

Leveraging ADF Resources for Private Sector Development

Discussion Paper

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AFRICAN DEVELOPMENT FUND

Executive Summary

Deputies have endorsed private sector development as a key crosscutting theme for ADF-12, and asked Management to identify innovative solutions to address challenges impeding the development of the private sector in low-income countries (LICs) and to promote the private sector as a key engine of growth and poverty reduction. This paper responds by proposing two instruments that would leverage ADF funding to promote private sector development in LICs.

The instruments would help the Bank Group to enhance further its role as a catalyst for private investment. First, with the support of ADF resources, the ADB Group can take advantage of its competitive edge to progressively deploy risk-sharing instruments that will leverage its risk capital base and strong project origination expertise. Risks would be shared among the Fund, the Bank, and private lenders. Second, working through its comparative advantage, the Bank Group would mitigate government performance and thus enable commercial/private lenders to invest in projects in LICs.

Management therefore proposes to introduce two ADF-funded guarantee instruments to foster the development of the private sector in LICs and to attract private sector financing to projects benefiting ADF countries. The guarantees would consist of mutually supportive instruments that would leverage the ADF resources used to develop the private sector in LICs. These instruments would target operations at both the macro and the micro level. On the macro level, a first loss portfolio guarantee (FLPG) pilot program would guarantee a proportion (up to 10 percent) of the first loss of a defined portfolio of newly issued, non-sovereign ADB projects in LICs. At the micro level, a political risk guarantee instrument would mitigate transactional risk by issuing guarantees to private investors/lenders with respect to government performance in project implementation.

Piloting a first loss portfolio guarantee (FLPG) would allow the ADB to expand significantly its private operations in LICs. In turn, ADB private sector operations generally catalyze up to 5 times their value in private sector financing, thereby bringing the maximum leverage to 25. The FLPG would be financed by a “top slice” of UA 100 million from the overall ADF-12 replenishment as a seed contribution towards a facility that would provide up to 10 percent first loss coverage on new assets entering the ADB LIC private sector portfolio.

The political risk guarantee—or partial risk guarantee (PRG)— would be a financial instrument available to regional member countries through their Performance-Based Allocations. In light of the lessons learned from other multilateral development banks, Management suggests that only 25 percent of the nominal value of the guarantee be charged to the country. An indicative pipeline analysis shows high demand for this instrument.

The new instruments would be launched on a pilot basis and managed and operated within the existing institutional structure. The Bank Group’s capacity in private sector activities has been significantly strengthened in recent years and the ADB has demonstrated its capacity to deliver a steady flow of developmentally strong non-sovereign projects. As the new instruments are applied and lessons are learned, the Bank Group will make the requisite adjustments.

Deputies’ feedback will help determine the proposals to be submitted to the Board of Executive Directors for approval. Specifically, Deputies are invited to provide guidance on the design and implementation of the proposed instruments and approve their financing modalities.

Table of Contents

Abbreviations	iv
1. Introduction and Background.....	1
2. Rationale for Introducing New African Development Fund Instruments	1
<i>The role of the private sector in Africa’s development.....</i>	<i>1</i>
<i>Challenges and opportunities of private sector financing in Africa</i>	<i>2</i>
<i>The Bank Group’s competitive advantage.....</i>	<i>3</i>
<i>Leveraging the African Development Bank Group’s transformative role.....</i>	<i>4</i>
3. Key Characteristics of the Proposed New Instruments.....	5
<i>First loss portfolio guarantee.....</i>	<i>5</i>
<i>Partial risk guarantee</i>	<i>7</i>
<i>Complementarity of the proposed instruments</i>	<i>10</i>
4. Implementation Modalities	10
<i>Strategic framework for private sector development in low-income countries.....</i>	<i>10</i>
<i>Resource implications of the first loss portfolio guarantee</i>	<i>11</i>
<i>Resource implications of the partial risk guarantee</i>	<i>11</i>
<i>Institutional setup</i>	<i>11</i>
<i>Results framework</i>	<i>12</i>
<i>Timeline.....</i>	<i>13</i>
5. Conclusion / For Deputies’ Guidance	13
Annex I: Detailed Description of the First Loss Portfolio Guarantee	14
Annex II: Detailed Description of the Partial Risk Guarantee	16
Annex III: Lessons Learned From Multilateral Development Banks’ Experiences with Guarantees.....	18
Annex IV: Preliminary Demand Analysis: Projects that might benefit from an African Development Fund partial risk guarantee.....	22
Annex V: Additional thoughts on leveraging funds for development: The partial credit guarantee.....	23

Tables

Table 1: The Benefits of Guarantees	8
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Figures

Figure 1: Financial Flows to African Low-Income Countries, 2001 to 2008	2
Figure 2: Risk Ratings and Indicators of Investor Protection in ADF and ADB Countries	2
Figure 3: The Impact of the First Loss Portfolio Guarantee on Low-Income Country Portfolio Proportions, 2011-2013	7
Figure 4: Basic Partial Risk Guarantee Structure	9
Figure 5: The Private Sector Development Triangle	10

Boxes

Box 1: Synergies Between the African Development Bank and the African Development Fund	3
Box 2: Consolidating and Strengthening Capacity for Private Sector Operations With the African Development Bank	12

Abbreviations

ADB	African Development Bank
ADF	African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
ADOA	Additionality and Development Outcome Assessment
AfDB	African Development Bank
AsDB	Asian Development Bank
FLPG	First Loss Portfolio Guarantee
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
LIC	Low-Income Country
MIC	Middle-Income Country
MIGA	Multilateral Investment Guarantee Association
OPSM	Private Sector Department
PBA	Performance-Based Allocation
PCG	Partial Credit Guarantee
PRG	Partial Risk Guarantee
RMF	Results Measurement Framework
SPV	Special Purpose Vehicle
UA	Unit of Account

LEVERAGING ADF RESOURCES FOR PRIVATE SECTOR DEVELOPMENT

1. Introduction and Background

- 1.1 During the ADF-11 Mid-Term Review and the ADF-12 consultative meetings, Deputies endorsed private sector development as a key crosscutting theme for ADF-12 and asked Management to identify innovative ways for the Fund to support private sector development in low-income countries (LICs) as an engine of growth and poverty reduction. This paper responds by proposing, for Deputies' consideration and guidance, two ADF-funded guarantee instruments that could leverage the ADF's contributions in support of the Bank-wide strategic priority of developing the private sector in LICs.
- 1.2 The first loss portfolio guarantee (FLPG) is an innovative proposal that would pilot a facility designed to complement and amplify the Bank's existing private sector operations in LICs. The second instrument, a partial risk guarantee (PRG), would mitigate political risk by insuring government performance. Both instruments are intended to buttress the strategic objectives put forward for ADF-12 and to complement existing instruments through which the ADF supports its beneficiaries.
- 1.3 The paper is organized in four sections. Section 2 discusses the rationale for introducing new instruments under the ADF framework in terms of the instruments' relevance and the Fund's comparative advantage. Section 3 discusses the two new instruments and puts forward design options for Deputies' guidance. Section 4 presents the resource implications of the new instruments and proposes implementation modalities. Section 5 concludes.

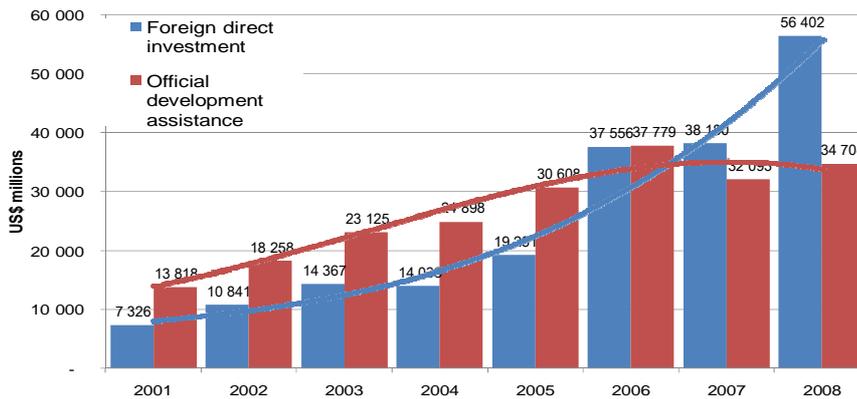
2. Rationale for Introducing New ADF Instruments

- 2.1 The rationale for introducing new ADF instruments relates to the need for new vehicles that can promote an enabling business environment in African LICs and help LICs' economies to grow. By leveraging ADF funds, the African Development Bank (ADB or Bank) Group can take advantage of its competitive edge to respond to challenges currently facing the private sector in LICs.

The role of the private sector in Africa's development

- 2.2 The private sector is an engine of accelerated economic growth and a source of resilience against economic shocks. Following two decades of private sector expansion on the African continent, the business environment in many African LICs has improved. Recent years have witnessed a shift from government borrowing to borrowing by non-sovereign players, who have become the most significant financiers and investors on the continent. While net resource transfers in Africa were dominated by official development assistance until the mid-1990s, private net resource transfers have assumed growing importance. This phenomenon illustrates the importance of the private sector for economic growth in African LICs (Figure 1).

Figure 1: Financial Flows to African Low-Income Countries, 2001 to 2008

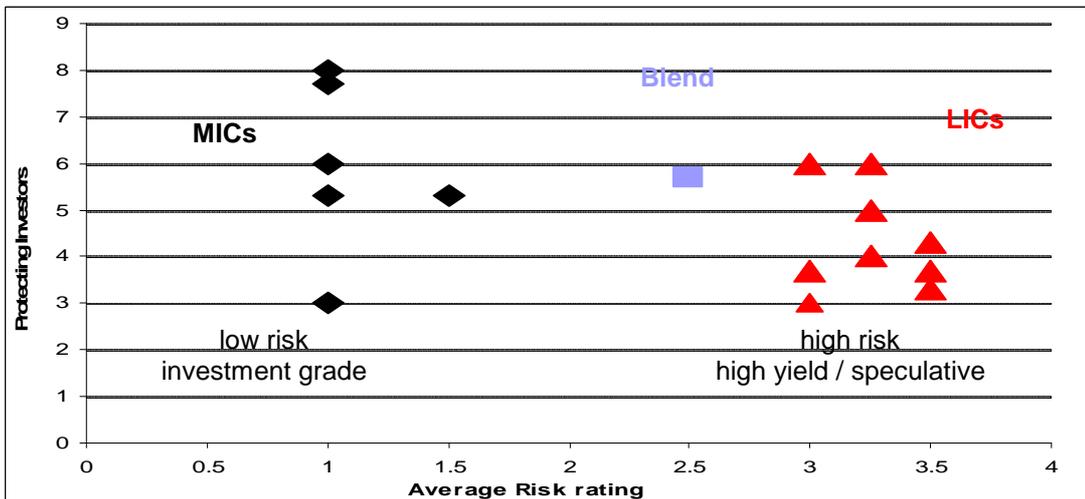


Source: African Development Bank

Challenges and opportunities of private sector financing in Africa

2.3 While governance and investor protection have been improving in African LICs, investors continue to perceive doing business in these countries as exceedingly risky. Whereas the World Bank's Ease of Doing Business indicator reveals that the level of investor protection in ADF countries is consistent with that enjoyed by investors in most ADB countries, credit rating agencies continue to classify LICs as non-investment grade (Figure 2). This perception of disproportionately high risk has a direct impact on the cost of private financing and capital in ADF countries, leading to increased—often prohibitive—private financing costs and, consequently, fewer private inflows into and domestic investment in LICs.

Figure 2: Risk Ratings and Indicators of Investor Protection in ADF and ADB Countries



Source: S&P, Moody's, Fitch, World Bank – Doing Business 2010 and African Development Bank

Notes: Credit risk agencies' ratings have been translated into the African Development Bank's credit risk rating scale (1=Very Low Risk to 10=Known Loss). All regional member countries that were rated by the agencies were included: Benin, Botswana, Burkina Faso, Cameroon, Cape Verde, Egypt, Gabon, Ghana, Kenya, Lesotho, Libya, Mauritius, Morocco, Mozambique, Namibia, Nigeria, Rwanda, Senegal, Seychelles, South Africa, Tunisia, and Uganda. The x-axis indicates the Doing Business 2010, "Protecting Investors" sub-index. Scale ranges from 1 to 10, with higher numbers indicating better investor protection.

ADB=African Development Bank; ADF = African Development Fund; LICs = low-income countries; MICs = middle-income countries

- 2.4 Private investment in Africa, particularly in infrastructure, has decreased markedly since the onset of the financial crisis. Estimates suggest that private investment in infrastructure in sub-Saharan Africa fell by 34 percent over the first three quarters of 2009.¹ Several large infrastructure projects in sub-sectors such as energy, transport, and telecommunications have been postponed because of a lack of financing. Meanwhile, Africa needs to spend at least US\$ 93 billion per year—roughly 15 percent of its gross domestic product—to maintain existing infrastructure and finance critical investments. Actual spending is only US\$ 45 billion per year.² This large financing gap points to the urgent need to attract new capital.
- 2.5 While African countries' access to capital markets is slowly resuming, risk-induced credit spreads remain much higher than before the crisis. In a number of countries, commercial lenders have withdrawn their services altogether or have scaled down financing. Trade finance remains constrained with commercial banks unwilling to underwrite guarantees or unable to provide trade credit. To mitigate this trend requires systemic interventions that enhance the availability of affordable long-term credit by simultaneously increasing liquidity and mitigating risks which are the goals of the proposed new instruments.

The Bank Group's competitive advantage

- 2.6 The ADB Group offers all regional member countries the unique opportunity to access both public and private investment finance under one roof. The Bank acts as both an advisor and a financier to its clients and by sharing risks, as a partner as well. The Bank Group's private sector development strategy harnesses the requisite skills and competencies across the organization in pursuit of an institution-wide agenda for private sector development. Indeed, private sector development efforts span all Bank functions, from country and sector strategies to assistance with policy and regulatory reform and non-sovereign and sovereign-guaranteed transactions. All of the undertakings required to achieve this agenda can be financed through the ADF window,³ except catalytic non-sovereign transactions in LICs, which are financed through the ADB window.
- 2.7 Within this framework, the Bank Group has built significant capacity to engage more deeply in private sector operations in LICs. During ADF-11, 64 percent of ADF funds were spent on infrastructure projects and 22 percent were spent on governance-related activities. In the non-concessional lending window (the ADB), 42 and 43 percent of all 2008 and 2009 investments respectively took place in ADF countries. Regional operations constituted, 20 percent and 50 percent in 2008 and 2009, respectively. The strong presence of ADB-supported activities in ADF countries allowed the Fund to establish policy dialogue with regional member countries and built capacity in combining financial instruments to fund infrastructure projects (Box 1).

Box 1: Synergies Between the African Development Bank and the African Development Fund

The institutional synergy between the financing windows of the African Development Bank (ADB) and the African Development Fund (ADF) places the ADB in the unique position of using both concessional and non-concessional resources for the benefit of low-income countries and tailoring financial solutions to meet these countries' needs. One way that the ADB has done this is by facilitating national or regional public-private partnerships. Examples in the current portfolio include the Nairobi-Mombasa Toll Road, where the ADB's private sector window is financing the construction of an important portion of the project. The Bujagali Dam in Uganda is similarly innovative, with power generation undertaken by a private consortium cofinanced by the ADB, and power transmission supported by ADF resources and the Japanese Government. The Dakar-Diamniadio Toll Road project also illustrates the synergies between the two windows of the Bank Group. In addition to these operations, the pipeline is regularly supplemented by new, similar projects.

¹ The World Bank. February 2010. *Assessment of the Impact of the Crisis on New PPI Projects: Update 5*.

² Agence française de développement/World Bank, Africa Infrastructure Country Diagnostic. 2010. *Africa's Infrastructure: A Time of Transformation*.

³ This includes the possibility of ADF member countries using part of their allocation towards equity in a public-private partnership.

Leveraging the African Development Bank Group's transformative role

- 2.8 As a core entity of the ADB Group, the ADF is uniquely positioned to leverage the Group's organizational structure. Armed with its public and private sector competencies and its Pan-African mandate, the ADF is uniquely positioned to help the Bank Group move from being an end investor in private sector operations to catalyzing true private investment. The ADF has an opportunity to leverage its role as LICs' financier by amplifying the scale and scope of Bank Group efforts to attract foreign and domestic private investment in LICs. The Bank Group's growing appetite for deepening and broadening its private sector operations footprint in LICs is reflected in the fivefold growth of annual non-sovereign financing approvals for projects in LICs (including fragile states) over the past 4 years: these approvals have grown from less than Units of Account (UA) 100 million in 2006 to UA 500 million in 2009.⁴
- 2.9 By directly contributing to the Bank Group's drive to finance private sector-driven economic growth, the ADF can mitigate the adverse risk perceptions associated with investing in LICs and expand the pool of long-term liquidity necessary to finance private sector participation in infrastructure development. By covering government performance risks that the market is able to neither absorb nor mitigate, the Fund could mobilize additional sources of financing, thereby enabling commercial/private lenders to further invest in projects in LICs. By scaling up the Bank Group's ability to finance non-sovereign transactions, it can enhance the availability and affordability of local long-term financing for private investment, thereby boosting the coverage, depth, and rate of implementation of private sector financing in LICs.
- 2.10 After extensive consideration of the costs, risks and impacts associated with the instruments used by comparators, this paper proposes, for Deputies' consideration and guidance, to leverage the ADF to support two complementary interventions on a pilot basis:
- *the first loss portfolio guarantee (FLPG)*, a macro-level intervention to scale up the relative share of Bank Group non-sovereign operations in LICs from 40 percent to up to 60 percent by seeding a facility to guarantee a share of the first loss of the cumulative portfolio of operations to be approved during the ADF-12 cycle; and,
 - *the partial risk guarantee (PRG)*, a micro-level, transaction-based, partial risk guarantee to mitigate the risks associated with government performance and/or the participation of a state-owned enterprise in project implementation.
- 2.11 The FLPG would boost the volume and catalytic impact of ADB-financed transactions. It is estimated⁵ that the FLPG would leverage up to five times its value in additional financing for private sector operations in LICs from the ADB window. In turn, ADB investments usually leverage five times their value in financing from other sources including the private sector. For example, a FLPG of UA 100 million could leverage up to UA 500 million in additional ADB loans to the private sector in LICs. Based on the historical catalytic impact of five times additional financing that ADB's private sector operations generally generate taking into account financing received from co-lenders⁶, this could boost overall non-sovereign investments in LICs by UA 2.5 billion. At present, the active pipeline of non-sovereign operations comprises UA 2.8 billion of potential investments, including UA 1.6 billion for LICs.⁷
- 2.12 An indicative pipeline analysis shows high private sector demand for the proposed government performance guarantees. Nine projects could benefit from a PRG with a total guaranteed amount of approximately UA 472 million (see Annex IV). This would considerably enhance the financial feasibility of projects, amounting to an estimated UA 5.2 billion in public-private partnership investments.⁸

⁴ Or about UA 600 million including the LIC proportion of multinational operations

⁵ Based on Monte Carlo simulations of the current LIC portfolio as at 31 October 2009 (used as a reference portfolio), it is estimated that the FLPG would leverage from two up to five times its value in additional financing for LICs from the ADB window depending on the confidence level interval used for the calculations. Leverage depends also on the Weighted Average Risk Rating and the Probability of Default of the reference portfolio. These figures exclude the additional multiplier arising from the usual five-times leveraging that ADB's investments in the private sector generate when taking into account additional financing received from co-lenders.

⁶ This number takes into account financing received from co-lenders

⁷ This figure concerns operations that entail financial close within 1-2 years.

⁸ Actual demand will concern government-associated projects where the government is

- willing and able to undertake the regulatory and fiscal reforms necessary to mitigate its performance risk;

- 2.13 Separate from these new proposed instruments, Deputies are reminded ADF countries do have the ability to use ADF resources for purchase of equity stakes in public private partnerships. Raising adequate amounts of equity for often very large public utility projects or other public-private partnerships is a challenge. Because such projects often bear significant national importance, government equity participation would not only help fill the equity gap but would also give the government a say and give it access to a proportion of revenue streams. While not strictly a new instrument, assisting governments in this regard could be reasonably expected to encourage them to consider equity participation in such projects: this participation would be funded by the country's Performance-Based Allocation (PBA). This arrangement would be particularly useful in cases where project output is exported, e.g., in the case of power plants set up in one country under comparatively better conditions, selling power to neighboring countries.⁹

3. Key Characteristics of the Proposed New Instruments

- 3.1 In the following, the paper presents a description of the two proposed instruments, a first-Loss portfolio guarantee and a Partial Risk Guarantee for deputies' considerations. Key characteristics are described and demand for instruments is estimated. More details on each of the presented instruments can be found in Annex I-IV.

First loss portfolio guarantee

- 3.2 For the past 3 years, the Bank has successfully achieved its target of approving 40 percent of private sector operations in LICs. The proposed General Capital Increase will give the Bank room to grow its overall non-sovereign portfolio beyond the current annual UA 1 billion target, with growth projected at 5 percent per annum.¹⁰ If the Bank is to amplify the impact of the General Capital Increase and boost the total volume of non-sovereign operations in LICs, the Bank would have to increase its LIC risk-bearing capacity. With the current assumptions and projections, the ADB could not raise the share of new private sector operations in LICs to 60 percent without constraining operations as early as 2011. The FLPG instrument would augment both the relative share and the total volume of risk capital utilized to finance new non-sovereign operations in LICs beyond notional General Capital Increase levels. The financial obligations of a proportion of the emerging private sector operations portfolio in LICs would be guaranteed by the ADF allowing the direct LIC portfolio to reach a proportion of 60 percent within the ADF-12 period.
- 3.3 The financial obligations of a reasonable proportion of the underlying credit assets of the emerging new private sector operations portfolio in LICs could be guaranteed by the FLPG allowing the share of approvals for operations in LICs to reach approximately 62 percent by the end of ADF-12 cycle. This share would incorporate between 10 and 15 percent of multinational operations with substantial LIC coverage.¹¹ Following a cautious roll-out schedule that allows for institutional learning,¹² the total lending volume in single-country LIC operations could grow up to UA 1.9 billion over the ADF-12 period (within a multiplier range of between 2 and 5) or UA 2.3 billion including multinational operations with substantial LIC coverage. The sector distribution of the guaranteed portfolio would increase infrastructure projects from 24 percent in the reference portfolio to 45 percent in the guaranteed portfolio, thus improving compliance with institutional objectives. Figure 3 illustrates how the portfolio of non-sovereign private sector loans would be distributed with and without the FLPG during

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- able to use concessional resources to do so (albeit substantially discounted resources, only counting towards 25 percent of its PBA or Country Assistance Strategy); and
 - able to bear the additional contingent liability associated with a counter-guarantee in terms of the Debt Sustainability Framework.

⁹ Part of the ADF loan could be earmarked for improving surrounding areas and ancillary facilities, such as roads, electricity distribution, housing, schools, and hospitals.

¹⁰ Under the General Capital Increase scenario, the cumulative volume of non-sovereign operations would amount to up to UA 1.5 billion each in LICs and middle-income countries and UA 750 million for all regional operations over the ADF-12 period. These figures assume that LIC operations continue to account for 40 percent of approvals.

¹¹ Only lending operations in multinational or regional operations with substantial LIC coverage would be considered eligible. All equity operations would be excluded.

¹² FLPG enables an incremental lending volume rate of 10 percent in 2011, 30 percent in 2012, and 60 percent in 2013

ADF-12, using a multiplier of 3 (two more scenarios are presented in Annex I).

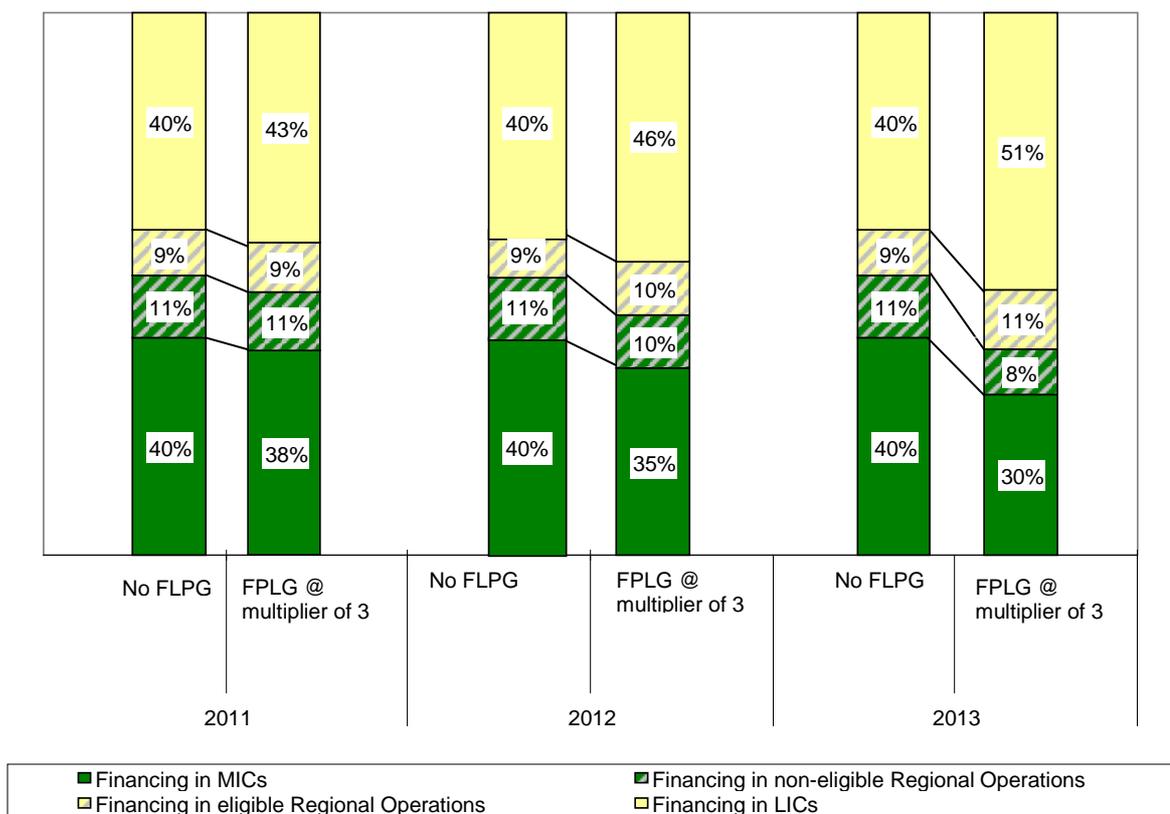
3.4 For these reasons, Management proposes that the ADF pilot a program under the following conditions:

- A facility should be created to cover first losses on a future non-sovereign loan portfolio of ADB private sector operations in LICs. ADF-12 would provide a seed contribution of UA 100 million toward this facility. The guaranteed amount would be capped at UA 100 million, estimated at 10 percent first loss coverage on a future “Guaranteed Portfolio” of UA 1 billion in LICs. As the guaranteed portfolio grows, the proportion of the guarantee would progressively reduce while remaining at UA 100 million in absolute terms.
- The guarantee would only cover new assets entering the ADB LIC private sector operations portfolio.
- The risk capital thus freed would be used exclusively for LICs. The credit profile of the emerging guaranteed portfolio would substantially mirror the reference portfolio both in terms of sectors and in terms of types of projects.
- Only certain types of assets would be eligible for coverage under the guarantee, namely, investment loans in LICs and regional operations with substantial LIC coverage. All equity investments and non-lending operations would be excluded.
- The guaranteed portfolio would comprise projects that have a potentially high development impact, that face high commercial and/or political risk, and in which the Fund’s participation offers high financial additionality. Each transaction would be assessed using the Bank’s standard private sector operation procedures—such as the Additionality and Development Outcome Assessment (ADOA), which are independent ratings provided by the ADB’s Research Department—and would be aligned with Country Strategy Papers, Bank Group policy, and credit assessments.

Key implementation features

- The facility could be governed by a framework agreement between the ADF and the ADB that would define all parameters and requirements. All projects that benefited from the FLPG would have to comply with the relevant provisions of the agreement.
- Particular attention would be paid to portfolio development and management to help ensure a regional balance among LICs benefiting from the FLPG. In the case of multinational or regional operations, only projects with substantial LIC coverage would be eligible.
- Prior to presenting FLPG-supported projects to the Board, the Operations Committee would, as part of its normal scrutiny of projects, review the suitability of applying the FLPG instrument.
- In the event that loans in the portfolio should default, the FLPG would compensate the ADB for first losses up to a cap of 10 percent of the portfolio’s outstanding value or UA 100 million, whichever is lower. Losses in excess of the guaranteed amount would be borne by the ADB.
- The ADB would pay a market-based fee or premium to the facility for the guarantee. The facility would earn interest as long as funds were not drawn.
- This pilot experience could be scaled up through additional voluntary bilateral contributions to top up the ADF’s seed contribution. A decision for the facility’s future—including possible mainstreaming into ADF programs—would follow a mid-term implementation review.

Figure 3: The Impact of the First Loss Portfolio Guarantee on Low-Income Country Portfolio Proportions, 2011-2013



Source: African Development Bank

Notes: MICs = middle-income countries; LICs = low-income countries; FPLG = first loss portfolio guarantee

3.5 The main risk of the FPLG relates to potential moral hazard, i.e., the inadvertent relaxation of rigor in due diligence and appraisal. A number of mitigants, such as risk sharing or limiting FPLG coverage to certain types of risk, are discussed in Annex I. However, the negative impact of such restrictions in terms of new lending to LICs should not be underestimated. Risks associated with the possible bunching of projects by country or by sector would be managed by forward-looking business development and portfolio planning during implementation.

Partial risk guarantee

3.6 By mitigating political risks, PRGs can mobilize private sector financing for development purposes, accelerate the flow of foreign direct investment, promote infrastructure development, open new markets, and encourage private sector participation in public-private partnerships. PRGs also incentivize governments to undertake the policy and fiscal reforms necessary to mitigate performance risk. All these effects contribute to LICs' developmental objectives and overall poverty reduction.

3.7 PRGs have been used successfully to leverage private funds in developing economies. The ADB already offers PRGs to middle-income countries and enclave projects in LICs. The Bank is also setting up a small and medium enterprise guarantee fund, within the ambit of Denmark's Africa Commission and in collaboration with the International Finance Corporation. It would be beneficial to build on the Bank's experience in this domain by extending the scope of the Bank's guarantee interventions to LICs. PRGs in LICs are likely to have the most benefits because LICs are where risks are perceived highest. By significantly reducing government counterparty risks, a PRG can leverage additional private investment for projects of national importance, especially but not limited to infrastructure projects. Management had

promised to propose an instrument to leverage infrastructure financing in LICs by backstopping government obligations to commercial banks under specific circumstances.

- 3.8 PRGs have been used effectively by sister institutions. For example, the International Development Association (IDA) started its pilot program in 1997 and recently mainstreamed it. Though presently limited to partial risk guarantees (PRGs), the program might be extended to partial credit guarantees (PCGs). An independent evaluation of the IDA's PRGs¹³ concluded that (i) PRGs had helped introduce complex public-private partnerships in high-risk, low-income countries; (ii) in several large partnerships, engagement and relationships with governments had proved critical to PRGs' success; and (iii) engagement through PRGs had provided a platform for reforming public-private partnership policies (See Annex III). In addition to these benefits, by requiring the application of all relevant ADB Group safeguard and procurement policies, ADF guarantees would increase the attention paid to mitigating adverse environmental impacts and would trigger the inclusion of strong fiduciary safeguards.
- 3.9 As summarized in Table 1, PRGs would benefit host country governments, private sector investors, and the ADB Group itself by (i) mitigating certain circumscribed political risks that are beyond the control of the private sector, thereby facilitating investments in LICs; (ii) enhancing project financial feasibility, sustainability, and bankability, thereby increasing the frequency of public-private partnerships in LICs; (iii) facilitating project developers' access to financing; (iv) lowering the overall cost of private finance and hence the cost of services to be provided by private projects (e.g., electricity and transportation); and (v) reinforcing government undertakings and providing incentives for strong regulatory frameworks, thereby lowering the chances of project default. These results would enable more numerous, more sustainable, and better projects for the economic benefit of all.

Table 1: The Benefits of Guarantees

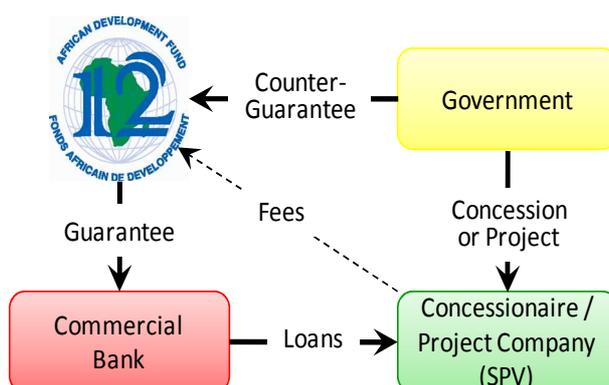
For the government	For the private sector	For the African Development Bank Group
Guarantees <ul style="list-style-type: none"> • attract private sector investment on better terms; • lower the cost of public services provided by private projects by lowering finance costs; • leverage Performance-Based Allocation resources for additional investment; • create greater market confidence; and • share risks fairly with the private sector. 	Guarantees <ul style="list-style-type: none"> • mitigate critical perceived political and regulatory risks that are beyond investors' control; • facilitate access to debt financing on improved terms (lower cost, longer tenors); • reduce the risk profile of investments and lower overall capital costs; and • enhance risk allocation structures. 	Guarantees <ul style="list-style-type: none"> • enhance synergies across the African Development Bank's lending windows; • leverage African Development Fund resources for private investment; • increase observance of Bank Group environmental and social and fiduciary safeguards; and • facilitate policy dialogue on regulatory and other investment climate issues.

Source: African Development Bank

- 3.10 Management therefore proposes to introduce the partial risk guarantee instrument to mitigate risks related to governments' ability to meet their contractual commitments. The PRG would insure private lenders or investors/project companies against the risk of a government or government-owned entities failing to perform its contractual obligations with respect to a private project (Figure 4).

¹³ World Bank, 2009. *The World Bank Group Guarantee Instruments, 1990-2007: An Independent Evaluation*.

Figure 4: Basic Partial Risk Guarantee Structure



Note: SPV=special purpose vehicle

Source: African Development Bank

3.11 Proposed key features of the instrument are as follows:

- The instrument would replicate ADF concessional funding terms and propose lower-than-market guarantee fees (around 75 basis points).
- A counter-guarantee would be required from the host government. A counter-guarantee is a powerful deterrent because defaulting denies the defaulter the approval and disbursement of ADF-funded projects and triggers cross default provisions.
- As per lessons learned from sister institutions, 25 percent of the guaranteed amount would be deducted from the country's PBA and transferred into a dedicated pool to cover all outstanding guarantees.¹⁴
- Guaranteed amounts would be limited to a country's PBA for any given cycle, thus enabling the country to access funding equivalent to 175 percent of its ADF allocation. Under this system, 100 percent of the PBA could be guaranteed, but only 25 percent of the allocation would be deducted. The country could then draw upon its remaining PBA (75 percent) using other financing instruments as outlined in its Country Strategy Paper.
- Guarantees would be restricted to government risk, not commercial risk.
- Guarantees would be non-accelerated: that is, payments from the ADF to lenders would only be made when due and could not be accelerated.
- Lenders with preferred creditor status would not be eligible for coverage.
- Guarantees would be available in the Bank's lending currency as well as in local currency.

A detailed description of the proposed instrument can be found in Annex II.

3.12 The Bank Group estimates that there is significant demand for a PRG within ADF countries. The total cost of pipeline projects potentially suitable for a PRG is over US\$ 5 billion. These projects are primarily in infrastructure. The current sector distribution of infrastructure projects in the pipeline that could be covered by a PRG is approximately 57 percent for energy, 38 percent for transport, and 5 percent for water and integrated infrastructure projects (see Annex IV). While the value of the risk to be covered depends on a multitude of project-related features,¹⁵ PRG demand for the next 1 to 2 years can be estimated at a face value of around UA 472 million. The Bank Group proposes to address part of this private sector market demand through a PRG pilot program that would initially service two or three transactions (with total exposure limited to UA 200 million) by the ADF-12 Mid-Term Review. Based on

¹⁴ At the onset of the IDA's PRG program, deductions covered 100 percent of the guaranteed amount. While this enabled the program to accumulate substantial reserves to cover losses, it also created a substantial deterrent to the use of PRGs.

¹⁵ For instance, institutional arrangements, financing structures, and the expected performance of governments and/or government-owned entities make accurate estimates difficult, even though in general, projects and sectors are known.

this experience, the Bank Group would make further proposals regarding the continuation of the program.

Complementarity of the proposed instruments

3.13 The proposed ADF-funded guarantee instruments would leverage funds for private sector development in distinct and complementary ways. First, the FLPG would increase transactions in LICs, opening the door to flows of additional capital that would boost the development of the private sector as an engine of economic growth. Second, the PRG would significantly lower the counterpart risk of projects for which LIC governments or government-owned enterprises have critical financial and regulatory obligations. This could enlarge the pool of domestic and foreign investors who otherwise shy away from the risks associated with projects that rely substantially on government performance. The larger pool would improve the availability and terms of relevant debt facilities.

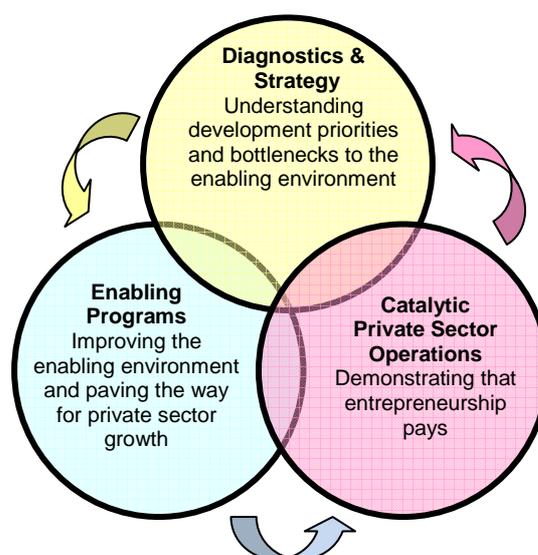
4. Implementation Modalities

4.1 The proposed instruments will be embedded in the Bank Group’s Strategic framework for the Bank Group. The innovative FLPG would be implemented on a pilot-level; the transaction instrument, the partial Risk Guarantee could be rolled out slowly while increasing further the Bank’s capacity. Implementation would occur on a pilot-level be embedded, managed, and operated within the existing institutional structure. The following chapter lays out the strategic embedment, resource implication, Implementation modalities including a paragraph on how the RMF would measure the success of the new instruments as well as a proposed time-line.

Strategic framework for private sector development in low-income countries

4.2 The Bank Group departments in charge of private sector operations, economic research and governance are joining forces to update the strategic framework guiding the Bank Group’s efforts to promote private sector development in Africa. Board discussions on the Mid-Term Review of the Private Sector Development Strategy and the Business Plan for Private Sector Operations in April 2010 specifically called for innovative instruments that the Bank could use to deepen and broaden the footprint of its private sector operations in LICs and incentivize improvements to the business environment. The new instruments proposed in this paper are critical building blocks of this approach and will give impetus to the Bank’s model for private sector development, represented here as the Private Sector Development Triangle (Figure 5).

Figure 5: The Private Sector Development Triangle



Source: African Development Bank

Resource implications of the first loss portfolio guarantee

- 4.3 In Cape Town, Deputies requested that no further set-aside be proposed. For that reason, Management proposes, as a financing option, for the FLPGa top slice of UA 100 million, to act as seed fund for the facility. ADB compensation (market-based guarantee fees) and interest earned would complement these resources over time.

Resource implications of the partial risk guarantee

- 4.4 ADF government performance guarantees are closely linked to country performance. ADF guarantees will be available to regional member countries through their PBAs. In light of the lessons learned from other multilateral development banks, it is suggested that only 25 percent of the nominal value of the guarantee be charged to the country. In other words, when an ADF beneficiary opts for a guarantee in relation to a specific project within its country development plan, 25 percent of the nominal amount of the guarantee would be deducted in the country allocation, with the government - through its counter-guarantee - bearing the risk for the remaining 75 percent.¹⁶
- 4.5 The risks associated with this design would be mitigated by non-accelerability, the accumulation of funds, the cap on guarantees, and the provision of counter-guarantees. First, ADF guarantees would be non-accelerable: disbursements would only follow the original repayment schedule of the underlying project. Payments would therefore be spread over an extended period of time, limiting the strain on ADF liquidity. Second, as more ADF-backed guarantees were issued, increasing funds would accumulate (each guarantee would produce funds worth 25 percent of the transaction). This accumulation would allow the Fund to managing its commitment capacity in the event that a guarantee was called. Third, each country's guaranteed total value would be capped at 25 percent of the country's allocation.¹⁷ Finally, none of the PRGs issued by multilateral development banks have been called to date because of the strong deterrent effect of the counter-guarantee provision. In the unlikely event that a guarantee should be called, the Fund's commitment capacity would allow it to sustain the missed payments, and the government's counter-guarantee would oblige it to repay the ADF, following the standard terms of ADF loans.

Institutional setup

- 4.6 The new instruments would be embedded, managed, and operated within the existing institutional structure.
- 4.7 The Bank Group's capacity to support private sector activities has been significantly strengthened (Box 2) and the ADB is able to deliver a steady flow of developmentally strong non-sovereign projects that follow sound banking principles in critical areas such as power (including renewable energy), transport, telecommunications, mining, construction materials, agribusiness, and financial intermediation for microenterprises and small and medium enterprises. The FLPG and the PRG would be spearheaded by the Private Sector Department in close cooperation with the Risk Management and the Legal Departments. The country and regional departments, that lead the Country Strategy Paper process, facilitate negotiations on the use of ADF resources, and conduct country dialogue would be partners in the implementation of the PRG.

¹⁶ In case a guarantee is called, the government's counter-guarantee will be converted into an ADF loan to that government. Since ADF loans have very long maturities and grace periods, the repayment schedule of the loan may not converge with that of the guarantee, which the ADF will fulfill from its liquidity. In that case, the ADF bears the liquidity risk.

¹⁷ For illustrative purpose, the limits can be calculated for an average ADF-country under ADF-11: For instances, the average ADF country's PBA allocation of approximately UA 102.4 million for the full cycle. It therefore could have used partial risk guarantees insuring investment of up to UA 102.4 million (= 100% of its PBA allocation). If it has insured the maximum possible amount, UA 25.6 million (= 25% of the insured value) would have been deducted from its allocation.

Box 2: Consolidating and Strengthening Capacity for Private Sector Operations With the African Development Bank

Following the rapid expansion of its non-sovereign operations over the past 3 years, the Bank entered 2009 resolved to consolidate and strengthen the management and functions of its non-sovereign business processes. This was seen as critical to sustain the quality of projects under preparation and to build capacity to manage the growing portfolio. Measures to date include the finalization of the major staff recruitment effort initiated in 2008 by filling all vacant senior positions at the Private Sector Department (OPSM), including three division management positions. Other notable initiatives include the rationalization of OPSM's divisional structure in favor of a better sector focus and stronger transaction support, e.g., with financial and economic modeling and environmental and social due diligence. In addition, to maximize competency for projects under consideration, Bank units with staff engaged in private sector operations formalized their teamwork into Project Appraisal Teams. Moreover, General Counsel and Legal Services created a new division only responsible for private sector operations. The additionality and development outcome evaluation launched by the Research Department in 2008 became fully operational in 2009 and now provides independent ratings of the development outcomes of projects: these ratings act as a counterpoint to the equally independent risk ratings provided by the Financial Risk Management Department. The Private Sector Department now also issues biannual project status reports for all active projects. These reports track three critical quality dimensions: (i) implementation progress, (ii) sustained commercial viability, and (iii) the achievement of development outcomes. Finally, a new online business manual to guide ADB non-sovereign operations across the private sector operations ecosystem is expected to be in place in the third quarter of 2010.

- 4.8 As the new instruments were applied, the Bank would accumulate experience and make necessary adjustments. Before launching the pilot phase, operational guidelines that address fee structures and operational modalities would be prepared, possibly with the assistance of external experts. The FLPG would be governed by a framework agreement negotiated between the ADF and the ADB. The agreement would detail all terms and conditions and specify the rights and obligations of each party in all transactions associated with the facility and the facility as a whole. Because of the Financial Management Department's substantial role in monitoring and managing the facility, it would evaluate the impact of including each new asset entering the guaranteed portfolio as part of its existing credit assessment function.
- 4.9 As only new assets would be eligible for the FLPG, these guidelines would be tested during the pilot phase and modified if necessary.
- 4.10 The growth in business volume over time would be consolidated with two measures: (i) increased reliance on partnerships among multilateral development banks/development finance institutions, inter alia by fully mobilizing the African Financing Partnership; and (ii) enhanced collaboration and synergy among concerned ADB departments.
- 4.11 In launching the pilot PRG program, ADB could benefit greatly from the experience of the World Bank Group and other multilateral development banks. For this reason, before launching the program, the Bank would develop the program's operational guidelines taking into account lessons learned in sister institutions.

Results framework

- 4.12 Measurement of the success of guaranteed operations would be mainstreamed following the procedures established for all private sector operations. To improve its reporting system for operations, the Bank has developed a four-level Result Measurement Framework (RMF). The RMF will improve the way the Bank routinely monitors development outcomes across operations, especially in the private sector. The RMF will not measure the progress of the new instruments per se but will track the outputs and outcomes of projects they support.
- 4.13 The guarantees will be subject to the same ADOA framework and the same RMF as other Bank operations. Building on the progress made by ADOA, the RMF for ADF-12 will incorporate a set of Core Sector Indicators for private sector operations to help the Bank aggregate and report on a sizeable set of development outcomes that have often been overlooked in the past. First, the RMF will track a set of Core Sector Indicators that provide information about the economic and financial success of the operation. These indicators are common to all private sector operations and were designed within the ADOA framework (see

ADF-12 discussion paper “The Results Measurement Framework”). Second, the RMF will track the development outcomes of private sector operations through sector-specific Core Sector Indicators (for roads, water, power, etc.). These indicators will allow staff to aggregate the results of public and private sector operations, develop a more comprehensive picture of the Bank’s contribution to country outcomes, and track the performance of private sector operations separately from other Bank activities.

- 4.14 The pilot phase will mainstream measurement of the guaranteed operations’ success in terms of their outcomes: the number and volume of guarantee operations and the number and volume of guarantees that default (the default rate). Additional dimensions of guarantees will be tracked to monitor their effectiveness and underlying risks; for instances the leverage effect in terms of additional UA of capital leveraged per UA of guarantee.

Timeline

- 4.15 Depending on Deputies’ feedback, operational documents, including detailed guidelines and procedures, will be prepared for approval by the Board of Directors.
- 4.16 To allow sufficient time for the development of an operational framework that draws on early experience, a first review of the instruments could take place during the ADF-13 consultations.

5. Conclusion / For Deputies’ Guidance

- 5.1 ADF-financed guarantees would give the Fund the means to achieve its objectives for developing the private sector in LICs, both through the demonstration effect of catalytic transactions and by improving the business environment. Deputies’ feedback will determine the shape of proposals to be submitted to the Board of Executive Directors for approval by June 2011.
- 5.2 Specifically, Deputies are invited to provide guidance on the following points
- Design of the two proposed instruments (FLPG and PRG)
 - Implementation arrangements; i.a. piloting a FLPG and a slow roll-out of the PRG
 - Resource implications of the proposed new instruments and their financing modalities.

Annex I: Detailed Description of the First Loss Portfolio Guarantee

Mechanics of the proposed portfolio guarantee

The first loss portfolio guarantee (FLPG) entails the provision of irrevocable guarantees by the African Development Fund (ADF) to compensate the African Development Bank (ADB or Bank) for all credit losses that might arise from impairment of a predetermined proportion of the underlying credit assets of the non-sovereign low-income country (LIC) portfolio of new assets approved during the ADF12 period. The “Guaranteed Amount” will be capped at 10 percent of outstanding loans or UA 100 million, estimated at 10 percent of a future “Guaranteed Portfolio” of UA 1 billion, whichever is lowest. As the guaranteed portfolio grows, the proportion of the guarantee will progressively reduce, while remaining at UA 100 million in absolute terms.

It is envisaged that subject to the satisfactory assessment of the FLPG instrument during a Mid-Term Review, efforts to mobilize further resources from bilateral donors to top up the “seed” allocation provided by the ADF will be launched.

ADF proceeds (supplemented with bilateral resources as the case may be) in an amount equivalent to the Guaranteed Amount (increased by any bilateral contributions) will be set aside in an escrow account designated to cover potential payments to the ADB under the FLPG.

The ADF and the ADB will jointly establish a framework agreement for the FLPG, including binding credit parameters for the Guaranteed Portfolio. These parameters will be designed such that the Guaranteed Portfolio has a credit profile that overall, is substantially similar to the credit profile of the existing non-sovereign portfolio in LICs (the “Reference Portfolio”). This ensures that the risk that the ADF will assume on future loans is consistent with the risk inherent in the current Reference Portfolio. Examples of credit parameters to be defined may include restrictions to certain LICs, a Weighted Average Risk Rating (WARR) not to be materially worse than the WARR of the Reference Portfolio, a Weighted Average Loan Life (WALL) no longer than the WALL of the Reference Portfolio, maximum single obligor credit exposure, maximum country/sector concentration, maximum tenor, etc. A maximum size would be defined for the Guaranteed Portfolio, as would a term for the guarantee.

The Guaranteed Portfolio will also mirror the Reference Portfolio in terms of sectors and types of projects (with a likely increase of the proportion of infrastructure) as well as development outcomes and additionality features. It will aim to optimize the geographical distribution across LICs.

The ADB may add new non-sovereign credit assets in the Guaranteed Portfolio, as long as these assets are fully compliant with the agreed credit parameters up to the agreed maximum size. The projects for which an FLPG is considered will be subject to the normal project review process for strategic alliance, commercial viability, additionality and development outcomes (ADOA), rigorous Country Team reviews and independent ratings for risk and ADOA. The Operations Committee will be entrusted with considering a project’s suitability for an FLPG.

The Bank will pay the ADF an annual premium in return for the guarantee. The price of the FLPG to the Bank would be negotiated with the ADF at closing of the framework agreement and in general, would be based on comparable market practice by modeling expected claims on the guarantee.

The ADF (and any bilateral participants) bears all credit losses on the Guaranteed Portfolio up to the Guaranteed Amount. Any other losses of the Guaranteed Portfolio are for the account of the ADB.

Benefits

- *Leveraging ADF resources for private sector development in LICs:* The use of ADF resources would stimulate economic growth and poverty alleviation by expanding the private sector in LICs.
- *Growing capacity for non-sovereign lending to LICs:* Given the envisaged growth trajectory of private sector operations in LICs, the proposed portfolio guarantee is necessary to ensure compliance with established WARR requirements and prudent management of the Bank’s balance sheet.
- *Leveraging ADF funding:* ADF funding that is employed for providing the FLPG generates a higher multiplier of new ADB investment than do direct ADF loans.

Challenges and risks

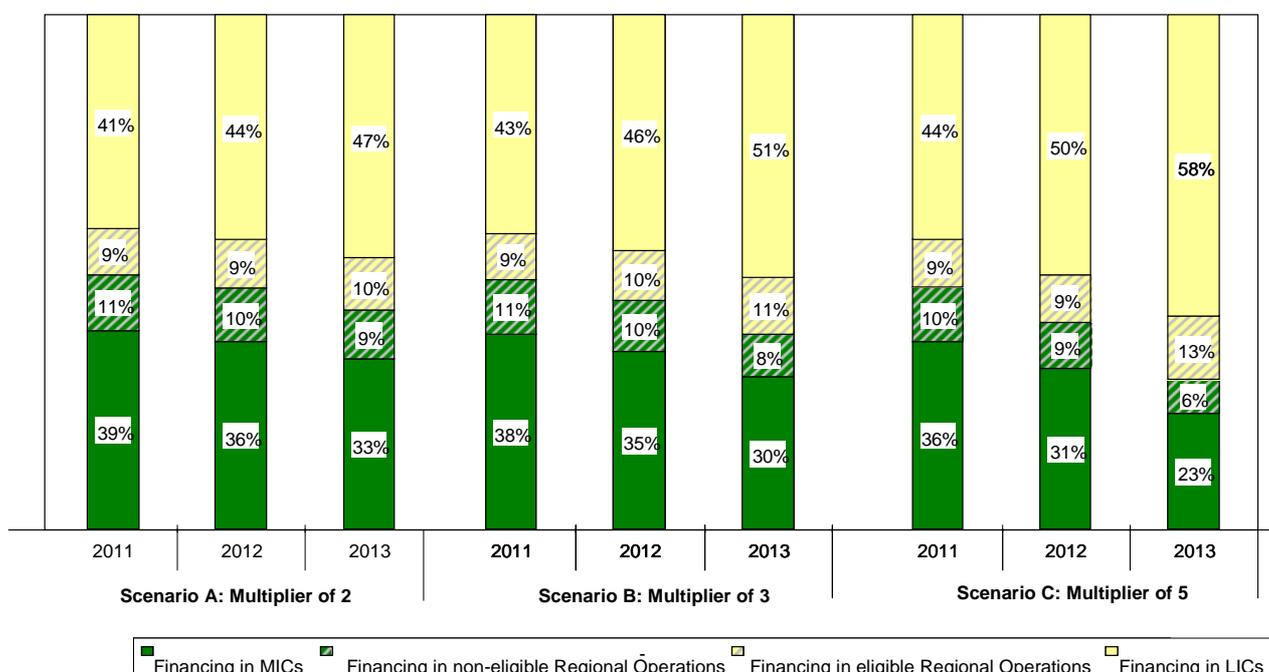
- *Greater ADB exposure to “tail risk”*: The first loss portfolio guarantee (FLPG) will be designed and priced such that the scaled-up portfolio will have the same level of risk for a given statistical level of confidence (between 95 and 99.9 percent to achieve a multiplier of 5 to 3). However, losses in the tail would be shouldered by the ADB.
- *Potential for moral hazard*: Knowing that a FLPG was in place could, in theory, lead to unintentional relaxation of Bank credit standards. A number of options could be considered to reduce the risk of moral hazard in the application of ADB credit processes. These could include structuring the ADF portfolio guarantee as a “partial guarantee” or “pari passu” (i.e. 50/50) so that the Bank feels the “pain” of any losses from the beginning. Alternatively, given the weight of political risk in LICs, the FLPG could be limited to predetermined events of a political nature. This said, the negative impact in terms of new lending to LICs of such restrictions should not be underestimated, as a reduction of the portfolio coverage would significantly reduce the scope for portfolio growth and impact on private sector development in LICs.

Several simulations under different scenarios have been made to estimate the likely multiplier effect of the FLPG.

- *Scenario A*: uses default probabilities as approved in Capital Adequacy Framework. The multiplier is approximately of 2.
- *Scenario B*: uses less conservative default probabilities, which are closer to those used by other MDBs, and a confidence level of 99.99 percent. The multiplier is approximately of 3.
- *Scenario C*: the same as scenario B but with a confidence level of 95 percent. The multiplier is approximately of 5.

Table I-1 illustrates the geographic distribution of private sector approvals under the three scenarios.

Table I-1: Geographic Distribution of Private Sector Approvals under Three First Loss Portfolio Guarantee Scenarios



Note: MICs = middle-income countries; LICs = low-income countries

Source: African Development Bank

Annex II: Detailed Description of the Partial Risk Guarantee

Mechanics of the proposed guarantee

The African Development Fund (ADF or Fund)'s partial risk guarantee (PRG) would insure private investors against specific, well-defined risks related to the failure of a government or a government-owned entity to honor its commitments. These risks would typically include political force majeure (i.e., expropriation), currency inconvertibility, regulatory risk (adverse changes of the law), and various forms of breach of contract (e.g., subsidies or government or government-owned entity payments under offtake or supply agreements).

The PRG would be flexible enough to meet project needs in a number of ways. For example, the ADF could provide a guarantee to debt providers on outstanding loans. This guarantee would significantly improve the terms of the debt. In exchange, the project company would pay fees to the ADF. In case of default caused by a covered risk, the ADF would make payments to debt providers on a non-accelerated basis (i.e., payments would be made as and when due). The government would provide a counter-guarantee that would be called by the ADF should the ADF have to make payments under the PRG.

Other structures are possible. For example, the PRG could cover payments by a utility to the project company up to a specific limit (e.g., several months of expected payments). In this case, the fees would be paid by the utility, while the enhancement provided by the PRG would benefit the project company directly and debt providers indirectly.

Depending on the structure, fees would be paid by the project company or the government or government-owned entity. Management proposes that the basic fee for the guarantee be similar to the ADF's concessional rate on loans (roughly 75 basis points). In addition, the ADF would charge other fees, such as front-end fees and processing fees.

Countries using an ADF PRG would be required to use a portion of their Performance-Based Allocation (PBA). Based on lessons learned from sister institutions, the ADF proposes that at least 25 percent of the guaranteed amount be deducted from the country's PBA and transferred into an accounting pool dedicated to insuring against the default of all outstanding guarantees. Countries would be restricted to using no more than 25 percent of their total PBA allocation for PRGs. This would limit total guaranteed amounts to the equivalent of a country's PBA for any given cycle, enabling the country to access funding equivalent to 175 percent of its ADF allocation: 100 percent in the form of the guaranteed amount (for which 25 percent of the PBA would be deducted) and the balance, 75 percent, for regular assistance funded through the PBA.

Benefits

- ***Mitigating political risk:*** The PRG would make investors and debt providers comfortable with risks that were beyond their control and that they might otherwise be unwilling to assume. This should increase investors' appetite for investing in LICs.
- ***Enhancing projects' financial feasibility:*** By substituting a triple-A rated counterparty for utilities or other government-owned entities that are often financially weak, the Fund's guarantee would significantly enhance projects' risk profile, sustainability, and bankability. This should accelerate the pace of development of private-public partnerships in low-income countries, particularly if PRGs are put in place early in the project cycle.
- ***Increasing access to debt finance:*** Even if some investors are prepared to take on certain political and counterparty risks in private-public partnerships, debt providers may not be willing to do so. The PRG could be used to allow project developers to obtain debt on better, more appropriate terms.
- ***Lowering the overall cost of private finance:*** Both equity and debt providers are willing to accept lower returns when risks are lower. In the case of concession agreements, lower hurdle rates on equity returns and less expensive, longer-term debt would lower the costs of the services provided by private projects in electricity, transportation and other area. The primary beneficiaries would be the local population.
- ***Stimulating policy dialogue:*** PRGs would provide an opportunity for the Fund to increase dialogue with governments about how to reinforce their investment climate. They would also

act as an incentive for strong regulatory frameworks, thereby reducing the risk of default.

Challenges and risks

- **Financial risk:** A new PRG would add financial risk if guarantees were called. Management therefore proposes seven mitigants: (i) a government counter-guarantee; (ii) non-accelerable guarantees so that payments are made over time; (iii) a partial PBA set-aside; (iv) portfolio diversification; (v) the pool of resources that would be created over time by setting resources aside; the portfolio diversification benefits that would be created over time by setting a pool of resources aside (vi) limitation of PRGs to a maximum of 25 percent of a country's PBA in any given ADF cycle; and (vii) launch of the PRG program on a pilot basis with total maximum exposure initially limited to UA 200 million.
- **African Development Bank Group capacity:** Although the African Development Bank (ADB or Bank) Group has significant experience providing finance for private-public partnerships, none of its staff is currently dedicated to PRGs. Management therefore proposes that during the pilot phase, external experts be brought in to support the Bank Group's project teams.
- **Operational risks:** PRGs would be appraised using existing processes to measure financial viability, strategic alignment, development impact, and additionality. All relevant safeguards with respect to procurement and environmental and social sustainability would apply.

Box II-1: Experiences with partial risk guarantees

Partial risk guarantees (PRGs) have been used widely by the International Development Association (IDA) and have proven effective at enabling public-private partnerships in Africa. The Jorf Lasfar Power project in Morocco, concluded in November 1997 for US\$ 1.4 billion, included a PRG for US\$ 180 million. The Azito Power Project in Côte d'Ivoire had a similar guarantee. A PRG from the IDA for US\$ 115 million also helped secure commercial financing for the Bujagali Hydroelectric Project. The West Africa Gas Pipeline Project for US\$ 590 million approved in January 2005, spanning Benin, Ghana, Nigeria and Togo, benefited from an IDA political risk guarantee of US\$ 50 million. This helped obtain a Multilateral Investment Guarantee Agency guarantee for US\$ 75 million and a commercial guarantee for US\$ 125 million, which together covered the government's obligations and helped bring the project to financial close.

Annex III: Lessons Learned From Multilateral Development Banks' Experiences with Guarantees

Guarantees are well-established risk mitigation instruments, widely used in finance. In response to rising demand, numerous private and national agencies and multilateral development banks offer guarantees that cover different types of risk. Reviewing the experience of multilateral development banks with these instruments will help generate a more informed proposal for the African Development Fund (ADF of Fund)'s guarantees. This annex therefore exposes lessons learned from multilateral development banks that offer guarantee products similar in nature and scope those proposed for the ADF.

Table III-1: The Use of Guarantee Instruments by Sister Institutions

	Partial Risk Guarantee		Partial Credit Guarantee		First Loss Portfolio Guarantee
	LICs	MICs	LICs	MICs	
IBRD	X	X		X	
IDA	X	X			
MIGA	X	X			
IFC				X	
AsDB	X	X	X	X	
IADB					
AfDB		X		X	

Source: African Development Bank

Notes: AfDB=African Development Bank; AsDB=Asian Development Bank; IADB=Inter-American Development Bank; IBRD=International Bank for Reconstruction and Development; IDA=International Development Association; IFC=International Finance Corporation; LICs=low-income countries; MICs=middle-income countries; MIGA=Multilateral Investment Guarantee Association

World Bank Group guarantees. The World Bank Group offers a range of guarantee products through its institutions (the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA)) and affiliates (the Multilateral Investment Guarantee Association (MIGA) and the International Finance Corporation (IFC)). MIGA offers political risk insurance covering mainly foreign investors' equity, quasi-equity, and non-equity direct investments for any combination of the following political risks: (i) transfer restriction, (ii) expropriation, (iii) war and civil disturbance, and (iv) breach of contract. The IFC offers credit guarantees for the performance of private borrowers. The IBRD offers partial credit guarantees (PCGs) supporting sovereign borrowing from IBRD-eligible countries, and both IBRD and IDA offer partial risk guarantees (PRGs) that cover traditional political risks and breach of contract in IBRD and IDA-eligible countries, respectively.

Effectiveness of and scope for World Bank Group guarantees. The World Bank Group's Independent Evaluation Group reviewed the World Bank Group's experience with guarantee instruments between 1990 and 2007.¹⁸ The evaluation concluded that (i) the IDA's PRGs had helped introduce complex public-private partnerships in high-risk, low-income countries using limited IDA resources; (ii) in several large public-private partnerships, the IDA's engagement and relationship with governments were critical to securing adequate financing for the project; and (iii) the engagement that took place through the IDA's PRGs had acted as a platform for furthering the reform of public-private partnership policies. The evaluation also found that demand for IDA PRGs was likely to continue, particularly in high-risk countries in Africa. An IDA PRG was to likely the instrument of choice in situations where (i) there was already significant policy dialogue on the private sector environment; (ii) high country or sector risk levels inhibited commercial financing; and (iii) the amount of financing requiring political risk mitigation was such that other providers had exceeded their exposure limits.

Constraints in the use of World Bank Group guarantees. The Independent Evaluation Group review revealed several barriers to the use of World Bank Group guarantees. First, PRGs' nature as an instrument of last resort¹⁹ and the lower-than-expected volume of private investments in infrastructure had narrowed the scope for PRGs. Second, the small number of commercially viable projects in sectors unrelated to energy (specifically, water and transportation) had constrained the use of guarantees in these sectors. Third, PRGs require long preparation times, reflecting both the

¹⁸ The World Bank Independent Evaluation Group. April 2008. *The World Bank Group Guarantee Instruments 1990-2007. An Independent Evaluation.*

¹⁹ World Bank Group guarantees are considered to be last resort instruments because it is World Bank Group policy to provide scarce concessional resources only after market-based options are exhausted.

complex nature of the underlying projects, the guarantees' extensive due-diligence requirements, and additional internal processing steps. Fourth, full country allocation requirements²⁰ had constrained the use of the IDA's PRGs. And fifth, few staff had expertise in the financial structuring of guarantees and many of those with experience had moved to new positions in the World Bank or had retired. According to the report, the guarantees' pricing had not been a significant constraint, because IBRD and IDA guarantee charges are based on loan-equivalent pricing and do not reflect sector or country risk.²¹ Finally, the requirement for a counter-guarantee for IDA PRGs had been an advantage in some cases but a constraint in others: an advantage when the requirement successfully engages the client government and a constraint when it discourages governments because of its contingent liability implications.

IBRD's experience with partial credit guarantees

The Independent Evaluation Group review pointed out that the limited number of PCGs issued—mostly in support of large public power projects—had (i) helped public agencies access commercial markets on better lending terms, primarily by lengthening the loan tenors; and (ii) introduced or re-introduced borrowers to commercial markets. However, PCGs were also found to have lessened the World Bank Group's leverage in advancing sector reforms, and possibly to have been inappropriately timed. The unsatisfactory outcomes of two PCG projects²² showed that the use of the instrument had reduced the World Bank Group's leverage to promote agreed reforms by front-loading financial support for the project: unlike direct IBRD loans, where disbursement is based on expenditures, guarantees allow the obligor to undertake large portions of foreign debt long before the funds are truly needed. As a consequence, the obligor may well be straddled with debt that the obligor as yet lacks the capacity to repay. Finally, exceptionally liquid capital markets between 2002 and 2007 had undermined the value of PCGs by allowing countries to access markets directly on favorable terms. The Independent Evaluation Group's evaluation nevertheless concluded that scope exists for PCGs to help countries regain access to capital markets during market downturns, as well as to assist higher-income, well-performing IDA countries access markets directly at more favorable terms.

Management of the IDA's guarantee program

In reviewing experience with the guarantee pilot program, the IDA highlighted some useful issues with regard to management. The most relevant for this paper involve (i) incentives for staff to fully consider using of guarantees; (ii) staff members' and potential beneficiaries' limited knowledge of the guarantee instrument; and (iii) inadequate coordination within the World Bank Group around risk mitigation instruments. With regard to incentives, the review concluded that staff viewed guarantees as high-risk operations because guarantees involve the private sector, require engagement with multiple parties, and necessitate extensive preparation time (3 years on average, compared to 12 months for IDA credits) that often leads to higher rates of non-completion than are achieved with IDA credits. Within the World Bank Group, scarce knowledge of the guarantee instrument has limited the instrument's deployment in projects in which their use might be warranted and has required staff with specialized product knowledge to be seconded across the institution and to the institution's clients, which further prolongs preparation times.

The lack of macro-level coordination between the IBRD/the IDA, MIGA, and the IFC—all of which have unique competencies and offer supposedly complementary risk mitigation instruments—and inadequate micro-level coordination between country directors and staff responsible for the guarantee program, have also limited the use of guarantees. Guarantees require extensive preparation and should benefit private sector investments in sectors and projects recognized as key to the client country's development. They should therefore be invoked as far upstream as possible, either when preparing the Country Assistance Strategy or during the initial phases of project design.

²⁰ Until 2004, IDA policy required the full nominal amount of the guarantee to be set aside from the country's allocation. The IDA then modified its policy to require only 25 percent of the value of the guarantee. The result of this modification was that in the next 3 years, the IDA approved more than double the guarantees that it had approved in the previous 6 years.

²¹ Because the IBRD Articles of Agreement and a decision of the Board of Directors of IDA require a government counter-guarantee, the risk of default on the commercial loan is passed onto the government. The loan thus represents the same risk as a normal lending operation.

²² A third unsatisfactory PCG consisted of a policy-based guarantee issued to Argentina. The IBRD' self-evaluation found that in all three cases, the unsatisfactory outcomes were more reflective of weaknesses in the programs themselves than of weaknesses in the guarantee.

Asian Development Bank guarantees

The Asian Development Bank offers both PCGs and PRGs. In its review of its experience with PRGs,²³ the Asian Development Bank identified a number of factors that may have caused weaker-than-expected demand: (i) coverage of the PRG instrument confined to Build-Operate-Transfer and Build-Operate-Own projects, (ii) a low prudential limit of US\$ 50 million per project or 25 percent of project cost, (iii) lack of a co-guarantee program,²⁴ (iv) difficulty in securing governments' counter-guarantees, (v) lack of a targeted communication strategy, and (vi) lack of organizational focus and cross-departmental cooperation.

African Development Bank guarantee products

Beginning in 2000, the ADB offered PRGs and PCGs in a pilot program that lasted for 2 years. Subsequent to the pilot program, the ADB mainstreamed the two products. PRGs and PCGs are now offered to ADB regional member countries with the same fees as are applied to ADB loans, and charges calculated on loan-equivalent basis. To date, limited use has been made of the products: ADB guarantees have primarily taken place in the financial sector, more particularly in support of small and medium enterprises. A total of UA 61 million for six operations has been approved by the Board since 2005 (Table III-2).

Table III-2: Operations With ADB Guarantees, 2005-2010

Year of Approval	Country	Project Name	Sector	Net Amount Approved (Units of Account)
2005	Kenya	GOWE Kenya	Financial Services	10,000,000
2006	Cameroon	GOWE Cameroon	Financial Services	10,000,000
2008	Ghana*	Barclays Bank – Ghana Export Oriented Small and Medium-sized Enterprises Guarantee Programme	Finance (small and medium enterprises)	20,000,000
2008	Tanzania	CRDB Bank	Financial Services (microfinance)	8,000,000
2008	Zambia**	Zanaco	Financial Services	8,000,000
2009	Algeria (ADB-country)	Maghreb Leasing	Financial Services (leasing)	5,300,000

Source: African Development Bank

Notes: *= Cancelled; **=unsigned; ADB = African Development Bank

Lessons learned from ADB guarantee products

ADB Management has suggested a number of reasons for the limited use of ADB guarantee products.

- PCGs compete unfavorably with direct lending. PCGs require more resources to be mobilized and necessitate that local commercial lenders with an appetite for guarantees be identified. Moreover, compared to direct lending, PCGs are more legally, financially, and operationally complex, owing to the greater number of parties involved and the negotiations necessary to lower commercial lenders' margins or lengthen their maturities. Finally, senior loans are more directly aligned with corporate performance management indicators (which favor volume of lending) and staff incentives.
- The Bank lacks a designated unit to coordinate the provision and use of guarantees.

²³ Asian Development Bank. *Review of the Partial Risk Guarantee of the Asian Development Bank*. November 2000.

²⁴ Under a co-guarantee program similar to MIGA's Cooperative Underwriting Program, the Asian Development Bank as the guarantor-of-record would issue a guarantee for the entire coverage amount requested, but would retain only a portion of exposure for its own account. One or more private insurers would underwrite the remaining guarantee capacity.

- Guarantee execution and monitoring capacity within the Bank is not yet strong. Broadly speaking, Bank staff have limited knowledge of the guarantee instrument, and limited or no training is offered.
- To date, the Bank's range of guarantee products is mainly limited to PCGs for ADB countries. This limits flexibility and coverage.
- Clients are not fully aware of the advantages of guarantees, partly because the Bank has not sufficiently marketed the product.

Summary of lessons learned

Multilateral institutions implementing guarantee programs have experienced common problems and issues during the implementation phase. The main causes of limited demand or the limited use of guarantees were found to be

- the instruments' greater complexity, coupled with fewer corresponding skills and expertise within the institutions;
- a lack of internal and external marketing;
- inadequate staff incentives to foster the use of the guarantee products, and insufficient coordination within or across institutions; and
- the requirement of a client government counter-guarantee.

Annex IV: Preliminary Demand Analysis: Projects that might benefit from an African Development Fund partial risk guarantee

The table below presents a preliminary estimate of potential demand for the African Development Fund's proposed partial risk guarantee. The table has evaluated the Private Sector Department's current pipeline of projects in infrastructure to identify projects for which a partial risk guarantee could be relevant.

Country	Estimated Private Sponsor Demand for a PRG in Projects Currently in the Pipeline* (US\$ million)	Project	Sector	Total Project Amount (US\$ million)	Estimated Demand for a PRG (US\$ million)
Ethiopia	250	Gibe III Hydropower Plant	Energy	1,937	250
Ghana	80	Cenpower IPP	Energy	350	80
Kenya	200	Northern Corridor Nairobi Concession	Transport	995	100
		Lake Turkana Wind Project	Energy	471	100
Madagascar	20	Sandandrano Water Supply	Water	62	20
Senegal	107	New Dakar Airport	Transport	570	40
		Dakar Toll Highway	Transport	400	67
Zambia	60	Itthezi-Thezi Hydropower Generation	Energy	200	60
Total				5201	817

Note: *The actual amount of PRGs that could be extended to projects in a country would be capped at 25% of the country's Performance-Based Allocation. PRG = partial risk guarantee.

Source: African Development Bank

Annex V: Additional thoughts on leveraging funds for development: The partial credit guarantee

In addition to the proposed instruments, the African Development Fund (ADF or Fund) is brainstorming possibilities to help well-performing ADF countries access markets, extend debt maturities, and lower borrowing costs. Partial credit guarantees (PCGs) could be ring-fenced and the proceeds of bond issues dedicated to high value-added sectors like infrastructure and energy. Particular varieties of PCG, for instance the tenor extension guarantee, aim mainly at extending the terms of financing by guaranteeing last payments, thus incentivizing private lenders to bridge the gap. The debt issuance guarantee, in contrast, seeks to reduce the interest spread on the overall amount guaranteed. These two declinations can be combined for greater impact.

In Africa, an ADF-financed PCG would enable first-time issuing countries to secure more funding and offer longer maturities than if the countries were to operate on a stand-alone basis. All recent bond issues by single B-rated African countries carried a coupon in the 8.5 to 9.0 percent range for 3 to 10 years, irrespective of the low interest rate environment.²⁵ Rating agencies have issued indicative guidance on the rating uplift to be expected from multilateral development banks' guarantees: bonds issued with a multilateral development bank's PCG would be rated 3 to 6 notches above bonds without such a guarantee.²⁶ This uplift would enable a single B-rated country to achieve a funding level of BB or better. The Bank's involvement in the transaction could also ensure that the proceeds of the bond issue were well managed and targeted at the priority sectors indicated in the issuer's Country Strategy Paper.

There is ample evidence of demand for PCG in ADF countries. The Bank regularly receives calls from investments banks and firms advising ADF countries, requesting credit enhancements for first-time international bond issues. Market intelligence indicates that Kenya, Nigeria, and Tanzania are all considering or have finalized plans to issue bonds before the end of 2010. In addition, countries such as Uganda and Zambia are examining the possibility of launching international issue bonds in the near future. These countries constitute a pool of potential beneficiaries of ADF guarantees. This does not mean that they would all turn to the ADF for this type of assistance. By their nature and given rating agencies' guidance on multilateral development bank-backed international bond issues, PCGs would be largely restricted to a relatively narrow group of countries that are already close to accessing markets on a stand-alone basis. If a country is not perceived as creditworthy or has not even been rated, a PCG would not make a difference.

The experience of sister institutions confirms that a PCG of bond issues could significantly reduce interest rates and create considerable leverage. The International Bank for Reconstruction and Development (IBRD)'s PCG allowed Thailand to decrease its annual interest charges by 5.10 percent. In Argentina, the guarantee enabled the country to issue a significantly larger bond (US\$ 1.2 billion) than would otherwise have been possible at the time. The size of the bond issue was 6.3 times the value of IBRD's guarantee. The ADB has witnessed similar leverage with the guarantee it extended to Seychelles in December 2009: the US\$ 10 million rolling reinstatable PCG facilitated the restructuring of approximately US\$ 320 million in debt.

While the cost of guaranteed funds would be significantly lower than the cost of non-guaranteed borrowings, the guaranteed debt would nevertheless be loaded at much higher costs and less favorable terms than regular ADF loans. Regular ADF loans stipulate a 50-year repayment period, including 10-year grace period, and carry a fixed service charge of 0.75 percent per year on outstanding balances and a commitment fee of 0.50 percent on the undisbursed portion. As a result of their harder terms, guaranteed debts could have the reverse effect of reducing a country's prospective repayment capacity, deteriorating its Debt Sustainability Framework and making it more eligible for ADF grants. This risk must be weighed against the benefits of the country's accessing more funding because of the leverage of an ADF guarantee—funding that would take up only a fraction of its Performance-Based Allocation and make more efficient use of scarce ADF allocations.

²⁵ On 22 December 2009, Senegal issued a US\$ 200 million, B+ rated, 5-year bond with a coupon of 8.75 percent

On 4 October 2007, Ghana issued a US\$ 750 million, B+ rated, 10-year bond with a coupon of 8.50 percent

On 3 October 2006, Seychelles issued a US\$ 230 million, B rated, 5-year bond with a coupon of 9.125 percent

²⁶ Depending on guarantee coverage, conditionality and claim processing, subrogation rights, etc.