ADF-13 MID-TERM REVIEW

Smoothing the Advanced Commitment Capacity: Concessional 'Bridge' Loan to the African Development Fund

A Brief Note

11-13, November 2015

AFRICAN DEVELOPMENT FUND

1. Introduction

1.1 This paper lays the basic principles of a proposed 'bridge' loan to the African Development Fund as part of a menu of the innovations explored during the ADF-14 Working Group deliberations. The African Development Fund (ADF) will be replenished for the 14th time in 2016, with resources provided by (i) donors and (ii) the Bank's internally generated loan reflows and investment income (the Advanced Commitment Capacity, ACC, as explained in Annex I). While donors' contributions have increased over time and stabilized at UA 3.8 billion for ADF-12 and ADF-13, the ACC fell by UA 1 billion during ADF-13 (Figure 1). The lower ACC is due to two main factors.

- *Lower returns*. The average return of the liquidity portfolio was 4.5% for ADF-12 but estimated at 2.65% for ADF-13, resulting in lower projected cash reflows from investments.

- *Change in the loan cancellation pol*icy. While in the past, all cancelled loans reflowed to the next ADF replenishment, as from ADF-13, only 30% of cancelled loans are considered as reflows, given that other 70% are re-assigned to beneficiary countries.

1.2 Based on assumptions agreed during ADF-13, the ACC should remain at around UA 1 billion[1] for ADF-14 and ADF-15 and is expected to increase to UA 2.1 billion starting with ADF-16. The main reason for the increase in the ACC starting from ADF-16 is the expected growth in loan reflows due in part to change in loan pricing adopted during ADF-13 when financing terms were hardened.

1.3 Hence, if part of the post-ADF 15 ACC could be front-loaded, financial support could be provided to ADF recipient countries earlier. Such resources would allow the Bank to support these countries' efforts to meet the Sustainable Development Goals (SDGs) in a timelier manner. The innovation being proposed here is for the ADF to contract a concessional loan to frontload part of the ACC, thereby bringing forward its lending capacity.

1.4 Following the introduction, the mechanics, feasibility and benefits of a 'bridge' loan are presented. Section 3 concludes.

2. Mechanics of a 'Bridge' Loan

2.1 A 'bridge' loan would allow the ADF to borrow resources in order to improve its general liquidity level and increase the ACC for the next two replenishment cycles when the ACC is projected to be at its lowest. The ADF would frontload resources to support more operations earlier in recipient countries and would reimburse the loan from ADF-16 when reflows into the Fund are expected to exceed outflows.

Possible Suppliers of a 'Bridge' Loan

2.2 The Fund can legally contract a concessional loan but not a non-concessional one (Annex II). As a result, it cannot borrow directly from international capital markets. While the AfDB could lend to the ADF,[2] it cannot provide (i) grant financing, (ii) a loan that contains a grant element or (iii) a loan that results in a financial burden for the Bank. On

[1] The recalibration of the ACC for ADF-14 may yield a revised ACC. Higher administrative expenses and lower interest rates would translate into a lower ACC.

[2] Article 14(1) of the Agreement establishing the Bank allows the Bank "to provide or facilitate financing for any regional member, political subdivision or any agency thereof or for any institution or undertaking in the territory of any regional member as well as for international or regional agencies or institutions concerned with the development of Africa." (Emphasis added). The Fund is indisputably an international institution concerned with the development of Africa and would therefore qualify.

the one hand, the ADF Board would need to certify that the loan is on concessional terms. On the other hand the AfDB Board would need to certify that the same loan does not contain a grant element. Hence arises an impossibility.

2.3 The most feasible option would be for one or more donors (which could be a non-RMC, a RMC or a philanthropic actor) to provide such a concessional loan to the ADF. This could be done in the form of (i) Concessional Donors Loans (CDLs) that are part of donors' contributions to the replenishment as it is the case with the International Development Association (IDA), or (ii) direct injections into the Bank's ACC of donor's contributions in the form of a 'bridge' loan that will allow frontloading future internal generated resources at an earlier stage.

2.4 Donors who provide the 'bridge' loan would receive ADF burden-sharing recognition and allocation of voting rights based on the grant element of the loan.[3] To remain attractive to donors, the discount rate would have to be relatively higher than the "all-in-cost" coupon rate of the 'bridge' loan. Based on the recent experience of IDA for CDLs it is reasonable to assume that the concessional "all-in-cost" coupon rate for a 17 years maturity would not exceed 1.5%. Table 1 presents the computation of the grant element for the proposed discount rate and for various scenarios of interest rates for the 'bridge' loan and indicates grant element levels fluctuating from 18.74% for a 'bridge' loan at 0% to 4.68% for a 'bridge' loan at 1.5%.

Table 1: Grant Element for the Proposed Discount Rate and for Various 'Bridge' Loan Interest Rate Scenarios

Maturity	Weighted Average Maturity	Discount Rate	Interest rate on the bridge loan (cost of borrowing)				
			0.00%	0.50%	1.00%	1.50%	2.00%
7/17	12.25	2.01%	18.74%	14.05%	9.37%	4.68%	0.00%

Estimated Impact of a 'Bridge' Loan on the Advance Commitment Capacity

2.5 It is proposed that the ADF contracts a concessional loan of UA 1 billion to smooth the ACC. On the basis of ADF-13 assumptions, such a 'bridge' loan to the ACC will bring the ACC to UA 1.7 billion for every ADF cycle starting ADF-14. The ACC would be higher by UA 700 million than without a 'bridge' loan during ADF-14 and ADF-15. However, the ACC would then be lower with the 'bridge' loan than without one for ADF-16, 17 and 18 cycles.

2.6 One of the main appeals of the 'bridge' loan is that it would increase the total resource envelope of the ADF, thereby benefiting all ADF eligible countries, including in fragile situations. Assuming the same level of donors' contributions as for ADF-13, allocable resources should increase by 14.2% (See Table 2). The Performance-Based Allocation (PBA) and the Regional Operations (RO) envelopes would increase by 23.0% and 14.2%, respectively. However, the Transition Support Facility (TSF) would not increase automatically and is assumed to remain the same as in ADF-13 (UA 1.07 billion) because ring-fenced TSF funds are not a predefined share of available resources.

[3] The grant element is the present value of the financial benefit to the Fund for contracting the 'bridge' loan. It depends on the terms and conditions of the 'bridge' loan and on the discount rate used to determine the present value of the financial benefits.

2.7 While the average ADF country PBA would increase by 22.2%, the corresponding increase would exceed 40% for at least ten (10) countries compared to ADF-13. Indeed, the current eighteen (18) transition states, also known as countries in fragile situation, would be the main beneficiaries of the proposed ‘bridge’ loan given that their indicative PBAs is expected to increase by 28.5 percent for the entire ADF-14 cycle (Table 3).

Figure 1: Advance Commitment Capacity Projection (ADF-9 to ADF-18)

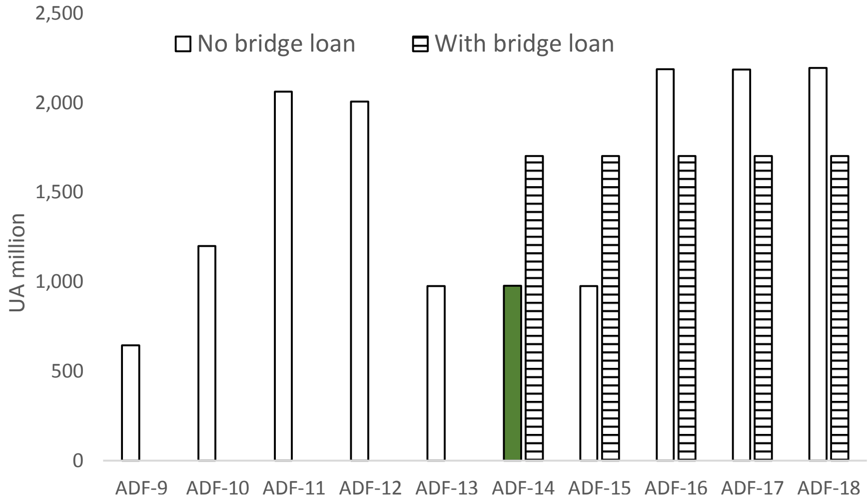


Table 2: ADF-13 vs. ADF-14 Resources with a ‘Bridge’ Loan (UA million)

Envelope	ADF-13	ADF-14 with bridge loan	Change
Transition Support Facility (TSF)	662	662	0
Regional Operations (RO)	1,074	1,226	14%
Private Sector Facility (PSF)	165	Not applicable	Not applicable
Performance-Based Allocation (PBA)	3,213	3,952	23%
Resource Envelope	5,114	5,840	14%

Note: Using the same assumptions as under ADF-13 the ADF-14 resource envelope would be the same as under ADF-13.

Table 3: Impact of a ‘Bridge’ Loan on ADF-14 PBAs by Group of Countries UA million

	ADF-13		ADF-14 with bridge loan		Change (%)
	PBA	Share (%)	PBA	Share (%)	
Transition States (ie: countries in fragile situation)	809	26	1,080	29	34%
Non-Transition states	2,290	74	2,708	72	18%

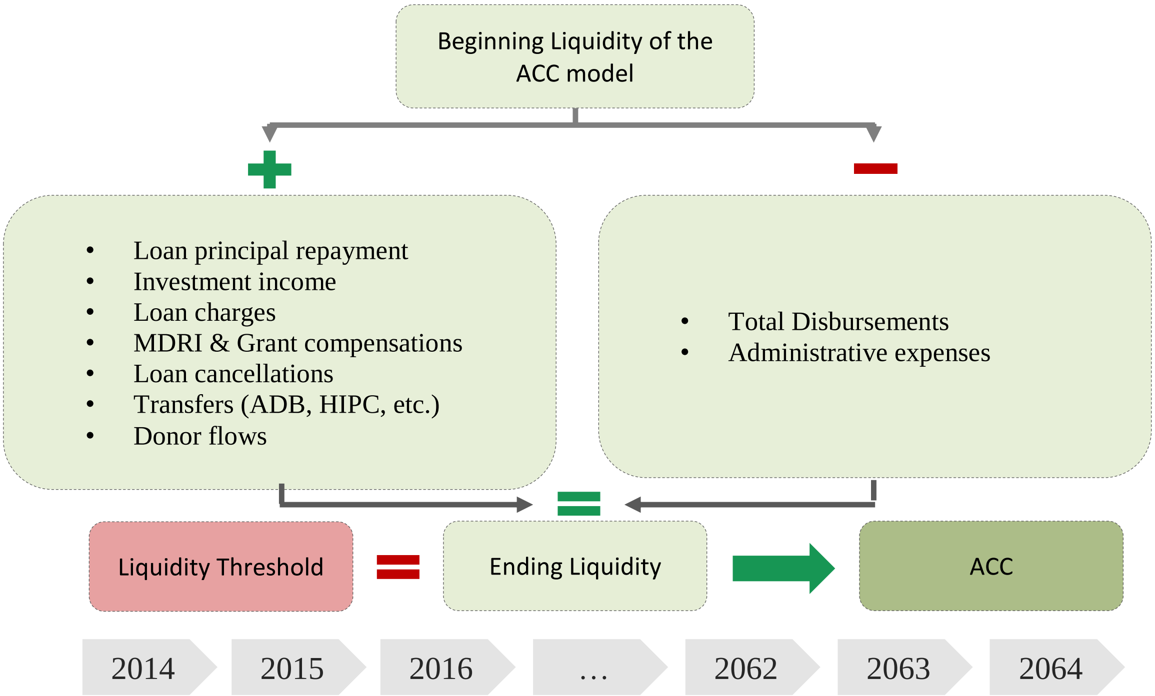
3. Conclusion

3.1 A ‘bridge’ loan to the ADF financing framework would have several advantages. It represents an opportunity to scale-up donor subscriptions to ADF in a constrained fiscal environment. In addition to increased allocable concessional financing and fairly straightforward implementation, the ‘bridge’ loan would not have major legal implications. In short, the proposed ‘bridge’ loan would offer the Bank the opportunity to scale up its development finance contributions, particularly in regard to meeting the newly-agreed Sustainable Development Goals (SDGs).

3.2 If Deputies agree to the proposal in principle, Management will provide a full paper on the ‘bridge’ loan and how it will interact with other instruments for the first ADF-14 meeting.

ANNEX I: The Advance Commitment Capacity

The Advance Commitment Capacity (ACC) represents the level of resources that can be committed during each replenishment, based on internally generated resources. It is based on a very long term projection model (50 years) of the Fund's major cash flows presented in the figure below. The ACC is based on a set of deliberately conservative assumptions as well as safety margins to support future disbursements and mitigate the risk of over-commitment. In this projection model, the liquidity must be maintained above the threshold specified in the Fund's liquidity policy.



ANNEX II: Can the ADF Borrow?

Article 4 of the Fund Agreement provides that the Fund's resources shall consist of:

(i) subscriptions made by the Bank;
(ii) subscriptions made by State participants;
(iii) other resources received by the Fund; and
(iv) funds derived from operations or otherwise accruing to the Fund.

The Fund's "other resources" are further elaborated in Article 8 where it is provided that the Fund may enter into arrangements to receive other resources, including grants and loans, from members, participants, States which are not participants and from any public or private entity or entities. This article further specifies that:

a) such resources are given to the Fund pursuant to arrangements that are made on terms and conditions which are consistent with the Fund's purposes, operations and policies, as well as do not impose an undue administrative burden on the Fund or the Bank;

b) such arrangements are on terms that permit the Fund to comply with Article 15(4) and (5) of its Agreement (concerning procurement, as amended);

c) such arrangements are approved by an 85% majority vote of the total voting power of the Board of Directors of the Fund, in the case where they are being entered into with a State that is not a member or State participant in the Fund or an agency of such a State; and

d) such arrangements are on concessionary terms. The Fund shall not accept any loan (except temporary accommodations required for its operations) which is not on concessional terms and shall not borrow in any market or, as a borrower, guarantor, or otherwise, participate in the issue of securities in any market and shall not issue negotiable or transferable obligations evidencing indebtedness for loans received.

There is thus no legal obstacle preventing the Fund from contracting a 'bridge' loan, provided the restrictive conditions imposed by Article 8 of the Fund Agreement are strictly adhered to and observed.