Policy Brief 2

Capital Market Development in Sub-Saharan Africa

The ODI research series for financial development in Africa

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Key messages

Capital markets play an important complementary role for bank financing for mobilising large-scale and long-term finance.

Establishing a strong enabling environment including high quality regulation, market practices and financial infrastructure is the first step for developing capital markets.

Deepening the investor base through regulatory reform to widen the scope of investments for pension, insurance and mutual funds and to attract new investor classes is essential.

It is also important to bring equity and bonds to market that are tailored for new investors, including corporate and local currency bond markets as well as niche products such as green bonds.

Regionalisation of capital markets and the emergence of financial hubs in sub-Saharan Africa could further add to market momentum.

About this series

The ODI research series for financial development in Africa funded by FSD Africa

FSD Africa is a specialist development agency working to build and strengthen financial markets across sub-Saharan Africa. Its mission is to reduce poverty through a 'market systems development' approach addressing the structural, underlying causes of poverty by improving how financial market systems function.

As part of its work, FSD Africa invests in breakthrough research, analysis and intelligence-gathering projects to provide policy-makers, regulators, development actors, investors and financial service providers with vital market insights and information and that contributes to long-term change.

As part of this research, FSD Africa has partnered with ODI, the independent global development think-tank, to address policy issues in financial sector development in Africa. This includes a series of working papers by and for leading academics and an accompanying series of briefing papers focused on the policy implications of research targeted at policy-makers, regulators and the broader stakeholder community.

The research programme is accompanied by joint FSD Africa and ODI dissemination events in the region and internationally to present and debate the policy implications of the research findings.

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Acronyms

IFI	international financial institution

1 Introduction

Capital markets play an important complementary role for bank financing in economic development. They are particularly important for mobilising the large-scale and long-term finance needed for infrastructure and capital investments in the private sector.

Capital market development has progressed in sub-Saharan Africa over the past two decades and there are now 28 stock exchanges with listed equity and bonds, and more than $1 trillion has been raised.

However, exchanges in Africa are smaller than in other frontier markets. This is partly explained by non-financial constraints – most critically the need for scale and growth in the real economy as a prerequisite for capital market development.

It also relates to the need for high quality regulation, market practices and financial infrastructure to provide the groundwork for capital market development.

Some countries now have the fundamentals in place, but even among the leaders in capital market development, progress has been slow. The ‘critical mass’ in the issuer and investor base has not been achieved.

This briefing paper considers how to tackle these issues, highlighting the need for a sequential approach to capital market development. This means that policy should first focus on establishing the fundamentals for capital market development. This is discussed in Section 2.

Once these fundamentals are in place, policy can focus on deepening the investor and issuer base. Measures to support this are discussed in Sections 3 (investors) and 4 (issuers).

Section 5 concludes, discussing the potential gains from greater regionalisation of capital markets in sub-Saharan Africa.

More detailed discussion and the full academic evidence is included in the working papers referenced at the end of this briefing.

2 Establishing the fundamentals

Capital market development is dependent on a groundwork of a strong enabling environment including coordination mechanisms, strong regulatory and legal frameworks and adequate financial infrastructure. In sub-Saharan Africa, there has been good progress on building such frameworks, but there is much that still needs to be done, especially in low-income countries. Progress could be accelerated and strengthened by the measures discussed below.

Given most readers will be familiar with these basics, they are not detailed further. We refer the interested reader to the in-depth working papers in the FSD Africa–ODI series and the recent International Monetary Fund paper (2021) detailing sequencing and assessment frameworks.

2.1 National development programmes

Policymaking needs to take a holistic view of capital market development. One way to achieve this is to coordinate through a regional or national capital market programme that sets high-level policy goals and acts as an ‘umbrella’ to coordinate more detailed interventions across multiple stakeholders in the public and private sectors. Such programmes typically have very broad mandates and a formal role in coordinating the development of regulatory frameworks, establishing stock, bond and derivative exchanges, coordinating with private investors and enacting supportive legislation.

In Africa, most countries have established national programmes, typically within the central bank or capital markets authority. There are also regional authorities in the East African Community and the West African Economic and Monetary Union.

However, some are too constrained and insufficiently holistic – for example, lacking a mandate to coordinate across all stakeholders or facing restrictions relating to legislative reforms. Assessing these programmes to see if they could be strengthened would be useful.

2.2 Improving the listings process

A key gap in the current frameworks is that primary issuances are too large, costly and complex. The main problems are lengthy administrative procedures, unachievable conditions, high transaction costs and insufficient professional knowledge.

Reducing the complexity of listings and minimum sizes would be helpful. One possibility is an upper limit for fees. This has been effective in Mauritius.

Condition and processes also need to be simplified especially for smaller companies. This could be done by establishing less onerous 'alternative asset markets' for such companies.

Technical assistance from donors to identify and support first-time issuers is also useful and should be continued.

2.3 Leveraging technology

Technology has become an essential aspect of market infrastructure, including automated trading, clearing and settlement systems. It improves efficiency, integration and participation in markets.

Many stock exchanges across the Africa have introduced automated trading systems. This includes Botswana, Ghana, Kenya, Nigeria and South Africa.

These need to be extended to include end-to-end processing of trading, clearance and settlement.

3 Building the investor base

Capital market development is strongly correlated with the depth of the investor base. The investor base in sub-Saharan Africa is too thin. Per capita income limits domestic savings, but in middle-income countries there is considerable scope for increasing the investor base. Policies to accelerate this are discussed below.

3.1 Domestic institutional investors

African pension and insurance funds hold nearly a trillion dollars of assets. These are predominantly invested in government bonds, a limited selection of ‘blue chip’ corporate securities, and foreign assets. This is explained by regulatory and fiduciary restrictions and a lack of suitable alternative assets in domestic markets.

In some countries, regulations restrict investments to government bonds and forbid foreign securities. Reforms to reduce barriers to new asset classes should be a policy priority.

Care needs to be taken, however, to balance this against maintaining appropriately prudent risk profiles. This could include replacing limits on asset categories with regulations that set limits on credit risk (thus allowing corporate bonds to be included in portfolios) or introducing risk-based portfolio limits.

Such reforms have been successful in Asia and Latin America and have resulted in significant growth in domestic investment by institutional investors.

3.2 New investor classes

The investor landscape has become significantly more diversified. Investors with rising importance include specialists such as socially responsible investors, green investors, regional and international sovereign wealth funds and crowdfunding platforms.

These new investors’ asset preferences and investment horizons are compatible with the policy goals of the region. There should be a focus on attracting these investors into African capital markets.

A key policy goal should be building green bond markets. Some central banks have already made significant progress in establishing the regulatory frameworks for this including in Kenya and Nigeria. To date, however, only 16 green bonds have been issued in the region.

Sovereign wealth funds – including domestic funds such as Nigeria's and international ones such as those from the Middle East – have already made large-scale direct investments, most notably in infrastructure.

Finally, a significant success in the region has been mobilising funds from retail investors using crowdfunding and similar platforms. More than 60 crowdfunding platforms are operating in Africa with clusters in South Africa, Nigeria and Kenya. More than $250 million is being raised annually from these funds and they have proved to be a popular alternative to other savings methods for households. They have included both private and public-led initiatives (the latter, for example, includes M-Akiba in Kenya).

These innovations should be encouraged but need to be accompanied by safeguards to ensure that products are suitable and that customers are treated fairly and have adequate financial literacy to make the right choices.

Attracting all these investors requires an increase in suitable assets. This is discussed in the next section.

3.3 International investors

International investors will be important for building critical mass in capital markets. They could be especially important in relation to green finance because of the huge level of international interest in this asset class. Efforts should be made to attract further international investors into sub-Saharan Africa's capital markets.

However, this needs to be accompanied by careful management of cross-border capital flows and the risks of financial instability that they create.

One approach adopted by emerging markets elsewhere has been to only semi-liberalise capital markets to foreign investment. However, for countries with weaker economic fundamentals and scale, such polices can be a significant deterrent to foreign investors and suppress the development of foreign inflows. Nevertheless, current account management is seen as a key tool in managing foreign investment in capital markets to the benefit of host economies.

3.4 Regionalisation of markets

A further issue to consider is whether sub-Saharan Africa can gain from regionalization of capital markets. In Asia and Latin America, this has brought greater efficiency and liquidity to markets and increased access for smaller economies.

There are such initiatives in Africa being coordinated through existing regional organisations. These include the West African Capital

Markets Integration Council and the Economic Community of West African States. Goals include integrating through cross-listings, cross-border investment and integrated trading platforms. The 2018 African Continental Free Trade Area has also established free movement of capital, which can help with market development.

However, the initiatives are focused on sub-regional organisations whose mandates are usually constrained. A regional body with a broader mandate could lead, for example, greater harmonisation of platforms and regulation and benefit all countries in the region by accelerating mobilisation of finance to develop the 'real' economy.

4 Delivering new assets

A key constraint on capital market development in sub-Saharan Africa is the limited number and diversity of listed instruments. Domestic exchanges are dominated by government bonds, with few or no corporate bond markets and limited equity markets. This creates a ‘vicious circle’ whereby the lack of a suitable products limits demand from investors.

Tackling this by supporting greater numbers and more innovative primary issues tailored to the needs of key investor classes should be a key policy goal. This is discussed further below.

4.1 Corporate bond markets

More needs to be done to bring corporate issuers to market. There are a significant number of medium and larger corporates in the region suited to bond-issuing either on main markets for larger issuers or on alternative asset markets designed for smaller companies.

Successful approaches to date have included donors acting as anchor investors and providing technical assistance for new issuers. This should be scaled further and diversified to include private sector development. However, more needs to be done to replicate strong demonstration transactions.

There should also be donor-sponsored preparation funds for companies to help them meet standards necessary for public listings (such as governance and reporting standards). Such technical assistance funding for first-time issuers translates into lower transaction costs for follow-on transactions.

4.2 Green bond markets

Initiatives in the region to develop green bond markets have included strengthening legal and regulatory frameworks through national green bond programmes in Morocco, South Africa, Nigeria and Kenya.

These have introduced clear guidelines and governance for green bonds, including independent certification and monitoring of proceeds, issuing benchmark sovereign green bonds and developing securitisation vehicles.

These are all welcome and important initiatives. However, only 16 bond issuances have been issued across the region, representing only 0.3% of total green bond issuances by value.

International financial institutions (IFIs) have significant levels of ‘market ready’ green assets on their balance sheets, including green infrastructure assets. IFIs could use these as the underlying assets for green bonds or securitisations in domestic markets with credible green finance frameworks.

Further, although IFIs have mobilised significant finance globally for green infrastructure through innovative funds and blended finance, there proportion that has gone to sub-Saharan Africa is minimal. IFIs need to include a greater allocation to the region and especially its low-income countries and sectors that otherwise face large financing gaps (such as employment-intensive manufacturing and agriculture).

Key further paper in the FSD Africa–ODI series: Tyson, J. (2021) Green bonds in sub-Saharan Africa. See references

4.3 Local currency bonds

Another key focus should be the development of local currency bond markets. Policy has already made headway to support primary bond issuances with co-financing by private investors. For example, development finance institutions are acting as anchor investors and providing targeted technical assistance for issuing private sector local currency bonds.

The African Development Bank has issued the world’s first multi-jurisdictional, fixed-income exchange traded fund to invest in local currency government and quasi-government bonds in African countries.

The goal of such instruments is to provide demonstration effects and indirectly stimulate market deepening, but there is currently limited evidence of such effects to date.

Nevertheless, such initiatives should be continued and expanded in conjunction with improvements in impact measurement.

4.4 Private equity ‘exits’

Private equity funds have been active in Africa, with more than 1,400 deals since 2013 and more than $4 billion invested as of 2020. The top markets in the region are Nigeria, Ghana, Kenya, Uganda and Tanzania.

However, private equity funds find it is difficult to exit assets via capital markets (as they would do in advanced economies) and instead use private transactions.

This means that there is an opportunity to encourage exits by private equity funds via capital markets, including primary equity. Policy support from capital market authorities and development partners should strategise around how to realise this opportunity.

4.5 Product incubators

Capital markets in the region are dominated by vanilla bonds and equities. More sophisticated and diverse securities and derivatives would help accelerate market deepening.

A key area in this regard is securitisations. These have the potential to provide diversified assets and risk-pooling that can attract a wider investor base, including institutional investors and retail investors.

Further, they have the potential to act as aggregators and risk diversifiers in sectors such as agriculture, where financing is scarce and granular and where concentration of risk in single 'names' is a significant deterrent to investors. There has been some donor support for small-scale incubators to develop securitisation in the region and these efforts should be continued and scaled.

A further key area for product innovation is derivatives. Currently, there are limited derivative markets in the region despite their importance for liquidity and risk management.

One successful approach development finance institutions have used is to act as seed-funders of market-makers in derivatives. Expansion of such incubation and scaling of successful models for new classes of derivatives, such as interest rate and credit derivatives, would be an important initiative to support capital market deepening.

5 Concluding remarks

Capital markets are an essential complement to banking systems but developing them relies on a strong enabling environment. In several middle-income countries in the region, this has effectively been achieved.

For such countries, policy support needs to turn to deepening the investor base by identifying key investor classes and developing products to meet their needs.

As well as domestic investors, institutional funds, crowdfunding and international private investors, this should include emerging investor classes such as green and socially responsible investors and sovereign wealth funds.

Attracting such investors will require investment products including corporate bonds, local currency bonds, derivatives and securitisations.

This will tackle both the demand and supply constraints and contribute to increasing critical mass in primary and secondary capital markets.

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Further reading

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