Toward a Buy-Down Mechanism

ADF WG Paper
(Revised version for the ADF WG report)

4th ADF Working Group Meeting
29-30 May 2015
Abidjan, Cote d'Ivoire

AFRICAN DEVELOPMENT FUND DEVELOPMENT FONDS AFRICAIN DE DEVELOPPEMENT

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 represent. This paper was prepared for the fourth meeting of the ADF Working Group held on May 29-30, 2015, in Abidjan, Cote d'Ivoire and was revised during July 2015. The information provided in the paper is not meant to be exhaustive but to facilitate discussions among members of the ADF Working Group and does not reflect any value judgements on the part of the Bank Group and its Management.

Executive Summary

This paper responds to the ADF Working Group's request for elaboration on the Buy-Down mechanism which was initially presented at the first ADF-13 Replenishment meeting. The purpose of the mechanism is to increase available resources for the benefit of the neediest regional member countries (RMCs) of the African Development Bank. Under the proposed mechanism[1], eligible RMCs would be able to use their AfDB headroom to receive the equivalent of their Performance Based Allocation (PBA). The ADF eligible RMCs countries would then be compensated for harden terms through grants from ADF.As some countries which are on the graduation path would no longer utilize their ADF allocations, this would unlock resources for the remaining ADF countries.

The amount of additional resources for the neediest countries is estimated to range from UA 0.22 billion to UA 1.2 billion during ADF-14. Additional resources increase with the number of eligible countries.

The potential drawbacks of such a mechanism would be (i) its negative impact on the ACC which is mitigated when the ADF compensation is paid following the standard disbursement profile and when the mechanism targets countries on path of graduation and (ii) its increasing impact on the grant share in the ADF, which could lead to more compensation from donors in the future.

In terms of AfDB risk exposure, the potential impact is mixed. Overall, the Buy-Down mechanism should not adversely affect the Bank's risk exposure as the diversification benefits of the Bank's portfolio outweigh potential additional risk exposure to ADF eligible countries.

Two options for structuring and implementing the mechanism are considered.

- Preferred option (former Option B): *Modify the ADF operational framework*. Eligible ADF countries would use their AfDB headroom to receive the equivalent of their PBA on AfDB terms and they would be compensated for harder terms through transfers in grants from ADF. The remaining ADF countries would enjoy more resources. With this mechanism, instead of providing loans to countries on the path of graduation, ADF would provide grants. Grant resources from the ADF would then be deployed alongside AfDB's own financing. The concessionality of the loan–grant package will be equal to the ADF concessionality so that the eligible countries continue to receive the same amount of concessional resources.
- Alternative option (former Option A): *Create a dedicated facility*. Eligible ADF countries use their AfDB headroom to receive the equivalent of their PBA on ADF terms. The AfDB would be compensated for any income foregone through transfers from the Facility seeded by an ADF contribution and other donor contributions. The remaining ADF countries would enjoy more resources.

[1]The initial idea proposed that ADF would directly compensate the AfDB for granting loans on ADF terms to eligible countries but the concept was revised due to legal issues.

Table of Contents

Boxes

Tables

Abbreviations

ACC	Advance Commitment Capacity
ADF	African Development Fund
ADF WG	African Development Fund Working Group
ADF-13	Thirteen African Development Fund Replenishment
ADF-14	Fourteen African Development Fund Replenishment
AfDB	African Development Bank
DSF	Debt Sustainability Framework
FSO	Fund for Special Operations
IADB	InterAmerican Development Bank
IDB	Islamic Development Bank
MVA	Modified Volume Approach
PBA	Performance Based Allocation
PCG	Partial Credit Guarantee
PSF	Private Sector Credit Enhancement Facility
RMC	Regional Member Country
TSF	Transition Support Facility
UA	Unit of account

TOWARD A BUY-DOWN MECHANISM

1. Introduction

1.1. During the first ADF-13 replenishment meeting, a list of innovative financing instruments was presented by the AfDB Group management to ADF Deputies for consideration as part of an effort to increase the impact of the Fund's resources. One option – a Buy-Down mechanism- (also referred to as the *Modified Framework for Assistance to Creditworthy Countries)* was well received. Under this mechanism, eligible ADF countries would use their AfDB headroom to receive the equivalent of their Performance Based Allocation (PBA) on ADF terms. The AfDB would be compensated for any income foregone through transfers from ADF. The freed ADF resources are then allocated to the remaining ADF countries. However, the option was not pursued due to potential legal issues related to Article 31 of the ADF Agreement and its limited financial impact. At that time, the mechanism could only be applied to one country.

1.2. Under ADF-13, the PBA envelope has decreased by UA 1 billion compared to the ADF-12 envelope. In 2014, 29 countries received a lower PBA country allocation compared to 2013. For 12 of those countries, the allocation fell by at least UA 10 million. This reduction in funding created very challenging situations for the ADF-only countries in light of the robust project pipelines they had prepared to meet their huge infrastructure needs combined with other external shocks. The proposed mechanism is therefore relevant given the very large needs in ADF countries.

1.3. Since more RMCs are currently on the path of graduation, the potential demand for such a Buy-Down mechanism may increase. Further exploration of innovative mechanisms such as the one proposed is also in line with the Bank Group's Ten Year Strategy which seeks to enhance synergies between the AfDB and ADF, while increasing the leverage effect of the Bank Group's amended Credit Policy. It is also worth noting that Buy-Down mechanisms exist in other international organizations. For instance, the EU Infrastructure Trust Fund offers interest rate subsidies on a project level. In addition, at the InterAmerican Development Bank's (IADB), less advantaged member countries receive grants from the Fund for Special Operations (FSO) which are blended with IADB non concessional financing. Finally, in 2014 the Islamic Development Bank (IDB) and the Gates Foundation announced their intention to set up a pro-poor Buy-Down Facility.

1.4. During past ADF Working Group (WG) meetings, participants supported the Buy-Down mechanism but asked for further elaboration on its structure and compatibly with the Credit Policy and debt sustainability of concerned countries. Participants also sought to know how the resulting savings would be allocated among ADF countries. This paper responds to these questions.

1.5. The paper is divided into five sections. Following the introduction, Section 2 summarizes the main principles of the proposed mechanism including some variations to the list of eligible countries and its likely financial impact on resources available for the neediest RMCs. Section 3 presents the mechanism's likely impact on the Advanced Commitment Capacity (ACC) and on the risk exposure of the AfDB. Section 4 explores ways to structure and implement the mechanism. Section 5 concludes.

2. Principles of the Buy-Down Mechanism

Background

2.1. With the sustained economic growth, it is expected that more African countries will exit from the low income country category over the next decade. On the other hand, those countries remaining in the low-income category will most likely be fragile or vulnerable and require even more financial resources, especially in light of their rapid population growth. To partially alleviate this constraint, eligibility to loans from the AfDB sovereign window was extended under certain conditions to ADF-only countries in May 2014.

2.2. Opportunities remain to further leverage AfDB lending capacity for sovereign and non-sovereign operations. While the headroom is updated regularly, as of March 31, 2015, UA 26 billion was available for ADF countries (Table 1), far greater than the projected ADF-14 PBA allocation. A Buy-Down mechanism is consistent with the amended Credit Policy of the Bank Group and increases opportunities to tap into the AfDB window, to free up resources for ADF-only countries.

Table 1: ADF Countries Headroom under AfDB Window - March 31, 2015

(Millions UA)

Regional Member Countries (RMC)	ADF-14 Estimated allocation	AfDB Headroom
Blend	261	3 527
Graduating	40	3 360
Gap	237	6 167
Green light	1 310	13 054
Total	1 848	26 108

The Mechanics of the Buy-Down Mechanism

2.3. Initially, the idea was that ADF would directly compensate the AfDB for granting loans on ADF terms to eligible countries. However, direct transfers from ADF to the AfDB create legal challenges. Under the current proposed mechanism, eligible ADF countries would use their AfDB headroom to receive the equivalent of their PBA and the eligible ADF countries would then be compensated for any income foregone through transfers from ADF that may be consistent with what is elaborated upon in section 4 below . The freed ADF resources will then allocated to the remaining ADF countries. The Buy-Down mechanism is one option to further use the AfDB lending capacity and provide more concessional resources to the Bank Group's neediest RMCs. Section 4 (Implementation Options) will further elaborate on how ADF resources could be creatively deployed to make this happen. An alternative option based on the creation of a facility is also presented.

2.4. Blend and graduating countries can already access the AfDB sovereign window and the mechanism would therefore be applied to them (for a comprehensive presentation of AfDB country categories See Annex I). Potential eligible countries without enough headroom for AfDB borrowing would continue to be entitled to their ADF PBA allocation.

2.5. Box 1 below highlights the mechanics of the Buy-Down with a simplified example.

Box 1: Mechanics of the Buy-Down

The assumptions are as follows:

- ADF eligible countries are one blend country X and a pool of ADF-only countries.
- The PBA allocation of blend country X is UA 100 million.
- The pool of ADF-only countries PBA allocation is UA 1 billion.
- The Buy-Down mechanism is applied to the blend country X
- For each UA 10 million granted by AfDB to the blend country in place of the ADF, UA 1.4 million will be needed as compensation.

Impact of the mechanism	Without the mechanism	With the mechanism
Concessional resources for the blend country X	100	100
Non-concessional resources for the blend country X	No change	No change
Amount of ADF resource used	100 in loans	14 in grants
Total available resources for the pool of remaining ADF countries	1000	1086

2.6. The AfDB will not be directly compensated for the resulting foregone income and not for the credit risk carried by the Bank. The mechanism would not introduce changes in the level of concessional funding available to eligible countries. It would thus be fully compliant with the Bank Group's Debt Sustainability Framework (DSF). ADF resources which would no longer be used for blend and graduating countries could be reallocated to ADF-only countries.

Estimated Financial Impact and Allocation of Liberated Funding

2.7. The remaining ADF countries would enjoy more resources estimated as varying from close to UA 0.22 billion to UA 1.2 billion during ADF-14. The amount is smaller when only blend and graduating countries are eligible and higher when Gap and Green light countries are also included.

Table 2: Estimated Financial Impact

(UA million)

RMCs	ADF-14 Estimated PBA allocation	Amount borrowed from AfDB in place of ADF	ADF compensation	Amount available for the remaining ADF only countries
Blend	261	261	37	**224**
Graduating	40	40	6	**34**
Gap	237	237	33	**204**
ADF Green light	1310	1310	524	**786**
Total	*1848*	*1848*	*600*	*1248*

Notes: See Annex II.

2.8. In the simulations, all freed up resources are allocated to the neediest RMCs through the Performance Based Allocation (PBA) system. A proportion of the released amounts could be allocated to the countries on the path to graduation in the form of a topped up allocation so as to create more incentives for them[2]. A portion of the resources could also be used to mitigate any adverse impact on the ACC (see Section 3).

The Absorptive Capacity of Eligible Countries

2.9. The AfDB has developed a facility to provide supplementary funding to the poorest and most fragile countries. The Transition Support Facility (TSF), formerly Fragile States Facility, was established in 2008. It has three distinct windows. Its Pillar I provides supplementary support to eligible countries. It has always been fully utilized by the end of the ADF cycles. The success of the TSF's Pillar I shows how countries are able to easily and timely absorb additional resources when they are made available.

3. Impact on the Advanced Commitment Capacity, the donor grant compensation scheme and AfDB Risk Exposure

Impact on the ACC

3.1. By limiting the use of ADF resources by some countries and depending on how the ADF compensation is paid, the Buy-Down mechanism will result in a decrease of the ACC by UA 5 -127 million during ADF-14 and UA 7-140 million during ADF-15 if the mechanism is applied to blend, graduating and gap countries. In the case the mechanism is extended to ADF green light countries, the ACC would decrease by UA 43-587 million during ADF-14 and by UA 42-591 million during ADF-15 (See Annex III).

3.2. The **decrease in the ACC** with the Buy-Down mechanism is mitigated when the ADF

[2] Provided the operational guidelines of the ADF remain the same, countries that are pushed out completely from the ADF may no longer have access to the ADF series of instruments such as the Regional Operation envelope or the guarantee products. Such incentives could therefore be useful.

compensation is paid following the standard disbursement profile and when the mechanism targets countries on path of graduation.

Impact on the donor grant compensation scheme

3.3. In order to mitigate the reduction of future reflows resulting from increased grant financing, State participants have agreed since ADF-9 to compensate the Fund for foregone reflows above 7.5% of the replenishment amount, as the reflows arise, using the "pay-as-you-go" approach. Each State participant's contribution to grant compensation is based on its normalized burden share for the corresponding replenishment.

3.4. An amount of UA 4.9 million representing the 2014 and 2015 compensation for grants extended during ADF-9 and ADF-10 has become due during ADF-13. It has been agreed that the due compensation will increase gradually as set in Annex IV.

3.5. In order to determine the indicative proportion of grants for the year, the Fund uses the outcome of the relevant Debt Sustainability Analysis. For ADF-13, the indicative proportion of grants was assumed to 33.45%. With the Buy-Down mechanism, the ADF would provide grants instead of loans and this would increase the share of grants in the Fund under ADF-14 and ADF-15. This is presented in Table 3 which assumes the same envelope for each set aside as for ADF-13[3].

Table 3: Impact of the Buy-Down Mechanism on the share of grants in the ADF

Envelope	ADF-13					ADF-14					ADF-15				
	Loans		Grants		Total	Loans		Grants		Total	Loans		Grants		Total
	Nominal	%	Nominal	%		Nominal	%	Nominal	%		Nominal	%	Nominal	%	
PBA (Inlc. grant discount)	2,424.6	75.5%	788.7	24.5%	3,213.3	2,160.8	67.2%	1,052.5	32.8%	3,213.3	2,116.9	65.9%	1,096.3	34.1%	3,213.3
TSF	246.5	36.2%	434.4	63.8%	680.9	246.5	36.2%	434.4	63.8%	680.9	246.5	36.2%	434.4	63.8%	680.9
RO and RPG (Incl. grant surcharge)	755.3	70.4%	318.0	29.6%	1,073.3	755.3	70.4%	318.0	29.6%	1,073.3	755.3	70.4%	318.0	29.6%	1,073.3
PSF	-		165.0	100.0%	165.0										-
Total	3,426.3	66.8%	1,706.1	33.2%	5,132.5	3,162.6	63.7%	1,804.9	36.3%	4,967.5	3,118.7	62.8%	1 848.8	37.2%	4,967.5

Impact on the AfDB risk exposure

3.6. In terms of **AfDB risk exposure**, the potential impact is mixed (Table 4). On the one hand, the Bank's Risk Adjusted Capital (RAC) ratio would increase because of the increased diversification of the AfDB portfolio. Similarly, the Bank's Risk Capital Utilization Rate (RCUR) would also increase as exposure to countries using the Buy-Down mechanism would increase. The Bank's risk profile would remain strong if the RAC remained above the threshold of 15% and the RCUR below 100%. Overall, the Buy-Down mechanism should not adversely affect the risk exposure of the Bank and would rather contribute to marginally improve the RAC[4].

[3] PSF is not included as it is a one side contribution.
[4] Increase of the RAC ratio means better allocation of the Bank's risk capital.

Table 4: Impact of the Buy-Down Mechanism on Main Prudential Ratios

	Additional exposure for AfDB (UA million)	Impact on RAC	Impact on RCUR
Prudential ratios without the mechanism	0	**17.1%**	**61.2%**
Blend/graduating/gap only	538	**+ 0.12**	**+ 0.6**
Green light	1310	**+ 0.30**	**+ 1.5**
Combined	1848	**+ 0.39**	**+ 2.2**

3.7. If the Buy-Down mechanism is applied to gap and green light ADF countries, the same risk assessment as the one in the revised Credit Policy would be conducted to vet the creditworthiness of potential eligible countries in order to protect the Bank from the additional risk taken. ADF Countries that may not deemed eligible to the AfDB window after the creditworthiness assessment will continue to receive their PBA from the ADF.

.

4. Implementation of the Buy-Down Mechanism

4.1. The initial idea proposed that ADF would compensate directly the AfDB for granting loans on ADF terms to eligible countries. However, any structure selected will have to be consistent with the provisions of Article 31 of the ADF Agreement which provides that "the Fund shall be an entity juridically separate and distinct from the Bank and the assets of the Fund shall be kept separate and apart from those of the Bank. Nothing in the Fund Agreement shall make the Fund liable for the acts or obligations of the Bank, or the Bank liable for the acts or obligations of the Fund". On this basis, although the Fund can contribute to a Buy-Down mechanism, the Fund itself cannot be made liable in any way, either directly or indirectly, for any obligations due to the Bank resulting from the establishment of a Buy-Down mechanism.

4.2. In general, the financial reporting and accounting for an instrument such as a Buy-Down mechanism would have to be in conformity with the prevailing financial reporting standards including the substance of the transaction. Some of the critical considerations that determine the accounting treatment of an instrument are: the decision-making power; the governance structure; the extent of the entity's independence; the degree to which the transaction is perceived as arms-length; the primary beneficiaries of the Buy-Down and how decisions over operational activities relating to the transaction will be made.

4.3. We note that nothing in the ADF Agreement prevents the ADF from making a grant to the AfDB. However, for the foregoing reasons, if that grant is managed by the Fund or even by the Bank, this might lead to a conflict of interests which violate Article 31(3), and issues of consolidation of accounts, could arise. It should be recalled that the Bank holds 50% of the voting power on the Board of Directors of the Fund.

4.4. Finally, under Article 15(2)(a) of the ADF Agreement, the Fund is prohibited from granting financing if, in its opinion, the borrower can obtain such financing from another source on reasonable terms. What constitutes "reasonable terms" is determined on a case by case basis at the time of project design. Should ADF Deputies retain this option, the mechanism would have to take into account this proviso.

Preferred Option (former option B): Modify the ADF operational framework to open grant eligibility to countries on the path of graduation and deploy ADF grants alongside AfDB's financing.

4.5. Eligible ADF countries would use their AfDB headroom to receive the equivalent of their PBA on AfDB terms and they would be compensated for harder terms through grants[5] from ADF. The grants[6] would be deployed alongside AfDB's financing. The ADF's operational policy (including the application of the DSF) would have to be revised to open up grant eligibility to countries on the path of graduation. The concessionality of the loan–grant package will be equal to the ADF concessionality so that the eligible countries continue to receive the same amount of concessional resources.

4.6. In order to mitigate the negative impact of the Buy-Down mechanism on the ACC, the ADF grants compensations should be allocated to projects and be disbursed following the standard disbursement profile.

Option A: Create a dedicated Buy-Down facility to enhance lending abilities of the Bank.

4.7. A vehicle would be created to enhance the lending abilities of the Bank. Eligible countries would receive financing from the AfDB with the ADF concessionality. The facility would then compensate the Bank for the income foregone. The facility could be funded by several sources: (i) a seed contribution from the ADF (ADF would set-aside funding for this purpose) and (ii) voluntary bilateral and multilateral contributions from member countries and other donors.

4.8. Drawing upon the Private Sector Credit Enhancement facility (PSF) experience, an operationally and financially autonomous facility could be established as a Trust Fund to administer and manage the Buy-Down mechanism. As long as the ADF is willing to set aside resources for this purpose, proactive legal engineering can be used to determine a feasible vehicle for achieving the intended purposes.

Phasing in the Mechanism

4.9. There is a provision in the Transition Framework for Countries Changing their Credit Status (Annex I) that offers positive incentives to graduating countries which would prefer increased and faster access to AfDB resources instead of ADF resources. In this case, countries can phase in AfDB resources on AfDB terms more quickly by foregoing ADF resources, at a ratio of two AfDB Units of Account (UA) for every foregone ADF UA. Strengthening the dialogue with potential eligible RMCs to encourage them to use this provision would also free up resources for more interventions in other ADF recipient countries. However, as the provision has not been used because the AfDB headroom is very large and potential candidates may prefer maintaining their access to concessional resources; the Buy-Down mechanism could be introduced on a gradual basis.

5. Conclusions.

5.1. This paper is a response to the ADF Working Group request for further elaboration of the Buy-Down Mechanism. Eligible countries would receive the equivalent of their PBA through the AfDB at the equivalent conditions as under the ADF. As a result, remaining ADF countries which are the neediest would have access to more resources as soon as the mechanism is set.

[5]The ADF uses currently a Modified Volume Approach (MVA) to treat grants. Under the MVA, a grant discount of 20% is applied to countries to avoid moral hazard. Should the preferred option (former option B) be selected by the ADF WG, this rule will have to be considered and discussed. In the case of the alternative option (former option A), the application of the grant discounts to allocations that are not made directly to RMCs should be further discussed.

[6]ADF uses currently a Modified Volume Approach (MVA) to treat grants. Under the MVA, a grant discount of 20% is applied to countries to avoid moral hazard. Should option B be preferred by the ADF WG, this rule will have to be taken into account. In the case of option A, the application of the grant discounts to allocations that are not made directly to RMCs should be further discussed.

5.2. The cost benefit analysis of the Buy-Down mechanism is summarized in Annex IV. While it would be easier to simply encourage and accompany regional member countries so that they borrow more from the AfDB, a Buy-Down mechanism is relevant to increase rapidly available resources for the neediest African countries. The demand and the conditions are there. The needs in ADF countries are very large. More RMCs are on the graduation path. There is currently enough headroom in the AfDB window to serve countries eligible for the Buy-Down mechanism. The mechanism would not downgrade the risk exposure of the Bank. While the mechanism would introduce some complexity in the framework for assistance to countries, more resources would be available for the neediest RMCs.

Annex I: AfDB Group's Country Classification and Corresponding Resources Available

		Creditworthiness to Sustain AfDB Financing	
		No	**Yes**
Per capita income above the ADF operational cut-off level for more than 2 years	**No**	Countries below cut-off level and not creditworthy: ADF-only countries on regular/advance ADF terms **(also known as Category A countries)**	Countries below cut-off level and creditworthy: blend countries eligible for AfDB resources and for ADF resources subject to a cap and on blend terms **(also known as Category B countries).**
	Yes	Countries above cut-off level and not creditworthy: gap countries not eligible for AfDB resources but eligible for ADF resources on blend terms (Category A)	Country above cut-off level and creditworthy: Only eligible for AfDB resources **(also known as Category C countries)** Exceptionally, graduating countries are eligible for ADF resources on blend terms during a 2 to 5-year phasing-out period

Notes: *All countries can borrow from the AfDB non-sovereign window. Creditworthy RMCs (blend & graduating countries) are eligible for both AfDB resources and ADF resources. The ADF resources are subject to a cap and are provided on blend terms. Blend countries can access their performance based ADF allocation (PBA) which is equivalent to 50% of their basic allocation. For graduating countries towards AfDB only status, a transition period[7] of 2 to 5 years is applied (i.e. the country receives 100% of its ADF PBA allocation in year 1 and 50% in year 2, or, it receives 100% of its ADF PBA allocation in year 1; 80% in year 2; 60% in year 3; 40% in year 4 and 20% in year 5)[8].*

There is a provision in the transition framework for countries changing their credit status that creates incentives for the voluntary acceleration of graduation. In order to encourage graduation in line with a country-tailored approach, positive incentives are offered to graduating countries that would prefer more and faster access to AfDB resources instead of ADF resources. This would free up resources to be available for more interventions in other ADF recipient countries. In this way, the length of the transition period can even be shortened to less than two years. More precisely, the transition period as determined in the graduation program can be tailored to phase in AfDB resources on AfDB terms more quickly by foregoing ADF resources, at a ratio of two AfDB Units of Account (UA) for every foregone ADF UA. As of today, this provision has not been used by RMCs.

[7] See the Transition Framework for Countries Changing Credit Status.

[8] In April 2011 the Bank Group adopted the Transition Framework for Countries Changing Credit Status (ADB/BD/WP/2011/20/Rev.2), which guides each transition process from one Category to another. It prescribes that the Bank will prepare a transition program for each country being reclassified; setting out how the Bank will accompany the country in its transition to its new status. The country-tailored transition program will be included in a programming document, such as an update to the Country Strategy Paper (CSP). The Transition Framework also sets out the criteria determining the length of the transition period in the case of graduation to Category B or C, which varies from 2 to 5 years. This is determined by a number of guiding criteria such as measures of the pervasiveness of poverty and the relative level of human development; measures of the rate of economic growth and related revenue; and measures of financial need and use of Bank group resources.

Annex II: Estimated Freed up Funding for the Remaining ADF countries (in UA million)

RMCs	ADF-14 Estimated PBA allocation	Amount borrowed from AfDB in place of ADF	ADF compensation	Amount available for the remaining ADF only countries
Blend	261	261	37	**224**
Graduating	40	40	6	**34**
Gap	237	237	33	**204**
ADF Green light	1310	1310	524	**786**
Total	*1848*	*1848*	*600*	*1248*

Notes: *The estimated volume of ADF resources made available through this mechanism, that would be reallocated to the remaining ADF-only countries is based on the projected list of blend, graduating, gap and low risk of debt distress (i.e. "Green light" countries during the ADF-14 cycle).*

If the mechanism was applied to ADF green light countries, this category of countries should have access to a volume of concessional funds on regular/advanced terms. According to the revised Credit Policy, this category of countries would also have access to non-concessional funds from the AfDB provided access to sovereign AfDB window is granted according to the appropriate Risk assessment. In order to calculate the estimation we have assumed that all green light RMCs would receive loans on regular terms.

The calculation of the total needed for compensation is derived from the difference in terms of present value (or the difference in grant elements) between the AfDB loans versus the equivalent loans with ADF terms.

While the pricing parameters of AfDB loans are directly linked to the yield curve (swap curve) as well as the funding levels of the Bank in international capital markets (funding margin), the calculations are based on the following assumptions: 20 year loan and a 5 year grace period. While there is not a constant AfDB rate because the funding margin fluctuates semi-annually, and any rate communicated by the Bank also changes every 6 months, the indicative lending rate level used for the computation as of today is 2.85 %. The discount rate used for the calculation of the grant element is 6%. Using those assumptions, a subsidy of around 14 % of the nominal loan is required to bring back the grant element to 35% for a blend loan.

That gap is indicated in the Table below:

	Blend	Regular	AfDB
Grant element	35%	61%	21%
Difference	14%	40%	0%

For each UA 10 million granted by AfDB to a blend country/graduating country in place of the ADF, UA 1.4 million will be required as compensation (14%).

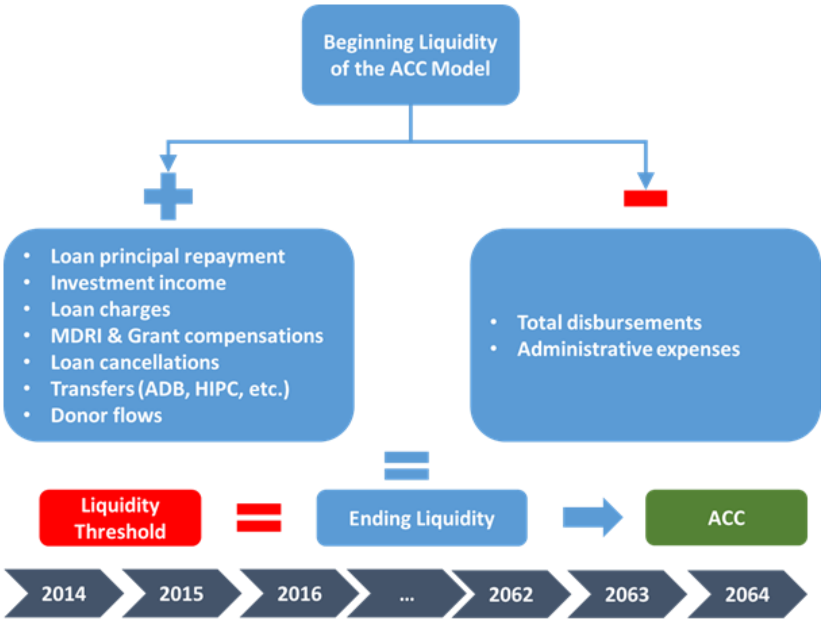
For each UA 10 million granted by AfDB to a green light ADF country in place of the ADF, UA 4.0 million will be required as compenation (40%).

Annex III: Estimated Financial Impact on the Advanced Commitment Capacity

The Advanced Commitment Capacity (ACC), which is long term in nature (50 years), is fixed for each three year replenishment period. 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. This enables the ADF to make advance commitments from its internally generated resources and expected future cash reflows.

The ACC capitalizes on two important structural characteristics of the Fund: i) that most internally generated resources are future cash flows that can be estimated with a degree of certainty; and ii) ADF loans and grants generally take several years to fully disburse (on average 10 years), which enables additional resources to be committed in the meantime. The key internally generated cash flow items impacting the ACC model are summarized in Figure III-1, which also indicate that following the determination of the ACC, the Fund's liquidity should remain above a certain threshold level to minimize liquidity risk issues.

Figure III-1: Key internally generated cash flow items impacting the ACC model



It is a challenge to estimate the net benefit of a Buy-Down mechanism for several reasons. A growing number of countries that no longer require the ADF enables the resources to be used for the remaining ADF-only countries. This means also less repayments and a greater pressure on internally generated resources.

As the ACC is computed every three years, it is difficult to provide an estimate of the impact on a very long term. However, the below Table III-2 provides simulations under ADF-14 and ADF-15. <u>These simulations are indicative and are based on ADF-13 assumptions which will be revised in 2016.</u> Based on several ADF compensation disbursement assumptions, three scenarios are presented. It should be noted that the main impact of the proposed scheme on the ACC will occur after five years (ie: after ADF-14), when repayments on loans to blend and graduating countries are expected to begin. Scenario 3 is not viable but is proposed for illustrative purpose.

By limiting the use of ADF resources by some countries and depending on how the ADF compensation is paid, the Buy-Down mechanism will result in a decrease of the ACC by UA 5 -127 million during ADF-14 and UA 7-140 million during ADF-15 if the mechanism is applied to blend, graduating and gap countries. In the case the mechanism is extended to ADF green light countries, the ACC would decrease by UA 43-587 million during ADF-14 and by UA 42-591 million during ADF-15.

The decrease in the ACC with the Buy-Down mechanism is mitigated when the ADF compensation is paid following the standard disbursement profile and when the mechanism targets countries on path of graduation.

Table III-2: Estimated impact on the ACC during ADF-14 and ADF-15.

(UA million)

	ADF compensation	ADF-14 ACC	Impact	ADF-15 ACC	Impact
Without the mechanism	0	978	0	978	0
Scenario 1: ADF Compensation paid following the standard disbursement profile					
Blend/graduating/gap only	76	973	-5	971	-7
Blend/graduating/gap and ADF green light	600	935	-43	936	-42
Scenario 2: ADF Compensation paid following a linear 3-Year profile					
Blend/graduating/gap only	76	903	-75	903	-75
Blend/graduating/gap and ADF green light	600	391	-587	387	-591
Scenario 3: ADF Compensation paid following a linear 3-Year profile					
Blend/graduating/gap only	76	851	-127	838	-140
Blend/graduating/gap and ADF green light	600	Not enough liquidity			

Note: Simulations assume that the amount of ADF compensation needed during ADF-15 is the same as the one estimated for ADF-14.

After ADF-15, the ACC is expected to reach UA 2.2 billion. Therefore, the impact of the Buy-Down mechanism would be less significant.

Annex IIV: ADF-9, 10, 11 and 12 Consolidated Grant Compensation Schedule[9].

(UA Thousand)

ADF-9, 10, 11 and 12 consolidated grant compensation schedule (UA thousand)													
Country	2013	2014	2015	2016	2017	2018	2019	202x	203x	204x	205x	206x	Total
ARGENTINA	-	-	-	-	-	-	-	194	676	861	861	278	2,870
AUSTRIA	6	16	45	140	241	309	470	13,264	34,033	37,256	33,571	4,835	124,188
BELGIUM	10	26	76	174	268	332	477	12,898	31,928	34,775	30,681	4,270	115,916
BRAZIL	2	6	16	20	20	20	30	1,039	2,574	2,863	2,519	433	9,542
CANADA	28	72	208	488	763	948	1,311	33,786	81,890	88,776	77,321	10,329	295,920
CHINA	10	26	76	178	278	346	497	13,341	32,998	35,890	31,654	4,338	119,632
DENMARK	18	48	139	228	294	339	437	11,395	26,313	28,613	24,101	3,449	95,375
EGYPT	-	-	-	-	-	-	-	26	90	115	115	37	383
FINLAND	9	24	69	163	254	316	478	13,971	35,815	39,391	35,449	5,365	131,305
FRANCE	45	117	339	890	1,452	1,831	2,611	67,337	164,956	178,274	156,416	19,978	594,247
GERMANY	51	134	387	817	1,221	1,493	2,219	62,201	155,714	169,810	150,842	21,143	566,033
INDIA	1	3	8	19	29	37	50	1,289	3,130	3,413	2,974	425	11,378
ITALY	26	69	199	451	695	860	1,228	32,649	80,198	87,050	76,462	10,278	290,168
JAPAN	54	141	408	847	1,256	1,531	2,050	51,224	120,677	130,139	111,276	14,194	433,797
KOREA	4	10	29	69	108	134	195	5,694	14,561	16,111	14,463	2,325	53,703
KUWAIT	1	3	8	18	28	35	48	1,236	2,983	3,231	2,806	372	10,769
THE NETHERLANDS	23	59	171	408	642	801	1,175	32,063	80,056	87,142	77,304	10,628	290,472
NORWAY	22	57	164	384	600	746	1,064	28,392	70,021	76,149	67,040	9,192	253,829
PORTUGAL	4	10	30	66	100	124	179	4,836	11,958	13,000	11,464	1,564	43,335
SAUDI ARABIA	3	9	25	46	65	77	108	2,925	7,096	7,734	6,735	956	25,780
SOUTH AFRICA	1	2	5	13	20	25	38	1,139	2,954	3,268	2,957	471	10,894
SPAIN	14	37	106	244	378	469	677	18,448	45,855	49,987	44,209	6,198	166,624
SWEDEN	25	64	185	434	678	843	1,161	29,736	71,871	77,868	67,700	8,995	259,560
SWITZERLAND	18	48	139	303	460	566	751	18,517	43,532	46,928	40,070	5,095	156,428
UNITED KINGDOM	34	88	255	698	1,156	1,466	2,429	74,476	196,552	216,312	197,935	29,640	721,042
UNITED STATES OF AMERICA	72	189	547	1,096	1,595	1,932	2,547	63,903	149,948	162,171	138,235	18,335	540,571
Total	481	1,259	3,637	8,194	12,604	15,582	22,231	595,979	1,468,377	1,597,127	1,405,160	193,125	5,323,757

Annex V: Strengths and Weaknesses of the Buy-Down Mechanism

Buy-Down mechanism	Strengths	Weaknesses
Relevance and timing	Such a mechanism is relevant given the very large needs in ADF countries and given a growing number of countries are on the graduation path. There is currently enough headroom in the AfDB window to serve countries eligible for the Buy-Down mechanism. More resources would be therefore available for the countries that are most in need.	As there is currently large headroom in the AfDB window, it would be easier to simply encourage regional member countries to borrow more from the AfDB. There is a provision in the transition framework for countries changing their credit status that offers positive incentives to graduating countries that would prefer more and faster access to AfDB resources instead of ADF resources. In this case, the length of the transition period can even be shortened to less than two years. Countries can phase in AfDB resources on AfDB terms more quickly by foregoing ADF resources, at a ratio of two AfDB Units of Account (UA) for every foregone ADF UA. Strengthening the dialogue with potential eligible RMCs to encourage them to use this provision would free up resources to be available for more interventions in other ADF recipient countries.
Degree of simplicity	Option B is simpler because it builds on	The mechanism would introduce complexity in the framework for assistance to countries. The amount of concessional resources will be calculated through the ADF methodology (PBA) but granted by the AfDB which uses the operational country limit methodology (based on the risk). It is also proposed that potential eligible countries which do not have enough headroom for AfDB borrowing should continue to be entitled to their ADF PBA allocation. Therefore, some creditworthy countries may continue to get resources from the ADF. Requiring an additional amount set aside in the case

[9] Numbers are provisional and could be subject to future revisions.

	existing entities.	of Option A could undermine the PBA approach.
Transaction costs	Option B would involve less transaction costs.	Substantial administrative and transaction costs in the case of option A.
Financial impact	Despite the ADF contribution in grants and the decrease in ACC, between UA 224 million and UA 1.2 billion would be generated for the remaining ADF only during the ADF-14.	Negative impact on the ACC during the ADF-14 and the ADF-15. The negative impact is smaller if the ADF compensations are disbursed following the standard disbursement profile and limited to countries on path of graduation (blend and graduating countries).
Compliance with existing policies and frameworks	Compliance with Debt Sustainability Framework and with the Credit Policy. The AfDB will provide loans to ADF countries only if there is enough AfDB headroom.	Provided, the operational guidelines of the ADF remain the same, another weakness is the fact that countries that are pushed out completely from the ADF may no longer have access to the ADF series of instruments such as the Regional Operation envelope or the guarantee products.
Risk impact and mitigation	The Buy-Down mechanism would not downgrade the risk exposure of the Bank.	
Scaling up potential	Large potential with Option A as ADF donors and other partners could contribute to the facility.	Limited with Option B