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ADF Long-Term Financial Sustainability and Capacity

Discussion Paper

ADF-12 Mid-Term Review
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Praia, Cape Verde

AFRICAN DEVELOPMENT FUND

Executive Summary

The African Development Fund (ADF or the Fund) has supported low-income countries in Africa in their economic and social development since 1974.

It is important for the Fund to regularly examine its financing framework in order to optimize the use of its resources and protect its commitment capacity. This is particularly crucial in the current financial and economic crisis, with many donors facing budgetary constraints and high social demands.

This paper builds on the Board of Directors' informal discussion of January 2012 on the document "ADF Long-Term Financial Sustainability" (ADF/BD/WP/2011/148). Firstly, the paper undertakes an in-depth assessment of the Fund's financial situation; notably, its financial structure and income dynamics, financial policies and risk management. Next, it sets out measures and initiatives that Management is undertaking during the Twelfth General Replenishment of the African Development Fund (ADF-12) period to protect the resources pledged for development. Finally, the paper suggests a number of avenues for further exploration in the ADF-13 discussions aimed at strengthening the ADF's financial capacity to fund new operations and to ensure appropriate use of ADF resources.

Until recently the Fund had generally been reporting positive financial results. For the last two years, however, the Fund's financial results have been negatively affected by three key factors: (i) structural issues related to developments in its financial framework, primarily linked to forgone income from debt relief and grants; (ii) endogenous issues linked to financial policies on lending terms, administrative expenses and liquidity management; and (iii) exogenous issues related to market risks, such as interest rate and currency exchange rate movements.

Financial projections of the Fund's sources and uses of income indicate that its reported deficit is not likely to improve in the short or medium term unless interest rates, which are at historically low levels, start rising. A significant part of the deficit may be considered as arising from financial accounting reporting principles, given that the Fund is fully compensated for forgone loan income from grants and the Multilateral Debt Relief Initiative. The Fund's financial situation thus remains fundamentally sound, with its long-term financial sustainability depending essentially on donors' contributions and on the adequate management and careful preservation of its internally generated resources.

Nevertheless, in order to improve the Fund's financial outlook, Management undertook several measures to address the issues under its purview during the ADF-12 period. These include: (i) enhanced disclosure of forgone income due to debt relief and grants, (ii) stringent cost control and budgetary discipline, (iii) a conservative investment strategy, and (iv) risk management measures to reduce interest rate and currency risks.

Going forward, Management proposes to explore several options to enhance the Fund's financial capacity through additional internally generated resources, to ensure the efficient management of donor resources. These options are:

i. **Revising the ADF lending terms:** In the document discussed informally by the Board in January, three options for revising the Fund's lending terms were analyzed; namely, increasing commitment fees from 50 bps to 75 bps, increasing service charges from 75 bps to 100 bps and decreasing the maturity of all new loans for ADF-only countries from 50 to 40 years. Of the three options, Management thinks that the third strikes the most appropriate balance between the various issues facing the Fund.

ii. **Differentiating financial terms among groups of ADF-only countries**: Countries eligible for the ADF window have grown increasingly diverse, yet all can draw on the Fund's resources at the same level of concessionality (grant element). Management favors distinguishing groups of ADF-only countries in accordance with their capacity to shoulder different lending terms, so as to strengthen the Fund's financial capacity and sustainability.

iii. **Encouraging graduation:** A number of ADF-eligible countries are in a good position to meet the income and creditworthiness criteria for eligibility for the ADB window in the medium term. Management proposes to undertake regular creditworthiness assessments and engage with the ADF countries most likely to graduate, so as to free up resources for use by the most needy ADF recipients.

iv. **Accelerated and voluntary repayment of ADF loans**: Management proposes to consider introducing provisions for accelerated repayment and voluntary prepayment of ADF loans for countries that have graduated from the concessional window, similarly to the International Development Association and the Asian Development Fund.

v. **Possible new and innovative financial instruments**: Management intends to explore various options for better leveraging Bank Group resources through new instruments, arrangements and financial innovation, and seeks an exchange of views and ideas with Deputies.

Subject to Deputies' guidance, Management proposes to further elaborate on these options for discussion during the ADF-13 consultations.

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Abbreviations and Acronyms

ACC	Advance Commitment Capacity
ACE	Accelerated Encashment
ADB	African Development Bank
ADF	African Development Fund
AsDF	Asian Development Fund
bps	basis points
CCTA	Cumulative Currency Translation Adjustment
CEAS	Cumulative Exchange Adjustment on Subscriptions
GNI	Gross National Income
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
LIBOR	London Interbank Offered Rate
MDB	Multilateral Development Bank
MDG	Millennium Development Goal
MDRI	Multilateral Debt Relief Initiative
NDR	Net Development Resources
PBA	Performance Based Allocation
PPG	Public and Publicly Guaranteed
RMC	Regional Member Country
SDR	Special Drawing Right
UA	Unit of Account

ADF LONG-TERM FINANCIAL SUSTAINABILITY AND CAPACITY

1. Context

1.1 In line with its mandate, the African Development Fund (ADF or the Fund) has supported low-income countries in Africa in their economic and social development since 1974. This support has been on highly concessional terms, commensurate with the scale of countries' needs and their limited ability to repay loans. At the same time, the ADF was established as a revolving fund, with the expectation that at some point, the reflows from previously extended loans would suffice to fund new operations.

1.2 It is important for the Fund to regularly examine its financing framework in order to optimize the use of its resources and protect its commitment capacity to finance new projects and programs. This is particularly crucial in the current financial and economic crisis, with many donors facing budgetary constraints and high social demands.

1.3 In recent years, the Fund has been recording deficits in its financial statements as a result of new developments in the financial framework of the ADF, coupled with exogenous factors such as adverse exchange rate movements and declining interest rates. These deficits have triggered the concern of state participants and other stakeholders about the Fund's long-term financial sustainability.

1.4 In the current resource-constrained environment, it is important to continue ensuring the Fund's long-term capacity to commit to new operations in eligible Regional Member Countries (RMCs) and to ensure an appropriate use of the Fund's resources for development purposes. A forward-looking view is called for, taking into account the changing context on the continent and the medium-term prospects of the countries currently eligible for the ADF. Over the next 10 years, for example, the ADF will likely be faced with varying market circumstances and changes to its client base as countries develop and eventually graduate from the ADF to the African Development Bank (ADB). This should be borne in mind when examining the Fund's current financial situation and longer-term outlook.

2. Objectives

2.1 This paper builds on the Board of Directors' informal discussion of January 2012 on the paper "ADF Long-Term Financial Sustainability" (ADF/BD/WP/2011/148).

2.2 The objective of this paper is threefold. First, it undertakes an in-depth assessment to inform Deputies of the Fund's financial situation; notably, its financial structure and income dynamics, financial policies and risk management (Section 3). Second, it sets out measures and initiatives that Management is undertaking during the Twelfth General Replenishment of the African Development Fund (ADF-12) period to improve the Fund's long-term sustainability through the enhancement of its internal resource-generating capacity (Section 4). Finally, the paper suggests a number of avenues for further exploration in the ADF-13 discussions, aimed at strengthening the ADF's capacity to fund new operations and to ensure an appropriate use of ADF resources (Section 5). Management seeks Deputies' guidance on these areas for further work.

3. Factors Affecting the Fund's Financial Situation

3.1 Like the concessional windows of other Multilateral Development Banks (MDBs), the Fund reported deficits in its financial statements for 2010 and 2011, which triggered concerns about the Fund's long-term financial sustainability.[1] As will be explained in this section, the situation is not alarming in the short to medium term and can largely be explained by the way in which

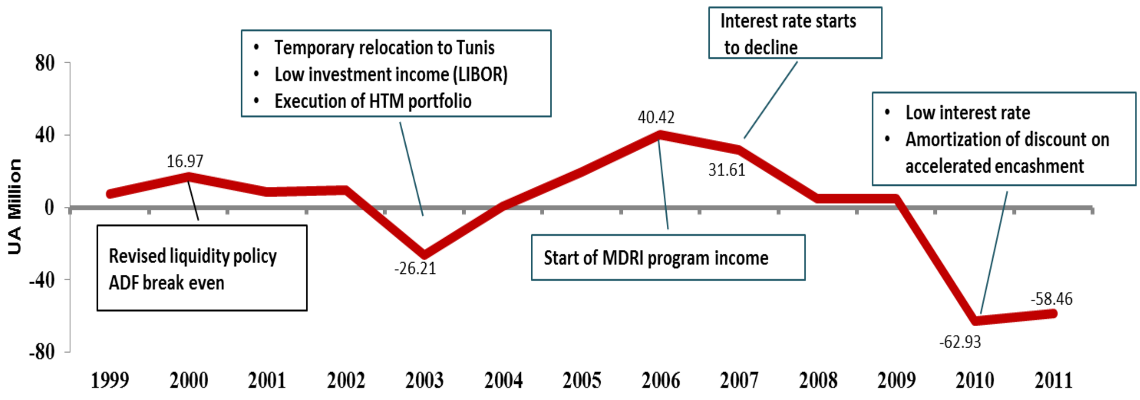
[1] The Asian Development Fund and International Development Association also experienced deficits in 2010 and 2011, as presented in Annex I.

certain items are accounted for in the Fund's income statement. At the same time, it is worth noting that the ADF is operating in the context of an increasing global scarcity of capital (mostly from sovereigns), ongoing financial-market turbulence, increasing market volatility, budgetary pressures on donor countries and increasing financing gap pressures on beneficiary countries.

3.2 When analyzing the situation, it is worth recalling that the Fund's stakeholders have historically insisted on the necessity to ensure its long-term financial sustainability, defined as the consistent ability to generate income equal to or greater than its expenditures. The challenges of ensuring that the Fund generates positive financial results were emphasized during the ADF-7 negotiations. As a result, the Fund's charges were reviewed in 1995 to include a commitment charge of 50 basis points (bps) on undisbursed balances in addition to the service charge of 75 bps on disbursed balances. In 1999, Management embarked on a review of the ADF liquidity policy, which concluded that the Fund should seek to break even and should be allowed to hold liquidity above its operational requirements to achieve this objective.[2] Since then and until 2009, the Fund reported positive results, except for a deficit of Units of Account (UA) 26.2 million in 2003 primarily due to expenses related to the Bank's relocation to Tunis and to the low interest rates at that time.

3.3 The Fund's financial results, as reported in its income statement, have recently been negatively affected by three key factors: (i) structural issues related to developments in its financial framework, primarily debt-relief initiatives and the associated forgone income from grants and debt relief (Multilateral Debt Relief Initiative, MDRI); (ii) endogenous issues linked to financial policies on lending terms, administrative expenses, investment, and liquidity management; and (iii) exogenous issues related to market risks such as interest rate and currency exchange rate movements. The first of these factors can be considered as an accounting reporting issue, as it negatively affects the income statement but not the Fund's long-term financial sustainability/capacity. The latter two affect long-term financial sustainability as well as income. The various drivers and events affecting the Fund's revenues are summarized in Figure 1.

Figure 1: Evolution of Fund's Financial Results



Notes: LIBOR = London Interbank Offered Rate; HTM = held to maturity

[2] Please refer to document *"Revised ADF Liquidity Policy Paper",* ADF/BD/WP/99/42/Rev.2 which indicates the following in section 4: "To the extent that the Fund's revenue earning loan assets do not generate sufficient revenue to defray all its expenditures, the Fund needs to maintain liquid assets at a level that is higher than needed for strictly operational purposes, in order to generate a positive level of net income, as directed by Deputies. The Board authorizes Management to adjust the target liquidity level upwards, to at least break-even."

Structural Issues (Grants and MDRI)

3.4 In the last few years, the Fund has undergone structural changes due to the increase in the percentage of grants and the implementation of MDRI (see Annex II) that resulted in a reduction of reported loan income. Although the Fund is fully compensated by donors for forgone income on grants[3] and MDRI[4], such compensation cannot be reported as revenue in the income statement because of the form in which the compensations are received by the Fund. Specifically, for the MDRI, donor funds received as compensation for charges on cancelled loans are received and accounted as additional subscriptions to the ADF for which voting rights are extended to the donors, and therefore they are not reported as revenue in the ADF's income statement, while the grant compensation is a retention of amounts that would otherwise have been allocated for loans as liquidity for the stabilization of the Fund's commitment capacity.

3.5 As such, due to the full compensation of the Fund, the increase in grants and MDRI does not have to be perceived as a deterioration of the Fund's financial sustainability and commitment capacity. The reported impact on the income statement of the Fund is more from the financial accounting reporting perspective, which does not affect the financial sustainability of the Fund. However, because the compensation for forgone income cannot be reported as revenue, the Fund's income statement would not present a break even position.

3.6 The forgone income due to grants and MDRI not captured in the income statement amounted to UA 68 million in 2011, which explains the deficit of UA 58 million recorded the same year. Table 1 presents the adjusted surplus/(deficit) for the stated years, if the compensation for the impact of increased grants and MDRI loan cancellation were to be reported as revenue in the income statement.

Table 1: Effect of Grants and MDRI Forgone Income on ADF Net Income

UA million

	2008	2009	2010	2011
Reported (Deficit)/Surplus	**4.66**	**4.70**	**(62.93)**	**(58.46)**
Grant Income forgone	16.00	20.00	24.00	29.00
MDRI Income forgone	37.00	38.00	38.00	39.00
Income after adjustment for compensation of MDRI and grants	**57.66**	**62.70**	**(0.93)**	**9.54**

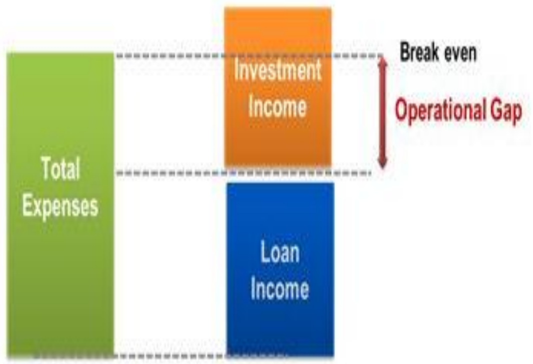
3 The Fund is compensated for forgone income on grants through an upfront charge (grant surcharge) retained in liquidity, while forgone principal reflows are expected to be received from donors during future replenishments on a "pay-as- you-go" basis.

4 Under the MDRI, donors have committed to make additional contributions to ADF to match dollar for dollar the total amount of cancelled loans and service charges on such loans.

Endogenous Issues (Financial Policy Management Issues)

3.7 Financial policies related to lending terms, administrative expenses, and investment and liquidity management affect the ADF's financial results and must be adequately monitored to ensure that the Fund can generate a positive result. The Fund's income from loans and investments should generally exceed administrative expenses, as illustrated in Figure 2. The figure also shows the operational gap, which is defined as the difference between administrative expenses and loan income. If loan income is insufficient to cover administrative expenses, investment income could in some circumstances cover the operational gap.

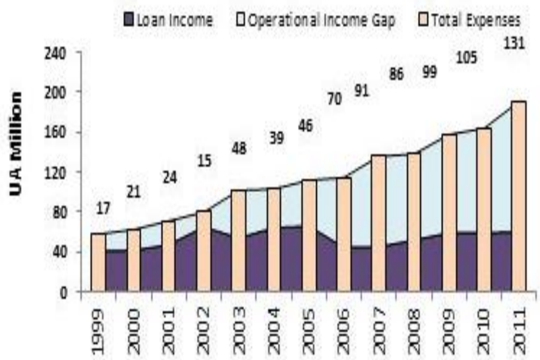
Figure 2: ADF Income Structure



3.8 For the last couple of years, the Fund has recorded financial deficits for the following reasons:

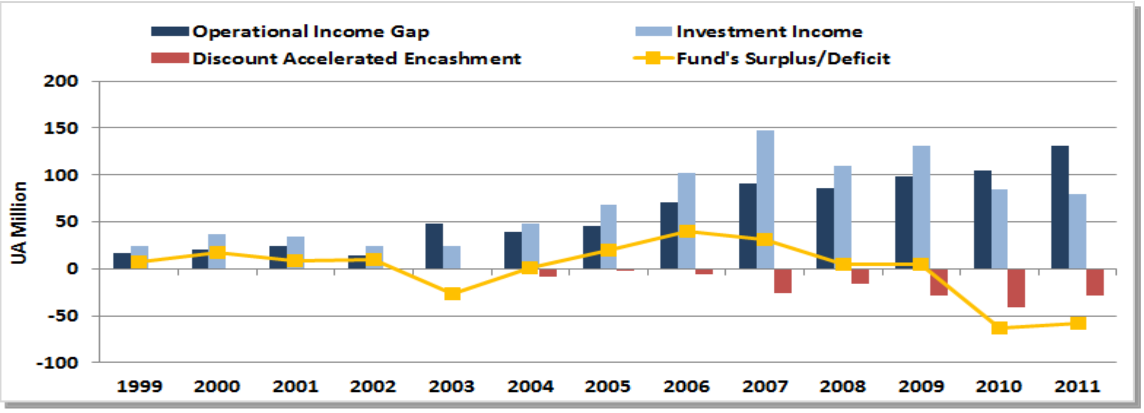
- Owing to the growth of its activities, Bank Group administrative expenses have been increasing since 2006 (see Figure 3) and have not been offset by similar growth in the Fund's loan income, which covers only 36% of the administrative expenses attributed to the Fund. This coverage ratio is much lower than that of other MDBs, and can be explained by (i) the impact of forgone loan income from grants and MDRI since 2006, and (ii) the fact that outstanding loans represent a larger share of other MDBs' operating assets compared to those of the Fund (see Annex I). As a consequence, the Fund relies more heavily on investment income to fill its operational gap.

Figure 3: ADF Operational Gap



- The current global low interest environment has a significant impact on the Fund's investment income and hence the ability of the investment income to cover the deficit (see Figure 4). It is important to stress that the Fund applies a prudent investment policy which is more geared to the preservation of its capital, for the management of its investment portfolio.

Figure 4: Coverage of Operational Income Gap with Investment Income



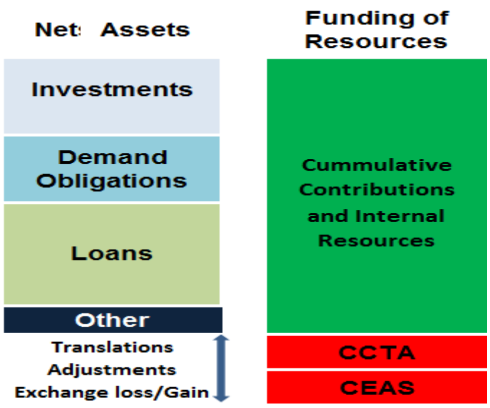
Exogenous Issues: Interest Rate Risk and Currency Risk

3.9 **Interest rate risk:** As indicated above, the currently low level of interest rates is the primary external factor affecting the Fund's financial results. Owing to the ADF's financial structure, its net income is strongly influenced by the income generated by its investment portfolio, on which it relies to close the income gap. The investment portfolio is very sensitive to prevailing interest rates worldwide, and its income contribution to the Fund fluctuates in line with these. For example, the Fund's investment portfolio, which returned more than 4% in 2006, provided below 2.2% in 2011 (this is in line with the return generated by other MDBs: see Annex I). Thus the Fund's net income has been decreasing significantly over the past three years (See Figure 4).

3.10 There is also a need to optimize the management of interest rate risk deriving from the discount granted to state participants when they accelerate the encashment of the promissory notes used to pay for ADF subscriptions. For the ADF-12 replenishment, the discount rates were defined during the replenishment negotiations at a time when interest rates were high, but in the currently low interest rate environment, the Fund has difficulty recouping these discounts through the income generated by investments.

3.11 **Currency risk:** The Fund is also affected by currency exchange rate risk in the form of Cumulative Currency Translation Adjustment[5] (CCTA) and Cumulative Exchange Adjustment on Subscription[6] (CEAS). In the current circumstances, CCTA and CEAS are sources of currency translation losses, which affect the Fund's resource base as well as its potential commitment capacity (see Figure 5) and therefore will continue to be vigilantly monitored and managed.

Figure 5: Currency translation



[5] The Cumulative Currency Translation Adjustment (CCTA) measures translation risks which occur when the Fund's Net Assets (Net Development Resources & Outstanding Loans) denominated in the Fund's operational currencies (basket of SDR currencies) are revalued periodically against the SDR at different rates for reporting purposes.

[6] Cumulative Exchange Adjustment on Subscriptions (CEAS) occurs due to the change in the SDR value of a subscription between the exchange rate used for the determination of pledges and the date the payments are received. As donor countries generally provide their subscriptions in their national currencies, the SDR value of this subscription fluctuates against the SDR.

Prospects

3.12 Projections of the Fund's sources and uses of income indicate that its reported deficit situation arising from the low returns on investment is not likely to improve in the short or medium term unless there is a reversal of interest rate trends. The Fund's financial deficit directly affects its net development resources and consequently the resources available for commitment capacity. Even when taking into account stress tests with a further decrease of 50 bps in interest rates (which are already at a historically low level), however, the Fund's annual deficit will not increase significantly and is not expected to exceed UA 100 million in the coming years. This amount would be further reduced below UA 32 million if the additional resources that will be received as compensation for forgone income from grants and MDRI are taken into account. Therefore Management does not expect the current financial deficit to worsen beyond such a level, and the deficit could improve if interest rates start to rise.

Financial Results (Sustainability) Versus Financial Capacity

3.13 In light of the assessment performed above, Management has explored a number of measures aimed at improving the Fund's financial performance. While developing these, the question was raised whether Management should put more emphasis on the financial results of the Fund as reported in the income statement (ability to break even) or on its financial capacity to fund new operations (ability to enhance the commitment capacity).

3.14 As indicated earlier, the Fund's deficit is attributable to structural, endogenous and exogenous factors for which limited leeway and controls are available. Indeed, as per its mandate, the Fund must maintain an adequate level of concessionality for the loans it extends. Furthermore, the deficit reported so far and projected in the medium term does not have a significant impact on the Fund's financial performance, as it is largely explained by the structural changes highlighted above (forgone income from grants and MDRI for which it gets compensated by donors). Thus Management believes that the Fund should put more emphasis on measures aimed at enhancing the Fund's financial capacity by increasing its commitment capacity to fund new operations over the long term.

3.15 Nevertheless, it should be noted that measures aimed at addressing financial results and measures aimed at increasing financial capacity are complementary and interrelated. On the one hand, by reducing deficits, the Fund protects its commitment capacity and the resources available for development purposes. On the other hand, by increasing its commitment capacity, the Fund builds potential for additional loans, yielding increased loan income and enhancing its ability to break even.

4. Measures Undertaken During ADF-12 to Improve Financial Sustainability

4.1 This section outlines various measures that Management has already taken or is in the process of taking during the ADF-12 period. These measures are essentially aimed at limiting the negative impact of the financial results on the Fund's commitment capacity available for development. Possible additional measures to be considered for the ADF-13 period are set out in Section 5. Given its limited control over exogenous and structural factors, however, Management believes the mitigation measures should focus on protecting and maximizing the Fund's commitment capacity rather than improving the financial results as reported.

4.2 The measures undertaken during ADF-12 can be categorized into three types: (i) financial-resource management measures focusing on enhancing disclosure of forgone income due to grants and MDRI; (ii) financial policy measures aimed at reducing the Fund's operational gap, mainly related to budgetary and cost-control measures and maintaining a prudent investment strategy; and (iii) risk mitigation measures related to currency and interest rate management in order to preserve the Fund's commitment capacity.

Financial Resources Management Measures

4.3 **Enhanced disclosure of forgone income due to MDRI and grants**: Management is not considering changing the modalities of grant provision or MDRI implementation, which are critical for Low-Income Countries (LICs). However, their impact on the Fund's reported net income position cannot be ignored. Management believes that greater clarity and transparency in reporting on this issue would be beneficial, and has therefore started to publish supplementary disclosures in order to provide a comprehensive picture of the Fund's performance. This is accomplished through periodic disclosures of the impact of the forgone income from grants and MDRI, as reported in ADF Financial Statements (see document ADF/BD/WP/2012/16).

Financial Policy Measures

4.4 **Stringent cost controls and budgetary discipline**: The Bank Group's commitment to administrative efficiency and cost containment (see the Mid-Term Review paper "Institutional Effectiveness") helps to reduce the pressure exerted by administrative expenditures on the Fund's deficit/operational gap. Despite increasing demands on the Bank Group to scale up its development assistance, Management continues to implement cost savings and efficiency measures in order to contain administrative expenses[7]. In addition, the administrative cost-sharing formula for apportioning expenses between the ADB and the ADF is reviewed by the Board of Directors every three years. The next review will take place in 2013.

4.5 **Continued implementation of a prudent investment strategy**: Pursuant to the Liquidity Policy (see footnote 2), liquidity levels have previously been adjusted in order to enhance the Fund's income generation capacity and enable investment income to cover the Fund's operational gap. It is important, however, to recall that the primary purpose of the Fund's liquidity is to provide a buffer against the uncertainty of cash flows under both normal and stress situations. The current decline in investment income is directly related to the current low interest rate environment that prevails in financial markets, affecting the Fund and its peers. Market volatility and an uncertain macro-economic outlook mean that striving to generate higher investment income entails taking more risk which, to a large extent, is not consistent with the objective of preserving the integrity of the Fund's resources. Therefore, in the current challenging global financial market environment, Management proposes to maintain the overarching twin objectives of the Fund's investment strategy: strengthening the risk profile of the investment portfolios and limiting the volatility of their returns. This investment strategy has successfully helped the Fund to achieve reasonable investment returns while protecting treasury assets from losses and the negative impacts of the financial crisis.

Risk Management Measures

4.6 As set out in more detail in the Board document "ADF Long-Term Financial Sustainability", Management has taken measures to protect the Fund's replenishment resources against potential losses resulting from adverse market rate movements. These measures consist mainly of (i) a better alignment of the Fund's net assets to the currency composition of the SDR (Special Drawing Right), and (ii) the creation of a distinct portfolio to invest the proceeds from accelerated encashment of promissory notes. In addition, for ADF-13, Management intends to propose a revised framework for accelerated encashment in order to further mitigate interest rate risks. Through these risk management measures, the exposure of the Fund's commitment capacity to market risk is minimized, and the risk of over-commitment of resources and subsequent inability to meet disbursement requests is further mitigated.

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[7] As a result of cost control measures, the total bank group administrative expenses for 2011 remained the same as for 2010 despite increase in activities; and as part of cost containment measures, headcount increase was frozen in the 2012 budget.

5. Potential Measures to Strengthen ADF Financial Capacity and Ensure an Appropriate Use of Resources, to be Discussed during the ADF-13 Consultations

5.1 The purpose of this section is to present options to strengthen the ADF's financial capacity to fund new operations over the long term, and to ensure an optimal use of ADF resources for development purposes, which goes beyond the issue of ADF financial sustainability (the Fund's ability to consistently generate income equal to or greater than its expenditure).

5.2 The countries eligible for the ADF have grown increasingly diverse in terms of their level of income, (in) equality and socio-economic development, and circumstances such as structure of the economy and availability of natural resources (see Annex III for several illustrations). This diversity implies that the Bank should regularly re-evaluate the ADF's eligibility criteria and financing terms in order to adequately address the needs of RMCs, respond to their changing priorities and development objectives, and ensure an appropriate allocation of ADF resources among eligible countries.

5.3 The ADF's most significant source of funding is donor contributions, which represent 67% of total resources for ADF-12.[8] The Fund's internally generated resources (or Advance Commitment Capacity, ACC) increased from UA 1.2 billion for ADF-10 to UA 2.01 billion for ADF-12. This limited level of the ACC and the continued substantial needs of ADF countries imply that strong efforts will be required from both the Bank Group and donors to help the Fund sustain the pace of its development assistance to eligible RMCs. Apart from ensuring the adequate management of donor resources, Management proposes to explore several options to increase the Fund's financing capacity and to ensure that the available resources are allocated appropriately.

5.4 These options are: (i) revised ADF lending terms, (ii) differentiated financial terms among groups of ADF-only countries, (iii) encouragement of graduation, (iv) accelerated repayment and voluntary pre-payment of ADF loans, and (v) possible new and innovative financial instruments. These options are not mutually exclusive. Subject to Deputies' guidance, Management proposes to further elaborate on these for discussion during the ADF-13 consultations.

Revised ADF Lending Terms

5.5 In January 2012, during the informal Board discussion on ADF long-term financial sustainability, several options for the revision of the Fund's lending terms were analyzed (see document ADF/BD/WP/2011/148), with the objective to improve the Fund's internally generated resources, reflows (loan principal repayments and loan charges), and financial capacity. The following three options were considered: Option 1 - Increase of the commitment fees from 50 bps to 75 bps; Option 2 - Increase of the service charge from 75 bps to 100 bps; and Option 3 - Decrease of the maturity of the loans for ADF-only countries[9] from 50 to 40 years.

5.6 In the Board document, Management recommended Option 3 for the following reasons:

(i) It has no immediate financial impact on ADF-only countries given that loan service charges are not increased;

(ii) It has a high positive financial impact for the Fund over the long term, as shorter maturities will increase reflows as well as the Fund's ACC after the 10-year grace period. With these additional reflows that will enhance its commitment capacity, the Fund can increase its outstanding loan base, thus improving the Fund's cost coverage ratio and decreasing the sensitivity of the income statement results to revenues from the investment portfolio;

(iii) It enables the Fund to maintain a level of concessionality equal to or above the concessional window of other MDBs (IDA and AsDF). A review of the term structure of sister institutions' soft windows (summarized in Annex I) indicates that the Fund has the

[8] The total resource envelope for ADF-12 amounts to UA 6.1 billion and includes Advanced Commitment Capacity, or internally generated resources, of UA 2.01 billion.

[9] Maturity of loans for blend and gap countries was already reduced from 50 to 30 years in ADF-12.

longest loan maturity and the highest degree of concessionality among MDBs.

5.7 Annex IV provides additional details on the pros and cons, and on the financial impact, of the three options.

5.8 While in general Board members did not object to the proposal of reducing the maturity of loans for ADF-only countries, the principal guidance received was to explore differentiating lending terms within the category of ADF-only countries, with the objective to maintain soft lending terms for the most vulnerable countries while considering the application of harder terms to the most economically advanced countries.

5.9 Thus, the options presented to revise the ADF lending terms could be considered in conjunction with a proposal to differentiate financial terms among ADF-only countries.

Differentiating Financial Terms

5.10 In accordance with the Bank Group's Credit Policy, RMCs are currently classified as ADF-only (category A, including gap countries), ADB-only (category C) or a blend (category B), as set out in Table 2.

Table 2: African Development Bank Group Country Classification as of 01/01/2011 (ADF-12)

		Creditworthiness to Sustain International Bank of Reconstruction and Development Financing*	
		No	**Yes**
Per capita income above the ADF/IDA operational cut-off for more than 2 consecutive years	**No**	ADF-only countries on regular ADF terms	Blend countries eligible for ADB resources and for ADF resources subject to a cap and blend terms
	Yes	Gap countries not eligible for ADB resources but eligible for ADF resources on blend terms	Eligible only for ADB resources. Exceptionally, graduating countries are eligible for ADF resources on blend terms during a 2- to 5-year phasing-out period

* *The ADB's Credit Policy prescribes that World Bank country classification criteria be followed; hence, the references to IBRD financing and the International Development Association's operational cut-off.*

5.11 Over the years the ADF-only countries have grown increasingly heterogeneous in terms of their economic and financial capacity (see Annex III). The category now includes fragile states with low income per capita, a high risk of debt distress and low levels of human development, and countries with relatively high income per capita and human development, low risk of debt distress and substantial access to the international financial markets. The fact that countries with such large differences can draw resources from the ADF at the same concessionality level raises the question of whether it would be more appropriate to distinguish among different groups of ADF-only countries that share similar levels of economic and human development, and to apply differentiated lending terms that are better aligned with their economic circumstances.

5.12 Applying harder financial terms to ADF-only countries that have the capacity to shoulder them would be in line with the ADF mission of focusing on the neediest countries in Africa. Differentiated lending terms would also contribute to the Fund's medium- and long-term financial sustainability and capacity. Preliminary internal projections show that the Fund is likely to be catering solely to ADF-only countries by 2025, as all blend and gap countries would have graduated to the ADB. Absent any changes in lending terms including differentiation, the ADF would be providing only grants and highly concessional loans, and the percentage of grants would be substantially higher than what it is today (since a number of loan-only countries would have graduated). In this context, decreasing the overall concessionality level embedded in the Fund's portfolio by hardening the terms for certain groups of ADF-only countries would substantially contribute to the maintenance of its future financial capacity.

5.13 Management proposes to examine various criteria for grouping ADF-only countries and applying differentiated lending terms. These would include but are not limited to countries':

- Level of economic, social and/or infrastructure development;
- Capacity to access international financial markets on a durable and sustainable basis;
- Fiscal and financial management capacity and reporting.

5.14 The criteria may also further distinguish fragile states that receive loans as well as small countries with limited ADF resources whose creditworthiness is hampered by unique characteristics (high transport costs, e.g., land locked countries, severe human capital constraints, small population, etc.) that make it difficult to pursue economies of scale. Annex V contains examples of three options for distinguishing and applying differentiated lending terms to two groups of ADF-only countries on the basis of (i) income level, (ii) income level and access to international financial markets, and (ii) level of human development and infrastructure capacity. If Deputies agree for Management to explore these and/or other alternatives, additional quantitative and qualitative analysis will be conducted to determine their statistical robustness and ability to strengthen the Fund's financial capacity and sustainability.

5.15 The principle of applying differentiated financing terms has been implemented by other MDBs such as the IDA and AsDF, and ADF has been applying this principle in ADF-12 by differentiating the financing terms of ADF loans between ADF-only countries on the one hand and gap, blend and graduating countries on the other (see Table 2). In line with the guidance received from Board members and the current proposal of differentiating ADF lending terms within the category of ADF-only countries based on their economic, financial and social development, Management proposes to examine different pricing options to achieve a level of concessionality (grant element) that is commensurate with the characteristics of each identified group. It is important to highlight that, subject to Deputies' guidance, the Fund will seek to maintain a level of concessionality for ADF-only countries above or equal to that offered by its peers. In all cases, applicable financial terms will need to be consistent with the Bank Group Policy on Non-Concessional Debt Accumulation and that of the IMF and the World Bank (WB), including countries' DSA classification.

5.16 If Deputies agree to pursue this option, further work will include simulations of how differentiation would affect ADF financial sustainability and capacity.

Encouraging Graduation

5.17 Eligibility for graduation from ADF to blend or ADB-only is currently determined by countries' Gross National Income (GNI) per capita (Atlas method) and level of creditworthiness. Countries whose GNI per capita surpasses the operational cut-off (USD1,195 for FY 2012-13) for more than two consecutive years and that are assessed to be creditworthy for non-concessional financing on ADB terms, graduate to ADB-only status. Countries with an income level below the operational threshold but that are found creditworthy are classified as blend[10].

5.18 According to internal projections, around 20% of the current ADF-eligible countries are expected to be in a position to graduate to the ADB before 2024. These countries are approaching or have already surpassed the GNI per capita threshold, show low levels of risk of debt distress and benefit from consistent access to international financial markets. In addition, some of them have substantial natural resources (oil, etc.) whose exploitation can fuel economic growth and rapidly increase per capita income.

5.19 For the Fund, the graduation of eligible countries will free up resources that can be used for other, needier ADF recipients, thereby further promoting an efficient use of resources for development.

[10] In exceptional circumstances, blend countries can graduate to ADB-only status despite their income being below the threshold.

5.20 For the countries in a position to graduate, however, there may be trade-offs to consider. Even when countries can access a higher volume of financing upon graduation to the non-concessional window[11], the trade-off between volume and cost of funding may not be straightforward. Two main factors contribute to this: (i) the substantial gap between the grant share embedded in ADF loans (66% for ADF-only countries and 41% for blend and gap) and that of ADB loans (22%), and (ii) country access to large volumes of financing from other sources on terms that are comparable to those provided by the ADB.

5.21 In this context, Management proposes to take a more pro-active approach towards graduation. The Bank will undertake regular, periodic creditworthiness assessments of ADF countries approaching the income threshold and will engage in discussions with these countries, focusing on the process and advantages of graduation. These include the potential increased volume of resources that they would have access to from the ADB public-sector window, ADB private-sector window, Middle Income Countries Trust Fund, other trust funds managed by the Bank, and possibly the capital markets; the financial instruments and other services that they would be able to make use of; and the support that the Bank can offer in attracting more third-party financing, improving the regulatory environment and business climate, strengthening domestic financial markets, etc. Further analysis will highlight that a graduation to ADB status may in fact be beneficial to the country in terms of the amount of overall subsidy available through the Bank's operations. This is due to the fact that the volume of lending available under the ADB window is likely to be significantly higher than under the ADF window, thereby counterbalancing the lower grant component. Management will inform the Board of the potential reclassification of countries that are likely to graduate. This will allow Management to anticipate changes in the composition of the Fund's lending mix and enable countries to better prepare for changes in their financial terms.

5.22 The financial impact of the graduation of countries to blend or ADB-only status on the long-term sustainability and financial capacity of ADF will depend on the number of graduating countries, those in each lending category, and the differentiation (if any) of lending terms among ADF-only countries.

Accelerated Repayment and Voluntary Prepayment of ADF Loans

5.23 Recognizing that member countries' economic circumstances change over time, and that a number of them will graduate from the Fund to the ADB thanks to substantial economic development and achieving creditworthiness, the Fund should have provisions in place that build on such structural changes by modifying the profile of the member's repayment obligations so as to better align with the country's improved ability to repay loans. Management proposes to create such provisions, which would result in faster repayment of outstanding ADF loans and thus improve the Fund's commitment capacity, by introducing (i) an accelerated-repayment clause in all new ADF loan agreements starting in ADF-13 (2014) and (ii) a framework for voluntary prepayment of ADF loans by countries that have graduated to the ADB.

5.24 The accelerated-repayment clause would stipulate that the member country can be required to accelerate the repayment of the loan if the following two conditions are met: the country's GNI per capita has remained above the operational cut-off for more than two consecutive years, and it is creditworthy for borrowing from the ADB. The member would be able to choose a Principal Option, which doubles the rate at which principal is repaid to the Fund (i.e., shortens the loan's maturity) or an Interest Option which, while maintaining the maturity of the outstanding loan, increases the interest rate applicable to such loan so as to achieve the same concessionality as the Principal Option. (For more details, see Annex VI.)

5.25 Management sees the introduction of an accelerated-repayment clause as a simple, transparent and fair mechanism to redirect Fund resources from its more economically successful members to the poorer and more disadvantaged borrowers. Given the forward-looking nature of this clause, and the difficulty of applying it retroactively to existing loan agreements (consent of the member country would be required), Management does not expect it to have a material impact on the Fund's short-term financial position. A full study on

[11] See *Transition Framework for Countries Changing Credit Status*. ADB/BD/WP/2011/20/Rev.2, para. 4.9.

the impact of the introduction of the Accelerated Loan Repayment clause on the long-term financial sustainability of the Fund will be prepared for the ADF-13 discussions.

5.26 A framework for voluntary prepayment of loans would complement the accelerated-repayment clause in that it would apply to all ADF loans outstanding to graduated countries that do not contain the acceleration clause. The framework would allow the Fund to offer discounts to countries if and when they decide to prepay their ADF loans, in order to incentivize them. The guiding principles and operating methodology of a Voluntary Loan Prepayment Framework would be very similar to what has been done in the ADF at the donor level, with discounts on the accelerated encashment of notes. The prepayment discount offered will be determined case by case, depending on the prevailing market conditions and hedging possibilities. The rate used to calculate the prepayment discount will not exceed that of the investment return that the Fund expects to achieve with the funds over the disbursement period of the relevant replenishment. (See Annex VI for more details.)

5.27 While financial impacts of voluntary prepayment may initially be limited, it is expected that in the long run, as more countries graduate, the impact would be greater and more resources would be freed up for ADF-only countries. Based on the periodic creditworthiness assessments of ADF countries approaching graduation, it will be possible to project the countries that will become ADB-only in the next 5 to 10 years and the impact that accelerated loan repayment and voluntary loan prepayment would have on ADF resources.

5.28 Accelerated repayment and voluntary prepayment have been successfully employed by sister institutions. The IDA and the AsDF have, since the late 1980s, included an acceleration clause in all of their loan agreements. They decided to exercise the accelerated-repayment clauses in the outstanding loan agreements of eligible countries for the first time in IDA-16 and AsDF-XI, yielding additional resources for these replenishments of UA 1.2 billion and UA 150 million, respectively. In addition, the IDA and the AsDF also have a framework for voluntary prepayment of concessional loans by borrowers that have graduated to the non-concessional window. In IDA-16, voluntary prepayments yielded an additional UA 592 million for the replenishment.

5.29 Management seeks Deputies' guidance on its proposal to introduce an accelerated-repayment clause as of ADF-13 (2014), and on whether it should further explore the development and implementation of a Voluntary Loan Prepayment framework in ADF-13, including discussions with the ADB countries that it concerns.

Possible New and Innovative Financing Instruments

5.30 Due to the high degree of concessionality of the ADF (long repayment period, no interest, low service charge and commitment fees), the level of reflows is insufficient to provide a substantial amount of new financing to meet RMCs' needs. At the same time, given that many traditional donor countries are facing financial difficulties, there is need to look at ways of better leveraging the Fund's resources through co-financing arrangements and financial innovation. Management intends to explore various options for introducing new instruments or financing modalities and, to this end, seeks an open exchange of views and ideas with Deputies at the Mid-Term Review on the most appropriate options for the ADF.

6. Conclusions and Recommendations

6.1 In the current resource-constrained environment, with most donors facing budgetary issues and high social demands, it is imperative to optimize the use of the Fund's resources and protect its commitment capacity. Given that the Fund's revenue-earning loan assets do not generate sufficient revenue to cover all of its expenditures and that the scope for adjusting loan terms is limited due to low income countries' need for concessional financing terms, Deputies' guidance is particularly sought on whether Management should focus on measures required for the ADF to break even (i.e., increasing loan income) or a combination of these with measures aimed at protecting and preserving ADF's commitment capacity.

6.2 The impact of the current deficit does not threaten the Fund's financial sustainability and capacity in the short or medium term. The magnitude of the deficit may largely be considered as arising from financial accounting reporting concept and is limited when taking into account the full compensation for forgone income from grants and MDRI. In addition, the situation will gradually improve as outstanding loans will build up over time and if short-term interest rates, which are currently historically low, start rising.

6.3 During ADF-12, Management has already taken measures within its purview to limit negative effects on the Fund's resources and improve its financial performance. Deputies' guidance and views are sought on the following additional options, for discussion during the ADF-13 replenishment, to enhance further the Fund's long-term capacity to finance new operations and ensure an appropriate use of ADF resources:

- Revision of ADF lending terms;
- Differentiation of financial terms among groups of ADF-only countries;
- Encouragement of graduation;
- Accelerated repayment and voluntary prepayment of ADF loans; and
- Possible new and innovative financial instruments.

6.4 These options are not mutually exclusive. Based on Deputies' guidance, Management will develop concrete proposals for discussion during the ADF-13 replenishment consultations.

Annex I: Comparative Analysis with Other MDBs' Concessional Windows

Comparison of Deficit/Surplus

In recent years, both the IDA and AsDF have reported a deficit at some point (Table I-1). Unlike ADF however, these two funds are not required to break even. Their financial-management objective is to protect their commitment capacities from currency and interest rate risks. It is also worth noting that both the IDA and AsDF report grants as expenses rather than allocation of development resources, as does the ADF. In addition, the IDA recognizes net income transfers from the IBRD and IFC as income, while the ADF recognizes net income transfers from ADB as other resources.

Table I-1: Net Income of Multilateral Development Banks

Net Income	2009	2010	2011
International Development Association - IDA (USD million)	**1,850**	**(1,077)**	**(2,332)**
Asian Development Fund - AsDF (USD million)	**(424)**	**(676)**	**(976)**
African Development Fund - ADF (UA million)	**5**	**(63)**	**(58)**

Comparison of Outstanding Loans

The comparative analysis in Table I-2 below indicates that outstanding loans represent a larger share of the IDA and AsDF balance sheets and generate a larger share of their earnings, explaining the better coverage of expenses. This also indicates that the ADF's balance sheet depends more heavily on the performance of its investment portfolio.

Table I-2: Comparison of Loans Outstanding as a Percentage of Operating Assets and Loan Income as a Percentage of Operating Income

Outstanding Loans as a % of Operating Assets				
	2008	2009	2010	2011
IDA	--	80	80	81
AsDF	81	84	85	84
ADF	61	63	67	70

Operating Assets = Loans + Investments

Loan Income as a % of Operating Income				
	2008	2009	2010	2011
IDA	--	61	50	74
AsDF	49	67	73	77
ADF	32	31	41	48

Operating Income = Income from Loans + Investments

Comparison of Return on Investment

A comparative analysis of other MDBs' financial statements indicates that the Fund's investment strategy compares favorably with that of the IDA and AsDF, as their return on investment is comparable or lower than the ADF's (Table I-3).

Table I-3: Comparison of Return on Investment (%)

	2008	2009	2010	2011
International Development Association - IDA	--	2.88	1.88	1.10
Asian Development Fund - AsDF	4.31	2.50	2.05	1.75
African Development Fund - ADF	3.38	4.18	2.72	2.20

Comparison of Lending Terms

For countries eligible for the concessional window only, **the Fund has the longest maturity for its loans among all its peers and the highest degree of concessionality.** The comparative lending terms in Table I-4 indicate that for a loan of a similar amount, given the identical service and commitment charges for the IDA and ADF, one would expect a larger amount of loan income in present value terms from the IDA, whose loans are repaid over 40 years, compared with 50 years for the Fund. The situation is even more pronounced for the AsDF, as not only is the maturity of its loans shorter, but also the interest rate charges are higher.

Table I-4: Comparative Lending Terms of Multilateral Development Banks' Concessional Windows

	Product Type	Maturity	Grace Period	Service Charge (%)	Commitment Charge (bp)	Interest Charge (%)	Concessionality (%)	No. of blend countries	Blend/gap loans as a % of outstanding loans
IDA-16	Regular	40	10	0.75	0 – 50	0	60		
	Blend and gap	25	5	0.75	0 – 50	1.25	35	25	36*
	Hardened terms	25	5	0.75	0 – 50	2.80	20		
AsDF	Regular	32 for project loan	8	0	0	1.00 during grace period 1.50 during amortization period	Between 43 and 49		
		24 for program loans	8	0	0				
	Blend	25 for all loans	5	0	0	2.00 during entire period		15	71
ADF	Regular	50	10	0.75	50	0	66		
	Gap, blend and graduating	30	8	0.75	50	1.00	41	4	0

* *36% of IDA total commitments as of June 2011.*

Regarding gap and blend countries, other MDBs also apply less concessional lending terms than does the Fund, and the outstanding loan balance of these types of loans is more significant. The Fund introduced differentiated loan terms for gap, blend and graduating countries only during ADF-12. These differentiated loan terms currently apply to only four countries[12] that have a negligible disbursed and outstanding balance, as they apply only to loans approved since 2011. For other MDBs, harder terms are applied to a larger number of countries and represent a larger proportion of outstanding loans. This is particularly the case for the AsDF, where 15 countries are classified as blend out of 28 countries eligible to borrow from the concessional window, and approximately 71% of the outstanding loan balance[13] is disbursed to blend countries. As regards the IDA, out of 80 countries currently having access to the concessional window, 16 are categorized as blend and 9 are categorized as gap eligible to borrow on blend terms. As of 30 June 2011, 20 countries received blend term credits in IDA-16, representing 36% of IDA total commitments for the fiscal year. Therefore, the larger share of blend and hardened terms for the IDA and AsDF is generating more income.

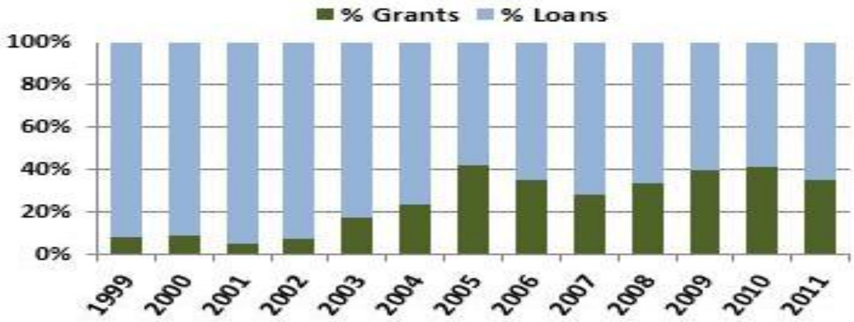
[12] Differentiated loan terms are applied to one blend country (Nigeria), one gap country (Republic of Congo) and two graduating countries (Angola and Cape Verde).

[13] AsDF outstanding as of 30 September 2011.

Annex II: Increasing Level of Grant and MDRI Forgone Income

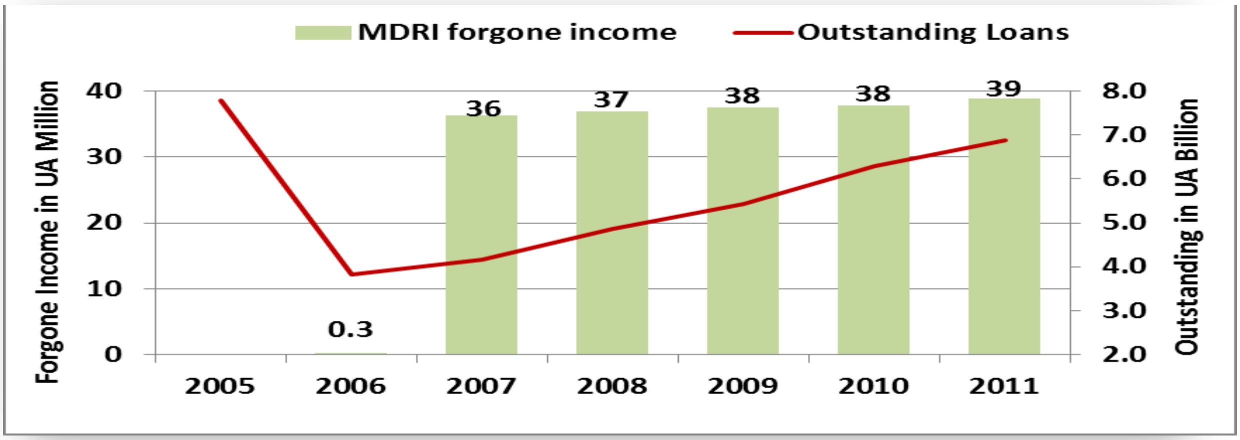
As illustrated in Figure II-1, including the Fragile States Facility, the share of grants in new Board approvals was below 10% before 2002, and exceeded 40% in 2005, 2009 and 2010. For 2011, the loan/grant mix is 76/24, in line with ADF-12 projections. The forgone income from grants since 2003 has averaged UA 12 million per year. Although the Fund is compensated for forgone income on grants through an upfront charge, such compensation is not accounted for as income for the Fund, but rather is retained in liquidity.

Figure II-1: Grants and Loans Approvals



Loan charges on loans cancelled under the MDRI would have formed part of the Fund's loan income. However, although the loan charges associated with cancelled loans will be compensated, such compensations are received in the form of additional subscriptions and are accounted for as such and not as loan income. While to the extent that the dollar-for-dollar compensation is received in full and on time the Fund is financially indifferent with respect to MDRI cancellations, the fact remains that *reported* income has been reduced, thereby contributing to the worsening of the operational income gap. Forgone income arising from MDRI, shown in Figure II-2, has averaged UA 31 million per year since 2006. Figure II-2 also shows that the outstanding loans dropped from UA 7.79 billion in 2005 to UA 3.89 billion in 2006 following loan cancellations under the MDRI.

Figure II-2: MDRI Forgone Income



Annex III: Descriptive Statistics and Growth Evolution of ADF-only Countries

This annex illustrates the increasing heterogeneity observed among ADF-only countries and the increased financial capacity of a number of them in recent years. Key points include:

- The poorest ADF-only countries exhibited slower economic growth than richer ADF-only countries during the last decade, thus increasing the income gap between countries within the category.
- Financial capacity, as measured by the level of Gross National Income per capita (GNI pc), the risk of debt distress and the access to international financial markets, has increased remarkably for some ADF-only countries, but not for others.
- GNI pc is in general a good indicator of human development among ADF-only countries, but there are some exceptions.

Overview

Since the implementation of the current Bank Group Credit Policy in 1995, only four countries have graduated from ADF to ADB-only (see Table III-1). Currently, of the 40 ADF-eligible countries, 37 are classified as eligible for ADF-only (Category A, see Table III-2). Within this category, just one gap country receives different (harder) financial terms, as its GNI pc has remained above the IDA's operational cut-off for more than two consecutive years.

Table III-1: ADF Graduations 1995-2011

Country	Year of Graduation
Egypt	1999 (from blend to ADB-only)
Equatorial Guinea	1999 (from ADF-only to ADB-only)
Cape Verde	2009 (from ADF-only to blend) 2011 (from blend to ADB-only)
Angola	2011 (from ADF-only to ADB-only)

Table III-2: Number of Countries per Category in ADF-12*

		Creditworthiness to Sustain IBRD Financing	
Per capita income above the ADF/IDA operational cut-off for more than two consecutive years		**No**	**Yes**
	No	ADF-only: 36	Blend: 1
	Yes	Gap: 1	ADB-only: 15**

* *Does not include South Sudan. ** Among the 15 ADB-only countries, Angola and Cape Verde are in the process of graduating and therefore remain eligible for ADF resources during the transition period.*

General Characteristics of Growth, 2000-2010

The 2000-2010 period was characterized by a growing divergence in income level between countries in the ADF-only category and by richer countries' growing (on average) faster than poorer ones, with differences in relative incomes between richer and poorer countries increasing. In addition, the richer countries within the category have tended, on average, to display higher economic growth rates than the poorer ones. As a result, countries that started the decade at the upper tail of the distribution (i.e., richer) also tended to end the period in that position.

Table III-3 shows the evolution of the two groups of countries: the countries with GNI pc above the average in 2000 ("richer"), and the countries with GNI pc below the 2000 average ("poorer"). The average per capita growth rate for the countries belonging to the richer group was 2.7%, while per capita growth was on average 2.2% in the poorer group. More variation, however, was observed in the richer group, which ended the decade with a wider distribution of outcomes. In other words, countries that started in the "rich" group in 2000 tended to grow at higher rates, but with greater differences in performance among them. Yet the group of poorer ADF-only countries registered a much higher percentage of countries displaying negative growth rates, at 20% versus 8% for the richer group.

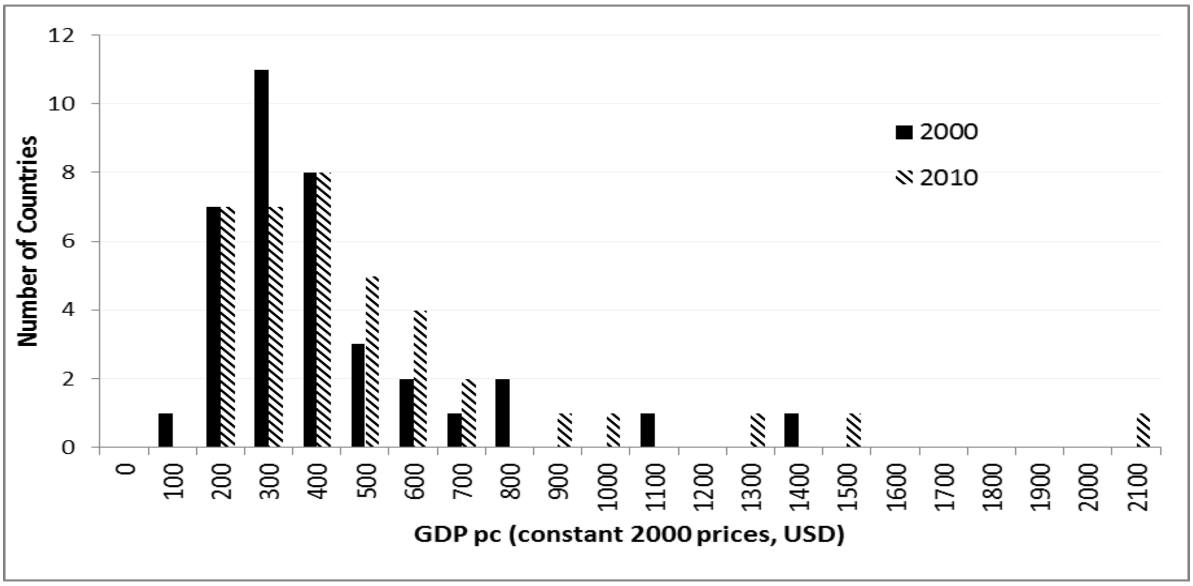
Table III-3: Annual Real Per Capita Growth Rates, ADF-only Countries, 2000-2010

	Average per Capita Growth Rate (%)	Standard Deviation (measure of variation/dispersion)	Percentage of Countries with Negative Growth (%)
ADF-only richer in 2000	2.72	3.13	8.33
ADF-only poorer in 2000	2.24	2.38	20.00
Overall	**2.40**	**2.66**	**15.78**

Source: ADB.

Figure III-1 shows the change in the distribution of the ADF-only countries in terms of GDP per capita between 2000 and 2010. While the overall distribution has moved toward higher levels of GDP per capita, the bulk of ADF-only countries are still at the lower tail of the distribution. We also observe a considerable increase in the gap between the richest and the poorest country in the group (from USD 1,218 in 2000 to USD 1,971 in 2010) and a higher dispersion of outcomes (from a standard deviation of 250 in 2000 to 389 in 2010).

Figure III-1: Distribution of ADF-only countries' GDP per capita in 2000 and 2010

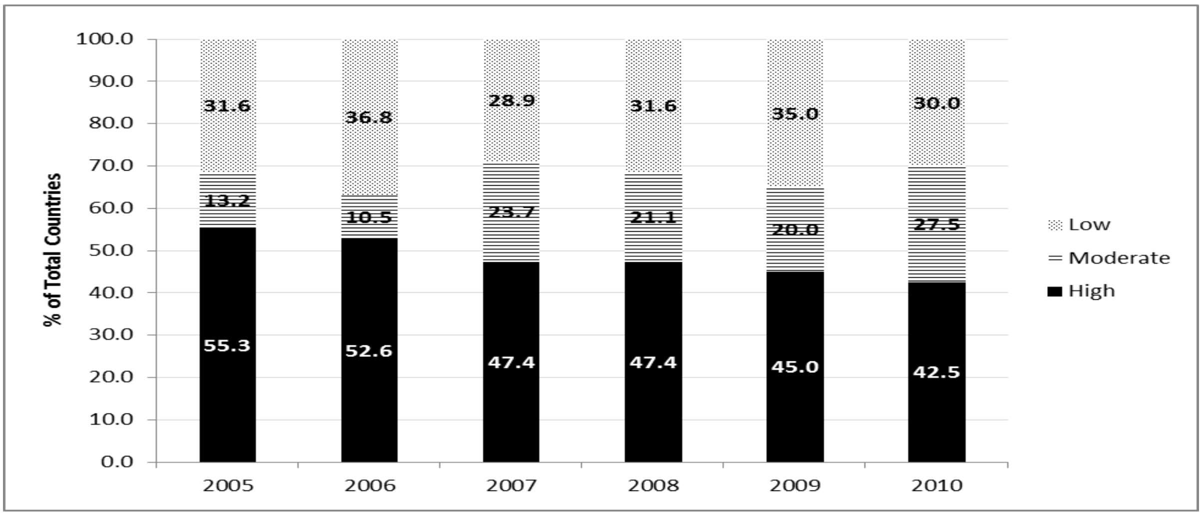


Source: ADB.

Risk of Debt Distress and Access to International Financial Markets

Figure III-2 and Table III-4 focus on the financial capacity of ADF-only countries to shoulder harder lending terms. Figure III-2 shows that the overall debt-distress risk profile of ADF-only countries, as measured by IMF/WB Debt Sustainability Analyses, improved during the period 2005-2010. The percentage of countries with a high risk of debt distress decreased from 55.3% in 2005 to 42.5% in 2010, while the share of countries with a low or moderate risk increased from 44.7% in 2000 to 57.8% in 2010. This latter group of countries now has more capacity to borrow.

Figure III-2: Risk of Debt Distress in ADF-only countries, 2005-2010



Source: International Monetary Fund.

Another dimension to measure a country's financial capacity is in terms of its capacity to access international financial markets. Table III-4 lists all ADF-only countries that issued public and publicly guaranteed debt at some point during 2005-2009, along with their risk of debt distress and their GNI pc (Atlas method) in 2010. In addition to Cape Verde, which graduated in 2011, there are several countries with a 2010 GNI pc above 80% of the 2010 operational cut-off for ADF eligibility[14], either low or moderate risk of debt distress and registered access to international financial markets between 2005 and 2009; namely Cameroon, Ghana, Mauritania, Senegal and Zambia. In other words, several ADF-only countries exhibit a considerably higher financial capacity than the other ADF countries.

Table III-4: ADF-only Countries with Public and Publicly Guaranteed (PPG) Debt

	PPG External and Commercial Bonds (Disbursement in USD Million)						2010 GNI pc (% of 2010 operational cut-off for ADF-only)*	2010 Risk of Debt Distress
	2005	2006	2007	2008	2009	Cumulative 2005-2009		
Cameroon		1.4			8	9.4	98.7	Low
Cape Verde	0.9	0.1				1.0	268.9	Low
Ghana	47.2	28.9	796.2	55.9	276.7	1204.9	105.5	Moderate
Kenya	28.4	1.3				29.7	66.4	Low
Madagascar				0.1	0.0	0.1	37.5	Low
Mali	3.2	1.5			2.5	7.2	51.1	Low
Mauritania	15.5				15.6	31.1	90.2	Moderate
Senegal		4.1			200.0	204.1	89.4	Low
Tanzania	19.1	13.2	3.1			35.4	45.1	Low
Zambia	2.7	52.3	1.7	0.1		56.8	91.1	Low

* *Operational threshold in 2010 equal to USD 1,175.*

Sources: IMF for PPGs and risk of debt distress; WB for 2010 GNI pc, Atlas method.

GNI pc and Human Development

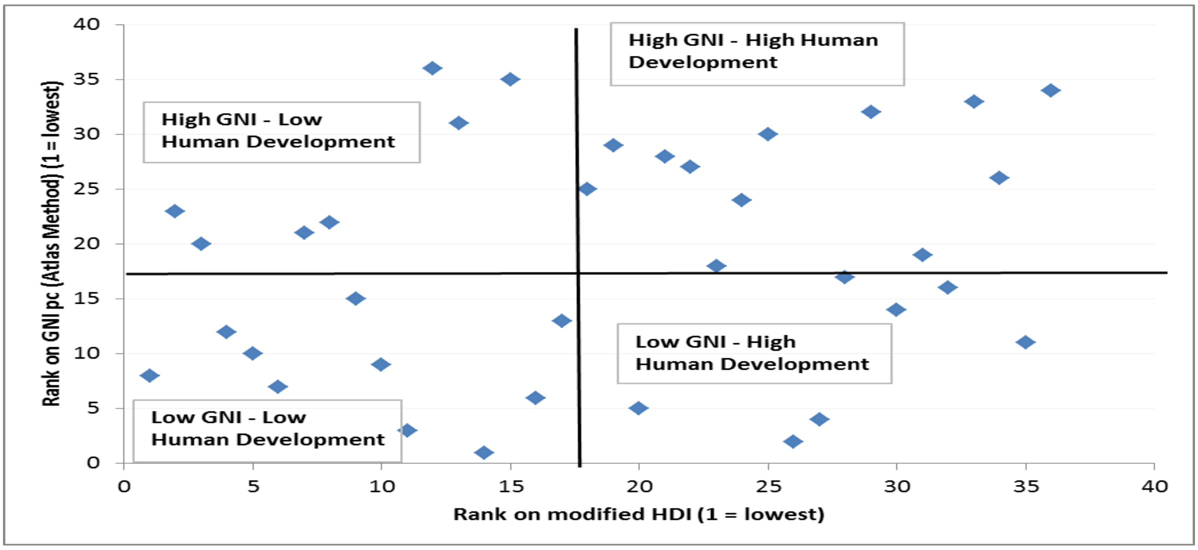
While GNI pc is a generally accepted indicator of economic progress and capacity, it does not necessarily measure how well-off people are in terms of their level of human development or standard of living. To test this relationship among the group of current ADF-only countries, Figure III-3 plots countries' relative position in terms of GNI pc (Atlas method) against their ranking on the health and

[14] The IMF uses 80% of the operational cut-off as a reference point for graduation from its concessional financing window under the market-access criterion.

education components of the Human Development Index[15]. To facilitate the analysis, the Figure is divided into four areas in accordance with the level of both variables.

The Figure shows that for most ADF-only countries, the relationship between the two indicators is positive: on average, countries with a higher GNI pc tend to score higher on the health and education indicators in the HDI, and vice versa. This implies that GNI pc can be seen as a fair indicator of the level of human development in ADF countries[16]. There are, however, some exceptions of concern located in the upper left quadrant: for this group of seven ADF-only countries, a relatively high GNI pc corresponds to a relatively low level of human development.

Figure III-3: GNI pc vs. Score on Health and Education Indicators in 2010 (Ranking)



[15] Geometric mean of the scores on the education and health indicators included in the HDI (thus excluding GNI pc) as calculated using the HDI methodology.

[16] The main difference between GDP and GNI is that the latter includes the income received from other countries (e.g. interest and dividends) less similar payments made to other countries

Annex IV: Financial Impact of Hardening the ADF Lending Terms under Various Scenarios

There is a direct link between the lending terms, the level of concessionality enjoyed by borrowers, and the financial sustainability and capacity of the Fund. Hardening lending terms reduces the concessionality (grant element) of loans to borrowers, but improves the financial sustainability of the Fund. There are three major options for hardening lending terms: (i) increase of the commitment fees on undisbursed balances, (ii) increase of the service charge or interest rate and (iii) decrease of the maturity of the loans or shortening of the grace period.

In general, increasing the commitment fee, the service charge or the interest rate will generate more income in the short and medium term, while shortening the maturity or grace period will over time generate more reflows to be recycled for new commitments. In the document on ADF long-term financial sustainability discussed informally by the Board in January 2012, three options were considered: Option 1 - Increase of the commitment fee from 50 bps to 75 bps; Option 2 - Increase of the service charge from 75 bps to 100 bps; and Option 3 - Decrease of the maturity of the loans for ADF-only countries from 50 to 40 years. Table IV-1 below summarizes the pros and cons of these options.

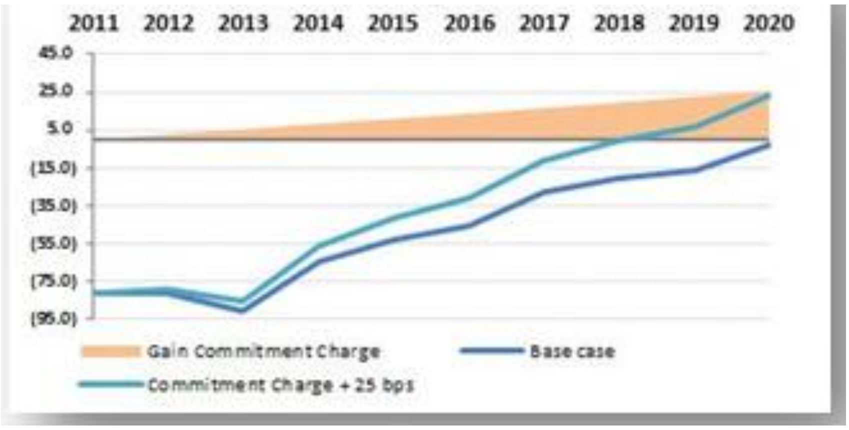
Table IV-1: Summary of Pros and Cons for the Three Options for Hardening Lending Terms of ADF-only Countries

	Pros	Cons
Option 1: Increase of the commitment fees from 50 bps to 75 bps	- Additional income in the short term - Possible acceleration of disbursement - Improved financial sustainability	- Immediate increased burden on ADF-only recipient countries - No significant additional loan reflows compared to current lending terms - Limited increase of the commitment capacity in the short and medium term - Higher commitment fees than IDA
Option 2: Increase of the service charges from 75 bps to 100 bps	- Additional income in the short and medium term - Improved financial sustainability	- Immediate increased burden on ADF-only recipient countries - No significant additional loan reflows compared to current lending term - Limited increase of the commitment capacity in the short and medium term - Higher service charge than IDA
Option 3: Reduction of the loan maturity from 50 to 40 years	- No increased burden on ADF-only recipient countries in the next 10 years - In the long term, increased reflows due to faster repayment of loans - Improved financial commitment capacity and long-term sustainability - Alignment with IDA lending terms for competitiveness	- No additional income in the short and medium term - No improvement of the financial sustainability in the short and medium term

Financial Impact of Option 1: Increasing the commitment fee from 50 bps to 75 bps

Assuming commitment fees are raised by 25 bps from their current level of 50 bps, all other financing terms remaining the same, the degree of concessonnality would decrease slightly from 66% to 64.4% but would remain above peers' (60% for IDA and 49% for AsDF). This scenario would bring in additional revenue in the short term, with additonal income estimated at UA 26 million for 2020. The scenario would also possibly induce borrowers to accelerate the rate of loan draw-downs thereby increasing the volume of loans disbursed and outstanding, which would result in increased revenues in future years. However, this option would lead to higher commitment fees than the IDA's and immediately increase the burden on ADF-only recipient countries. In addition, loan reflows and accelerated commitment capacity would not improve and would remain less favorable than those of other MDBs, for which loans have shorter maturities.

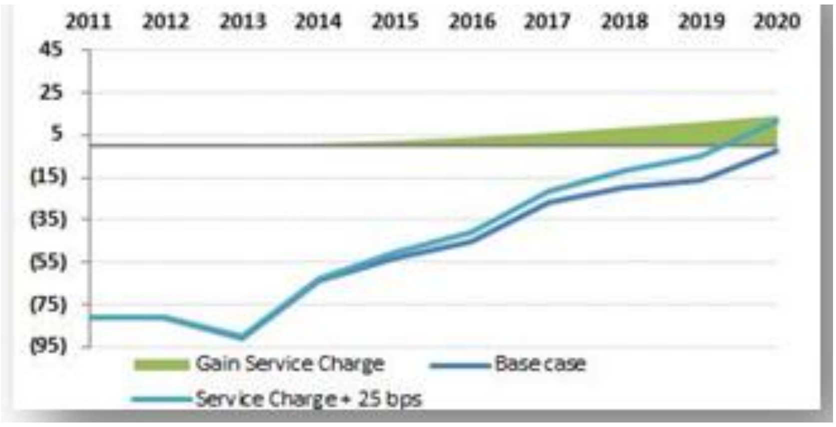
Figure IV-1: Option 1: Increasing the commitment fee from 50 bps to 75 bps



Financial Impact of Option 2: Increasing the service charge from 75 bps to 100 bps

Assuming that service charges are increased to 100 bps from their current level of 75 bps, all other financing terms remaining the same, the degree of concessonality would decrease from 66% to 62.3%, but would remain above peers'. This scenario would bring in additional revenue in the short and medium term, with additional income estimated at UA 14 million in 2020. However, this option would also lead to higher service charge than the IDA's and immediately increase burden on ADF-only recipient countries. In addition, loan reflows and accelerated commitment capacity would not improve and would remain less favorable than those of other MDBs, for which loans have shorter maturities.

Figure IV-2: Option 2: Increasing the service charge from 75 bps to 100 bps



Financial Impact of Option 3: Reducing loan maturity from 50 to 40 years

Assuming that the maturity of ADF loans is reduced from 50 to 40 years with the grace period remaining at 10 years, the degree of concessionality of ADF loan would decrease from 66% to 60%, similar to the IDA's. This scenario would not generate additional loan income in the short and medium term but would result in significant loan reflows after the 10-year grace period. The loan reflows expected from this scenario are evaluated by using the hypotetical case of a single loan pool of UA 1 billion and by estimating the impact of loan reflows on the Advanced Commitment Capacity (ACC).

Impact of reflows for a single loan pool

An analysis is provided on the impact of loan reflows when the loan maturity is reduced from 50 to 40 years for a single hypothetical loan pool of UA 1 billion over a period of 80 years, all other lending parameters being equal, and not taking into account the impact of new additional loans granted in subsequent years.

Figure IV-3 below clearly indicates that loan reflows would start increasing after the 10-year grace period. Figure IV-4 provides information on the size of the increase compared to the original size of the loan pool and indicates that after 40 years, additional reflows (compared to 50 years maturity) are estimated to represent approximately 41% (408/1000) of the original loan pool, while they will represent approximately 68% (682/1000) of the original loan pool after 80 years.

Figure IV-3: Cumulative Reflows from Single Loan Pool of UA 1 billion

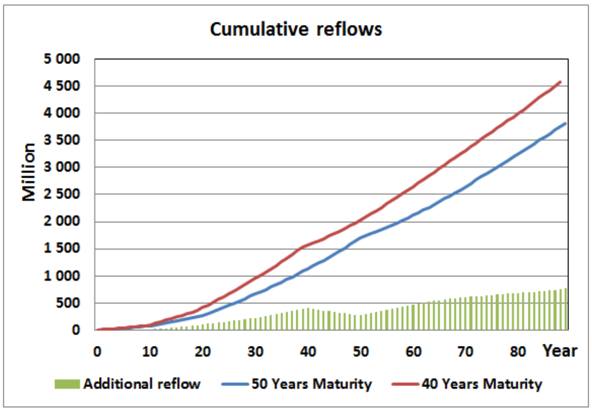
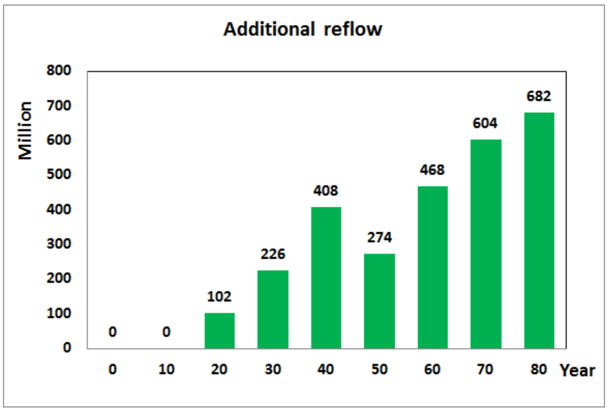


Figure IV-4: Comparison between Additional Reflows for Loans of 50- and 40-year Maturities



Impact of loan reflows on the Fund's ACC

Assuming that future replenishments will be maintained at the same level as ADF-12, the Fund's cash-flow analysis indicates that reflows will start rising exponentially after the grace period, starting from 2025, and will average annually approximately UA 270 million. This scenario would also have a positive impact on the Fund's ACC starting from ADF-16, when reflows are expected to arise. The ACC is expected to increase by approaximately UA 300 million for ADF-16[17] and for subsequent replenishments.

Conclusion

Of the three options presented in the Board document, Management's believes that Option 3 "Reduction of the loan maturity from 50 to 40 years" strikes the most appropriate balance between the various issues facing the Fund, including the need to address its financial deficit and to protect its long-term financial sustainability and capacity, while continuing to provide concessional financing commensurate with ADF countries' circumstances and needs, in comparable terms to its peers operating in Africa (mainly the IDA).

In the current context, with many donors facing budgetary constraints, Option 3 particularly addresses the issue of increasing internally generated resources, through the increase in the expected additional reflows it would generate in medium and long term. This, in turn, would lead to an improvement in the Fund's commitment capacity, which would enable it to scale its operations, thus further enhancing its importance as the reference provider of development finance in Africa.

The financial impact of differentiated lending terms applied to groups of ADF-only countries will be analyzed as part of the further work following Deputies' guidance on the criteria and parameters of such differentiation.

[17] Key assumptions made for the determination of the ACC for ADF-12 (loan cancellations, transfers from ADB, investment income, etc.) are maintained and the reduction of the loan maturity applies to all ADF-only countries.

Annex V: Examples of Differentiating Among ADF-only Countries

In this annex we develop, for illustrative purposes, three options for distinguishing groups of ADF-only countries, on the basis of (i) income level, (ii) income level and access to international financial markets, and (iii) income level, human development and infrastructure capacity. If Deputies agree to explore these and/or other alternatives further, additional quantitative and qualitative analysis will to be conducted to determine statistical robustness and the ability to strengthen the Fund's financial capacity and sustainability. Different pricing options (combination of maturity, grace period, commitment fee, service charge and interest rate) to achieve a level of concessionality that is commensurate with the characteristics of each identified group will also be developed.

General Working Assumptions

For simplicity, the three options presented in this Annex are based on the premise that two groups of countries will be distinguished within the ADF-only category. The analysis assumes that the criteria for classifying countries as ADF-only (Category A, including gap), blend (Category B) and ADB-only (Category C) will not change; it also assumes that the differentiation of ADF lending terms between ADF-only and blend/gap/graduating countries will remain as it is today. The analysis in this annex therefore refers to the 36 ADF-only countries excluding gap countries. Finally, the current criterion for defining the financial mix of grants and loans in countries' ADF allocations is also assumed to remain unchanged: the IMF/WB Debt Sustainability Framework (DSF) traffic light classification[18].

Option 1: Gross National Income Per Capita

This option uses countries' income level (as measured by the GNI per capita, Atlas method) as the sole criterion for distinguishing groups of countries within the ADF-only category. Countries with a GNI pc above the average of all the countries in the category are included in the "high" GNI pc group, while the rest are included in the "low" group[19]. The grouping would be revised at the beginning of each ADF cycle in order to limit volatility in countries' lending terms during the cycle.

Resulting Grouping

Table V-1 shows the resulting grouping into high and low if Option 1 is applied. The average GNI per capita of all the countries in the category is USD 653, and 13 countries are above the average (i.e., in the high group) while 23 are below (in the low group).

Harder loan terms would apply only to "High" ADF-only countries eligible for loans, i.e., "green" or "yellow" in the DSF classification. Currently 22 ADF-only countries receive either 50% or 100% of their Performance Based Allocation (PBA) in the form of loans (i.e., exhibit low or moderate risk of debt distress). Within this group, eight countries are in the high group while the other 14 are in the low group. Table V-2 shows the share of each of group in terms of PBA allocation. Under this grouping, the high-income group concentrates almost 33% of the PBA envelope and 35% of all loans provided to ADF-only countries in 2012.

If countries change their color of Debt Sustainability Framework traffic light during the ADF cycle and their financial mix changes, then the lending terms that apply to their group will also apply to them. For example, if Guinea Bissau's DSF classification changes from red to yellow, then the lending terms applied to the low group would apply to the loan portion of its allocation.

18 According to the current methodology, countries with a high risk of debt distress (i.e., "red" as per the IMF/WB DSF traffic-light classification) receive 100% of their PBA allocation in the form of grants. Countries with moderate risk of debt distress (i.e., "yellow") receive 50% of their allocation in the form of grants and 50% in the form of loans. Finally, countries exhibiting low risk of debt distress ("green") receive 100% of their allocation in the form of loans.

19 If this option is put forward, further analysis will be required to define whether an absolute rather than a relative threshold would be more suitable.

Table V-1: Grouping of ADF-Only under Option 1 (GNI pc)

Country	2011 DSF Status	2010 GNI pc (Atlas Method; USD)	Group
Sudan*	Red	1,340	High
Djibouti	Red	1,310	High
Ghana	Yellow	1,230	High
São Tomé & Príncipe	Red	1,200	High
Cameroon	Green	1,180	High
Côte d'Ivoire*	Red	1,160	High
Senegal	Green	1,090	High
Zambia	Green	1,070	High
Lesotho	Yellow	1,040	High
Mauritania	Yellow	1,030	High
Kenya	Green	790	High
Benin	Green	780	High
Comoros*	Red	750	High
Chad	Yellow	620	Low
Mali	Yellow	600	Low
Guinea-Bissau*	Red	590	Low
Burkina Faso	Red	550	Low
Tanzania	Green	530	Low
Rwanda	Yellow	520	Low
Uganda	Green	500	Low
Togo*	Yellow	490	Low
Central African Republic*	Yellow	470	Low
Zimbabwe*	Red	460	Low
Gambia	Red	450	Low
Mozambique	Green	440	Low
Madagascar	Green	430	Low
Guinea	Red	400	Low
Ethiopia	Green	390	Low
Niger	Green	370	Low
Sierra Leone*	Yellow	340	Low
Eritrea	Red	340	Low
Malawi	Yellow	330	Low
Liberia*	Green	200	Low
Congo DRC*	Red	180	Low
Burundi*	Red	170	Low
Somalia	Red	170	Low

* *Countries benefiting from Pillar I of the ADF's Fragile States Facility. Note: 2010 GNI pc threshold (average) was USD 653.*

Table V-2: 2012 PBA Allocation per Group under Option 1

Group	% of 2012 PBA Envelope	% of 2012 PBA Loans
High GNI pc	33.65	35.5
Low GNI pc	66.34	64.4
Total	**100**	**100**

Table V-3: Strengths and Weaknesses of Option 1

Strengths	Weaknesses
Clear and simple criterion. Reliable data available for all African countries.	Does not account for differences in development needs (e.g., inequality, progress in terms of MDGs, etc.). Not an exhaustive measure of countries' capacity to shoulder differentiated lending terms.

Option 2: GNI Pc and Access to International Financial Markets

This option uses countries' GNI pc (Atlas Method) relative to a threshold and their degree of access to internal financial markets as the criteria to distinguish groups within the ADF-only category. Countries with a GNI pc (Atlas method) greater than or equal to 80% of the ADF operational cut-off (USD 1,175 in 2010), *and* a cumulative public or publicly guaranteed (PPG) external debt issuance in international markets between 2005 and 2009 of at least 50% of their ADF-12 2012 PBA allocation, are included in the "high income/high access" group while the rest are included in the "low income/low access" group. The grouping would be revised at the beginning of each ADF cycle in order to limit volatility in countries' lending terms during the cycle.

Resulting Grouping

Table V-3 shows the resulting grouping into "high" and "low" if the Option 2 criteria are applied to the ADF-only countries. Only four countries currently meet both criteria and are therefore included in the "high income/high access" group, while the remaining 32 countries are in the "low" group. Table V-4 shows the share of each of group in terms of PBA allocation. Under this grouping, the high group concentrates almost 14% of the PBA envelope and the loans provided to ADF-only countries in 2012.

Table V-4: Grouping of ADF-Only under Option 2 (GNI pc and access to financial markets)

Country	Cumulative PPG between 2005 and 2009 (as % of ADF-12 PBA allocation)	2010 GNI pc (Atlas method) (as % of ADF operational cut-off)	2011 DSF Status	Group
Mauritania	565.35	95.81	Yellow	High
Ghana	483.72	114.42	Yellow	High
Senegal	193.84	101.40	Green	High
Zambia	53.57	99.53	Green	High
Tanzania	9.30	49.30	Green	Low
Kenya	8.68	73.49	Green	Low
Cameroon	8.26	109.77	Green	Low
Mali	5.93	55.81	Yellow	Low
Madagascar	0.14	40.00	Green	Low
Sudan*	0.00	124.65	Red	Low
Djibouti	0.00	121.86	Red	Low
São Tomé & Príncipe	0.00	111.63	Red	Low
Côte d'Ivoire*	0.00	107.91	Red	Low
Lesotho	0.00	96.74	Yellow	Low
Benin	0.00	72.56	Green	Low
Comoros*	0.00	69.77	Red	Low
Chad	0.00	57.67	Yellow	Low
Guinea-Bissau*	0.00	54.88	Red	Low
Burkina Faso	0.00	51.16	Red	Low
Rwanda	0.00	48.37	Yellow	Low
Uganda	0.00	46.51	Green	Low
Togo*	0.00	45.58	Yellow	Low
Central African Republic*	0.00	43.72	Yellow	Low
Zimbabwe*	0.00	42.79	Red	Low
Gambia	0.00	41.86	Red	Low
Mozambique	0.00	40.93	Green	Low
Guinea	0.00	37.21	Red	Low
Ethiopia	0.00	36.28	Green	Low
Niger	0.00	34.42	Green	Low
Sierra Leone*	0.00	31.63	Yellow	Low
Eritrea	0.00	31.63	Red	Low
Malawi	0.00	30.70	Yellow	Low
Liberia*	0.00	18.60	Green	Low
Congo DRC*	0.00	16.74	Red	Low
Burundi*	0.00	15.81	Red	Low
Somalia	0.00	15.81	Red	Low

* *Countries benefiting from Pillar I of the ADF's Fragile States Facility.*

Table V-5: 2012 PBA Allocation per Group under Option 2

Group	% of 2012 PBA Envelope	% of 2012 PBA Loans
High GNI pc/high financial access	13.69	13.98
Low GNI pc/low financial access	86.31	86.02
Total	**100%**	**100%**

Table V-6: Strengths and Weaknesses of Option 2

Strengths	Weaknesses
Clear and simple criteria. Reliable data available for all African countries. More complete measure of countries' capacity to shoulder differentiated lending terms. Incentives for countries to limit their non-concessional borrowing.	Does not account for differences in development needs (e.g., inequality, progress in terms of MDGs, etc.). Potential disincentive for countries to seek market resources. Lag in market access data.

Option 3: GNI pc, level of Human Development and Infrastructure Capacity

This option groups ADF-only countries in accordance with their level of human development and infrastructure capacity by using a combination of GNI pc, the social indicators included in the Human Development Index and the African Infrastructure Development Index produced by the African Development Bank.

Building the Composite Index

Four indicators are used for the construction of the Human Development & Infrastructure Development (H&I) Index employed here: GNI pc (Atlas method, World Bank), the HDI Education Index (UNDP), HDI Health Index (UNDP) and the African Infrastructure development Index (ADB). A country's score on the H&I Index is the sum of its scores on the four rescaled indicators. Countries that score above the average are included in the high group, while those scoring below average are included in the low group. The grouping would be revised at the beginning of each ADF cycle in order to limit volatility in countries' lending terms during the cycle.

Resulting Grouping

Table V-5 contains the resulting grouping if Option 3 is applied to the current ADF-only countries. The average score on the H&I Index is 1.70; there are 19 countries above the average (high group) and 16 countries below the average (low group).

Harder loan terms would apply only to the "High" ADF-only countries eligible for loans, i.e. "green" or "yellow" in the DSF classification. Currently 22 ADF-only countries receive either 50% or 100% of their PBA allocations in the form of loans (i.e., exhibit low or moderate risk of debt distress). Of these, 13 countries are in the high group while the remaining 9 are in the low group. Table V-6 shows the share of each of group in terms of 2012 PBA allocation. Under this grouping, the high group concentrates 48% of the total PBA envelope and more than 51% of all loans provided to ADF-only countries in 2012.

If countries change their color of DSF traffic light during the ADF cycle and their financial mix changes, then the lending terms that apply to their group would also apply to them. For example, if Côte d'Ivoire's DSF classification should change from red to yellow, then the lending terms applied to the high group would apply to the loan portion of its allocation.

Table V-7: Grouping of ADF-only Countries under Option 3

Country	Human Development and Infrastructure Index	2011 DSF Status	Group
São Tomé & Príncipe	3.33	Red	High
Ghana	3.28	Yellow	High
Senegal	2.57	Green	High
Comoros*	2.54	Red	High
Djibouti	2.54	Red	High
Cameroon	2.44	Green	High
Kenya	2.39	Green	High
Sudan*	2.34	Red	High
Mauritania	2.33	Yellow	High
Gambia	2.19	Red	High
Zambia	2.12	Green	High
Lesotho	2.11	Yellow	High
Madagascar	2.07	Green	High
Côte d'Ivoire*	2.07	Red	High
Zimbabwe*	1.94	Red	High
Uganda	1.85	Green	High
Benin	1.81	Green	High
Togo*	1.80	Yellow	High
Rwanda	1.76	Yellow	High
Tanzania	1.70	Green	Low
Malawi	1.64	Yellow	Low
Liberia*	1.33	Green	Low
Guinea	1.26	Red	Low
Eritrea	1.17	Red	Low
Mali	1.10	Yellow	Low
Guinea-Bissau*	1.07	Red	Low
Burkina Faso	1.07	Red	Low
Burundi*	1.03	Red	Low
Ethiopia	0.93	Green	Low
Congo DRC*	0.85	Red	Low
Central African Republic*	0.78	Yellow	Low
Mozambique	0.70	Green	Low
Chad	0.61	Yellow	Low
Niger	0.55	Green	Low
Sierra Leone*	0.48	Yellow	Low

* *Countries benefiting from Pillar I of the ADF's Fragile States Facility. Notes: 2010 composite index threshold was 1.70. Sources: WB and UNDP. Values for Somalia for Education, Income and Infrastructure Indexes were assumed to be equal to the Group's minimum.*

Table V-8: 2012 PBA Allocation per Group under Option 3

Group	% of 2012 PBA Envelope	% of 2012 PBA Loans
High H&I	48.13%	51.46
Low H&I	51.86	48.53
Total	**100**	**100**

Table V-9: Strengths and Weaknesses of Option 3

Strengths	Weaknesses
Data available for all countries except Somalia. Considers explicit social development indicators in addition to GNI pc. Infrastructure component aligned with the Bank's Operational Priorities. Infrastructure index measures dimensions of inclusive growth that are not captured by the HDI. High concentration of ADF-only loans in high human development/high infrastructure capacity group.	Not a comprehensive measure of social development needs (although more comprehensive than Options 1 and 2). Not an exhaustive measure of countries' capacity to shoulder differentiated lending terms.

Annex VI: Accelerated Repayment and Voluntary Pre-payment of ADF Loans

This annex sets out Management's initial thinking on the contours of an Accelerated Loan Repayment Clause and a Voluntary Prepayment Framework. These thoughts are subject to discussion with the ADF Deputies, followed by further elaboration and presentation of a concrete proposal for consideration and approval by the Board of Directors. The exact parameters of the clause and the framework will be shaped by these discussions.

Accelerated Loan Repayment Clause

In a context of an increasing global scarcity of capital, Management believes the Fund should strive to ensure that its limited resources are allocated equitably among recipient members, with due regard to the needs of the lowest-income countries in particular. Member countries' economic circumstances change over time, and some (will) experience (very) rapid economic growth and achieve creditworthiness, meaning that they will transition from the Fund into the Bank Group's less concessional window, the ADB. The Fund should therefore have provisions in place that can accompany such structural changes -- provisions that could be used to modify the profile of the member's repayment obligations, reducing their concessionality and making them more commensurate with the lending terms for the member's new borrowings at the ADB. A clause in ADF loan agreements stipulating that the member country shall repay the loan in an accelerated manner once it has graduated to ADB-only status is such a provision.

Applying an accelerated loan repayment clause in the context of the Fund could be done easily and transparently. A borrowing member could be subject to loan repayment acceleration if the following two conditions are met:

- its GNI per capita has remained above the ADF operational cut-off for more than two consecutive years; and
- it is found creditworthy for borrowing on ADB terms.

The acceleration clause would therefore generally be exercised only once a country has graduated from the concessional window to the non-concessional window of the Bank Group. Satisfaction of both criteria would trigger a review, which takes into account country and other factors deemed relevant. Based on the findings of the review, the Board of Directors could endorse the amendment of the member's loan terms with the Fund. The member could then choose a Principal Option, which doubles the rate at which principal is repaid to the Fund (i.e., shortens the loan's maturity) or an Interest Option which, while maintaining the maturity of the outstanding loans, increases the interest rate applicable to such loans so as to achieve the same concessionality as the Principal Option. In both cases, a minimum grace period of, for example, eight years should have elapsed. Finally, it is important to note that it would be proposed that the clause include a provision accounting for a potential deterioration of the member's economic condition, at which point, after the member's request and conditional upon the Board of Directors' approval, the modification of the lending terms could be reversed.

The inclusion of this type of accelerated loan repayment clause is not new in the context of Multilateral Development Banks. It was first introduced in 1987 by the International Development Association and was refined in 1996 to increase operational effectiveness. The Asian Development Fund has also included this clause in its lending terms since 1988. The IDA and the AsDF decided to exercise the accelerated-repayment clauses in their loan agreements for the first time in IDA-16 and AsDF-XI, respectively. This yielded additional resources for the replenishments of UA 1.2 billion and UA 150 million, respectively.

Management believes that, as of ADF-13 (2014), the Fund should amend its lending terms and include an accelerated loan repayment clause with similar terms to those of its sister institutions, because:

- It is a standard loan agreement clause within the context of MDBs;
- It is a simple and transparent mechanism to redirect Fund resources from its more economically successful members to its poorer and more disadvantaged borrowers;
- It is a fair mechanism, as it can be applied only once a member has been able to sustain an improved economic position for a significant length of time and has graduated out of the ADF to the ADB window;
- It is a gradual mechanism, as even after the application of the acceleration clause the loans remain (highly) concessional when compared with standard ADB terms and, more importantly,

with market terms;

- It is flexible:
  - Firstly, even when a country satisfies the objective quantitative criteria to be eligible for loan-repayment acceleration, it is still subject to an economic review that takes into consideration member- and market-specific factors deemed relevant at the time of appraisal, which must be subsequently be approved (or rejected) by the Fund's Board of Directors**;**
  - Secondly, the acceleration of the lending terms can be reversed following a borrowing member's request and provided that the approval of the Fund's Board of Directors has been obtained. The original lending terms would thus be restored with respect to the remaining amount of the loan withdrawn and outstanding.

Given the forward-looking nature of this clause, and the difficulty of applying it in a retrospective manner (consent of the member country would be required), Management does not expect it to have a material impact on the Fund's short-term financial position. The effects would rather be felt in the long term, as the clause is included in more loan agreements and more countries graduate. A full study on the impact of the introduction of the Accelerated Loan Repayment clause on the Long-Term Financial Sustainability of the Fund will be prepared for the ADF-13 discussions.

Voluntary Loan Prepayment Framework

As presented above, the introduction of an accelerated loan repayment clause in the Fund's lending terms as of 2014 would not have an immediate impact on its financial sustainability, nor would it alleviate per se the concern that, in the near future, the Fund's resources will be allocated appropriately among its borrowing members given very diverse economic performances.

Therefore, as a complement to the acceleration clause, Management proposes to also develop a voluntary loan prepayment framework. This would allow the Fund to offer discounts to countries if and when they decide to prepay their outstanding ADF loans.

The guiding principles and operating methodology of the voluntary loan prepayment framework are highly similar to what has been done in the ADF at the donor level, with a discount provided for the accelerated encashment of their promissory notes and through the creation of the Fund's accelerated-encashment portfolio (ACE portfolio). The cornerstones of such framework at the ADF would be as follows:

Eligibility

The voluntary loan prepayment framework would be available only to member countries that have graduated from ADF- to ADB-only status and that are willing to prepay their outstanding ADF loans either by prepaying them in full, by voluntarily accelerating repayment of those loans that do not include an accelerated-repayment clause (which would constitute the bulk of the ADF loan book), and/or by accelerating repayments beyond what they are contractually obligated to in the case of loans that (will) contain the (new) accelerated repayment clause. For administrative efficiency, discounts would be offered only when the member country elects to prepay or accelerate all or a significant proportion of its outstanding loans, i.e., the member would not be able to pick and choose individual loans to pre-pay/accelerate.

The voluntary loan prepayment framework could in first instance apply only to countries with ADB-only status with outstanding ADF loans. These countries, with a total of approximately UA 447 million of loans outstanding, are: Angola, Botswana, Cape Verde, Egypt, Equatorial Guinea, Gabon, Mauritius, Morocco, Namibia, the Seychelles and Swaziland.

Ensuring the Fund's financial sustainability

Discounts offered to member countries that have graduated would not come at the expense of other member countries or the financial sustainability of the Fund. To that effect, the rate used to calculate the prepayment discount would not exceed that of the investment return, and a proper hedging mechanism will be set. The discount would therefore be determined case by case, depending on the prevailing market conditions and hedging possibilities.

The IDA and the AsDF already have established voluntary loan-prepayment frameworks, and Management would draw upon their experience when developing a similar framework for the ADF. It is noteworthy that for IDA-16, voluntary prepayments yielded an additional UA 592 million for the replenishment.

Benefits

A member country that elects to prepay or accelerate the repayment of its ADF loans would benefit from a discount on its outstanding loan principal amount and a reduction of its loan servicing cost[20], while contributing to making more resources available for less developed countries and giving a positive signal of its support for the ADF.

An additional incentive that could be offered is the possibility, currently included in the AsDF's framework, that if the actual investment income earned from the prepayment exceeds the foregone loan charges and the discount granted, the net investment income would be treated as a contribution by the prepaying country to the Fund. This could be a way for ADB countries that are ADF graduates to become donors, thereby demonstrating their solidarity with the needier countries and strengthening the African character of the ADF.

A voluntary loan prepayment framework, together with the introduction of an accelerated loan repayment clause, provide incentives to graduating member countries to prepay or accelerate payment of their loans with the Fund, while freeing up resources that can then be focused on the continent's neediest countries.

[20] These two advantages will become more relevant if/when interest rates revert to their historical mean.