

ADF-14

## The Role of ADF in Private Sector Development

Discussion paper

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**AFRICAN DEVELOPMENT FUND**

## Executive Summary

***A buoyant and dynamic private sector is crucial to deliver the Sustainable Development Goals (SDG) in Africa's low income countries.*** Income generation and job creation by the private sector will ensure 'no-one is left behind'. Ultimately, private sector growth delivers the diversified tax base needed by countries to fund services and goods without depending on aid. The leverage to turn the 'billions' of available development finance into the 'trillions' needed to achieve the SDGs can only take place in partnership with the private sector.

***Over the past decade, the rate of growth of the African Development Bank Group's private sector development portfolio - encompassing both sovereign and non-sovereign guaranteed operations - has outpaced that of the overall portfolio. On a stand-alone basis, the growth rate of the ADB's non-sovereign operations portfolio has also exceeded that of comparable MDBs.*** Historically, the Bank Group supported private sector development (PSD) in low income countries through sovereign operations to improve the business climate and promote good economic governance. Development Partners recognise that governance reforms must be complemented by investment in catalytic, transformative private sector projects, to crowd in commercial financing and deliver development results. From marginal and speculative positions before 2006, the Bank Group has significantly scaled up its non-sovereign operations (NSOs) in ADF countries, using the ADB window.

***Increasingly, the Bank Group is using innovative approaches for blending commercial and concessional finance to support projects with high social returns.*** This includes ADF loans to governments to invest in Public Private Partnerships (PPPs) and the use of blended financing pools, such as renewable energy funds that catalyse commercial capital into new low carbon technologies. The Bank Group also introduced new instruments under ADF, including the Partial Risk Guarantee (PRG), the Partial Credit Guarantee (PCG) and the Private Sector Credit Enhancement Facility (PSF), for which there is now seeing a robust increase in utilisation. The PSF has shown itself to be an effective tool in enabling the Bank to pursue new financing opportunities in countries in transition and in riskier sectors. Full commitment of current PSF resources is expected to be reached over the course of 2017.

***The scaling up of the Bank Group's private sector operations has reaped significant development results.*** Over the past two ADF cycles, over 1.6 million people in ADF countries benefitted from the Bank's various private sector operations. Seven ADF countries saw improvements in their business climate as a consequence of Bank Group interventions. Over 26,000 jobs were directly created and \$700 million in government revenues were directly generated by private sector projects.

***Yet, there remain significant challenges in supporting private sector development in ADF countries.*** Low income countries tend to have a less conducive business environment, a wider infrastructure gap and higher operational risks, especially those in fragile situations. This means that it is harder for the Bank Group to penetrate markets in low income countries and fragile situations. While 50% of the active NSO portfolio is in ADF-eligible countries, more than half of it is concentrated in just five 'gap', 'blend' and 'transition to ADB' countries. The Bank Group needs to scale up its support to private sector development in situations of fragility, while also targeting small and medium enterprises (SMEs) and women entrepreneurs so as to overcome the fragility trap.

***Looking forward, the Bank Group needs to scale up its private sector operations to meet the transformational ambitions of the High 5 operational priorities of the Bank Strategy.*** Management is purposefully injecting private sector orientations into its activities with public sector clients and will continue to do so over the course of ADF-14, in line with the strategic priorities of the Bank Group. This approach has prompted a shift in sector strategy and programmes, including: (i) positioning agriculture as a business opportunity; (ii) driving sector-wide reforms and availing risk sharing instruments to enable private investment in lighting and powering Africa; (iii) targeting women entrepreneurs and youth to improve the quality of life for African people; (iv) making private sector driven and public sector enabled African industrialisation a priority, and (v) integrating small domestic

markets to achieve the economies of scale needed for African enterprises to compete domestically, regionally and globally. A renewed emphasis on public-private partnerships is also fundamental to the Bank's new business delivery model.

However, non-sovereign Bank lending is expected to hit multiple capital risk constraints soon, which will hinder its ability to continue operating within the parameters of 'business as usual' ambitions. At a time of renewed ambition to deliver the Bank's High 5s and new Development and Business Delivery Model (DBDM), the pressures are all the more acute. They will be felt mostly in low income countries and fragile situations, which take up more risk capital. This paper identifies three options for the ADF to scale up support to private sector financing in low income countries. Management identifies an expansion of the PSF's resources (Option A) by an additional UA 200 million as a priority for ADF-14, in order to maintain the momentum and support the scale up of investment under the High 5 agenda.

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## List of Acronyms

ADF	African Development Fund
ADB	African Development Bank
AGTF	Africa Growing Together Fund
ALSF	African Legal Support Facility
ANRC	Africa Natural Resources Center
AREF	Africa Renewable Energy Fund
CDL	Concessional Donor Loans
DBDM	Development and Business Delivery Model
DFI	Development Finance Institution
FAPA	Fund for Africa Private Sector Assistance
FI	Financial intermediary
GAP	Governance Action Plan
GEF	Global Environment Facility
GTF	Governance Trust Fund
GW	Gigawatt
ISP	Institutional Support Project
LIC	Low Income Country
MDB	Multilateral Development Bank
MSME	Micro, Small and Medium Enterprise
NSO	Non-Sovereign Operation
PBA	Performance Based Allocation
PBO	Program Based Operations
PPP	Public Private Partnership
PSF	Private Sector Credit Enhancement Facility
PSD	Private Sector Development
PCG	Partial Credit Guarantee
PPP	Public Private Partnership
PRG	Partial Risk Guarantee
RMC	Regional Member Country
RO	Regional Operation
SDG	Sustainable Development Goals
SEFA	Sustainable Energy Fund for Africa
SME	Small and Medium Enterprise
SOE	State Owned Enterprise
UA	Unit of Account
USD	United States Dollar
TSF	Transition Support Facility
TYS	Ten Year Strategy

## 1. Introduction

1.1 The Sustainable Development Goal (SDG) framework recognises that building vibrant and systematic partnerships with the private sector is a vital prerequisite to a transformative agenda that accelerates poverty reduction and sustainable development in the post-2015 era. At the UN Financing for Development conference in Addis Ababa in 2015, the 'Agenda for Action' emphasised the role of domestic resource generation and leveraging traditional DFI finance to fund the achievement of the SDGs. This brought the private sector to the fore, as both a generator of tax revenues and a source of finance for development.

1.2 Over the last ADF cycles, the Bank Group private sector development (PSD) role has intensified, using mutually supporting sovereign and non-sovereign operations (private sector, NSO). The Bank Group has expanded the range of instruments used to attract and leverage private resources, particularly long-term financing for infrastructure. This has led to significant development results, with the Bank Group's operations estimated to have benefited over 1.6 million people in ADF countries.

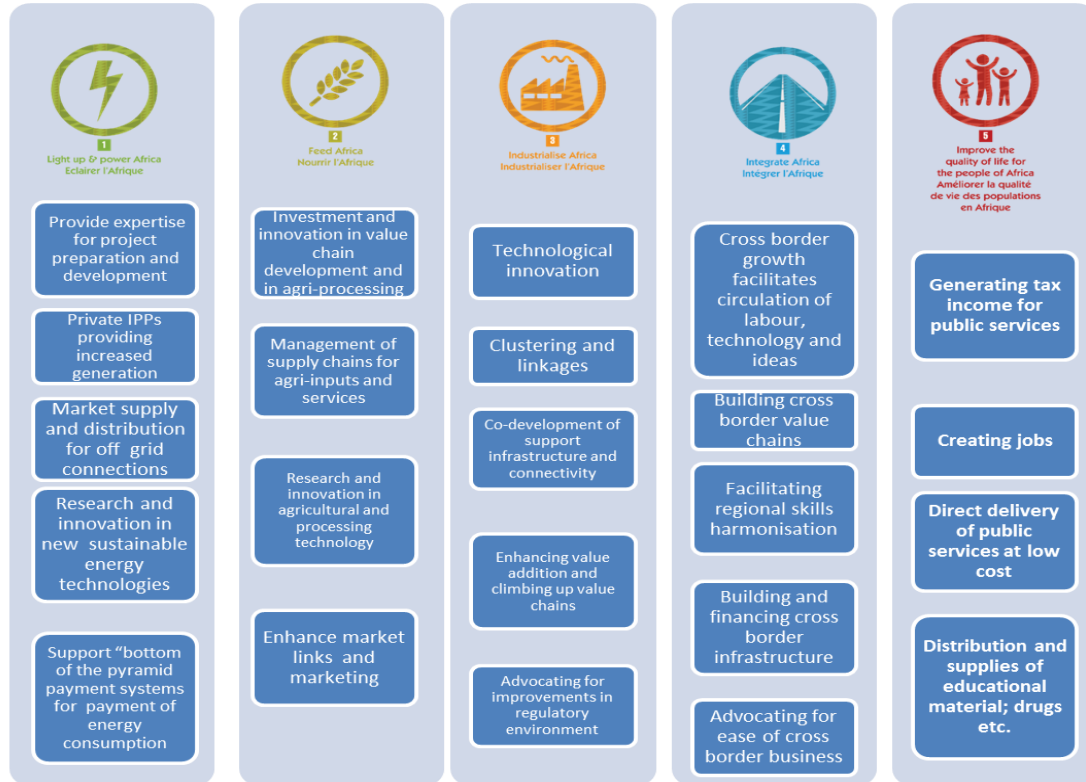
1.3 The scaling-up of ADF's role in PSD is sought at a time the Bank Group is initiating a new Development and Business Delivery Model (DBDM) which will make the Bank more efficient, effective, and better positioned to deliver greater development impacts. It aims to scale up and accelerate the delivery of the Bank Strategy and the High 5 priority goals: (i) Light up and power Africa, (ii) Feed Africa, (iii) Industrialise Africa, (iv) Integrate Africa, and (v) Improve the quality of life for the people of Africa.

1.4 At the request of ADF Deputies, this paper elaborates how ADF-14 will support PSD in Africa. Following this introduction, Section 2 provides an overview of PSD challenges and opportunities in ADF countries, and clarifies the Bank Group's strategic responses. Section 3 highlights the Bank Group's experience through its sovereign and non-sovereign operations, and explores cases where it has piloted the use of blended concessional and non-concessional funding. Section 4 captures the needs, opportunities and challenges relating to scaling up the Bank Group's engagement in PSD, while Section 5 presents options for ADF-14 to boost the Bank Group's development results through the private sector.

## 2. Strategy and Policy Background.

2.1 ***Africa's rapidly expanding private sector is an engine of wealth and job creation and is essential to delivering the Bank Strategy and the High 5s.*** The private sector now generates 70% of Africa's output, 70% of its investment and 90% of its employment. Both the Bank Strategy and the High 5s highlight the importance of using development finance to leverage and catalyse commercial finance to put ADF countries towards a path of inclusive and green growth. For example, of the 70 GW of additional generating capacity needed in ADF countries to achieve the Light up and Power Africa High 5 priority, around 40 GW is expected to be provided through Independent Power Providers. The private sector is also key to deliver a considerable number of new off grid connections in ADF countries. Similarly, the 60% of the African active population engagement in the agriculture sector will only experience significant change in their lives if agriculture is supported as a business. Likewise, scaling up job creation to ensure Africa reaps its demographic dividend, requires support to entrepreneurship, strengthening of business know-how and skills, and the creation of durable labour market linkages

**Figure 1: How the Private Sector contributes to the High 5s**



2.2 Building on the Bank Strategy, specific strategies and policies guide the Bank Group's activities and set the tone for its engagement. This includes the Private Sector Development Strategy and Policy 2013-2017, the Governance Action Plan 2014-2018, and the Financial Sector Development Strategy and Policy 2014-2019. The guiding principles of the Bank's involvement in the private sector are that it must be selective in its interventions, demonstrate its additionality, maintain high standards of financial integrity and attract other partners and additional resources. Priority areas include improving Africa's investment and business climate, expanding access to social and economic infrastructure, promoting enterprise development, increasing access to financial services by the underserved and broadening and deepening Africa's financial systems.

2.3 However, supporting PSD in low income countries poses specific challenges. In many low income ADF countries, private enterprise bears the additional burden of contending with restrictive business environments, poor infrastructure, persistent electricity shortages and difficulties in gaining access to finance. Investors' risk perceptions, especially for countries in fragile situations, means that significant returns on investment will be required. A risk premium of around 10-15% is required by investors in Africa compared to other regions and this rises for LICs and countries in situation of fragility. For the Bank Group, financing a private sector project in a fragile state utilises between three and four times as much capital as the same project would in an ADB country.

2.4 Bank Group's support to PSD has a key state building function in countries in situations of fragility. Job creation and the demonstration effects of successful private sector projects in countries in transition have been identified as drivers in building resilience. A large and diverse private sector can also be a strong advocate for policy reform and a force for good governance. Moreover, by generating tax income and

expecting public goods in exchange a buoyant private sector, the social contract is strengthened between state and citizens, creating stronger systems of accountability.

### **3. Bank Group experience supporting PSD in ADF countries**

3.1 ***The Bank Group has used a range of instruments to support PSD in ADF countries.*** There are three main channels through which the Bank Group has provided its support, notably: (i) sovereign operations; (ii) non-sovereign operations using ADB resources; and (iii) combined use of concessional and non-concessional funding. The basic structure of the Bank's support to the private sector in ADF countries builds on the traditional separation of non-sovereign operations through the non-concessional ADB window and sovereign operations through the ADF window (sections i and ii below). However, over the past years the Bank has increasingly put in place innovative blending and risk management instruments to leverage concessional resources and address key market failures, to achieve delivery of full developmental impact (section iii).

#### ***i. Sovereign Operations***

3.2 The Bank Group has a long history of engagement in PSD in ADF countries through its sovereign operations. Before the Bank Group's first private sector transactions kicked off, the ADF was already supporting improvements to the investment climate, strengthening of regulatory, institutional and financial frameworks and investing in infrastructure and education. Such interventions are critical for creating the connectivity to markets and requisite human capital to raise productivity and competitiveness of the private sector.

3.3 Over the last two ADF cycles, sovereign operations have increasingly delivered the Bank's PSD corporate mandate. Interventions supporting PSD through ADF sovereign lending encompass a range of areas including regulatory reforms notably for PPPs; trade facilitation; support for micro, small and medium enterprises development and access to credit; and strengthened financial markets. As at 30 May 2016, the current active ADF portfolio, which was largely approved over the past two ADF cycles, has 30 Institutional Support Projects (ISPs) supporting PSD with a total value of UA 190 million. In the same portfolio, there are two active Policy Based Operations (PBOs) with at least one component targeting PSD, as well as a partial credit guarantee of \$40 million. Numerous PBOs have supported PBOs but these do not form part of the current active portfolio, as the operations have successfully come to an end. The share of PBOs with the PSD component has increased significantly in the recent past and this trend is expected to continue during the ADF-14 cycle.

#### **Box 1: Enhancing private sector participation in the power sector through policy dialogue**

The Bank approved a loan of UA 50 million in May 2015 to finance the Tanzania Power Sector Reform and Governance Support Programme (PSRGSP), as part of a three year, UA 100 million programmatic approach. The objective of the operation is to promote inclusive growth and enhanced economic competitiveness through power sector reforms, with particular emphasis on enhancing private sector participation in the sector. The programme has resulted in the retirement of 60MW of electricity supplied through high cost emergency power plants, resulting in significant savings from capacity charges; introduction of smart metering, resulting in enhanced control of electricity theft and revenue leakage; and revision of electricity tariffs as part of gradual steps to achieve cost reflective levels. All these actions are positive developments, paving the way for Independent Power Producers to enter the market of power generation in Tanzania.

3.4 The Bank is also supporting PSD through specialist advisory services in sectors with high levels of technical specialisation, through dedicated initiatives or centres. This includes support to governments in ADF countries, through the African Legal Support Facility (ALSF), to improve legal and contractual



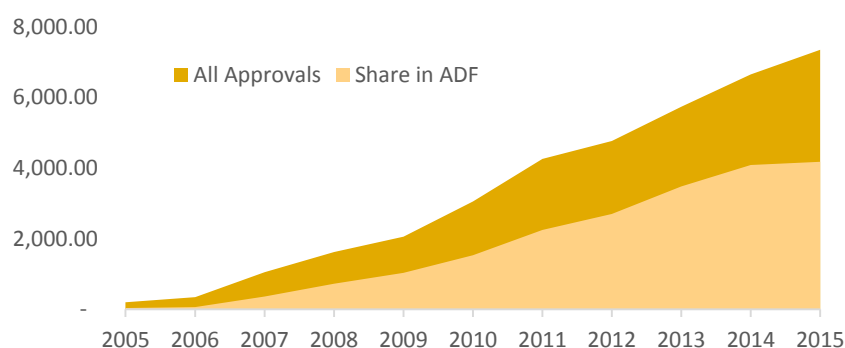
frameworks underpinning complex transactions between the private and public sector – mostly in the area of natural resources, infrastructure and PPP. The ALSF has been providing capacity to African officials in the planning, structuring and negotiation of PPPs (see box 2). By providing robust legal foundations for transactions with the private sector, this work aims to ensure a predictable legal environment that allows the private sector security when investing in risky projects. Support and capacity building to sovereign clients for regulatory reform and policy development are also provided on a grant basis through Trust Funds, such as the Governance Trust Fund (GTF) and the Fund for African Private Sector Assistance (FAPA).

3.5 The Bank also mobilised support to PSD through partners. For example, the Bank provided a grant of \$15 million to the Investment Climate Facility (ICF), contributing to 73 business climate improvement projects in 36 countries over a nine year period. The Bank is also helping RMCs to assimilate all stages of preparation and development of PPPs, as well as the legal and fiduciary risks by the creation PPP Advisory hubs. These hubs are expected to lead the mainstreaming of PPP in country and sector programmes and thereby generate a constant deal flow of quality bankable projects, with a high rate of transactions reaching financial close.

## ii. *Non-sovereign operations using ADB resources in ADF countries*

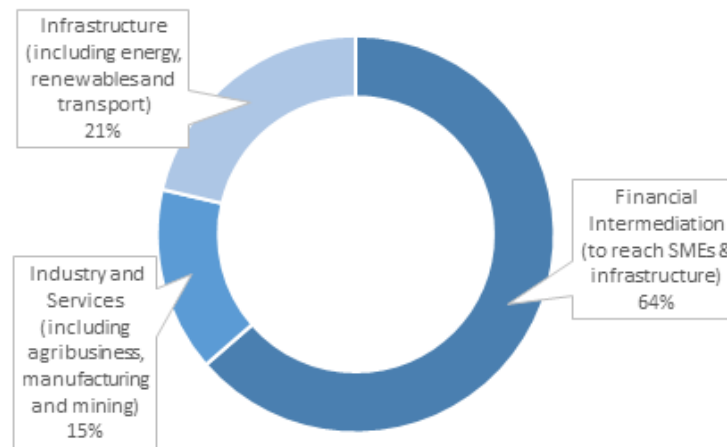
3.6 ***Over the past 10 years, the Bank's non-sovereign portfolio has grown strongly. The non-sovereign portfolio increased*** both in absolute terms and as a share of the total Bank Group portfolio, growing from 2% of all Bank Group operations in 2006 to 30% in 2016. In relative terms, this is faster growth than experienced by comparable Multilateral Development Banks, signalling a sustained and continuing demand for private sector products of the Bank. A significant share of NSOs goes to low income countries (currently more than 50% of active NSOs). This includes both stand-alone investments as well as the AfDB's investments in financial intermediaries, including pan-African funds and regional DFIs.

**Figure 2: Cumulative NSO approvals in active portfolio (UA millions, signed)**



3.7 ***The Bank's NSOs in ADF countries cover a range of sectors, in line with country needs.*** Financial sector interventions occupy a significant portion of the private sector portfolio of operations in ADF countries. To reach a broader range of clients, particularly SMEs, the AfDB needs to work with viable intermediaries because it would not be cost-effective or efficient to reach on its own. In the industry and services segment, the Bank's portfolio is driven by operations in mining (5.6% of total NSOs in ADF countries), agribusiness (4.1%) and manufacturing (3.1%). Meanwhile, the infrastructure segment is driven by energy operations including thermal, hydro, solar and wind power (9.7%) and transport including ports, roads, airports and rail (8%).

**Figure 3: NSO operations in ADF countries by sector**

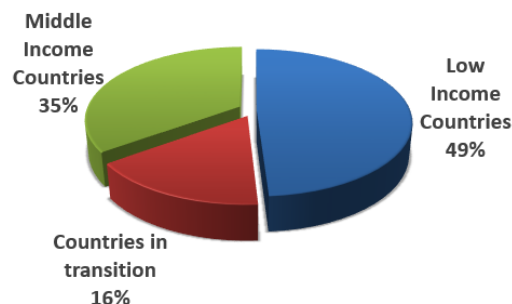


**Box 3: Reaching the under-served: the Africa SME Program**

The SME Program was designed as a means to address the significant challenges faced by SMEs in accessing finance, both from the demand and supply side. Taking as its focus the Tier 2 and Tier 3 financial institutions (FIs) that tend to have a wider base of SME clients, the Program extends Lines of Credit for on lending to SMEs, accompanied by technical assistance funded through FAPA. So far, the Program has covered 10 FIs, including in countries AfDB had not yet reached through its NSOs (e.g. Burkina Faso and Benin). Initial results are positive, although some important constraints have emerged, with lessons that can extend to other efforts to reach underserved segments. First, the Program continues to be constrained by the risk appetite of the ADB. Lower ticket size transactions also tend to be viewed unfavourably due to the high overhead costs relative to deal size. Moreover, the Program is not designed to offer equity and guarantees, for which the AfDB experiences significant demand. These lessons learned are built on in the reminder of this paper.

**3.8 In addition to its loan portfolio, the Bank also takes a highly selective approach to equity participation in financial intermediaries and private equity funds.** These investments are designed to achieve a catalytic role in ADF countries, where traditional investors have little risk appetite and direct investing is not feasible given the small deal size. The Bank supports an active indirect (underlying) portfolio of 376 companies in both ADF and ADB countries, amounting to UA 170 million in investments as at end 2015 (see figure 4). However, the portfolio growth increases the rate of utilisation of the Bank's risk capital and the equity ceiling limit applies pressure on further equity portfolio growth.

**Figure 4. Equity portfolio (Direct and Funds) distribution by country income category**



3.9 ***The Bank has also taken on a role as shareholder in regional financial institutions*** which provide debt, equity and guarantees to the private sector. This includes Afreximbank, Africa Trade Insurance Agency, Africa Guarantee Fund, Africa-Re, East African Development Bank (EADB), PTA Bank, and The Currency Exchange (TCX), among others. Equity to regional DFIs and specialised independent vehicles allow these institutions to leverage their balance sheet by at least 4 times, and more for those institutions specialising in the provision of guarantees. Regional DFIs can also handle smaller size transaction, reaching less served market segments, such as SMEs, women-headed businesses and projects in fragile states.

3.10 The Bank has reached new ADF countries through NSOs, but the portfolio still tends to be concentrated. Over the past two years, for the first time, the Bank Group has engaged in the private sector in Benin, Burkina Faso, Gambia and Niger. Nevertheless, the ADF private sector portfolio tends to be concentrated in Nigeria (36%) and Kenya (10%), followed by Cote D'Ivoire (9%), Ghana (6%) and Cameroon (5%). There is an important underlying rationale for supporting the Nigerian private sector, given its sizeable population and vast private sector needs. As Nigeria transitions to an ADB country, the Bank will need to find innovative ways to expand the range of ADF clients, to maintain the same level of support.

3.11 Although the Bank Group's ability to provide sophisticated solutions to the private sector in low income countries and situations of fragility has increased over time, growth might be experiencing a slowdown. Risk capital constraints in countries facing fragility are significant, as NSOs in ADF countries utilise a higher share of risk capital and weighting on prudential ceilings. Nearly all RMCs facing fragile situations are rated high or very high risk, so any NSOs in those countries would have at least a high risk rating. Meanwhile, the total exposure to high risk transactions, excluding equity investments, is limited to 10% of the risk capital allocation to private sector operations, a threshold which the Bank will soon meet.

3.12 The Bank Group's investments in regional funds and intermediaries, which can ultimately reach lower income countries, aim to balance out these risks. However, over the past 2 ADF cycles, only 8% of private sector investment in ADF countries has gone directly to countries in transition. Moreover, the scale up of multinational operations supporting cross boundary investment by financial institutions means that support to private sector in fragile states take place through this additional channel also. Nevertheless, independent evaluations have commended the Bank's engagement in LICs, where AfDB has been more active than other DFIs.

### ***iii. Combined use of concessional and non-concessional funding***

3.13 ***Drawing on its unique positioning, the Bank has deployed innovative blended approaches to PSD.*** The Bank Group is able to share experiences and work in concert to serve both governments and private enterprise. This is an important value proposition, as a mix of concessional resources blended with private investment is needed to overcome the market failures hampering private sector development in low income countries, to leverage resources by lowering the cost of finance for the private sector and to enhance credit structures, mitigate risk or catalyse additional finance.

3.14 ***Blending is taking place through channelling resources to governments for use in PPPs and by unpacking project components.*** The Bank Group has done this successfully in several instances, for example, in the case of the Dakar Toll Road (see box 4). Blending of concessionary and non-concessionary resources through public clients is achieved by unbundling project components into those that can be assigned to the public sector and those for private enterprise. For example, the Bank supported the Itezhi-Tezhi hydropower project in Zambia, where the Bank provided the Zambian government with \$55 million ADF funds to finance the construction and operation of a 120 megawatt hydropower plant at Itezhi-Tezhi dam under a PPP structure and also provided a senior loan of \$35 million from the ADB window.

**Box 4: Blending ADF and ADB resources for transformational infrastructure: the Dakar Toll Road project**

Congestion on the Dakar peninsula and travel time to and from Dakar has been drastically reduced by the construction of the 25 km, 4- to 6-lane Dakar-Diamniadio toll highway. This PPP project, approved in 2009, is helping to shape the urban planning and renewal of Dakar. Its impact is felt across Senegal, with entrepreneurs and farmers gaining improved access to inputs and markets. To support this innovative project, the Bank approved \$68 million from the ADF and \$14 million from its private sector window. This is one of the first PPP projects for the Bank in the transport sector, and it has been viewed as a model in other regional member countries. It has proved to be a good example of how to leverage concessional resources by channeling non-sovereign operations to a low-income ADF country

3.15 ***The Bank also has access to some (limited) blended financing pools that allow concessional finance through private sector vehicles.*** An example is the Sustainable Energy Fund for Africa (SEFA), a multi-donor Trust Fund supporting sustainable private-sector led growth in African countries through the efficient utilisation of clean energy resources. SEFA, with an additional contribution from the Global Environment Facility (GEF), is a co-sponsor of and the largest investor in the Africa Renewable Energy Fund (AREF), a private equity vehicle solely focused on small and medium-sized independent power projects and deploying mature renewable technologies in sub-Saharan Africa. SEFA and GEF's \$29.5m investment, financed through concessional donor resources, is structured as junior equity, allowing a higher return for other investors. This has catalysed investments from other DFIs and commercial investors of up to \$200 million in equity. The Bank, as an implementing agency, has also blended third party resources with its own resources to support low-carbon technologies that have significant potential for long-term greenhouse gas emissions savings. As an implementing entity of the CIF and the GEF, AfDB has provided a total of \$4.3 billion in the form of different financial instruments (e.g. concessional debt, equity, grants) and is working with a view to deploying convertible financial instruments and guarantees.

3.16 Over the past two ADF cycles, the Bank introduced new risk participation and guarantee instruments. The ADF Partial Risk Guarantee (PRG) operates by insuring private lenders against well-defined political risks (political force majeure, regulatory risks, breach of contract), in the event that a government or a government-related entity fails to honour certain specified commitments. To date, the ADF-PRG has been used to support eight private sector operations,<sup>1</sup> for a total level of guaranteed exposure of UA 146 million. Thanks to its leverage factor and catalytic impact, this required the use of only UA 36 million of PBA allocation but catalysed around \$2.7 billion in additional investments.

3.17 The ADF Partial Credit Guarantee (PCG) is another leveraged instrument, which is designed to help address the challenges faced by well-performing ADF countries. The instrument also targets State Owned Enterprises (SOEs) in eligible ADF countries, to mobilise domestic and external commercial financing. The instrument provides a partial guarantee to debt service obligations of eligible countries and SOEs. While take up for PCGs has been slow, due to the relative novelty of the instrument, a recent scale up of marketing efforts led to the build-up of a more substantial pipeline. The current economic conjuncture in the continent, calling for countercyclical borrowing at sustainable cost, is also likely to push demand for PCGs. The first ADF PCG was approved in 2016 with a total guarantee exposure of \$40 million for Madagascar to reduce the costs of a \$55 million commercial loan. As a leveraged instrument, only \$10 million will be deducted from the country's Performance Based Allocation. More recently, a PCG of \$4 million in local currency was approved for Tanzania to raise long term funding from the Tanzania local currency bond markets for on-lending to local banks.

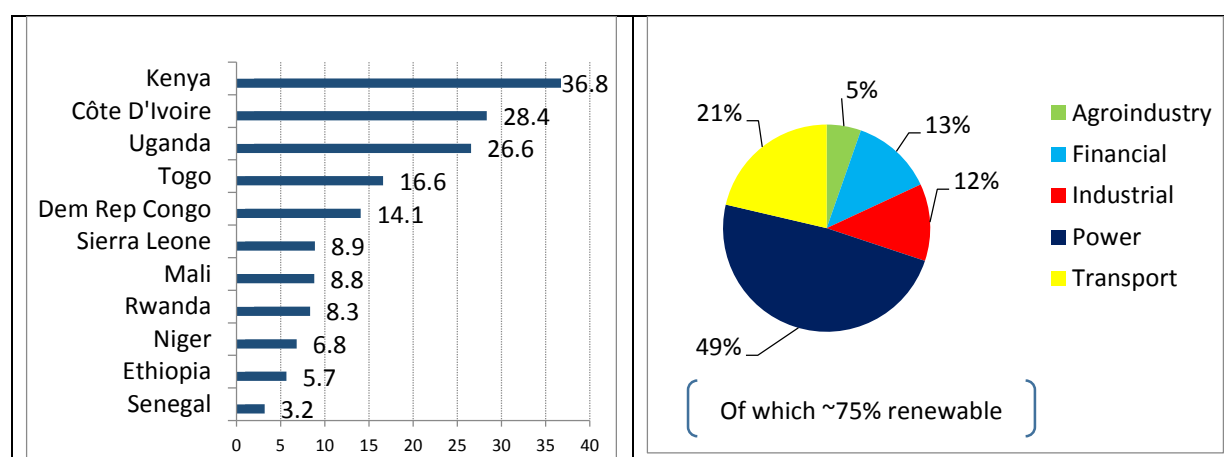
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<sup>1</sup> Wind power project in Kenya; four Independent Power Producers in Nigeria in the context of the privatisation of the electricity sector; and three geothermal projects in Kenya.

3.18 Crucially, the total guarantee exposure ceiling for combined PRGs and PCGs of UA 500 million might be reached sooner than anticipated. Currently PRG transactions approved or being formally requested stand at around UA 270 million. PRG and PCGs saw interest especially from the energy sector but there are also equally important opportunities to deploy these instruments in other sectors and at the macro-level. The Light up and Power Africa High 5 envisages a further scale up of Bank activities in the sector, and this is likely to draw on these two instruments. Moreover, because PCGs tend to be lumpier in size, as their utilisation picks up, there is an expectation that demand for the two instruments will soon build up to the overall limit. During the mid-term review of the ADF, the ceilings of both PCG and PRG will be reviewed.

3.19 ADF 13 introduced a further innovative risk participation instrument with the Private Sector Credit Enhancement Facility (PSF). The PSF is designed to use the transactional capability of the Bank's non-sovereign operations and be deployed without recourse to sovereign counter-indemnity. The PSF is a special purpose vehicle, with an initial ADF-funded UA 165 million capital offering credit enhancement to a portfolio of transactions in LICs. The Facility provides an avenue for the ADF to leverage its ADB window, by co-opting the Bank's capability to support private sector projects in ADF-eligible countries. The PSF's take up has been significant since effectiveness in May 2015: by end of 2015, a third of the PSF's exposure capacity had already been allocated to 15 ADB private sector transactions, of which more than 50% were in fragile states. Examples of approved projects include power generation projects in Kenya, Cote d'Ivoire and Sierra Leone, and an industrial plant in the Democratic Republic of the Congo. The PSF utilisation rate is expected to reach 40% by end Q2 2016, thanks to robust interest in PSF participation from fragile states and regulated sectors (power, transport and renewable energy). In order to ensure strategic deployment of the risk bearing capacity of the PSF (its equity capital), the origination of PSF participations has evolved towards a sector programming approach. Transactions are prioritised on the basis of alignment with the High 5s, expected development outcomes and geographic and sector diversification benefits, as well as meeting the PSF prudential requirements required for effective capital relief.

**Figure 5: Sector and country distribution of PSF-backed projects as at end Dec 2015**



3.20 **Through smart partnerships, the Bank has leveraged its own resources.** Beyond funding, the Bank Group can leverage knowledge and expertise, drawing on the comparative advantage of other partners. For instance, the Japan funded EPSA initiative, replenished for \$2 billion in 2012, is refinancing the Bank's private sector operations through credit lines (NSLs) to the Bank. Six credit lines, totalizing \$1.2 billion equivalent, have been extended to the Bank to refinance the Bank's non-sovereign exposures. Part of the financing has been channelled to ADF countries to address infrastructure shortages (for example,

in Uganda, Madagascar, Nigeria and Ghana). The recently established Africa Growing Together Fund (AGTF), funded by China, provides \$400 million in additional resources to co-finance private sector operations alongside the Bank. To date, one operation has been approved in an ADF country, Senegal, with more low income countries in the pipeline.

#### 4. Results, Lessons learned, Needs and Challenges

4.1 ***The Bank's portfolio in support of PSD delivered clear development impact.*** The Bank Group's presence as a finance partner has a signal effect on other investors and lenders, such that each \$1 invested by the Bank Group is estimated to mobilise an additional \$5 in financial support.<sup>2</sup> The Bank's contribution towards private sector development is tracked through its Results Management Framework, with main outcomes for PSD set out in Table 1, with the detailed report at Annex I.

**Table 1: Summary of Results**

	2010-2015	2016-2018
	Achieved	Expected
Government revenue from investee projects and sub projects (\$ million)	709	654
SME effect (turnover from investments) (\$ million)	541	960
Jobs created	35,600	36,122
Of which jobs for women	17,800	19,000
Number of ADF countries where the Bank operates that have improved business environment.	7	

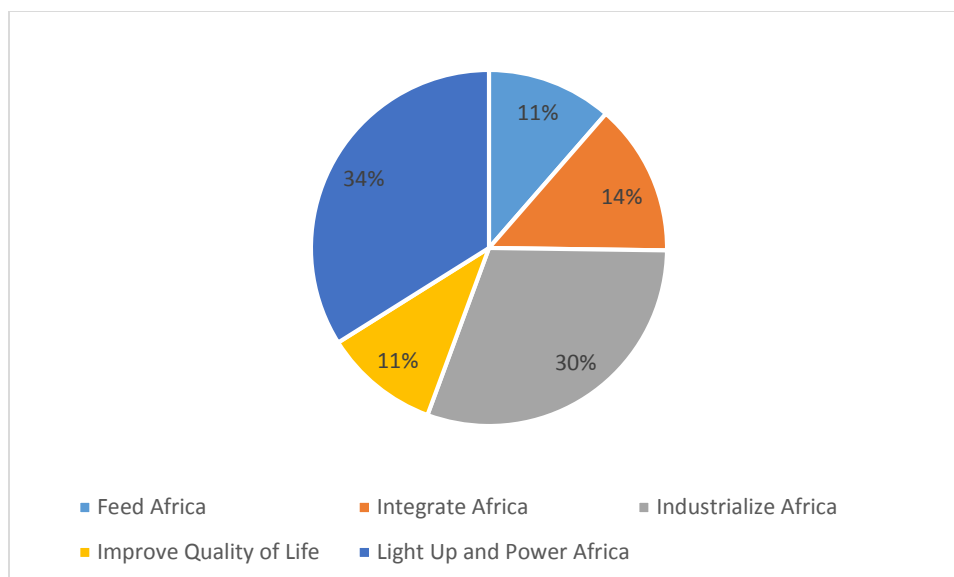
4.2 ***The Bank Group is seeing more demand than ever for enhanced PSD in ADF countries.*** It is estimated that ADF countries will require \$130 billion annually over the next ten years to move their current growth trajectory.<sup>3</sup> A significant amount of this funding will need to come from the private sector. Demand is reflected in a large pipeline projected for Bank NSOs over the next three years. The current pipeline of NSO deals in ADF countries exceeds UA 9.7 billion over 2016-2019. These projects fall across numerous areas of the High 5s, with the largest share going to industrialisation and light up Africa, as seen in Figure 7.<sup>4</sup> This should be viewed as an estimate of pent-up demand, even though not all operations can be expected to come to closure.

#### Figure 6: Composition of NSO pipeline in ADF countries by H5

<sup>2</sup> Independent Evaluation of Non-Sovereign Operations 2006-2011 Summary Report (March 2013)

<sup>3</sup> From ADF-14 Replenishment Meetings Presentation Abidjan 2016

<sup>4</sup> The attribution of NSO pipeline to High 5 areas assumes that Industrialise Africa is supported through investing in small and medium enterprises via financial intermediaries, as well as direct investments into domestic processing, agri-business, value chains, natural resources and supply of services. It also includes support to Light Up and Power Africa, with significant investment planned in oil and gas, geothermal, solar and LNG. To address the need to Feed Africa, projects are being prepared to support agricultural value chains in ADF countries, including via financial intermediaries, with a view to support agricultural small holders. Improving the African Quality of Life will be supported through projects in the health and education sectors, as well as investments in supporting Africa's microfinance space. Finally, Integrate Africa is planned to be addressed through multi-national infrastructure projects and regional financial infrastructure investments.



4.3 ***This level of demand cannot be met through the current financial capacity of the Bank.*** In its 2016-2018 Budget, the Bank is projecting an average lending capacity for NSOs of approximately UA 950 million per annum in ADF countries, which is far less than both projected demand and the level of ambition required to meet the SDGs and the High 5s.

4.4 Moreover, ***even assuming a conservative lending scenario, the Bank Group will soon meet risk and capital constraints.*** These constraints are expected to have a larger effect on projects in ADF countries than on those in middle income countries (MICs). There are three specific constraints, set out in the next paragraphs.

4.5 ***The risk-profile of the NSO portfolio as a whole:*** The Bank Group aims to maintain the weighted average risk rating of its overall NSO portfolio within a certain band that is aligned to rating agencies' expectations, which is equivalent to a 'B' rating in their rating scale.<sup>5</sup> The country risk rating of all ADF countries averages around the 'B' mark and project-specific risks are added this to compound the project risk rating and, in turn, the risk capital utilisation. Thus, projects in ADF countries tend to have higher risk ratings than those in ADB countries. Historically, the Bank has balanced its portfolio risk profile with large, low-risk transactions in MICs. However, over the past five years, a number of factors have contributed to reduce the average rating of ADB eligible countries, which is undermining the effectiveness of this strategy. This means that the Bank will be challenged to support new projects in ADF countries at the scale envisaged in the H, without placing the NSO portfolio's Weighted Average Risk Rating under pressure.

4.6 ***The share of the portfolio comprising high risk rated projects:*** Currently, the share of high risk NSOs - set at 10% of operational risk capital for NSOs - is hovering near the limit, with pipeline projections showing the limit would be breached, if all else is unchanged. Twenty-one fragile and transition countries have average country risk ratings that automatically put projects in these countries in the high risk category. This constrains operations in sectors that attract the highest risk ratings, notably agribusiness, energy, transport and industry/manufacturing, which are all crucial to achieving the High 5s.

<sup>5</sup> Equivalent to a "4" on the Bank's 10 point rating scale.

4.7 ***The utilisation of equity capital:*** The equity risk capital utilisation is soon to reach its 15% ceiling. While risk limits could be changed by policy, a generalised relaxation may affect the overall credit rating of the AfDB.

4.8 Therefore, as the Bank comes up against these risk constraints, its ability to invest in the private sector for higher risk ADF countries will be disproportionately affected, unless innovative solutions to increase the efficiency of use of the Bank capital to tackle these constraints are introduced or scaled up.

4.9 ***We have learned lessons from the past decade of NSOs operations, which can make the Bank Group's support more efficient and effective.*** Evaluations of the Bank Group's non-sovereign operations,<sup>6</sup> whilst largely positive, identify several key areas for improvement. In particular, these centre on the need to: (i) scale up support to fragile states by increasing risk bearing capacity; (ii) improve the Bank Group's targeting of disadvantaged groups through innovations; (iii) supporting the uptake of local currency lending; and (iv) strengthen its processing to better serve NSO clients. These lessons are captured in Table 2.

4.10 ***ADF resources could be leveraged to overcome some of these challenges.*** A number of bilateral donors and DFIs are already blending concessional resources with commercial funding, to support the private sector in Africa. Some examples of blended financing initiatives in ADF countries are included in Annex 4. In general terms, use of concessional finance<sup>7</sup> to support private sector activities can be justified by a gap between private returns and social returns deriving from a project, which means that the private sector operating on purely commercial terms would not undertake a developmentally beneficial project. It is often difficult to identify the externalities that reduce private returns below social returns, and it is important to address the potential pitfalls of using concessional finance to directly support private sector activities, such as moral hazard, adverse selection, misallocation of scarce concessional resources, and delayed market transformation. These arguments and mitigating measures, in line with the discussions at the Working Group composed of the main DFI undertaking Private Sector Operations,<sup>8</sup> are summarised in Annex 2.

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<sup>6</sup> Independent Evaluation of Non-Sovereign Operations 2006-2011 Summary Report (March 2013); Independent Evaluation of Bank's Group Assistance to Small and Medium Enterprises 2006-2013 (September 2015)

<sup>7</sup> *Concessional finance is defined as financial products (equity, guarantees and loans) provided on terms that are explicitly more favourable than those available from the market.* Terms that determine concessionality include refers interest rates, tenure or repayment profile for a loan, or required returns for equity. In this sense, it is worth noting that even lending through the ADB window currently provides elements of concessionality, as it typically offers longer tenure terms than commercially available loans.

<sup>8</sup> DFI Guidance for Using Investment Concessional Finance in Private Sector Operations [accessible at: <http://www.ebrd.com/downloads/news/roundtable.pdf>]



**Table 2: Lessons from Bank Group PSD operations in ADF countries**

<b>Lesson</b>	<b>Challenges &amp; Opportunities</b>
<i>The Bank Group has faced limitations in scaling up NSOs in countries in fragile situations</i>	<p>NSOs in countries in transition face acute risk constraints. This leaves an important financial gap, as countries in transition already receive less FDI per capita than other ADF countries (\$24 against \$105 in 2014.). In countries in transition, private sector investment is likely to have the greatest impact both at country and continental GDP level. However, the Bank's risk capital limit for high risk can no longer support their growth trajectory through private financing.</p> <ul style="list-style-type: none"> <li>→ Well-designed private sector projects in high risk environments can deliver large developmental impacts, both from the point of view of early stabilisation through employment and increased incomes and more generally a 'peace dividend'.</li> <li>→ Bank Group support can help catalyse additional investment by shifting risk perceptions and test successful business models, creating significant demonstrative effects.</li> </ul>
<i>The Bank has at times found it difficult to reach the more vulnerable groups and especially women, through its NSOs.</i>	<p>This challenge extends to female entrepreneurs, who face sector wide constraints but also gender specific ones: women-owned SMEs are likely to face higher borrowing costs, be required to collateralise a higher share of loans and have shorter-term loans than male-owned SMEs. The typical features of women-owned SMEs (small in size, limited savings, and no credit history) further compound these challenges. These barriers lead to lack of access to finance being cited by women across the continent as the largest obstacle to doing business.<sup>9</sup></p> <ul style="list-style-type: none"> <li>→ There are significant development gains in enabling groups, that are historically discouraged from undertaking formal business activities by cultural prejudice or power relations.</li> <li>→ While the Bank Group is constrained in its ability to reach these groups directly and must work with intermediaries, Bank support can encourage additional lending to this segment by reducing its real and perceived risk.</li> </ul>
<i>There are significant synergies between sovereign and non-sovereign operations supporting private sector development.</i>	<p>The policy dialogue generated by sovereign operations supporting the reform of the business climate provide an important risk mitigation tool for the Bank's direct investments. At the same time, large NSOs can provide powerful incentives for RMCs to address the main blockages and constraints deriving from regulatory and policy weaknesses. The Bank's Private Sector Development Strategy and Policy 2013-2017 is designed to reap the benefits of the synergies between NSOs and SOs for private sector development.</p>
<i>Limited ability to extend loans in local currency are often at the root of the difficulties in reaching bottom-of-the-pyramid businesses.</i>	<p>The prevalent use of foreign-exchange funding limits the reach of Bank operations, as MSMEs' financing needs are usually in local currency and financial intermediaries are hesitant in bearing foreign-exchange risks.<sup>10</sup> While the Bank Group is able to offer local currency products, their uptake has been limited due in part to the Bank Group's need to pass on its cost of funding local currency to the client.</p> <ul style="list-style-type: none"> <li>→ Possibilities of leveraging concessional resources to support local currency lending to MSMEs could provide significant development gains.</li> </ul>
<i>In order to meet rising demand, it is important to strengthen internal capacity to improve speed of processing across all NSOs.</i>	<p>The Bank's processing times for NSOs exceed that of its sister MDBs.</p> <ul style="list-style-type: none"> <li>→ A stronger effort will be made in the context of the new DBDM to create economies of scale in identifying and matching the required internal skills. The DBDM offers a significant opportunity to enhance skills and improve business development and origination through its push to move closer to its clients to enhance delivery.</li> </ul>

## 5. Options for ADF-14 and Beyond

**5.1 Management is purposefully injecting private sector orientation in its activities with public sector clients, and will continue to do so over the course of ADF-14 in order to help implement the strategic priorities of the Bank Group.** This approach has prompted a shift in sector strategy and programmes: (i) positioning agriculture as a business opportunity, (ii) driving sector-wide reforms and availing risk sharing instruments to enable private investment in lighting and powering Africa, (iii)

<sup>9</sup> World Bank Group (2015) *Enterprise Survey data* [available at: <http://www.enterprisesurveys.org/>]

<sup>10</sup> Evaluation of Bank Group Assistance to Small and Medium Enterprises 2006-2013 Summary Report (September 2015)

targeting women entrepreneurs and youth to improve the quality of life for African people, (iv) making private sector driven and public sector enabled African industrialisation a priority, and (v) integrating small domestic markets to achieve the economies of scale needed for African enterprises to compete domestically, regionally and globally. A renewed emphasis on public-private partnerships is also fundamental to the Bank's new business delivery model.

**5.2 Adopting innovative mechanisms to leverage existing and additional financial resources will be key to crowd in the private sector.** Noting the constraints faced by the ADB window in terms of its risk bearing capacity and need to maintain a 'AAA' rating, various options have been explored to scale up private sector support through the ADF window. The Bank Group's strategic approach in selecting the options takes into account a number of principles:

- Continuing to exploit the synergies between sovereign operations supporting reforms to the business climate and non-sovereign operations providing direct finance in transformative projects;
- Mitigating the constraints posed by risk limits on a further scale up of NSOs in low income countries;
- Increasing inclusivity by reaching out to market segments currently under-served by non-sovereign finance;
- Crowding in additional finance from the private sector and other partners;
- Minimising market distortions through the application of a 'minimum concessionality'<sup>11</sup> principle.

**5.3** As summarised in Table 2 and expanded upon in the following paragraphs, three options are proposed for consideration and guidance. Additional technical details are included in Annex 5.

**Table 3: Proposed options to scale up support to private sector financing in ADF countries**

	Proposal	Instruments	Proposed (existing) ADF Set Aside	Estimated envelope
<b>A</b>	Scaling up PSF	Credit risk participation in loans, with possibility to diversify eligible financial instruments and intermediaries	Existing: through Private Sector Credit Enhancement Facility (PSF)	UA 200 Million
<b>B</b>	Pillar IV TSF for NSOs	Loans, guarantees	Existing: through Transition Support Facility (TSF)	UA 100 Million
<b>C</b>	Blended finance investment.	Loans, guarantees, possibility to include equity	New vehicle/dedicated window.	UA 200 Million

**5.4 The introduction of Concessional Donor Loans (CDLs) as an innovative financing instrument under ADF-14 is a further element to consider in shaping options.** CDLs aim to increase the overall ADF envelope by allowing the Fund to borrow from donor countries at concessional terms in addition to receiving traditional grants. CDLs blend with grant resources and are not earmarked for any specific use. While concessional, the amount of CDLs that can be taken on without impairing the sustainability of the

<sup>11</sup> The concessionality embedded in a financing package should not be greater than necessary to induce the intended investment ('minimum concessionality' principle) and maximise the leverage of private funding.

ADF is driven by ADF's returns – the harder the terms, the higher the amount of CDLs that can be sustainably taken. If everything else is equal, lending to the private sector on harder (but still concessional) terms than made available to public sector clients is one way of maximising the amount of CDLs and the financial resources available, to support achievement of the SDGs and the High 5s. 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.

5.5 ***In order to facilitate prioritisation, the four options are assessed against specific criteria.*** The criteria that have been proposed are as follows: i) Ease of implementation that reflects the legal and institutional context of the Bank Group, including the possible operational costs; ii) Leverage and financial impact that addresses the need to catalyse additional resources, whilst maintaining a low 'set aside' for donors; iii) Impact on sustainability of ADF as measured by the ability of the proposal to generate returns (income) so as to maximise the long term support to low income countries; and iv) Added value over existing instruments that measures the degree to which the proposal bridges a gap that could not be filled by existing instruments.

#### ***Option A – Scaling up the PSF.***

5.6 ***Overview.*** The ADF-13 set aside some resources for PSF, because (i) there were pressures on ADB risk capital (at the time, these were primarily linked to country-specific risk capital allocations); and (ii) it was recognized that NSOs have a development impact aligned with the ADF's mandate. The pilot phase of the PSF showed significant take-up of the Facility since it became operational in May 2015. The PSF is enabling the Bank to free up room against its risk capital limit and undertake higher risk-high impact operations, especially in countries in transition. To ensure that the results of the new High 5 agenda and planned major increase in the Bank Group's private sector lending does not leave behind ADF countries, the PSF will need to be scaled-up, in a way that is commensurate with the overall NSO growth trajectory. A contribution from the ADF would reinforce, and be complementary to, initial discussions with partners on options to re-ensure the PSF and thus increase its leverage. An allocation of UA 200 million is thus proposed from ADF-14.

5.7 A number of design options have also been identified to enhance the impact of the PSF beyond its pilot period. These include diversifying the financial institutions with which the PSF shares private sector risks, as well as the increasing the range of eligible instruments covered by the Facility. Elaboration and design work has begun on these options and will incorporate lessons from the pilot phase. They will be subjected to stress and market-testing and to rating agency consultations before feeding in to a proposal to the ADF Board by the end of the pilot period, in time for swift implementation.

5.8 ***Identified demand.*** The Bank Group's 2016-18 budget projects a significant increase of NSO lending in low income countries compared to previous ADF cycles. The pilot phase of the PSF showed considerable take-up of the Facility since it became operational in May 2015. Its total commitment capacity is projected to be reached over the course of 2017.

5.9 Maintaining the momentum and supporting the scale up of activity under the High 5 priorities, while at the same time addressing the risk limits and continuing to push support to the private sector in situation of fragility and in high impact and high risk sectors, calls for an augmentation of resources to the PSF from the ADF-14. An increase in resources will serve as a strong sign of commitment, which will draw other partners into supporting the PSF.

5.10 ***Benefits and limitations.*** Having experienced a rapid uptake in the year since its effectiveness, the PSF has proven to be an efficient and effective tool for leveraging. A significant benefit of this option is that it proposes to expand something that is already operational. Beyond scaling up, any changes to the

PSF's current business model, such as a diversification of eligible financial institution and instruments, may require an evolution in the PSF legal structure and leverage model e.g. incorporation and official credit ratings.

### ***Option B – Establish a new pillar under the Transition Support Facility for private sector***

5.11 **Overview.** Meeting the SDGs in countries in transition will require a significant scaling up of financing to private sector to help these countries to escape the fragility trap. Due to the risk bearing capacity of the Bank as well as countries' risk profiles, available non-concessional resources could only meet a marginal proportion of transition countries' demand for private investment. Under this option, a 'Pillar IV' would be set up under the Transition Support Facility with an allocation of UA 100 million to stimulate private sector activity, with an exclusive focus on countries in fragile situations. Building on the example of the creation of the TSF Pillar I that overcame the limitations of the PBA formula to increase public sector assistance to fragile situations, the proposed Pillar IV could become a game changer to increase the Bank's private sector portfolio in these countries. This would be undertaken on a pilot basis, using a blending approach with the ADB window, to improve economic opportunities for targeted sectors and vulnerable groups

5.12 **Identified Demand.** There is currently no dedicated resource pool exclusively for the private sector in transition countries, in spite of significant unmet demand coming from project sponsors. Under this option, TSF resources would be used to co-finance private sector entities through guarantees (for example, to support SME lending, women, young entrepreneurs, SMEs in agriculture, labour intensive manufactures) and local currency loans.

5.13 **Benefits and Limitations.** This proposal is expected to have a highly significant leverage factor by tackling some of the challenges which limit private initiative in transition countries. It is also expected to have a strong demonstration effect. Its implementation could be done within existing structures, though guidelines for the use of funds would need to be established. These will include processes and safeguards to enshrine the 'minimum conditionality' principle in investment decisions. This option also brings a significant advantage over existing instruments, given that there is currently no dedicated resource pool exclusively for private sector investment in Africa's transition countries. In addition, while the PSF may allow the Bank Group to do more in transition countries by enhancing the Bank's own risk bearing capacity, the benefits of concessional pricing are not passed directly on to the ultimate beneficiaries of these investments. The non-sovereign ADB window continues to operate exclusively on commercial terms, with ADB alone being unable to blend its financing terms to reflect externalities or public goods aspects of projects. Under this option however, such blending would be made possible and would lower the cost of finance for the end-beneficiary. The selection and design of the blending structure will be targeted and tailored to the specific context and the nature of the externality or financing barriers, while avoiding long-term subsidy-dependence in a given sector.

### ***Option C – Blended finance investment vehicle***

5.14 **Overview.** The existing modalities supporting the private sector via the ADB window do not go far enough to support certain disadvantaged groups, due to a combination of size, risk appetite and other factors. The Bank Group would be seeking to play a greater role in pioneering and facilitating the uptake of projects, which may have returns below commercial rates, but do have high development impacts. This option considers the possibility of leveraging ADF resources for private sector investment on blended terms i.e. with an element of concessionality. Under this option, UA 200 million is proposed for blended finance investment. ADF resources would be used for co-financing with the ADB window or other

investors on a highly selective basis, targeting under-served groups, and ensuring that guidelines to minimise market distortions and ensure application of minimum conditionality are in place.

**5.15 Identified Demand.** Estimated demand considers current pipeline initiatives for which concessional resources are being sought (but are unavailable or insufficient) to be used alongside ADB resources. This includes initiatives in the area of financing women entrepreneurs, SMEs in the agriculture value chain, youth and renewable off-grid energy projects. Without concessional resources to lower the cost of finance offered to beneficiaries of these innovative initiatives, it is estimated that the reach of these initiatives would be limited. The instruments covered under this option would include loans and guarantees (including portfolio guarantees), with the possibility to extend to equity. An indicative envelope of UA 200 million could be used to pilot this proposal for several initiatives, subject to a careful screening and selection process.

**5.16 Benefits and Limitations.** This option is expected to have a strong leverage impact by crowding in investment to underserved segments, where there are large development gains. Moreover, this option brings significant benefits over existing instruments. Not only would it increase resources beyond the exposure limit constraint for high risk countries (as in the case of PSF) but it would lower the borrowing cost for the client (which the PSF is unable to do). The Bank Group can currently only do this by channelling concessional resources through governments (for example, in the case of PPPs). Moreover, while some blended finance pools are available for climate related projects (SEFA), there are presently no similar funds to target priority groups, such as women and youth in ADF countries. Nevertheless, this option is expected to have higher implementation costs than the others. Costs would include the resources required to set up the Blended Finance Investment Partnership, as well as the establishment of guidelines, laying out specific criteria and processes for the use of funds. While lessons learned from other blended vehicles could be taken into account, there would be a significant scale-up period in order for this option to be fully operationalised.

**Table 4: Prioritization Criteria for Selected Proposals**

Proposal	Ease of implementation	Leverage and financial impact	Impact on ADF reflows	Added value over existing instruments
Scaling up the PSF	Strong	Very strong	Strong (indirect)	Strong
Pillar IV TSF for NSOs	Medium	Strong	Medium	Strong
Blended finance investment	Low	Very strong	Medium	Very strong

## **6. Options for ADF-14 and Beyond**

**6.1** The global financing agenda stemming from the Addis Ababa ‘Agenda for Action’ is increasingly looking at using blending and risk participation instruments. A number of development partners already make extensive use of similar instruments to reach out to high risk/high impact segments. The Bank Group sees significant opportunities to scale up its private sector support, although constraints exist. It is harder for the Bank Group to penetrate markets in low income countries and fragile situations due to market and operational factors, as well as the ADB’s own risk limits. With private sector lending expected to soon hit multiple risk constraints, the pressure will be felt most in low income countries and countries in transition, which take up more risk capital. For the Bank Group to maximise resources available to achieve the SDGs in low income countries, it needs a bold mix of innovative financing instruments that leverages concessional finance to crowd in investment.

6.2 To recap, the three options proposed in this paper for consideration and discussion are summarised in Table 4 below. They are not mutually exclusive, and each addresses a specific constraint to scaling up support to the private sector in a transformational manner.

**Table 5: Overview of Proposed Options**

	Proposal	Proposed (existing) ADF Set Aside	Est envelope
A	Scaling up the PSF	Through PSF	UA 200 M
B	Introduce a pillar IV TSF for NSOs	Through TSF	UA 100 M
C	Blended finance investment	New vehicle	UA 200 M

6.3 Management rates the option of scaling up the PSF (option A) as the preferable and thus recommends that, in the short term, it be considered for immediate implementation under the ADF-14. This would allow for the continuation of the significant rate of commitment the PSF has rapidly achieved since becoming fully operational. The other options can be considered for further discussion with Deputies and implementation over the medium term.

6.4 Deputies are invited to share their views on this paper and provide guidance with respect to Management's proposals.

## ANNEX I: Results of private sector development in ADF Countries

- Bank operations achieved 95% or more of their targets<sup>1</sup>
● Bank operations achieved 60-94% of their targets
 ● Bank operations achieved less than 60% of their targets
 ● Data are not available to measure performance

PRIVATE SECTOR	2010-2015		2016-2018	
	Expected	Delivered	Rate	Expected
<span style="color: green;">●</span> Government revenue from investee projects and sub-projects (US\$ million)	722	709	98%	654
<span style="color: green;">●</span> SME effect (turnover from investments) (US\$ million)	526	541	103%	960
<span style="color: orange;">●</span> Microfinance granted	12 348	10 463	85%	15 978
<span style="color: green;">●</span> Microfinance clients trained in business management	262	281	107%	-
<span style="color: green;">●</span> Power capacity installed	231	231	100%	327
<span style="color: green;">●</span> of which renewable energy	113	113	100%	176
<span style="color: green;">●</span> Length of transmission and distribution lines rehabilitated or installed (km)	612	612	100%	86
<span style="color: green;">●</span> People with new/improved electricity connections	1 232 179	1 232 179	100%	203 112
<span style="color: green;">●</span> Transport - road constructed, rehabilitated or maintained (km)	459	459	100%	92
<span style="color: green;">●</span> ICT - people with improved access to basic ICT services	424 853	424 853	100%	645 056
<span style="color: grey;">●</span> Water - drink water capacity created (m3/day)	-	-		164 444
<span style="color: green;">●</span> <b>Jobs created</b>	32 229	35 603	110%	36 122
<span style="color: green;">●</span> <b>Permanent Jobs</b>	26 215	25 421	97%	30 941
<span style="color: orange;">●</span> Agriculture	1 376	1 256	91%	-
<span style="color: green;">●</span> Finance	23 871	23 071	97%	19 554
<span style="color: green;">●</span> Industry	120	120	100%	93
<span style="color: green;">●</span> Infrastructure	848	973	115%	11 294
<span style="color: green;">●</span> <b>Temporary jobs</b>	6 014	10 182	169%	5 180
<span style="color: grey;">●</span> Agriculture	-	-		-
<span style="color: green;">●</span> Finance	5 792	9 612	166%	-
<span style="color: grey;">●</span> Industry	-	-		394
<span style="color: green;">●</span> Infrastructure	222	570	257%	4 786
<span style="color: green;">●</span> <b>Jobs supported</b>	951	984	103%	<b>2 248</b>
<span style="color: green;">●</span> Agriculture	319	319	100%	-
<span style="color: green;">●</span> Finance	347	401	116%	1 387
<span style="color: grey;">●</span> Industry	-	-		-
<span style="color: orange;">●</span> Infrastructure	286	264	92%	861
GOVERNANCE				
<span style="color: orange;">●</span> Countries with improved competitive environment <sup>2</sup>	13	7	54%	

### Notes:

.. = data not available; ha = hectares; km = kilometres; MW = megawatts; m3 = cubic metres; SME = small or medium-sized enterprise; US\$ = United States dollars; ICT = information and communication technology

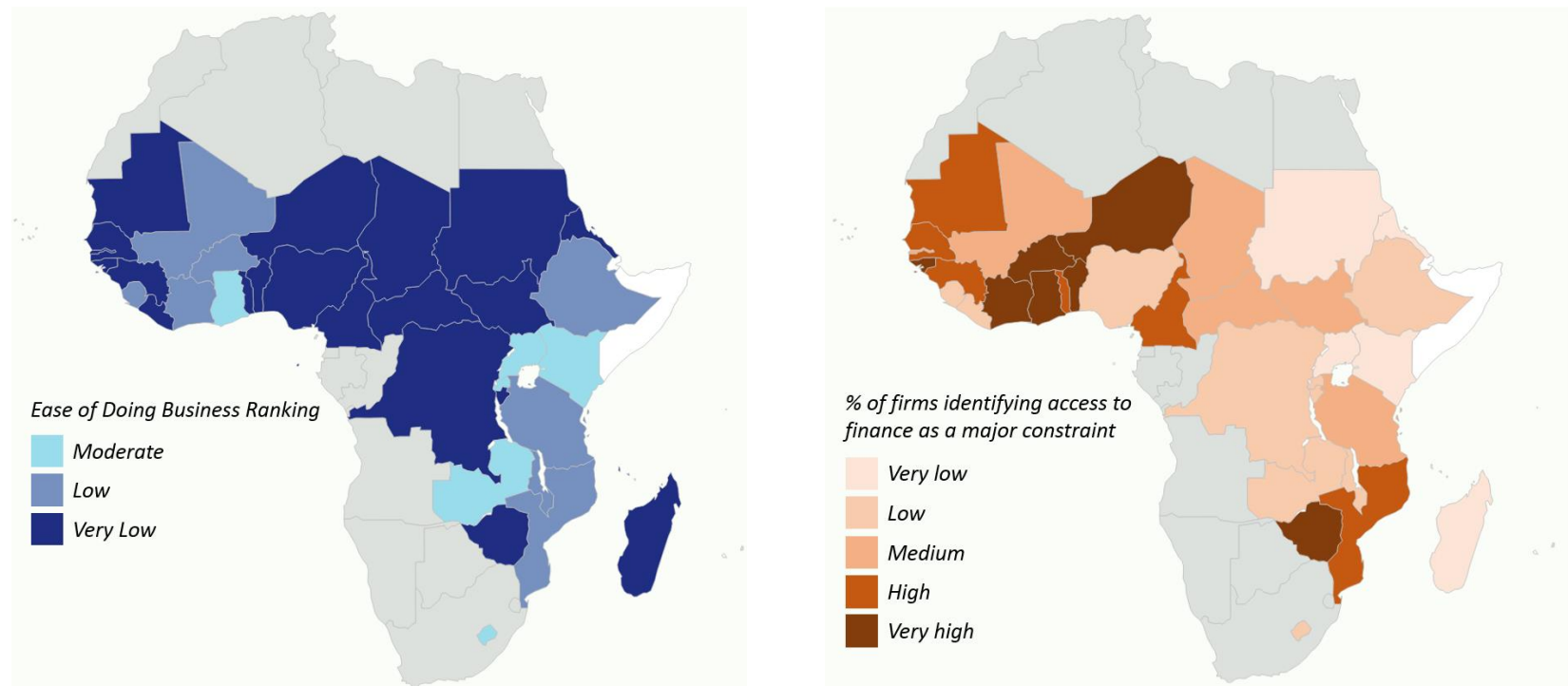
1. The performance indicator for governance applies different thresholds. Given the nature and attribution distance, the levels for the traffic lights are different from other indicators: green, 75% and above, amber, 50%–75%, and red, below 50%.

2. Public sector support to improve business environment.

Note: UA figures from material converted at 1 UA= \$1.38.

Source: African Development Bank

## ANNEX 2: ADF Countries' Heterogeneous Private Sectors



Source: Ease of Doing Business Ranking 2016 and Enterprise Survey Data (accessed May 2016)



### ANNEX 3: Challenges and mitigating measures in using concessional resources for NSOs

Challenges	Mitigating Measures
Direct loans to the private sector are riskier than sovereign loans. A default on an ECDL-financed private sector project will bring more risk to ADF internally generated flows downstream.	The management of risk would fall within the Bank risk management framework, which is set to maintain a standalone triple A rating. Hardened terms would allow increasing the amount of CDLs that could sustainably be taken on, maximising financial resources to support the achievement of the SDGs and H5s.
Crowding Out: Direct concessional lending to private borrowers would compete with and non-concessional sources of development finance, including flows from the AfDB non-sovereign window, commercial and bilateral financing sources.	ADF-backed private sector finance could be used to crowd in more leverage from investors, inducing greater willingness to put private capital risk. An emphasis is to be put on <b>minimum bankability</b> , aiming to utilize the right amount of concessionality to make a project just viable. Studies have shown a six-fold increase in total capital raised when blended finance is available.
Concessional finance may undermine the formation of sustainable markets and provide low value for money. It may delay transformation if substituted for policy reform or institutional development.	Accompanying measures to ADF NSOs are needed to ensure that underlying structural change. Sovereign operations targeting reforms to the business environment
Misallocation of scarce concessional resources that could be used for public goods and public service infrastructure.	Decades of experience have proven private sector capability to deliver public goods and infrastructure. Left alone, private business will not prioritise affordable service provision to poor, vulnerable populations but imbalances in access may need to be corrected.
Adverse selection, leading lower quality projects to be financed thus risks misallocating funds to unworthy projects (adverse selection) or encouraging imprudent, excessive borrowing (moral hazard).	Target clear market failures and externalities, such as a focus on situation of fragility or targeting less privileged groups, where perception of risks prevent the right pricing of development outcomes; Rules on time-bound concessionary finance and increasingly strict justification for 'repeat deals' are required to ensure medium term commercial sustainability.
Distorting DFIs incentives as they 'compete' on concessionary financial terms.	Ensure coordination with other DFIs providing concessional finance to avoid undermining market oriented efforts of others and ensure coherent signals to the market.

#### ANNEX 4: Examples of Blended Finance Initiatives in ADF Countries

Name of Fund/ Facility	Description	Approx. Size (in USD)	Primary Investment Regio	Primary Sector
<a href="#">African Agricultural Capital Fund</a>	The African Agricultural Capital Fund (AACF) was established in 2011 by USAID to invest \$25 million in growth capital to boost the productivity and profitability of Africa's agriculture sector. In order to attract investors, USAID's Development Credit Authority guaranteed 50 percent of an \$8 million commercial loan from J.P. Morgan's Social Finance Unit to AACF. The fund is also supported by \$17 million in equity investment from the Bill & Melinda Gates Foundation, the Gatsby Charitable Foundation, and the Rockefeller Foundation. The fund will also have access to \$1.5 million in USAID-funded business development services, primarily funded under the US Feed the Future initiative, to improve investee companies' operations, competitiveness, and access to markets.	\$25 million	East Africa	Agriculture
<a href="#">African Agriculture and Trade Investment Fund</a>	The Africa Agriculture and Trade Investment Fund is a closed-ended investment company, established by KfW alongside German Federal Ministry for Economic Cooperation and Development (BMZ), Deutsche Bank AG and other private investors. Parallel to the Fund, EUR 6 million in grant resources are made available through a Technical Assistance Facility to support AATIF investments in realizing their developmental potential. Additionally, the TA Facility pursues research and development activities to promote agri-finance in Africa.	\$142 million	Sub-Saharan Africa	Agriculture
<a href="#">African Health Markets for Equity</a>	The African Health Markets for Equity (AHME) partnership is a \$60 million investment by the Bill and Melinda Gates Foundation and the UK's Department for International Development to increase coverage of priority health technologies and interventions amongst the poor. Operating in Nigeria, Kenya and Ghana, this five-year initiative will undertake coordinated work in policy reform, technology for health communication, strengthening of patients' ability to pay, and improved provider access to capital.	\$60 million	Nigeria, Ghana, Kenya	Health
<a href="#">Beira Agricultural Growth Corridor Catalytic Fund</a>	This partnership encourages responsible private investment in commercially viable, early-stage agribusinesses in Mozambique. The project has two key elements: (1) a Mozambican not-for-profit membership organization that supports changes at the policy level; and (2) the Catalytic Fund, a social venture-capital investment vehicle managed by impact investor AgDevCo, which invests in emerging agribusinesses.	\$23 million	Mozambique	Agriculture
<a href="#">Conflict-Affected and Fragile Economies Facility</a>	The facility provides political risk insurance to encourage private-sector investment in fragile and conflict-affected countries. The Facility will use donor partner contributions and guarantees (Canada and UK) as well as MIGA guarantees to provide an initial loss layer to insure investment projects in conflict-affected and fragile economies. MIGA is targeting an initial amount of \$80 million from donor partners.	\$80 million	Global	No specific focus
<a href="#">EU-Africa Infrastructure Trust Fund</a>	Established in 2007, the EU-AITF aims to increase investment in infrastructure in Sub-Saharan Africa by blending long-term loans from participating financiers with resource grants. The EU-AITF offers technical assistance in support of all project phases, interest-rate subsidies to decrease the EU-AITF financiers' loan interest rates, and investment grants to finance project components or part of the investment. Financial instruments include guarantees, risk mitigation measures, equity or quasi-equity investments or participation.	\$934 million	Sub-Saharan Africa	Infrastructure
<a href="#">Green Africa Power</a>	GAP, which is part of the Private Infrastructure Development Group (PIDG), seeks to encourage renewable energy generation projects in Africa. It aims to address barriers by reducing the upfront cost of capital while maintaining overall commercial returns, providing cover for specific construction phase risks and using policy dialogue to move towards cost reflective tariffs. The UK Government is capitalising GAP with initial funding of £95 million towards costs and investment. The Norwegian Government has also committed funding of NOK 300 million (~£25 million). GAP offers intermediate capital/mezzanine finance and contingent lines of credit to privately-owned renewable power generation projects.	\$164 million	Sub-Saharan Africa	Energy

<a href="#">GuarantCo</a>	GuarantCo provides guarantees to lenders to support local currency financing for infrastructure projects in low-income countries. The governments of Australia, UK, Sweden, and Switzerland (through PIDG) and Netherlands (through FMO) provide the funding for GuarantCo. GuarantCo is part of the Private Infrastructure Development Group	\$450 million	Global	Infrastructure
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*Source: OECD & WEF (January 2016). Insights from Blended Finance Investment Vehicles and Facilities*

### ANNEX 5: Summary of Key Features of Proposals

Instrument	Description	Benefits	Estimated leverage and & financial impact	Issues and risks	Implementation Challenges
<b>Scaling up the PSF</b>	<b>Scaling up</b> the risk bearing capacity of the PSF for higher NSO financing levels in ADF countries. Options to evolve the eligible financial institutions and instruments may also be considered and presented at detailed design stage to ADF Board.	<ul style="list-style-type: none"> <li>- Ensure that the results of the new H5 agenda and planned major increase in the Bank Group's private sector lending benefits ADF countries and in particular fragile states</li> <li>- Would increase reflows into the ADF indirectly, by increasing ADB transaction volume (releasing risk capital that would be deployed by the Bank) and in turn net income.</li> <li>- Sub-option of diversifying eligible institution would increase the mobilization of potential co-financiers; extend volume &amp; maturity of co-financing; support smaller size transactions via DFIs.</li> <li>- Sub-option of diversifying eligible instruments could free up equity headroom (if equity made eligible), sub-debt can achieve many of the catalytic features of equity but allows for capital roll-over.</li> </ul>	<p>All options allow the Bank to free up headroom against its risk capital and undertake new operations especially in countries in transition. The minimum estimated leverage would be at least x3 as currently estimated for the PSF. However, a diversification of eligible instrument would have a lower leverage</p> <p>All income from PSF operations reflow to more PSF participations in ADF eligible countries only.</p>	- The sub-options may have implications for the business model, leverage effect of ADF resources, and legal structure of the PSF, which would need to be appropriately stress and market tested.	
<b>Pillar IV TSF for NSOs</b>	A "Pillar IV" would be set up under the TSF to stimulate private sector activity in countries in fragile situations.	This option brings significant advantage over existing instruments given that there is currently no dedicated resource pool exclusively for private sector investment in Africa's transition countries. It would allow an expansion of NSOs in countries in transition, where ADB portfolio is still relatively low; It would allow ADB to blend its financing terms to reflect externalities or public goods aspects of projects, thus mitigating moral hazard and maintaining standards of due diligence while reducing cost of capital for beneficiaries.	This proposal is expected to have a highly significant leverage factor by tackling some of the challenges which limit private initiative in transition countries. It is also expected to have a strong demonstration effect	Stringent guidelines for the use of funds would need to be established.	Its implementation could be done within existing structures.
<b>Blended finance investment</b>	ADF resources would be leveraged for private sector investment on blended terms.	Benefits include: Promote private sector development in underserved segments where there are large development gains; Avoid potential for leakages when channelling resources for the private sector through government entities; Increase resources beyond exposure limit constraints for high risk projects; though blending structure with ADB and/or other commercial investors mitigates moral hazard and maintains high standards of due diligence.	This is expected to have a significant leverage factor by crowding in other private sector investors. It is also expected to have a strong demonstration effect for projects that are ultimately bankable over the longer term but have risky incubation periods.	Highly selective eligibility criteria must be applied to ensure effective use of concessional resources.	If funds are used in partnership with the ADB, operational costs would be limited as ADB would undertake its own due diligence. However, there would be implementation costs of setting up a new instrument.

