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UN-HABITAT

Financing institutions in Africa

Today, roughly one out of six inhabitants of large and small cities lives in slums. But by assuming that city life necessarily equates with improved lives, the world has, thus far, found it relatively easy to ignore the woefully inadequate living conditions implied in this statistic. But this has not been the case.

In the face of such demand for housing and shelter, many developing countries around the world continue to face deficits in public budgets and weak financial sectors. The global funding and assistance provided barely allows for the delivery of service and international financial assistance to poor countries is clearly not meeting the current demand for housing finance.

The situation is compounded by the fact that many countries are suffering from a legacy of external borrowing. Some countries in Africa have a debt service to GDP ratio as high as 400 per cent. Developing countries also suffer from a lack of domestic savings within the national economies, with African countries only managing to have a savings rate of about 14 per cent as opposed to 21 per cent in Europe and 35 per cent in South East Asia.

The combination of structural adjustment, rapid urbanization, weak municipal planning and services, and a distinct slum economy has created conditions for radical changes in the formal private sector – and hence, a new source of finance for housing and urban infrastructure. The banking sector and private utility companies are two important examples of finance. The flip side of structural adjustment has been that banks have grown in number with the advent of market liberalization, privatization and related financial sector reforms.

While many banks have confined lending to traditional, higher-income markets, others have diversified lending to reach rapidly growing urban populations, building upon precedents set in slums by entrepreneurs and urban poor organizations. Innovation of this kind has been accelerated by competition among banks for traditional, higher-income markets, the lucrative business of micro-finance, and downward pressure on interest rates. Primary mortgage institutions have also emerged especially in countries with established domestic capital markets that can subscribe to debt instruments as a source of long-term financing so essential for housing finance.

The formal financial institutions do not make a profit out of low income households, which in turn do not have the collateral required to get a loan. Thus, a majority of low-income households finance their shelter investments through their own savings or informal credit from various sources (relatives, friends, money lenders). The realisation that hundreds of millions of low-income urban households remain largely excluded from borrowing, has led to the exploration of innovative finance mechanisms. In particular, shelter microfinance and community funds have grown considerably in recent decades, through multiple explorations and innovations.

Shelter microfinance programmes provide small-scale lending to individuals for housing investments (constructions, improvements and extensions). Community funds are provided by institutions to groups or community organizations for collective housing construction or development of land, infrastructure or services.

Both approaches are better designed to help poor urban households to address their shelter needs because they involve small-scale lending which is suitable for incremental shelter investment strategies common among low-income households.

Furthermore, shelter microfinance loan interest rates are generally lower than those for enterprise loans whilst community fund interest rates are often subsidized. They also have flexible collateral or underwriting requirements that are within reach for low-income households.

Group borrowing mechanisms characteristic of community fund approaches are particularly effective in targeting low-income households.

There is also a growing trend of combining loan provision through shelter microfinance and community fund programmes with more comprehensive neighborhood improvement and poverty reduction initiatives such as settlement upgrading infrastructure and services), land development and enterprise lending. Community funds are particularly appropriate for slum upgrading as well as infrastructure development as these are unaffordable for the poor as individualised developments and can only be undertaken with groups.

However, in their efforts to target low-income households, both approaches are faced with two particular challenges. The first involves the risk of excluding the poorest households from being able to get loans.

Shelter microfinance programmes often target the higher income urban poor such as those with formal employment or diversified livelihood strategies. The requirement for secure tenure to access shelter microfinance in some cases may further define the client group as being the 'not so poor'. In the case of community fund mechanisms, the poorest households, most of which rely on daily savings, may not be able to contribute towards group or community savings, thereby facing exclusion.

Tenants without secure tenure rights and women are also at risk of being denied loans through community funds. Moreover, community funds require relatively stable communities that may not be the case for the poorest neighbourhoods of many urban areas.

Institutions involved shelter microfinance, for their part, also have difficulty in securing sufficient loan capital, thereby curbing their outreach. Longer loan repayment terms create greater term risk for shelter microfinance providers. Shelter microfinance agencies also find it difficult to set low interest rates and small loan sizes that weigh the borrower's demands against their own financial needs. Similarly, community fund programmes often struggle to secure subsidies from state funds, NGOs and international development agencies, without which they are unable to maintain low interest rates.

Despite all of this, shelter microfinance and community funds strategies continue to flourish and more agencies are becoming involved, including municipal and central government agencies as well as private sector agencies not previously involved in such activities. This is particularly so in light of growing urban poverty and the suitability of these two approaches to target low-income households.

There is an urgent need to increase the scale of operations of shelter microfinance and community fund operations. Scale and sustainability can be realised through concerted efforts of financial institutions, governments and donors. It is particularly important that governments encourage the expansion of microfinance and community fund lending for shelter investments by creating the necessary legal and regulatory environment.

Though, financial assistance from the World Bank and bilateral donors has been key to slum improvement, there is the need for creation of innovative financial institutions and instruments to provide access to capital markets – with the International Finance Corporation, (IFC), the United States Agency for International Development (USAID), the Emerging Africa Infrastructure Development Fund, UN-HABITAT, among others in the forefront in efforts to develop and attract multiple forms of financing for slum upgrade programmes.

Successful models have demonstrated that when supported by local and central governments, local residents can provide about 80% of resources required for slum upgrades, what is needed is Public sector borrowing to fund slum upgrades and support for slum dwellers savings associations and credit schemes.

BUILDING AFRICA'S DEVELOPMENT BANK:

- *Africa's historical low growth* has simply not been enough to make a real dent in the continent's widespread poverty, especially over the past quarter-century. Africa's GDP per capita in real terms is today about the same as it was in 1980; for Sub-Saharan Africa it is about 10% lower. Although rates have recently accelerated—more than 20 economies had growth above 5% in 2005—growth will have to be raised and sustained if African countries are to have any chance of reaching middle-income status within the next generation or two.

- *Africa has mostly missed the globalization boom*, with large swathes of the continent untouched by the expansion in world trade and investment. Africa's share of global trade, for example, has dwindled from an already low 5% in the 1960s to less than half that level today. There are some bright spots, such as expansion in private interest in African banking and telecommunications, but for the most part, the business climate in Africa remains inhospitable and countries lack the linkages to the global economy.
- *Africa faces a crowded aid field* where official aid has doubled since 2000 reaching $29 billion in 2004, with pledges by the G8 and other donors for substantial increases again in the near future. Even with these large flows, assistance is highly fragmented with the average country in Africa receiving aid from 30 or more official donors, plus hundreds of non-governmental actors. In addition, aid has been increasingly concentrated in particular areas, especially social services delivery.

INFRASTRUCTURE INCLUDES TRANSPORT, WATER AND ENERGY

- *Regional integration efforts have mostly failed*, resulting in a continent with many small segmented economies and few markets of any real size. Out of the 53 economies on the continent, only six have GDPs of more than $20 billion (about the size of Lithuania) and nearly half of the economies are less than $4 billion.

1. Make economic growth the defining objective of the Bank

Africa's development agenda is both wide and deep, but nothing else will matter unless the continent finds a way to grow rapidly, grow equitably, and grow sustainably. The Bank must therefore focus the bulk of its resources on helping to generate greater economic activity. Establishing growth as the AfDB's overarching goal implies that the Bank will have to work to:

- *Promote private sector development*. Unleashing Africa's entrepreneurial energy is a necessary precondition for long-term economic progress. Private economic activity—and only private economic activity—can provide future employment and the ongoing tax revenues needed to support investments in social services.
- *Help to connect Africa's markets*. Given the continent's relatively small markets, Africa's future economic growth will depend on linking its internal markets as well as connecting to the global economy. There are three parts to this connectivity challenge.

First, poverty will be reduced only if the poor are tied into national markets, especially rural and agricultural producers with urban consumers. Second, the continent's fragmented national economies must be integrated in order to reduce transaction costs to intraregional trade and investment and to create markets of sufficient size to promote efficiency and attract external investors. Third, African economies can and must be linked to global markets.

- *Improve governance*. More transparent and accountable interactions between the government and other actors and containing corruption are necessary if Africa is to put itself on a sustainable path to prosperity.

2. Specialize in one sector that matters to growth:

Infrastructure

A fundamental precondition for the Bank's rebound is that it prove its ability to be a serious player among Africa's donors. Given current human resources, the Working Group believes that to do this it must focus—at least initially—narrowly on its operational activities. The Working Group recommends that the AfDB concentrate, over the course of the next 3-5 years, exclusively on infrastructure—especially on transportation, electricity, and water infrastructure deficits that can be shown to be key constraints to private sector development. The Working Group was clear that it was not arguing that the AfDB become solely an infrastructure bank, but rather that the next step along the road to full recovery must be to demonstrate operational competency in one area critical to Africa's development.

Infrastructure was selected as the focus because it is a sector:

- *Of relative internal strength*. The AfDB already has substantial experience in infrastructure (representing nearly 40% of new project approvals) and it has built a relatively positive reputation in this sector.

- *Relevant for clients in both lending windows*. Infrastructure investment and expertise is in strong demand by the entire spectrum of AfDB borrowers, allowing the Bank Group to build capacity that can be used by both the hard and soft windows. This is not only a more efficient use of limited staff and capital, but it also helps to ensure that the Bank remains relevant, especially to its North African borrowers.
- *Where the Bank has an existing mandate*. The AfDB has already been given responsibility for managing infrastructure investment and promotion by the New Partnership for Africa's Economic Development (NEPAD) and a special coordinating role by the Infrastructure Consortium for Africa launched in late 2005.
- *That can serve many needs*. Addressing infrastructure needs and investment is one constructive way to approach the three areas of the growth agenda defined above.
- Recent evidence suggests that the cost and reliability of transport and energy are major barriers to private sector competitiveness in Africa.
- Infrastructure investment is an essential means to connecting the poor to markets, to promoting regional integration, and to fostering the flow of goods and services. Multi-country roads and electricity grids in particular are seen as critical to enhancing cross-border trade and more efficient energy distribution.
- Infrastructure governance is an important part of the broader governance agenda, and an area in need of major improvement. If the AfDB could help upgrade selection, tendering, procurement, construction, and management of infrastructure, it would make a valuable contribution toward Africa's fight to reduce corruption and demonstrate its ability to improve governance.
- Many other critical challenges for Africa, such as social sector targets embodied in the Millennium Development Goals, have significant infrastructure components. While designating infrastructure as the primary area of specialization is in some ways a natural progression of the Bank's current approach, it is not without major challenges. Success will depend on enhancing expertise and capacity in a range of activities, from project preparation and feasibility studies to investment of the Bank's own capital and encouraging participation of private partners.

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