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Debt Sustainability:
Proposed Changes to the Debt Sustainability Framework and the Non-Concessional Borrowing Policy

Discussion Paper

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Executive Summary

This paper responds to Deputies' request that Management examine recent revisions to the Debt Sustainability Framework for Low-Income Countries and the IMF's debt limit policy guidelines with a view to recommending necessary adjustments to the ADF's operational policy. In January 2010, the Boards of Directors of the IMF and the World Bank approved a revised staff guidance note on the application of the Debt Sustainability Framework. The new guidelines consider factors such as remittances, domestic debt, state-owned enterprises, debt held by external private creditors, and the impact of public investments on growth. The guidelines also propose measures to minimize the impact of modest fluctuations in countries' policy and institutional performance ratings on indicative debt distress thresholds. In addition, the IMF amended its external debt limit policy and concessionality framework to more accurately reflect the diversity of country circumstances as regards their debt vulnerability and debt management capacity.

These revisions will impact the Bank Group's operations and policies in three areas. First, the ADF's terms of financing, including grant eligibility, are based on a country-by-country analysis of the risk of debt distress that draws on IMF/World Bank Debt Sustainability Analyses. Second, the Bank Group's Non-Concessional Borrowing Policy is based on the IMF's definition of concessionality, and its design and implementation are closely coordinated with those of International Development Association and IMF policies. Third, the Bank Group's debt management capacity-building initiatives are closely linked to and coordinated with IMF and World Bank activities.

To reflect the operational implications of the revisions to the Debt Sustainability Framework and the IMF's debt limit policy, Management proposes modest adjustments to the ADF's Debt Sustainability Framework implementation modalities and the Bank Group's Non-Concessional Borrowing Policy. Specifically, Management proposes to:

- incorporate the threshold measure designed to smoothen the impact of modest year-to-year fluctuations on countries' Country Policy and Institutional Assessment scores, Debt Sustainability Framework performance classifications, and financing terms;
- expand the Bank Group's participation in Debt Sustainability Analysis missions and other debt sustainability exercises;
- introduce flexibility to the Bank Group's concessionality limits, consistent with the new IMF concessionality framework, to allow eligible beneficiary countries take on prudent levels of non-concessional borrowing; and
- consistent with this flexibility, streamline the disincentive measures of the Bank Group's Non-Concessional Borrowing Policy and further incentivize compliance, especially as regards reporting planned non-concessional borrowing.

Strong debt management capacity is central to the flexibility introduced in the revised non-concessionality framework. While several African low-income countries have improved their fiscal and macroeconomic positions as a result of policy reforms and Heavily Indebted Poor Country/Multilateral Debt Relief Initiative debt relief, many still experience debt vulnerability that is largely the product of structural economic factors and weak debt management capacity. This vulnerability has been exacerbated by the global financial and economic crisis and a concessional financing space that is limited and possibly shrinking. Collective effort by all stakeholders to develop low-income countries' debt management capacity has thus become a priority area of engagement that extends beyond debt relief. In the context of the Bank Group's efforts to promote debt management capacity in regional member countries, Management recommends several targeted enhancements to internal Bank processes, capacity-building measures, and external collaboration initiatives between the Bank and its development partners.

Overall, the Bank Group's approach to these issues remains rooted in its Paris and Accra commitments to donor harmonization and coordination. As such, the adjustments proposed here do not introduce parallel technical or policy frameworks. Instead, they focus on core operational modalities that address the diverse circumstances of regional member countries. They also reflect the Bank Group's capacity and aspirations to play a more substantive role in promoting long-term debt sustainability in beneficiary countries while maintaining a clear division of labor with the World Bank Group and the IMF.

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Abbreviations

ADB	African Development Bank
ADF	African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
ALSF	African Legal Support Facility
CPIA	Country Policy and Institutional Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Country
IDA	International Development Association
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
NPV	Net Present Value
PEFA	Public Expenditure and Financial Accountability
PRGF	Poverty Reduction Growth Facility
RMC	Regional Member Country

DEBT SUSTAINABILITY: PROPOSED CHANGES TO THE DEBT SUSTAINABILITY FRAMEWORK AND THE NON-CONCESSIONAL BORROWING POLICY

1. Background

1.1 In January 2010, the Boards of Directors of the International Monetary Fund (IMF) and the World Bank approved a revised staff guidance note on the application of the Debt Sustainability Framework (DSF) for low-income countries.[1] This followed a comprehensive review, in close consultation with the African Development Bank (ADB or Bank) Group and other multilateral development banks, to enhance the flexibility of the DSF without compromising low-income countries' long-term debt sustainability. The IMF also completed a review of its external debt limit policy in 2009 and adopted a more flexible concessionality framework that takes into account the diversity of country circumstances with respect to countries' debt vulnerability and their capacity to manage public resources. This shift will allow low-income countries with adequate capacity and borrowing headroom to take on additional non-concessional loans going forward.

1.2 The revisions of the DSF and the IMF's debt limit policy have direct operational and policy implications for the Bank Group in three key areas:

- The African Development Fund (ADF or Fund)'s terms of financing are based on a country-by-country analysis of the risk of debt distress that draws on IMF/World Bank debt sustainability analyses (DSAs)[2];
- The Bank Group's Non-Concessional Borrowing Policy is based on the IMF's definition of concessionality and its design and implementation are closely coordinated with the International Development Association (IDA)'s approach[3] [4]; and
- The Bank Group's debt management capacity-building initiatives are closely linked to and coordinated with IDA and IMF activities.

1.3 The Bank Group's approach to integrating the revised DSF and concessionality frameworks are rooted in its Paris and Accra commitments to donor harmonization and coordination. As such, the adjustments proposed in this paper do not introduce parallel technical or policy frameworks but rather focus on applying the IMF-World Bank framework using informed judgment and taking the specificity of African countries into account. The adjustments also reflect the Bank Group's capacity to play a more substantive role while respecting its comparative advantage and a clear division of labor with sister development banks.[5]

1.4 This paper builds on the Eleventh General Replenishment of the African Development Fund (ADF-11) Mid-Term Review paper *Update on ADF Activities in Support of Debt Sustainability*[6] and begins by briefly updating Deputies on recent changes to the DSF's operational modalities and the IMF's external debt limit policy. It then proposes a number of associated harmonization amendments to the Bank Group's Non-Concessional Borrowing Policy. Lastly, it proposes targeted enhancements to internal Bank processes, capacity-building initiatives, and external collaboration between the Bank and its development partners on debt management issues.

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1 International Development Association and International Monetary Fund. January 2010. *Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries*.

2 African Development Fund. January 2005. *Report of the Consultative Meetings on the Tenth General Replenishment of the African Development Fund*. Document ADF/BD/WP/2005/06.

3 International Development Association. June 19, 2006. *IDA Countries and Non-Concessional Debt: Dealing With the 'Free Rider' Problem in IDA14 Grant-Recipient and Post-MDRI Countries*.

4 International Monetary Fund. August 2009. *Debt Limits in Fund-Supported Programs – Proposed New Guidelines*.

5 One of the Bank's key comparative advantages is its strong working relations with its regional member countries, which allow Bank staff to apply informed judgment in case-by-case decisions.

6 African Development Fund. October 2009. *Update on ADF Activities in Support of Debt Sustainability*. Helsinki, Finland.

2. Recent Debt Sustainability Framework Reforms and Their Operational Implications for the Bank Group

2.1 Subsequent to the introduction of the DSF in 2005, the Bank Group, sister multilateral development banks and financial institutions, and many bilateral donors have increasingly used the DSF to determine the financing terms to extend to low-income countries (i.e., their mix of grants and loans). They have also taken complementary actions to enhance the coordination and implementation of the framework: (i) the DSF has increased reliance on forward-looking DSAs since 2007; (ii) the Bank Group and the World Bank have adopted non-concessional borrowing policies; and (iii) ADB staff have taken greater part in World Bank and IMF DSA missions. Meanwhile, in regional member countries, non-traditional donors have increased their role and activities significantly, creating opportunities for increased and diverse sources of development financing for African low-income countries while increasing debt sustainability-related risks and challenges.

2.2 Against this background, in 2009 the IMF and the World Bank assessed the DSF's effectiveness at capturing and forecasting countries' debt vulnerabilities. This exercise was followed in January 2010 by a revised IMF-World Bank staff guidance note that outlined a number of changes to the DSF's analytical methodology and implementation modalities in order to more adequately address (i) country performance threshold effects; (ii) the impact of debt-financed investments on growth; (iii) the effect of remittances on debt sustainability; (iv) state-owned enterprise debt; (v) domestic debt and debt held by external private creditors; and (vi) the views of country authorities. These changes and their implications for Bank Group operations are summarized below.

2.3 <u>Country Performance Threshold Effects:</u> Client countries and the shareholders of participating multilateral development banks had expressed concern about the impact of modest year-to-year fluctuations in Country Policy and Institutional Assessment (CPIA) ratings on debt distress classifications, and by extension, the appropriateness of the financing terms extended by donor agencies. Under the existing methodology, modest fluctuations in a CPIA score that falls near an indicative DSF policy performance threshold (i.e. a score that falls just below or above the performance thresholds of 3.25 and 3.75)[7] could produce a large and sudden shift in financing terms as countries' DSF classification changes from one category to another. When coupled with ADF and IDA grant volume reductions, this shift can create significant financial volatility and complicate development planning and execution.[8]

2.4 To address these concerns, the revised staff guidance note added a trigger designed to limit the impact of minor CPIA fluctuations on annual DSF traffic light country classifications and financing terms. Specifically, beneficiary country performance classifications only adjust immediately when the updated CPIA 3-year moving average breaches the applicable policy performance threshold by more than 0.05. If the breach is equal to or less than 0.05, the country's policy performance classification only changes if the breach is maintained for 2 consecutive years. This amendment applies to improvements as well as to deteriorations in CPIA scores. See Annex I for an illustration of the impact of this trigger on ADF countries.

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[7] The DSF's three performance categories are "strong" (CPIA score of 3.75 or greater), "medium" (CPIA score between 3.25 and 3.75), and "poor" (CPIA score of 3.25 or below). See Annex I for debt distress thresholds.

[8] For illustration purposes, consider a "medium" performing country with a net present value debt-to-export ratio of 130 percent. An immaterial deterioration in this country's 3-year average CPIA score from 3.26 to 3.24 would cause it to be reclassified from a "medium" to a "poor" performer. This would shift the country's debt distress threshold (e.g., from a net present value debt-to-exports ratio of 150 percent to 100 percent) and reclassify the country to "red light" status. In response, the ADF and the IDA would apply a 20 percent grant volume reduction on the overall level of assistance provided. Hence, the country would receive substantially lower gross assistance volumes due to a very minor change in its CPIA score.

2.5 The Impact of Debt-Financed Investments on Growth: According to the revised staff guidance note, DSAs will henceforth more closely examine government efforts to promote an enabling policy environment and governments' ability to capture returns on public investment.[9] This is an area in which the Bank Group could play a more active role. The Economic Development Research Department has undertaken analytical work on growth diagnostics since 2009. While the work program currently focuses on selected West African countries, these efforts could be scaled up in terms of both their thematic scope and their geographic coverage so as to address targeted data demands concerning the DSAs of African low-income countries. These efforts would be closely coordinated with the World Bank and the IMF.

2.6 Remittances: The revised guideline provides flexibility to include remittances in DSAs on a case-by-case basis when to do so meets clearly defined conditions: (i) workers' remittances are a reliable source of foreign exchange; and (ii) breaches of thresholds under the DSA baseline or stress tests, excluding the impact of remittances, are not protracted (i.e. do not extend beyond the currently permissible maximum length of 10 years). In this event, remittances may serve to adjust a beneficiary country's debt distress risk classification. The Economic Research Development Department, in collaboration with the World Bank, has initiated comprehensive studies on remittances and migration in 10 African countries.[10] This research will contribute to each country's DSA. Given the importance of remittances to many beneficiary countries, Management plans to expand these efforts over the Twelfth General Replenishment of the African Development Fund (ADF-12) period and beyond.

2.7 State-Owned Enterprise Debt: The revised guidelines allow analysts to remove a state-owned enterprise's external debt from the DSA, under certain conditions, if the enterprise can borrow without a public guarantee and if its operations pose limited fiscal risk.[11] Bank Group staff experienced in working with state-owned enterprises—such as country economists—will contribute to these aspects of DSAs.

2.8 Domestic Debt and Privately-Held External Creditor Debt: The guidance note reiterates the requirement that all low-income countries' DSAs consider both public domestic debt and public external debt. For the former, DSAs will cover broader public sector liabilities, including those of the central bank, the central government, local and regional governments, and state-owned enterprises. Going forward, DSAs will thoroughly review domestic debt risk when domestic debt stocks exceed 15-20 percent of gross domestic product and/or in the event of a rapid, recent accumulation of domestic debt.[12]

2.9 Country Authorities' Views: The revised guidance note recommends a stand-alone, systematic presentation of country authorities' views in future DSAs. In situations where authorities' views differ significantly from the views of staff, alternative DSA scenarios may be prepared based on those authorities' assumptions.

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[9] World Bank and IMF staff will achieve this by conducting a systematic and realistic assessment that incorporates empirical analysis and draws upon techniques that range from simple growth accounting to more complex, targeted, and resource-intensive methodologies, such as growth diagnostic studies and general equilibrium models.

[10] The 10 African countries are Burkina Faso, Burundi, Ethiopia, Ghana, Kenya, Nigeria, Rwanda, Senegal, South Africa, and Uganda. In Burundi, Ethiopia, Ghana, and Rwanda, data will be drawn from existing household surveys. In Burkina Faso, Kenya, Nigeria, Senegal, South Africa, and Uganda, tailor-made surveys have been conducted.

[11] For each enterprise whose debt could qualify for exclusion from the external DSA, the assessment team would begin by collecting any information that could help it determine the enterprise's fiscal risk profile. This information might relate to (i) managerial independence; (ii) relations with the government; (iii) the frequency of audits; (iv) the publication of comprehensive annual reports and the protection of shareholder rights; (v) financial indices and sustainability data; and (vi) other risk factors determined on a case-by-case basis. By illustration, a state-owned enterprise that carried out uncompensated quasi-fiscal activities or had a negative operating balance would be considered at high fiscal risk.

[12] The guidance note specifically recommended that domestic debt assessments not affect the classification of a country's external debt risk, and by extension, the determination of the appropriate mix of grants/loans.

Operational Implications for the Bank Group and Management's Proposals

2.10 Management proposes to incorporate the country performance threshold effect measure into the DSF's country classification system to ensure harmonization with the IDA and other multilateral development banks. The other DSF reforms do not directly impact the Bank Group's implementation modalities. Rather, they contribute to broader assessments of beneficiary countries' risk of debt distress risk and indirectly feed into the DSF "traffic light" classification system. Therefore, Management does not recommend changes in light of these methodological reforms.

2.11 With regard to implementation, introducing flexibility into the DSF and elements such as remittances and growth analyses into DSAs creates the opportunity for a broader and deeper engagement on the part of the Bank Group. Accordingly, Management plans to further expand the Bank Group's active engagement in DSA missions[13] and other debt diagnostic and advisory activities. The Bank Group will expand its team of debt experts over time,[14] increase debt-related training for country economists, and establish a more structured process for internal and external coordination. The resource requirements of these changes are likely to be modest, since full DSA exercises are completed every 3 years, with less intensive updates compiled annually. In the immediate term, the Bank Group will continue to engage in DSA missions and debt-related activities in select beneficiary countries while expanding its institutional capacity with a view to playing a more substantive role in future. The strategic importance of debt sustainability will also be discussed more comprehensively in the relevant sections of Country Strategy Papers.

3. Non-Concessional Borrowing Policy

The IMF's New External Debt Limit Policy and Concessionality Framework

3.1 The fiscal and external debt situation of several African low-income countries has improved substantially in recent years as a result of Heavily Indebted Poor Country/Multilateral Debt Relief Initiative (HIPC/MDRI) debt relief, improved revenue mobilization efficiency, and strong economic growth. Nonetheless, in the context of the large unmet demand for concessional financing, regional member countries are increasingly facing difficult trade-offs between short-term development financing needs and long-term debt management issues, particularly in light of the global financial crisis and the fast-approaching Millennium Development Goals milestone. Some of these countries are considering the merits and drawbacks of non-concessional loans. At the same time, several African low-income countries that have benefitted from HIPC/MDRI debt relief continue to experience deteriorating debt sustainability outlooks due to existing vulnerabilities and exogenous shocks.

3.2 These circumstances led the IMF to assess changes in low-income countries' financing patterns and to consider the implications of those changes on its policies.[15] The IMF's principal conclusions were that (i) low-income countries' debt vulnerability remains high and calls for continued concessional resources to finance development expenditures, and (ii) the previous one-size-fits-all approach to non-concessional debt limits should be replaced with a more nuanced framework that takes the diversity of countries' circumstances into account. Accordingly, in August 2009, the IMF's Board of Directors adopted new guidelines on debt limits in Fund-supported countries.

[13] Bank Group staff can contribute to various components of the DSA process, such as the design of the macroeconomic baseline, the design of alternative scenarios, analysis of the debt distress rating, and the drafting of the write-up. To date, Bank staff have participated in DSA missions in the Central African Republic, Republic of Congo, Cote d'Ivoire, Guinea, Liberia, and Togo.

[14] These staff members will coordinate closely with country economists and other Bank staff to provide information and guidance for DSA missions.

[15] See International Monetary Fund. 2009. *Changing Patterns in Low-Income Country Financing and Implications for Fund Policies on External Financing and Debt*.

3.3 The IMF's revised debt limit guidelines offer countries with higher public resource management capacity and lower external debt vulnerability the prospect of greater flexibility to take on prudent levels of new non-concessional borrowing. Previously, the contracting of non-concessional debt was uniformly prohibited, while the contracting of concessional debt was without specific limits. Under the new guidelines, the old concessionality limit continues to apply to countries with lower capacity and higher debt vulnerability. This will prevent these countries from accumulating non-concessional loans. In special circumstances, very modest non-concessional loans will be allowed.

3.4 In addition, country DSAs will be used to determine countries' debt vulnerability and a two-step assessment will be used to determine their public resource management capacity. Countries with moderate or low risk DSA ratings ("yellow" and "green light" countries) are automatically categorized as "lower vulnerability" while those with a high risk DSA rating ("red light" countries) are categorized as "higher vulnerability." In the two-step capacity assessment, countries are first categorized as "higher capacity" or "lower capacity" based upon two quantitative indicators: an index of five CPIA components[16] and Public Expenditure and Financial Accountability (PEFA) indicators.[17]

3.5 The IMF's framework utilizes average sub-CPIA and PEFA scores of IDA blend countries (excluding Zimbabwe) to determine a higher public resource management capacity threshold of 3.7 for the sub-CPIA index and 2.6 for the PEFA assessment. The rationale for this approach is that because IDA blend countries enjoy market access to non-concessional financing, they should be seen as having higher capacity to manage those resources responsibly (including full repayment over time). Their average performance scores are therefore a reasonable operational performance classification threshold. Countries that score above the threshold on one indicator and below on the other (the "grey zone") undergo a second step in which additional indicators and/or qualitative assessments are considered.

3.6 The resulting concessionality matrix (Table 1) and debt limit framework provide guidance for (i) determining non-concessional borrowing limits for countries with lower capacity and lower debt vulnerability, and (ii) operationalizing a more nuanced approach (average concessionality requirements or present value targets) in countries with greater capacity.

[16] The sub-CPIA index is made up of the following components: (1) fiscal policy; (2) debt policy; (3) the quality of budgetary and financial management; (4) the quality of public administration; and (5) transparency, accountability, and corruption in the public sector.

[17] PEFA assessments cover 28 indicators grouped into three broad categories: (1) budget credibility, (2) transparency, and (3) budget processes. As of fall 2009, PEFA assessments were available for 57 low-income countries.

Table 1: The International Monetary Fund's Concessionality Matrix and Classification of ADF Countries[18]

		Extent of Debt Vulnerability	
		Lower (Green and Yellow DSF Traffic Lights)	**Higher (Red DSF Traffic Light)**
Capacity	**Lower** sub-CPIA<3.7 PEFA<2.6	Minimum concessionality (loan-by-loan) requirement based on the previous system, but added flexibility for non-concessional external debt (i.e., higher and untied non-zero limits if consistent with the maintenance of low debt vulnerability)	Minimum concessionality (loan-by-loan) requirement based on the previous system likely higher than 35%, with limited or no room for non-concessional borrowing
		***Indicative ADF Country Classification** (existing IMF assessments)*	
		Angola, Central African Republic, Ethiopia, Ghana, Malawi, Mali, Mozambique, Niger, Senegal, Sierra Leone, Tanzania, Uganda, Zambia	*Burkina Faso, Burundi, Comoros, Congo Dem. Rep., Congo Rep., Cote d'Ivoire, Djibouti, Gambia, Guinea, Liberia, Sao Tome & Principe, Togo*
	Higher sub-CPIA>3.7 PEFA>2.6	Minimum average concessionality (total loan) requirement applied to external or total public borrowing; for the most advanced low-income countries, no concessionality requirement and overall nominal debt limit if needed	Overall limit on the present value of external or total public debt or average concessionality at a higher level; for the most advanced low-income countries, ceilings on nominal external or total public debt
		***Indicative ADF Country Classification** (existing IMF assessments)*	
		Cape Verde	*None*

Source: *African Development Bank*

Note: *As of March 2010, the IMF had not produced concessionality classifications for the following ADF countries: Benin, Cameroun, Chad, Eritrea, Guinea Bissau, Kenya, Lesotho, Madagascar, Malawi, Nigeria, Rwanda, Somalia, Sudan and Zimbabwe. ADF=African Development Fund; CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; IMF=International Monetary Fund; PEFA=Public Expenditure and Financial Accountability*

3.7 *Lower Capacity:* Most ADF countries fall into this category. In the case of countries with lower capacity and lower debt vulnerabilities, the new IMF debt limit policy allows customized non-concessional borrowing limits to prevent future deterioration in those countries' DSA risk rating. DSAs will include "realistic" assumptions concerning non-concessional borrowing over the entire 20-year forecasting period[19] and additional "speed bumps" as warranted in countries with large borrowing space (particularly post-MDRI countries whose external debt ratios are far below DSF indicative thresholds). In the case of countries with lower capacity and higher vulnerability, existing concessionality limits will continue to apply with little change.

3.8 *Higher Capacity:* For countries with higher public resource management capacity and lower debt vulnerability, the IMF will apply minimum concessionality requirements to external or total public borrowing levels. The new debt limit policy will allow for the removal of all concessional requirements for those low-income countries with high capacity, high income per capita, strong macroeconomic track record, significant market access, and a satisfactory track record in managing non-concessional financing. For those countries with higher capacity and higher debt vulnerability, the IMF will apply overall present value limits on external or total public debt levels.

[18] As of March 2010.

[19] For inclusion of non-concessional borrowing in DSAs, see, for example, the Ghana 2007 IMF Article IV Report, where non-concessional borrowing is assumed to spread throughout the entire 20-year forecasting period. International Monetary Fund. June 2007. *Ghana: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ghana*. IMF Country Report No. 07/210

Implications for ADF Operations and the Bank Group's Non-Concessional Borrowing Policy

3.9 In practical terms, the IMF's new debt limit policy will have a modest impact on ADF operations and the Bank Group's Non-Concessional Borrowing Policy in the near term. Nonetheless, given its potential implications for the Bank Group's Non-Concessional Borrowing Policy over time, this paper proposes a number of adjustments and new measures to integrate the new IMF guidelines and ensure harmonization across sister multilateral development banks. The two main areas of consideration are (i) selecting metrics to determine capacity thresholds; and (ii) ensuring an appropriate mix of disincentive measures to promote compliance, especially in light of the additional flexibility in concessionality limits for some regional member countries.

I. <u>Determining Financial Management Capacity Thresholds</u>

3.10 To determine appropriate public resource management capacity indicators for regional member countries, Management first explored whether the Bank Group should pursue an approach other than the IMF's, i.e., average IDA blend sub-CPIA and PEFA country scores.[20] There are only three ADF blend countries: Cape Verde, Nigeria, and Zimbabwe. Because of its arrears status, its lack of creditworthiness, and its inability to access ADB and World Bank loans, Zimbabwe is a notional blend. As for Nigeria, while it remains an ADF blend country, it was reclassified as an IDA-only country in 2006. This leaves Cape Verde as the only African country classified as blend by both the World Bank Group and the ADB.

3.11 Management has examined several scenarios for ADF blend countries. First, utilizing an average ADF blend threshold based on Nigeria and/or Cape Verde would produce a substantially *higher* performance threshold for the sub-CPIA index (Table 2).[21] If Zimbabwe were included (in contrast to IMF practice), the related ADF blend sub-CPIA index thresholds would become substantially *lower* than those produced under IMF guidelines.

Table 2: Financial Management Policy Capacity Thresholds[22]

	Sub-CPIA Index	
Country Category	**World Bank Data**	**ADB Data**
PRGF-Eligible	3.2	-
IDA-Only *	3.1	-
IDA Blend	**3.7**	**-**
ADF-Only	3.0	3.3
ADF Blend		
Cape Verde, Nigeria, Zimbabwe	3.0	3.2
Cape Verde, Nigeria	4.0	4.1
Cape Verde	4.3	4.5

Source: *World Bank and African Development Bank staff calculations*

Note: *ADF=African Development Fund; CPIA=Country Policy and Institutional Assessment; IDA=International Development Association; PEFA=Public Expenditure and Financial Accountability; PRGF=Poverty Reduction and Growth Facility*

[20] Currently, the following countries are classified as IDA blend countries: Armenia, Azerbaijan, Cape Verde, Dominica, Georgia, Grenada, India, Pakistan, Saint Lucia, Saint Vincent, Vietnam, Uzbekistan, and Zimbabwe. Every country, with the exception of Zimbabwe, has access to the World Bank window. IMF debt limit guidelines exclude Zimbabwe from IDA blend score calculations.

[21] Specifically, the sub-CPIA rating threshold would exceed 4.0, versus 3.7 for IDA blend countries.

[22] The figures are based on 2008 World Bank and ADB CPIA data.

3.12 In light of these issues, Management recommends that the average IDA blend score be applied to determine the "higher" public resource management capacity threshold and associated ADF implementation modalities. Furthermore, Management recommends that the Bank Group utilize the World Bank's CPIA data to determine country scores for the sub-CPIA index. This is important because the annual CPIA assessments conducted by the Bank Group and the World Bank seldom produce identical scores.[23] Using the ADB's CPIA data would result in different Bank Group and World Bank country classifications. For instance, the World Bank's 2008 sub-CPIA data would cause ten ADF countries to be classified differently (Annex II).[24] Both of these proposals aim to ensure harmonization with the IMF and sister multilateral development banks and the consistent application of concessionality limits across countries. The Bank Group would continue to use its CPIA country scores for its performance-based allocations.

II. <u>Adjustments to the Bank Group's Non-Concessional Borrowing Policy Measures</u>

3.13 Measures from the Bank Group's Non-Concessional Borrowing Policy are built around four complementary components (Annex III): (i) strengthening partnerships and coordination; (ii) strengthening reporting and monitoring; (iii) capacity building; and (iv) applying disincentive measures. The new IMF guidelines do not directly impact the first three policy measures, which remain valid. Hence, the adjustments discussed in this section relate specifically to the Bank Group's Non-Concessional Borrowing Policy disincentive measures.

3.14 Overall, Management proposes to adopt the IMF concessionality framework as discussed in paragraphs 3.4 to 3.7 to guide the Bank Group's decisions as regards regional member countries' non-concessional borrowing. Management also proposes to use an integrated Non-Concessional Borrowing Policy Matrix (Annex IV) that combines the new concessionality framework with the specific disincentive measures presented below. These measures would continue to be implemented in close coordination with the IMF and the IDA.

3.15 Table 3 summarizes current Bank Group Non-Concessional Borrowing Policy disincentive measures and the areas where adjustments are warranted in light of the new concessionality framework. To summarize, existing disincentive measures would be maintained for "red" and "yellow light" countries irrespective of their public resource management capacity[25] but would make some changes for "green light" countries. This approach is based upon the Bank Group's existing Non-Concessional Borrowing Policy rationale of promoting long-term debt sustainability and addressing free-rider and cross-subsidy concerns.

[23] For ADF countries, the correlation between World Bank and ADB sub-CPIA index scores is 0.77. The correlation between overall CPIA scores is 0.78.

[24] The ten countries are Benin, Kenya, Liberia, Madagascar, Mali, Rwanda, Senegal, Tanzania, Uganda, and Zambia. World Bank CPIA data was not available for Liberia in 2008.

[25] Under the new IMF concessionality limit guidelines, "yellow light" countries are classified as having a lower external debt vulnerability. However, the Bank Group recommends that existing Non-Concessional Borrowing Policy disincentive measures be maintained for these countries to address free-rider concerns and promote prudent long-term debt sustainability.

Table 3: The Bank Group's Current Non-Concessional Borrowing Policy Disincentive Measures and Proposed Adjustments

DSF Traffic Light Status	Current Disincentives	Proposed Adjustments
Red-Light RMCs	*Step-1, low-level breach* : Increase volume discount on entire allocation from 20% to 40%	Maintain current measures
	Step 2, medium-level breach : Increase volume discount on entire allocation above 40%	
	Step 3, medium-level breach : Apply Step 2 and lower maturity from 50 to 20 years	
	Step 4, high-level breach : Apply Step 3 and increase interest rate to 200 basis points below ADB fixed rate	
	Repeated breach: Extend/deepen volume reduction or harden terms	*Repeated Breach:* Suspend ADF grant access and harden terms
Yellow-Light RMCs	*Steps 1 and 2* : Same measures as for red-light RMCs concerning the grant component *Step 3 and 4* : Same measures as for red-light RMCs	Maintain current measures
	Repeated Breach: Extend/deepen volume reduction or harden terms	*Repeated Breach:* Suspend ADF grant access and harden terms
Green-Light RMCs	*Step 1, low-level breach* : Apply moderate terms (lower maturity from 50 to 40 years, apply 10-year grace period, charge 0.75% service charge and 0.5% commitment fee) with a grant element less than 60%	Eliminate Step 1
	Step 2, medium-level breach : Apply hardened terms (lower maturity from 40 to 20 years, apply 10-year grace period, charge same fees) with a grant element less than 45%	Maintain Steps 2 and 3
	Step 3, high-level breach: Harden terms further (apply Step 2 and increase the interest rate to 200 basis points below the ADB fixed rate) with a grant element less than 20%; or, possibly apply a volume discount for fragile post-MDRI countries	
	Repeated breach: Extend/deepen volume reduction or harden terms	*Repeated Breach:* Extend/deepen hardened terms; apply volume discount for fragile post-MDRI countries
All ADF-only RMCs	*Non-reporting:* No disincentives	*Non-reporting:* Reduce ADF nominal allocation by 10%

Source: *African Development Bank*

Note: *ADB=African Development Bank; ADF=African Development Fund; MDRI=Multilateral Debt Relief Initiative; DSF=Debt Sustainability Framework; RMCs=regional member countries*

3.16 Currently, the Non-Concessional Borrowing Policy's disincentive measures reflect two factors: the magnitude of the breach relative to the previous standardized IMF concessionality limit of 35 percent[26] and the country's ADF allocation. The Bank Group will continue to apply this general approach going forward. However, the previous one-size-fits-all concessionality limit will be replaced by country-specific limits based upon each country's public financial management capacity, its debt vulnerability, and its DSA profile.[27]

[26] "Low" refers to a breach where a non-concessional loan has a concessionality level close to 35 percent and is small relative to the country's ADF allocation. "Medium" applies where the concessionality level is much less than 35 percent and/or the loan is large relative to the country's ADF allocation. "High" is when the concessionality level is much less than 35 percent and/or the loan is a multiple of the country's ADF allocation.

[27] The IMF will establish these country-specific concessionality limits annually.

3.17 For “green light” countries with *lower* public resource management capacity,[28] Management proposes that moderate disincentive measures be eliminated and stronger ones be maintained. The need for moderate disincentives will be negated by the flexibility introduced in the revised concessionality limit; furthermore, moderate disincentives have had limited effect.[29] For “green light” countries with *higher* capacity, Management proposes that moderate disincentive measures be eliminated and stronger ones be applied in light of breaches of IMF and Bank Group concessionality limits in the previous year. Overall, this approach will give regional member countries the flexibility to access prudent levels of non-concessional financing while practicing rigor with respect to the sustainability of their long-term debt.

3.18 In addition, to gradually improve transparency and communication with national authorities, Management proposes modest adjustments to non-concessional borrowing reporting requirements. The original Non-Concessional Borrowing Policy did not outline procedures in the event of non-reporting. Management now proposes two measures to maintain incentives for full reporting and to uphold the sanctity of Bank Group contracts while not overly reducing recipient countries’ assistance volumes.

- If a “red light” or “yellow light” country breaches the reporting requirement on planned non-concessional borrowing, the ADF will reduce its nominal ADF grant allocation by 10 percent.[30]
- If a “green light” country breaches the reporting policy, the ADF will reduce its nominal loan allocation by 10 percent.

4. The Bank Group’s Role in Promoting Debt Management Capacity

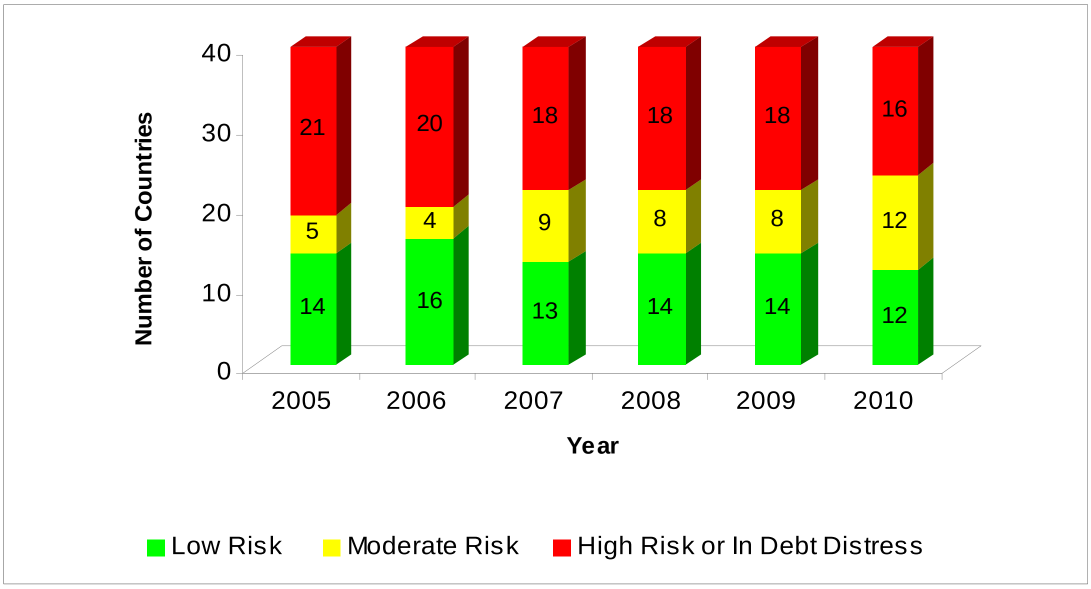
4.1 There is a demonstrated need for the Bank Group to scale up its role in building regional member countries’ debt management capacity. According to 2009 CPIA scores, over half of ADF countries rate “poor” or “medium” with respect to their debt policy performance. Furthermore, many countries continue to experience significant debt vulnerability and the risk of debt distress, even after receiving substantial HIPC/MDRI assistance in recent years. In many countries, this vulnerability has been exacerbated by the global financial and economic crisis. As of end-2009, 13 of 22 post-completion point HIPCs were rated as having a “high” or “moderate” risk of debt distress. A review of DSF risk classifications of the DSAs of the Bank’s 40 ADF countries between 2005 and 2010 also shows that the number of green and red light countries has remained fairly constant, despite 12 countries having reached the completion point or decision point during that period (Figure 1). In the 2010 DSF classification update, three countries’ DSA risk ratings improved from red to yellow (Central African Republic, Chad and Rwanda) while another three countries’ ratings deteriorated (Angola and Ghana’s ratings went from green to yellow and Burkina Faso’s rating went from yellow to red).

[28] Of the countries classified in this category, the Bank Group and the World Bank have already applied moderate terms to Ghana. In addition to Ghana, the World Bank applied hardened terms for Angola in 2007, prior to the Bank Group’s adoption of its Non-Concessional Borrowing Policy.

[29] The reduction in loan maturity from 50 to 40 years has a negligible impact on overall concessionality levels. In essence, this ADF disincentive produces terms equivalent to regular IDA credits. The change would bring the Bank Group’s Non-Concessional Borrowing Policy in line with comparable IDA policy.

[30] In the event of actual non-concessional loan transactions, this non-reporting disincentive would be applied in tandem with the original Non-Concessional Borrowing Policy’s 20 to 40 percent grant volume reduction.

Figure 1: Trend in Risk of ADF Countries' Debt Distress Classification, 2005-2010



Source: *African Development Bank*

Note: *Six countries changed traffic light status in 2010 compared to their 2009 classification. Ghana and Angola changed from green to yellow; Burkina Faso changed from yellow to red; and the Central African Republic, Chad and Rwanda changed from red to yellow. ADF=African Development Fund*

4.2 Currently, the Bank Group's capacity to implement substantial debt management initiatives is fairly limited. While the Bank Group's governance portfolio supports downstream public finance reforms in beneficiary regional member countries, the number of Bank staff with debt management expertise is small. For that reason, the Bank Group's participation in joint IMF-World Bank DSA missions in recent years has been mostly ad hoc. At the strategic level, an increased role in debt management capacity building is fully consistent with Levels 1 and 3 of the Bank Group's Governance Strategic Directions and Action Plan 2008-2012.[31] These levels seek to help regional member countries strengthen country systems and their capacity to manage public resources and aim to support regional initiatives to improve economic and financial governance.

4.3 The Bank Group therefore intends to pursue several work streams to expand its role in building regional member countries' debt management capacity:

- It will expand debt management capacity-building activities within its broader governance portfolio.
- It will finalize formalities for membership in the Debt Management Facility and possibly take on a donor coordination role in selected regional member countries.
- It will enhance partnerships and synergies with the other multilateral development banks, including the IDA's Debt Reduction Facility, to address commercial debt issues in HIPCs.
- It will deepen partnerships with non-traditional donors to promote debt management capacity building and information-sharing.

4.4 *Expanding debt management capacity-building programs within the Bank Group's governance portfolio:* The Bank Group will further expand its financial governance activities to better address regional member countries' debt management issues. Governance programs now focus mainly on economic governance and public financial management, especially revenue and expenditure management, and increasingly the business environment. In line with the Governance Strategic Directions and Action Plan 2008-2012, efforts are being made

[31] African Development Bank. 2008. *Governance Strategic Directions and Action Plan: GAP 2008-2012.* ADF/BD/WP/2008/40.

to expand governance programs to include external and domestic debt management issues. The Bank Group's governance portfolio interventions will promote debt sustainability by developing appropriate debt management policies and strategies through policy-based programs and policy dialogue; restructuring and strengthening the capacity of regional member countries' debt management units; and developing effective legal and regulatory debt management frameworks thought capacity-building projects. The Bank is also working with and through Africa Regional Technical Assistance Centers (AFRITACs) to leverage additional resources, particularly for technical assistance related to sound debt management.

4.5 *Participating in the Debt Management Facility:* As reported at the ADF-11 Mid-Term Review, the Bank Group is in the process of becoming a donor and a key partner in the Debt Management Facility. This will provide the Bank Group with a coordinated and cost-effective way to address regional member countries' needs while deepening its expertise. The Bank Group's role and participation will focus on two areas: (i) upstream work in debt diagnostics, technical assistance, and capacity building; and (ii) knowledge production and dissemination. The Bank's participation will allow it to provide strategic support for debt management reform and capacity-building efforts at the country level. Over time, the Bank Group could assume a donor coordination role for Debt Management Facility activities in targeted regional member countries and could help countries share lessons learned.[32]

4.6 *Strengthening partnerships and synergies with other multilateral development banks, including the IDA Debt Reduction Facility, to address commercial debt issues in HIPCs:* The Bank Group is working with the World Bank and the IMF to assume a lead role in coordinating support for African governments' efforts to better address debt management issues and thus increase their capacity to predict debt trends and keep indebtedness within sustainable limits. In particular, the Bank Group has been instrumental in creating the African Legal Support Facility (ALSF), which increases regional member countries' access to sound technical legal advice when dealing with debt recovery lawsuits. It is common for so-called vulture funds to purchase the debt of weak debtor nations at a heavy discount and then sue those countries to recover the debt at full face value plus interest and penalties. The ALSF is structured as an independent entity, legally distinct from the Bank. It will act as a clearinghouse for qualified legal assistance in the defense of vulture fund lawsuits, creating African capacity to both defend the suits and negotiate complex commercial contracts and concessions on a level playing field. It will also establish a knowledge database that will enhance and entrench capacity-building activities.

4.7 *Increasing partnerships and coordination with non-traditional donors:* Non-traditional donors offer African countries extensive benefits beyond discrete development financing. These benefits include greater trade and investment flows,[33] technology transfers, and South-South policy dialogue. The Accra Agenda for Action highlighted the need for stronger partnerships with emerging donors. The Bank Group is well placed to assume a more strategic and catalytic role in engaging non-traditional donors in Africa. It already has strong partnerships with a number of emerging donor agencies, inter alia through the joint implementation of development projects and programs. Going forward, Management plans to deepen these partnerships to include debt management capacity-building activities and more comprehensive information exchanges. Specifically, the Bank Group will establish bilateral and possibly multilateral discussion fora with leading non-traditional donors and pursue joint action plans to further build debt management capacity in ADF beneficiary countries. These efforts will serve to inform regional member countries of best practices and experiences from emerging donor governments concerning the development of sound debt management policies and institutions.

[32] In addition to Debt Management Facility programs, many bilateral donors have active debt management programs in the region. For example, France, the United States, and the United Kingdom have technical assistance programs in the areas of taxation, debt, and capital markets.

[33] For example, China-Africa trade has grown exponentially in the last few years. Africa's imports from China increased from US$7.8 billion in 2003 to US$48.6 billion in 2008, while Africa's exports to China increased from US$7.1 billion in 2003 to US$43.4 billion in 2008. Overall, Chinese foreign direct investment in Africa reached US$5.5 billion in 2008.

5. Conclusion and Issues for Consideration

5.1 Management has examined the operational and policy implications of recent revisions to the World Bank/IMF's DSF and the IMF's new external debt limit policy guidelines. Taking regional member countries' particular needs and circumstances into account, and respecting its Paris and Accra commitments to donor harmonization and coordination, Management proposes to

- incorporate the CPIA threshold effect measure into the DSF classification system to harmonize Bank classifications with the classifications of the IDA and other multilateral development banks;
- give some beneficiary countries the flexibility to contract prudent non-concessional borrowing by aligning Bank Group Non-Concessional Borrowing Policy measures and objectives with the new IMF concessionality framework;
- use average IDA blend scores and World Bank CPIA data to determine public financial management performance thresholds for the concessionality framework and Non-Concessional Borrowing Policy measures; and
- eliminate moderate disincentive measures for "green light" countries, maintain other Non-Concessional Borrowing Policy measures, and apply disincentive measures in response to breaches of the Bank Group's non-concessional loan reporting requirements.

5.2 Deputies are invited to take note of this report and endorse Management's proposed operational enhancements and policy adjustments.

Annex I: The Impact of Applying the Proposed Policy Performance Threshold Measures on ADF Countries

In this annex, we illustrate how Management's proposed CPIA threshold measures would have impacted four ADF countries: the Democratic Republic of Congo, the Gambia, Madagascar, and Zambia (Table I-1). These countries' CPIA scores in the 2006-2009 period placed them within 0.05 of the Debt Sustainability Framework's performance category thresholds of 3.25 and 3.75. Only Zambia maintained a CPIA moving average score above the threshold for two consecutive periods: under the proposed changes, this would have classified it as a "strong" performer. The Democratic Republic of Congo and the Gambia would have maintained a "poor" performance category classification. Lastly, Madagascar would have maintained a "strong" performance rating despite its 3-year moving average score decline to 3.73 over the period.

Table I-1: Indicative Impact of Policy Performance Thresholds

No.	Country	Moving Avg (2006-2008)	Moving Avg (2007-2009)	Distance from Closest DSF Indicative Threshold	Proposed Threshold Measure - Potential Impact	Breach for 2 Consecutive Years
1	Angola	3.02	3.15	-0.10	No	-
2	Benin	3.94	4.04	0.29	No	-
3	Burkina Faso	4.03	4.13	0.38	No	-
4	Burundi	3.11	3.07	-0.18	No	-
5	Cameroon	3.54	3.66	-0.09	No	-
6	Cape Verde	4.30	4.38	0.63	No	-
7	Central Afr. Rep.	2.74	2.86	-0.39	No	-
8	Chad	3.02	3.09	-0.16	No	-
9	Comoros	2.41	2.44	-0.81	No	-
10	Congo, Dem. Rep.	3.24	3.30	0.05	Yes	No
11	Congo, Rep.	2.76	2.81	-0.44	No	-
12	Cote d'Ivoire	3.04	3.14	-0.11	No	-
13	Djibouti	2.70	2.82	-0.43	No	-
14	Eritrea	2.41	2.40	-0.85	No	-
15	Ethiopia	3.49	3.53	-0.23	No	-
16	Gambia, The	3.23	3.26	0.01	Yes	No
17	Ghana	4.12	4.17	0.42	No	-
18	Guinea	3.12	3.16	-0.09	No	-
19	Guinea-Bissau	2.89	3.03	-0.23	No	-
20	Kenya	3.94	4.00	0.25	No	-
21	Lesotho	3.73	3.74	-0.01	No	-
22	Liberia	3.48	3.60	-0.15	No	
23	Madagascar	3.78	3.73	-0.02	Yes	No
24	Malawi	3.55	3.60	-0.15	No	-
25	Mali	4.05	4.15	0.40	No	-
26	Mauritania	3.59	3.59	-0.16	No	-
27	Mozambique	3.60	3.61	-0.14	No	-
28	Niger	3.53	3.60	-0.15	No	-
29	Nigeria	3.59	3.65	-0.10	No	-
30	Rwanda	3.94	4.07	0.32	No	-
31	Sao Tome and Principe	3.27	3.33	0.08	No	-
32	Senegal	3.97	4.02	0.27	No	-
33	Sierra Leone	3.28	3.33	0.08	No	-
34	Somalia	1.00	1.07	-2.18	No	
35	Sudan	2.68	2.66	-0.59	No	-
36	Tanzania	3.71	3.97	0.22	No	-
37	Togo	3.23	2.93	-0.33	No	-
38	Uganda	3.63	4.10	0.35	No	-
39	Zambia	3.81	3.80	0.05	Yes	Yes
40	Zimbabwe	2.35	1.79	-1.46	No	-

Table I-2: Debt Sustainability Framework Debt Distress Thresholds

	Indicative Policy-Dependent Thresholds		
Debt indicators	**Low CPIA ≤ 3.25**	**Average 3.25<CPIA<3.75**	**High CPIA≥3.75**
NPV of Debt/GDP (%)	30	40	50
NPV of Debt/Export (%)	100	150	200
Debt Service/Export (%)	15	20	25

Source: *African Development Bank*

Note: *CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; GDP=gross domestic product; NPV=net present value*

Annex II: Country Capacity Classifications: The Impact of the Bank Group's Sub-Country Policy and Institutional Assessment Data

	Sub-CPIA Index		Classification Implications		
	AfDB Data	**World Bank Data**	**AfDB Data**	**World Bank Data**	**Difference**
Angola	2.9	2.7	Lower	Lower	-
Benin	4.3	3.5	Higher	Lower	**Yes**
Burkina Faso	4.2	3.8	Higher	Higher	-
Burundi	3.1	2.8	Lower	Lower	-
Cameroon	3.6	3.1	Lower	Lower	-
Cape Verde	4.5	4.3	Higher	Higher	-
Central African Republic	2.8	2.4	Lower	Lower	-
Chad	2.8	2.4	Lower	Lower	-
Comoros	2.0	1.9	Lower	Lower	-
Congo DRC	2.7	2.5	Lower	Lower	-
Congo, Rep. of	3.2	2.5	Lower	Lower	-
Cote d'Ivoire	2.6	2.2	Lower	Lower	-
Djibouti	3.1	2.7	Lower	Lower	-
Eritrea	2.1	2.4	Lower	Lower	-
Ethiopia	3.7	3.4	Lower	Lower	-
Gambia	2.8	2.9	Lower	Lower	-
Ghana	4.0	3.8	Higher	Higher	-
Guinea	3.1	2.8	Lower	Lower	-
Guinea-Bissau	2.8	2.2	Lower	Lower	-
Kenya	3.8	3.6	Higher	Lower	**Yes**
Lesotho	3.7	3.5	Lower	Lower	-
Liberia	3.8		Higher	Lower	**Yes**
Madagascar	3.9	3.6	Higher	Lower	**Yes**
Malawi	3.5	3.2	Lower	Lower	-
Mali	4.0	3.7	Higher	Lower	**Yes**
Mauritania	3.2	3.1	Lower	Lower	-
Mozambique	3.5	3.6	Lower	Lower	-
Niger	3.6	3.3	Lower	Lower	-
Nigeria	3.7	3.6	Lower	Lower	-
Rwanda	4.0	3.7	Higher	Lower	**Yes**
Sao Tome & Principe	3.3	3.0	Lower	Lower	-
Senegal	3.8	3.4	Higher	Lower	**Yes**
Sierra Leone	3.5	3.1	Lower	Lower	-
Somalia	1.0		Lower	Lower	-
Sudan	2.7	2.2	Lower	Lower	-
Tanzania	4.0	3.7	Higher	Lower	**Yes**
Togo	2.9	2.2	Lower	Lower	-
Uganda	3.7	3.8	Lower	Higher	**Yes**
Zambia	3.8	3.3	Higher	Lower	**Yes**
Zimbabwe	1.4	1.1	Lower	Lower	-

Source: *African Development Bank*

Note: *ADB=African Development Bank; CPIA=Country Policy and Institutional Assessment*

Annex III: Summary of the Bank Group's Current Non-Concessional Borrowing Policy

In May 2008, the Boards of Directors of the African Development Fund (ADF or Fund) and the African Development Bank (ADB or Bank) approved a new Non-Concessional Borrowing Policy to address the risk of free-riding on ADF grant assistance and Heavily Indebted Poor Country/Multilateral Debt Relief Initiative (HIPC/MDRI) debt relief. The policy seeks to strike a prudent balance between ensuring long-term debt sustainability in beneficiary countries and financing development expenditures in support of the Millennium Development Goals.

The ADF and other multilateral development banks aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms. The Debt Sustainability Framework suggests an appropriate mix of concessional loans and grants based upon the beneficiary country's debt profile and performance.

The ADF's Non-Concessional Borrowing Policy is built upon the following guiding principles: (i) strong partnership and coordination with sister multilateral development banks, the International Monetary Fund, and bilateral agencies; (ii) measures should be effective; (iii) measures should be implementable; and (iv) diversity in country circumstances require some flexibility and a case-by-case approach. Within these principles, the Bank Group policy focuses on four broad areas (see Annex III for a status update on agreed actions):

i. Deepen Donor Coordination and Partnerships
   - Adopt a common strategy for dealing with the free rider issues, including proactive use of advocacy and moral suasion;
   - Expand Bank Group participation in joint International Monetary Fund/International Development Association forward-looking debt sustainability analysis exercises;
   - Broaden participation in Debt Sustainability Framework outreach exercises with multilateral development banks and bilateral agencies to promote its usage as a common creditor approach to concessionality.

ii. Strengthen Reporting and Monitoring
   - Establish an inter-departmental Committee to monitor regular reporting on the status of non-concessional borrowing in grant-eligible and HIPC/MDRI debt relief beneficiary regional member countries;
   - Incorporate a requirement in all new loan and grant Agreements for beneficiary countries to inform the Bank at least 3 months in advance of any new planned non-concessional borrowing and/or collateralized external transactions; and
   - Add a specific clause in grants agreements for Fragile State Facility supplementary resource recipients to indicate that a volume reduction will apply, or supplementary resources would not be forthcoming, in the event of new non-concessional borrowing.

iii. Enhance Collaboration in Capacity Building
   - Collaborate more closely with other partners, especially the International Development Association, to improve debt data quality, recording and reporting, as well as in building institutional capacity in regional member countries with respect to debt management, macroeconomic and fiscal management.

The Bank Group also outlined a number of disincentive measures to address non-concessional borrowing in recipient countries. The ADF policy largely tracks the International Development Association's disincentive measures on regional member countries that breach the Bank Group's non-concessional borrowing policy, by applying volume discounts and hardening of terms on borrowers while exercising some degree of flexibility on a case-by-case basis. These measures are directly tied to each country's Debt Sustainability Framework debt distress classification (i.e., "red light", "yellow light", or "green light"). These disincentive measures should not be seen as punitive – instead as a means of emphasizing the fact that countries that can afford non-concessional resources may need to cede scarce resources to more needy ADF beneficiaries.

i. If a "red light" or "yellow light" country breaches the Bank Group's Non-Concessional Borrowing Policy, then the ADF will reduce the country's nominal ADF grant allocation by 20% to 40%;

ii. If such a country consistently borrows from third parties on non-concessional terms, the policy would suspend access to grants, and harden terms – possibly in combination with further volume reductions;

iii. For “green light” countries that breach the Non-Concessional Borrowing Policy, hardened terms will be applied. Specifically:
   - Moderate terms (40 years maturity, 10 years grace period, 0.75% service charge, and 0.5% commitment fee), with a grant element of less than 60%;
   - Hardened terms (20 years maturity, 10 years grace period, same charges), with a grant element less than 45%;
   - Higher level hardened terms will apply (hardened terms, plus interest rate at 200 basis points below the ADB fixed lending rate) with a grant element less than 20% - already applicable to Angola – will be extended to post-MDRI “green light” resource-rich countries with high levels of market access; or
   - Consider volume reductions for fragile “green light” MDRI beneficiaries which lack economic diversification, have small export bases, and are highly vulnerable to exogenous shocks that could easily slip them back into “yellow light” or even “red light” status; debt sustainability analyses, country economic work, and further analysis will be used to identify, in consultation with other multilateral development banks, “green light” countries for which volume reductions instead of hardened terms would be recommended.

Moreover, the Bank Group’s Non-Concessional Borrowing Policy includes a number of additional measures to more appropriately address specific circumstances in HIPC/MDRI eligible countries. HIPCs that breach the policy during the interim period, such as the Democratic Republic of Congo, will be required to make concerted efforts to revise the contracted lending on concessional terms. This also reflects the broader requirements for qualifying for irrevocable debt relief at completion point. If the HIPC fails to alter the borrowing to concessional terms, then the Bank Group will withhold extended interim debt relief.[34]

[34] This disincentive measure will not impact previously agreed interim debt relief for the specified country. Instead, it will prevent the country from accessing extended interim debt service relief.

Annex IV: Proposed Bank Group Non-Concessional Borrowing Policy Implementation Matrix

		Extent of Debt Vulnerability	
		Lower (Green and Yellow DSF Traffic Lights)	**Higher (Red DSF Traffic Light)**
Capacity	**Lower** sub-CPIA<3.7 PEFA<2.6	***Concessionality Limit***	
		Minimum concessionality requirement based on the previous system, but with added flexibility on non-concessional external debt (higher and untied non-zero limits if consistent with the maintenance of low debt vulnerability)	Maintain minimum concessionality requirement based on previous debt-by-debt approach, likely higher than 35%, with limited or no room for non-concessional borrowing
		Non-Concessional Borrowing Policy Application	
		Maintain "green light" country measures: (1) hardened terms; (2) higher hardened terms; or (3) possible volume discount for fragile post-MDRI countries	Maintain "red" and "yellow light" country measures: (1) reduce the ADF grant volume from 20% to 40% or (2) suspend ADF grant access and harden terms after repeated non-concessional borrowing
		***Indicative ADF Country Classification** (existing IMF assessments)*	
		Angola, Central African Republic, Ethiopia, Ghana, Malawi, Mali, Mozambique, Niger, Senegal, Sierra Leone, Tanzania, Uganda, Zambia	*Burkina Faso, Burundi, Comoros, Congo Dem Rep., Congo Rep., Cote d'Ivoire, Djibouti, Gambia, Guinea, Liberia, Sao Tome & Principe, Togo*
	Higher sub-CPIA>3.7 PEFA>2.6	***Concessionality Limit***	
		Minimum average concessionality requirement applied to external or total public borrowing; for most advanced low-income countries, no concessionality requirement and overall nominal debt limit if needed	Overall limit on the present value of external or total public debt or average concessionality at a higher level; for the most advanced low-income countries, ceilings on nominal external or total public debt
		Non-Concessional Borrowing Policy Application	
		Provide case-by-case flexibility to accommodate prudent non-concessional borrowing, but retain ability to apply "green light" country measures as warranted: (1) hardened terms; (2) higher hardened terms; or (3) possible volume discount for fragile post-MDRI countries	Maintain "red" and "yellow light" country measures: (1) reduce ADF grant volumes from 20% to 40% or (2) suspend ADF grant access and harden terms after repeated non-concessional borrowing
		***Indicative ADF Country Classification** (existing IMF assessments)*	
		Cape Verde	*None*

Source: *African Development Bank*

Note: *ADF=African Development Fund; CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; IMF=International Monetary Fund; PEFA=Public Expenditure and Financial Accountability*