The Creation of the African Investment Bank

A Concept Note:

Background

In recent years, Africa has become synonymous with poverty in international circles. Of the 42 developing countries classified by the International Monetary Fund and the World Bank Group as “heavily indebted poor countries” in 1997, 33 were from Africa. Today, it is estimated that the vast majority of people who live in sub-Saharan Africa survive with less than $1 a day. This is true for rural areas where small farmers carry out subsistence activities and in urban areas where the informal sector is increasing rapidly. Efforts by the international community to make Africa a full participant in world goods and capital markets through numerous “Initiatives” have generally been unsuccessful. The economic and social indicators of African countries remain alarmingly weak.

Apart from a few oil-producing countries, Africa continues to suffer from chronic foreign trade and fiscal deficits, huge external debt burden and a heavy reliance on imports of manufactured goods. In the absence of a strong private sector, African countries are unable to compete in international markets. Under these circumstances, it is unlikely that they will achieve the millennium development goals (MDGs) set by the United Nations for 2015. Also, it is not clear how they can successfully face the challenges resulting from the process of globalization and take advantage of the opportunities it offers. Many African countries have designed and implemented homegrown development policies with the support of bilateral and multinational financial institutions. Unfortunately these policies did not enable them to take off economically because of the failure to create a favorable environment for private sector development and accelerate the process of economic integration in Africa.

Under the leadership (umbrella) of the African Union (AU), African countries are now determined to address collectively the challenges they face. To that end, the AU has designed a Strategic Plan, which aims at achieving rapid economic growth and reducing poverty, as well as making Africa more competitive in the world economy in the medium-term and beyond. This strategy emphasizes the importance of accelerating regional integration, strengthening the private sector and modernizing rural economic activities, through appropriate policy actions. As the experience of Asian countries shows, the implementation of strong financial and structural policies in an environment characterized by transparency and the application of good governance practices will be essential for the success of the proposed strategy.

Regarding financial policies, it has become increasingly evident, in other parts of the world, that the provision of financial services to households, private and public enterprises, and to governments contributes significantly to the acceleration of overall output growth and poverty reduction.

All African countries already possess modern financial systems, which are still too small and often lack the necessary resources to meet the domestic demand for credit. The establishment of nonblank financial institutions such as pension funds and insurance companies to provide services that the commercial banks cannot or are not willing to offer has had so far no significant impact on the total supply of financial services. Meanwhile, government –owned development and commercial banks, created after political independence, have been either closed or privatized as one of the conditions included in adjustment programs supported by the International Monetary Fund (IMF), the World Bank and the African Development Bank.

Partly reflecting this development, demand and time deposits of the commercial banks are very low in many African countries. A review of financial systems in sub-Saharan Africa, conducted by a staff team of the IMF revealed that, deposit-taking financial institutions' demand and time deposits represented 62 percent of GDP in OECD countries in 1996 compared with only 26 percent in African countries. Although more recent data are not available, it is not evident that this percentage has significantly changed during the last decade. Indeed, total loans and advances of national banking sectors as a percentage of GDP continue to represent only a small proportion of total banking assets in most countries.

Low levels of credit in African economies are the consequence of various factors often cited by commercial banks. National banking systems appear to suffer from the lack of efficiency, narrow product offerings and limited client bases. There is also the lack of saving deposits resulting from low per capita incomes and *capital flight*. Other factors, which keep total bank credit low, include weak corporate governance and poor regulatory and supervisory structures. The size of non-performing loans is another reason why banks are, allegedly, reluctant to provide much-needed credit to investors.

To increase the volume of bank credit, the AU must act on two fronts. First, it must urge African countries to pursue their efforts aimed at making the existing financial systems more efficient. Second, it must assume leadership in the establishment of new financial institutions, at the continental level, that will be able to attract foreign resources, mobilize domestic savings (in part by developing capital markets), and allocate investible funds efficiently. In the process, an important objective will be an improvement in the provision of financial services to the informal and rural sectors of the economies. Following the example of Asian countries, financial institutions can develop a variety of schemes to make lending to the poor in urban and rural areas not only sustainable but also profitable. Such a lending should not be limited to what is traditionally known as *micro-finance*.

The growth of rural economic activities continues to be slow partly because the national banking systems in African countries are not prepared to adequately meet the credit needs of low-income earners and the rural poor. In many cases, these income groups cannot open bank accounts and benefit from payments and other services offered by the formal banking systems. Very often, they have to resort to informal credit networks.

Due to the fact that domestic banking systems are characterized by numerous weaknesses and are unable to satisfy the credit needs of their economies, African countries have had to rely in recent years on outside sources for their investment financing. In that context, regional developments banks, the African Development Bank, the International Development Association and the International Finance Corporation of the World Bank Group, and bilateral aid agencies have financed investment projects in Africa.

These institutions have played an important role in the development of basic infrastructures, schools, health centers, telecommunications, power plants, etc. However, it must be recognized that the resources they provide are not sufficient to cover the total demand for investment financing in African countries. This is particularly true for the financing of *multinational projects* intended to promote regional integration. Also, only small amounts of resources have been allocated to *private sector development* and the *modernization* of rural economic activities.

Request for the Creation of African Union's Financial Institutions

It is against this background that Heads of State and Government of the Member States of the African Union requested, in the Syrte Declaration and in Article 19 of the African Union's Constitutive Act, a speedy establishment of three important financial institutions "the rules and regulations of which must be defined in protocols". These institutions are: (1) The *African Central Bank*; (2) the *African Monetary Fund*; and (3) the *African Investment Bank*. All these three institutions are expected to raise the level of investment activity, thereby contributing significantly to the economic development of Africa.

As a first step towards the establishment of these financial institutions, the recent Summit meeting (January…February…2005) of the Heads of State and Government of the Member States of the African Union, decided[1], that "the *African Investment Bank* shall be located in the Great Socialist People's Lybian Arab Jamahiriya". In addition the Chairperson of the AU Commission was requested, "to undertake the necessary preparatory activities for the elaboration of the necessary legal instruments and submit progress reports thereon to future Summits". As a follow up to that request, this note deals with other issues that must be addressed by Member States of the African Union before the *African Investment Bank* can begin its operations.

These issues include: (i) the mandate of the African Investment Bank; (ii) the conditions for its membership and shareholding; (iii) the sources of its funds; (iv) the structure and the responsibilities of its management; and (v) its lending operations and cooperation with financial institutions involved in the financing of investment projects in Africa. It should be noted that, the suggestions made in this paper are only tentative, as they will have to be confirmed by the findings of a forthcoming *feasibility study*. At this stage, the "agreements establishing" both the African Development Bank and the Asian Development Bank can serve as useful guides for the drafting of a future agreement on the creation of the African Investment Bank. The final document will require a legal work, which will be more detailed and will take into account the conclusions of the aforementioned feasibility study. Therefore, further steps will be required before an *Agreement Establishing the African Investment Bank* can be reached and ratified by Member States of the African Union.

The Mandate of the African Investment Bank

What is an "*Investment bank*"? Strictly speaking, it is a financial institution, the main function of which is to serve as an *intermediary* between issuers and ultimate purchasers of securities. In that capacity, it advises governments and corporations on how to raise capital for their investment undertakings. It also sells bonds and shares to investing institutions and individuals.

[1] / See decision : Assembly /AU/Dec.64-IV)

The prospective *African Investment Bank* (to be called hereafter "Bank") may carry out these activities. However, it will slightly differ from a typical Investment Bank in the sense that it will also make loans and equity investments for the economic development of Member States of the African Union. In that context, its objective will be to cover the financing gap that presently exists in priority areas defined by the African Union in its medium-term Strategic Plan.

Therefore, high priority will be given to investment projects, which are in line with the objectives of that Strategic Plan and those of the New Partnership for Africa's Development (NEPAD). The Bank will lend its resources at a rate that reflects the cost of borrowings on capital markets. At the same time, however, it will open a "soft loan window" for the purpose of granting loans on very concessional terms to low income Member States of the African Union. In this group of Member States, its lending strategy will aim at achieving the objectives of economic growth, reduce poverty, improve the status of women, support human development (education and health) and protect the environment in these countries, mainly in rural areas.

The Bank will offer investment-banking services in all Member States of the African Union. In addition, it will finance investment projects that are most likely to accelerate the physical and economic integration of African countries. These projects will focus on the development of: (1) transport infrastructure (national and international roads and highways, ports, airports, pipelines); (2) sources of energy, including oil exploitation; and (3) telecommunications. Also, it will support private sector development and make African economies more complementary with the view of promoting intra-regional trade.

In pursuing its objectives, the Bank will coordinate its actions, to the extent possible, with bilateral and multilateral public organizations as well as national entities whether public or private, which provide investment financing in Africa. It will also seek close cooperation with investment institutions, which already operates inside and outside Africa in order learn from their experiences. It is hoped that the activities of the Bank will create an environment that will attract sizeable amounts of capital inflows, in the form of foreign direct investment, to Africa. In that connection, efforts will be made to persuade the African Diaspora to bring the capital they keep in foreign countries into investment projects sponsored by the Bank. Such capital inflows will reduce the need for additional public sector borrowing in the future and put African economies on a higher growth path.

Membership and Sources of Funds

It is proposed that at the time of the creation of the Bank, its membership be exclusively reserved to Member States of the African Union, i.e. to 53 countries. However, the issue of granting membership to countries outside Africa [2] could be considered at any time if a majority of 80 percent of the membership, representing at least 75 percent of the total voting power of the total membership agrees. If and when membership will be open to countries outside Africa, the admission of new members to the Bank's Board will require 80 percent of the total number of membership representing not less than three-quarters of the total voting powers of the members. Even if membership is granted to countries outside Africa, their total shareholding shall not exceed 25 percent [3]of the subscribed capital.

In Member States, the main subscribers to the Bank's capital will be the *national Central Banks and the Governments*. In cases where governments are unable to subscribe because of budgetary constraints, Central Banks will subscribe on behalf of the governments. Central Banks and governments of the Member States the African Union will have to agree on an initial amount of authorized capital[4]. It is suggested to ask Member States to make pledges on the amounts of capital they will be willing to put in the initial capital of a prospective African Investment Bank.

These pledges will constitute the "paid in" portion of the initial authorized capital. There will be a provision in the agreement indicating that the amount of capital subscribed by one of the "five African regions" shall not exceed 25 percent of total capital to be subscribed. It is proposed that, once the amount of capital to be subscribed is determined, each Member State should be allowed to subscribe its share one-half in the form of "paid-in" capital and the other half as "callable capital"[5]. This arrangement can be modified if Member States prefer a different proportion.

[2] / Countries from outside Africa will be called "non-regional countries".
[3] / In the Asian Development Bank, total shareholding of non-regional member countries cannot exceed 40 percent of total subscribed capital.
[4] / It is not clear from the records how the initial amounts of "authorized capital" of both the African Development Bank (AfDB) and the Asian Development Bank (ADB) were determined. The initial authorized capital stock of AfDB was 250,000,000 units of account (SDRs) and that of ADB was one billion US dollars. Following five general capital increases, the authorized capital of AfDB is currently about SDR 22 billion.. The authorized capital of ADB was also increased a number of times and is now around over US$ 51 billion
[5] / Both the AfDB and ADB requested their members to purchase 50 percent of their initial capital as "callable shares". AfDB members agreed to make payments for the "paid-in" portion of the initial capital

The "paid-in" portion will be paid in five equal annual installments[6]. Member States will have to give one-half of each installment in convertible currency and the other half in local currency. The share of each Member State will not be transferable. The "callable capital" will constitute a guarantee for the Bank's securities and thus will facilitate its borrowing of funds in capital markets around the world. Other financial resources of the Bank will be obtained through borrowings and/or contributions made by some member countries or donors on a voluntary basis.

Increases in the authorized capital will be subject to an 80 percent majority vote by the Board of Governors. In the event of an increase in subscribed capital, the Board of Governors, subject to an 80 percent vote, will determine the percentage to be paid by each member and the arrangements for payments. Each member will be allowed to increase its subscription provided that such an increase does not have the effect of reducing the percentage shares of Member States of the African Union below 75 percent of the total subscribed capital.

If the Bank has to settle its financial obligations on a short-term basis or needs additional funds for its operations, the Board of Directors will have the authority to require payment of the balance of the subscribed capital held by members of the Bank. Members of the Bank will be liable only up to the amount of "callable shares" they hold.

Management Structure and Responsibilities

A Board of Governors, a Board of Directors and a Management Team will be responsible for the management of the Bank. The *Board of Governors* will be the highest policy-making body and will consist of one Governor for each member and one alternate. Governors and their alternates will be individuals with national or international experience in economic and financial matters. Also, they must be nationals of member countries.

The Board of Governors will be responsible for issuing general directives for lending policies of the Bank in lines with the overall objectives set out in the Strategic Plan of the African Union. The Board of Governors will be empowered to take measures in order to ensure that its directives are properly

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stock only in convertible currency. It was also agreed that if there were calls for unpaid subscriptions, they should be uniform in percentage on all "callable shares".

[6] / The AfDB allowed its members to pay in 6 installments. The first installment was to be 5 percent, the second 35 percent and the remaining four each 15 percent. Different arrangements could be proposed.

implemented. At the annual meetings of the Bank, the Board of Governors will designate one governor as "Chairman" of the meetings. The Chairman will hold office until the next annual meeting unless the Board of Governors decides otherwise. Governors will not receive remuneration from the Bank. However, the Bank may reimburse them for expenses incurred in attending meetings of the Board. The Board of Directors will be responsible for calling meetings of the Board of Governors[7].

Apart from the above-mentioned responsibilities, amendments to the Bank's Articles of Agreement, the admission of new members and the authorization for capital increases/ decreases will require the approval of the Board of Governors. Its approval will also be required for (a) the annual reports of the Board of Governors; (b) the annual balance sheet and profit and loss account of the Bank; and (c) the Rules and Regulations of the Bank. The Board of Governors will elect the President of the Bank, suspend or remove him from office and determine his remuneration and conditions of service. Other powers of the Board of Governors will include the determination of the remuneration of the directors and their alternates. It will indicate what activities are not compatible with the duties of a Director or Alternate Director.

Decisions of the Board Governors will require a majority representing more than 50 percent of the subscribed capital. Certain decisions may require a "qualified majority" to be defined in the rules and regulations of the Bank. For decisions requiring unanimity, abstentions by members of the Board of Governors present or represented will not prevent their adoption. With the exception of certain powers specifically reserved to the Board of Governors under the Articles of Agreement, it will delegate its powers to the Board of Directors.

The *Board of Directors* will be responsible for the conduct of the general operations of the Bank. Each Director and his/her alternate will represent a "constituency" holding at least 5 percent of total voting powers of the membership. On that basis, each geographic region will be represented by a maximum of 5 directors. At the same time, the total number of Directors will not exceed 20. Directors and their alternates will be elected every 4 years. No Director should be allowed to hold office for more than 5 terms.

[7] / In AfDB, a meeting of the Board of Governors will be called if 5 members of the Bank or members having 25 percent of total voting power request such a meeting. However, a quorum for any meeting requires a majority of the number of governors or their alternates, representing not less than 75 percent of the total voting power of the members.

The Board of Directors will be responsible for approving loans, guarantees, equity investments and borrowings by the Bank. It will also sets policy guidelines with respect to Bank operations, including its financial policies and borrowing programs. The Board of Directors will ensure that Bank operations are in conformity with the general directives issued by the Board of Governors.

Each Director will have one vote on the Executive Board. She/He may delegate his/her vote in all cases, according to procedures to be specified in the "Rules and Procedures" of the Bank. Decisions by the Executive Board (or Board of Directors) will require a majority representing more than 50 percent of subscribed capital. The "Rules and Procedures" of the Bank will indicate how many members of the Executive Board constitute *the quorum* needed for the adoption of decisions.

The *Management Team* will consist of a President, an Executive Vice-President[8] and a number of Vice-Presidents to be determined. The Board of Governors, on a recommendation from the Board of Directors, will appoint the President for a period of five years. This appointment will be renewable for two terms. The number of members of the Management Team may be increased/ reduced with the approval of the Board of Governors. The President, the Executive Vice-President and other members of the Management Team cannot be nationals of the same geographic region.

The Management Team, under the leadership of the President as Chairman of the Board of Directors, will be responsible for the daily business of the Bank. The remuneration of members of the Management Team will be determined and reviewed periodically by the Board of Governors.

Bank staff will be under the authority of the President. They will be appointed and discharged by him. In the appointment and promotion of staff, personal ability and qualifications should the dominant criteria. However, an equitable representation of nationals of Member States will also be needed. The Management Team and the staff of the Bank will be responsible only to the Bank and will be totally independent of outside influence in the performance of their duties.

[8] / The ADB has a "Managing Director General" who coordinates the activities of the Vice Presidents.

Cooperation with Other Institutions and Lending Operations

The Bank will seek close cooperation with bilateral and multilateral institutions actively involved in the financing of economic development in Africa. It will also establish contacts with banking and other financial institutions in the countries where it carries out its operations. The Bank will grant investment financing, in the form of loans, guarantees and equity to Member States of the African Union or to private or public sector if funds are not available on more favorable terms from other national or international sources.

In particular, it will encourage private sector investment in infrastructure development in the form of B.O.T. The Bank will not be allowed to grant financing for investment projects to be implemented outside the territories of the Member States of the African Union. In addition, when granting a loan to an entity other than a Member State, the Bank will not always make loans conditional on a guarantee from the Member State in whose territory the investment project will be implemented. However, in certain cases when the Bank deems it advisable, it will require that the Member State in whose territory a project is to be carried out, or a public agency or any other entity of that member acceptable to the Bank, guarantee the repayment of the principal and the payment of interest and other charges on the loan in compliance with the terms of that loan.

In considering an application for a loan or guarantee, the Bank will have to assess the ability of the borrower or its guarantor to meet their future obligations under the loan contract. In case of a direct loan made by the Bank, the borrower will be permitted by the Bank to draw its funds only for the purpose of meeting expenditures incurred in connection with project implementation. The Bank will have to avoid that a disproportionate amount of its resources is used for the benefit of any region. The Bank will seek to maintain a reasonable diversification of its investment between regional and private sector projects. In addition, its equity investment will have to be diversified.

Furthermore, the total amount outstanding, at any given time, of loans and guarantees granted by the Bank will not be allowed to exceed 200% of the sum of its subscribed capital, reserves, non-allocated provisions and profit and loss account surplus[9]. The amount of the Bank's disbursed equity participations will not exceed at any time an amount corresponding to the sum of its paid-in

[9] / The European Investment requires 250%.

subscribed capital, reserves, non-allocated provisions and profit and loss account surplus. The Bank will protect itself against possible exchange risks. To that end, it will include in loan and guarantee contracts such clauses as deemed appropriate.

Interest rates applied on Bank loans as well as commissions and other charges will be adjusted to conditions prevailing on the capital markets and will be calculated in such a way that the income received from lending operations will enable the Bank to meet its debt-related obligations, cover its expenses and risks and to build up a reserve fund. The Bank will not grant any reduction in interest rates to borrowing parties. But, if a reduction in the interest rate appears necessary in view of the nature of the investment project to be undertaken, another source of funds will be required to provide a grant in order to assist the borrowing party towards the payment of interest.

The Bank will finance an investment undertaking in the productive sector of the economy only after it has concluded from the financial analysis of the project that interest and amortization payments will be covered out of operating profits. In the case of other investment projects, the Bank will require a commitment by the Member State in which the investment is made. Bank financing will also be granted if the investment project is expected to contribute to an increase in economic productivity in general and promote the establishment or functioning of the internal market. The Bank will make its loans conditional on international invitations to tender being issued. In that context, however, priority will be given to enterprises residing in Member States of the African Union.

Any public or private entity will be able to apply directly to the Bank for financing. However, the applications will have to be made through the Member State on whose territory the investment project will be implemented.

The Bank will be allowed to borrow funds in and outside the member countries if necessary for its operations. The Bank will also be allowed to sell and buy the securities it has issued or guaranteed or in which it has invested, provided it has obtained prior approval from any country where the securities are to be bought or sold. The Bank will have the power to underwrite, or participate in the underwriting of, securities issued by any entity for purposes consistent with the mandate of the bank. In all cases, the Bank will be expected to build up progressively, a reserve fund of up to 15% of the subscribed capital. The resources of the reserve fund will have to be available on a short notice in order to meet the obligations of the Bank.

If a Member State fails to meet the obligations of the membership or the obligation to pay its share of the subscribed capital or to service its debt owed to the Bank, the granting of loans or guarantees to that Member State or its nationals could be suspended by a decision of the Board of Governors. A suspension of a Member State does not Member State it or its nationals from their obligations towards the Bank.

Further Steps Towards the Creation of the African Investment Bank

If this note is approved as a basis for discussion, the next step towards the creation of the Bank should be a *feasibility study* to be conducted during a two-month period beginning as soon as possible. The team conducting this study will have to discuss with authorities and development financial institutions operating in the five geographic regions. These discussions are expected to facilitate the identification of the demand for the services that the Bank intends to offer. At the same time, the study will examine what will be needed for these services to be offered in an efficient manner by the Bank.

Therefore, discussions with the authorities will center around: (1) the proposed mandate of the prospective Bank; (2) the amount of resources individual Member States will be willing to commit in the form of "paid-in" capital; (3) criteria for membership of the Bank, particularly as regards the admission of non-regional members; (3) the size of the Board of Directors and whether Directors will have to conduct Bank business on a daily basis or will have to meet periodically; (4) rules, governing the appointment of the Management team and the number of terms of the President; and (5) the definition of the various tasks and staffing needs of the Bank and the design of its "organizational chart".

With financial institutions, the feasibility study will discuss the various forms of cooperation that could be considered. For example, in order to conduct country and regional lending operations the Bank will need strategic studies. Will other institutions be willing to share their studies with the Bank or will there be the possibility of joint missions? Should one envisage cooperation with private investment institutions in Europe, the Americas and Asia and under which conditions?

Upon completion of that study, a team of legal experts will be asked to draft an agreement that will be submitted to the consideration of the Heads of State and Government of the African Union. Once that draft document is approved it will be finalized and send to Member States for ratification. The ratification of the "Agreement Establishing the African Investment Bank" by the Member States representing at least 50 percent of the voting powers of the total membership will mark the beginning of the Bank's operations. A precise timetable can be proposed for each phase. If the feasibility study begins immediately, the draft document could be ready around November 2005. However the ratification process could take time. In the cases of the African Development Bank and the Asian Development Bank it took on average two years.