CHAPTER 8 INSTITUTIONAL OPTIONS FOR MEETING REGIONAL DEVELOPMENT FINANCE NEEDS

Introduction

8.01 Institutional options for ensuring the availability of sufficient development finance at the sub-regional level were considered in 1992-93 when SADC became a development community before South Africa joined. The AfDB Study (1993) cited earlier briefly reviewed four options for the provision of sub-regional development finance in SADC. It did so at a time when private sector financing and co-financing possibilities were less developed than they are now.

8.02 The Phase I Report for this research project looked into the same issue in mid-1996. Its conclusion was that the case for making special development funding arrangements in SADC was not strong. The Report felt therefore that it was not worth exploring institutional options further. The basic conclusion of the Phase I report is borne out again by the more detailed study that has been undertaken in Phase II. Nevertheless, to meet the requirements of the ToR this chapter looks into the institutional options which SADC policy-makers might consider if they decide to proceed with a sub-regional DFI. In the process of so doing, one option has emerged that is worthy of serious consideration.

The Main Options

8.03 The three options (a to c below) considered five years ago by the AfDB study involved creating sub-regional development financing capabilities by:

(a) converting an **existing institution** to serve the sub-region, using either the PTA/COMESA Bank or the DBSA as the core;
(b) creating an entirely **new institution;**
(c) creating a **sub-regional network** of national DFIs - after restructuring and strengthening them financially with the DBSA as its hub; and
(d) a fourth option (independent, or an adjunct to the others) is: establishing a **SADC Development Fund or Financing Facility** (or different debt and equity funds for infrastructure and/or industrial financing in SADC) to be administered by an existing institution on behalf of all SADC members.

8.04 Clearly in this study, building a sub-regional DFI around the COMESA Bank was not considered a relevant option to pursue since it was not a SADC institution. In any event, the AfDB Study had already concluded that the COMESA Bank would not provide a viable core around which to develop sub-regional capabilities based on its undeveloped and untested institutional capacity. Moreover the ‘sub-region’ for a DFI centred around the COMESA Bank would be much larger (and riskier) an environment than SADC. It would embrace a number of countries that had, for a variety of reasons, become economically unviable. For those reasons, this chapter focuses on the other options.

8.05 It should be acknowledged *en passant* that in considering the four options outlined above, some thought was given initially to the possibility of a DFI from a country other than South Africa (more particularly one of the DFIs from Botswana, Mauritius or Zimbabwe) being considered as the ‘core’ of a future sub-regional institution. A quick, preliminary examination of the capacities of these institutions suggested that none of them had the capabilities (financial, technical, analytical, human resource or information technology) equivalent to those possessed by DBSA. On the basis of that evaluation, that would in all likelihood be substantiated by deeper study, it was decided to concentrate on DBSA and, cursorily, the South African IDC, as the only serious contenders among extant national DFIs for playing a wider sub-regional role.

Option 1:   Converting DBSA into a Sub-Regional DFI

8.06 If SADC's member governments concluded that a sub-regional DFI would be a useful institution to have, the most expedient option would be to build around the DBSA which already exists as a major South African DFI with an established record. Unlike the IDC an inherent sub-regional orientation has been embedded in the institution's psyche from the outset. In considering this option careful analysis was undertaken of the advantages, disadvantages and other issues which may affect its viability.

8.07 The *advantages* of building sub-regional development finance capability around the DBSA would be the following:

- DBSA already exists; therefore no new institutional structure, with its attendant (and unnecessary) additional administrative costs would need to be created specifically for SADC.

- Using DBSA would avoid the problem of sub-regional institutional proliferation and competition within SADC. It would pre-empt protracted negotiations among SADC governments about where a sub-regional DFI should be located.

- DBSA's post-transformation *national* mandate is aligned with what the mandate and operating principles of a sub-regional DFI might be, i.e.

  * independent, autonomous operation guided by the institution’s Board and management;
  * a financial structure capitalised but not sustained by the state;
  * maximising the development impact of public and private sector resources and not crowding them out;
  * opening up markets and assuming clearly defined risks which only a public institution could take because the private sector would be unlikely to take such risks at the present time; and
  * acting as a bridge between public and private capital so as to expand spatial and sectoral activities in the market

- DBSA has an established operating track record in financing ‘sub-regional’ development within South Africa's provinces and at local/municipal levels. The development problems and capital financing needs of South Africa’s provinces and local governments are not dissimilar to those of other countries in the region.

- It has a capable management and professional staff structure and is a repository of the human and technical skills of the kind needed to address SADC's development financing challenges. Widening its operating ambit to the SADC sub-region could be achieved almost immediately on a marginal rather than full cost basis.

- DBSA has experience of cross-border sub-regional development financing in SADC through its role in the Lesotho Highlands Water Project, its support in developing the Maputo Corridor (involving Mozambique) as well as the Maguga Dam Project (involving Swaziland).

- DBSA is in a good position to mobilise for sub-regional purposes the skills of other DFIs in South Africa - e.g. the IDC as well as South Africa's other specialised DFIs: i.e.

the Agricultural & Land Bank, the SBDC and Khula and the National Housing Finance Corporation;

- It has considerable experience with resource mobilisation in domestic and international capital markets having issued DEM bonds in the German market and borrowed from the Japan EXIM Bank and EIB. It is now a recognised name in these markets and establishing its reputation as a credible sub-regional borrower would not be an issue.

- It already possesses the specialised financial engineering and packaging skills that a sub-regional DFI in SADC would need to develop and has considerable experience of working with other sources of funding, both official and private.

- DBSA has done extensive policy research and analysis of regional issues in SADC. It has developed a strong base of knowledge on sub-regional integration, particularly in the areas of trade, finance and investment through its Southern Africa Programme. It has often supported the SADC Secretariat and South African government agencies with assistance in examining specific sub-regional issues concerning SACU and SADC.

- Its Centre for Policy and Information has come to be recognised as one of the sub-region's more influential centres of analytical work on regional (SADC and SACU) issues. That capacity could be developed and used for wider sub-regional purposes at only a small incremental cost.

- DBSA has established sound working relationships with the two major MDBs - the World Bank and AfDB. Those relationships provide it with a special advantage as a SADC interlocutor-cum-intermediary in working with these two MDBs on sub-regional issues.

8.08 This array of arguments in favour of building regional capabilities around the DBSA appears sufficiently overwhelming to suggest disregarding the other options. But these advantages notwithstanding, there are also *disadvantages* and other issues (discussed below) to be considered before concluding that using DBSA as the fulcrum of development finance in SADC would be optimal. These include the following:

- Despite its *latent* sub-regional operating potential DBSA is essentially a South African DFI with a history of being an apartheid institution. Although irrelevant to the future of the institution that has emerged after the transformation of 1995-96, that history still has a bearing which cannot be completely ignored.

- Because of its history, DBSA remains in the nascent stages of evolving from being an *extension agency* of central government, operating at the provincial and local level, into an independent DFI with the ‘normal’ characteristics of national DFI's in other parts of the world.

- Though substantial, DBSA's balance sheet is a remnant of its inheritance. The Government of South Africa is now its sole shareholder and equity capital provider. At the same time, it is also the final obligor in maintaining the integrity of DBSA's loan portfolio - i.e. central government is DBSA's ultimate borrower in the event that intermediate levels of provincial and local government (which are the putative borrowers) default on their obligations.

- Thus DBSA is, in essence, a round-tripping vehicle being used by central government to leverage its capital and finance (and monitor) provincial and local/ municipal governments, and their respective development finance corporations, at its own ultimate sovereign risk.

- Neither DBSA's internal sources nor its users of capital funds are therefore genuinely independent and distinct from each other. DBSA is thus effectively ‘intermediating’ and augmenting resources within a closed system of public and quasi-public finance. Within that system only its external creditors and private providers of funds from the domestic market are independent agents at arms-length. In lending to DBSA, they are taking a sovereign South Africa risk, not a clean DBSA institutional risk.

- DBSA is, at present, taking neither a capital risk nor a portfolio risk. Those risks are being borne indirectly by the government of South Africa. In that sense DBSA is structured more like a global or regional MDB and not like a national DFI. That may be an argument in its favour from one viewpoint, but it is also a contra- argument given the way that the discipline of development finance is evolving.

- In a strict constructionist sense, DBSA continues to perform financial *agency* functions for the central government in lending to, and monitoring the capital expenditure performance of, provincial, local and municipal governments. It is not intermediating between independent sources and users of funds at its own risk. Nevertheless, it is providing useful project appraisal, financial engineering and resource mobilisation functions to augment the budgetary resources available to central, provincial, and local governments, and their entities - by involving private and other sources of funding in the projects to which it lends.

- For these reasons, DBSA may be seen by the government of South Africa as a unique national asset, and a special purpose public financing vehicle (rather than a DFI per se), created and transformed for the purposes of leveraging (through development financing) *internal fiscal transfers* between central and other levels of government.

- As such the government of South Africa may be unwilling to offer DBSA to SADC as a core around which a sub-regional institution might be built; mainly because it would then need to deal with the difficult question of whether DBSA would be able to handle its internal leveraging and external development financing roles simultaneously without actual or perceived conflicts-of- interest arising between those two separate and distinct roles.

- By the same token, of course, if SADC governments agree that a sub-regional DFI is needed, then using the DBSA as a core would save the government of South Africa the need for making a large additional fiscal commitment to a new institution. The DBSA option would allow the government to utilise the public resources that have already been invested in the DBSA as its contribution to a sub-regional DFI.

- This ‘no-additionality’ option has the added advantage of the government also utilising its existing institutional infrastructure for a wider sub-regional purpose without going through the laborious process of creating a new organisation with the problems and costs which that will entail.

- DBSA has been assigned a *specialised* sectoral role as an *infrastructure financing institution* in order for it to fit within the framework of the very complex and elaborate post-apartheid development financing system that has evolved in post-apartheid South Africa. Within South Africa DBSA finances small and mid-sized reticulated infrastructural projects.

- Large infrastructure projects in power, telecommunications and transport are financed directly by independent sectoral utilities and institutions such as Eskom, Telkom, and Transnet working with the larger local and international commercial and investment banks without necessarily involving DBSA. For example, DBSA was not involved in the partial privatisation of Telkom which recently took place.

- Paradoxically, however, at the *sub-regional* level DBSA is involved with mega-projects such as Lesotho Highlands Water and the Maputo Corridor in which agencies like Eskom, Telkom and Transnet are not directly involved as the project sponsors or promoters.

- DBSA's specialised role as an infrastructure financing institution is well-suited to meeting the challenges of sub-regional development finance; which is likely to be required mostly for sub-regional infrastructure. Yet it limits DBSA from playing a wider role unless its *sub-regional* remit is specifically enhanced.

- Widening DBSA’s operating remit for SADC projects *outside* South Africa may be incompatible with confining its operating remit *inside* the country. That duality will introduce an uncomfortable tension *within* DBSA as well as *between* DBSA and its DFI cohorts in South Africa.

- DBSA's history, structure, operating experience and institutional interests have been sub-regionally oriented and inclined from the time of its establishment. Yet, its sister DFI - the IDC - also has the resources and ability to play a sub-regional role, although it has not been specifically geared to (nor does it seem particularly interested in) doing so.

- Following its post-apartheid transformation, IDC's remit is to finance *industrial* projects within South Africa. But, if the Mozal (Mozambique Aluminium) smelter project is a precursor, IDC might also become involved in financing similar projects in SADC thus becoming a second serious contender for providing industrial development finance to the sub-region as well.

- For example, IDC is conducting a feasibility study (financed by USAID) for a project - involving the production of iron through direct reduction - located in the north-eastern part of South Africa. The possibility of using Mozambican gas (from Pande) as a reductant is being considered. If that proves feasible IDC might finance a gas pipeline from Pande to the project site. The ferro-project would thus become another integral sub-regional project.

- IDC is also closely involved in SACU negotiations for a new arrangement through the Customs Union Task Team (CUTT). It has been involved in researching a more equitable revenue sharing formula and in evaluating the impact of a SADC-FTA on SADC's different members.

- Its present operating remit precludes IDC from infrastructure financing of the type DBSA undertakes. That dividing line between IDC and DBSA is an artificial one, peculiar to South Africa's historical circumstances. It does not make economic sense in any domestic environment. Nor does it make any sense in a sub-regional one. The demarcation between DBSA and IDC is the outcome of respecting the separate identities of the two institutions and the politically determined boundaries between them as these have evolved. It has not been guided by the dictates of economic and financial rationality.

- DBSA has an established institutional culture, identity and management structure, which has been through the trauma of one post-transformation rationalisation and re-organisation in 1995-96. Another transformation to embrace a sub-regional role in 1998-99 will provide a second shock to a senior management and staff structure, which has not yet begun to come together. It will not be easy for DBSA to accommodate and absorb new staff from other SADC countries at all levels of its managerial hierarchy and to undertake a sudden organisational expansion after a sudden contraction without stretching the resilience of the institution to its limit.

- Similarly DBSA's Board, which is presently a domestically oriented entity, will need to be restructured to accommodate Directors representing all SADC countries. Unless accomplished with sensitivity, to avoid the bureaucracy and rigidity associated with such board structures in global and regional MDBs, such a change runs the risk of making DBSA less efficient and effective than it might otherwise be at the sub-regional level.

- In a similar vein, DBSA also has an established capital structure (as well as extant domestic and international liabilities) into which new shareholders would have to be accommodated. That may raise as many problems with negotiating the value of its shares, and the pricing of entry for new shareholders, than would an entirely new capital structure. Such a valuation and pricing exercise would, of course, not be impossible to undertake. But it would raise issues and complexities of a different order of magnitude than would arise with the creation of a new DFI with a new capital structure.

- DBSA's effective equity capital base and net worth (including the development fund and accumulated reserves) presently stands at nearly ZAR 5 billion. If other SADC members were to be brought into that size of capital structure along the lines suggested in Chapter 7 earlier, the total capital of the institution would need to be increased to ZAR 9 billion with the additional ZAR 4 billion being contributed by other SADC countries - an amount nearly twice as large as might be necessary at the present time.

- By coming into DBSA's existing capital structure, the other SADC countries would assume their proportionate share of DBSA's existing external liabilities amounting to about ZAR 450 million equivalent and Rand liabilities of ZAR 1.1 billion - unless special (and unduly complex) financial arrangements were made to segregate the existing portfolio and liabilities, from DBSA's new portfolio.

- By the same token, unless special arrangements were made, other SADC shareholders would also be taking their share of proportionate risk on DBSA's existing loan and investment portfolio of about ZAR 6.2 billion which represents loans outstanding to various government entities and public financial corporations in South Africa.

- The financial implications of sub-regionalising DBSA are of a variety frequently dealt with in the private sector when financial entities are taken over, merged or involve the entry of new shareholders. They are much less typical - virtually unprecedented on this scale - when they involve bringing new government shareholders into an institution previously owned by a single government.

- Global and regional MDBs have well-established rules, protocols and share valuation procedures to accommodate the entry of new members. These have been worked out and time tested. But such arrangements have been built into the basic design of the institutions concerned. That is not the case with DBSA.

- If the option of converting the DBSA into a sub-regional DFI is seriously pursued by SADC governments there can be no question that contentious financial complexities will arise; but they can be dealt with and resolved if the political will exists to find the right solutions.

Option 2: Creating a New Sub-Regional DFI for SADC

8.09 Logically, the advantages/disadvantages of establishing a new sub-regional DFI are the obverse of the disadvantages/advantages of utilising an existing *national* development financing institution as a core around which to build *sub-regional* capabilities. To recapitulate the advantages of a new DFI briefly for the record:

- A new DFI would start with a clean slate and have no historical baggage for shareholders to carry. It could be capitalised at the right level and would raise no complicated issues concerning the valuation or pricing of its shares.

- Its capital structure could be consensually agreed to accommodate the interests of all shareholders. That could be done on a basis more relevant to the development financing challenges confronting SADC now and in the future rather than requiring 11 of 12 potential share-holders to fit into straight-jackets tailored by the requirements of one government and by an existing institution's history.

- It might be easier to construct the design of a new DFI in a manner which accommodated the medium-term needs of SADC members while leaving open for the future the specific possibility of its privatisation (with shareholdings spread throughout SADC) if its financial position was strong enough in 10-15 years. That option might be more difficult (though certainly not impossible) to construct in the case of an existing national DFI being converted for sub-regional use.

- A new DFI would not be bound either by having its *sub-regional* role artificially circumscribed (e.g. by being limited only to the financing of one particular sector or another) by any other mandate nor by having a history as an agency of government rather than as an independent intermediary.

- A new DFI would not have to contend with an extant public-sector portfolio concentrated in the largest SADC economy. Nor would SADC governments face the prospect of sharing the burden of existing portfolio risk or of an existing liability structure that they had no role in building up.

- A new sub-regional DFI would require the largest economy of the region to make a substantial contribution of additional resources (by way of capital and guarantees) for sub-regional purposes. While that may result in additional resources being earmarked for sub-regional purposes, that factor alone may not guarantee an enhancement of sub-regional welfare.

- By the same token, a large commitment of additional resources might deter South Africa from agreeing to a new SADC-DFI. It might prefer to deploy resources already invested in DBSA as its contribution to the sub-region rather than providing additional resources in a constrained fiscal situation.

- A new SADC-DFI would side-step the 'turf' issues that would inevitably have to be contended with if one or other of the major existing South African DFIs (i.e. DBSA or IDC) constituted the core of a sub-regional institution. It would prevent institutional 'border conflicts' from arising between existing DFIs with specific sectoral mandates and with artificial lines drawn between them.

8.10 These advantages notwithstanding, the *disadvantages* of having a new sub-regional DFI would be that:

- Creating yet another new sub-regional institution in SADC might not make such sense to donors or to other external interlocutors when the record of sub-regional DFIs in Africa and in COMESA have not been salutary. It would be redolent of Africa's failed experience of achieving integration through a proliferation of sub-regions with accompanying institutions without discernible commensurate gain.

- Using the administrative costs of DBSA for 1996 as a guide, a new sub-regional DFI would involve annual operating costs of US$30-40 million equivalent annually and a start-up cost of around US$25-30 million in the first year. By comparison, using DBSA as the platform for a sub-regional DFI the start-up costs would be reduced to around US$5 million and the additional (incremental) annual operating costs could be contained to between US$10-15 million.

- The creation of a new DFI would involve SADC members in protracted, difficult negotiations about where such an institution should be located and how it should be managed and staffed. The first difficulty would not arise if DBSA were chosen as the core of a new sub-regional DFI. Discussions on the second difficulty would be more muted and less protracted given the reality of an existing structure within which to accommodate the regionalisation of management and staff.

- It would take at least 2-3 years (probably 4-5 years) before adequate staff and institutional capacity was built up in a new institution. Since nature abhors a vacuum it is likely that, during such an interregnum, extant national DFIs - working individually or together in meeting market demand (as IDC is doing with Mozal and the iron project and DBSA is doing with Lesotho Highlands, Maputo Corridor and the Maguga Dam) - would dominate the high ground of sub-regional development financing. If that happened (and it is difficult to see how it could be prevented) the argument for creating a new SADC-DFI would be vitiated even before it had the chance to take-off.

- A new institution would have no established operating or financial track record. It would take some years to establish and prove itself as a credible and creditworthy borrower. If the experiences of the last two MDBs created (the AfDB and EBRD) are a guide, the outcomes of these processes, even in the case of large MDBs with more powerful shareholders, is not guaranteed.

- By contrast, an existing credible and creditworthy institution would 'hit the ground running' in financing sub-regional projects without going through a 'proving' period. For that reason, the amounts a new SADC-DFI could mobilise and finance in the first five years of existence (between 1998-2002) would certainly be lower than would be the case if an existing institution such as the DBSA were to be chosen as providing the sub-regional core.

- A new sub-regional DFI would need to rely heavily on DBSA and other similar institutions for policy analysis and research support on sub-regional issues for the first 3-5 years of existence, thus creating a uncomfortable nexus between itself and such other institutions. It is unlikely that the functions being carried out by the DBSA (and IDC) at present would immediately cease or be ceded to a new sub-regional DFI simply because it had been created.

- A new sub-regional DFI might attract support from particular donors (interested in promoting their own objectives and agendas) and from institutions in domestic and international capital markets anxious to accommodate new borrowers with credible sovereign backing. But it would not attract the support of the major global and regional MDBs. Instead it might experience difficulty in carving out a niche for itself relative to these institutions which may see a new SADC-DFI as an unnecessary invasion of their own turf.

Option 3: Creating a Sub-Regional DFI Network instead of a DFI:

8.11 The foregoing paragraphs suggest that delicate judgements will need to be made by SADC policy-makers in deciding which of the above two options to take in organising the availability of sufficient development finance for meeting sub-regional (as distinct from national) needs. In reaching such a decision much will depend on the views and attitudes of the South African government on:

- Whether it wants DBSA to become a SADC-wide resource with the added advantage that such an option would mean saving on providing additional budgetary resources in capitalising a new DFI for SADC - assuming, in the first place, that it is convinced of the need for such an institution; or

- Whether it prefers, for the foreseeable future, to use DBSA as a national resource to act as an intermediating agency between central and lower levels of government in South Africa, until the post-1994 political regime settles down and a firm nexus is established in the process of negotiating centre-province financial transfers, before confusing DBSA with a dual mandate which may involve inherent conflicts; or

- Whether it would prefer to set up a new SADC-DFI despite the additional budgetary cost in the belief that: (i) such an institution would contribute to the process of sub-regional integration; and that (ii) the additional cost would be worthwhile in the wider interests of its neighbours in the region and, ultimately in its own long-run self-interest. South Africa is, of course, well aware that its own national interests are likely to be threatened by economically weak and insecure neighbours whose political and social problems will, if unattended to, inevitably spill over into South Africa.

8.12 Before concluding on the two options evaluated above, SADC member governments need to consider a third option. It does not involve establishing a sub-regional DFI - new or converted. Instead it employs extant national DFIs in all SADC member countries to form a ***strong, inter-active sub-regional development financing network***. Such a network would co-operate to ensure that adequate developmental finance is available wherever and whenever it is needed in SADC.

8.13 Such an option may seem at first glance, to be a compromise offered to avoid a difficult choice between Options 1 and 2. On closer examination, however, it is not. It is a distinct option which takes a genuinely different approach; one which is perhaps more in keeping with the ethos of the times and permits greater flexibility. Clearly, weaving an efficient, effective DFI network in SADC will pose its own unique problems and complexities. These will need to be overcome. But, in the short, medium and long-term, their resolution may prove to be a more tractable and productive way of dealing with SADC's sub-regional development financing problem than would the creation of a special DFI. Interestingly, this option also compels SADC governments to deal swiftly and urgently in rectifying the non-performing asset portfolio problems of national DFIs by either:

- *rehabilitating them* (perhaps privatising them before they go through a second round of bad performance because of directed or constrained portfolio choice); or

- *winding them up* and allowing other institutions from within and outside the country to undertake their roles and functions.

8.14 On paper a sub-regional network of national DFIs does not seem as neat and clean a solution to the development financing challenges of SADC as does the establishment of a separate, specialised institution for that purpose. That view, however, presupposes that: (i) *sub-regional development finance* needs can be defined and identified clearly; and (ii) such needs are distinct from development finance needs at the *national* level. In practice, such a distinction is neither as obvious nor as clear-cut as idiomatic use of the adjective 'sub-regional' in the vernacular of committed SADC integrationists suggests.

8.15 Attempts to extrude a precise definition of a *sub-regional project*, and to delineate clearly between sub-regional and national projects, as well as concomitant appreciation of their particular development finance needs, indicate immediately how vague and diffuse the concepts of 'sub-regional projects' and 'sub-regional development finance' actually are. After considerable investigation, this study concludes that the terms 'sub-regional projects' and 'sub-regional development finance' - while perhaps valid in communicating the sense of something different from the normal - are suggestive and evocative rather than indicative or meaningful from an operational viewpoint.

8.15 Indeed, on close scrutiny, the SADC portfolio of projects reveals itself to be mostly a 'wish-list' type collection of either 'hard' (involving physical investments) or 'soft' projects involving studies, training, research, seminars, computer modelling, planning, co-ordination and institution building measures of various sorts ranging from the trivial to the significant. In most of these projects the sub-regional element was somewhat elusive and not immediately apparent.

8.15 The SADC portfolio in the *Review and Rationalisation of the SADC Programme of Action* runs to some 472 'projects' of which 102 projects have not been fully identified or costed. Of the 370 projects that have been costed, 108 involved costs of less than US$ 1 million and were mainly for institutional bolstering and studies of various types. A total of 337 projects (including the uncosted ones) were 'soft' and ineligible for development financing on their own while the remaining 135 projects required some kind of physical investments to be made. These 135 'hard' projects comprised:

- 85 *national* infrastructure projects involving the rehabilitation of ports, airports, roads, power plants, transmission lines, telecommunications exchanges/networks, and railways. Typically these can be (and invariably have been) financed either by national DFIs (if such projects are relatively small) or by the traditional MDBs (if they are sufficiently large). There is no clear need for a mezzanine level of sub-regional finance for such projects except perhaps from private commercial sources in member countries.

- 50 sub-regional infrastructure *linkage* projects between countries such as transport networks, telecommunications linkages and power transmission lines or oil/gas/water pipelines. These usually involved two or at most three countries. In the past such projects have been traditionally financed either through the budgets of the respective national governments, by their national DFIs, or by the MDBs, with some coordination involved on the part of the governments specifically concerned. ***These sub-regional projects involving physical investments that directly affected two or more countries were estimated to amount to a total cost of about US$1.8 billion to be invested over the next ten years.***

8.18 It could be argued, quite validly, that all of the projects in the SADC wish-list have some sub-regional implications, externalities or multiplier effects. But in that respect, they are no different from many private sector industrial, mining or construction projects located in a particular country to serve the sub-regional market or that involve some sub-regional multiplier effect. For example, a toothpaste manufacturing plant in South Africa set up to cater to SADC-wide market demand is a 'sub-regional project' even if it is not as unusual, exciting, or seen to be as deserving of public or development finance support as an infrastructure or heavy industry project. If all such projects were to be categorised as *sub-regional*, the term would lose any operationally useful meaning.

8.19 As far as the 'soft' projects are concerned, these are clearly sub-regional in the sense of supporting the build-up of SADC-wide institutional capacity - e.g. training programmes in particular sectors or for specific sector co-ordinating agencies, establishing data banks, improving information and monitoring systems, undertaking feasibility or hydrological studies, improving sector co-ordination through more general programmes of action, etc. Such projects may well be essential and worthwhile. But they are not really candidates for development financing *per se*. They appear instead to be more suitable candidates for grant funding from national budgets, from the private sector, or from donor funded technical assistance facilities.

8.20 It is precisely because the distinction between sub-regional and national projects is unclear, and often confused, that the case for a special institution to meet *sub-regional* development finance needs is weak. Indeed the rationale for such an institution is not obvious; it would have to be contrived. On the other hand, the case for rationalising and reducing the number of national DFIs - perhaps even not having any in the smaller countries - is strong. Just as it would make economic and financial since for SADC to have only one or two international airlines and perhaps three or four regional feeder airlines (from the viewpoint of capturing economies of scale and developing a critical mass), it would make equivalent sense - and be more economical and effective - for the SADC region as a whole to have fewer DFIs.

8.20 Given the size and limited diversity of its regional economy, SADC - if it did not comprise twelve separate sovereign entities - would only need two or three agricultural and rural banks, no more than three or four small-industry financing institutions, a similar number of construction and housing finance institutions, and perhaps two or three DFIs financing industry and infrastructure. Instead, every SADC member country - no matter how small - has attempted to have the full range of specialised DFIs. Some of these are so small that they have no realistic prospect of ever achieving critical institutional mass. In the process of such deliberate, but unnecessary, institutional proliferation at the national level, SADC countries have collectively wasted scarce administrative and financial resources. In the new SADC dispensation there is strong *raison d'être* for not continuing with these counter-productive courses of action simply to accommodate the private agendas of powerful public figures or in the mistaken (and very expensive) belief that a nation state cannot exist without its own airline or DFI.

8.21 If it is agreed that development finance in SADC should have a sub-regional dimension then adding yet another supra-national DFI (whether new or converted) to the existing inventory of national DFIs would run counter to new wisdom and could be construed as a step in the wrong direction. It might be better to achieve the objective of sub-regionalising development finance by permitting existing national DFIs to develop sub-regional perspectives and capabilities through a combination of voluntarily agreed *co-operative* as well as constructively *competitive* strategies. Indeed that is precisely what is happening in the private commercial banking sector in SADC and will happen increasingly in the private insurance sector and in capital markets.

8.23 The underlying fundamentals and dynamics of DFIs as financial institutions are really no different from those of these other financial intermediaries. What prohibits them from evolving in the same way and spreading their reach over the region is their institutional mind-set. That, in turn, is governed by their public ownership, and their consequent inability to make independent choices in terms of operating domain or to develop strategic partnerships with their counterparts in neighbouring countries. Publicly-owned national DFIs do not operate across national borders because doing so would raise the question of why taxpayers in one poor country should subsidise - since *development finance* invariably incorporates an element of subsidy without which the term becomes irrelevant - the development of poor neighbouring countries when there are pressing developmental priorities to be attended to at home. Those questions rarely arise in the case of private institutions with a development finance orientation - mainly because the ‘subsidy’ is provided to or through them in a different, less conspicuous, way.

8.24 For all these reasons, it might be more logical and rational to set aside options involving the creation of a special supra-national DFI in SADC and focus instead on a more pragmatic approach involving better utilisation of national DFI assets for regional purposes. The sequential steps that would be involved are:

- *First*, form a SADC-wide DFI-network with a *Regional Development Finance Resource-Centre* (SADC-DFRC) as the hub to facilitate implementation of the steps listed below. The DFRC could be donor-funded at start-up. But it should have a time-bound commitment to achieving independent, self-sustaining funding through membership fees and user charges paid by the DFI community over a period of five years. A DFRC would probably fare best if it was attached for the time being to the DBSA, which has the capacity to run it well for the benefit of the SADC sub-region.

- *Second*, launch a sub-region wide process of dealing with DFIs' *non-performing assets* at the level of individual, national DFIs through a combination of: aggressive collection strategies for eliminating overdues and arrears by seizing and liquidating collateral; early settlement of accounts among parastatals; write-downs where necessary; followed by capital restructuring and strengthening.

- *Third*, increase the operating and financial *autonomy and independence* of DFIs. That would necessarily involve changing ineffective managements in failed or weak DFIs and taking measures aimed at across-the-board improvements in the professionalisation of management and staff along with measures for general institutional strengthening, improvements in information technology and, across-the-board capacity-building.

- *Fourth*, encourage the formation of informal and formal *operating partnerships* leading to *strategic alliances* between DFIs of the same ilk across SADC. Such partnerships should focus on joint research/analytical studies activities, followed by joint project development, appraisal and financing and later on joint institutional initiatives across a wider range of resource allocation and joint resource-mobilisation activities.

- *Fifth*, move towards increasing corporatisation, followed by *privatisation*, of financially sound DFIs through the sale of government-owned shares (in tranches) in domestic and regional capital markets;

- *Sixth*, encourage groups of similar national DFIs to take up *cross-ownership shareholdings* in one another (either on a negotiated or through open market-share purchases) wherever that might make commercial sense and result in consolidating successful strategic alliances;

- *Seventh*, permit commercial and investment banking groups, and securities firms, to acquire control over privatised DFIs. That would mark the final stage in the transition from relying on specialised DFIs to *relying on* broad and deep *capital markets* that are willing and able to finance a full range of activities and operate across the risk-reward spectrum without requiring further special public or 'development finance' interventions except in the most unusual of circumstances.

8.24 The first step to establish the proposed DFRC (and attach it to DBSA for administrative oversight purposes) can be taken almost immediately if consensus is achieved at SADC ministerial and DFI-industry levels that such a resource centre would add value. The opinion of those DFI senior executives who attended a one-day seminar at the invitation of the DBSA in June 1997 was that such a centre would add value and that detailed ideas concerning such a centre should be formulated sooner rather than later. The DFRC should be independent of DBSA. It should be 'owned' collectively by all the DFIs in SADC - as its subscribing members - rather than by either SADC as an entity, its secretariat or by the South African government. The DFRC should, in other words, be an 'industry-owned' self-help organisation rather than a governmental or quasi-governmental organisation, if the risk of constraining its effectiveness is to be avoided.

8.25 The broad functions, objectives and modus operandi of such a DFRC are developed in greater detail in Annexure A. This has been done in illustrative terms for the purpose of careful consideration, rather than as a recommendation for immediate adoption and implementation, by SADC ministers. The DFRC would be a vehicle for achieving the following advisory and capacity building purposes:

- capacity-building throughout the regional DFI community;
- regional bonding of DFIs at the management and staff level;
- experience sharing in managing affairs and dealing with problems;
- confidence-building within the DFI community in its collective capacity;
- a central hub for information technology;
- specialised software development for tailored (sector-specific) DFI information systems;
- building a DFI *intra-net* in SADC to facilitate information sharing and communications within the DFI community;
- developing a policy research and analysis capability to support the SADC-DFI community's closer interaction with governments (individually and collectively) on issues concerning resource allocation, regional and international resource mobilisation and sub-regional project/investment promotion and development; and
- providing advisory services to SADC governments and to DFIs (e.g. on a systemic approach to dealing with non-performing assets).

8.27 The DFRC should be designed to be a resource centre not just for traditional DFIs (i.e. those financing industry and infrastructure) but also for the other types of sector-specific

DFIs operating in the agricultural and rural sector, for SME development, low-cost housing, micro-enterprise lending and providing gender credit.

8.28 In fostering a SADC network of DFIs, a specific recommendation which this study makes is to establish a permanent Working Group or Standing Working Party of selected DFI chief executives in SADC (comprising one senior figure from each country) as part of the institutional infrastructure supporting FISCU. This standing committee should come under the purview of SADC ministers of finance and should be seen as equivalent to the committees of key central bank officials and senior treasury officials. It should meet regularly to carry forward a specific agenda aimed at implementing the steps and achieving the objectives outlined above. The same committee should be charged with the broad oversight responsibility for designing, launching and operating the proposed DFRC and appointing its first head. Such a committee could also begin to consider specific financing plans, draw up on a cooperative basis for financing properly developed sub-regional projects which were determined to be in need of public/development financing support.

8.29 Once the DFRC has been launched it could, in addition to its other functions, immediately assist SADC member governments in addressing the portfolio problems of the DFIs in the sub-region and developing a medium term plan for implementing the other five steps. Its capacity-building functions would be undertaken through a combination of formal and informal activities involving:

- Short executive retreats, symposia and seminars of upto a week's duration. These would be organised separately for CEOs, COOs, CFOs, chief legal officers, chief HR managers, chief IT managers, institutional risk managers, and internal auditors of DFIs engaged in similar types of activities across the region. The frequency and content of such events would be developed by the cohort groups themselves (i.e. demand-led) with the details, logistics and facilitation arrangements being undertaken by the DFRC's professional staff.

- Practical training courses scheduled in advance and offered on a regular basis of between 2-12 weeks (depending on the level of staff attending). These would cover both the general knowledge and skill needs of all DFIs as well as courses tailored to particular needs of sector-specific groups of DFIs. Such courses would be developed in a SADC-specific context but would borrow from ‘best practices’ which have evolved in other parts of the world.

- Regular (quarterly, semestral or annual) meetings of DFI executives at senior and middle-management levels. These would not involve a formal training element but would be organised thematically with information-exchange, experience-sharing and encourage a higher level of intra-industry communication at both personal and official levels in order to develop a broader regional perspective

- Regular exposure of DFI managers and staff to government ministers, central bankers and top executives in the private financial sector of SADC countries to facilitate communication between DFIs and other sources of finance

- Regular exposure of DFI executives to senior personnel from the MDBs and their private sector financing affiliates, from major global securities houses and global capital market exchanges, from major funds and global asset managers, from bilateral investment and project financing agencies, from export-import banks and export credit agencies, and from long-term investors interested in taking institutional portfolio equity stakes in long-gestating projects with steady cash returns in the long-term.

8.30 By undertaking these activities the DFRC would broaden and deepen a regional and multi-sectoral perspective in the DFI community in SADC which would enable a new ‘internal market forces dynamic’ to emerge and fill regional development financing needs. It would achieve a degree of bonding and confidence- building across DFIs in SADC which does not exist today except at a superficial level. Moreover, such activities would enable the DFRC to keep the DFI community in SADC abreast of the latest trends and developments in development financing theory and practice, in the use of new technology for front and back-office purposes, and in developing a sub-regional capability to develop and hone the human resource base in the DFI system. Thus a pro-active DFRC acting on behalf of all its members would nudge the region's development financing capacity, knowledge and skills base gradually towards the cutting edge. Together, the combined effect of these capacity-building initiatives would result in the DFRC adding value by providing inputs that are presently missing within the DFI system in SADC - i.e. the obvious gaps to which some SADC policy-makers are reacting by looking for an institutional solution when the answer may lie in a network solution.

8.31 A SADC-DFRC organised along these line at the centre of a SADC-DFI web, should attract financial, technical , advisory and resource-person assistance and support from the donor community as well as from private financial institutions. It fits well within the overarching concept which propelled the African Capacity Building Initiative (ACBI) and could benefit from establishing strategic links with the World Bank's Economic Development Institute (EDI) as well as the African Development Bank's DFI training institute from both of whose experience and resources (staff, case study material, course content etc.) it could borrow and adapt to the SADC-specific situation.

8.32 The other issues (advantages and disadvantages) pertinent to this option which need to be taken into account by SADC policy-makers include the following:

- The network option will not require significant additional financial (budgetary) resources to be committed either to the equity capital of, or to guarantees provided on behalf of, a specialised sub-regional DFI. The proposed DFRC could be financed at the outset by a combination of donors and DFIs themselves without relying on government subventions or support.

- Instead, this option would permit budgetary resources to be directed to the task of dealing with the non-performing assets of *national* DFIs and to recapitalising and strengthening those DFIs which are worth saving, while compelling governments to wind up institutions which are unviable. In the medium such resources might be recouped through the proceeds of privatisation - a possibility which also applies in the case of a new or converted sub-regional DFI providing it is eventually privatised.

- The network option precludes difficult, contentious and protracted negotiations in SADC on burden-sharing, management and staff representation, and location which will inevitably be part and parcel of the process of establishing a sub-regional DFI.

- The network option, if adopted by SADC, could be put into effect almost immediately while the other options would take some time to implement.

- The focus of the development financing problem in the region would revert under this option back to individual projects, rather to the filling of a perceived (but vague, undefinable and unquantifiable) regional development financing gap.

- In doing so, it would result in more practical and realistic solutions to project financing difficulties. SADC government capital and guarantees could be directed to specific large projects with clear regional benefits and implications than to a regional institution with a confused mandate.

- That, in turn, would result in more transparent and clear-cut decision-making on the part of governments and a clearer apportionment of the costs and benefits of providing public capital and development finance than would be the case in setting up a SADC-DFI.

- The network option has the additional benefit of strengthening national DFIs and utilising their capabilities which neither of the options for establishing a sub-regional DFI would have. Rather than being the centre of a sub-regional network of DFIs, a separate DFI runs the risk of overlapping and competing counter-productively with national DFIs.

- The network option would attract the support and co-operation of the MDBs in a way which establishing a SADC-DFI would not. The MDBs would probably see it as a durable and effective approach to solving to the portfolio and financial problems which national DFIs in SADC presently have. A new or converted sub-regional DFI might be seen as actually adding to and possibly even exacerbating those problems.

- The network option specifically provides for the building of capacity and skills in DFIs at the national level in the mutual interest of the sub-region. By contrast, a SADC-DFI may well drain national DFIs of their best human and technological talent leaving national DFIs (which may not be able to compete with a sub-regional DFI in providing the same incentives or attractions immediately) to be hollowed out and thus to atrophy.

- The network option essentially uses the national resources of the region to work collectively and voluntarily towards a common purpose within a systemic incentive framework. On the other hand, the sub-regional DFI approach implicitly makes an artificial distinction between sub-regional and national resources and institutions and creates a perception of competing and conflicting interests between the two (which is what is happening throughout the EU at the present time, endangering its trajectory towards unification).

Option 4: Establishing a SADC Financing Facility or Fund (or Funds?)

8.33 Finally, a fourth option that should be considered is a SADC development *fund* rather than a SADC development financing *institution*. Such a fund could be an adjunct to the other three options. The possibility of establishing private sector debt and equity funds for financing infrastructure and industrial projects in SADC has already been alluded to earlier (Chapter 2). These funds can be raised by private investment banks and asset management companies working in conjunction with capable national DFIs (e.g. DBSA, IDC, BDC, ZIDC, DBM). The type of fund being suggested here is a development fund financed by multilateral and bilateral donors with a combination of hard and soft resources (i.e. non-concessional as well as concessional) but managed by one or more eligible DFIs which meet certain tests of capability.

8.34 Such a fund could be used to augment the *public finance* resources needed for long-gestating regional infrastructure projects that have an element of commercial viability, and for which productive public-private finance partnerships need to be formed. Under such partnerships public finance would be applied to accommodating risks which the private sector was unwilling or unable to take at the present time. The SADC development fund could also be used for regional projects that are not commercially attractive. Such projects might include: first stage investments in river basin and sub-regional water resource management, the management of regional environmental commons, certain types of rural and feeder road connections to derive the full benefit of trans-regional highways, the management and maintenance of game parks, migration routes and animal sanctuaries which cross national borders within SADC.

8.35 They might also include other sub-regional projects that have high economic returns but may not have assured and immediate financial returns through independent cash flow streams which can be applied to service debt or generate sufficient profits for eventual dividend returns on equity - e.g. investments in improved ground systems for sub-regional air traffic navigation and control and air traffic safety.

8.36 Such a *SADC Development Fund* would be useful in financing those projects that are not sufficiently large to justify the costs associated with external funding (from MDBs or donors) in each individual instance but where a number of such projects are ready to be financed. Moreover it would need to be clearly established that such a fund could be managed more efficiently and effectively at the sub-regional rather than at either the project, national, regional or global levels. The present list of projects in SADC's investment portfolio suggests that there may be a number of such projects in the cost range of US$5-15 million which might be better handled through such a Fund.

8.37 Contributing to such a fund would be attractive to potential funders only if the DFIs involved in managing such a fund had demonstrated competence and capability in the areas of: project selection and appraisal; monitoring project construction and implementation; and in project supervision in the operating phase. Moreover such intermediaries would need to have tight control systems which ensured probity and efficiency in monitoring disbursements, ensuring that funds are applied for the purposes specified and agreed, ensuring that procurement is undertaken on a fair and transparent basis, and that repayments from project agencies or governments are collected on schedule. Based on their performance records, most DFIs in SADC would not pass these tests at the present time. For that reason, such a fund should initially be managed by either one but no more than three or four DFIs which can meet those tests of eligibility, with one or two of those DFIs - again DBSA would appear to be the best candidate - being the focal point for overall fund management.

8.38 Despite wide differences in per capita incomes across SADC, it is not analogous to the EU case in that there is no realistic possibility of structural funds being generated from within SADC to permit fiscal transfers from wealthier to poorer members. The SACU compensatory arrangement is sometimes seen in those terms. But that arrangement is, indirectly, more of an indirect, opaque subsidy to South Africa's manufacturers than a real resource transfer to the smaller SACU countries. Nor would SADC succeed if a demand for internally generated structural funds were built into current integration arrangements. Though there may be relative income differences between them, no SADC country is as yet sufficiently wealthy in absolute terms to consider making fiscal transfers from its own budget to other SADC countries.

8.39 In these circumstances, the *SADC Development Fund* being proposed would be financed mainly by donors, the EU and MDBs. Relatively wealthy SADC economies such as Botswana, Mauritius, Namibia and South Africa could make token contributions to such a Fund in the interests of regional commitment and solidarity. If that happened, the proposed Fund could fulfil a part of the role that structural funds are supposed to play in regional integration arrangements - i.e. accelerating the development of poorer parts of the region so that their per capita income levels can converge, over time, with those of the richer parts.

8.40 The real question is whether donors - when presented with the alternative of financing a SADC development fund - would then channel their aid flows that are now going directly to the poorer countries of SADC through such a Fund or whether the Fund would result in additionality at the regional level without disturbing extant flows to individual countries. A second question is whether, even without additionality, development assistance for investment in the poorer countries of SADC would be better managed and prove to be more effective if part of it was managed through a regional fund .

8.41 These are easy questions to pose in theory but difficult to answer conclusively in practice. Establishing a *SADC Development Fund* would incur a clear risk that a proportion of existing aid funds to individual countries *might* be diverted from the countries themselves and channelled instead through the Fund. There is a possibility that such a Fund might result in a degree of 'subtractionality' if the regional alternative were to result in a net loss of aggregate aid. Equally, there is the possibility that a SADC development fund may actually result in some additionality of aid flows. What makes the question impossible to answer properly is that no assumption can be made about what the base level of aid flows to countries in the region are likely to be, even in the short run. The only certainty is that if present trends continue, SADC as a whole is likely to get steadily diminishing amounts of aid although there may be shifts in the allocation of such aid to countries within SADC. The establishment of a *SADC Development Fund* may make no real difference to that outcome.

8.42 Thus questions about additionality are probably red herrings - as they have invariably proven to be in the past. Whether SADC decides to establish a sub-regional development fund depends on: (i) the expectations and preferences of donors and the poorer countries in SADC concerning future aid flows and how they would wish to see them channelled; and (ii) whether a regional funnel will prove to be a more efficient and effective resource allocation and results-oriented mechanism than the current basis of aid provision is deemed to be.