ADF-11 Resource Allocation

Discussion Paper

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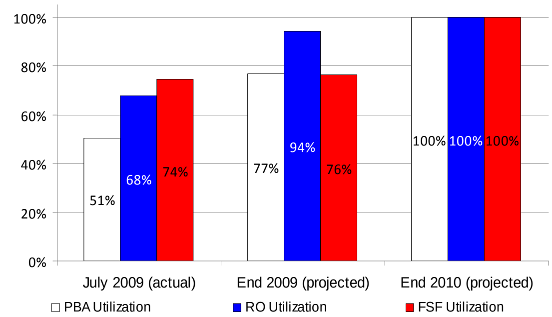
Executive Summary

This paper discusses the implementation of the agreed framework for the allocation of African Development Fund (ADF or the Fund) funds during the Eleventh General Replenishment of the African Development Fund (ADF-11) period.

Total expected resources under ADF-11 amount to UA 5.95 billion. As of end-July 2009, resources available for commitment (i.e., internal resources and received unqualified subscriptions) stood at UA 4.253 billion, of which UA 3.14 billion or 74 percent had been committed. In addition, the pipeline of ADF operations scheduled for presentation to the Board of Directors between August and end-December 2009 totaled UA 1.35 billion, i.e. more than the Fund's current commitment capacity of UA 1.12 billion, based on received unqualified subscriptions as of August 20, 2009. Thus, in 2009, ADF will be unable to authorize commitments corresponding to its full 2009 pipeline unless all subscriptions are paid as due. Furthermore, Deputies are invited to pay (in cash or in promissory notes) the third installment of their subscription as soon as possible and to authorize the early commitment of their subscription in order to allow the ADF to continue to provide resources to ADF countries in early 2010.

ADF resources available for allocation are divided between PBA resources, which represent 75 percent of total resources after deductions for contingencies, and supplemental resources for regional operations (17.5 percent) and fragile states (7.5 percent). Part of the resources provided under these set-asides are linked to country PBAs but are not strictly allocated under the PBA system. The figure at right shows the status of commitments for each these resources and demonstrates that resource allocation will have been heavily frontloaded by the end of 2009.

Actual and Projected Status of the Use of ADF-11 Resources



The changes to the PBA framework and formula agreed for ADF-11 were implemented in the 2008 and 2009 PBA exercises. With regards to the PBA framework, these changes consisted of switching to the calendar year, using moving averages for GNI per capita, keeping population data constant during the cycle and only recording problem projects in the CPPR. Changes to the PBA formula included keeping governance separate from the CPIA and using an additive formula that keeps all weights constant. The allocation results show that the revised PBA mechanism is effective at directing more resources to stronger performers: 65 percent of resources in 2008 and 64 percent of resources in 2009 were allocated to the two strongest performance quintiles.

Nonetheless, in implementing the agreed framework, a number of issues related to the design and the application of the PBA formula emerged:

(i) The volatility of CPPRs remains much higher than any other component of the Country Performance Assessment formula.

(ii) The reduction in allocations resulting from MDRI netting out may pose operational challenges for the Fund in a limited number of countries in the medium term.

(iii) The impending graduation of Cape Verde to ADB eligibility raises the need for the Bank to develop a graduation policy that will provide blend countries with an adequate mix of resources during their transition to creditworthiness for pure ADB financing.

Bank staff has been working on addressing these issues and has explored various solutions in close consultation with the multilateral development banks' technical group on PBA when indicated. To avoid disconnects within the cycle, most of these issues should be resolved in the context of the Twelfth General Replenishment of the African Development Fund (ADF-12) rather than in mid-cycle. Management will present detailed proposals to Deputies during the ADF-12 discussions.

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Abbreviations

ADB	African Development Bank
ADF	African Development Fund
ADF-8	Eighth General Replenishment of the African Development Fund
ADF-9	Ninth General Replenishment of the African Development Fund
ADF-10	Tenth General Replenishment of the African Development Fund
ADF-11	Eleventh General Replenishment of the African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
CPIA	Country Policy and Institutional Assessment
CPPR	Country Portfolio Performance Rating
DSF	Debt Sustainability Framework
FSF	Fragile States Facility
MDRI	Multilateral Debt Relief Initiative
PBA	Performance-Based Allocation
PBL	Policy-Based Loan
RMCs	Regional Member Countries
RO	Regional Operation
RPG	Regional Public Good
UA	Units of Account

ADF-11 RESOURCE ALLOCATION

1. Introduction

1.1 This paper presents the implementation of the agreed framework for the allocation of African Development Fund (ADF or the Fund) funds during the Eleventh General Replenishment of the African Development Fund (ADF-11) period. It briefly presents resources currently available for allocation under the Performance-Based Allocation (PBA) system and discusses the agreed set-asides for regional operations (ROs) and fragile states. It also reviews experience to date with the enhancements of the framework introduced during ADF-11. Finally, it identifies a number of remaining issues regarding the application of the PBA system.

2. Resources Available for Allocation Under ADF-11

2.1 The African Development Bank (ADB or the Bank)'s regional member countries (RMCs) currently count 38 ADF-only eligible borrowers (including one country in the process of graduating) and two blend countries[1] (see Annex I: Classification of Regional Member Countries). The eligibility of these countries for ADF resources is determined by country creditworthiness, country performance and gross national income per capita. Operations in ADF-only countries may also be financed by the Bank's private sector window and by non-concessional resources for enclave projects, provided that the operations and projects in question meet the relevant eligibility criteria[2]. In addition, a few borrowers that are currently inactive due to sanctions are expected to re-engage during the course of ADF-11, subject to clearance of their arrears with the Bank Group.

Overall Resources

2.2 Total expected resources under ADF-11 amount to UA (Units of Account) 5.948 billion. As highlighted in Table 1, resources available for commitment (i.e., internal resources and received unqualified subscriptions) stand at UA 4.253 billion.

2.3 As of end-July 2009, UA 3.135 billion or 74 percent of the resources available for commitment had been committed. The balance available for commitment stood at UA 1.12 billion. The pipeline of ADF operations scheduled for presentation to the Board of Directors between August and end-December 2009 is estimated at UA 1.35 billion, i.e. higher than the Fund's current commitment capacity based on received unqualified subscriptions. Thus, ADF will be unable to authorize commitments corresponding to its full 2009 pipeline unless all subscriptions are paid as due (see Annex II: Status of ADF Subscriptions and Payments). Deputies are therefore invited to pay the third installment of their subscription (in cash or in promissory notes) as soon as possible[3] and to authorize the early commitment of their subscription[4] in order to allow the ADF to continue to provide resources to ADF countries in early 2010.

[1] Blend countries are countries eligible for both ADF and ADB resources. For more information, see the ADF-11 Mid-Term Review paper, "Issues Concerning the Blend Country Regime and the Adoption of a Graduation Policy for ADF Countries".
[2] Criteria of access to ADB financing for high development impact projects are being reviewed in the context of a current examination of the flexibility granted to ADF countries to borrow on a non-concessional basis.
[3] According to the ADF-11 Resolution, the third instalment is scheduled to be paid on or before April 30, 2010.
[4] In accordance with the ADF-11 Resolution (article 8a), the third instalment of unqualified subscriptions can be committed as of March 31, 2010.

Table 1: ADF-11 Resources and Uses as of July 31, 2009

	Expected Resources [5] *as of Feb.2, 2009*	Available Resources (Commitment Capacity) [6] *as of July 31, 2009*	Committed Resources [7] *as of July 31, 2009*	Balance
Fragile States Facility	408.43	515.17	382.42	**132.75**
of which Pillar I: supplemental	*253.94*	*253.94*	*133.02*	120.92
of which Pillar II: arrears clearance	*129.1*	*235.84*	*232.60*	3.24
of which Pillar III: targeted	*25.39*	*25.39*	*16.80*	8.59
Regional Operations envelope	965.27	965.27	656.74	**308.53**
Performance-Based Allocation resources	4,142.15	2,779.86	2,094.29	**685.57**
Project Preparation Facility	15.33	15.33	2.03	**13.30**
Contingencies	416.9	-22.83	0.00	**-22.83**
TOTAL	**5,948.08**	**4,252.80**	**3,135.48**	**1,117.32**

Source: *Unless indicated otherwise, all data presented in tables are generated internally by the ADB*

Performance-Based Allocation Resources

2.4 Resources available for allocation to countries under the PBA framework (see Annex III: The Performance-Based Allocation Process) are made up of total ADF-11 replenishment resources, plus carry-over resources from previous ADF replenishments, less deductions for contingencies and set-asides. As agreed in the Deputies' Report, set-asides consist of two priority programs for ROs (17.5 percent of the ADF-11 envelope) and fragile states (7.5 percent of the ADF-11 envelope). These set-asides are linked to country PBAs but are not strictly allocated under the PBA system[8]. After deducting contingencies[9] and set-asides, total resources expected to be available for PBAs under ADF-11 equal UA **4.142 billion[10]** (Table 1).

2.5 Of UA 4.142 billion in resources expected to be allocated under the PBA system, UA 2.094 billion (51 percent of the PBA envelope) has been committed. Of the balance, UA 1,085 million has been programmed for the Board's consideration by end-2009. This amount will increase to UA 1,371 million by first quarter 2010. So far in ADF-11, 64 percent of country PBA commitments have been for investment projects and 36 percent have been for policy-based loans (PBLs). The significant share of PBLs is due in part to high demand early in the

[5] See African Development Fund. February 13, 2009. *2009 Country Allocations Under ADF-11.* ADF/BD/IF/2009/43.

[6] See African Development Fund. July 2009. *Statement of Commitment Capacity (SCC) as at June 30, 2009*. ADF/BD/IF/2009/194. Available resources for FSF Pillar II include the carry-over of UA 102.94 million from the ADF window of the Post-Conflict Country Facility plus UA 3.80 million in interest. Available resources for FSF Pillar III only include ADF resources, i.e. it does not include the UA 60 million ADB net income allocation.

[7] This amount includes surcharges on grants as derived from the Statement of Commitment Capacity. The overall amount without the grant surcharges stands at UA 3.034 billion.

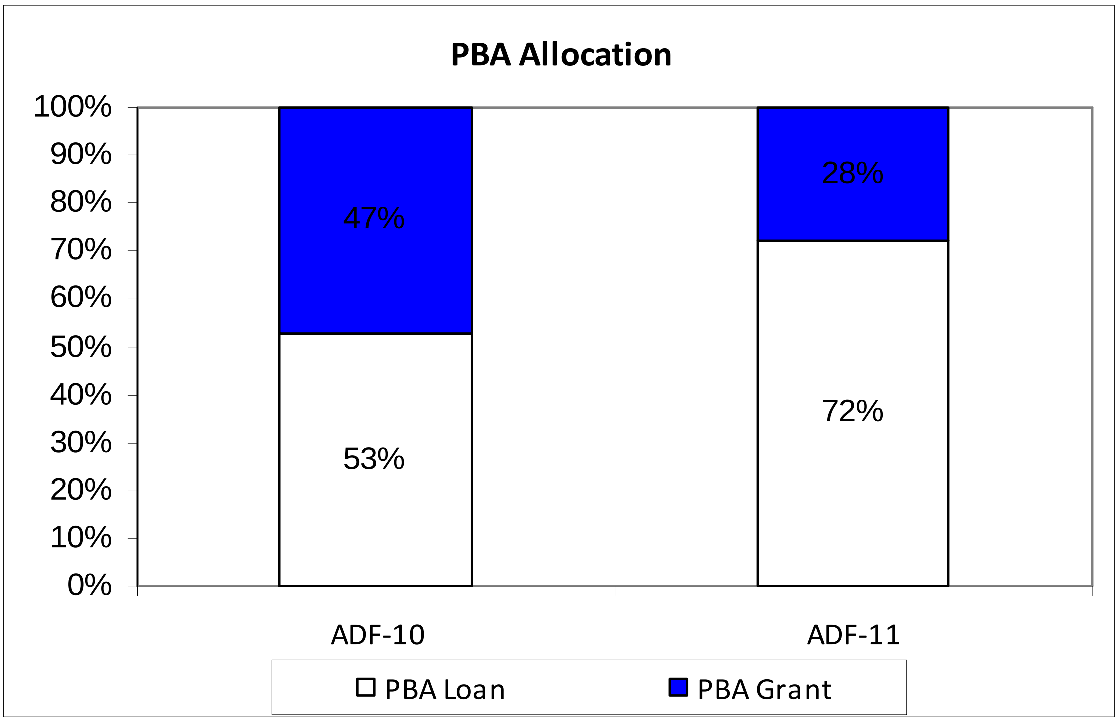
[8] See African Development Fund. *Strategic and Operational Framework for Regional Operations*. ADF/BD/WP/2008/16; and African Development Fund. *Strategy for Enhanced Engagement in Fragile States.* ADF/BD/WP/2008/10.

[9] The following contingencies are applied: (i) a 1 percent contingency for exchange rate adjustments on unpaid subscriptions, to cover possible net adverse exchange rate differences between the agreed-upon replenishment rates for the subscriptions and the spot rates on the dates the subscriptions are actually paid; (ii) a contingency to cover accelerated encashment contingencies for the ADF-11 period. These were originally computed as 2 percent of total contributions and were adjusted in 2009 to take account of accelerated encashment schedules and past payment patterns; and (iii) a contingency for both late and qualified subscriptions to ensure that only the resources available during the replenishment period are allocated (based on previous replenishment patterns, this amount is estimated at UA 350 million). The amount of these three contingencies will be revised regularly to reflect actual contributions. These contingencies currently represent 7 percent of overall resources.

[10] As of February 2, 2009. Additional contributions will be reported in next year's allocation exercise.

cycle for fast-disbursing instruments. The current 2009-2010 pipeline indicates that the share of PBLs will fall below the 25 percent ceiling for PBLs agreed for ADF-11 by the end of the cycle. However, in the context of the economic and financial crisis, ongoing dialogue with RMCs indicates that there is solid demand for crisis-related PBLs to replace investment projects, which may lead PBLs to exceed the 25 percent ceiling. Management is closely monitoring this ratio and will report to the Board of Directors if demand exceeds the 25 percent threshold. Figure 1 illustrates the distribution of PBA approvals in loans and grants. This distribution follows the agreed Debt Sustainability Framework (DSF).

Figure 1: Shares of Loans and Grants in PBA Approvals During ADF-10 and ADF-11



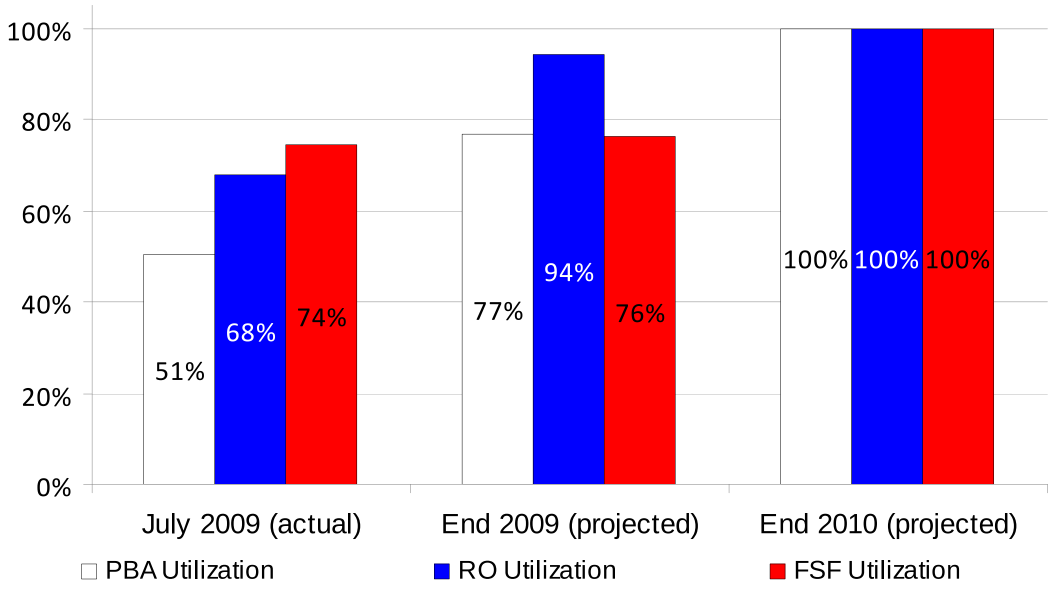
Note: *ADF-11 figures correspond to approvals as of end-July 2009*

Resources Available for Regional Operations and Fragile States

2.6 Of the UA 965.27 million earmarked for ROs, UA 656.74 million have been committed to support 16 ROs including eight Regional Public Goods projects (RPGs). This brings the utilization rate of the RO envelope to 68 percent. A large part of the remaining funds (UA 308.53 million) is expected to be committed by end-2009 as key flagship operations are presented to the Board.

2.7 UA 382.42 million of UA 515.17 million earmarked for the Fragile States Facility (FSF) has been committed (74 percent utilization rate). FSF resources are expected to be exhausted by the third quarter of 2010 (Figure 2).

Figure 2: Actual and Projected Status of the Use of ADF-11 Resources



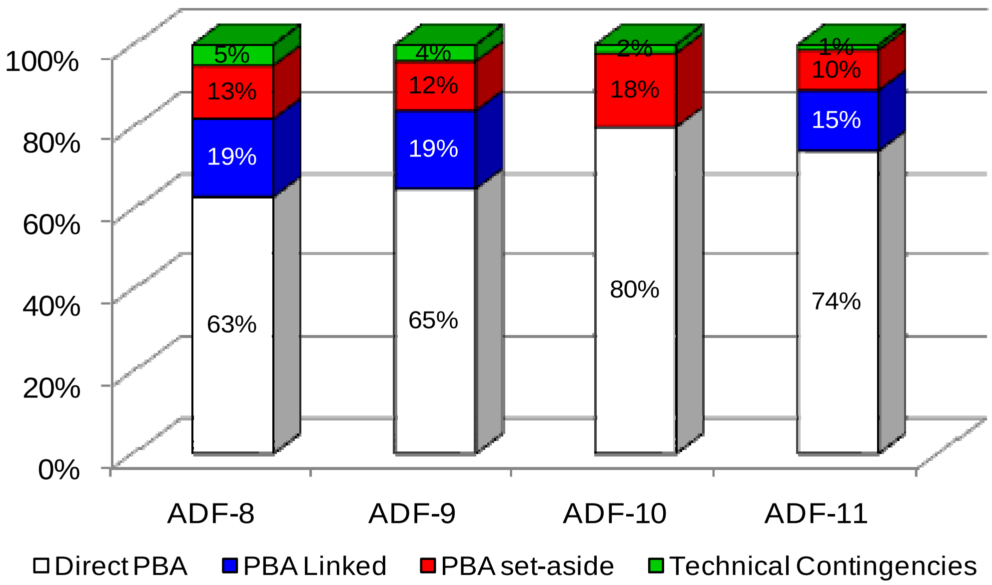
3. ADF-11 Resource Allocation Framework

PBA System and Enhancements

3.1 **Trends in PBAs**. Since 1999, the ADF has used the PBA framework to allocate the bulk of its resources to eligible countries. As shown in Figure 3, during the periods of the Eighth and Ninth General Replenishments of the African Development Fund (ADF-8 and ADF-9), namely 1999-2001 for ADF-8 and 2002-2004 for ADF-9, 82 percent and 85 percent of total resources were either strictly allocated under the PBA framework (63 percent under ADF-8 and 65 percent under ADF-9) or were allocated with reference to the PBA framework (19 percent). The PBA-linked portion corresponded to an additional allocation of 50 percent of the standard PBA allocation which was made available to high-performing countries to finance PBLs. Under the Tenth General Replenishment of the African Development Fund (ADF-10), this PBL allotment was incorporated into the standard PBA system and 80 percent of total resources were thus allocated strictly under the PBA framework, with the balance going to various set-asides, including a 10 percent set-aside for ROs. For the ADF-11 replenishment, Deputies reaffirmed the centrality of the PBA as an allocation system, with 75 percent of resources allocated strictly under the PBA system and 15 percent of resources linked to the PBA system through multiplier systems.[11]

[11] Additional resources available under the RO framework correspond to twice the one-third contribution from the participating country's PBA. Exceptions to the cost-sharing rule for RPGs and countries with allocations under UA 20 million are not counted as PBA-linked. Top-up resources under Pillar 1 of the FSF are a multiplier of the ADF-10 PBA of eligible countries.

Figure 3: Share of PBA-Related Resources from ADF-8 to ADF-11



Note: *Technical contingencies do not include the late and qualified subscription contingency of UA 350 million*

3.2 **ADF-11 Framework.** Two series of key adjustments to the ADF-10 allocation framework were agreed upon for ADF-11 to increase the predictability of the allocation process and simplify the formula for greater transparency. The first series of adjustments involved five key improvements:

- The alignment of ADF countries' PBA exercise to the calendar year and to operational programming;
- The use of the DSF classification as of January 1 of each operational year;
- The use of the latest available population data as a constant throughout the ADF-11 cycle to smooth population swings within the cycle;
- The use of a 3-year moving average to calculate per capita income for the annual country allocation process; and
- The change of the Country Portfolio Performance Rating (CPPR) to include actual problem projects only rather than actual and potential problem projects and to use quarterly data and a compressed scale.

3.3 To simplify further the formula, the following adjustments were agreed and applied to the allocation process, in line with the adjustments made in the 15th replenishment of the International Development Association:

- To stop double counting governance, the Country Policy and Institutional Assessment (CPIA) is now split into two parts, one of which regroups three clusters (A, B and C) and the other of which (cluster D) that now represents the governance factor, with the governance effective weight unchanged.
- A new additive formula has been applied but as per Deputies' request, the effective weight of key variables remains unchanged relative to the formula used in ADF-10.

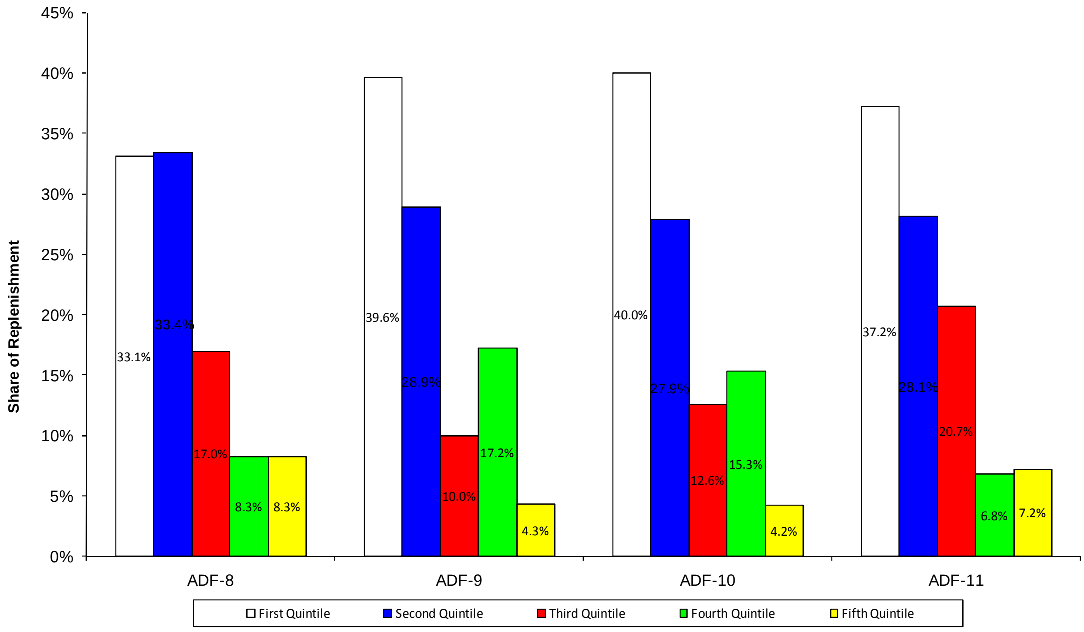
3.4 The agreed adjustments have been applied to 2 consecutive years (2008 and 2009) and have yielded the results discussed below.

Allocation Results

3.5 The allocation of ADF resources to ADF-eligible RMCs is a three-step process that takes place annually (Annex III). First, resources are allocated to eligible countries based on annual assessments of country circumstances using the PBA formula. Second, country-specific financing terms (loans, grants, or a loan/grant combination) are determined using the agreed joint World Bank-International Monetary Fund DSF classification. Third, debt relief to eligible RMCs under the Multilateral Debt Relief Initiative (MDRI) is deducted from beneficiary countries' allocations and resources provided by donors to compensate ADF for MDRI debt cancellations are then re-allocated to all ADF-only RMCs on the basis of the PBA.

3.6 **Performance Distribution.** Top performers have consistently received a large share of ADF replenishments (Figure 4). The share of total ADF resources allocated to the best performing quintile increased from 33 percent under ADF-8 to 40 percent under ADF-10. Under ADF-11, the best performing quintile continues to receive a significant share of resources (37 percent). The decrease in the relative share of the first quintile between ADF-10 and ADF-11 is primarily due to the reclassification of Tanzania and Senegal from the first to the second quintile due to a drop in performance. This trend shows that the allocation mechanism is effective at directing more resources to stronger performers.

Figure 4: Resource Allocation by Performance From ADF-8 to ADF-11
Percentage resources allocated to each quintile



3.7 Within the ADF-11 cycle, the allocation of resources by performance in 2008 and 2009 confirms that most resources are channeled to the two strongest performing quintiles (65 percent of resources in 2008 and 64 percent in 2009) (Figure 5). Figure 6 confirms that the first two quintiles receive higher per capita allocations as well.

Figure 5: Resource Allocations by Performance by ADF-11 Year

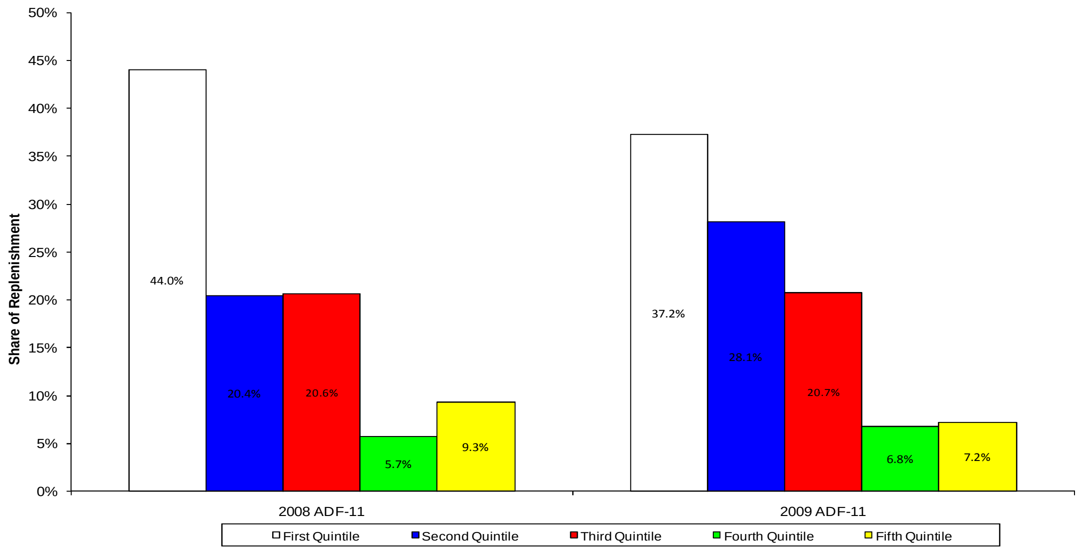
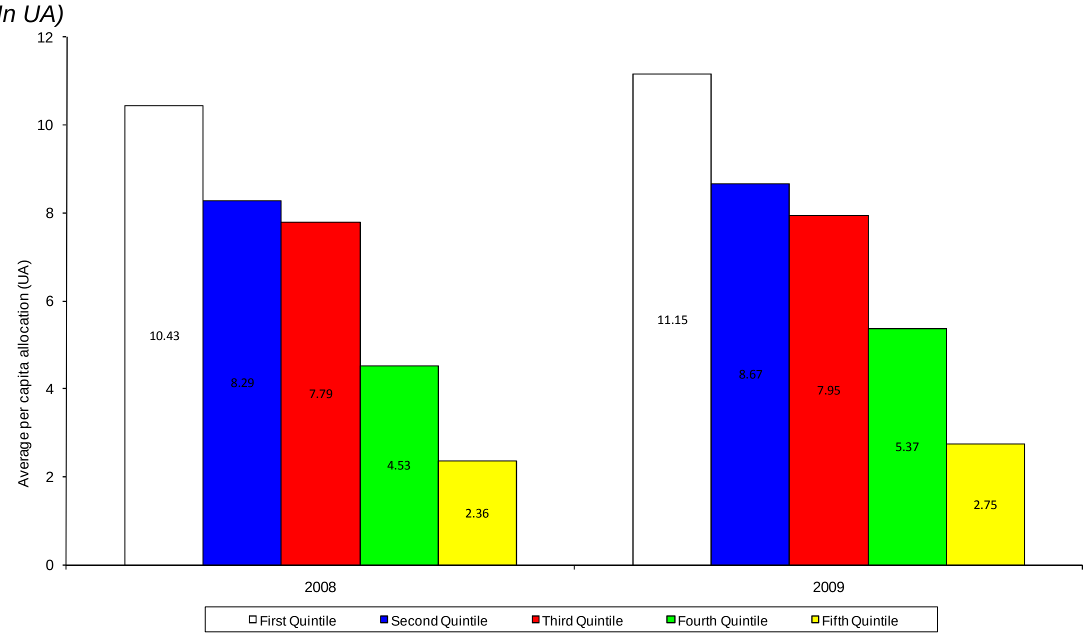


Figure 6: ADF-11 Average Per Capita Allocations by Performance (Excluding Outliers)[12]
(In UA)



3.8 **DSF and MDRI Adjustments.** As detailed in Annex III, the joint World Bank-International Monetary Fund DSF is used to determine countries' grant financing eligibility based on their risk of debt distress. As during ADF-10, a 20 percent volume discount is applied to all grant allocations. This discount is sub-divided into two portions: (i) an incentive-related portion of 9.88 percent designed to prevent moral hazard and help maintain the strength of the ADF's incentive system as reflected in its PBAs;[13] and (ii) a charges-related portion of 10.12 percent to cover foregone reflows and charges on loans.

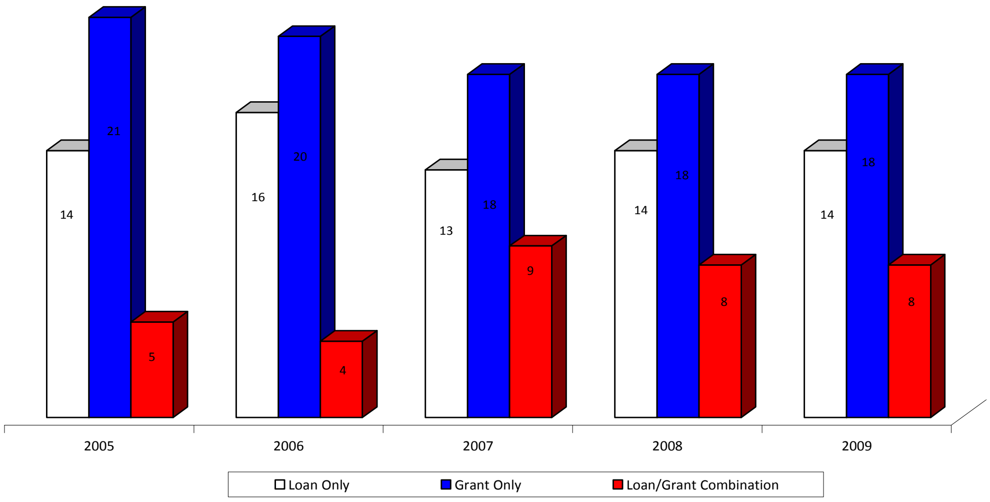
[12] Average per capita allocations can be very vulnerable to the effect of outliers, such as small countries whose allocation can be several times the average of a quintile as a result of the minimum ADF allocation. Such countries have therefore been excluded from the calculations in Figure 6.

[13] The proceeds from the application of the incentive-related discount are reallocated to all ADF-only countries using the PBA formula in order to limit the moral hazard associated with granting more favourable terms to countries with a moderate or high risk of debt distress.

3.9 Resources that come out of the special pool earmarked for ROs are ordinarily provided on the same terms (loans or grants) as is the beneficiary country's PBA allocation. In the case of fragile states eligible[14] for grants, the PBA-related country allocation is only subject to the charges-related portion of the volume discount. In other words, the incentive-related portion of the volume discount does not apply.[15]

3.10 The overall share of grants decreased steadily from 34.3 percent in 2005 to 25.6 percent in 2009. This reflects changes in DSF country rankings and the results of annual PBA exercises. Over the period, the number of countries at high risk of debt distress (grants only) declined, while the number of countries at moderate risk (loan/grant combination) increased (Figure 7).

Figure 7: DSF Allocation Classifications
(Number of countries per category)



3.11 The Multilateral Debt Relief Initiative (MDRI) provides 100 percent cancellation of eligible ADF, International Development Association and International Monetary Fund debt owed by heavily indebted poor countries that have reached the completion point. Through a netting-out mechanism, the foregone debt service payments of countries that qualify for debt relief under the MDRI are deducted from those countries' allocations in any given year. Resources provided by donors to compensate the ADF for MDRI debt cancellation are then re-allocated to all ADF-only countries, using the PBA system. This helps to ensure that all ADF countries benefit from the MDRI rather than only HIPCs, and links the transfer of resources to country performance.

3.12 While the MDRI netting-out mechanism may have some effect on country allocations (the ADF allocations of some 16 countries decreased this year due to netting out), debt cancellation through MDRI provides countries with much-needed budgetary relief. In addition, the net flows to each MDRI country (allocation minus loan repayments) remain at least the same as prior to the MDRI debt cancellation and netting out, and in most cases improve due to the re-allocation of the netted out amounts.

[14] For allocation planning purposes, this paper defines fragile states as the nine countries potentially eligible for Pillar I of the FSF. Should these countries become ineligible, the appropriate adjustments will be made.

[15] The volume discount on grants does not apply to top-up allocations under Pillar I of the FSF since these allocations, although linked to the PBA, are not strictly allocated under the PBA system.

4. Fragile States and Regional Operations Frameworks

Enhanced Engagement in Fragile States

4.1 As agreed with Deputies, a special allocation of 7.5 percent of ADF-11 resources less contingencies, i.e. UA 408.43 million, has been allocated to the FSF. The resources of Pillar II of the FSF were augmented with carry-over resources from the Post-Conflict Country Facility in the amount of UA 179.36 million. Finally, because of the high demand for FSF resources, the Board of Directors approved the allocation of UA 60 million from 2008 ADB net income to support FSF Pillar III activities (Table 2).

Table 2: Fragile States Resources

Source / Window	ADF-11 Allocation	PCCF Carry-Over ADF	PCCF Carry-Over ADB	Earnings From PCCF Resources	ADB Allocation From 2008 Net Income	Total Resources
I.Supplemental	253.94	-	-		-	253.94
II.Arrears clearance	129.10	102.94	62.70	13.72	-	308.46
III.Targeted support	25.39	-	-	-	60.00	85.39
Total Resources	**408.43**	**102.94**	**62.70**	**13.72**	**60.00**	**647.80**

Note: *PCCF = Post-Conflict Country Facility*

4.2 **Under Pillar I** of the FSF, supplementary (top-up) allocations to nine countries in post-crisis and transition situations were provided in addition to their allocations under the normal PBA process. The amount of each country's supplementary allocation was determined by multiplying by 1.97 the average of the country's two best yearly allocations during ADF-10 (a process referred to as "High 2") (Table 3). A cap of UA 60 million and a floor of UA 10 million apply. 58 percent of resources of that window have been committed to support Burundi, the Central African Republic, Comoros, Côte d'Ivoire, Guinea-Bissau, Liberia and Sierra Leone.

Table 3: Allocations of Countries Potentially Eligible for Pillar I as of 2009

Country	"High 2" ADF10 alloc. w/o PCEF & 5 mn	Top-Up applying floor and cap *	2009 ADF-11 Final Country Allocations	Final allocation including ADF-11 and Top-up
Burundi	23.45	46.09	46.28	92.38
Central African Republic	6.03	11.85	17.72	29.57
Comoros	0.49	10.00	5.26	15.26
Congo DRC	193.78	60.00	187.06	247.06
Cote D'Ivoire	23.33	45.87	45.77	91.64
Guinea-Bissau	2.05	10.00	11.86	21.86
Liberia	6.62	13.01	31.72	44.73
Sierra Leone	21.75	42.76	29.03	71.79
Togo	7.30	14.36	28.25	42.60
Total	**284.81**	**253.94**	**402.95**	**656.89**

Top-up factor (excl. floor and cap countries)	**1.97**

Based on high 2 excl. PCEF & 5 mn

* The amounts of UA 60 million and UA 10 million refer to cap or floor

4.3 **Under Pillar II**, resources were provided to finance the arrears clearance programs of two countries re-engaging with the Fund: Togo and Côte d'Ivoire. These arrears clearance operations took place in July 2008 and March 2009 and corresponded to 83 percent of the resources available under that window.

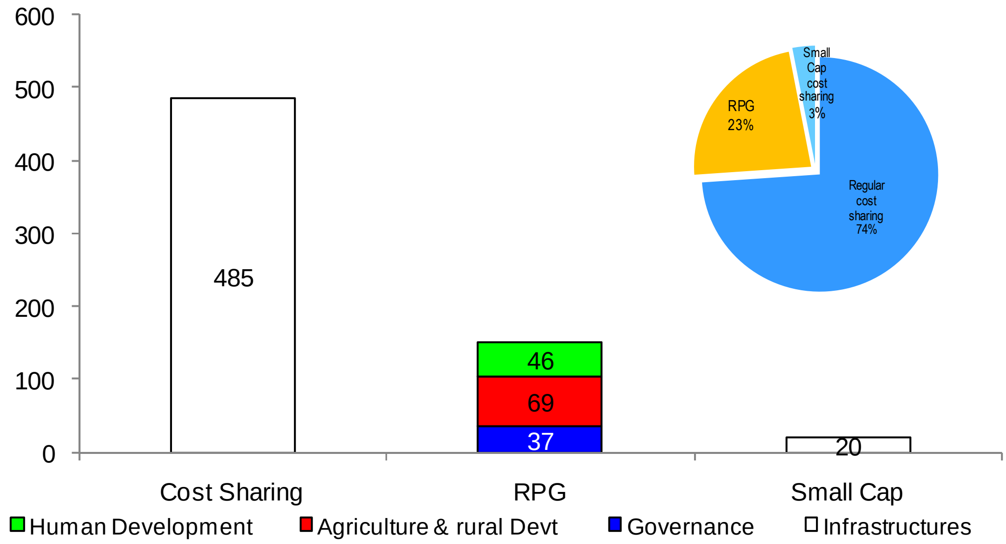
4.4 **Under Pillar III**, as of July 2009, technical assistance and capacity building were provided to 14 fragile states for a total investment of UA 16.80 million (66.2 percent of Pillar III prior to a transfer from 2008 net income).

Increased Support for Regional Operations (ROs)

4.5 In line with the strategic directions agreed in the Deputies' Report, a strategic and operational framework for ROs was adopted in March 2008. This framework has the following structure: (i) a special allocation of up to 17.5 percent of ADF-11 resources net of deductions for contingencies (UA 965 million) is set aside to finance the costs of ROs not financed from country allocations; (ii) a requirement (hereafter referred to as cost sharing) has been adopted that one third of project costs be financed from the participating country's PBA, subject to a cost-sharing cap of 10 percent of the country's PBA in the case of countries with an allocation of UA 20 million or less; and (iii) exemptions to cost sharing are being considered by the Board on a case-by-case basis for RPGs that meet certain agreed criteria.

4.6 Sixteen ROs were approved as of end-July 2009 for a total amount committed of UA 943 million, of which UA 657 million (70 percent) is being financed from the designated RO envelope and UA 286 million (30 percent) is being financed by cost sharing coming from PBA resources. Of the 16 ROs, eight projects had cost sharing and eight were RPG operations with no cost sharing. Within the amount financed out of the RO envelope, 74 percent (UA 485 million) financed projects with cost sharing from participating countries while 26 percent (UA 171 million) financed projects fully or partially exempted from cost sharing, either because the projects in question were RPGs exempted from cost sharing or, in a limited number of cases, because some participating countries were subject to the small allocation exception (Figure 8).

Figure 8: Regional Operations Cost Sharing and Exemptions
(In UA millions)



5. Emerging Issues

5.1 In implementing the agreed framework over the past 2 years, Bank staff have identified and examined certain issues related to the design and the application of the PBA formula that will need to be addressed. To avoid disconnects within the cycle, most of these issues should be resolved in the context of the Twelfth General Replenishment of the African Development Fund (ADF-12) rather than in mid-cycle. Bank staff has been working on addressing these issues and exploring various solutions. They have also shared analysis and experience on a number of these issues with the multilateral development banks' technical group on PBA. For the most part, these issues are still under discussion at both the technical and the policy levels. Management will reflect on these matters and present proposals to Deputies during the ADF-12 discussions.

Portfolio Volatility and its Impact on Allocations

5.2 Substantial volatility in CPPRs remains a main source of volatility in ADF country allocations, as is the case at other multilateral development banks. To reduce the volatility of CPPRs, a revised CPPR methodology was adopted under the ADF-11 framework (similar to IDA-15). Using this methodology, CPPRs were modified to include only actual problem projects instead of actual and potential problem projects (potential problem projects had been identified as a key source of volatility), and to use quarterly rather than annual data. However, experience with the 2008 and 2009 allocation rounds reveals that the volatility of CPPRs remains high for many countries (Table 5) and much higher than any other component of the Country Performance Assessment formula (Table 4).

Table 4: Portfolio Volatility

Average Variation 2008-2009		
CPIA	**CPPR**	**Governance Rating**
2 percent	25 percent	5 percent

Note: *These averages exclude ratings with zero variation and are calculated on the absolute value of the variations (i.e. without distinguishing positive from negative variations)*

5.3 Several factors account for the swing in portfolio ratings from one year to the next, particularly the quality of the ratings and the size of the portfolio. While efforts are being undertaken to improve the quality of the ratings through various supervision enhancement procedures presently being implemented by the Quality Assurance and Results department, the small size of the portfolios of ADF countries—which average 11 projects, with a wide variation between countries—remains a key factor. The smaller the number of projects in the portfolio, the larger the impact on the CPPR of a deterioration in the performance of one of the projects.

Table 5: Portfolio Volatility and Its Impact on Allocation

Percent Change in CPPRs, 2008 to 2009			
Somalia	n.a	Gambia	0.0%
Sudan	n.a	Ghana	0.0%
Comoros	n.a	Guinea	0.0%
Liberia	n.a	Madagascar	0.0%
Zimbabwe	n.a	Malawi	0.0%
Burundi	42.9%	Mali	0.0%
Djibouti	33.3%	Mozambique	0.0%
Congo, Rep.	28.6%	Nigeria	0.0%
Guinea-Bissau	28.6%	Rwanda	0.0%
Burkina Faso	25.0%	Sierra Leone	0.0%
Chad	25.0%	Tanzania	0.0%
Ethiopia	25.0%	Togo	0.0%
Lesotho	12.5%	Uganda	0.0%
Mauritania	12.5%	Zambia	0.0%
Angola	0.0%	Benin	-20.0%
Cameroon	0.0%	Kenya	-20.0%
Cape Verde	0.0%	Niger	-20.0%
Central African Rep.	0.0%	Senegal	-20.0%
Congo Dem. Rep.	0.0%	Côte d'Ivoire	-33.3%
Eritrea	0.0%	Sao Tome & Principe	-33.3%

5.4 Various options to further reduce the volatility of portfolio ratings and improve the quality of ratings are being considered. Detailed proposals will be presented to Deputies as part of the ADF-12 consultations.

Impact of MDRI Netting Out on Country Allocations

5.5 The amount of debt cancellation provided under the MDRI will increase steadily over the coming years and will reach its peak around 2025. These amounts will be netted out from MDRI countries' allocations and re-allocated to all ADF countries, as described earlier. While the overall level of MDRI netting out is expected to remain low relative to total allocations, the volatility in individual country allocations resulting from MDRI netting out may pose operational challenges for the Fund. On the basis of conservative assumptions, internal estimates of the impact that MDRI netting out could have on ADF countries' allocations over the next 20 years show that while the allocations of around half the ADF countries would not be affected or would be positively affected by netting out and re-allocation, the allocations of a significant number of countries could decrease by up to 15 percent, and the allocations of a minority of countries could decrease by more than 25 percent. While the ultimate impact of MDRI netting out will depend on the size of future replenishments, these estimates illustrate the likelihood that the Fund's ability to provide financial support in the form of ADF allocations to some ADF countries could be significantly undermined in the future as a result of netting out.

Graduation Policies

5.6 The impending graduation of Cape Verde, the first country to become a blend country since the Bank adopted the World Bank's Credit Policy in 1995, and the possible graduation of additional countries, raises the need for the Bank to develop a graduation policy to provide blend countries with an adequate mix of resources during their transition to creditworthiness for pure ADB financing. It is in that context that several issues requiring Deputies' guidance have emerged: (i) the continued relevance of the 5 percent aggregate cap on ADF resources available to blend countries and its possible replacement by country-specific caps; (ii) the adoption of a phasing-out period for ADF resources for countries that become ADB-eligible; and (iii) differentiated terms applicable to ADF-only and blend countries. These issues are discussed in more detail in the ADF Mid-Term Review paper "Issues Concerning the Blend

Country Regime and the Adoption of a Graduation Policy for ADF Countries”.

6. Conclusion and Recommendations

6.1 This report has presented the implementation of the ADF’s resource allocation framework for the ADF-11 cycle. It has confirmed the key role of the PBA system as the core resource allocation mechanism under ADF-11 and has identified related implementation issues and concerns. Deputies are invited to take note of the progress and issues highlighted here.

6.2 Furthermore, in order to avoid a gap in ADF's commitment capacity at the end of 2009 and/or first quarter of 2010, Deputies are invited to pay the third installment of their ADF-11 subscription as early as possible and to authorize the early commitment of their subscription.

Annex I: Classification of Regional Member Countries

A. Countries Only Eligible for ADF-Resources*

Angola
Benin
Burkina Faso
Burundi
Cameroon
Cape Verde
Central African Republic
Chad
Comoros
Congo, Republic
Congo, Democratic Republic
Côte d'Ivoire
Djibouti
Eritrea
Ethiopia
Gambia
Ghana
Guinea
Guinea-Bissau
Kenya
Lesotho
Liberia
Madagascar
Malawi
Mali
Mauritania
Mozambique
Niger
Rwanda
Sao Tomé & Principe
Senegal
Sierra Leone
Somalia
Sudan
Tanzania
Togo
Uganda
Zambia

B. Countries Eligible for a Blend of ADB and ADF Resources

Nigeria
Zimbabwe

C. Countries Only Eligible for ADB Resources

Algeria
Botswana
Egypt
Equatorial Guinea
Gabon
Libya **
Mauritius
Morocco
Namibia
Seychelles
South Africa
Swaziland
Tunisia

* *Except for limited ADB lending for enclave and private sector projects*

** *Libya is not a borrowing member country*

Annex II: Status of ADF Subscriptions and Payments Received as of September 4, 2009

	STATE PARTICIPANTS	Basic Contributions In UA	Payments Received In UA	Remaining Value In UA	Total Qualified subscriptions In UA	Portion of qualified subscriptions for 2008-2009 in UA
1	AUSTRIA	86,545,324.77	57,994,289.79	(28,551,034.98)	-	-
2	BELGIUM	66,863,048.35	44,610,992.15	(22,252,056.20)	-	-
3	BRAZIL [1]	6,557,936.09	-	(6,557,936.09)	6,557,936.09	4,371,957.40
4	CANADA	184,878,367.89	123,252,245.26	(61,626,122.63)	-	-
5	CHINA	79,900,949.59	53,267,300.16	(26,633,649.43)	-	-
6	DENMARK	44,333,039.38	44,333,039.38	-	-	-
7	FINLAND	89,221,984.30	89,221,984.30	-	-	-
8	FRANCE	347,115,129.81	231,410,087.42	(115,705,042.40)	-	-
9	GERMANY	400,000,000.00	266,666,667.00	(133,333,333.00)	-	-
10	INDIA	6,434,446.57	4,289,631.06	(2,144,815.51)	-	-
11	ITALY [2]	-	-	-	-	-
12	JAPAN	261,438,951.84	174,292,634.57	(87,146,317.28)	-	-
13	KOREA	32,474,255.40	21,649,503.60	(10,824,751.80)	-	-
14	KUWAIT	6,656,704.51	6,656,704.51	-	-	-
15	THE NETHERLANDS	201,061,741.61	134,041,164.35	(67,020,577.27)	-	-
16	NORWAY	167,029,491.84	111,352,994.56	(55,676,497.28)	-	-
17	PORTUGAL	29,621,698.79	19,747,799.79	(9,873,899.00)	-	-
18	SAUDI ARABIA	16,394,840.22	10,929,893.48	(5,464,946.74)	-	-
19	SOUTH AFRICA	6,223,940.75	4,149,293.83	(2,074,646.92)	-	-
20	SPAIN	110,938,733.94	73,959,155.96	(36,979,577.98)	-	-
21	SWEDEN	160,994,399.97	107,329,599.98	(53,664,799.99)	-	-
22	SWITZERLAND	91,186,539.84	60,791,026.12	(30,395,513.72)	-	-
23	UNITED KINGDOM	547,150,748.56	364,767,165.71	(182,383,582.85)	-	-
24	UNITED STATES OF AMERICA [3]	306,944,198.52	-	(306,944,198.52)	208,575,157.23	106,260,424.82
	TOTAL	3,249,966,472.52	2,004,713,172.95	(1,245,253,299.57)	215,133,093.31	110,632,382.22

1 The subscription of the State participant is qualified until 2011

2 State participant has not yet deposited its Instrument of Subscription but pledged UA 194,642,996 during the final replenishment meeting

3 State participant has not yet paid the first two instalments; however payment of USD 150 million (UA 98,369,041.30 of the UA 204,629,466.12 due for 2008 and 2009) is expected shortly

Annex III: The Performance-Based Allocation Process

1. The allocation of available ADF resources to ADF-eligible RMCs for projects, programs and technical assistance operations is a three-step process. First, resources are allocated to eligible countries using the PBA formula. Second, country-specific financing terms (loans, grants, or a loan/grant combination) are determined using the agreed DSF. Third, debt relief to eligible RMCs under the MDRI is netted out of the countries' allocations and donor replacement funds are re-allocated to all ADF-only RMCs.

First Step: Application of the PBA Formula

2. Available resources are allocated using this PBA formula:

$$A_i = (CPA_i)^4 \ \ x \ \ \left(GNI/P\right)_i^{-0.125} \ \ x \ \ P_i^1$$
$$CPA_i = 0.26 \ CPIA_{(A-C)_i} + 0.58 \ GR_i + 0.16 \ CPPR_{(REV)_i}$$

Where:	A_i	is the allocation for country *i*
	CPA_i	is the Country Performance Assessment score for country *i*
	$(GNI/P)_I$	is the gross national income per capita for country *i*
	$CPIA_{(A\text{-}C)I}$	is the Country Policy and Institutional Assessment rating for country *i*
	GR_i	is the governance rating for country *i*
	$CPPR_{(REV)i}$	is the revised Country Portfolio Performance Rating for country *i*
	P_i	is the population for country *i*

3. The PBA formula has two main determinants:

   - Country need as determined by gross national income per capita (GNI/P) and country population (P);
   - Country performance as determined by the Country Performance Assessment score.

4. It was agreed to apply the following modifications to the PBA system during the ADF-11 period:

   - To increase the predictability of the country allocation,
     - the PBA exercise is to be conducted on a calendar year basis, using DSF ratings as of January 1 of each operational year.
     - the latest available population data from agreed sources will be held constant over the cycle: under ADF-11, 2007 United Nations population data series are used.
     - a 3-year moving average is to be used for per capita income: the 2005-2007 data from the World Bank's World Development Indicators are used in this cycle while the 2004-2006 data from the same source were used for the 2008 allocations.
     - the CPPR will only comprise actual problem projects and will use quarterly data rather than annual data.

   - To simplify the formula and improve transparency in line with the 15th replenishment of the International Development Association,
     - The CPIA rating will only include the first three clusters (A,B,C) of the agreed indicators in order to avoid counting governance twice.
     - The governance rating will now comprise the current CPIA cluster D.
     - A new additive formula making the weights of each variable explicit will be used to calculate the allocations.
     - The country performance rating will be equal to 0.26 CPIA A-C +0.58 CPIA D + 0.16 CPPR REV.

- o The ADF basic country allocation will be equal to the base allocation plus (country performance rating)4*(GNI/capita)-0.125*population.
- o The effective weight of each of the key Country Performance Assessment variables will be unchanged relative to the formula used under ADF-10.

5. An increase in GNI/P will cause per capita allocation to drop, while an increase in the Country Performance Assessment score caused by the net positive impact of the CPIA, the governance rating and the CPPR, will cause per capita allocation to grow. The population variable (P) converts per capita country allocations to total country allocations. Countries with relatively high populations are allocated more resources in absolute terms.

6. In addition, the following operational procedures have been applied in running the ADF-11 allocation:

   - Single country allocations may not exceed 10 percent of the total resources available to ADF-only countries, equivalent to UA 393.5 million in 2009. This cap has been applied at the basic allocation stage, i.e. on the initial results of the PBA process. Any excess of calculated amounts over capped amounts has been re-allocated to the rest of the ADF-only countries using the PBA formula.

   - A base and minimum of UA 5 million have been applied for all countries. Final allocations have been adjusted to reflect that minimum allocation.

   - Two blend countries, Nigeria and Zimbabwe, continue to be capped at 5 percent of available resources and their allocations are not subject to further adjustment (i.e., through the DSF, incentive portion reallocations, MDRI and minimum allocation adjustments).

   - For countries without an active portfolio (often countries under/or coming out of sanction), the CPPR has been assigned a zero value. Effectively, this means that the CPPR weight in the formula (0.16) is added to the CPIA, which brings the CPIA's weight from 0.26 to 0.42.

   - As per the proposal made to the Board of Directors regarding the Bank's response to the financial crisis[16], the allocations for Sudan and Somalia, countries under long-term sanction, have been allocated to the other ADF-only countries on the basis of the PBA.

   - Cape Verde has been maintained as an ADF-only country and its allocation has been calculated on that basis, pending its formal graduation to blend status (expected in the course of 2009) and subject to the conclusions of upcoming discussions on the blend country regime.

Second Step: The DSF and the Modified Volume Approach

7. The DSF is used to determine each country's risk of debt distress. It is based on two criteria: (i) the institutional strength and the quality of policies to withstand debt distress and (ii) country-specific debt burden indicators (i.e., the net present values of the debt/gross domestic product ratio, the debt/exports ratio and the debt service/exports ratio). Countries are classified by three "traffic lights," where red indicates a high risk of debt distress, yellow indicates a moderate risk of debt distress and green indicates a low risk of debt distress. Countries in the red category qualify for 100 percent grants, countries in the green category qualify for 100 percent loans and countries in the yellow category qualify for a 50/50 loan/grant combination.

8. Under ADF-11, a modified volume approach has been applied. The primary purposes of this approach are to cover the administrative charges for grant allocations up-front and to strengthen the incentive structure of the PBA system. The modified volume approach applies a 20 percent volume discount to all grants. This discount is sub-divided into a 10.12 percent charges-related portion and a 9.88 percent incentives-related portion. The PBA method is then used to re-allocate the incentives-related portion to all ADF-only countries in order to reinforce the PBA system's incentive structure. As was agreed in the Deputies' Report, the PBA-related country allocations of

[16] Documents ADB/BD/WP/2009/08 and ADF/BD/WP/2009/05

fragile states[17] eligible for grants are subject to the charges-related discount and are exempt from the incentive-related discount. The discount on grants does not apply to top-up allocations under Pillar I of the FSF. The grant share of the allocation of each country after the DSF is applied, is maintained throughout the allocation process.

Third Step: The MDRI Netting-Out Effect

9. The entry into effect of the MDRI in September 2006 introduced an additional step into the ADF resources allocation process. The foregone debt service payments of countries qualifying for debt relief under the MDRI are deducted from those countries' allocations through the netting-out mechanism. Resources provided by donors to compensate the ADF for the MDRI are re-allocated to all ADF-only countries using the PBA system.

[17] For allocation planning purposes, this document defines fragile states as the nine countries potentially eligible for Pillar I of the FSF. Should these countries become ineligible, the appropriate adjustments will be made.