Catalysing Private Sector Investment in Low-Income Countries and Fragile Situations:

Proposal for Blended Finance

ADF-14 Third Replenishment Meeting
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Executive Summary

This paper outlines a proposal for Blended Finance involving ADF resources as a means of crowding in additional private sector investment into Africa's low income countries. Under this proposal, the Fund's concessional resources would be used strategically alongside non-concessional finance from other partners in order to improve the reward/risk mix for private sector Borrowers as a catalyst for financing high-impact projects. The proposal – which will be further developed as part of the agenda of the ADF Working Group -- envisions a specific focus on Small and Medium Enterprises (SMEs), climate change response, agribusiness and food security.

In order for Africa's low-income countries to fulfil the ambitions of the Sustainable Development Goals (SDGs), there is a need to mobilize significant additional financial resources, including from the private sector, in line with the global consensus on financing for development enshrined in the Addis Ababa Agenda for Action. Private finance will be critical in helping Africa's low-income countries to transform and grow in a sustainable way, providing jobs, particularly for those that are most vulnerable and enabling countries to broaden their financing base and exit aid dependence. The good news is that private flows to developing countries are already increasing, reflecting increased attention on investment opportunities in global growth markets. But the bad news is that they often struggle to make inroads into the projects, sectors and countries where they can have the maximum development impact.

This is where Blended Finance comes can play a critical role. Private investors sometimes have good reasons for avoiding country markets such as those of most ADF countries: returns are too low for the level of risk, markets do not always function as well as they should do, and local investment climates can be challenging to work in. They may also have some less founded reasons for staying away – not recognizing the rewards on offer, or perceiving a risk that is higher than the reality, based on outdated assessments of country potential.

To address the gap in private sector investment into these countries, the African Development Bank Group explored how to make aid spending go further and crowd-in more private investment. Blended finance can catalyse private investors by rewarding them for generating public goods and development outcomes. For example, blended finance can alleviate market failure, improve the required returns of first-movers in frontier markets and compensate for the sunk costs of introducing new technologies.

The Bank Group has already made significant efforts to increase its portfolio of Non-Sovereign Operations (NSOs) in ADF countries over the past decade, but investors' risk perception and the high cost of funding will continue to hinder reaching the needed scale, unless new financial instruments are introduced.

Under the proposal, Bank Group Management is seeking endorsement for the concept of an ADF Window for Blended Finance. The window would provide co-financing resources with the ADB, with a proposed focus on agriculture, climate finance and financing to SMEs – critical areas in advancing the Bank Group's goals of contributing to more inclusive and sustainable growth in Africa. Identified projects which target the creation of jobs for the youth or women or support enterprises started by the youth and women will be prioritised for accessing blended finance resources.

Through the Window for Blended Finance, the ADF would for the first time be able to finance private sector clients directly, thereby complementing its ongoing support to governments for business climate reforms and improved economic governance. By providing an anchor for delivery, the window will build on the Bank Group's previous experiences in blending concessional and non-concessional resources for high impact projects. The Bank Group will ensure that processes for deploying blended finance are streamlined and a unique repository of lessons learned in pricing concessional products is established, in order to transparently benchmark pricing decisions.

The proposal reflects the important need to mitigate potential moral hazards and minimise creation of market distortions. A robust and transparent governance structure will identify and originate operations that meet clear pre-defined eligibility criteria and satisfy the key guiding principles for blended financing. These principles include (i) minimum concessionality which ensures that the amount of ADF concessional resources allocated under a Project will be kept at the assessed minimum amount; (ii) additionality of blended finance which demonstrates that the development objectives of the investment cannot be

achieved without the ADF financing component; and (iii) financial sustainability which demonstrates that the business model is commercially viable after a first phase with concessional support. The products would be 'market linked' and would be carefully monitored against a risk management framework, which will be developed for approval by the ADF Board.

The Bank Group Management is thus seeking Deputies' endorsement for the concept proposed in this paper for an ADF Window for Blended Finance to participate in private sector blended financing operations. Management has proposed that the Working Group of Deputies, which was part of ADF-13, be continued, and one of whose tasks would be to help refined this proposal, including its operational guidelines, with a view to reporting on its work at the ADF mid-term review.[1] The final proposal will be presented to Deputies for an allocation decision during the ADF-15 replenishment discussions

[1] See, Section 9.2 of the ADF-14 Deputies' Report.

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ACRONYMYS

ADB	African Development Bank
ADF	African Development Fund (The Fund)
ADF countries	Regional Member Countries eligible for ADF development assistance
ADF-14	Fourteenth replenishment cycle of the African Development Fund
ADOA	Additionality and Development Outcomes Assessment
AfDB	African Development Bank
Bank	African Development Bank
Bank Group	ADB, ADF, and NTF, and associated Special Funds
CDC	Commonwealth Development Corporation
CIF	Climate Investment Funds
DBDM	(Bank Group's) Development and Business Delivery Model
DFI	Development Finance Institution (bilateral or multilateral)
EU	European Union
EU-AIF	European Union's Africa Investment Facility
FDI	Foreign Direct Investment
GDP	Gross domestic product
GEF	Global Environment Fund
FAPA	Fund for Africa Private Sector Assistance
FX	Foreign currency exchange
IFC	International Finance Corporation (subsidiary of the World Bank Group)
IMF	International Monetary Fund
IPP	Independent Power Producer
KfW	Kreditanstalt für Wiederaufbau (Reconstruction Credit Institute: Germany's bilateral DFI)
NTF	Nigeria Trust Fund
NSO	Non-sovereign operation
OECD	Organisation for Economic Cooperation and Development
PBO	Policy-based (or programme-based) operation
PPP	Public-Private Partnership
PSD	Private sector development
PSF	Private Sector Credit Enhancement Facility
RMF	Results Management Framework
SDGs	Sustainable Development Goals
SDR	Special Drawing Right (IMF's financial accounting unit)
SEFA	Sustainable Energy Fund for Africa
SME	Small or Mid-Sized Enterprise
TCX	The Currency Exchange
UA	Unit of Account (equivalent to the IMF's SDR): the Bank Group's financial accounting unit
USD or US$	United States Dollar
WEF	World Economic Forum

CATALYZING PRIVATE SECTOR INVESTMENT IN LOW INCOME COUNTRIES AND FRAGILE SITUATIONS: PROPOSAL FOR BLENDED FINANCE

1. Introduction

1.1. **This paper has been prepared at the request of ADF Deputies for presentation at the third ADF-14 Replenishment Meeting**. It builds on a paper presented at the second ADF replenishment meeting on 30 June-1 July 2016.[2] The paper took stock of the Bank Group's work in support of private sector development in low income countries and fragile situations. It noted that, while support to governments to reform the business environment remains central to the ADF's approach, the Bank Group has experienced a significant increase in demand for finance to the private sector in ADF countries. An executive summary of the first paper is at Annex I.

1.2. **A sizable scale up of the Bank's Non-Sovereign Operations (NSOs) in low income countries and particularly in fragile situations is needed for the private sector** to play its role towards the achievement of the Sustainable Development Goals and the High 5s. To help achieve this, Bank Group's Management put forward two proposals at the second replenishment meeting. The first proposal was an additional allocation to the Private Sector Credit Enhancement Facility (PSF) to sustain the current momentum, and the second was a blended finance mechanism allowing ADF funds to provide direct support to the private sector in ADF countries. Deputies at the second replenishment meeting endorsed the PSF top up, and requested further details on a proposal for the ADF's participation in the Bank Group's provision of blended financing.

1.3. **Blended finance is broadly defined as parallel use of concessional (i.e. grants and below market rate loans) and non-concessional financial products**, to provide overall financing on terms that would make projects financially viable and/or financially sustainable.[3] In this paper, we use blended finance in a slightly narrower sense, referring to the parallel deployment of concessional and non-concessional finance to improve the reward/risk mix for a borrower.

1.4. The current paper outlines a proposal for delivering blended finance to accelerate private sector development in low-income countries, especially those in various situations of fragility**.** Following this introduction, the rest of the paper is organized as follows: section 2 of this paper summarizes the case for blended finance in the African context; section 3 illustrates experiences in delivering blended finance; section 4 analyses specific barriers that blended finance can help overcome; section 5 describes the design features and governance structures of the proposal; and section 6 outlines potential risks and mitigation measures. Conclusions are presented in section 7.

2. Catalysing the private sector in ADF countries: Opportunities and constraints

2.1. **The private sector in Africa's low income countries remains substantially underdeveloped and private investment is well below potential.** Yet, in fragile situations, the private sector has a particularly important role in supporting post-conflict stability, structural transformation and economic growth. Domestic credit to the private sector, an indicator for the level of private sector financing deployed within a country, stands at 132% of GDP globally, but is a meagre 20% in Africa's low income countries and significantly lower at 14% for countries in situations of fragility (Figure 1). The capital required to accelerate Africa's private sector development exists, but Africa's low income countries have been less successful than other developing regions in attracting these investments.[4] This is a

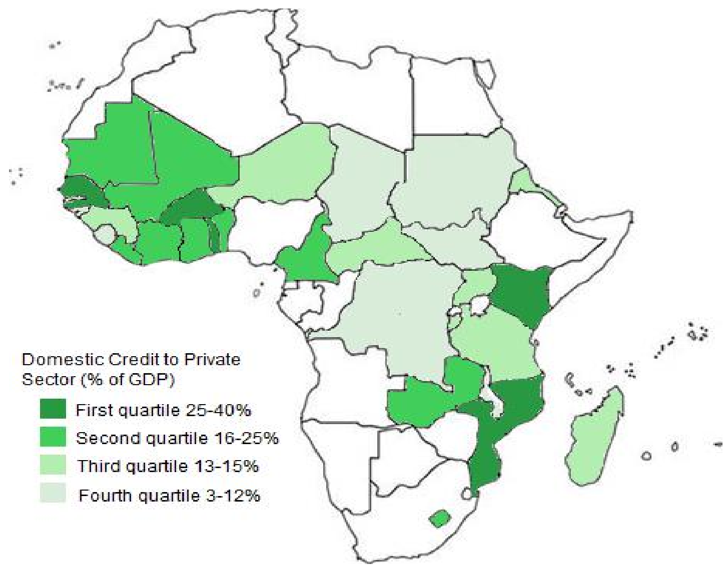
[2] 'The role of ADF-14 in Fragile Situations' paper was submitted to the ADF-14 2nd Replenishment Meeting

[3] OECD/World Economic Forum (2015): "A how-to Guide for Blended Finance"

[4] OECD (2014), *Development Co-operation Report 2014: Mobilising Resources for Sustainable Development*.

reflection of the existing systemic economic weaknesses and institutional constraints which increase the cost of doing business in low income economies.

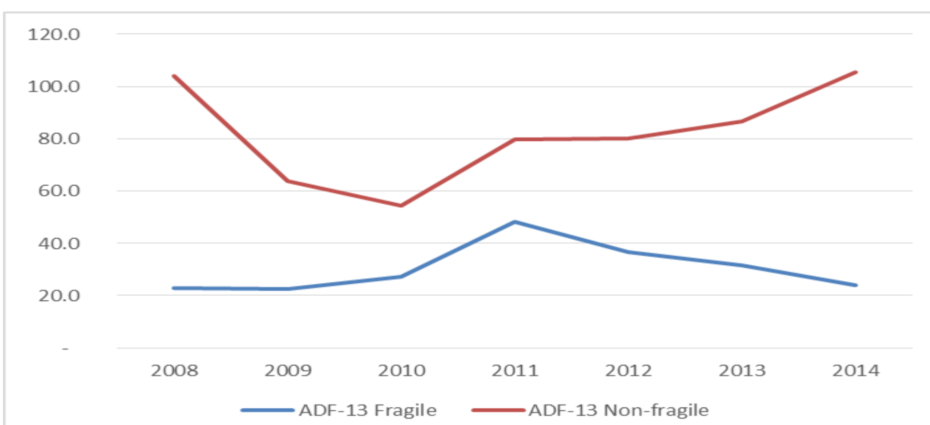
Figure 1: Domestic Credit to Private Sector (% of GDP) in ADF Countries



Source: World Development Indicators (2015)
ADF countries that have not been shaded are those where data is not available.

2.2. **In countries facing fragile situations, the challenges are further compounded by restrictive business environments, limited capacity of project sponsors and shallow capital markets**. These barriers translate into a shortfall in finance to the private sector. The deficiencies of the domestic financial sector in countries in transition are compounded by a gap in Foreign Direct Investment (FDI). As Figure 2 illustrates, FDI per capita is lower for ADF countries in fragile situations than for other ADF countries and this gap has widened further with the fall in commodity prices, since countries in transition are heavily reliant on investment in natural resources.

Figure 2: Gap in per capita FDI for countries in transition (USD millions)



Source: World Development Indicators 2015

2.3. **A specific constraint to investment in fragile situations is that pioneer investors find it difficult to appropriate full returns to their first-mover advantage**. A pioneer investor entering an untested market faces significant ex-ante uncertainties and recoups few of the benefits of the demonstration effect. Yet we observe that once the business model has been tested, the new entrants who follow the leader as competitors, often capture the bulk of the returns. This lowers the incentive for first-movers to invest in riskier markets. Thus, the market failure justifies providing access to concessional resources for pioneer investments, especially in situations of fragility, in order to support the market discovery process.

2.4. **Strikingly, while countries in fragile situations are disadvantaged in attracting private sector investment, they also have less access to the range of development finance instruments to leverage potential sources of private sector finance**. For example, an OECD report shows that states in fragile situations received less than 23% of finance leveraged by risk guarantees between 2009 and 2011.[5]

2.5. **The ADF has been making significant investment in technical assistance to governments to improve the investment climate, but governance reforms take time to have effect**. It is increasingly clear that supporting viable investments in imperfect business climates can deliver visible benefits, including early stabilisation through employment, increased incomes, and 'peace dividends' alongside the demonstration and catalytic effects of 'first movers' in frontier markets. In addition, cooperation with the private sector can enhance the effectiveness of governance reforms.

2.6. **The ADF is well placed to continue improving the business enabling environment through the provision of technical assistance and programme-based operations (PBOs) that assist countries build their capacities and attract private investors**. To enhance the Fund's effectiveness in this domain, Management proposed using TSF Pillar III to support targeted investment facilitation specifically in fragile situations at the ADF-14 2nd Replenishment Meeting[6], recognizing that in fragile situations, investment promotion agencies tend to lack the capacity to perform this function effectively.

2.7. **However, complementary instruments targeting the private sector are urgently needed to crowd-in investment in the hardest-to-reach markets**. Beyond traditional DFI interventions, blended finance can be used to target specific development challenges and leverage private investment to meet them. Blended finance can attract private sector investors to countries in transition where projects would otherwise be unviable due to the high costs of non-commercial risks. It can provide longer tenors and grace periods required to match longer lag time for project returns. It can also be used to support pioneering or early-stage investments that might otherwise not take place. Blended finance can typically be used to reduce the financing hurdles or disincentives faced by disadvantaged groups such as women, youth entrepreneurs and underserved segments of the economy.

3. Crowding-in private investment – The role of blended finance

3.1. **By blending concessional and non-concessional resources, all actors in a Blended Finance transaction benefit from win-win-win solutions.** For the providers of concessional finance, the wins involve the getting the ability to magnify the impacts of small resource envelopes to leverage larger amounts of non-concessional finance: from 'billions to trillions'. Wins for private investors and non-concessional financiers, the winds involve securing viable returns on worthwhile projects. And most of all, the wins for people in Africa's most poorest countries involve having more funds being channelled to their emerging and frontier markets, in the right way, to really help transform economies, societies, and lives.

[5] OECD (2015): "States of Fragility Report: Meeting Post-2015 Ambitions"

[6] 'The role of ADF-14 in Fragile Situations' paper was submitted to the ADF-14 2nd Replenishment Meeting

3.2. **Over the past decade, blended finance has moved from a niche activity to one used by a range of development finance organisations**. There is a growing consensus in the development arena that the use of concessional finance to support directly the private sector is justified in cases where the socio-economic benefit or cost would not be borne by private investors because of market failures.[7]

3.3. **A number of bilateral donors and development partners have embraced the use of blended finance, as a way to align the financial returns of projects with its socio-economic returns.** The most recent example is IDA Deputies' endorsement of the IDA private sector window, a concept which – though developed after that of the Bank Group - is broadly similar in nature. At least twenty-nine funds provide concessional finance to the private sector in Africa, through interest rate subsidies, guarantees, project preparation grants, insurance and equity.[8] These funds are, at least in part, co-funded through donor grants from bilateral and multilateral partners. Blended finance can either be provided through 'market linked' instruments so it is priced to mimic market behaviour albeit at rates below those prevailing in the market, or in the form of pure grants. The former approach is adopted by the International Finance Corporation (IFC), which has been providing concessional lending to private sector projects through donor funded trust funds to blend with IFC non-concessional funds since 1996. In 2008, a specialised Blended Finance Unit was established at the IFC to manage and streamline use of concessional finance. The EU has also developed the Africa Investment Facility (AIF), a blending instrument which covers lending both to public and private entities in the form of grants providing technical assistance, risk sharing instruments and investment funding targeting energy, transport, water and sanitation, agriculture, SMEs lending, health and education.[9] Grants from the EU AIF can be blended with non-concessional funds from eligible partner organisations and EU Member States to provide a range of financial products. The Intra-American Development Bank and bilateral development banks such as KfW and CDC also have deployed blended finance facilities.

3.4. **The African Development Bank Group has also piloted blended finance instruments for low income countries, as set out in the paper presented at the second meeting of the ADF-14 Deputies**. In most cases, the ADF provided concessional finance through a sovereign entity that invested into a private sector project, while the ADB directly funded the private sector component of the transaction. The Bank Group also provided blended finance directly to the private sector, especially in the area of climate finance, where concessional finance is provided by dedicated trust funds such as the Sustainable Energy Fund for Africa (SEFA), the Green Environment Fund (GEF) and the Climate Investment Fund (CIF).[10] Box 1 provides an example of successful use of concessional finance to catalyse private investment, while Annex II summarises the main lessons learned by the Bank Group in using blended finance.

3.5. Building on these experiences and the know-how accumulated, the remainder of this paper proposes a stronger direct role of the ADF in supporting private sector investment in Africa's low income countries, and especially those in transition from fragile situations.

[7] DFI Guidance for Using Investment Concessional Finance in Private Sector Operations
[8] OECD & WEF (January 2016). Insights from Blended Finance Investment Vehicles and Facilities
[9] The EU AIF subsumes the EU Africa Infrastructure Trust Fund, created in 2007 and other grant-based concessional facilities.
[10] The CIFs are global US$ 8.1 billion funds comprising the Clean Technology Fund (CTF) and the Strategic Climate Fund (SCF), which encompasses three programmes: Scaling-up Renewable Energy Programme (SREP), Forest Investment Programme (FIP) and Pilot Programme on Climate Resilience (PPCR). Resources are co-implemented by Multilateral Development Banks, of which AfDB is one of the Implementing agencies.

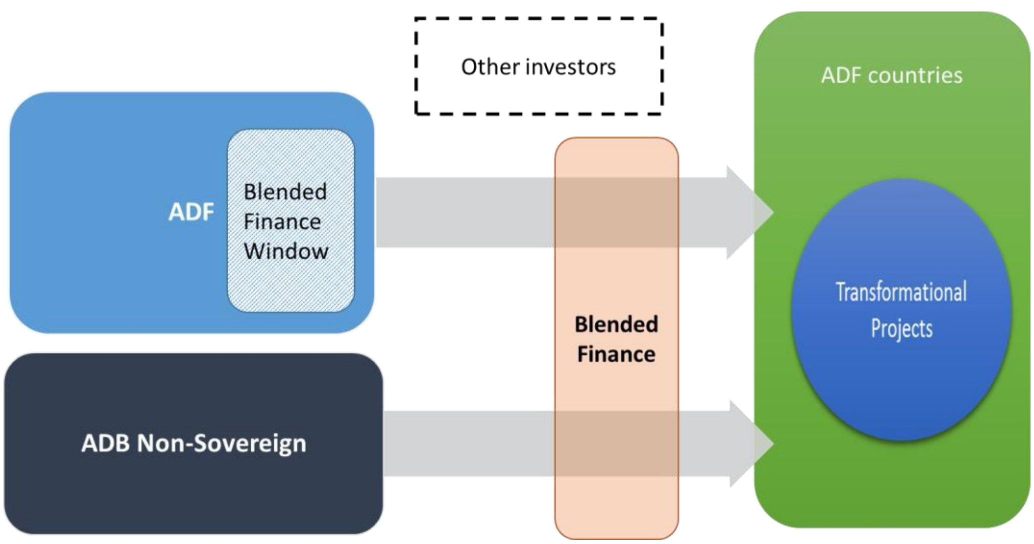
Box 1. The Africa Renewable Energy Fund

The Bank participated in the financing of a US$ 200 million Africa Renewable Energy Fund (AREF). AREF is a privately-managed vehicle in which the AfDB (US$ 25 million), SEFA (US$ 35 million) and the GEF (US$ 4.5 million) are cornerstone investors. Resources were deployed in the form of junior equity which had a capped rate of return thereby potentially enhancing the returns for other investors. This arrangement was able to catalyse the participation of more risk-averse and commercially-oriented investors in AREF. This has enabled AREF to move quickly through the fund-raising phase and reach the final subscription target of US$ 200 million within 18 months from the start of operations in March 2014. The Fund has worked with a wide range of investors (including commercial investors) and has subsequently committed 32% of capital raised (Q2 2016) to projects across a range of countries and technologies, including the first Independent Power Producer (IPP) in geothermal energy in Ethiopia.

4. Enhancing the catalysing role of the ADF: A concept proposal for blended finance

4.1. **Building upon the AfDB's significant and successful scale up of non-sovereign operations in low income countries since 2005 and on the track record of the ADF in facilitating governance reforms**, Management proposes to step up provision of blended finance in ADF countries, especially in countries affected by fragility. Under this proposal, the Bank Group's ADF and ADB windows would, on a pari-passu basis, extend direct financing to qualified private sector investors on concessional and non-concessional terms. While the two types of resources will be provided in parallel through their respective independent financing windows, the effect of blending them would reduce the effective cost of financing to the private borrowers, boost rates of returns and narrow the gap between the identified project socio-economic return and investors' risk-adjusted financial rates of return. The proposed structure is illustrated in Figure 3. In principle, no new special vehicle would be set up to allow for speedier implementation of the proposal, and straightforward re-flows of resources into the ADF. In the analytical process leading elaborating the concept of the ADF Window for Blended Finance, staff carried out an initial appraisal of existing alternative vehicles and financing instruments (as outlined in Annex III). Further analytical work on design options would be undertaken by the ADF Working Group.

Figure 3: The ADF's participation in Blended Finance

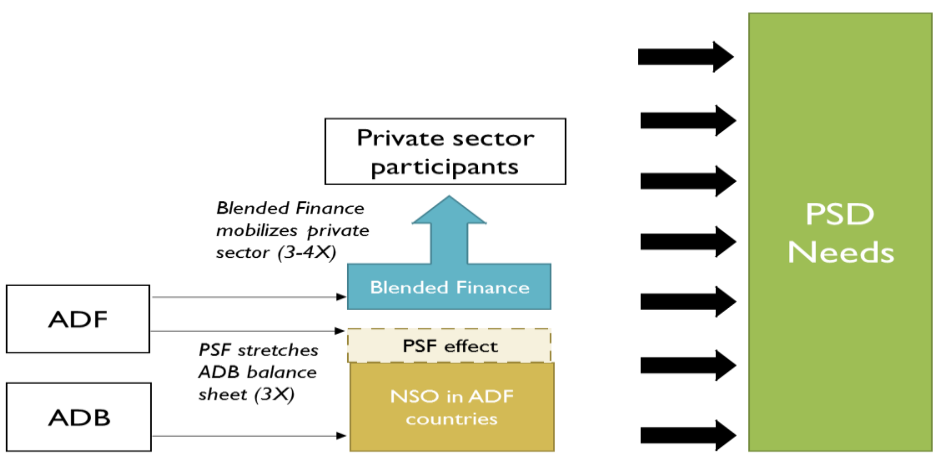


4.2. **The Window for Blended Finance presents an opportunity to expand the ADF's participation in blended financing operations to catalyse private investments in the ADF countries**. Until now, the ADF's participation in co-financing with the ADB Private Sector window have been limited to the narrow scope of PPPs using sovereign entities as intermediaries for concessional and non-concessional lending. Depending on context, channelling funds through a sovereign entity creates an extra layer to an already complex transaction. It involves the sovereign entity taking on additional debt, and could increase the risk of financial leakages. In contrast, when it is clear that the private sector is the best channel to deliver the project, direct provision of blended finance to the private sector would avoid burdening the sovereign balance sheet.

4.3. **Moreover, an ADF window presents an opportunity to streamline business processes for blended finance**, shorten the investment time lag, reduce transaction costs compared to applying to an external funding source, and ensure that lessons learned are retained and disseminated. The Bank group, like other DFIs, is going through a 'learn-by-doing process' to test the most effective approach for using blended finance in different contexts. An ADF Window for Blended Finance would also allow enable the Bank Group to more fully leverage its brand and comparative advantage, consolidate its knowledge base and strengthen its voice on behalf of the African continent in the global dialogue on blended finance.

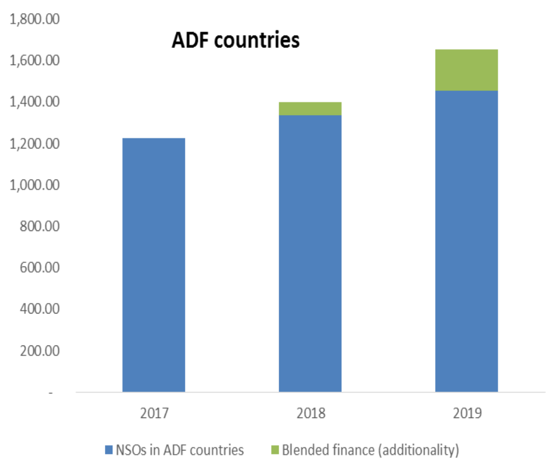
4.4. **The ADF's participation in blended finance is in line with the "billions to trillions" paradigm adopted by the multilateral development finance institutions within the framework of the Addis Ababa Agenda for Action**. There is a strong case for setting up a specific ADF window given the sheer size of the funding needs and the development impact of additional finance, if appropriately designed and managed. The Window for Blended Finance, by changing the risk/reward proposition for private sector participants and so its catalytic effect is not limited to the Bank's balance sheet. Instead, its primary function is to mobilise additional private sector investment, as illustrated in Figure 4 below. It is estimated that blended finance lending from the ADF directly to an NSO could crowd-in 3 to 4 times the value of the ADF financing in additional private sector resources.

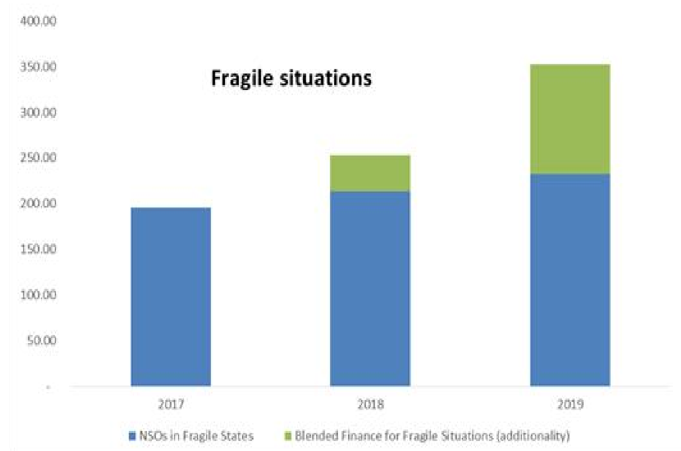
Figure 4: Blended Finance to Attract Private Sector Investments



4.5. **The ADF Window for Blended Finance is expected to deliver additional finance for NSOs in fragile situations**, compared to a 'business as usual' status quo. In order to illustrate the potential of the concept, Figure 5 shows the estimated additional funding over and above the projected pipeline of NSOs in ADF countries and in the subset of fragile situations. The simulation is done over the next three years for which projections are available in order to provide a sense of magnitudes involved, and will be updated for the relevant implementation period in due time. While the projections are illustrative only, they suggest that the ADF Window for Blended Finance could provide a significant boost to private sector financing, especially in situations of fragility which would be allocated the majority of funding.

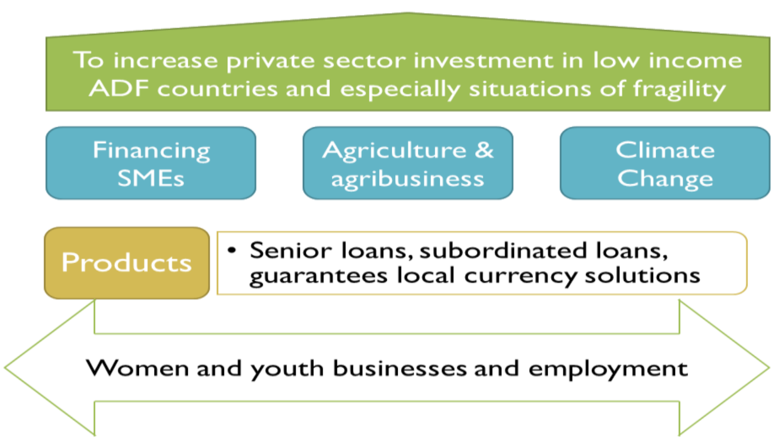
Figure 5: Additionality of ADF Window for Blended Finance (UA million)





4.6. **The scope of ADF support to blended finance in its pilot phase over the ADF-14 period would prioritise investment in situations of fragility and focus on three strategic areas consistent with the Ten Year Strategy and the High 5 priorities**. These areas would be: a) financing SMEs; b) agriculture and food security; and c) climate change related projects, including renewable energy. Across all three areas, projects that have a strong component targeting women-headed businesses and promoting youth and women's employment would be prioritised in accessing funds. Using blended finance in this way would allow selectivity to focus on those sectors most relevant to the High 5s and which, in the Bank Group's experience, have the largest market failures, and thus justify the use of concessional finance.

Figure 6: Strategic areas and scope



4.7. **Climate Change responses**. **The wider benefits to society of climate mitigation and adaptation investments are not captured by private investors**, because un-priced public goods make financial returns often too low and/or the risks too high for projects to be feasible. The Bank Group has repeatedly experienced these constraints. In a number of cases, traditional financial products require too high returns to support fully the adoption of new technologies that in the long term would become sustainable and cheaper once they are more widely adopted. In other cases, traditional financial products provide too short tenor or insufficient grace period on principal repayment, causing a mismatch with the long implementation cycles of typical climate adaptation and mitigation projects. An example is provided by forestry projects aimed at the restoration of degraded forest reserves. Such projects are generally constrained by the lack of long-tenor loans and adequate grace periods, which private sector investors prefer, given the long time it takes for forests to mature. Combining an ADB-priced loan with a concessional loan (where concessionality can be structured in the form of a longer grace period) would enable such projects to go ahead and would catalyse other financiers by offering them higher returns. The resulting development impacts are significant and include providing an important carbon sink as well as delivering employment generation in rural areas and generation of tax revenue to the government.

4.8. **Agriculture & Agribusiness. Agriculture accounts for over 60% of African jobs, but it has not been able to attract adequate private capital to accelerate and sustain the growth in productivity required.** The scale of resources required for transforming the African agricultural sector is estimated at US$ 280-340bn over 10 years.[11] The Bank Strategy for Agricultural Transformation makes it clear that agriculture can only be put on the path of accelerated and sustainable growth only if it is driven by commercially viable agribusiness and agroindustry enterprises. However, risk-adjusted returns are not yet sufficient for the private sector to provide the quantum of investments needed. Exposure to regulatory risk, global commodity prices fluctuations, and increasing climatic variations—all these factors mean that agribusiness projects in low-income countries face high risk exposure, resulting in reduced access to investment finance.

4.9. **Further, the full development impact of agribusiness requires support to be provided to small producers and out-grower schemes of larger processing ventures**. The high start-up cost of such ventures, however, means that it is only commercially viable if the promoters can access finance at below-market rates. When sector-specific risks are compounded by high country risks due to fragile situations, an element of concessional finance is essential to crowd-in viable private sector investment in the short term. The relative lack of dedicated concessional finance facilities for the agriculture sector compared to other sectors limits private sector participation in Africa's agricultural transformation. There is an opportunity to structure blended finance products to credit-enhance agriculture and agribusiness projects, by raising expected returns for private investors through the provision of subordinated debt, which would mitigate the risks inherent to the sector and help catalyse additional finance. [12]

4.10. **Small and Medium Size Enterprises (SMEs). SMEs account for nearly two thirds of jobs in the ADF countries but face systemic barriers in accessing finance.** SMEs in Africa are estimated to face a credit gap of US$ 70 - 90bn: access to credit would need to increase by 300 per cent[13] to close the gap. The odds are particularly skewed for women-headed SMEs, which have lower access to formal banking than those headed by men. Women-headed SME face higher borrowing costs, are required to collateralise a higher proportion of loans they receive and have shorter loan tenors than male-owned SMEs.

[11] AfDB (2016) Strategy for Agricultural Transformation in Africa 2016-2025
[12] ADF would not be used to take a subordinated position to ADB but only invest on a *pari passu* level with ADB.
[13] IFC Enterprise Finance Gap Database (2011)

4.11. **Blended financing involving a range of financing instruments and products can be used to catalyse increased private sector financing for SMEs.** For example, the provision of concessional portfolio guarantees to financial intermediaries for lending to SMEs can increase their willingness to take structured risks and provide increased financing to such enterprises, providing a valuable demonstration effect. SMEs in countries in fragile situations are often disconnected from local, regional and global value chains mainly because of lack of managerial and technical capacity, lack of compliance to international standards, weak value chains and private sector ecosystem and limited access to finance. SME linkage programs—i.e. business linkages, local content, SME promotion and incubation—can be developed and financed to address the capacity building and value chain strengthening, and through blended finance provided to local banks to on lend to participating SMEs in a competitive package, that could include a lower interest rate, a longer tenor or a risk sharing mechanism. Blended finance can also be utilized as an incentive to anchor firms to integrate local SMEs in their supply chain and contribute to a local content program.

4.12. **Mobilising local currency funding**. A lack of local currency for investment is a key barrier across the Africa's private sector and is an additional binding constraint to the three problem areas of climate finance, agriculture and agribusiness and SMEs. Lack of access to finance in local currency means that borrowers who derive their revenue streams in local currency but can only borrow in hard currency, are exposed to significant foreign exchange risks. This has a particularly negative impact on poorer countries and smaller businesses. Poorer countries, and especially those in fragile situations, have less developed domestic capital markets and are therefore most exposed to currency mismatch, as highlighted in Box 3. Moreover, smaller businesses have less diversified balance sheets and poorer access to hedging instruments and so are more vulnerable to foreign exchange risk. Addressing the lack of local currency financing would therefore have a clear redistributive and pro-poor impact.

Box 3: Currency risks – a constraint to development finance in Africa?

Currency risks have recently come to the fore in the African continent with a new wave of currency devaluations in the wake of falling commodity prices. This often undermines the very concessionary element of loans denominated in hard currency. For example, Bank staff calculations suggest that since 2006, the Malawian Kwacha, the Zambian Kwacha, and Sierra Leone's Leone have seen cumulative devaluations against the Bank Group's UA of 430%, 200%, and 89% respectively. It means that an ADF loan's interest rate of 0.75% in hard currency would have equaled a staggering 36% rate in local Malawian Kwacha.

The impact of currency devaluation is felt in non-sovereign operations too. An ADB long tenor US$ loan to a Zambian financial intermediary for SME on-lending may have appeared financially viable in the short term, but the severe depreciation of the Zambian Kwacha would have resulted in significant costs to the intermediary and these costs are likely to have been passed on to beneficiary SMEs.

This suggests that innovative financing instruments that reduce clients' exposure to currency risk are likely to deliver a stronger development impact than highly concessional loans in hard currency.

4.13. **However, for existing local currency financing mechanisms that use hedging instruments, the equivalent local currency cost includes a significant premium that results in extremely high financing costs,** due to illiquid local money markets and under-developed local capital markets. By leveraging the AAA rating of the ADB, the Bank Group has attempted to respond to this challenge by adopting ten African currencies as official lending currencies and offering local currency loans, funded by ADB local bond issuances or synthetic local currency loans constructed using counterparties such as The Currency Exchange (TCX).[14] However, these measures have only had limited success, particularly in regard to the sectors that are already underserved. Less than 10% of the Bank Group's SME assistance interventions has been provided in local currency, despite SMEs considerable needs.

4.14. **The availability of blended finance can address this barrier, for example by providing a subsidy for loans swapped to local currency**, which will provide affordable local currency loans in countries where no market solutions are available, as well as encourage investors and lenders to lengthen financial maturities. Thus beneficiary SMEs would not be obliged to take on either local currency loans with excessive interest rates, or to assume FX risk associated with hard currency loans. Deploying blended finance to support local currency finance would be combined with existing technical assistance and regulatory reform through the sovereign ADF window to stimulate the emergence of a local market for currency hedging, thus creating a public good in the long term.

5. The ADF blended finance window: Concept design

Eligibility criteria

5.1. **The operations eligible for direct financing from the proposed Window will be only those sponsored by private sector operators in the ADF countries**, in hard-to-reach socio-economic or disadvantaged segments or in countries affected by fragility, which are targeting any of the three strategic areas outlined in Section 4. In addition, the blend financing operations will be assessed critically against the following three key principles:

1. **Minimum concessionality.** The amount of ADF concessional resources allocated to the borrower will be kept to a minimum necessary to make the transaction feasible;

2. **Additionality of the blended finance component.** The request for blended finance would need to demonstrate that the development objectives of the investment could not be achieved without the ADF component;[15] and

3. **Financial sustainability**. The project would need to demonstrate that the business model is commercially viable after a first phase with concessional support. To this end, the average tenor of the ADF product will be set indicatively at 10 years, with a range from 7 to 15 years, with no possibility of re-financing or repeat business with the ADF.[16]

5.2. **The range of financial products offered as co-financing to private sector clients** would include senior loans, subordinated loans and guarantees. Across the three targeted areas, the ADF Window for Blended Finance will also offer financial products to reduce the cost of local currency lending.

5.3. **The products would be 'market linked'**. This means that while priced below market rates, they would mimic market behaviour. The very objective of the instrument is to catalyse investment in situations which the private sector finds too risky to invest in and so, full risk-based pricing is unlikely to be possible. The actual price of the ADF product will be determined on the basis of the 'minimum concessionality' principle, using a transparently determined 'commercial rate' as a benchmark to measure the amount of concessionality embedded in each transaction, and on the basis of the risk management framework that will be established as part of the operational guidelines. The operational

[14] The Currency Exchange (TCX) is a fund established by a group of development partners (including the AfDB) in 2008 which provides derivatives to hedge the currency and interest rate mismatch that arises from cross-border investments.
[15] ADB NSOs are already subject to an additionality test through the Additionality and Development Outcomes Assessment (ADOA). The criteria proposed here goes further for the ADF.
[16] The actual tenure for each transaction will be determined on the basis of the minimum concessionality needed to make the transaction feasible, with certain types of projects requiring concessionality in the form of longer tenure.

guidelines will set out the working parameters further, including the maximum transaction size of the ADF portion, and the share of ADF portion to the ADB portion.

Governance and implementation arrangements

5.4. **The governance structure of the Window for Blended Finance would be designed to mitigate the risk of moral hazard** (i.e. the incentive to use cheaper finance from the ADF to render more viable excessively weak or risky ADB deals), minimise administrative costs and enhance commercial criteria in the selection of investment. The project appraisal and due diligence would follow the same processing track as ADB non-sovereign operations. However, a dedicated Blended Finance team would be actively involved in the origination process and will be responsible for the approval process of the concessional component, advising on the pricing and structuring of the blended package and would monitor the results achieved. The Blended Finance team would be composed of an administrator and support staff, with similarities with the PSF model. The team's five responsibilities would be: ensure compliance of blended finance requests with the three key principles outlined in section 5.1; advise on financial structure and pricing; monitor the commercial viability and sustainability of the portfolio; track risk and portfolio status; and ensure the reporting of results. The ADF window will be the lender of record for the ADF portion of the blended financing, and this would be governed by a legal agreement between the ADF and the concerned entity.

5.5. **Implementing the proposed governance arrangements for blended finance provision would require a relatively modest increase in internal capacity**. As far as possible, existing identification, appraisal, monitoring and supervision processes would be used, together with a specific role for an independent team to provide a check on the appropriate deployment of concessional finance. By creating an instrument for blended finance, the ADF could create efficiency gains and economies of scale and overcome the current fragmented approach to blending.

5.6. **The proposal would leverage the Bank Group's significant experience in originating and managing NSOs**, following the major growth of the NSO portfolio in low income countries over the past decade. The Bank has increased its capacity to identify, appraise and manage NSOs and has piloted new instruments. It introduced a range of special funds for climate finance and risk mitigation instruments for ADF countries, which, after an introductory period, are now seeing an increase in take-up. Similarly, the establishment of a Special Operations Unit to manage workout and recovery of underperforming investments represents a significant milestone for the Bank Group's private sector engagement. As the blended finance instrument evolves beyond the pilot phase, it will be important to take into consideration eventual additional origination, portfolio management and legal capacity, with due distinction on its different nature. The experience of the PSF shows how it is possible to achieve very significant rates of utilisation with a lean staff complement, provided that the appraisal and approval processes are designed to minimise transaction costs.

5.7. **A number of further actions are being implemented across the Bank Group to strengthen the Bank's overall capacity to support private sector growth in low income countries.** The new Development and Business Delivery Model (DBDM) adopted by the Bank to support the implementation of the High 5 priorities is underpinning the strategic reorganisation of teams. Among the actions underway is the creation of new complexes to operationalise the High 5s, adapting Key Performance Indicators to create enhanced incentives for efficient project management and streamlining the project life cycle to achieve effectiveness of Bank Group. Other important initiatives that are under way include: a revision of the Bank Group's Delegation of Authority Matrix aligned to the new organization structure and the objectives of the DBDM; an overhaul and streamlining of the respective business process flows for Bank Group's sovereign and non-sovereign financing operations, with a view to increasing process efficiency and enhancing quality-at-entry, and enhancing results-based management of operations with a view to strengthening the development effectiveness of Bank Group operations; adapting KPIs to further create incentives for efficient project management; and streamlining the project life cycle to achieve effectiveness of Bank Group operations within 6 months of their approval.

5.8. **With regard to non-sovereign operations, Management is putting special emphasis on better measurement, recording and reporting of the development results of those operations**. The new Results Management Framework (RMF) will clarify the logic of intervention of private sector operations and introduce a streamlined logical framework to track outputs and outcomes. In order to allow for greater consistency across operations, progress indicators will draw from those used in the project's Additionality and Development Outcomes Assessment (ADOA) report and from a pool of sector indicators. Projects will report on development progress in revamped monitoring tables, as well as at completion. This new approach will contribute to learning and help steer decisions based on the actual impacts achieved. A comprehensive training programme on the principles of results-based management and the use of its tools targeting a cadre of private sector specialists from the Bank will be rolled out following approval of the new RMF.

6. Risks and mitigating measures

6.1. **A Window for Blended Finance would expose the ADF to commercial risks, including credit risk and potentially currency risk**. This will require an adapted operational framework, with specific risk provisioning. It will need rules on portfolio diversification to avoid concentration. Investment and portfolio management rules will ensure that the ADF Window for Blended Finance's maximum exposure will be capped at a pre-determined maximum amount. By the very nature of blended finance, which is designed to facilitate private sector participation in high-risk situations and economic segments, there is possibility of losses, especially in the case of products where full risk pricing would eliminate the concessionality benefit of the financing. Management, however, will ensure that the resources allocated to the window are diligently and prudently managed. To this end, a specific risk management framework will be developed as part of the operational guidelines for blended financing operations.

6.2. **An indicative amount of UA200m, which is a working assumption reflecting demand, provided the basis for an initial simulation of the financial impact of the Window on ADF sustainability.** The findings suggest that, due to faster disbursements, the impact of the Window on the Advanced Commitment Capacity of the ADF would initially be negative for the next ADF cycle following its introduction, but will turn positive for subsequent replenishments as loan reflows are expected increase due to shorter maturities and higher interest rates. Also, due to the more favourable loan pricing, the proposed new window would bring about additional net income for the Fund estimated at approximately UA 15 million annually over a 15 year projection period. However, these projections assume a high risk portfolio composition with an average rating between 5- and 5+, due to the rating of countries of operation. Therefore a rigorous management of portfolio quality will be necessary to ensure that the share of Non-Performing Loans (NPL) does not exceed 15% of the outstanding portfolio. Beyond this NPL threshold, the proposed new window would become detrimental to the Fund's long-term sustainability, due to a high level of loan loss provisions.

6.3. **In addition, a number of residual risks and mitigating measures will be considered in the management of the operations co-financed by the proposed ADF Window**. These are outlined in Table 1.

Table 1: Risks and Mitigation Measures

Risks	Mitigating factors
Market distortion and crowding out of Private investors	- Use of 'minimum concessionality' principle to ensure concessional element does not exceed the minimum needed for transactions to be feasible. - Concessional finance will be "market linked" to provide market incentives to borrowers. - Time limited availability of concessional loan ensures financial sustainability. - Rules on maximum share of total Bank Group financing in NSOs continue to apply.
Moral Hazard and "Arm's Length Dealing" between ADB and ADF	- Separate team to assess Blended Finance request. - Decision on deployment of concessional finance made by committee not involved in ADB transaction. - Parallel ADB and ADF Board approvals.
Reputational risk for the Bank	- Robust eligibility criteria and transparent processes. - Bank Group environmental, social and fiduciary safeguards will continue to apply.

7. Conclusions

7.1. **The concept proposed in this paper should be viewed within the broader context of the multi-faceted ADF support to the private sector in low income countries and fragile situations**. Provision of programme-based lending and technical assistance to Governments to improve the governance ecosystem and strengthen the investment climate will remain the main pillar of the Fund's approach. Blended finance can help high-impact investments proceed, but should be seen as complementary to more comprehensive reforms of the business enabling environment.

7.2. **The use of blended financing would complement and reinforce the ADF's governance and institutional support programmes aimed at improving the business environment in the ADF countries**. Experience suggests that the impact of policy dialogue and technical assistance in support to governance reforms are magnified by catalytic, demonstrative, direct interventions in support of high impact private sector projects. The two are mutually reinforcing: policy dialogue and technical assistance creating the preconditions for successful investments, while innovative projects demonstrating in practice the advantage of sound policy and providing reform-minded policymakers with demonstrable results.

7.3. **The significant and growing demand for NSOs in low income countries and situations of fragility calls for increased use of innovative financial instruments and strategic deployment of DFI's concessional resources.** The Bank Group Management thus recommends that Deputies endorse the concept proposed in this paper for an ADF Window for Blended Finance to participate in private sector blended financing operations; and that the ADF Working Group is tasked with helping to refine this proposal, including its operational guidelines, with a view to reporting on its work at the ADF-14 mid-term review. The final proposal would then be presented to Deputies for an allocation decision during the ADF-15 replenishment discussions.

Abidjan, November 2016

ANNEX I: Executive Summary of, 'The role of ADF in private sector development' – paper presented at the second ADF replenishment meeting, 30 June-1 July 2016.

A buoyant and dynamic private sector is crucial to deliver the Sustainable Development Goals (SDG) in Africa's low income countries. Income generation and job creation by the private sector will ensure 'no-one is left behind'. Ultimately, private sector growth delivers the diversified tax base needed by countries to fund services and goods without depending on aid. The leverage to turn the 'billions' of available development finance into the 'trillions' needed to achieve the SDGs can only take place in partnership with the private sector.

Over the past decade, the rate of growth of the African Development Bank Group's private sector development portfolio - encompassing both sovereign and non-sovereign guaranteed operations - has outpaced that of the overall portfolio. On a stand-alone basis, the growth rate of the ADB's non-sovereign operations portfolio has also exceeded that of comparable MDBs. Historically, the Bank Group supported private sector development (PSD) in low income countries through sovereign operations to improve the business climate and promote good economic governance. Development Partners recognise that governance reforms must be complemented by investment in catalytic, transformative private sector projects, to crowd in commercial financing and deliver development results. From marginal and speculative positions before 2006, the Bank Group has significantly scaled up its non-sovereign operations (NSOs) in ADF countries, using the ADB window.

Increasingly, the Bank Group is using innovative approaches for blending commercial and concessional finance to support projects with high social returns. This includes ADF loans to governments to invest in Public Private Partnerships (PPPs) and the use of blended financing pools, such as renewable energy funds that catalyse commercial capital into new low carbon technologies. The Bank Group also introduced new instruments under ADF, including the Partial Risk Guarantee (PRG), the Partial Credit Guarantee (PCG) and the Private Sector Credit Enhancement Facility (PSF), for which there is now seeing a robust increase in utilisation. The PSF has shown itself to be an effective tool in enabling the Bank to pursue new financing opportunities in countries in transition and in riskier sectors. Full commitment of current PSF resources is expected to be reached over the course of 2017.

The scaling up of the Bank Group's private sector operations has reaped significant development results. Over the past two ADF cycles, over 1.6 million people in ADF countries benefitted from the Bank's various private sector operations. Seven ADF countries saw improvements in their business climate as a consequence of Bank Group interventions. Over 26,000 jobs were directly created and $700 million in government revenues were directly generated by private sector projects.

Yet, there remain significant challenges in supporting private sector development in ADF countries. Low income countries tend to have a less conducive business environment, a wider infrastructure gap and higher operational risks, especially those in fragile situations. This means that it is harder for the Bank Group to penetrate markets in low income countries and fragile situations. While 50% of the active NSO portfolio is in ADF-eligible countries, more than half of it is concentrated in just five 'gap', 'blend' and 'transition to ADB' countries. The Bank Group needs to scale up its support to private sector development in situations of fragility, while also targeting small and medium enterprises (SMEs) and women entrepreneurs so as to overcome the fragility trap.

Looking forward, the Bank Group needs to scale up its private sector operations to meet the transformational ambitions of the High 5 operational priorities of the Bank Strategy. Management is purposefully injecting private sector orientations into its activities with public sector clients and will continue to do so over the course of ADF-14, in line with the strategic priorities of the Bank Group. This approach has prompted a shift in sector strategy and programmes, including: (i) positioning agriculture as a business opportunity; (ii) driving sector-wide reforms and availing risk sharing instruments to enable private investment in lighting and powering Africa; (iii) targeting women entrepreneurs and youth to improve the quality of life for African people; (iv) making private sector driven and public sector enabled African industrialisation a priority, and (v) integrating small domestic markets to achieve the economies of scale needed for African enterprises to compete domestically, regionally and globally. A renewed emphasis on public-private partnerships is also fundamental to the Bank's new business delivery model.

However, non-sovereign Bank lending is expected to hit multiple capital risk constraints soon, which will hinder its ability to continue operating within the parameters of 'business as usual' ambitions. At a time of renewed ambition to deliver the Bank's High 5s and new Development and Business Delivery Model (DBDM), the pressures are all the more acute. They will be felt mostly in low income countries and fragile situations, which take up more risk capital. This paper identifies three options for the ADF to scale up support to private sector financing in low income countries. Management identifies an expansion of the PSF's resources (Option A) by an additional UA 200 million as a priority for ADF-14, in order to maintain the momentum and support the scale up of investment under the High 5 agenda.

ANNEX II: Lessons learned from blended finance and non-sovereign operations in fragile situations and under-served segments

In line with the findings of the Bank's independent evaluation on non-sovereign operations (NSOs)[17], the Bank has made significant efforts to increase its NSO portfolio in situations of fragility. Within the confines of the Bank's risk management framework, the share of NSOs in fragile situations has been rising steadily over the past years and currently stands at 16% of the total share of NSO operations in ADF countries. Situations of fragility are characterized by challenging business climates, high indirect costs of weak infrastructure, regulatory challenges, low labour productivity and other factors that have an impact on the commercial viability of private ventures. In addition, political risk is often cited as a major concern for investors interested in these environments.

Experience shows that traditional financing instruments at the disposal of DFIs, particularly those that require sovereign counterparty engagements, are not always appropriate to address the specific challenges and risks of private sector development in situations of fragility where the ability of the sovereign counterparty to enforce agreements is limited and commercial insurance is either not available or only at short tenors and prohibitive costs. This calls for the deployment of catalytic concessional resources to support private entities that are more inclined to take risks but may not be able to, given the prevailing state and market failures.

The Bank's experience in developing the private sector in fragile situations also points to:

- **The low capacity and cloud of investment promotion agencies.** Experience shows that in capital-scarce economies in fragile situations, FDI can have a transformational impact by paving the way to second wave investors. Investment promotion agencies in these countries tend to lack the capacity or simply do not have knowledge of global markets if the country has been cut off the global economy due to economic crisis or conflict. Targeted support to build the capacity of these agencies to facilitate FDI in specific (sub)-sectors and projects is therefore an important short-term complement to the longer-term efforts of reforming the investment climate and catalysing direct investment.

- **The importance of building local private sector capacity.** In fragile environments, capacity weaknesses of the private sector impair their ability to start and grow their (informal) businesses. While there has been a traditional focus on building public sector capacity and reforming the business enabling environment as a means to promoting the private sector in fragile situations, there is a need to strengthen SMEs and support institutions, such as chambers of commerce, business associations, service providers and others. This needs to be complemented by targeted initiatives to rebuild financial markets, banks and other financial intermediaries.

- **Development partners need to accept that working with and through the private sector in fragile situations is resource-intensive, both at project and corporate level.** Local expertise to provide services aimed at promoting PSD (trainings, TA, etc.) is scarce and more hands-on support is required. Pooling resources and programs with non-traditional development players needs to be explored, for instance, in special economic zones.

[17] ADB/BD/WP/2013/44 and ADF/BD/WP/2013/30, entitled "Independent Evaluation of Non-Sovereign Operations 2006-2011"

- **Adopting a regional approach to private sector development in fragile environments is essential.** In view of the high risk profiles and diverse market opportunities, development partners need to work with **(sub-) regional intermediaries and sponsors**, such as commercial banks, development banks and regional private equity funds to pool risks, diversify the portfolio and achieve economies of scale.

Financing Small and Medium Enterprises (SMEs) is an important element of developing the private sector in low income countries, where the prevalence of large companies is less significant. The Bank's Independent Evaluation Department carried out an evaluation of the Bank's support to Small and Medium Enterprises over the 2006-2013 period, highlighting an important set of lessons and experiences that in many cases can be applied to broader programmes targeting hard-to-reach market segments.

- A persistent gap in the Bank's product mix is the limited use of local currency lending, which hinders its ability to effectively reach SME beneficiaries;

- Combining investment and technical assistance operations squarely focused on SMEs is important in ensuring that implementation capacity is matched by finance and vice-versa;

- SMEs is an intrinsically riskier segment; consequently programmes more tightly focused on SMEs also saw a higher share of non-performing loans.

- The monitoring and evaluation of SME assistance operations is challenging, requiring design of appropriate measuring tools and the collection of a significant mass of data, and is further complicated by the two-tiered structure of most SME operations, which in principle requires information from both immediate beneficiaries (banks, equity funds, etc.) and ultimate beneficiaries (the SMEs).

The Bank has also **delivered blended finance solution through the climate funds** it manages on behalf of global donors[18] for projects that advance climate resilience and reduce greenhouse gas emissions in a range of sectors, including power, agriculture and forestry sectors. By late 2015, AfDB had successfully mobilized around USD 1 billion for a total of 40 projects which it has co-funded in the tune of USD 1.6 billion.

In implementing those resources, the Bank acquired significant experience and understanding of what it takes to deliver robust blended finance packages:

- The need to minimize subsidies to the beneficiaries with the objectives of ensuring long-term financial sustainability and avoiding market distortion. Establishing minimum concessionality is challenging: inevitably, the final financing terms need to be established on a case-by-case basis depending on project specific risks and/or barriers. Finding the right level of concessionality is largely a matter of client needs, market conditions and negotiations. It is important to establish clear benchmarks for each sector and project type, in order to have clear references guiding pricing decisions; in particular, it is useful to establish a single repository of operational data, experiences and lessons to provide a reference guide for future decisions. In this respect,

[18] Mainly from the Climate Investment Funds and the Global Environment Facility but also from the Sustainable Energy Fund for Africa.

centralizing the process of structuring blended finance products for climate finance in a dedicated specialized team has been useful.

- Mitigation of moral hazard requires continuous surveillance and a clearly established set of ex-ante rules when in the implementation of blended financing in parallel to own-funds by committing “to exercise the same degree of care as it exercises with respect to the administration of its own resources”. In particular, the two-phased approval process adopted by the Climate Investment Funds and the Global Environment Facility ensures that an independent entity, in this case the relevant oversight committees where donors are represented, that have the final approval authority on the proposed concessionality.

The implementation of the **Private Sector Credit Enhancement Facility (PSF)**, which has now seen a significant take up of its resources, over the course of ADF 13 also provides some important experiences in setting up innovative instruments to reach under-served and risky segments:

- The adoption of an **unfunded risk participation methodology** enables a focus on risk, a key disabler to private financing in ADF countries. In light of corporate KPIs which put emphasis on ADB own balance sheet approval and disbursement volumes, this enables the PSF to be complementary and additional- rather than competing with the ADB’s own capital and ability to source liquidity from the markets on favourable terms. In turn, it enables the PSF to effectively co-opt the NSO transactional capacity of the ADB, and has been a critical factor for swift deployment of PSF resources.

- It is important to **manage moral hazard** by preserving an arms-length relation between the investment of the non-concessional arm of the Bank and the decision of risk participation through the PSF. A separate decision-making authority (the ADF Board), an independent administrator, a clear separation between the origination function and the decision to risk-participate the transaction by deploying scarce concessional resources are made independently. Experience of the PSF shows that this can be done with relatively limited resources.

- **Establishing new stand-alone vehicles that meet ex-ante all legal, financial, auditing, and risk management parameters is an iterative but time intensive process.** Building-in a piloting phase enables implementation to move forward while providing opportunities to refine the business model, operational and legal arrangement on the basis of experience;

- **Clear eligibility criteria for PSF risk participation** are important to establish up front realistic expectations about the role of the facility, and guide investment decisions. This includes setting out key portfolio parameters, including a prudent maximum transaction size.

- If the facility is to be financially self-sustainable, **portfolio balancing – the inclusion of moderate alongside high risk project, is a key factor**. This however means that the facility cannot devote all its resources to riskiest segments unless it treats at least some of its resources as grants which would reduce the level of leverage achieved.

ANNEX III: Summary of current instruments used to support private sector development and alternatives considered

Instrument	Funding	Summary Overview	Challenges or gaps
Private Sector Credit Enhancement Facility (PSF)	ADF	**Overview:** A risk participation vehicle for low income countries, sharing up to 66% of credit default losses on ADB NSOs. **Key features**: Uses transactional capability of the Bank. Enables the Bank to stretch its balance sheet to increase private sector financing in LICs. Significant leverage factor (estimated at 3 times liquidity pool). Allows the Bank to do more NSOs in ADF countries and, particularly, in fragile states. **Financial products**: Risk participation in ADB loans and guarantees.	Does not change pricing for borrower and other investors.
Partial Risk Guarantee (PRG)	ADF	**Overview:** Insures commercial lenders against political risks in the event government or related entity fails to honour specified commitments. **Key features:** Intended to crowd-in private lenders to PPPs. Only 25% of nominal value of guarantee is deducted from country's PBA. **Financial products:** Guarantee covering defined political risks.	Requires sovereign counter-indemnity, a 'last mile' instrument.
Partial Credit Guarantee (PCG)	ADF	**Overview:** Partial guarantee to debt service obligations of eligible countries and SOEs. **Key features:** Supports LICs to access markets and lower borrowing costs for their projects. Only 25% of nominal value of guarantee is deducted from country's PBA. **Financial products:** Guarantee covering sovereign credit risks.	Mostly used for sovereign borrowing rather than for SOEs, so support to PSD is mostly indirect through macroeconomic stabilisation. Requires sovereign counter-indemnity, a 'last mile' instrument.
Climate Funds (CIF, SEFA)	Various bilateral donors	**Overview:** Enables greater private sector participation in climate action. Supports investments in clean technologies. **Key features:** Allows blending of concessional finance with commercial investment to lower the overall required rate of return for commercial investors, allowing risky climate mitigation and green technology projects to go ahead. **Financial products:** Grants, loans, equity.	Single focus, limited funding pool.
Technical Assistance (e.g. Governance Trust Fund and Fund for Africa Private Sector Assistance)	Various bilateral donors	**Overview:** In addition to work in public financial management and sector governance, the GTF & FAPA promotes the business-enabling environment. **Key features:** Provides useful complement to ADF and ADB operations allowing piloting new initiatives and capacity building for PSD. **Financial products:** Grants, seed equity (in case of FAPA).	Limited resources, capacity must be combined with investment to reach scale.

Alternatives Considered

To complement these existing initiatives that support private sector development in ADF countries, alternative financial instruments were explored as part of the ADF-14 replenishment. The focus was to use the ADF to directly support the private sector, as a means to crowd-in additional finance. Alternative structures were explored and are set out below.

Instrument	Summary Overview	Benefits	Challenges
Blended Finance (via separate legal entity)	**Overview:** Use separate legal entity as a conduit for blending. **Financial products:** Could be through risk participations on ADB NSOs, but acceptance of lower returns (for concessional portion of blended finance).	- Might benefit from leverage factor for capital adequacy/liquidity purposes. - Could provide products subordinated to ADB.	- Would still require time to develop operational guidelines. - Entity would need to be ‘fit for purpose’ and consultations with rating agencies would need to occur, if it were to be rated. - Could result in significant time lags.
Pillar IV Transition Support Facility	**Overview:** ‘Pillar IV’ would be set up under the Transition Support Facility. **Financial products:** Credit guarantees in countries in fragile situations.	- Entire allocation dedicated exclusively to countries in fragile situations.	- Requires administrative set-up / establishment. - Selects NSOs on basis of country classification rather than market segment/business characteristics

ANNEX IV: Indicative results chain

Specific measured outputs and outcomes will be derived from the design of operations that will leverage the Window for Blended Finance. This illustrative results framework illustrate the estimated impact of the proposed facility. Specific numerical targets will be determined in programme operations for each transaction submitted for approval.

Objective	Indicator/measure	Indicative target
Outcomes		
Create sustainable employment, particularly in countries in fragile situations	Number of additional jobs created (of which women) in countries in fragile situations	Monitored through Bank Group RMF
Contribute to fiscal stability	Government revenue from investee projects and sub-projects in fragile situations	Monitored through Bank Group RMF
Contribute to climate smart renewable energy	Power capacity installed through renewable energy	Monitored through Bank Group RMF
Unlock Africa's agriculture potential	People benefitting from improvements in agriculture	Monitored through Bank Group RMF
Enhance productivity of SMEs, including youth & women owned businesses	SME effect (turnover from investments), including share from women and youth owned businesses	Monitored through Bank Group RMF
Outputs		
Catalyse additional finance from private sector investors	Flows of commercial investment into transactions supported by the Window for Blended Finance	1:3 ratio of external funds to Bank Group funding in fragile situation and high impact sectors
Mobilizing additional ADB funds into hard to reach segments	Amount of additional ADB funds viably deployed pari-passu with ADF window	At ratio of at least 1:3 of ADB to ADF Window's resources mobilised.
Increased access to local currency finance	Transactions in local currency supported by the Window for Blended Finance	At least one transaction supported in pilot phase
Reaching situations of fragility	Share of resources from the Window for Blended Finance deployed in fragile situations	Over 50% of resources
Implementation milestones		
Originate pipeline of high impact projects	Identification of high impact transactions with potential eligibility for Blended Finance	TBD
Operational manual	Delivery of operational manual to ADF Board	TBD
First Blended transaction	First transaction submitted to ADF and ADB Board for approval	TBD

ANNEX V: Examples of possible proposals to be considered for blended finance

Example: Rural Electricity Access

Championing universal access to clean energy services is one of the High 5 priorities (Hi5s) that have been identified by the Bank Group as a major part of its support to the African countries' efforts towards achieving the Sustainable Development Goals by 2030. Attaining the goal of universal access to clean energy, however, will be especially challenging in view of the widely dispersed patterns of homesteads in rural areas, where most of the population in Sub-Sahara Africa still lives. Fortunately, a range of off-grid renewable energy supply systems now provide technically feasible and financially competitive solutions that can be efficiently rolled out in the rural areas.

Under current estimates, across the continent, only 26% of rural households have access to electricity. The access rate is below 10% in most of the ADF countries, especially in countries in transition from conflict or other fragile situations. The New Deal on Energy, the Bank Group's strategy to light up and power Africa, has set an aspirational target of 95% of rural households having access to electricity by 2025. A large part of the new energy supply capacity to meet the increased consumption by rural households is expected to be provided by off-grid renewable energy systems, especially solar power systems, mini hydro, and biogas digesters.

The technical feasibility and reliability of stand-alone, off-grid renewable energy systems is not in question. However, the financing of commercially viable rural energy supply initiatives faces two distinct challenges.

The first challenge is that, while energy needs of individual households can be met by installing autonomous systems, and households will consume a stream of energy services over an extended period of 10-15 years, the typical rural household does not have the financial capacity to meet an upfront lump-sum expense to invest in the energy supply system. This problem would be solved by attracting a renewable energy provider to finance, procure, install and service stand-alone energy systems for households. Some of the costs will be in hard currencies, such as for imports of solar panels and batteries from the most competitive suppliers, while other costs will be incurred in the local currency.

The second problem is that while rural households may be able to maintain periodic payments for energy services over the economic life of their energy systems if the monthly rates are set maintained at an affordable level, these revenues to the energy provider will be in the local currency.

Typically, to finance the rural energy supply roll-out, the energy provider draws the necessary resources from its own capital, possibly leveraging additional resources from domestic and/or external financial institutions, including the African Development Bank Group. In the case where the energy provider mobilises additional financing and incurs repayment obligations, it not only faces credit risks linked to the ability or willingness of its clients to continue honouring their periodic rate payments, but it also faces the risk of currency depreciation.

If these problems are not addressed, an ambitious roll-out of off-grid renewable energy access would remain too risky. The ADF and ADB Blend Financing facility can catalyse access to renewable energy services at prices that are affordable for rural households, especially in countries in affected by fragilities, through a transaction model such as the one outlined below:

(a) The ADF provides to a renewable energy provider direct financing on appropriate concessional terms to be blended (at the level of the borrower, with no commingling of funds) with AfDB non-concessional NSO resources, and possibly climate finance and Technical Assistance support. The financing resources are provided in hard currency but possibly also in local currency. These resources support the client in procuring materials, such as solar panels, batteries, cables, switches, hydro power turbines, transformers, and services from local and external suppliers to assemble off-grid energy systems.

(b) Additionally, the Bank Group's could provide to the renewable energy provider a local currency partial credit risk guarantee, which would cover the risk of the rural energy consumers defaulting on their periodic rate payments to the rural energy provider.

The ADF would provide solutions to manage the currency exchange margin of converting, or swapping, its local currency receivables from the client energy provider into hard currency.

Example: Developing Inclusive SME Value Chains

In line with the Bank's Ten Year Strategy and the High 5 priorities, the objective of the Inclusive Enterprises Initiative is to promote the development of viable enterprises linked to public and private sector projects funded by the Bank Group. The Inclusive Enterprises Initiative draws lessons from the Inclusive Industries Program (IIP) that was piloted in the Bank's Private Sector Department from 2013 to 2015. The Initiative will be implemented through the business model outlined below:

- **Eligibility criteria**: Enterprises eligible for support under the Initiative must be anchored on public or private projects supported by the Bank Group in any sector. There are two selection criteria: (a) the project must have a high quality at entry, and demonstrable strong commitment by the sponsors to implement it on a timely basis; and (b) the project's business model must provide adequate opportunities for local micro, small and mid-sized enterprises (MSMEs) in upward and downward linkages of the value chain. The Bank pays particular attention to ensuring that women entrepreneurs have equal access to business opportunities.

- **Commitment:** In addition to the two eligibility criteria, another important condition is an expression of strong commitment by the sponsor of the anchor project to promote an inclusive business model for creating opportunities for local MSMEs. The sponsor may be a country authority or a private company. The sponsor's commitment would be formally expressed by signing a letter of understanding with the Bank, spelling out the terms of the collaboration between the two in support of inclusive local enterprises development.

- **Oversight:** Whenever an anchor project is selected to participate in the Initiative, an 'Inclusive Enterprises Program' will be developed with the project sponsor. The program's design and implementation will be overseen by a Bank-wide multi-sectoral team involving the participation of all relevant departments, including the Private Sector Technical Assistance Team, chaired by the country manager.

- **Possible examples:** An Inclusive Enterprises Program could be any of the following hypothetical examples: (i) a range of agricultural and agro-industrial suppliers linked to a mining project; (ii) support for a government to develop local content through MSME linkages to large infrastructure projects; (iii) maximising the use of local suppliers in the petrochemical industry; (iv) technical assistance to MSMEs through business management capacity building, technical capacities such as maintenance of phytosanitary standards, and training in critical production skills; and (v) linking smallholder food producers with markets to facilitate affordable and quality food supply in a project zone or around a city.

Resources

An Inclusive Enterprises Program will use a combination of the Fund for African Private Sector Assistance (FAPA) and potentially ADF funding made available through the window for Blended Finance (subject to consideration and approval by the ADF Board), to underwrite programme design and capacity building.

When a viable programme has been developed and agreed upon among the Bank Group, the sponsor of the project, and MSME stakeholders, financing for the programme's realisation would be provided by: (a) the project sponsor's commitments; (b) capital investments from MSME operators' own savings; (c) catalytic financing by the proposed Blended Finance facility; (d) financial support from other bilateral and multilateral development agencies; and (e) credit lines and innovative venture capital participations from local and subregional financial intermediaries, including local and subregional development banks and private equity funds.