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Interview with Nana Spio-Garbrah,
Manager at the African Development Bank Group

AFRICAN DEVELOPMENT BANK GROUP
GROUPE DE LA BANQUE AFRICAINE DE DÉVELOPPEMENT

February 2024 – London, UK

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Q1.

Many of you reading this piece, might have seen articles about innovative ideas being championed by the African Development Bank (AfDB) such as the hybrid capital debt issuance and the re-allocation of Special Drawing Rights (SDRs) held at the IMF. Could you provide some background on these proposals and how they could impact AfDB's (and other MDB's) lending capacity if these proposals are taken on board?

Yes, the African Development Bank has been at the forefront of financial innovation for economic development. We recently launched a sustainable $750 million perpetual subordinated hybrid capital note, making it the first issuance of this type by a multilateral development bank. This transaction demonstrates AfDB's pioneering role in optimizing its balance sheet in line with the G20 Capital Adequacy Framework (CAF) recommendations.

Hybrid capital instruments are an efficient way to increase lending capacity. The instrument is structured to be recognized as 100% equity from an accounting (IFRS) and credit rating agency perspective. It allows AfDB to leverage each $1 received into up to $4 of lending and helps ensure competitive pricing for our clients. The Bank's pioneering work on hybrid capital within the MDB community will surely open the floodgates for our sister institutions to mobilize new financing opportunities for emerging markets in other regions.

Another transformative initiative is the proposed channeling of Special Drawing Rights (SDRs) for climate and development finance. You may recall that following the approval by the IMF Board of Governors in August 2021, following the historic $650 billion issuance of SDRs, the International Monetary Fund's (IMF) quota system was heavily skewed in favour of developed countries, with Africa only receiving $33 billion or 5% of the global amount. IMF member countries have since agreed to channel $100 billion of their unused SDRs through the existing Poverty Reduction and Growth Trust (PRGT) for low-income countries, and through the Resilience and Sustainability Trust (RST). This is good. However, AfDB developed an alternative solution, which consists of channelling SDRs toward MDBs.

Given the MDB business model, we can multiply the SDRs allocated to us by three to four times and transform these resources from static foreign reserve assets into lending instruments at an affordable cost thanks to our AAA rating.

This solution, developed in collaboration with the Inter-American Development Bank, means that for example, $5 billion of SDRs channelled by SDR-rich countries to the African Development Bank can be transformed into $15 to $20 billion of new financing for the African continent - resources that can be used to address climate resiliency and other global goals.

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This solution has garnered strong support from countries such as France, Japan, Spain and the United Kingdom. The IMF Executive Board is expected to opine on the use of hybrid capital as an eligible instrument for the channeling of SDRs, which should help pave the way for other countries to participate in this highly innovative and transformative initiative. This will significantly boost the Bank's lending capacity at a time when MDBs are being asked to do more given the pressing needs facing the African continent. We are glad to have been at the forefront of developing this solution which we hope will indeed help other peer institutions and other emerging markets and regions.

That said, each MDB has its unique balance sheet and risk capital considerations. However, the risk perception surrounding Africa means as the continent's premier AAA-rated financing institution and only dedicated multilateral development bank, we must look to financial innovation to do all we can to meet the continent's needs. We approach this with passion and a sense of urgency.

This mindset and institutional culture is particularly important if we are to play our countercyclical role, which requires us to go into fragile and transition economies as a partner to our regional member countries. Therefore, it is imperative for the African Development Bank to be at the forefront of financial innovation.

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Q2.

How does the African Development Bank view the non-payment insurance product and where can it add value across its balance sheet?

The AfDB is constantly looking to bring in private capital and institutional investor markets to promote access to an African asset class they might not be willing to invest in otherwise.

We work with highly rated counterparties and the reinsurance market to create risk sharing opportunities which improve the AfDB's risk profile as measured by internal metrics such as the Risk Capital Utilization Rate, concentration risk and Weighted Average Risk Rating. Such balance sheet optimization transactions help to reduce the risk capital consumed and creates additional lending headroom for the Bank which in turn, allows us to provide more development assistance without solely relying on additional shareholder capital. In the long-term, replicated balance sheet optimization transactions will sensitize markets to the true risk of investing in Africa which is quite palatable, and help mobilize more resources for climate and overall development.

Our growing relationship with the insurance industry has been pivotal to us achieving our lending targets and to our ability to close several innovative transactions. While we engaged insurers in the past on a portfolio basis, we have begun to build a strong track record with insurers and reinsurers as part of a private sector mobilization strategy which involves deploying non-payment credit insurance at project origination. In this respect, we can synthetically grow our lending headroom towards certain deals and countries by playing a guarantor of record role and syndicating the insurance market behind us. This was the basis of our formation of the Africa Co-Guarantee Platform on the sidelines of the Africa Investment Forum in 2018, for example.

The Africa Co-Guarantee Platform consists of the major risk mitigation providers in Africa namely Guarantco, Africa Export-Import Bank, ICIEC and ATIDI joining forces to scale up their capacity to intermediate risk mitigation solutions towards trade and project finance transactions and sovereign lending. Through the platform, we successfully closed a partial credit guarantee transaction for EUR 195 million to enable the Republic of Benin to mobilize an ESG loan from an international commercial bank, the proceeds of which will be exclusively used to finance green, social and governance projects in compliance with Benin's SDG Financing Framework. The transaction was executed in June 2023 with the participation of ATIDI as a second loss cover provider complementing the ADF first loss guarantee. The mobilization of reinsurers through ATIDI complementing the Fund's guarantee enabled Benin to raise a loan of EUR 350 million at a lengthened tenor and an interest rate estimated at 290bps below its Eurobond yield curve for similar maturities. More recently, we closed another structure for Cote d'Ivoire involving reinsurers mobilized through ICIEC.

Outside of the Africa Co-Guarantee Platform, we have had tremendous success in our partnership with the private insurance market. In December 2022, the AfDB approved a loan of up to USD 100 million to a manufacturing client in Nigeria at a time where there was a growing headroom constraint. We were able to mobilise USD 50 million in insurance cover to allow us to proceed with this transaction which aligns with our 'Industrialise Africa' priority area and will increase the availability of jobs in the country. Similarly, the Bank approved a partial credit guarantee of USD 345 million equivalent in Renminbi to facilitate Egypt's inaugural issuance of a Sustainability Panda Bond of approximately USD 500 million to finance ESG projects under the country's Sovereign Sustainable Financing Framework. Effective in October 2023, Egypt's Sustainable Panda bond is the first ever Panda Bond issued in China by an African sovereign and crowds in capacity from a panel of five private insurers who provided insurance capacity towards scaling up the size of the Bank's guarantee.

Last but not least is our transaction with you, Texel – the landmark Room 2 Run Sovereign (R2RS). In October 2022, the AfDB concluded the structuring and signing of this landmark balance sheet optimization transaction on its sovereign portfolio. The UK's Foreign Commonwealth and Development Office (FCDO) and three private insurers from the London insurance market participated covered a reference portfolio of USD 2 billion of sovereign exposures, freeing up an estimated equivalent amount of additional lending capacity. Under the R2RS, private insurers face the Bank directly covering principal defaults up to USD 400 million on a first loss basis while FCDO is positioned as a second loss guarantor for USD 1.6 billion on the same reference portfolio. That fact that the private market was able to take that first loss risk demonstrates the strong partnership and confidence we have in one another.

Q3.

Based on the G20 CAF report, mobilizing risk transfers for sovereign exposures was viewed as difficult as "the margins on sovereign loans are not sufficient to cover the cost of the insurance". Has AfDB found this to be a stumbling block?

African Development Bank's preferred creditor treatment and historical loan performance has proven to provide sufficient comfort to unlock capacity in our unfunded risk transfer transactions . Our sovereign pricing, as is the case for most MDBs, is public information and currently priced at 80 basis points. This is in line with our mandate and purpose to provide access to low-cost development financing to ensure roads are built, trade takes place efficiently and children can be educated to their fullest potential.

The private sector has an understandably different set of driving forces and pricing against perceived risk. The joy for us is finding where those two forces converge in the proverbial Venn diagram. In some cases, it requires simple education around our historical default rates, cross default provisions and preferred creditor status. As an MDB, the Bank does not write-off sovereign loans owed by member countries and there is no precedent of write-offs in the history of MDBs. In the same vein, MDB loans are not rescheduled by the Paris Club in case of a country default.

All past defaults have been resolved and there have been no new defaults in the last 10 years, including during the COVID-19 pandemic and ongoing Russia-Ukraine conflict. Even Sudan recently resolved its arrears in May 2021. The Bank's Preferred Creditor Status is very active and strong. Furthermore, underlying loans are all guaranteed by the Ministry of Finance of the relevant sovereign shareholder of African Development Bank.

Sovereign loans and guarantees that become 180 days overdue trigger a default, that leads to sanctions and when one sovereign loan or guarantee to a regional member country is in default, the entire portfolio to that country automatically cross-defaults. MDB sovereign transactions are nearly risk-free for insurance market participation and many of our partners can price accordingly. In cases where they may be facing the client directly, as was the case in the 2022 Room 2 Run Sovereign transaction, collaboration with shareholders such as the United Kingdom through the FCDO was key to bringing about a palatable blended pricing.

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Q4.

Blended Finance and structural enhancements such as tranching of risk can help to attract private capital into development finance exposures. How has AfDB used this technique in the past and how could insurance market participants help to leverage such structures?

One of the principal structures where we deployed tranching to attract private sector involvement was the 2018 synthetic securitization transaction under the Room 2 Run program (R2R-SST) of the African Development Bank. It remains the first and only synthetic securitization carried out by a multilateral on its private sector portfolio and marked a major shift in the way MDBs manage their balance sheets to expand lending capacity.

This transaction facilitated the transfer of a portion of the risk embedded in a USD 1 billion portfolio of AfDB loans to a group of private investors namely Newmarket and Africa50. The R2R-SST created an estimated USD 650 million in additional lending headroom at inception where the unlocked risk capital was agreed to be deployed towards renewable energy projects on a best-efforts basis. The tranching was key in that the transaction and was designed with three detachment points.

Firstly, there was a junior tranche retained by the AfDB absorbing losses of up to 2 % (the first attachment point) which corresponded to USD 20 million of protection at origination. This means that the portfolio would have to incur USD 20 million in losses before the investor tranche would be triggered – a highly unlikely scenario even for private sector transactions given the African Development Bank's intense due diligence requirements and the fact the that only well performing and derisked assets were included in the portfolio.

Secondly, there was the mezzanine tranche which was subscribed by an investor group comprised of Africa50 and International Infrastructure Finance Company II (IIFC II), through a Risk Participation Agreement (RPA), covering losses after the junior tranche is depleted, bringing protection to USD 152.5 million at origination.

This was then topped up by a third loss tranche, which was to be provided by the European Commission (EC) through an unfunded guarantee in the very remote case the junior and mezzanine tranche were absorbed.

The subordination of the AfDB to the mezzanine tranche investors is an approach that has worked extremely well in a number of transactions. Our hope is that those investors who have seen the power of the Bank's preferred creditor treatment, including during COVID-19 where there was not a single default, can rise on the risk appetite scale in the next transaction and work with us on a pari passu basis.

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