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Bonds: A Viable Alternative for Financing Africa's Development

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African perspectives. Global insights.

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ABSTRACT

Since the financial crisis of 2008 loans from banks have become more difficult to obtain. African countries increasingly have explored alternatives to raise capital for their economic development projects. Experience in some African countries and other developing regions indicates that bonds present opportunities to raise funds to finance capital-intensive projects, particularly infrastructural schemes, that take place over long periods of time. There are various types of bonds African governments can issue. Capital markets in many African countries, however, remain largely underdeveloped and lack the necessary regulatory structures to bolster the confidence of investors to attract investment in local bond markets. These bond markets are characterised by the issuing of bonds mostly by national governments. State, local government and corporate bond issues are almost non-existent. The lack of market infrastructure fundamental for the development of secondary markets on which bonds can be traded presents critical impediments to bond market development in African countries. Although there is evidence that bond markets in Africa are opening up, if governments and firms in African countries are to access capital for development through issuing bonds, financial and regulatory reforms are needed to accelerate the development of debt capital markets which in turn would contribute to the growth of bond markets in Africa.

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ABBREVIATIONS AND ACRONYMS

ACSA	Airports Company of South Africa
AfDB	African Development Bank
BESA	Bond Exchange of South Africa
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
CDS	Central Depository Account (Kenya)
COJ	City of Johannesburg
CSCS	Central Securities Clearing Systems Ltd (Nigeria)
DCI	Development Corporation for Israel
DMO	Debt Management Office (Nigeria)
DMTN	Domestic medium-term note programme (South Africa)
Eepco	Ethiopian Electric Power Corporation
FGN	Federal Government of Nigeria
GOK	Government of Kenya
GSE	Government sponsored entity
IDC	Industrial Development Corporation (South Africa)
NSE	Nigerian Stock Exchange
NSEC	Nigerian Securities Exchange Commission
PSMM	Primary Dealers and Market Makers (Nigeria)
Sanral	South African National Roads Agency
SOE	state-owned enterprise
UF	Unidad de Fomento (Chile)

INTRODUCTION

Disruptions in financial markets resulting from the 2008 global financial crisis led to a severe scarcity of funds from the banks which previously had provided capital for public infrastructure development, mainly through loans. Governments came under severe financial pressure as the capacity to use finance for large-scale infrastructure projects has been greatly reduced. Project developers began seeking alternative finance for such undertakings and in consequence the landscape of infrastructure financing is changing.

Across the world – especially in Africa – economic growth is becoming an increasing priority. Analysts agree that economic infrastructure is one of the drivers of growth and that a lack of finance constitutes a major obstacle to infrastructural development. Of late there has been an intensified focus on raising funds through alternative financing initiatives, particularly capital market borrowing. With a steady decline in the availability of bank loans, governments and project developers are increasingly using alternative funding sources such as wealth funds, pension funds, public-private partnerships and bonds to finance infrastructure projects.[1]

In pursuing the broad, multifaceted development agenda regarded by many African countries as the favoured path towards economic development, bonds present a mechanism for African governments to raise the necessary capital. For some African governments, completing infrastructure projects is an integral part of those plans. Nevertheless, for various reasons the use of bonds to finance such schemes in Africa remains insufficiently explored. Those reasons include the absence of a secondary market on which bonds can be traded, the underdeveloped state of non-bank financial institutions, a weak institutional investor base,[2] the lack of appropriate regulations to secure investors and make bond issuers accountable, and a high level of unfamiliarity with the process of structuring and issuing bonds.

Emphasising experience from selected countries to inform best practices, this paper aims to highlight the various types of bonds African governments can issue to raise capital for infrastructure projects. The paper also briefly examines the benefits of developing a bond market and suggests ways to address the challenges faced by governments in issuing bonds as a financing mechanism.

TYPES OF BOND

Bonds are debt instruments through which finance for infrastructure development can be raised. African governments and businesses can select from different types of bonds[3] to find the best vehicle for raising capital. Not all bonds are the same and some financial economists argue that the structure of a bond is of itself a strong determinant for the amount of capital investors may be willing to commit. The interest rate, maturity period and flexibility in paying interest, and the length of the 'lock-in' period[4] stand out as among the most important deciding factors.

Bonds differ according to the interest rates they offer. Some pay a fixed rate of interest until the bond matures, while others offer floating rates that are reset periodically (usually every six months) to adjust to changing market interest rates. Zero-coupon bonds differ from other types of corporate bonds in that no interest payment is made to holders until the bond matures. Instead, at maturity a single payment is made that is higher than the initial price at which the bond was purchased. Investors in zero-coupon bonds do, however, pay annual taxes on the interest the bond yields before the compounded interest is paid out on maturity.

Bonds may also be classified as secured, senior unsecured bonds, and junior (or 'subordinated') unsecured bonds. Secured bonds are backed by specific assets that companies have pledged as collateral. Unsecured bonds that have no collateral backing are known as debentures and have a general claim on the firm's assets and cash flows. Debentures are further classed as senior and junior debentures.

Municipal bonds

Municipal bonds are debt securities issued by cities and municipalities to fund their daily operations and finance the construction of capital-intensive projects such as roads, schools and hospitals. Investors generally purchase municipal bonds on the promise of steady interest repayments until the bond matures. Depending on the prevailing regulations, the interest earned on municipal bonds may be exempt from national, state and municipal taxes.

Government entities mainly issue two types of municipal bond: general obligation bonds and revenue bonds. General obligation bonds are not secured by any assets but are backed by the 'full faith and credit' of the issuing government entity, as it holds the power to tax residents and thereby raise funds to repay investors. By contrast, revenue bonds are not backed by the government entity's taxing power but by revenues from a specific project or source, such as highway tolls or lease fees. Some revenue bonds have a non-recourse feature, in which case if the revenue stream dries up, bondholders cannot obtain redress through litigation to force the issuer to make payment. Although municipal bonds are considered a safe type of investment there are risks associated with them as there are with any form of financial investment. These include call risk (the risk that the issuer may redeem the bond prior to its maturity), credit risk, interest rate risk, inflation risk and liquidity risk.

Agency bonds

Agency bonds, also known as state-owned enterprise (SOE) bonds, are issued by government agencies and government sponsored entities (GSE) and are considered a low-risk investment. SOE bonds are backed by the full credit and faith of the national government, which lowers the risk profile of such instruments; the two main risks associated with them are political and liquidity risks. GSE bonds on the other hand are not guaranteed by the national government: GSEs in fact are government-chartered private corporations mandated to raise funds for requirements of public interest such as housing. Although GSE bonds are not fully backed by the national government, the government charter on which they are founded provides a level of credibility. Furthermore it is unlikely that a national government would allow a GSE to default on its bond payments while delivering on its mandates, because GSEs play an important role in ensuring broad economic stability.

Government bonds

Government bonds constitute government debt and are issued and backed by the national government. They are classed among the safest financial investments and fall into four main categories: treasury bills, treasury notes, treasury bonds and treasury inflation protected securities. The main differences between them lie in their maturity dates and the structure of interest payments.

Treasury bills mature in one year or less and their key feature is that bondholders do not receive any interest – rather the bonds are sold at a discount to face value. The full government backing for treasury bills coupled with their short maturity period makes such bills the least risky government bond.

Treasury notes mature at one and 10 years and investors receive interest payments every six months. Treasury notes differ from treasury bills in that investors in treasury notes pay the full price of the bond upfront whereas bills are sold at a predetermined discount on par value.

Treasury bonds are similar to treasury bills but the maturity period for the bond is 10 to 30 years. Investors also receive interest payments every six months.

Treasury inflation protected securities are government bonds designed to protect against inflation. These bonds are issued with maturities of five, 10 and 30 years. While regular interest payments made to investors every six months stay constant until the bond matures, the principal paid when the bond reaches maturity adjusts with inflation.

Corporate bonds

Corporate bonds are bonds issued by private or public firms. Investors who purchase these bonds essentially lend money to the company that issues the bond, which in turn confers on the issuer a legal commitment to pay interest on the principal and return the principal to investors when the bond matures. An important advantage of corporate bonds is that they make it possible to raise capital without diluting ownership of the firm: unlike stock issues which confer equity ownership, investors in bonds do not own any part of the company that issues the paper. Even in the event that a firm has financial problems, it still has a legal obligation to pay interest on its bonds and to return the principal to investors, an obligation shareholders do not enjoy.

Corporate bonds are generally classified according to their maturity, which can be short term (less than three years), medium (four to 10 years) or long term (more than 10 years). Longer-term corporate bonds normally offer investors higher interest rates but also come with higher risks. The credit quality of corporate bonds and the firms that issue them are critical: the risk of defaulting on interest payments makes the creditworthiness of the firm a major concern for the investor. Credit rating agencies assign ratings to bonds based on an evaluation of the likelihood of a firm's defaulting on its bond payments.

Using risk as the underlying criterion, corporate bonds are also classified as 'investment' and 'non-investment' grade. Investment grade bonds are considered safer than non-investment grade; bond repayments are projected to be paid on time, indicating that the bond and the bond issuer are stable investments. Non-investment grade bonds (also known as 'high yield' or 'speculative') normally offer higher interest rates to compensate for the higher level of risk. Risks associated with corporate bonds include credit or default risk, interest rate risk, inflation risk, liquidity risk and call risk.

Sovereign bonds

Sovereign bonds are bonds sold and guaranteed by a national government. They are often referred to as 'sovereign' or 'external' debt because the process of raising capital requires a government to issue bonds in a foreign currency and sell them to foreign investors. Because purchasers are outside the issuing country the debt is regarded as external. This feature distinguishes sovereign bonds from other government bonds. Usually the currency chosen for issuing sovereign bonds is stronger than the issuing country's own currency. This is widely considered as a security feature that protects bondholders because the economies of many countries issuing sovereign bonds are unstable. Capital from the sale of sovereign bonds is known as sovereign debt. Sovereign bonds add to a country's sovereign debt and technically are owed by the issuing government. Payments on sovereign bonds are made in the currency in which the bond is denominated. Sometimes governments have to divert funds from internal spending or increase taxes to find the capital to pay debt on sovereign bonds and the main risk associated with sovereign bonds is that of a government default on bond payments.

Diaspora bonds

Diaspora bonds are bonds issued by governments and directed to citizens and individuals originating from the country but living elsewhere. Hence they are a form of government debt targeted at its national community abroad. Sales of diaspora bonds may be restricted to citizens of the issuing country, or can be opened to other investors but with citizens receiving preferential rates on bond purchases.

By issuing diaspora bonds countries with large communities overseas can tap into the wealth and savings of their citizens resident in foreign countries. A successful issue of diaspora bonds as a means of accessing new funding can help improve a country's sovereign debt ratings. Also, due to the patriotic and familial ties citizens in the diaspora may retain with their home country, they may continue to purchase the bond even when markets are sceptical about the economic outlook in the issuing country. For this reason governments may be able to raise more capital than they otherwise would, by issuing diaspora bonds to patriotic buyers prepared to accept much lower returns than they might obtain on the open market. Diaspora bonds have varying payment periods and maturity dates. Nigeria, Uganda, Ghana, Cape Verde, South Africa and Kenya are among African countries currently structuring diaspora bond programmes.

Islamic bonds

Islamic bonds are securities issued mainly by governments, Islamic banks and other corporations in Islamic countries. National and in some cases state governments in those countries are the main issuers. A successful issue of Islamic bonds requires a high level of interest from investors along with regulatory structures that help to develop secondary markets. Although called 'bonds', Islamic bonds differ significantly from the conventional variety. Unlike the acquisition of conventional bonds, purchasing Islamic bonds represents ownership in a tangible asset, as stipulated in the regulations that govern Islamic finance. These bonds are structured to abide by Sharia law, which forbids interest payments, cannot be used to buy traditional debt, to share in profits or receive rental income. Consequently the bonds are inherently asset-backed securities and can be issued for existing or future assets. Revenue from the underlying asset provides investors with guarantees that they will receive a share of profits from those assets. Investors in Islamic bonds do not earn interest payments – interest on investments is forbidden in Islamic finance. In instances where Islamic bond certificates represent debt to an investor, the certificate cannot be traded on the secondary market; instead it is held until maturity or sold at its face value.

BONDS AND CAPITAL FOR INFRASTRUCTURE DEVELOPMENT

In many African countries it is normal for governments to raise capital by obtaining loans rather than by issuing debt in the form of bonds. Loan finance, however, should be evaluated against an appraisal of the advantages of bonds.

From the investor's point of view, given their low volatility – bonds are long-term investments and hence suffer less from the day-to-day volatility that characterises many other types of securities – instruments such as municipal bonds, agency bonds and government bonds are widely considered to be more secure than many other investments. Also, due to their structure and attributes as an asset, bonds are highly liquid on secondary markets (granted that these markets are mostly under-developed in Africa). Furthermore, bondholders are protected by law and issuers are obliged to pay bondholders at least some amount of the value of their bonds in the event that the issuer goes bankrupt. Finally, municipal, agency and government bond issues enjoy tax exemptions, which add to their attraction.

Seen from the bond issuer's perspective the cost of borrowing using bond issues is lower than loans from a bank. In the latter case interest rates and various parameters of the loan are set by the bank, whereas in issuing bonds the bond issuer sets the interest rate and other important terms such as repayment periods. Issuing bonds therefore presents governments and private companies with an alternative for raising capital at lower cost. For private firms, as has already been noted, issuing corporate bonds also presents an opportunity to raise capital without diluting equity in the company. Issuing debt enables institutions to control their assets using capital raised from bond issues. Issuing bonds is also advantageous in developed capital markets because bond issues generally are free from covenants and restrictions that otherwise can interrupt capital flows into infrastructure projects. It is critical to note however that issuing debt in the form of bonds as a means to finance infrastructure carries inherent risks which can be managed only by establishing structures to oversee the legal and regulatory aspects of bond issues. In developing such bond issues, the issuer must also take into account risks associated with project feasibility and possible delays in construction.[5]

BOND MARKETS IN SELECTED AFRICAN COUNTRIES

Complex transactions can take place only in developed financial markets. Although at present financial markets in many African countries are under-developed, it is possible for governments to take steps to develop them in such a way as to support the growth of bond markets in order to provide additional capital. The process will take time but the benefits of developing bond markets sufficiently to improve access to capital for infrastructure development could make it worthwhile.

The South African bond market

The most popular type of bond in the domestic South African bond market is the Republic of South Africa (RSA) government bond, primarily issued to support the country's fiscal budget. The market for RSA government bonds is exclusive and open only to selected primary dealers permitted to take part in the primary auctions of these bonds; the South African government does, however, issue RSA retail savings bonds, better suited to retail investors. RSA government bonds and RSA retail bonds are guaranteed by the South African government. Municipal bonds with maturities of more than one year are issued by city councils. Their main purpose is to raise capital for development projects. Municipal bonds are not, however, guaranteed by the South African government.

A feature of the South African bond market is the high level of activity of SOE and corporate issuers in the primary market, issuing short- and long-term debt. Bond Exchange of South Africa (BESA), a public company, operates and regulates the long-term debt securities and interest rate derivatives market in South Africa. Although South Africa's bond market is the most developed in Africa, the secondary market on which bonds are traded is largely under-developed, a situation that presents challenges for investors seeking to purchase and trade bonds.

Although South Africa's financial market is considered advanced, the use of bonds as instruments to finance infrastructure development is not widely practised and bank finance is currently regarded as a more acceptable alternative. Some financial and economic analysts believe that the slow acceptance of bonds can be directly linked to a lack of the policy and regulatory structures needed to support the development of secondary bond markets; a lack of general public awareness of the benefits of bonds; and an absence of widespread understanding of the necessary processes successfully to structure, develop and implement bond issues.

There are, however, cases in which bonds have been used to finance South Africa's infrastructure projects. In September 2008, under its domestic medium-term note (DMTN) programme the South African National Roads Agency (Sanral) issued six bonds amounting to ZAR 850 million[6], to fund the Gauteng Freeway Improvement Programme (GFIP). Two of the bonds were inflation linked with maturity dates set at 2013 and 2023, and four were fixed-rate bonds with five- to 20-year maturities. Due to legal problems attending an electronic tolling system as an integral part of the GFIP, subsequent bond issues failed to raise additional capital for Sanral.

In March 2009 the Airports Company of South Africa (ACSA), as part of its ZAR 12 billion (approximately $1.16 billion in March 2009)[7] DMTN programme placed a bond issue to raise ZAR 1.1 billion (approximately $106.5 million) from the domestic market.

The bond was issued in three tranches comprising a seven-year fixed-rate bond, a five-year inflation-linked bond and a 14-year fixed-rate bond. In 2012, in line with the South African government's development policy highlighted in its New Growth Path and Industrial Policy Action Plan 2, the Industrial Development Corporation (IDC) issued a ZAR 5 billion green bond to raise capital to fund infrastructure development in the renewable energy industry. The green bond was set to mature in 2026. In early November 2013 the South African energy utility Eskom, issued a ZAR 1 billion ($96.8 million) bond under its DMTN programme to raise additional capital to fund new electricity generating plants. The interest rate was set at 8.5% and the bond matures in 2042. The bonds issued by Sanral, IDC and Eskom were guaranteed by the South African government.

Although the South African bond market is dominated by RSA government bonds and corporate bonds issued by SOEs,[8] some private firms have issued corporate bonds. In 2012 South African Breweries South Africa (SABSA) Holdings issued ZAR 1 billion in corporate bonds with an annual interest rate of 7.125%. The bond, which matures in 2018, was guaranteed by SABMiller, SABSA Holdings' parent company. In April 2013 Soitec SA, a French renewable energy firm, issued a ZAR 1 billion 16-year solar financing bond to fund the development and construction of its 44 million MWe (Megawatt electrical) concentrated photovoltaic plant at Touws River in Western Cape Province. The interest rate was set at 11%; the bond was the first of its kind in South Africa.

Since 2004 the City of Johannesburg (COJ) has issued seven bonds, all listed on BESA. The main purpose of the issue is to finance a capital expenditure backlog estimated at ZAR 8 billion. The second issue, a ZAR 1 billion ($90 million in October 2014, but $154 million in October 2004) bond issued in 2004 and maturing in 2016, was the only one to offer guarantees for investors, partially backed as it was by the International Finance Corporation and the Development Bank of Southern Africa. The remainder of COJ's bonds were unsecured, and all of them were tax deductible.

In 2013 the City of Tshwane raised ZAR 1.39 billion (approximately $139 million) by issuing two inaugural but unsecured bonds with maturity dates of 10 and 15 years respectively, to finance a long-term capital expenditure programme that included infrastructure development in the city. The interest rates for the bonds were set respectively at 9.11% and 10.20%.

The Nigerian bond market

Federal Government of Nigeria (FGN) bonds are the most common type on the Nigerian bond market. They are issued by the Debt Management Office (DMO) which regulates activities in Nigeria's bond market. One of their main purposes is to reduce the country's fiscal deficit. The Central Bank of Nigeria (CBN) acts as the issuing house and registrar for the bonds, the maturity dates of which vary but do not exceed 10 years. The Central Securities Clearing Systems Ltd (CSCS) is the depository for bonds listed on the Nigerian Stock Exchange (NSE). Nigeria has no separate central body that trades bonds; hence FGN bonds are listed and traded on the NSE. FGN bonds are considered one of the safest investments in the Nigerian domestic currency because they are backed by the full faith and credit of the government and income on purchased bonds is exempt from taxes. Primary Dealers and Market Makers (PDMM) – banks and discount houses appointed by the DMO – are dealers in FGN bonds. Once issued, FGN bonds essentially are not directly available to the general public. PDMMs are required to market and distribute primary issues of FGN bonds and to promote secondary market activity, which at present is non-existent in the Nigerian bond market.

State and local government[9] bonds also feature in Nigeria's bond market. Bonds issued by state governments are more prominent and bonds issues by local governments are rare. According to the Nigerian Securities Exchange Commission (NSEC), which regulates the Nigerian capital market, 20 states in Nigeria issued bonds between 1986 and 2012 to finance development projects which generally included infrastructural schemes. Within that period some states (such as Lagos, Edo, Delta, Kaduna and Ekiti) issued more than one bond. In 2011 the Niger state government issued a seven-year NGN[10] 9 billion (approximately $54 million) bond to raise funds for the construction of roads. The interest rate was set at 14%. Also in 2011 Gombe state issued a seven-year NGN 2 billion ($12 million) bond with an interest rate of 15.5%. The state issued the bond mainly to raise capital for the construction of township and regional roads. In 2012 the Lagos state government issued a seven-year NGN 8 billion bond with an interest rate set at 14.5% while in the same year the Osun state government issued a seven-year NGN 3 billion bond. Both these issues were to fund the construction of water and transport infrastructure projects. Nigerian state and local government bonds are tax deductible but not guaranteed by the federal government. In practice they are backed by the ability of state and local governments' to levy taxes, and the income from completed projects such as highway tolls and railway revenues.

According to the DMO, 20 private firms raised NGN 200 billion between 2005 and 2012, to finance business operations through bond issues on the international capital market. Corporate bond issues in Nigeria are dominated by banks and insurance companies. In 2010 Flour Mills of Nigeria Plc. issued a five-year senior unsecured, NGN 35 billion bond with a 12% interest rate and the following year United Bank of Africa issued a seven-year NGN 35 billion unsecured bond with an interest rate of 14%. In 2012 the Federal Mortgage Bank of Nigeria also issued a NGN 30.56 billion ($184 million) unsecured bond with a 17.25% interest rate. In Nigeria, most corporate bonds are issued through private placements and not directly to the public. Like local governments, SOEs rarely issue bonds.

The Kenyan bond market

The most common type of bond in the Kenyan market is the Government of Kenya (GOK) treasury bond. This is a medium- to long-term bond with varying maturity dates set between one and thirty years. The Central Bank of Kenya (CBK) acts as the issuing authority for government treasury bonds. Most GOK treasury issues are fixed- and floating-rate bonds, and zero coupon bonds issued mainly to fund the government's budget deficits. By 2009 GOK had issued 68 treasury bonds. Such bonds are listed and traded on the Nairobi Stock Exchange (NSE); their combined value in 2009 was KES[11] 350 billion ($3.8 billion). Investors interested in buying bonds at the NSE are required to open a Central Depository Account (CDS) with the CBK. The CDS is the investor's securities trading and holding account. GOK treasury bonds are guaranteed by the full faith and credit of the national government.

GOK also issues special purpose infrastructure bonds to raise capital to fund infrastructure projects. In February 2009, the government closed its first 12-year infrastructure bond offer after successfully raising KES 18.5 billion ($203.8 million). The annual interest rate was set at 12.5% with interest paid twice a year, and principal repayment was set at 2015, 2017 and 2021 to accommodate short- to medium- as well as long-term investors. The instrument can be classified as a general obligation bond to raise capital to fund road, energy and water infrastructure projects.

More recently, in September 2013 the Kenyan government issued its second 12-year general obligation infrastructure bond to raise KES 36 billion ($396.5 million) for financing large-scale infrastructure projects. The interest rate was set at 11%, the principal to be paid out in the fourth, eighth and 12th years, to provide investors with some level of flexibility. In addition bond holders could use bond certificates as collateral to obtain credit from any financial institution in Kenya. The impact of the bond issues on the Kenyan economy, in terms of the economic benefits of projects financed through them, is yet to be determined. The capital was raised to finance projects focused on developing Kenya's transport, energy and water sectors.

While Kenya is the only African country in which the central government issues infrastructure bonds, corporate bond and municipal bond issues are almost non-existent. Nevertheless there have been a few examples of corporate bond issues. By 2009 seven companies had issued 10 corporate bonds with a total value of KES 10 billion ($110.1 million) and maturity dates ranging from two to eight years, traded on the NSE. In 2012 the Nairobi-based Centum Investment Group issued a KES 3.2 billion ($35.2 million) five-year senior unsecured bond. The issue comprised fixed and floating rate bonds with 13.5% and 12.75% interest rates respectively. Safaricom Ltd, Kenya's largest telecommunications company, and the SOE Consolidated Bank are also notable among the few Kenyan companies to have issued unsecured corporate bonds.

BOND ISSUES IN SELECTED COUNTRIES

Apart from in Kenya, Nigeria and South Africa, some countries within and beyond Africa have begun to issue bonds to raise capital for infrastructure development. Types of bond include diaspora bonds, Islamic bonds and sovereign bonds. It is useful to highlight some critical differences and to analyse the largely underdeveloped state of bond markets in African countries, through assessment of some successful bond issues.

Diaspora bonds in Ethiopia, India and Israel

Ethiopia

The Ethiopian financial market is greatly under-developed and lacks important financial structures necessary for capital market development, such as stock and bond exchanges. The Ethiopian government, however, needed to raise capital to fund the Grand Ethiopian Renaissance Dam (then known as the Millennium Dam) on the River Nile. The dam is designed to increase the generating capacity of the Ethiopian Electric Power Corporation (Eepco), an SOE, in order to export electricity to neighbouring East African countries and in the process generate revenue to fund economic development in Ethiopia. Obtaining bank loans for a project with an estimated cost of $4.8 billion proved difficult due to bilateral tensions with Egypt over water security issues, the lack of availability of international financing, and concerns over Ethiopia's ability to sustain its external debt. Taking advantage of Ethiopia's large diaspora, in 2008 Eepco issued the Millennium Corporate Bond (MCB), Ethiopia's first diaspora bond, to tap into the financial assets and resources of Ethiopians within the country and abroad. The bond was open only to Ethiopians and individuals who could trace their roots to Ethiopia. It was backed by revenue from the project and guaranteed by the Ethiopian government. The interest rate was set at 4%, 4.5% and 5% respectively for five, seven and 10 years. For the duration of the bond the interest on investment was exempt from taxes and bondholders could use the bond certificate as collateral when borrowing from financial institutions within Ethiopia. The Eepco bond was underwritten by the National Bank of Ethiopia and marketed by the Commercial Bank of Ethiopia (CBE).[12]

Most analysts considered the MCB issue largely unsuccessful because it failed to raise adequate capital for the project. In structuring the bond, the Ethiopian government had failed to provide a platform for open dialogue through which it could have been advised by experts. Investors lacked trust in the government as guarantor of the bond and a perception of risks linked to the project's earning ability and resultant revenue-generating capacity also had a negative impact on the issue. The Ethiopian government also failed to broaden its scope in marketing the MCB as it sold the bonds to Ethiopians only, through the CBE and Ethiopian embassies around the world.

In 2014 the Ethiopian government issued its second diaspora bond, the Grand Renaissance Dam bond (GRDB). The bond was set to mature in five and 10 years and its varying interest rates were structured using London Interbank Offered Rate (Libor): they offered five years at Libor +1.25%, six to seven years at Libor +1.5% and eight to 10 years at Libor +2%. Like the MCB, the government issued the GRDB in foreign currencies (US dollars, British sterling and Euros) as well as in the domestic Ethiopian currency. In establishing its diaspora bond programme, the Ethiopian government sought to promote direct investment in the national economy especially by its citizens in the diaspora.[13] Generally, diaspora bonds are designed to tap the sentiment of citizens who feel they can make a contribution to developing their country of origin. However appealing that idea might seem, decisions to invest are usually based on logic rather than sentiment and citizens in the diaspora may hesitate to invest in diaspora bonds when corruption in their countries of origin is rife and governments cannot be trusted. It can be argued that Ethiopia's diaspora bond issues could have been more successful had the government been more transparent and less autocratic in its handling of the matter.

Israel pioneered the issue of diaspora bonds in 1951 in a programme administered through the Development Corporation for Israel (DCI), established by the Israeli government. Although the bonds targeted Israelis in the diaspora, unlike Ethiopia's diaspora bond programmes – which were mainly marketed in Ethiopia – the Israeli government registered the DCI with the US Securities Exchange Commission (SEC). This allowed Israel's diaspora bonds to be exchanged and traded as listed securities and become subject to regulations governing financial markets in the US, the world's largest bond market. The government of Israel has continued to issue revenue-backed project bonds through the DCI, with subsequent bond issues focused on infrastructure development.

The DCI also established retail agencies within the US as well as in other countries to make the bonds more accessible to the Jewish diaspora. DCI bonds were mostly fixed and floating rate bonds with maturity periods ranging from one to 20 years with bullet repayments.[14] Interest rates were set a little higher than US treasury bills, thereby providing Israelis with a greater incentive to invest in the bond. By 2012 the DCI had successfully raised more than $32 billion through bond issues.[15] Israel did not employ commercial or investment banks, or brokers, to sell its diaspora bonds which were marketed by the DCI directly to the Israeli diaspora with the Bank of New York acting as its fiscal agent. Although Israel does not seek ratings from international credit rating agencies its diaspora bond issues have been successful. Their continued success can be attributed to the trust in the Israeli government held by those in the Jewish diaspora, evidenced by the proper use of proceeds from the bond to finance infrastructure development, the bond guarantee provided by the government, the structuring and marketing of diaspora bond issues, and transparency in the continuous review and the implementation of policies affecting the diaspora bond.[16]

In general, however, if a country issuing diaspora bonds opens the bond to all investors, credit ratings may be necessary in order to improve the bond's overall ability to attract sophisticated investors. In addition, for diaspora bonds to be successful, transparency in the use of proceeds is critical.

India also established its diaspora bond, issuing specific bonds in 1991, 1998 and 2000 as a way of accessing additional 'cheaper' capital to support its balance of payments. Through the State Bank of India (SBI) the government issued Indian Development Bonds (IDB), Resurgent Indian Bonds and Indian Millennium Deposits to raise $1.6 billion, $4.2 billion and $5.5 billion respectively. India used only fixed-rate bonds with a five-year maturity period with bullet repayment. The bonds, which were issued in different foreign currencies, were sold exclusively to individuals with Indian origins and heritage; the bonds were not listed on any securities exchange. SBI also sold the bonds through selected international banks. The government promoted sales of the bonds by fixing interest rates 2% higher than US treasury bills. It targeted non-resident Indians and used the IDB specifically as a vehicle to bring back funds that migrant Indians had withdrawn early in 1991 when India experienced a balance of payments crisis.

Whereas Israel views its diaspora as a source of capital for economic development, India issued diaspora bonds opportunistically as a means of raising capital to finance specific national requirements. The Ethiopian diaspora bond shows elements from the Israeli and Indian models in that the bond was restricted to Ethiopians and was used opportunistically.

Islamic bond issues

Islamic financing procedures and banking are globally recognised as an alternative to the Western model of banking and financial market development. Through approximately 600 financial institutions operating in 75 countries globally, Islamic financial assets reached $1.3 trillion in 2013. Unlike conventional financing mechanisms, Islamic financial practice prohibits the charging or collection of interest on capital deposited or invested. This lowers the cost of borrowing capital; hence Islamic bonds present an opportunity to raise affordable development finance. Islamic finance requires borrowed capital to be directly linked to real economic activity and transactions must be related to a tangible, identifiable asset. Issuing Islamic bonds could help African countries diversify their investor base and tap into the assets of the global Islamic financial community to generate capital for their infrastructure development.

Nigeria

The Nigerian Securities and Exchange Commission in March 2013 approved new rules to facilitate the issue of Islamic bonds – commonly known as 'sukuk' bonds from the Arabic term for a legal instrument – and opened up a new source of revenue for economic development. In September 2013 the south-western state of Osun issued Nigeria's first sukuk bonds, denominated in Nigerian currency, and raised NGN 11.4 billion for its infrastructure development. The bond is set to mature in seven years and investors receive fixed returns of between 14.25% and 14.75%. The Osun sukuk bond issue is an example of financial innovation by a sub-national government entity; the bond was given an 'A' rating by Augusto & Co, a Nigerian credit rating agency.

Such initiatives can make a substantial contribution to the development of local bond markets in African countries. The challenge, however, lies in establishing conditions that can make sukuk bond issues attractive to all investors, rather than simply the Islamic community which better understands the principles that govern Islamic finance.

Elsewhere in Africa

Gambia and Sudan have been selling sukuk bonds to their citizens on a small scale, to raise development capital. Sudan in 2012 sold sukuk bonds denominated in local currency that were worth $160 million. Senegal is currently structuring a $200 million Islamic bond to be issued in 2014 to finance infrastructure and energy projects. South Africa, Mauritania and Kenya are also establishing plans for sukuk bond issues in the near future.

Middle Eastern and Asian countries

Middle Eastern and Asian countries including Indonesia, the United Arab Emirates, Malaysia and Saudi Arabia have issued Islamic bonds to generate revenue for infrastructure development. In countries with large populations of Muslims and advanced Islamic finance operations, the Islamic bond market comprises corporate, sukuk, sovereign and quasi-sovereign bonds. Unlike the cases of Nigeria and Gambia, however, where the bond issue was restricted to the country's nationals, Middle Eastern countries structured bond issues as asset-backed securities and marketed them globally to people of Islamic faith. In 2008 the Indonesian government issued its first sukuk bond to reduce its budget deficit and by 2012 the issue had reached $3.4 billion, third only to Saudi Arabia and Malaysia, which had issued sukuk bonds worth $6.4 billion and $31 billion respectively.

Sovereign bond issues in Africa

Ghana

In 2007 the Ghanaian government issued a 10-year $750 million bond to raise development capital from the international capital market. The bond was listed on the London Stock Exchange with an interest rate set at 8.5%. At the time of issue, the international credit rating agencies Standard & Poor (S&P) and Fitch gave the bond

'B+ stable' and 'B+ positive' ratings respectively. The issue was intended mainly to raise capital to finance Ghana's energy and transport infrastructure development projects and was guaranteed by the national government. The government's sovereign bond was primarily a means to access funds from international capital markets in an effort to diversify Ghana's sovereign debt structure – prior to the bond issue Ghana had relied mainly on concessional debt from multilateral institutions to finance its economic development.

Rwanda

In 2013 the Rwandan government issued a 10-year $400 million sovereign bond with an interest rate set at 6.875%. The bond was designed mainly to raise capital to repay government loans, complete a convention centre in Kigali and finance a hydropower project. At the time of issue, S&P and Fitch rated Rwanda's sovereign bond issue 'B stable'. Although the bond was guaranteed by the national government, analysts expressed concerns over Rwanda's ability to repay investors, given that more than one-third of the government budget was funded by international donors.

Gabon, Nigeria and Zambia

Gabon, Nigeria and Zambia have also issued sovereign bonds and Kenya and Tanzania are planning debut sovereign bond issues on the international capital market.[17]

LESSONS FOR AFRICAN COUNTRIES

Bonds present African countries with an opportunity to raise capital from debt markets for their infrastructural development. Given the challenges that face the capital markets of many African countries, however, and the lack of the structures necessary for the development of their bond markets, it might seem that without major fiscal and macro-economic reforms and the further development of secondary markets to increase the liquidity of bond trading, raising capital through bonds is at best a distant option. Undeniably, an important early step for African countries would be to demonstrate an understanding of the various types of bonds, then develop the legal and regulatory frameworks necessary to bolster the confidence of purchasers demanding high levels of transparency when investing in bonds.[18]

By their nature infrastructure projects require large capital funding and an extensive time period for completion. Since 2008 bank loans have become even more difficult to obtain, and raising capital through bond issues can contribute to satisfying the long-term financing requirements for such projects. When conducted appropriately, issuing bonds can also help the development of domestic financial markets by opening up local debt markets, thereby increasing access to capital. Whether successful or not, corporate and public bond issues by private business and national, state and local governments hold important lessons for Africa.

If bond markets are to grow, African governments must implement macro-economic policies that open up and then deepen their debt capital markets. Responsible fiscal policies are critical for bond market development; hence those governments would have to take practical steps to develop the institutional infrastructure necessary to foster the growth of local bond markets. The most important of these measures would include establishing rating agencies, improving secondary market trading platforms, developing exchanges explicitly for trading in bonds, upgrading clearing and settlement systems and revamping the regulatory environment.[19]

Governments can begin this process by implementing pension and insurance reforms to help in the creation of institutional investors for bonds. The importance of such institutions in bond markets cannot be overestimated. Pension funds and mutual funds, among others, create a demand for fixed income securities and can contribute to improving corporate governance and increasing competition in bond markets. For this reason policies to develop a diversified institutional investor base could increase investment activity in bond markets and ensure a sustained demand for bonds. Governments should also improve regulation to ensure adequate financial disclosure and reporting, so that investors are sufficiently informed about the risks associated with a particular bond issue and – in the case of corporate bonds – the issuing firms. This level of transparency and accountability would help increase investors' trust in the reliability of national bond markets and encourage their sustained involvement in them.

As noted earlier in the review of selected bond markets in Africa, the most common bonds are those issued by national governments; but issues by state and municipal governments can help to develop bond markets. For this process to be successful, national governments should ensure that the bonds issued by state and municipal governments are rated by independent credit rating agencies, both to help provide investors with credible information on the nature of the bonds in which they intend to invest and to create ratings benchmarks for other types of debt. Governments can also contribute to developing local bond markets through municipal bond issues. In doing so they can embark on a process through which municipalities are shortlisted and screened according to criteria intricately linked to the bond issue process, and to the real development of the projects the proposed issue would finance. Using examples from the US municipal bond market, some of those criteria could include the presence of experienced staff members qualified to manage large-scale projects so as to avoid cost overruns, and the presence of municipal staff who understand specific details of particular projects and can master complex financial structures. In this context it may be noted that as part of its bond market reform process, the US established the Municipal Securities Rulemaking Board to establish fair practices for underwriting and issuing municipal bonds. In the municipal bonds market in Mexico, projects with an 'A' rating from at least two different top credit rating agencies are regarded as a minimum standard for projects for which municipalities were preparing bond issues.

Governments should also strive to explore different ways of enhancing the credit of bond issues, to reduce the cost of borrowing while encouraging broader investor interest. In this it is important for domestic credit rating agencies to develop competencies in analysing the true value of bonds, taking into account the legal and economic factors impacting projects. It is also of critical importance that bond issuers, rather than obtaining financial advice solely on marketing the issues, focus on strengthening the bonds' creditworthiness. Understanding the role that this plays in the overall development of bond markets is important in strengthening the foundation for the development of debt capital markets in Africa. In reforming its bond market the US over time shifted from general obligation bonds such as those currently favoured by many African countries, to revenue bonds; this ensured that the true credit quality depended on the economic and financial feasibility of issuers and projects rather than the backing of national governments using their tax regime to attract investors. African countries have the opportunity to move from issuing general obligation bonds to project-specific revenue bonds, although the establishment of economic policies focused on financial market reforms would ultimately determine the pace of such a transition. In developing bond markets, African countries can also learn from Mexico, which in the late 1990s began a series of reforms to provide state and local government structures with greater independence. In contrast to previous practice, state and local government debt was no longer backed by the federal government, thereby encouraging the former entities to be more accountable for their own financial situation.

African governments must also encourage innovation in capital markets to promote the development of bond markets, following examples from countries such as Chile, which in the 1990s developed its local capital markets and financed infrastructure using a number of financing alternatives, including bonds.[20] In Chile in 2008, infrastructure project bonds accounted for 20% of corporate bonds, with 90% of this amount held by pension and insurance funds. The success of Chile's infrastructure bond development programme can broadly be attributed to macro-economic stability in terms of financial and economic reform, political stability and a strong legal system that stifles corruption. A key feature of capital market reform in Chile was the government's decision to extend the linkage of financial transactions to an inflation index. In 1968 the Chilean government created the Unidad de Fomento (UF), a unit of account linked in value to an inflation basket. Originally used for international loan finance instruments, this 'flat' currency allows financial institutions to plan for the long term without worrying about the risks associated with inflation on the value of money, the system having ensured that investors were paid real interest and the capital invested was protected. Essentially, the UF isolates inflation risks and enabling investors to carry out the long-term financial transactions necessary for the development of bond markets. At present, in Chile most bonds are denominated in UF.

Finally, African governments can take steps to arrange tax codes on bank deposits that investors are encouraged invest in bonds rather than keep their money on deposit. For bond markets in Africa to develop, governments have to widen the spectrum of local issuers and reduce over-reliance on banks as issuers of corporate bonds. This can be done by encouraging companies to issue bonds through private or hybrid placements while increasing the period of offer within which bonds are auctioned. Importantly, credit ratings can make those bond issues that are not government-guaranteed attractive to investors; in developing bond markets the need for guarantees for investors cannot be overestimated. All these efforts can contribute to developing the secondary markets that are essential for the growth of domestic bond markets.

CONCLUSION: THE PRESENT SITUATION

Research by the African Development Bank (AfDB) and the World Bank suggest that \$93 billion is needed every year to finance the infrastructure projects needed for Africa to develop and accommodate its increasing population. A study by the Programme for Infrastructure Development in Africa, an African Union initiative, estimates an investment of $68 billion for regional projects alone, is needed every year until 2020. In the light of such a requirement the issue of bonds as debt instruments to raise capital can provide an important source of revenue. In particular, infrastructure project bonds serve as an additional avenue for raising funds from local or international capital markets, as interest payments and repayment of the principal are secured by the cash flow from specific projects. Infrastructure bonds can be issued by private sector firms without any government intervention.[21]

At present in South Africa as in most African countries, bond issues generally cannot be classed as infrastructure bonds per se. In most cases they are general government bonds from which infrastructure development projects may or may not be financed. They are not project-specific; have no income stream directly linked to an underlying asset such as a toll road, a dam or a solar farm; and interest and principal repayments are only possible using tax revenue from governments. It should be noted, however, that some progress is being made to familiarise African countries with the processes associated with issuing infrastructure bonds. The AfDB in August 2012 announced plans to establish a $22 billion infrastructure bond for African countries from which projects such as airport and port construction can be financed: the bond would be issued as a corporate bond by the Africa50 Infrastructure Fund set up by the AfDB to mobilise financial resources and unlock private financing to address Africa's infrastructure gap. With the Africa50 Fund the AfDB seeks to tap into and leverage the reserves of African central banks, the resources of pension funds, sovereign wealth funds, the African diaspora and high net worth individuals on the continent.

Along with the use of infrastructure project bonds, governments can establish diaspora bond programmes and sell Islamic bonds to raise capital on the debt market. In order to successfully establish the use of bonds as a source of capital, however, they would have to ensure domestic macro-economic stability, which entails implementing fiscal and monetary policies that promote reforms which could attract investment in national bond markets. It would also help to develop independently regulated capital markets, as well as to establish rules and procedures for issuing bonds.

Governments can play an important role in stimulating local bond markets by constantly issuing bonds through development finance institutions as a way of familiarising the market with the process of issuing bonds. In addition, by implementing reforms to grow secondary markets governments can encourage private companies to issue infrastructure bonds tied to specific projects, as a means of increasing transparency in the bond issuing process thus offering investors the clarity needed to make sound decisions. Although the case studies in this paper provide evidence that some countries are exploring bond issues, in Africa bonds remain a largely unpopular model with private firms and investors alike.

Factors that account for the lack of development of bond markets in Africa include the absence of regulatory bodies to monitor and supervise bond issue processes, and the overall high level of complexity associated with developing a bond market, an undertaking in which many African countries at best have very little experience. For example, in 2003 the Development Bank of Southern Africa was the most active lender to municipalities in South Africa with 65% of its funding going to the six largest metropolitan municipalities in the country. This effectively shut out private investors and gave municipalities no reason to explore alternative methods of raising capital, a situation that partly contributed to weakening the market for municipal bonds in South Africa.[22]

The absence of secondary markets through which investors can trade their bonds before the stipulated maturity dates presents a further challenge for the development of bond markets in Africa. When committing to particular projects or firms, investors require a degree of assurance that they can exit investments whenever they deem it appropriate. The secondary trading market provides investors with this certainty, thus bolstering the confidence needed to spur investment in bonds, some of which have long lock-in periods that tie up capital.

For bond markets to be developed effectively, African governments would have to demonstrate an understanding of the advantages of bonds as viable instruments for raising capital on debt markets – an understanding that might trigger the financial reforms necessary to support the development of bond markets in Africa.

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8 Sanral, ACSA and IDC are all state-owned enterprises.

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