Concessional Donor Loans

Discussion Paper

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AFRICAN DEVELOPMENT FUND

DISCLAIMER

This paper does not necessarily reflect the views of the African Development Bank Group (AfDB), its Board of Directors or the countries they represents. This paper was prepared for the fourth meeting of the ADF Working Group held on 29-30 May, 2015. The views proposed in the paper are not meant to be exhaustive but to facilitate discussions among members of the ADF Working Group.

Executive Summary

Concessional debt has traditionally been used mostly in bilateral aid. However, of late, because of the culmination of circumstances including donor financial constraints and the willingness of some donors to scale-up their development assistance through MDBs but not exclusively in the form of grants, MDBs have started introducing concessional donor loans (CDLs) in their financing frameworks. The African Development Fund seeks to incorporate concessional debt into its ADF-14 financing framework as one of a number of innovative initiatives.

Donors providing concessional debt shall be compensated on the basis of the grant element imbedded in their loans to the Fund. The discount rate should be high enough to provide an incentive to donors willing to provide concessional loans to the Fund, but low enough to generate a grant element that is considered equitable by donors making all their contributions in the form of grants.

The demand for ADF concessional debt during the ADF-14 replenishment cycle will be constrained by the limited demand for loans on blend terms that include an interest rate of 1%. The volume of such loans during ADF-14 is estimated at UA 551.87 million representing 17% of the resources allocated through the PBA.

The use of CDLs by the Fund during the ADF-14 replenishment cycle shall require the modification of the Fund's Asset-Liability Management guidelines to raise the debt ceiling and the introduction of appropriate risk management measures. Their use will also require the incorporation of the specific requirements for concessional donor loans in the ADF-14 Resolution. Such requirements shall include, among other relevant issues, the array of possible currencies of denomination, the general terms and conditions and payment and repayment schedules of the concessional donor loans.

Finally, in addition to the direct impact of CDLs on the amount of resources mobilized during the replenishment cycle, CDLs also impact the size of the replenishment indirectly through a positive effect on the advance commitment authority attributable to the fact that the CDLs will be paid-in over a three year period compared to the standard 10-year encashment period for subscriptions in the form of grants..

The guidance of the Working Group is sought on the following issues:

(i) ***Minimum grant contribution.*** The minimum grant contribution that ADF members must make to be eligible to subscribe to ADF-14 in the form of CDLs is 90% of ADF-13 burden share.

(ii) ***Discount rates.*** A discount rate of either 1.75% or 1.00%.

(iii) ***Currency of denomination of CDLs****.* The paper proposes the SDR and SDR component currencies only.

(iv) ***The terms and conditions of CDLs.*** It is proposed that CDLs should have:

- A maximum interest rate of 0.50%.
- Grace periods and maturities no shorter than the Fund's blend/graduating lending terms, and
- Repayment profile that matches that of the Fund's blend/graduating lending terms.

(v) **Prioritization rules** that shall be used in the event the Fund receives proposals for CDLs over the amount it can consider for that replenishment.

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Abbreviations

ADF	African Development Fund
AfDB	African Development Bank
ALM	Asset Liability Management
CDL	Concessional Donor Loan
IDA	International Development Agency
MDB	Multi-Lateral Development Bank
PBA	Performance Based Allocation
SDR	Standard Drawing Right

CONCESSIONAL DONORS LOANS

1. Introduction

1.1 This paper is in response to a request from the African Development Fund Working Group (ADF-14 WG) following discussions on a presentation on concessional donor loans (CDLs) during its 3rd meeting in London UK. Specifically, it was requested that the paper examines the potential demand impact as well as the implementation framework for CDLs.

1.2 Until recently, CDLs were essentially used for bilateral assistance, with donor contributions to multilateral development banks limited to grants and capital subscriptions. However, due to a combination of factors (e.g. donors' financial constraints, declines in multilateral development banks' internal resources, increasing financing needs in fragile/low income countries, increasing financing from private sector entities to multilateral development banks, access by some beneficiaries to international capital markets, etc.), CDLs are being gradually considered by donors as a key financial instrument to support multilateral institutions.

1.3 Based on the success of other initiatives (such as Climate Investment Funds) which have shifted from exclusive reliance on grant financing, CDLs were introduced at the World Bank Group during the Seventeenth International Development Association (IDA-17) replenishment cycle financing framework in order to augment the quantum of resources available to the institution. Although the proceeds of the CDLs are part of the general pool of resources for the replenishment, it is understood that they would, in practice, be used to finance operations in countries where blend and hardened terms, with interest rates on average higher than the expected borrowing interest rates, can be applied.

1.4 This paper is organized into 8 sections. Following this introductory section, section 2 defines the CDL within the African Development Fund (ADF or the Fund) context and enumerates factors or principles to be taken into consideration in developing the product so as to make it attractive to all stakeholders. It then examines the potential demand for ADF loans on blend or hardened terms during the ADF-14 replenishment cycle and beyond as well as the potential supply of CDLs. Section 3 discusses the grant element in CDLs. Section 4 discusses donor recognition and prioritization rules in the case of over subscription. Section 5 examines risk management aspects and section 6 operational considerations. Section 7 estimates the impact of concessional donor loans on the Advance Commitment Capacity of the Fund. Finally, section 8 presents issues for consideration.

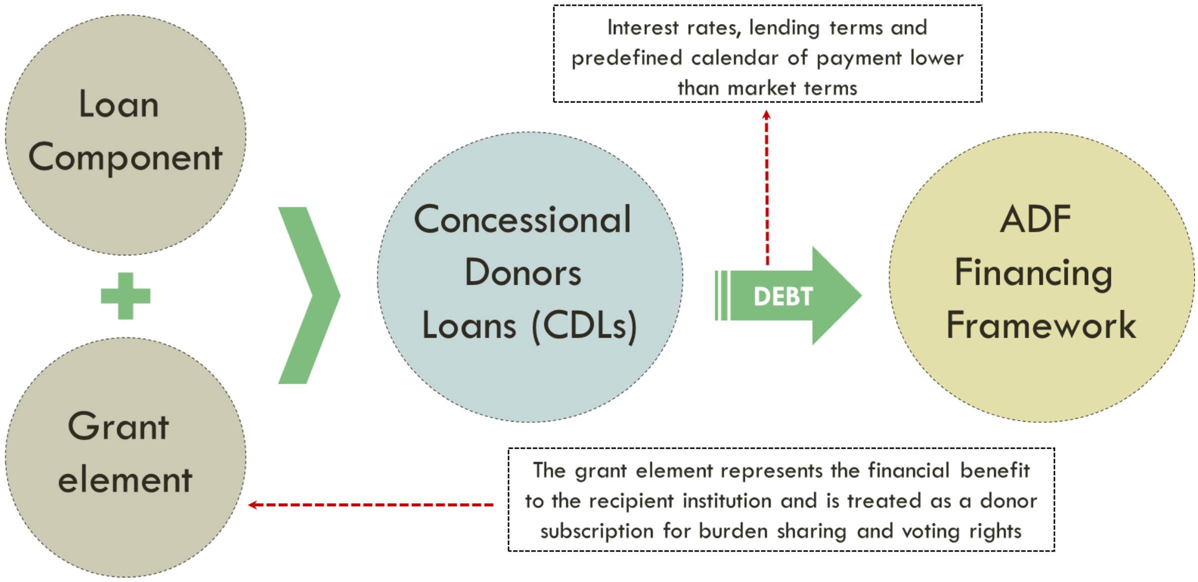
2. Demand and Supply

The Product

2.1 Concessional donor loans are loans offered to development partners by donors at interest rates significantly lower than market rates to supplement available grant resources. CDLs may be seen as being comprised of two parts: a loan component and a grant element. The grant element represents the financial benefit of the CDL to the Fund. To make the CDLs attractive to potential donors, it is proposed that donors who contribute to ADF-14 in the form of CDLs be compensated through the award of burden shares and voting rights commensurate with the grant elements of their CDLs (Chart 1).

2.2 There are no legal obstacles for the Fund to contract loans. Article 8(1) of the Fund Agreement authorizes borrowing. However, such loans must be contracted by the Fund on concessional terms (Article 8(5); and used by the Fund on terms consistent with its purposes, operations and policies. Furthermore, Article 8(2) of the Fund Agreement stipulates that such loans should not impose an undue administrative or financial burden on the Fund or the African Development Bank (AfDB or the Bank).

Figure 1: Concessional donors loans components and key features



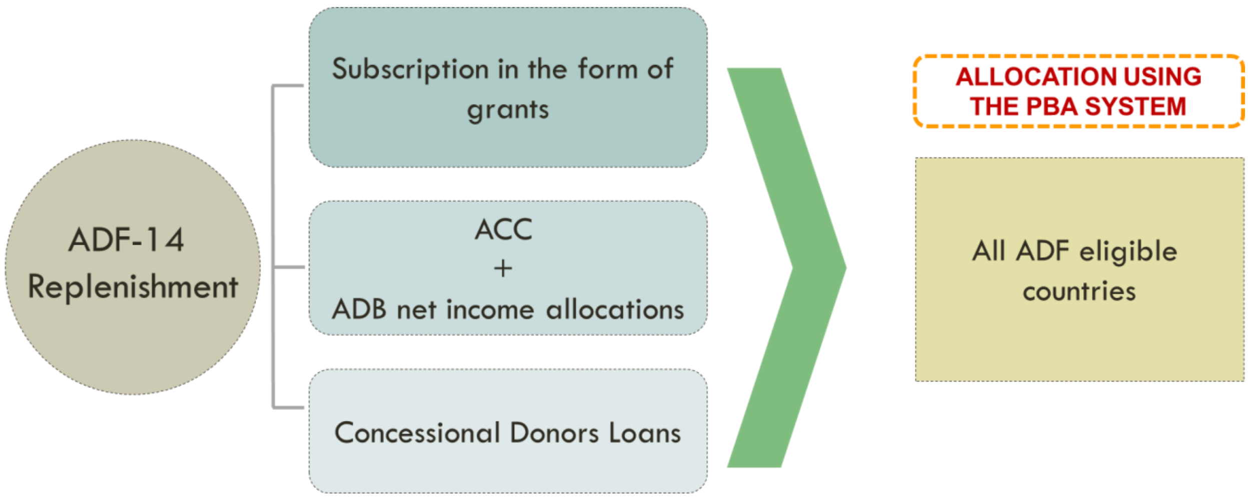
2.3 To be consistent with the Fund Agreement and taking into account other considerations, the proposed African Development Fund CDLs respond to the following main principles:

- 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.

Demand for CDLs

2.4 The design features of CDLs are such that there is no distinct demand for the product other than the general demand for ADF resources. CDLs are intended to provide resources that form part of the general pool of resources for the replenishment cycle. CDL proceeds are allocated through the performance based allocation (PBA) system in the same way as donor subscriptions in the form of grants and internally generated funds (chart 2). However, one of the key principles of their design is that CDLs should be self-contained in the sense that cash inflows from ADF loans funded with their proceeds should be sufficient to cater for CDL debt service. To the extent that the interest rate on CDLs is greater than zero, the total volume of CDLs cannot be higher than the volume of ADF loans with an interest rate, assuming that the 75 basis points service charge on ADF loans will continue to be retained to defray administrative costs. Consequently, the demand for CDLs is constrained by the volume of lending to gap, blend and graduating countries that carry an interest rate of 1%.

Figure 2: Allocation of concessional donor loans



2.5 The volume of ADF-13 resources allocated to gap, blend and graduating countries is estimated at UA 551.76 million, or 17.80% of the resources allocated, or to be allocated, through the Performance-Based Allocation (PBA) System during the replenishment cycle (Table 1). On the basis of the graduation scenario presented in a companion paper, "Implications of the Graduation Process for the Bank and ADF Countries", the volume of ADF-14 replenishment cycle resources[1] that is expected to be allocated to gap, blend and graduating countries is projected to decrease to UA 536.87 million representing 17.0% of total resources. During the ADF-15 cycle, UA 725.60 million is projected to be allocated to the same category of ADF borrowers representing an increase to 23.0% of the resources allocated through the PBA during the replenishment cycle.

2.6 These figures, especially those for the ADF-15 replenishment cycle, depend not only on the graduation scenario retained but also on the transition periods, which can be up to 5 years[2]. Another factor that could have an impact on the demand for CDLs is further hardening of the lending terms for ADF-only regional members, especially those in the "Advance" sub-category by introducing an interest rate[3].

Table 1: Projected Allocations to Countries by Credit Category for ADF-13, 14 and 15 Cycles

Country category	ADF-12		ADF-13		ADF-14		ADF-15	
	UA million	%	UA million	%	UA million	%	UA million	%
Gap, Blend, Graduating	248.12	6.6%	551.76	17.8%	536.87	17.0%	725.60	23.0%
Gap	*22.10*	*0.6%*	*251.91*	*8.1%*	*236.47*	*7.5%*	*327.77*	*10.4%*
Blend	*194.40*	*5.2%*	*169.53*	*5.5%*	*260.70*	*8.3%*	*269.94*	*8.5%*
Graduating	*31.63*	*0.8%*	*130.32*	*4.2%*	*39.70*	*1.3%*	*127.90*	*4.0%*
ADF-Only	3,488.71	93.4%	2,540.61	82.2%	2,613.29	83.0%	2,434.07	77.0%
Total	**3,736.83**	**100.0%**	**3,092.37**	**100.0%**	**3,150.16**	**100.0%**	**3,159.68**	**100.0%**

1 It has been assumed that ADF-14 envelope will be the same as ADF-13 envelope in real terms, using the ADF-13 inflation rate of 2.2%.

2 Two of the two regional members currently in transition have been subjected to a 5-year transition period while the other has been granted only a 2-year transition period.

3 The lending terms for regional members in this sub-category currently include a maturity of 40 years, a grace period of 5 years, a service charge of 0.75%, a commitment fee of 0.50% and no interest charge. As of March 31, 2015, five countries are under this category: Benin, Chad, Kenya, Mauritania and Senegal.

Potential Supply

2.7 Climate investment Funds, and most recently the IDA-17 experience with concessional partner loans, indicate that there is significant interest in the use of concessional debt as a means of scaling up contributions to the concessionary windows of MDBs. In the case of IDA, as part of it seventeenth replenishment, five partners contributed a total of SDR 2.896.41 million in Concessional Partner Loans (Table 2).

Table 2: Concessional Loan Contributions to IDA-17

Contributing Partners	Loan Amount				Loan Terms		
	SDR Million	Currency	FX	NC[4] Million	Maturity	All cost in SDR terms	Coupon Rate in NC
China	663.49	USD	1.50718	1,000.00	25/5	1.00%	TBD
France	373.45	EUR	1.15142	430.00	25/5	0.00%	0.00%
Japan	1,287.85	JPY	147.833	190,836.45	40/10	1.00%	0.55%
Saudi Arabia	78.05	USD	1.50718	117.63	25/5	0.00%	0.61%
United Kingdom	493.57	GBP	0.98466	486.00	25/5	0.00%	0.14%
Total	2,896.41						

Source: IDA-17 Final Report

2.8 The fact that these IDA partners, whose contributions to IDA-17 included concessional partner loans, are also State participants in the ADF does not necessarily mean that they will provide CDLs to the Fund during the ADF-14 replenishment cycle. However, it is an indication that they could consider providing CDLs to the Fund in order to scale up their contribution to the next replenishment. Of the 5 IDA partners, two are from Europe, two from Asia and one from the Middle East, indicating that there is widespread interest in the use of concessional debt in MDB financing. At the ADF-13 MTR, and, more importantly, during the ADF-14 replenishment negotiations, more information on the interest of State Participants and regional members of the Bank Group in providing concessional debt to the ADF will be gathered. It is worth noting that in the case of IDA, the indicative donor's expression of interest for contributing to the IDA-17 replenishment though the CDLs played a key role in determining the final discount rate.

3. Determination of Grant Element

3.1 The burden shares and voting rights associated with CDLs are based on the grant element of CDLs. As previously stated, the grant element represents the present value of the financial benefit to the ADF of contracting a CDL. It depends on the terms and conditions of the CDLs, the terms and conditions of the loans to gap, blend and graduating countries and on the discount rate used to determine the present value of the financial benefits estimated annually. To comply with the last principle listed in paragraph 2.1.3 relating to the fact that CDLs must be self-contained, it shall be assumed that grace and maturity periods for CDLs and principal repayment schedule will be the same as those of ADF loans to gap, blend and graduating countries, i.e. 5 years and 30 years respectively[5].

Discount Rate

3.2 The discount rate is a key variable for estimating the grant element. As donors are recognized based on the grant element of their CDLs, it is important to select a discount rate that will provide a strong incentive to contribute to ADF through CDLs, and that, simultaneously, will be considered equitable by donors providing only grants. There are two approaches to determining the discount rate to be used in estimating the grant element: (i) the net income earned approach, based on actual financial benefits accruing to the Fund from the use of CDLs, and (ii) the net cost savings approach, based on the estimated cost savings when ADF raises funds through issuing CDLs compared to an equivalent loan mobilized from the capital markets. The grant element estimated on the basis of market rates would be unstable across replenishments as it would depend on prevailing interest rates. For this reason, and

4 National currency

5 Borrowing terms that are softer, i.e., longer grace and maturity periods would also satisfy the basic principles.

because basing the grant element on a theoretical approach could lead to granting donors burden shares and voting rights that do not represent realisable financial benefit to the Fund, the net income earned approach is preferable[6]. It is simple, stable and equitable across replenishments.

Estimation of Grant Element

3.3 Using the net income earned approach, the discount rate shall be estimated as the all-in cost of ADF loans to gap, blend and transition countries, excluding commitment fees, i.e. 1.75% comprising the service charge on ADF loans of 0.75% and an interest rate of 1.0%. A discount rate of 1.0% shall also be considered on the basis of the fact that the 0.75% service charge is used to defray the Fund's administrative and operational expenses related to the projects and programs funded with the proceeds of CDLs, as is the case with all other ADF loans. For the purpose of this paper, it shall be assumed that the CDL borrowing rate shall fall in the range 0% to 0.5%. The loan repayment schedule shall be identical to those of the loans financed, i.e. 5-year grace period and 30 year maturity.

3.4 Table 3 below indicates that for a discount rate of 1.75% the grant element decreases from 23.65% for a CDL borrowing rate 0.00% to 16.86% for a CDL borrowing rate of 0.50%. For a 1.00% discount rate, the grant element decreases from 14.50% for a CDL borrowing rate of 0.00% to 7.20% for a CDL borrowing rate of 0.50%[7]. Furthermore, the figures in Table 3 indicate that the grant element of CDLs is very sensitive to both the discount rate and the borrowing interest rate. It increases with the discount rate and decreases with the CDL borrowing rate.

Table 3: Grant Element for Varying Discount Rates and Borrowing Rates

Maturity & Grace Period	Weighted Average Maturity	Discount Rate	Interest Rate on Concessional Donor Loan				
			0.00%	0.10%	0.25%	0.40%	0.50%
30/5	17.75	1.75%	23.65%	22.29%	20.26%	18.22%	16.86%
30/5	17.75	1.00%	14.50%	13.05%	10.87%	8.69%	7.20%

Source: Resource Mobilization and External Finance Department Estimates

4. Donor Recognition and Prioritization Rules

Donor Recognition

4.1 To be eligible to subscribe to ADF CDLs during the ADF-14 replenishment cycle, donors shall be required to maintain a minimum baseline burden share comprising two components: i) make a minimum contribution in the form of grants, and ii) at least meet their ADF-13 burden share on a grant equivalent basis. It is proposed that the minimum contribution in the form of grants be set at 90% of ADF-13 grant subscriptions, compared to 80% used in IDA-17[8].

4.2 Table 4 illustrates how a donor can satisfy the minimum baseline burden share requirement by using an acceptable combination of subscriptions in the form of a grant and a CDL. For purposes of the example, it has been assumed that total ADF-14 subscriptions are the same as ADF-13 subscriptions. A donor, who subscribed to UA 100 during ADF-13 in the form of grants, but can only make a grant subscription of UA 90 during ADF-14, can meet the minimum criteria on a grant equivalent basis by also providing a CDL of UA 59.31. However the CDL must be at an interest rate of 0.5%, a maturity of 30 years and a grace period of 5 years. A 1.75% discount rate must also be used. The grant element of the CDL,

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6 IDA also used the net income earned approach and derived a discount rate of 2.65% based on loans on blend and hardened terms.

7 The grant elements for the discount rate of 1.75% compare favorably to the grant elements of three of the five IDA-17 concessional Partner loans presented in Table 2, which range from 15.52% to 32.12% (figures derived from the IDA-17 draft resolution in the IDA-17 Final Report. The grant elements of the other 2 IDA partners that provided CDLs are not given as they did not seek recognition.

8 Given that ADF lending on blend terms is not expected to exceed UA 536.87 million, ADF-14 replenishment cycle CDLs cannot exceed UA 536.87 million. If a discount rate of 1.75% is assumed, the total grant element will be between UA 90.52 (536.87x16.86%) and UA 126.97 (536.87x23.65%)). If donors use CDLs only to top up and maintain their burden shares, requiring a high percentage of the contribution in the form of grants, say 90% compared to IDA's 80% would make it easier for several donors to participate in ADF's CDL scheme.

estimated at UA 10, is obtained by multiplying the CDL by the applicable grant element percentage in Table 3 (UA 10 =UA 59.31x16.86%). Consequently, his total ADF-14 subscription is UA 100 on a grant equivalent basis, the same as his ADF-13 subscription.

4.3 If a discount rate of 1% is used, the grant element percentage would be 7.20% (see Table 3). The donor would need to subscribe to a CDL of UA 139 to generate a grant element of UA 10 (139x7.20%). In both cases the requirement that at least 90% of the donor's ADF-14 replenishment cycle contribution is in the form of grants to make the donor eligible is met, as the UA 90 grant contribution is 90% of UA 100.

Table 4: Illustration of Baseline Burden Share Requirements

ADF-13 Basic Subscription in (UA)	**100**
Concessional Loan Offer for ADF-14	
Amount (UA)	59.31
Maturity	30
Grace period	5
Interest rate	0.50%
Discount rate	**1.75%**
Grant element percentage	16.86%
ADF-14 Subscription (Assuming donor subscriptions at same level as ADF-13)	
Minimum subscription in the form of grant in UA (a)	90
Grant element of concessional loan (UA) (b)	10
Minimum grant equivalent subscription (UA) c = (a) + (b)	**100**

4.4 Donors that subscribe to CDLs shall be compensated with burden shares and voting rights commensurate with the grant elements in their concessional loans as estimated by the Fund. During replenishment exercises, contributions in the form of grants and the grant element of contributions through CDLs shall have equal weight when estimating burden shares and voting rights.

Prioritization Rules

4.5 CDLs are designed to provide an opportunity to donors who want to scale-up their contributions to the Fund. If loan offers by donors exceed the debt limit, ADF would need transparent rules that promote additionality, equitable access and fairness to determine which CDL offers would be accepted first. To achieve these objectives, it is proposed that the Fund use a 2-step process similar to the one adopted by IDA. The two steps are as follows:

(i) First stage: prioritization based on ADF-14 core burden shares.

(ii) Second stage: prioritization based on additionality.

4.6 Annex I illustrates how the prioritization rules will be applied.

4.7 There are other prioritization rules that can also be considered. One such rule could be to rank all the loan proposals by their all in costs in UA (SDR) terms and select the cheapest first.

5. Risk Management Considerations

Risk of Substitution

5.1 The introduction of CDLs is intended to lead to additional resources for the Fund in future replenishments, to enable it to continue to support ADF eligible countries in general and low income or fragile and conflict affected states in particular. It is therefore necessary to ensure that CDLs are not used to substitute for grant contributions. The minimum grant contribution and the requirement that the total contribution of a member subscribing through CDLs be at least equivalent to its ADF-13 contribution on a grant equivalent basis mitigates the risk of substitution.

Financial Risks

5.2 The introduction of CDLs into ADF's financial framework requires appropriate financial risk management measures. The main risks that are likely to arise from debt funding include liquidity risk, interest rate risk, currency risk and credit risk. Liquidity risk related to CDLs can arise in two ways: firstly, the risk that there is insufficient liquidity when a request for disbursement from a qualifying project or country is received and the risk that funds are not available to service CDLs. Both risks shall be mitigated by the design of the CDL. It shall be required that the proceeds of the CDL be paid in cash in three annual instalments, the first of which shall be no later than one month after the effectiveness of ADF-14. Secondly, only CDLs that at least match the repayment terms of loans on ADF gap, blend and graduating countries, i.e. 5-year grace period, 30-year maturity, straight line amortization and half yearly repayments, shall be accepted. Thirdly, the interest rates on CDLs shall be fixed, to match the fixed ADF lending rate. Finally, the Fund already has policies and tools addressing these risks, which will be modified to mitigate any specific or residual risks arising from the use of CDLs.

6. Operational and Legal Considerations

Currency Denomination of CDLs

6.1 State Participants make their grant subscriptions in the currency of their choice[9]. However, if donors were permitted to subscribe to CDLs in all convertible currencies, this would impose a significant administrative burden on the Fund which would not be consistent with Article 8 (2) of the Fund Agreement. It is therefore recommended that CDLs should be denominated in either the Fund's unit of account equivalent to the SDR or in SDR component currencies.

Review of ADF Asset Liability Management Guidelines

6.2 There will be a need for Management to review ADF ALM Guidelines to identify changes required to accommodate the use of CDLs in ADF's financial framework. Two items already identified include:

- The need to increase the debt limit to accommodate CDLs, and
- The need to increase the Prudential Minimum Level of Liquidity to take into account CDLs debt service requirements.

6.3 The current debt limit is 2% of the Fund's cash and investments. As stipulated in the Fund's General Authority on Asset Liability Management in paragraph 2.7.4, although the Fund does not borrow funds for the purposes of supporting its lending operations, it may obtain short term facilities (overdraft facilities, lines of credit, or other temporary accommodations) for the purpose of settling financial market trades or the execution of such transactions, or to facilitate the management of the Treasury portfolio. The Fund's General Authority shall be modified to specifically allow for borrowing for the purpose of on-lending.

6.4 The existing Liquidity Policy links the Fund's target liquidity level to net disbursements. With the incorporation of debt in the Fund's financing framework through CDLs, it will be necessary to also link the target level of liquidity to CDL debt service requirements.

Legal Considerations

6.5 The use of CDLs shall require incorporation in the ADF-14 resolution of the requirements of using debt in the Fund's financing framework. The ADF-14 Resolution must therefore specifically authorize that the grant element of CDLs be counted as a contribution for the purposes of computing burden shares and voting rights. Consequently, an agreement has to be reached on all the key variables related to the use of CDLs such as discount rates, amounts, borrowing terms and payment modalities before the completion of replenishment negotiations.

6.6 Donors using CDLs must enter into a written agreement with the Fund in such a form as is acceptable to the Fund. The Bank Group has experience in borrowing from members as the Bank borrowed from sovereign countries during its early years, before it had access to capital markets. The CDL agreements shall specify that the loan shall be disbursed in three annual instalments the first of which

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9 Certain requirements relating to inflation and convertibility must be observed.

shall be no later than one month after the effective date of ADF-14 and the other two as agreed with the Fund. The latter shall be reflected in the ADF-14 Agreement.

Specification of CDL Borrowing Terms.

6.7 The borrowing terms are critical in determining the impact of using CDLs in ADF's financing framework on the long-term financial viability and sustainability of the Fund. The lower the interest rate on CDLs, the higher the financial benefit to the Fund and the greater its ability to absorb any residual financial risk that may arise from the use of debt in the Fund's financing framework. The analysis in this paper has assumed that the CDL interest rate shall be no higher than 0.5% per annum and that the repayment profile shall replicate blend lending terms, i.e., a grace period of 5 years, a maturity of 30 years and straight-line amortizing repayments. Repayment terms that are softer, i.e., with a longer grace period and a longer maturity would also be acceptable.

7. Impact of Concessional Donor Loans on Advance Commitment Authority

7.1 In addition to the direct impact of CDLs on the amount of resources mobilized during the replenishment cycle, CDLs also impact the size of the replenishment indirectly through a positive effect on the advance commitment authority. The current ACC model assumes that all subscriptions made during a replenishment cycle are encashed on the basis of a 10-year standard encashment schedule. However, subscriptions made by way of CDLs shall be encashed (disbursed to the Fund) in three equal annual instalments, in other words using a 3-year accelerated encashment schedule. As demonstrated in a companion paper, accelerated encashment has a positive impact on Advance Commitment Capacity.

7.2 To demonstrate the positive impact of CDLs on the ACC, a simulation was carried out using the ADF-13 assumptions and the following specific assumptions relating to the CDL:

CDL Amount: UA 500 million
Interest Rate: 0.5%
Grace Period: 5 years
Maturity: 30 years
CDL encashed (disbursed to the Fund) in three equal annual instalments during ADF-14 replenishment cycle.

7.3 It was also assumed that the CDL would be additional to the regular ADF-14 subscriptions as projected in the ADF-13 ACC model. Table 5 below shows that under the assumptions above, ACC for ADF-14 would increase from UA 978 million to UA 1,200 million, i.e., by UA 222 million, bringing the total increase attributable to the CDL to UA 722 million. As explained in the paper on accelerated encashment, the increase in ACC is due to the fact that the CDL is paid-in during the replenishment period, while the disbursements to the beneficiaries funded with the proceeds of the CDL take place over the normal ADF disbursement period. Consequently, there is a build-up of incremental liquidity which impacts the ACC positively.

Table 5: Impact of Concessional Donor Loans on Advance Commitment Capacity

(Amounts in UA million)

Projected ADF-14 ACC	978
Projected ADF-14 ACC assuming ADF-14 CDL of UA 500 million	1200
Projected Increase in ADF-14 ACC attributable to CDL	**222**

Source: Financial Management Department

8. Issues Requiring Guidance

8.1 The guidance of the Working Group is sought on the following issues:

(i) ***Minimum grant contribution.*** It is proposed that the minimum grant contribution that ADF members must make to be eligible to subscribe to ADF-14 in the form of CDLs be 90% of ADF-14 contribution and that total contribution should be no less than the ADF-13 contribution of the member in **grant equivalent terms**.

(ii) ***Discount rates.*** Two options of discount rate are considered in this paper to compute the grant elements of concessional loans: 1.75% equivalent to the sum of ADF service charge and the interest rate on blend loans, and 1.00% equivalent to the interest rate on ADF blend loans.

(iii) *Currencies of denomination of CDLs.* The paper proposes the SDR and SDR component currencies only.

(iv) ***The terms and conditions of CDLs.*** It is proposed that CDLs have:

- A maximum interest rate of 0.50%.
- The grace periods and maturities no shorter than corresponding blend lending terms, and
- Repayment profile matching that of ADF loans to Blend, Gap and Graduating countries.

(v) The prioritization rules to be used in the event of over-subscription.

Annex I : Prioritization Rules for Concessional Donor Loans

The concessional donor loan option is designed as a mechanism for donors seeking to significantly scale up their contributions. As a result the loan option will only be available to donors who meet the minimum base line burden share requirement, i.e., ADF-13 burden share on a grant equivalent basis. In the event that CDL offers exceed the debt limit, which for ADF-14 shall be taken to be the maximum possible lending on blend terms, ADF would need transparent Rules to determine which offers to accept first, so that the two key principles of additionality and equitable access are respected. To achieve both objectives the following 2 stage process is proposed. For this illustration it has been assumed that ADF-14 donor subscriptions shall amount to UA 4,000 million, an ADF-14 debt limit of UA 500 million with an interest rate of 0.5%, a 5-year grace period and a 30-year maturity. The discount rate for determining the grant element has also been taken to be 1.75%.

First stage: prioritization based on ADF-13 burden shares. Loan offers would be prioritized based on ADF-14 core burden shares up to a specified percentage, which for the purpose of this example is taken to be 60%. This is illustrated in Table I.

Table I : Illustration of First stage Prioritization Based on ADF-14 Core Burden Shares

Maximum debt limit			500		
Portion prioritized in stage 1:		(60% of total)	300		
Countries	A	B	C	D	E
Loan offer	**200**	**150**	**150**	**100**	**200**
ADF-13 basic burden shares	10.00%	10.00%	10.00%	10.00%	10.00%
ADF-14 core burden share from grant contributions	9.50%	5.00%	10.00%	11.00%	15.00%
Potential burden share from grant element of loan offer	0.84%	0.63%	0.63%	0.42%	0.84%
ADF-14 burden share incl. grant element of loan offer	**10.34%**	**5.63%**	**10.63%**	**11.42%**	**15.84%**
Meets minimum baseline burden share requirements	Yes	No	Yes	Yes	Yes
Stage 1 prioritization based on ADF-14 core burden share (i.e., Minimum loan offer that would be accepted from donor)	28.5		30	33	45

Country A that had a burden share of 10.00% in ADF-13 pledges to subscribe to 9.5% of UA 4,000 million the target replenishment level for ADF-14 and offers a CDL UA 200 million. The potential grant element of the offer is UA 33.42 (200x0.1686) that would generate an ADF-14 burden share of 0.84% if the entire offer was accepted. The total grant equivalent of burden share of Country A is 10.34% (9.50% + 0.84%). Country A therefore meets the minimum burden share requirements as it maintained its ADF-13 burden share of 10% on a grant equivalent basis including the loan offer (10.34%) and is ADF-14 core burden shares from grant contributions is greater than 90% (95%). Since Country A meets the minimum burden share requirements at least UA 28.5 million (300x9.5%) of its loan offer would be accepted in stage 1.

Country B does not meet the minimum burden share requirements and would consequently no portion of its loan offer will be accepted in stage 1.

Countries C, D, and E meet the minimum burden share requirements and would be allocated UA 30 million (300x10%), UA 33 million (300x11%) and UA 45 million (300x15%) respectively during the first stage.

Second stage: Prioritization based on additionality: In stage 2, the remaining debt limit would be allocated in order of priority to the donors with the highest percentage change in core burden shares in ADF-14 compared to ADF-13. This is illustrated in Table II.

Table II : Illustration of Second stage Prioritization Based on Additionality					
Maximum debt limit			500		
Portion prioritized in stage 2			200		
Unutilized stage 1			163.5		
Total Debt prioritizedunder stage 2:			**363.5**		
Countries	**A**	**B**	**C**	**D**	**E**
ADF-13 basic burden shares	10%	10%	10%	10%	10%
ADF-14 core burden share from grant contributions	9.50%	5.00%	10.00%	11.00%	15.00%
Percentage change in ADF-14 core vs. ADF-13 burden share	-5.00%	-50.00%	0.00%	10.00%	50.00%
Meets minimum baseline burden share requirements	Yes	No	Yes	Yes	Yes
Loan offer	**200**	**150**	**150**	**100**	**200**
Less: Loan offer accepted in stage 1	28.5		30	33	45
Unused loan offer	171.5	150	120	67	155
Rank based on percentage change in core burden share	4	na	3	2	1
Stage 2 prioritization (Offers of donors meeting the min. baseline requirements accepted up to the maximum debt limit)	21.5		120	67	155
Portion of loan offer not accepted	**150**	**150**	**0**	**0**	**0**

Following from the stage 1, the remaining debt limit is UA 363.5 million i.e., UA 200 million reserved for stage 2 plus the unused balance from stage 1 of UA 163.5 million. The countries meeting the minimum baseline burden share requirements with remaining unused loan offers are ranked in stage 2 based on the percentage change in their core burden shares for ADF-14 compared to ADF-13. Country B is not ranked because it did not meet the baseline burden share requirements.

Country E is ranked number 1 with a percentage change of 50%. Its remaining used offer UA 155 million is accepted first. The second ranked is country D and it also gets is remaining allocation of UA 67 million. Country C ranked third also gets its remaining offer of UA 120 million. Country A the fourth ranked gets the remaining balance of UA 21.5 million.

If there were a remaining balance after stage 2, it would be allocated to countries that did not meet the minimum baseline burden share requirements at the discretion of the Fund.