The UK's financial sector and sub-Saharan Africa: partnerships for development

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Briefing note

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The economic development of low-income countries is central to the UK's international development strategy because it is the key to long-term and permanent poverty alleviation. Achieving this will require appropriate policies and institutions *and mobilisation* of between $2 and $5 trillion of finance annually for the next 15 to 20 years.[1]

DFID's new Economic Development Strategy highlights the critical role that the UK's financial sector can play in providing such finance, with the Secretary of State stating, '**the City of London can become a leading financial centre for the developing world, supporting economic growth, job creation and an exit from aid.'**

Such a role presents **a 'win-win' opportunity**. For sub-Saharan African countries, this is an opportunity to mobilise the scale of private finance needed. For the City of London, this will allow it to capitalise on its global dominance in financial services both through participation in London's capital markets and through UK financial institutions extending their businesses into the rapidly expanding economies in the region.

However, there is a need to manage **financial and governance risks for both issuers and investors and for further work to overcome constraints to private finance.** DFID can play a critical role in tackling these issues including through finance from the CDC Group.

These issues are discussed in more detail below to set out the background for discussion in the meeting. Examples of finance raised to date are also highlighted in the boxes.

The 'win-win' opportunity

The City of London already plays an important role in financing sub-Saharan Africa, having issued more than $20 billion in sovereign bonds since 2011[2] and more than $5 billion in new listings and rights issues on the London Stock Exchange [3](LSE), and hosted regional private equity funds with more than $16 billion[4] under management. This has provided government financing in a

[1] Source: UN and UNCTAD, "Financing for Development' conference 2015
[2] Source: ODI
[3] Source: LSE
[4] Source: EMPEA

form that has been liquid, relatively low cost and without the burdensome conditionality that comes with financing from institutions such as the IMF or World Bank. It has also been a key source of capital for the private sector including in extractives, telecommunications and consumer services. Boxes 1-3 capture some of the successes.

This financing by the City of London has been made possible by a number of factors, including the scale and depth of its capital markets, which are unmatched globally in terms of financial expertise and the depth of the investor base for emerging and frontier markets. In addition, it has well-regarded UK legal systems and regulation, liquid secondary markets and specialist risk expertise. These skills are complementary of and can support financial sector development in-country.

Building further on these achievements will serve sub-Saharan African needs for government and private sector financing which will both accelerate economic development and provide a new strategic direction for the UKs financial services.

Box 1: Catastrophe bonds

Globally there is a $75 billion market in insurance-linked securities. The most popular are catastrophe bonds which allow developing countries to insure against weather and other related natural disasters through bonds which then allow risk to be transferred from insurers to institutional investors with risk appetite for asset classes with higher yields and diversification benefits. Thus insured parties, insurers and investors all benefit from the 'win-win' created by these bonds.

The City of London has been at the heart of the development of this market both because it is the global centre for insurance and because of its deep pool of institutional investors. Post-Brexit, new regulation is being developed to allow for improved legal structures and issuance times to support further growth in insurance-related bonds and provide a competitive edge to offshore financial centres such as Bermuda. This new regulatory framework due to be completed in 2017.

Importantly, the development of these commercial bond markets in developing countries has been a challenge due to attempts to provide them through development agencies. For example, the World Bank has been providing support for such bonds since 2009, including for risks from floods, pandemics and earthquakes. However, the level of issuance has been limited. The development of private markets has the potential to expand the use of these securities for the benefit of all.

Box 2: UK institutions in sub-Saharan Africa

The City of London hosts UK financial institutions that are global leaders in banking and insurance. Such institutions, including Standard Chartered in banking and Prudential in insurance, are building on-shore businesses in sub-Saharan Africa to serve households and corporations.

Such foreign businesses accelerate financial development for host countries through increasing competition, increasing financial access and by improving standards for corporate governance and regulation. They also increase domestic savings and increase household welfare through providing services such as savings accounts and insurance products tailored to African customer needs.

Sources: ODI African Development Bank.

Barriers to achieving a 'win-win' outcome

In order for 'win-win' outcomes to be achieved, a number of issues need to be addressed, as, despite significant progress, there are several existing barriers for both issuing countries and investors.

Firstly, investor risk appetite is constrained by a number of factors. Most important of these is political and macroeconomic risk including weak investment frameworks and corruption. There are also insufficient bankable projects and unsupportive 'ecosystems' including in infrastructure. There is also a need for responsible investment standards to be set and enforced.

Secondly, for countries that issue bonds and receive private finance, there is a need to maintain debt sustainability and financial stability. Risks to doing so include excessive borrowing, inappropriate use of funds, foreign exchange risks, refinancing risks and unstable capital flows.

From a development perspective, there is also a concern that financing and development needs are mismatched. To date, financing has been concentrated in a limited number of countries and sectors. Greater diversification, including into employment-intensive sectors such as manufacturing and agricultural processing, is needed for development impact to be achieved.

Box 3: Sovereign bonds

Between 2011 and 2016 more than $20 billion of sovereign bonds for sub-Saharan African countries was issued through the London markets. The City of London was able to do this successfully by tapping into its extensive investor base and allowing bonds to be issued in the context of UK legal jurisdiction and established secondary markets.

For sub-Saharan African governments these funds have been key sources for fiscal financing and infrastructure investment and were issued at attractive yields and little or no conditionality.

However, the bonds also highlight some of risks that such issues entail. Some countries have suffered losses on FX because bonds were issued in USD, not local currency. This is especially for countries, such as Nigeria, Ghana and Zambia, which have suffered sharp currency devaluations. Refinancing and further issues have also become more difficult since 2015 because of the downturn in African economies leading to reduced liquidity and higher yields with only one issuance in 2016.

In addition, there have been instances of poor governance. In particular, Mozambique issued bonds through Credit Suisse, BNP Paribas and VTB Bank which were not subject to the required public processes. This had led to a restructuring as well as investigations by international financial regulators and the IMF and the suspension of donor aid. These issues highlight the need for 'best practice' from both financiers and governments involved in private financing in the region.

Sources: ODI, IMF, the Financial Times.

The role of DFID

Partnership between DFID, the City of London and sub-Saharan African governments is critical to addressing these barriers and delivering a 'win-win' outcome for all parties.

A number of policy options can be considered. Most important is to develop strategies for closing the 'eco-system' gaps including providing development financing for infrastructure (including through multi-lateral development agencies such as the World Bank and African Development

Bank) and technical assistance to improve governance and regulatory frameworks in recipient countries.[5]

Another option is to increase the capacity of the UK's bi-lateral development agency, CDC. Legislation currently making its way through Parliament would allow DFID to increase its exposure to CDC by up to $6 billion initially. This would provide significant potential to develop bankable projects and demonstration projects in some of highest-risk countries (see Box 4)

Another could involve mitigating or sharing risk with the private sector such as through guarantees, co-investment vehicles and partnerships including public-private partnerships; further application of development funds for these purposes should be considered. One such partnership is between CDC and Standard Chartered to share default risk in Sierra Leone (see Box 5).

There are specific UK institutions that can directly support British companies by developing 'win-win' activities. For example, UK export finance can help companies to export, invest or provide a services in Africa. Examples include providing guarantees for building hospitals or undertaking mining activities in Ghana. These are 'win-win' scenarios for African economic development if these financial solutions are the most efficient option.

Box 4: CDC Group

In early 2017, the UK's development finance institution, CDC Group, received parliamentary approval for up to $6 billion of further capital for investment in low-income countries in Africa and South-East Asia.

The CDC Group's mission is to invest to support the growth of businesses that will, in turn, create jobs. Sectors supported include manufacturing, agribusiness, infrastructure, financial institutions, construction, health and education. As at December 2016, CDC's portfolio totaled £3 billion in nearly 1,300 companies.

There are significant opportunities for CDC to engage in transformational projects in Africa, by addressing capital market failures and fulfilling financing needs in areas such as manufacturing, infrastructure and SMEs.

Sources: the CDC Group, the Financial Times, the Guardian.

Box 5: A partnership between CDC and the City of London

The CDC Group, the UK's development finance institution, and Standard Chartered Bank agreed a risk participation agreement (sharing the default risk) in February 2015 to support new working capital lending of up to $50 million to businesses in Sierra Leone. It came at a time when working capital needs were high after the outbreak of Ebola, which led the economy to contract by nearly a quarter. As one example, the Benco Trading company imports and distributes construction materials received a loan.

Source: CDC, DFID.

[5] ODI's Supporting Economic Transformation (SET) programme has recently launched Hoekman, B. and D.W. te Velde (eds.) (2017) *Trade in services and economic transformation, a new development policy priority*, see http://set.odi.org/. This paper suggests that development policy-makers focus more on services sectors and the role that trade can play in this.