Zambia Capital Markets Indaba – summary of deliberations and outcomes

On April 2\textsuperscript{nd} to 5\textsuperscript{th} the Securities and Exchange Commission (SEC), the Capital Markets Association of Zambia and Financial Sector Deepening Africa (FSDA) convened an Indaba in Livingstone with the theme: “Repositioning the Zambian Capital Markets as an Enabler to Achieving Sustainable and Significant Economic Growth”. This document summarizes the outcomes of the deliberations of the Indaba.

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1. **Challenges posed by the Zambian capital markets context**

In recent years, the largest challenges faced by capital markets in Zambia relate to the fiscal and monetary environment.

The following points were emphasized in setting the stage for the deliberations of the Indaba:

- **Macroeconomic factors are inhibiting capital market deepening, although the trend has become more supportive as of late.** High interest rates coupled with a sizeable government borrowing requirement are squeezing corporate earnings, crowding out corporate bond issuance and discouraging capital market deepening. Bank of Zambia has kept high rates to limit the effects of the terms of trade shock resulting from the fall in copper prices in 2014/2015. As a result inflation has fallen from 22.9% in February 2016 to a more sustainable 6.7% in March 2017.
The domestic market for longer-term investment is underdeveloped. Many long-term projects are funded on a short-term basis domestically or, if funded on a longer-term basis, reliance is placed on foreign direct investors and denomination of deals in USD.

The size of capital markets is small (as measured in terms of their capitalization relative the GDP) – smaller in Zambia compared even to neighboring smaller economies, such as Botswana and Namibia.

The liquidity of the Zambian equity and bond markets is weak – an observation that applies in similar measure to the corporate bond market and to the market for Government securities. The pattern is to buy and hold.

Regulatory responsibility for capital market development is divided among three agencies (Securities and Exchange Commission (SEC), the Bank of Zambia (BoZ) and the Pensions and Insurance Authority (PIA)) each with their own compliance requirements, with the Ministry of Finance (MoF) providing overall oversight. While the SEC has responsibility for development and oversight of the capital market, the BoZ is the agent of the Government with regard to issuance of government securities, and the PIA overseas institutional investors and sets guidelines for their investments. Thus, implementing the SEC’s mandate of implementing the national vision for development of the capital market requires coordination both among the regulators and between the regulators and the MoF.

In meeting these challenges the following questions were posed in opening the Indaba:

- **What would constitute a successful outcome?** Participants asked whether the aim of the Indaba could be broadened beyond deepening the local capital markets to encompass other means of intermediating long-term finance.
- **Where would Zambia be able to learn from experiences elsewhere?** Drawing on innovations undertaken elsewhere could benefit the process of deepening of long-term finance in Zambia.
- **Would Zambia be able to benefit from regional markets?** To what extent would regional markets replace or complement the development of the domestic market?
- **How would reforms best be delivered?** What are the appropriate roles of Government and the private sector in driving the deepening of long-term finance in Zambia?

2. **Overarching conclusions of the Indaba**

By way of introduction it is worth emphasizing two overarching conclusions of the Indaba:

a) While public markets are integral to intermediation of larger levels of capital, the scope of the long-term financing agenda extends beyond public capital markets

Many countries in Sub-Saharan Africa have established the rudiments of institutional infrastructure for capital market development, but struggle with very low levels of provision of long-term finance. In considering how best to provide long-term finance to enterprises and for the finance of infrastructure there is a tendency to disregard the natural progression from informal to formal, or unlisted to listed sources of finance. Only gradually will financing of infrastructure move from being financed by Government, donors and foreign direct investors. Gradual moves that start with greater participation by banks, private equity investors, and eventually to the issuance of capital markets instruments supported (at least initially) by facilitation through partial guarantees are to be expected. Similarly, enterprise finance starts

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1 According to paragraph 9 of the Securities Act (2016) the function of the SEC is to “create and promote conditions in the capital markets aimed at ensuring an orderly growth, integrity and development of capital markets.”
All too often the attention of the authorities is predominantly focused on the last stage of these processes - the formal, listed markets for long-term finance. These formal markets are really the tip of the iceberg, and moving more finance into these formal public markets is unlikely to succeed while the informal and unlisted markets are not functional and vibrant. Financiers (whether governments or private sponsors) will gradually work their way towards the formal market, but this brings with it requirements in terms of transparency and accountability, e.g. in terms of sharing financial information and well-identified governance structures. While public formality in the provision of capital allows larger levels of capital to be intermediated, it also brings with it information, transaction and enforcement costs. So, while private markets continue to play a significant role as a source of funding even in developed capital markets, availability of funding from formal public markets is associated with benefits in terms of transparency, openness and benchmarking of the markets.

Progression to greater reliance on market finance does not take place in a vacuum, and filling long-term financing gaps depends on understanding to what extent financing provided by the informal market is performing roles that might be assumed by funding vehicles that are, or could be, available on the public market. In moving towards more reliance on formal, listed markets the intention is that project sponsors and enterprises will be able to raise a greater proportion of project funding more efficiently from unrelated, third-party investors. For example, it will gradually be possible for government financing of infrastructure to be augmented with issuance of debt funds or project bonds. Funds provided to enterprises by family and friends or venture capitalists can be supplemented with issuance of corporate bonds or private equity and IPOs. The important point is to see the deepening of formal markets as part of a continuum, rather than as an objective in itself. Among the challenges here is the development of trust in the public market and its ability to provide funding in terms of products and costs that will be attractive to borrowers and investors.

b) Reform is contingent on the strong commitment of the authorities

Due to the complexity and tailor-made nature of long-term funding engagements, enhancing the role of local markets depends on consistent commitment by high level policy-makers. All too often long-term finance does not attract the attention it requires to succeed. Public capital markets are set up, but they remain prestige projects and the link between issuance on the formal market and other conduits of finance is neglected. PPP units are established, but commitment to the PPP process is not shared by all parties in Government and there is not a common level of understanding across various Government agencies about the importance of PPPs or about which rules and procedures to adopt in assessing/implementing PPPs. As importantly, the various measures suggested here for strengthening the provision of long-term finance are interconnected, and achieving them in isolation will not result in the desired impact.

Providing the impetus to develop the domestic market for long-term finance requires policy initiative and coordination that does not naturally reside with regulators.
responsible for particular segments of the market. In Zambia, several regulators are involved – the Securities and Exchange Commission (SEC), the Pension and Insurance Authority (PIA) and the Bank of Zambia – and their involvement is focused primarily on the formal markets. If the SEC is to fulfill its mandate in developing the capital market, coordination both between the SEC and the other regulators and between the SEC and the MoF – with overall responsibility for financial sector policies – will be paramount. In fostering PPPs, coordination is also required between sector ministries and the Ministry of Finance. Either the mandate of the regulatory authorities needs to be expanded, or the Ministry of Finance needs more seriously invest in taking on the overall mandate for coordination among these various agencies. One organization needs to have the responsibility for embedding efforts in the broader agenda identified by the Indaba, as discussed in more detail below.

Deepening the Zambian capital market with the aim of achieving scale economies and reaching self-sustainability depends on Government support. While not discussed in detail at the Indaba, the support of both policy-makers and regulators, not least the MoF that has budget authority and responsibility for coordinating efforts by all parties, will be crucial in moving towards self-sustained development both in terms of providing technical support and funding.

3. Deepening the liquidity of fixed income markets: an imperative prior for capital market development

Despite progress in establishing the Kwacha Government debt market, developing depth and liquidity in the bond market remains a challenge. Liquidity of Government debt is crucial not only in attracting investors to the market, but also in developing benchmark pricing for Kwacha-denominated debt. Without an interest rate benchmark it becomes very difficult for potential non-government issuers to set an appropriate interest rate for their borrowing instruments. The differential between risky and “risk-free” bonds reflects the market’s view of the risk premium, which can be used in setting prices on similar loans. Thus, a well-functioning secondary market in Government debt is a crucial stepping-stone to increase the availability of fixed income shorter- and longer-term obligations. Several factors were identified as potentially having a positive impact on the liquidity of the secondary market in Government securities:

- **Broadening the institutional investor base.** Efforts to establish a primary dealer system rely on the existence of diverse investor base, so it will be important to complement reforms designed to encourage secondary market trading with measures to strengthen the institutional investor base. Outsourcing investment decisions being undertaken by NAPSA, see further discussion in Section 6 below, has an important role to play here, as does facilitating over-the-counter trading in Government bonds among institutional investors.
- **Benchmark bonds.** Strengthening Government debt management policy is critical, with a view to rationalizing the number of Government bond issues to enhance liquidity in specific benchmark issues. Establishing benchmark Government bond issues will require the Government to re-open issuance in existing series and to take more care in planning for retirement of larger outstanding bonds before they mature.
- **Primary dealerships.** Strengthening the market for Government securities can occur by establishing a small group of committed players responsible for trading and distributing government securities, known as a primary dealer system. These players are normally required to observe qualifying requirements for minimum capital, governance and ethics,

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2 Currently there are over 100 domestically-traded government securities. Secondary market trading of Government bonds is limited and takes place mostly in the form of bilateral OTC trades between banks that are then reported to LuSE.
etc. and required to participate actively in the secondary market by providing two-way quotes. Primary dealers are required to build distribution channels, acting as market intermediaries and to promote the dissemination of market information. In return they are granted a seal of approval supported by certain privilege that may include privileged access to primary auctions and to exercising trades on the repo market (see below) as well as to exercising non-competitive bids. In making sure primary dealers live up to their commitments, it will be important that the authorities develop a set of conditions that primary dealers are required to fulfill, and are prepared to step in and sanction those primary dealers that fail to live up to their obligations.

- **Repurchase agreements.** Much of the liquidity in markets for Government securities lies in the forward market for these securities – repurchase agreements (repos) are collateralized loans involving the sale and subsequent repurchase of Government securities at a pre-specified time and date. These contracts, which combine an immediate sale of a Government security with an agreement to reverse the transaction at a specified future date, are an essential element in increasing liquidity in the Government securities market before an active secondary market for government securities develops. The introduction of a repo market in Government securities will also create a more level playing field on the interbank market, as repos are collateralized instruments that facilitate interbank lending by minimizing the credit risk exposure of each counterpart. Currently there is uncertainty as to whether Zambia’s Insolvency Law provides the necessary support for the relevant close-out netting clauses in the standard repurchase agreements.\(^3\) Ensuring that the legal foundation and supporting market trading infrastructure is in place to support universal adoption of a global master repurchase agreement by market participants will be crucial element in strengthening the liquidity of the Government security market. Among other issues that may impact the use of repos and therefore deserve to be explored further are the absence of benchmark bonds (i.e. the absence of suitable reference bonds) as described above, and the design of the BOZ’s monetary policy interventions which may discourage the development of interbank money market operations.

- **Strengthening the execution and reporting of trading of Government bonds.** Both the Bank of Zambia (BoZ) and LuSE run central security depositaries (CSDs) for Government bonds and there have been issues establishing a reliable record of ownership and in reconciling trades as between the two systems. The BoZ system is newer and has the advantage of being linked to the BoZ’s real time gross settlement system, providing automated real time delivery versus payment. Ensuring reliable execution of trades (finality of settlement) and timely reporting of over-the-counter trades speaks for linking the two systems or possibly integrating the two depositary systems. In this context, the BoZ and SEC can also improve price transparency by ensuring that banks comply in reporting secondary trades to the LuSE.

It is important to underline the complementary nature of the suggested reforms outlined above: for example, it is unlikely that primary dealers will be able to live up to their commitment to make two-way markets in government securities unless they can engage in trading on the repo market and there is a market for over-the-counter trading in Government bonds.

In addition to supporting the deepening of local currency debt markets, the urgency of undertaking the steps outlined above cannot be overemphasized, given the

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\(^3\) Close-out netting implies that in the event of counterparty bankruptcy or any other relevant event of default specified in the relevant agreement, all transactions or all of a given type are netted (i.e. set off against each other) at market value. The alternative would allow the liquidator to choose which contracts to enforce and which not to (and thus potentially to "cherry pick").
Government’s recent increasing reliance on Eurobond debt issuance. While these Euro-issues may carry a considerably lower nominal interest rate than domestic issues, such ‘savings’ have been overwhelmed by the costs associated with the depreciation of the Kwacha. Avoiding reliance on debt with such uncertain and potentially high ex-post service costs is a high priority.

Efforts to support issuance of fixed-income corporate bonds are being supported by donors. Presentations were made at the Indaba describing efforts by the IFC and the African Local Currency Bond Fund (sponsored by KfW) to support issuance of fixed-income corporate bonds. They emphasized the importance of benchmark yield curves while also bringing other factors into focus that can support the development of the corporate fixed income market, such as:

- strengthening professional capacity to prepare the required issuance documentation;
- shortening the time taken to receive the necessary regulatory approvals;
- increasing transparency and putting pressure on costs and fees charged in the market;
- increasing transparency by encouraging that issuers be required to provide credit ratings;
- introducing structured finance (such as asset-backed securities and covered mortgage bonds) to increase the level of security provided to the lender; as well as
- leveraging facilitation mechanisms, such as partial credit guarantees and anchor investments, offered by donors and private firms, that can provide comfort to investors and thereby give access to a wider investor base.

Although such pioneering efforts are helpful, the overall conclusion is that unless prior steps are taken to support the strengthening of the Government securities markets, it is unlikely that the corporate bond market, let alone other more complex markets that rely on the sovereign yield curve to provide guidance on pricing, can ‘take off’ – i.e. the efforts supported by donors to stimulate the development of the corporate bond market are unlikely to be successful without continued ‘life support’ to help stabilize and improve the Government securities market.

4. Limited prospects for increased issuance and liquidity on the listed market

Hitherto the outcomes of efforts to increase new issuance activity and the size of free float on the LuSE have been disappointing. As a percentage of GDP, market capitalization (averaging about 15 percent) and market turn-over (averaging about 3 percent) remain largely unchanged over the past decade.

The low level of market activity is an issue the LuSE has in common with small stock exchanges in many countries in Sub-Saharan Africa, and it is doubtful that there is any ‘quick or easy fix’ to this dilemma. The latest IPO listing was in September 2014. Prior to this listing, there were 2 IPOs between 2008 and 2014. Although an Alternative Market was established in 2015, there has been no issuance on this market. Hitherto there have been only 13 issuers of corporate bonds and medium-term notes. In recent years, new issuance activity has been hampered by the high domestic interest rates, combined with relatively high issuance fees (sometimes supplemented by the costs of guarantees) and short-term nature of the issues (implying that bank borrowing is a ready substitute).

Developing markets for long-term finance by focusing on the listed/quoted formal market, the “top-downwards approach” may prove frustrating. This is an approach which has frustrated champions of formal markets outside the larger financial centers in Sub-Saharan Africa. Building a reliable pipeline of issuance activity and increasing trading volumes are challenges faced even in the relatively large financial centers in Sub-Saharan Africa, such as
Kenya and Nigeria. Based on these observations a broader approach to developing the market for long-term finance – focusing on supporting the deepening of other market segments, such as the markets for Government debt, private placements and unlisted equity – is advisable. Such an approach is best seen as complementing efforts to develop formal markets: the development of these unlisted market segments will support local market deepening of long-term finance, thus eventually supporting the deepening of formal markets for quoted bonds and equities.

The equity market could be stimulated by reducing transactions costs and increasing free-float, but the impact of such measures should not be exaggerated. Costs could be reduced by imposing a cap on listing fees, making enterprise results and annual reports available online (rather than obliging enterprises to print and mail such materials), and reducing the costs of holding AGMs. These steps make sense, but their impact on listing or trading activity should not be overestimated. The proposal that the 25 percent free float requirement be implemented more strictly might help in stimulating liquidity, but it is important not to exaggerate the impact of measures designed to ‘force-feed’ changes in market behavior.

Efforts by the Industrial Development Corporation to restructure state-owned enterprises with a view to privatizing them are confronted by regulatory and substantial hurdles. One key challenge is the requirement that enterprises listing on the LuSE demonstrate a track record of three years of profitability. There are also substantial issues relating to the underlying viability of the businesses that the IDC has been mandated to privatize. Experience from the former Soviet Union and from Zambia’s own privatization efforts suggests that restructuring of publicly-owned enterprises with a track-record of poor governance, bloated cost structures and ineffective, costly business models, is costly and time-consuming and may well not succeed. What may be needed are other arrangements such as asset sales, unbundling of markets, and wholesale takeovers.

5. Enhancing the role of private equity

The ‘turn-around’ mentality behind private equity addresses the needs of enterprises with high growth potential, while also recognizing that such enterprises may not yet live up to the requirements for being listed. The philosophy behind private equity is that PE managers entrusted with investors’ capital are charged with: (a) identifying potentially suitable investee enterprises, (b) engaging with enterprise owners in investing in the identified enterprises, and (c) monitoring the enterprises’ performance so as to ensure that the returns required by investors are achieved. Investee firms may not yet be able to document their track record in terms of the cash-flow and profitability required to attract investment by external third parties.

Private equity could fill an important gap in supporting the growth of enterprises that might eventually qualify for listing on the formal exchange. However, Zambia faces a number of challenges in moving towards and encouraging this outcome:

- **Limited scope for traditional PE in Zambia.** Economies of scale in identifying suitable investee enterprises, undertaking restructuring and investment in such enterprises, and monitoring enterprise performance for a return typically realized over ten years drives PE fund managers to invest in larger enterprises. This restricts the scope of PE investment in Zambia, where the number of suitable investee enterprises is limited.

- **Expertise and institutional capacity sourced abroad.** Given that opportunities for PE in Zambia are limited, expertise and institutional capacity for private equity is sourced abroad
largely from South Africa). As in most cases in Sub-Saharan Africa, PE funds active in Zambia are established off-shore with domicile in Mauritius. This is due to the well-developed legal framework, tradition for tax transparency supported by double-tax treaties with most jurisdictions, and well-developed administrative capacity. While replicating this set-up in Zambia may be an appropriate longer-term objective, currently there is no alternative to off-shore domicile.

With these challenges in mind, the case can be made for a Government-sponsored initiative to support the development of a local PE fund that serves smaller enterprises and develops local expertise. Characteristics of such a fund could include:

- **Government sponsorship, preferably shared with impact investors.** While Government funding support will be important to start with, it is crucial that the Government’s involvement is strictly ‘arms-length’ – to make sure that the structure is robust, relying predominantly on private sector management expertise. This will mean appointing the fund manager according to a competitive process and pre-determined criteria as to professional knowledge and experience, appointing a professional oversight board that fulfills requirements as regards professionalism and technical knowledge, while also providing the selected fund manager with considerable autonomy as regards investment decision-making.

- **Encouraging investment by non-Governmental sponsors.** While Government sponsorship (with the governance safeguards outlined above) may be necessary in a ‘proof of concept’ phase, involvement of non-Governmental investors will be crucial over time so as to provide both a more robust governance framework and to augment the amount of available funding. Following the proof of concept phase the fund will be better able to attract investment from impact investors. One source of funding suggested at the Indaba was investment by the diaspora. Were a mezzanine debt investment model to be adopted rather than investment in traditional equity (see further discussion below), then the more stable income stream associated with subordinated debt could make investment in such a mezzanine fund attractive to local Zambian institutional investors.

- **Mandating a focus on smaller enterprises** resulting in smaller investments. Due to the costs associated with identifying potential investee enterprises, assessing their business plans, and – once an investment has been made – monitoring their performance there are significant economies of scale associated with private equity. For these reasons traditional PE funds tend to invest in larger enterprises, and even those that are initially set up to service smaller enterprises tend to gravitate towards investing in larger enterprises. As the purpose of the proposed fund is to address the private equity needs of smaller enterprises, this will inevitably result in higher costs (per invested $), and the fund will need to provide for the fund manager to earn higher fees than associated with traditional private equity.

- **Several advantages are associated with providing mezzanine financing rather than traditional equity**:  
  - Mezzanine investments in the form of preferred debt are likely to be more attractive to the owners of smaller enterprises, as they do not require them to surrender equity in their enterprises. While enterprise owners stand to benefit from the greater pool of capital provided by private equity investors (and in turn by public equity markets), they are faced with the costs that follow from ownership by third parties, including greater accounting, legal and reporting costs, and less flexible decision-making. In addition, owners of smaller enterprises may be reluctant to share with the increase in firm value of the enterprises they have founded with third parties.

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4 Examples of mezzanine debt funds active in Sub-Saharan Africa are GroFin and Business Partners.
The use of mezzanine debt removes any perception that the Government, as a fund sponsor, is investing directly in the SME sector.

Issues relating to being able to find buyers for investee enterprises as the time of exit by the fund manager are resolved, as mezzanine debt is self-liquidating.

As mezzanine debt can be structured to provide investors with a steady interest income stream as well as access to dividends, such funds can be structured as permanent capital vehicles rather than as funds that have a limited life. This has the advantage of providing resources for re-investment. The permanence of the fund will also encourage the establishment of local expertise by providing a permanent anchor for PE activities in Zambia, and will hopefully encourage investment by non-Government investors (likely to be impact investors in the first instance).

Eventually, when the mezzanine fund has built a track record, it would be desirable that local institutional investors participate in the fund. Given that the fund yields a regular income stream, it would be a more appropriate investment for institutional investors than traditional PE. It will be important that the PIA’s investment guidelines for institutional investors sanction such investments, regardless of the country of domicile. Once the local legal, regulatory and institutional framework is established, it may be possible to ‘on-shore’ private equity funds and establish them in Zambia, but this would seem to be a secondary objective compared to increasing investment in Zambian enterprises.

6. Strengthening the institutional investor base

Strengthening the institutional investor base was a core theme emphasized during discussions at the Indaba. While private pension and insurance schemes are supervised by the Pension and Insurance Authority (PIA), the largest institutional investor, the National Pension Scheme Authority (NAPSA), manages the assets of mandatory National Pension Scheme. NAPSA administers approximately two-thirds of total pension fund assets and remains outside the oversight provided by the PIA, and is not subject to the PIA’s investment guidelines.

It is unfortunate that NAPSA manages its portfolio in-house rather than delegating authority to private investment managers. As part of the outsourcing process NAPSA would need to develop a framework that compensates third-party managers for maximizing profitability under agreed constraints as to risk-taking. Under such a framework it would be advisable to develop separate guidelines for managing long-term and short-term investments, as these functions require specific skills: it is all too easy for those in charge of day-to-day liquidity management to invest in a sub-optimal way for the long term. These efforts would support more active participation in the non-government bond market and equity markets and stimulate the development of the local investment management industry.

Obliing NAPSA to follow the PIA’s investment guidelines and expanding the role of the private sector in managing NAPSA’s portfolio will help develop the local fund management industry. While such a demand-side ‘push’ will be important, there may be constraints on the supply side. It transpired from information provided by African Life, the largest domestic fund manager, that approximately 50 percent of its investments are allocated (in roughly equal parts) to real estate and foreign equities. Such large investments abroad and other managers or funds are more reluctant to invest offshore, either due to lack of knowledge/expertise with international markets or of the attractive yields offered by domestic assets. Fund managers may also be reluctant to invest abroad as such investments require MOF approval. Providing clearer guidance or pre-approval for certain off-shore investments would remove the uncertainty of MOF pre-approval.
in relatively illiquid domestic assets, suggest that domestic investment opportunities are constrained due to the limited availability of suitable domestic financial assets. Thus the bottleneck to increasing greater investment in domestically-intermediated financial assets – and thereby improving the efficiency in the allocation of scarce domestic savings – would appear to rest with the supply of suitable securities in which to invest, rather than with the deficient demand for such securities.

In this context the PIA should be encouraged to adopt a more proactive and inclusive stance to product innovation. For example, while institutional investors could benefit from the risk-diversification offered by exchange-traded funds (ETFs), such investments are not currently encompassed by the PIA’s investment guidelines. Including ETFs in the investment guidelines would encourage the development of a local market for ETFs.

7. Enhancing the role of private-public partnerships in financing investment in infrastructure

Increasingly policy-makers in Sub-Saharan Africa and other emerging markets (such as in Asia and Latin America) are placing greater emphasis on the role of the private sector in financing infrastructure investments. This reflects very large investment needs combined with the limited availability of government and donor funding. While it makes good sense to leverage public funding with private sector investment in an effort to bring down costs and enhance efficiency, putting in place workable legal, regulatory and implementation frameworks has proven to be challenging. Such structures must foster a well-prepared pipeline of transactions, ensure an open and transparent contracting process, and instill investor confidence – not least on the part of the public sector – to live up to mutual obligations over the quite lengthy timeframe of such projects. Thus, while conceptually attractive, private-public partnerships (PPPs) have proven to be difficult to implement. Lessons learnt from Zambia and elsewhere confirm the imperative of dedicated commitment of political, technical and financial resources, if the prospect of leveraging private financing is to be realized.

Presentations at the Indaba by the Columbian Development Bank Financiera de Desarrollo Nacional (FDN) and the IFC confirmed the scope of commitment required to making PPPs successful. In addition to having the required legal framework in place, the Columbian efforts build on considerable investment in institutional strengthening and financial innovation:

- **Establishing a framework for distribution of the risks associated with infrastructure investment** (construction, maintenance, financing and user demand) between the public and private sectors is an important aspect of the institutional framework for PPPs. As part of the framework, dispute settlement mechanisms that allow for swift resolution and limit eventual losses are important. For the Government, it is crucial to accurately assess and monitor the size of the risks it has assumed, and establish contingency funding to make up for any shortfall in project financing or implementation.
- **Establishing an autonomous PPP agency with a dedicated mandate to strengthen the project preparation process.** Strong commitment to PPPs across government agencies (the Ministry of Finance and relevant sector Ministries as well as the PPP agency), combined with transparent and competitive contracting processes and sound contract management are fundamental to the success of any PPP program.

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6 Among the institutional reforms emphasized as crucial to the Columbian experience was strengthening of the Government securities market to provide a reliable benchmark for pricing longer-term fixed income commitments. See discussion in section 3 of this note.
• **Facilitating the process of arranging funding for PPPs.** In the case of Columbia, a specialized team which arranges the funding of PPPs has been assembled by Financiera de Desarrollo Nacional, a partially public investment bank. FDN is a public sector institution run as a private sector bank and licensed as a non-deposit taking financial intermediary. The private sector shareholding has proven crucial to strengthening the corporate governance of the FDN and preventing the institution from being captured by short term political interests. This has allowed a technically-oriented stable management team to run the company independent of the political cycle.7

The first two areas outlined above support the supply of infrastructure PPPs. The third area focuses on fostering investor demand. Both supply and demand factors need to be addressed in stimulating the development of PPPs. Given that local infrastructure investments predominantly generate income in local currency, ‘crowding in’ domestically-sourced funding provided by local institutional investors is particularly appropriate. In encouraging local institutional investment, considerable efforts will need to be devoted to:

- **Training local institutional investors** (their investment committees and trustees) to build understanding and technical capacity in project appraisal and due diligence. This includes financial structures, risk-analysis and monitoring, and contractual arrangements. Such capacity development will build domestic investor confidence and enable them to commit to investments in unlisted instruments, such as infrastructure bonds;
- **Building investment partnerships** that encourage participation of international direct investors, foreign donor agencies and development finance institutions alongside local banks and institutional investors;
- **Building skills within the PIA to understand and evaluate new instruments.** There is a need for the PIA, working with the SEC, to be proactive in supporting introduction of new assets classes into the PIA’s investment guidelines. While the primary objective of the regulator is to safeguard the savings channeled through non-bank financial intermediaries such as pension funds and insurance companies, it will be important to make appropriate allowance for infrastructure investments8.
- **Judicial use of credit enhancements to mobilize funding from local institutional investors.** The high level of risk-aversion of institutional investors can be assuaged by including credit enhancements as part of the local bond issuance program, such as partial political risk or credit guarantees, and liquidity and interest rate guarantees. While attractive to prospective investors, such credit enhancements should provide catalytic support to specific transactions rather than be seen as a permanent feature. Thus, it is important that their use occur in instances where the potential for encouraging replication of the underlying issuance without the support of credit enhancements is greatest.

8. **Encouraging the development of a market for private offerings**

There are further measures that need to be considered in supporting the development of PPPs and other types of long-term funding. This section suggests how the Zambian authorities could encourage the issuance of alternative debt instruments that, while not

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7 In the relatively short existence of its project finance program, the FDN has achieved eight financial closings on sizeable investments in road-building. FDN has leveraged relatively limited government resources with funding provided by local banks, institutional investors and international sources.

8 This would seem consistent with the current guidelines that do not set a limit on pension fund investments in corporate bonds and set a 30 percent ceiling on investments in real estate.
necessarily listed on the exchange, could facilitate funding in the infrastructure and enterprise sectors. Two possible infrastructure finance innovations that are gaining ground in emerging markets are infrastructure debt funds and project bonds; see brief description in Box 1.

**Box 1: Using unlisted capital markets vehicles to support infrastructure financing**

**Infrastructure debt funds** are collective investment schemes whose underlying assets are infrastructure loans or bonds. The funds (i) buy existing loans made by banks to infrastructure project companies, (ii) make new loans to these companies or participate in syndications of loans along with banks, and/or (iii) buy bonds issued by these companies. Given their underlying assets, investors receive as income the flows stemming from the loans and/or bonds (minus fees and operating costs). They are usually structured as closed-end funds, are unlisted and are placed through private offerings exclusively to qualified buyers, mainly institutional investors.

Currently such funds mostly invest in infrastructure in advanced economies. However, the number of funds targeting infrastructure in emerging markets is growing. In practice, many of these funds aim at providing exposure in emerging market infrastructure assets to foreign institutional investors. In addition, a few examples exist of “domestic” infrastructure debt funds constituted in emerging markets to attract domestic institutional investors. Examples can be found in Columbia, India, Peru and South Africa.

**Project bonds** can be used as an alternative debt funding instrument for infrastructure projects, complementing traditional bank financing. Project bonds can be listed or unlisted and proceeds can be used for both greenfield and brownfield projects. They are attractive, as they allow companies/developers to access additional sources of capital and reduce all-in funding costs compared to bank lending. Project bonds also help align the needs of domestic and foreign institutional investors, by providing long-term and stable cash flows while tending to produce the lower default and higher recovery rates associated with infrastructure assets.

Globally, project bonds represent only a small portion of the debt financing of infrastructure. However, their use and importance in total debt financing is growing. Prior to the 2008/9 financial crisis most experience with project bonds was in advanced economies, such as Canada, United Kingdom and the United States, with the main exception of Chile. In 2012, the EU launched the Europe 2020 Project Bond Initiative, to address dropping infrastructure projects investment levels in Europe. The decline in investment funds was due to strengthened prudential bank regulation, less activity by monoline insurers, and governments’ strained fiscal and budgetary positions. The initiative succeeded in improving capital market financing for large infrastructure projects, and in attracting institutional investor capital aided by credit enhancements designed to improve the credit quality of the senior debt tranche. Project bond issuances in Brazil and Mexico involved similar support in the form of partial guarantee schemes to bring down the risk for investors. In recent years, a number of emerging markets ranging from Brazil, Mexico, and Peru to Russia, Kenya, Nigeria and South Africa have issued their first rounds of project bonds.

**A well-functioning legal and regulatory framework for Special Purpose Vehicle (SPVs) is a necessary pre-condition for establishing markets for tailored instruments such as debt funds and project bonds.** SPVs are the legal structure used in defining commitments between project sponsors and third parties providing project funding. SPVs provide the legal structure for arranging issuance of privately-offered debt instruments, such as debt funds and project bonds, but are also vehicles for other conduits of long-term financing, such as mutual funds and private equity funds. An important aspect in using SPVs will be to ensure tax transparency on funding supported by such structures – i.e. to make sure that tax ‘pass-through’ applies to the use of SPVs and there is certainty as regards the tax applied to investors (avoiding double taxation).

**Namibia has been an innovator in encouraging institutional investors to diversify their investments using SPV structures.** While the Namibian market is relatively small in absolute terms, Namibia has pioneered reforms in the framework for institutional investment due to
sizeable asset accumulation in the form of pension savings. Recently, the authorities in Namibia revised the institutional framework regarding the establishment of SPVs to allow for and encourage the investment of pension funds into domestic, unlisted assets. The Pension Funds Act was amended in 2014, with Regulation 28 requiring pension funds and insurance companies to place between 1.75 and 5 percent of their assets in locally unlisted investments. Regulation 29 supports institutional investors by setting out the requirements for SPVs which qualify under the investment guideline. Requirements for such SPVs include setting up an independent Board of Trustees with fiduciary duty towards the SPV and its investors. The Board must appoint fund managers licensed to manage unlisted investments in debt or equity consistent with their own objectives. Most SPVs in Namibia have so far invested in real estate and SME debt. Fees average around 2-3% of assets under management – which is a high PE-style cost, but the regulator, NAMFISA, sees the overall impact on pension funds’ costs as limited, as these instruments will only form a small overall percentage of the total portfolio.

While SPVs can be used as vehicles for private offerings, they can also be used as conduits for listed financing as has been the case in Mexico. Once the market for unlisted private offerings has been explored and found to be attractive to issuers and investors, listing of SPVs may be a next step – an approach that is consistent with the graduated approach to capital market development outlined in Section 2. Listing would increase awareness among a broader number of potential investors and result in greater liquidity of the instruments issued by the SPV. In Mexico, the regulator, Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR), has eased investment restrictions gradually as alternative investments have become available for pension funds. In July 2009 significant regulatory changes were made to create a new type of structured securities known as CKDs (Certificados de Capital de Desarrollo), which are traded on the Mexican Stock Exchange. As the principal sources of capital for these instruments are the Mexican mandatory pension funds, part of these regulatory changes involved amending the investment rules for pension funds to allow for the possibility of making investments in private equity, real estate and infrastructure projects.

In addressing local funding gaps, every effort should be made to further explore the potential role that SPVs could play in deploying institutional investment capital. Nampro, a Namibian SPV, which focuses on supporting the financing of small enterprises, provides an interesting example. The Nampro Fund is a bridging finance solution for SME’s experiencing high growth and needing short term finance to meet their supply contracts obligations. Initially funded by the Government Institutions Pension Fund through an N$160 million allocation, the Fund’s capitalization is N$300 million and has funded over N$400 million worth of facilities to SME’s. The NamPro Fund is committed to modern principles and practices of good corporate governance.

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9 Investment fund assets constitute 130 percent of Namibian GDP, of which 60 percent come from pension funds and 20 percent from insurance companies. Fifty percent of investment fund assets are invested abroad, and there is a strong political imperative to find suitable domestic investment opportunities.

10 The requirement for listing is driven by the Retirement Savings System Law that requires pension funds to invest in publicly offered securities registered on the stock exchange.

11 The use of CKDs in Mexico is not altogether beneficial. As Mexican pension are obliged to invest only in listed securities, several PE funds have found it necessary to list adding costs to meet regulatory requirements. There are few benefits from listing, as there is very little liquidity on the secondary market. Other countries in Latin America (Chile, Peru, and Columbia) have followed the example of Canada and Australia where pension funds can invest in both listed and unlisted SPVs.

12 The Fund’s Trust Governing Board (TGB) has established three sub-committees -- Audit, Risk and Compliance Committee (ARCC), Conflicts Resolutions Committee (CRC) and an Investment Committee (IC).
The Nampro Fund’s primary focus is to provide local SMEs with access to short-term working capital funding in the form of bridging finance. Nampro leverages the credit-worthiness of reputable larger corporates, Government departments/Ministries, state-owned enterprises or viable local government authorities contracting with the SMEs for their services. Nampro provides funding for contracts (usually up to one year), purchase order finance and invoice discounting as well as the issuing of bid bonds and performance guarantees in support of SME bids for awards of contracts. The Fund also provides SMEs that are awarded service contracts with asset-backed finance (lease finance) to meet the plant and equipment requirements needed to service the contracts.

A possible extension of the Nampro’s current business model would be to establish a reverse factoring platform. Reverse factoring is a type of financing where a financial firm (the factor) purchases accounts receivables issued by certain larger reputable firms. This reduces information problems, as the factor only needs to assess the credit-worthiness of a select number of larger buyers. Reverse factoring takes the form of asset sales, not loans, and thus helps firms as they are not dependent on updated secured lending laws, or well-functioning registries and foreclosure mechanisms. Setting up regulations that sanction the operation of factoring funds, with clear regulatory requirements and risk management guidelines, would encourage the establishment reverse factoring. Nacional Financiera (NAFIN), a Mexican development bank, provides an online platform for reverse factoring, enabling SMEs that operate within supply chains (delivering their products to larger firms) to borrow against their receivables. Suppliers participating in the program are required to be screened by buyers (large credit-worthy firms) and need to be invited to join the chain, thereby effectively outsourcing supplier screening to the buyers. All transactions are carried out on an electronic platform, which reduces transaction costs and improves efficiency and security. NAFIN is responsible for the development, production, and marketing costs related to the electronic platform. Examples of similar platforms can be found in Chile, Paraguay and Peru, and adoption of reverse factoring is currently being explored in Kenya.

The authorities also have a role to play in encouraging development of the market for private offerings. It is unlikely that instruments such as project bonds, debt funds or other SPVs will be listed on the stock exchange, as they are usually one-time in nature and target relatively sophisticated professional investors. Nonetheless, as such unlisted instruments can play a potentially important role in facilitating long-term finance, it is important that issuance of such securities be encouraged – e.g. through streamlining the registrations process, reducing approval times and introducing fast-tracking mechanisms such as shelf registration. In the medium term the capital market will stand to benefit from greater depth in the unlisted market as with growing issuance, volumes issuers and investors will want to move towards greater price competition and transparency as offered by the formal market.

In this context, it will be to the advantage of both market participants and the SEC to promote hybrid options that encourage the use of private offering mechanisms. These hybrid trading platforms do not encompass the full disclosure obligations and costs associated with public listings. As alternative private-offering mechanisms that can be designed to contain issuance costs (e.g. not requiring a full prospectus) and to target specific groups of qualified professional institutional investors, such hybrid trading platforms can provide an important stepping stone between private placements and the listed market.

9. Suggested next steps

In deepening long-term finance in Zambia the importance of strong commitment by the authorities cannot be over-emphasized. This will entail support by the Ministry of Finance,
commitment by the SEC and coordination with other regulators (SEC, BoZ and PIA) and among the agencies of Government, as well as strong communication with private sector transaction sponsors and investors.

Such commitment and coordination could be bolstered by developing a capital markets master plan. In recent years such plans have been developed in several countries in Sub-Saharan Africa, including Kenya, Uganda and Rwanda. While such plans create focus and momentum, they also take time to produce, as does creating consensus around their implementation. This, in parallel with developing a capital markets masterplan and by way of testing the level of commitment of various stakeholders, it would be advisable to move forward in implementing some of the broadly-endorsed suggestions arising from discussions at the Indaba.

The two approaches outlined here are not mutually-exclusive and could be undertaken in parallel. Gaining momentum in implementing some of the next steps would create confidence that there is commitment to the broader agenda of the master plan. The danger is that the master plan becomes so far-reaching and technically complex that its implementation remains an ambition.

As outlined in this note, among appropriate those next steps discussed at the Indaba that promise to yield near-term impact are:

- Creating greater institutional investor support to strengthening the depth and vibrancy in the market for local securities by outsourcing the investment decision-making of NAPSA while also extending PIA regulatory authority to encompass NAPSA, including as regards observing investment guidelines 13;
- Deepening secondary-trading on the market for fixed income benchmark Government securities can be supported by:
  - Establishing deeper benchmark issues of Government bonds;
  - Introducing a primary dealer system with a view to actively promoting greater secondary market liquidity;
  - Introducing a global master repurchase agreement that allows investors to flexibly adjust their risk exposures; and
  - Increasing reliability in the execution and reporting of trades in Government bonds by strengthening market infrastructure.
- Exploring the design/feasibility of establishing a permanent capital vehicle providing mezzanine funding to address the longer-term financing gap experienced by Zambian SMEs;
- Undertaking a concerted effort to strengthen the legal, regulatory and institutional universe relating to PPPs by:
  - Strengthening the overall framework for distributing risks associated with PPPs;
  - Establishing an autonomous PPP agency dedicated to strengthening project preparation;
  - Considering options to support facilitation of funding of PPPs

The agenda around facilitating the establishment of special purpose vehicles is closely linked to PPPs, as SPVs provide the legal/institutional structures that project sponsors use in initiating private offerings.

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13 This reform is fundamental to establishing a secondary market for fixed income securities. The following suggested next steps relating to establishing benchmark pricing in Government securities are unlikely to take-off unless measures are taken to deepen the domestic institutional investor base.
Annex: Infrastructure and Enterprise funding escalators

Infrastructure Funding Escalator

Major sources of capital
- Government financing
- Government financing supplemented by donor/concessionary financing
- Government and donor financing
- Involvement of commercial banks and international investors
- Government and donor financing
- Increasing role of financial markets (banks, private equity)
- Emergence of capital market solutions (e.g. project bond)
- Private financing leveraged by official financing through contingent instruments (e.g. risk guarantee)
- Growing role of institutional investors

Data availability
- Data kept private leading to information asymmetry and high agency costs
- Higher data transparency leading to reduced risks and increased capital availability

Enterprise Funding Escalator

Major sources of capital
- Grants
- Family and friends
- Crowdfunding
- Business angels
- VCs
- Banks
- Private placement
- VCs
- Banks
- Private equity
- Private equity
- Banks
- IPO
- Main market listing

Data availability
- Data kept private leading to information asymmetry and high agency costs
- Higher data transparency leading to reduced risks and increased capital availability