ADF-13 MID-TERM REVIEW

Implementation of Innovative Financing Instruments under ADF-13

Discussion Paper

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Executive summary

Better and smarter development financing, including the mobilisation of private sector sources, is needed to achieve the Sustainable Development Goals in Africa. For this purpose, several catalytic and innovative financing instruments have been rolled out to leverage African Development Fund (ADF) resources, by crowding in both AfDB and commercial finance.

This paper takes stock of the Bank's implementation of these innovative financing instruments, agreed at the ADF-13 replenishment. It also discusses the challenges faced and how Management intends to address them for the remainder of this funding cycle.

Since the approval of the **Partial Risk Guarantee (PRG)** under ADF-12, it has been utilised to support two projects in Kenya and one in Nigeria. With a total guarantee face value of UA 146 million, it has helped to catalyse over $2.7 billion in investments. The attractiveness of the instrument lies in its ability to insure private lenders against well-defined political risks, related to the failure of a government or a government-related entity to honour specified commitments. This reduces the risks to private lenders and so leverages impact on a country's Performance Based Allocation.

Since the approval of the **Partial Credit Guarantee (PCG)** under ADF-13, the Strategic Framework and Operational Guidelines were approved in December 2013 to guide its implementation. The PCG serves to partially guarantee the debt service obligations of eligible countries and State Owned Enterprises (SOEs) and therefore improves access to finance with lower borrowing costs. It allows well-performing, eligible ADF countries and SOEs to catalyse more resources at more reasonable terms, in order to finance their development needs.

The **Private Sector Credit Enhancement Facility (PSF)** was introduced under ADF-13 as a credit-enhancement, special purpose vehicle to enable the AfDB's risk capital to support more projects in Low Income Countries (LICs). It started with an initial seed grant of UA 165 million. The PSF Strategic Framework was approved by the ADF and AfDB Boards in May 2015. Implementation has commenced, with the identification of an initial portfolio and pipeline of transactions which will ensure rapid utilisation of the PSF resources.

Key Challenges and measures to address them

Demand is growing for political and credit-risk mitigation instruments, targeting sovereigns and SOEs. However, few PRG and PCG enquiries meet the eligibility requirements set for the ADF products. The uptake of these structured finance instruments has therefore been selective but progressive. A number of factors have affected the pace of their deployment, including the requirement for sovereign counter-indemnity, limited client awareness of the cost benefit of PRGs and PCGs relative to loans and grants, and the need to build in-house structured finance expertise among the operations team which works with sovereign counterparts.

For the future, Management proposes to extend the utilisation of the PRG and the PCG, through a range of measures. These include: (i) continuing client outreach activities and collaboration with other development partners; (ii) pursuing the activities of the Bank Guarantee Task Force; (iii) shoring up skills around the instruments and engaging new experts; and (iv) extending the ADF PCG to ADF countries classified as having moderate risk of debt distress, provided they are eligible for AfDB financing under the revised Bank Group Credit Policy.

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Abbreviations

ADF	African Development Fund
AfDB	African Development Bank
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
EIF	European Investment Fund
GDC	Geothermal Development Corporation
GoG	Government of Ghana
JICA	Japan International Cooperation Agency
KETRACO	Kenya Electricity Transmission Company
KPLC	Kenya Power Lighting Company
LICs	Low Income Countries
LNG	Liquefied Natural Gas
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency
MTR	Mid-Term Review
NBET	Nigerian Bulk Electricity Trading Plc
NCDA	Non-Concessional Debt Accumulation
NSO	Non-Sovereign Operations
NSE	Non-Sovereign Entities
ODA	Official Development Assistance
PBA	Performance Based Allocation
PCG	Partial Credit Guarantee
PPP	Public-Private Partnership
PRG	Partial Risk Guarantee
PSF	Private Sector Credit Enhancement Facility
PSFA	Private Sector Credit Enhancement Facility Administrator
PSO	Private Sector Operations
RMCs	Regional Member Countries
SEFA	Sustainable Energy Fund for Africa
SDGs	Sustainable Development Goals
SOE	State Owned Enterprise
VRA	Volta River Authority

Implementation of Innovative Financing Instruments under ADF-13

1. Introduction

1.1. The African Development Bank (AfDB) Group is targeting its finance to achieve the Sustainable Development Goals, working closely with the private sector. The Bank Strategy (2013-2022) emphasises the importance of using its financial strength and its reputation as Africa's own Bank to bring in additional finance, in order to deliver on its mandate. To leverage African Development Fund (ADF) resources by crowding-in AfDB and commercial financing, the Bank Group has rolled out some innovative financial instruments.

1.2. The Bank introduced the ADF Partial Risk Guarantee (PRG) in ADF-12, to leverage ADF resources. During ADF-13, Deputies then approved the introduction of two more innovative financial instruments, the ADF Partial Credit Guarantee (PCG) and the Private Sector Credit Enhancement Facility (PSF). These provided the ADF with a suite of financial instruments to catalyse additional resources.

1.3. This paper reports on the Bank's progress since the introduction of these ADF financial instruments, and identifies the challenges faced during implementation. It also sets out the opportunities for scaling up their deployment and impact. The paper is structured in four sections. Following this introduction, Section II discusses the implementation of ADF guarantee instruments, Section III discusses the implementation of the PSF and Section IV pulled together the conclusions and recommendations of the paper.

2. Assessment of the Implementation of the ADF Guarantee Instruments

Description of the ADF Guarantee instruments

2.1. This subsection describes the instruments and highlights their individual characteristics.

<u>ADF Partial Risk Guarantee</u>

2.2. In May 2010, Deputies agreed to add Partial Risk Guarantees (PRGs) to the ADF's range of financial instruments. The ADF PRG was introduced to leverage resources from the private sector and other co-financiers for ADF countries, including in fragile states. It operates by insuring private lenders against well-defined political risks, related to the failure of a government or a government-related entity to honour certain specified commitments. These risks include political force majeure, currency inconvertibility, confiscation, expropriation, nationalisation and deprivation. They also include regulatory risks, such as adverse changes in law, and various forms of breach of contract.

<u>ADF Partial Credit Guarantee</u>

2.3. The ADF PCG is another leveraged[1] instrument, which is designed to help address the challenges faced by well-performing ADF countries. These countries are assessed as

[1] It is a leveraged instrument that consumes only a fraction of a country's Performance Based Allocation (PBA) - For a guarantee amount of 100, only 25 (i.e. 4x leverage factor) would be deducted from the host country PBA.

being at low risk of debt distress (green light countries) and as having adequate debt management capacity. The instrument also targets State Owned Enterprises (SOEs) in eligible ADF countries, to mobilise domestic and external commercial financing. The instrument provides a partial guarantee to debt service obligations of eligible countries and SOEs, by supporting: (i) the extension of debt maturities; (ii) improved access to capital markets for public sector investment projects, particular infrastructure; (iii) the decrease in effective borrowing costs; (iv) mobilisation of long-term resources from international and domestic capital markets; and (v) sovereign mobilisation of commercial financing for policy or sectorial reforms.

2.4. Table 1 provides a snapshot of the ADF Guarantee Instruments.

Table 1: Snapshot of the ADF Guarantee Instruments

	PRG	PCG
Purpose	Insures private lenders against well-defined political risks, related to the failure of a government or a government-related entity to honour certain specified commitments.	Partially guarantees debt service obligations to help eligible countries/SOEs to mobilise domestic and external commercial financing on improved terms.
Approved to-date projects using the instruments	3 projects	-
Operationalising the instruments	- Strategic Framework and Guidelines have been approved by the Board of Directors in 2011. - Marketing strategy for the period 2014-2015 launched. - Constitution of a Guarantee Taskforce.	- Strategic Framework and Guidelines have been approved by the Board of Directors in 2013. - Marketing strategy for the period 2014-2015 launched. - Constitution of a Guarantee Taskforce.
Challenges	-Limited client awareness of the cost/benefit of PRGs relative to loans and grants. - Limited in-house structured finance expertise to work with sovereign counterparties. - Absence of Bank-wide key performance indicators to use guarantee products versus loans.	- Few PCG enquiries meet the eligibility requirements set for the ADF products. - Limited client awareness of the cost/benefits of PCGs vis à vis loans and grants. - Limited in-house structured finance expertise to work with sovereign counterparties. - Absence of Bank-wide key performance indicators to use guarantee products versus loans.

Progress on PRG and PCG implementation

2.5. **Institutional and Operational Arrangements:** Detailed operational guidelines, set out in the Strategic Framework and Operational Guidelines, were adopted for the PRG in 2011 and for the PCG in 2013[2]. These provide the framework, with principles and modalities, to guide the Fund in extending the instruments. The processing of the ADF

[2] In December 2013, the ADF Board of Directors (ADF Board) approved the Strategic Framework and Operational Guidelines (the "Framework") of the ADF PCG instrument. The Framework outlines a set of principles that guide the issuance of the PCG as well as institutional requirements for its smooth implementation. The Framework for the ADF PCG is aligned with the Non-Concessional Debt Accumulation (NCDA) policy of the Bank Group, which amongst other parameters give some ADF-only regional member countries the flexibility to prudently contract non-concessional borrowing in line with their debt vulnerability and their debt management capacity. Accordingly, in the design of the ADF PCG instrument, the authorization to raise non-concessional borrowing using the instrument was limited to only ADF-only countries with low risk of debt distress (green light countries).

guarantees makes use of procedures, which are closely linked to those that govern the processing and implementation of the ADF loans. Clearly defined accountabilities are assigned to various functional departments.

2.6. **Marketing, Awareness Building and Demand Creation:** The Bank has undertaken a range of measures to promote the use of these financial instruments. It has provided intensive awareness and focused training activities for Bank staff and has organised outreach activities for both RMCs and for private sector investors and lenders. Management launched a two-year marketing strategy for the period 2014-2015, focusing on 2 main pillars: (i) reinforcing awareness and use of the full menu of existing products among Bank staff and borrowers; and (ii) ensuring the successful implementation of all newly approved Bank Group financial instruments. In 2014, a total of twenty-one marketing, awareness and training events took place, reaching an audience of over 895 Bank staff and clients. Marketing and awareness initiatives are also being pursued in 2015, with relevant departments delivering a series of workshops in certain regional member countries. Staff attached to field offices have also participated in building additional, front-line support. Appraisal and identification missions, conferences, forums, and such events are also used as opportunities to disseminate knowledge on the instruments, in order to strengthen clients' understanding of the Bank's guarantees.

2.7. **Collaboration efforts:** The Bank is collaborating with other development partners, including the Multilateral Investment Guarantee Agency, the World Bank, the US Overseas Private Investment Corporation and USAID, to ensure that the ADF guarantees are offered in parallel with other guarantee and insurance products. In particular, the US Government's Power Africa Initiative has identified the need for guarantees to support Africa's energy sector and has expressed formal interest in working with the Bank.

2.8. **Government Consent:** ADF guarantees require the consent of the host government in order for the Fund to extend the product to beneficiary projects, particularly since the country provides the requisite counter-indemnity. Accordingly, the Bank is seeking to sensitise authorities in RMCs about the benefits of guarantees and in particular to reassure them that they do not create any additional conditional liability[3] for governments. This has been critical in ensuring their support for related projects.

2.9. **Constitution of a Guarantee Taskforce:** Following the approval of the ADF PRG Framework in 2011, the Bank's Guarantee Task Force was constituted to identify, prepare and support the implementation of ADF guarantee transactions. Given the multidisciplinary and specialist skills required to manage guarantee instruments, the Task Force includes focal points from organisational units responsible for energy, legal services, private sector operations, treasury, environment and social safeguards issues. Indeed, the Task Force has been very instrumental in executing the first ADF PRG of the Bank Group.

2.10. **Internal capacities:** Guarantee instruments are more complex than both sovereign and non-sovereign debt financing transactions. To increase the utilisation of the guarantee instruments, it has been necessary to build internal capacity on this form of financing. The Bank currently has professional staff with requisite skills to support the guarantee

[3] The Government's indemnity of Fund does not increase the Government's contingent liabilities as the Government is already directly / indirectly obligated to the private sector on the same liabilities.

operations, but scaling up the guarantee portfolio will require hiring new specialised staff as well as training and knowledge transfer for existing staff, through structured in-house courses to broaden the guarantee expertise.

Demand for ADF Guarantees

2.11. In this section, the paper will assess demand for ADF guarantees, highlight those transactions which have been approved since the introduction of the instruments, and describe the potential pipeline projects.

ADF Partial Risk Guarantee

2.12. Since its approval in 2011, the ADF-PRG has been utilised to support three key private sector operations in the energy sector under PPP structures: (i) the Lake Turkana Wind Power project (LTWP) in Kenya; (ii) the privatisation of the power sector in Nigeria, by providing support to four identified independent power producers (IPPs); and (iii) a programme supporting three geothermal IPPs projects in the Menengai steam fields in Kenya.

2.13. The ADF PRG's operations success to date is encouraging and can be measured in terms of its (i) outcome, which is the number and volume of PRG operations supported; and (ii) output, which is the volume of guarantees over total project financing or over commercial debt mobilised. As a result of the 4 times leverage factor, the ADF PRGs approved to date have enabled UA 36.4 million of the ADF PBA to guarantee UA 145.6 million and helped catalyse over $2.7 billion[4] of investments.

Table 2: Projects supported by the ADF PRG

Name	Lake Turkana Wind Project	Power Sector Privatization	Geothermal Development Corporation (GDC) Menengai IPP Project
Country	Kenya	Nigeria	Kenya
Date of approval	October 2013	December 2013	October 2014
Main characteristics	The AfDB is leading the structuring and financing of the 300 MW LTWP project from the private sector window. The ADF is providing a PRG with a face value of UA 17.4 million to cover certain obligations of the Kenyan government and governmental entity in connection with the transaction.	The PRG with a face value of UA 120 million is provided in a programmatic approach, to cover several independent power producers. To date, the Nigerian Bulk Electricity Trading Plc has approved the 495 MW Okija power project, where the AfDB is acting as the lead arranger for the debt financing; the 250 MW Ikot Abasi gas-fired power project; phase one of the 1200MW Zuma coal fired power plant; and a brownfield project, the 330MW Transcorp Ughelli gas-fired power plant.	PRGs will be extended in support of three IPPs, which won a tender to generate power from the Menengai geothermal field. The programme provides guarantees against non-payment under Power Purchase Agreements between Kenya Power Lighting Company (KPLC) and the IPPs, due to either (i) KPLC's inability to take power generated and ready to be evacuated by the IPPs or (ii) the IPPs' inability to generate power, due to GDC's default under power and steam supply agreements.
Value added	The PRG covers the	The PRG covers several	The PRG increases the

[4] Estimated investments in the projects are as follows: LTWP at EUR 655 million; Nigeria Power Sector Privatisation at $1.8 billion for the total project cost for the three greenfield independent power producers; and GDC Menengai IPP Project at $272.9 million.

of the PRG	payment obligations of KETRACO to the project for Deemed Generated Energy of up to EUR 20 million, in the event that the transmission line is not ready once the power plant has been commissioned. It will secure the timely delivery of a 400 km transmission line, to be built by the government owned Kenya Electricity Transmission Company (KETRACO). Lenders to the LTWP identified this risk as a major impediment to the commercial viability of the project.	independent power producers. It will catalyse investment of approximately $1.8 billion.	bankability of each IPP project and contributes to increased access to clean energy. With a total PRG value of UA 8.24 million, the program will not only mitigate the risk of non-payment to the IPPs but also enable the further development of renewable energy projects by virtue of its demonstration effect across the energy sector.

ADF Partial Credit Guarantee

2.14. The ADF PCG has not yet been utilised to support operations. However, many requests have been received about the guarantee from investment and commercial banks, SOEs, and sovereign and private sector project developers, which has demonstrated an increasing interest. One potential use of the ADF PCG progressed significantly, following a project identification mission in September 2014, which considered the instrument for the aviation sector in East Africa. This culminated in a formal request from the host government and advanced discussions with the relevant SOE in March 2015, about instruments to support the financing of an airline fleet. The proposed transaction was, however, cancelled when the SOE informed the Bank Group that its need for finance was urgent and the Bank's internal approval process would not meet the SOE's timeline.

2.15. Enquiries have also been received to use the ADF PCG for syndicated loans, in particular from financial institutions seeking to make loans to energy projects and other capital intensive expansion programmes of commercially-run SOEs. Additionally, the Bank has been approached by counter party banks, requesting credit enhancement on their derivative transactions, or swaps, with ADF member countries, in order to hedge interest rate and currency risks related to sovereign international bond issues. There is also an emerging interest to use the instrument for non-conventional financing, including for leasing and mortgage-backed securities.

Pipeline and Pre-Pipeline Projects for both Instruments

2.16. There is ongoing demand for the ADF PRG and PCG, with private sector project developers in Cameroon, Ghana[5], Kenya and Uganda engaging the Bank on the

[5] In February 2015, a formal request was received from the Government of Ghana (GoG) for an ADF PRG for the Ghana 1000 Gas to Power Integrated Project, to back the payment obligations of the Electricity Company of Ghana for an exposure of up to $120 million i.e. UA 85 million. A preparation mission has already taken place to assess the project and collect the necessary documents for a full appraisal of the project. In April 2015, the ADF received another formal request from the GoG for Quantum Power, a gas infrastructure entity, undertaking a liquefied natural gas (LNG) project, involving the installation, commissioning and operation of the infrastructure required to import, store, re-gasify LNG and deliver re-gasified LNG to Ghana National

possibility of using the guarantees to develop power projects.

2.17. While the demand for the PRG has been concentrated in the energy sector, the instrument is introduced during the initial design phases for a range of projects, to encourage its use in different sectors. The feasibility of leveraging the financing instruments is also being considered across those non infrastructure sectors requiring credit enhancement to mitigate government exposure.

Challenges and proposed adjustments

2.18. There are a number of challenges affecting the utilisation of these innovative ADF financing instruments. The introduction of the instruments is taking some time because of their new and complex nature, which potential clients are not familiar with and may not easily understand. Secondly, marketing and building awareness of the financial instruments, both with the Bank and externally, have been more challenging and time consuming than anticipated. Thirdly, the operations team working with sovereign counterparts have limited exposure and experience in the deployment of structured finance products.

2.19. Management is therefore taking several opportunities to scale-up the utilisation of the PRG and PCG. The Bank will continue with **the marketing initiatives and client outreach** activities, alongside collaborating with other development partners. In addition, **the Bank Guarantee Task Force** will shore up the skills required to promote the financial instruments, as well as recruit new skills to broaden the guarantee structuring expertise. Furthermore, since corporate performance management indicators tend to favour volume of direct lending, Management will introduce incentives for staff to close non-direct lending transactions. **Key Performance Indicators** will also be introduced, which will encourage the use of innovative project structures and instruments as well as leveraging the Bank's limited resources. These measures will all mainstream the utilisation of guarantees products across the Bank Group.

2.20. **Counter Indemnity Provision:** The ADF guarantees require the RMC's counter-indemnity, to mitigate credit risk and ensure the financial sustainability of the ADF. Additionally, the issuance of a sovereign counter-indemnity confirms that the project to be guaranteed is of importance to the government. Commercial lenders have also reiterated the requirement for the eligible SOE to obtain a counter-indemnity from the host government, in order to access the ADF PCG. This feature has been a limiting factor in the demand for the use of the instrument by SOEs. Indeed, some governments may be unwilling to issue the counter-indemnity if they have already earmarked their Performance Based Allocation for other priority projects and programmes or expect their commercially-run SOEs to access commercial funding without government support. Management will continue to market the guarantees and explain the purpose of the instruments including the need for counter indemnity provision from the government.

2.21. **Eligibility:** The revised Bank Group Credit Policy[6] allows those ADF-only countries with low or moderate risk of debt distress (green light and yellow light countries,

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Petroleum Corporation (GNPC) , a governmental entity, and the related off-takers. The ADF PRG with an expected face value of UA 53 million will back the payment obligations of the GNPC under a Facilities Use Agreement with Quantum Power. An appraisal mission was undertaken in September 2015 for the project.

6 ADB/BD/WP/2014/48/Rev.1; ADF/BD/WP/2014/31/Rev.1 – Diversifying the Bank's Products to Provide Eligible ADF- Only Countries Access to the ADB Sovereign Window.

respectively) to access the AfDB sovereign window to finance viable projects, subject to certain eligibility criteria which includes compliance with the Non-Concessional Debt Accumulation policy of the Bank Group. In designing the ADF PCG instrument, authorisation to raise non-concessional borrowing using the instrument was limited to ADF-only countries, with low risk of debt distress (green light countries). Although this limitation has not presented any implementation challenges, it may restrict expansion of the guarantee, as it becomes more mainstreamed. Therefore Management proposes to **extend the scope of eligibility of the ADF PCG to countries classified as having moderate risk of debt distress.** This promotes harmonisation and will also help increase demand. Moreover, it introduces consistency, since currently SOEs in both green and yellow light countries, subject to certain eligibility criteria and a counter-indemnity from the host country, are able to utilise the instrument[7].

2.22. **Total Guarantee Exposure Ceiling:** The ADF PRG and PCG share a combined exposure ceiling of UA 500 million, which may constrain the future utilisation of the guarantees based on current demand. While no ADF PCG transaction has yet been approved, there have been UA 267 million approvals and formal requests for PRG transactions. This already accounts for more than 50 per cent of the combined exposure limit of 500 UA million. Also, transaction amounts requiring PCG support are usually larger than related PRG transactions[8]. As a result, it is probably that as expected demand the ADF PCG is realised, the ADF guarantee ceiling may be reached sooner than anticipated.

[7] While the ADF PCG is available to only green light countries (low risk of debt distress), SOEs in both green and yellow light countries subject to some eligibility criteria and a counter-indemnity from the host country are able to utilise the instrument. The availability of the ADF PCG to SOEs in yellow light countries, while excluding the host country from accessing the instrument, has raised some level of concern and discussions as the country has the underlying obligation should there be a default by the SOE. Management considers that this risk is however mitigated by the stringent eligibility criteria required for SOE's to access the instrument. SOEs will be additionally evaluated and appraised using similar principles applied to non-sovereign guaranteed entities seeking assistance under the Bank's private sector window. Hence, the comprehensive private sector assessment of the financial viability of the SOE and the project it wishes to finance will apply along with other related private sector operations approval processes. The project eligibility requirement will ensure that eligible SOEs can access the ADF PCG only for self-sustaining high impact projects with significant economic and financial returns and demonstrable capacity to repay the guaranteed debt. Collectively, this will limit the event or risks of default, and thus the potential for the counter-guarantee to be triggered. While the aforementioned provides support for eligible SOEs in yellow countries to utilise the ADF PCG, the extension of the instrument to the host country will eliminate the inherent concern of an otherwise ineligible country assuming the underlying liability, in the event of a default by the SOE.

3. The Private Sector Credit Enhancement Facility

3.1. Table 3 summarises the main characteristics of the Private Sector Credit Enhancement Facility (PSF), positive developments and challenges.

Table 3: Snapshot of the PSF

	PSF
Purpose	Stretch the AfDB's risk capital to support more projects in ADF countries, including fragile states, beyond what it could otherwise finance on its own.
Projects supported by the facility	Non Sovereign Operations in ADF-eligible countries
Positive developments	• Framework and Guidelines approved by the Board of Directors. • Recruitment of the PSF administrator. • Pre-identification of a portfolio of eligible operations.
Challenges	• A comprehensive legal analysis of the Framework of facility took place. Extensive consultations were held with rating agencies and auditors. Benchmarking with peer Multilateral Development Banks was undertaken. However these actions delayed the approval by the Board of Directors. • The selection process for the initial portfolio needs to take into account strategic considerations in addition to portfolio construction parameters. • The initial portfolio should focus on transactions in ADF only and fragile states but should not contain only riskier projects.

Description of the PSF and its Operational Framework

3.2. The PSF provides an avenue for the ADF to invest in development results through the private sector, by co-opting the Bank's Private Sector Operations (PSO) capability to support private sector projects in ADF-eligible countries. The PSF is geared to catalyse additional private investment, by leveraging the transactional capability of the private sector window of the AfDB. The PSF is a special purpose vehicle offering credit enhancement to a portfolio of transactions in LICs.

Setting up the PSF

3.3. The PSF is an operationally and financially autonomous facility, with its resources separated from those of the AfDB and the ADF. A seed contribution of UA 165 million has been earmarked under ADF-13 as a grant to the Facility. Its credit enhancement capacity is backed by the liquidity of a reserve pool, that requires an adequate non-recourse seed contribution from various sources/donors to cover potential losses without recourse to ADF or other potential donors. Further non-recourse donations will be solicited to expand the capacity of a successful PSF. Given the specific nature of the PSF as a captive guarantee provider to the Bank's PSO in ADF-eligible countries, the ADF Board of Directors exercise oversight over the Facility which has its own governance rules and procedures. The ADF Board of Directors approves risk participations by the PSF in each PSO in compliance with the Framework and Guidelines.

3.4. The PSF uses the capital adequacy and risk management frameworks of the Bank to ensure that its capital resources are sufficient to meet its guaranteed portfolio risk exposures. Simulations performed to estimate PSF capital relief consistent with the Bank's triple-A rating, indicate that the PSF can leverage approximately three times its capital resources. The UA 165 million seed capital grant to the PSF will guarantee up to UA 495 million of PSO exposures in ADF-eligible countries.

3.5. Extensive consultations were held with rating agencies and auditors, benchmarking with peer Multilateral Development Banks, and legal reviews conducted to address legal, governance and risk management issues. A comprehensive legal analysis reviewed structuring options for the PSF to ensure compliance with the Bank's and the ADF's statute particularly the Charter provisions, financial reporting, corporate governance as well as financial risk management considerations.

3.6. Extensive consultations were also undertaken with the ADF and AfDB Boards to finalise the PSF's Strategic Framework and Guidelines. Enhancements were introduced in light of Board guidance, in terms of the need to (a) specify eligibility criteria for PSF cover, (b) mitigate moral hazard and adverse selection risks, (c) elaborate the criteria, process and implications of mobilising additional contributions for the PSF beyond the ADF, and (d) clarify the institutional arrangements for PSF administration. The PSF Strategic Framework and Guidelines were also approved by the ADF and AfDB Boards.

PSF Implementation

3.7. The PSF's implementation has started on a pilot basis following the approval of strategic framework by the ADF and AfDB Boards in May 2015. The approval delay was mainly due to completing a comprehensive legal analysis of the Framework of the facility as well as extensive consultations with rating agencies and auditors, and the benchmarking with peer Multilateral Development Banks. The Framework will be reviewed towards the end of the pilot phase, which coincides with the end of the ADF-13 cycle, and it will be amended in light of lessons learned.

3.8. A PSF Administrator (PSFA), responsible for the day-to-day management of the PSF and for mobilising additional contributions towards the PSF reserve pool, has been recruited. The PSFA will also mobilise legal, risk and treasury management services, and will be responsible for results reporting. During the pilot period, these services will be provided by the Bank to ensure efficiency and minimise transaction costs, in line with the practice of sister institutions with similar facilities.

3.9. To ensure the mainstreaming of the Facility, management has also taken the following measures:

- Organisation of sensitisation sessions with relevant investment staff, who are responsible for Non-Sovereign Operations (NSO) financing, to highlight the implications and modalities of the PSF for operations in eligible countries;
- Pre-identification of a portfolio of eligible operations to mitigate the risk of idle commitment of the capital earmarked from the ADF and achieve effective deployment. This initial portfolio will release UA 46.4 million of ADB risk capital for new transactions in ADF eligible countries. While adhering to the eligibility and prudential parameters set out in the PSF Framework and Guideline, this initial portfolio focuses specifically on overcoming capital constraints limiting the future growth of ADB NSO in higher risk countries, sectors and segments- such as countries in transition, agribusiness and infrastructures, as well as small and medium enterprises. It will be presented for ADF Board approval by the end of October 2015.

- Development of risk participation agreement documentation.

3.10. In addition, Management has engaged with commercial and official guarantee and insurance providers, as secondary risk-participants for the Bank's NSO. This endeavour is intended to enable the PSF to be used as a warehousing facility, for transactions during the riskiest period (construction), ahead of their partial sell-down to these commercial and official risk participants. Implementing this approach will further enhance the risk bearing capability of the PSF and its ability to enable the Bank, to scale up NSO financing in ADF eligible countries.

3.11. A utilisation rate of between 20 and 30 percent is targeted by the Mid Term Review (MTR) milestone, in November 2015. Achieving this utilisation rate is contingent on extending cover to existing eligible portfolio assets in countries where headroom pressures are highest. This will release country and high risk headroom for new NSO. Efforts will be made to utilise the PSF strategically, as a warehousing facility.

3.12. The pipeline of new projects to be considered for PSF cover is robust. In accordance with the guidelines for PSF portfolio construction, it is well diversified in terms of country, sector, and instrument exposures. The ADF Board will have opportunity to approve projects as the portfolio is being developed.

4. Conclusions and Recommendation

4.1. Innovative financing instruments to leverage ADF resources and stimulate additional private sector investments in LICs need time to mature, given their complexity. Management will take several measure to scale-up the utilisation of the PRG and the PCG. It will continue marketing initiatives and client outreach activities and collaborate with other development partners. The Bank Guarantee Task Force will enforce the skills and expertise needed to promote the financial instruments, including for structuring the guarantees. Thirdly, Key Performance Indicators will mainstream the utilisation of guarantees product across the Bank Group. Finally, Management proposes to extend the ADF PCG eligibility to ADF countries classified as having moderate risk of debt distress. This extension would promote harmonisation and help increase demand. It would also introduce consistency as SOEs in both green and yellow light countries, subject to some eligibility criteria and a counter-indemnity from the host country, are already able to utilise the instrument. The amount of total Guarantee Exposure Ceiling will be discussed during ADF-14 replenishment negotiation.

4.2. The PSF's implementation has started on a pilot basis. A PSF Administrator has been recruited and is responsible for the day-to-day management of the PSF and for mobilising additional contributions. An initial portfolio of eligible operations has been identified to ensure robust utilisation of the capital earmarked from the ADF and this has been presented for ADF Board approval in October 2015. After the pilot period, partial sell-down of the PSF portfolio to commercial and official risk participants might optimise the PSF by recycling its resources. In addition, two variations of the PSF are being considered at the behest of the ADF Working Group, in order to offer more targeted forms of guarantees. One option is to utilise the PSF guarantee to cover political risks only for more leverage and the second is to expand the beneficiaries of the PSF guarantee to commercial co-financiers for more crowding-in.

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