

# Legal and Institutional Frameworks as Determinants of Access to Capital by Developing Countries

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Cape



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**Declaration**

I, GITAU ROBERT GITONGA, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Works of others cited or referred to are accordingly acknowledged.

Signed: .....

Date: .....

This Mini-thesis has been submitted for examination with my approval as University Supervisor.



Signed: .....

Advocate MS Wandrag

Date: .....

## **Dedication**

To my Mum, brothers and sisters,  
Without you ...  
... I would not be,  
... because of you,  
your love, your sacrifice,  
your infinite patience,  
your guidance and careful nurturing,  
... I am.



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5. Internal Loans Act (Chapter 420) Laws of Kenya
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7. Public Roads Toll Act
8. Road Maintenance Levy Fund Act

## **Key Words**

Bonds; Capital markets; Debt Instrument; Developing countries;  
Development; Infrastructure; International Financial Institutions; Official  
Development Assistance; Risk; Risk Management; sub-Saharan Africa;



## Introduction

### 1.1.0. Background

This study is carried out against the background of certain truisms: that efficient transport, reliable energy, safe drinking water and modern telecommunication systems are critical to attracting foreign direct investment (FDI), expanding international trade and achieving long-term investment and growth.<sup>1</sup> Developing countries and in particular sub-Saharan Africa have continued to maintain poor infrastructure, which results in, inadequate trade and transport facilitation systems that continually penalise these countries with regard to their participation in and expansion of international trade.<sup>2</sup>

Similarly, Africa has continued to lose out to other regions of the world with regard to its attractiveness as a destination for FDI. The latest World Bank statistics show that Africa commands a meagre 2.6 percent of the total inward stock of FDI.<sup>3</sup> In this Report the developed countries are shown to command over 70 percent of inward FDI, while the developing countries command slightly under 30 percent of inward FDI.<sup>4</sup> This shows

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1 M Dailami et al., 'The challenges of financing infrastructure in developing countries' in *World Bank global development finance report* (2004) 149.

2 TR Lakshmanan 'Transport and trade facilitation: An overview' in TR Lakshmanan *et al.* (ed), *Integration of transport and trade facilitation: selected regional case studies*. p6 "...inadequate trade and transport facilitation systems... creates an efficiency penalty". See also, African Development Bank, *Globalization and Africa's Development, African Development Report, 2003* p14 "... In 2000, Africa's share of world export was only 2.7 percent and sub-Saharan Africa's share of export of goods fell from 1.9 to 1.4 percent during the 1990s".

3 World Bank, 'FDI for developing and transition economies: implications for development' in *World investment report* (2006).

4 World Bank, *World investment report* (2006) p7.

that Africa is not only losing out to the developed countries but also to the other developing countries that have put in place mechanisms that have seen those regions become attractive destinations for inward FDI.

While the foregoing does not go a long way in explaining the great problems of the developing countries' infrastructure, availability of infrastructure, particularly efficient transport services, is crucial for economic development; as transport services are essential for reaching world markets,<sup>5</sup> strengthening global integration and attracting FDI.<sup>6</sup> For instance, with globalisation there is a continuous shift of manufacturing industries to countries offering competitive advantage in transportation, since transport has become part of the production and distribution process to obtain a competitive advantage for manufactured goods.<sup>7</sup> Therefore, the central contribution of good infrastructure towards the development of a country cannot be gainsaid.

It is thus acknowledged that infrastructure is essential in the development of a country with regard to improving its competitiveness for FDI, expanding international trade and achieving long-term investment and growth.<sup>8</sup> It is therefore clear that infrastructure development in sub-Saharan Africa holds the key to integration of the region in the world

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5 'Nyachae plan to create 150,000 ministry jobs' *Daily Nation* 15 March 2007 (online edition) <http://www.nationmedia.com> "... approximately 15 per cent of tea went to waste as it failed to reach the factory in time for processing during the wet season".

6 United Nations Conference on Trade and Development (UNCTAD) Efficient transport and trade facilitation to improve participation by developing countries in international trade. Available on <http://www.unctad.org> (accessed on 03 February 2007).

7 D Grimsey & MK Lewis *Public private partnerships: The worldwide revolution in infrastructure provision and project finance* (2004) p 26 "... transport investment can generate a relocation of industry and economic activity".

8 See M Dailami *et al* (n1).

economy, and therefore reduction of poverty in accordance with the millennium development goals (MDGs).<sup>9</sup>

Infrastructure *per se* is a wide term. While there would be a general consensus that tangible capital assets such as bridges, roads, streets and tunnels are infrastructure, others would cast the net much wider. A distinction is often made between ‘hard’ (physical) and ‘soft’ infrastructure.<sup>10</sup> This study would not like to focus on infrastructure as such, but would like to keep the idea of roads at the back of the reader’s mind since certain aspects of the investment models are based on the improvement of the road network.

### **1.1.1. Transport Networks and Trade Facilitation**

Although there is no consensus on the definition of trade facilitation, the International Chamber of Commerce (ICC) defines trade facilitation as,<sup>11</sup>

... the adoption of a comprehensive and integrated approach to simplifying and *reducing the cost* of international trade transaction, and ensuring that the relevant activities take place in an *efficient*, transparent and predictable manner based on internationally accepted norms and standards and best practices (own emphasis).

This study emphasizes costs and efficiency because they are attributable to infrastructure, and secondly, because if transport costs contribute high proportion of the value of goods, it results in increased prices and

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9 Goal number one; eradicate extreme poverty and hunger. <[www.un.org/millenniumgoals/](http://www.un.org/millenniumgoals/)> (accessed on 15/10/2006).

10 Argyit al., *Infrastructure and economic development*, in Committee for economic development for Australia (CEDA) information paper No 60, (1999).

11 Commission on Customs and Trade Regulations, ‘ICC recommendations for a WTO agreement on trade facilitation’, available on <http://www.iccwbo.org/policy/customs/id557/index.html> (last accessed on 6 march 2007); see also Ambassador Matthias Meyer, Switzerland, (Chairman’s Summary) International Ministerial Conference on Transit Transport Cooperation, Roundtable on Trade Facilitation Measures Almaty, Kazakhstan, Thursday, 28 August 2003 “... Trade facilitation is about providing an environment for trade and transport that reduces the cost of international trade transactions”.

undermines the competitiveness of exports in foreign markets. Overall high transport costs limit a country's participation in international trade. It is therefore not surprising that Africa in general, and sub-Saharan Africa in particular, has the highest transport cost rates in the world,<sup>12</sup> and also has the lowest share of international trade.<sup>13</sup>

Some of the factors that contribute to high transport costs in Africa include: (a) inadequate infrastructure networks; and (b) inefficient transport operations.

#### *Inadequate infrastructure networks*

Despite the recognition that infrastructure is important for development and the adoption of several initiatives by the African countries including the ambitious Trans African Highways (TAH) network<sup>14</sup> conceived in the early 1970s, missing links still exist.<sup>15</sup>

The missing links clearly illustrate not only the poor state of physical integration between African countries, but also shows a significant incapacitation of intra-African trade, because the physical condition of cross-border links generally affects traffic levels and the quality of transport services between countries. Improved land transport linkages

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12 United nations economic commission for Africa (UNECA) 2004, "Assessing regional integration in Africa" in ARIA I, p54 "... transport costs are high in Africa in general and in landlocked African countries in particular - averaging 14% of the value of exports. Also UNCTAD shows that the freight cost as a percentage of total import value was 13 % for Africa in 2000".

13 Committee on regional cooperation and integration UNECA, (2005) Trade facilitation to promote intra-Africa trade, available at <http://www.uneca.org> (last accessed on 6 march 2007).

14 The TAH network is made up of 9 highway sections namely: Cairo-Dakar, Algiers-Lagos (Trans-Saharan Highway), Tripoli-Windhoek, Cairo-Gaborone (Trans-East African Highway), Dakar-N'Djamena (Trans-Sahelien Highway), N'djamena-Djibouti, Lagos-Dakar (Trans-Coastal Highway), Lagos-Mombasa, and Beira-Lobito.

15 An analysis of 103 cross-border TAH links (TAH sections leading to border posts) shows that 33 % are unpaved roads in various conditions - good, fair and poor, 16% are paved roads in poor condition and 38% are paved roads in good or fair condition.

reduce transport costs, which in turn promote economic activity and cross-border trade.

It is inordinate to assume that the African states have blatantly refused to implement, or to maintain, the various infrastructures within their domain. It is important to determine the major cause of the problem. The International Ministerial Conference on Transit Transport Cooperation<sup>16</sup> noted that the endeavour to have the developing countries' infrastructure match that of the developed countries would require time and resources. It further suggested that partnerships with the foreign private sector might offer the possibility to improve these transport services.

#### *Inefficient transport operations*

Inefficiency of transport services is mainly an offshoot of inadequate infrastructure networks or poorly maintained networks. However, it may be manifested in several ways, including: high vehicle maintenance costs, poor market information, existence of transport cartels, poor knowledge of operating costs, poor operating practices, and poor routine maintenance, all of which lead to high vehicle operating costs and low vehicle utilisation.<sup>17</sup>

Transport operators usually transfer the burden of high vehicle operating costs to consumers by raising fares. Similarly, operators increase fares to offset low revenues due to low vehicle utilisation.<sup>18</sup>

### **1.1.2. Investment in Infrastructure**

It is estimated that US\$ 622 billion was invested in developing countries' infrastructure from 1992 to 2003.<sup>19</sup> Figure 1.0<sup>20</sup> below, shows the

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16 See Ambassador Matthias Meyer (n11).

17 See UNECA committee on regional cooperation and integration (n13).

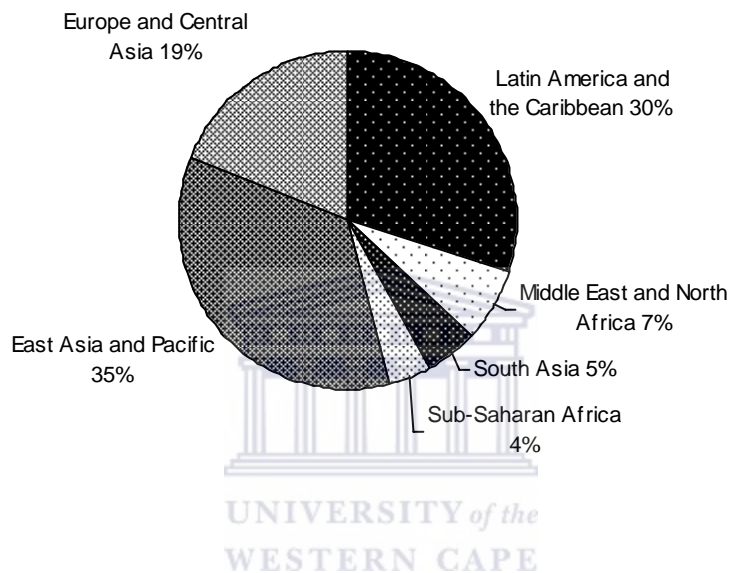
18 *Ibid.*

19 See M Dailami *et al* (n1) p 149.



distribution of the investments in infrastructure during the same period; it signifies that sub-Saharan Africa still lags behind other developing regions in attracting investments in infrastructure, only getting a meagre 4 percent of the total investment.

**Figure 1.0: Regional composition of international investment in infrastructure, 1992-2003**



The same study reveals that the sub-Saharan Africa region is in dire need of infrastructure with the least density of paved roads per square kilometre of land.<sup>21</sup>

All these revelations, and taking into consideration the central role infrastructure, particularly roads, would play in the development of the sub-Saharan Africa region, are indicative of bottlenecks in a healthy flow and mobilisation of capital from national and international markets to sub-Saharan countries' infrastructure.

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20 *Ibid.*

21 See M Dailami *et al* (n1) p 154 "Africa has 0.08 km/sq. of paved road per km/sq of land".

### **1.2.0. Statement of the Problem**

The traditional sources of funds, the International Financial Institutions (IFIs), are not able to meet the huge capital demands of the developing countries as a whole for infrastructure.<sup>22</sup> In addition, the conditions attached to the IFIs programmes are in most cases value reducing and work as limitations in accessing capital by the countries that need it the most.<sup>23</sup>

On the other hand, global commercial capital markets, viewed from the perspective of their size, depth, sophistication and range of instruments, have the potential to fund all economically viable infrastructure projects in developing countries. The sub-Saharan African countries so far still experience bottlenecks in drawing from these global commercial capital markets.

This study examines this enormous task of lack of access to capital by developing countries from the viewpoint of lack of adequate legal and institutional frameworks that would ease their access to global commercial capital markets.

Though there are other ways of looking at the problem, including from an economic and social perspective, this study opts to look at the way policies, institutions and regulation affect investment in infrastructure.

### **1.3.0. Scope of the Research**

The proposed study is very extensive, as developing countries need capital for virtually everything, ranging from health care, education, provision of basic social amenities, housing etc.

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22 e.g. it is estimated that only 8% of the funds available for infrastructure in developing countries came from official development assistance, See M Dailami *et al* (n1) p 154.

23 Mosley, Paul *et al* *Aid and Power- The World Bank & Policy-Based Lending* Vol. 1(1991).

The methods of raising capital proposed in the study are not peculiar to infrastructure. Raising money from the capital markets, and the public private partnerships (PPPs), can also be applied in other fields if government needs and policy are conducive thereto.

The researcher proposes to limit the scope of the study to the interface between investment and infrastructure, narrowing it down to roads financing. It has well been demonstrated that infrastructure sits at the core of a country's development.

This study will keep referring to developing countries and sub-Saharan Africa, though this is a wide group. The study will draw upon international best practices, but where it needs to use an example, it will refer to a specific country.

The study also draws upon other disciplines such as economics and finance. However, it will not engage those disciplines but will endeavour to highlight the interface between those disciplines and the study of law, limiting the scope to issues of domestic law and international law.

#### **1.4.0. Research Objective**

The objective of the research is to draw a relationship between legal and institutional frameworks in a country, and the competitiveness of that country as a destination for investment either as real investment or portfolio investment for infrastructure development.

The study will therefore endeavour to show that some bottlenecks with regard to investment have a legal solution, while in certain instances the establishment of certain institutions, or ensuring the efficient functioning

of those institutions where they exist, is essential in enhancing investor confidence.

The study explores the possibility of using law to achieve certain ends in the markets, which will be termed as: using of legal instruments as a tool for market engineering. In this examination the study takes recognised market norms from other disciplines and gives them legal efficacy. For instance, how the law affects liquidity and trading in government papers.

With regard to institutional frameworks, some institutions are a prerequisite to some market functions, e.g. a securities exchange is essential for the development of a secondary market for government papers. Similarly, a strong institutional framework for protecting creditors' rights, effective covenants, and reliable avenues of legal enforcement and remedies would enhance confidence amongst investors. These would to a great extent reduce risk for investors, and subsequently lower the cost of capital.

#### **1.5.0. Significance of the Study**

Undertaking the study is important for two reasons. First, it brings forth the issue of trade facilitation from a viewpoint that is more pressing and relevant to African countries. Indeed, it is increasingly being realised that tariffs, quotas and other trade policies are only one element of the overall cost of trade, and that efforts to improve customs procedures, minimize the trade distorting impact of standards, and *reduce transport costs*, may have a higher payoff than reciprocal reductions in overt trade policy barriers, because logistical, institutional and regulatory barriers are often more costly and generate no offsetting revenue (own emphasis).<sup>24</sup>

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<sup>24</sup> World Bank, *Global economic prospects: Trade regionalism and development*, (2005) p37.

Secondly, the need to increase investment in African countries is really pressing. As has already been illustrated, Africa fares badly with regard to its competitiveness as a destination for inward FDI, as well as with regard to the density of paved road coverage.<sup>25</sup> The study highlights a possible relationship between investment and infrastructure development. Though there are arguments to the effect that infrastructure develops after investments,<sup>26</sup> the most compelling view in the competitive world is that good infrastructure attracts investment.

### **1.6.0. Hypotheses**

The study is based on three hypotheses: one, that good legal and institutional frameworks within a country boost a country's competitiveness as a destination for investment; two, good legal and institutional frameworks within a country increase predictability, reduce investors' risks and subsequently reduce the cost of capital; three, availability of capital to a country is proportional to the amount invested on infrastructure, that is, the more money at the disposal of a country, the more is spent on improving infrastructure.

### **1.7.0. Literature Review**

This study does not pretend to pioneer research in the area of financing government projects. Neither does it claim to be the first on private capital participation in public projects. The World Bank and the International Monetary Fund, (IMF),<sup>27</sup> RW Ngugi *et al.*,<sup>28</sup> and A Harwood,<sup>29</sup> have undertaken extensive research on how to develop capital markets. Their research were very informative in carrying out this

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25 See M Dailami *et al* (n1) p 154.

26 See UNCTAD (n6).

27 The World Bank & The IMF, *Developing government bond markets: A Handbook* (2001).

28 RW Ngugi *et al.*, 'Stock market development : what have we learned?', in RW Ngugi *et al* (ed) *Finance and development* (2004).

29 A Harwood (ed) *Building local bond markets: An Asian perspective*(2000).

study. T Endo<sup>30</sup> carried the research further to issues of developing market infrastructure for secondary markets for government bonds. The World Bank and IMF<sup>31</sup> further enrich the study with regard to issues of regulating financial systems and financial markets.

M Klein,<sup>32</sup> RG Gelos *et al.*,<sup>33</sup> DA Grigorian<sup>34</sup> the World Bank<sup>35</sup> and P Rigby *et al.*,<sup>36</sup> have researched on risk managements and determinants of risk, and the effects of risk on the cost of capital.

H Kalsi and K Barnes<sup>37</sup> write about contemporary issues with regard to private debt finance or participation of private capital in public projects. D Grimsey and MK Lewis<sup>38</sup> pursue research on public private partnerships (PPPs) and detail the history and development of the PPPs to the present time.

However, though the study heavily relies on other researchers' findings, it can be distinguished therefrom, and seeks to apply them to solve some problems that are pressing in the developing countries with regard to access to capital.

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30 Unpublished: T Endo 'Developing efficient market infrastructure and secondary market of government bonds in developing countries' unpublished paper presented in the 5th regional workshop on Developing Government Bond Markets in Sub-Saharan Africa, Johannesburg, South Africa (2003)

31 The World Bank & The IMF, 'Assessing the Legal Infrastructure for Financial Systems' in *Financial sector assessment: A handbook*, (2005) 223

32 M Klein, 'Risk, taxpayers, and the role of government in project finance', World Bank policy research working paper (1996).

33 RG Gelos *et al.*, 'Sovereign borrowing by developing countries: What determines market access?' IMF working paper WP/04/221.

34 DA Grigorian, 'On the determinants of first time sovereign bond issues', IMF working paper WP/03/184.

35 World Bank report, *Private capital flows to developing countries, the road to financial integration* (1997).

36 P Rigby *et al.*, '*Criteria*', Standard & Poor's criteria for debt rating (2001).

37 H kalsi & K Barnes "Private debt finance for developing countries' in World Bank, *Global development finance: Harnessing cyclical gains for development* (2004) 37.

38 D Grimsey & MK Lewis *Public private partnerships: The worldwide revolution in infrastructure provision and project finance* (2004).

In addition, the area of research is not very much explored, and most of the available works relate to the developed countries and the big developing countries; therefore they are oblivious of the needs of some small developing and least developed countries (LDCs).

### **1.8.0. Methodology**

The approach of the study is analytical, based on desktop research. The desktop research entails a literature review of the available materials (see literature review).

The researcher relies on both primary sources of information, such as Acts of Parliament, international agreements, statutes of international bodies, and secondary sources, such as commentaries, works of scholars, newspaper articles etc.

### **1.9.0. Chapter Breakdown**

The study will be completed in five chapters. Chapter 1 is the introduction to the study and introduces the thinking underlying the study, as well as the study itself. It comprises of the background, statement of the problem, objectives, hypotheses and literature review.

Chapter 2 sets out the legal and institutional framework that would enable a government to participate effectively in the capital market. It discusses government bonds and their attractiveness to investors, and how a government could improve the government bonds competitiveness in the markets and trading to develop capital markets, while safeguarding against bad effects such as exchange risks and crises.

Chapter 3 looks at the direct participation of the private sector in government project financing and the enabling legal and institutional

frameworks. Since this relates more to the area of contract, the study looks at the ways to enforce contracts, dispute resolution, and the enforcements of awards/ damages. This is looked at with a view to enhancing investor confidence and reducing the cost of capital.

Chapter 4 examines an innovative debt financing model based on the Kenya fuel levy fund. The model is built on the assumption of the government debt being risk free because it is backed by the ability of the government to pay its debts through taxation. The Kenya fuel levy is a tax on fuel that is earmarked for road maintenance rehabilitation and development but has not been innovatively utilised e.g. through securitisation of the fund to get huge debt for road development and maintenance.

Chapter 5 draws some important lessons from the foregoing study, and contains recommendations and conclusions.





## **Governmental, Institutional and Market Based Sources of Capital**

### **2.1.0. Introduction**

According to standard neoclassical economic theory, capital scarce countries should borrow large amounts of capital to finance domestic investment that they cannot finance through other means, or to smooth national consumption.<sup>1</sup> The need to finance governments' deficits, new investments, development projects such as infrastructure etc., is complemented by the development of sources, and various methods, through which governments can raise the requisite capital.

The choice of the finance facility that a particular government would choose is dependent on many variables. However, at the top of the considerations would be the cost of obtaining the finance in terms of interest rates, availability of the finance facility as and when the country needs the funds, grace period before repaying the principal and interest, the duration of the loan, and the flexibility accompanying the utilisation of the funds.

This Chapter briefly introduces some of the methods that sub-Saharan Africa countries have relied upon in financing government operations, such as loans and grants from other governments, loans and grants from the International financial institutions e.g. World Bank, IMF, African Development Bank (AfDB) etc., loans from commercial banks, either

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<sup>1</sup> L Robert, Why doesn't capital flow from rich to poor countries? (1990) 80 *American Economic Review*, Papers and Proceedings 92.

locally or internationally, trade credit from suppliers, and selling of government debt papers/bonds.

The Chapter concludes by looking into the development of a government bond market as one of the developing ways that sub-Saharan African governments can utilise to develop resilience to changing donor countries' foreign policy, negative effects and vulnerability of their economies to such risks associated with foreign debt, and getting long-term capital to finance infrastructure development.

### **2.2.0. Loans and Grants from other Governments**

It is difficult to give a full account of this source of funds (otherwise called official development assistance (ODA)<sup>2</sup>) because of its disjointed nature. The funds are in many instances formalised through a bilateral lending agreement, therefore making it hard to trace how they are disbursed other than when disclosed through membership organisations like the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU).<sup>3</sup> However, it is shown that, mostly, such loans or grants are made by the developed countries to the developing countries.<sup>4</sup> In other cases the developed countries have extended these funds through the international financial institutions, such as the World Bank<sup>5</sup>, AfDB<sup>6</sup> etc.

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2 The full definition of ODA according to OECD glossary of statistical terms is 'Flows of official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 percent (using a fixed 10 percent rate of discount)'.

3 OECD and EU keep statistics of Official Development Assistance, see [www.oecd.org](http://www.oecd.org) and <http://europa.eu>.

4 Sub-Sahara Africa and development finance', selected essays on development finance and the role of the lawyer in international debt operations. [www.unitar.org/dfm](http://www.unitar.org/dfm) .

5 The World Bank is a trustee of the Global Environment facility (GEF) as well as an implementing agency. GEF is a trust fund by the donor countries that provides grants to developing countries for projects that benefit the global environment and promote sustainable livelihoods in local communities. More information about GEF can be accessed on <http://www.gefweb.org/> (accessed on 27/03/2007).

The United States of America (USA) channels some of its development assistance through the Millennium Challenge Corporation (MCC).<sup>7</sup> The MCC is responsible for the stewardship of the Millennium Challenge Account (MCA), which receives funds appropriated by Congress every year.<sup>8</sup> The eligibility criteria for funds in the MCA are based on demonstration of a commitment to policies that promote political and economic freedom, investments in education and health, control of corruption, and respect for civil liberties and the rule of law.<sup>9</sup>

Similarly, the EU has the European Development Fund (EDF)<sup>10</sup> which is the main instrument for providing community aid for development cooperation in the African Caribbean and Pacific states (ACP) and the overseas countries and territories (OCT). The EDF is not yet under the direct Community budget, and therefore is still funded by member states, is subject to its own financial rules, and is managed by a specific committee. Member states continue to have their own bilateral agreements and implement their own initiatives with developing countries that are not financed by the EDF or any other Community fund.<sup>11</sup>

Despite this multifaceted approach to ODA, it is agreed that the amount of finance available to the developing countries is still below the

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6 The AfDB is one of the seven executing agencies of GEF which includes four regional development banks and UN affiliate bodies. See <http://www.gefweb.org/> (accessed on 27/03/2007).

7 The Millennium Challenge Corporation (MCC) is a United States Government corporation designed to work with some of the poorest countries in the world, it was established in January 2004.

8 <http://www.mcc.gov/about/index.php> (accessed on 26/03/2007).

9 *Ibid*, also see [www.usaid.gov](http://www.usaid.gov) (accessed on 26/03/2007).

10 Founded in 1957 under the Treaty of Rome with the view of granting technical and financial assistance, initially to African countries which at the time were still colonised and with which some member states had historical links. Available at <http://europa.eu> (accessed on 26/03/2007).

11 See <http://europa.eu/scadplus/leg/en/lvb/r12102.htm> (accessed 26/03/2007).

threshold required to propel them to the internationally agreed level of development.<sup>12</sup> The conference in Monterrey of the heads of states and governments on financing for development pointed out that,<sup>13</sup>

...a substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals and objectives, including those contained in the Millennium Declaration.

The conference further resolved to make concrete efforts towards setting aside 0.7 percent of donor countries' gross national product (GNP) as ODA to developing countries. However, Norway, Denmark, Luxemburg, Sweden and the Netherlands are the only countries that have been able to meet this target.<sup>14</sup> On the contrary, OECD statistics show that aid flows in 2005 to the poorest countries in sub-Saharan Africa actually stalled.<sup>15</sup>

The flow of the concessional funds from developed countries to sub-Saharan Africa is not certain. Most of the funds that were available as ODA in 2005 were in the form of debt relief;<sup>16</sup> though welcomed, it does not provide the requisite capital for new investments. Policy makers in sub-Saharan Africa face an arduous task to come up with concrete policies that will see the region changing from over-reliance on official

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12 United Nations, 'Monterrey consensus of the international conference on financing for development', (2003) available at [www.un.org/esa/ffd](http://www.un.org/esa/ffd) (accessed on 26/03/2007).

13 UN conference of heads of state and governments, Monterrey, Mexico, 21 and 22 March 2002.

14 See [http://en.wikipedia.org/wiki/Official\\_development\\_assistance#\\_note-0](http://en.wikipedia.org/wiki/Official_development_assistance#_note-0) also OECD final ODA data for 2005 <http://www.oecd.org/dataoecd/52/18/37790990.pdf> (accessed on 25/03/2007).

15 Statistics at <http://www.oecd.org/dataoecd/52/18/37790990.pdf> (accessed on 27/03/2007).

16 The lion's share of the aid increase in 2005 came from debt relief grants, which more than tripled, OECD final ODA data for 2005 <http://www.oecd.org/dataoecd/52/18/37790990.pdf> (accessed on 25/03/2007).

finance which is comprised of loans and grants from agencies and governments of developed economies.<sup>17</sup>

### **2.3.0. Loans and Grants from International Financial Institutions**

International financial institutions (IFIs) are basically intergovernmental bodies created for different purposes in accordance with their Articles of Agreement. The study briefly introduces The World Bank (i.e. International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA)), IMF and AfDB as some of the most common sources of finances for the sub-Saharan Africa region.

#### **2.3.1. The World Bank**

The World Bank Group,<sup>18</sup> as it is rightly called, is comprised of:

1. International Bank for Reconstruction and Development (IBRD),
2. International Development Association (IDA),
3. International Finance Corporation (IFC),
4. Multilateral Investment Guarantee Agency (MIGA), and
5. International Centre for Settlement of Investment Disputes (ICSID)

IBRD, IDA and IFC are the lending arms of the World Bank Group; however, IFC lends to the private sector and therefore will not be discussed in this study. MIGA and ICSID will be discussed later on in the study.

IBRD and IDA are commonly known as the World Bank.<sup>19</sup> However, though both are vital sources of financial and technical assistance to developing countries around the world, IBRD focuses on middle income

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17 'Sub-Sahara Africa and development finance', selected essays on development finance and the role of the lawyer in international debt operations. [www.unitar.org/dfm](http://www.unitar.org/dfm) .

18 See <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0> accessed on 26/03/2007.

19 Ibid.

and creditworthy-poor countries, while IDA focuses on the poorest countries in the world.<sup>20</sup>

### IBRD

IBRD came into existence on 27/12/1945 following international ratification of the agreements reached at the United Nations Monetary and Financial Conference of July 1 to July 22, 1944, at Bretton Woods, New Hampshire.<sup>21</sup> Its purpose then was to finance the reconstruction of nations devastated by World War II (WWII); now its mission has expanded to fighting poverty by means of financing states, giving guarantees for private investment, etc.<sup>22</sup>

Member states subscribe for share capital in the Bank by having 20 percent of the allotted shares as paid up or subject to call, and the remaining 80 per cent as callable capital.<sup>23</sup> Since the members' contribution as share capital is not enough, and furthermore the majority of it is not paid up, IBRD relies on the international capital markets<sup>24</sup> to raise the funds it lends to its borrowers, and for its operations. It issues bonds which have a high credit rating<sup>25</sup> of 'AAA' (the highest possible) because they are backed by member states' callable share capital, as well as by borrowers' sovereign guarantees.<sup>26</sup>

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20 *Ibid.*

21 see Preamble IBRD article of agreement on <http://siteresources.worldbank.org/EXTABOUTUS/Resources/ibrd-articlesofagreement.pdf> (accessed on 26/03/2007).

22 Article 1: Purpose, IBRD articles of agreements.

23 Article II: Membership in and Capital of the Bank, IBRD articles of agreements.

24 IBRD raises most of its funds on the world's financial markets see <http://web.worldbank.org> (accessed on 26/03/2007).

25 The IBRD bonds are 'AAA' rated, see <http://web.worldbank.org> (accessed on 26/03/2007).

26 See 'Raising Capital' what is the World Bank <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,ontentMDK:20040558~menuPK:34559~pagePK:34542~piPK:36600,00.html> (accessed on 26/03/2007).

Due to the low cost of borrowing that IBRD enjoys, it is able to pass on low interest rates to its borrowers (developing countries), making its interest rates more competitive than the rates offered in the international capital markets to some borrower countries due to lack of high credit rating.<sup>27</sup> Similarly, IBRD offers long term loans to borrowers e.g. some countries may get terms of repayment with a grace period of 8 years and overall repayment period of 20 years.<sup>28</sup> Furthermore, IBRD provide borrowers with products that give them the flexibility to select terms that are consistent with their debt management strategy and suited to their debt servicing capacity.<sup>29</sup>

However, since the Bank's most valuable asset is its credit rating, it obliges IBRD to maintain stringent risk management strategies to reduce credit exposure and default risk. Amongst the strategies it applies are: limiting the amounts of loans disbursed, and ensuring that disbursement is only to creditworthy borrowers.<sup>30</sup> Such stringent measures cut out many of the sub-Saharan African countries from the funds of IBRD, since most countries in the region do not meet the threshold for borrowing from IBRD by virtue of their lack of

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27 The low borrowing cost spreads obtained by IBRD in the markets have enabled IBRD clients to borrow from the IBRD at fine spreads over the London Inter-Bank Offered Rate (LIBOR). For example, from 1993 to 2002, the lending rate on the Variable-Spread Loan (VSL) ranged from LIBOR + 0.37% to LIBOR + 0.54%.; the lending rate as of July 1, 2002 on the Fixed-Spread Loan (FSL) was LIBOR + 0.55%. For borrowers eligible for interest rate waivers, the net lending rate ranged from LIBOR + 0.12% to LIBOR + 0.29% for VSLs, and as of July 1, 2002 was LIBOR + 0.30% for FSLs in US\$. In contrast, direct borrowing costs in international capital markets for most IBRD borrowers may range from LIBOR + 1.00% to LIBOR + 7.00%. see <http://treasury.worldbank.org/Services/Financial+Products/FAQs/Financial+Products.html> (accessed 27/03/2007).

28 see Financial terms and conditions of IBRD loans, at <http://wbln0018.worldbank.org/Institutional/Manuals/OpManual.nsf/whatnewvirt/4E2546F2C36F02708525672C007D08DC?OpenDocument#foot> (accessed on 27/03/2007).

29 Ibid. IBRD offers two loan products for new loan commitments: fixed-spread loans, and variable-spread loans (VSLs, formerly known as variable-rate single currency loans or VSCLs).

30 International Bank for Reconstruction and Development 'Information Statement' September 2005, see also supra n19.



creditworthiness, and since their gross national income (GNI) per capita is less than that required to borrow from IBRD.<sup>31</sup>

### IDA

The realisation that poorer developing countries needed softer terms than those that could be offered by IBRD, so that they could afford to borrow the capital they needed to facilitate growth, led to the formation of IDA in 1960.<sup>32</sup> The purposes of IDA are outlined in the Articles of Agreement as,<sup>33</sup>

... to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world included within the Association's membership, *in particular by providing finance to meet their important developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans*, thereby furthering the developmental objectives of the [IBRD] and supplementing its activities (own emphasis).

IDA is therefore the leading source of concessional credits and loans to sub-Saharan Africa, with 39 countries out of the 82 countries eligible to draw on IDA credits being from Africa.<sup>34</sup> IDA credits have maturities of

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31 Countries are eligible for IBRD on the basis of creditworthiness. The operational cut-off for IBRD eligibility for fiscal 2006 was a 2004 GNI per capita above \$965, using Atlas methodology. Although IDA can extend eligibility temporarily to countries that are above the operational cut-off and are undertaking major adjustment efforts but are not creditworthy for IBRD lending. An exception has been made for small island economies. See World bank annual Report 2005 also available on <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/EXTANNREP/EXTANNREP2K5/0,,contentMDK:20647778~menuPK:1578499~pagePK:64168445~piPK:64168309~theSitePK:1397343,00.html>. (accessed on 27/03/2007).

32 World Bank, 'IDA history' what is IDA? at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21206704~menuPK:83991~pagePK:51236175~piPK:437394~theSitePK:73154,00.html> (accessed on 27/03/2007).

33 IDA Articles of Agreement Article one: Purpose

34 World Bank, what is IDA? at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21206704~menuPK:83991~pagePK:51236175~piPK:437394~theSitePK:73154,00.html> (accessed on 27/03/2007).



20, 35 or 40 years, with a 10-year grace period before repayment of principal begins.<sup>35</sup> Thus IDA credits and loans are a long term concessional source of funds. Also, there is no interest charge, though credits do carry a small service charge, currently 0.75 per cent on funds paid out.<sup>36</sup>

IDA's credits are focused towards primary education, basic health services, clean water and sanitation, environmental safeguards, business climate improvements, infrastructure and institutional reforms.<sup>37</sup> The rationale is that the projects pave the way for economic growth, job creation, higher incomes and better living conditions. However, just being a poor country does not make a country eligible for IDA funds; the funds are allocated to the borrowing countries in relation to their income levels<sup>38</sup> and record of success in managing their economies and their ongoing IDA projects.<sup>39</sup>

Despite the focus areas of the IDA funds being wide and therefore making them overstretched, there is little room for its expansion since IDA relies on replenishment.<sup>40</sup> Donors meet every three years to review IDA's policies and to replenish IDA funds which comprise contributions

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35 World Bank, 'IDA lending' what is IDA? at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21206704~menuPK:83991~pagePK:51236175~piPK:437394~theSitePK:73154,00html> (accessed on 27/03/2007).

36 *Ibid.*

37 *Ibid.*

38 IDA borrowing countries must have a GNI per capita of below \$965. However, IDA can extend eligibility temporarily to countries that are above the operational cut-off and are undertaking major adjustment efforts but are not creditworthy for IBRD lending. An exception has been made for small island economies. See World bank annual Report 2005 also available on <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/EXTANNREP/EXTANNREP2K5/0,,contentMDK:20647778~menuPK:1578499~pagePK:64168445~piPK:64168309~theSitePK:1397343,00.html>. (accessed on 27/03/2007).

39 *Ibid.*

40 World Bank, 'IDA funding' what is IDA? at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/html> (accessed on 27/03/2007).

by governments of the richer member countries, funds derived from IBRD's income, and from borrowers' repayments of earlier IDA credits.<sup>41</sup>

Donors who are mostly the wealthy members of IDA,<sup>42</sup> contribute most of the funds, e.g. donor contributions accounted for more than half of the US\$33 billion in the IDA14 replenishment.<sup>43</sup> The problem with donor reliance is that IDA is not self-sufficient and therefore vulnerable to global events, e.g. the war on terror, natural calamities like tsunami which are potential aid diversion interests to the donors.<sup>44</sup>

### **2.3.2. International Monetary Fund (IMF)**

IMF was conceived in July 1944 at the United Nations Monetary and Financial Conference at Bretton Woods, New Hampshire,<sup>45</sup> and just like IBRD it is a Bretton Woods Institution. It came into effect in December 1945 when its first 29 member countries signed its Articles of Agreement.

The IMF performs three main activities:<sup>46</sup>

1. Monitoring national, global, and regional economic and financial developments, and advising member countries on their economic policies ('surveillance');

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41 *Ibid.*

42 The top ten contributors are, US, UK, Japan, Germany, France, Sweden, Italy, Canada, Netherlands and Switzerland in that order. Less wealthy nations that also contribute to IDA are Turkey and Korea. <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,,contentMDK:21205385~pagePK:51236175~piPK:437394~theSitePK:73154,00.html> (accessed on 28/03/2007).

43 IDA 14 is the latest replenishment negotiations ending February 2005. <http://siteresources.worldbank.org/IDA/Resources/Updaterecentdevelopments.pdf> (accessed on 28/03/2007).

44 See e.g. the IDA 14 received good contributions due to the 2004 tsunami which placed to fund the countries affected. . <http://siteresources.worldbank.org/IDA/Resources/Updaterecentdevelopments.pdf> (accessed on 28/03/2007).

45 What is IMF? 'why was it created', <http://www.imf.org/external/pubs/ft/exrp/what.htm> (accessed on 28/03/2007).

46 IMF Article of Agreements: Art I-Purposes as extrapolated in, What is IMF? 'how does IMF serve its member countries?', <http://www.imf.org/external/pubs/ft/exrp/what.htm> (accessed on 28/03/2007).

2. Lending members hard currencies to support policy programs designed to correct balance of payments problems; and
3. Offering technical assistance in its areas of expertise, as well as training for government and central bank officials.

The study focuses on the lending role of the IMF which is for the purpose of correcting balance of payments problems,<sup>47</sup> and the ability of the IMF programs to signal that a country's economic policies are on the right track.

The IMF is not a development institution. It does not and, under its Articles of Agreement,<sup>48</sup> it cannot provide loans to help poor countries build their physical infrastructure, diversify their export or other sectors, or develop better education and health care systems.<sup>49</sup> This is the job of the World Bank and the regional development banks.<sup>50</sup> However, the introduction of the Poverty Reduction and Growth Facility (PRGF) which lends on concessional fixed interest rates terms,<sup>51</sup> to the low income countries has come under scrutiny as dabbling in the work of the World Bank and other development banks in development policy lending.<sup>52</sup>

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47 *Ibid.*

48 IMF Article of Agreements: Art I-Purposes.

49 What is IMF? 'how does IMF help poor countries?', <http://www.imf.org/external/pubs/ft/exrp/what.htm> (accessed on 28/03/2007), see also article of agreement, <http://www.imf.org/external/pubs/ft/aa/index.htm> (accessed on 28/03/2007).

50 Policy-based lending in support of a country's policy program accounts for about one-third of the World Bank's annual lending. The Bank's other lending instrument – investment lending – funds projects such as road and school construction. <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20237378~menuPK:34457~pagePK:64003015~piPK:64003012~theSitePK:4607,00.html> (accessed on 27/03/2007).

51 PRGF offer a fixed interest rate of 0.5 per cent, and with a maturity of 10 years. What is IMF? 'Instruments of IMF lending', <http://www.imf.org/external/pubs/ft/exrp/what.htm> (accessed on 28/03/2007).

52 See What is IMF? how does IMF help poor countries? (n49).

On the other hand, IMF programs signal that a country's economic policies are on the right track thereby reassuring investors and the development community.<sup>53</sup> IMF's endorsement of a country's policies can make it easier for that country to borrow on affordable terms in international capital markets or from other lenders.<sup>54</sup>

The requirement, that for a country to be a member of the World Bank it has to be a member of the IMF,<sup>55</sup> ensures that all of the countries in sub-Saharan Africa are members of the Fund. Therefore, besides ensuring that the region's microeconomic policies are put under scrutiny by the Fund, the countries can take advantage of the its programmes, like the policy support instrument (PSI), to enhance confidence for their activities in the international capital markets while raising capital for infrastructure development.

### **2.3.3. African Development Bank (AfDB)**

The Agreement establishing the AfDB came into force on 10/09/1964 after twenty member states subscribed to 65 per cent of the initial authorised share capital.<sup>56</sup>

The purposes of the Bank are outlined in Article 1 of the agreement establishing AfDB:<sup>57</sup> "... to contribute to the sustainable economic

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53 The Policy Support Instrument (PSI), introduced in October 2005. PSI signal to donors, multilateral development banks, and markets the Fund's endorsement of a member countries' effective economic programs/policies. <http://www.imf.org/external/np/exr/facts/psi.htm> (accessed on 28/03/2007).

54 Under a mechanism introduced by the IMF in 2005—the PSI—countries can request that the IMF regularly and frequently review their economic programs to ensure that they are on track. Supra n49.

55 Article II Section 1 IBRD articles of agreement – membership is open to the members of the fund and Article II Section 1 IDA articles of agreement – membership is open to membership of the IBRD. [www.worldbank.org](http://www.worldbank.org) (accessed 27/03/2007).

56 Agreement establishing the AfDB, see Article 65 on Entry into force. Also available on [http://www.afdb.org/pls/portal/docs/PAGE/ADB\\_ADMIN\\_PG/DOCUMENTS/LEGALINFORMATION/AGREEMENT\\_ESTABLISHING\\_ADB\\_JULY2002\\_EN.DOC](http://www.afdb.org/pls/portal/docs/PAGE/ADB_ADMIN_PG/DOCUMENTS/LEGALINFORMATION/AGREEMENT_ESTABLISHING_ADB_JULY2002_EN.DOC) (accessed on 30/03/2007).

57 Article 1 agreement establishing AfDB.

development and social progress of its regional members individually and jointly.” In this regard the agreement outlines some functions in Article 2 to help the bank implement its purposes which may be summarised as:<sup>58</sup>

1. Financing of investment projects and programmes relating to economic and social development; and
2. Provision of technical assistance.

The Bank provides long-term financing to suit the needs of its borrowers. Loans may have a maximum maturity of up to twenty years, inclusive of the grace period.<sup>59</sup> Though project specific grace periods may be incorporated in the loan structure to take into account the cash flow profile and needs over the life of the project, they generally do not exceed five years.<sup>60</sup>

Like IBRD, AfDB relies on its high credit rating to be able to borrow in the international capital market at competitive rates, and then pass on those rates to its borrowers.<sup>61</sup> The major rating agencies, Moody's, Standard & Poor's, Fitch and the Japanese Credit Rating Agency have assigned an AAA rating to AfDB long term senior debt, and an AA+ to its subordinated debt. The outlook on all the ratings is stable and reflects the Bank's strong membership support, healthy capital adequacy, preferred creditor status and strong financial condition.<sup>62</sup>

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58 Article 2 Agreement establishing AfDB.

59 AfDB guidelines for public sector loans – maturity, available [http://www.afdb.org/pls/portal/docs/PAGE/ADB\\_ADMIN\\_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF](http://www.afdb.org/pls/portal/docs/PAGE/ADB_ADMIN_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF) (accessed on 30/03/2007).

60 AfDB guidelines for public sector loans – grace period.

61 The bank's interest rates terms equals to base rate plus lending margin where the lending margin for the sovereign borrowers is currently pegged at 40 basis points. See Financial products offered by the AfDB. Publication available on [http://www.afdb.org/pls/portal/docs/PAGE/ADB\\_ADMIN\\_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF](http://www.afdb.org/pls/portal/docs/PAGE/ADB_ADMIN_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF) (accessed on 30/03/2007).

62 Ratings of AfDB [http://www.afdb.org/portal/page?\\_pageid=473,968878&\\_dad=portal&\\_schema=PORTAL](http://www.afdb.org/portal/page?_pageid=473,968878&_dad=portal&_schema=PORTAL) (accessed on 30/03/2007).

The Bank's clients are the member states,<sup>63</sup> public sector enterprises<sup>64</sup> and private sector enterprises.<sup>65</sup> Interest rates are calculated as a base rate plus a lending margin. The Bank offers floating, variable and fixed base rates. The lending margin for public sector sovereign guaranteed loans for regional member countries is set at forty basis points, while that of the public sector enterprises and private sector enterprises is dependent on project specific risk-based margins.<sup>66</sup>

This is a good initiative for Africa and particularly the sub-Saharan African region. However, the region still needs more funds to achieve the internationally agreed development goals and objectives, including those contained in the Millennium Declaration, as was noted by the participants in the Monterrey conference on financing for development.<sup>67</sup>

#### **2.4.0. Loans from Commercial Banks either Locally or Internationally**

Governments are eligible to borrow from commercial banks either locally or internationally. However, commercial banks funds are somewhat different from the other sources of funds discussed in the preceding sections. While a government can access funds to fund general budgetary deficits, e.g. to pay salaries of civil servants, because it is suffering from balance of payment deficits or funding for policy change e.g. from ODA,

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63 Financial products offered by the AfDB. Publication available on [http://www.afdb.org/pls/portal/docs/PAGE/ADB\\_ADMIN\\_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF](http://www.afdb.org/pls/portal/docs/PAGE/ADB_ADMIN_PG/DOCUMENTS/FINANCIALINFORMATION/BROCHURE%20ENGLISH%20REVISED%2024%20JUNE%2005.PDF) (accessed on 30/03/2007).

64 majority sharer capital is owned by the government or by corporation, the capital of which majority is owned by the Government of an eligible country, including cases of full (or 100%) ownership. Refer to Financial products offered by the AfDB note 62.

65 To be eligible for financing, an enterprise should be privately owned and managed, meaning that more than 50% of its voting shares must be in private hands. Refer to note above.

66 see Financial products offered by the AfDB (n 63).

67 see UN conference of heads of state and governments (n13).

World Bank and IMF, the same may not apply to commercial bank financing. Commercial banks in most cases insist on security for their loans, thereby making commercial banks' finance project based, since the project or expected income<sup>68</sup> from the project can be tendered as security for the loan.

Because the study's focus is on investment in transport infrastructure, it is hard to conceive of a situation where the government might tender a constructed road as security in event of default, because roads are public utilities which in many cases have no direct monetary returns to the government. However, with the innovative styles of financing infrastructure e.g. toll roads where the users pay for the use of the road,<sup>69</sup> such a scenario is not hard to conceive since the revenue generated by tolls could be securitised.

Banks, on the other hand, may not be willing to solely assume the funding and credit risks of huge loans associated with infrastructure projects, or the borrowing requirements for the infrastructure project may be beyond the funding and credit risk capacity of a single lender. In other cases, the statutory liquidity requirements may be prohibitive despite the willingness of a bank, particularly where the bank has a shallow capital base.<sup>70</sup> As a result some loans are arranged as syndicates with the funds jointly provided by two or more lenders. Though there is a single loan agreement, each participant to a syndicated loan maintains a

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68 Expected income can be securitised as an asset because businesses can be able to predict future cash flow. See discussion on securitization in A Harwood (Edt) *Building Local Bond Markets: An Asian perspective* IFC publication 2000.

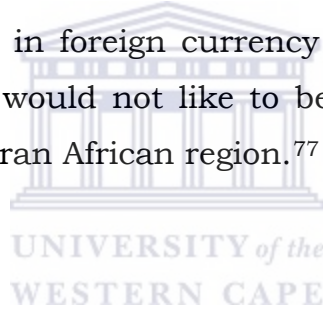
69 See D Grimsey & MK Lewis Public private partnerships: The worldwide revolution in infrastructure provision and project finance (2004) for general discussions on PPPs.

70 See e.g. Kenya Banking Act (Cap 488 Laws of Kenya) sec 10 (1) limits on advances credits and guarantee such that a banking institution cannot give advances, credit, guarantee or incur liability to the tune of 25 per centum on one client / client and his associates.



separate claim and bears the credit risk for the portion of the loan that it has provided.<sup>71</sup>

The study has hitherto impliedly insisted on some qualities in the finance facility for infrastructure financing, viz, it should be long-term, and the cost of finance should be low to facilitate development and guard against bad externalities, such as the financial crises suffered in East Asia.<sup>72</sup> However, in the sub-Saharan African region the inflation rate is high,<sup>73</sup> which feeds directly into the length of time to maturity of possible loans and the cost of borrowing.<sup>74</sup> Similarly, exchange rate volatility is not good either; if external conditions deteriorate, debt servicing costs on existing loans automatically increase.<sup>75</sup> Deterioration in global conditions can cause currency to weaken and asset value to decline; debt costs, however, if they are fixed in foreign currency increase.<sup>76</sup> Maturities are also short, as the banks would not like to be exposed to the exchange rate risks of the sub-Saharan African region.<sup>77</sup>



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71 Institutional Markets Section, syndicated lending *Domestic Markets Department Bulletin* (2005) also available on [http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu\\_sep05/PDF/bu\\_0905\\_1.pdf](http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_sep05/PDF/bu_0905_1.pdf). (accessed on 30/03/2007).

72 A Harwood et al. *The crisis in emerging financial markets: a World Bank Group report* -Brookings conference (1999) available on [www.brookings.edu](http://www.brookings.edu) (accessed on 25/11/2006). Role of foreign investors in the Asian debacle ... it is widely accepted that foreign banks extended excessive short-term credits (in foreign currencies) to emerging-market borrowers and pulled back when crisis hit.

73 The Heritage Foundation, *2007 Index of economic freedom sub-Saharan Africa (region E)* available on <http://www.heritage.org/index/> (accessed on 31/03/2007) [sub-Saharan Africa inflation is] 15 percent on average which is twice as high the next worst region.

74 The World Bank & The IMF, *Developing government bond markets: A Handbook* (2001).

75 A Harwood (ed) *Building Local Bond Markets: An Asian perspective* IFC publication (2000).

76 *Ibid.*

77 D Ratha and U Dadush, the role of short-term debt in recent crises *Finance and development magazine*, December 2000 Volume 37, Number 4. online edition available on <https://www.imf.org/external/pubs/ft/fandd/2000/12/dadush.htm> (accessed on 29/03/2007) ... The rapid build-up of short-term debt was a key factor in the financial crises that rocked Mexico in 1994-95, East Asia in 1997-98, and Russia and Brazil in 1998-99.



Long term policies should be put in place in the region, since in the foreseeable future banks will continue to be the main vehicles through which savings are channelled into investments.<sup>78</sup> Encouraging savings through managing inflation and encouraging local currency funding, would be some of the immediate solutions to participation of bank funding in infrastructure development. Maintaining credible policies in exchange rates would see the stabilisation of exchange rates; thereby reducing the exchange rate risks and encouraging foreign investors' capital participation in infrastructure development.

In more developed financial systems like those of the USA and Australia syndicated loans have acquired characteristics similar to those of privately placed corporate bonds.<sup>79</sup> This has seen the loans acquire longer maturities and the development of a secondary market for lenders to trade in their loan shares, much like bonds.<sup>80</sup> Similarly, a strong supply of funds from domestic and foreign banks leads to narrowing of spreads.<sup>81</sup>

### **2.5.0. Selling of Government Debt Papers**

Debt papers generally are instruments that obligate the issuer to pay the holder the principal plus interest. Therefore, they are essentially an I.O.U (I owe you contract) issued by the issuer (borrower) and purchased by the holder (investor).

Government debt papers comprise of treasury bills (T-bills) and treasury bonds (T-bonds). The difference between the two is that T-bills are short-

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78 see A Harwood et al. (n72).

79 see *Domestic Markets Department Bulletin* (n71).

80 *Ibid.*

81 *Ibid.*

term, with maturities of one year and less,<sup>82</sup> while those of T-bonds are above one year.<sup>83</sup> Bonds are further classified by the length of maturity:<sup>84</sup>

- Short-term bonds – mature in the next few years, e.g. one to three years.
- Intermediate-term bonds – come due within three to ten years
- Long-term bonds – mature in more than ten years and generally up to thirty years

This classification is arbitrary; the USA treasuries with maturity between one to seven years are called treasury notes, while those with maturities above seven years are called treasury bonds.<sup>85</sup> However, most of the time, longer-term bonds pay higher yields (coupon or spread) than short-term bonds.<sup>86</sup>

This section of the study looks at some of the legal and institutional frameworks in developing the government bonds for the purposes of raising long-term debt for financing infrastructure development.

### **2.5.1. Conceptualising the bond market**

The bond market is made up of different players, as illustrated in figure 2.0. The main ones are the issuers and investors; in this case the government is the issuer with the long-term financial needs, while the investors could be savers in the economy or outside with the need to place their savings or other liquid funds in interest bearing securities.

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82 Investing glossary on the web, [http://www.investorwords.com/5060/Treasury\\_bills.html](http://www.investorwords.com/5060/Treasury_bills.html) (accessed on 02/04/2007).

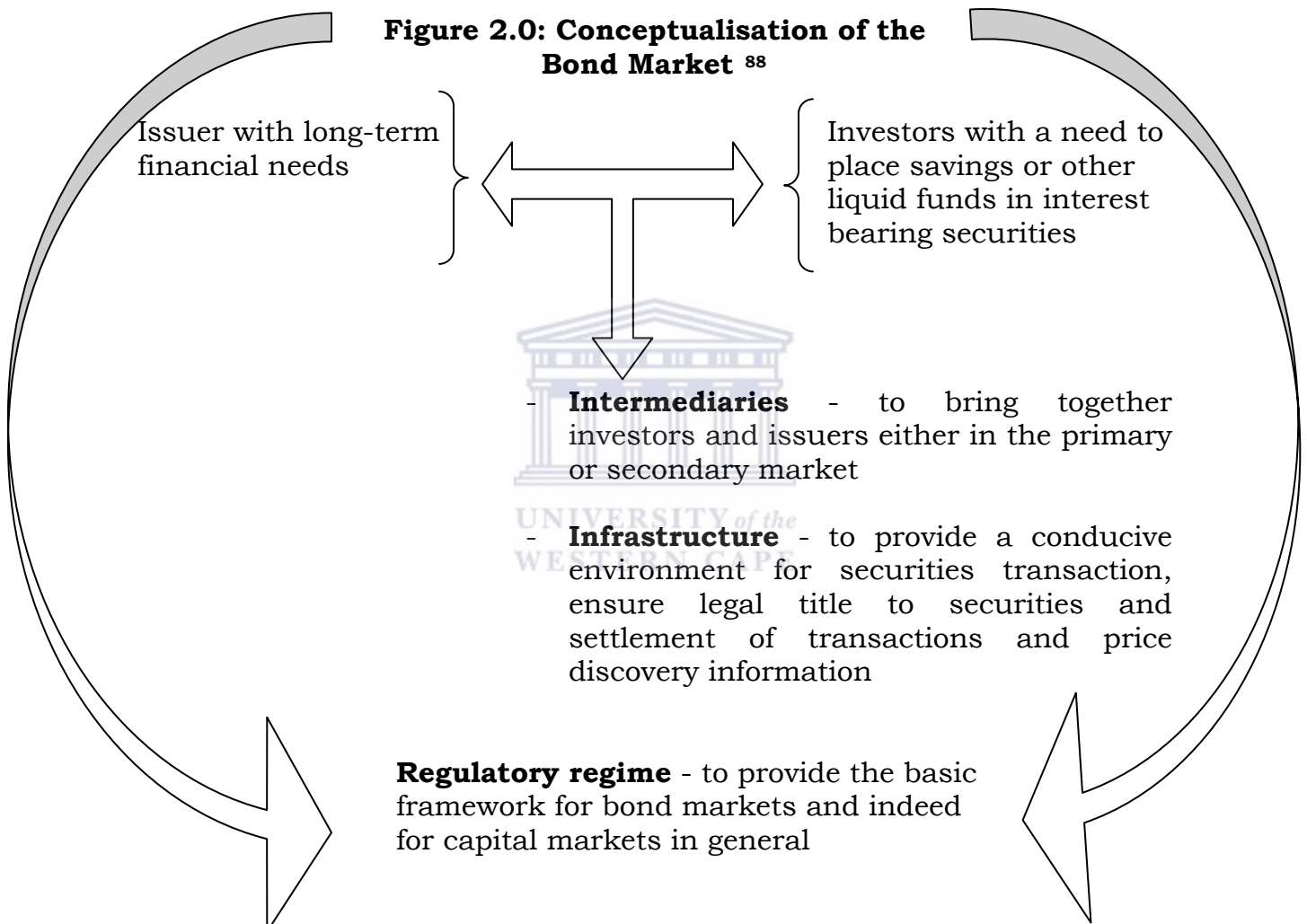
83 Investing glossary on the web, <http://www.investorwords.com/521/bond.html> - a debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. cf. in the US, government paper with maturity between 1&7 years is called Treasury Note (accessed on 02/04/2007).

84 K Morris, bonds and other lending investments *Wall street journal guide to understanding money and investing*, (2000).

85 See investing glossary on the web, ( n 83).

86 See K Morris (n 84).

The issuer and the investors are linked together by the intermediaries,<sup>87</sup> the level of the market notwithstanding. This is because the intermediaries have a role to play in the primary and secondary markets in bringing together the issuer and investors. These transactions are carried out in an environment that allows safe dealings.



The objective being that clearing, settlement and depository operations are surer and quicker, ensuring availability of securities to the buyer and funds to the seller for their next financial transactions after their trade is executed. The whole market should be regulated by a regulatory regime

<sup>87</sup> This include dealers, brokers, investment banks etc.

<sup>88</sup> Source: Authors Understanding.

that ensures that all players are well protected and the integrity of the market is maintained.

Efficient bond markets are characterised by a competitive market structure, low transaction costs, low levels of fragmentation, a robust and safe market infrastructure, and a high level of heterogeneity among market participants.<sup>89</sup>

#### *Advantages of developing a government bond market*

The development of a domestic government bond market provides a number of important benefits if the prerequisites<sup>90</sup> for a sound development are in place. The benefits include:

1. Funding of government's budgetary deficits;
2. Reduced need for foreign currency financing which is potentially damaging, and avoids build-ups of foreign currency denominated debts;<sup>91</sup>
3. Strengthens the transmission and implementation of monetary policy, including the monetary targets or inflation objectives, through the open market operation (OMO).<sup>92</sup>
4. Coupled with prudent debt management, could help governments reduce their exposure to interest rate, currency and other financial risks.
5. In the long term it would reduce the debt service cost, if based on market forces.<sup>93</sup>

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89 The World Bank & The IMF, ( n74).

90 see The World Bank & The IMF (n74) p36 "Prerequisites for establishing an efficient government domestic currency securities market include a credible and stable government; sound fiscal and monetary policies; effective legal, tax, and regulatory infrastructure; smooth and secure settlement arrangements; and a liberalized financial system with competing intermediaries".

91 See D Ratha and U Dadush (n77) for the role played by short-term foreign currency-denominated debt.

92 See The World Bank & The IMF, ( n74) p8 Most countries are moving from the use of direct monetary policy tools, such as interest rate controls and credit ceilings, to the use of indirect monetary policy instruments, such as open market operations. Indirect monetary policy instruments have the advantage of improving the efficiency of monetary policy by having financial resources allocated on a market basis.

6. Helps change the financial system from a primary bank-oriented to a multilayered system, where capital markets can complement bank financing – also creating competition for banks and therefore the introduction of new products at competitive prices.
7. Developing a government securities market supports the development of bond markets for the sub-national and corporate sectors. The relatively risk free assets provided by government bonds establish a reference for pricing sub-national and corporate bonds, commercial papers or any kind of private sector fixed income securities.<sup>94</sup>

### **2.5.2. Developing Government Bonds – Legal Framework**

Legal environment, as described by both legal rules and their enforcement (enforcement is discussed in the next chapter), matters for the size and extent of a country's capital market.<sup>95</sup> A good legal environment protects the potential financier (investor) against expropriation, thereby raising their willingness to surrender funds in exchange for securities, and thus expands the scope and depth of capital market.<sup>96</sup>

The study looks at the legal framework in the light of:

1. Increasing government bond credibility by reducing uncertainty, and so reducing the risk and the cost of capital.

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93 DA Grigorian, IMF Working Paper, 'on the determinants of first-time sovereign bond issues' (2003) p 6 "...countries that made repeated issues have established a track record – by, among other things, having issued at least one outstanding bond – there is little uncertainty about the spread at which these countries will sell their subsequent issue".

94 See The World Bank & The IMF, ( n74) p 67 "some governments such as those of Hong Kong, China which run government budget surplus and thus do not need issue bonds, developed a government bond market as a benchmark for their large mortgage market and the nascent corporate bond market."

95 R La Porta et al. *Legal determinates of external finance*, NBER working paper series, Working Paper 5879 (1997).

96 *Ibid.*

2. Increasing market participation by domestic and foreign investors to increase liquidity in the market so as to reduce the cost of capital and increase the length of maturity.

Though part of the legal framework is specifically for government bonds, some parts, particularly with regard to secondary markets, apply to a cross-section of the market, since government bonds are traded alongside other securities in the securities' exchange.

#### Increasing government bond credibility

Government bonds are a special type of securities traded on the faith of the government's ability to pay its obligations under the debt instruments.<sup>97</sup> Unlike corporate bonds, mortgage bonds etc., where there is some kind of a security, government bonds are backed by the faith that the government is able to pay at least through increasing tax or printing new money. However, the perception of risk or the possibility of the government to renege on its commitment to pay, leads to an increase in the borrowing cost for the government in terms of a high coupon rate.<sup>98</sup>

An effective legal framework is a key foundation of an effective government securities market. The legal framework should set out clear government borrowing authority and establish the process for issuance of government securities.

By setting out clear authority to borrow, the law establishes explicit parameters for the government in borrowing, and serves to connect the

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97 RG Gelos et al. *IMF Working Paper*, 'sovereign borrowing by developing countries: what determines market access?' WP/04/221 (2004) p4 "... the ability of a sovereign government to borrow on international credit markets depends on its perceived ability to repay and on the incentives it will have to do it".

98 Coupon rate is the rate of interest on the government paper, may be referred to as spread or yield.

debt obligation to the government or state, thereby providing investors with the assurance of repayment when the government changes hands.<sup>99</sup> Lack of clarity regarding the borrowing authority can increase the cost of debt financing because there is uncertainty as to government's control over payment, e.g. if it is not clear which organ of the state has the mandate to borrow and authorize payment. Credit-rating agencies focus on this clarity or ambiguity in legislative control of government borrowing activity as a way of measuring the prospects of the government servicing its debt.<sup>100</sup>

The authority to borrow may be entrenched in the constitution e.g. as in Sweden and Kenya. However, due to the rigidity of the constitutions, they give a general authority which is implemented by an Act of Parliament.<sup>101</sup> The legislation governing government borrowing may establish details of borrowing authority, including issuance limits, internal procedures, transparency, and accountability. These details might also be contained in guidelines, policies, or regulations that accompany the legislation.<sup>102</sup>

### *Increasing market participation*

The legal framework can be effective in increasing market participation, particularly by making provision for a secondary market, protection of investors to enhance confidence, and provision for foreign investors' capital participation.

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99 See The World Bank & The IMF, ( n74); see also Kenyan constitution Section 103 authorises for all debt incurred by the government to be charged on the consolidated fund.

100 Issue Credit Rating Definitions by Standard & poor's available on [http://www2.standardandpoors.com/spf/pdf/fixedincome/Emerging\\_102004R.pdf?vregion=us&vlang=en](http://www2.standardandpoors.com/spf/pdf/fixedincome/Emerging_102004R.pdf?vregion=us&vlang=en) (accessed on 03/04/2007).

101 See e.g. Kenya constitution Section 103 authorises for all debt incurred by the government to be charged on the consolidated fund. Internal Loans Act (Cap 420) section 3 gives the powers to borrow in Kenyan shillings to the minister in charge of finance and prescribe such methods which include issuing bonds.

102 See Internal Loans Act (Cap 420 law of Kenya).

Secondary market as a platform for trading in government securities is covered under institutional frameworks. This section looks at the legal framework of the secondary market that enhances participation and increases liquidity, thus lowering the cost of capital.<sup>103</sup> The benefits of liquid secondary markets are adequately explained by the World Bank and IMF:<sup>104</sup>

Government securities can have *near-money like properties* when secondary markets *facilitate rapid and low-cost conversion into cash ...* Secondary markets also open avenues for risk management through various types of transactions whose pricing can be derived from government securities markets. These unique features of government securities markets help deepen the number and type of transactions in government securities which, in turn, help *achieve the aim of establishing liquid and efficient secondary markets* (own emphasis).

Having a near-money like properties in government securities is an attribute that would encourage the participation of short term investors in long term government bonds, because investors are able to convert their investments into cash when they need the money, and at low cost. This subsequently reflects on the cost of government funding. The near-money properties are only achievable in a liquid and efficient market. The study therefore looks at the legal factors that affect liquidity in the market.

“Market liquidity”, is a business, economic or investment term that refers to an asset's ability to quickly be liquidated or converted through an

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103 Institutional Markets Section, 'syndicated lending' Domestic Markets Department Bulletin September 2005 also available on [http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu\\_sep05/PDF/bu\\_0905\\_1.pdf](http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_sep05/PDF/bu_0905_1.pdf). (accessed on 30/03/2007) ...a strong supply of funds from domestic and foreign banks leads to narrowing of spreads.

104 See The World Bank & The IMF, ( n74) p18.



action of buying or selling without causing a significant movement in the price, and with minimum loss of value.<sup>105</sup> A market is considered liquid if there are ready and willing buyers and sellers in large quantities.<sup>106</sup>

Market liquidity may therefore be affected by the following factors:

1. Transaction costs which comprises of taxes, brokerage commissions, fees payable to the regulator, the clearing house, the depository, etc. These costs should be low enough in order to constantly meet the investor's trading needs. Taxes<sup>107</sup> decrease the efficiency of financial markets by reducing liquidity and increasing transaction costs.<sup>108</sup> Similarly, high brokerage commissions and fees add to the transaction costs. When transaction costs are high, investors have no motivation to trade since their earnings are reduced.
2. A diversified investor base for government securities is important for ensuring high liquidity and stable demand in the market. A diversified investor base with different time horizons, risk preferences, and trading motives, ensures active trading, creating high liquidity.<sup>109</sup> Policy should be made to encourage diversification of investors in government securities, e.g. for domestic participants, more saving should be encouraged because banks in developing countries will continue to be the main vehicle through which savings are channelled into investments.<sup>110</sup> In the same light governments can, through appropriate reform programs, licensing, regulations and supervision, encourage wholesale investor institution that invest in government

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105 See definition on <http://en.wikipedia.org/wiki/Liquidity> (accessed on 02/04/2007).

106 *Ibid.*

107 These include transaction taxes and stamp duties levied on the securities on trading.

108 P Shome, and GS Janet. "Financial Transactions Taxes." *Tax Notes International*. (1996).

109 See The World Bank & The IMF ( n74) p68.

110 see A Harwood et al. (n72). see also The World Bank & The IMF, ( n74) p18 "... government-backed pension or social security systems through specialized funds has also provided a large, stable demand for fixed-income securities in countries where such funds are active".

securities for income hedging, trading and repo transactions. Government can also develop a retail investor base, and can further broaden and diversify the investor base by opening the market to foreign investors.

Market participation can also be enhanced through laws that encourage investor protection, by reducing transfer risks which are embodied in exchange controls and nationalisation of foreign assets which affect the ability to repatriate returns.

### **2.5.3. Developing Government Bonds – Institutional Framework**

A sound institutional framework for a government bond market should embody good governance practices, prudent procedures, efficiency and a strong capacity for managing risks. The study looks at some of the institutions that are critical in the development of a government bond market: the central bank, security regulatory organisation (SRO), the central securities depository system (CSDS), and the securities exchange.

#### *The Central/Reserve Bank*

In many countries, the central bank provides services for government debt managers, including operating T-bills and T-bonds, undertaking cash management operations, and providing registry services.<sup>111</sup> In some markets, like that of Kenya, the central bank could also undertake foreign currency borrowing and domestic borrowing.<sup>112</sup> Such roles of the central bank, or any other government agency that carries out the role of debt manager for the government, should be set out in the country's laws. To eliminate doubt on the part of potential investors in government

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111 see The World Bank & The IMF, ( n74) 'overview' p1-57.

112 See External Loans and credit Act (Cap 422 Laws of Kenya) and Internal Loans Act (Cap 420 laws of Kenya).

bonds, the law should clearly indicate that financial obligations incurred by a delegated agency fully and wholly bind the state.<sup>113</sup>

As regards the management of the institution delegated with the authority to manage government debt: it should be run professionally, and the managers/ directors, and in case of the central or reserve banks, the governor, should be independent of political manipulation. Following prudent procedures and corporate governance principles in running critical institutions increases investor confidence and substantially reduces the investor's perception of operational risks.<sup>114</sup>

#### Security regulatory organisation (SRO)

In most countries where there is an infrastructure for a secondary market,<sup>115</sup> government securities trade along with all other securities. Effective regulation is necessary to support and maintain the integrity of the market. Because government securities are often defined as “exempt securities,” i.e. exempt from the stringent disclosures to which corporate bonds, for example, are subject, it is important to ensure that this status does not undermine the integrity of the market.

The government should therefore establish a regulatory authority which should, in turn, have the legal authority to make and enforce rules and regulations related to market and business conduct, market

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113 See e.g. The Kenyan Constitution section 103(1); all debt charges for which the Government of Kenya is liable shall be a charge on the Consolidated Fund; Cap 422 section 4 provides “The repayment of all sums of money borrowed under [External Loans and Credit Act], and the payment of all money payable by the Government for goods or services purchased on credit under this Act, and the payment of all interest and other charges payable in respect thereof, shall be charged on the consolidated fund and issued out of it without further appropriation than this Act”.

114 This includes a range of different types of risks, including transaction errors in the various stages of executing and recording transactions; inadequacies or failures in internal controls, or in systems and services; reputation risk; legal risk; security breaches; or natural disasters that affect business activity.

115 Only 14 out of 47 sub-Saharan Africa countries have a stock/ securities exchange. See <http://www.economywatch.com/stock-markets-in-world/sub-saharan-africa.html> (accessed on 14/03/2007).

intermediaries and trading systems.<sup>116</sup> The SRO should be operationally independent of government, preferably with autonomy over its budget.<sup>117</sup>

Central securities depository system (CSDS)

CSDS provides the services of securities account maintenance, registration services, depository services and settlement services.<sup>118</sup> Development of a secure and credible depository and settlement system eliminates settlement risks<sup>119</sup> which are evident in less-developed securities markets; thus encouraging more participation in the securities market by domestic and foreign investors.

The World Bank and IMF advocate efforts to link CSDSs (custody arrangements) on a cross-border basis when markets systems are well developed to broaden the market base.<sup>120</sup> For markets with a large foreign investor component, an efficient link between the national central securities depository and an international central securities depository, such as EUROCLEAR or Clearstream, is important for market development. International institutional investors prefer to hold their securities from different markets in one central place, where liquidity from the sale of securities from one country can be used immediately to fund the acquisition of securities from another.<sup>121</sup> The preference for the use of international central depositories, however, also has its

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116 See e.g. the objectives of Kenyan Capital Markets Authority, *inter alia* ... the creation, maintenance and regulation, of a market in which securities can be issued and traded in an orderly, fair, and efficient manner, through the implementation of a system in which the market participants are self regulatory to the maximum practicable extent ... the protection of investor interests.

117 see The World Bank & The IMF, ( n74) p290.

118 D Russo et al governance of security clearing and settlement systems, European Central bank, occasional paper series No 21 (2004) also available on <http://www.ecb.int/pub/pdf/scpops/ecbocp21.pdf> (accessed on 02/04/2007).

119 Refers to the potential loss that the parties could suffer as a result of failure to settle, for whatever reason other than default, by the counterparty.

120 see The World Bank & The IMF, ( n74) p31.

121 *Ibid.*

background in a more practical back-office argument, as it is administratively easier for the securities manager to deal with only one depository.

Furthermore, the objective of clearing, settlement and depository operations is surer and quicker availability of securities to the buyer and funds to the seller for their next financial transactions after their trade is executed.<sup>122</sup> For this reason, ensuring quicker and safer operations of the CSDS through automation would enhance liquidity and reduce operational risks associated with a manual order matching, confirmation, delivery of securities, and payment of funds, thus enhancing participation.

#### Securities exchange

Establishment of a securities exchange in a market for government securities enhances participation, since it provides an avenue for participation by investors with different time horizons not necessarily fixed to the maturity of the bond. Only fourteen out of the possible forty-seven countries in sub-Saharan Africa have a securities exchange.<sup>123</sup> Even without examining the depth of trading in existing exchanges these figures show that the quantities are wanting.

The exchange is also an effective way of regulating the market, particularly its role in intermediary regulation, together with the SRO, i.e. brokers, dealers and investment banks allowed to trade on the exchange. The better the exchanges effectively and prudently manage the role, the more the realisation of integration of the capital markets in the society; therefore widening the reach and depth of the market. With more

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122 T Endo 'Developing efficient market infrastructure and secondary market of government bonds in developing countries' (2003)

123 see <http://www.economywatch.com/stock-markets-in-world/sub-saharan-africa.html> (accessed on 14/03/2007).

brokers not concentrated only in cities, the more the participation in the capital market's operations.

Enhancing efficiency and reliability through adoption of new technology, e.g. electronic trading systems (ETs), and internet trading, is good for the market. However, new technologies work best in well founded markets where there are no constraints on either the supply or demand sides. The efficiency helps the investors in price discovery in real time; therefore the securities are well priced and the conclusion of a deal is not delayed.

#### **2.5.4. Developing Government Bonds – Macroeconomic Stability**

The stability of the macroeconomic conditions in a country is essential to building an efficient market and establishing the credibility of the government as an issuer of debt securities.<sup>124</sup> Similarly, credible domestic currency, credible and stable government, and sound monetary policies, are some of the vital conditions that domestic and foreign investors will look for before purchasing government securities, especially medium and long term instruments.<sup>125</sup>

Inflation and interest rates usually move in tandem.<sup>126</sup> When inflation is high, interest rates also go up, and thus the cost of funding. If a country has volatile inflation it does not only affect the cost of funds but also the maturities, since investors keep the period short so as to maintain the value of their investment through reinvestment every time interest rates change. Similarly, the types of government securities are limited, e.g.

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124 See World Bank and IMF, ( n74); T Endo (n122).

125 *Ibid.*

126 KM Morris Stocks, bonds and Wall Street, *wall street journal, guide to understanding money and investing* (2004).

some instruments, like deep discount bonds, are not attractive to investors.<sup>127</sup>

The issue of Inflation Indexed Bonds<sup>128</sup> is one of the ways that a country can use to mitigate the effects of inflation its attraction of investors to participate in its government securities market.

A credible exchange rate regime is important, especially for governments seeking foreign investment in domestic government securities markets. To help ensure this, government polices on fiscal, monetary, capital account, and debt management, need to be viewed as sustainable and consistent by both local and foreign investors. If exchange rate regimes are perceived to be unsustainable, the exchange rate risk premium will rise rapidly, accompanied by the related costs of funds, and the inability of the government to raise funds beyond very short maturities.<sup>129</sup>

### **2.6.0. Conclusions**

This chapter highlighted the various sources of funds for the developing countries. Concessional sources are preferred because they have no negative effects to the economies of the developing countries. However, concessional funds are subjected to the foreign policies of the donor countries and many conditions that are value reducing.

The proposal to develop a government bond market is looked at as one of the ways sub-Saharan African governments can utilise to develop resilience to changing donor countries' foreign policy, negative effects and

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127 D Woodard, *Treasury inflation protected securities*, <http://matualfunds.about.com/cs/bondfunds/a/tips.htm> (accessed on 04/04/2007).

128 It is a bond that provides protection against inflation i.e. the principal is increased by the change of inflation over a period and as the principal increases, the interest rate is applied to the increased amount. *Ibid.*

129 See World Bank and IMF, ( n74); T Endo (n122).

vulnerability of their economies to such risks associated with foreign debt, and getting long-term capital to finance infrastructure development.

It is envisaged that a government bond market, if it is well managed, would:

- I. Provide funding for government's budgetary deficits;
- II. Reduce need for foreign currency financing which is potentially damaging, and avoid build-ups of foreign currency denominated debts;
- III. Strengthen the transmission and implementation of monetary policy, including the monetary targets or inflation objectives, through the open market operation (OMO);
- IV. Coupled with prudent debt management, could help governments reduce their exposure to interest rate, currency and other financial risks;
- V. In the long term it would reduce the debt service cost, if based on market forces;
- VI. Help change the financial system from a primary bank-oriented to a multilayered system, where capital markets can complement bank financing – also creating competition for banks, and therefore the introduction of new products at competitive prices;
- VII. Support the development of bond markets for the sub-national and corporate sectors. The relatively risk free assets provided by government bonds establish a reference for pricing sub-national and corporate bonds, commercial papers or any kind of private sector fixed income securities.

However, the sub-Saharan African countries must establish a proper regulatory legal framework and a market infrastructure that favours development of a government bonds market. In this regard, the



government must be able and willing to protect and enforce property rights, encourage wider participation in the market through appropriate reform programs, licensing, regulations and supervision, and further broaden and diversify the investor base by opening the market to foreign investors.



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## Utilising Private Sector Capital

### 3.1.0. Introduction

Competitive markets will generally tend to under-produce infrastructure services because they frequently provide public good. This means that benefits are shared across the community in such a way that those who do not wish to buy the service cannot be excluded from the benefits created by those who do. However, a purely public approach to infrastructure development is weighed down by problems that include government bureaucracy, political meddling and interference, lack of funds for new investments, and often poor management and maintenance of facilities.<sup>1</sup>

Economic liberals, on the other hand, think that the government should only do what cannot be done in the market.<sup>2</sup> Seldon candidly puts it that,<sup>3</sup>

... government should act not where it is better than the market but only where there is no market ... whenever it is used, government is so disappointing or worse – inefficient, unaccountable and corrupt – that it is best not to use it at all except for functions where all its faults have to be tolerated to obtain the services required.

The anti-government sentiments withstanding, the history of the development of transport infrastructure has had a mixed fortune with

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1 See SV Berg, et al. *Private initiatives in infrastructure*, (2002). Also RR Officer, 'The respective roles of government and the private sector and public/private partnership' presented in *public private partnership forum, the accounting foundation*, (2003).

2 The market theory was propounded by Adam Smith in his book *An inquiry into the nature and causes of the wealth of nations*.

3 Seldon A Capitalism, (1990) p158.

periods dominated by private capital<sup>4</sup> in the eighteenth and nineteenth centuries, followed by public financing<sup>5</sup> for most of the twentieth century, and lately the development of the public private partnership (PPP).<sup>6</sup> This history cannot be brushed aside, because it attests to various events in history. For example, the move from private financing of the eighteenth and the nineteenth centuries is marked by the major World Wars in the early twentieth century which had a major impact on infrastructure due to destruction during the war. This indicates that, the private sector capital is risk sensitive, particularly on infrastructure projects which tend to have longer pay-back and build-out periods.<sup>7</sup>

PPP seeks to get the best of both approaches to infrastructure, employing private sector innovation and business acumen where appropriate, while allowing overall planning, coordination and regulatory control of the infrastructure networks to reside in public hands.

Under a successful PPP the government or other end users are purchasers of the infrastructure services, e.g. where the public is charged tolls to use a road or the government pays shadow tolls to a private company for public usage of a road. Therefore the government does not bear the risks that are inherent in the provision of the infrastructure (road), i.e. risks in the design, financing, construction, operation and maintenance of the road for the time of the PPP contract.

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4 Reference can be made to Turnpikes which were in place in England as early as 1663 and in the USA in 1792. A turnpike is a road partly or wholly paid for by fees collected from travellers at tollgates.

5 During this period the private sector was also actively involved through tenders for construction, design, and maintenance. However, it is distinct because it was public sector driven.

6 See D Grimsey, & MK Lewis, Public private partnerships: *The worldwide revolution in infrastructure provision and project finance* (2004) p41.

7 This concept is also appreciated in R Sheppard et al, *Financing infrastructure in Africa: how the region can attract more project finance*, (World Bank public-private infrastructure advisory facility (PPIAF)) Gridlines Note No. 13 (2006).

Since the study is about raising capital for infrastructure development, it will not look in detail at the various forms of PPPs, but at the legal and institutional frameworks in a country that would act as incentive for the private capital mobilisation and participation in transport infrastructure development.

This Chapter looks at the organisation of PPPs with the aim of showing that the organisation itself is one of the determinants of private capital participation in project finance, risk allocation in a PPP contract to achieve value for money, and the legal and institutional framework in a country that would generally make a country attractive to private project capital.

### **3.2.0. The organisation of PPPs**

A PPP organisational structure brings together a number of parties for an infrastructure investment in the form of a special purpose vehicle (SPV or Project Company) created specifically for the project.<sup>8</sup> In an ideal situation participants in a PPP would include:

- I. The public sector procurer (the government, local governments and agencies, state-owned entities);
- II. The sponsors who as equity investors normally create a special purpose vehicle (SPV or project company) through which they contract with the public procurer, and principal subcontractors;
- III. Financiers;
- IV. Subcontractors; and
- V. Other involved parties such as advisers (legal, financial, technical), insurer, rating agencies, underwriters, etc.

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<sup>8</sup> See D Grimsey, & MK Lewis, (n6) p182.

### 3.2.1. Special Purpose Vehicle (SPV)/ Project Company

This is a separate legal entity, generally a company established to undertake the activity defined in a contract or tender. At this stage of the discussion it is important to note that for a country to attract investment package in the form of SPVs, the law must recognise such companies and maybe give some incentive.<sup>9</sup> The institutions given the mandate to register companies must also be efficient, because SPVs are put together by the prospective investors a short while before tendering for an infrastructure project.<sup>10</sup>

The execution of a PPP contract generally depends on the type of PPP agreement that the parties have entered into. This may include, but is not limited to:<sup>11</sup>

*Build, own, operate (BOO)* – the developer is responsible for design, funding, construction, operation and maintenance of the infrastructure facility during the concession period, with no provision for transfer of ownership to the government. At the end of the concession period the original agreement may be renegotiated, a new agreement may be negotiated, or the facility may be purchased by the government. Operation refers to the provision of some or all of the services related to the facility's use.

*Build, own, operate transfer (BOOT)* – it is just like BOO but the ownership and the operating rights at the end of the concession period

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9 See e.g. Kenyan Minister for Finance in the 2005 National Budget Speech "... Securitisation based on bankable assets and ability to generate cash has become a viable alternative in most emerging markets, particularly for institutions providing infrastructural services to raise long term capital. In this regard, [the Minister proposed] to exempt investment income of Special Purpose Vehicles (SPVs) from income tax. This is to encourage institutions providing infrastructural services to set up SPVs for purposes of issuing asset backed securities".

10 'State to speed up registration of companies', *Business Daily* 17 April 2007. In Kenya it takes about 300 days to register a company, while in Botswana and South Africa it takes less than a month to complete the process. This story is also available on <http://bdafrica.com> (accessed 17/04/2007).

11 See D Grimsey, & MK Lewis, ( n6) p6-8.

reverts to the government. The agreement is structured in such a way that the concessionaire will recoup investment and some operating profits during the time of the concession, and therefore the government has no obligation to compensate for the residue value of the facility.

*Build, operate, transfer (BOT)* – the infrastructure facility is designed, financed, operated and maintained by the concessionaire for the period of the concession. Legal ownership of the facility may or may not rest with the concession company.

*Design, build, finance (DBF)* – involves the procurement of an infrastructure facility using private finance, without private sector operation and provision of the associated services.

*Design, build, finance and operate (DBFO)* – the service provider is responsible for the design, construction, financing and operation of the infrastructure facility.

The PPP agreement is defined by the functions of the concessionaire in executing the agreement. Highly specialised activities are bundled together, such as finance, design, construction, operation and maintenance, which can only be serviced effectively through a consortium. This may consist of engineering and project management firms, construction companies, financial underwriters and operating enterprises who may participate as equity investors in the SPV. The SPV may also subcontract some of the activities.<sup>12</sup>

The formation of the separate legal entity is important for the following reasons.

- I. To allow lending to the project to be non-recourse to the sponsor by virtue of the limited liability nature of the SPV;

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<sup>12</sup> *Ibid.*

- II. To enable assets and liabilities of the project not to appear on the sponsors' balance sheet by virtue of no sponsor having a majority share holding in the SPV, and application of consolidation principles when preparing the group accounts;<sup>13</sup>
- III. For the benefits of the project lenders, to help to insulate the project from a potential bankruptcy of any of the sponsors (bankruptcy remoteness);<sup>14</sup> and
- IV. For project rating purposes.<sup>15</sup>

### Financier-led approach

This is a new approach developing in Australia<sup>16</sup> where specialised investment banks take a more active role in managing the SPV. The bank takes up a hundred per cent of the equity in the SPV and manages the bidding process. Since the bank cannot perform all the specialised functions, it concludes contracts with other parties that come together to form a consortium (after the bidding process).

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13 International Accounting Standard 27 (IAS 27) consolidated and separate financial statements available on <http://www.iasplus.com/standard/ias27.htm> (accessed on 15/04/2007). In an amendment effected in 1998 SIC 12 addresses when a special purpose entity (SPE) should be consolidated by a reporting enterprise under the consolidation principles in IAS 27. Under SIC 12 an entity must consolidate a SPE when, in substance, the entity controls the SPE. The control of an SPE by an entity may be indicated if: the SPE conducts its activities to meet the entity's specific needs; The entity has decision-making powers to obtain the majority of the benefits of the SPE's activities; the entity is able to obtain the majority of the benefits of the SPE's activities through an 'auto-pilot' mechanism; by having a right to the majority of the SPE's benefits, the entity is exposed to the SPE's business risks; and the entity has the majority of residual interest in the SPE. See <http://www.iasplus.com/interps/sic012.htm> (accessed on 15/04/2007).

14 In case of bankruptcy the receiving manager would take over the assets of the bankrupt company and its subsidiaries; an SPV would not be affected since it is not a subsidiary of any of the sponsors.

15 See P Rigby et al., *Criteria*, Standard & Poor's Criteria for Debt Rating (2001) ... Project finance is supposed to be non-recourse to the sponsor. Some lender credit assessments are often based on the sponsor's reputation, its creditworthiness, or both—the implication being that the sponsor will support the project in difficult times. However, particularly when the sponsor is rated higher than the project, if the sponsor suffers a rating downgrade, the rating of projects carried out in an SPV would not be affected.

16 See D Grimsey, & MK (n6) p 234.

The model is interesting because, as noted in Chapter 2, for the foreseeable future in the developing world banks will continue to be the main vehicles through which savings are channelled into investments.<sup>17</sup> However, in countries like Kenya, Uganda and Tanzania, where the Banking Acts prohibit banks from engaging in none core business it may limit the involvement of a significant section of private sector capital in infrastructure development. With regard to the Kenyan Banking Act,<sup>18</sup> banks are not allowed to

... acquire or hold, directly or indirectly, any part of the share capital of, or otherwise have a beneficial interest in, any financial, commercial, agricultural, industrial or other undertaking where the value of the [bank's] interest would exceed in the aggregate twenty five per cent of the core capital of the [bank].

However, a proviso provides:<sup>19</sup>

A shareholding in a corporation established for the purposes of promoting development in Kenya and approved by the minister shall not be subject to the [foregoing provision].

It adds more bureaucracy to the process of establishing the SPV, by requiring the approval of the minister, and also as regards the time taken in registering a company.<sup>20</sup> Taking into consideration that such companies are registered to take part in the bidding process, the extra bureaucracy does not help in attracting private sector capital in infrastructure development.

### **3.3.0. Allocating Risks**

In a good PPP contract risks are well allocated, so that none of the parties bears an excessive amount of the risk. For example, when

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17 A Harwood et al. *The crisis in emerging financial markets: a World Bank Group -Brookings conference report* (1999) available on [www.brookings.edu](http://www.brookings.edu) (accessed on 25/11/2006).

18 Banking Act (Cap 488) Laws of Kenya section 12(b).

19 Banking Act (Cap 488) Laws of Kenya section 12(b)(ii).

20 The time taken to register a company in Kenya is 300 days see (n10).



activities are bundled together and contracted out to a single private party through an SPV, from a government's point of view, risk transfer is most effective if there is a 'whole of life cycle' contract with a single private party.<sup>21</sup> This reduces the burden on the part of the government to enter into many contracts with different parties, and the logistics of policing them.

On the other hand, private parties take on risk if that risk can be appropriately priced, managed and mitigated, which involves transferring that risk to third parties by way of subcontracting or insurance.<sup>22</sup> If the risk is one that carries a significant probability of interrupting or diminishing the returns to the project company, a significant premium may be demanded to assume that particular risk. This in turn increases the cost of financing the project, and the price paid by the government or other end users.

Because risk is priced by the market, value for money is improved by the transfer of appropriate risk, as the project company is able to reduce either the probability that the risk will occur, the financial consequences if it does eventuate, or both. There comes a point, however, when this transfer becomes sub-optimal. If risks that in fact cannot be best managed by the private sector continue to be transferred to the project company, value for money will decline since the premium demanded by the private sector will outweigh the benefits to the public procurer.<sup>23</sup> Therefore, optimum rather than maximum risk transfer is the objective of the PPP arrangement.

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21 See D Grimsey, & MK Lewis, (n6) p 80.

22 See risk management on [http://en.wikipedia.org/wiki/Risk\\_management](http://en.wikipedia.org/wiki/Risk_management) (accessed on the 15/04/2007). see also K Kwaku Managing political risk in project financing (talking notes).

23 *Ibid.* See also D Grimsey, & MK Lewis, (n6) p 80.

### **3.3.1. Mitigating Risks**

The private sector, by investing in a developing country's infrastructure, is exposed to various risks. While some of the risks are market related and can best be handled in the market, e.g. exchange rate risks since, the mode of income for the project is the local currency, others like expropriation risks, political risks, regulatory risks, including adverse changes in the law to affect the operation or income of the infrastructure project, can only be mitigated by involvement of the government.

Road transport infrastructure may also be affected by some other peculiar risks, such as cash flow risks. Apparently this should be a market related risk and should be taken care of by the project company through the market. However, the nature and importance of transport infrastructure, where too many charges would have a trickle effect on the whole of the economy through an increase in the cost of transport (hence reducing competitiveness of the country's products in the international market (refer to Chapter 1)) and the fact that alternative routes could be used by road users to beat the road user charges,<sup>24</sup> means that these risks should be mitigated by the government as well.

There are various methods which could be used to mitigate the mentioned risks since they cannot be well assessed and priced in the market. These would include government guarantees, multilateral development bank guarantees, and the multilateral investment guarantee agency (MIGA) insurance.

#### Government Guarantees

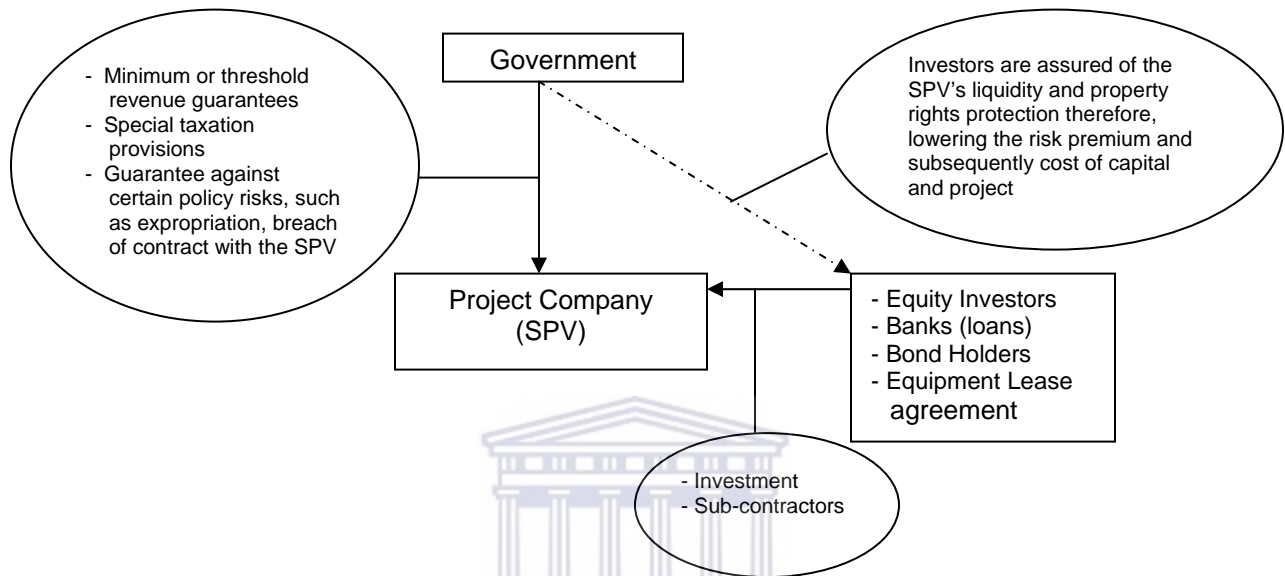
National government may provide guarantees to the investors in a SPV and the lenders (such as the banks and other debt holders) against

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<sup>24</sup> See lessons from Melbourne City Link, discussed in D Grimsey, & MK Lewis, (n6) p 37.

certain policy risks<sup>25</sup> by minimum or threshold revenue guarantees to provide reassurance to bankers and other debt holders (without increasing public sector risks),<sup>26</sup> special taxation provisions<sup>27</sup> etc.

**Figure 3.0: Government Guarantee<sup>28</sup>**



By the government providing a guarantee to the SPV, as illustrated in figure 3.0, it assures the investors and the parties with whom the SPV has subcontracted that the SPV will be able to meet its obligations due to the assured liquidity. This lowers the cost of the project financing and thus the cost of the project.

### Multilateral Development Bank Guarantees

Multilateral development banks (MDB(s)) such as the IBRD, IDA and AfDB offer guarantee facilities. The MDBs' long term relationship with a host country for infrastructural investment acts as an extra incentive for

25 Adverse change of law and or expropriation. A country should have Investment protection laws see e.g. Kenya; Foreign Investments Protection Act (Cap 518) Laws of Kenya.

26 Offering a revenue guarantee should not become a hindrance to development of good market based incentives to increase revenue for the project company.

27 Kenya Minister of Finance National Budget Speech (n9).

28 Source: Author's understanding of government guarantee.

government to perform its part of the contract, since if it defaults, and the guarantee is called upon and paid out, the member country concerned is obliged to repay the MDB concerned. If the concerned country fails to do so in accordance with the agreed terms, the MDB can withhold other facilities provided to that country by the MDB.<sup>29</sup>

The partial risk guarantees (PRGs) offered by the MDBs could be used in addressing sovereign risks<sup>30</sup> faced by private sector infrastructure providers. By covering specific obligations of the government to a privately sponsored project, PRGs ensure payment, in the case of default, of a guaranteed loss resulting from non-performance of such obligations by the government. The MDB would then call on the counter guarantee that the country gave to the MDB.

PRGs are relevant where there is a high risk of policy reversal and where the counter guarantee and involvement of the Banks are critical in securing, improving the terms of, or catalyzing, long term private financing that is required to finance infrastructure project.<sup>31</sup> The availability of these facilities may be cited in the bidding documents as an option, so that bidders may reflect such availability in their bid price.

The MDB's guarantee (as illustrated in Figure 3.1) can benefit the host government and the project company as a borrower in several ways:<sup>32</sup>

- I. By covering risk that the market cannot assume, the guarantee can facilitate access to financing that would not otherwise be available for certain projects, thus making them possible.

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29 See, World Bank, *The World Bank guarantee: leveraging private finance for emerging markets* (2002).

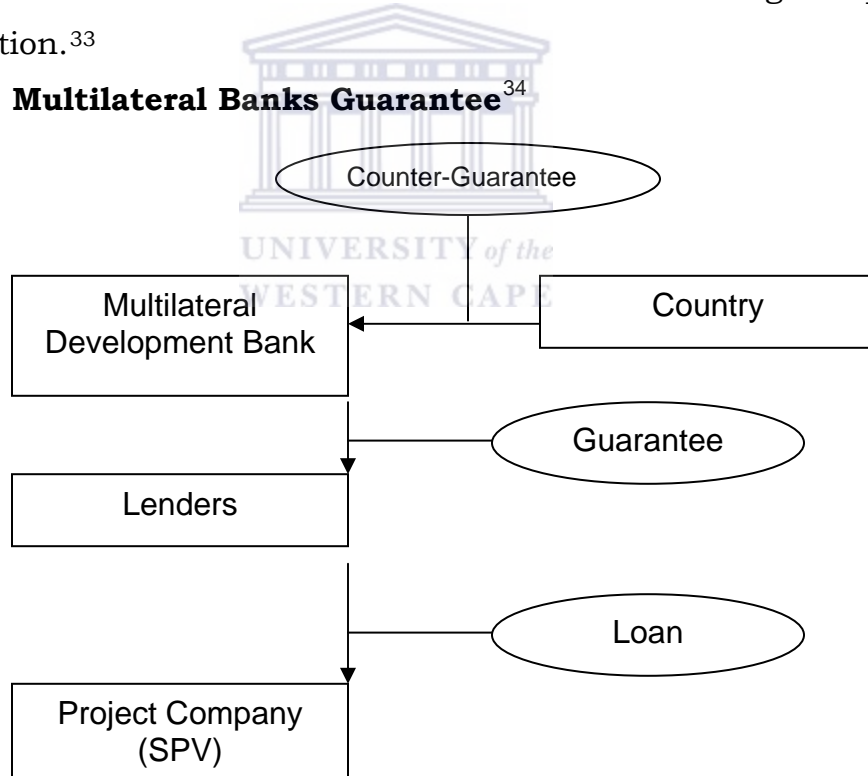
30 Sovereign risks are risks that are attached to the dealing with a sovereign.

31 *Ibid.*

32 World Bank, *World Bank Guarantee handbook* (1997).

- II. The guarantee can extend the maturity of loans beyond the loan period that would be possible without the guarantee, thereby allowing for a lower unit cost of output over the life of the project.
- III. The guarantees provide borrowers (public and private) with greater flexibility in choosing the most appropriate financing sources (currencies, markets, interest rates benchmarks etc.) for their needs.
- IV. For host governments, PRGs can reduce their exposure to a project by passing commercial risks to the private sector
- V. For commercial bank lenders, PRGs may obviate the need to make provision for 'country risk' as required by their regulator.
- VI. Participation of the MDBs also gives the 'seal of approval' to the projects concerned because of the additional monitoring and project evaluation.<sup>33</sup>

**Figure 3.1: Multilateral Banks Guarantee**<sup>34</sup>



<sup>33</sup> See, D Grimsey, & MK Lewis, (n6) p 230.

<sup>34</sup> P, Benoit, *Mitigating project risks: World Bank support for government guarantees*, Public policy for the private sector (1996).

### Multilateral Investment Guarantee Agency (MIGA) insurance

As a member of the World Bank Group, MIGA's mission is to promote FDI into developing countries, to help support economic growth, reduce poverty, and improve people's lives.<sup>35</sup> MIGA strives to achieve its objectives through insuring foreign and local investment<sup>36</sup> against political or non-commercial risks; mediating disputes between investors and governments; and advising governments on attracting investment.<sup>37</sup>

MIGA will be looked at in connection with its role in insuring investors against political or non-commercial risks for which it's best known. With Africa's risk prevalence being perceived to be higher than in other parts of the world,<sup>38</sup> risk insurance for investors is a safe bet. MIGA covers the following risks: currency inconvertibility and transfer restriction, expropriation, war and civil disturbance, and breach of contract.<sup>39</sup>

Transfer restriction cover protects against losses arising from an investor's inability to convert local currency (capital, interest, principal, profits, royalties, or other monetary benefits) into foreign exchange for transfer outside the host country. The cover also insures against excessive delays in acquiring foreign exchange caused by the host government's actions or failure to act. Currency devaluation is not covered.

Expropriation cover offers protection against loss of the insured investment as a result of acts by the host government that may reduce or

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35 See about MIGA on <http://www.miga.org/sitelevel2/level2.cfm?id=1069> (accessed on 16/04/2007).

36 Eligible investors include nationals of any MIGA member country, provided they are not nationals of the country where the investment is being made. Under certain conditions, however, investments made by nationals of the host country may also be eligible.

37 See <http://www.miga.org> (accessed on 16/04/2007).

38 K Kwaku Managing political risk in project financing(talking notes).

39 See <http://www.miga.org/sitelevel2/level2.cfm?id=1058> (accessed on 16/04/2007).

eliminate ownership of, control over, or rights to the insured investment. This policy also covers partial losses, as well as "creeping expropriation," a series of acts that over time have an expropriatory effect. *Bona fide*, non-discriminatory measures taken by the host government in the exercise of its legitimate regulatory authority are not considered expropriatory.

War and civil disturbance cover protects against loss due to the destruction of, disappearance of, or physical damage to, tangible assets caused by politically motivated acts of war or civil disturbance, including revolution, insurrection, and coups d'état. Terrorism and sabotage are also covered. War and civil disturbance cover also extends to events that result in the total inability of the project enterprise to conduct operations essential to its overall financial viability.

Breach of contract cover protects against losses arising from the host government's breach or repudiation of a contractual agreement with the investor. In the event of such an alleged breach or repudiation, the investor must be able to invoke a dispute resolution mechanism (e.g., arbitration) set out in the underlying contract, and obtain an award for damages. The investor may file a claim if, after a specified period of time, payment is not received.

MIGA's insurance does not only provide assurance of payment in case of loss, but also benefits investors and lenders in several other ways:<sup>40</sup>

- I. MIGA's relationship with shareholder governments provides additional leverage in protecting investments thereby deterring harmful actions.

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40 *Ibid.*

- II. MIGA intervenes at the first sign of trouble to resolve potential investment disputes before they reach claim status, helping to maintain investments and keep revenues flowing, and thus being a mediator in disputes.
- III. MIGA's insurance acts as a guarantee that helps lower borrowing costs through reducing risk-capital ratings of projects. Similarly, it helps investors obtain project finance from banks.
- IV. Through providing insurance cover for up to 15 years (in some cases 20), MIGA increases the tenor of loans available to investors, allowing for a lower unit cost of output over the life of the project.

MIGA's insurance is broad, and could cover new<sup>41</sup> cross-border investments originating in any MIGA member country destined for any developing member country. Types of foreign investments that can be covered include equity, shareholder loans, and shareholder loan guaranties, provided the loans have a minimum maturity of three years. Loans to unrelated borrowers can be insured, provided a shareholder investment in the project is insured concurrently or has already been insured. Other forms of investment, such as technical assistance and management contracts, and franchising and licensing agreements, may also be eligible for cover.<sup>42</sup>

### **3.4.0. Legal and Institutional Framework**

In Chapter 2 this study looked at the legal and institutional framework with regard to availability of laws on the statute books. This section looks at the legal and institutional framework with regard to enforcement. La

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41 New investments are those that have neither been made nor irrevocably committed by the time the investor submits a preliminary application for a guarantee to MIGA. Other investments may also be eligible and are considered on a case-by-case basis.

42 See <http://www.miga.org> (n39).



Porta *et al*<sup>43</sup> assert that a good legal environment protects the potential financier (investor) against expropriation, thereby raising their willingness to surrender funds in exchange for securities. This assertion holds water even when viewed not only from a securities' market point of view. Legally, securities are property, and what matters is sanctity of property derived from the law.

Beim and Calomiris<sup>44</sup> argue that there is more to law than just the existence of the law on the books. They say: “[e]very country has some kind of laws on the books, but not every country is said to live under the rule of law.” They single out corruption and judicial inefficiency as some of the hindrances with regard to enforcement of the laws. This section looks at these two factors (corruption and judicial inefficiency) as one, because judicial inefficiency can be an antecedent of corruption. It further looks at other investor friendly methods of solving investor disputes.

### **3.4.1. Corruption and Judicial Inefficiency**

Beim and Calomiris, while talking about incidences of corruption, aptly put it that,<sup>45</sup>

... [if] judges, police and government officials can be bribed to favour some person or company. [ ... ] Almost by definition, a bribed judge or policeman or other public official will do something unfair – that is, contrary to what an impartial agent would have done under whatever law prevail.

Therefore, corruption produces negative effects with regard to investment regardless of good policies and laws on the books.

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43 R, La Porta *et al. Legal determinates of external finance*, NBER working paper series, Working Paper 5879 (1997).

44 DO, Beim & CW, Calomiris, *Emerging financial markets*: (2001) p154.

45 *Ibid.*

Corruption in sub-Saharan Africa is widespread, but measuring its extent is inherently challenging. The World Bank Institute (WBI)<sup>46</sup> and Transparency International (TI)<sup>47</sup> publish indexes that attempt to measure perceptions of corruption across a large number of countries.

The WBI and TI indexes rank many sub-Saharan African nations among the most corrupt worldwide; however, both indexes assess perceptions rather than actual incidences of corruption, and both institutions recognize that these indexes are imprecise. That notwithstanding, the situation in the sub-Saharan Africa region is complicated, as TI asserts:<sup>48</sup>

... a history of autocratic and unaccountable government, as well as conflict and crisis throughout the continent have posed particular challenges to governance and the fight against corruption in Africa to the point that several countries have become virtually synonymous with graft.

This is appalling, particularly when research results continue to show that corruption has a significant impact on economic growth, and that the most affected are capital investments.<sup>49</sup>

#### World Business Environment Survey (WBES)

Our study presents some statistics collected by the International Finance Corporation's (IFC's) World Business Environment Survey (WBES)<sup>50</sup> on

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46 See Governance and Anticorruption on <http://web.worldbank.org/WBSITE/EXTERNAL/WBI/EXTWBIGOVANTCOR/0,,contentMDK:20708444~menuPK:1928447~pagePK:64168445~piPK:64168309~theSitePK:1740530,00.html> (accessed on 13/04/2007). WBI produced its first corruption index in 1996 and updates it every two years.

47 See about TI on [http://www.transparency.org/contact\\_us/work](http://www.transparency.org/contact_us/work) (accessed on 13/04/2007). TI first published its Corruption Perception Index in 1995 and updates it annually.

48 See [http://www.transparency.org/regional\\_pages/africa\\_middle\\_east/about/africa](http://www.transparency.org/regional_pages/africa_middle_east/about/africa) accessed on (13/04/2007).

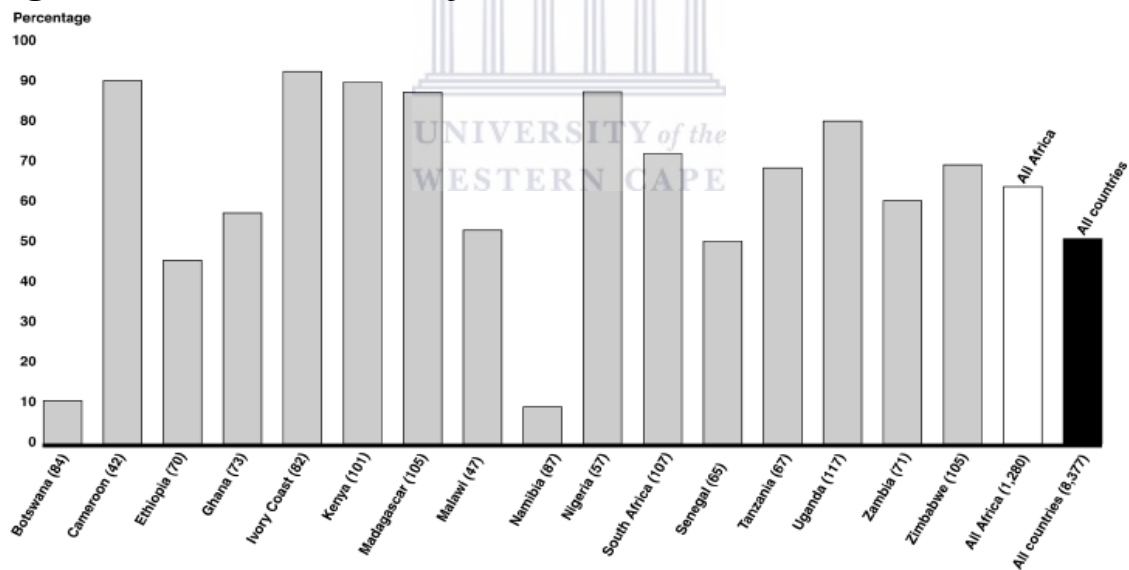
49 W, Shang-Jin, *How taxing is corruption on international investors?* (1997) NBER Working Paper no. 6030 National Bureau of Economic Research; and M, Paolo, Corruption and growth, *Quarterly Journal of Economics* (1995) p110.

the basis of some responses from 1,629 businesses in 16 countries in sub-Saharan Africa. (Botswana, Cameroon, Ivory Coast, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Namibia, Nigeria, Senegal, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe). The purpose of the survey was to better understand constraints that hinder private business development in the region.

In this study questions relevant to corruption were examined. In the analysis an extra column is provided to show the average global perception.

1. How problematic has corruption been for the operation and growth of your business? Figure 3.2 presents an analysis of responses of ‘moderate obstacle’ or ‘major obstacle’.

**Figure 3.2: moderate or major obstacles** <sup>51</sup>



Source: GAO analysis of WBES data.

50 See WBES on <http://www.ifc.org/ifcext/economics.nsf/Content/IC-wbes> (accessed on 17/04/2007).

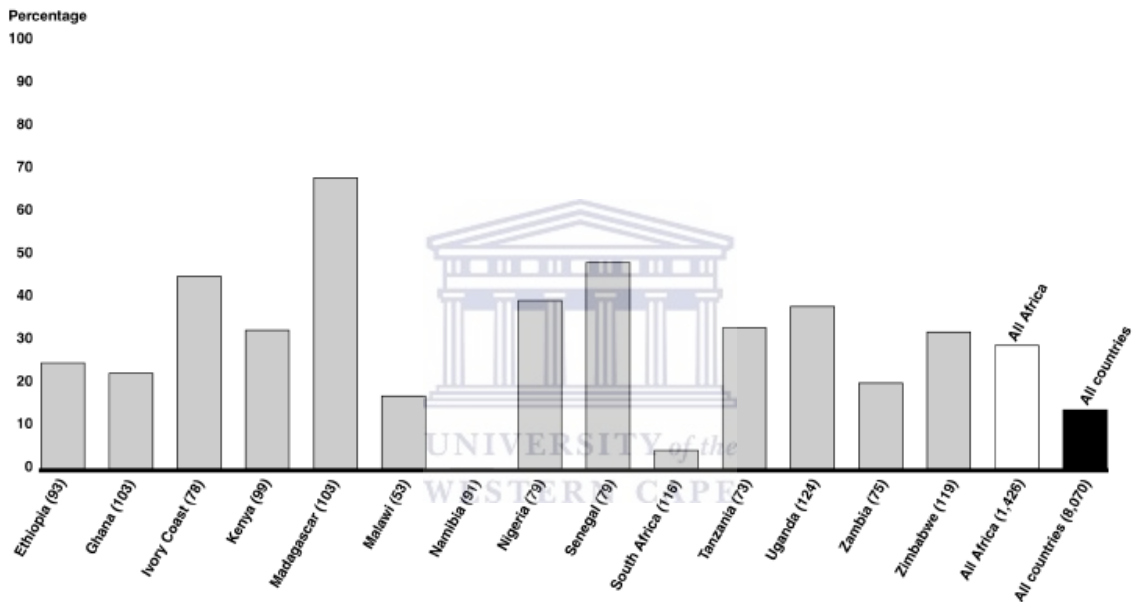
51 Adapted from The United States General Accounting Office (GAO) Report to the Subcommittee on African Affairs, Committee on Foreign Relations, U.S. Senate. <http://www.gao.gov/new.items/d04506.pdf> (accessed on 17/04/2007).

Notes: Options for the responses were: no obstacles, minor obstacles, moderate obstacles and major obstacles.

Figures in parenthesis indicate the number of firms that responded in each country.

2. Do firms like yours often need to make extra unofficial payments to gain government contracts? The range of answers presented in Figure 3.3 is ‘Always,’ ‘Usually’ or ‘Frequently’

**Figure 3.3: Always, Usually or Frequently**<sup>52</sup>



Source: GAO analysis of WBES data.

Notes: Options for the responses were: always, usually, frequently, sometimes, seldom, and never.

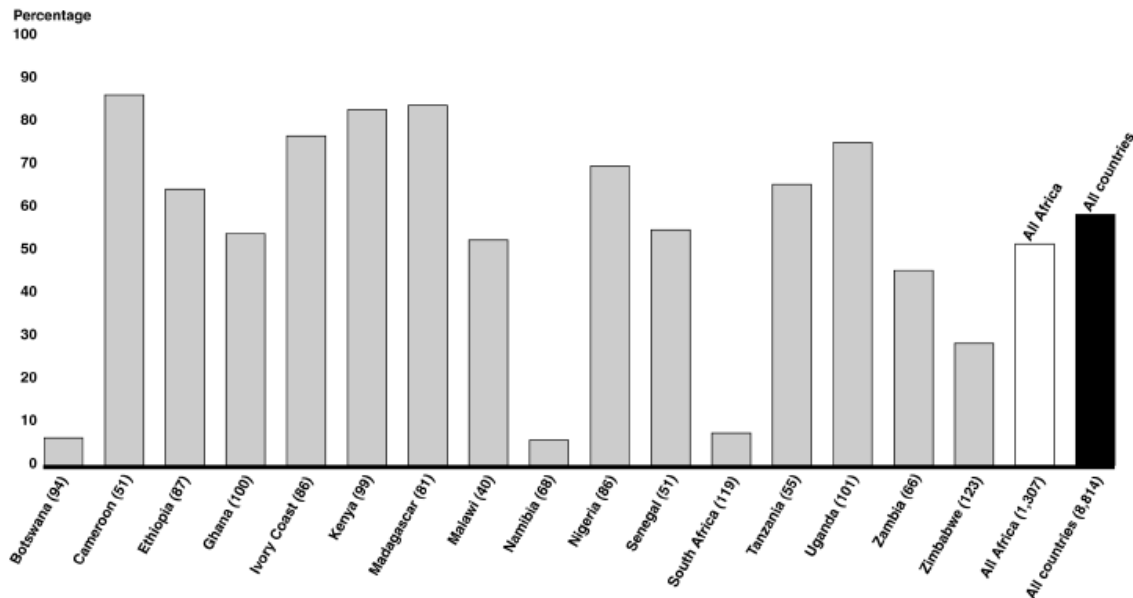
Figures in parenthesis indicate the number of firms that responded in each country.

The final question that is looked at with regard to this survey is-

3. How often do you associate ‘honest/un-corrupt’ as description of the court system in resolving business disputes? Figure 3.4 gives the analysis of those who responded ‘Never,’ ‘Seldom,’ or ‘Sometimes’.

<sup>52</sup> *Ibid.*

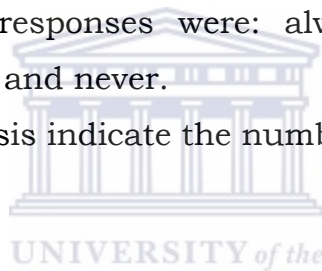
**Figure 3.4: Never, Seldom, or Sometimes**<sup>53</sup>



Source: GAO analysis of WBES data.

Notes: Options for the responses were: always, usually, frequently, sometimes, seldom, and never.

Figures in parenthesis indicate the number of firms that responded in each country



This survey confirms three fundamental things with regard to this study:

- I. That corruption is indeed a great hindrance to private capital utilisation, as illustrated by responses from business people in the region that corruption is a moderate to a major obstacle to their business growth;
- II. That corruption has significantly eroded the confidence that business people have in the courts as neutral arbiters in disputes; and
- III. That the region, relative to the world average, is ravaged by corruption, particularly official corruption, which is like an unofficial tax that increases the cost of doing business.<sup>54</sup>

<sup>53</sup> See United States General Accounting Office (n50).

<sup>54</sup> see W, Shang-Jin & M, Paolo (n49).

### 3.4.2. Dispute Resolution

Watter Mattli<sup>55</sup> argues that the various *fora* for dispute resolution and their procedures are understood to be an indirect product of rational selection, where actors select those institution that are most effective and appropriate for given disputes.

Private parties have an overwhelming choice of *fora*, procedures, and methods of dispute resolution that range from litigation in national courts, and in rare occasions in international courts,<sup>56</sup> to arbitration, mediation and conciliation.

Litigation in national courts (as discussed in the previous section) is clouded by corruption perception in most sub-Saharan African countries, and would not offer an investor friendly dispute resolution. Litigation in international courts is very limited, and, therefore, it may not have a significant impact in the region;<sup>57</sup> currently only the Common Market for Eastern and Southern Africa (COMESA) Court accepts such disputes originating from its member states. Mediation and conciliation are non-binding. This section therefore looks at arbitration as a method of settlement of commercial<sup>58</sup> and investment disputes.

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55 W Mattli, 'Private justice in a global economy: from litigation to arbitration', *International Organisation* (2001)55 p 919-947. Also available on <http://journals.cambridge/downloads> (accessed on 17/02/2007)

56 Very few international courts have their jurisdiction extended to deal with international disputes of private parties. These include, European Court of Justice, COMESA Court; and may be soon the East African Court of Justice under the proposed extended jurisdiction.

57 21 out of the 47 countries in sub-Sahara Africa are members of COMESA, but the court has also registered very few cases.

58 Covers activities such as: sale of goods, distribution agreements, commercial representation or agency, leasing, consultancy, transportation, construction work, joint ventures, investment, financing, insurance, exploitation agreements or concession and other forms of industrial business cooperation – United Nations Commission for International Trade Law (UNCITRAL) Model Law, Article 1(1).

### Arbitration

Arbitration is a private method of dispute resolution chosen by parties themselves as an effective way of putting an end to a dispute, without recourse to courts of law.<sup>59</sup> Parties may refer their disputes to *ad hoc* arbitration (conducted pursuant to rules agreed by the parties themselves or laid down by the arbitral tribunal) or institutional arbitration (administered by a specialist arbitral institution under its own rules of arbitration).<sup>60</sup>

Arbitration offers a number of advantages over litigation as a means to resolve disputes, including:

- I. Speedy resolution of disputes by a neutral forum chosen by the parties.
- II. Involvement of experts in the resolution of a dispute, particularly where the dispute requires specialised expertise.
- III. International enforceability: international treaties that govern the recognition and enforcement of arbitral awards (such as the New York Convention<sup>61</sup>) have much greater acceptance internationally, than treaties for the reciprocal enforcement of judgments of courts of law.
- IV. Privacy and confidentiality: parties must consent to the publication of their disputes; this offers privacy and confidentiality, unlike litigation where the judgments are reported and the proceeding could be a constant news item.
- V. Continued relationship: parties to arbitration would more often than not have a continued relationship after the dispute, due to its

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59 A Redfern et al. *Law and practice of international commercial arbitration* (2004) p1 “The award is binding amongst the parties unless successfully challenged in a court of law or reviewed by the arbitral tribunal”.

60 See A Redfern et al (n59).

61 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York, on 10 June 1958.

conciliatory nature. This would be an added advantage in a working environment where parties work in a consortium.

Nonetheless, the practice of resolving disputes by arbitration only works because it is held in place by a complex system of national laws and international treaties.<sup>62</sup> In the words of Lord Mustill:<sup>63</sup> “it is now firmly established that more than one national system of law may bear upon an international arbitration.” Therefore, for a country to lure investors through easing the methods of dispute resolution, it must be prepared to pass laws that govern recognition and enforcement of the agreement to arbitrate, and the recognition and enforcement of the awards of the arbitral tribunal.

In most cases arbitration takes place in a neutral seat which may be in a third country, particularly where it involves foreign investments. A country should also consider being a member of the 1958 - Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).<sup>64</sup>

*International Convention on Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention<sup>65</sup>)*

The ICSID Convention came into force in 1966. It is administered by the World Bank Group under the International Centre for Settlement of

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62 As we will see, the support of international treaties such as the New York Convention of 1958 on the recognition and enforcement of foreign awards, is essential to the effectiveness of arbitration internationally.

63 *Channel Tunnel Group Ltd v. Balfour Beatty Construction Ltd* [1993] A.C. 334 at 357.

64 The Convention is widely recognized as a foundation instrument of international arbitration. It requires courts of contracting States to give effect to an agreement to arbitrate when seized of a matter covered by an arbitration agreement, and also to recognize and enforce awards made in other States, subject to specific limited exceptions. The Convention entered into force on 7 June 1959. see [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html) (accessed on 20/04/2007).

65 It may also be referred to as the Washington Convention.



Investment Disputes (ICSID).<sup>66</sup> This Convention is discussed because of the new grounds it has established for the settlement of investment disputes, and its ability to facilitate increased flows of international investments.<sup>67</sup>

Prior to the ICSID Convention disputes that involved foreign nationals and host states could only be taken to a court of law with the express waiver of a state's sovereign immunity.<sup>68</sup> Therefore, if foreign private investors got into a dispute with the host government, they would have to ask their own government to take up their case at an inter-state level: diplomatic protection.<sup>69</sup> The ICSID Convention broke new ground by giving both private individuals and corporations who were investors in a foreign state the right to bring legal proceeding against that state in their own name and on their own behalf before an international arbitral tribunal.<sup>70</sup> In the words of Sir Elihu Lauterpacht:<sup>71</sup>

...for the first time a system was instituted under which non-state entities – corporations or individuals – could sue states directly; in which state immunity was much restricted; under which international law could be applied directly to the relationship between the investor and the host state ...

Because ICSID arbitration is governed by an international treaty, it is delocalised, or denationalised. By this I mean that national law is excluded from any control of any ICSID arbitration. The provisions in the Convention regarding challenge to, recognition of, and enforcement of ICSID awards can attest to this fact. Article 53 of the ICSID Convention

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66 See <http://www.worldbank.org/icsid/about/about.htm> (accessed on 20/04/2007).

67 *Ibid.*

68 see A Redfern et al. *Law* (n59) p 549.

69 Prior to ICSID, international tribunal were open only to states.

70 ICSID Convention Art. 25, Jurisdiction of the Centre.

71 Sir Elihu Lauterpacht in his foreword to Christoph Schreuer, *The ICSID Convention: a commentary* (2001) p xi-xii.

provides that the award of ICSID arbitrators is binding on the parties and not subject to any appeal or any other remedy, except those provided by the Convention itself. These remedies include: interpretation of the meaning or scope of the award;<sup>72</sup> revision on the ground of discovery of a previous unknown fact of decisive importance;<sup>73</sup> and annulment by an *ad hoc* committee.<sup>74</sup>

In concluding this section I would like to underscore the fact that national legal systems are very important to the success of arbitral processes. With the exception of ICSID arbitration, parties to arbitration may find themselves falling back on the courts for interim measures, and often for enforcement of an arbitral award. Therefore, the sub-Saharan African countries cannot escape the fact that something urgent needs to be done to improve the corruption and inefficiency perceptions of the court process in their countries.

### **3.5.0. Conclusions**

The discussions in Chapter 2 were centred on the ways the government can raise more money at least cost for infrastructure development. However, Chapter 3 brings in the concept of private sector since the government even with the money must at the very least engage private companies for construction of the infrastructure.

Minimising risks for both the government and the private sector should be a priority in achieving low cost project financing and value for money for the government. In achieving value for money the government must ensure that the risk transferred to the private entity is not optimal, but appropriate in a way that the best placed party to bear the risk should

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72 ICSID Convention Art. 50.

73 ICSID Convention Art. 51.

74 ICSID Convention Art. 52.

bear the risk at minimum cost. Mitigating risk which cannot be well priced by the market is also another way of reducing the cost of capital through: government guarantees, multilateral development bank guarantees, and the multilateral investment guarantee agency (MIGA) insurance.

The benefits flowing from proper risk allocation and mitigation by way of guarantees and insurance would include:

- I. By covering risk that the market cannot assume, the guarantee/ insurance can facilitate access to financing that would not otherwise be available for certain projects, thus making them possible.
- II. The guarantees/ insurance can extend the maturity of loans for a longer loan period that would otherwise not be possible without the guarantee, thereby allowing for a lower unit cost of output over the life of the project.
- III. The guarantees/ insurance provide borrowers (public and private) with greater flexibility in choosing the most appropriate financing sources (currencies, markets, interest rates benchmarks etc.) for their needs.

Similarly, the private sector is very wary of disputes, particularly if the disputes are not likely to be fairly determined or the system is so inefficient as to cause unwarranted delay. Corruption is one of the hindrances in sub-Saharan Africa to fair adjudication of disputes, and inefficiencies in the court process.

Alternative dispute resolution methods, such as arbitration, in which parties have more faith should be embraced. In this regard, countries in the sub-Saharan Africa region would need to enact laws that govern recognition and enforcement of the agreement to arbitrate, and the recognition and enforcement of the awards of the arbitral tribunal. For

wider recognition and enforcement of arbitral awards countries in sub-Saharan Africa should assent to international conventions, such as the New York Convention and the ICSID Convention.



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## **Need for Innovative Financing: Case of Kenya Road Maintenance Levy Fund**

### **4.1.0. Background**

The development and maintenance policies of the Kenyan road infrastructure have a pre-independence background. Having been a British colony which had been earmarked for settlement, she benefited from some British policies with regard to the development of her infrastructure.<sup>1</sup>

Roads and road transport are very important to the Kenyan economy. Therefore the Government of Kenya (GoK), from independence in 1963, embarked on a process of formulating and implementing many policies for rapid economic growth and development, which, in one way or another provided direction to the development, maintenance and repair of the road network.<sup>2</sup> The attention that the GoK gave and continues to give to the development of the road infrastructure attests to the importance of roads and road transport in Kenya. Table 4.0 attempts to show the central stage that road transport plays, by indicating the levels

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- 1 See e.g. Nyangito, HO, and Kimenye LN *Agricultural development policies in Kenya, 1963–95*. (1999) that; “attempts to address the rural development problem during the closing years of colonial administration [were] published in the Swynnerton Plan of 1954 as a blueprint for modernizing agriculture in African reserves”.
  - 2 See e.g. RoK (Republic of Kenya). 1964. *First National Development Plan 1964–1970.*; 1970. *Second National Development Plan 1970–1974.* 1974. *Third National Development Plan, 1974–1978.*; 1983. *Fifth National Development Plan, 1984–1988.*; 1984. *National Transport Plan 1984.*; 1988. *Sixth National Development Plan 1989–1993.*; 1993. *Seventh National Development Plan 1994–1996.*; 1997. *Eighth National Development Plan 1997–2001.* etc.

of output by various modes of transport in the country from 1975 to 1998.

**Table 4.0: Kenya transport service sector** (Output in K£ millions)<sup>3</sup>

Transport type	1975	1980	1985	1990	1995	1998
Road	35.8 (24.4)	92.3 (33.1)	248.8 (45.1)	476.9 (44.3)	810.7 (36.3)	870.7 (33.7)
Railway	25.4 (17.3)	32.9 (11.8)	57.7 (10.5)	94.5 (8.8)	225.0 (10.1)	187.4 (7.3)
Water	34.5 (23.6)	62.7 (22.5)	89.2 (16.2)	134.2 (12.5)	372.3 (16.7)	408.6 (15.8)
Air	39.9 (27.2)	41.6 (14.9)	86.8 (15.8)	268.2 (24.9)	471.1 (21.1)	650.5 (25.2)
Pipeline	–	18.6 (6.7)	23.4 (4.2)	31.1 (2.9)	197.8 (8.9)	278.0 (10.8)
Incidental services	10.9 (7.4)	31.2 (11.2)	45.2 (8.2)	72.7 (6.7)	153.8 (6.9)	186.7 (7.2)

Note: Figures in parentheses are percentages of the share of each service in the transport sector output.

Financing strategies for the development, maintenance and repair of the road network have also had a life of their own. Over the years the focus on various modes of financing strategies has significantly changed. However, the status of the road network has continued to deteriorate. The World Bank in one of its reports says:<sup>4</sup>

The primary problem with the Kenya road sector is not the quantity but the quality of the network. This is the consequence of two rather different factors

- Conditions on most paved and unpaved roads have deteriorated significantly through a lack of maintenance and, on the main paved network, the overloading of vehicles
- Traffic growth has resulted in a substantial network of unpaved roads carrying traffic levels that would justify paving the roads: about 2,500 km of unpaved roads carry over 200 vehicles per day.

3 Wasike, WSK *Road infrastructure policies in Kenya: Historical trends and current challenges*, KIPPRA Working Paper No. 1 (2001).

4 World Bank. *Staff appraisal report: Kenya: Nairobi-Mombasa Road Rehabilitation Project.* Report No. 13798-KE. (1995).

Though the problems identified with regard to the Kenyan road sector infrastructure are not just related to financing, this study looks at only the financing aspect in line with its focus on access to capital for developing countries. This section looks at possible innovative methods of financing the road sector in Kenya within the existing legal and institutional framework. It starts by giving the background to the development of the existing institutional framework, then examines the development of the financing strategy and finally discusses innovative financing methods.

#### **4.2.0. Road Institutions and Road Classification in Kenya**

Kenyan roads are broadly categorised according to the authority primarily responsible for their management. They are categorised as national, district, urban and special purpose roads.<sup>5</sup>

National roads are the main highways of the classified road network, comprising Class A, B, and C roads, and are managed by the Roads Department of the Ministry of Roads and Public Works (MoR&PW). These roads provide for mobility in a national context, and the traffic on these roads is usually associated with longer travel distances.

Further classification of national roads is based on the functions of a certain road as defined below,

Class A - these are international trunk roads linking international boundaries or terminating at international ports.

Class B - these are national trunk roads linking provincial headquarters and centres of national importance.

Class C - these are primary roads linking district headquarters to each other or to higher class roads

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<sup>5</sup> Classification can be accessed on the Kenya Roads Board website on <http://www.krb.go.ke/Classification.php> (accessed on 25/044/2007).

District roads comprise Classes D and E, and other unclassified rural roads (excluding urban roads<sup>6</sup>), and are managed by the District Roads Committees (DRCs). They primarily serve local traffic. The further classification of district roads is based on their functions, as defined below,

Class D - Secondary roads linking locally important centres to each other or to higher class roads.

Class E - Minor roads linking minor centres.

The other unclassified rural roads are managed by either DRCs or County Councils.

Special purpose roads or Class F, include roads for tourist, township, or agriculture purposes; any roads used for strategic purposes, such as roads falling within national parks, game reserves and forests; security roads; and roads in areas producing certain agricultural commodities, like tea, coffee sugar etc. special purpose roads are managed by various government agencies, such as: Kenya Wildlife Services (KWS), under the Ministry of Tourism; Forest Department under the Ministry of Environment and Natural Resources; coffee, tea, and sugar boards etc, all falling under the Ministry of Agriculture.

The disjointed nature of the institutional framework for the roads sector may have been a factor in the sector's poor performance in maintaining the network.<sup>7</sup> A study by the Institute of Economic Affairs (IEA)<sup>8</sup> also saw this as the principal reason for the poor performance of the entire road

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6 Urban roads are those falling within the urban areas and administered by City, Municipal and Town Councils.

7 Wasike, WSK (2001) (n3).

8 IEA *Our problems our solutions: An economic and public policy agenda for Kenya.* (1998).



transport sector, since it is difficult to coordinate the activities of the various road agencies, to determine their financial requirements, and to address the problems of the road sector in a synchronised manner.

#### **4.2.1. Kenya Roads Board (KRB) an Institutional Framework**

In 1999 the GoK, in a bid to improve the management of and the institutional framework for roads, tabled the Kenya Roads Board Act<sup>9</sup> in Parliament. The objective was to develop an institutional framework within which the management of the entire road network could most effectively be undertaken.<sup>10</sup> The Act provides for the establishment of the Kenya Roads Board (KRB) which is composed of major stakeholders in the roads sector (who constitute the majority of its membership) and representatives of relevant government ministries or departments.<sup>11</sup>

The Act outlines the major tasks of the KRB as follows:<sup>12</sup>

- To coordinate implementation of all policies relating to the maintenance, rehabilitation and development of the road network
- To coordinate maintenance, rehabilitation and development of the road network with a view to achieving efficiency, cost-effectiveness and safety
- To administer funds derived from the fuel levy and any other funds that may accrue to the board
- To determine the financial allocations for road agencies and evaluate the delivery of works through technical, financial and performance audits

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9 The Kenya Roads Board Act, No. 7 of 1999

10 Attorney-General's notes to The Kenya Roads Board Act, No. 7 of 1999.

11 The stakeholders include the Kenya National Chamber of Commerce and Industry, the Kenya National Farmers' Union, the Automobile Association of Kenya, road contractors, road transporters, and the Kenya Association of Tour Operators. The government is represented by the Ministry of Transport, Information and Communications (MoITC), the Ministry of Roads and Public Works (MoRPW), the Ministry of Finance and Planning, and the Ministry of Local Government.. (Kenya Roads Board Act, Sec 7 and schedule 1).

12 Kenya Roads Board Act Sec 6.

- To ensure that all procurement of works is conducted in accordance with the guidelines and criteria set by the board
- To recommend to the Minister responsible for roads the areas for study and research; the specifications, design standards and classification for roads; vehicle types and dimensions; axle-load limits; and road safety measures

In essence the KRB provides an institutional framework within which the entire road network is managed, and is entrusted with the authority to efficiently use its funds to develop, rehabilitate and maintain the road network.

Having the institutional framework within one institution at least solves the problems of disjointed institutional framework envisaged by Wasike and IEA.<sup>13</sup> However, the issue of adequacy of funds has been a big problem. The Minister responsible for transport, at a workshop held in September 2006, disclosed that<sup>14</sup> the government needed Kshs 100 billion (approximately US\$1.45 billion; exchange rate US\$1- Kshs 69) to reconstruct poor sections of the country's poor road network and a further Kshs 12 billion (approximately US\$ 174 million) each year for maintenance.

#### **4.3.0. Financing Strategies for the Kenyan Road Network**

In the 1960s and 1970s the policy of decentralised road delivery was operationalised through assigning county councils the responsibility for collecting cess<sup>15</sup> from the sale of agricultural products, and road tolls on major highways.<sup>16</sup> The money, buttressed by donor funding, was used to

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13 Wasike, WSK (2001) (n3).

14 'State requires Sh100b to upgrade road network' *The East African Standard*, September 19, 2006.

15 Cess is a tax levied on agricultural products by the local governments.

16 Wasike, WSK (2001) (n3).

improve communication and transportation in the rural areas. However, waning donor interest, due to their dissatisfaction with the government's procurement and accounting procedures, saw the reduction of donor funds, and the various programmes<sup>17</sup> for improving access to rural areas grinding to a halt.<sup>18</sup>

In 1984 the GoK enacted the Public Roads Toll Act<sup>19</sup> to provide for the collection of tolls on public roads; to establish a Public Roads Toll Fund; and for connected purposes.<sup>20</sup> Moneys collected as tolls were to be paid into the Public Roads Toll Fund which was managed by the Ministry responsible for roads.<sup>21</sup> However, the tolls were not very effective due to the way the government implemented the system, and were prone to corruption.

In 1993 the government scrapped tolls on the road network (leaving a transit toll for international traffic) and implemented the collection of the road maintenance funds through a petroleum fuel levy. In this regard the Road Maintenance Levy Fund Act<sup>22</sup> was enacted to provide for the imposition of a road maintenance levy on petroleum fuels; for the establishment and administration of a Road Maintenance Levy Fund (RMLF); and for connected purposes.<sup>23</sup> The Act provides that the RMLF shall consist of the proceeds from the levy and the transit tolls levied under the Public Roads Toll Act.<sup>24</sup> It further introduced efficacy in the

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17 The GoK had initiated various programmes which included; Rural Access Roads Programme (RARP); Minor Roads Improvement and Maintenance Programme (MRP); Kenya Market Development Programme (KMDP).

18 Wasike, WSK (2001) (n3).

19 Public Roads Toll Act (Cap 407) Laws of Kenya.

20 Long title of Public Roads Toll Act.

21 Section 7 Public Roads Toll Act.

22 Road Maintenance Levy Fund Act No. 9 of 1993.

23 Long title to Road Maintenance Levy Fund Act No. 9 of 1993.

24 Road Maintenance Levy Fund Act No. 9 of 1993, sec 7(2).

collection of moneys for road repairs and maintenance. Unlike the public roads toll, which was collected on the road by government agents,<sup>25</sup> and provided opportunity for corruption, the levy is collected by the petroleum fuel marketers who are registered as remitters in accordance with the Act.<sup>26</sup>

However, the public roads toll and the road maintenance levy funds both lacked institutional backing at inception, since they were held and managed under the Ministry concerned with roads. The Department for Roads under the Ministry is one of the road agencies concerned with national roads. However, the petroleum fuel levy applied to all classes of roads, and it should have been applied to the maintenance of all roads in the country. Such anomalies were cured by the creation of the KRB<sup>27</sup> which *inter alia*, was mandated to manage the Kenya Roads Board Fund.<sup>28</sup> The Act provides:<sup>29</sup>

There shall be paid into the Fund -

- a) all proceeds from the Road Maintenance Levy Fund;
- b) such moneys or assets as may accrue to or vest in the Board in the course of the exercise of its powers or the performance of its functions under this Act or under any other written law;
- c) such sums as may be payable to the Board pursuant to this Act or any other written law, or pursuant to any gift or trust;
- d) all moneys from any other source provided for or donated or lent to the Board.

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25 Public Roads Toll Act sec 4: 'The Minister shall appoint toll collectors who shall collect tolls at toll stations and perform such other duties as may be prescribed by the Minister for the purpose of this Act'.

26 Road Maintenance Levy Fund Act sec 4.

27 IEA (n8).

28 Kenya Roads Board Act sec 31, creation of the fund.

29 Kenya Roads Board Act sec 31(2).

The Act also provides for an allocation criteria for the distribution of the proceeds of the RMLF among all the concerned road agencies, as shown in the KRB's accounts (see annex one). KRB allocates funds to road agencies for the maintenance, rehabilitation and development of the categories of roads in respect of which they are designated.<sup>30</sup> This institutional framework consolidates the funding aspects of the road network, and facilitates consultation between KRB and the road agencies, as provided for under section 19 of the Act.<sup>31</sup> This section states:

1. The Board shall indicate to the road agencies at least a year in advance –
  - a) the amount of money likely to be available to the Board for allocation in the coming year;
  - b) the priorities of the Board in funds allocation in the coming year; and
  - c) the criteria to be applied in making allocations.
2. Every road agency shall, at least six months before the commencement of every financial year, submit to the Board an annual roads programme in such form and containing such details as the Board shall specify, outlining a comprehensive plan of action for the development rehabilitation and maintenance of roads under the charge of the roads agency and the estimated costs of every activity required to implement the plan of action.
3. The road agency shall select the roads to be included in its programme.
4. The Board shall review, individually, the annual roads programmes submitted to it by the road agencies and shall consolidate the annual roads programme into annual public roads programme which shall:
  - a) specify the amounts allocated for the maintenance, rehabilitation and development of each class of roads;

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30 Kenya Roads Board Act Sec 20.

31 Kenya Roads Board Act Sec 19.

- b) match the cost of implementing the annual roads programme with revenues collected or estimated to be collected by and within the Fund; and
  - c) identify roads requiring maintenance, rehabilitation or development in order of priority, taking into account social and economic requirements of the country or any part thereof in which roads are located.
5. The Board shall submit to the Minister and the Minister for Finance the annual roads programme for approval and the approved programme shall form the basis of funds allocation and auditing of works by the Board and shall not be varied by the road agency without the prior written approval of the Board.

The KRB presents a good working institutional framework for the financing strategy for which the study opts, viz where there is one institution that is responsible for the financing of all initiatives for the development, maintenance and rehabilitation of the road network.

#### **4.4.0. Innovative Financing**

Kenya had the first sovereign credit rating done by Standard and Poor's (S&P) in 2006.<sup>32</sup> Though it was praised as a strong credit rating for a first time assessment, the rating of B+ for long-term foreign currency, BB- for long-term local currency, and B for short-term foreign and local currency sovereign credit ratings<sup>33</sup> are not sufficiently impressive to access the international capital markets at competitive spreads. Ketka and Ratha argue that investment grade debt should be rated BBB and above to attract investors.<sup>34</sup>

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32 'Kenya given strong global credit rating', *Saturday Nation*, September 09, 2006

33 *Ibid.*

34 S Ketka & D Ratha, *Development financing during a crisis: securitization of future receivables*, (2001)

This section discusses issuing of debt instruments collateralised by future receivables to allow the borrower to obtain a credit rating that is superior to that of the sovereign (and thus allows a reduction in financing costs). Securitization using future earnings also monetises the future earnings, and is used as a source of capital in the current period. We envisage a model based on the RMLF which is managed by the KRB as a component of the Kenya Road's Board Fund.<sup>35</sup> KRB is the statutory body that is entitled to receive and manage all the funds in RMLF<sup>36</sup>

Legal framework with regard to the RMLF

The Kenyan RMLF was established by the Road Maintenance Levy Fund Act, Act No. 9 of 1993.<sup>37</sup> The Act also provides that the RMLF shall consist of the proceeds from the petroleum fuels levy and the transit tolls levied under the Public Roads Toll Act.<sup>38</sup> All monies accruing to the RMLF shall be paid into a special account established by the KRB.<sup>39</sup> The Kenya Roads Board Act provide for the management of the fund as part of the Kenya Roads Board Fund.<sup>40</sup>

The collection and remittance of the RMLF funds is administered under the Road Maintenance Levy Fund Act and the Public Roads Toll Act. For petroleum fuels levy, the remitting party, a petroleum fuel marketer, registers with the Chief Engineer in the MoR&PW, who is the collector,<sup>41</sup> while payment is made to the revenue authority through the Commissioner of Customs and Excise.<sup>42</sup> For transit tolls, revenue

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35 Established under sec 31 of the KRB Act; *supra* note 28.

36 Kenya Roads Board Act Sec 31(2)(a).

37 Kenya Roads Board Act Sec 7.

38 Kenya Roads Board Act Sec 7(2).

39 Kenya Roads Board Act Sec 7(3).

40 IEA (n8).

41 Road Maintenance Levy Fund Act Sec 4 (2).

42 Road Maintenance Levy Fund Act third schedule.

authority staff are positioned at the border points, and such tolls are collected there.

The study asserts that, though the levy is a tax, it can be distinguished from a general tax, since it is appropriated for the purposes of maintenance, rehabilitation and development of the road network.<sup>43</sup> A general tax is appropriated for whatever use by the government through the annual budget of financial estimates presented to the national assembly. This distinction is very important with regard to two things:

- I. The rating of the transaction by the rating agencies if KRB decides to issue debt guaranteed/ secured by the future flows to the RMLF. That is, the funds collected by the revenue authority on behalf of RMLF cannot be diverted to any use by the government other than the one specified by the law.
- II. For the purposes of getting a waiver from the IBRD's and other development banks' negative pledge clause<sup>44</sup> (see annex 2). If KRB issued debt collateralised by the future receivables of the RMLF, then it would mean that such debt would be given priority over the IBRD and other development banks' loans to the government; this would violate the negative pledge clause in the IBRD's and other development banks' loan agreements. However, if it is shown that the funds in the RMLF usually are appropriated for maintenance, rehabilitation and development of the road network, and not to settle the government's external debt, and therefore do not prejudice the country's position to meet its other debt obligations, then a waiver may be granted.

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<sup>43</sup> Kenya Roads Board Act Sec 39 (4).

<sup>44</sup> IBRD General Conditions for Loans Dated July 1, 2005 (as amended through October 15, 2006)



#### **4.4.1. Securitisation<sup>45</sup> of Public Debt with Future Receivables**

Securitisation means an arrangement which involves the transfer of assets or risk: (i) to a bankruptcy remote special purpose vehicle (SPV) (ii) by way of an insolvency proof sale, where such transfer is funded by the issuance of debt securities to investors, and payments to investors in respect of such debt securities are principally derived, directly or indirectly, from the cash-flows of the assets.<sup>46</sup> It could also be understood as an assignment, where the assignor transfers to the assignee all or part of, or an undivided interest in, the assignor's contractual right to payment of a monetary sum 'receivable' from a third person.<sup>47</sup> The assets in this case are the future receivables due to the originator; for public debt, the originator may be the government or a public body. Future receipts that have been securitised in the past include: (1) crude oil and other mineral receivables, (2) airline ticket, telephone, credit card, or electronic remittances receivables, (3) other export receivables, and (4) government revenues.<sup>48</sup>

This study also provides a diagram in Figure 4.1 of a general model used for securitisation of future receipts for raising foreign currency denominated debt. The originator sells its rights and interests in future receivables for an upfront price to the offshore entity, the SPV that finances its purchase by issuing debt securities whose servicing is collateralised by the receivables. To ensure that future receipts are good collateral, the originator provides irrevocable instructions to foreign importers that purchase its exports, requiring them to make payments to

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45 Securitised borrowing can also be referred to as 'asset-backed' or 'collateralised'.

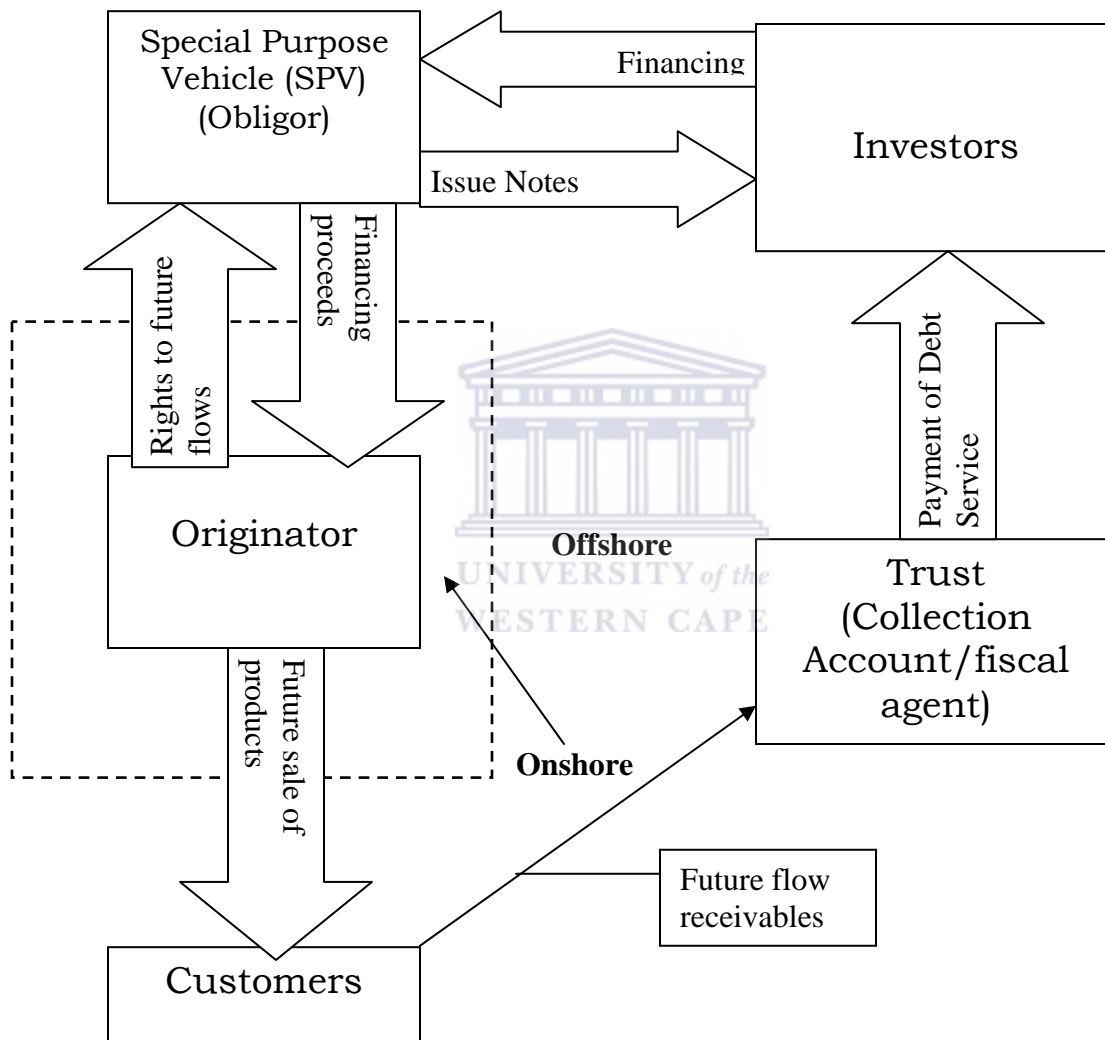
46 See definition by Kenya Capital Markets (Asset Backed Securities) Regulations, 2006. Regulation 3(1).

47 United Nations Commission on International Trade Law (UNCITRAL) Receivables Financing, *Analytical Commentary on the Draft Convention on Assignment of Receivables in International Trade* (2001).

48 See S Ketka & D Ratha, (n34).

an escrow account controlled by the arrangement's trustee.<sup>49</sup> The trustee pays for debt service to the investors (principal and interest), and the monies that remain are paid back to the originator through the SPV (obligor).

**Figure 4.1: Structure of a Typical Collateralised Future Receipts Arrangement** <sup>50</sup>



49 IMF *Assessing Public sector borrowing collateralized on future flow receivables* (2002).

50 C Nigel, *The Potential Role for Securitizing Public Sector Revenue Flows: An Application to the Philippines*, IMF Working Paper No. 02/106 (2002).

The model also helps in the enhancement of the credit rating of the transaction. The general structure of a secured financing arrangement (as outlined in Figure 4.1) is designed specifically to mitigate the various risks through:<sup>51</sup>

- I. Ensuring that foreign currency flows needed to service the debt are always outside of the originator's local jurisdiction in order to eliminate transfer and convertibility risk (and thus allow the issuer to pierce the sovereign ceiling);
- II. Backing the securitisation with sales to obligors that are investment-grade and based in industrial countries to reduce obligor risk;
- III. Establishing the SPV in an offshore, tax-neutral jurisdiction that is outside the tax jurisdiction of the originator's home government, in order to eliminate tax risk; and
- IV. Ensuring that the future flow receivables and the debt service obligations are denominated in the same foreign currency, and thus to remove any exchange risk.

However, the situation of Kenya is somewhat different from the one envisaged in the general model presented by the IMF<sup>52</sup>, C Nigel<sup>53</sup> and S Ketka & D Ratha<sup>54</sup> since there is no sale of goods as envisaged. The receivable which is a tax is generated in Kenya and is collected in Kenyan shillings (local currency).

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51 See, IMF (n49).

52 *Ibid.*

53 See C Nigel (n 50).

54 See S Ketka & D Ratha, (n34).

#### **4.4.2. KRB's RMFL Future Receivables Securitisation**

In this section this study will illustrate, using Figure 4.2, a possible financing model for KRB using future receivables from RMFL funds. This section will also identify the various risks in the model and how they can be mitigated.

##### *Future Tax Receivables*

Future tax receivables (government revenue) in the opinion of Ketka and Ratha<sup>55</sup> are the most risky future revenue to secure an investment grade debt.<sup>56</sup> Though their opinion holds water, this study will show that the structuring of the legal framework has much to do with the risk perception where government revenue is involved.

Ketka and Ratha based their conclusions on the risk connotation on the government revenues from debt issued by the Argentinean Provinces backed by future receivables from the federal tax coparticipation payments.<sup>57</sup> Though the co-participation payments are sufficiently protected under the law, and there is an assurance that the federal government will meet its obligation to the provinces to distribute a certain percentage of the co-participation revenue to them; the co-participation payments are not entirely appropriated for a specific purpose. On the other hand, the RMFL is entirely appropriated to the maintenance, rehabilitation and development of roads, in fact, the Act envisage a situation where, if there is a surplus, the KRB may invest the surplus in government securities or place them in an interest bearing account.<sup>58</sup> Therefore the government cannot divert monies collected by

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55 See S Ketka & D Ratha, (n34).

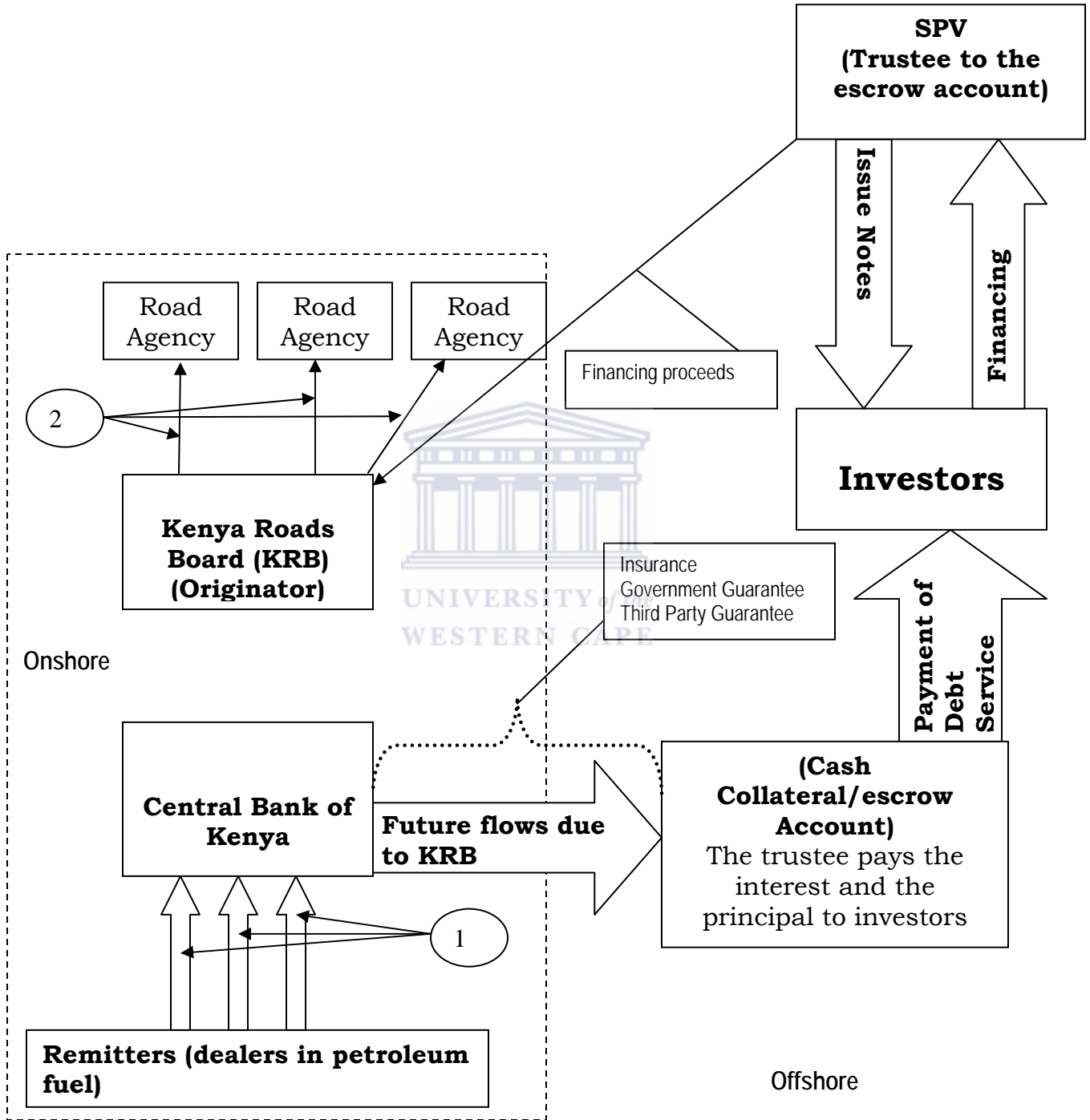
56 See, IMF (n49).

57 Federal tax coparticipation in Argentina refers to a situation where most taxes are collected by the federal government, which then redistributes the revenue to the provinces.

58 KRB Act Sec 33.

means of the RMFL or any other components of the KRB Fund, to any other use other than the one intended by the Act.

**Figure 4.2: securitisation of future fuel levy receivable in foreign currency**



**Notes**

1. Remitters pay the petroleum fuel levy through the revenue authority to the Central Bank
2. KRB distributes funds to road agencies for road maintenance, rehabilitation and development

However, the perception of risk with regard to the political commitment of the government to respect the legal structure of the KRB to enter into collateralised financing using future receivables, is reliant on the government's respect for the rule of law, and maintenance of strict budgetary controls. With regard to the rule of law, the government must, without delay, pass on the monies collected/ remitted to the Central Bank into an account operated by the KRB as provided for by the Act,<sup>59</sup> or into an account held in trust (as illustrated in Figure 4.2). As far as budgetary controls are concerned, the government must always maintain the strict fiscal discipline that would not allow it to infringe on the revenue meant for the KRB, particularly because of the ease with which the funds are generated and collected.

The dealings between the Central Bank and the offshore escrow account may also have some risks associated to it. This may include:

#### Performance Risk

This concerns questions such as whether the originator of the debt is capable of generating cash flows to service the secured debt, or is legally barred from issuing secured debt by virtue of negative pledge clauses in respect of other debts. The rating agencies when rating the transaction, would look at: the ability of the legal framework to assign future cash flow to the SPV; effects of bankruptcy, reorganisation, or insolvency upon future cash flow; and the ability of the originator to generate the cash flow.

The government may give a counter guarantee for the payment of the RMFL funds to an escrow account established outside its jurisdiction. Similarly, a third party guarantee, such as from the World Bank, AfDB or

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<sup>59</sup> Road Maintenance Levy Fund Act Section 7(4).

other financial institution, may be sought, to enhance prompt payment by the government.

With regard to negative pledge clauses usually contained in loan agreements: disallowing the government to incur further debt, or ensuring that no other external debt shall have priority over the prior debt in the allocation, realisation and distribution of foreign exchange held under the control of the borrower or for its benefit (Annex 2). The government may seek a waiver from the application of the clause if it is able to show that the funds in the RMLF are appropriated for maintenance, rehabilitation and development of the road network, and not to settle the government's external debt, and therefore do not prejudice the country's position to meet its other debt obligations.

The ability to pay is primarily determined by how the RMLF funds are collected. According to the financial statement for the 2001/2002 financial year<sup>60</sup> the KRB raised around Kshs 8.2 billion; in financial year 2003/2004 the KRB raised Kshs 9.05 billion;<sup>61</sup> and, finally, in financial year 2005/2006 the KRB raised Kshs 15 billion.<sup>62</sup> This indication of growth in collection is encouraging and presents a good indication for the future flow growth. The steady growth, and the possibility of continued growth in the future, would present a positive appeal for the debt instruments issued on the strength of the RMLF's receivables.

### Exchange Rate Risk

The exchange rate risk would concern questions like: are there currency mismatches between the receivable inflows and the debt service outflows? In this case the future flows are denominated in local currency;

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60 Annex 1.

61 Road Maintenance Levy Fund (RMLF) Interim Report year 2003/2004. available on <http://www.krb.go.ke> (accessed on 27/04/2007).

62 'Sh2.1bn for constituency roads', Daily Nation, October 19, 2006.

therefore, rating may reflect this risk by capping the transaction rating to the sovereign rating. However, a government undertaking to bear the exchange risk, by matching the deposits made to the escrow account and the currency of debt service, would substantially reduce the exchange risk. Adoption of good exchange rate policies, as discussed in Chapter 2, would also help alleviate this risk. MIGA insurance would also come in handy to assure the investor that the government is committed to ensure an open exchange rate policy.

#### *Transfer and Convertibility Risk*

Here the question is: what is the risk that a government, faced with a balance of payments crisis, will impose restrictions that limit foreign currency debt repayments by domestic borrowers, or have recourse to measures to limit net outflows of foreign currency? Such risks include the imposition of exchange controls, multiple exchange rate practices, the freezing of bank accounts, and foreign exchange surrender requirements. If the ratings agency can establish that the borrower will not be hampered in accessing foreign currency and transferring it to investors outside the country, then the agency will consider rating the issue above the sovereign ceiling. MIGA insurance would also be very useful in ensuring that the government honours the agreement to pay the investors in foreign currency (see Chapter 3, Multilateral Investment Guarantee Agency (MIGA) Insurance). Similarly, a country's balance of payments would be enhanced if it had a robust export industry which would receive a strong boost from developed infrastructure.

The exchange rate risk, and the transfer and convertibility risk may be substantially reduced by issuing the securities in the domestic market. This would also contribute to the development of the domestic markets, as discussed in Chapter 2.



Collateralised future receivable borrowing has its flip side as well, which includes:

*Reducing future fiscal flexibility*<sup>63</sup>

Assigning a future stream of revenue to service collateralised debt amounts to an earmarking operation and reduces future fiscal flexibility. By limiting the resources under the control of the budget, earmarking constrains the budget's ability to adjust to changing priorities and circumstances. In the model presented of collateralised borrowing, a particular concern (in addition to the problem of an inflexible debt service schedule) is that the related escrow accounts can lock in cash that would otherwise be available to the government. These idle cash balances represent an inefficient use of resources because they could be used for other purposes, for example, reducing short-term borrowing costs. The government could find itself in the position of building up cash balances in the SPV, while simultaneously borrowing at high interest rates or running arrears. Further, the government ability to alter the amount of the fuel levy (e.g. to reduce the amount paid as fuel levy by the consumers of petroleum products) is constrained since it is used as collateral.

#### **4.5.0. Conclusions**

RMLF is used as the model that Kenya would easily be able to improve on to increase on the funding for the maintenance rehabilitation and development of the country's infrastructure. The Kenyan RMLF was chosen because Kenya is a country in the sub-Saharan Africa region and experiences the same problems that many other sub-Saharan Africa countries do.

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63 IMF (49).

Though Kenya is able to raise money for road maintenance, rehabilitation and development through a tax on petroleum fuels and transit tolls from transit traffic, the money has often been too little to provide for the huge demand. The Chapter highlights the need for securitisation to monetise future receivables for current expenditure on infrastructure.



## **Conclusions and Recommendations**

This study started by showing the importance of transport infrastructure in trade facilitation development, and as a means of attracting FDI. It went further to concur with the argument put forward by the World Bank:<sup>1</sup> that overall cost of trade is not all about quotas and other trade policies, but also customs procedures, trade distorting impact of standards, and *transport costs* (own emphasis). The World Bank's study is specifically important in its assertion that improving custom procedures, minimizing trade distorting standards and reducing *transport costs* (own emphasis) may have a higher payoff because logistical, institutional and regulatory barriers are often costly and generate no offsetting revenue.<sup>2</sup> This study is hinged on the argument that good transport infrastructure substantially reduces the cost of doing business and increases the competitiveness of a country's products, and the country as a destination for FDI (see Chapter 1).<sup>3</sup>

However, the study would also want to dispel the notion that transport infrastructure is the sole factor that propels development, facilitates the inward flow of FDI, and reduces in the cost of doing business in a country. Though the study underscores transport infrastructure as an underlying factor in development, we would like to assert that investment in transport infrastructure:

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1 World Bank, *Global economic prospects: Trade regionalism and development*, (2005).

2 See World Bank (n1) p 37.

3 See also D Grimsey, & MK Lewis, *Public private partnerships: The worldwide revolution in infrastructure provision and project finance* (2004) p 25. "... recent studies confirm a significant positive relationship between productivity and infrastructure and suggest that infrastructure may be a key determinant of comparative advantage between countries."

- I. Would only generate relocation of industries and economic activities in the long run. This occurs when firms decide to relocate because of change in accessibility brought about by transport infrastructure investment. However, relocation in the short run could be actuated by a significant change in transport cost, if the change is material.<sup>4</sup>
- II. Is not a continuous process and the investment is determined by specific needs. Therefore, at certain stages of economic development transport infrastructure may be a constraint on growth, but, once the constraint is dealt with, further investment does little to expand productive capacity.<sup>5</sup>

This study also makes an observation that the main problem with the maintenance and development of infrastructure in sub-Saharan Africa is a lack of funds. The International Ministerial Conference on Transit Transport Cooperation<sup>6</sup> also highlighted the lack of funds as the major impediment of the developing countries' infrastructure matching that of the developed countries. Therefore, the study not only interrogated the benefits of infrastructure, but, also how legal and institutional frameworks determine access to capital for these countries to develop their infrastructure.

Chapter 2 looked at the various sources of capital that are available to developing countries. It was noted that many developing countries, particularly in sub-Saharan Africa, rely on official development assistance (ODA), thereby exposing themselves to policy and priority changes by donor countries. Similarly, concessional funds from the International Development Association (IDA) are exposed to the

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4 See D Grimsey, & MK Lewis (n3) p 26.

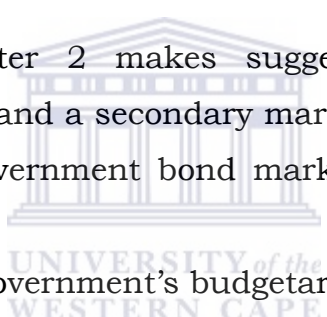
5 *Ibid.*

6 International Ministerial Conference on Transit Transport Cooperation, Roundtable on Trade Facilitation Measures Almaty, Kazakhstan, (2003).

developed countries' policies and priorities, since the developed countries' contribution to IDA's replenishment comprises over 50 per cent of the IDA kitty.<sup>7</sup>

On the other hand many countries in the sub-Saharan Africa region are not eligible to borrow from the International Bank for Reconstruction and Development (IBRD) because they do not meet the threshold for borrowing from it by virtue of their lack of creditworthiness, and since their gross national income (GNI) per capita is less than that required to borrow from the IBRD. Similarly, their participation in commercial banks lending and international capital markets is characterised by short maturities and high interest rates.

In its conclusion Chapter 2 makes suggestions for developing a government bond market and a secondary market for government bonds. It is envisaged that a government bond market, if it is well managed, would:

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- VIII. Provide funding for government's budgetary deficits;
  - IX. Reduce need for foreign currency financing which is potentially damaging, and avoid build-ups of foreign currency denominated debts;
  - X. Strengthen the transmission and implementation of monetary policy, including the monetary targets or inflation objectives, through the open market operation (OMO);
  - XI. Coupled with prudent debt management, could help governments reduce their exposure to interest rate, currency and other financial risks;

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<sup>7</sup> Donors who are mostly the wealthy members of IDA, contribute most of the funds, e.g. donor contributions accounted for more than half of the US\$33 billion in the IDA14 replenishment. See <http://siteresources.worldbank.org/IDA/Resources/Updaterecentdevelopments.pdf> (accessed on 28/03/2007).

- XII. In the long term it would reduce the debt service cost, if based on market forces;
- XIII. Help change the financial system from a primary bank-oriented to a multilayered system, where capital markets can complement bank financing – also creating competition for banks, and therefore the introduction of new products at competitive prices;
- XIV. Support the development of bond markets for the sub-national and corporate sectors. The relatively risk free assets provided by government bonds establish a reference for pricing sub-national and corporate bonds, commercial papers or any kind of private sector fixed income securities.

However, the sub-Saharan African countries must establish a proper regulatory legal framework and a market infrastructure that favours development of a government bonds market. In this regard, the government must be able and willing to protect and enforce property rights, encourage wider participation in the market through appropriate reform programs, licensing, regulations and supervision, and further broaden and diversify the investor base by opening the market to foreign investors.

Chapter 3 looked at how a government can encourage wider participation of the private sector in infrastructure development and maintenance through public private partnership (PPP). In that chapter it was observed that private capital is risk sensitive, particularly with regard to infrastructure projects, which have long build-out and pay-back periods. The study appreciates that risk can not be completely eliminated; therefore the objective should be, to share risk between the government and the private entities to achieve value for money by the government.

In achieving value for money the government must ensure that the risk transferred to the private entity is not optimal, but appropriate in a way that the best placed party to bear the risk should bear the risk at minimum cost. The chapter also proposes other methods which could be used to mitigate some of the risks which cannot be well priced by the market. These include: government guarantees, multilateral development bank guarantees, and the multilateral investment guarantee agency (MIGA) insurance.

The benefits flowing from proper risk allocation and mitigation by way of guarantees and insurance would include:

- IV. By covering risk that the market cannot assume, the guarantee/ insurance can facilitate access to financing that would not otherwise be available for certain projects, thus making them possible.
- V. The guarantees/ insurance can extend the maturity of loans for a longer loan period that would otherwise not be possible without the guarantee, thereby allowing for a lower unit cost of output over the life of the project.
- VI. The guarantees/ insurance provide borrowers (public and private) with greater flexibility in choosing the most appropriate financing sources (currencies, markets, interest rates benchmarks etc.) for their needs.

Similarly, the private sector is very wary of disputes, particularly if the disputes are not likely to be fairly determined or the system is so inefficient as to cause unwarranted delay. The study looked at corruption as one of the hindrances in sub-Saharan Africa to fair adjudication of disputes, and inefficiencies in the court process. It further proposed alternative dispute resolution methods, such as arbitration, in which parties have more faith. In this regard, countries in the sub-Saharan Africa region would need to enact laws that govern recognition and

enforcement of the agreement to arbitrate, and the recognition and enforcement of the awards of the arbitral tribunal. For wider recognition and enforcement of arbitral awards countries in sub-Saharan Africa should assent to international conventions, such as the New York Convention and the ICSID Convention.

Chapter 4 looked at innovative ways that could be used in financing road transport infrastructure, using the Kenyan Road Maintenance Levy Fund (RMLF) as the model. The Kenyan RMLF was chosen because Kenya is a country in the sub-Saharan Africa region and experiences the same problems that many other sub-Saharan Africa countries do. Though Kenya is able to raise money for road maintenance, rehabilitation and development through a tax on petroleum fuels and transit tolls from transit traffic, the money has often been too little to provide for the huge demand. The Chapter highlights the need for securitisation to monetise future receivables for current expenditure on infrastructure.

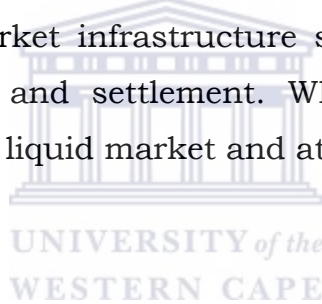
Overall the study's objective is to establish a relationship between legal and institutional frameworks in a country, and the competitiveness of that country as a destination for investment, either as real investment or portfolio investment, for infrastructure development. When investors feel secure because of the protection provided by the law, and that the rule of law would prevail, they tend to:

- I. Invest, because they have confidence in the particular market;
- II. Invest for a longer period, thereby prolonging the maturities in the loans and bonds, thus allowing for a lower unit cost of output in a project over the life of the borrowing; and
- III. Lower the risk premium, and therefore the cost of capital goes down.



Therefore, the sub-Saharan Africa governments should concentrate on improving or establishing the legal framework and institutions that would enhance investor confidence. Protecting investors is one of the very basic requirements that is a prerequisite to attracting investment. Protection should not only be in the statute books, but also in practice, thereby making the fight against corruption and other systemic inefficiencies a priority.

Institutions that favour the development of a government bond market should also be established where they do not exist and where they do they should be strengthened. Autonomy in regulation of the secondary market by the securities regulation commission/ authority is necessary to assure the investors that the government does not influence prices on its bonds. Secondary market infrastructure should also be efficient to enhance price discovery and settlement. When all these factors are combined, they produce a liquid market and attract investors.



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## Annex 1: Relevant Part of KRB Accounts 2002

### KENYA ROADS BOARD

INCOME & EXPENDITURE ACCOUNT FOR THE PERIOD  
ENDED 30TH JUNE 2002

	NOTE	ACTUAL (KSHS)	BUDGET (KSHS)
Road Maintenance Levy Fund Receipts	<b>2</b>	8,162,793,664.40	7,975,761,200.00
<b>INCOME</b>			
Fuel Levy Fund		114,009,639.00	241,772,836.00
Ministry of Local Government		19,761,197.05	
Interest Earned		3,497,159.40	
Sale of Tender		168,000.00	
		137,435,995.45	241,772,836.00
<b>EXPENDITURE</b>			

### NOTE 2:

#### Road Maintenance Levy Fund Disbursements

		ACTUAL (KSHS)	BUDGET (KSHS)
Receipts		8,162,793,664.40	7,975,761,200.00
Less: Refund Min. of Energy		(214,600,046.40)	
<b>NET RECEIPTS</b>		<b>7,948,193,618.00</b>	<b>7,975,761,200.00</b>
<b>Disbursements:</b>			
Kenya Roads Board		114,009,639.00	239,272,836.00
Ministry of Roads & Public Works		4,234,070,453.85	4,546,183,884.00
Ministry of Roads & Public Works	DRC	1,339,458,630.85	976,233,170.88
Ministry of Local Government	DRC	894,222,358.00	937,949,517.12
Constituencies		1,155,000,000.00	1,276,121,792.00
<b>TOTAL DISBURSEMENTS</b>		<b>7,736,761,081.70</b>	<b>7,975,761,200.00</b>
<b>BALANCE</b>		<b>211,432,536.30</b>	

The amount of Kshs 7,622,751,442.70 has been disbursed to Road Agencies which are Government Departments and which are subject to audit by the office of the Controller and Auditor General.

## **Annex 2: IBRD Negative Pledge Clause**

### **General Conditions for Loans**

#### **ARTICLE VI**

#### **Financial and Economic Data; Negative Pledge**

##### Section 6.02. *Negative Pledge*

(a) It is the policy of the Bank, in making loans to, or with the guarantee of, its members not to seek, in normal circumstances, special security from the member concerned but to ensure that no other External Debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such member. To that end, if any Lien is created on any Public Assets as security for any External Debt, which will or might result in a priority for the benefit of the creditor of such External Debt in the allocation, realization or distribution of foreign exchange, such Lien shall, unless the Bank shall otherwise agree, *ipso facto* and at no cost to the Bank, equally and ratably secure all Loan Payments, and the Member Country, in creating or permitting the creation of such Lien, shall make express provision to that effect; provided, however, that if for any constitutional or other legal reason such provision cannot be made with respect to any Lien created on assets of any of its political or administrative subdivisions, the Member Country shall promptly and at no cost to the Bank secure all Loan Payments by an equivalent Lien on other Public Assets satisfactory to the Bank.

(b) The Borrower which is not the Member Country undertakes that, except as the Bank shall otherwise agree:

- (i) if it creates any Lien on any of its assets as security for any debt, such Lien will equally and ratably secure the payment of all Loan Payments and in the creation of any such Lien express provision will be made to that effect, at no cost to the Bank; and
- (ii) if any statutory Lien is created on any of its assets as security for any debt, it shall grant at no cost to the Bank, an equivalent Lien satisfactory to the Bank to secure the payment of all Loan Payments.

(c) The provisions of paragraphs (a) and (b) of this Section shall not apply to: (i) any Lien created on property, at the time of purchase of such property, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; or (ii) any Lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.