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Corporate Risk Management: Challenges in sub-Saharan Africa

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Currency risk is a topic of much debate in this region.

Although sub-Saharan Africa has witnessed a substantial improvement in informational efficiency, economic growth and, in some instances, political stability, managing financial risks for corporates on the continent still remains a high priority. Despite attempts to formalise and improve the local equity, interest rate and currency markets, progress is often slow in this region and is further hindered by legal, regulatory and other market factors. Illiquidity in these markets is exacerbated by the fact that banks are not willing to warehouse substantial illiquid risks, and there are almost no secondary markets to lay these off. Multinational corporations (MNCs) looking to expand their footprint in sub-Saharan Africa will face typical financial risk management and hedging constraints, as well as atypical operational and administrative risks. In addition, in this environment, skilled resources are most often scarce and expensive. Currency risk, in particular, is a topic of much debate in this region, especially since Africa has managed to attract an increasing amount of foreign direct investment (FDI), while FDI has been declining worldwide. It has been suggested that equity markets encourage and stimulate economic growth by attracting foreign investment that, in turn, creates liquidity. Currently there are 29 formal stock markets in Africa, but unlike South African financial markets, the majority of African countries' markets are in their infancy, are illiquid and have little or no market depth. Stock markets in Nigeria, Botswana and Zambia can be considered relatively liquid, in comparison to other African countries, with instruments exhibiting tenors of at least one year and occasionally longer. Ghana, Kenya and Uganda have operational but less liquid markets. Derivatives in these regions are therefore scarce or non-existent.

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Risk mitigation hurdles

Given that the African countries and markets are under-developed, local corporates and MNCs face risk mitigation hurdles that are not present in the developed world. Operational, administrative and infrastructural inefficiencies can impede corporates in various ways. For instance, some financial markets require the physical delivery of documentation when money is moved between banks. Some banks do not offer Internet banking; and, consequently, to obtain a bank statement, one has to be physically present at a branch of the bank. Other cash-based markets (predominantly West African countries) indirectly impose additional costs for the security involved in the transportation of cash (for example in the fast-moving consumer industry). Cash management plays an important role for MNCs internationally; however, operating in African countries exhibits added difficulties. For example, in some African countries there are large gaps between borrowing and lending rates, which can result in significant costs for businesses and influence how they manage a surplus or shortage of funds. The focus for sub-Saharan African corporates is on the ability to obtain local or foreign funding and the management of currency risk, which arises from a mismatch in the currency denomination of the assets, liabilities, income and expenses. This is especially relevant for MNCs with subsidiaries in sub-Saharan Africa, or those that are considering entering these markets. Raising significant funding in the majority of these countries is a challenge, and the corporate bond markets tend to be limited and highly illiquid, due to the non-existence of formal secondary markets. Corporates in this region have two options – either to borrow in local currency where possible or to borrow in foreign currency (e.g. USD or EUR) – and each of these options has its own set of difficulties. Significant amounts of local debt can be relatively expensive and, in many cases, cannot be hedged in local currency, due to a lack of derivative instruments, while borrowing in foreign currency (e.g. USD or EUR) opens the door for currency risk exposure. Exchange controls and a lack of liquidity are the main impediments to effective cash and currency risk management. They are by no means independent of one another, and regulation can very often drive hedging activities, thereby increasing liquidity in the local markets. For example, in June 2012 the Zambian government banned the use of foreign currencies, including the US dollar, in business transactions, to force market participants to borrow and trade in the local currency.

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The impact of exchange controls and regulatory regimes

Foreign exchange regulations pose a significant problem for businesses in sub-Saharan Africa, which emanates from the various exchange control regimes and which hampers the flow of currency across African borders. South Africa, Malawi, Ethiopia, Mozambique, Namibia, Swaziland and Lesotho are examples of sub-Saharan African countries that have exchange control requirements in place; some of these more restrictive than others. As a result, centralised treasury management under these regimes is particularly difficult in terms of investing and borrowing abroad, as well as effectively managing currency risk. Historically, many South African MNCs registered companies in Mauritius in order to create a centralised treasury in a relaxed exchange control regulatory environment, which allowed for more liberal capital flow. This practice allowed these companies to overcome an obstacle which restricted the free flow of funds in highly regulated exchange control regimes. South Africa's exchange control regulations have recently been relaxed somewhat and now provide listed South African MNCs with the opportunity to register a subsidiary as a non-resident company to provide for more liberal movement of currency without the usual restrictions. South African exchange controls now also allow for hedging of exposures of less than six months without approval (hedges with a term greater than six months still require approval from authorised dealers). Exchange controls add an additional level of complexity and often restrict the way in which risk and cash are managed. For instance, in terms of South Africa's Exchange Control Regulation 6, any foreign currency held by South African MNCs in foreign bank accounts needs to be swept back to South Africa within 30 days, which complicates currency transaction risk and cash management.

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Lack of liquidity in the underlying markets

Local operations and revenues that are funded through the use of foreign debt are exposed to exchange rate gap risk and need to hedge accordingly. In order to address this gap risk, under ordinary circumstances, a corporate would look to vanilla, tradable instruments such as cross-currency swaps or forward exchange contracts (FECs) to manage or mitigate its risk. Market activity in most sub-Saharan countries, however, is very low and by no means comparable to the norm for developed countries. Hedging a local currency denominated loan using a local currency vanilla interest rate swap is not always possible, and where interest rate swaps do exist, they can often be very costly for trades with significant notional sizes. Similarly, wide bid-offer spreads make hedging of foreign exchange trades greater than one million USD increasingly expensive, which is the result of emerging market banks (and those that trade emerging market instruments) not being willing to hold illiquid instruments without adequate reward. In addition, to hedge themselves out, these banks in turn also have to incur significant costs. International emerging market banks are not necessarily directly responsible for exorbitant hedging costs for these types of instruments. They are required to incur a capital charge for counterparty credit risk in the form of a credit valuation adjustment (CVA), as per Basel III. US banks, in particular, are also restricted in speculative or proprietary trading in these markets due to the implementation of the Volcker rule post the 2007–2010 crisis, which is a further factor that impedes liquidity. Furthermore, International Swaps and Derivatives Association (ISDA) master agreements, which govern over-the-counter (OTC) derivatives in most countries (specifically with regard to counterparty credit risk and the netting of exposures in the event of a counterparty default), may not retain authority in some jurisdictions. These costs and impediments deter international banks from participating in African markets, which exacerbates illiquidity and increases instrument prices. While more attractive pricing for products is sometimes available from local banks, the drawback is that these banks often exhibit high counterparty credit risk (in certain countries Basel I is not yet being complied with).

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Managing or mitigating risk

Managing or mitigating risk is a worldwide focus area, which is often driven by international regulations and accepted guidelines (e.g. Basel Committee on Banking Supervision, the King Report on Corporate Governance, and the Solvency Assessment and Management [SAM] framework for insurance companies). Even though these might not directly address corporate financial risk management, shareholders and investors worldwide are increasingly demanding evidence of a comprehensive and effective risk management framework. Many entities in Africa elect not to hedge market risks due to the factors as described. Often corporates may choose not to hedge currency risk on the basis that some African currencies tend to be less volatile against the US dollar than against other major crosses; however, this does not always hold true. When monetary authorities fail to maintain the local currency at a set level against a reserve currency, it can result in sharp devaluations (RMB Global Markets Research March 2013, page 3), which supports the case for hedging currency transaction risk. Translation risk, i.e. the risk of translating foreign currency denominated values of assets and liabilities into the reporting currency, is another type of currency risk for which hedging should be considered. Often the perceived risks of operating a treasury in sub-Saharan Africa are greater than the real risks. Undoubtedly the actual risks and impediments are significant; however, they are not unsolvable, and innovative solutions can sometimes be structured to manage financial risks. For example, high correlation between a combination of liquid currencies and commodities can often make for a good proxy hedge instead of an illiquid and costly instrument, and natural hedges should also be considered in a company's hedging strategy. Many operational and regulatory impediments for corporates and MNCs in sub-Saharan Africa are not likely to be resolved in the near future; however, financial markets are developing, and financial institutions are becoming more skilled in providing solutions for corporates to mitigate and manage their risks.

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