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Long-Term Financial Capacity of the ADF

Discussion Paper

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AFRICAN DEVELOPMENT FUND

Executive Summary

The African Development Fund (ADF or the Fund) has supported the economic and social development of low-income countries in Africa since 1974. It is important for the Fund to regularly examine its financing framework and to optimize its development assistance capacity. This is particularly crucial in the fiscally constrained circumstances of many donor countries. Furthermore, the current low interest rate environment poses particular challenges and continues to reduce the Fund's returns on the investment portfolio.

Against this backdrop and following the initial discussions at the ADF-12 Mid-Term Review, the objectives of this paper are threefold:

- Project the level of ADF-13 resources (internally generated resources (IGRs) in the form of the Advanced Commitment Capacity and fresh donors' contributions) and assess its financial capacity under various scenarios;
- Develop options for improving the Fund's financial capacity and for ensuring appropriate use of ADF resources, such as differentiated financial terms among groups of ADF-only countries as well as accelerated and voluntary prepayment for graduated countries.
- Explore possible innovative uses or applications of ADF resources to help catalyze or crowd in larger volumes of resources for worthy development projects in low income countries (LICs) of the Bank Group.

The Advanced Commitment Capacity (ACC), estimated at UA 950 million for ADF-13, is significantly lower than the UA 2,007 million achieved for ADF-12. This is due primarily to the prevailing low interest rates resulting in lower investment income and the reduced level of cash inflows expected from loan cancellations. The lower ACC is also the result of a self-adjusting mechanism built into the Advanced Commitment Authority scheme, which ensures that the Fund minimizes the risk of over-commitment. Through the recalibration of the ACC every three years, the model enables the Fund to only frontload loan commitments in compliance with its liquidity policy.

The implementation of the revised Bank Group Loan Cancellation policy since 2011 results in lower inflows for the ACC, as under the revised policy, only 30% of cancelled ADF resources are reallocated to the general pool of ADF resources, as opposed to 100% under the previous policy. However, it should be emphasized that ADF countries whose operations have been cancelled retain the remaining 70 % of cancelled resources and can re-commit these to new projects. Based on the projected volume of cancellations, this amount is projected to reach approximately UA 210 million for each replenishment. Although not flowing through the ACC, these are resources that are available to ADF countries in addition to the ACC and donors' contributions, and that enable the Fund to achieve its development mandate.

The limited ACC for ADF-13 and the continuing substantial needs of ADF countries imply that strong efforts will be required from both the Bank Group and donors to help the Fund sustain the pace of its development assistance to eligible regional member countries (RMCs) and fulfill its mandate.

Management proposes several options to differentiate and harden the Fund's lending terms in order to apply more appropriate lending terms to heterogeneous ADF countries and boost its internal revenue generating capacity. It recommends to revise the current lending terms applied to ADF-only and Blend countries in order to increase the level of loan reflows and the commitment capacity of the Fund. Management therefore proposes to introduce a new framework for grouping the ADF-only countries into two groups based on their economic situation (ADF-only Regular and ADF-only Advanced), and to apply differentiated lending terms in line with the debt sustainability capability of each group.

Following Deputies' guidance at the ADF-12 Mid-Term Review on this subject, Management will proceed with the introduction of an accelerated repayment clause and a voluntary prepayment framework for countries that have graduated from the ADF. In addition, to leverage the scarce ADF resources, Management is exploring the introduction of new financing instruments that would crowd in more private and other sources of financing for development projects in low income countries.

The measures briefly described here are intended to enhance not only the Fund's long term financial capacity, but also the significance of its development assistance activities.

Deputies are therefore invited to:

- Note the indicative Advanced Commitment Capacity and level of replenishment resources for various scenarios of donor contributions.
- Endorse Management's proposals for (i) differentiated framework among groups of ADF-only countries; and (ii) hardened lending terms for ADF-only and Blend countries.
- Take note of Management's intentions to proceed with arrangements for accelerated repayment and voluntary prepayment of ADF loans for countries that have graduated from the concessional window, starting in ADF-13.
- Provide guidance on the innovative financing instruments that Management is exploring.

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Abbreviations

ACA	Advance Commitment Authority
ACC	Advance Commitment Capacity
ADB	African Development Bank
ADF	African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
ADF-13	Thirteenth General Replenishment of the African Development Fund
AsDF	Asian Development Fund
GNI	Gross national income
IDA	International Development Association
IGRs	Internally Generated Resources
MDB	Multilateral development bank
MDRI	Multilateral Debt Relief Initiative
PBA	Performance Based Allocation
RMC	Regional Member Country
UA	Unit of Account

1. Introduction

- 1.1 The African Development Fund (ADF or the Fund) has supported the economic and social development of low-income countries in Africa since 1974. It is important for the Fund to regularly examine its financing framework and to optimize its development assistance capacity. This is particularly crucial in the current fiscally constrained circumstances of many donor countries. Furthermore, the current low interest rate environment poses particular challenges and continues to negatively impact the Fund's income due to a lower achievable return on the investment portfolio.
- 1.2 This paper presents a review of the long-term financial capacity of the ADF in the context of the consultations on the Thirteenth Replenishment of the Fund. Following the initial discussions at the ADF-12 Mid-Term Review, the objectives of this paper are threefold:
- Provide a projection of the level of ADF-13 resources (internally generated resources (IGRs) in the form of Advanced Commitment Capacity (ACC) and fresh donors' contributions) and assess its financial capacity under various scenarios;
 - Develop options for improving the Fund's financial capacity and for ensuring appropriate use of ADF resources, such as differentiating financial terms among groups of ADF-only countries as well as accelerated and voluntary prepayment for graduated countries.
 - Explore possible innovative uses or applications of ADF resources to help catalyze or crowd in larger volumes of resources for worthy development projects in low income countries (LICs) of the Bank Group.
- 1.3 The paper has five sections. Following the introduction, Section 2 summarizes the evolution of ADF financial resources since inception, reviews the main underlying assumptions of the Advance Commitment Authority (ACA), and examines estimates for ADF financial resources under various replenishment scenarios. Section 3 provides options to improve the Fund's financial capacity starting with ADF-13. Section 4 presents a set of innovative financial instruments. Section 5 provides some conclusions and recommendations.

2. ADF Financial Resources

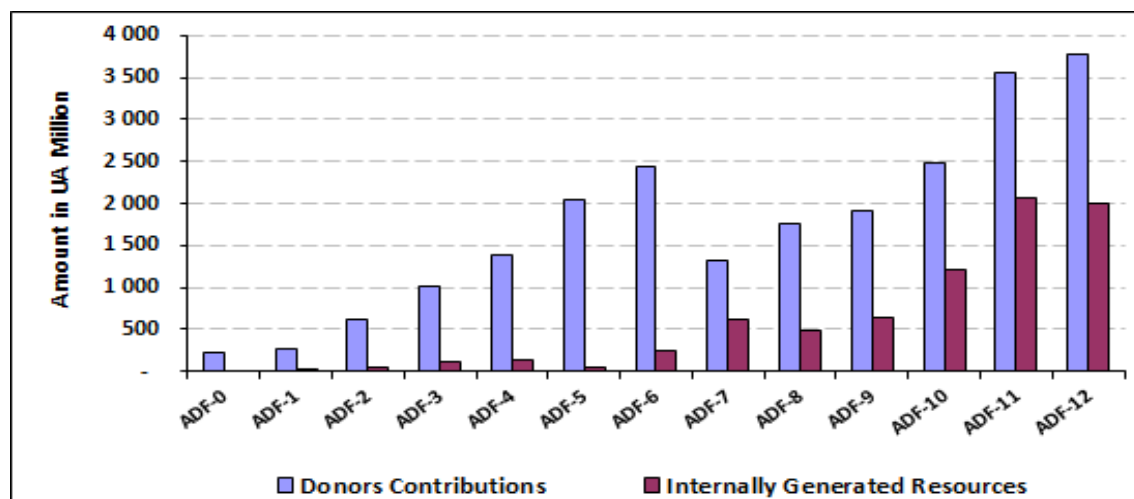
- 2.1 This section presents the evolution of the Fund's replenishments since inception, as well as the evolution of ADF net income since 1999. It then provides estimates of the ACC and the Fund's replenishment resources under various scenarios for ADF-13 donor' contributions.
- 2.2 To fulfill its mandate, the ADF relies on two main sources of funds: (i) contributions from donors that are normally replenished every three years; and (ii) IGRs including the African Development Bank's (ADB) net income allocation. As a highly concessional vehicle that provides loans with only minimal charges and grants, the ADF is not authorized to augment its commitment capacity by borrowing from capital markets. So, donor contributions, loan reflows and any accumulated surplus constitute the Fund's primary resource base.

Historical evolution of the Fund's financial resources

Evolution of ADF replenishment levels

- 2.3 Contributions from State participants are the most significant source of funds. State participants' strong support resulted in an increase in donor contributions in nominal terms from UA 215 million at the Fund's inception in 1973 to UA 3.769 billion for ADF-12 (Figure 1).

Figure 1: Evolution of ADF replenishment levels



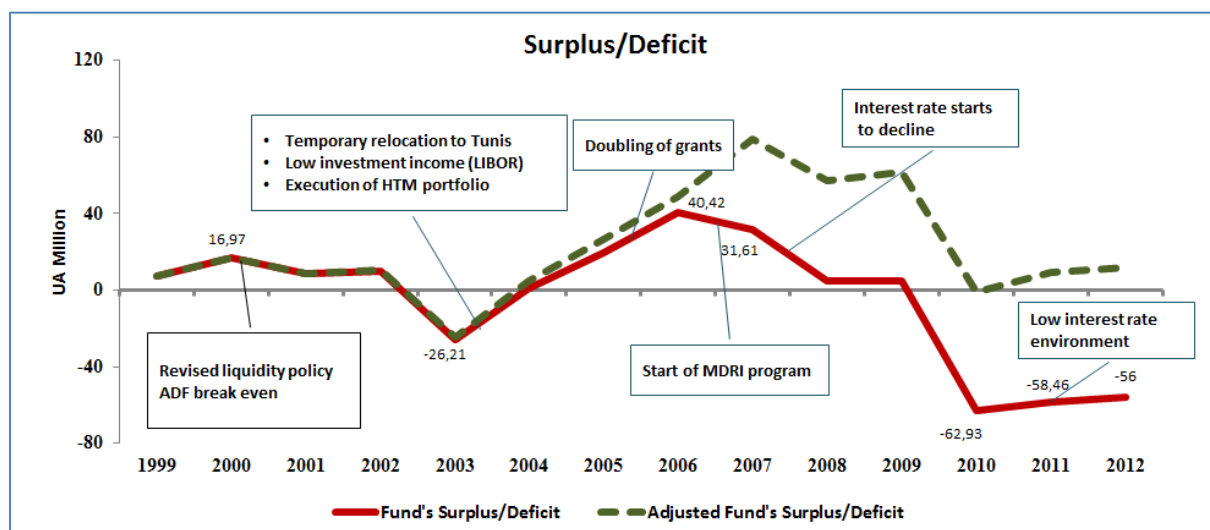
- 2.4 In addition to donor subscriptions, ADF committable resources for any replenishment period include IGRs, comprising loan reflows (repayments and cancellations) and transfers of net income from the Bank. The Bank has consistently supported the Fund by transferring part of its net income on a yearly basis. For the ADF-12 replenishment cycle, the Bank has so far transferred UA 70 million to the Fund (UA 35 million annually).
- 2.5 From the ADF-10 replenishment cycle, the ACA Scheme¹ was introduced to maximize the Fund's commitment capacity from IGRs while ensuring the Fund's financial integrity. The ACA framework takes into account projected cash flows and enables higher loan and grant commitments than if IGRs were based only on current cash flows. As a result, the Advance Commitment Capacity (ACC) rose substantially from UA 638 million for ADF-9 to UA 1.2 billion for ADF-10, and to UA 2.0 billion for ADF-11 and ADF-12. IGRs currently represent 33% of replenishment resources.

Historical evolution of the Fund's net income

- 2.6 The Fund's reported income has in recent years been reduced by two key factors: First, changes in the Fund's financial structure with the implementation of debt-relief initiatives (Multilateral Debt Relief Initiative (MDRI)) and the increase in the proportion of grants which result in forgone income from loans; Second, exogenous issues with the significant plunge in interest rates resulting in the decrease of the Fund's investment income. The first factor is an accounting and reporting issue that affects the Fund's reported income but in principle not its overall financial capacity, as the Fund is expected to be fully compensated by donors for the MDRI and for grants. The second will continue to impair both the Fund's income statement and its long-term financial sustainability, as long as interest rates remain at the current low levels. Figure 2 depicts the evolution of the Fund's financial results adjusted for forgone income on the MDRI and grants, as well as the various events that affected the Fund's revenues since 1999.

¹ See document ADF/BD/WP/2005/18 entitled "Advance Commitment Authority Scheme".

Figure 2: Evolution of Fund's financial results, 1999–2012



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

- 2.7 Consequently, due to the full compensation received on grants and the MDRI, the reduction of loan income in the financial statements should not be perceived as a deterioration of the Fund's financial sustainability and commitment capacity. Table 1 presents the Fund's financial statements for the period 2008–2012, adjusted for forgone loan income.

Table 1: Fund income statement adjusted by forgone income on MDRI and grants, 2008–2012

	2008	2009	2010	2011	2012 ^a
Reported (deficit)/surplus	4.66	4.70	(62.93)	(58.46)	(56.00)
Grant income forgone	16.00	20.00	24.00	29.00	29.00
MDRI income forgone	37.00	38.00	38.00	39.00	39.00
Income after adjustment for compensation of MDRI and grants	57.66	62.70	(0.93)	9.54	12.00

a. Estimate as of September 2012.

Projection of the Fund's financial resources

- 2.8 The Fund's financial resources are assessed through the projection of both its IGRs and donors' contributions.

Advanced Commitment Capacity estimates for ADF-13 and core assumptions

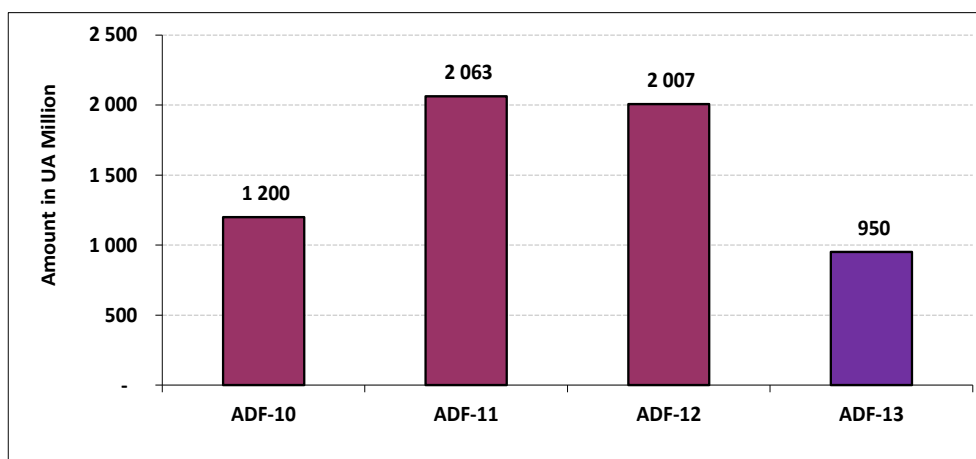
- 2.9 The ACA is the scheme used to determine the ACC. The ACA is long-term in nature, fixed for each replenishment period and based on a set of deliberately conservative assumptions and safety margins built into the model to support future disbursements and mitigate the risk of over-commitment. The ACA model is recalibrated at the beginning of each replenishment period (every three years) to account for differences between estimated and actual cash flows and to determine the ACC for the next replenishment. This recalibration prevents the risk of over-commitment and preserves the integrity of previously committed ACC amounts.
- 2.10 The ACA model analyzes the Fund's financial integrity over 50 years to capture the full impact of the Fund's cash flows over an entire project cycle from loan signature to full repayment. Central to the model is its differentiation among donor contributions, liquidity, and IGRs. The model generates ACC, the main indicator of the Fund's long-term financing capacity. Table 2 lists the evolution of key assumptions of the ACA model from ADF-10 to ADF-13.

Table 2: Evolution of core assumptions for the ACA model

Assumptions	Comments	ADF-10	ADF-11	ADF-12	ADF-13
Expected increase in donor contributions for future replenishments	To establish the ACC for the baseline scenario, donor subscriptions for future replenishments are conservatively assumed to remain unchanged in real terms. The nominal amount of donor contributions is estimated to increase by the cumulative rate of inflation (for the special drawing right-SDR) of the previous replenishment period. The same inflation rate is used to project future increases in donor contributions.	0%	7%	4.49%	6.84%
MDRI compensation expected to be received	In addition to regular contributions, donors are expected to make additional contributions during future replenishments to cover 100% of MDRI costs for all heavily indebted poor countries (on foregone principal and interests) on a pay-as-you-go basis. Based on historically observed MDRI recovery rate, the model assumes a percentage of contributions for MDRI compensations that will be received in ADF-13 and in future replenishments.	0%	84%	90%	93% (incl. lag of 3%)
Share of grants for the Replenishment	The grant level for each replenishment is determined on the basis of a debt sustainability analysis. Based on the level of grants observed during ADF-12, the share of grants in ADF-13 and future replenishments is assumed.	44%	28.4%	30.65%	34.5%
Upfront compensation for forgone income on grants used to estimate the ACC	A volume discount is deducted from grants extended to ADF countries (20% for ADF-12) and include: 1) An upfront grant charge is deducted from the Grant amount as compensation for forgone service charges and returns to the liquidity pool used to estimate the ACC (14.57% for ADF-12). 2) The remaining discount amount allocated under PBA to ADF-only countries (5.43% for ADF-12). The upfront compensation for ADF-13 will be adjusted when the replenishment discount rate will be fixed.	11.9%	10.12%	14.57%	14.57%
Annual increase in administrative expenses	These expenses are in line with the three-year approved budget program and thereafter are projected to increase annually at the indicated percentage.	3%	3%	3%	3%
Annual transfers from ADB	The model assumes an annual net income transfer from the ADB, in UA millions	10	20	35	35
Repayment Sensitivity Factor	To account for delayed repayments by countries in arrears to the Fund, only a certain percentage of loan repayments flows is expected to be received on an annual basis.	85%	85%	90%	90%
Disbursement Sensitivity Factor	To account for grant compensation and loan cancellations, reductions in disbursement flows are maintained at a certain percentage of signed loans.	93.18%	93.18%	95.18%	95.18%
Investment return rate	The rate of return of the investment portfolio is estimated on the basis of prevailing interest rates	Flat rate: 3.42%	Flat rate: 4.45%	Forward curve averaging 4.5% annually	Forward curve averaging 2.65% annually
Minimum prudential level of annual liquidity	To comply with the Fund's liquidity policy, the level of liquidity is maintained at a percentage of projected disbursements for the following three years.	100%	75%	75%	75%
Effective Loan cancellations returning to the liquidity pool	The model assumes a certain level of annual cancellations in nominal terms, in UA millions. During ADF-12, the loan cancellation policy was modified and only 30% of loan cancellations are re-injected in the liquidity pool while 70% remain allocated to the country. Accordingly, for ADF-13 we assume that only UA 30 million (30% of the gross cancellations of UA 100 million) will return to the liquidity pool used to estimate the ACC.	0	100	100	30
Estimated Advance Commitment Capacity	Level of the Advance Commitment Capacity resulting from the model, in UA millions	1,200	2,063	2,007	950

- 2.11 Based on the assumptions of Table 2 and assuming that donors' subscriptions remain constant in real terms compared to ADF-12 (adjusted by the 6.84% inflation rate for the SDR). The ACC for ADF-13 is estimated at UA 950 million

Figure 3: Evolution of the Advanced Commitment Capacity (UA million)

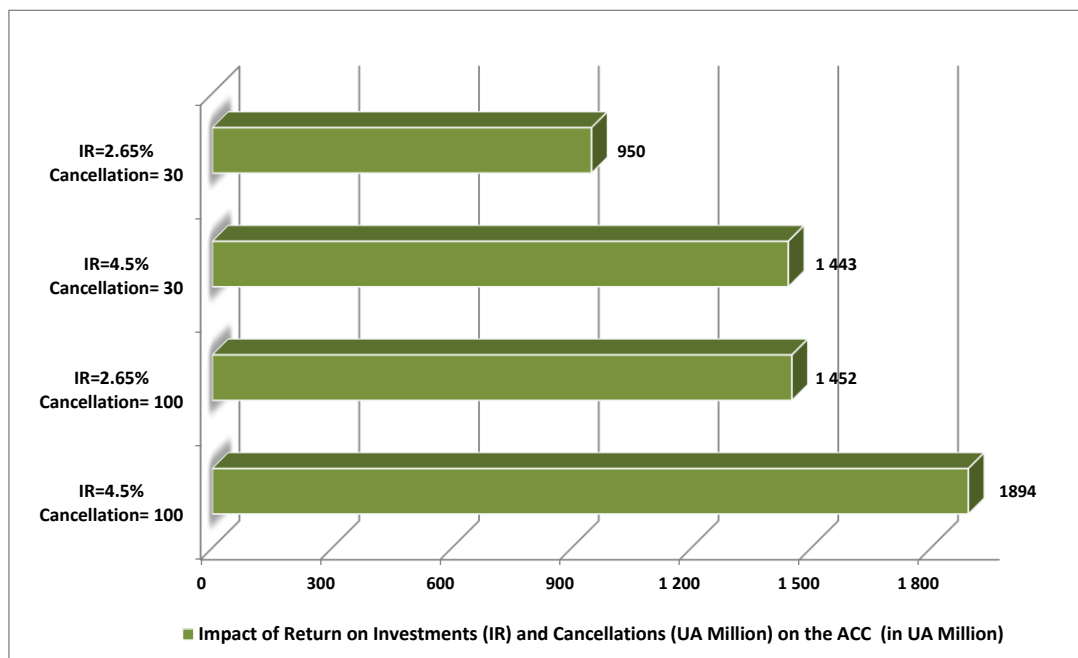


Explanation for the low ACC for ADF-13

- 2.12 As Table 2 indicated, the key assumptions for the determination of the ACC level remain basically unchanged, except for the expected return on investment and the level of loan cancellations returning to the liquidity pool. The changes in these two assumptions together largely explain the lower ACC expected to be achieved for ADF-13 (UA 950 million) when compared with ADF-12 (UA 2,007 million).
- On the lower expected returns on investment, the decline in interest rates on international capital markets has drastically reduced income from the investment portfolios. For ADF-12, based on prevailing forward rates, an average investment return of 4.5% was estimated. Due to current market conditions, an average of only 2.65% can be assumed for ADF-13.
 - On the lower level of loan cancellations, the ADF-12 ACC assumed that annual loan cancellations of UA 100 million would be re-injected in the liquidity pool for the period starting from ADF-12. But, based on the revised cancellation policy², while annual loan cancellations are still assumed to be maintained at approximately UA 100 million, only UA 30 million of these cancellations are now assumed to be re-injected in the liquidity pool starting from ADF-13. The remaining 70 % (approximately UA 70 million per year or UA 210 million per replenishment) are retained by the ADF countries whose operations have been cancelled. The countries can re-commit these resources to ongoing operations or new activities. Therefore, even though these resources do not flow through the ACC, they constitute additional resources that enable the Fund to achieve its development mandate.
- 2.13 Figure 4 illustrates the impact of interest rates and loan cancellations on the ADF-13 ACC , and shows that under the same assumptions as ADF-12, the ACC level for ADF-13 would be UA 1.894 billion.

² See document ADF/BD/WP/2010/62/Rev.3/Approval entitled "*Revised Guidelines on cancellation of approved loans, grants and guarantees*". According to the revised Cancellation policy, 70 % of cancelled resources will be retained by the country for commitment to ongoing operations or new activities consistent with the Country Strategy Paper, while the remaining balance of 30% will be returned to the general resource pool for re-allocation.

Figure 4: Impact of interest rates and loan cancellations on the ADF-13 ACC



Other factors affecting the ACC and compliance with liquidity policy

- 2.14 In addition to the cash inflows (investment income and loan cancellations), it is worth recalling that the ACC level is also driven by the following cash flows:
- Expected loan reflows (loan income and principal repayments) from past and future commitments, as well as MDRI and grant compensations;
 - Net income allocation from the African Development Bank;
 - Loan disbursements; and
 - Administrative expenses.
- 2.15 These cash inflows and outflows affect the Fund's liquidity which must comply with the liquidity policy stipulating that the Fund should hold sufficient liquidity to cover between 50% and 75% of the moving average of projected disbursements for the next three years. However, because the ACA model takes into account a much longer time horizon of 50 years than the short term objective of the liquidity policy, it assumes a more conservative minimum liquidity constraint (the upper range of the liquidity policy). The minimum liquidity is the key safety margin of the ACA model which protects the Fund from various risks, primarily an increase in the pace of disbursements, a decrease in net inflows (loans repayments or transfers from the ADB), or adverse currency or interest rate fluctuations reducing the Fund's cash flows or net income.
- 2.16 By recalibrating of the ACC every three years, the ACA is also a self-adjusting mechanism to ensure that the Fund continues to comply with its liquidity policy and does not run any risk of over-commitment. When there is ample liquidity available, the ACA enables the Fund to frontload loan commitments while ensuring compliance with the liquidity constraint. However, when the available liquidity falls due to negative cash flows impacting the model, the level of the ACC must be adjusted to prevent additional frontloading of loan commitments and to reduce the risk of over-commitments.
- 2.17 One of the key variables improving expected future reflows is the level of expected loan reflows which depends primarily on lending terms applied. In general, the expected impact of changes in lending terms (higher service charges and shorter loan maturities) in the short term is very limited because the new lending conditions only apply to newly approved loans. But, in the medium to long term, changes in lending conditions can improve the Fund's IGRs. Therefore, Management is proposing herein, new lending terms to improve the Fund's financial resources

in the medium and long term (Section 3).

- 2.18 Donor compensation for foregone principal and charges on loan cancellations under the MDRI are expected to increase over time and will affect the ACC. Based on the historically observed MDRI recovery rate, the model assumes a certain percentage of contributions for MDRI compensations that is expected to be received during ADF-13 and in future replenishments. However, full and timely payment of MDRI compensation by all donors would contribute to increasing the ACC by UA 71 million to UA 1,021 million from the baseline level of UA 950 million during the ADF-13 period.

Scenarios for ADF-13 donor contributions and the impact of various replenishment scenarios on the ACC

- 2.19 Assuming that donor subscription levels remain unchanged in real terms and based on an estimated compounded inflation rate of 6.84% for the 2011-2013 period, the low case scenario for ADF-13 donor contribution amounts to UA 4.03 billion and the ADF-13 ACC is estimated to be approximately UA 950 million as previously indicated. So, the total replenishment resources will amount to UA 4.98 billion which represents a decrease of 14% in nominal terms from ADF-12.
- 2.20 Other scenarios for donors' subscriptions and the derived ACC have been considered and are indicated in Figure 5 and Table 3.

Figure 5: ADF-13 donor subscriptions scenarios

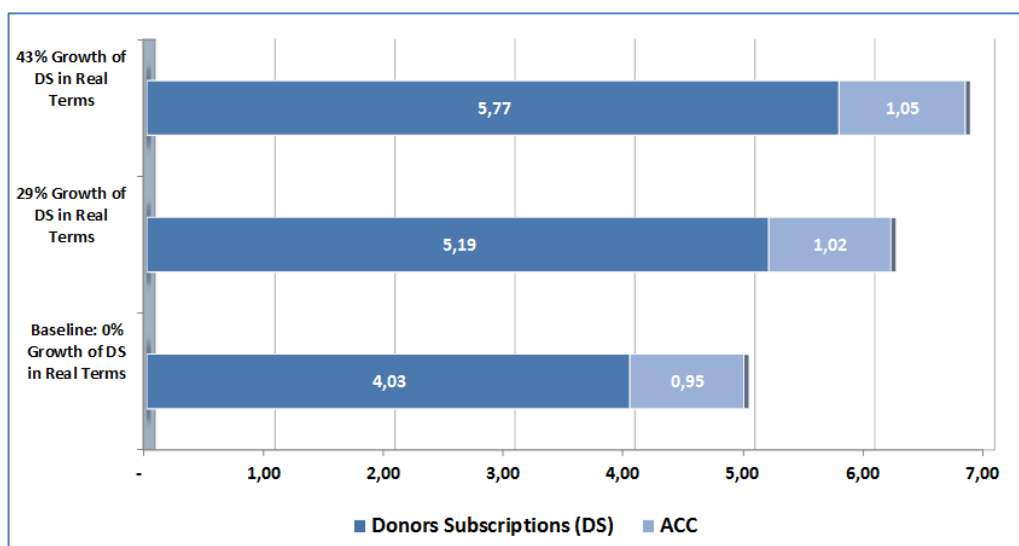


Table 3: Scenarios for ADF-13 replenishment levels

Scenarios	ADF-13 total resources (TR)		Donor Contributions (DC)		ACC	
	Level	Variance with ADF-12 TR	Level	Variance with ADF-12 DC	Level	Variance with ADF-12 ACC
Low case: 0% growth of donor contributions in real terms	4.98	-14%	4.03	6.84%	0.95	-53%
29% growth of donor contributions in real terms	6.20	7%	5.19	38%	1.02	-49%
43% growth of donor contributions in real terms	6.82	18%	5.77	53%	1.05	-48%

Comparison of the Fund's IGRs with other multilateral development banks (MDBs)

- 2.21 Both the Asian Development Fund (AsDF) and the International Development Association (IDA) have significantly higher IGRs than the Fund (Table 4).

Table 4: Comparison of other MDBs' IGRs with the ADF

(UA billions)

Institution	IGR	Donor resources	Total resources	IGRs as a % of total resources
AsDF X	4.3	2.8	7.1	61%
IDA16	11.7	17.6	32.8	46%
ADF-12	2.0	3.7	5.70	35%

Note: AsDF X = Tenth Replenishment of the Asian Development Fund; IDA16 = Sixteenth Replenishment of the International Development Association.

- 2.22 The Fund's lower IGRs compared with its peers are mainly explained by the following factors : i) lower loan reflow (income and repayment); ii) higher sensitivity to interest rate, and iii) lower Net Income transfers from the non-concessional windows when compared to other MDBs (particularly IDA).

Lower loan reflows (income and repayment)

- The ADF has more concessional lending terms than IDA and the AsDF (longer maturities and lower service charges) resulting in lower cash inflows from loan income and reflows. Also, IDA and the AsDF have more blend countries (both in number and percentage terms), to which hardened terms are applied (See Table I-4 in Annex I).
- The ADF has a lower share of outstanding loans on its balance sheet than IDA or the AsDF which translates in lower loan income and reflows than its peers, further explaining its lower IGRs. The lower volume of outstanding loans is mainly explained by the fact that the ADF was more strongly impacted by MDRI loan cancellations and has a higher percentage of grants than other MDBs. (See Annex I – Table I-2)
- As a result, loan repayments for 2011 as a percentage of total outstanding loans represented only 0.67% for the Fund, compared with 3.6% for the AsDF and 2% for IDA respectively (See Table I-1 in Annex I).

Higher sensitivity to interest rate

- The ADF relies more on investment income for its IGRs and is therefore more sensitive to the level of interest rates, primarily because its investment portfolio represents a larger share of its balance sheet than other MDBs (outstanding loans represent a lower share of the Fund's balance sheet. See Table I-2 in Annex I). So, the income statement of other MDBs is less sensitive to interest rate fluctuations than the Fund's, and IGRs are expected to be less affected by the recent decline in interest rates. In other words, ADF's operating income depends more heavily on the performance of its investment portfolio and due to the current low interest rate environment the Fund's investments do not generate enough net income to increase IGRs. Again, the fall in expected investment income is one of the main factors explaining the low ADF-13 ACC level.

Lower Net Income transfers from the non-concessional window

- Both IDA and the AsDF generally receive higher net income transfers from their respective group non-concessional windows than the Fund (See Table I-1 in Annex I). The past three years, the total amount of net income transfers received by IDA from International Bank for Reconstruction and Development and International Finance Corporation was UA 1,958 million, about 6% of IDA-16 replenishment. AsDF received UA 240 million from the Asian Development Bank about 4% of AsDF-X replenishment; and the ADF received UA 110 million from ADB or 2% of ADF-12 replenishment.

When comparing the percentage of net income transferred by the non-concessional windows of MDBs to their concessional windows, the Bank is well in line with the AsDB and the IFC, who have been transferring on average 20% of their allocable income over the past 2 years as indicated in Table I-5 of Annex I. However, the IBRD transferred a much higher percentage of its allocable income to IDA during the same period (an average of 51% over the past 2 years).

It should also be noted that since 2011, the Bank's net income allocations to the Fund are based on an Income model whose ultimate goal is to strike a balance between development assistance and financial solidity or integrity, and which also specifies that transfer to reserves should have the first claim in the net allocation process. Given the Bank's challenging environment and with rating agencies' review of their rating methodologies giving more emphasis to the stand-alone credit profile of MDBs, net income transfers to the Fund should continue to be analyzed and determined with due consideration to the Bank's Income model.

- 2.23 When comparing IGRs between the Fund and IDA, note that IGRs for IDA-16 include one-off measures related to voluntary prepayments and accelerated repayments that are not likely to recur in future replenishments. Excluding the IDA exceptional measures, the Fund's IGRs compares favorably with IDA's, but remain lower than the AsDF's.

3. Measures to Strengthen ADF's Financial Capacity and Ensure an Appropriate Use of Resources

- 3.1 Following the initial discussion at the ADF-12 Mid-Term Review and Deputies' guidance, this section presents options for strengthening the ADF's financial capacity to fund new operations over the long term, and to ensure an optimal use of ADF resources for development purposes.
- 3.2 The countries eligible for the ADF have grown increasingly diverse in terms of their incomes, economic structures, natural resource bases, (in)equality and socio-economic development. This implies that the Bank should regularly re-evaluate the ADF's eligibility criteria and financing terms to adequately address the needs of regional member countries (RMCs), respond to their changing priorities and development objectives, and ensure appropriate allocations of ADF resources among eligible countries.
- 3.3 The limited level of the ACC and the continuing substantial needs of ADF countries imply that strong efforts will be required from the Bank Group and from donors to help the Fund sustain the pace of its development assistance to eligible RMCs. Management proposes several options to increase the Fund's financing capacity and to ensure that the available resources are allocated on appropriate terms: (i) differentiated financial terms among groups of ADF-only countries, (ii) encouragement of graduation, and (iii) accelerated repayment and voluntary prepayment of ADF loans.

Differentiation of lending terms

- 3.4 In accordance with the Bank Group's credit policy, regional member countries are currently classified as ADF-only (category A, including gap countries), ADB-only (category C) or a blend (category B; table 5).

Table 5: Current Bank Group country classification

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

Note: * The ADB's credit policy prescribes that World Bank country classification criteria be followed; hence, the references to International Bank for Reconstruction and Development financing and the International Development Association's operational cut-off.

- 3.5 Over the years the ADF-only countries have grown increasingly heterogeneous in terms of their economic and financial capacity. The category now includes fragile states with low income per capita, a high risk of debt distress and low levels of human development, and countries with relatively high income per capita and human development, low risk of debt distress and substantial access to the international financial markets. At the ADF-12 Mid-Term Review, Deputies agreed that the fact that countries with such large differences can draw resources at the same level of concessionality raises the question of whether it would not be more appropriate to distinguish among different groups of ADF-only countries that share similar levels of economic and human development, and to apply differentiated lending terms that are better aligned with their economic circumstances. Applying harder financial terms to ADF-only countries that have the capacity to shoulder them is in line with the ADF mission of focusing on the neediest countries in Africa. Differentiated lending terms would also contribute to the Fund's medium- and long-term financial sustainability and capacity.
- 3.6 The principle of applying differentiated financing terms has been implemented by other MDBs such as IDA and the AsDF. The ADF has also been applying this principle in ADF-12 by differentiating the financing terms of ADF loans between ADF-only countries and gap, blend and graduating countries (see Table 5). In line with the guidance from Board members during discussions on the "ADF Long Term Financial Sustainability" and from Deputies at the ADF-12 Mid-Term review, Management proposes to differentiate ADF lending terms within the category of ADF-only countries based on their economic, human and infrastructure development. Management also proposes different pricing options to achieve a level of concessionality (grant element) commensurate with the characteristics of each identified group. It is important to highlight that, subject to Deputies' guidance, the Fund will seek to maintain a level of concessionality for ADF-only countries above or equal to that offered by its peers. In all cases, applicable financial terms will need to be consistent with the Bank Group Policy on Non-Concessional Debt Accumulation and with that of the International Monetary Fund and the World Bank, including countries' Debt Sustainability Analysis classification.
- 3.7 Following the discussions at the ADF-12 Mid-Term Review, Management presents two options for grouping ADF-only countries and applying differentiated lending terms, based on levels of economic, human and infrastructure development:
- Gross national income (GNI) per capita.
 - The Africa Human and Infrastructure Development Index (AHIDI).
- 3.8 GNI per capita is a well-known indicator and is used in the Bank Group's Credit Policy to differentiate ADF from ADB countries. However, it has been criticized as an imperfect indicator of development level, since it does not capture income distribution aspects or social, infrastructure and human welfare dimensions. These aspects are particularly important in Africa's resource-based economies, where the informal and the rural sector are prominent.
- 3.9 The Africa Human and Infrastructure Development Index (AHIDI) is a composite index of the United Nations Development Programme's (UNDP) non-income Human Development Index and the ADB's Africa Infrastructure Development Index. The components are weighted equally and have been rescaled to Africa to obtain an AHIDI that could vary between 0 and 1. (See

Annex II)

- 3.10 The AHIDI does not include the GNI per capita but only retains non-monetary indicators of health, education and infrastructure development, as supported by economic literature. The recent adoption of concepts such as “quality of growth”, “green growth” or “inclusive growth” by international organizations also reflects more concern about non-monetary dimensions of well-being. By including infrastructure indicators, the AHIDI is moreover better aligned with the Bank Group’s Long-Term Strategy and the operational priorities of the ADF. As a simple combination of indices that are produced annually by the ADB and the UNDP, the AHIDI is easy to calculate and monitor.
- 3.11 In light of these arguments, and given the fact that GNI per capita is already used in the Bank’s Credit Policy to differentiate ADB from ADF countries, Management recommends option 2 (AHIDI) for differentiating among ADF-only countries in ADF-13. The grouping would first be established in December 2013 and would be reviewed every year. For illustrative purposes, applying the country data as used in the calculation of the 2012 ADF country allocations, this would result in an “advanced” group of 20 countries and a “lower” group of 16 countries (see Annex II for details).

Table 6: Proposed Framework for differentiation of lending terms for ADF-only countries

		Risk of debt distress	
		High	Low/moderate
AHIDI above cut-off point	No	ADF-only Red light countries eligible for grants only	ADF-only countries eligible for regular ADF terms
	Yes	ADF-only Red light countries eligible for grants only	ADF-only economically advanced countries eligible for new ADF hardened terms

Proposals for hardened lending terms and impact on the ACC

- 3.12 The Fund currently has the longest maturity for its loans and thus the highest concessionality (see table I-4 in Annex I). For gap and blend countries, other MDBs also apply less concessional lending terms than the Fund and the outstanding loan balance related to these types of loans is larger. Furthermore, with IDA and the AsDF considering a further hardening of lending terms for both their regular and blend countries in their next replenishments, Management proposes a revision of ADF lending terms. However, the proposed revised differentiated lending terms ensure that the Fund maintains a level of concessionality above or equal to that offered by its peers.

Hardened and differentiated lending terms proposals

- 3.13 To improve the Fund’s financial capacity and apply more appropriate lending terms to heterogeneous countries, new hardened and differentiated lending terms aimed at increasing reflows have been explored. The various proposals are assessed for their positive financial impact on the ACC. It is important to note that revised terms will only apply to ADF loans provided to green and yellow light countries, as set out in Table 6. The grant portions of yellow light countries’ allocations as well as red light countries are not affected by these proposals. It should also be noted that the more concessional lending terms will be applied to Fragile States eligible for Fragile States Facility Pillar I, regardless of which group they fall in.
- 3.14 The revised lending terms introduce three levels of differentiation for ADF-only and Blend countries:
- “Regular” lending terms to be applied to the less economically advanced ADF-only countries and to Fragile States.

- “Advance” lending terms to be applied to the more economically advanced ADF-only countries (two options are proposed: Advance Option 1 or Advance Option 2);
 - “Blend” lending terms to be applied to blend, gap and graduating countries (two options are proposed: Blend Option 1 and Blend Option 2).
- 3.15 Regular: The “Regular” lending terms include a reduction in the loan maturity from the current 50 years to a proposed 40 years (table 7). For these lending terms, the grace period of 10 years, the service charges and the commitment fee remain unchanged, but the amortization rates are adjusted proportionally to the shorter maturity. Result: a concessionality (grant element) level of 63%, compared with 66% when the loan maturity was 50 years.
- 3.16 Advance Option 1: The first option for the “Advance” lending terms maintains the loan maturity at 40 years, similar to “Regular” terms. However, the grace period is shortened to 5 years and the principal is amortized linearly. The service charges and the commitment fee remain unchanged. Under these conditions, the grant element will stand at 51%.
- 3.17 Advance Option 2: The second option for the “Advance” lending terms reduces the loan maturity to 35 years and shortens the grace period to 5 years. The amortization schedule has more weight towards the end of the repayment period. The service charges and the commitment fee remain unchanged. Under these conditions, the grant element will stand at 50%.
- 3.18 Blend Option 1: The first option for the “Blend” lending terms holds the loan maturity at 30 years but shortens the grace period by 3 years from 8 years to 5 years (table 7). A linear amortization scheduled is proposed. The service charges, the commitment fee and interest rate remain unchanged. The proposed terms will bring down the grant element from the current 41% to 35%.
- 3.19 Blend Option 2: The second option for the “Blend” lending terms reduces the loan maturity to 25 years and shortens the grace period to 5 years. The amortization schedule has more weight toward the end of the repayment period. The service charges and the commitment fee remain unchanged. However, the interest rate is increased by 25 basis points to 1.25%. Under these conditions, the grant element will stand at 34%, equal to the terms proposed by IDA for similar countries.
- 3.20 Noted that of concessionality of all the proposed options compares favorably with the terms proposed by IDA for the same category of countries, except blend option 2, which proposes the same lending terms and concessionality as IDA.

Table 7: Differentiated lending terms options

	Lending term	Maturity (years)	Grace period (years)	First period (years)	Amortization rate	Second period (years)	Amortization rate	Service charge (%)	Commitment fee (%)	Interest rate (%)	Concessionalit y (%)	Increase in ACC of ADF-13	Increase in ACC of ADF-16
ADF-only	Baseline: 50/10	50	10	10	1%	30	3%	75	50	0	66%	-	-
	Regular: 40/10	40	10	10	2%	20	4%	75	50	0	61%	+0%	+7%
	Advance 1: 40/5	40	5	-	2.857%	-	2.857%	75	50	0	51%	+3%	+54%
	Advance 2: 35/5	35	5	5	2%	25	3.6%	75	50	0	50%	+3%	+45%
Blend, gap and graduating	Baseline: 30/8	30	8	11	3%	11	6.1%	75	50	1%	41%	-	-
	Blend 1: 30/5	30	5	-	4%	-	4%	75	50	1%	35%	1%	15%
	Blend 2: 25/5	25	5	10	3.3%	10	6.7%	75	50	1.25%	34%	1%	13%

3.21 Table 7 provides an assessment of the various lending terms options proposed, mainly through the expected increase in the ACC for ADF-16, and also through the estimated level of concessionality. Assuming that all countries that currently receive ADF-only loans (currently representing 93% of ADF outstanding loans) are now provided loans under either Regular, Advance 1 or Advanced 2 terms, the ACC in ADF-16 will increase respectively by 7%, 54% and 45% compared to the current terms (baseline scenario). Therefore, Management recommends to apply Advance 1 lending terms to the most economically advanced ADF-only countries, as these terms generate a higher ACC than Advance 2 lending terms, and also a higher concessionality level (51% vs 50%).

3.22 Regarding lending terms to be applied to Blend, Gap and Graduating countries (currently representing 7% of ADF outstanding loans), Table 7 indicates that, when compared to the Baseline scenario, Blend 1 lending terms are expected to generate a higher ACC in ADF-16 than Blend 2 lending terms (an increase of 15% vs 13%), and also have a higher concessionality level (35% vs 34%). Therefore Management recommends to apply Blend 1 lending terms to this category of countries.

Financial impact of the differentiated lending terms using AHIDI (Africa Human and Infrastructure Development Index)

3.23 As indicated in Annex II, the selection of AHIDI as the criteria for differentiating ADF-only countries will result in a group of 16 countries with “low AHIDI” to which Regular lending terms will be applied (representing 49% of Performance Based Allocation (PBA) loans), while Advance lending terms will be applied to a group of 20 countries with a “high AHIDI” (representing 51% of PBA loans).

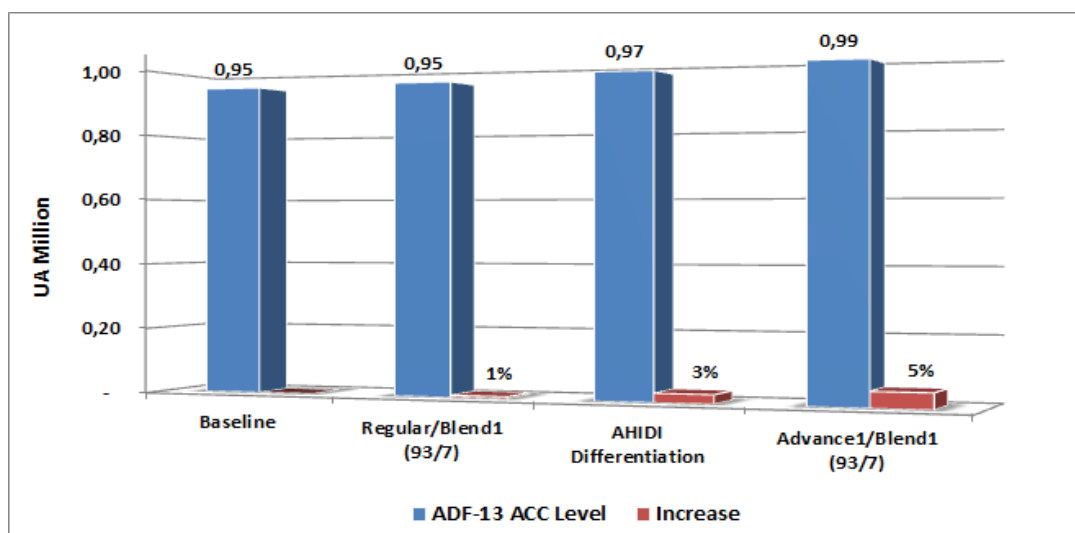
3.24 Figure 6 assesses the financial impact of various lending scenarios, compared to the baseline scenario, in order to have a range of the expected increase in the ACC when differentiated lending terms are applied on the basis of the AHIDI criteria. These scenarios are a combination of the lending term options of Table 7:

- Baseline: All ADF-only countries loans (93% of loan volume) receive the current ADF-only terms, while all Blend countries (7% of loan volume) receive the current Blend terms.
- Regular/Blend1: All ADF-only countries (93%) receive the new Regular lending terms, while all Blend countries (7%) receive Blend 1 lending terms. This scenario represents the

low case scenario, in the (theoretical) case that all ADF-only countries are classified in the “lower” economic development group.

- **AHIDI Differentiation:** 46% of loan volume is provided on ADF-only Regular lending terms (low AHIDI countries), while 47% is provided on ADF-only Advance 1 terms (high AHIDI countries). Blend countries (7%) receive Blend 1 lending terms. This scenario represents the most likely scenario in case the grouping presented in Annex II is maintained.
- **Advance1/Blend1:** All ADF-only countries (93%) receive Advance1 lending terms, while all Blend countries (7%) receive Blend 1 lending terms. This scenario represents the high case scenario, in the (theoretical) case that all ADF-only countries are classified in the more economically advanced group.

Figure 6: Impact of new lending terms on ADF-13's ACC (UA million and % increase)

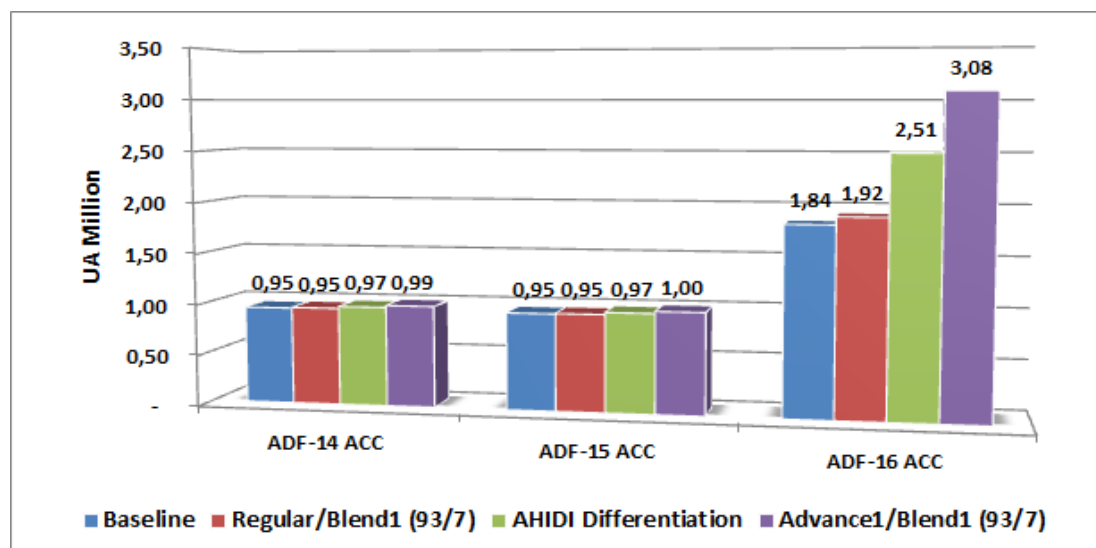


Note: The shares of the current loans volume are 93% for ADF-only countries and 7% for blend countries. AHIDI differentiation scenario is a mix Regular (46%)/ Advance1 (47%) / Blend1 (7%)

- 3.25 As already explained, changes in lending terms generally do not have a significant impact in the short term. Accordingly, the lending term scenarios presented above have a very limited impact on the Fund's advanced commitment capacity for ADF-13, and result in an increase of the ACC from 1% to 5% when compared to the baseline scenario, as illustrated in Figure 6. Although the revised lending terms are less concessional, their limited impact in ADF-13 is mainly explained by the time lag effect, as the new terms will only apply to new loans, in combination with the grace period, which results in a delay before loan reflows start to materialize.
- 3.26 Figure 7 shows that the impact on the increase of the ACC will be also limited for ADF-14 and ADF-15. However such impact becomes significant starting ADF-16, with an ACC above the baseline scenario level by 4%, 36% and 67% respectively for the scenarios Regular/Blend1, AHIDI Differentiation and Advance1/Blend1. In absolute terms, while the baseline scenario would yield an ACC for the ADF-16 replenishment of UA 1.84 billion, scenario Regular/Blend1 would give an ACC of UA 1.92 billion; scenario AHIDI Differentiation would provide an ACC of UA 2.51 billion and scenario Advance1/Blend1 an ACC of 3.08 billion. The significant increase in the ADF-16 ACC for all scenarios is mainly due to the additional cash inflows³ that the Fund is expected to start generating.

³ Liquidity projections indicate that the additional cash inflows will enable the release of the Fund's liquidity constraint (requirement to cover 75% of annual disbursements). Starting from 2021, the Fund is expected to generate sufficient cash inflows to cover adequately its major cash outflows, thereby generating excess liquidity for additional loan commitments.

Figure 7: Expected benefit of the new lending terms on the ACC of future replenishments



3.27 In light of that analysis, the impact of the AHIDI differentiation criteria, if implemented, will result in a marginal increase of 3% for ADF-13 ACC compared to the current lending terms. However, the increase will be more significantly and around 36% for ADF-16. In absolute amount, the ACC will reach UA 2.51 billion compared to UA 1.84 billion under current conditions. It should be noted that the financial impact of the differentiated lending terms will also depends on the level of the mix between low and high AHIDI ADF-only countries that will be achieved over time.

Recommended lending terms

3.28 Management recommends the lending terms specified in Table 8, starting with ADF-13.

Table 8: Recommended differentiated lending terms

	Lending term	Maturity (years)	Grace period (years)	First period (years)	Amortization rate	Second period (years)	Amortization rate	Service charge (%)	Commitment fee (%)	Interest rate (%)	Concessionalit y (%)
ADF-only	Regular: 40/10	40	10	10	2.0%	20	4%	75	50	0	61%
	Advance: 40/5	40	5	—	2.9%	—	2.9%	75	50	0	51%
Blend, gap and graduating	Blend: 30/5	30	5	—	4.0%	—	4.0%	75	50	1%	35%

3.29 The key benefits of implementation of those lending terms for the Fund will be:

- Enable the Fund to substantially increase its future commitment capacity starting ADF-16 by approximately 36% compared with the current lending terms, depending on the number of countries in each credit classification (ADF-only AHIDI groups and Blend).
- Apply differentiated lending terms commensurate with the economic situation of ADF countries and their debt sustainability
- Maintain concessionality above or equal to that offered by other MDBs.

Encouraging graduation

- 3.30 Eligibility for graduation from ADF to blend or ADB-only is currently determined by (GNI) per capita (Atlas method) and by creditworthiness. Countries whose GNI per capita surpasses the operational cut-off (USD 1,195 for 2012) for more than two consecutive years— and that are assessed to be creditworthy for non-concessional financing on ADB terms—, graduate to ADB-only status. Countries with an income below the operational threshold but that are found creditworthy are classified as blend.
- 3.31 A number of ADF-only countries are approaching or have already surpassed the GNI per capita threshold, show low levels of risk of debt distress and benefit from consistent access to international financial markets. In addition, some of them have substantial natural resources whose exploitation can fuel economic growth and rapidly increase per capita income. For the Fund, the graduation of eligible countries will free resources for other, needier ADF recipients, thereby further promoting the efficient use of resources for development.
- 3.32 As set out at the ADF-12 Mid-Term Review, Management will take a more pro-active approach towards graduation during the ADF-13 period. The Bank will undertake regular, periodic creditworthiness assessments of ADF countries approaching the income threshold and will engage in discussions with these countries, focusing on the process and advantages of graduation. These include:
- The potential increased volume of resources they would have access to from the ADB public-sector window, ADB private-sector window, Middle Income Countries Trust Fund, other trust funds managed by the Bank, and possibly the capital markets.
 - The financial instruments and other services they would be able to make use of.
 - The support the Bank can offer in attracting more third-party financing, improving the regulatory environment and business climate, strengthening domestic financial markets, and so on.
- 3.33 Further analysis will highlight that graduation to ADB status may be beneficial for the country in the amount of overall subsidy available through the Bank's operations. The volume of lending available under the ADB window is likely to be significantly higher than under the ADF window, counterbalancing the lower grant component. Management will inform the Board of the potential reclassification of countries likely to graduate. This will allow Management to anticipate changes in the composition of the Fund's lending mix and enable countries to better prepare for changes in their financial terms.
- 3.34 The financial impact of the graduation of countries to blend or ADB-only status on the long-term sustainability and financial capacity will depend on the number of graduating countries and on those in each lending category.

Accelerated repayment and voluntary prepayment of ADF loans

- 3.35 Recognizing that member country economic circumstances change over time, and that a number of them will graduate to the ADB thanks to sustainable economic development and attainment of creditworthiness, Deputies at the ADF-12 Mid-Term Review agreed that the Fund should, similarly to its peers, have provisions that build on such structural changes by modifying the profile of countries' repayment obligations, better aligning them with their improved financial capacity. Starting in ADF-13, Management will therefore introduce an accelerated-repayment clause in all new ADF loan agreements and a framework for the voluntary prepayment of ADF loans. These provisions will result in faster future repayment of ADF loans, and thus in an increased commitment capacity, ultimately benefiting the neediest countries in Africa.

Accelerated repayment

- 3.36 The accelerated repayment clause will stipulate that a member country can be required to accelerate the repayment of its ADF loans if the following two conditions are met: the country's GNI per capita has remained above the operational cut-off for more than two consecutive years, and it is creditworthy for borrowing from the ADB. This clause is a simple, transparent and fair mechanism to redirect the Fund's resources from its more economically successful members to the poorer and more disadvantaged borrowers. Given the forward-looking nature of this clause, Management does not expect it to have a material impact on the Fund's short-term financial

position.

- 3.37 Accelerated repayments has been successfully employed by sister institutions. IDA and the AsDF have, since the late 1980s, included an acceleration clause in all their loan agreements. If the Fund had had this clause in its loan terms, the graduation of Egypt, Equatorial Guinea, Cape Verde and Angola to the ADB would have increased the ACC by UA 40 million— from UA 950 million to UA 990 million⁴.

Voluntary prepayment

- 3.38 A framework for voluntary prepayment will complement the accelerated-repayment clause by enabling and encouraging the prepayment of ADF loans that currently do not contain an acceleration clause. It will allow the Fund to offer financial incentives to graduated countries in the form of discounts if and when they decide to prepay their ADF loans. The guiding principles and operating methodology of this framework would be very similar to what is already offered at the donor level: discounts on the accelerated encashment of promissory notes. As with the donor discounts, prepayment discounts would be determined case by case, depending on the prevailing market conditions.
- 3.39 While financial impacts of voluntary prepayment may initially be limited, it is expected in the long run that, as more countries graduate, the impact would be greater and that more resources would be freed up for ADF-only countries. For example, in IDA-16, China made a voluntary prepayment of USD 1.0 billion on its outstanding IDA loans. For this, China received a discount of USD 110.78 million, which it passed entirely on to IDA as a donor contribution to the replenishment, and the remaining USD 889 million (special drawing right 592 million) increased IDA's internal resources. For the ADF, if all the recently graduated countries decided to pre-pay their ADF loans, the Fund would have received UA 54.28 million in additional contributions, and IGRs would have increased by UA 247.63 (Table 9).

Table 9: Potential impact of voluntary prepayment of ADF loans by graduated countries

(UA million)

Country	Contribution/discount	Additional IGR
Angola	5.92	25.03
Cape Verde	20.43	75.70
Equatorial Guinea	4.21	23.52
Egypt	23.73	123.38
Total	54.28	247.63

Note: Discount could become a contribution if graduated countries decide to pass it to the Fund.

4. Possible Innovative Financing Instruments

- 4.1 ADF reflows are insufficient to provide substantial new financing to meet RMC needs. Therefore it is warranted to look at ways of better leveraging the Fund's scarce resources through co-financing arrangements and financial innovation in order to increase the overall level of financial resources flowing to ADF countries. Accordingly, Management is exploring possible innovative applications of ADF resources for consideration by ADF Deputies, and seeks Deputies' views and guidance.
- 4.2 In that regard, six innovative products have been analyzed and could be broadly classified in 4 categories that overlap:
- Guarantees— to leverage ADF resources in order to mobilize private sector financing and facilitate the flow of investments to fund more non-sovereign projects in low-income countries. This includes the Default Loss Portfolio Guarantee, ADF Partial Credit Guarantee and part of the Development Finance Institutions (DFI) facility.

⁴ Outstanding loans of Egypt, Equatorial Guinea, Cape Verde and Angola stand at UA 302 million as of December 2012. Accelerated repayment would result in a cumulative amount of approximately UA 100 million during the next 15 years.

- Loans or Grants for Equity investments— to play a catalytic role in developing public-private partnership (PPP) projects in low-income countries or to strengthen the capital base of regional development finance institutions (DFIs). This includes the Private Sector Matching Fund and another part of the DFI facility.
 - New sources of financing— to free up ADF resources to be reinvested in new projects (ADF Loan Buy-Down).
 - Blending— to improve the synergy between the ADB and ADF for more operational efficiency and to free up ADF resources for the neediest countries (Modified Framework for Assistance to Creditworthy Countries and Default Loss Portfolio Guarantee)
- 4.3 The six innovative products have been prioritized based on the estimated envelope required for their implementation, the ease of their implementation and readiness to start, the estimated leverage impact, and the outstanding legal issues that still need to be addressed. In light of that analysis, four products out of the six are presented here (ADF Loan Buy-Down, Partial Credit Guarantees, Private Sector Matching Fund and DFI facility). The key features of those four instruments are summarized in this section, while further details are provided in Annex III and IV. The other two products, for which additional work is still required, mainly to address legal issues linked to their blending structure involving transactions between the ADB and the ADF, are presented in Annexes III and IV (Modified Framework for Assistance to Creditworthy Countries and Default Loss Portfolio Guarantee).
- 4.4 With increasing demands from ADF countries, the innovative products would help crowd in additional sources of financing for development projects in low-income countries. The new financing instruments would also enable the Fund to achieve additional leverage on its resources for the benefits of its recipient countries. It is estimated that UA 1 invested, in these new instruments would have a multiplier effect and enable the Fund to mobilize approximately UA 5 to finance additional private sector projects in low-income countries (Table 10).

Description of the financing instruments

ADF Loan Buy-Down

- 4.5 The ADF Loan buy-down facility would offer to donor countries and other interested parties the possibility of prepaying to the ADF the outstanding amount of a loan (or particular set of loans) owed by a given ADF country. This prepayment could target loans for projects in specific sectors or with specific objectives such as renewable energy, environment, education, water and poverty reduction. These initiatives could also be tied to conditions, obliging the beneficiary country or selected project to meet certain landmarks and objectives before the pre-payment could take place. The Fund could then recycle the pre-paid amounts through the general ADF financing window. The main benefits would be additional resource mobilization and enhancing the Fund's profile as one of the premier channels of aid and concessional finance into Africa. This instrument doesn't require any set aside envelope. Because implementing the buy-down would involve multiple parties, coordination, promotion, deployment and reporting activities could increase the Fund's operational costs.

ADF Partial Credit Guarantees

- 4.6 Partial credit guarantees (PCGs) are currently offered by the ADB to ADB countries. They could be extended to ADF countries on a pilot basis. PCGs cover commercial lenders against all risks of debt service default on a specified portion of commercial / private debt (bonds and loans) and can be used to mobilize commercial financing for project finance, financial intermediation, and policy based finance. Similar to the ADF Partial Risk Guarantee (PRG)⁵, the ADF PCG would be structured as a leveraged instrument that would consume only a fraction of the country's PBA. Specifically, for a guarantee amount of 100, only 25 would be deducted from the country's PBA. The ADF PCG program would be piloted with a total maximum exposure initially limited to UA 300 million. But only a maximum UA 75 million would be deducted from the PBA of the

⁵ Several projects for which the ADF Partial Risk Guarantee is considered include: Kenya -Lake Turkana – Awaiting government of Kenya request. Kenya - Geothermal Development Company / Menengai –awaiting government of Kenya request. Nigeria - Nigeria Energy Sector reform – (a meeting is planned for January 2013 to discuss the proposal).

beneficiaries' countries.

- 4.7 An ADF PCG would enable ADF countries or their public / state institutions to access commercial finance only for a limited number of priority sectors like infrastructure and agriculture or for domestic resource mobilization. The key issues to address while implementing PCG are associated with defining stringent eligibility criteria that take into account country indebtedness, debt management capacity and compliance with the Bank's Non-Concessional Debt Accumulation Policy. In addition, guarantees are legally more complex than direct lending, owing to the greater number of parties involved, and would increase the Fund's operating costs.

Private Sector Matching Fund

- 4.8 In ADF-12, the possibility was created for ADF countries to use part of their performance-based country allocation for equity investment in public private partnership (PPP) projects. A Private Sector Matching Fund is a new financial envelope that builds upon this arrangement by providing additional loans or grants to eligible countries for the same purpose. The facility would encourage borrowing countries to develop more PPPs with private sector participation. The Matching Fund would match for the government's contribution in equity for a PPP in that country or region, provided that the government is able to confirm the participation of a minimum of 2x contribution from the private sector to the equity of the PPP. It would serve as an incentive to governments to collaborate and co-invest with private investors to develop PPPs in infrastructure and other key areas of the economy and lead to inclusive growth. The debt would come from a combination of public and private financiers.
- 4.9 To be effective, the Matching Fund could start with an initial envelope of UA 300 million. The overall PBA envelope of the ADF countries would be reduced by the size of the set-aside.

DFI Facility

- 4.10 A DFI Facility would increase the financing opportunities for infrastructure development and small and medium enterprise development in Africa through African DFIs, by crowding in private sector financing. It would include two key instruments:
- Partial Risk Guarantee to enhance the obligations of African regional and sub-regional DFI' member countries to promptly pay-in their respective pro-rata share of callable capital in case there is a first call. This would lead to an improvement in the credit rating of DFIs, which in turn would improve the terms of their fundraising activities from commercial lenders. DFI PRG is an extension of use the existing ADF PRG, with the difference being that the guarantee would be extended to government-owned DFIs, as opposed to RMCs themselves.
 - Equity Financing Instrument to provide concessional financing (loans or grants) to regional and sub-regional DFIs' member countries to finance an increase in paid-in capital and clear arrears on capital installments due, particularly for fragile states. This would improve DFI creditworthiness.
- 4.11 The main challenge in implementing this facility would be the capacity to allocate a sufficient envelope to make the Partial Risk Guarantee and the Equity Financing Instrument for DFIs efficient given the limited resources of the Fund. It is estimated that a facility of UA 300 million might contribute to clearing all the existing arrears on due capital installments, particularly for fragile states, and contribute to enhancing the quality of UA 1.2 billion in the callable capital of regional/sub-regional DFIs.

Estimate leverage and financial impact

- 4.12 Most of the instruments presented require an additional set asides from the PBA envelope of ADF resources. But they will have a catalytic effect and could generate a multiplier of approximately 5 times the resources set aside, enabling the Fund to mobilize additional resources from various sources to finance additional projects in low-income countries (Table 10).

Table 10: Estimated financial impact of innovative products

Financing instrument	Estimated envelope (UA million)	Estimated leverage impact
1. ADF Loan Buy-Down	No set aside required	NA
2. ADF Partial Credit Guarantees)	75 from PBA allocations	8X
3. ADF Private Sector Matching Fund	set-aside of 300	9X
4. DFI Facility	set-aside of 300	4X
		5X

Note: NA = Not applicable; 5X = the average estimated leverage of the four financing instruments

- 4.13 Management proposes to hold open discussions on these instruments and those presented in Annexes III and IV at the first ADF-13 replenishment meeting. On the basis of this discussion and Deputies' guidance, Management will craft further proposals for the second replenishment meeting.

5. Conclusion

- 5.1 The ACC of UA 950 million for ADF-13 is significantly lower than the UA 2,007 million for ADF-12 primarily due to lower interest rates and lower loan cancellations. The limited ACC and the continuing substantial needs of ADF countries imply that strong efforts will be required both from the Bank Group and from donors to help the Fund sustain the pace of its development assistance to eligible regional member countries and fulfill its mandate.
- 5.2 In the current resource-constrained environment, with most donors facing budgetary issues and high social demands, it is also imperative to optimize the use of the Fund's resources and protect its commitment capacity. Apart from ensuring the adequate management of donor resources, Management proposes several options to increase the Fund's financing capacity and to ensure that the available resources are allocated appropriately. By hardening the lending terms commensurate to the socio-economic circumstances and debt sustainability of recipient countries, Management is fully committed to increasing IGRs and therefore the Fund's commitment capacity.
- 5.3 In addition, innovative financing instruments are being explored to leverage the Fund's scarce resources, help crowd in more private and other sources of financing for development projects in low income countries and increase the overall level of financial resources flowing into ADF countries.
- 5.4 Deputies are therefore invited to:
- Take note of the indicative level of ACC and level of replenishment resources for various scenarios.
 - Endorse Management's proposals for (i) differentiating framework among groups of ADF-only countries; and (ii) new differentiated lending terms for ADF-only and Blend countries.
 - Take note of Management's intentions to proceed with arrangements for accelerated repayment and voluntary prepayment of ADF loans for countries that have graduated from the concessional window starting with ADF-13.
 - Provide views and guidance on the innovative financing instruments explored by Management.

Annex I: Comparative Analysis of the concessional windows of MDBs

Table I-1: Comparison of key items of the income statement, the balance sheet and the cash flows statements

	in UA Million	2009			2010			2011		
		AfDF	IDA	AsDF	AfDF	IDA	AsDF	AfDF	IDA	AsDF
KEY BALANCE SHEET ITEMS										
1	Disbursed and Outstanding Loans	5,433	75,263	18,639	6,297	75,649	19,318	6,878	83,525	19,679
2	Undisbursed Loans	3,789	19,353	3,571	3,918	20,464	3,403	3,729	25,373	3,770
3	Outstanding Investments	3,148	18,475	3,652	3,103	18,765	3,511	2,897	21,651	3,865
4	Total Operating Assets (1+3)	8,581	93,738	22,291	9,400	94,415	22,829	9,775	105,176	23,544
KEY CASHFLOW ITEMS										
5	Loan Income	59	534	181	59	558	194	62	598	211
6	Investment Income	132	1,082	91	84	614	72	68	213	64
7	Total Operating Income (5+6)	191	1,616	273	143	1,172	266	130	811	275
8	Loan Repayment	51	1,455	563	47	1,566	604	46	1,667	711
9	Income Transfers Received	25	823	80	50	389	80	35	747	80
10	Other inflows (Subscriptions encashment + MDRI)	1,210	4,848	433	1,111	5,820	542	1,243	5,053	722
11	Total Inflows	1,477	8,741	1,349	1,351	8,947	1,492	1,454	8,279	1,788
12	Administrative Expenses	- 158	- 650	- 133	- 164	- 1,057	- 151	- 159	- 1,144	- 170
23	Total disbursements (Loans and Grants)	- 1,726	- 6,146	- 1,680	- 1,165	- 7,640	- 1,270	- 1,297	- 6,855	- 1,249
14	Total outflows	- 1,884	- 6,796	- 1,813	- 1,329	- 8,697	- 1,421	- 1,456	- 7,999	- 1,419
15	Net cash flows	- 407	1,945	- 464	22	250	71	- 2	280	369
RATIOS FOR ANALYSIS OF LOAN PORTFOLIO										
	Outstanding Loans as % of Operating assets	63%	80%	84%	67%	80%	85%	70%	79%	84%
	Loan Income as % of Operating Income	31%	33%	67%	41%	48%	73%	48%	74%	77%
	Undisbursed as % of Total Outstanding and Disbursed	70%	26%	19%	62%	27%	18%	54%	30%	19%
RATIOS FOR ANALYSIS OF INVESTMENT PORTFOLIO										
	Outstanding Investments as % of Operating Assets	37%	20%	16%	33%	20%	15%	30%	21%	16%
	Investment Income as % Operating Income	69%	67%	33%	59%	52%	27%	52%	26%	23%
	Average Return on Investments	4%	6%	3%	3%	3%	2%	2%	1%	2%
RATIOS FOR ANALYSIS OF ADMINISTRATIVE EXPENSES										
	Expenses as % of Total Outstanding & Disbursed	3%	1%	1%	3%	1%	1%	2%	1%	1%
	Expenses as % of Total Operating Income	83%	40%	49%	115%	90%	57%	122%	141%	62%
	Expenses as % of Total Replenishment									
	IDA Investments include Derivative assets and recievable from investments									
	The transfer figures for IDA is from both IBRD and IFC *									

Comparison of loan portfolios

Outstanding loans represent a larger share of IDA and AsDF operating assets leading to a high proportion of loan income as a percentage of operating income, when compared with the Fund (Table I-2). As a result, IDA and AsDF are expected to generate a higher volume of IGR from their outstanding loans.

Table I-2: Comparison of outstanding loans and loan income

Outstanding loans as a % of operating assets				Loan income as a % of operating income		
	2009	2010	2011	2009	2010	2011
IDA	80%	80%	79%	33%	48%	74%
AsDF	84%	85%	84%	67%	73%	77%
ADF	63%	67%	70%	31%	41%	48%

Note: Operating assets = loans + investments; operating income = income from loans + investments.

Comparison of investment portfolio

A comparative analysis of table I-3 indicates that outstanding investments represent a larger proportion of the Fund's operating assets, leading to a higher proportion of investment income as a percentage of operating income, when compared with other MDBs.

This indicates that the Fund's IGR depends more on the performance of its investment portfolio and the current low interest rate environment is expected to negatively impact the Fund's IGR than other MDBs.

Table I-3: Comparison of investment portfolio and investment income

Investment Portfolio as a % of Operating Assets				Investment Income as a % of operating Income		
	2009	2010	2011	2009	2010	2011
IDA	20%	20%	21%	67%	52%	26%
AsDF	16%	15%	16%	33%	27%	23%
ADF	37%	33%	30%	69%	59%	52%

Note: Operating assets = loans + investments; operating income = income from loans + investments.

Comparison of lending terms

The Fund has the longest maturity for its loans and therefore the highest concessionality. For gap and blend countries, other MDBs also apply less concessional lending terms than the Fund and the outstanding loan balance related to these types of loans is more significant. The Fund introduced differentiated loan terms for gap, blend and graduating countries only during ADF-12. These differentiated loan terms currently apply to only four countries and have a negligible disbursed and outstanding balance, as they were only approved in 2011. For other MDBs, hardened terms are applied to a larger number of countries and represent a larger proportion of outstanding loans. This is particularly the case for the AsDF, where 15 countries are classified as blend out of 28 countries eligible to borrow from the concessional window, and approximately 71% of the outstanding loan balance is disbursed to blend countries.

For IDA, out of 81 countries currently having access to the concessional window, 25 countries are categorized as blend and gap eligible to borrow with blend term credits. Therefore, the largest share of blend and hardened terms for IDA and AsDF is generating more income.

Table I-4: Comparative lending terms of MDBs—concessional regular windows

	Product Type	Maturity	Grace Period	Service Charge (%)	Commitment Charge (Bp)	Interest Charge	Concessi onality	# Of Blend
IDA	Regular	40	10	0.75	0 – 50	0	62%	25 out of 81
	Blend	25	5	0.75	0 – 50	1.25%	35%	
AsDF	Regular and blend	32 for project loans	8	0	0	1% during grace period;	Between 43% and 49%	15 out of 28
		and 24 for program loans	8	0	0	1.5% during amortizati on period.		
ADF	Regular	50	10	0.75	50	0	66%	4 out of 41
	Gap, blend and graduating	30	8	0.75	50	1%	41%	

Comparison of net income transfers from the nonconcessional windows

ADB's net income transfers to the Fund from its allocable income are comparable with those of AsDB to AsDF and IFC's to IDA. Indeed, Table I-5 illustrates that for the past 2 years, the average share of net income transfer to allocable income of the 3 institutions to their concessional windows was respectively 20% for ADB, 21% for AsDB and 19% for IFC. The situation is different for IBRD which transferred a higher percentage of its allocable income to IDA with an average transfer of 51% for the past 2 years.

It should be noted that since 2011, the Bank's net income allocations to the Fund have been based on an income model whose ultimate goal is to strike a balance between development assistance and financial solidity or integrity, and which also specifies that transfer to reserves should have the first claim in the net allocation process. Given the challenging environment in which the Bank performs and with rating agencies reviewing their rating methodologies to give more emphasis to the stand-alone credit profile of MDBs, net income transfers to concessional windows should continue to be analyzed and determined with due consideration to the Bank's income model.

Table I-5: Net transfer from nonconcessional windows

		2010	2011	Average Transfer
ADF *	ADB's income before distribution	214	165	
	ADB's Allocable Income	236	192	
	Transfer to ADF	50	35	
	Transfer as % of Allocable Income	21%	18%	20%
IDA **	IBRD's income before distribution	800	1,023	
	IBRD's Allocable Income	764	996	
	Transfer to IDA	383	520	
	Transfer as % of Alloc Income	50%	52%	51%
	IFC's income before Grant	1946	2179	
AsDF **	Grants Transfer to IDA	200	600	
	Transfer as % of Income	10%	28%	19%
	AsDB's income before distribution	626	609	
	AsDB's Allocable Income	583	577	
	Transfer AsDF	120	120	
	Transfer as % of Alloc Income	21%	21%	21%

* Amount in million UA

** Amount in million USD (\$)

Annex II: Options for Differentiation among ADF-only Countries

At the ADF-12 Mid-Term Review, Management presented, for illustrative purposes, three options for distinguishing groups of ADF-only countries: income level; income level and access to international financial markets; and income level and human and infrastructure development. Following Deputies' guidance and further internal reflection, Management refined and narrowed the options for discussion to: income level measured by the GNI per capita and human and infrastructure development level measured by the African Human and Infrastructure Development Index developed by the ADB.

Based on the preliminary analysis and the arguments outlined earlier, Management favors the second option. The grouping of ADF-only countries would be determined in December of each year, applying the data also used in the calculation of the performance-based country allocations for the following year. Harder loan terms would apply only to ADF-only countries in the "high" group eligible for loans, "green" or "yellow" in the DSF classification, with the exclusion of fragile states eligible for FSF Pillar I, to whom only the most concessional terms would apply.

General Working Assumptions

The two options in this annex are based on the premise that two groups of countries will be distinguished within the ADF-only category: "high" and "low" income for option 1 and "high" and "low" level of human and infrastructure development for option 2. The analysis assumes that the criteria for classifying countries as ADF-only (Category A, including gap), blend (Category B) and ADB-only (Category C) will not change; it also assumes that the differentiation of ADF lending terms between ADF-only and blend/gap/graduating countries will remain. The analysis in this annex therefore refers to the 36 ADF-only countries excluding gap countries. Finally, the current criterion for defining the financial mix of grants and loans in countries' ADF allocations is also assumed to remain unchanged: the IMF/WB Debt Sustainability Framework (DSF) traffic light classification.

Transition between groups

For countries eligible for loans (moderate or low risk of debt distress according to the IMF/World Bank Debt Sustainability Framework), the transition between ADF-only groups would follow the same principles currently being applied to the transition between ADF-Only and Gap/Blend. Transition from the low group to the high group, i.e. application of the harder lending terms, would occur after three consecutive years in the high category. This would allow for proper planning and prevent sudden movements in ADF lending terms. Reverse transition (i.e. from high to low) would occur immediately. As it is the case today, new lending terms will be applied only to new ADF loans.

Countries changing traffic light and becoming eligible for loans (going from high to either moderate or low risk of debt distress according to the DSF) would be taken into consideration when performing the grouping the following December. The same would apply to countries going from low/moderate to high risk of debt distress.

Treatment of Fragile States

Fragile states eligible for FSF Pillar I, regardless of their income or human and infrastructure development would not be subject to 'Advance' lending terms, but only to the more concessional terms for ADF-only countries ("Regular").

Option 1: GNI per Capita

This option uses countries' income (as measured by the GNI per capita, Atlas method) as the sole criterion for distinguishing groups of countries within the ADF-only category. Countries with a GNI per capita above the average are in the high income ("high") group, while the rest are in the lower income ("low") group. To limit sudden movements in the classification following the change in the risk of debt distress of countries, the average used is the one corresponding to all ADF-Only countries (i.e. including the "red" ones).

Resulting grouping

Table II-1 shows the resulting grouping into "high" and "low" if Option 1 is applied, using data for the 2012 ADF country allocations. The average GNI per capita of all the countries in the category is USD 653, and 13 countries are above the average (in the high group) while 23 are below (in the low group).

Harder loan terms would apply only to “high” ADF-only countries eligible for loans, “green” or “yellow” in the DSF classification. Currently 22 ADF-only countries receive either 50% or 100% of their PBA in the form of loans (exhibit low or moderate risk of debt distress). In this group, 8 countries are in the higher income group and the other 14 in the lower income group. The high-income group concentrates almost 34% of the PBA envelope and 36% of all loans provided to ADF-only countries in 2012, (table II-2).

Table II-1: Grouping of ADF-only under Option 1 (GNI per capita)

Country	2010 GNI pc (Atlas Method; USD)	Group	2011 DSF Status	Grant/Loan Mix
Sudan*	1,340	High	Red	Grants Only
Djibouti	1,310	High	Red	Grants Only
Ghana	1,230	High	Yellow	50% Loans on “Advance” terms, 50% Grants
São Tomé & Príncipe	1,200	High	Red	Grants Only
Cameroon	1,180	High	Green	100% Loans on “Advance” terms
Côte d'Ivoire*	1,160	High	Red	Grants Only
Senegal	1,090	High	Green	100% Loans on “Advance” terms
Zambia	1,070	High	Green	100% Loans on “Advance” terms
Lesotho	1,040	High	Yellow	50% Loans on “Advance” terms, 50% Grants
Mauritania	1,030	High	Yellow	50% Loans on “Advance” terms, 50% Grants
Kenya	790	High	Green	100% Loans on “Advance” terms
Benin	780	High	Green	100% Loans on “Advance” terms
Comoros*	750	High	Red	Grants Only
Chad	620	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Mali	600	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Guinea-Bissau*	590	Low	Red	Grants Only
Burkina Faso	550	Low	Red	Grants Only
Tanzania	530	Low	Green	100% Loans on “Regular” terms
Rwanda	520	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Uganda	500	Low	Green	100% Loans on “Regular” terms
Togo*	490	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Central African Republic*	470	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Zimbabwe*	460	Low	Red	Grants Only
Gambia	450	Low	Red	Grants Only
Mozambique	440	Low	Green	100% Loans on “Regular” terms
Madagascar	430	Low	Green	100% Loans on “Regular” terms
Guinea	400	Low	Red	Grants Only
Ethiopia	390	Low	Green	100% Loans on “Regular” terms
Niger	370	Low	Green	100% Loans on “Regular” terms
Sierra Leone*	340	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Eritrea	340	Low	Red	Grants Only
Malawi	330	Low	Yellow	50% Loans on “Regular” terms, 50% Grants
Liberia*	200	Low	Green	100% Loans on “Regular” terms
Congo DRC*	180	Low	Red	Grants Only
Burundi*	170	Low	Red	Grants Only
Somalia	170	Low	Red	Grants Only

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

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

Group	% of 2012 PBA Envelope	% of 2012 PBA Loans
High GNI pc	34	36
Low GNI pc	66	64
Total	100	100

Table II-3: Strengths and Weaknesses of Option 1

Strengths	Weaknesses
Clear and simple criterion. Reliable data available for all African countries.	<ul style="list-style-type: none"> - The GNI measure does not accommodate infrastructure and human well-being aspects, which are particularly important in Africa's resource-based economies and where the informal and the rural sector are prominent. - The GNI per capita neither captures distributional aspects or social, infrastructure and human welfare dimensions.

Option 2: Level of human and infrastructure development

This option groups ADF-only countries in accordance with their level of human and infrastructure development by using a non-monetary combination of the social indicators included in the UNDP's Human Development Index and the African Infrastructure Development Index produced by the ADB.

Building the composite index

Three indicators are used for the construction of the African Human and Infrastructure Development Index (AHIDI): the HDI Education Index (UNDP), HDI Health Index (UNDP) and the African Infrastructure Development Index (ADB). A country's score on the AHIDI is the sum of its scores on the three rescaled indicators. Countries that score above the ADF-only average are included in the higher development level group ("high"), and those scoring below average in the lower development group ("low").

Resulting Grouping

Table II-4 contains the resulting grouping if Option 2 is applied to the current ADF-only countries, using data for the 2012 ADF country allocations. The average score on the AHIDI is 0.24; with 20 countries above the average (higher development group) and 16 countries below the average (lower development group).

Harder loan terms would apply only to the "high" ADF-only countries eligible for loans (i.e. "green" or "yellow" in the DSF classification). Currently 22 ADF-only countries receive either 50% or 100% of their PBA allocations in the form of loans (exhibit low or moderate risk of debt distress). Of these, 14 are in the high group and the remaining 8 in the low group. The high group concentrates 48% of the total PBA envelope and more than 51% of all loans provided to ADF-only countries in 2012, (table II-5).

Table II-4: Grouping of ADF-only countries under Option 2

Country	Human and Infrastructure Development Index	Group	2011 DSF Status	Grant/Loan Mix
Sao Tome and Principe	0.48	High	Red	Grants Only
Comoros*	0.43	High	Red	Grants Only
Ghana	0.42	High	Yellow	50% Loans on "Advance" terms, 50% Grants
Kenya	0.37	High	Green	100% Loans on "Advance" terms
Gambia	0.37	High	Red	Grants Only
Cameroon	0.36	High	Green	100% Loans on "Advance" terms
Zimbabwe*	0.36	High	Red	Grants Only
Togo**	0.35	High	Yellow	50% Loans on "Regular" terms, 50% Grants
Malawi	0.34	High	Yellow	50% Loans on "Advance" terms, 50% Grants
Benin	0.33	High	Green	100% Loans on "Advance" terms
Senegal	0.33	High	Green	100% Loans on "Advance" terms
Uganda	0.33	High	Green	100% Loans on "Advance" terms
Liberia**	0.31	High	Green	100% Loans on "Regular" terms
Madagascar	0.31	High	Green	100% Loans on "Advance" terms
Zambia	0.29	High	Green	100% Loans on "Advance" terms
Mauritania	0.29	High	Yellow	100% Loans on "Advance" terms
Lesotho	0.29	High	Yellow	50% Loans on "Advance" terms, 50% Grants
Djibouti	0.29	High	Red	Grants Only
Côte d'Ivoire*	0.28	High	Red	Grants Only
Rwanda	0.27	High	Yellow	50% Loans on "Advance" terms, 50% Grants
Congo (DRC)*	0.24	Low	Red	Grants Only
Burundi*	0.21	Low	Red	Grants Only
Tanzania	0.21	Low	Green	100% Loans on "Regular" terms
Sudan*	0.2	Low	Red	Grants Only
Guinea	0.19	Low	Red	Grants Only
Guinea-Bissau*	0.17	Low	Red	Grants Only
Central African Republic*	0.15	Low	Yellow	50% Loans on "Regular" terms, 50% Grants
Mali	0.13	Low	Yellow	50% Loans on "Regular" terms, 50% Grants
Sierra Leone*	0.12	Low	Yellow	50% Loans on "Regular" terms, 50% Grants
Burkina Faso	0.11	Low	Red	Grants Only
Ethiopia	0.1	Low	Green	100% Loans on "Regular" terms
Mozambique	0.09	Low	Green	100% Loans on "Regular" terms
Eritrea	0.05	Low	Red	Grants Only
Niger	0.04	Low	Green	100% Loans on "Regular" terms
Chad	0.04	Low	Yellow	50% Loans on "Regular" terms, 50% Grants
Somalia	0	Low	Red	Grants Only

*Countries benefiting from Pillar I of the ADF's Fragile States Facility..**The higher level of concessionality applies to Fragile States receiving all or part of their ADF allocations in the form of loans. Notes: 2010 composite index threshold was 0.24. Sources: ADB and UNDP. Non-income HDI for Eritrea and Somalia were assumed to be equal to the Group's minimum. AIDI value for South Sudan assumed equal to that of Sudan for 2010

Table II-5: PBA Allocation per group under Option 2, 2012

Group	% of 2012 PBA Envelope	% of 2012 PBA Loans
High H&I	48%	51%
Low H&I	52%	49%
Total	100	100

Table II-6: Strengths and weaknesses of Option 2

Strengths	Weaknesses
<p>Data available for all countries except Eritrea and Somalia.</p> <p>Considers explicit education, health and infrastructure development indicators.</p> <p>Infrastructure component aligned with the Bank's Operational Priorities.</p> <p>Infrastructure index measures dimensions of inclusive growth that are not captured by the HDI.</p> <p>High concentration of ADF-only loans in high human development/high infrastructure capacity group.</p>	<p>Data on HDI not available for Somalia and Eritrea (assumed to be equal to the minimum of the group in 2010).</p> <p>Data on Infrastructure Index not available yet for South Sudan (assumed equal to Sudan for 2010).</p>

Annex III: Summary of the key features of innovative financing instruments

Instrument	Description	Benefits	Issues and risks	Implementations challenges	Estimated leverage and financial impact
1. ADF Loan Buy-Down	<ul style="list-style-type: none"> Donor Country and/or other interested parties offers to prepay an ADF loan owed by a given ADF country. 	<ul style="list-style-type: none"> Additional resources mobilization; Free up resources to be redeployed in new projects Enhances the Fund's profile (as one of) the premier channel(s) of aid and concessional finance flow into Africa; Loan prepayment increases the speed of reflows for the Fund and, Advanced Commitment Capacity 	<ul style="list-style-type: none"> Discount granted to donors for Loan Buy downs could potentially not be recouped depending of the level of interest rate. Could be considered as a duplication of HIPC fund. 	<ul style="list-style-type: none"> Involved multiple parties increase the Fund's operational costs through coordination, promotion, deployment and reporting. Dedicated team to operationalize the product 	<ul style="list-style-type: none"> Financial not known. Preliminary contacts need to be initiate with potential donors to test their appetite for this product
2. ADF Partial Credit Guarantees (PCG)	<ul style="list-style-type: none"> ADF provides a guarantee for syndicated loans and bond issues 	<ul style="list-style-type: none"> Leveraging ADF resources (more than 8 times) for private sector development in Low income countries PCG could raise the rating of a transaction by 3 to 6 notches Utilized to support mobilization of private funds for project finance, financial intermediation, and policy based finance Effective tool to assist higher-income, well performing ADF countries that are on the verge of accessing markets directly in obtaining more favorable market credit terms PCG has the potential to help mobilize local capital markets for public investment needs Catalyzes private sector participation No set-aside required, financed from PBA allocations 	<ul style="list-style-type: none"> Associated borrowing may be a risk to debt sustainability issues as well as unsustainable borrowing Extending PCGs to Low income countries could be construed as condoning reckless debt accumulation and a breach of the Bank's non-concessional debt accumulation policy 	<ul style="list-style-type: none"> Dedicated team to market the product An implementation approach that rests on mainstream business processes and mobilizes specialist skills Need to set up a number of safeguards and stringent criteria based on debt burden (traffic light assessment), financial viability of projects (project-level considerations) as well as coordination with international finance institutions, like IMF Sufficient levels of leverage to make the instrument attractive 	<ul style="list-style-type: none"> leveraged instrument that will consume only a fraction of the country's Performance Based Allocation For a guarantee amount of 100, only 25 would be deducted from the host country PBA. As the Fund would guarantee less than 50% of the exposure, leverage effect would be more than 8 times. Commitment capacity of ADF to be increased by 75% of the face value of every PCG extended
3. ADF Private Sector Matching Fund	<ul style="list-style-type: none"> ADF provides loan or grant to Low income countries for equity investment in PPP projects 	<ul style="list-style-type: none"> Leveraging ADF resources for private sector development in Low income countries More PPP/private sector investments in small countries and Low income countries Facilitate and incentivize the government's participation with equity in its PPPs. Help to relax the binding constraint of 	<ul style="list-style-type: none"> Sufficient envelop to make the make the product efficient 	<ul style="list-style-type: none"> Implementation will build on existing instrument. PBA envelope would be reduced New set-aside envelope 	<ul style="list-style-type: none"> Envelope of UA 300 million in ADF-13 in order to leverage a significant number of PPPs across the African Low income countries. Enabling the equity in PPPs (10:10:10) with the Private

		Sustainable Lending Limits (SLL).			Sector Matching Fund would create a minimum multiplier of 1:9 for each PPP
4. DFI Facility	<ul style="list-style-type: none"> ADF provides PRG to DFI, or loan to LICs for equity financing in regional DFI 	<ul style="list-style-type: none"> Partial Risk Guarantee (PRG) will improve the credit rating of DFIs to an investment-grade status Equity Finance Instrument (EFI) would support the strengthening of the paid-in capital position of DFIs 	<ul style="list-style-type: none"> Sufficient envelop to make the PRG and EFI for DFIs efficient 	<ul style="list-style-type: none"> Implementation will build on existing instruments. Stringent criteria to determine eligible DFI 	<ul style="list-style-type: none"> A Facility of UA 300 million might contribute to clearing all the existing arrears on due capital installments, and contribute to enhancing the quality of UA 1.2 billion callable capital of regional/sub-regional DFIs. This implies support to 4-5 DFIs.
5. Default Loss Portfolio Guarantee (DLPG)	<ul style="list-style-type: none"> ADF provides a guarantee to the ADB to increase ADB non-sovereign portfolio in Low income countries 	<ul style="list-style-type: none"> Leveraging ADF resources for private sector development in Low income countries Increase intervention in Low income countries beyond the current the Bank's exposure limit constraints 	<ul style="list-style-type: none"> Potential legal issue or conflict of interest. ADB will be the beneficiary of the guarantee and is the trustee of ADF Modeling challenges to determine the fair pricing of the transaction. Potential for moral hazard as FPLG could potentially lead to unintentional relaxation of Bank credit standards. 	<ul style="list-style-type: none"> Dedicated team to operationalize the product New set-aside envelope, PBA envelope decreases 	<ul style="list-style-type: none"> Estimated leverage between two up to five times the guarantee amount. Start with UA 100 million could found up to UA 300 million additional private sector projects
6. Modified Framework for Assistance to Creditworthy Countries under ADF	<ul style="list-style-type: none"> Volume of ADF allocation calculated for blend and graduating countries is provided by the ADB instead; ADF compensates the ADB for the interest differential required to increase the concessionality of ADB loan to the appropriate level 	<ul style="list-style-type: none"> Free up ADF resources from donors to be more focused on ADF-Only countries For ADF-12 it would have freed UA 21.41 million of Angola, UA 8.42 million of Cape Verde, and UA 191.77 million of Nigeria. This represents a total of UA 221.6 million or 6% of total available resources for PBA allocation Improve synergy, coordination and knowledge transfer between ADB and ADF for more operational efficiency 	<ul style="list-style-type: none"> Potential legal issue or conflict of interest. ADF will provide interest subsidies to ADB and ADB is ADF Trustee ADB will provide loans to ADF countries only if there is SLL headroom. The instrument might not be applied to private sector loans as they are by definition non concessional. 		<ul style="list-style-type: none"> For ADF-12 would have freed UA 221 million or 6% of total available resources for PBA allocation For each USD 10 million given by the ADB to a blend or transition country, the ADF would contribute with USD 1.58 million during the whole life of the loan (25 years) in net present value.

Annex IV: Possible ADF Innovative Financing Instruments

1. ADF Loan Buy-Down

Definition Offer to donor countries (and other interested parties such as Endowment Funds) the possibility of prepaying to the ADF the outstanding amount of a loan (or particular set of loans) owed by a given ADF country. This form of direct debt relief could target loans granted to finance projects in specific sectors or with specific objectives such as renewable energy, environment, education, water, and poverty reduction. These initiatives could also be tied to conditions, obliging the beneficiary countries or selected projects to meet certain landmarks and objectives before the pre-payment / debt relief could take place. The Fund can then recycle the pre-paid amounts through the general ADF financing window.	
Identified demand / Example of projects Buy-downs in the health sector have been successfully implemented in Pakistan and Nigeria and have been supported by the World Bank, the United Kingdom, the United Nations Foundation, the Bill & Melinda Gates Foundation and Rotary International. Donors have provided a total of more than US\$100 million for buy-downs, facilitating health projects of about US\$ 190 million.	
Indicative envelop or amount of the guarantee	<ul style="list-style-type: none"> Not applicable, loan buy downs require new grant financing from an external Donor;
Benefits	
For LIC	<ul style="list-style-type: none"> Additional resource mobilization of aid and concessional finance flow into Africa; Free up ADF resources that can be redeployed into new projects; Loan prepayment increases the speed of reflows for the Fund and the Advanced Commitment Capacity; Increases access to ADF funding; Improves accountability when linked to results and milestones; Can target specific projects or sectors that increase inclusiveness and green growth;
Issues/risks	
Legal issues	<ul style="list-style-type: none"> None;
Compliance with credit policy and Debt Sustainability Framework	<ul style="list-style-type: none"> The prepayment of (part of) the Low income countries ADF-loans increases debt sustainability;
Other issues/risks	<ul style="list-style-type: none"> When buy downs are offered below par, recouping the discount granted to donors will depend on the success of the hedging / investment strategy; Involves multiple parties, which can increase the Fund's operational costs through the coordination, promotion, deployment and reporting activities; Some conceptual overlap with the HIPC initiative;
Implementation challenges	
Easy or difficult to implement?	<ul style="list-style-type: none"> Easy to implement but requires resource mobilization efforts, and, eventually, additional project monitoring and reporting (in the cases that Loan Buy-Down is tied to milestones);
Operational cost (dedicated team or resources)	<ul style="list-style-type: none"> Can be operationalized through the Bank's Resource Mobilization platforms;
Impact on the PBA	<ul style="list-style-type: none"> None
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> Does not increase leverage; Increases the speed of reflow of the Fund's development resources, enabling it to provide further support to Low income countries and regional member countries.
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> Not quantifiable for the moment;

2. ADF Partial Credit Guarantees (PCG)

Definition

Guarantees are effective in mobilizing private sector financing and leveraging resources, particularly for facilitating the flow of investments to high risk sectors and countries. Accordingly, to leverage the ADF's capital base as well as leverage resources from the private sector and other co-financiers for ADF countries, including fragile states we propose the extension of partial credit guarantees (PCGs) to ADF countries on a pilot basis.

PCGs cover commercial lenders against all risks of debt service default on a specified portion of commercial / private debt (bonds and loans), and can be used to mobilize commercial financing for project finance, financial intermediation, and policy based finance. Subject to predefined eligibility criteria that take into account country indebtedness, debt management capacity and the compliance to the Bank's Non-Concessional Debt Accumulation Policy, the proposed ADF PCG will enable ADF countries or its public / state institutions to access commercial finance only for a limited number of priority sectors like infrastructure, agriculture and for domestic resource mobilization.

Identified demand / Example of projects

Over the past couple of years, the Bank has received several inquiries from investment banks arranging first time international bond issues / syndicated loans for a number of Regional Member Countries (RMCs). There might have been greater demand for PCGs if ADF countries had been eligible.

Indicative envelop or amount of the guarantee

- The ADF PCG program would be piloted with a total maximum exposure initially limited to UA 300 million.

Benefits

For low income country

- Leveraging ADF resources for public / private sector development in Low income countries.
- Leverage effect: more resources available to the respective country.
- Effective tool to assist higher-income, well performing ADF countries that are on the verge of accessing markets directly in obtaining market credit.
- Enhance the credit profile of a country, which translates into improved funding costs (longer term loans and cheaper funding). For instance, a PCG for Low income countries could raise the rating of a bond issue by three to six notches.
- Utilized to support mobilization of private funds for project finance, financial intermediation, and policy based finance.
- PCG has the potential to help mobilize local capital markets for public investment needs.

Issues/risks

Legal issues

- Non-standard legal contracts. Guarantees are legally more complex than direct lending, owing to the greater number of parties involved.

Compliance with credit policy and Debt Sustainability Framework

- Deterioration of the country DSA since guaranteed debt would be non-concessional.
- Extending PCGs to Low income countries for international bond issues could be construed as condoning reckless debt accumulation and a breach of the Bank's non-concessional debt accumulation policy.

Other issues/risks

- Need to set up a number of safeguards and stringent criteria based on debt burden (traffic light assessment), financial viability of projects (project-level considerations) as well as coordination with international finance institutions, like IMF.

Implementation challenges

Easy or difficult to implement?

- The PCG product is already being offered under the ADB window.
- An implementation approach that rests on mainstream business processes and mobilizes specialist skills.
- Though a limited number of guarantees have been issued, the Fund

	<p>does not foresee any implementation challenges as the Bank has experience in booking, billing and accounting for guarantees.</p> <ul style="list-style-type: none"> • Sufficient levels of leverage to make the instrument attractive.
Operational cost (dedicated team or resources)	<ul style="list-style-type: none"> • The PCG is already standard product in the Bank and would not require additional operational considerations. • Dedicated team to market the product.
Impact on the PBA	<ul style="list-style-type: none"> • Would consume 25 percent of the face value of the guarantee from the country's PBA.
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> • 4x: For a guarantee amount of 100, only 25 would be deducted from the host country PBA. • As the Fund would guarantee less than 50% of the exposure, leverage effect would be more than 8 times.
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> • Commitment capacity of the ADF to be increased by 75% of the face value of every PCG extended.

3. *ADF Private Sector Matching Fund*

Definition

The Private Sector Matching Fund is proposed as a new financial envelope under ADF-13 to provide loans or grants to eligible countries for equity investment in PPP projects, as an extension of the possibility created in ADF-12 for countries to use their PBA allocations for this purpose. The facility would encourage borrowing countries to develop more Public Private Partnerships (PPPs) projects with private sector participation. The Private Sector Matching Fund would contribute 1x to match the government's contribution of 1x in equity for a PPP in that country or region. This matching would be triggered when the government is able to confirm the participation of a minimum of 2x for contribution from the private sector to the equity of the PPP.

The ADF Private Sector Matching Fund would serve as an incentive to governments to seek collaboration and co-investment with private investment for development of PPPs in infrastructure and other key areas of the economy leading to inclusive growth. The debt would come from a combination of public and private financiers. The Matching Fund is another way of allocation of the ADF funds to the low income countries, with a focused objective of private sector development.

There will be Private Sector Prioritization and Selection Framework developed which would give more weight to the least developed countries and fragile states to incentivize more PPP/private sector projects in small allocation countries. A parallel is the Regional Operations Prioritization and Selection Framework which ranks regional operations.

Identified demand / Example of projects

Mozambique: The Three-year indicative allocation for Mozambique is UA132.5 million. The country has a strong pipeline of PPPs. The government requires additional support for financing these PPPs.

Examples:

Itezhi-Tezhi Power Project, Zambia: This project involve the design, construction and operation of a 120MW hydropower station over an existing dam in Zambia as well as a 280 km transmission line to send the power to the nearest load center.

An SPV, Itezhi-Tezhi Power Corporation (ITPC) will implement the 25 year power concession under a BOOT scheme and will be owned equally by TATA Africa (50%) and ZESCO (50%), the national power utility. The Zambian government used part of its PBA allocation to finance ZESCO's equity participation in the SPV.

Total project cost is estimated to be USD 239 million for the hydropower station and USD 114 million for the transmission line.

Henri-Konan Bridge, Côte d'Ivoire: The Henri-Konan Bridge is an essential infrastructure project financed in Côte d'Ivoire. In this case, the government has to borrow by issuing costly short-term T-bills to finance the equity participation of the government in this PPP.

Indicative envelop or amount of the guarantee	The Private Sector Matching Fund is proposed to be an envelope of UA 300 million in ADF-13 to create an effective envelope to leverage a significant number of PPPs across the African Low income countries.
Benefits	
For low income countries	<ul style="list-style-type: none"> • It would help leverage more funds from the private sector. • It would give small allocation countries more opportunities to have PPP/private sector investments in those countries. • It could potentially facilitate the resources mobilization from alternative sources of funding toward ADF such as foundations, non-ADF donors, and so on. • It would help to relax the binding constraint currently imposed on ADB operations by the Sustainable Lending Limits (SLL). • It would enable the low income countries to develop more PPPs and projects in their countries. • It would facilitate and incentivize the government's participation with equity in its PPPs.
Issues/risks	
Legal issues	<ul style="list-style-type: none"> • No foreseen legal issues
Compliance with credit policy and Debt Sustainability Framework	<ul style="list-style-type: none"> • The Private Sector Matching Funds would be allocated to the countries according to the DSF, with the mandate that these funds be used as equity in the identified PPP.
Other issues/risks	
Implementation challenges	
Easy or difficult to implement?	<ul style="list-style-type: none"> • Easy to implement as it is just another way of allocation of the ADF funds to the low income countries for investing in PPP equity
Operational cost (dedicated team or resources)	<ul style="list-style-type: none"> • It will be a new set-aside envelope responding to one of the core operational priorities of the ADF on private sector development. • The envelope could be managed by the Bank's Private Sector Department.
Impact on the PBA	<ul style="list-style-type: none"> • The overall PBA envelope would be reduced by the size of the set-aside.
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> • 1x of ADF funds from the PS Matching Fund with 1x from the government's PBA would leverage a minimum of 2x from the private sector. There is a leverage of a minimum of 100% for the ADF contribution.
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> • Private Sector Operations have a minimum leverage of 1x to 7x with respect of co-financing for every dollar of Bank funds. While the PPP leverage is not available at this time, projects are typically 30:70 equity to debt. Therefore, enabling the equity in PPPs (10:10:10) with the Private Sector Matching Fund would create a minimum multiplier of 1:9 for each PPP. This would be multiplied by the volume of PPPs funded.

4. *DFI Facility*

Definition

The DFI Facility would contribute to increased financing opportunities for infrastructure development and SME development in Africa through African DFIs, by crowding in private sector financing. It would include two key instruments:

1. Partial Risk Guarantee (PRG), which would be used to enhance the obligations of African regional and sub-regional DFIs' member countries to promptly pay-in their respective pro-rata share of callable capital in case there is a first call. This would lead to an improvement in the credit rating of DFIs, which in turn would entail an improvement in the terms of its fundraising activities from commercial lenders.
2. Equity Financing Instrument (EFI), which would be used to provide concessional financing to regional and sub-regional DFIs' member countries to finance an increase of paid-in capital

and, equally important, to clear arrears on due capital instalments, particularly for fragile states which face competing demands for resources. This would contribute to improve DFIs' creditworthiness.	
Identified demand / Example of projects For a regional/sub-regional DFI to graduate to a "BBB" rating category it is estimated that the proposed PRG should cover approximately 30-40 percent of their total callable capital or USD 130-170 million in the case of EADB and USD 290-390 million in the case of PTA Bank. Considering that African DFIs' aggregate callable capital is estimated at USD 5 billion, the potential demand for the proposed PRG instrument is in the range of USD 375–500 million. This assumes that 25 percent of the notional of the PRG would be deducted from the country's Performance Based Allocation (see below). Demand for the EFI is estimated at USD 300 million, including the estimated current arrears of about USD 60-80 million.	
Indicative envelop or amount of the Facility	UA 300 million
Benefits	
For Low income countries	<ul style="list-style-type: none"> • Support initiatives in the areas of private sector development in Low income countries, particularly infrastructure development and SME development • Increase intervention in Low income countries beyond the current Bank's exposure limit constraints • Maximize efficiency (through the leverage effect, particularly of the PRG) and effectiveness (through catalyzing private investors) • Promote infrastructure development and SME development as a key engine of growth and poverty reduction
Issues/risks	
Legal issues	<ul style="list-style-type: none"> • No particular legal challenge is envisaged in the implementation of the proposed products as the PRG builds upon an existing instrument and the EFI is a straightforward back-to-back agreement
Compliance with credit policy and Debt Sustainability Framework	<ul style="list-style-type: none"> • In processing the PRG, a thorough appraisal of the DFI benefiting from the credit enhancement will be conducted, with a particular focus on commercial viability. Only DFIs meeting the necessary requirements will be eligible.
Implementation challenges	
Easy or difficult to implement?	<ul style="list-style-type: none"> • The proposed products are easy to implement as they build on existing instruments.
Operational cost (dedicated team or resources)	<ul style="list-style-type: none"> • The DFI coordinator within OPSM would be assigned to implement the proposed products
Impact on the PBA	<ul style="list-style-type: none"> • Individual RMCs shares will be determined.
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> • 4X for the PRG, 1X for the EFI.
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> • A Facility of USD 400 million might contribute to clearing all the existing arrears on due capital installments, particularly for fragile states, and contribute to enhance the quality of USD 1.5 billion callable capital of regional/sub-regional DFIs. This implies support to 4-5 DFIs that, by achieving an investment grade status, could mobilize additional private sector financing

Other Innovative Financing Instruments still under exploration

5. Default Loss Portfolio Guarantee (DLPG)

Definition <p>The objective is to increase the lending capacity of the ADB to fund non-sovereign projects in ADF countries by using a default loss portfolio guarantee provided by ADF. The DLPG will create risk capital headroom to be used to fund new non-sovereign portfolio in Low income countries beyond the current sustainable lending limit (SLL).</p> <p>The ADF will provide a guarantee to the ADB and the Bank will pay a premium to the Fund. The guarantee will cover the part of the losses of the underlying credit assets within the non-sovereign low-income country portfolio. This guarantee is offered over a predetermined time period and up to a certain limit. The introduction of this innovative product is in line with ADF goal to support initiatives in the areas of private sector development</p>	
Identified demand / Example of projects <p>Part of the Non-sovereign ADB portfolio in Low income countries. The ADF and the ADB will jointly establish binding credit parameters for the prospective portfolio that will benefit from ADF guarantee ("The Guaranteed Portfolio"). The ADB can add new credit assets to the guaranteed portfolio, so long as they are fully compliant with the established parameters.</p> <p>Only two MDBs are known to have developed similar products: the European Investment Bank (EIB) and the Nordic Investment Bank (NIB). EIB's product is a "first" loss guarantee, while that of NIB is a "tail" loss guarantee. The NIB believes that the tail loss version eliminates the problem of moral hazard. Although the EIB thinks that their product is workable, they face modeling challenges, similar to the modeling of tranches of collateralized debt obligations. In particular, they have not yet been able to determine a fair pricing.</p>	
Indicative envelop or amount of the guarantee	UA 100 million
Benefits	
For low income countries	<ul style="list-style-type: none"> • Support initiatives in the areas of private sector development in Low income countries • Increase intervention in Low income countries beyond the current the Bank's exposure limit constraints • Promote the private sector in Low income countries as a key engine of growth and poverty reduction
Issues/risks	
Legal issues	<ul style="list-style-type: none"> • The fact that the ADB would be the beneficiary of a guarantee from the Fund could be problematic regarding the use of the Fund resources because ADB is the Trustee of the ADF. However the ultimate beneficiaries of the effect of the guarantee are Low income countries
Compliance with credit policy and Debt Sustainability Framework	<ul style="list-style-type: none"> • The guarantee will not be extended directly to the countries but to the ADB for scaling up the relative share of Bank Group non-sovereign operations in Low income countries
Other issues/risks	<ul style="list-style-type: none"> • Modeling challenges to determine the fair pricing of the transaction. • Potential moral hazard: the DLPG could lead to unintentional relaxation of Bank credit standard. To mitigate that risk ADB and ADF could share the losses or "pari passu" (i.e.50/50) or the guarantee should not cover the first loss but rather the intermediary or last losses of the portfolio. • Setting a confidence level of 99.99% as used for AAA institutions for the maximum amount to be guaranteed would lead to a low leverage.
Implementation challenges	
Easy or difficult to implement?	<ul style="list-style-type: none"> • The assessment of the project to guarantee is achievable using the existing assessment tools. The main challenge remains the modeling of the product for adequate risk coverage
Operational cost (dedicated team or resources)	<ul style="list-style-type: none"> • A team will design the key features of the DLPG product

Impact on the PBA	<ul style="list-style-type: none"> The PBA envelope would decrease by the size of the set-aside
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> 1x to 3x It is estimated that the DLPG would leverage up to three times its value in additional financing for private sector operations in Low income countries from the ADB window (depending on the confidence level of the calculations).
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> DLPG of UA 100 million could leverage up to UA 300 million additional private sector loans in Low income countries.

6. *Modified Framework for Assistance to Creditworthy Countries under the ADF*

Definition	
<p>The ADB provides the volume of ADF PBA allocations for countries that are creditworthy (blend and graduating). The Fund then compensates the ADB for the interest rate differential for the loan to maintain the same concessionality level of the ADF.</p> <ul style="list-style-type: none"> The Bank provides a loan to a Blend or graduating country under the current ADB loan terms (25 years maturity, 5 years grace and 1.14% interest plus commissions and fees). The government pays only the component of interest for the loan to have the grant share equivalent to that under an ADF loan on blend terms (currently 30 years maturity, 8 years grace and 1% interest plus commissions and fees). The ADF provides the differential between the ADB rate and the portion paid by the government. <p>The framework also takes full advantage of the synergy between the Bank and the Fund windows, since only a limited number of countries are eligible to receive ADB financing among which only a few are actually borrowing. ADB window has “excess capacity” and the ADF has “excess demand” because the overwhelming majority of African countries have to share its limited pool of concessional resources. This is also in line with the Long Term Strategy which recommends that the Bank could be more effective, and unlock additional resources by blending ADB and ADF resources to provide tailored instruments for a diverse set of regional member countries. In addition, third parties such as donors or foundations may be interested to participate in such blending, in order to support transition countries.</p>	
Identified demand / Example of projects	
All the future ADF blend and transition countries (such as Ghana).	
Indicative envelop or amount of the guarantee	<ul style="list-style-type: none"> UA 221 million under ADF-12, likely to increase
Benefits	
For low income countries	<ul style="list-style-type: none"> ADF resources would be focused on ADF-Only countries The capacity of the Bank to operate in countries which are creditworthy would increase and would strengthen the incentives for countries to graduate. Indeed, the framework might eliminate the need of the 50% discount and the 10% Cap on Blend countries and the need of 10% Cap on transition countries For ADF-12 it would have freed UA 21.41 million of Angola, UA 8.42 million of Cape Verde, and UA 191.77 million of Nigeria. This represents a total of UA 221.6 million or 6% of total available resources for PBA allocation during ADF-12 for ADF-Only countries. The impact for future cycles would be even larger as countries like Ghana (UA 238.76 million allocation in ADF-12) start graduating from ADF
Issues/risks	
Legal issues	<ul style="list-style-type: none"> ADF will provide interest subsidies to ADB while it is its Trustee
Compliance with credit policy and Debt Sustainability Framework	<ul style="list-style-type: none"> ADB will provide loans to ADF countries only if there is SLL headroom Private sector loans are not targeted by this product as they are by definition non concessional
Other issues/risks	
Implementation challenges	
Easy or difficult to implement?	<ul style="list-style-type: none"> Need to be structured to avoid the issue of the trustee relation with ADB - possibly through an independent special purpose vehicle legally and financially separate from both the ADB and the ADF (which could

	be open to participation by third parties)
Operational cost (dedicated team or resources)	<ul style="list-style-type: none">
Impact on the PBA	<ul style="list-style-type: none"> The envelope for PBA allocations of ADF-only countries would increase.
Financial impact	
Assessment of the leverage	<ul style="list-style-type: none"> Leverage of approximately 7X Additionally, third parties such as donors or foundations may be interested in participating in the blending in order to support transition countries
Quantitative assessment of financial impacts	<ul style="list-style-type: none"> For each USD 10 million given by ADB to a Blend or Graduating Country, the ADF would contribute with USD 1.58 million during the whole life of the loan (25 years) in Net Present Value (approximately 7X leverage). Interest rate differential to be covered by ADF = 1.876% Current grant share of sovereign guarantee loans under ADB conditions: 27% Current grant share of sovereign guarantee loans under ADF conditions for Blend: 41%