CHAPTER 7 SUB-REGIONAL DEVELOPMENT FINANCE IN SADC: THE ISSUES

Introduction

7.01 The previous six chapters of this study have looked into various aspects of development finance in SADC and other sub-regions. They have examined in some detail:

- the 'moving target' nature of development finance;
- its complementarity with other sources of funds;
- investment needs at the national and sub-regional levels in SADC;
- development finance needs for specific sectors and special purposes;
- the nature of *sub-regional* projects;
- the functioning and experience of national and sub-regional DFIs; and
- problems that have arisen with non-performing assets (NPAs) in DFIs.

7.02 This chapter (Chapter 7) focuses on sub-regional *burden-sharing* issues that will need to be considered by SADC members in establishing a new regional DFI. The chapter that follows (Chapter 8) considers the main options which might be considered by SADC policy-makers for meeting national and sub-regional development finance needs before the report concludes (Chapter 9).

Sub-regional Development Finance and Burden-Sharing

7.03 Establishing and launching *national* DFIs is a simpler process than launching DFIs, or any other institutions that involve more than one government in their ownership. The key decisions to be made in the *national* case usually involve addressing such issues as:

- What are the aims and purposes of the institution?
- Is the shareholding to be public, private or mixed?
- If it is a public-private mix, then what should be the respective proportions?
- Which public and/or private entities are to be involved in the shareholding?
- What should their relative shareholdings and relationship with each other be?
- Are the shares of the company to be listed on domestic/international markets?
- Are the liabilities are to be funded or guaranteed by the shareholders?
- Is the DFI is to be registered under prevailing national Company Law?
- Or is it to be established as a statutory entity under special enabling legislation?
- What arrangements are needed for overall policy-direction (i.e. at the Board level) and the day-to-day management (executive functions) of the institution?
- What is the proper division of responsibilities/labour between the two?
- What should be the relationship between the DFI and the government - arms length or a closer executing agency type of relationship?
- What should the government's role be in appointing/dismissing Board Directors and/or Executive Managers?
- Up to what level of management should government have the right to intervene?
- Should the DFI provide subsidised directed credit to targeted borrowers or operate on a purely commercial basis or both?
- How should the exchange or other financial risks taken by the institution at the behest of government be passed on or covered? ... and so on.

Lower level issues - such as the organisation structure, financial structure, and operating, financial, institutional and administrative policies of the institution in question - are then usually left to the Board and management of the DFI to resolve.

7.04 But when it comes to establishing a *sub-regional DFI* in SADC involving twelve governments as shareholders, such questions assume a higher order of complexity. There may be twelve different views to be reconciled on each answer. At the same time, plurilateral, sub-regional DFIs also raise other critical and complicated issues such as:

- Establishing the case for, and purposes of, a new sub-regional DFI;
- Having a set of clear, consensually shared understandings on what the sub-regional DFI should and should not do, or finance;
- Its place of incorporation, registration and operation;
- The framework of Articles of Agreement and Bye-laws;
- The acceptance of these by national legislatures under binding treaty arrangements covered as a specific part of the SADC Treaty;
- Arbitration provisions and jurisdictions for settlement of disputes;
- The basis, criteria and formulae for determining the relative shareholdings of each country;
- Provisions allowing for periodic adjustments of these holdings as the relative economic standing of countries changes;
- Burden-sharing arrangements in meeting any special costs and liabilities or in providing concessional or intermediate funding to the institution; or in providing joint and several guarantees for its borrowings and covering its exchange and other financial risks;
- Understandings concerning choice (and nationality) of President, senior executives and Board Members;
- Provisions for ensuring reasonably representative distribution of the different SADC nationalities in the Board, management and staff of the institution;
- Currencies in which shareholdings and other (callable capital, guarantee or default) obligations of shareholders are to be denominated and paid;
- Provisions and procedures for the authorisation, subscription and paying-in of share capital and for future general or special increases of such capital by member countries;
- Provisions for the establishment of concessional funds or affiliates and for their dissolution;
- Provisions for non-subregional or non-African members in the shareholding structure and the proportionate shareholding as well as operational relationship between SADC and non-SADC shareholders;
- Standard-of-value and maintenance-of-value provisions and protocols to ensure that changes in the relative value of holdings denominated in different national currencies are periodically allowed and adjusted for;
- Understandings about the delineation of functions between the regional (AfDB) sub-regional (SADC level) and national DFIs of different types;
- Understandings on relationships between a possible sub-regional DFI for SADC and other sub-African DFIs (e.g. EADB, or the COMESA Trade & Development Bank) as well as regional (AfDB, EIB etc.) and global (World Bank, IFAD) DFIs.

7.05 These questions, as well as those listed under paragraph 7.03, do not provide an exhaustive list of all the issues that will arise in establishing a new sub-regional DFI. But they provide a sufficient indication of the main questions and, immediately and implicitly, of the difficulties that SADC members are likely to face in resolving them. These issues are technical and economic; but what usually complicates their resolution - and requires protracted (often unproductive) negotiations - are the different political motives, objectives and agendas of the countries involved. Such agendas often make the obvious *economic* answers to core questions *politically* unpalatable. The diplomatic manoeuvring that then becomes necessary to reconcile different political motives often leads to sub-optimal decisions (e.g. the decision to establish the PTA Bank in the least propitious of locations) which, hopefully, will be avoided in the case of SADC.

7.06 Nonetheless, to explore the feasibility of a sub-regional DFI (as required by the ToR), these issues require initial exploration of sufficient depth to establish whether: (i) there is a case for having a new sub-regional DFI in SADC; and (ii) the political will exists in all the member countries, and especially in the creditworthy countries, to commission a more detailed, full-scale pre-investment feasibility study. For that reason, these questions will be taken up in turn in the paragraphs and sections that follow.

The Need for and Purposes of a new Sub-regional DFI in SADC

7.07 As observed at the beginning of this chapter, this study and others have undertaken several reviews, at differing levels of depth, of: (i) the nature and financing needs of *sub-regional* projects in SADC; (ii) experience at the *national* level with development finance and DFIs in SADC along with inventories of existing DFI assets in the sub-region; (iii) evolutionary patterns in the operating and project financing stance of the major *global* and *regional* MDBs (i.e. the World Bank and African Development Bank) operating in sub-Saharan Africa and in SADC; (iv) experiences with other sub-regional development banks in Africa and elsewhere; and, finally, (v) the larger and continually expanding role being played by *private commercial* sources in financing industrial and infrastructure projects.

7.08 These analyses do **not** lead to a firm, unequivocal conclusion *on economically rational grounds* that SADC needs a new sub-regional development bank. There is no clear case for establishing such an institution. Nor is it clear whether such an option would have any advantages over other options - an issue explored more fully in the next chapter. There is even less of a case for relying on large amounts of development finance if SADC governments proceeded to privatise -- more vigorously and swiftly - state-owned enterprises that are presently involved in industrial, mining, infrastructure and large-scale agriculture operations.

7.09 Privatisation would enable SADC and its members to avail more fully of the wider range of financial options which exist in regional and global capital markets to rehabilitate, upgrade and expand infrastructure and productive capacity at national and sub-regional levels. If undertaken simultaneously across the sub-region, privatisation would result in a more rapid, wider and deeper degree of *regionalisation* of infrastructure, as well as of firms and enterprises, than would be possible by relying on *status quo* parastatal structures and supporting them with development finance. That is clearly a subjective judgement on the part of the authors of this report. It can be argued one way or the other almost indefinitely, depending on differences in opinions and viewpoints about what is feasible and desirable in the context of SADC and its member countries.

7.10 That said without prejudice to the possibility of SADC members deciding to proceed with establishing a sub-regional DFI, what might such an institution do to justify its existence? Based on experience elsewhere, such a DFI ought to have a wide remit rather than one too circumscribed and constrained in its portfolio choices (either by location, project type or sector) and thus exposed to covariant, adverse selection risk. Too narrow an operating remit and confinement to a particular sector - even one as large as infrastructure - usually has a detrimental impact on the ability of any DFI to achieve and maintain long-term financial viability and sustainability.

7.11 Extrapolating from that conclusion, if a new sub-regional DFI were to be established in SADC, it should be permitted to finance commercially viable projects in all the *infrastructure* sub-sectors, as well as in *industry, mining, construction, large-scale agro-industry* and possibly even large-scale land swap programmes should they ever be undertaken on a cross-regional basis (as suggested by the AfDB's Study on *Economic Integration in Southern Africa, 1993*). It is not evident that a sub-regional DFI should get involved (even as a wholesaler of funds) in providing development finance for agriculture and rural credit, SMEs and micro-enterprises, low-cost housing credit, or gender credit. These are areas that should legitimately be left to DFIs at the national level. However, a sub-regional DFI might act as a clearinghouse for information-exchange in these specialised areas of activity so that individual experience can be shared across the region and lessons concerning successes and failures can be learned. Moreover, should SADC or its donors decide to incorporate sub-regional *structural development funds* (as in the EU) to accelerate the development of the least developed countries and provinces in SADC, a sub-regional DFI would be the obvious institutional choice for intermediating and allocating such funds.

7.12 Clearly, it would be problematic if a sub-regional DFI with a wide operating remit were to compete with national DFIs in financing small national projects (even if they had obvious regional implications, externalities or multipliers) which were within the capacity of the latter to handle. It would need to focus on projects of a *larger* size. But the definition of *larger* in this context should be relative rather than absolute. The actual cut-off limit should depend on the financing capacities of national DFIs in the countries concerned. That limit would vary. In South Africa national DFIs are capable of financing projects with a total cost of US$1 billion or more. But, it is unlikely that even in prosperous Botswana the two national DFIs would be able to finance projects a tenth of that size. Thus a sub-regional DFI would need to develop flexible *wholesale-retail* funding relationships, cemented through co-financing arrangements, with the smaller national DFIs in SADC countries; although that feature has not yet been characteristic of sub-regional DFIs in other parts of Africa.

7.13 Finally, from an institutional capacity-building perspective, a sub-regional DFI if established, should be at the hub of a *new SADC network* of the several national DFIs which exist across the sub-region. Some of these DFIs are at an incipient stage of developing a network structure to facilitate information exchange and enhance their own capacities by relying more on one another. These DFIs have met on a few occasions to explore how they might cooperate but those efforts have not yet borne tangible fruit. However, at a recent meeting of some of the sub-region's DFIs hosted by the DBSA in June 1997 a clear desire was expressed to formalise such efforts and to co-operate in key areas on a programmatic basis. Such a desire needs to be acted upon and followed-up.

7.14 There is a clear need across all DFIs in SADC to develop a joint capacity in:

- dealing with *non-performing assets* on a systemic basis;
- skills development, capacity and institution building;
- *regular networking* at executive levels;
- formal training on various aspects of project financing;
- aspects of DFI management for various functions at various staff levels;
- establishing common operating, financial and management *information systems,* standards and protocols;
- keeping abreast of the latest hardware and software developments in *information and communications technolog;y*
- building an information-exchange and communications DFI *intranet* across SADC;

- establishing a joint capacity to deal with the rest-of-the-world (RoW) in attracting *inward foreign investment* and on other issues of common interest; and
- encouraging the *regionalisation* of infrastructure and industry;
- facilitating the development of, and jointly financing, *regional projects;*
- fostering *intra-regional cross-shareholding linkages* at the level of firms;
- working jointly for the progressive lowering and eventual elimination of barriers to cross-border capital flows and direct/portfolio investments within SADC.

Articles of Agreement and By-laws of a Sub-regional DFI for SADC

7.15 At this early juncture it would be premature, if not presumptuous, to specify (even in draft form) the Articles of Agreement or Bye-laws of a possible sub-regional DFI for SADC. Such an exercise could, however, be undertaken and discussion drafts produced relatively quickly following a decision to proceed by SADC's policy-makers. Discussion drafts could be prepared using the templates available - i.e. the Articles of the major global, regional and sub-regional MDB's and their affiliates. For the purposes of this study, an attempt has been made to adumbrate possible approaches (as subjects for future discussion rather than as firm proposals) to dealing with the principal issues that such Articles would need to address:

- *Purposes* : Discussed above in paragraphs 7.11 to 7.15

- *Membership:* should include the SADC-12 and any future members that join SADC. The key issue to be resolved is whether non-SADC and non-African members (and possibly private shareholders) should be invited into the shareholding of a sub-regional DFI at the outset. In the event of a SRDB being established in SADC the study's recommendation would be to have the Articles as *inclusive* as possible on the issue of membership, but to launch the DFI (if that decision were eventually to be made by all members) with just the SADC countries as members. An early second stage might involve bringing in some European and Asian donor countries providing that they could be attracted into such a venture. That is an unlikely prospect if their experience with other regional and sub-regional banks is any guide. The Articles and its share-capital provisions should be drafted with a view to anticipating and permitting eventual privatisation and the listing of the DFI's shares on capital markets.

- *Capital*: The initial *authorised* capital would probably need to be around US$5 billion (or ZAR 25 billion equivalent). The immediately subscribed and *paid-in* amount would need to be in the region of US$1-2 billion (or about ZAR 5 to 10 billion) if a sub-regional DFI was to play a meaningful role in financing or guaranteeing large-scale infrastructure projects. The full paid-in requirement would need to be made up-front without recourse to delayed-payment instruments (i.e. notes encashable on future dates).

- *Gearing:* The gearing (or debt/equity) ratio could, in present international market circumstances, be an all-inclusive 5:1 (allowing for outstanding liabilities - i.e. borrowings + guarantees + contingent assets/liabilities - over capital to be accumulated up to five times the amount of paid-in capital plus accumulated free reserves - i.e. unencumbered net worth).

- *Currencies:* Capital should be contributed by all members in *convertible* usable currencies and not in inconvertible national currencies or in synthetic units of account if the problems experienced by the MDBs are to be avoided and future privatisation provisions are to be incorporated at the outset. A sub-regional DFI in SADC should have its equity denominated in either one of the international reserve currencies (preferably US dollars given uncertainties regarding the Euro and the irrelevance of the Japanese Yen to the SADC situation) or in South African Rands (ZAR), the most widely used regional currency. In the latter case, however, it would essential for the Rand to be stable and fully convertible to inspire sufficient regional and international confidence that it will not be vulnerable to continual devaluation pressures arising from inability to contain domestic macroeconomic imbalances in South Africa's internal and external accounts.

At the present time, it might be wiser to adopt a US dollar standard of denomination, in order to provide the requisite degree of international credibility, and reduce the possibility of sudden large exchange risks, or breaches of the gearing ratio, if the sub-regional DFI does most of its borrowing from outside the region. Loans made by the sub-regional DFI could be in a range of international or regional currencies (depending on currency requirements for project costs or on the borrowing preferences of project entities) using derivative instruments to hedge risk and maintain values.

- *Currency Risk:* No currency risk should be taken by the sub-regional DFI on its own balance sheet in either its lending or treasury operations. Such risks would need to be borne by borrowers or hedged on their behalf (and account) through derivative contracts with credible counterparties.

- *Lending Terms, Rates and Spreads*: The sub-regional DFI should at all times operate on commercially sound principles. It should not undertake lending or guarantee operations at subsidised rates or on intermediate terms. Its lending rates and charges should be set at levels which cover its cost of funding, its costs of maintaining liquidity, and its administrative costs (which should be kept as lean as possible). At the same time, its lending terms should be sufficiently competitive with prevailing commercial terms to make it an attractive institution for project entities to borrow from. Where it may need to develop a comparative advantage with its capital structure and backing is in being able to provide funds with longer grace periods and maturities than competing institutions. It should also be able to provide unique value-added inputs into complex project financing packages which enable project risk mitigation and cost minimisation. Its product range should therefore extend well beyond straight long-term loans (which is what most traditional DFIs still specialise in) into a more responsive range of financial products and services including equity investments (on a common or preferred basis) and derivatives.

- *Guarantees:* Until the sub-regional DFI has established its own credit-worthiness in regional and global capital markets its borrowings will need to be backed by the joint and several guarantees of its member-shareholders. The guarantees most meaningful to markets would be those of the four internationally creditworthy SADC countries and, to a lesser extent, of the three other countries with intermediate creditworthiness. Should these guarantees be called, the Articles should provide for procedures that ensure quick payments by guarantors and avoid protracted delays in obligations being met in full.

- *Reserves:* In the early years of its operations the sub-regional DFI should not pay out any dividends from operating profits to shareholders until net reserves had been built up which were equivalent to the amount of fully paid-up capital. In building up and managing its reserves, the DFI would need to pursue ultra-conservative financial policies.

- *Provisions:* The sub-regional DFI should be required to make provisions against its outstanding loan and guarantee assets (including contingent assets) which are in accordance with the most stringent international accounting standards. In the first 10 years of its operations the DFI should make a statutory provision of at least 2% of all outstanding (and contingent) assets even if its portfolio condition did not necessarily warrant that large an amount as a prophylactic provision.

- *Preferred Creditor Status:* The sub-regional DFI would need to have preferred creditor status to enable it to raise resources on finer terms and provide it with leverage vis-à-vis its borrowers. The degree to which it is preferred will depend on the seniority accorded to other MDBs (especially the IMF, World Bank and AfDB) as prime preferred creditors and the guarantees or security provided for obligations to international private creditors, or local financial institutions.

- *Location:* The sub-regional DFI should have its headquarters located either in the major financial centre of its largest shareholder, **or** in a SADC financial centre which had:

  (a) a well developed financial market with regional capabilities. Such a market would have operating offices/branches of a sufficient number of global commercial and investment banks operating in it to permit the DFI to mobilise regional and international resources, and to manage its treasury operations and investment management functions efficiently and effectively;

  (b) an established business service and support infrastructure with access to high-quality telecommunications, a regional transport hub for travel, high-quality information technology installation, service, support facilities and high quality local accounting, legal and business consulting services;

  (c) an adequate supply of local staff with various skill mixes at all professional and support staff levels;

  (d) adequate housing, educational and health care facilities to attract high quality professional staff and executive management from the region; and

  (e) a safe and secure living environment

  The proposed DFI would need to have an operating branch office in the capital of each SADC country. Realistically, the eligible principal locations for the headquarters of such an institution within SADC would be in the Johannesburg-Pretoria corridor, Port Louis or Harare. The Johannesburg-Pretoria corridor meets more of the essential requirements outlined than any of the other locations; except perhaps for the safety and security factor.

- *Governors and Board :* Contrary to what is usual in other MDBs and regional or sub-regional DFIs, the DFI for SADC should dispense with a Board of Governors. It should rely on a commercial corporate structure with the Board of Directors being the ultimate instrument of governance. Members of the Board should be appointed by each country shareholder. They should not be permanent, resident Executive Directors (a requirement which has created major problems in some MDBs and particularly the AfDB) but part-time non-executive Directors, able to devote a significant amount of their total time to oversight of the DFI. They should be eminent, accomplished people with a track record of achievement in the private sector and with experience on the boards of other large regional or international private financial institutions. They should not automatically be ministers, senior government officials or managers of parastatals. Shareholders should be involved, through the Board, in appointing the Chairman of the Board and (learning from the experience of other MDBs) separating that function from that of President and Chief Executive Officer of the DFI. The Chairman's role should be to handle the shareholders and the international politics of the DFI. The President's function should be to focus on providing strong professional leadership and management to the DFIs executive team and staff. Shareholder involvement and intrusion into senior appointments should stop at that point.

- *Management:* It should be left to the Chairman and the President to appoint the top executive team. That team, in turn, should be responsible and accountable for developing the middle and lower management and staff structures of the organisation and for the appointment of special policy and decision-making committees. Those sub-structures should be built flexibly, with due regard for competence, efficiency, and effectiveness of the DFI yet ensuring, to the extent possible, equitable and inclusive SADC-wide representation in the staff of the institution; without compromising its effectiveness and competence through a ‘quota-culture’.

  In a sub-region with countries as unequal as those in SADC it will be difficult to resist the temptation on the part of the largest regional shareholder to appoint one of its own nationals as Chairman as well as the President. However, succumbing to that temptation (as happened in the case of the World Bank) may compromise the ability of the DFI to establish a genuinely regional identity and to be accepted by the rest of the region as a genuinely sub-regional (rather than a national) institution. The DFI for SADC should set new standards in the appointment process by placing emphasis on the ‘best person available for the job’ rather than resolving this issue on the basis of the usual political negotiations and compromise. Such processes invariably result in sub-optimal choices of candidates for institutional leadership and thus compromise the prospects of the DFI in fulfilling its mandate and expectations.

- *Voting Rights:* If voting rights in the subject DFI were strictly proportional to shareholding, and if the shareholding were confined to the members of SADC, no country apart from South Africa would have any say in determining the policies and actions of the sub-regional DFI. That would happen simply because of the overwhelming size of South Africa's ownership share on the basis of any pertinent criteria (see below). One difficult issue that will need to be confronted is that of constructing an acceptable formula for a *disproportionate* voting structure. Such a structure should be aimed at limiting South Africa's *voting* share in the DFI to no more than 45% or 49% of total votes (even if its shareholding on criteria based grounds exceeded that proportion by a large margin). Such a voting safeguard would require it to seek the agreement of at least one or two of the smaller SADC countries on policy issues and would avoid the risk of sub-regionalism being vulnerable to unilateralism on the part of the hegemon.

  Alternatively, a series of key matters could be listed in the Articles on which at least 85% of the total votes would be required thereby giving other shareholders a degree of veto (i.e. negative voting) power. A third option would be to divide the DFI's shareholding structure into two parts i.e. voting shares and non-voting shares. A fourth option would be to provide the smaller SADC countries with free voting shares in some proportion to their relative size vis-à-vis each other (excluding South Africa) and issue a sufficient number of such shares to reduce South Africa's voting share to the regionally desirable level. A fifth option would be to include non-SADC shareholders from the outset with the total SADC share being limited to no more than 55% of the total shareholding.

All of these options, and others, will need to be considered if a sub-regional DFI is to have genuinely sub-regional rather than unilateral decision-making. Otherwise it runs the risk of becoming simply another South African DFI with a sub-regional operating remit to which other countries subscribe capital without having any real say in determining its policies or in the management of its affairs. Of course a disproportionate voting structure would need to be voluntarily agreed to by South Africa in the first place - which may be a stumbling block to establishing such a DFI. Moreover a disproportionate voting structure would need to be unwound when the sub-regional DFI was eventually privatised, simply because private entities do not easily accommodate such structures. They are usually contrived for meeting political objectives and for inter-governmental convenience rather than for efficient decision-making purposes.

- *Advisory Council*: It is matter of choice whether the sub-regional DFI's Board of Directors should be augmented by a statutorily-required Council of International Advisers who would be ‘friends of the DFI’ in influential global circles and would help it with overall governance, enhance its image in global capital markets and provide it with a set of useful international connections. This device may be a useful mechanism for ensuring a degree of appropriate restraint being exercised by the Board of Directors in the absence of a Board of Governors. In a world which is globalising very rapidly, this is a device to which an increasing number of private corporations are resorting in order to enhance the quality of their corporate governance and to bring it up to international cutting edge standards. It is an option which is worthwhile for SADC policy-makers to consider without its being a mandatory feature in the Articles.

- *Standard of Value and Maintenance of Value Provisions:* Depending on the currency of denomination for the capital of the sub-regional DFI, the Articles would need to provide for standard-of-value provisions and maintenance-of-value provisions **if** (i) capital contributions were permitted in national or other currencies; and (ii) the currency of denomination itself were to fluctuate in absolute terms against another established standard - e.g. in the case of the IBRD and IMF the price of gold or, if the sub-regional DFIs capital was to be denominated in Rands, and there was a standard of value provision fixing the value of the Rand at a certain US dollar exchange rate as of the date of the institution's establishment. These problems can be avoided if capital is denominated in an international currency (US dollars) and shares are bought by all shareholders in that currency only. Such measures are also desirable to permit eventual privatisation of the DFI as and when that becomes a desirable option.

7.16 There are of course a host of other detailed technical issues which would need to be covered by the sub-regional DFI's Articles and Bye-laws. These include, *inter alia*:

- Subscription procedures and issue price of the initial shares;
- Divisions of and calls on subscribed capital;
- Limitations on shareholder liability to their capital and to their joint guarantees;
- Paying-in and settlement protocols for subscribed shares;
- Restrictions on the disposal, transfer or pledging of the DFI's shares;
- Strictures on the use of resources;
- Enunciation of general principles to guide operations and financial management;
- Protocols for dealings between member-shareholders and the DFI;

- Rights of the DFI to act in a manner which protects its interests;
- Specific conditions under which the DFI might extend financial facilities;
- Strictures on the use of those facilities by the borrower concerned;
- Loans to other DFIs in the region;
- Provisions for approval, commitment, disbursement and repayment of financial facilities extended by the DFI;
- Provisions for specific coverage of exchange risks;
- Provisions for meeting the liabilities of the DFI in the event of default or bankruptcy;
- Strictures on engagement in political activity;
- Establishment of specific committees (loan and investment committees, etc.);
- Conditions relating to dealings with other multilateral DFIs and organisations;
- Use of depositories in each member country;
- Eligible holdings of securities and currency for treasury/liquidity management;
- Rules governing publication/ dissemination of information made available to the DFI on a confidential basis;
- Statutory provisions; allocations of net income; and build-up of reserves;
- Suspension of operations and consequent settlement of all obligations;
- Provisions for the withdrawal or suspension of membership or the temporary suspension of membership rights;
- Settlement of accounts with governments ceasing to be members;
- Status, immunities and privileges accorded to the DFI with regard to judicial process, immunity of assets from seizure, immunity of archives and information; freedom of asset movements without restrictions; domestic taxation and to its Directors, management and staff;
- Arbitration and dispute settlement procedures and specification of jurisdictions to which the DFI may be subject in the event of legal action;
- Provisions and procedures for the amendment, interpretation and effectiveness of the Articles.

Shareholding

7.17 Covering all of the above issues in this report would be tantamount to drafting the Articles themselves. Such an attempt will be eschewed, as it is unnecessary and premature. What it is essential to focus on however are the criteria to determine relative shareholdings and the sharing of obligations across the different SADC members in establishing a possible sub-regional DFI. The broad basis and the general principles on which such proportions are established among countries in plurilateral or multilateral DFIs (and in burden-sharing for meeting the costs of the UN or its specialised agencies, programmes, conferences and funds), is sufficiently well established by now throughout the MDB community. But the specific techniques and formulae used to establish the shareholding of each member in each different DFI or entity are often different in each case. The end-results are as often the result of political negotiations rather than of objective criteria application resulting in skewed outcomes. Sometimes results are also skewed by special contributions which particular countries are willing to make to the ordinary or special resources of the multilateral DFIs. Moreover, the formulae used often tend to be rigid and inflexible so that they do not automatically reflect the changes that have occurred in the relative economic standings and weight of countries relative to each other.

7.18 In most cases, sophisticated and elaborate mathematical models have been built to undertake sensitivity analysis and to permit varying the weight of each variable or factor that is incorporated into the overall formula eventually agreed for establishing relative shareholdings and voting rights. This option could not be availed of in the case of this study because of time and budget constraints. Nor would the construction of such a model have been justified at this stage of investigation. Instead, what this study does is to provide an illustrative (and somewhat crude) basis of calculations for preliminary, indicative purposes. The results are sufficiently robust not to be affected by more than a margin of 10% each way around the mean percentages indicated. It is doubtful that very sophisticated modelling would yield substantially different results.

7.19 The main reason for that conclusion is the overwhelming economic weight of South Africa in SADC and consequently its equivalent weight in the shareholding of any sub-regional DFI. However, eventual resort to more sophisticated modelling will be essential to determine options for constructing a scheme of disproportionate voting rights among SADC countries in order to give the smaller economies a meaningful voice in the sub-regional DFI. Such modelling will be necessary if a decision is made by SADC's key decision-makers to proceed, even in principle, with establishing a sub-regional DFI.

7.20 The usual variables, which are included in determining the relative share of any country in a multilateral DFI, are the following:

- relative size of GNP/GDP and GNP/GDP per capita
- relative size of population
- relative holdings of international reserves
- relative size of total trade
- share of sub-regional, regional or world trade
- degree of trade dependence in GDP
- surpluses generated by special factors (oil, mineral or other such revenues)
- share in total sub-regional investment

The figures and ratios relating to the above variables are usually calculated using the latest available three-to-five year moving averages to smooth out the large annual fluctuations which occur in commodity and aid dependent economies. Using any one year's figures is likely to mislead and misinform judgements which need to be more resilient.

7.21 In SADC two particular problems arise in determining the relative proportionate shares of individual countries in a sub-regional DFI. The *first* is the relatively high share of unrecorded transactions that affect GDP, trade, private remittances, unrecorded private foreign assets, and capital flows by amounts of between 20-50% of recorded amounts. The degree of unrecorded distortions are probably highest in the case of the poorest economies so that relying on recorded figures to calculate proportionate holdings introduces an element of bias against them.

7.22 *Second,* there may be a theoretical/conceptual case for also applying *discount factors* in determining relative shareholdings in a sub-regional DFI. These discount factors might revolve around the relative and absolute extent of external debt and debt service and the relative/absolute dependence on foreign aid as a proportion of the budget, of imports and GDP. Yet, calculating and applying a discount would be contentious. Moreover, the discounts would tend to offset distortions caused by unrecorded transaction and both would affect the same countries. Also, it is unlikely that adjusting for either unrecorded distortions (which would require relying on guesswork) or for discount factors would result in more than very slight, marginal changes in perhaps increasing the relative shareholdings of Botswana, Mauritius and Namibia, while lowering by similarly insignificant amounts the shares of Mozambique, Tanzania and Zambia.

7.23 The likely determinants and outcome of eventual shareholdings across SADC countries in a sub-regional DFI are indicated in the table below which, for each of the variables shown, reflects average relative values for the 1994-96 period:

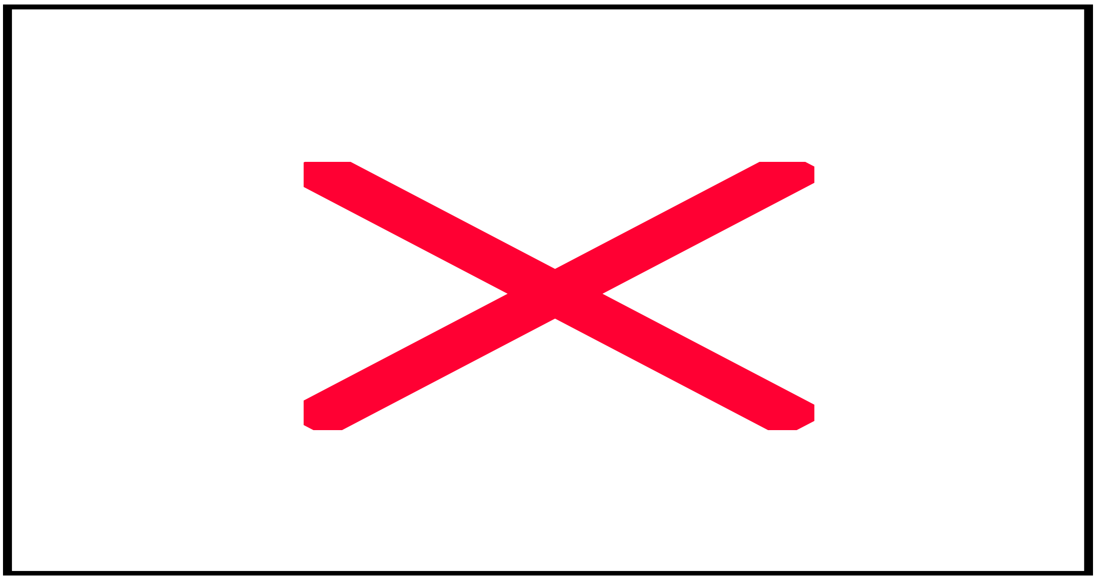
Table 7.A Sample determinants of Shareholdings in a Future SADC - DFI

(Percentages)

Country *Weight:*	*GDP* *30%*	*Popn* *+ 10*	*Rsvs* *+25%*	*Trade* *+20%*	*N. Inv.* *+15%*	*Share* *=100%*
Angola	6.02	7.86	2.08	9.27	8.30	6.205
Botswana	2.18	1.06	36.17	3.53	-4.62	9.777
Lesotho	0.49	1.47	4.72	4.53	3.85	2.961
Malawi	1.08	7.99	0.79	1.24	0.00	1.575
Mauritius	2.33	0.81	6.35	3.75	3.52	3.637
Mozambique	1.69	12.23	3.24	1.21	1.33	2.985
Namibia	2.02	1.11	5.03	3.37	4.22	3.276
South Africa	71.91	30.65	30.79	61.00	69.25	54.921
Swaziland	0.78	0.67	2.03	1.86	0.30	1.232
Tanzania	3.68	21.26	1.96	2.47	2.82	4.643
Zambia	2.13	6.78	1.93	3.02	5.02	3.148
Zimbabwe	5.71	8.11	4.91	4.76	6.01	5.603
SADC Total:	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

7.24 The above table is based on a relatively simple construct which weighs five key variables: GDP (30% weight), population (10% weight), international reserves (25% weight), total trade (20% weight) and net foreign investment (direct and portfolio - 15% weight) for all the SADC countries. These variables and weights are purely illustrative. The weights for each variable can, of course, can be changed to reflect any consensually agreed formula. The number and type of variables can also be made more sophisticated by adding other variables such as, for instance: the proportion of population in poverty in each country; foreign aid dependence; level of industrialisation (i.e. share of GDP accounted for by manufacturing); relative share of intra-sub-regional trade (which would weight the shareholding even more in favour of South Africa); treating FDI and FPI as separate variables with differentiated weights rather than an aggregated variable with a single weight; relative shares of intra-SADC investment; and net foreign assets (NFA). This last variable has been tested. It skews the results disproportionately in favour of Botswana and against other SADC countries, in particular South Africa, which has averaged *negative* NFAs between 1994-96 of nearly US$5 billion while Botswana had *positive* NFAs of a roughly similar average amount over the same period.

7.25 Clearly a more sophisticated matrix of variables and weights would need to be derived to test different variables and weights. But, the few sensitivity tests which have been undertaken on a rough-and-ready spreadsheet for the purposes of this study suggest that, using the most relevant variables and assigning weights within logically defensible boundaries (in terms of economic rather than political logic), the relative shareholdings across all SADC countries prove to be reasonably robust within the ranges shown below:



7.26 As the table above shows, South Africa would clearly dominate the shareholding in any SADC-DFI - with a share, using standard approaches, criteria and methodology, of between 50-58% of total equity. Botswana would be the next largest shareholder, mainly because of the weight attached to reserves. Its share of around 9% would be about 4% higher (at the expense of South Africa) if ownership of *net foreign assets* were to be taken into account. However, given its population and its relative share of the sub-region's economy and trade, even a 9% shareholding may appear high (especially relative to Mauritius and the other SACU economies). Botswana's relative share makes its position analogous to that of Saudi Arabia in the World Bank. Angola, Tanzania and Zimbabwe, with shareholdings varying in a narrow range between 5-7%, constitute the next tier in the pyramid. The seven countries making up the final tier have shareholdings stretching across a wider range from 1.5% (Swaziland) to 4% (Mauritius) and include Lesotho, Namibia, Malawi, Mozambique and Zambia in between.

7.27 Clearly, the shareholdings that might materialise in the event of a sub-regional DFI being established would be determined by political negotiations centred around available technical calculations. The figures in Column 4 of the above table have been shown to illustrate where such negotiations might conclude. No significance should be attached to these figures other than regarding them as guesswork on the part of the authors of this report. Needless to say the figures in Columns 4 and 5 are based on real GDP figures (the African Development Indicators series) without adjusting for differences in purchasing power parity (PPP). If 1993-95 average PPP figures were used instead (Column 2), there would be a small shift in the shareholding pattern. It needs to be emphasised however that the methodology for deriving PPP figures is subject to greater controversy than that used for deriving the standard series of indicators. In any event, resorting to available PPP figures in this instance would not make a large enough difference to shareholding outcomes to justify their use.

7.28 As observed earlier, the shareholding (and therefore the burden-sharing) pattern that emerges from the application of the basic tested criteria in multilateral DFIs would clearly necessitate a system of *disproportionate* voting if South Africa's clear majority was to be moderated to avoid the possibility of unitary rule. This pattern would suggest that at least 9% (and possibly up to 14%) of the votes associated with South Africa's shareholding should be reallocated to the other eleven countries in proportion to their shareholdings vis-à-vis each other. The resultant adjusted voting structure (again crudely calculated for illustrative purposes using a 9% reallocation) shown in the last column of the table above would bring South Africa's total voting rights down to 45% and increase the votes of all the other countries proportionately as shown.

Equity Financing of a SADC-DFI based on Indicative Shareholdings

7.29 Taking the indicative shareholding structure shown above as a guide, and assuming that the SADC-DFI in question is initially capitalised at around US$1 billion or (rounded out) at ZAR 5 billion, the resulting paid-in capital contributions of the different SADC countries are shown below. The assumption of a minimum capitalisation requirement of the US dollar and ZAR amounts suggested is based on the fact that the *effective net worth* of the two significant national DFIs in South Africa, IDC and DBSA, stood at about ZAR 8.2 billion and ZAR 4.8 billion respectively at the end of 1996. A sub-regional DFI would have little credibility if its initial capitalisation were significantly less than those amounts. The amounts shown in the table below are not insignificant, especially for South Africa, and questions would arise in all SADC countries, which are under budget constraints, as to whether such contributions for a sub-regional DFI represents the highest priority use of scarce resources at the present time.

7.30 If SADC member governments were determined to proceed with a establishing a sub-regional DFI, but could not afford to make budgetary contributions of the size indicated above, one possibility would be for them to use the capital assets which they have already invested and accrued (i.e. effective net worth) in their existing DFIs and pool these assets into a sub-regional DFI structure operating under a rationalised, unified management. In the case of South Africa, for example, the resources invested by the government in the DBSA - which are now nearly twice the amount indicated for South Africa's contribution in the table above - could be contributed to the core of a new regional institution built around the DBSA. Given the realities of shareholding distribution, that would effectively mean rationalising all the DFI assets and management in SADC under the leadership and direction of a major South African DFI - a proposition that might pose difficulties for SADC governments, assuming for the moment that the South African government was even willing to contemplate such an unlikely possibility.

7.31 Such an option, though theoretically feasible, will be more difficult to implement in practice than might initially be conceived. Apart from complexities regarding the determination of appropriate cross-exchange rates to be used in countries outside the MMA, intractable problems would arise in assessing portfolio quality, writing down or writing-off NPAs, valuing fixed assets, liquid assets and the residual (i.e. post write-down) loan and equity portfolios of these national DFIs in net present value terms. Even if it were politically acceptable or practicable, such an option would result in the sub-regional DFI performing national DFI functions and tasks as well. While that might eliminate one layer of development financing from the sub-regional system it would mean that many SADC governments would effectively be giving up sovereign control over development financing in their countries. That may be a rational step to take in economic terms. Whether it would be seen in the same way in political terms remains to be seen.

Table 7.C Contributions to Share Capital if a Future SADC-DFI was created

Country	*Assumed Share %*	*Capital Contribution with Capital of US$ 1Bn (in US$ mn)*	*ZAR 5 Bn (in ZAR mn)*
Angola	6.25	62.50	312.50
Botswana	9.00	90.00	450.00
Lesotho	2.50	25.00	125.00
Malawi	2.00	20.00	100.00
Mauritius	4.00	40.00	200.00
Mozambique	3.50	35.00	175.00
Namibia	3.25	32.50	162.50
South Africa	54.00	540.00	2700.00
Swaziland	1.50	15.00	75.00
Tanzania	5.25	52.50	262.50
Zambia	3.00	30.00	150.00
Zimbabwe	5.75	57.50	287.50
Total	**100.00**	**1000.00**	**5000.00**

Callable Capital and Guarantee Burdens to Secure Borrowings

7.32 In addition to their shareholdings in any sub-regional DFI that is set up, SADC governments will need to provide guarantees either for:

- *callable capital* if they decide to resort to the same separation of paid-in and callable capital that is now a feature of all the MDBs and the CDB; or

- for *borrowings* undertaken by the SADC-DFI if there are no built-in callable capital provisions which oblige the shareholders to protect creditors.

A capital structure which features callable capital (Mistry: 1995) with a 1:1 gearing ratio would provide a frame within which the SADC-DFI could borrow without having to seek guarantees for each borrowing. Callable capital would make it less expensive in cash terms for SADC governments to fund their subscriptions to the DFI's equity; but it would oblige them to meet a large contingent liability should the DFI run into financial difficulties.

7.33 In the case of SADC, a callable capital feature in the equity structure would, however, highlight the unfortunate reality that only three of SADC's twelve member countries are sufficiently creditworthy to underpin the borrowings that any sub-regional DFI might undertake. For that reason, this study takes the view that if a SADC-DFI is established, and its design is structured from the outset to facilitate its eventual privatisation, it would be preferable to avoid a callable capital feature.

7.34 In the absence of callable capital, a sub-regional DFI would require the joint and several guarantees of its members to support any borrowings its undertook. If such a DFI was empowered to make equity investments up to an aggregate amount of 50% of its paid-in capital and it had a gearing (debt/equity) ratio limit of 5:1 - i.e. enabling its aggregate outstanding borrowings, guarantees and contingent liabilities to exceed no more than five times its net worth - the free capital available to creditors in the event of liquidation would, at the limit, be constrained to one-tenth of the amount borrowed in the absence of guarantees. Few domestic or regional creditors would be willing to lend to a sub-regional DFI in SADC on that basis. On the other hand, long and protracted inter-governmental negotiations and parliamentary approvals would be needed if guarantees were to be provided individually for each borrowing that took place. A framework agreement among the SADC members (as an enshrined feature in its Articles of Agreement) would therefore be needed for the provision of joint and several guarantees by SADC members to underpin borrowings by the sub-regional DFI to the limit of its gearing ratio.

7.35 Joint and several guarantees effectively mean that each government would, in law, be obligated to meet not just its share, but also the full amount of outstanding obligations to creditors in the event of: (i) a repayment default by the sub-regional DFI; and (ii) the other joint guarantors being unable or unwilling to meet their share of the obligations. Clearly, in undertaking its operations and financing them with borrowings or by providing guarantees, the sub-regional DFI will only reach its debt/equity limit over a period of time. It is likely that a 5:1 limit will be reached over a period of 7-10 years at which time a new capital increase may be required (Table 7.D).

7.36 To provide an illustration of the rate at which contingent guarantee liabilities would accrue to the SADC-DFI's shareholders, it is assumed for simplicity's sake, that the borrowing build-up to the gearing limit occurs over 8 years allowing for gradual accretion of the DFI's net worth over that period of time. The table below outlines the individual obligations that would be assumed by each SADC member if its liabilities were shared on a joint basis, assuming no change in relative shareholdings over that period of time. The 'several' feature of joint and several guarantees would mean that, legally, each SADC country would also be responsible for the SADC-DFI's total outstanding obligation as well; and parliamentary approval may be necessary to ensure that each country could legally take on such large obligations.

7.37 The amounts shown in the table, though illustrative, indicate the possibility of significant annual increases in the guarantee liabilities of SADC members to support the borrowings of a sub-regional DFI, assuming that its operations grow at the assumed pace. If they did not, the question that would arise would be whether a sub-regional DFI was necessary in the first place. The build-up of liabilities shown below is significant in relation to total government expenditure in each country and would be significant relative to the borrowings of these countries from other MDBs, especially the World Bank and the African Development Bank.

7.38 That might raise other complexities regarding the *negative pledges* that these countries automatically make as borrowers under loan and credit agreements with those two preferred creditors. Such negative pledges require that, no collateral or security should be provided to other creditors by borrowers and, if such security is provided, then the MDBs should also be fully secured with senior collateral for their own exposure. Thus the assumption of such guarantee liabilities would impose a double burden from a budgetary (and possibly parliamentary) approval point of view even if such liabilities did not actually materialise.

Table 7.D Country Obligations to Support Borrowings of a Future SADC-DFI

(Millions of US Dollars)

Country	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
DFI Net Worth $B	1.00	1.10	1.17	1.25	1.33	1.42	1.52
Oust. Borrowings $B	0.00	1.00	2.00	3.00	4.00	5.00	6.00
Debt/Equity Ratio	0.00	0.91	1.71	2.40	3.00	3.52	3.95
Angola	0.0	62.5	125.0	187.5	250.0	312.5	375.0
Botswana	0.0	90.0	180.0	270.0	360.0	450.0	540.0
Lesotho	0.0	25.0	50.0	75.0	100.0	125.0	150.0
Malawi	0.0	20.0	40.0	60.0	80.0	100.0	120.0
Mauritius	0.0	40.0	80.0	120.0	160.0	200.0	240.0
Mozambique	0.0	35.0	70.0	105.0	140.0	175.0	210.0
Namibia	0.0	32.5	65.0	97.5	130.0	162.5	195.0
South Africa	0.0	540.0	1080.0	1620.0	2160.0	2700.0	3240.0
Swaziland	0.0	15.0	30.0	45.0	60.0	75.0	90.0
Tanzania	0.0	52.5	105.0	157.5	210.0	262.5	315.0
Zambia	0.0	30.0	60.0	90.0	120.0	150.0	180.0
Zimbabwe	0.0	57.5	115.0	172.5	230.0	287.5	345.0

Creditworthiness and Credibility of SADC Guarantees in Financial Markets

7.39 As indicated earlier, of the twelve SADC countries only South Africa has a confirmed credit rating by a recognized international rating agency. It has an investment grade rating (with a Moody's rating of Baa3 and a Standard & Poor (S&P) rating of BB+ for foreign currency debt and BBB+ for local currency debt) in the lower decile of investment grade paper. South Africa, which is classified by the World Bank as a *less-indebted middle-income country* (i.e. with an acceptable level of external indebtedness) has a roughly similar footing in international credit markets to Colombia, Greece, India, Indonesia, Poland and Tunisia. It is classified lower than Chile, China, Cyprus, the Czech Republic, Malaysia, Malta, Panama and Thailand. But it has a higher rating than Argentina, Brazil, Egypt, Mexico, Pakistan, the Philippines, Russia, Turkey and Venezuela.

7.40 The other two countries, which would also attract investment grade ratings, are Botswana and Mauritius. The former has not needed to borrow because of its large surplus reserve position while the latter has borrowed prudently in small amounts relative to its economy and international reserves. Botswana would probably be rated 3-4 grades above South Africa (probably at A-1 by Moody's and A+ by S&P) while Mauritius may be rated 1-2 steps above (probably at A-2 by Moody's and AA- by S&P). But in both cases such ratings would only hold for limited amounts of external borrowings before ratings began to slip because of over-exposure relative to the size of their economies and reserves.

7.41 Under the World Bank's stylised classifications, SADC member countries fall into four categories reflecting external indebtedness indicators shown in the following table:

Table 7.E The International Credit Standing of SADC Countries (1995-96)

(Percentages)

Country	*WB Class**	*EDT/GNP**	*EDT/XGS**	*TDS/XGS**
Angola	SILI	307.1	342.5	9.0
Botswana	LIMI	16.3	24.0	3.2
Lesotho	LIMI	44.6	108.8	6.6
Malawi	SILI	166.8	499.6	25.3
Mauritius	LIMI	45.9	75.0	9.0
Mozambique	SILI	443.6	1192.5	35.7
Namibia	LIMI	2.4	4.1	2.4
South Africa	LIMI	23.9	111.9	6.9
Swaziland	LIMI	24.0	24.2	2.2
Tanzania	SILI	207.4	585.2	17.4
Zambia	SILI	191.3	528.7	201.9
Zimbabwe	MILI	76.1	182.4	20.0

Notes : SILI = Severely Indebted Low-Income; LIMI = Less-Indebted, Middle-Income
MILI = Moderately Indebted, Low-Income; EDT = Total External Debt; XGS = Exports
TDS = Total Debt Service

7.42 An objective interpretation of the above table would suggest that Lesotho, Namibia and Swaziland should be the strongest rated (i.e. the most creditworthy) borrowers of all because of their inordinately low comparative debt ratios and their classification as *less-indebted, middle-income* countries. As was suggested in Chapter 2, however, that is not the case in reality. Unlike Botswana, which has established its own credibility over a sufficiently long-period of time, the three smaller SACU nations are seen as economies which are heavily dependent on South Africa for their incomes and exports.

7.43 Lesotho is almost entirely dependent on compensatory revenues from SACU, and remittance earnings from South Africa. Its income will increase as the Lesotho Highlands Project comes on stream but even that revenue will be dependent on South Africa. Swaziland is excessively dependent on income from a single commodity - sugar - and on access to the South African market. Namibia is developing a more independent economic and export profile, becoming more like Botswana in the process. But it needs to be recalled that Namibia's strong debt indicators are largely due to South Africa's unilateral decision to cancel all of Namibia's debt obligations to it.

7.44 Angola's and, to an extent, Zimbabwe's creditworthiness are perhaps lower than they might be (given their obvious economic and export potential) mainly because of market perceptions about the impact of domestic politics on their economic prospects. The other four economies (Malawi, Mozambique, Tanzania and Zambia) are only just beginning to emerge from a state of prolonged over-indebtedness. They have resorted to extensive and repeated debt rescheduling, restructuring and cancellation and still remain excessively indebted to preferred creditors (i.e. the World Bank, IMF and the AfDB) thus making it risky for commercial creditors to increase their exposure in these countries at the present time.

7.45 For that reason, the ability to support any external or regional borrowings undertaken by a sub-regional DFI in SADC would rest heavily on the three creditworthy countries and, to a limited extent, on Zimbabwe's intermediate creditworthiness, providing that is not eroded over the coming years. That reality makes the financial viability of a sub-regional DFI in SADC heavily dependent on the political views and proclivities of these three countries, and the willingness of their leaderships and populations to use their creditworthiness 'headroom' for the benefit of neighbouring countries in SADC. Given their domestic pressures, problems and priorities it is not obvious that any of these three countries would be enthusiastic about supporting the establishment of a new sub-regional DFI which depended so heavily for its resource mobilisation capacity on so asymmetric a distribution of credit-bearing capacity.

7.46 That situation could, of course, change over the coming years if peace were to become more firmly established in Angola and economic recovery in the larger, populous countries of the region were to be sustained; with resultant changes in market perceptions about their economic prospects and their creditworthiness. But, until that occurred, the political under-currents in a sub-regional DFI - which depended so heavily on the creditworthiness of only three of its twelve members - would be inherently unstable. The DFI would be subject to political and managerial capturing by these countries, and could become alienated from its client base in the poorer countries. It is difficult to see how, under such circumstances, sub-optimal outcomes in the management, operations and finances of a sub-regional DFI could be avoided. Finally, it has to be remembered that the three creditworthy countries in SADC also have *national* DFIs, which are financially strong, in relative, if not in absolute terms. Thus they are much less dependent on the establishment of a sub-regional DFI to augment either the funding or the institutional capacities which they already possess. The situation is of course the opposite for the other nine countries whose national DFIs, where they exist, are in a financially precarious situation and whose institutional capacities have been severely damaged.

Board and Management Responsibility for a Sub-regional DFI

7.47 A sub-regional DFI with a shareholding structure in which South Africa, by virtue of its economic size, was overwhelmingly dominant would be subject to having that dominance reflected in its Board, management and staff; if not initially, then certainly over the long-term. Moreover, most of the *intra-regional* borrowings of a SADC-DFI would, in all likelihood, be raised in South African bond markets with smaller amounts perhaps being raised in Botswana, Mauritius, Namibia and Zimbabwe in the foreseeable future. The bulk of the borrowed resources would, however, probably come from international capital markets as observed earlier. A South African shareholding larger than that of the combined shareholding of the other eleven SADC members, coupled with dependence on South Africa's markets for resource mobilisation, would inevitably result in a sub-regional DFI with a South African complexion and views influencing the way in which the institution functioned. That would be true even if non-SADC shareholders were to participate in the shareholding of the institution from the outset. Given South Africa's advantage in possessing a surplus of the skills and support services that such an institution would need, and the distinct possibility that such a DFI, if created, would probably be located in South Africa, that outcome would be inevitable in any event.

7.48 There is, of course, nothing inherently problematic about such an outcome. But would it be politically palatable to the other eleven SADC members? Moreover a question arises about whether another quintessentially South African DFI needs to be created to serve SADC, when South Africa already has several DFIs almost all of which are capable of playing a wider regional role at relatively small marginal cost in economic and financial, if not in political, terms.

7.49 If South Africa's influence in a sub-regional DFI was to be diluted to permit a genuinely SADC flavour to percolate through the institution then, as has been the case with other multilateral DFIs which have one or two dominant shareholders, conscious policies would need to be pursued to ensure a *disproportionately larger* representation of Directors, senior managers and staff from other SADC countries. Their professional cultures and operating styles would be different and management would face the problems that all MDB management have faced (without ever having fully succeeded) in fusing them within a unified single and distinct corporate culture and identity. Trade-offs would need to be made between qualifications and nationalities (or even sub-nationalities) which would inevitably affect staff perceptions, staff morale and organisational effectiveness.

7.50 The task of creating an effective sub-regional DFI in these circumstances is certainly not impossible. It has had to be confronted and surmounted in other instances in other MDBs, other regions and sub-regions. But those problems have not been resolved overnight. In many MDBs they continue to persist and to affect adversely organisational effectiveness and performance. It would be naive therefore to underestimate or trivialise the difficulties that will be confronted by the management of any new sub-regional DFI in dealing with these issues. Indeed the prospects of a productive outcome would be enhanced considerably if these difficulties were acknowledged up-front, and discussed and resolved through consensus within the sub-region transparently and candidly.

7.51 Though possible, it would be premature at this early stage to specify in any detail the Board and management structure for any future sub-regional DFI until SADC members have made greater progress toward deciding to proceed. The obvious Board structure that suggests itself for a SADC-DFI would be a 14-member Board with one Director representing each member country, a Chairman representing the interests of the institution and the sub-region as a whole as its thirteenth member, and a President / Chief Executive Officer (CEO) as the fourteenth. To enhance the standing and profile of the DFI in regional and global financial markets the Chairman and the CEO should of course both be established figures who are well-known in the sub-region's and international financial systems. As with all organisations of this nature, the CEO would need to be supported by a top executive team comprising a chief operating officer (COO), a chief financial officer (CFO), a chief legal officer (CLO), a chief administration officer (CAO) responsible for the development and safeguarding of the institution's human and administrative resources, a chief information technology officer (CITO) and a corporate secretary to deal with Board and member-country relationships on virtually a full-time basis.

7.52 Bearing in mind the intended focus of a sub-regional DFI on promoting and financing regional projects which knit the region's infrastructural and industrial sinews together in a tighter weave, its organisational structure for *operations* would need to be governed by the demands of sector and sub-sector investments across countries rather than by the national demands of development financing in each country. Thus the SADC-DFI's operational organisation would need to cater to the needs of:

- *sub-regional infrastructure,* with units specialising in power, telecommunications, transport, and construction, and with each of these areas having sub-units which specialised even further into individual sub-sectors (e.g. under the transport directorate, specialised units would be needed to deal with sub-regional investments in roads, railways, air transport, sea transport, and pipelines);

- *sub-regional industry* with units to deal with regional mining and mineral beneficiation, heavy industrial projects - steel, cement, glass, chemicals petrochemicals, plastics, etc. -

capital goods manufacturing and large regional-scale plants for manufacturing transport equipment and appliances; and

- *special sub-regional projects* such as for example land mine clearance and land rehabilitation in Angola and Mozambique;

- *sub-regional privatisation*: Apart from helping to finance new investments in the above three major areas, a sub-regional DFI would need to organise itself for dealing with the politically contentious and financially complex issues of privatisation in these sectors and developing internally the array of special skills required for that purpose.

Eligibility and Allocation Criteria and Prudential Exposure Limits

7.53 In mobilising and allocating financial resources, a sub-regional DFI would need to deal fairly with, and pre-empt, concerns about the allocation of its resources across: SADC member countries, specific sectors and sub-sectors, and the consequent portfolio risks that it exposes itself to. Of course it could avoid having formal criteria for country/project eligibility and for the annual/cumulative allocation of its funding facilities. It could simply finance any worthwhile project that came to its attention or promoted by it. But that approach might result in a concentration of exposure in the larger and richer countries of SADC. These, by definition, would have a larger number of projects with sub-regional dimensions (especially where industrial projects are concerned) to be financed. In the type of situation which SADC finds itself in, and given the raison d'être for considering setting up a sub-regional DFI in the first place, it is difficult to see how the derivation and application of formal eligibility and allocation criteria could be avoided. In that event, what should such criteria be?

7.54 Unlike the global or regional MDBs, a sub-regional DFI in SADC would not be lending primarily to *countries* on a sovereign risk basis but to specific *project entities* (i.e. public or private corporations or their subsidiaries). To the extent that its lending was to *public* corporations that were not financially independent of governments - i.e. did not have autonomous control over their own unencumbered net revenue streams which could be attached or garnered to meet debt-servicing obligations - some of the eligibility criteria developed by other MDBs for *country borrowers* might need to be applied. The usual criteria which are applied to determine country eligibility are: (i) creditworthiness and the ability to service incremental debt obligations; (ii) access to other sources of funds for the same purpose; (iii) debt servicing track-record; (iv) vulnerability to external shocks which might affect the borrower's ability to service debt; (v) the quality of economic management; and (vi) actual economic performance over the last 3-5 years.

7.55 Usually a sixth, *poverty*, criterion is also applied by MDBs to channel more of their concessional resources to the poorer countries; but that criterion might not be relevant in the case of a SADC-DFI unless it intermediated concessional funds provided by donors. The age-old unresolved dilemma that exists in applying country eligibility and allocation criteria is whether MDBs (or sub-regional DFIs) should reward good performance by increasing the amount of funds allocated to successful countries; or whether a *poverty bias* in allocation decisions results in perverse incentives by directing scarce resources to countries which are poor *because of* a record of poor economic management and performance and which are incapable of utilising resources efficiently.

7.56 A SADC-DFI which was dependent on mobilising non-concessional funds from capital markets - rather than concessional funds from donors, in which event it might have a different orientation and complexion - could not afford to lend *on a sovereign risk basis* to the six countries of the sub-region that are presently eligible only for access to the soft windows of the major MDBs: i.e. Angola, Lesotho, Malawi, Mozambique, Tanzania and Zambia. It could lend only to the five SADC members eligible for the non-concessional resources of the MDBs: i.e. Botswana, Mauritius, Namibia, Swaziland and South Africa; and those eligible for a blend of the two types of resources i.e. Zimbabwe. However, sovereign risk lending is unlikely to be the main business of the SADC-DFI except to the extent that lends to parastatals.

7.57 Taking these considerations into account it would, nonetheless, be wise to apply allocation criteria that resulted in limiting the SADC-DFI to having: (i) no more than 25% of the outstanding portfolio of the SADC-DFI exposed in any one country; and (ii) aggregate outstanding exposure in any single borrowing country being limited to no more than 5 or 6 times the relative share of the DFI's accumulated net worth, subject to the overall portfolio exposure limit of 25% being respected. Obviously, the second limit would apply only to countries other than South Africa whose share in any SADC-DFI would be well in excess of the first limit. The operational and financial implications of these two prudential criteria would need to be explored further at the detailed feasibility study stage in the event of a decision being made to proceed with a SADC-DFI.

7.58 The main business of the sub-regional DFI is likely to be in the area of *project finance* i.e. lending for projects with sub-regional dimensions and lending against assets and net revenue streams which can be isolated and attached. Country eligibility and allocation criteria will obviously play a role in guiding policy and managerial judgements about the prudential limits on total exposure for projects within any country, no matter how sound the projects financed in that country are. But, a sub-regional DFI will need to have eligibility and allocation criteria for the *projects* it finances as well. If the SADC-DFI is to be financially self-sustaining and viable over the long-term, it will be restricted to financing mainly those private and public projects which generate independent cash flows which are not channelled into government budgetary revenues unless they are in the form of after-profit and after-tax dividends. Such projects will need to be technically, commercially, financially and economically feasible, viable and profitable.

7.59 The specific rate-of-return tests to determine viability on each of these frontiers should be left to the management of the SADC-DFI to decide. These cut-offs should be set sufficiently above the domestic financial cost of capital (in the case of financial returns) and above the real opportunity costs of capital (in the case of economic returns). Projects which may be economically viable and attractive but financially dependent on budget support (e.g. public investments in primary education or primary rural health) should not be financed by a sub-regional DFI unless it is intermediating soft funds. Projects in the social sectors should be eligible for funding if they met private financing tests e.g. investments in private universities, special training schools, or hospitals which meet sub-regional (as opposed to only national) needs and are run on commercially viable lines.

7.60 As with prudential criteria to limit country risk exposure, a sub-regional DFI would need to be guided by limits on sector risk expossure as well, through criteria which limited covariant or cyclical risks as well as the concentration risks involved in lending too large a proportion of the total portfolio to particular companies and/or groups of companies engaged in similar types of activity.

7.61 For the purposes of discussion and further consideration by SADC's policy-makers in the event of a decision being made to proceed with a sub-regional DFI, the following criteria might be considered:

- the SADC-DFI should not finance (through loans and equity) more than 30% of the total cost of any single project;
- it should require that the debt/equity ratio for projects it finances is less than 3:1;
- no single *sector* (a term that would need to be carefully defined) should account for more than 15% of the SADC-DFI's outstanding exposure at any time;
- loan exposure in a single project or to a single company should not exceed 5% of the outstanding portfolio;
- loan exposure to any conglomerate or group of associated inter-linked companies should not exceed 10% of the outstanding portfolio;
- total equity exposure in a single company should not exceed 5% of the DFI's net worth;
- equity exposure to companies within the same group should not exceed 10% of the DFI's net worth; and
- total loan and equity exposure in *public enterprises* across the region should be limited to no more than 50% of the SADC-DFI's total loan and equity portfolio.

7.62 Criteria of this nature would serve a dual purpose. *First*, they would ensure dispersion of the sub-regional DFI's funds over a wider range of activities and countries and would avoid excessive concentration of resources in any one country thus accommodating concerns about fair distribution of resources across the sub-region. *Second*, they would contain the overall risks that a sub-regional DFI would be exposed to, thus strengthening its financial position. But the discussion of eligibility and allocation criteria in this section should be kept in perspective. Though required under the ToR, it is a discussion that is premature. It becomes relevant only in the event of a decision being made to proceed with establishing a sub-regional DFI and should not be interpreted as pre-judging or pre-empting such a decision.

Sources of Funds for a Sub-regional DFI

7.63 As alluded to earlier, a sub-regional DFI may be a more attractive borrower - from the viewpoint of potential *private* markets for funds - than are national DFIs in countries other than Botswana, Mauritius, South Africa. It is possible that private sources of funds might also consider lending smaller amounts to national DFIs in Namibia and Zimbabwe under specific conditions. This judgement would need to be tested at a later stage. But at the present time it would appear from preliminary soundings on a hypothetical basis, that providing a sub-regional DFI's direct borrowings or bond issues were backed by the guarantees of SADC's creditworthy countries, such sources of funds might include:

- SADC capital markets in South Africa and, to a more limited extent, from special sources of funds in Botswana and Mauritius;
- capital markets in Asia (Japan, Hong Kong, Malaysia and Singapore);
- the euro-currency capital market in London and other European centres; and
- syndicated loans from regional and global commercial bank consortia.

7.64 Bond-issues by a sub-regional DFI on regional or international capital markets are unlikely to attract maturities of much longer than five years in the initial rounds except at a fairly high premium. That may result in a funding and term transformation risk being incurred if the SADC-DFI needs to finance long-gestating projects with facilities requiring long periods of interest capitalisation and even longer maturities. However, it is possible that the maturity on international bond issues could be lengthened through structured World Bank or AfDB guarantees or other tailored credit enhancements to provide capital markets with the degree of comfort necessary to assume longer term risks.

7.65 It is less clear that a sub-regional DFI would be regarded as an attractive borrower for direct lending by either the World Bank or the African Development Bank in light of their experience with lending to DFIs in general and to African sub-regional DFIs in particular. Both these institutions are moving away from financing DFIs to financing broader local and sub-regional capital market development. Moreover, these MDBs and, in particular the AfDB, might well take the view that, when it comes to financing sub-regional projects in Southern Africa, the AfDB could be involved directly without the need for a sub-regional bank. Rather than introduce a fourth tier of publicly-owned DFI at the sub-regional level - between the global, regional and national DFIs that already operate in SADC - the World Bank and AfDB would, at this juncture, prefer to see the development of private sector and capital market capacity to undertake cross-border project financing in Southern Africa building on the private financial institutional infrastructure and capacity which already exists.

7.66 However, it is possible that other multilateral sources of funds - in particular the European Union and the European Investment Bank - may favour supporting the establishment and funding of a SADC-DFI. For their own reasons, and based on their special experience in Europe, these sources of funds may believe that an institution similar to the EIB is a necessary component of the sub-regional institutional infrastructure that southern Africa needs to bring achieve progressively closer integration.

7.67 That belief may also be shared by some bilateral official sources of funds (European aid agencies, export credit corporations and bilateral investment companies) that might find it easier to deal with a single sub-regional DFI that is capably managed than with a plethora of smaller national DFIs. Sources of aid funds may enable the sub-regional DFI to incorporate a soft-window in its structure as an intermediary for concessional bilateral or EU funds to be deployed for sub-regional developmental purposes. This particular possibility needs to be specifically explored by SADC governments with the EU and with individual European governments at a fairly high policy level in order to obtain a more accurate assessment of its likelihood.