



Ministerial Conference on the Financial Crisis

BRIEFING NOTE: 3

The Current Financial Crisis: Implications for Private Sector Operations

**Ramada Plaza Hotel, Tunis, Tunisia
November 12, 2008**

1. INTRODUCTION

1.1 The global financial crisis, which began almost 2 years ago as a localized problem in the US sub-prime residential markets, has now spread into a global financial disaster. Even though Africa and the African Development Bank look better positioned to “weather the storm” than many markets and institutions, it is clear that no financial institution or business will be entirely spared the effects of the crisis.

1.2 As the spillover from the crisis begins to trickle down into Africa, the ADB and other Development Finance Institutions are preparing to play a “counter-cyclical” role to provide credit in areas where commercial players have retreated. Nevertheless, the Bank and other DFIs are bound to follow prudential banking standards or risk putting their own survival into question. Given the enormous needs, how can our institutions responsibly respond?

1.3 This short note accompanies a presentation on the same subject. The purpose is twofold: first, to provide a quick analysis of the early signals of the effects of the financial crisis on private sector operations in Africa, and second, to open a discussion on what the Bank’s private sector operations might do to reduce the impact of the crisis so that Africa’s private sector can avoid losing too much of the growth momentum that has been built up over the past decade.

1.4 The note is organized into two sections. The first section briefly analyzes how the global financial crisis appears to be affecting the private sector in Africa. Although it is too early for a rigorous analysis of these impacts, early anecdotal evidence points to several reasonable conclusions. The second section presents some initial reactions to the crisis and how the Bank and other DFIs that are active in private sector operations might respond.

2. IMPACT OF THE CRISIS ON AFRICA’S PRIVATE SECTOR

2.1 The global financial crisis will eventually affect both “Wall Street” and “Main Street”. In the short-term, however, the immediate impact has been most strongly felt by the financial sector including short-term credit such as trade finance.

2.2 *International Banks* International banks that had been active in Africa are either fully or partially retreating as they attempt to protect themselves against collapse in their home markets. The depth and breadth of the financial crisis has called into question virtually all assumptions about market disruptions and the ability of even the largest financial institutions to have access to a steady supply of credit. Recently we have even seen a number of large and creditworthy project finance transactions in middle income countries that had presumably reached “financial close”, looking for additional financing. Transactions, including trade finance, that are going ahead are facing a substantial “re-pricing of risk”.

2.3 *Private Equity* International and domestic private equity investors are bringing a record number of new Africa-focused funds to market. Although the crisis will

undoubtedly lead to a more cautious attitude, many players see excellent value developing in the market given the recent decline in stock prices.

2.4 African Banks The initial assessment is that most African banks and other financial institutions including the insurance industry are in reasonable shape compared to their international counterparts. Although they have benefited from a lack of integration in the global economy, there are still concerns about possible unseen losses local stock markets or on foreign exchange exposures caused by the sharp devaluations of emerging market currencies. With an economic slowdown looming non-performing assets are bound to rise and although deposit bases seem solid for now, long-term funding is at a premium. Even the most creditworthy banks have approached DFIs like the ADB for term financing.

2.5 Subregional DFIs The picture for Africa's subregional DFIs is mixed. The larger players enter the crisis with solid balance sheets (well capitalized and liquid) and limited currency mismatches. However, the smaller DFIs have limited funding flexibility, foreign exchange exposures and portfolios that are exposed to weakness in the SME sectors. Although these DFIs regularly come to the ADB for debt financing, several have recently undertaken recapitalization exercises to strengthen their balance sheets.

2.6 Infrastructure The impact of the crisis on the financial sector is also being transmitted quickly down into the real sectors. Although demand for basic infrastructure services remains strong in sectors such as power, logistics and telecommunications, many projects are being squeezed for lack of funding. For those fully private or public-private projects that are able to secure credit, rising financing costs will stress affordability at a time when consumers are likely to be cautious. On the positive side, however, construction costs will level off or decline and lower fuel costs will help many projects.

2.7 Resource Industries Many resource-based projects will go into "hibernation mode" in response to the sudden decline of commodity prices. However, since many African projects will be "low cost producers" their underlying economics remains strong.

2.8 Tourism and Manufacturing Sectors that are likely to be most affected in the short-term are those that depend on immediate international demand. An initial scan suggests that tourism and manufacturing may be affected first although this could be offset by more competitive pricing following currency devaluations. Insufficient trade finance will also affect both exporters and importers.

2.9 ADB and DFIs The expected overall effect of the credit crisis is a general contraction of private sector activity. No sector will be spared and the weak may not survive. The ADB and other DFIs have witnessed a sudden surge in demand for financing from both the financial and real sectors to fill the void created by the market withdrawal of the international commercial banks. However, the DFIs are unlikely to be able to compensate for even a fraction of the missing commercial financing and this will undoubtedly lead to some tough choices about which projects to finance.

3. POSSIBLE RESPONSES FROM THE ADB

3.1 Given the sudden absence of international commercial financing on the Continent, the DFIs will be called upon to play a counter-cyclical role to fill at least part of the gap. This is a role that DFIs operating in other parts of the developing world have played during previous crises in Asia, Russia, and Latin America. It would be the first time, however, for the African Development Bank.

3.2 The ADB finds itself in entering this crisis in arguably the strongest financial condition of its existence. The sovereign portfolio has benefited from a more prudent credit policy, arrears clearance for post conflict countries and debt relief for the most indebted countries. The non-sovereign portfolio is growing but appears to be well positioned to withstand a downturn. The Bank is well capitalized and its risk management systems have been sharpened over the past decade. Nevertheless, funding costs have fluctuated sharply and even for AAA rated institutions the depth and breath of supply of long term credit is questionable.

3.3 **Financial Prudence** These strengths notwithstanding, as the Bank responds to the call to play a counter-cyclical role it must avoid the natural temptation to “go beyond its means”. Although the Bank can support a short term surge in demand, it must carefully assess its capacity to respond by establishing clear limits for how much additional credit it will provide given the Bank’s risk capital base, how quickly this credit can be provided given funding constraints, and for how long can the Bank continue to run “over-capacity” without putting its own financial health at risk? The need for a DFI “bailout” must be carefully avoided.

3.4 **Portfolio Management** Despite the health of its current portfolio, inevitably there will be casualties as Africa’s economies slow. Although the fundamental economics of most projects should remain solid, many projects will face cash flow constraints that will be exacerbated by restricted credit. To avoid unnecessary project collapses, the Bank will intensify its portfolio oversight and prepare for rapid and flexible “workouts” for clients in distress.

3.5 **Selectivity** The surge in demand for financing from the private sector windows of the DFIs will impose a new degree of selectivity in order to adequately balance responsiveness and financial prudence. Institutions such as the ADB should focus on sectors that combine: i) strong development relevance (i.e. are critical to maintaining momentum in long-term economic growth), and ii) defensive features that will provide a degree of protection to the Bank as it enters this economic downturn.

3.6 An initial scan of sectors with these characteristics suggests that the Bank’s current infrastructure-centric strategy remains highly relevant. Demand for essential economic infrastructure such as power, logistics and telecommunications will remain far above current supply even under a downturn scenario. The Bank’s strategy to support African growth through financial institutions also remains highly relevant as evidenced by the recent surge in demand. The Bank will focus on financial institutions that play a central role in providing credit (long-term and trade finance) for Africa and which will

benefit from strong national support. The Bank will continue to support large scale extraction and refining operations with strong sponsors and a long-term outlook. The Bank will be cautious of taking excessive direct SME credit exposures.

3.7 Collaboration The surge in demand will place a large burden on DFIs from a financing perspective. It will also stretch the processing capacities of DFIs, whose staff numbers are relatively inelastic. This will put a premium on processing efficiency, which in turn will increase the importance of intensified DFI collaboration to avoid wastage and duplication. Collaborative platforms such as the African Financing Partners will be critical for maximizing the response capacity of the DFIs. Other instruments such as the IFC's proposed fund for financial institutions also make sense in an environment where prudence and speed is simultaneously needed.

4. CONCLUSIONS

4.1 Although the global financial crisis has yet to be fully felt on the Continent, its early effects are already evident in most parts of Africa's private sector. The brunt of the crisis has been initially taken by the financial sector, where international credit has virtually dried up, but the effects on "Main Street" are also emerging.

4.2 The ADB and other DFIs have a role to play to at least partially offset the sudden shortage of credit on the Continent. However, as a financial institution with capacity limits, the Bank must rise to the occasion while applying prudent banking practices. The need for a DFI "bailout" must be absolutely avoided.

4.3 While the Bank's current private sector operations' strategies appear to be broadly suitable for an increased role during the crisis, some fine-tuning of its strategies is justified. Initially, the Bank must establish new risk limits balancing its expanded role and its financial soundness. It must intensify portfolio management and be prepared for an inevitable increase in workouts and to deal with them flexibly and responsively. It must exercise a new degree of selectivity for new operations focusing on projects that combine strong development relevance and some degree of protection for the institution. Finally, increased demand will place pressure on the processing capacities of all DFI. This will increase the importance of intensified collaboration using platforms such as the African Financing Partnership.