

# **The Long-Term Financial Integrity of the African Development Fund**

**Discussion Paper**

ADF-12 Replenishment  
February 2010  
Cape Town, South Africa



**AFRICAN DEVELOPMENT FUND**

## Executive Summary

Preparations for ADF-12 are taking place under very different circumstances than those that prevailed for ADF-11. At that time, growing optimism in Africa and abroad encouraged positive assumptions about the volume of the Fund's internal resources. The recent global financial and economic crises and the Fund's rapid response to help mitigate their adverse effects on ADF-countries have put the Fund's resources under severe pressure. With the crisis affecting Africa deeply over the course of 2009, many years of steady economic growth resulting from improved governance and sound reforms are increasingly in jeopardy. ADF countries in particular have been impacted by enormous and concurrent drops in commodity prices, foreign direct investment, and bilateral aid. As one of the few sovereign financing windows available to these countries, the ADF has experienced a sizeable increase in requests for assistance.

During ADF-12, the Fund expects its ability to contribute internally generated resources to be substantially lower than during ADF-11, when it contributed UA 2,063 million. This decrease will be primarily due to two factors. First, because of current low interest rates, the ADF expects income from its investments to decline by almost 50 percent in 2010 compared to 2009. Second, loan cancellations during ADF-11 were significantly lower than the UA 300 million expected, partly because cancellation proceeds were allowed to return to countries in response to the food and financial crises. Thus, despite Management's best efforts to maximize the level of internal resources within prudential limits, the Advance Commitment Capacity (ACC) for ADF-12 is only expected to reach UA 1,763 million. This decrease compared to ADF-11 implies that significant additional donor resources will be necessary to do no more than match the total replenishment level of ADF-11. To sustain the Fund's laudable achievements in Africa will require more effort from us all.

In addition to interest rates and loan cancellations, the size of the ACC is influenced by MDRI compensation, ADB net income transfers, and administrative expenses. To help protect the long-term financial integrity of the ADF, Management will pursue avenues liable to increase internally generated resources. These avenues could include (i) continued improvements in portfolio management; (ii) a proposal that subject to the ADB's financial performance, the Board of Governors approve the transfer to the Fund of larger portions of the Bank's net income (including all or significant portions of the income obtained from arrears clearances) than the portions assumed in current ACC estimates; (iii) examination and possible adjustments of the cost-sharing mechanism between the ADF and the ADB to reflect recent and expected future evolutions in the institutions' activities (and, by extension, their cost drivers); and (iv) an increase in the level of compensation under the MDRI.

## Table of Contents

<b>Abbreviations .....</b>	<b>iii</b>
<b>1. Context.....</b>	<b>1</b>
<b>2. The ADF’s Financial Resources .....</b>	<b>1</b>
<i>Donor Subscriptions.....</i>	<i>2</i>
<i>Internally Generated Resources and the Advance Commitment Authority (ACA) .....</i>	<i>2</i>
<i>Core Assumptions of the ACA and Their Evolution Since ADF-10 .....</i>	<i>3</i>
<b>3. The ADF’s Future Financial Capacity .....</b>	<b>4</b>
<i>Modalities for ADF-12 Donor Contributions .....</i>	<i>4</i>
<i>Scenarios for ADF-12 Resource Levels and Implied Donor Contributions.....</i>	<i>6</i>
<i>Simulated ACC Levels and Options to Increase Internally Generated Resources .....</i>	<i>7</i>
<i>ADF Net Income Dynamics and Projections.....</i>	<i>11</i>
<b>4. Conclusion.....</b>	<b>14</b>
<b>Annex I: Summary of the Sensitivities of the ACC and Variance Analysis Between ADF-12 and ADF-11 .....</b>	<b>15</b>
<b>Annex II: The ADF’s Investment Portfolio Strategy Compared to the Strategy of the International Development Association .....</b>	<b>16</b>

### Tables

Table 1: Evolution of the ACA Model’s Core Assumptions .....	3
Table 2: The ADF-12 Encashment Schedule for Indicative Donor Pledges .....	5
Table 3: Three ADF-12 Replenishment Scenarios, With Percent Increases .....	6

### Figures

Figure 1: The Evolution of the ADF’s Replenishment Levels .....	2
Figure 2: Three ADF-12 Replenishment Scenarios.....	6
Figure 3: Evolution of ADF Cash Flows and Liquidity .....	7
Figure 4: Advance Commitment Capacity in ADF-12 at Different Interest Rates.....	8
Figure 5: Advance Commitment Capacity in ADF-12 at Different Levels of Loan Cancellations.....	9
Figure 6: Advance Commitment Capacity for ADF-12 at Different Levels of MDRI Coverage .....	9
Figure 7: ADF Operational Income Gap to be Covered by Investment Income .....	12
Figure 8: Investment Income’s Coverage of the Operational Income Gap .....	13
Figure 9: Projected Yearly ADF Net Incomes by Return On Investment Scenario and Their Implications for the Advance Commitment Capacity.....	14

## Abbreviations

ACA	Advance Commitment Authority
ACC	Advance Commitment Capacity
ADB	African Development Bank
ADF	African Development Fund
ADF-5	Fifth General Replenishment of the African Development Fund
ADF-6	Sixth General Replenishment of the African Development Fund
ADF-8	Eighth General Replenishment of the African Development Fund
ADF-9	Ninth General Replenishment of the African Development Fund
ADF-10	Tenth General Replenishment of the African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
ADF-14	Fourteenth General Replenishment of the African Development Fund
IDA	International Development Association
IGRs	Internally Generated Resources
MDRI	Multilateral Debt Relief Initiative
NTF	Nigeria Trust Fund
UA	Units of Account

# **THE LONG-TERM FINANCIAL INTEGRITY OF THE AFRICAN DEVELOPMENT FUND**

---

## **1. Context**

- 1.1 Preparations for the Twelfth General Replenishment of the African Development Fund (ADF-12) are taking place under very different circumstances than those that prevailed for ADF-11. At that time, growing optimism in Africa and abroad encouraged positive assumptions about the volume of the Fund's internal resources. The recent global financial and economic crises and the Fund's rapid response to help mitigate their adverse effects on ADF-countries have put the Fund's resources under severe pressure. With the effects of the crisis affecting Africa deeply over the course of 2009, many years of steady economic growth resulting from improved governance and sound reforms are increasingly in jeopardy. ADF countries in particular have been impacted by enormous and concurrent drops in commodity prices, foreign direct investment, and bilateral aid. As one of the few sovereign financing windows available to these countries, the ADF has experienced a sizeable increase in requests for assistance.
- 1.2 During ADF-12, the Fund expects its ability to contribute internally generated resources to be substantially lower than during ADF-11, when it contributed UA 2,063 million. This decrease will be primarily due to two factors. First, because of current low interest rates, the ADF expects income from its investments to decline by almost 50 percent in 2010 compared to 2009. Second, loan cancellations during ADF-11 were significantly less than the UA 300 million expected, partly because cancellation proceeds were allowed to return to countries in response to the food and financial crises. Thus, despite Management's best efforts to maximize the level of internal resources within prudential limits, the Advance Commitment Capacity (ACC) for ADF-12 is only expected to reach UA 1,763 million. This decrease compared to ADF-11 implies that significant additional donor resources will be necessary to do no more than match the total replenishment level of ADF-11. To sustain the Fund's laudable achievements in Africa will require more effort from us all.
- 1.3 This paper explores the long-term financial integrity of the Fund, especially its financial sustainability, in part by examining the Fund's primary sources of funds and factors that affect their volume and the timing of their provision. The paper is organized in four sections. Following this introduction, Section 2 summarizes the evolution of ADF financial resources up to ADF-11 and reviews the main assumptions behind the Advance Commitment Authority (ACA) model in effect since the Tenth General Replenishment of the African Development Fund (ADF-10) in 2005.<sup>1</sup> Section 3 examines the Fund's future financial capacity, first by describing the dynamics of the Fund's net income; second by considering different replenishment scenarios for ADF-12; and third by analyzing the sensitivity of the Fund's projected net income to various factors. Section 4 offers concluding remarks.

## **2. The ADF's Financial Resources**

- 2.1 The ADF was established in 1973 to help the African Development Bank (ADB or Bank) contribute to the economic and social development of the Bank Group's regional member countries. The Fund's role and relevance to its regional members increased significantly in 1995, when the Bank changed its credit policy. Since then, most regional member countries (38 out of 52) are eligible for development financing assistance from the Bank Group on concessional terms only, primarily through the Fund.
- 2.2 To fulfill its mandate, the ADF draws on two main sources of funds: (i) donor subscriptions to periodic replenishments, which normally occur every 3 years; and (ii) internally generated resources (IGRs). As a concessional vehicle that provides loans with marginal charges and grants, the ADF cannot augment its commitment capacity by borrowing from capital markets.

---

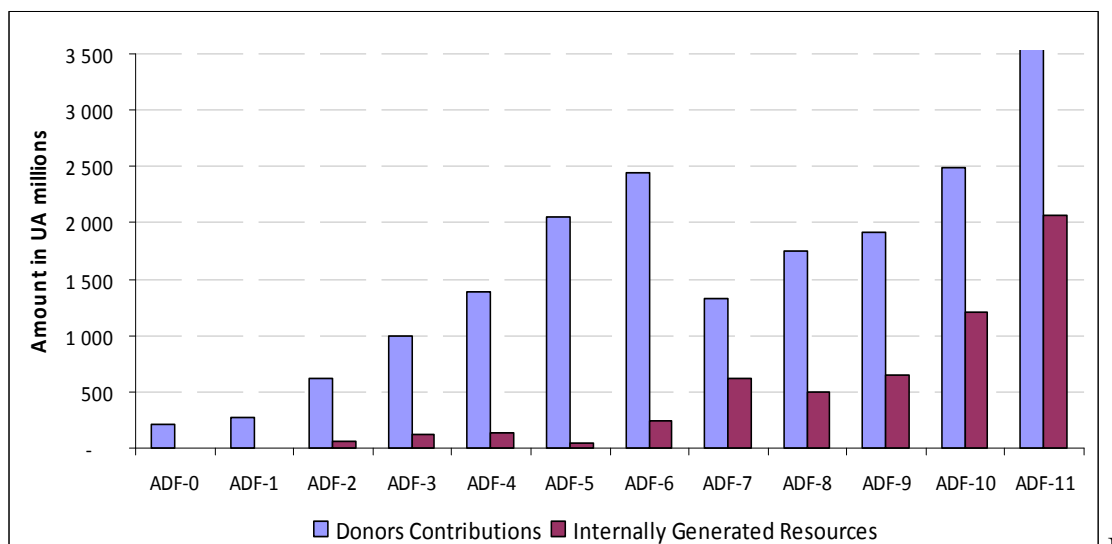
<sup>1</sup> African Development Fund. 2005. *Advance Commitment Authority Scheme* (ADF/BD/WP/2005/18).

Thus, donor contributions, loan reflows and an accumulated surplus constitute the Fund's primary resource base.

### **Donor Subscriptions**

- 2.3 Contributions from State Participants constitute the ADF's most significant source of funds. Fund participants comprise non-regional State Participants, one regional country (South Africa), and the Bank itself. As illustrated in Figure 1, State Participants' strong support has steadily raised donor contributions in nominal terms from UA 215 million at the Fund's inception in 1973 to UA 3.562 billion for ADF-11.

**Figure 1: The Evolution of the ADF's Replenishment Levels**



**Note:** UA=Units of Account

**Source:** African Development Bank

### **Internally Generated Resources and the Advance Commitment Authority (ACA)**

- 2.4 In addition to donor subscriptions, ADF committable resources for any replenishment period include internally generated resources (IGRs), comprising loan reflows (repayments and cancellations) and transfers of net income from the Bank. ADF loans are highly concessional, are generally repaid over 40 years preceded by a 10-year grace period, and carry a service charge of 0.75 percent. Loans approved after June 1996 carry a 0.50 percent commitment fee on unused commitments. As a consequence of these concessional terms, the low lending volumes of early replenishment cycles, the slow build-up of repayments, and subsequent debt relief initiatives, reflows are now relatively low. Nevertheless, loan cancellations and surpluses have helped increase IGRs from one replenishment period to the next. In addition, the ADB has consistently supported the Fund by transferring net income every year. This explains why despite marginal loan repayments, IGRs averaged UA 262 million or 13 percent of the Fund's total resources until the Ninth General Replenishment of the African Development Fund (ADF-9).
- 2.5 In ADF-10, the Advance Commitment Authority (ACA) was introduced to maximize the Fund's commitment capacity from IGRs while ensuring the Fund's financial integrity. The ACA framework enables higher levels of loan and grant commitments than would be possible if the Fund were only to consider funds that were immediately available.
- 2.6 To avoid over-commitments that could reduce the Fund's future commitment capacity or even prevent it from making disbursements as planned, the ACA strictly respects the Fund's liquidity policy by ensuring that for each of the next 50 years, liquidity at the beginning of the year covers at least 50 to 75 percent of the moving average of 3 years of expected annual

disbursements.<sup>2</sup> In order to retain an adequate safety margin, the ACA model maintains minimum liquidity of 75 percent of expected annual disbursements.

- 2.7 In this way, the ACA has allowed the Fund to use IGRs to increase its commitment capacity substantially. Thus, from UA 645 million during ADF-9, IGR resources almost doubled to UA 1.20 billion in ADF-10 and reached UA 2.06 billion in ADF-11. The ACC represented 33 percent and 37 percent of total available resources under ADF-10 and ADF-11 respectively, compared to 13 percent on average for replenishments before ADF-10.

**Core Assumptions of the ACA and Their Evolution Since ADF-10**

- 2.8 The ACA is long-term in nature. It is fixed for each replenishment period and is based on a set of deliberately conservative assumptions and safety margins that are built into the model to support future disbursements and mitigate the risk of over-commitment. Changes to the model's parameters during a given replenishment period do not immediately change commitment capacity for that replenishment. For example, interest rates or loan cancellation levels that deviated from those assumed to determine the ACC for ADF-12 would not change the amount of the ACC during ADF-12. Rather, the ACA model is recalibrated at the beginning of each replenishment period (i.e., every 3 years) to account for differences between estimated and actual cash flows and to determine the ACC of the next replenishment. This both prevents the risk of over-commitment and preserves the integrity of previously extended ACC amounts.
- 2.9 The ACA model analyzes the Fund's financial integrity over 50 years so as 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 between donor contributions, liquidity, and IGRs. The model generates Advance Commitment Capacity (ACC), the main indicator of the Fund's long-term financing capacity. Table 1 lists the key parameters of the model and shows their evolution for ADF-10, ADF-11, and ADF-12.

**Table 1: Evolution of the ACA Model's Core Assumptions**

Assumptions	Comments	ADF-10	ADF-11	ADF-12
Donor Contributions in Future Replenishments	To establish the baseline scenario, donor subscriptions for future replenishments are conservatively assumed to remain unchanged in real terms. In other words, the nominal amounts are assumed to increase by the assumed cumulative rate of inflation over the previous replenishment period.	0%	7%	4.49%
MDRI Compensation	In addition to regular contributions, donors pledged to cover 100% of MDRI costs for all heavily indebted poor countries (on foregone principal and interests) by making additional contributions to future replenishments on a pay-as-you-go basis without leaving a financing gap.	0%	84%	85%
Grant Share in Replenishment	The grant level for the replenishment is determined as per the debt sustainability analysis. For the purpose of this paper, the share of grants in ADF-12 is assumed to remain the same as that in ADF-11.	44%	28.4%	28.4%
Compensation for Grants	In addition to regular contributions, donors would finance 100% of foregone principal reflows resulting from grants through additional contributions in future replenishments, on a pay-as-you-go basis. Foregone charges income is included as a volume discount on subscriptions as upfront compensation.	11.9%	10.12%	10.12%
Administrative Expenses	These expenses are based on the relevant budget program and are set to increase annually thereafter at the percentage indicated.	3%	3%	3%

<sup>2</sup> These three years consist of the current year, the previous year and the next year.

ADB Transfers Per Year	Constant annual transfer from ADB net income, in UA millions	10	20	35
Repayment Sensitivity Factor	To account for delayed repayments by countries in arrears to the Fund, repayment flows are maintained constant at a percentage of expected loan repayments.	85%	85%	90%
Disbursement Sensitivity Factor	To account for grant compensation and loan cancellations, reductions in disbursement flows are maintained constant at a percentage of signed loans.	93.18%	93.18%	95.18%
Investment Return Rate	The rate of return of the investment portfolio	3.42%	4.45%	Forward curve
Minimum Prudential Level of Annual Liquidity	A percentage of the following 3 years' projected disbursements	100%	75%	75%
Loan Cancellations	Constant annual cancellations in nominal terms, in UA millions	0	100	100
Advance Commitment Capacity	Level of the Advance Commitment Capacity resulting from the model, in UA millions	1,200	2,063	1,763

**Note:** ADB=African Development Bank; MDRI=Multilateral Debt Relief Initiative; UA=Units of Account

**Source:** African Development Bank

- 2.10 The ACC for ADF-12 is expected to be substantially lower than the UA 2,063 million achieved for ADF-11, primarily because of low interest rates and low loan cancellations (para. 3.11-3.17). Using the assumptions presented in Table 1, the baseline ACC level going into ADF-12 will be UA 1,763 million. Annex I summarizes how assumed changes between ADF-11 and ADF-12 impact the ACC.

### 3. The ADF's Future Financial Capacity

- 3.1 The ADF's financial integrity is determined by two factors. The most important factor is the Fund's ability to generate enough donor contributions and IGRs to respond to the financing requirements of regional member countries. This section of the paper (paras. 3.2 to 3.30) presents modalities for ADF-12 donor contributions, simulations of ACC levels, and ways to augment the ACC for ADF-12. The second factor is the Fund's management of its net income. The Fund manages its net income in such a way as to avoid generating deficits in the long term. This issue is discussed in the context of the current low interest rate environment (paras.3.31 to 3.37).

#### **Modalities for ADF-12 Donor Contributions**

- 3.2 Since ADF-10, Deputies have committed to maintaining total donor subscriptions for subsequent replenishments at a level that is least unchanged in real terms from the level of UA 2,517 million subscribed in ADF-10. In ADF-11, donor contributions of UA 3,518 million far surpassed this commitment—which corresponded to UA 2,637 million—topping it by 33 percent. The cumulative Special Drawing Rights inflation rate from 2008 to 2010 is 4.49 percent. Adjusting ADF-11 donor contributions of UA 3,518 million by this inflation rate would equate to UA 3,677 million in contributions in ADF-12. However, given the huge development needs of ADF countries and the many requests for funding received by the Fund<sup>3</sup>, the overall level of ADF-12 resources should be at least maintained at the ADF-11 level adjusted for inflation. Based on this premise, the minimum total replenishment for ADF-12 would amount to UA 5,878 million. As previously explained, the ACC is expected to be lower in ADF-12 than in ADF-11, which means that to reach the ADF-11 level would require donors to contribute UA 4,115 million, an increase of 16 percent.

<sup>3</sup> See the ADF-12 paper *Overview paper: ADF-12 Strategic Directions and Indicative Lending Scenarios*, February 2010, Cape Town, South Africa.

### Maintenance of a 10-year encashment schedule

- 3.3 Donors' contributions should be encashed so as to accommodate expected disbursements from loans financed during each replenishment period while complying with the Fund's liquidity policy. To achieve this objective, Management reviewed grant and loan disbursement profiles with a view to validating current assumptions and avoiding the risk of over-commitment. This review showed that increased institutional effectiveness had yielded a shorter time lapse between approval and first disbursement. Furthermore, the amount of loans approved, signed and disbursed in the same year had increased from 10 percent to 15 percent of annual commitments. In addition, policy-based operations are now fully disbursed within 3 years, versus 5 to 6 years in the past. These changes have affected the disbursement profile.
- 3.4 Despite this increase in the disbursement rate during the 3 years following loan approval, Management proposes to maintain an encashment period of 10 years as in previous replenishments (Table 2). At the same time, Management proposes to accelerate the amounts encashed during the first 5 years.

**Table 2: The ADF-12 Encashment Schedule for Indicative Donor Pledges**

(UA millions)

Year	Amount Approved	Signed Loans	Disbursement Amounts	Year-End Liquidity	Encashment Schedule	
					Amounts	%
2011	1,372	206	36	172	207	5.0
2012	1,372	1,372	275	323	426	10.3
2013	1,372	1,372	516	414	607	14.8
2014		1,166	662	372	620	15.1
2015			595	311	534	13.0
2016			498	273	460	11.2
2017			437	254	417	10.1
2018			406	224	376	9.1
2019			358	209	343	8.3
2020			334	0	125	3.0
<b>Total</b>	<b>4,115</b>	<b>4,115</b>	<b>4,115</b>		<b>4,115</b>	<b>100</b>

**Note:** UA=Units of Account

**Source:** African Development Bank

### MDRI and Grant Compensations

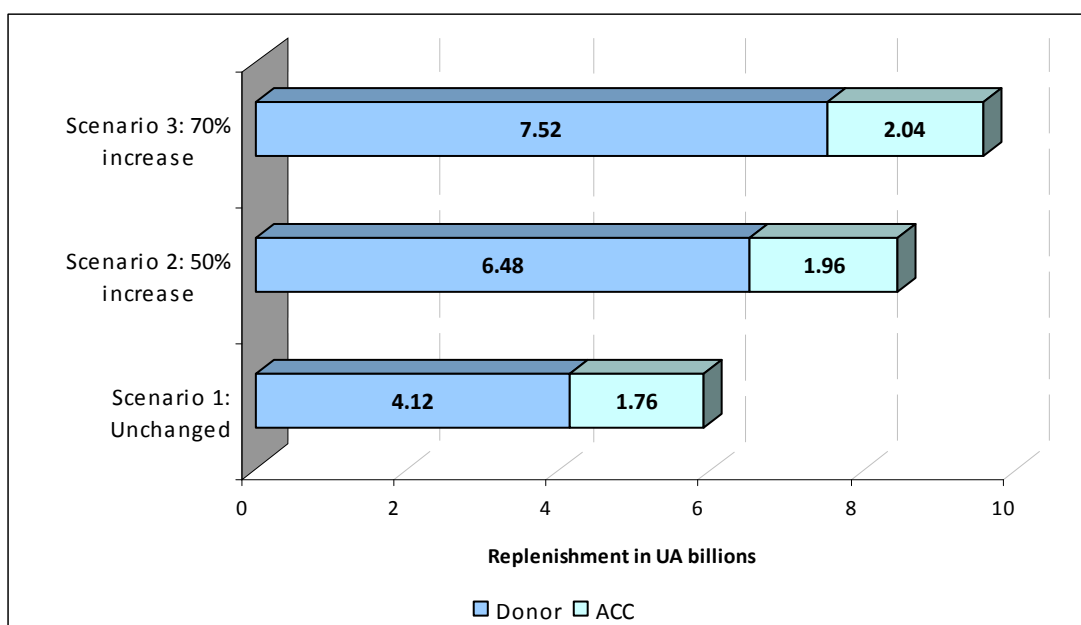
- 3.5 The MDRI has altered the Fund's financing framework by cancelling certain future loan reflows (starting in 2006) that had already been committed under prior ADF replenishments, and by substantially lowering the volume of loan reflows that will become available to support future ADF financing operations. However, donors pledged to fully compensate cancelled loan reflows by making additional contributions on a pay-as-you-go basis. Although so far, donors have given the Fund almost 100 percent of the promised compensation, the ACA-model applies a coverage factor of 85 percent for ADF-12 similar to that used for ADF-11, to capture the effect of delays in the timing of payments from certain donors. Figure 6 in para. 3.19 shows how the MDRI coverage factor impacts the ACA.
- 3.6 ADF-12 will be the first replenishment cycle under which the compensation for foregone principal repayments on grants comes due. Donors have pledged to cover foregone principal repayments on grants since ADF-9. The ACC is much less sensitive to grant compensation than to MDRI compensation, given that grant compensations are a lower amount. The ACA model therefore assumes that 100 percent of reflows will be covered by donors.

### Scenarios for ADF-12 Resource Levels and Implied Donor Contributions

3.7 Figure 2 and Table 3 illustrate scenarios for three levels of ACC resources during ADF-12. These scenarios can be summarized as follows:

- The **Base Scenario (Scenario 1)** represents current resources adjusted for inflation. This scenario adjusts ADF-11 resources by a Special Drawing Rights inflation rate of 4.49 percent from 2008 to 2010. Under this scenario, resources total UA 5,878 million, with donor contributions increasing by 16 percent over ADF-11. Scenario 1 would allow the Fund to finance 47% of the prospective pipeline for the ADF-12 cycle.
- **Scenario 2** Under this scenario, resources rise by 50 percent to reach UA 8,438 million, with donor contributions increasing by 82 percent over ADF-11. Scenario 2 would allow the Fund to finance 68% of the prospective pipeline for the ADF-12 cycle.
- **Scenario 3** represents a 70 percent increase in resources. Under this scenario, resources reach UA 9,563 million, with donor contributions increasing by 111 percent over ADF-11. Scenario 3 would allow the Fund to finance 77% of the prospective pipeline for the ADF-12 cycle.

**Figure 2: Three ADF-12 Replenishment Scenarios**



**Note:** ACC=Advance Commitment Capacity; UA=Units of Account

**Source:** African Development Bank

**Table 3: Three ADF-12 Replenishment Scenarios, With Percent Increases**

(UA millions)

Scenarios	ADF-12 Resources		Donors		ACC	
	Level	Increase	Level	Increase	Level	Increase
<b>Scenario 1</b>	5,878	4.5%	4,115	16%	1,763	-15%
<b>Scenario 2</b>	8,438	50.0%	6,479	82%	1,959	-5%
<b>Scenario 3</b>	9,563	70.0%	7,519	111%	2,044	-1%

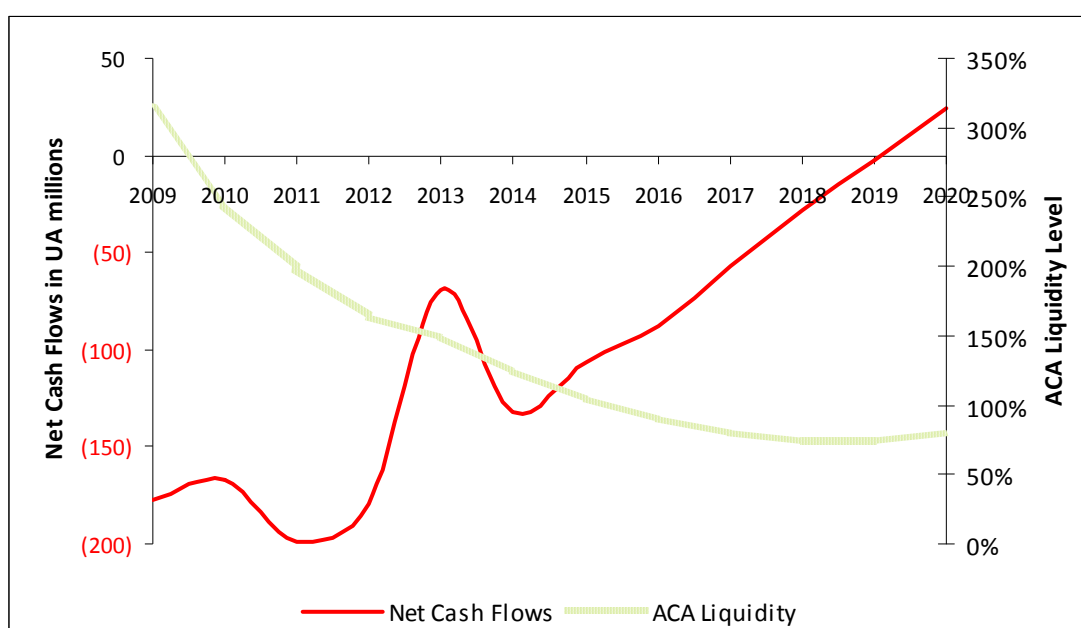
**Note:** ACC=Advance Commitment Capacity; UA=Units of Account

**Source:** African Development Bank

### **Simulated ACC Levels and Options to Increase Internally Generated Resources**

- 3.8 The Fund's ACC is expected to decrease by 15 percent over ADF-11, from UA 2,063 million to approximately UA 1,763 million. This decrease will result from several factors: (i) current low interest rates, which decrease the Fund's investment income; (ii) the lower level of loan cancellations observed during ADF-11; and (iii) slightly faster loan disbursements. The ACC's sensitivity to different assumptions is analyzed further in para 3.11 to 3.30.
- 3.9 Figure 3 indicates that ADF net cash flows (primarily loan cancellations, loan repayments, loan and investment income, net income transfers, expenses and disbursements) are expected to grow steadily over time. The peaks observed in 2010 and 2013 are due to expected net income transfers. The growth is primarily due to an increase in loan repayments and loan income as the ADF portfolio grows: disbursements are expected to rise more slowly. As a result of these cash flows, liquidity is expected to reach its minimum level around 2018 and 2019.

**Figure 3: Evolution of ADF Cash Flows and Liquidity**



**Note:** ACA=Advance Commitment Authority

**Source:** African Development Bank

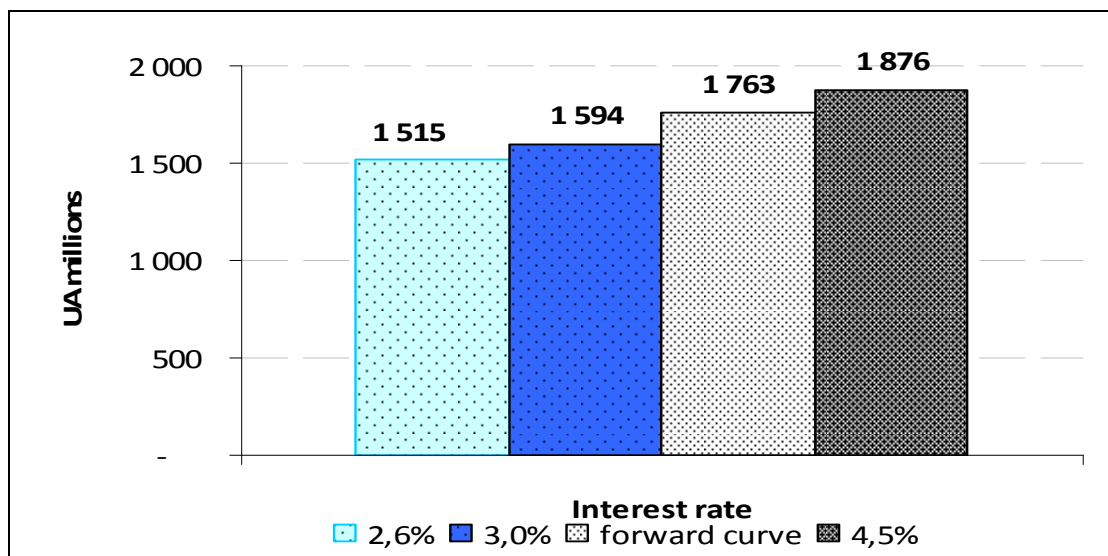
- 3.10 The next few sections (paras. 3.11 to 3.30) describe the ACC's sensitivity to loan cancellations, MDRI compensation, ADB net income transfers, and the Fund's share of the Bank Group's administrative expenses.

#### The Impact of Interest Rates

- 3.11 The ACC is strongly influenced by interest rates. The Fund's investment strategy is very conservative and aims above all to preserve capital. Currently investment income constitutes the largest source of ADF income. Thus, interest rates have a significant effect on the ADF's income (Annex I).
- 3.12 Under ADF-10 and ADF-11, the ACA model assumed a constant return on investment that estimated investment portfolio returns using prevailing interest rates. For ADF-12, however, Management proposes to use forward rates, aligning interest rates during the projection period to market expectations. Figure 4 shows the impact of different interest rate assumptions on the ACC.

**Figure 4: Advance Commitment Capacity in ADF-12 at Different Interest Rates**

(UA millions)



**Note:** UA=Units of Account

**Source:** African Development Bank

- 3.13 It is worth noting that the ACA model is very sensitive to interest rates, and that a parallel shift of 1 percent in interest rates would increase the ACC by approximately UA 191 million.

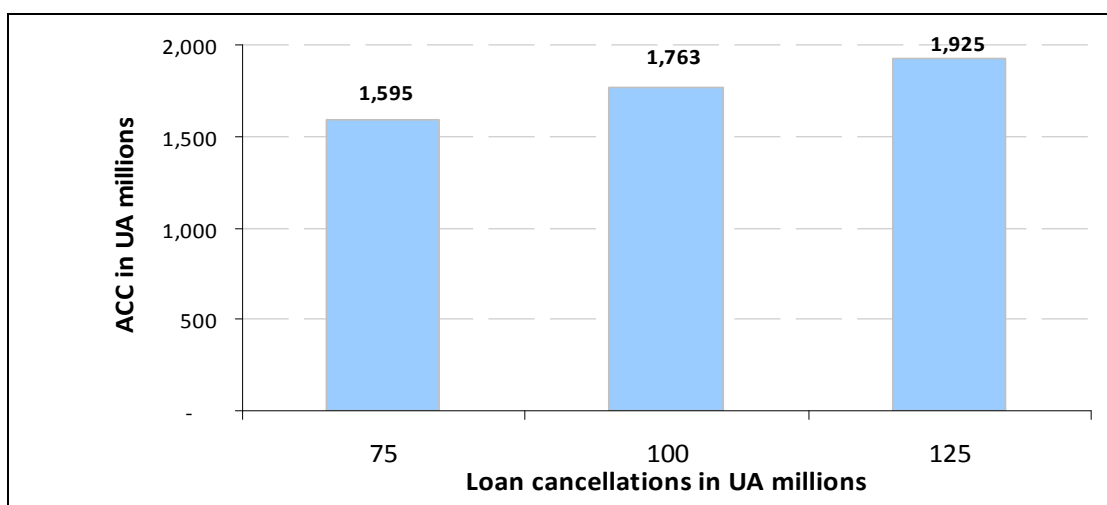
#### The Impact of Loan Cancellations

- 3.14 The amount of cancelled loans impacts the ACC significantly. The ACA model currently assumes that all loans cancelled during a replenishment period are transferred to the general pool of resources that becomes available to countries in subsequent replenishments.
- 3.15 The ACA model assumed cancellations of UA 100 million per year during ADF-11, based on loan cancellations observed over the preceding 10 years. However, in response to the food and financial crises and at the request of shareholders, the Fund has restructured loans in order to optimize its deployment of resources. For example, UA 104 million from cancellable loans were used to fund the African Food Crisis Facility during ADF-11. Thus, the cumulative amount of loans cancelled as of 31 December 2009 only reached UA 47 million. An additional UA 53 million is expected to be cancelled before the end of the replenishment, bringing the total for the ADF-11 period to UA 100 million. This exceptional, crisis-induced loan restructuring has allowed the Fund to react quickly to ADF countries' changed needs. However, it has also led to lower cancellations overall.
- 3.16 For ADF-12, the ACA model will maintain its base case assumption of loan cancellations of UA 300 million. As Africa moves out of crisis, exceptional loan restructuring will cease and the amount of cancellable loans can be expected to rise back to historic levels. In order to further enhance the quality of the portfolio, Management is considering ways to strengthen the implementation of its loan cancellation policy.<sup>4</sup> The current stock of cancellable loans as of December 31, 2009 is UA 660 million.
- 3.17 To demonstrate the ACC's sensitivity to loan cancellations, Figure 5 illustrates the impact of three levels of loan cancellations: UA 75 million, UA 100 million and UA 125 million.

<sup>4</sup> Management is considering a loan relocation policy that provides incentive for RMCs and thus enables increased enforcement of the loan cancellation policy: Cancelled resources could be immediately reallocated with a percentage to the country and the remainder to the ACC.

**Figure 5: Advance Commitment Capacity in ADF-12 at Different Levels of Loan Cancellations**

(UA millions)



**Note:** ACC=Advance Commitment Capacity; UA=Units of Account

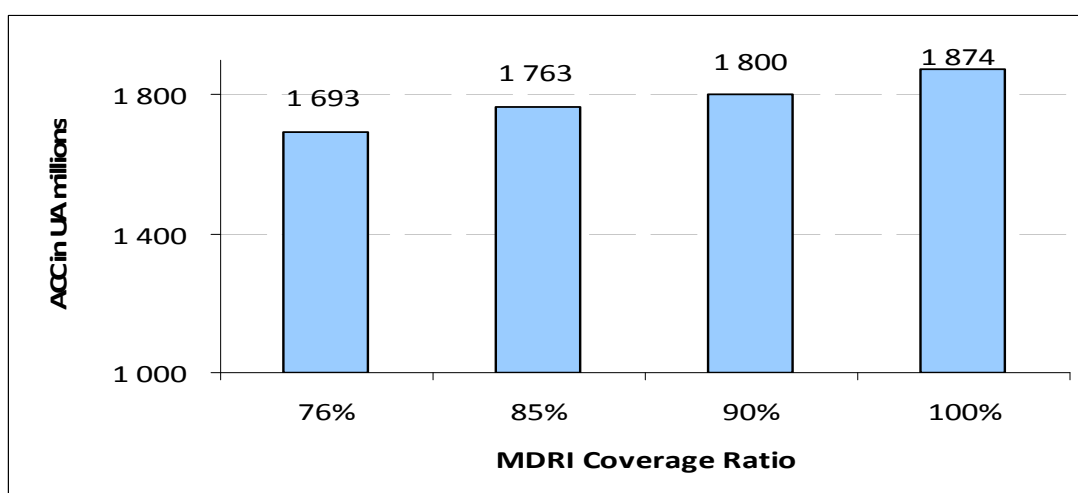
**Source:** African Development Bank

#### The Impact of MDRI Compensation

- 3.18 Donor compensation for foregone principal and charges due to loan cancellations under the MDRI impact the ACC significantly. Figure 6 shows how the ACC can vary according to MDRI compensation coverage.
- 3.19 The current coverage ratio assumption of 85 percent is conservative, and brings the ACC to UA 1,763 million. If the number of countries providing qualified or unqualified commitments for their MDRI obligations increases, the ACC automatically improves substantially. Donors are therefore encouraged to submit unqualified commitments for the ADF-12 disbursement period (2011-2023) before the end of the replenishment discussions.

**Figure 6: Advance Commitment Capacity for ADF-12 at Different Levels of MDRI Coverage**

(UA millions)



**Note:** UA=Units of Account

**Source:** African Development Bank

## The Impact of ADB Net Income Transfers

### *Increasing annual ADB net income transfers*

- 3.20 A cash inflow that supports the Fund's ACC is net income transfers from the Bank to the Fund. For the Eighth General Replenishment of the African Development Fund (ADF-8), ADF-9, and ADF-10, the ADB Board of Governors approved an allocation of UA 30 million from the Bank's net income to the Fund. The net income transfer for ADF-11 increased to UA 60 million (UA 20 million annually), as indicated in Table 1.
- 3.21 For ADF-12, an increase in the annual net income transfer to UA 35 million would yield an ACC of UA 1,763 million, approximately UA 102 million more than were net income transfers to remain at UA 20 million. Management intends to propose that the ADB's Board of Directors consider an annual transfer of at least UA 35 million from the Bank to the Fund during the ADF-12 period. This proposal will be discussed during the Board meetings on the Bank's Medium-Term Financial Outlook and Net Income Allocation for 2009 scheduled for March 2010. The proposal is reflected in the baseline ACC scenario for ADF-12.

### *Transfer of the balance of UA 52 million available in the Fragile States Facility*

- 3.22 Similarly, Management is currently analyzing the possibility of transferring to the ADF, an outstanding balance of UA 52 million currently available in Fragile States Facility accounts and not expected to be used immediately. Once authorized, this additional transfer of resources will raise the ACC by UA 41 million.

### *Transfer of UA 80 million related to the arrears clearance of Zimbabwe*

- 3.23 During the ADF-12 replenishment period, Management expects to clear Zimbabwe's arrears. As with prior arrears clearances, Management will propose that the ADB's Board of Directors consider transferring all or part of the income realized from the arrears clearance to the ADF. This additional transfer of ADB net income would increase the ACC by UA 57 million.

## The Impact of Loan Repayment Sensitivity

### *Increasing the loan repayment sensitivity from 85 percent to 90 percent*

- 3.24 To cushion future arrears by ADF borrowers, the ACA model established a safety margin around loan repayment sensitivity. In 2005, based on the observation that loans in arrears represented 12 percent of the outstanding portfolio, a haircut of 15 percent on loan repayments was established. With the arrears clearance mechanism, the outstanding volume of loans in arrears improved significantly: currently, loans in arrears only account for 6 percent of the outstanding portfolio. Management therefore proposes to increase the ACC's sensitivity to loan repayments by reducing the haircut for non-performing loans to 10 percent. This change in the model would increase the ACC by UA 33 million.

## The Impact of Administrative Expenses

- 3.25 The administrative costs of the ADB Group, which comprises the ADB, the ADF and the Nigeria Trust Fund (NTF), are incurred by the ADB on behalf of the Bank Group. The ADF and the NTF reimburse the ADB according to a cost-sharing formula that was established in 1994. The objective of the cost-sharing formula is to estimate the fair value of the costs incurred by the ADB in the administration of the ADF, as required by Article 31 of the "Agreement establishing the African Development Fund."

- 3.26 The assignment of costs is primarily determined by the number of lending operations under implementation and supervision and by the number of lending operations approved in any one year.<sup>5</sup> Using the number of operations (as opposed to their value) reflects the fact that the time spent to prepare, approve and supervise loans is generally independent of the size of the transaction. According to the formula, each Bank Group entity's share of expenses changes with the number of operations approved and under implementation.
- 3.27 The management fees that the ADF pays to the ADB for its share of Bank Group administrative expenses affect the Fund's operating income and therefore the ACC. Management is currently reviewing the cost-sharing formula to ascertain whether recent evolutions in the businesses of the ADF and the ADB are reasonably accommodated and to determine what adjustments, if any, should be made. The findings of this review will be shared with Deputies.
- 3.28 The ADF is currently held to incur 71.5 percent of the Bank's Group administrative expenses. Should Management's review of the formula change the ADF's share of the Bank's Group administrative expenses by approximately 5 percent, the ACC will be impacted by approximately UA 110 million compared to the base case.

#### The Impact of ACC Front-Loading

- 3.29 It will be possible for the Fund to draw on the ACC for ADF-12 as soon as Deputies adopt the ADF-12 replenishment in 2010. By drawing on the ACC, the Fund would be able to meet demand that cannot be satisfied by the resources available under ADF-11. Since the ACA model assumes an even distribution of commitment and financing instruments over the replenishment period, this front-loading would not particularly impact the level of the ACC as long as the amount of increased commitments in 2010 is offset by the same amount in 2011: i.e., as long as overall commitments in 2010 and 2011 are in line with commitments expected for 2011 without front-loading.

#### Conclusion

- 3.30 While the ACC is expected to be approximately 15 percent lower for ADF-12 than for ADF-11, Management is exploring various ways to maximize the ACC and will prepare further proposals for the next replenishment meeting.

#### ***ADF Net Income Dynamics and Projections***

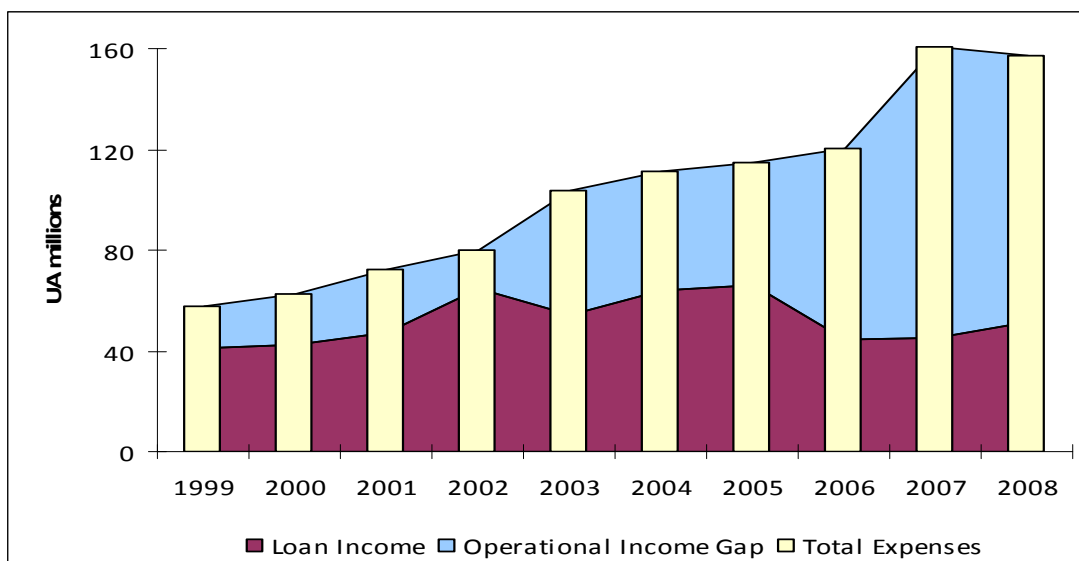
- 3.31 This section will examine the Fund's Net Income Dynamics and related projections. Unlike that of the ADB, the ADF's balance sheet has essentially no liabilities, as the Fund does not issue debt and shareholders provide contributions as opposed to equity. Furthermore, the Fund has only one type of expense: the management fees it pays for its portion of the Bank Group's administrative expenses. The Fund, like the ADB, holds two main types of assets: (i) loans approved and disbursed, and (ii) cash and treasury investments resulting from donors' contributions, loan reflows and net income.
- 3.32 Although both categories of assets yield income, the concessional nature of the loans provided by the Fund limits the loan portfolio's contributions to total income. This produces an operational income gap with regard to the payment of management fees (Figure 7). In other words, the primary role of the investment portfolio, after servicing disbursements, is to generate enough income to cover the Fund's portion of the Bank Group's administrative expenses.

---

<sup>5</sup> The cost-sharing formula can be summarized as follows: common administrative expenses are divided into operational expenses (approximately 60 percent of the total) and non-operational expenses (the balance). Operational expenses are shared according to the number of lending operations that take place during the year and the number of lending operations under active loan supervision and implementation at the end of the previous year. Non-operational expenses are shared on the basis of the relative asset size of the three institutions (the ADB, the ADF and the NTF) at the beginning of the year.

**Figure 7: ADF Operational Income Gap to be Covered by Investment Income**

(UA millions)



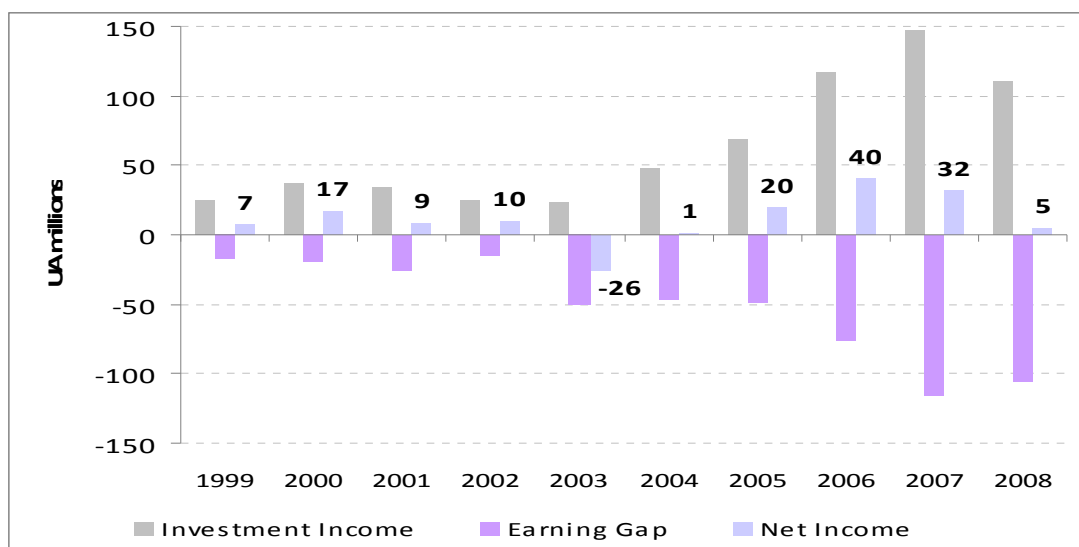
**Note:** UA=Units of Account

**Source:** African Development Bank

3.33 For the Fund to at least break even, the investment portfolio must generate enough returns to cover the operational income gap. The Fund has consistently met this objective and on average, has even generated modest surpluses over the last several years. In addition to protecting capital, the Fund's investment strategy has stabilized returns on investments (Annex II provides more details on the Bank's investment strategy and compares it to that of the International Development Association). Indeed, as shown in Figure 8, the increase in the size of the Fund's investment portfolio owing to arrears clearances and debt relief mechanisms implemented since 2006, has, with the exception of 2003, been instrumental in maintaining the level of investment income above the operational income gap since 1999. Because the trading portfolio represents around 60 percent of the total investment portfolio and 10 percent of the held-to-maturity portfolio maturing each year, however, investment income remains sensitive to fluctuations in interest rates.

**Figure 8: Investment Income's Coverage of the Operational Income Gap**

(UA millions)

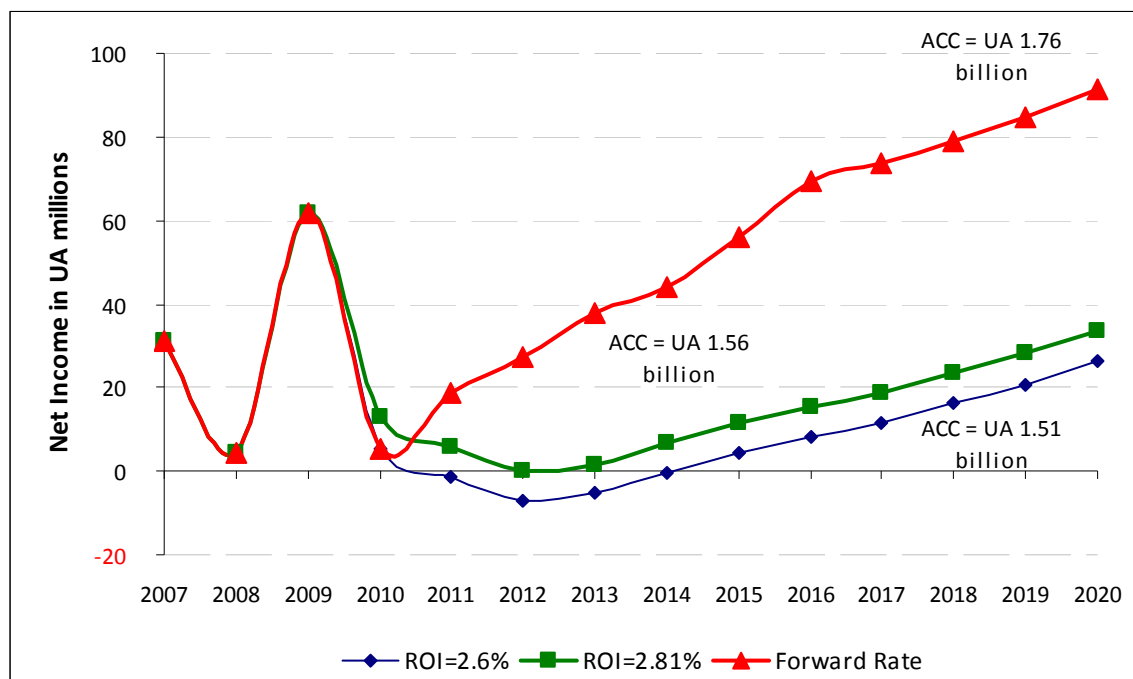


**Note:** UA=Units of Account

**Source:** African Development Bank

- 3.34 With a constant return on investment of 2.6 percent, the Fund is expected to report negative income between 2011 and 2020 (Figure 9). Because the Fund's expenses consist primarily of its share of Bank Group administrative expenses and are insensitive to interest rate fluctuations, the only ways to augment the Fund's net income are to increase loan income and/or increase investment income.
- 3.35 The first option, to increase loan income, depends primarily on the size of the loan portfolio, which can only increase if donor subscriptions rise significantly. For instance, maintaining a positive net income until 2020 would require State Participants to contribute around UA 15 billion during ADF-12. An alternative would be to combine an increase in the loan portfolio with higher loan charges. For instance, a 50 basis point increase in loan charges (service charges only) combined with an increase in donor contributions to approximately UA 7 billion would allow the Fund to not only break even but report positive net income until 2020.
- 3.36 The second option, to increase investment income without raising the portfolio's risk profile, depends primarily on interest rates. With prevailing interest rates, the portfolio's performance is estimated at approximately 2.6 percent, and the Fund will record a net income deficit in 2012 and 2013. A slightly higher portfolio performance of 2.81 percent would enable the Fund to avoid deficits (Figure 9).
- 3.37 It is important to recall that until now, the ACA model has used a flat interest rate curve, based on prevailing interest rates, to project future investment income. However, given current low interest rates and expected rate increases, maintaining this assumption would underestimate the Fund's performance. Management believes that using forward rates, which are good indicators of the evolution of short-term interest rates, would be a realistic approach to estimating the Fund's investment income. Using forward interest rates would improve the Fund's projected net income and ACC levels noticeably (Figure 9).

**Figure 9: Projected Yearly ADF Net Incomes by Return On Investment Scenario and Their Implications for the Advance Commitment Capacity**



**Note:** ACC=Advance Commitment Capacity; ROI=return on investment

**Source:** African Development Bank

## 4. Conclusion

- 4.1 The Fund's ACC for the ADF-12 period is expected to decrease by approximately 15 percent compared to ADF-11. This decrease can be attributed to several factors, the most important of which are a decrease in investment income owing to low interest rates, and the crisis-induced low level of loan cancellations in ADF-11. In contrast, the ACC's high level following the introduction of the ACA model in ADF-10 and ADF-11 was underpinned by full compensations for debt relief initiatives, high interest rates, and numerous loan cancellations.
- 4.2 The decrease in the ACC and increased demand from ADF countries imply that greater 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. For its part, Management undertakes to pursue all opportunities liable to increase IGRs, including (i) continued improvements in portfolio management; (ii) a proposal that subject to the ADB's financial performance, the Board of Governors approve the transfer to the Fund of larger portions of the Bank's net income (including all or significant portions of the income obtained from arrears clearances) than the portions assumed in current ACC estimates; (iii) examination and possible adjustments of the cost-sharing mechanism between the ADF and the ADB to reflect recent and expected evolutions in the institutions' activities (and, by extension, their cost drivers); and (iv) an increase in the level of compensation under MDRI.
- 4.3 Management requests Deputies' views and guidance on these issues, and will prepare further proposals for the next replenishment meeting.

### Annex I: Summary of the Sensitivities of the ACC and Variance Analysis Between ADF-12 and ADF-11

	Key Assumptions	ACC Level		
<b>ADF-11</b>	- Annual loan cancellations of UA 100 million for ADF-11 and subsequent replenishments	<b>2,063</b>		
	- Interest rate of 4.45%			
	- MDRI coverage ratio of 84%			
	- Annual ADB transfer of UA 20 million			
	- Repayment sensitivity factor of 85%			
		<b>Variance: ADF-12 to ADF-11</b>		
<b>ADF-12 Baseline scenario</b>	ADF-12 ACC using ADF-11 base case assumptions except 2008 and 2009 actual cash flows	<b>1,763</b>	-144	<b>1,919</b>
	- Changes in the loan disbursement profile, the note encashment schedule and the inflation rate		-108	1,811
	- Annual loan cancellations of UA 100 million for ADF-12 and subsequent replenishments		No change	1,804
	- Loan cancellations of UA 33 million per year for ADF-11 instead of UA 100 million		-137	1,674
	- Constant interest rate of 2.6%		-395	1,279
	- Interest rate using forward curve <sup>6</sup>		+252	1,531
	- Increase in ADB annual net income transfers from UA 20 million to UA 35 million		+102	1,633
	- Transfer of UA 52 million from the ADB's Fragile States Facility account in 2010		+41	1,675
	- Transfer of UA 80 million related to Zimbabwe's arrears clearance		+57	1,732
	- Repayment sensitivity factor of 90%		+31	1,763
<b>Variance With ADF-11 ACC Level: 2,063 versus 1,763</b>			<b>-300</b>	<b>-15%</b>

**Note:** ACC=Advance Commitment Capacity; ADB=African Development Bank; MDRI=Multilateral Debt Relief Initiative; UA=Units of Account

**Source:** African Development Bank

<sup>6</sup> A 10 basis point parallel shift on the interest rate curve would increase the ACC from UA 1,763 to UA 1,782.

## **Annex II: The ADF's Investment Portfolio Strategy Compared to the Strategy of the International Development Association**

The ADF's investment portfolio is divided in two components:

- The trading portfolio. The trading portfolio's primary objective is to meet disbursement requirements. This portfolio is invested in short-term assets against a 3-month interest rate benchmark. The main reason for using this benchmark is to preserve the nominal value of the funds under investment.
- The investment portfolio. The investment portfolio's primary objective is to generate a stable stream of net income with higher returns than the returns generated by short-term assets. This portfolio is held to maturity in order to avoid the volatility that is generally observed in portfolios that are marked to market. The investment portfolio has a 5-year duration, with the maturities of assets spread equally from 1 to 10 years in order to benefit from the higher returns of long-maturity bonds.

The combination of these two portfolios reduces the sensitivity of investment income to interest rate fluctuations and helps achieve a relatively stable stream of net income while preserving the capital under investment.

The primary purpose of the International Development Association (IDA)'s liquidity management strategy is to ensure that funds are available on a timely basis in the amount necessary to meet future cash flow requirements, including disbursements for credits, grants and administrative expenses. IDA also seeks to maximize returns, subject to loss constraints, to generate investment income and increase the internal resources available for future replenishments.

IDA's investment policy seeks to achieve these dual objectives through a tranching approach, under which total liquidity is divided into two tranches:

- Tranche 1, the cash flow immunization portfolio, ensures that IDA is able to cover its projected liabilities. These are currently interpreted as all projected net cash outflows over a 20-year horizon. The target size for Tranche 1 is equal to the present value of IDA's future net cash outflows, and the portfolio is invested so that it mirrors the projected net cash outflow stream.
- Tranche 2, the return maximization portfolio, comprises residual liquidity and is invested so as to maximize returns based on historical analysis, subject to risk and loss constraints and with an investment horizon of 3 years. Due to its longer duration, this portfolio is subject to volatility when interest rates fluctuate.

Comparing the two institutions' investment strategies shows that IDA's portfolio has a longer duration than the ADF's portfolio, especially in the case of the ADF's trading portfolio. As a result, when interest rates drop, the IDA's valuation gains are more important than those of the ADF. This explains why IDA recorded exceptional investment income in 2009. In contrast, a portfolio like IDA's is more difficult to manage in a rising interest rate environment, and the volatility caused by interest rate fluctuations may deplete the capital under investment.