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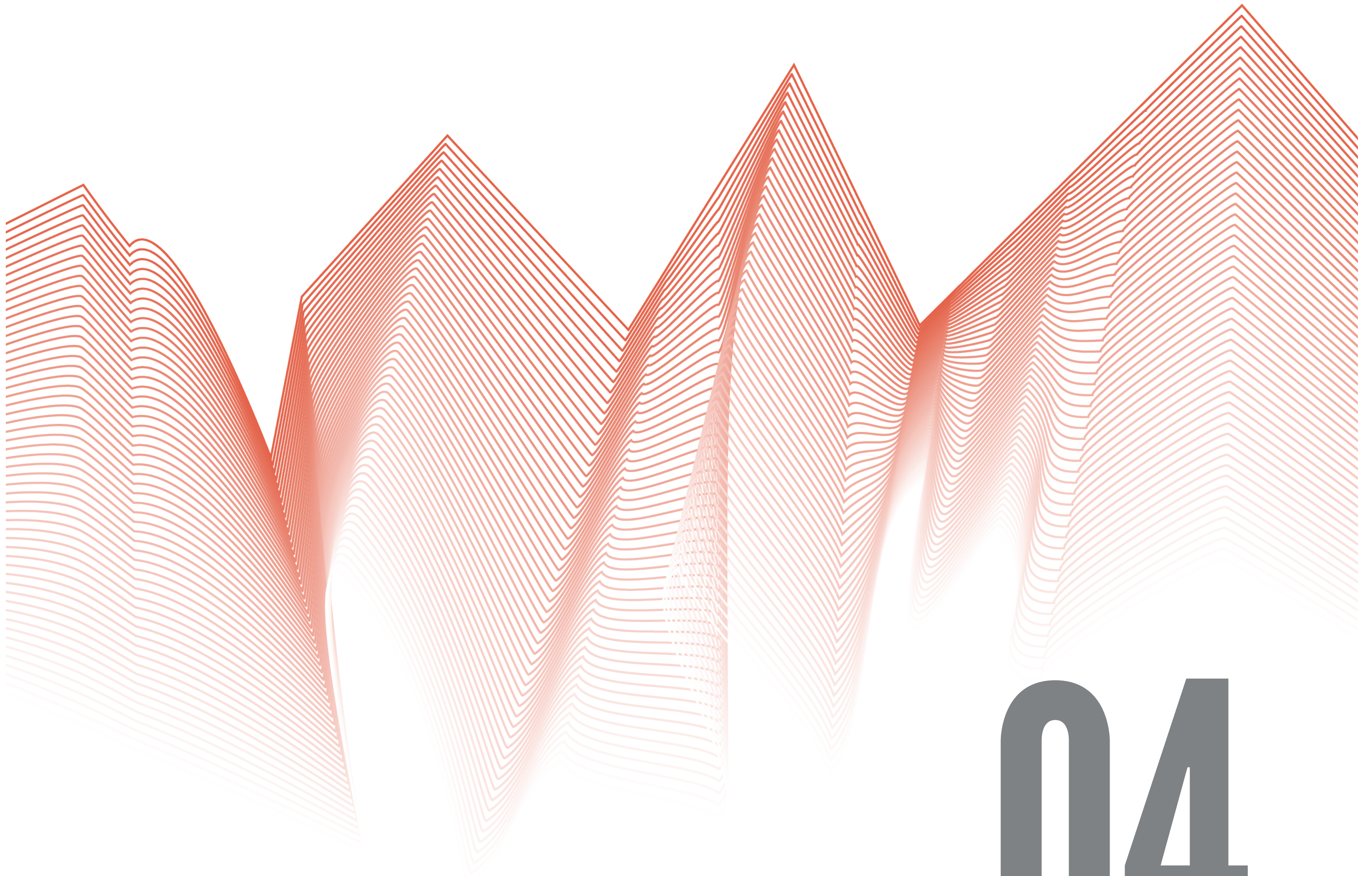

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THE AFRICAN DEVELOPMENT BANK: READY TO FACE THE CHALLENGES OF A CHANGING AFRICA?

Christopher Humphrey

The African Development Bank: Ready to Face the Challenges of a Changing Africa?

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till
Expertgruppen för biståndsanalys (EBA)

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Preface

More than half of Sweden's international development cooperation funding is channelled through multilateral organisations. Given the strong focus on Africa, the African Development Bank (AfDB) is an important channel for Swedish aid. During the 2011 – 2013 period the AfDB received close to SEK 2,5 billion, which makes Sweden a substantive donor to the AfDB.

Interventions and programs financed by loans from the multilateral development banks are often key to broader national strategies. By financing projects that cannot attract funding from commercial banks only, the multilateral development banks can enable and support investments that would not come through. Aid channelled through multilateral development banks may, accordingly, have a large impact and be very effective.

However, the effectiveness of the multilateral banks depend on their specific business model. Like other multilateral development banks, such as the World Bank and the Asian Development Bank, the AfDB consists of two parts: a Bank and a Fund. The *Bank* gives loans to creditworthy African countries (mainly middle income countries) on commercial terms. The *Fund,* on the other hand, gives loans on preferential terms or even outright grants to poorer African countries (low income countries).

These two parts of the AfDB are highly interdependent, with regard to both finance and operations. Problems in one part (Bank or Fund) of the AfDB translate into problems for the other part. The Bank, which is the parent of the group, raises resources for lending by issuing bonds, mainly on international capital markets. Net income from the commercial loans contributes to finance the administration running both parts of the institution. The Bank is owned by African governments and a number of non-regional governments.Without its OECD members, the Bank would not get the preferential treatment it gets on financial markets and therefore would not be able to have a sufficient profit margin on loans to middle income countries in order to finance the administration.

The author of the report, Dr. Christopher Humphrey from the Department of Political Science at the University of Zürich, describes the interactions between the *Bank* and the *Fund* part of the institution and analyses the challenges that AfDB currently faces at large but also because of this close interdependence. The recommendations in the

report are partly based on this analysis, but also on the wider experiences and knowledge the author has gained through long-term study and engagement with various multilateral development banks.

The business model of the AfDB that is described is similar to those of other multilateral development banks. Hence, the challenges emerging from this interplay are relevant for other development banks such as the World Bank.

It is our hope that the current report will contribute to wider knowledge and an intensified discussion, in Sweden and elsewhere, of the African Development Bank. It is about time to think about this given the current rapid economic growth taking place in many African countries. External funding, public and private, increasinly flows to the continent and different sources of new finance are emerging. As African economies rapidly grow, old models and institutions may need to be questioned, and new approaches developed to meet current and emerging challenges. The African Development Bank, as a key organisation for the African continent, deserves a serious discussion of this kind. This discussion could also feed into a more general discussion of the effiency of multilateral banks.

The author has been accompanied by a reference group, chaired by Mr. Torgny Holmgren of the EBA. The analysis and views expressed in the report are the sole responsibility of the author.

Lars Heikensten

EBA Chair

Sammanfattning

Afrikanska utvecklingsbanken står inför en paradox: just när banken skulle kunna spela en viktig katalytisk roll för afrikansk utveckling är dess operativa förmåga kraftigt begränsad. Många afrikanska länder upplever nu en positiv utveckling i form av ökad stabilitet, ekonomisk tillväxt och mänsklig utveckling. Som ledande afrikansk utvecklingsorganisation skulle Afrikanska Utvecklings-Banken (AfDB) kunna spela en central roll till stöd för denna positiva utveckling genom projektfinansiering och kunskapsförmedling. Men bankens relevans begränsas av en rad olika operativa och finansiella brister. Detta gäller särskilt i förhållande till de medelinkomstländer i regionen som håller på att bli Afrikas tillväxtmotorer.

AfDB har många kvaliteter som kan hjälpa Afrikanska länder att hantera det 21a århundradets utvecklingsutmaningar. AfDB grundades för 50 år sedan av 23 afrikanska länder och banken är fortfarande majoritetsägd av afrikanska regeringar. Det afrikanska ägarskapet är en avgörande förutsättning för att AfDB ska mötas av tillit från bankens låntagarländer. Det regionala ägarskapet kombineras med betydande Afrika-specifikt utvecklingskunnande samt en stark finansiell position – en unik kombination bland regionens utvecklingsorganisationer. AfDB är dessutom delvis ägt av regeringar utanför regionen (53 afrikanska aktieägande regeringar och 25 icke-afrikanska aktieägande regeringar), vilket gör att man fungerar som ett forum för interaktion mellan Afrika och resten av världen.

AfDB riskerar att förlora sin relevans för medelinkomstländer, vilket i sin tur påverkar organisationens långsiktiga livskraft. I likhet med många andra multilaterala utvecklingsbanker har AfDB två ”fönster” för utlåning: Ett för medelinkomstländer på marknadsmässiga villkor, och ett andra för fattigare medlemsländer, vilka lånar under starkt subventionerade villkor. AfDB:s marknadsbaserade operationer står inför svårigheter, eftersom många av medlemsländerna inte lånar från AfDB trots att dessa länder har trängande behov av stora investeringar. Oviljan att låna hänger ihop med en rad faktorer både på utbuds- och efterfrågesidan. Alla multilaterala utvecklingsbanker står i dagens situation inför likartade utmaningar, men de är särskilt svåra för AfDB. De hotar att underminera såväl den finansiella soliditeten som utvecklings-relevansen hos banken som helhet.

AfDB:s arbetsmetoder och finanspolicy måste ändras så att banken under kommande årtionden förmår maximera sin betydelse för Afrikas utveckling. Denna studie fokuserar två typer av hinder: arbetsmetoder som minskar AfDB:s attraktivitet som finansieringskälla, och en finanspolicy som begränsar AfDB:s flexibilitet när det gäller att maximera resurser för att möta de utmaningar som låntagarländerna står inför. Dessa hinder påverkar i första hand AfDB:s marknadsbaserade långivning till medelinkomstländer. Men även andra låntagarländer påverkas: en svag, marknadsbaserad projekt-långivning innebär minskade nettovinster för banken och därmed mindre resurser att satsa på fattigare länder. Det innebär också att AfDB skaffar sig färre erfarenheter och mindre kunnande kring utvecklingsprojekt i medelinkomstländer att förmedla till fattigare länder. Banken står därtill oförberedd inför att fler länder nu kan låna på marknadsmässiga villkor i takt med att de Afrikanska ekonomierna växer. Ett starkt marknadsmässigt engagemang är avgörande för att AfDB ska kunna tillhandahålla stöd till utveckling i alla bankens afrikanska medlemsländer, såväl nu som under kommande år.

Studien lyfter fram centrala hinder och föreslår lösningar, så att AfDB kan förverkliga de mål man satt upp i sin strategi för 2013-2022. AfDB:s strategi, "AfDB Strategy for 2013-2022: At the Center of Africa's Transformation", lyfter fram flera nyckelområden, vilka både är anpassade till Afrikas behov och till bankens egna styrkor: investeringar i infrastruktur, regional integration, privatsektor-utveckling och insatser för att möta de särskilda behov som fragila stater uppvisar. Att man valt en sådan fokusering – snarare än att slå in på den generella väg som andra utvecklingsbanker har valt – kan hjälpa AfDB att bli effektivare. Att strategin även betonar vikten av att samarbeta med andra biståndsgivare och med regionala politiska organisationer – och därmed agera katalytiskt och inte enbart själv genomföra projekt – visar också på en beundransvärd realism. Trots det kommer de operativa hinder som analyseras i denna rapport att begränsa AfDB:s möjligheter att nå uppsatta mål, så länge bankens ägare och operativa ledning inte tar itu med dem.

Rapporten är skriven på uppdrag av Expertgruppen för Biståndsanalys (EBA), men rekommendationerna är lika relevanta för ägare och intressenter från andra länder än Sverige. Många intressenter är inte helt medvetna om de svårigheter som AfDB står inför. Som en följd av detta inser man inte heller vilka svåra

utmaningar som banken måste hantera. Många intressenter fokuserar förståeligt nog på den biståndsfinansierade långivningen till Afrikas fattigaste länder. Därmed inser de inte hur viktig den marknadsbaserade långivningen är för AfDB:s övergripande effektivitet. Denna rapport syftar till att redogöra för utmaningar som AfDB:s verksamhet står inför i medelinkomstländer och därmed bidra till en mer informerad syn på hur banken bäst bör agera framöver. Analysen baseras huvudsakligen på offentligt tillgänglig data och dokument, men också på omfattande intervjuer inom AfDB, liksom inom andra utvecklingsbanker.

De föreslagna alternativen till reformer riktas både till bankens ägare och till dess operativa ledning. Förslagen gäller AfDB:s arbetsmetoder, inklusive de byråkratiska procedurerna för att bevilja lån, bankens roll för att mobilisera resurser och för att förmedla kunskaper. Reformförlagen omfattar även AfDB:s finanspolicies, exempelvis bankens kreditvärdighet, graden av koncentration i låneportföljen, lånefönstren och bankens privatsektor-arbete. Huvuddelen av reformförslagen syftar till att göra AfDB mer dynamiskt, anpassningsbart och förmöget att ta större risker i syfte att bättre bidra till kontinentens utveckling. Centrala reformområden omfattar:

- Förenkla de byråkratiska procedurerna så att låntagare möts av färre hinder, samtidigt som risk-hantering sker på ett sätt som ökar bankens handlingskraft utan att kvalitet offras.
- Förstärk AfDB:s kunskapstjänster så att banken bättre bidrar till utveckling.
- Fortsätt att öppna upp för långivning på marknadsmässiga villkor till allt fler länder, på mer varierade villkor, vilket innebär att AfDB:s resurser får större genomslag.
- Analysera noga för- och nackdelarna med att bibehålla kreditvärdighet på AAA-nivå, och undersök om en lägre kredit-rankning kan öka bankens utvecklingseffekt.
- Öka användningen av innovativa finansiella instrument, som exempelvis syndikerade lån, samfinansierings-arrangemang, portföljutbyten med andra multilaterala utvecklingsbanker, så att ökade resurser kan skapas och finansiella risker minskas.

- Omorganisera privatsektorinsatser antingen under en ny vice-president eller placera den i en ny separat IFC-liknande organisation så att den tekniska kapaciteten och kvaliteten i projekten kan förbättras.

Summary

The African Development Bank faces a paradox: at exactly the time when it could have a major catalytic impact on Africa's development path, it faces significant restrictions to its operational ability. Many countries in Africa are showing signs of establishing a virtuous cycle of stability, growth and human development. As a leading African development institution, the African Development Bank Group (AfDB) could play a critical part in facilitating this transition through project finance and knowledge transfer. Instead, a series of operational and financial restrictions limit its relevance, especially for the region's emerging middle-income countries that are becoming Africa's growth engines.

The AfDB has many qualities that can support African countries to tackle their development challenges in the 21st century. The AfDB was created by 23 African countries 50 years ago and is still majority-owned by African governments, a critical trait to generate trust among recipient countries. This regional ownership is combined with significant Africa-specific development expertise and a financial position of considerable solidity—a unique combination among development institutions in the region. As well, the AfDB is partly owned by governments from outside the region (53 African shareholding countries and 25 non-regional shareholding countries), thus serving as a forum to channel cooperation and interactions between Africa and the rest of the world.

The AfDB is in danger of losing relevance to its middle-income country members, which affects the viability of institution. Like several other multilateral development banks (MDBs), the AfDB has two lending "windows": one for middle-income member countries at market-based financial terms, and a second for poorer member countries on highly concessional terms. The AfDB's market-based operations are facing difficulties, with many members not borrowing despite pressing investment needs, due to a combination of demand and supply factors. This challenge is common to all MDBs in current global conditions, but is particularly difficult for the AfDB, and threatens to undermine the financial solidity and developmental relevance of the bank as a whole.

The AfDB's business practices and financial policies need to change for the bank to maximize its development impact in Africa

in the coming decades. This study focuses on two sets of obstacles: business practices that reduce the attractiveness of the AfDB as a source of funding, and financial policies that limit the AfDB's flexibility in maximizing its resources to address the needs of borrower countries. These obstacles in particular impact the AfDB's market-based operations to middle-income countries. However, all borrower countries are affected: weak market-based project lending means less net income that can be dedicated to poorer countries, less developmental experience that can be transferred from middle-income to poorer countries via the AfDB, and a bank unprepared for an increase in countries accessing market-based lending as Africa grows. Strong market-based engagement is essential for the AfDB to provide development support for all its member countries, both now and in the years to come.

The study highlights key obstacles and proposes ways to resolve them, such that the AfDB can bring the goals outlined in its Strategy for 2013-2022 into operational reality. The "AfDB Strategy for 2013-2022: At the Center of Africa's Transformation" defines several key areas of focus that are well-suited to Africa's needs and the bank's own strengths: infrastructure provision, regional integration, private sector development and the special requirements of fragile states. This focus can help the AfDB be more effective, as opposed to taking the more generalist approach of other major MDBs. The strategy's emphasis on partnering with other development aid providers and regional political institutions—acting as a catalyst and broker as much as a direct provider—also demonstrates commendable realism. However, the operational obstacles analyzed in this paper will limit the AfDB's ability to achieve these goals, unless addressed by shareholders and management.

The paper was commissioned by Sweden's Expert Group for Aid Studies (EBA), but recommendations are equally relevant to shareholders and stakeholders from other countries. Many stakeholders are not fully aware of the difficulties facing the AfDB, and as a result do not appreciate the difficult challenges that need to be tackled to strengthen the bank. In particular, stakeholders understandably focus on concessional lending to Africa's poorest countries, and do not realize the importance of non-concessional operations for the AfDB's overall effectiveness. This study attempts to clarify the challenges facing AfDB's activities in middle-income countries to develop a more informed consensus among shareholders

on how to best take the bank forward. The analysis is based mainly on publicly-available data and documents and also on extensive interviews at the AfDB, as well as at other development banks to provide a comparative perspective.

The suggested reform options are directed at both shareholders and management of the AfDB. The suggestions concern the AfDB's business processes, including its loan approval bureaucracy, leveraging of resources and role as knowledge provider. Suggestions for reform also relate to the AfDB's financial policies, such as its credit rating, portfolio concentration, lending windows and private sector operations. The thrust of the reform options is to enable the AfDB to be more dynamic, adaptable and able to take risks in the interests of the continent's development. Key reform areas include:

- Streamline bureaucratic procedures to make dealing with the bank less cumbersome for borrowers, using risk-based procedures that improve agility without sacrificing quality.
- Strengthen the AfDB's knowledge services to increase its developmental value-added
- Continue opening the credit policy to broaden the pool of non-concessional borrowers, thus expanding the impact of AfDB resources and diversifying the loan portfolio
- Carefully analyse the costs and benefits of maintaining AAA bond rating, and consider whether a lower rating might increase the bank's developmental impact.
- Scale up innovative mechanisms to leverage more resources and reduce financial risks, such as loan syndication, co-financing arrangements, portfolio swaps among other MDBs or portfolio guarantees.
- Reorganize private sector operations either in a new vice-presidency or a separate IFC-like institution, to improve technical capacity and project quality.

The Current State of African Development

The economic performance of Africa as a whole has improved tremendously in recent years. As highlighted by numerous observers in recent years,[1] many countries in Africa are showing signs of establishing a virtuous cycle of stability, growth and human development. Average annual GDP growth in the continent was nearly 5 percent over the last decade, despite the negative effects of the global financial crisis on key export markets, and is projected to reach 6 percent in the coming years.[2] External investment in Africa is also rising sharply. Total external financial flows to Africa have risen from under USD 50 billion in 2001 to an estimated USD 200 billion in 2013.[3] Cumulative net foreign investment in 2001-2012 was six times as high as the previous decade.[4] Public finances are also, on the whole, much improved, with public debt in Africa's poorest countries averaging around 43 percent of GDP in 2012 (down from 112.6 percent in 2005),[5] driven down by debt relief programs, windfall commodity revenues and improved fiscal management.

Despite these impressive gains, many African countries continue to face very serious economic weaknesses. The composition of investment inflows is highly uneven. For example, low-income countries in Africa attract about 25 percent of external flows, despite comprising 50 percent of the continent's population, and 70 percent of portfolio investment goes to one country (South Africa).6 Many countries affected by social unrest—such as Mali, Somalia, South Sudan, Democratic Republic of Congo, among others—receive minimal investment, far below what is needed to break the cycle of poverty and conflict. Foreign direct investment remains focused on commodity extraction, and the majority of infrastructure investment is geared toward telecommunications services, with huge unmet needs

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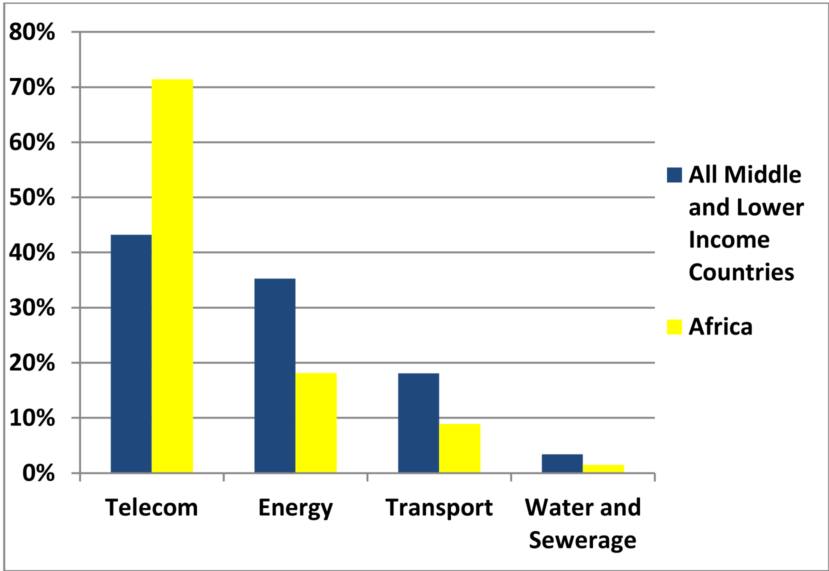
[1] Most notably The Economist magazine's "Africa Rising" cover, from 2 March 2013.
[2] Annual Development Effectiveness Review, AfDB 2014.
[3] African Economic Outlook, 2014.
[4] Ibid.
[5] See IMF Regional Economic Outlook: Sub-Saharan Africa, 2013, p. 80. The figures are unweighted averages of public debt levels from all borrowing countries eligible for concessional lending from the World Bank and AfDB, apart from Sudan, Somalia and Djibouti (data not available).
[6] Private Participation in Infrastructure Database, World Bank (ppi.worldbank.org).

in transport, water and energy (Figure 1). For example, Africa—with over 1 billion people—generates about as much electric power as Germany, with only 80 million. A World Bank study estimates that Africa requires USD 93 billion a year in infrastructure investment to sustain economic growth, with a gap of nearly USD 50 billion per year.7

Figure 1. Sectoral Distribution of Private Infrastructure Investment, 1990-2012



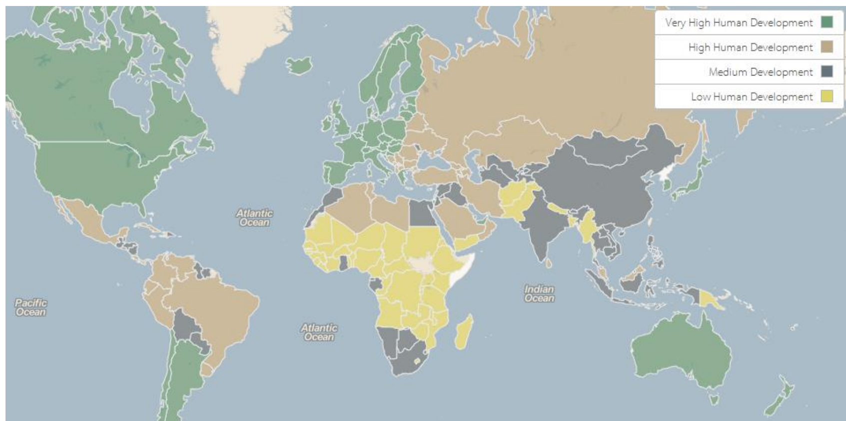
Source: Private Participation in Infrastructure Database, World Bank (ppi.worldbank.org).

The broad economic upswing in the continent over the last several years has not yet led to major improvements in the lives of most Africans. Because so much economic activity is based on capital-intensive commodity production, job creation has been weak, particularly among youth, a shocking 60 percent of whom are unemployed.[8] Extractive industries account for more than half of all exports from sub-Saharan Africa, and in some countries more than 90 percent, compared to just 10 percent in Asia. Agriculture still accounts for two-thirds of Africa's workforce, much of it small-scale or

[7] World Bank 2009, Africa's Infrastructure: A Time for Transformation; Africa Infrastructure Investment Report 2013, Commonwealth Business Council.
[8] AfDB Investor Presentation, 2014.

subsistence farming with low productivity and earnings. Real incomes are up 30 percent in the past decade, but poverty remains very high, with over 40 percent of the continent's population—more than 400 million people—living on less than $1.25 per day and economic inequality on the rise.[9] Sub-Saharan Africa accounted for more than a third of the world's extreme poor in 2010, up from only 11 percent in 1981.[10] Social indicators are also sobering. Of the 46 countries with the lowest scores on the 2013 United Nations Human Development Index, 36 are in Africa, while only five African countries are in the top 100 in HDI (Figure 2).[11]

Figure 2. World Human Development Index, 2013



Source: United Nations Development Programme, Human Development Report, 2013.

The demographic panorama in the coming decades adds even greater urgency to accelerating economic growth and translating it into job opportunities. Africa's current population of 1.1 billion is expected to more than double to 2.4 billion by 2050, which will then equal one-quarter of the world's population.[12] The evolution of the working population (15-64 years of age) between 2010 and 2050 is predicted to be -19 percent for Europe, -15 percent for China and +159 percent for the Africa continent.[13] Each year on average for the next four

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[9] AfDB Annual Development Effectiveness Report, 2014.
[10] World Bank, State of the Poor: Where are the Poor and Where are they Poorest? PREM, 2013.
[11] The highest ranked, at 46th place, is the island nation of Seychelles.
[12] United Nations, World Population Prospects: the 2012 Revision.
[13] Ibid., Vol. 1, Table A.31.

decades, an additional 22.7 million people are projected to enter the workforce.[14] This is an incredible opportunity for dynamic development if these workers find productive outlets for their energy, but at the same time a massive risk for social instability if they do not. Much of North Africa's unrest in recent years has been driven by youth frustrated by a lack of opportunities, and this is a warning sign of what could occur in the rest of the continent in coming years.

External development cooperation can play an important role in helping convert the continent's optimistic potential into reality. Development cooperation—particularly from multilateral development banks like the AfDB[15]—can: i) overcome market failures and provide the security needed to attract private investment to projects with high financial and development returns but also high risks; and ii) support investments and policy reforms needed to strengthen social development outcomes and create the conditions for dynamic, sustained economic activity. Africa is on the cusp of a virtuous cycle of stability, economic growth and improved living standards, and development cooperation can facilitate this process.

The Role of the African Development Bank

The African Development Bank Group (AfDB) is one of a "family" of international development institutions called multilateral development banks (MDBs) (see Box 1). The AfDB was created 50 years ago by 23 African countries, and today has 53 African shareholding countries and 25 non-regional shareholding countries. It provides financing (mainly loans, but also equity investments and guarantees) for development projects within the African continent.

[14] The UN data predicts a population increase of 910 million people between ages 15 and 64 between 2010 and 2050.

[15] This paper departs from the assumption that MDBs are relevant across the globe and particularly in Africa, and focuses on how the AfDB can best fulfill its function as an MDB in Africa. Arguing for the continued relevance of MDBs would involve extensive analysis of the activities and gaps of private financial flows, bilateral donors and government fiscal situations. Such an analysis is beyond the scope of this paper.

Box 1. What is a Multilateral Development Bank?

Multilateral development banks (MDBs) are financial institutions created by governments via international treaties to provide financing and technical assistance for the purpose of development. The first MDB, and the best known, is the World Bank, created in 1944. Currently about 20 MDBs exist, including the major regional MDBs like the AfDB (founded 1964), the Inter-American Development Bank (1960) and the Asian Development Bank (1966) as well as specialized MDBs like the Islamic Development Bank, the Andean Development Corporation or the Banque Ouest Africaine de Développement. In July 2014 the BRICS countries announced the creation of a new MDB, indicating the continued relevance of this institutional model.

Policies and operations of an MDB are approved by member country representatives through voting, with voting power in most cases in proportion to the amount of capital each country has contributed. MDBs have traditionally lent to member national governments, although now many also lend to private sector borrowers and sub-national governments. Resources are lent for both direct investment in economic or social infrastructure as well as budget support loans linked to policies, administrative reforms or training. MDBs package their lending with knowledge transfer and technical assistance related to development issues.

One of the key characteristics of MDBs is that they raise much of their resources for lending by issuing bonds on capital markets, rather than budgetary allocations from member governments. Backed with the capital of shareholder governments, most MDBs are very highly rated by bond rating agencies and have a very low cost of funding. As a result, they are able to lend to member countries at low interest rates and long maturities (20-30 years), and still have a margin left over to cover MDB administrative costs. These administrative costs can include developmental research, technical assistance, as well as other public goods. The reliance of MDBs on capital markets for funding means they must pay close attention to their finances, but it is important to note that MDBs are non-profit institutions.

Some countries face very high developmental needs and are unable to pay the market-based financial terms. As a result, some MDBs have created "concessional" lending windows that offer low (or zero) interest, long-term loans or grants to poorer countries. Concessional resources do not come from issuing bonds, but rather from regular donations from wealthy government, as well as allocations out of the net income generated by non-concessional lending.

As with the World Bank, Asian Development Bank (AsDB) and Inter-American Development Bank (IADB, the AfDB has two main lending "windows" through which it provides resources to borrowers: [16]

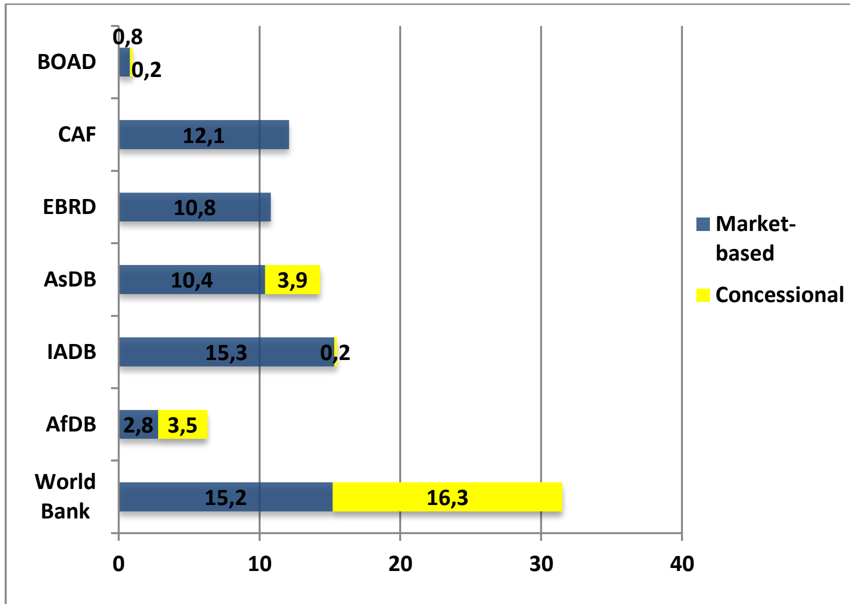
The *non-concessional African Development Bank (ADB)* which lends at market-based rates for medium and long-term maturities (max. 20 years)

The *concessional African Development Fund (ADF)*, which lends at minimal or zero interest to poorer countries at longer maturities (35-50 years), or offers grants.

The AfDB is the smallest of the major regional MDBs in terms of lending volume, with total lending of USD 6.3 billion in 2013 (Figure 3). Of that, USD 2.8 billion was committed by the ADB non-concessional window, and USD 3.5 billion by the ADF. On average over 2011-2013, the ADB has committed slightly more than the ADF: USD 3.8 billion on average per year compared to USD 3.1 billion in concessional ADF funding.

[16] Like many MDBs, the AfDB also operates a series of trust funds established by different donors, the oldest of which is the Nigerian Trust Fund. These trust funds form a relatively small share of operations, and are not analyzed in this report.

Figure 3. 2013 Lending Commitments by Selected MDBs (USD Billions)



Source: Annual reports, 2013.

Notes: BOAD = West African DB, CAF = Andean Development Corporation, EBRD = European Bank for Reconstruction and Development, AsDB = Asian DB, IADB = Inter-American DB. Includes sovereign and non-sovereign loans for all MDBs except for the World Bank (which lends to non-sovereign borrowers from its IFC operations, not included here). Of the MDBs listed here, EBRD lends mainly to the private sector (about 85% of portfolio), while the others are less: AfDB 21%, CAF 20%, IADB and AsDB both about 5%.

The non-concessional ADB lending window raises resources for lending by issuing bonds, mainly on international capital markets.[17] The ADB lending window is self-financing, and does not require contributions from shareholders, apart from their shareholding capital contributions. In the interests of ensuring financial stability and protecting its AAA bond rating and hence low cost of funding, the ADB—like all MDBs—limits the size of its lending portfolio as a function of its equity capital (shareholder capital plus reserves). If shareholders wish to increase the bank's lending capacity, they may be required to contribute to a capital increase. The ADB's capital has increase six times since the bank was founded, most recently in 2010.

[17] The ADB and other MDBs also make private placements, for example with central banks, sovereign wealth funds, or elsewhere.

The concessional ADF window, on the other hand, charges zero interest rates or offers outright grants, depending on the economic conditions of the borower countries (Table 1). Hence it is not a viable financial concern in the traditional sense, and is financed by contributions by donor shareholder countries rather than through debt. Thus far, 13 replenishment rounds have occurred since the ADF was created in 1974, with the latest covering 2014-2016.[18] Recipient countries are allocated ADF resources based on GNI per capita, creditworthiness and several performance criteria.[19]

Table 1. Concessional and Non-Concessional Borrowing Countries, 2013

Non-Concessional (ADB)		Concessional (ADF)	
	Green: low risk debt distress (100% loans)	Yellow: moderate risk debt distress (50% grants/50% loans)	Red: high risk debt distress (100% grants)
Algeria	Benin	Burkina Faso	Burundi
Angola	Cameroon	Central African Rep.	Comoros
Botswana	Cape Verde*	Chad	D.R. Congo
Egypt	Congo Rep. of	Cote d'Ivoire	Djibouti
Equatorial Guinea	Ethiopia	Ghana	Eritrea
Gabon	Kenya	Guinea	Gambia
Libya	Liberia	Guinea Bissau	Sao Tome Principe
Mauritius	Madagascar	Lesotho	Somalia
Morocco	Mozambique	Malawi	Sudan
Namibia	Nigeria*	Mali	Zimbabwe
Seychelles	Senegal	Mauritania	
South Africa	Tanzania	Niger	
Swaziland	Uganda	Rwanda	
Tunisia	Zambia*	Sierra Leone	
		Togo	

Source: AfDB website.

Note: Classifications for 2013 ADF-12 resources, hence does not include South Sudan. *Blend countries eligible for ADB and ADF resources.

This study focuses on challenges facing ADB non-concessional lending. The healthy functioning of the non-concessional lending

[18] Donor contributions totalled about USD 5.8 billion. The largest contributor is the UK (15.9%), followed by German (10.4%), the US (10%), France (9.5%), Japan (7.6%), Canada (5.5%) and Sweden (5.4%).

[19] For details, see Annex IV, ADF 13 Report: Supporting Africa's Transformation.

window is fundamental to the effectiveness of the entire institution in middle-income and lower-income countries alike, both currently and in the coming decades, for a number of reasons:

- Most of the world's poor currently live in middle-income countries, as numerous reports have highlighted.[20] The AfDB's middle-income country members still benefit from developmental assistance to continue growing and to better distribute the fruits of growth in a way that support improved living standards for all, especially the poorest. This is particularly true currently in northern Africa, where several middle-income countries are going through political and economic turbulence.
- Most of Africa's countries are currently low-income, but this will not continue forever. The AfDB needs a strong non-concessional lending division to be prepared for the emergence of more middle-income countries and a decline in funding for the concessional ADF window. This, for example, has been the case with both the IADB and the AsDB (Figure 3).[21]
- A critical comparative advantage of MDBs is their ability to transfer knowledge, leveraging the experiences of previous development projects to the benefit of other countries. This is particularly useful between more advance middle-income countries and poorer countries. If the AfDB has no meaningful engagement with Africa's middle-income countries, this knowledge transfer advantage will be lost.
- The revenue from ADB lending funds a sizeable portion of the AfDB's administrative budget, including staff salaries, research, data collection and other developmental public goods.
- ADB lending generates annual net income, a portion of which is allocated each year to supplement donor commitments to ADF (USD 72 million annually in 2014-16). Hence, a decline in non-concessional lending weakens AfDB's ability to provide resources to Africa's poorest countries.

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[20] See for example Sumner, 2011 and Birdsall 2001.

[21] The IADB currently has only four countries eligible for concessional finance, while the AsDB is now considering folding all its concessional operations into its non-concessional window. See AsDB 2014a.

The Strengths of the AfDB

The AfDB has a unique set of characteristics that cannot be easily duplicated by other development institutions operating in Africa.

The AfDB can intermediate substantial resources—several billion USD each year—at very low interest rates and long maturities, which is fundamental to the long-term nature of tackling developmental challenges. Although the AfDB's financial position has weaknesses—as this report will discuss in some detail—it is nonetheless has a solid equity capital bases that can sustain non-concessional development lending operations for many years to come without need for shareholder contributions.

The multilateral nature of the AfDB positions it well in terms of legitimacy and development effectiveness. Bilateral development projects are often fragmented and respond to the domestic political agendas of the donor country, and not always the priorities of recipient countries. As well, bilateral funding is vulnerable to budgetary restrictions and changes in political administrations in donor countries. Newer bilaterals—such as China, India and Brazil—are ramping up their involvement in Africa, but are in many cases focused mainly on securing contracts for national companies or access to natural resources, rather than African development per se.[22] By grouping together 78 shareholding countries under an international treaty, the AfDB's governance gives its operations a less politicized and more technical character than bilateral donors, strengthening its legitimacy in the eyes of recipients.

Other multilateral development institutions operate in Africa, but none have the AfDB's continent-wide perspective and African ownership. The World Bank and several smaller regional multilateral banks[23] have important roles to play in Africa, and have some advantages over the AfDB. For example, the World Bank's global experience and knowledge services are top-notch, and some of the regional banks are highly agile and adaptable. But the AfDB is truly

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[22] On this issue, see among many others "Into Africa: China's Wild Rush", H. French, New York Times 16 May 2014 and "China's Strategy to Secure Natural Resources," T. Moran, Peterson Institute, 2010.

[23] These include the PTA Bank, Banque Ouest Africaine de Développement and the East African Development Bank. As well, the new BRICS bank is likely to operate in Africa, although the scale and timing of operations remains unclear.

African in character: created by Africans, 60 percent owned by African countries, and the largest development institution dedicated solely to the continent.[24] As such, it can develop a vision for the region's engagement with the world economy and promote both national and regional activities to realize that vision, rather than atomized individual projects without a regional perspective. Its trajectory and majority-African staff give it a repository of specialized knowledge and understanding of Africa, and it has the scale and credibility to play an important convening role amongst governments, private sector and other international organizations.

Key Challenge: Lending to Middle-Income Countries

Lending from the AfDB's non-concessional finance window is flat or even declining, which poses a major challenge to the institution as a whole. Weak non-concessional lending threatens the basic financial model of the AfDB, and indicates that it is not doing its job to be relevant to middle-income borrowing countries. Remaining useful to middle-income members is difficult, due to the increasing sophistication of their public administrations and demands for improved MDB services.[25] Middle-income countries are no longer willing to accept cookie-cutter traditional development loans based on an MDB's priorities and timeline.

Evidence suggests that the AfDB has not yet been able to adapt to this new reality, and is as a result not well-positioned to support a fast-changing Africa. Several of the 14 non-concessional African countries (Table 1) are borrowing only small amounts from the AfDB or not at all. As a result, lending is falling well below AfDB's capacity, based on its capital. Lending in 2009 during the global financial crisis, and as expected turned downward in subsequent years, in line with expectations and the activity of other MDBs (Figure 4). However, AfDB's lending has fallen off much more than expected. This underperformance means that a sizeable share of the non-concessional lending window's capital is sitting idle.

In 2010, shareholders agreed on a major increase in ADB's capital. The increase was essential to ensure that the ADB had the resources

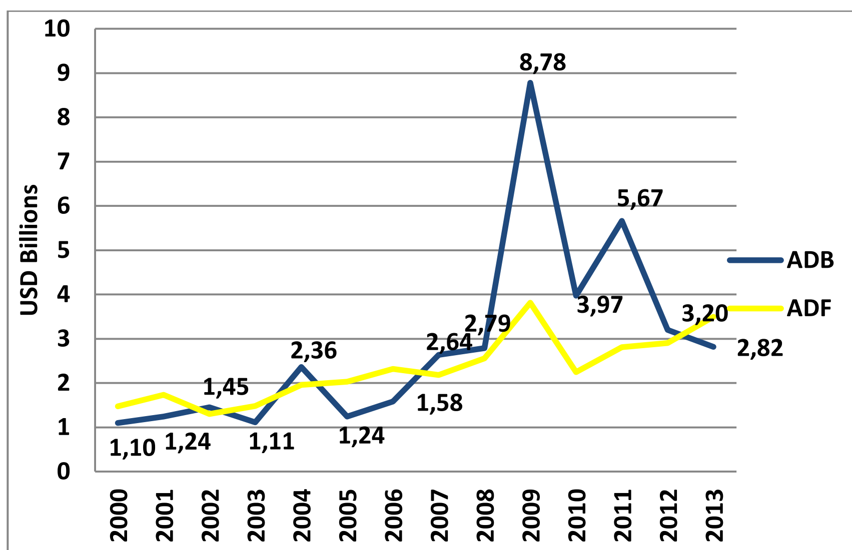
[24] The World Bank operationally divides Africa into two separate divisions, meaning it is structurally unable to take a holistic, region-wide perspective on the continent.
[25] See World Bank 2006 and AsDB 2006 for their respective middle-income strategies.

needed to provide counter-cyclical lending during the crisis, while not undermining its own financial stability. At the same time, shareholders saw the capital increase as an opportunity to position the ADB to take a major leap forward in the scale of its engagement, in line with the rising development prospects of the continent.[26] The weak performance of lending commitments in the last two years suggests that the ADB is falling short of this goal.

At the time of the capital increase, the bank projected annual non-concessional lending commitments from 2010 to 2020, to make the best use of the new capital while remaining within the conservative financial policies required by shareholders. The AfDB is falling well short of these projections (Table 2). In 2013, the ADB window committed less than half the amount that shareholders had projected for that year. Public sector lending was particularly weak—only USD 1.2 billion was committed, down from USD 2.2 billion the previous year and well below the USD 3.4 billion projected for 2013 at the time of the 2010 capital increase.

[26] "Proposal for a Framework for Managing GCI Resources and Large Loans," AfDB 2011.

Figure 4. AfDB Loan Commitments, 2000-13



Source: AfDB annual reports.

Note: Includes grants, equity, guarantees, private sector lending and debt relief.

Table 2. Projected vs. Actual Non-Concessional Loan Commitments (USD Billions)

	2010 (proj)	2010	2011 (proj)	2011	2012 (proj)	2012	2013 (proj)	2013
Sovereign	1.88	2.40	3.82	4.39	3.57	2.24	3.44	1.22
Non-Sovereign	1.86	1.57	1.70	1.26	1.97	0.95	2.04	1.60
Total	3.74	3.97	5.53	5.67	5.53	3.20	5.47	2.82

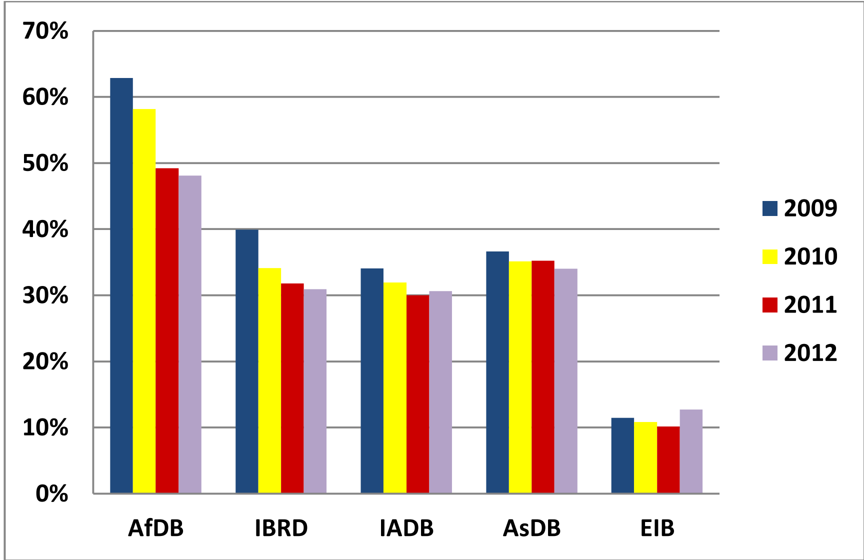
Source: Projections from Proposal for a Framework for Managing GCI Resources and Large Loans (2011); actual from AfDB annual reports.

Notes: Includes HIPC relief and grants. Using FX rates from annual reports.

The non-concessional balance sheet indicates that shareholder capital was under-employed even before the 2010 capital increase took effect. The ADB's equity-to-loans (E/L) ratio was by far the highest of the major MDBs, and although the ratio has declined somewhat over the

past four years it is still well above its comparators (Figure 5).[27] This means that for every dollar of ADB's equity capital (comprised of paid-in capital[28] plus reserves), the bank is generating far fewer development loans than other MDBs. Thus, the lending of the AfDB is highly conservative compared to i) the already-conservative projections made at the time of the 2010 capital increase and ii) the activities of other MDBs.

Figure 5. Shareholder Equity as % of Outstanding Loan Portfolio



Source: MDB annual reports.

Note: Equity is defined as paid-in capital plus reserves. From annual reports of each MDB.

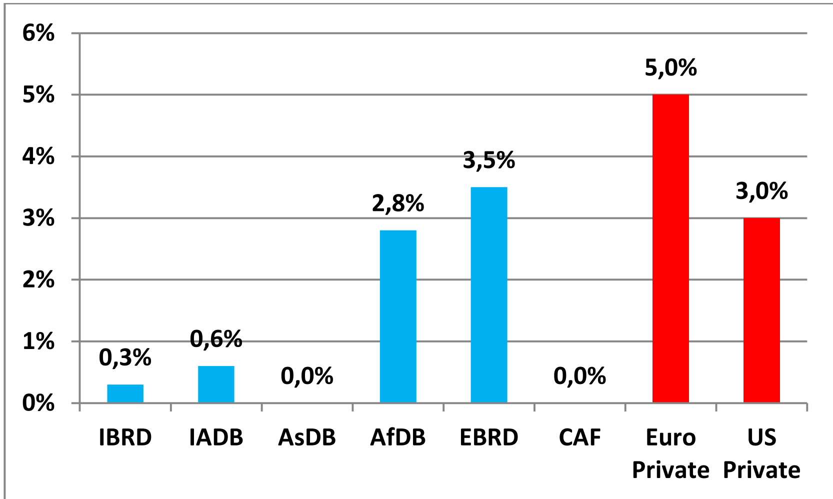
It should be noted that the financial management of MDBs is far more conservative than private banks, even though MDBs have the additional security of callable capital and preferred creditor status that private banks do not enjoy. For example, the equity-to-loans ratios for several major private banks are half or less than most MDBs: Barclays

[27] Research on other MDBs indicates that even their lower E/L level is well above what is required for strictly financial reasons (Humphrey, 2014).

[28] The shareholder capital of the AfDB (as well as the World Bank and other major MDBs) is made up of i) paid-in capital and ii) callable (or guarantee) capital. This latter is unique to MDBs, and does not exist for private financial institutions. Callable capital is a financial guarantee offered by MDB shareholders, which an MDB can theoretically call on if required to face a financial emergency. The callable capital of the AfDB and of other MDBs has never been called upon.

(13.7 percent), HSBC (14.7 percent), Deutsche (14.6 percent), or UBS (17.4).[29] Nor can it be argued that the AfDB and other MDBs have higher equity-to-loans ratios to protect against a riskier loan portfolio–MDB non-performing loan ratio are generally well below the averages of private banks (Figure 6), with the exception of the EBRD (which lends mainly to the private sector).

Figure 6. Non-Performing Loans as % of Total Loan Portfolio, 2013



Source: 2013 annual reports for MDBs; BIS 2013 for private banks.

Note: Private bank data represents averages for Euro area and U.S. In all cases, NPL refers to loans more than 90 days past due or in non-accrual status.

Because of this risk-averse financial management, only 62 percent of the ADB's equity capital was being used for development operations in 2013, compared to the 74 percent projected by shareholders during the 2010 capital increase for that year.[30] Hence, the ADB did not utilize over USD 1 billion in equity capital in 2013 that shareholders had projected to be used (within already conservative financial policies), which would have translated into over USD 3 billion in public sector loans or over USD 2 billion in private sector loans. This performance suggests that the ADB is not making the best use of shareholder equity to achieve development results.

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[29] All data from 2013 annual financial statements. It should be noted that these ratios are considerably higher than pre-2008, when ratios of 8-10% were common.
[30] "Proposal for a Framework for Managing GCI Resources and Large Loans," AfDB 2011.

Obstacles Limiting Non- Concessional Lending

The decline in market-based lending has multiple causes, but many relate to the AfDB's business practices and financial policies. Several countries eligible for lending on non-concessional terms—such as South Africa, Angola, Botswana and Namibia—are not borrowing, even though they have many pressing investment needs and still have headroom to take on loans with the AfDB. Others, particularly countries in North Africa, are restricted from borrowing more due to the AfDB's concerns about high portfolio exposure to countries perceived as risky by credit markets.

The section below analyzes several key obstacles that limit the AfDB's ability to better utilize its resources to promote development in middle-income African countries. The first part briefly reviews the complex environment in which the AfDB operates and growing financial alternatives, which are important limitations and must be taken into account. The next two sub-sections review key business practices and financial policies that further restrict the AfDB, but which can be changed if shareholders and management agree on a shared vision for the future of the bank.

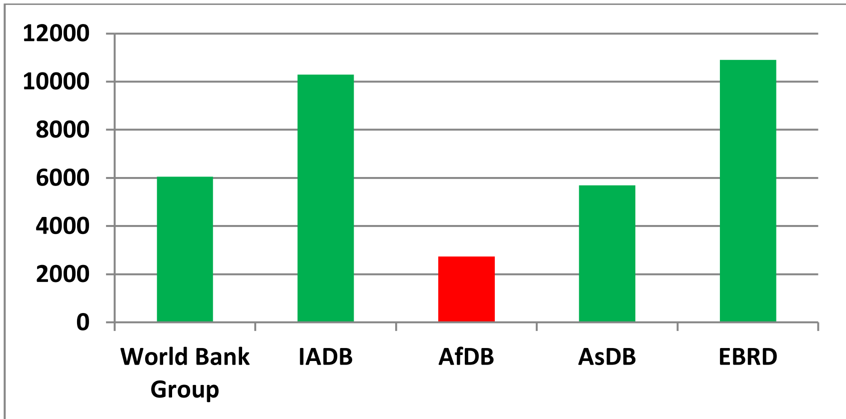
Context: Operating Environment and Financial Alternatives

The AfDB's operating environment is in many ways more challenging than other MDBs. The relative underdevelopment of many African countries (Figure 7) limits the AfDB's ability to undertake development operations. Out of 30 countries in the world experiencing significant social violence or open conflict in 2012, 14 are in Africa. [31] Three of these countries—Nigeria, the Democratic Republic of Congo and Egypt—are among the four most populous nations on the continent, meaning their conflict has an outsized impact on the well-being of the region's population and destabilizes what should be the most powerful poles of economic growth. As well, 24 out of the world's 47 "fragile states" are in Africa.[32] The situation

[31] Uppsala Conflict Data Program, 2014.
[32] OECD DAC International Network on Conflict and Fragility, 2013.

of many African countries means that AfDB clients—both public and private—have on the whole less absorptive and implementation capacity for investment projects compared to other regions, as well as, in many cases, less robust institutional frameworks and socio-political stability.

Figure 7. GDP Per Capita, MDB Borrowing Countries (USD)



Source: World Development Indicators, 2013.

Notes: In GDP PPP, 2005 international USD. All groupings are weighted country averages. Includes concessional, non-concessional and blend borrowers in all cases.

Alternative sources of external finance are increasing rapidly in many African countries, and are in some cases displacing the AfDB. Chinese and Indian bilateral lenders have been very active in Africa for several years, and are being followed by an expanded presence of the Brazilian development bank BNDES.[33] Sub-regional development banks—notably Banque Ouest Africaine de Développement in West Africa, the East African Development Bank, and PTA Bank in southeast Africa—have ambitious expansion plans. The new MDB being created by the BRICS countries will potentially undertake major operations in Africa. Foreign direct investment flows to the region rose from USD 12 billion in 2002 to over USD 60 billion in 2012, and access of African governments to international capital markets is increasing quickly. Sub-Saharan governments issued USD 4.6 billion in bonds in

[33] BNDES will open an office in South Africa later this year, according to a personal communication from a BNDES official working in the international division.

2013, the highest level ever.[34] These flows are expected to continue rising steadily in the coming years.[35]

These new financing sources give many countries choices that did not exist in the past, which is putting competitive pressure on the AfDB. Many countries now have choices, and depending on the circumstances may prefer other financers to the AfDB for a number of reasons, including speed and volume of lending, lack of environmental or social safeguards, or political reasons, among others.[36] The increased choice is certainly positive from the point of view of borrowers, but it also brings risks. Political leaders may choose to take more expensive loans from other sources to suit their short-term interests, even though they may have less positive developmental impacts and can increase a country's debt load. The same pressures are impacting the IADB in Latin America and the AsDB in Asia, but those MDBs have been much quicker to react and change to remain attractive to their borrowing clients.

AfDB Business Practices

Several aspects of how the AfDB offers loans and other development services restrict borrower country demand. This sub-section considers loan approval bureaucracy, loan pricing and size and knowledge services, all of which have a major impact on demand in middle-income borrowing countries. These factors are also relevant in lower-income countries, but because poorer countries have few options for financing and can access highly concessional resources, they have less of an impact on demand. However, this may change in the future.[37] Other issues—for example environmental and social safeguards, administrative decentralization and procurement policies—are also

[34] "Sovereign Bonds in Sub-Saharan Africa: Good For Growth or Ahead of Time?" Dirk Willem te Velde, Overseas Development Institute, 2014.

[35] Recent data suggests sovereign bond spreads in Africa are increasing, meaning capital markets may not be a reliable source of development finance going forward. Zambia paid 8.625 percent on a 10-year, USD 1 billion note issued in early 2014, compared to 5.63 percent for its first bond market issue in 2012 ("IMF warns 'rising' African nations on sovereign debt risks", Financial Times, May 29, 2014).

[36] For a discussion of these issues, see The Age of Choice: Developing Countries in the New Aid Landscape, Greenhill, Prizzon, and Rogerson, ODI, 2013; as well as "Shopping for Development: Multilateral Lending, Shareholder Composition and Borrower Preferences," Humphrey and Michaelowa, 2013, World Development.

[37] In fact, ODI 2013 indicates that these factors may already be at play in some concessional countries in Africa and elsewhere.

worth analyzing in detail, but are beyond the scope of the present study.

Loan Approval Bureaucracy

A key reason some countries are less inclined to borrow from the AfDB is the bank's highly bureaucratic and inflexible operating style, according to a recent client survey.[38] In some ways the AfDB still operates as if its borrowing clients had no other options for financing. This is patently no longer the case, and it is essential that the bank change its mentality and business processes to keep up with the new reality in the region. Many governments and private firms would like to work more with the AfDB, but are not willing to put up with the lengthy delays and bureaucratic hurdles, according to survey feedback. Delays represent a significant opportunity cost, especially for projects with high economic and developmental impacts. It should come as no surprise that some borrowers are willing to pay higher interests rates in exchange for accessing resources in a matter of weeks, rather than the two years or more between beginning loan preparation and first disbursement at the AfDB.[39]

Slow procedures at the AfDB (and other MDBs) are the result of a culture of risk aversion and process obsession, derived largely from mandates and controls imposed by shareholders.[40] Over the decades, the AfDB has accumulated a bewildering array of policies, procedures and requirements that borrowers must grapple with to access bank services. Shareholders understandably wish to ensure project quality, but the levels of control and oversight has left staff risk-averse and process-obsessed. While each individual element may have been put in place for a valid reason, the cumulative effect has left the AfDB extremely slow. Public sector loans take on average more than a year to reach board approval, or even longer for private sector loans. In an age of much greater choice and with a growing focus on the private sector, borrowers—especially middle-income countries with various financing options—will not accept this.

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[38] The Preferred Partner? A Client Assessment of the African Development Bank. AfDB, 2012.

[39] Staff interviews, AfDB.

[40] The role of especially non-borrowing country shareholders in imposing bureaucratic restrictions and mandates is documented extensively in Humphrey 2013 in the case of the IADB and World Bank, as well as by Gutner 2002. Interviews with staff and EDs as part of this study confirm that similar dynamics are underway at the AfDB.

An AfDB project must face 20 formal review and approval steps between the initial request for financing and board approval,[41] including i) initial screening by the country economist; ii) writing and approving the project brief; ii) writing and approving the project identification report (two approvals); iii) writing and approving the project preparation report; writing and approving the project concept note (seven approvals); and writing and approving the project appraisal report (nine approvals including board). In each case, documents must be written and circulated in advance of meetings, and in the case of concept note and appraisal report, peer review and comments incorporated. The appraisal report must also be officially translated prior to the board meeting, adding further weeks of delay. Four or sometimes five country missions are required throughout this process.

The AfDB is similar to the World Bank in terms of loan approval speed, but slower than the other two major regional multilateral banks. The recent experiences of the IADB show what concerted efforts to improve business processes can accomplish. IADB loan processing speed has dropped in half during the last five years, from 12 months in 2009 to under six months in 2012.[42] The AsDB has also revised business processes starting in 2011, shortening the length of loan documents to accelerate preparation and review stages and instituting summary procedures for loans under USD 200 million and other types of lower risk projects.[43] Reforms to AfDB business procedures in 2013 included a number of improvements, including electronic document processing and some changes in the level of approval required for projects of different value.[44] However on the whole the changes are relatively minor and unlikely to result in significant efficiency gains.

Smaller MDBs are frequently much faster. For example, the CAF in Latin America is well-known for approving loans in under three months for most operations, or even under a month when governments make urgent requests.[45] Anecdotal reports suggest that the PTA Bank in southern Africa and BOAD in west Africa—both of which compete with the AfDB for clients—are much faster than the

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[41] AfDB Operations Manual, Revised March 2013.
[42] See IADB's Development Effectiveness Overview, 2010-2013.
[43] Interview, AsDB.
[44] Interviews, AfDB.
[45] See Humphrey and Michaelowa 2013.

AfDB. The fact that these banks have limited or no input from non-borrowing members points to the role of shareholding and governance in loan approval policies.

Project implementation following approval is equally problematic for the AfDB. The average length of time between approval and first disbursement at the AfDB was 11 months in 2013 overall and 16 months for private operations, compared with the AsDB's 10 months in 2012 for all operations.[46] The IADB measures the gap between effectiveness and first disbursement at 21 days for sovereign operations in 2012 and 8 days for non-sovereign, compared to about 60 days for all AfDB operations in the same year.[47]

Bank processes are part of the cause of these delays, and are perceived as such by clients. In surveys, borrower clients fault the AfDB for being below average in terms of processes after loan approval but prior to loan effectiveness as well as procurement and disbursement times after loan effectiveness.[48] Implementation delays result in higher costs—in procurement, AfDB administrative budget, and opportunity costs—and threaten the success of the project.

Loan Pricing and Size

AfDB market-based loans are more attractive than most other financing sources in financial terms. Although the loan terms of different MDBs are not directly comparable, the maturities and interest rates offered by the AfDB's non-concessional window match up well with other MDBs (Table 3),[49] and are far better than the vast majority of African countries can access from commercial banks or through bond issues on global or domestic capital markets. The 10 African countries issuing sovereign bonds on international capital markets between 2007 and 2013 raised USD 8.1 billion at an average interest rate of 6.2 percent and an average maturity of 11.2 years, compared to about 1 percent and 20 years for the AfDB.[50] Traditional bilateral sources of development finance are often at financial terms

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[46] AfDB 2014 Annual Development Effectiveness Review and AsDB 2012 Development Effectiveness Review.
[47] 2012 IADB Development Effectiveness Report.
[48] The Preferred Partner? A Client Assessment of the African Development Bank, 2012.
[49] For a discussion of MDB loan pricing and links to shareholder interest, see Humphrey 2014.
[50] "Sub-Saharan Africa's Eurobond Borrowing Spree Gathers Pace," The Guardian, 26 June 2013.

comparable to the AfDB, though in relatively small quantities, while new bilaterals (notably China and India development and export-import banks) tend to offer terms better than the markets but well above the AfDB,[51] and with significant restrictions on how the resources can be spent. As a result, on purely financial terms AfDB loans appear very attractive.

Table 3. Financial Terms for Variable Lending Rate Non-Concessional Loans, USD (2014)

	Maximum Maturity (Years)	All-In Interest Rate
AfDB	20	0.994% (to end-Jan. 2014)
IADB	25	1.22% (Q1 2014)
AsDB	19	0.57% (March 2014)*
IBRD	18	0.83% (to June 2014)*

Source: Lending rates published on each MDB treasury webpage.

Notes: Loan interest rates are not directly comparable due to variation in terms. Maturity does not include grace period. "All-in" includes annualized value of fees. Terms relate to public sector loans only, and are uniform for all countries. Private sector lending varies by project.

* Rates are for the longest-maturity loan available.

The size of available AfDB loans is an important limitation for borrowers. African countries face a tremendous deficit in infrastructure investment—nearly USD 50 billion a year according to some estimates[52]—and urgently seek financing to close the gap. However, the scale of infrastructure projects and the relatively small envelope of resources the AfDB can offer due to risk and exposure restrictions mean that the bank's loans are not significant enough to meet country demand. Transformative projects in energy generation and transportation, especially those at the regional level that the AfDB is prioritizing, require hundreds of millions or even billions of dollars to complete, in many cases well beyond the AfDB's capacity. This partly explains the willingness of many countries to pay considerably

[51] Brautigam 2009 found that the Chinese Ex-Im Bank offered loans in Africa at an average interest rate of 3.6 percent and a grace period of four years and maturity of 12 years, with considerable variation depending on country and project. As well, the loans often come with requirements to source Chinese labor and inputs, thus further reducing the developmental spin-off for the borrower country.

[52] See for example World Bank 2009.

higher interest rates to new bilaterals such as China or for private bond issues: they can offer the large amounts of resources needed.[53]

Other MDBs have dealt with this problem by seeking to leverage private resources along with their own loans. MDBs can utilize their activities, relationships and regional knowledge to attract and channel other resources into projects, particularly through loan syndication for private sector projects. Syndication generally can take two forms, either as an A/B loan program—wherein the MDB is the lender of record ("A"), and the external financer provides a set amount of resources as part of the overall loan package via the MDB ("B")—or as a parallel loan—wherein the MDB and the external source each conclude separate loan agreements with the borrower, on a project designed and administered by the MDB. The EBRD and especially the IFC have very strong loan syndication programs, while the AsDB is making a concerted push in this direction in recent years (Table 4). Syndication for public sector loans is not currently feasible for MDBs, but may be worth exploring going forward.

Table 4. Syndication Activity in Selected MDBs, 2012

	AsDB	EBRD	IFC
Syndications, USD	USD 200 mln	USD 1.6 bln	USD 2.7 bln
% of non-sovereign loan commitments	2.2%	16.9%	31.8%

Source: Annual reports, 2012.

The AfDB has only recently begun an active syndication program. The guidelines for loan syndication at the AfDB were issued first in 2008, and the first transaction (USD 410 million B loan in South Africa) was not signed until 2011. Since then, only one other transaction has reached signing, the Lake Turkana Wind Farm in 2014 (USD 10 million B loan). Scaling up these activities going forward should be an integral part of the AfDB's push to mobilize greater external resources. The AfDB's syndication team (based in the private sector operations division) is small. This is an area where the AfDB may wish to dedicate resources to hiring staff with considerable private sector

[53] See, for example, the description of a USD 3 billion China Development Bank loan to Ghana in 2012, described by Sanderson and Forsythe, 2013, Chapter 3. This single loan was larger than the entirety of AfDB non-concessional lending in 2013.

experience and connections, as the payoff in terms of maximizing developmental impact with a limited use of risk capital is very high.

Other MDBs have implemented various incentives to mobilize external project resources. The publicized headline financing numbers of the EBRD and IFC—the two multilaterals most successful in this area—are not the amounts of actual direct commitments by the MDBs themselves, but rather the total amount of resources brought to bear for developmental purposes, including both own resources and those brought in through their activities. The AsDB has also begun this practice, a strong signal to its staff and its clients of the priority it is beginning to place on its role as an assembler of development finance, and not just a direct lender. The IFC also gives individual investment officers who originate projects formal credit for all external resources mobilized as a material incentive.[54] The EBRD is currently moving in this direction as well.[55] The AsDB now offers incentives at the level of regional departments, granting an increase of at least 2 percent for two years in the regional allocation over the original amount if certain third-party finance mobilization targets are achieved.[56]

Knowledge Services

A perceived weakness in developmental knowledge and policy advice also limits country demand for AfDB services. As countries move into middle-income status, they increasingly seek out multilateral knowledge as much or more than pure financing. This is a key attraction of World Bank, partly offsetting its lengthy and bureaucratic loan procedures. Extensive interviews with government officials in Latin America highlight the extreme importance they place on knowledge services as a key factor in their desire to engage in operations with the World Bank.[57] The new AfDB Strategy for 2013-2022[58] highlights knowledge products as critical, and focuses on the AfDB as a "knowledge broker" rather than just a direct generator of knowledge itself. While this may be a laudable aim in light of the AfDB's limitations, the strategy does not spell out how this will

[54] Interviews, IFC Treasury.
[55] Interview, EBRD Treasury.
[56] AsDB, Developmental Effectiveness Review, 2012.
[57] The author undertook over 100 interviews with government officials in 10 countries in Latin America and the Caribbean between 2012 and 2014 for academic research and as part of a consultancy project with the IADB.
[58] See AfDB Strategy for 2013-2022: At the Center of Africa's Transformation.

happen in operational terms such that the bank is perceived as providing valuable value-added to clients—essential to maintain close links with middle-income countries.

The AfDB is not well known for its knowledge services, and quality is perceived to be low by clients. In a recent client survey, 90 percent of respondents reported that they either occasionally or never use AfDB statistics and research, due to lack of awareness or a perception that the material was not current or useful to address real-world policy decisions.[59] Similarly, only 24 percent of regional government officials felt that the AfDB provided above-average policy advice, while 42 percent said it was below average.[60] The AfDB's production of research is also weak—only 31 products in 2012, down from 60 in 2009 and well below the 2012 target of 112.[61] These findings are further substantiated by an internal evaluation of the bank's economic and sector work (ESW).[62] The evaluation reported that AfDB ESW production is not well coordinated or thought out strategically within the bank, it does not have high visibility in client countries, and is not well used by AfDB operations staff in conjunction with development operations.

AfDB Financial Policies

A legacy of financial weakness, cautious shareholder-driven policies and the views of capital markets all limit AfDB's room to maneuver in offering financing to member countries. Expanding non-concessional lending to new public and private sector borrowers is essential for the AfDB to increase its relevance and strengthen its finances. However, shareholders have imposed restrictive financial policies that hamstring the AfDB's ability to provide services to Africa through the non-concessional lending window, which in turn further weakens the AfDB's finances.

[59] The Preferred Partner? A Client Assessment of the African Development Bank, 2012.
[60] Ibid.
[61] AfDB 2012 Development Effectiveness Review.
[62] Review of the African Development Bank's Economic and Sector Work, AfDB Operation Evaluations Department, 2013.

Credit Rating

Many of the operational limitations facing the AfDB—in particular restrictions on non-concessional lending to riskier sovereign and non-sovereign borrowers—are motivated by the goal of maintaining its AAA bond rating. Because of the repayment difficulties faced by the AfDB in the 1990s, the relatively high risk of many potential borrowers in Africa compared to other regions of the world and the high concentration of AfDB's loan portfolio, the bank has faced pressure on its AAA rating, and in fact lost it for several years in the late 1990s (Table 5).

Table 5. AfDB Sovereign Rating History (S&P)

1984	1987	1990	1995	2003-14
AA	AA+	AAA	AA+	AAA

Source: S&P Supranationals Special Edition, 2012, p. 8.

The credit rating agencies have modified their criteria for evaluating MDBs in a way that has strongly impacted the AfDB. In the wake of the global financial crisis, credit rating agencies revised their methods for evaluating multilaterals. Rating agencies now pay considerably closer attention to the loan portfolios and other financial ratios of each MDB then they did in the past. The callable capital provided by shareholders is given less weight, and the perceived risks implied by geographic portfolio concentration and operations with the private sector are much more important.[63] Based on these new criteria, Standard and Poor's most recent review[64] downgraded the AfDB's "stand alone" credit rating[65] to AA, meaning another downgrade could result in losing the AfDB's overall AAA rating.

Maintaining AAA has important developmental benefits—notably making it easier to offer low-cost, long maturity loans to borrowers—but it also comes with operational costs. The need to maintain AAA has meant that the AfDB cannot expand lending to some non-concessional countries now badly in need due to country limits, it

[63] Standard and Poor's, 2012.
[64] Standard and Poor's, January 27, 2014.
[65] I.e., not accounting for shareholder guarantee (callable) capital. In essence, the "stand alone" rating evaluates the AfDB as if it was a normal financial institution, without any official backing and based strictly on its financial performance. Shareholder backing via callable capital gives the stand-alone rating an additional boost to arrive at the final overall rating.

cannot open lending to some ADF countries that would be willing to pay a market-based interest rate, and it must be cautious in moving into private sector lending, where demand and potential developmental payoff is huge.

In purely financial terms it does not appear that the AfDB's operational capacity would be undermined by a one- or two-step downgrade, although many shareholders oppose this. The AfDB might expect borrowing costs to increase by somewhere in the vicinity of 50-100 basis points—potentially at the lower end of the range if the downgrade was calculated as part of an announced business strategy with clear goals and strong support from shareholders. In light of other financial options facing many regional borrowers, it is unlikely that such a price increase would have a significant impact on demand for non-concessional lending.[66]

Consider the case of the Andean Development Corporation (CAF): even with a AA- rating operating in a region (Latin America) with more established access to capital markets than Africa, the CAF has a loan portfolio the same size as the AfDB (about USD 16 billion) with lending in about the same number of countries (14 vs. 16). Despite this pragmatic reality, many borrower and non-borrower shareholders are adamantly against permitting a downgrade for a mixture of political and financial reasons.

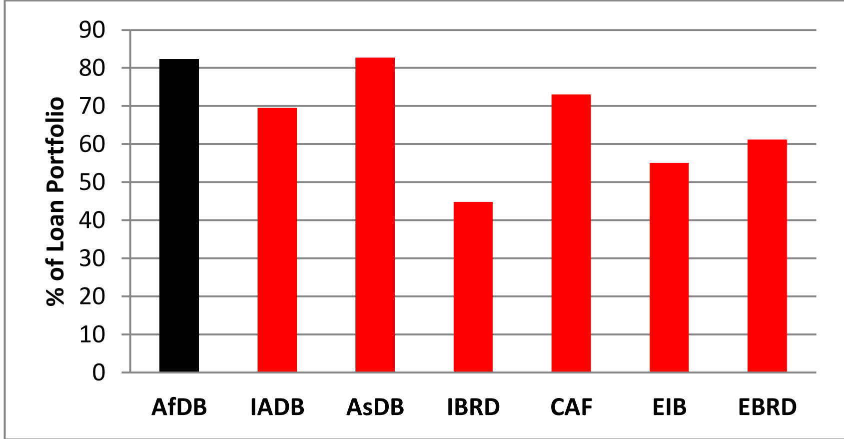
Portfolio Concentration

High concentration in the AfDB's non-concessional loan portfolio and the risk perception of rating agencies further restricts lending. AfDB's non-concessional loan portfolio is highly exposed to its top five borrowers—over 80 percent, similar to the AsDB but well above the IADB and CAF (Figure 8). While portfolio concentration is to a degree inevitable for regional MDBs, two of the AfDB's top five borrowers—Tunisia and Egypt—are currently facing serious socio-political difficulties that negatively impact the perceived riskiness of the bank in the eyes of capital markets. By contrast, the largest borrowers from the other major MDBs (such as China, India, Indonesia, Brazil and Mexico) are all relatively stable politically and

[66] The AfDB's credit rating has no impact on concessional lending rates, since resources for the ADF do not come from bond issues, but rather donor contributions and ADB net income allocations.

economically. Because of this concentration problem, the AfDB is restricted from increasing non-concessional lending to North African countries, although several would borrow more to address pressing investment needs.[67]

Figure 8. Share of Loan Portfolio to Top 5 Countries, 2012



Source: MDB 2012 annual reports.

Note: AfDB figures are as a share of sovereign portfolio—non-sovereign loans are not listed by country in the annual report. IADB, AsDB and CAF include non-sovereign lending, while the IBRD does not.

Concessional vs. Non-Concessional Lending Policy

A number of concessional ADF countries are eager to borrow at non-concessional terms, but have been unable to and are as a result accumulating more expensive private debt (Table 6). These countries are paying several hundred basis points more in interest rates for shorter maturity loans than those offered by the ADB non-concessional lending window, but are not actually permitted to borrow from that window. Not only does this limit the AfDB's developmental relevance in these countries, but it also means they are once again accumulating high-priced, short-term external debt—the

[67] Because of northern Africa's financial needs and the inability of the AfDB to ramp up its own support to its members, the EBRD has launched a new program of lending to the region, even though it falls outside of the region for which that MDB was created. Since 2012 the EBRD has lent over 1 billion in 38 different projects in Egypt, Jordan, Tunisia and Morocco. Shareholders approved beginning Libya's membership process in 2014. See EBRD 2014.

very trend that necessitated the debt relief initiatives of recent years, and one that future budgets must pay for rather than being used for investment or social spending.[68]

Table 6. Selected Recent Sovereign Bond Issues by ADF Countries

Country	Year of Issue	Yield at Issue (%)	Amount USD	Maturity
Senegal	2011	8.75	500 mln	10 yr
Zambia	2012	5.625	750 mln	10 yr
Ghana	2013	7.875	750 mln	10 yr
Nigeria	2013	6.625	500 mln	10 yr
Rwanda	2013	6.875	400 mln	10 yr
Tanzania*	2013	6.46	600 mln	7 yr
Kenya	2014	6.875	1.5 bln	10 yr

Source: Web news reports.

* Tanzania issue was a private placement in the London market.

The AfDB's credit policy was put in place in the wake of the debt crises of the 1980s and 1990s, but no longer fits current reality. Due to difficulties faced by the AfDB in the 1980s and 1990s, when many borrower countries faced severe debt distress and the bank's financial stability was uncertain, shareholders imposed a strict credit policy that follows the same criteria as the World Bank's IBRD/IDA. This policy works well for the World Bank, because the high number of eligible non-concessional borrowers means it has a strong non-concessional portfolio. However, it is excessively rigid for the AfDB because it structurally excacerbates an already concentrated portfolio (as discussed above) and undermines the bank's ability to support regional borrowers.

Management recognized the need for change in the credit policy, and proposed a modification that shareholders approved in May 2014.[69] The new policy opens market-based lending to "green" and "yellow" category countries (see Table 1, above), but with several caveats. Notably, a country must have a "sustainable macroeconomic

[68] The IMF recently warned African countries of the risk of becoming overly reliant on bond markets for sovereign financing (see "IMF warns 'rising' African nations on sovereign debt risks", Financial Times, May 29, 2014).
[69] "Diversifying the Bank's Products to Provide Eligible ADF-Only Countries Access to the ADB Sovereign Window," AfDB/COSP May 2014.

position" and the loan must be approved by the AfDB's Credit Risk Committee[70]—both requirements that offer considerable degree of leeway to the bank. As well, the policy calls for more rigorous assessment of project development impact. How this will play out in practice is not yet clear, but the change is clearly a step in the right direction. If well implemented, this new policy has the potential to increase the AfDB's development impact through projects in more countries, improve its own financial strength and loan portfolio, and reduce the fiscal burden of debt repayments to borrower countries compared to private sources of finance (due to the lower interest rates on AfDB loans).

Private Sector Lending

Private sector activity is growing rapidly and has very high potential development impact, but it also brings risks. The AfDB is shifting to include a significant share of non-sovereign guarantee operations along with the more traditional public sector activity from its non-concessional lending window, as directed by shareholders and similar to the other two main regional MDBs. The AsDB is targeting 25 percent of approvals for private sector operations by 2020,[71] the IADB establishing a more flexible ceiling of around 20 percent of risk capital usage,[72] and the AfDB projecting a rise to 39 percent of annual commitments and 26 percent of the portfolio in non-sovereign operations by 2020.[73] The AfDB has moved most quickly toward reaching these goals—evidence of the very high demand and limited alternative supply of financing available to the private sector in the region (Figure 9).

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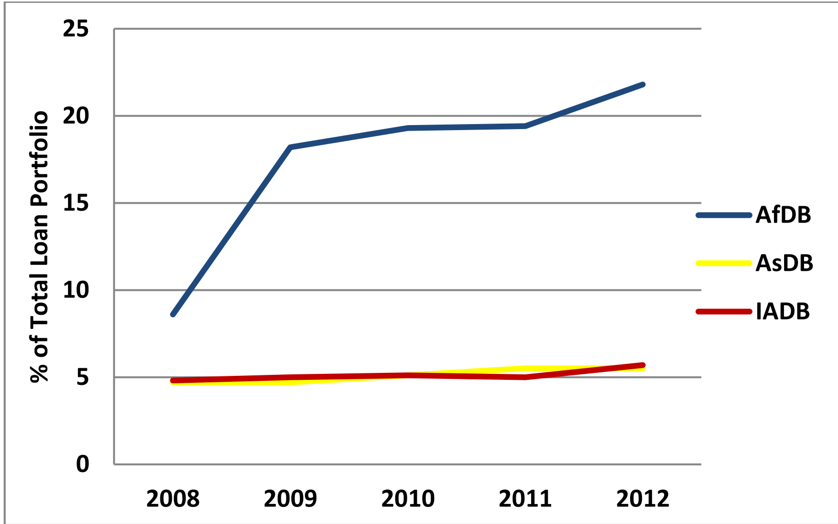
[70] Ibid., p. 4.
[71] AsDB, Mid-Term Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific, 2014, P. 32.
[72] Report on the Ninth Increase in the Resources of the Inter-American Development Bank, 2010, p. 15. However, the proposed "merge out" of the IADB's private sector operations into a new, IFC-type institution may change these targets. See Resolution AG-6/14 and CII/AG-2/14, March 30, 2014, IADB Board of Governors Meeting.
[73] Proposal for a Framework for Managing GCI Resources and Large Loans, 2011, p. 7.

Figure 9. Non-Sovereign Loans as Share of Total Loan Portfolio, 2008-12



Source: Annual reports, 2008-2012.

The sharp increase in private sector activity may have outpaced the AfDB's capacity, and could weaken the overall portfolio. Private sector financing operations are inherently riskier than sovereign-guaranteed loans, and this is particularly true in a less developed region such as Africa. This is not a reason to shy away from them—the AfDB's job is to assume risks in the interests of development—but it does require close attention. The AfDB, with about one-fifth of the non-concessional portfolio dedicated to private sector operations, already has a high level of non-performing loans relative to other MDBs, and most of these loans are to the private sector (Table 7). Ratings agencies have flagged the growth in private sector lending as an area of concern for the AfDB, and are closely watching how the bulge of new private sectors loans will perform in coming years, as loan grace periods finish.[74]

[74] See Standard and Poor's, "African Development Bank," January 27, 2014.

Table 7. Non-Sovereign and Non-Performing Loans (% of Total Portfolio)

	AfDB	IADB	AsDB	EBRD	CAF
% Non Sovereign in Total Portfolio	21.8	5.7	5.5	86.3	19.8
% Non-Performing Loans	2.8	0.6	0	3.5	0

Source: 2013 annual financial statements.

Note: Non-concessional loan portfolio only.

Part of the reason private sector lending is a greater risk at the AfDB compared to other multilaterals is a lack of internal capacity and a culture of public sector lending. The huge and sudden upswing in lending and equity investments for the private sector has occurred in an institution that is designed for public lending. This is exemplified by the fact that the AfDB private sector group does not have its own vice-presidency. By contrast, the AsDB and IADB each have their own vice-presidency, and the World Bank Group's International Finance Corporation (IFC) is an entirely separate institution with a strong culture of specialized expertise that strengthens the quality of private sector activity.[75] In light of the rapid recent and project future growth of this area, and the experiences of other MDBs, upgrading the institutional status of private sector operations at the AfDB should be considered.

[75] The IADB is also moving in this direction. Currently most IADB private sector operations are done through the Ordinary Capital lending window. However in the 2014 annual meeting, shareholders approved a move to "merge out" all private sector activity to the Inter-American Investment Corporation, which has a separate balance sheet and is analogous to the World Bank's IFC. See IADB Resolution AG-6/14 and CII/AG-2/14, March 30, 2014.

Summary of Analysis

The financial and organizational obstacles described above limit the AfDB's ability to take risks in the interests of development in Africa. Despite the AfDB's many strengths—African ownership and legitimacy, convening power, shareholder support, specialized knowledge of African developmental issues, financial capital—it is at the moment falling short of its potential to catalyze improvements to the living standards and economic opportunities of Africans. The factors limiting AfDB effectiveness are especially problematic for middle-income countries borrowing at market-based terms. However, they affect all borrower countries: weak non-concessional project lending means less net income for poorer countries, less developmental experience that can be transferred from middle-income to poorer countries via the AfDB, and a bank unprepared for an increase in countries accessing market-based lending as Africa grows. This also makes the AfDB less useful to non-borrowing shareholders, who contribute capital and take part in the AfDB's governance on the premise that the bank is a key channel to have a positive impact on African development.

The AfDB's performance in non-concessional project lending is also weakening its own financial sustainability, which in turn reduces its potential development impact even further. Not addressing the problems discussed above has the potential to become a vicious cycle, with the AfDB's financial situation deteriorating, leading to greater caution in lending, leading to further deterioration in finances and development impact. Weak demand by some borrowers and inability expand market-based lending to others due to financial caution mean that a sizeable portion of shareholder capital currently sits idle, not being employed in development operations. At the same time, the AfDB is not generating as much net income from non-concessional lending operations as it otherwise could, which could be used to contribute to developmental initiatives for the poorest via the concessional lending window.

Reform Options to Strengthen AfDB Relevance and Effectiveness

The AfDB has laid out a series of strategic goals for the next decade to increase its relevance and developmental impact.[76] The Strategy for 2013-2022 builds on a vision for Africa's transformation that moves beyond the traditional focus of addressing basic needs and easing poverty, and aims to move into a cycle of dynamic, sustainable growth. It posits two key medium-term objectives of inclusive growth and green growth, and orients five operational priorities for the AfDB to achieve these objectives: i) infrastructure development; ii) regional economic integration; iii) private sector development; iv) governance and accountability; and v) skills and technology.

This new strategy comprises a commendable vision for the AfDB's role in the coming years, but it must be supplemented by important reforms if it is to go beyond well-intended rhetoric and move into operational reality. The business practice and financial policy obstacles described in this report will prevent management and shareholders from achieving their goals for the AfDB, if not addressed squarely. The political and economic context facing Africa and the world as a whole has changed radically in recent years, putting considerable pressure on the AfDB. Deep change within the bank is essential such that it is able to play the catalytic development role for Africa that the AfDB was designed to play.

The AfDB should change its operational characteristics such that it can grow in tandem with the rise of Africa, and become a key resource for development financing and knowledge. To do so, the AfDB should seek lessons from the World Bank, IADB and AsDB, as well as multilaterals with a stronger focus on the private sector and greater operational flexibility, such as the Andean Development Corporation (CAF), the European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD). The shareholding and client base of these banks is not a match with the AfDB, but their operational style holds many valuable lessons, as their rapid growth and financial strength attest.

[76] See AfDB Strategy for 2013-2022: At the Center of Africa's Transformation.

Overcoming obstacles requires agreement not only within management, but perhaps more importantly at the level of governance. Like most MDBs, the AfDB's country shareholders have different ideas of how to best achieve institutional and developmental goals. The split is particularly pronounced between shareholders that borrow from the AfDB and those that do not. A further complication is the tensions between Anglophone and Francophone African countries, and between northern and sub-Saharan countries. Until country shareholders reach a degree of shared vision on how to proceed, the AfDB will be unable to make significant progress toward its goals. Each of the reform options reviewed below are followed by a tag indicating the primary responsibility—either shareholders, management or both. Obviously, input and agreement from both levels of governance are important, but in some cases management can take action within the policy framework already agreed upon among shareholders, while in other cases shareholder decisions are essential.

The focus of this report has been on change need to dynamize the AfDB's lending to middle-income countries on non-concessional terms, for reasons discussed above. However, many of these recommendations—particularly those related to business processes and knowledge—pertain equally to the ADF concessional lending window.

AfDB Business Processes

Loan Approval Bureaucracy

The AfDB has made some efforts to improve project processing, but much more is still to be done to be attractive as a source of financing and knowledge provision. The AfDB should look closely at the experiences of the IADB and AsDB to reduce loan approval processes within a similar overall framework of shareholder oversight. Further lessons can be gleaned from more nimble MDBs that are more experienced working with the private sector, such as the CAF, EBRD and IFC.

The trade-off with accelerated project processing is the potential for reduced ex-ante control over the quality of the project itself as well as related impacts, for example related to the environment, social impacts or financial transparency/efficiency. Hence any reforms must

be done with considerable care, balancing the need to reduce bureaucracy with quality control.

- Approval process reforms should seek the minimum level of information, review and approval required to achieve developmental goals. For example, it is not clear that the Board of Executive Directors needs to formally review and approve every project. The EBRD, AsDB and IFC use risk-based processes to accelerate project approvals for certain types of low-risk, small-scale and/or repeater projects.[77] ***Shareholders***

Leveraging Resources

Due to the massive scale of developmental needs in Africa, the AfDB should focus on leveraging external resources through its operations. The AfDB should make a concerted effort to ramp up loan syndication efforts and public-private partnerships (PPPs), leveraging its own resources with those of the private sector to achieve scale. While the main instruments needed to achieve these goals are in place at the AfDB, the deeper shift in organizational culture is still a work in progress.

- Implement incentives for project staff to mobilize external resources as at other MDBs, including crediting investment officers for external resources mobilized (IFC and EBRD) and/or increasing regional allocations if external mobilization targets are reached (AsDB). ***Shareholders and Management***

- Highlight not just the amounts of actual direct commitments but rather the total amount of resources brought to bear due to its activities, including external financing, as at the IFC, EBRD and AsDB. This includes not only private resources but also co-financing with other development lending institutions and bilateral sources. Doing so gives a strong signal to staff and clients of the priority the AfDB places on its role as an assembler of development finance, and not just a direct lender. ***Management***

- Consider dedicating budget resources to hiring staff with considerable private sector experience and connections to help ramp up AfDB's ability to bring in external financing to partner with its projects and bring financing to scale. The payoff in terms

[77] Interviews, EBRD, AsDB and IFC.

of maximizing developmental impact with a limited use of risk capital is very high. ***Shareholders and Management***

Knowledge

More sophisticated, targeted knowledge products and services—paired with financing and stand-alone—will be essential for the AfDB to remain relevant to middle-income countries. Traditional MDB knowledge products—especially the voluminous academic-style reports that take months or even years to produce—are no longer adequate. Government decision-makers face very serious constraints on their time, and require focused, concise and policy-relevant knowledge input. The World Bank has made considerable progress in this area, especially in middle-income regions such as Latin America that would be worth reviewing to glean lessons and good practices.[78] Some examples include: just-in-time policy briefs on key issues facing officials; suites of policy notes for new administrations; programmatic research products to address complex, ongoing challenges; and more formal knowledge exchanges with other MDBs. ***Management***

AfDB Financial Policies

Credit Rating

The AfDB should carefully analyze the costs and benefits of maintaining AAA bond rating. If the goal of a AAA rating inhibits the AfDB from taking the risks it was created to take, should it be maintained? While a downgrade is certainly not desirable, it could have potential benefits if done in a calculated, pre-announced manner with clear financial and developmental objectives. This would increase the AfDB's cost of funding, and hence the cost of its market-based loans, but the example of the CAF in Latin America (rated AA-) clearly demonstrates that an MDB can viably operate in middle-income countries without a AAA rating. The payoff in terms of operational flexibility would be greater lending volumes to i) existing ADB borrowers close to their borrowing limit; ii) current ADF borrowers who would like to take on ADB loan terms; and iii) non-sovereign

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[78] "Innovations in AAA: Repositioning the Bank in a Fast-Growing Region", World Bank OPCS, 2008.

borrowers in both ADF and ADB countries. ***Shareholders and Management***

The AfDB could create a separate private sector institution with its own capital structure to reduce the operational burden of maintaining AAA. This would similar to the IFC within the World Bank Group, and the IIC as part of the IADB.[79] Ratings agencies are specifically flagging the growing AfDB private sector portfolio as an area of concern, and removing this to a separate balance sheet could ease the situation. A new private sector lending wing would have less need to maintain AAA, as it would lend for projects with a clear potential for profit (and hence can charge higher interest rates) and also could differentiate financial terms for each project (unlike the public sector window). This would reduce rating pressure on the remaining public sector-focused institution, as riskier private sector loans would be taken off its balance sheet. ***Shareholders and Management***

A third possibility to maximize the AfDB's balance sheet would be to begin a program of portfolio guarantees, such as is currently under discussion with the Swedish government and the AsDB. The Swedish government is currently considering a proposal to provide a guarantee to back a portion of the AsDB's outstanding loan portfolio. With a AAA-rated country guaranteeing a group of loans, the AsDB will then not need to set aside its own equity capital to cover those loans, freeing up resources to be used for further lending. The operation would help the AsDB address capital constraints that it expects to face starting in 2017, and depending on the loans selected could also help reduce portfolio concentration (see below). While the details have not yet been finalized, the proposal is a creative way for certain shareholders to provide more support to an MDB, without requiring paid-in capital contributions. The AfDB may consider a similar proposal for loans to private sector clients or countries at their limit for market-based lending, thus reducing portfolio risk and concentration. ***Shareholders and management.***

[79] IADB shareholders are currently considering consolidating all private sector activity in a single institution, separate from the Ordinary Capital lending window and similar to the IBRD/IFC model. See "IADB Advances Towards Consolidation of its Private Sector Activities," Press Release March 30, 2014. IADB.

Portfolio Concentration

In light of the greater focus of rating agencies on portfolio characteristics, the AfDB needs to find ways to reduce geographic concentration of non-concessional lending. Reducing portfolio concentration creates a financially stronger loan portfolio, which benefits all borrowers due to greater AfDB financial strength, and it also would create headroom for the AfDB to lend non-concessionally to countries in need who are currently at or near their single borrower limit. The best solution in the *medium term* is to address the causes of reduced demand and restricted supply discussed elsewhere in this paper. In the *short term*, financial innovations could be explored involving exchanging loan exposure with other MDBs. The first two options mentioned below would require addressing a number of complex legal and financial obstacles, but they could alleviate the AfDB's concentration risk:

- An option currently being explored would be to exchange a share of the loan portfolio from countries with high AfDB exposure with another MDB for that of other countries where the AfDB does not face exposure problems.[80] With sufficient caution and care there is no reason this could not work in financial terms, provided both MDBs are willing and matching loan portfolios can be structured. ***Shareholders and Management***
- An even more innovative solution would be to create an established exposure swapping arrangement among several MDBs. This would ease the structuring of closely matching portfolio segments in terms of risk and size and would help not just the AfDB but also other regional MDBs like the AsDB and IADB, which face similar concentration pressures. ***Shareholders and Management***
- As discussed above, the AfDB could follow the lead of the AsDB and propose portfolio guarantee operations with willing donors. ***Shareholders and Management***

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[80] Recent news reports indicate that multilaterals have created a working group to look into the possibility of exposure exchanges. See "Optimizing World Bank Group Resources and Supporting Infrastructure Financing," a report prepared by World Bank staff for the February 2014 G20 meeting.

Concessional vs. Non-Concessional Lending Windows

Opening the non-concessional lending window to select countries currently eligible only for concessional borrowing is a positive step, and serves the interests of all AfDB shareholders. The recent policy change to open the non-concessional window can have multiple benefits: reduce concentration risk of the non-concessional portfolio and strengthen financial stability; reduce the future fiscal burden facing regional borrowing countries to repay private debt; and channel more resources to more countries for achieving development goals. However, the policy offers considerable leeway to different instances of bank management (Treasury, Risk and Operations) for implementation. Management will need to strike the right balance between safeguarding the AfDB's financial stability and the debt load of lower-income countries on the one hand, and increasing the AfDB's development impact and portfolio diversification on the other. ***Management***

Another possible change would be to better leverage ADF resources in combination with non-concessional financing. In a context of declining or at best flat ADF replenishments and massive investment needs in lower-income countries, the AfDB should consider creative options for combining ADF and non-concessional resources. This could be done on an individual project basis or for an entire country portfolio, or some combination thereof. ***Shareholders***

- A portion of ADF resources could be earmarked to provide guarantees or interest rate subsidies to non-concessional lending in ADF countries, as is currently under discussion at the World Bank.[81]
- The AfDB could refine the formula for blending ADB and ADF resources, and including a larger group of countries in a graded blend category. Here the AfDB could learn from the experiences of the IADB's concessional lending window, the Fund for Special Operations (FSO), which uses a more dynamic formula for blending ratios that evolve as country conditions change.[82] This technique utilizes concessional resources more sparingly and leads to a smoother path toward graduation to non-concessional lending.

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[81] Interviews, World Bank.
[82] Interview, IADB.

Private Sector Operations

Mitigating the higher risk implicit in greater non-concessional private sector lending requires a very strong focus on rigorously selecting and preparing projects before committing financing. A number of measures can be taken to improve project quality and minimize risk, including:

- Take a more active role in originating projects that combine high developmental impact with strong financials. AfDB staff—especially private sector specialists based in country offices who are more familiar with local conditions—could be much more active in selecting the best projects to suit AfDB goals. ***Management***
- Consider funding a dedicated private sector project preparation facility (PPF), particularly for non-concessional projects in lower-income countries. While some PPF financing exists,[83] resources are inadequate to the scale and complexity of private sector operations envisaged by the AfDB going forward. Such a fund could be supported with resources either from donors or AfDB net income. This could have an important impact in strengthening the quality of the portfolio. ***Shareholders and Management***
- Create a separate vice-presidency for private sector operations. This would be an important step toward developing a culture of specialized expertise to strengthen the quality of private sector activity—where staff focus not simply on standard loans but rather originating viable projects, selecting the most appropriate financial instrument, and mobilizing third-party resources to reach scale. ***Shareholders and Management***
- A more radical step would be to create an entirely separate institution along the lines of the IFC. The AfDB should keep a close watch on the moves the IADB is making in this direction, to learn from its experiences. This would have the benefit of creating a separate balance sheet that could be structured more appropriately to private sector activity. However, care would be required to ensure that institutional separation does not inhibit coordinating private sector operations with the AfDB's overall development goals. ***Shareholders***

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[83] Notably the ADF PPF and the NEPAD IPPF.

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