ADF-13 MID-TERM REVIEW

# Review of the Bank Group's Credit Policy and the Graduation

*Issues Note*

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**AFRICAN DEVELOPMENT FUND**

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# Abbreviations

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| ADF | African Development Fund |
| ADB | African Development Bank |
| CRC | Credit Risk Committee |
| DSA | Debt Sustainability Assessment |
| DSF | Debt Sustainability Framework |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| HIPC | Heavily Indebted Poor Countries Initiative |
| IMF | International Monetary Fund |
| LICs | Low Income African Countries |
| MDRI | Multilateral Debt Relief Initiative |
| NCDA | Non-Concessional Debt Accumulation Policy |
| OECD | Organisation for Economic Cooperation and Development |
| PAR | Project Appraisal Report |
| RAC | Risk-Adjusted Capital Ratio |
| RMC | Regional Member Country |
| UA | Unit of Account |

# Information Note on The Review of The Bank Group's Credit Policy and Graduation

## 1. Background

1.1 Since the 1998 review of the Bank Group's Credit Policy, the macroeconomic performance of most Low-Income African countries (LICs) has significantly improved. In particular, many African countries are now characterised by high economic growth with low or moderate risk of debt distress. This improvement is a result of several factors, including the Heavily Indebted Poor Country Initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI), public financial management and debt management reforms, stronger policies and global economic growth. However, these countries must now invest substantial resources to accelerate the structural transformation of their economies in order to achieve sustained growth. These investments cannot be met from scarce concessional resources.

1.2 This Information Note sets out the rationale for the Bank's 2011 amendment to its credit policy and what has transpired since then. The amendment was made in response to increased demand for resources from low-income Regional Member Countries (RMCs), with many of them indicating they could afford to absorb less concessional funding, especially if funds were allocated to high-return projects.[1] LICs are seeking to boost growth through higher levels of public investment, particularly focused on bridging large infrastructure gaps. They face both a wider range of external financing opportunities and limits on the supply of traditional concessional financing.

1.3 In 2011, the Bank Group amended its Non Concessional Debt Accumulation Policy (NCDA) to provide a more flexible and streamlined approach, to help ADF countries manage their debt sustainably whilst receiving non-concessional financial support. This amendment aligned Bank policy with current practices among peer organisations, including the changes in the IMF's external debt limit policy and concessionality framework. For ADF-only countries with low risk of debt distress ("green light" countries in the Debt Sustainability Framework), greater flexibility was applied to accommodate their non-concessional borrowing needs, reflecting their greater debt management capacity. This shift in Bank practice responded to the changing financing needs of low-income ADF countries at low or moderate risk of debt distress, helping them to meet their development objectives while maintaining a sustainable debt position.

1.4 The amendment helps selected ADF countries to achieve their growth potential and accelerate their pace towards graduation. The limited amount of non-concessional borrowing follows a rigorous evaluation process and is lent on very competitive terms, alongside the use of innovative instruments such as guarantees. In this way, the amendment helps countries improve their debt profile and move towards sustainable debt positions.

[1] African Development Bank: "The Preferred Partner? A Client Assessment of African Development Bank", 2013.

1.5 This Information note provides an update on: (i) the implementation of the amendment to the Credit Policy;[2] (ii) the Country Reclassification exercise; and (iii) the potential implications of both initiatives.

## 2. Implementation of the Amendment to the Credit Policy

2.1 Following the 2014 Bank amendment to its credit policy, two ADB window loans for public sector projects in ADF countries were approved by the Board in the same year. The "Uganda Markets and Agricultural Trade Improvement Programme MATIP 2" and the "Rwanda Transport Sector Support Project" Upgrading of Base Gicumbi-Rukomo-Nyagatare Road Phase I were judged to be viable projects that would make a major contribution to inclusive and sustainable growth, without jeopardizing debt sustainability. Other projects being proposed for financing under the amendment are also expected to demonstrate strong economic viability. Projects from Côte d'Ivoire, Tanzania and Ethiopia, among others, will be submitted this year for Board approval.

2.2 The loans of UA 57,504,234 to Uganda and UA 50,374,409 to Rwanda together constituted 1.1% of the ADB window's public sector outstanding portfolio as at 31 December 2014. The impact of the two loans on the Bank's Standard & Poor's Risk-Adjusted Capital (RAC) ratio is estimated to be positive, increasing it from 17.8% to 17.9%, as a result of the diversification effect. The Bank's Risk Capital Utilisation Rate would rise marginally, from 60.1% to 60.4%, as at 31 March 2015, due to the additional exposure.

2.3 This minimal additional public sector exposure in 2014 therefore has the impact of a marginal increase in the Bank's risk profile. The positive diversification effect of extending non-concessional funding to creditworthy ADF RMCs is expected to assume greater significance as additional high-return, public-sector projects are funded.

2.4 Close coordination at a corporate level will be needed to ensure that selectivity and project viability continue to be the key criteria in developing the pipeline of projects eligible for finance under the ADB sovereign window.

2.5 In addition, the IMF's recent policy reform on the use of conditionality on public external debt in Fund-supported programs (the "debt limits policy") will impact on the Bank's amended credit policy. Countries at low risk of debt distress will no longer be subject to limits on public external borrowing following recent reforms at the IMF. This implies that they will no longer have a negotiated limit for non- concessional borrowing established by the IMF, which is presently one of the criteria of the Bank's amended credit policy. Management is currently reflecting on the potential implications of the IMF reform on the Bank's existing policies.

2.6 Furthermore, Management will continue to enhance staff knowledge and skills on debt management practices and RMC needs. This will strengthen the Bank's advisory services and support the design and implementation of sound investment programs and mid-term debt strategies, as well increasing the Bank's internal capacity for managing the Debt Sustainability Framework (DSF).

[2] The key features of the Amendment to the Credit Policy as well as the policy implementation modalities are presented in annex 2.

## 3. Graduation Framework: Recent Trends and Mid-term Projections

3.1 The Bank Group has developed a new approach to graduation, to accompany RMCs' changing credit status. The objective of the Transition Framework is to ensure a smooth, predictable and sustainable transition through a flexible approach, tailored to specific country circumstances.

3.2 Under the Transition Framework, for each country undergoing changing credit status, a transition program will be drawn up defining the modalities of Bank Group support (such as specialised analytical work, policy advice and dialogue, and technical assistance) and the Bank Group's role in specific areas (for example, on private sector development). The transition program also determines the length of the transition period and the financing mix during this period.

3.3 To ensure a smooth transition for graduating countries, the transition program will involve a phasing out of ADF resources, in parallel to a progressive phasing in of ADB resources. The length of the transition period is determined on the basis of objective socio-economic criteria, with particular attention to a country's need for concessional funds. The socio-economic criteria are likely to include the pervasiveness of poverty, the relative level of human development and the rate of economic growth, as well as the level of financing needs and use of resources. For reversing countries, a transition period is not required as it is important for concessional ADF financing to be made available immediately.

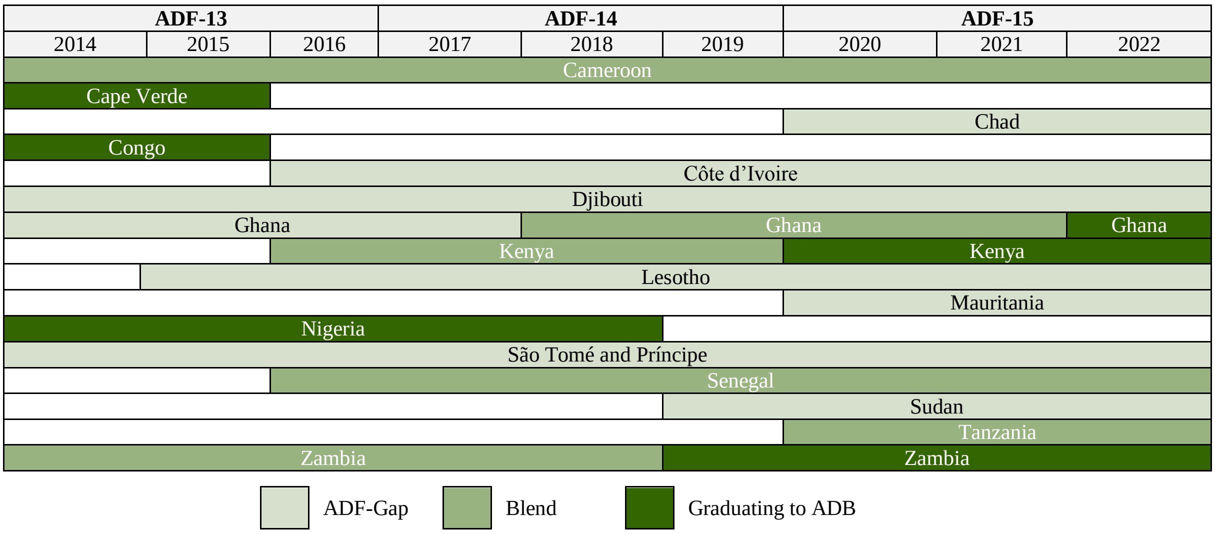
3.4 Graduation enables countries to access a larger volume of resources from the ADB Group than they would receive under the ADF alone. The Transition Framework offers incentives for voluntary acceleration of graduation. Graduating countries which prefer earlier and greater access to ADB resources can choose to forego ADF resources in exchange for ADB resources, following an informed dialogue with the Bank. However, any acceleration of the graduation has to respect the objective of ensuring a smooth and sustainable transition for the country.

3.5 In 2014, based on this Transition Framework and following a rigorous country creditworthiness assessment, Cameroon, Zambia and the Republic of Congo were reclassified. Cameroon has been reclassified as a blend country and a transition period towards ADB status will be defined once the country's GNI per capita remains above the IDA/ADF cut-off for two consecutive years. For Zambia, a phasing out/phasing in transition period of two years has been defined, at the end of which the country will be reclassified as an ADB country. In addition, Management has recently conducted creditworthiness assessments of Kenya and Senegal, to determine whether these two countries meet the conditions to be reclassified as blend countries. The reclassification of Kenya to blend status has been approved with effect from 1st September 2015. The outcome of the Senegal assessment will shortly be submitted to Senior Management for their decision.

3.6 Management forecasts that, by the end of ADF-15, 24 countries would remain ADF-only, 3 countries would be in the process of graduating to the ADB category, 3 could potentially graduate from ADF-only to blend status and 7 countries could potentially be classified as gap countries (ADF-only countries whose income levels are above the operational cut-off but which are not deemed creditworthy for non-concessional financing). In comparison, as of February 2015, 31 countries are ADF-only, 3 are graduating to the ADB category, 2 are blend and 4 are ADF GAP countries. If this projected graduation scenario materialises, it will represent a significant evolution compared to the beginning of ADF-12 when 37 out of the 41 countries eligible for the Fund were ADF-only.

**Table 1: ADF Countries' Ongoing Graduation and Graduation Projections Trend**

**(ADF-13-14-15)**




## 4. Conclusion

4.1. The amendment to the Bank Group's Credit Policy in 2014 has extended the Bank's non-concessionary (ADB) sovereign window to eligible low-income (ADF) countries. This amendment is now enabling low-income countries to access much-needed financial resources to finance critical infrastructure investments on terms that are significantly better than those provided by the market, thereby enabling them to address their development needs while sustaining their debt profile.

4.2. As macroeconomic conditions, growth prospects and debt sustainability improve for most ADF countries, Management will continue to monitor the situation proactively and trigger timely creditworthiness assessments, with the purpose of determining whether the countries should be reclassified.

## Drafting and reviewing team composition

| Members | Unit/Department |
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**Annex I: ADF Countries Eligibility Criteria for Loans from the ADB Sovereign Window**

All ADF countries will potentially be eligible for loans from the ADB sovereign window. However, eligibility does not guarantee access. ADF countries access to ADB sovereign resources, to finance viable projects, will be on a case by case basis. It will be granted subject to the fulfillment of the following criteria:

i. The country must be at low or moderate risk of debt distress, as determined by a debt sustainability assessment (DSA) of the IMF. When such an assessment is not available for a particular country, the Bank will undertake a DSA using the agreed methodology of IMF and discuss the outcome with the Government, the IMF and other relevant agencies.

ii. The country must have headroom for non-concessional borrowing, as determined by a Debt Sustainability Assessment carried out by the IMF and/or the World Bank, and in compliance with the IMF external debt limit policy for countries under Fund-supported programs and the Bank Group's Policy on Non-Concessional Debt Accumulation. For eligible countries, the level of financing will be determined on the basis of this headroom analysis as well as the country's envelope for non-concessional borrowing as determined by the Bank's operational country Limit. Under no circumstances will the financing exceed the operational country limit or its headroom for non-concessional borrowing, whichever is less.

iii. The country must have a sustainable macroeconomic position. Only those ADF countries that have achieved and maintained a stable and sustainable macroeconomic stance, consistent with positive growth prospects, will be eligible to access financing. This will be determined on the basis on a Special Risk Assessment.

iv. The country's request for financing must be approved by the Bank's Credit Risk Committee (CRC), based on the country's risk assessment.

## Annex II: Key Features of the Amendment to the Credit Policy

*Rationale for Revising the Policy*

Over the past decade, Africa's GDP grew on average by 4.7 percent a year. Excluding North Africa, part of which is in transition following the 2011 revolutions, South Africa and other sub-Saharan middle income countries, the LICs' average growth rate increased to 7 percent over this period. This solid growth record has been supported by several factors, including favorable commodity prices which benefited Africa's resource rich countries, the debt relief initiatives provided to most highly-indebted poor countries, and most importantly, sound policies adopted by African governments–both in terms of macroeconomic policies and with structural reforms.

The combination of strong growth, good macroeconomic management and debt relief produced a sharp decline in debt burdens for most sub-Saharan African economies during the last decade. As a result, the debt profile of ADF countries has profoundly changed. The external debt of ADF countries which averaged 90% of GDP in 1995 and 45% in 2005 fell to around 19% in 2012 with HIPC and MDRI debt relief. DSA projections suggest that the medium-term debt outlook for sub-Saharan Africa is generally favorable. These projections indicate that average debt-to-GDP ratios are expected to edge up only marginally in the next five years relative to end-2012 levels.

However, in order to further enhance the structural transformation of its economies, the continent needs to address a number of binding constraints, in particular infrastructure bottlenecks in low-income African countries. By addressing the infrastructure deficit alone, it is estimated that Africa's growth can increase by 2 percentage points per annum. These vast financing needs cannot be met only by scarce concessional resources. Hence, Africa must mobilize and leverage additional financing.

Many RMCs have already taken measures to access a menu of financing options. Some countries are proactively securing creditworthiness ratings from independent agencies, thereby signaling their economic strength. Consequently, at a time of quantitative easing by some OECD countries, this has facilitated their access to international markets for long term finance. These non-concessional resources complement concessional funding in support of Africa's transformation agenda.

It was therefore timely to introduce appropriate flexibility in the Credit Policy to assist those ADF countries that are at low or moderate risk of debt distress to meet their development objectives while maintaining a sustainable debt position. Non-concessional borrowing that is transparently contracted by RMCs with low or moderate-risk of debt distress and strong policies and institutions can complement – but not be substituted to – limited concessional resources to finance high expected development outcomes and projects, in particular those which contribute to the structural transformation of their economies.

*Policy implementation modalities*

Following the Board of Directors' approval of the proposal to diversify the Bank's products through providing eligible ADF-only countries access to the ADB sovereign window, Management elaborated a note on the implementation of the approved proposal to guide staff on a simple step by step procedure to determine ADF-only countries' eligibility to access ADB sovereign window. The process is organized as follows:

Step 1: Rating of the country's risk of debt distress

The rating of a country's risk of debt distress is drawn from the latest Debt Sustainability Assessment, as published by IMF or/and WB. When such rating is not available for a particular country, the Bank will undertake, at the request of the Government, a Debt Sustainability Analysis[3] using the agreed methodology of the IMF to come up with a rating of the risk of debt distress. As per this rating, to have access to ADB sovereign window, the country must be at low or moderate risk of debt distress. All countries that fall in the category of low to moderate risk of debt distress already commence putting in place such an assessment, in partnership with the Strategy and Policy Department (COSP) and other relevant Bank departments.

Step 2: Headroom for non-concessional borrowing

To have access to ADB sovereign window, an ADF country must have headroom for non-concessional borrowing, as determined by the DSA carried out by the IMF or the WB. In consultation with IMF, the World Bank and the Country authorities in charge of debt management, the country team is then called to provide the information related to the existence of headroom for non-concessional borrowing and the country's utilization of the headroom. Access to the ADB sovereign window is granted only when such headroom exists, as agreed with the Board.

Step 3: Special Risk Assessment

If the above two conditions are fulfilled, a special risk assessment of the country is conducted by COSP and the Risk Department (GCRD), based on information provided by the country economist, with the aim of independently evaluating the overall macroeconomic stance and risk profile of the country concerned. The assessment analyzes the factors that affect a government's long term willingness and ability to service its ADB sovereign debt on time and in full. The areas include an assessment of: (i) the structure of the economy and its growth prospects; (ii) the fiscal and balance of payments outlook including vulnerability to shocks; (iii) the debt sustainability including institutional capacity and track record in managing debt as well as the country's capacity to absorb additional debt; (iv) Bank's exposure to the country and the implications of additional lending to the country for the Bank's utilization of its risk capital.

Step 4: Clearance process

In line with the approved proposal by the Board and PD n°03/2012 which assigns the Credit Risk Committee (CRC) responsibility to oversee all credit risk issues related to sovereign and non-sovereign operations financed under the ADB window at project inception and throughout the project life cycle, the Special Country Risk note is submitted to the CRC for discussion and clearance. It should be mentioned that the project appraisal report (PAR) will be called to demonstrate that the project selection adheres to the provision 18 of the Amendment, notably by establishing its viability. Following the CRC clearance, the special risk note is submitted to the Board for consideration, along with the PAR, as part of the approval process for the project.

[3] For a detailed discussion and presentation of the debt sustainability framework, see http://www.imf.org/external/np/pp/eng/2013/110513.pdf