the increasing number of sources for long-term finance. Beyond commercial banks, development banks, capital markets, and other traditional sources, there is an increasing variety of nonbank financial sources that are gaining ground in Africa, including private equity funds and SWFs, and various financial instruments such as corporate bonds and partial risk guarantees. This chapter briefly touches on some of the central themes important in efforts to achieve improved long-term finance. It also demonstrates that Africa can find new and more well managed providers and new products and delivery channels of long-term finance. This will mean, however, that governments must play a facilitating rather than a market-replacing role. We advocate an appropriate regulatory touch in organized capital

markets that also fosters regional integration and cross-listing arrangements. We argue for a stronger role for more private arrangements wherever organized markets are too costly and cumbersome, including a stronger role for private equity funds. Ultimately, this will help (1) attract more long-term resources to Africa and (2) intermediate these resources more effectively.

The main messages in the analysis offered in this chapter are consistent with the overall messages of the book. Competition among different providers can prove critical in the provision of the resources and products necessary for long-term finance in Africa. As in chapter 3, looking beyond banking is important for firm finance, but also for other areas of long-term finance, including infrastructure and housing finance. Looking at the necessary services and, thus, beyond existing institutions and markets is critical in expanding long-term finance: looking beyond national capital markets to regional solutions and looking beyond organized exchanges to private solutions. Consideration of the demand-side constraints implies looking at nonfinancial constraints, as well as business development services. The ultimate goal is to turn investment into bankable projects, where *bankable* is broadly defined.

As in the case of the effort to expand access, policy recommendations have to be tailored to country circumstances. Larger or middle-income countries will have an easier time attracting international funding and can support a larger number of institutions, including capital markets. In the case of smaller and low-income countries, more emphasis has to be placed on linking to international markets and pushing for regional integration. Postconflict countries and countries with traditionally heavy government intervention in financial systems should have governance reform at the top of the policy agenda.

## Notes

1. We are not able to go into depth on many issues that we touch upon in this chapter. For more on infrastructure finance, refer to Sheppard, von Klaudy, and Kumar (2006) and Foster and Briceño-Garmendia (2010); for pension reform, refer to Stewart and Yermo (2009).

2. See Ndulu (2006) on the importance of closing this gap for the sake of Africa's growth performance.

3. For a detailed discussion on PPPs in infrastructure in Africa, see Shendy, Kaplan, and Mousley (2011).

4. For the following, see Walley (2010).

5. See "Africa's Banking Boom: Scrambled in Africa," *Economist*, September 18, 2010.

6. The full structure of the deal is such that the relative share of total senior debt and equity were 77.79 and 22.52 percent, respectively. The total senior debt package is as follows: ₦11 billion (Stanbic IBTC and Standard Bank London: 39.29 percent of the total debt package), ₦9.6 billion (African Development Bank), ₦9.4 billion (a syndicate of Nigerian banks), and ₦3.5 billion (standby debt from Nigerian banks). A mezzanine debt of ₦5 billion was provided by the Lagos state government, in addition to ₦5.318 billion in shareholder loans and ₦1 billion in standby equity.

7. Egypt, Ghana, and Nigeria have privately managed pension funds, but only for their mandatory schemes.

8. According to these guidelines, there should be no minimum level of investment in any asset, in particular in government debt. Social security funds should not be a means for governments to finance deficits.

- The investment strategy should set quantitative restrictions on the maximum levels of investment in different asset classes.
- The investment strategy should not permit holding more than a specific proportion of the total market value of the assets of a particular industry or enterprise.
- Investments in some types of assets may be forbidden (for example, unguaranteed loans or unquoted shares).
- A list of admitted (or recommended) assets could be applied based on the investment quality of the assets.

9. John Niepold, quoted in Christy (1998); see also Moss, Ramachandran, and Standley (2007).

10. In West Africa, the fiscal advantages offered through bonds issued in the zone do not equally benefit all bondholders within the region.

11. Direction des Assurances et de la Protection Sociale, February 2011.

12. "Capital risque: L'assouplissement de la réglementation préconisé," *L'économiste* (Casablanca), 3446, January 17, 2011, <http://www.leconomiste.com/article/capital-risquebr-l-assouplissement-de-la-reglementation-preconise>.

13. Current regulations on foreign exchange in Morocco authorize companies domiciled in Morocco to invest outside the country and to repatriate revenues. This is subject to several conditions, including (a) the investment aims at developing and consolidating the activities of the company and (b) the company has been operating for a minimum of three years. This second condition prevents newly established funds domiciled in Morocco from making investments outside the country.

14. Association Professionnelle Tunisienne des Banques et des Etablissements Financiers, <http://www.apbt.org.tn/fr/htm/fichespratiques/sicar.asp> (accessed February 3, 2011).

15. In 2004, Nigeria established the Excess Crude Account to store profits from oil sales so as to insulate the Nigerian economy from boom-and-bust cycles in commodity prices. The country is expected to launch the Nigerian Sovereign Investment Authority to stabilize macroeconomic fundamentals, accumulate savings for future generations, and develop critical infrastructure.

16. Introduced in 2007, the China-Africa Development Fund is essentially an equity fund, investing in Chinese enterprises with operations in Africa in agriculture and manufacturing industries, infrastructure (electric power and energy, transportation, telecommunications, and water), and natural resources (oil, gas, minerals).

17. An A/B loan may be split into one or more senior components and one or more subordinate components. The borrower is the same, and the collateral is the same, but the treatment of each loan component may be structured differently.

18. Current member states are Burundi, the Democratic Republic of Congo, Djibouti, Eritrea, Gabon, Ghana, Kenya, Liberia, Madagascar, Malawi, Rwanda, Sudan, Tanzania, Uganda, and Zambia.

19. See Lelarge, Sraer, and Thesmar (2010) for an assessment of the credit guarantee scheme in France and Larraín and Quiroz (2006) for Chile. See Beck, Klapper, and Mendoza (2010) for a survey of credit guarantee schemes around the world.