ADF-14 Second meeting

Innovative Financial Instruments for ADF-14

Discussion Paper

ADF-14 Second Replenishment Meeting
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AFRICAN DEVELOPMENT FUND

Table of Contents

Tables and Figures

Annexes

Executive Summary

During the ADF-13 replenishment, Deputies set up a Working Group on innovative financial approaches for ADF-14. The Working Group met four times and its conclusions were discussed during the ADF-13 Mid-Term Review in September 2015. During ADF-14 first replenishment meeting, based on recommendations of the Working Group, Management provided additional information to Deputies on three financing innovations which were favored:

- **Concessional Donor Loans (CDL)** which enables the Fund to borrow from donor countries on concessional terms to improve its commitment capacity to beneficiary countries.
- **Bridge Loan (BL),** which also enables the Fund to borrow from donor countries on concessional terms to improve its liquidity position. Contrary to CDLs, resources from BLs are not on-lent but are kept in liquidity to smooth the Advance Commitment Capacity (ACC) over several replenishments, particularly during ADF-14 and ADf-15.
- **Buy-Down Mechanism (BDM)**, which enables eligible ADF Regional Member Countries (RMCs) to borrow from the ADB window the equivalent of their Performance Based Allocation (PBA), provided they comply with the Bank's revised credit policy. ADF then compensates ADB for the differential lending terms between the 2 institutions and this approach free up resources for the remaining ADF countries.

The paper recalls that the BDM and CDL target the same category of most creditworthy ADF countries and indicates the preference for the CDL which is more beneficial to the Fund. The paper also clarifies the implementation framework for the three innovative instruments and formulates recommendations to Deputies regarding the key features of these instruments as follows:

Substitution rule
For donors planning to provide loans during ADF-14, **Management proposes to implement an 80/20 substitution rule** to ensure that donor countries provide at least 80 percent of their ADF-13 subscription in the form of grant contribution, while the remaining 20 percent will be provided on a grant-equivalent basis of their loans.

Discount rate and Grant-element
The discount rate is the rate used to discount the borrowing cost of the debt contracted and to determine the grant-element used in the computation of burden shares and voting powers. **Management proposes a discount rate of 2.65%,** equal to the rate implemented by IDA during IDA-17, to ensure that donor loans be provided with a similar recognition as in IDA-17 in terms of grant-element and burden.

Prioritization rule
Management also proposes a prioritization rule to ensure that ADF countries obtain concessional resources in their preferred currencies and to enable Management to rank offers received by Donors in a simple and fair way that benefits the Fund.

Proposed allocation of excess CDLs to a hardened term window
In the event that an excess amount of CDL is received, Management proposes to create a hardened term window, which will benefit the most creditworthy ADF countries.

Target borrowing terms for CDLs and BLs

Management also provides in the document indicative target borrowing terms for CDLs and BLs based on prevailing market rates to enable donor countries to make their previsions for commitments during ADF-14.

The concessionality of donor loans is a key factor to ensure that the Fund remain sustainable and continue to provide lending on concessional terms to its beneficiary countries.

Deputies are expected to approve Management's recommendations during the second replenishment meeting for a successful implementation of the innovative instruments.

Abbreviations

ACC	Advanced Commitment Capacity
ADF	African Development Fund
AfDB	African Development Bank
ALM	Asset Liability Management
AsDB	Asian Development Bank
BDM	Buy-Down Mechanism
BL	Bridge Loan
CDL	Concessional Donor Loan
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
IDA	International Development Association
MDB	Multilateral Development Bank
PBA	Performance-Based Allocation
RAC	Risk-adjusted Capital
RCUR	Risk Capital Utilization Rate
RMC	Regional Member Countries
SDR	Special Drawing Right
TSF	Transition States Facility
UA	Unit of Account
WG	Working Group

Innovative Financial Instruments for ADF-14

I. Introduction

1.1 During the ADF-13 replenishment, Deputies set up a Working Group on innovative financial approaches for ADF-14. The Working Group met four times and its conclusions were discussed during the ADF-13 Mid-Term Review in September 2015. Based on the recommendations of this working group, Deputies requested Management to further explore the implementation of three instruments:

- **Concessional Donor Loan (CDL)**: The CDL is a loan offered by a development partner to the ADF at concessional terms, with an interest rate significantly lower than market rates and long maturities. These loans supplement available grant resources, increase the global pool and thereby increase the Fund's commitment capacity to beneficiary countries.

- **Bridge Loan (BL):** The BL is a concessional donor loan whose proceeds are not lent to borrowers, but kept to improve the Fund's liquidity and thus enhance its internally generated resources and its Advance Commitment Capacity (ACC). The increase in ACC during the grace period of the Bridge Loan (ADF-14 and ADF-15) is compensated by a lower ACC when the loan is being repaid, starting from ADF-16.

  Donors providing both CDLs and BLs are recognised on the basis of the grant element embedded in these loans. The additional resources from both the CDLs and the BLs (Concessional Loans and ACC) will benefit the Fund's global resource envelope and therefore all ADF eligible countries, including those in fragile situations, as well as supporting regional operations.

- **Buy-Down Mechanism (BDM)**: The BDM enables eligible RMCs to borrow from the AfDB the equivalent of their Performance-Based Allocation (PBA). To maintain the concessionality of these loans, grant resources are then made available by ADF as compensation for the differential between ADF and AfDB lending terms. As eligible countries will use the AfDB window, the Buy-Down will increase resources available to the remaining ADF countries. The BDM would be applied to graduating countries, blend countries and ADF green light countries. ADF yellow and red light countries, as well as countries facing fragile situations, do not fall directly under the BDM but will benefit from a larger resource envelope.

1.2 During the first ADF-14 replenishment meeting, these three financing innovations were discussed and Deputies requested Management to provide additional information on the implementation framework for these instruments, as well as their impact on compensations for grants in the long term. A less optimistic scenario for grant contributions was also requested, as well as additional information on Management's proposal to use CDL proceeds for on-lending to the private sector.

1.3 This paper provides the requested information, clarifies the implementation framework for the three innovative instruments and formulates recommendations to Deputies. Regarding Management's proposal to use CDL proceeds to increase ADF support to the private sector in ADF countries (the so-called "enhanced CDLs"), further analysis has demonstrated that lending to the private sector on harder (but still concessional) terms than is offered to public sector clients is one way to maximise the total volume of CDLs and therefore the financial resources available to support the SDGs and the H5s. Given that CDL proceeds blend with grant resources and are not earmarked for any specific use, financing the private sector concerns the ADF as a whole, rather than the CDL part of its envelope. Blending CDLs into the ADF and designing tailored lending products for the private sector that address specific market failures provides more efficient solutions than a direct pass through of CDLs for private sector operations. In accordance with the Deputies' request, a separate paper on "The role of ADF in Private Sector Development" addresses this issue in a more holistic way. However, this paper proposes a hardened window for CDLs over and above what the ADF would be able to absorb on the existing lending terms.

The impact of the three innovative instruments on the Grant Compensation Mechanism is addressed in the "ADF-14 Financing Framework" paper.

1.4 The paper is organised in 6 sections. Following the introduction, Sections 2, 3 and 4 summarise the key principles of the three innovative instruments and their implementation framework. Each section presents Management's recommendation for the operational modalities of each instrument during ADF-14. Section 5 proposes a debt limit framework to ensure that the Fund's debt will be sustainable. Section 6 provides Management's recommendations.

II. Concessional Donor Loans

Main principles

2.1 The key principles governing CDLs are as follows:

- ***Protection of the ADF grant-component (no substitution effect):*** Grants should remain the main source of financing for ADF;
- ***Preservation of ADF's long-term financial viability:*** The Fund's financial sustainability should not be negatively impacted by the introduction of debt in its financial framework;
- ***Recognition of donors providing CDLs:*** Through the grant element of their contributions in the form of concessional debt, donors should be recognised in terms of burden shares and voting powers;
- ***No earmarking of the proceeds of the CDLs:*** To the extent possible, the proceeds of CDLs should benefit all ADF countries.

2.2 At the first ADF-14 meeting in March 2016, participants welcomed the proposal to introduce Concessional Donor Loans as a mechanism to provide additional resources to ADF beneficiary countries through the introduction of debt into the Fund's financing framework. Some participants expressed concerns about various risks associated with these innovative instruments, particularly the substitution risk of grants for loans. At the meeting and through follow-up conversations, several donor countries provided feedback on elements of their proposed loans. The following sections focus on five specific issues related to the implementation of CDLs during ADF-14: (i) proposal to mitigate substitution risk; (ii) discount rate to calculate the grant-element; (iii) the currency in which CDLs will be denominated; (iv) payment schedule for CDLs; and (v) prioritization rule for CDLs.

Proposed rule to mitigate the substitution risk

2.3 Introducing a debt funding option within the ADF Financial Framework could create perverse incentives for donors to reduce their grant contributions. The highly concessional nature of ADF resources implies that the predominance of grant funding should be maintained. When donors substitute their core grant contributions with loan contributions, it is important to ensure that the overall concessionality of the Fund's resources is not reduced and that the majority of ADF eligible countries, who still need strong concessional support, continue to receive concessional resources without negative consequences on the Fund's long-term financial sustainability.

2.4 To ensure that CDLs have a positive impact on the Fund's resources and to mitigate this substitution risk, Management recommended a substitution rule during the first ADF-14 meeting. The two major conditions of this substitution rule were that:

i) The total contribution of any donor country that provides loans to the Fund (a CDL or a BL) must be at least equivalent to its ADF-13 contribution on a grant-equivalent basis; and
ii) Donor countries should commit to providing at least 90% of their ADF-13 basic burden share in the form of grants.

2.5 This substitution rule is known as the 90:10 rule. It should be noted that, despite the substitution rule, Donors' grant contributions may equal or exceed their ADF-13 contribution. This would help preserve the grant -component of the Fund and ensure that grants remain its main source of financing.

2.6 Some Deputies interested in providing loans to the Fund expressed reservations about Management's initial proposed 90:10 rule and asked for additional flexibility. Specifically, they requested that the ADF align its substitution rule to that implemented by IDA during IDA-17, where donor countries were requested to provide at least 80% of their IDA-16 basic burden share in the form of grants, in addition to the requirement that their total contribution should be at least equivalent to IDA-16's contribution on a grant-equivalent basis: the 80:20 rule.

2.7 In response to this feedback, various simulations were run to determine the impact on the ADF-14 projected resource envelope of the two options. The results suggested that the 80:20 rule would benefit the Fund, as the total size of the resource envelope would increase while maintaining an adequate level of grant resources. The simulations suggested that grant resources would decrease by UA 154 million (4%) under the 90:10 rule, and decrease by UA 269 million (7%) under the 80:20 rule. However, under the 80:20 option, if donor countries maintain the same overall level of grant-equivalent resource as for the previous replenishment, the overall resource envelope would increase by approximately 20.5%, because of the additional CDLs that would be required. Management also believes that the 80:20 rule would encourage donors to increase their loan contribution and therefore exceed their overall ADF-13 contributions. Annex 1 provides the detailed analysis justifying the proposal for the 80:20 rule.

2.8 While impacting positively on the total replenishment, the 80:20 rule would reduce the level of direct grant contributions. However, this decrease remains manageable, given that the Fund will increase its resources in the form of debt, and the grant element associated with this additional debt. Given the expected concessional nature of the additional debt, we expect the Fund to be able to meet its debt service obligations without disrupting its operations or needing additional grant support from donors. Additional information on the adequacy of the debt management framework and risk management issues is provided in section 5.

2.9 **Recommendation**: Management recommends an 80:20 substitution rule to mitigate the substitution risk from grant to loan resources. This rule will apply to both CDLs and BLs.

Discount rate used to determine the grant-element

2.10 The grant-element of a CDL is defined as the present value of the financial benefit that the Fund derives when contracting the CDL, between the interest rate paid on the CDL and a discount rate. The discount rate should be equivalent to the loan income earned when CDL resources are on-lent. The more concessional the CDL, or the higher the discount rate, the higher the grant-element will be.

2.11 As donors are recognised based on the grant-element of their CDLs, it is important to select a discount rate that will provide a strong incentive for contributions in the form of loans, while at the same time will be considered equitable by donors that only provide grants. While different methodologies exist to determine the discount rate and calculate the grant-element, during the first ADF-14 meeting Management recommended retaining the "net income earned approach", which is also the methodology utilised under IDA-17. In this methodology, the discount rate was derived from the average net interest income expected to be earned on ADF terms applied to blend, gap and graduating countries, which are charged the least concessional terms among ADF borrowers. Based on this net income earned approach, Management proposed a discount rate of 1.75%, which included an interest rate of 1% and a service charge of 0.75% for the category of ADF countries borrowing on the least concessional terms.

2.12 During the first ADF-14 meeting, donors interested in providing CDLs highlighted the lack of attractiveness of the proposed discount rate of 1.75%, which they considered low. For comparison, based on the same "net income earned approach", IDA agreed on a discount rate of 2.65% which was applied to CDLs during IDA-17. It represented the level of loan charges to transitional support and blend countries which were borrowing on the least concessional terms.

2.13 Following consultations with several Donors, and with the objective of making CDLs attractive during ADF-14, Management proposes a discount rate of 2.65%. This will ensure that donors providing CDLs are recognised in a similar way as in IDA. However, given that ADF and IDA do not have the same concessionality embedded in their lending terms, the proposed discount rate will not reflect the actual value contribution of CDLs to the Fund. Table 1 provides the grant-element for CDLs for various levels of interest rates and for discount rates of 1.75% and 2.65%.

Table 1: Grant-element for CDLs, as a function of the discount rate.

Grace Period/ Average Maturity (Years)	Duration (Years)	Discount Rate	Interest rate on CDL (cost of borrowing)				
			0%	0.25%	0.5%	0.75%	1%
5-35	20.25	1.75%	26.6%	22.8%	19.0%	15.2%	11.4%
		2.65%	36.8%	33.3%	29.8%	26.3%	22.8%
5-40	22.75	1.75%	29.5%	25.2%	21.0%	16.8%	12.6%
		2.65%	40.2%	36.4%	32.6%	28.8%	25.0%

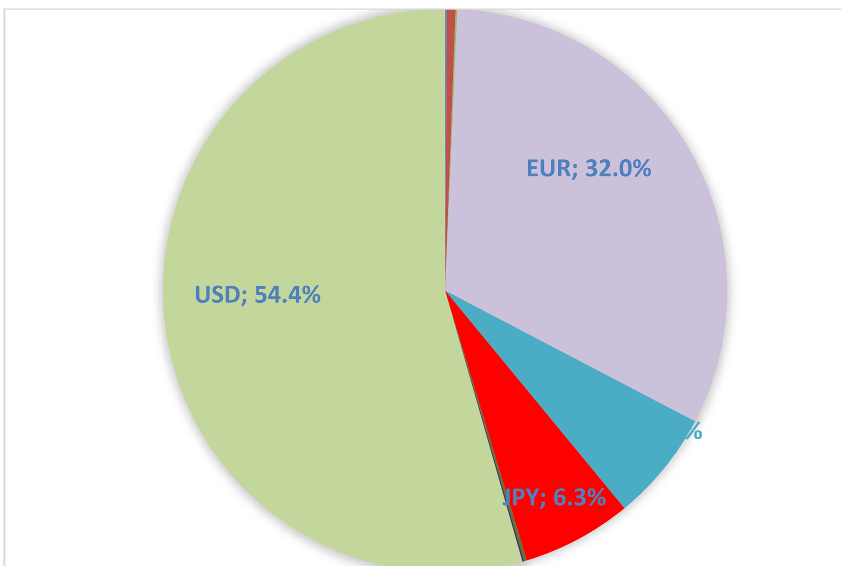
2.14 **Recommendation**: Management proposes a discount rate of 2.65% to encourage donor countries to provide a high volume of CDLs and to enable them to be recognised in the same way as in IDA-17, in terms of burden shares and voting powers.

Indicative terms and currency of CDLs

2.15 A fundamental difference between IDA and ADF is the currency denomination of loans provided to beneficiary countries. For ADF, while an SDR amount is approved for each loan, the loans are disbursed and denominated in any currency selected by the beneficiary countries from the SDR basket. This helps ADF borrowing countries to manage their currency risk, but results in a more complex currency risk management framework for the Fund. In the case of IDA, loans to borrowing countries are denominated in SDR. Recipients choose a payment currency during negotiations and are informed of the equivalent currency payment to be made on each billing date to reimburse their outstanding SDR loan balance and charges, based on prevailing exchange rates. Thus, for IDA countries, while SDR denominated loans result in additional currency risk and challenges in managing their debt, IDA's currency risk management framework is primarily in SDR and is simplified.

2.16 The historical behaviour of ADF beneficiary countries over the past 10 years indicates that the most commonly demanded currencies are the USD and the EUR. Figure 1 provides the currency composition of the Fund's outstanding loan portfolio.

Figure 1: Composition of outstanding ADF portfolio in SDR currencies as at 31 March 2016



2.17 ADF's currency risk management practice requires that proceeds from CDLs received in a given currency are on-lent in the same currency to reduce the currency risk on the loan. Therefore CDLs received in USD or EUR may remain in the currency in which they were received, as these currencies are highly demanded by ADF borrowing countries. CDLs received in currencies which are not highly demanded from ADF countries may be swapped, provided that the interest rate following the swap remains concessional and attractive to beneficiary countries. This is likely to be the case for CDLs received in GBP or JPY.

2.18 Table 2 provides indicative swap rates in JPY and GBP, based on prevailing rates as of May 2016.

Table 2: Mid-level market swap rates* for a given CDL currency

Currency of the CDL	Terms of the CDL	Interest rate after swap	
		USD	EUR
JPY	5-40 Year @ 0%	2.32%	0.82%
JPY	5-35 Year @ 0%	2.36%	0.83%
GBP	5-40 Year @ 0%	0.56%	-0.55%
GBP	5-35 Year @ 0%	0.54%	-0.61%
GBP	5-40 Year @ 1%	1.65%	0.33%
GBP	5-35 Year @ 1%	1.62%	0.29%

* These rates exclude applicable swap cost of about 0.2%-0.5%, depending on the swap counterparty.

2.19 It is worth noting that swapping GBP into EUR is the most cost-effective option and that swapping GBP into USD is also possible. Swapping JPY into EUR remains a viable option as CDL offers will be ranked by concessionality and pooled, to ensure that the average cost of the pool does not exceed the average interest loan income expected to be earned from loans funded by CDLs.

2.20 The indicative target terms for CDLs will be as follows:

- The expected size of CDLs is mainly a function of the volume of loans expected to be provided to blend, gap, graduating and green-light countries during the replenishment, as well as the Fund's debt management framework. On this basis, the expected size of CDLs for the base case scenario is approximately UA 1.5 billion.

- To comply with the Fund's debt management framework, the target maturity for CDLs should exceed the maturity of loans which are funded with CDLs, to ensure an adequate volume of loan reflows to reimburse the CDLs. Given that CDLs will be used to fund loans to ADF green-light countries with a 40-year maturity, the preferred maturity of CDL loans is 40 years, and should not be below 35 years.

- The maximum interest rate at which CDLs may be received in EUR and USD, which are the most demanded currencies by ADF borrowers, is 0.5%. This rate is set below the service charge of 75 bps for ADF loans, to enable the Fund to generate a slight positive margin from the management of the additional loans provided through CDLs. CDLs in GBP and JPY will need to be swapped either in USD or EUR, provided that an after-swap interest rate below 75 bps is achieved. Therefore the maximum interest rate for CDLs received in GBP and JPY should not exceed respectively 1% and 0.01%, as indicated in Table 3 below.

- In general, in order to enable the Fund to maintain strong financial sustainability following the introduction of CDLs, donors are encouraged to provide CDLs with the highest concessional conditions in their respective currencies, i.e. with a maturity preferably of 40 years (including a 5-year grace period) and an interest rate of or close to 0%.

Table 3: Indicative target terms for CDLs

Expected CDL size	Target Maturity	Currency & Borrowing rate	
		Currency	Maximum CDL interest rate
UA 1,500 million	Preference for 40 years Minimum: 35 years – incl. 5-year grace period	EUR	0.5 %
		USD	0.5%
		GBP*	1.0%
		JPY*	0.01%

*CDLs received in GBP and JPY will be swapped in either EUR or USD. The maximum CDL interest rates are indicatives and based on swap rates prevailing in May 2016.

2.21 **Recommendation:** Management receive CDLs in currencies which are either in demand by ADF beneficiary countries, namely EUR and USD, or which remain concessional when swapped into the preferred currencies of ADF beneficiaries. The indicative terms of CDLs are in Table 3 and will be updated as we approach the third replenishment meeting to provide sufficient time to donor countries for their decision-making process.

The payment schedule for CDLs

2.22 The payment schedule under which the ADF will receive CDL proceeds has an impact on ADF liquidity. The earlier the CDL proceeds are received, the more positive the impact on the Fund's ACC and the more flexibility the Fund will have to manage this liquidity before disbursements, provided that the proceeds are not invested in a negative interest rate environment.

2.23 As donors are already familiar with the 3-year encashment period implemented by IDA for CDLs, Management proposes a similar encashment period. However, donors will keep the flexibility to provide a faster encashment schedule.

2.24 **Recommendation**: Management proposes a payment schedule for CDLs of no more than 3 equal instalments that do not exceed the 3 years of the ADF-14 replenishment period.

The prioritization rule for CDLs

2.25 During the first ADF-14 meeting, Management proposed a two-step prioritization process similar to the one adopted by IDA. Deputies asked for a review of the prioritization rule with a view to making it simpler and more flexible. The sections below present the key features of the proposed priority rules which will enable the Fund to maximise CDLs while preserving its financial sustainability.

2.26 Management proposes a revised prioritization rule based on the following two priority factors:

- **<u>First priority factor:</u> the most concessional rate on the basis of the CDL currency after swaps**. As indicated in the previous sections, preference will be given to loans provided on highly concessional terms (with a maturity of at least 40 years and interest rate of 0%) and denominated in a currency that can easily be on-lent or swapped in a cost-effective way (at interest rates below 0.75%) in demanded currencies. All CDLs received will be ranked on the basis of their concessionality, taking into account two key elements: (i) the maturity of the CDL and (ii) the interest rate of the CDL. For currencies that will be swapped, the interest rate after swaps will be considered. CDLs will be retained only if they enable the Fund to remain financially sustainable based on the current pricing of ADF loans.

- **Second priority factor: the proportion of grants in the contribution**.
  Preference will be given to donors who provide a higher incremental share of grants in their contribution, above the minimum required by the 80:20 rule. As it is important to maximise the volume of grants during replenishments, ADF would encourage donors to retain a strong grant contribution while providing a CDL.

Proposed allocation of CDLs exceeding the expected amount

2.27 The prioritization rule provides the basis for ranking the CDLs following their concessionality, up to the total volume of loans to blend, gap, graduating and green-light countries on existing lending terms, while ensuring that the Fund remains sustainable and complies with its debt management framework. If the CDLs offered by donors exceed the expected volume of loans to blend, gap, graduating and green light countries, the same prioritization rule will be used to determine the additional resources that will be channelled to the same category of ADF creditworthy countries, at hardened but still concessional terms, provided that the Fund's financial sustainability is preserved.

2.28 The allocation of hardened-terms loans to ADF countries will be in addition to their regular performance-based allocation (PBA) and determined in proportion to their PBA. All blend, gap, graduating and green-light countries will be eligible for these additional allocations. Allowing these countries access to additional resources will help them overcome financing gaps and address their development challenges. These hardened terms from the ADF window will still be highly concessional when compared to commercial terms available to African countries. Annex 2 provides details on African countries that have recently leveraged resources in capital markets, at rates between 5.5% and close to 10%. The other key prioritization rule for additional CDLs above the volume of blend, gap, graduating and green-light countries is to ensure that they remain reasonably concessional when compared to AfDB terms for the sovereign window.

2.29 As explained in the Strategic Directions for ADF-14 paper, there is ample demand for such additional resources. Indeed, the current pipeline exceeds UA 10 billion, including UA 4.38 billion in regional operations and UA 6.12 billion in national operations. Close to half of the projects in the pipeline are at an advanced stage in the project cycle and would be ready for implementation as soon as the resources are available. Both the Fund and borrowing countries will be able to absorb an additional batch of concessional resources, assuming compliance with the Fund's debt management framework and debt sustainability assessments as done in coordination between the ADF and the Bretton Woods Institutions.

2.30 **Recommendation**: Management proposes a simple prioritization rule for CDLs based on two key factors: (i) the concessionality of the various offers received based on the currency of the CDL after swap, and provided that the Fund remains financially sustainable; and (ii) the proportion of grant in the contribution above the minimum required by the 80:20 rule. If the CDLs offered should exceed the expected allocation for blend, gap, graduating and green light countries, the same prioritization rule will be used to determine the additional resources that will be channelled to these ADF creditworthy countries, at hardened terms and based on the PBA system. The hardened terms will be determined based on the cost of the additional CDLs, but will remain concessional.

III. Bridge Loan

3.1 The purpose of a bridge loan is to improve the Fund's general liquidity level and increase the ACC by front-loading internally generated resources during the forthcoming two replenishment cycles, when the ACC is expected to be low. This will enable the Fund to commit a higher volume of operations in recipient countries during ADF-14 and ADF-15, while starting from ADF-16, when reflows into the Fund are expected to exceed outflows, the internally generated resources will be adjusted downward.

Discount rate used to determine the grant-element

3.2 Donors who provide a BL would receive a burden-share recognition based on the grant element of their loan. Similarly to the CDL, the burden shares and voting powers associated with the BL are based on the loan's grant-element. During the first replenishment meeting of ADF-14, Management used a "net income earned approach" to determine the discount rate. This discount rate was set up as the expected return of the BL's proceeds invested in a Held-to-Maturity (HTM) portfolio in the SDR currencies. On this basis, Management proposed a discount rate of 1.75%, which was found unattractive by donors potentially interested in providing BLs. For coherence reasons, Management now proposes to apply the same discount rate of 2.65% to both the BL and the CDL.

3.3 Table 4 provides the grant-element for BLs for various levels of interest rates and for discount rates of 1.75% and 2.65%.

Table 4: Grant-element for BLs, as a function of the Discount rate

Grace period/ Maturity (Years)	Average Duration (Years)	Discount Rate	Interest rate on the bridge loan (cost of borrowing)				
			0%	0.25%	0.5%	0.75%	1%
10-20	15.25	1.75%	20.8%	17.8%	14.8%	11.8%	8.9%
		2.65%	29.6%	26.8%	24.0%	21.1%	18.3%
10-25	17.75	1.75%	24.0%	20.6%	17.1%	13.7%	10.2%
		2.65%	33.8%	30.6%	27.4%	24.2%	21.0%

3.4 **Recommendation:** Similarly to CDLs, Management proposes as it is proposed to set the discount rate at 2.65% for BLs with an average investment portfolio maturity of 15 years.

Indicative target terms of BLs

Size, Maturity and grace period of the BL

3.5 Simulations were made to determine the optimal size, maturity and grace period of the BL, so as to smooth the ACC over several replenishments and to generate an optimal level of resources during ADF-

14 and ADF-15. Based on these simulations, the optimal size of the BL is set at UA 1 billion, while the optimal maturity and grace period are respectively 20 years and 10 years. A BL above UA 1 billion does not further increase the ACC, which reduces the attraction for the instrument. Similarly, a BL with a maturity exceeding 20 years does not provide additional value to the Fund in terms of liquidity risk management.

Currency and Interest rate of the BL

3.6 To ensure that the Fund mitigates its currency risk, the BL proceeds will remain in the currency in which they are received, rather than converted or swapped. As the Fund's liquidity is managed in SDR currencies, the BL will also be denominated in an SDR currency. Finally, in order to ensure that a BL generates sufficient returns to cover its debt service, the proceeds will be invested in high-grade, long-term treasury instruments in a Held-to-Maturity (HTM) portfolio matching the Fund's BL debt obligations. Management will thereby ensure that the BL is received at a cost that can be covered by the investment returns of the HTM portfolio, so that the Fund's financial profitability and liquidity are not negatively impacted.

3.7 Based on prevailing market rates as at May 2016, and the BL proceeds invested in a HTM portfolio with an average duration of 15 years, the maximum coupon rate of the BL should not exceed the levels indicated in Table 5.

Table 5: Indicative target terms for BLs

Expected CDL size	Target Maturity	Currency & Borrowing rate	
		Currency	Maximum BL interest rate
UA 1 billion	20 years - incl. 10-year grace period	EUR	0.5%
		USD	1.3%
		GBP	1.1%
		JPY	0.01%

3.8 **Recommendation:** Management would prefer to receive BLs at concessional rates, for an optimal amount of UA 1 billion, a maturity of 20 years and a grace period of 10 years. The BL should be denominated in a currency of the SDR basket and at a coupon rate that does not exceed the indicative amount specified in Table 5. Table 5 will be updated as we will approach the third replenishment meeting to provide sufficient time to donor for their decision-making process.

The payment schedule for BLs

3.9 The payment schedule under which the Fund will receive the BL proceeds has an impact on the ACC, as well as the ability to lock in the investment rates. In order to improve the Fund's liquidity position, it is important to receive the proceeds of the BL as early as possible, preferably in a single instalment, during the first year of ADF-14, in 2017. However, for donors who are not in a position to provide a single instalment, three equal instalments over the 3-year replenishment period may be considered, similarly to the CDLs. This longer payment period may impact the maximum BL interest rate, which will be re-estimated.

3.10 **Recommendation**: Management recommends that donors provide the BL in a single payment during the first year of the replenishment period. However, similarly to the CDL, a 3-year drawdown period may also be considered.

The prioritization rule for BLs

3.11 For the BLs, Management proposes a revised prioritization rule based on the following two priority factors:

- **<u>First priority factor</u>: Loan that provides the best value to the Fund.**
  Preference will be given to the BL which will provide the highest positive differential between the expected return in HTM investments earned on the proceeds and the borrowing cost of the BL.

- **<u>Second priority factor</u>: the proportion of grant in the contribution**.
  Preference will be given to donors who provided a higher incremental share of grants in their contribution, above the minimum required by the 80:20 substitution rule. As it is important to maximise the volume of grants during replenishments, ADF would encourage countries that maintain a strong grant contribution while providing a BL.

3.12 **Recommendation**: Management proposes a simple prioritization rule for BLs based on two key factors: (i) loans that provide the best economic value to the Fund when comparing the cost of borrowings with the return of the HTM investments; (ii) the proportion of grant in the contribution above the minimum required by the 80:20 rule.

IV. Buy-down Mechanism

4.1 The proposed BDM would reduce part of the ADF commitments to a set of countries, in order to free-up resources to fund additional operations in the remaining ADF countries. It takes advantage of the Bank's credit policy and its available lending headroom. The BDM leverages the ADB balance sheet in the following ways:

- Eligible ADF countries will be able to use their lending headroom to borrow from the AfDB window, up to the equivalent of their Performance-Based Allocation (PBA). The Fund will use its grant resources to compensate the Bank for the differential between ADF and AfDB lending terms.
- As a result, some countries would no longer utilise their ADF allocations and this will make additional resources available to the remaining ADF countries.

4.2 The BDM would be available to ADF countries which have sufficient lending headroom from the Bank. To ensure that the implementation of the BDM does not result in additional credit risk for the Bank, the ADF countries selected for the BDM will be the most creditworthy countries which currently have lending headroom with the Bank based on the revised credit policy – primarily ADF blend, graduating and green-light countries. Countries facing fragile situations would be excluded. Based on estimates as of May 2016, 9 ADF countries will be eligible for the BDM.

4.3 Our paper on the feasibility of the BDM presented at the first ADF-14 meeting remains valid; the key points are summarised in Annex 3. The document highlighted the competition between the BDM and the CDL, which are targeting the same category of ADF creditworthy countries. It concluded that the BDM was less attractive due to: (i) a negative impact on the ACC due to the expected reduction of loan reflows; (ii) a negative impact on the grant compensation framework due to the increased proportion of grants for ADF; (iii) the relative complexity of the framework when compared to CDLs. Based on this report, Deputies agreed during the first ADF-14 meeting that BDM would only be implemented if the Fund is not able to mobilise the volume of CDLs required to fund blend and graduating ADF countries (approximately UA 200 million).

4.4 **Recommendation:** Management maintains its recommendation of the first ADF-14 meeting and recommends the implementation of the BDM only if the volume of CDLs is insufficient.

V. ADF Debt Limit Framework

5.1 The introduction of debt into the Fund's financing framework requires appropriate risk management measures. To accommodate this additional debt, the ADF Asset and Liability Management guidelines will be amended to cover the incremental financial risks arising from the use of debt, and the Prudential Minimum Liquidity (PML) level required to ensure compliance with the Fund's liquidity policy will be adjusted.

5.2 Management will also implement a debt management framework to ensure that the debt supported by the Fund is sustainable. The key objectives of the debt management framework are as follows:

- To ensure the Fund meets its debt service obligations without disrupting its operations or having recourse to additional grant contributions from donor countries. The framework will ensure that debt would only be repaid by using reflows from the additional lending made possible with this debt, and not the Fund's original liquidity.

- To mitigate the reputational risk that would result if the Fund were not able to honour its obligations and default on its debt repayments.

5.3 The Fund's debt management framework will therefore include two key debt limits:

- A cumulative debt limit, set to ensure that the Fund's aggregate debt level remains within prudential limits when assessed relative to its total balance sheet, and taking into consideration the use of debt over successive replenishments.

- A prudential debt limit, primarily based on: (i) the expected reflows from the debt proceeds (reflows will depend on the lending terms of the category of ADF countries to which the proceeds will be on-lent; the higher the proceeds, the more adequate the coverage of the debt service and the debt limit will be); and (ii) the borrowing terms of the loan (the higher the concessionality of the donor loan, the more adequate the coverage of the debt service and the debt limit will be). As a result, the prudential debt limit will be scenario-specific and will depend on both the lending scenario for the debt proceeds and the debt concessionality.

5.4 The cumulative debt limit is set to match ADF Net Development Resources which include primarily Treasury assets and Demand obligations. This will ensure that, under stress conditions, the Fund will be able to monetise its Treasury assets and Demand obligations to cover its debt obligations. Thus, based on the projections of ADF Net Development Resources over the next three replenishments, the proposed cumulative debt limit is currently set at UA 5.4 billion.

5.5 On the other hand, as indicated in section 5.3, the prudential debt limit for the replenishment will depend on the lending scenario for the debt proceeds, as well as the borrowing terms of the debt contracted. Indicative terms are provided for various scenarios in the Fund's debt management framework. This prudential limit will be firmed up once donor contributions are confirmed for both grant and loan contributions. CDL offers above the sustainable prudential limit will be considered for the hardened term window.

VI. Summary of Management's Proposal to Deputies under ADF-14

Approval from ADF Deputies are hereby sought on the following recommendations:

Terms of the Concessional Loans

6.1 Financing Innovations in the form of CDLs and BLs are expected to represent a significant portion of the ADF-14 resource envelope as discussed in the "ADF-14 Financing Framework" paper and further summarized in annex 4. The financing scenarios will depend on both the level of grants and loans that the Fund will be able to mobilize. In order to help donor countries on the resources that they would like to commit during ADF-14, it is important to reach an agreement on the key features of these innovative instruments during the second replenishment meeting. ADF Deputies are therefore requested to approve Management's proposed recommendations on the key features of the innovative instruments.

Substitution rule

6.2 For donors planning to provide loans during ADF-14, the 80/20 substitution rule suggests that donor countries provide at least 80 percent of their ADF-13 subscription in the form of grant contribution, while the remaining 20 percent will be provided on a grant equivalent basis of their loans. While Management initially proposed a 90/10 substitution rule during the first ADF-14 meeting, following consultations with several donor countries and further analysis of the replenishment scenarios, Management concluded that the 80/20 substitution rule will benefit the Fund.

6.3 **Therefore, Management will appreciate if Deputies can approve the proposed 80/20 substitution rule.** This approach will encourage donors to provide concessional loans as an additional instrument to scale-up to their grant contributions.

Discount rate and Grant element

6.4 While Management initially favoured a lower discount rate of 1.75% based on the "Net Income Earned approach", following consultations with Donors willing to provide loans, a higher discount rate was requested to make the instrument attractive.

6.5 Therefore, Management will appreciate if Deputies can approve the proposed discount rate of 2.65%, to ensure that donor loans remain attractive and to provide a grant-element similar to IDA. **Management also suggests to continue to monitor discussions with IDA regarding the discount rate of IDA-18, to ensure the implementation of a uniform approach going forward.**

6.6 **Deputies are also requested to approve the application of the same discount rate to both CDLs and BLs**.

Prioritization rule

6.7 To ensure that the Fund remains sustainable, the debt proposed by Donors will need to be concessional and meet the prioritization rule proposed in section 2.26 for the CDL and 3.11 for the BL. These proposed prioritization rule will ensure that ADF countries obtain concessional resources in their preferred currencies and will enable Management to rank offers received by Donors in a simple and fair way that benefits the Fund.

6.8 Therefore, Management will appreciate if Deputies can approve the proposed prioritization rule.

Proposed allocation of CDLs exceeding the expected amount to a hardened term window

6.9 In the event that CDL offered exceed the amount to fund the targeted ADF categories (primarily blend, gap, graduating and green light countries) at current approved rates, Management proposes to create a hardened terms window, which will benefit the most creditworthy ADF countries, and which concessional rates will be slightly above rates currently applied to blend countries.

6.10 Therefore**, Management will appreciate if Deputies can approve the proposed creation of the hardened terms window,** which lending terms will be specified once CDL offers are confirmed.

Target borrowing terms for CDLs and BLs

6.11 The borrowing terms of loans will be a critical factor in determining the impact of innovative instruments on the Fund's financing framework and long-term financial sustainability. In order to ensure that the debt contracted is sustainable, it must be received at very concessional rates to ensure that the Fund continue to provide concessional financial assistance to its recipient countries. To meet this objective, the target lending terms for CDLs and BLs have been summarized in Table 3 and Table 5 based on prevailing market rates. These terms are indicatives and will be updated one month before the 3rd replenishment meeting to enable donor countries to make their previsions for commitments.

6.12 **Management would like Deputies to take note of the indicative borrowing terms for CDLs and BLs.**

6.13 **Management also encourages Donors to maintain ongoing communication regarding their intentions to provide CDLs and BLs on the basis of the indicative terms**. This will facilitate implementation of the innovative instruments and enable Management to firm up its financing scenarios.

Updated implementation Framework

6.14 Management further welcome Deputies' views on the overall revisions presented in this paper for implementing CDL and BL in ADF-14, including on the discount rate, currency and other terms of the loans and the related implementation framework.

Revising ADF's future lending terms and credit policy

6.15 Finally, do Deputies support, in principle, the idea of revising ADF lending terms involved in the ADF credit policy to enable the Fund to provide additional resources – to blend, gap, graduating and green light ADF countries – on hardened terms, should ADF receive CDLs in excess of its debt limit?

Annex 1: Impact analysis of the 80:20 vs. 90:10 substitution rule

This Annex offers simulations of the expected level of ADF resources under both the 80:20 and the 90:10 substitution rules.

The key assumptions of this simulation are as follows:

- There will be 0% growth in donors' grant contributions (the baseline replenishment scenario).
- Donor countries representing approximately 35% of ADF-13 contributions will be interested in providing CDLs to the Fund. Therefore, based on donor contributions of UA 3840 million during ADF-13, we assume that donors providing CDLs will represent UA 1,344 million in total contributions.
- CDLs will have an average maturity of 35 years (incl. 5-year grace period) and an interest rate of 0.5%. This correspond to a grant element of 29.80% based on a discount rate of 2.65%.

Applying the 90:10 vs. 80:20 prioritization rule would have the following key impacts:

1) Computation of the minimum required amount of CDLs
   The reduction of contributions in the form of grants is 10% of UA 1,344 million (ADF-13 contributions for donors providing CDLs) in the case of the 90:10 rule and 20% of UA 1,344 million for the 80:20 rule.

	(a)	(b)	= (a)/(b)
In UA millions	Reduction of contribution in the form of Grant	Grant element%	Minimum required amount of CDL
90:10 rule	134 (4% reduction of Grants)	29.80%	450
80:20 rule	268 (8% reduction of Grants)		900

*as per table

2) Impact on replenishment grant contributions and ACC

The ACC is negatively impacted by the reduction of contribution in the form of grants and positively impacted by the increase in the volume of CDLs. The overall impact of CDLs on the ACC is positive as indicated in the table below

Prioritization rule	ACC	Net ACC Increase (decrease)**
90:10 rule	UA 543 million	UA 128 million
80:20 rule	UA 585 million	UA 170 million

** Baseline ACC is set at UA 415 million.

3) Simulation for the impact on the resource envelope.

Therefore, the overall impact on the ADF-14 resource envelope based on the assumptions detailed above can be summarised as follows:

		ADF-14 Baseline Scenario	
	ADF-13	90:10 rule	80:20 rule
ACC	976	543	585
Donor subscriptions	3,840	3,686	3,533
Carry-overs	448	389	389
Minimum CDLs		450	900
Additional ACC from BL		895	895
Total resources	**5,264**	**5,963**	**6,302**
Growth rate:		*13.29%*	*19.72%*

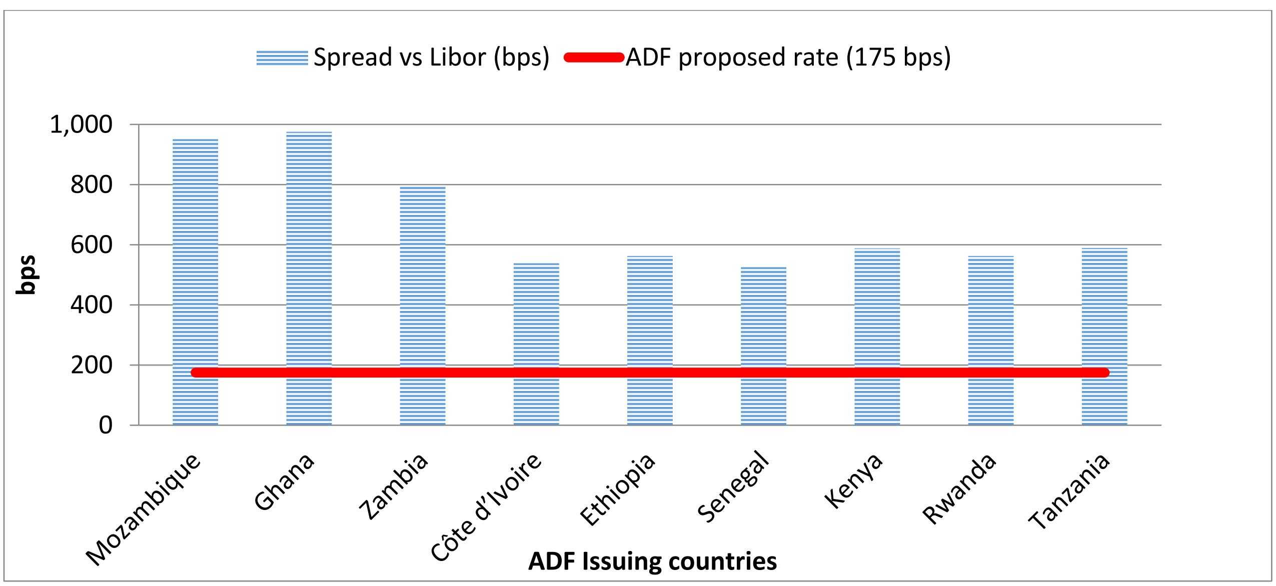
These figures are purely indicative as their purpose is to illustrate the potential impact of the two substitution rules. They do not represent Management's expectation for ADF-14.

Annex 2: List of African countries who issued Eurobonds on capital market

In the past 3 years, 19 African countries have issued Eurobonds, of which 9 are ADF eligible countries as indicated in the table below:

- 2 gap countries (Ivory Coast – yellow and Ghana – red)
- 3 blend countries (Kenya – green; Zambia – yellow; and Mozambique – yellow)
- 4 ADF-only countries (Ethiopia – yellow; Tanzania – green; Senegal – green; and Rwanda - green

Country	Rating	Size (Mln)	Currency	Tenor	Rate	Excess vs Libor 6m bps	Date of issuance
Mozambique	Caa1	726	USD	7Y	10.50%	951	Mar-16
Ghana	BB-/B1	1,000	USD	10Y	10.75%	976	Oct-15
Zambia	B/B	1,250	USD	10Y	8.97%	798	Jul-15
Côte d'Ivoire	B+/Ba3	1000	USD	10Y	6.38%	539	Mar-15
Ethiopia	B/B/B1	1,000	USD	10Y	6.62%	563	Dec-14
Senegal	B1/B+/B+	500	USD	10Y	6.25%	526	Jul-14
Kenya	B+/B+	1,000	USD	10Y	6.88%	589	Jun-14
Rwanda	B+	400	USD	10Y	6.63%	564	Apr-13
Tanzania	NR	600	USD	7Y	6.89%	590	Mar-13



Annex 3: The Buy-Down Mechanism

Main Principles

The proposed BDM would reduce part of the ADF commitment to a group of countries, in order to free up resources to fund additional operations in the remaining ADF countries. It takes advantage of the Bank's credit policy and available AfDB headroom. The BDM leverages the AfDB balance sheet, since eligible RMCs would be able to use their AfDB headroom to borrow from the AfDB the equivalent of their Performance Based Allocation (PBA). Extra grant resources would then be made available by ADF and/or a willing third party as compensation for the differential between ADF and AfDB lending terms. As a result, some countries would no longer utilise their ADF allocations. This would unlock resources for the remaining ADF countries.

To ensure that the pilot application of the BDM under ADF-14 is risk free, it is proposed to apply the BDM to the most advanced and creditworthy ADF countries (i.e. graduating countries, blend and ADF green-light countries). Countries facing fragile situations would be excluded. As of May 2016, the BDM would potentially be applied to 9 countries. ADF resources would be set aside for the mechanism.

Financial impact

The most important beneficiaries of the mechanism would be the remaining ADF countries, which have large needs for concessional financing. The gross amount of additional resources for them is estimated at around UA 553 million. There would be a very small reduction in the ACC (see weaknesses section below). The net amount of additional resources is estimated at around UA 542 million during ADF-14, assuming the compensation is paid over the disbursement profile. All the freed-up resources are allocated to the ADF remaining countries through the Performance Based Allocation (PBA) system.

Eligible countries which forego their ADF allocation would actually gain access to more resources, because extra grants would be provided on top of the equivalent of the PBA provided by the Bank on AfDB terms.

To create incentives for participating countries to forego their ADF allocation, a proportion of the released amounts could be allocated to them, in the form of a top-up allocation, or as technical assistance in addition to extra grants. They would also remain eligible for regional operations with ADF-14 financing.

The BDM would have no cost for ADF contributors in the short term. However, as the BDM will move borrowers from the ADF to the AfDB, part of the unlocked resources will be used to support countries eligible for grants. The volume of grants provided by the Fund will increase. In addition, if the grants made available to the eligible countries as compensation come from the ADF, the volume of grants in ADF-14 will increase. Hence, the BDM would impact the Grant Compensation Mechanism on the long term. See the ADF-14 Financial Framework paper for more details on the impact of the innovative Instruments on the Grant Compensation Mechanism.

Risks and downsides

The benefits of the diversification of the AfDB's portfolio would be larger than the additional risk taken by the Bank. The same risk assessment as the one in the Bank Group's current Credit Policy would be conducted and ADF countries that are not deemed eligible for the AfDB window after the creditworthiness assessment will continue to receive their PBA from the ADF. Overall, the BDM should not adversely affect the risk exposure of the Bank.

The mechanism will be in line with countries' Debt Sustainability Analysis (DSA). Eligible countries would have access to more resources because extra grants will be provided on top of the equivalent of the PBA provided by the Bank on AfDB terms. The package of resources will have the same level of concessionality.

The BDM would introduce additional complexity into the framework for assistance to countries. The amount of concessional resources will be calculated through the ADF methodology (PBA) but granted by the AfDB.

The BDM will result in a decrease of the ACC during ADF-14 through two effects: a "compensation" effect and a "grant share" effect. By limiting the use of ADF resources to some countries and pushing some borrowers to the AfDB window, the reflows to the ADF will decrease in the future and the share of grants in the ADF will increase. The BDM will therefore result in a decrease of the ACC in the future, because ACC assumptions include lower reflows in the future. In this case, the ACC would decrease by UA 11 million during ADF-14 if the mechanism is applied to blend, graduating and ADF green-light countries, assuming a payment of the contribution following the disbursement profile. The ACC would decrease by UA 1 million during ADF-14 if the mechanism is only applied to blend and graduating countries. The decrease is mitigated if the ADF compensation is paid following standard ADF conditions. If the compensation is not provided by the ADF, the decrease in the ACC during ADF-14 will be lower.

Estimated Freed up Funding for the Remaining ADF countries

Buy-Down mechanism - Resources available for remaining ADF countries (in UA million)

RMCs	ADF-14 allocation	Estimated Amount borrowed from AfDB in place of ADF	ADF Amount needed to compensate	Amount available for the remaining ADF only countries
Blend, and graduating	198	198	28	170
Green light	638	638	255	383
Total	836	836	283	553

The calculation of the total needed for compensation is derived from the difference in terms of present value (or the difference in grant-elements) between the AfDB loans versus the equivalent loans with ADF terms. For consistency, this computation is based on computations of ADF loan concessionality made during ADF-13 in line with IDA methodology.

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

BDM – level of compensation

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

For each UA 10 million granted by AfDB to a blend country/graduating country in place of the ADF, UA 1.4 million will be required as compensation (14%). For each UA 10 million granted by AfDB to a green light ADF country in place of the ADF, UA 4.0 million will be required as compensation (40%).

BDM's impact on the ACC

As the ACC is computed every three years, it is difficult to provide an estimate of the impact on a very long term. However, Table I2 below provides simulations under ADF-14. These simulations are indicative and are based on an ACC of UA 415 million. Based on several ADF compensation assumptions, three scenarios are presented. It should be noted that the main impact of the proposed scheme on the ACC will occur after five years (ie: after ADF-14), when repayments on loans to blend and graduating countries are expected to begin.

Depending on how the ADF compensation is paid, the BDM will result in a decrease of the ACC between UA 11 million and UA 195 million during ADF-14 if the mechanism is applied to blend, gap and graduating and ADF green-light countries. The key difference is whether the compensation is paid following the standard ADF profile (in which case the decrease in ACC is only by UA 11 million) or according to a linear 3-year profile (UA 195 million).

Estimated impact on the ACC during ADF-14 (UA million)

	ADF compensation	ADF-14 ACC	Impact
Without the mechanism	0	415	
Scenario 1: ADF Compensation paid following the standard ADF Disbursement Profile over 10 years			
Blend/graduating	28	414	-1
Blend/graduating and ADF green light	283	404	-11
Scenario 2: ADF Compensation paid following a linear 3-Year profile			
Blend/graduating	28	402	-13
Blend/graduating and ADF green light	283	220	-195

Annex 4: ADF-14 Financing Scenarios

In UA million	**ADF-13**	**ADF-14 Scenarios**			
		Sources of Financing			
Item	*Actual*	*Pessimistic (-5% increase in subscriptions)*	*Baseline (0% increase in subscriptions)*	*Central (5% increase in subscriptions)*	*Optimistic (10% increase in subscriptions)*
ACC (without Innovative Instruments)	976	382	415	448	479
Donor subscriptions	3,840	3,648	3,840	4,032	4,224
Additional contributions	20				
Initial Subscriptions	50				
Carry-over amounts	378	389	389	389	389
Total resources	**5,264**	**4,419**	**4,644**	**4,869**	**5,092**
Additional Resources	**n/a**	**1,851**	**2,380**	**2,910**	**3,442**
of which: Target CDL Amount		*1,000*	*1,500*	*2,000*	*2,500*
of which: Additional ACC from debt (BLs+ CDLs)		*851*	*880*	*910*	*942*
Total resources, including additional resources	**5,264**	**6,270**	**7,024**	**7,779**	**8,534**