

ADF-13 MID-TERM REVIEW

African Development Fund Working Group On Innovative Approaches For ADF-14

Final Report

11-13, November 2015

Disclaimer: The contents of this report are not necessarily representative of the views of the African Development Bank, of attendees at the Working Group meetings, or of any of the member governments of the Working Group.



AFRICAN DEVELOPMENT FUND

Summary Findings and Recommendations

The changing composition of ADF clients and possible implications:

Graduation out of ADF is likely to be modest to 2022 assuming retention of AFDB's graduation criteria. On the other hand, a significant proportion of funds could be subject to harder ADF terms given possible changes in seven countries to ADF-Gap, Blend or Transition status – though this is sensitive to the risk of economic shocks.

AFDB reports at the ADF-13 Mid Term Review (MTR) on its efforts to support its members to enhance their domestic revenue mobilisation (DRM), as part of the already planned papers, and that it sets out future plans to support DRM as part of the ADF-14 Replenishment process.

AFDB works more closely with other relevant multilateral development banks (MDBs) and the IMF in taking account of the combined debt sustainability implications of proposals for changes in graduation and lending policies before reaching decisions.

AFDB reports at the ADF-13 Mid Term Review (MTR) on its efforts to support its members to enhance their debt capacity building as part of the already planned papers, and that it sets out future plans to support this DRM as part of the ADF-14 Replenishment process.

AFDB sets out the options for the Bank's role in tackling pockets of poverty, circulating a draft following the MTR and in advance of the first ADF-14 Replenishment meeting to enable Deputies to provide comments before that meeting.

Enhancing the sources of finance

A number of different ideas have been explored and discussed by the AWG. It should however be noted that this in no way prejudices whether there will be any agreement to pursue these as part of the ADF-14 Replenishment

The AWG discussed a set of principles for any use of CDLs. These were:

- Their use should lead to additionality. Donors should not substitute grant funding with CDL funding,
- The amount of debt should be limited so that the risk associated with introducing debt in the Fund's financing framework remains manageable,
- Donors providing CDLs should be recognized and compensated,
- The proceeds of the CDLs should go into the general pool of replenishment resources and not be earmarked for financing any specific activities, or allocated to any specific regional members or category of regional members,
- The cash inflows generated from the operations funded with CDL proceeds should be sufficient to repay the CDLs, so that other Fund operations do not bear any costs related to the introduction of CDLs into the financing framework of the Fund.

Management should undertake further analysis for the first ADF-14 Replenishment meeting to examine: i) potential scope for CDLs given the expected composition of ADF clients and the inter-action with other innovations (see below), ii) the potential interest by donors in providing loans, iii) specific options to manage substitution risks including choice of discount rates, iv)

administration costs; v) any longer term implications for ADF financing and vi) underpinning all of these, lessons arising from the experience of IDA 17 and other replenishments.

There are clear benefits to ADF-14 in terms of generating additional resources from accelerating of donor encashments (whilst foregoing the resulting income benefits) or providing a bridging loan to the ACC. Whilst, many donors are unable to act in this way, other donors may wish to consider the desirability of these on a voluntary basis.

Management should update ADF Deputies at the first ADF-14 Replenishment meeting on the case (or otherwise) for shortening the encashment schedule to reflect the shorter average disbursement period.

ADF Deputies should request Management to submit an updated review of its overall liquidity policy as part of the ADF-14 replenishment process

Further consideration should be given to the potential adoption of the Buy-Down Mechanism given the UA400 million to UA1080 million net resources, depending on whether ‘Green List’ countries are included, that could be freed up for poorer ADF clients in ADF-14. The Bank should provide more specific proposals for the first ADF-14 Replenishment meeting on possible eligibility criteria, the longer term impact on ADF financial sustainability and portfolio.

Results-based financing offers the potential to attract additional financing – either through additional donor contributions for specific projects or a loan buy-down mechanism. The AWG identified potential benefits but also some issues on which views were mixed. The AWG deferred to Deputies to determine whether any more detailed consideration of the option will be warranted as part of the ADF-14 replenishment meetings.

The meeting in the margins of the February 2015 AWG meeting found no compelling evidence that ADF governance itself was a substantive constraint on attracting new donors. It is open, however, to AFDB Management to consult RMCs and non-traditional donors further on whether ADF governance should be an issue to consider as part of ADF-14 as well as more broadly on the factors that might encourage greater contributions.

All three of the principal proposals offer significant potential benefits. All possible pairings of these would complement each other with the possible exception of CDLs and the Buy-Down mechanism given that both are targeting the same clients. However, given Deputies’ reluctance to accept any mandatory accelerated encashment delinked from changes to disbursement schedules, there are only two viable options:

- The Interest Buy-Down mechanism that would impose less burden on donors; and
- CDLs which would have the biggest impact, at least in the medium term and subject to militating against any substantial substitution effect, unless the Interest Buy-Down mechanism was extended to all green Light ADF-only countries as well as Blend and Gap.

AFDB Management should test their analysis further for circulation of a paper by the ADF-13 MTR to enable Deputies to indicate where the Bank should focus its efforts in preparing proposals for ADF-14.

Improving the impact of ADF

AFDB Management should present a more comprehensive analysis, as part of a broader paper for the first ADF-14 Replenishment meeting, of the scope for improving current ADF private sector instruments, the likely results and feasibility of the proposed new approaches, particularly in terms of financial impact, leveraging, development results, administrative capacity and governance (including management of conflict of interest).

The AWG considered a presentation setting out a number of issues relating to the current PBA formula and possible alternatives which, however, also raised concerns for some members. The AWG recalled that the ADF-13 MTR will assess how the allocation has played out during ADF-13, allowing Deputies to consider the extent and nature of any possible review of the ADF allocation criteria and set asides as part of the ADF-14 Replenishment process.

TABLE OF CONTENTS

SUMMARY FINDINGS AND RECOMMENDATIONS.....	II
<i>The changing composition of ADF clients and possible implications:</i>	II
<i>Enhancing the sources of finance.....</i>	II
<i>Improving the impact of ADF.....</i>	IV
Acronyms and abbreviations.....	VI
1. Introduction.....	1
2. The changing composition of ADF clients and possible implications:.....	1
3. Enhancing the sources of finance.....	3
<i>Generic issues</i>	<i>3</i>
<i>concessional donor loans</i>	<i>4</i>
<i>accelerated encashment and bridging loans</i>	<i>5</i>
<i>interest buy-down mechanism</i>	<i>6</i>
<i>results-based financing.....</i>	<i>7</i>
<i>expanding the donor base.....</i>	<i>7</i>
<i>synergies and trade-offs</i>	<i>7</i>
4. Improving the impact of ADF	8
<i>Catalysing private sector finance.....</i>	<i>8</i>
<i>performance-based allocation.....</i>	<i>9</i>
Annex 1: Terms of reference for the ADF working group on innovative approaches for ADF-14.	10
Annex 2: comparison of three innovative sources of finance	13
Annex 3. List of papers and presentations	15

Acronyms and abbreviations

ACC	Advance Commitment Capacity
ADF	African Development Fund
AFDB	African Development Bank
ASDB	Asian Development Bank
AWG	ADF Working Group on Innovative Approaches
CDL	Concessional Donor Loans
DRM	Domestic Resource Mobilisation
FERDI	Fondation por les Etudes et Recherches sur le Developpement International
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
MDB	Multilateral Development Bank
MDG	Millennium Development Goal
MIC	Middle Income Country
MIGA	Multilateral Investment Guarantee Agency
MTR	Mid-Term Review
P4R	Program For Results
PBA	Performance-based Allocation
PCG	Partial Credit Guarantee
SDG	Sustainable Development Goals
SDR	Special Drawing Right
SSA	Sub-Saharan Africa
ToR	Terms of Reference

1. Introduction

- 1.1 The African Development Fund (ADF) is facing a changing global and regional environment. Many of its clients are increasingly able to self-finance their development needs and able to draw on other sources of finance. On the other hand, many are making little progress in tackling poverty and continue to have very substantial financing needs. As a result, there remains a continued need for a substantial ADF, but one which responds to these and other changing circumstances.
- 1.2 ADF Deputies agreed at the final ADF-13 Replenishment meeting that a working group be set up to facilitate consideration of these issues in advance of the start of the replenishment process for ADF-14 with the objectives of facilitating discussions on innovative approaches to sources of funding for ADF-14 and instruments to deploy ADF resources more effectively. It was agreed that the discussions would have a 10-15 year time horizon and should be consistent with the financial sustainability of ADF and the African Development Bank's (AFDB) Ten Year Strategy. The Terms of Reference (ToR) are attached at Annex A.
- 1.3 The ADF Working Group on Innovative Approaches (AWG) was accordingly launched in May 2014 at the AFDB's Annual Meeting in Kigali. It subsequently met in Washington (October 2014) and London (February 2015) and held its final meeting in Abidjan in May 2015.
- 1.4 Membership of the AWG was open and voluntary. ADF Deputies of the following countries participated as members of the Working Group: Austria, Canada, Finland, France, Germany, Italy, Japan, the Netherlands, South Africa, Spain, Sweden, Switzerland, the UK and the USA; with other countries observing from time to time. The AWG was co-chaired by South Africa and the UK.
- 1.5 This report records the findings and recommendations that emerged from the discussions held at the four AWG meetings grouped under three categories – analysis of the changing composition of ADF clients and graduation, innovative sources of finance and innovative allocation of finance. These would not have been possible without the high quality papers and presentations produced by the AFDB (see Annex B for a list of these papers). In addition, the AWG benefited from the following presentations:
 - Professor Guillaumont of the Fondation por les Etudes et Recherches sur le Developpement International (FERDI) on The Challenges of Vulnerability;
 - Matthew Martin of Development Finance International on debt sustainability;
 - Professor Pierre Jacquet, President of the Global Development Network on Thinking outside the box on the use of concessional finance.
- 1.6 Professor Ngaire Woods of Oxford University facilitated an informal special session (under Chatham House rules) on ADF governance in the margins of the London meeting.

2. The changing composition of ADF clients and possible implications:

- 2.1 The basis of any discussion of the future of ADF is the changing nature of its clients. For the various meetings of the AWG, AFDB Management produced successively deeper assessments of the possible changes in the income levels and creditworthiness of ADF

clients. These assessments analysed the likely trajectory of the various countries' graduation to harder terms (as gap, blend and transition countries) and ultimately out of ADF completely.

- 2.2 In undertaking this assessment Management took account of the recent strong growth performance of the region as a whole (5% a year), reflecting improved macro-economic management and much higher increased demand for natural resource exports, supported by increased foreign direct investment and access to capital markets. Whilst this has led to substantial progress in economic and social development across the continent, nearly 50% of the population in Sub-Saharan Africa (SSA) (more than 450 million people) still live on less than US\$1.25 a day. Management assume a slight slowing down of growth over the next decade (4.1%) reflecting reduced growth in demand for natural resources. With higher growth rates assumed to continue across much of Asia, the AFDB Bank expects that much of SSA will account for an increasing proportion of the world's poor.

Graduation

- 2.3 Management developed a model to project the growth rate of individual countries and their future credit-worthiness to the end of ADF-15 (2022). This suggests that seven countries representing a third of ADF-13 allocations may move from ADF-only status (Chad, Cote d'Ivoire, Ghana, Kenya, Mauritania, Senegal, Sudan, Tanzania, Zambia) with three, representing only 4% of ADF-13 allocations, graduating from ADF completely (Cape Verde, Congo, Nigeria). Members of the AWG noted, however, that these assumptions were sensitive to possible global, regional or country specific shocks which could lead to a reduced level of change.

- Graduation out of ADF is likely to be modest to 2022 assuming retention of AFDB's graduation criteria. On the other hand, a significant proportion of funds could be subject to harder ADF terms given possible changes in seven countries to ADF-Gap, Blend or Transition status – though this is sensitive to the risk of economic shocks.

- 2.4 The AWG considered the following possible implications.

Debt sustainability

- 2.5 Current ADF clients will be increasingly reliant on less concessional AFDB lending – not only as a result of countries changing their ADF status but also ADF-only countries that will be able to access AFDB lending following the adoption of the 2014 credit policy. At the same time these countries may also be experiencing a similar hardening of terms from the World Bank Group and the IMF, as well as potentially seeing a reduction in bilateral concessional funding triggered by their changing status in MDB concessional funds. As a result the AWG recommends that:

- AFDB reports at the ADF-13 Mid Term Review (MTR) on its efforts to support its members to enhance their domestic revenue mobilisation (DRM), as part of the already planned papers, and that it sets out future plans to support DRM as part of the ADF-14 Replenishment process.
- AFDB works more closely with other relevant multilateral development banks (MDBs) and the IMF in taking account of the combined debt sustainability

implications of proposals for changes in graduation and lending policies before reaching decisions.

- AFDB reports at the ADF-13 Mid Term Review (MTR) on its efforts to support its members to enhance their debt capacity building as part of the already planned papers, and that it sets out future plans to support this DRM as part of the ADF-14 Replenishment process.

Increasing focus of ADF on fragile countries

- 2.6 If the above shift in client composition were to take place fragile states would double their share of ADF resources (from 17% over ADF12 to 36% in ADF15). This potentially raises issues over the current Performance Based Allocation model that are considered in Section 4.

Distribution of Poor in Africa and Graduation Process

- 2.7 Management's modelling suggests that current graduation policies would lead to countries with large numbers of poor people being graduated out of ADF over the next three replenishments. It shows that whilst only 4% of those living of less than \$1.25 a day in Africa in 2015 are not eligible for ADF (some 19 million) by 2022 this is expected to increase to 42% (248 million) reflecting assumed ADF graduation¹. This raises the issue of what is the best way for the AFDB Group to help address pockets of poverty in Middle Income Countries (MICs) – is any change in the ADF graduation threshold or transition process warranted. Should additional criteria be introduced in the graduation criteria? Should the length of the transition out of ADF be extended? Should a separate concessional facility be created to target pockets of poverty in graduated MIC? Or would it be sufficient to ensure an appropriate focus in the AFDB portfolio?

- AFDB sets out the options for the Bank's role in tackling pockets of poverty, circulating a draft following the MTR and in advance of the first ADF-14 Replenishment meeting to enable Deputies to provide comments before that meeting.

3. Enhancing the sources of finance

Generic issues

- 3.1 The above analysis of ADF clients indicates a continuing need for substantial concessional resources, particularly to fragile states. Given the expectation of continued pressure on the development assistance budgets of traditional donors, the AWG considered possible innovations to enhance the availability of funding for future ADF replenishments.
- 3.2 The ToR called for the AWG to discuss innovative approaches for ADF-14 that would include both the improvement of the current sources as well as new sources that are not being implemented in the current grant model. The first AWG two meetings were used to consider a wide range of possible ideas to tap into new sources of finance. Some were not taken any further on the grounds that analysis undertaken elsewhere, including the

¹ Derived from Table 5 in the AFDB's *ADF Graduation: Implications for the AfDB and its Client Countries*, May 2015

IDA-17 Replenishment, indicated that they were unlikely to generate much potential. These included establishing a) an endowment to generate income that would finance further replenishments and b) seeking to raise revenue directly from charitable foundations and high worth individuals. It was also noted that the case for merging ADF concessional loans into the AFDB balance sheet was less than for the Asian Development Fund and IDA given the weaker creditworthiness of the ADF loan portfolio and that unlike IBRD and ASDB, AFDB was more demand constrained.

- 3.3 The remaining ideas are considered in more detail below with a final section assessing the potential synergies and trade-offs between them. The fact that these ideas were discussed in no way prejudices whether there will be any agreement to pursue these as part of the ADF-14 Replenishment

Concessional donor loans

- 3.4 The AWG recognised that concessional donor loans (CDLs) have become a feature of an increasing number of other replenishments (e.g. Green Climate Fund, IDA, IFAD) and considered the case for their introduction in ADF-14. A number of members felt that the introduction of CDLs could increase the total resources available to ADF14 as had been the case in these other replenishments (by matching financing available from donors who provide soft loans), by potentially attracting new donors, and by the consequential impact on increasing the Advance Commitment Capacity (ACC). Others expressed their concern at the possible high risk of substitution, questioned whether there was demand for CDLs in ADF 14, and argued that other mechanisms offered more potential.

- 3.5 The AWG discussed a set of principles for any use of CDLs. These were:

- Their use should lead to additionality. Donors should not substitute grant funding with CDL funding,
- The amount of debt should be limited so that the risk associated with introducing debt in the Fund's financing framework remains manageable,
- Donors providing CDLs should be recognized and compensated,
- The proceeds of the CDLs should go into the general pool of replenishment resources and not be earmarked for financing any specific activities, or allocated to any specific regional members or category of regional members,
- The cash inflows generated from the operations funded with CDL proceeds should be sufficient to repay the CDLs, so that other Fund operations do not bear any costs related to the introduction of CDLs into the financing framework of the Fund.

- 3.6 The AWG noted the following analysis by Management:

- The use of CDLs was constrained by the demand for loans on blend terms with an interest of 1%. Assuming ADF-14 was on a similar scale to ADF-13 an upper estimate of the potential is UA500m.
- Taking account of the beneficial impact on the ACC, CDLs could yield up to an additional UA722 million in resources.
- Other steps to manage the substitution risk would need to include the following:
 - a minimum contribution in ADF14 in the form of a grant. Management proposed a figure of 90%.

- CDLs can only be in SDRs or SDR component currencies with a maximum interests rate of 0.5% and tenor no shorter than ADF blend/graduating terms.
- Concessionality would be calculated using a discount rate. Management proposed a range of 1.00% to 1.75%.
- Prioritisation rules in the event that offers exceeded the ceiling. Management proposed use of ADF core burden shares and additionality to ADF-13 contributions
- The importance of transparency on applying the rules.

3.7 Members recognised the need for each of these elements but did not agree the specific proposals. They felt that strict conditions were a necessity if the CDL option would be brought forward but some felt that the numbers proposed were too exacting and would deter any CDL offers,.

- Management should undertake further analysis for the first ADF-14 Replenishment meeting to examine: i) potential scope for CDLs given the expected composition of ADF clients and the inter-action with other innovations (see below), ii) the potential interest by donors in providing loans, iii) specific options to manage substitution risks including choice of discount rates, iv) administration costs; v) any longer term implications for ADF financing and vi) underpinning all of these, lessons arising from the experience of IDA 17 and other replenishments.

Accelerated Encashment and Bridging Loans

3.8 The AWG noted the benefits of accelerating encashments in advance of the expected disbursement schedule with between UA370 million and UA425 million of additional resources generated as a result of the income on the increased liquidity in the ACC, by shortening the period from 10 to between 4 to 6 years². However, a number of members indicated that they could not accept this as they are explicitly required to prevent providing money in advance of need. It was however open to any other ADF donor to offer voluntarily to pay an accelerated encashment schedule without seeking any compensating benefit for their reported contribution and voting rights, as is already the case with a small number of donors.

3.9 Management flagged that the changing composition of ADF projects and programmes is shortening their disbursement schedule. This is likely, therefore, to lead to a proposal as part of ADF-14 to shorten the proposed encashment schedule.

3.10 The AWG also noted the benefits of a bridging loan to the ACC to even out expected inflows – effectively bringing forward the expected higher inflows in the future resulting from recent decisions to harden lending terms. An interest free loan would, for example, generate an additional UA700 million for ADF-14.

- There are clear benefits to ADF-14 in terms of generating additional resources from accelerating of donor encashments (whilst foregoing the resulting income benefits) or providing a bridging loan to the ACC. Whilst, many donors are unable to act in this way, other donors may wish to consider the desirability of these on a voluntary basis.

² This assumes that ADF14 is of a similar size to ADF13

- Management should update ADF Deputies at the first ADF-14 Replenishment meeting on the case (or otherwise) for shortening the encashment schedule to reflect the shorter average disbursement period.
- ADF Deputies should request Management to submit an updated review of its overall liquidity policy as part of the ADF-14 replenishment process

Interest Buy-Down mechanism

- 3.11 Unlike the World Bank and Asian Development Bank, the AFDB faces a shortfall in demand for its non-concessional window whilst its concessional window saw a significant reduction in size in ADF13. During the first ADF-13 Replenishment meeting, the Interest Buy-Down option was presented as an opportunity to leverage AFDB lending to creditworthy ADF countries, which would free up resources available for ADF-only countries. Eligible countries would use their headroom to receive the equivalent of the Performance-Based Allocation (PBA) on ADF terms, and the ADF would compensate the AFDB for any income foregone.
- 3.12 The AWG re-visited this option and requested further analysis on the structure, compatibility with the Bank's Credit Policy, and debt sustainability. Some members pointed out that the Interest Buy-down Option had advantages in terms of creating leverage, doing more with less and freeing up resources for low-income countries and fragile states. A concern that was raised during the ADF-13 replenishment relates to the potential legal issues emerging from Article 31 of the ADF Agreement, which establishes the Fund as a separate entity from the Bank that is not liable for any financial commitments undertaken by the Bank. To address this concern, ADF management presented two options. Option A would be the creation of a dedicated Buy-Down facility to enhance the lending abilities of the AFDB. Option B would be to modify the ADF operational framework and the Bank Group Credit Policy to open grant eligibility to countries on the path to graduation and deploy ADF grants alongside the AFDB's financing. Overall, members of the AWG leaned more towards the implementation of Option B due to its relatively simpler institutional arrangement.
- 3.13 If the mechanism were to be applied to blend, graduating and gap countries, the Interest Buy-Down mechanism could free up an estimated UA450m for remaining ADF countries less a knock-on decrease of the ACC of approximately UA17 million³. If it were extended further, to also include ADF countries at low risk of debt distress (the 'Green Light' countries), the total amount freed up would rise to UA1248m less a UA168 million decrease in the ACC. The impact is expected to be larger after ADF-14 as a result of further changes in the composition of ADF clients. Further analysis is needed to assess the possible detailed design and impact on ADF longer term finances.
- Further consideration should be given to the potential adoption of the Interest Buy-Down Mechanism given the UA400 million to UA1080 million net resources, depending on whether 'Green List' countries are included, that could be freed up for poorer ADF clients in ADF-14. The Bank should provide more specific proposals for the first ADF-14 Replenishment meeting on possible eligibility criteria, the longer term impact on ADF financial sustainability and portfolio.

³ This assumes that ADF14 is of a similar size to ADF13 and the change in composition of ADF clients set out the Bank's paper *ADF Graduation: implications for the AFDB and its Client Countries*.

Results-based Financing

- 3.14 At its second meeting the AWG considered the possibility of ADF establishing some form of results-based instrument similar to the World Bank's Programme For Results (P4R) in which additional donor contributions could be linked to the level of results achieved by the project. This could take the form of either:
- additional funding specifically to a project that could flow through ADF or a separate parallel mechanism; or
 - buy-downs of a loan by a donor that would free up the original ADF allocation for reallocation through the PBA.
- 3.15 Some members noted the potential advantages of such an approach in promoting a results culture. Some members raised possible disadvantages of earmarking and cherry-picking whilst others pointed to the potential additionality of finance. Given the relatively limited experience of such instruments in other MDBs it was agreed that any further consideration be deferred.
- Results-based financing offers the potential to attract additional financing – either through additional donor contributions for specific projects or a loan buy-down mechanism. The AWG identified potential benefits but also some issues on which views were mixed. The AWG deferred to Deputies to determine whether any more detailed consideration of the option will be warranted as part of the ADF-14 replenishment meeting.

Expanding the Donor Base

- 3.16 The AWG noted the Bank's assessment of the increasing potential to expand the ADF donor base and the suggestion that ADF governance might have an impact on attracting new donors. It also noted that a separate informal discussion was held in the margins of the February 2015 meeting, which found that there was no compelling evidence that governance of the ADF itself was as yet a constraint.
- The meeting in the margins of the February 2015 AWG meeting found no compelling evidence that ADF governance itself was a substantive constraint on attracting new donors. It is open, however, to AFDB Management to consult RMCs and non-traditional donors further on whether ADF governance should be an issue to consider as part of ADF-14 as well as more broadly on the factors that might encourage greater contributions.

Synergies and Trade-offs

- 3.17 The Bank provided analysis on the potential relative benefits and costs, equity and legal implications of accelerated encashment, CDLs and the Buy-Down mechanism; and their interplay. The results are summarised in Annex 3. All have either high or very high benefits and all pairings of these options would complement each other with one potential exception - CDLs and the Interest Buy-Down Mechanism that would potentially be targeting the same ADF clients. However, it was clear that there was no willingness by Deputies for any common acceleration of encashments delinked from disbursement schedules.

- All three of the principal proposals offer significant potential benefits. All possible pairings of these would complement each other with the possible exception of CDLs and the Interest Buy-Down mechanism given that both are targeting the same clients. However, given Deputies' reluctance to accept any mandatory accelerated encashment delinked from changes to disbursement schedules, there are only two viable options:
- The Interest Buy-Down mechanism that would impose less burden on donors; and
- CDLs which would have the biggest impact, at least in the medium term and subject to militating against any substantial substitution effect, unless the Interest Buy-Down mechanism was extended to all green Light ADF-only countries as well as Blend and Gap.

3.18 AFDB Management should test their analysis further for circulation of a paper by the ADF-13 MTR to enable Deputies to indicate where the Bank should focus its efforts in preparing proposals for ADF-14.

4. Improving the impact of ADF

4.1 The AWG also considered ways in which ADF could enhance its impact on the ground through better catalysing private sector investment and potentially changing the allocation of resources subject to the PBA.

Catalysing Private Sector Finance

4.2 The AWG considered a number of AFDB Management proposals at its second and third meetings.

4.3 ADF-13 saw the creation of the Private Sector Facility to use ADF resources to catalyse more private sector financing in low income countries, by providing guarantees to the AFDB on selected private sector operations for cover up to 50% of the exposure. At the second AWG meeting AFDB Management presented two possible adjustments. The first would target the coverage of the guarantee to specific types of risk, such as political risk, to enhance the cost effectiveness of the instrument. The second would expand the potential beneficiaries of its guarantees beyond just AFDB funded private sector clients to co-financing institutions potentially to increase the supply of finance available to clients and reduce their costs. AWG members saw the potential case for the first but expressed reservations about the second given the existence of other facilities such as MIGA - a clearer assessment of added value was needed.

4.4 In response to requests from the AWG for elaboration of the costs, benefits and risks of these options, Management presented a broader range of options comprising:

- a reiteration of the above second option as well as a proposal to extend the Partial Credit Guarantee (PCG) to enclave type projects in countries at risk of high debt distress as well as increasing the overall PCG ceiling;
- an off-balance sheet vehicle to scale up investment in micro, medium and small scale enterprises akin to the IADB's Multilateral Investment Fund; and
- modification to ADF to enable direct lending to non-sovereign entities with a wider range of instruments.

- 4.5 The AWG welcomed the innovative spirit of AFDB Management in putting forward these ideas but felt a greater depth of analysis was required to consider properly all the ideas, and for this to be done in the context of a clearer statement of the challenges the Bank was seeking to address and the interaction between the various proposals.
- AFDB Management should present a more comprehensive analysis, as part of a broader paper for the first ADF-14 Replenishment meeting, of the scope for improving current ADF private sector instruments, the likely results and feasibility of the proposed new approaches, particularly in terms of financial impact, leveraging, development results, administrative capacity and governance (including management of conflict of interest).

Performance-based Allocation

- 4.6 The February 2015 meeting of the AWG considered a presentation by Professor Professor Guillaumont of the *Fondation pour les Etudes et Recherches sur le Developpement International* (FERDI). He looked at the current ADF PBA formula against the criteria of effectiveness, equity and transparency. He sought to argue that the PBA gave insufficient weight to vulnerability, the aid allocation was very sensitive to small changes in the performance measure and works in a pro-cyclical manner, the performance measure is based on subjective judgements about policies, and the complex interaction of all the various elements results in no clear relationship between the allocation per capita and the performance score. As an alternative Professor Guillaumont proposed limiting ADF eligibility to the list of African Least Developed Countries, and simplifying the PBA with greater weight to vulnerability and thereby obviating the need for a separate fragility set-aside. The resulting discussion raised a number of issues about the extent to which the proposals would change the allocations and create a new set of challenges.
- The AWG considered a presentation setting out a number of issues relating to the current PBA formula and possible alternatives which. However, also raised concerns for some members. The AWG recalled that the ADF-13 MTR will assess how the allocation has played out during ADF-13, allowing Deputies to consider the extent and nature of any possible review of the ADF allocation criteria and set asides as part of the ADF-14 Replenishment process.

Annex 1: Terms of Reference for the ADF Working Group for the ADF Working Group on Innovative Approaches for ADF-14

Objective

Facilitate discussions on innovative approaches to (i) sources of funding for ADF-14, including sources outside the current grant model, and (ii) instruments to deploy ADF resources more effectively. The sources and instruments should be consistent with the financial sustainability of ADF, its core funding and underlying assumptions (e.g. potential for graduation of several ADF countries in the coming 5 years, 2014-2019). These discussions will be informed by exchanges on the broader strategic context for the operation of the ADF, including trends in concessional resources, in particular ODA to sub-Saharan Africa; discussions on the global development finance architecture and the role of ADF within it; the future composition of the ADF clientele; and the business model of the Bank Group, notably the articulation between ADB and ADF.

Composition

The working group consists of ADF Deputies or their appointed representatives. Membership is open and voluntary. Representatives from African donor and recipient countries and other international financial institutions will be encouraged to participate in the work of the group. All Deputies and observers will be copied on the communications of the working group.

Two co-chairpersons will be selected from amongst the working group members, with ADF staff performing the Secretariat function for the working group.

The group may invite researchers, technical consultants and others to contribute to its work.

Functioning

The working group will be a discussion forum with a consultative role, which will present its findings on options reviewed to all ADF Deputies and observers for consideration during the ADF-14 replenishment consultations. In its deliberations the working group will respect the issues that are within the purview of the ADF Board of Directors.

The working group will have a longer term perspective within the Bank's 10 year strategy and will recognize the significant potential changes in ADF clientele during this timeframe

AFDB will carry out the Secretariat functions of the Working Group while strategic documents and policy papers as well as broader initiatives may be issued by the working group members or commissioned to feed into the analysis of the working group summarized by the Secretariat.

The Secretariat will also ensure that relevant documents will be shared among members using the secured website. Knowledge products or any piece of work undertaken by the WG's members should be shared with the ADF working group secretariat.

The working group will disclose its findings and report to all ADF Deputies and observers as the work progresses.

The first meeting of the working group will be held during the AFDB Annual Meetings in Kigali, May 2014, and the second meeting will take place on the margins of the IMF/World Bank Annual Meetings in October 2014. It will present its final report to the ADF-13 Mid-Term Review, Q4 2015.

The working group members will in addition meet as required and can also carry out their exchanges and discussions in-person, through a dedicated website, email, audio and/or video conferences.

The working group may make presentations to or consult with ADF Deputies, RMC Representatives, representatives from other IFIs and observers on the margins of relevant gatherings such as the AFDB Annual Meetings or IMF/WB Annual Meetings.

It will collaborate with similar working groups established in the context of other IFIs, in particular IDA-17, so as to make the most effective use of the analytical work being done and the discussions taking place.

Issues for discussion

The working group will exchange views on the strategic context in which the ADF operates. This strategic context includes elements such as: (i) ongoing discussions on the global development assistance architecture and the future of concessional funding; (ii) trends in ODA and projections of HIPC and MDRI costs; (iii) ADF countries' growing access to market financing; (iv) expected developments in the composition of the ADB's and ADF's clientele; (v) Bank Group policy changes such as the recent amendment of the Credit Policy; and (vi) the consequences of this all for the long-term financial sustainability of the ADF and for the Bank Group's business model, in particular the articulation between ADB and ADF.

This exchange will inform subsequent more technical discussions on innovative approaches to sources of funding for ADF-14, including sources outside the current grant model, and instruments to deploy ADF resources more effectively. Other elements informing these discussions are a series of scenarios, projections and options to be prepared by Management as well as review of possible funding sources and financial instruments previously examined by ADF Deputies¹ and in other IFIs.

During the ADF-13 first replenishment meeting, six innovative financing instruments were presented to the ADF Deputies in the context of the discussion on the Fund's long-term financial sustainability. Based on Deputies' guidance, Management narrowed down its proposal to two instruments- the Partial Credit Guarantee (PCG) and a Private Sector Credit Enhancement Facility (PSF)- that were endorsed by ADF Deputies during the second replenishment meeting. The criterion to prioritize those instruments over the others was a combination of 4 factors: (i) ease of implementation and limited administrative cost; (ii) limit the number of set asides; (iii) demand; and (iv) leverage and financial impact. With the evolving circumstances, Management considers it worthwhile to revisit some of the other four instruments, with a view to further improving the use of ADF resources and its financial capacity.

The working group will explore opportunities to expand the sources of funding for ADF-14, including but not limited to:

- Measures to expand the donor base of the ADF;
- Other forms of contribution, such as contributions from ADF donors in the form of concessional loans in complement to the current grant model. ADF-14 could witness several countries achieving blend or gap status (with harder lending terms), which, together with stable macroeconomic conditions (low interest rates) and the existing price differentiation in the ADF, could justify a moderate amount of debt funding in the ADF;

- A Loan Buy-Down instrument: Offer to donor countries (and other interested parties) the possibility of (p)repaying to the ADF the outstanding amount of a loan (or particular set of loans) owed by a given ADF country. This product could be of particular interest for Donors when linked to performance based results.

The working group will develop and assess innovative uses of ADF resources. This may include the following ideas:

- Blending facilities (interest buy down): combining ADF concessional financing with ADB lending. The concept builds on the Modified Framework for Assistance to Creditworthy Countries under the ADF, an instrument already discussed during the 1st meeting of ADF-13, that had good acceptance from Deputies but was finally not selected due to the limited financial impact (since only one country could potentially benefit from it at that time). The prospects for graduation for several ADF countries could increase the demand for the product;
- Options for using the ADF to enable greater use of the ADB's capital, based on the example of the recently introduced Private Sector Credit Enhancement Facility, which leverages ADB investments in low-income countries.

The working group will decide on a more detailed list of the issues to examine in-depth at its second meeting.

Some Preliminary Background Documents

- *Long-Term Financial Capacity of the ADF*, discussion paper, ADF-13 first replenishment meeting, Tunis
- *ADF-13 Innovative Financing Instruments*, discussion paper; ADF-13 second replenishment meeting, Tunis

Annex 2: Comparison of Three Innovative Sources of Finance

Extracts from the AFDB's presentation *Synergies/Complementarities of the ADF-14 Proposed Financing Options* considered at the final AWG meeting in May 2015.

V. CONCLUSION

Comparative Financing Options

	Increases Resource Envelope	Target Beneficiaries	Who Pays?	Administrative Complexity	Compete with Other Options
CDLs	Yes if enough donors provide CDL	All ADF-Eligible RMCs	Subscribing Donors	Moderate	Yes
Buy-Down Mechanism	Indirectly and limited by negative impact on ACC	Neediest ADF countries	No payment required	Complex in the case of Option A . More simple with Option B	Yes
Accelerated Encashment	Yes	All ADF-Eligible RMCs	All Donors	Simple	No



17

V. CONCLUSION



Choice between **CDLs** and **Buy-Down Mechanism**

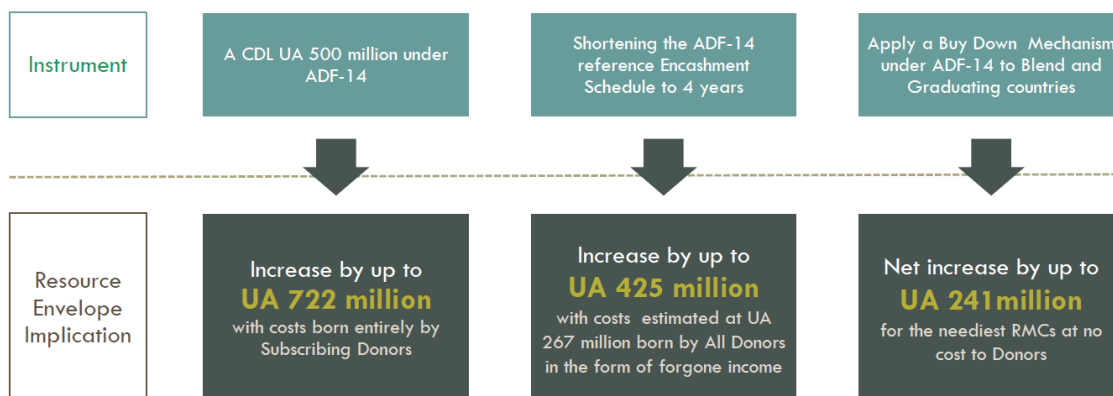
- For more resources for ADF countries and more simplicity
→ Combine **CDLs** and Accelerated Encashment
- For less burden on Donors
→ Combine **Buy-Down Mechanism** and Accelerated Encashment
- For highest contribution of single option to ADF-14 Replenishment envelope
→ Choose **CDLs**



18

V. CONCLUSION

Costs and benefits of options not subject to direct comparison



ANNEX 3. List of papers and presentations

1. ADF Graduation: Implications for the AFDB and its Client Countries
2. Concessional Donor Loans (CDLs)
3. Accelerated Encashment Schedule
4. Buy-Down Mechanism
5. Bridge Loan