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# ADF-12 Resource Allocation

**Discussion Paper**

ADF-12 Mid-Term Review
September 2012
Praia, Cape Verde

**AFRICAN DEVELOPMENT FUND**

# Executive Summary

This paper presents the allocation and use of the resources of the Twelfth General Replenishment of the African Development Fund (ADF-12) at mid-term and the expectations for the remainder of the cycle. It also presents Management's assessment of the status and expectations on the resources currently in Pillar II (arrears clearance window) of the Fragile States Facility (FSF), and makes a proposal concerning their use. Finally, it presents two issues for possible discussion during the ADF-13 consultations; namely, the cost-sharing arrangements for Regional Operations (ROs) and potential improvements to the Performance-Based Allocation (PBA) system.

As in ADF-11, the ADF-12 resources have been allocated to national country envelopes through the Performance-Based Allocation system, and to the two set-asides for ROs and Fragile States. At 31 July 2012, 15 months after ADF-12 took effect, Units of Account (UA) 2,622 million out of the total expected resources for the three windows of UA 5,876 million (45 percent) have been committed to new projects and programs. The utilization rate is expected to rise to 64 percent by December 2012 and to approach 100 percent by the end of the ADF-12 cycle, assuming that the resources for arrears clearance will be used.

Resources allocated through the PBA system have continued to flow to the best-performing countries, as measured by the Country Policy and Institutional Assessment. In addition, the new RO Selection and Prioritization Framework has strengthened the link between ROs and performance.

Pillar II of the FSF currently contains UA 362.29 million. Based on the countries' progress so far in meeting the technical requirements for arrears clearance and indications of ongoing efforts, Management's assessment is that Sudan and/or Zimbabwe could qualify for arrears clearance by the end of the ADF-12 period. Management believes that the Bank should remain ready to provide arrears clearance as and when countries meet the relevant conditions, and therefore proposes to retain the Pillar II resources within the Pillar throughout ADF-12. Management also recommends that any unused amount at the end of the cycle be rolled over to the same window in ADF-13.

Management has identified two emerging issues for discussion in ADF-13. Firstly, concerning the cost-sharing arrangements for ROs, Management proposes to examine and possibly consider adjustments to (i) the incentive mechanism and cost-sharing arrangements in order to further extend the overall share of ADF resources directed towards ROs, irrespective of any change to the relative size of RO envelope; and (ii) the cost-sharing exception for countries with small allocations, to ensure an equitable access to resources from the RO envelope among all ADF countries.

Secondly, concerning possible improvements to the PBA system, while maintaining an undiminished focus on performance, Management proposes to further explore five areas:

- stronger alignment of the aid allocation methodology to the African Development Fund's operational priorities;
- better capturing continent- and region-specific factors affecting development in RMCs;
- rewarding outcome-based performance;
- ensuring a meaningful engagement through the country allocation; and
- improvements to the resource allocation system for fragile states.

Management seeks Deputies' guidance on these issues.

## Table of Contents



### Figures



### Tables

## Abbreviations

| | |
|---|---|
| ACC | Advance Commitment Capacity |
| ADB | African Development Bank |
| ADF | 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 |
| ADF-13 | Thirteenth General Replenishment of the African Development Fund |
| CPA | Country Performance Assessment |
| CPIA | Country Policy and Institutional Assessment |
| DSF | Debt Sustainability Framework |
| FSF | Fragile States Facility |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| GR | Governance Rating |
| HIPC | Heavily Indebted Poor Countries |
| IDA | International Development Association |
| IFAD | International Fund for Agricultural Development |
| IFI | International Financial Institution |
| IMF | International Monetary Fund |
| I-PRSP | Interim Poverty Reduction Strategy Paper |
| MDB | Multilateral Development Bank |
| MDG | Millennium Development Goal |
| MDRI | Multilateral Debt Relief Initiative |
| MTR | Mid-Term Review |
| NTF | Nigeria Trust Fund |
| PBA | Performance-Based Allocation |
| PBO | Policy-Based Operation |
| PPA | Portfolio Performance Assessment |
| RMC | Regional Member Country |
| RO | Regional Operation |
| RPG | Regional Public Good |
| SCC | Statement of Commitment Capacity |
| SMP | Staff Monitored Programs |
| TWG | Technical Working Group |
| UA | Unit of Account |
| USD | United States Dollar |
| ZAADDS | Zimbabwe Accelerated Arrears Clearance, Debt and Development Strategy |

# *ADF-12 RESOURCE ALLOCATION*

## 1. Introduction

1.1 The Twelfth General Replenishment of the African Development Fund (ADF-12) took place at a time when both donor countries and African low-income countries were facing critical challenges, which have not diminished since then. Nevertheless, substantial resources were mobilized for ADF-12, in recognition of the African Development Fund (ADF or the Fund)'s role as an important channel for development financing on highly concessional terms. It was agreed that the ADF resources would continue to be channeled to the poorest countries, in line with the Bank Group's mandate to promote sustainable economic and social development and to reduce poverty. Country performance would continue to drive resource allocation decisions, in order to achieve the most effective employment of resources for development purposes.

1.2 This paper presents the implementation of the agreed framework for the allocation of ADF resources during the ADF-12 period. It presents the resources currently available for allocation under the Performance-Based Allocation (PBA) system and discusses the set-asides for regional operations (ROs) and fragile states (Fragile States Facility, or FSF). It also presents Management's assessment of the status and expectations on the FSF Pillar II resources for arrears clearance, and makes a proposal concerning these resources. Finally, it identifies some issues regarding the application of the RO cost-sharing system and a range of options for possible improvements to the PBA system, for discussion during the ADF-13 replenishment consultations.

## 2. Allocation and Use of ADF-12 Resources

2.1 The African Development Bank's (ADB or the Bank) regional member countries (RMCs) currently count 38 ADF-only countries, two countries in transition to ADB-only status, and one blend country (see Annex I: Classification of Regional Member Countries). Their eligibility for ADF resources is determined by their creditworthiness, performance and gross national income per capita and, in the case of the graduating countries, the length of the transition period. Specific ADF country allocations are based on performance and needs. 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 meet the relevant criteria.

### *Overall Resources at 30 June 2012*

2.2 Total expected resources under ADF-12 amount to Units of Account (UA) 6.266 billion. As highlighted in Table 1, internally generated resources and payments received on donors' subscriptions[1] available for commitment to projects and programs stood at UA 4.112 billion on 30 June 2012. On that same date, UA 2.374 billion or 58 percent of the resources available for commitment had been committed. The balance available for commitment stood at UA 1.738 billion.

[1] See Annex II: Status of ADF Subscriptions and Payments.

**Table 1: ADF-12 Resources and Uses at 30 June 2012**

*(UA million)*

| | Expected ADF-12 Resources[2] at 30 June 2012 | Available Resources (Commitment Capacity)[3] at 30 June 2012 | Committed Resources[4] at 30 June 2012 | Balance |
|---|---|---|---|---|
| Performance-Based Allocation resources | 3,885.80 | 2,091.67 | 1,616.03 | **475.64** |
| Regional Operations envelope | 1,162.50 | 1,162.50 | 536.13 | **626.37** |
| Fragile States Facility | 764.04 | 828.12 | 221.62 | **606.50** |
| *of which Pillar I: supplemental* | *404.94* | *404.94* | *201.50* | *203.44* |
| *of which Pillar II: arrears clearance* | *359.10* | *362.29* | - | *362.29* |
| *of which Pillar III: targeted* | - | *60.89* | *20.12* | *40.77* |
| Project Preparation Facility | - | 16.20 | 0.40 | **15.80** |
| Contingencies | 453.60 | 13.65 | - | **13.65** |
| **TOTAL** | **6,265.94** | **4,112.14** | **2,374.18** | **1,737.96** |

*Source: Unless otherwise indicated, all data presented in tables are generated internally by the African Development Bank.*

### *Performance-Based Allocation Resources*

2.3 Resources available for allocation to countries under the PBA framework (see Annex III: The Performance-Based Allocation Process) are made up of total ADF-12 replenishment resources, plus carry-over resources from previous ADF replenishments, less deductions for contingencies and set-asides. As set out in the ADF-12 Report, there are two set-asides: one for ROs (20 percent of the ADF-12 envelope) and one for fragile states (UA 764 million). These are linked to country PBAs but are not strictly allocated under the PBA system[5]. After deducting contingencies[6] and set-asides, total resources expected to be available for PBAs under ADF-12 equal UA 3.886 billion (Table 1).

2.4 As at 30 June, of the UA 3.886 billion in resources expected to be allocated under the PBA system during ADF-12, UA 1.616 billion (42 percent of the PBA envelope and 77 percent of available resources) has been committed. Thus far, 69 percent of country PBA commitments have been for investment and capacity-building projects while 31 percent have been for policy-based operations (PBOs). The share of PBOs in the approvals so far is due in part to high demand for fast-disbursing instruments early in the cycle. The 2011-2013 pipeline indicates that the share of PBOs in total PBA approvals will fall to approximately 21.5 percent by the end of the cycle, which is below the 25 percent ceiling for PBOs agreed for ADF-12.

2.5 Of the PBA approvals, 71 percent have been in the form of loans and 29 percent in the form of grants. The loan and grant mix of ADF allocations follows the agreed joint World Bank-International Monetary Fund Debt Sustainability Framework (DSF), which classifies countries as having a high, moderate or low risk of debt distress. [7]

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2 African Development Fund. 29 December 2011. *2012 Country Allocations Under ADF-12.* ADF/BD/IF/2011/245.

3 African Development Fund. 12 July 2012. *Statement of Commitment Capacity (SCC) at June 30, 2012*. ADF/BD/IF/2012/121. Available resources for FSF Pillar II include the carry-over of UA 3.19 million from ADF-11. Available resources for FSF Pillar III include the UA 60 million ADB net income allocation.

4 This amount includes surcharges on grants as derived from the Statement of Commitment Capacity.

5 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.

6 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-12 period; and (iii) an *ad hoc* contingency for late and qualified subscriptions to ensure that only the resources actually 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 annually to reflect actual contributions.

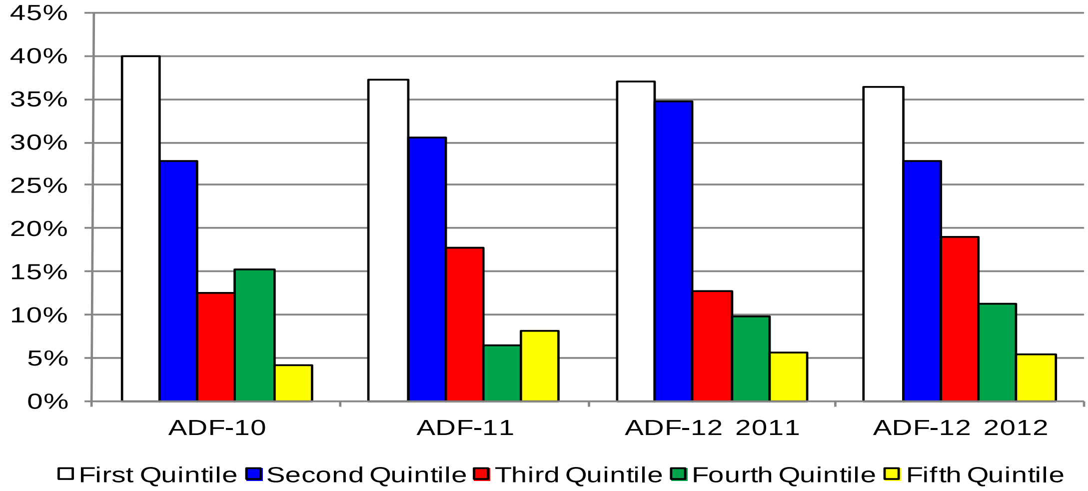
7 Countries with low risk of debt distress receive their allocation fully in the form of loans, countries with moderate risk of debt distress receive 50% of their allocation in the form of loans and 50% in the form of grants, and countries with high risk of debt distress receive their allocation fully in the form of grants.

2.6 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 performance and needs using the PBA formula. Second, country-specific financing terms (loans, grants, or a loan/grant combination) are determined using the 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. Finally, a minimum allocation of UA 5 million per cycle is applied.

2.7 **Performance**. As under previous ADFs, ADF-12 PBA resources have continued to be allocated to the best performing countries as measured by the Country and Institutional Performance Assessment (Figure 1). The bulk of the final allocated resources in 2012, namely 64.4 percent, goes to the two strongest-performing quintiles. In turn, 16.5 percent of total final resources go to the two lowest-performance quintiles. The allocation system thus continues to be effective at directing more resources to stronger performers.

**Figure 1: Resource Allocation by Performance, ADF-10 through ADF-12**

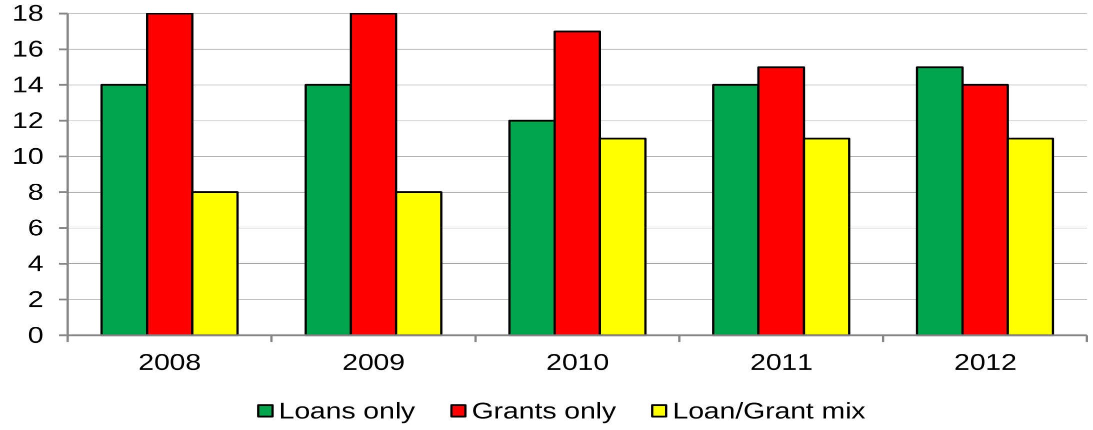
*(Percentage of PBA resources allocated to each quintile)*




2.8 **DSF and MDRI Adjustments.** As detailed in Annex III, the DSF is used to determine countries' grant financing eligibility based on their risk of debt distress. Figure 2 shows the evolution of the distribution of countries' allocations following the DSF during ADF-11 and ADF-12. Over the period, the number of countries at high risk of debt distress (grants only) declined, while the number of countries at low (loans only) and moderate risk (loan/grant combination) increased. In 2012, the number of loan-only countries exceeds the number of grant-only countries for the first time.

**Figure 2: Allocations by DSF Classification**

*(Number of countries)*




2.9 As during ADF-10 and ADF-11, 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 5.43 percent designed to prevent moral hazard and help maintain the strength of the ADF's incentive system, as reflected in its PBAs;[8] and (ii) a charges-related portion of 14.57 percent to cover foregone administrative charges.

2.10 Resources from the envelope earmarked for ROs are ordinarily provided on the same terms (loans or grants) as the beneficiary country's PBA allocation. In the case of fragile states[9] eligible for grants, the PBA country allocation is subject only to the charges-related portion of the volume discount; the incentive-related portion does not apply.[10]

2.11 The MDRI provides 100 percent cancellation of eligible ADF, International Development Association (IDA) and International Monetary Fund (IMF) debt owed by heavily indebted poor countries (HIPCs) 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.

2.12 While the MDRI netting-out and reallocation mechanism has effects on country allocations (this year, the ADF allocations of 15 countries decreased, and 23 countries' allocations increased, due to netting out), debt cancellation through MDRI provides countries much-needed budgetary relief. In addition, the net flows to each MDRI country (allocation minus loan repayments) remain at least the same as before the MDRI debt cancellation and netting out, and in most cases improve due to the re-allocation of the netted out amounts.

2.13 **Minimum allocation.** As the final step in the allocation process, it is ensured that all ADF countries receive a minimum allocation of UA 5 million for the three-year cycle (UA 1.667 million per year). Any country whose allocation after the MDRI adjustments is below this threshold sees its allocation topped up to the minimum level.

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8 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 favorable terms to countries with a moderate or high risk of debt distress.

9 This paper defines fragile states as the 12 countries eligible for Pillar I of the FSF.

10 The volume discount on grants does not apply to supplemental allocations under Pillar I of the FSF since these allocations, although linked to the PBA, are not strictly allocated under the PBA system.

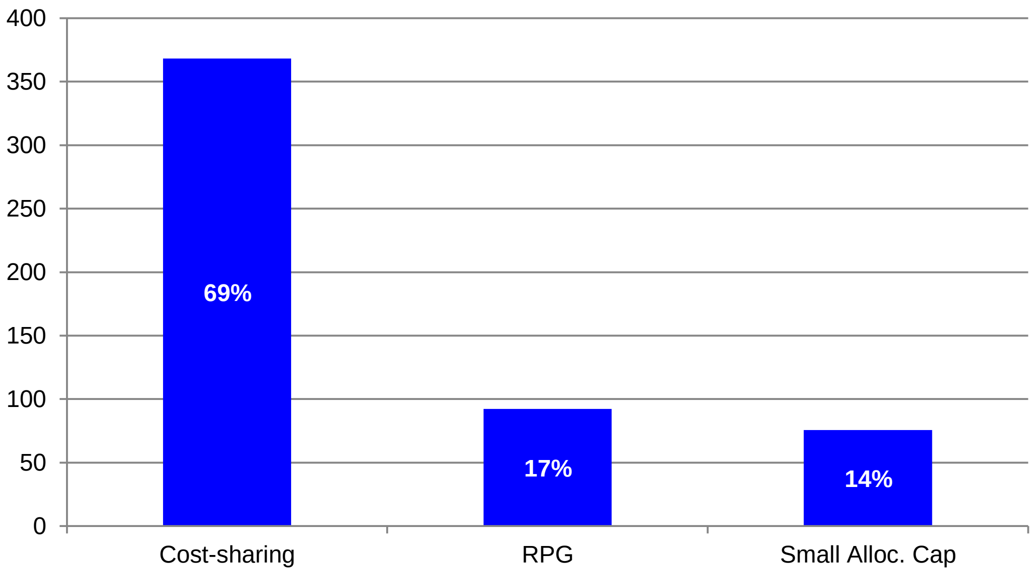
### *Resources for Regional Operations*

2.14 For ADF-12, it was agreed to increase the size of the RO envelope to 20 percent of ADF resources net of contingencies (currently UA 1,162.5 million). At the same time, an RO Selection and Prioritization Framework was developed in order to strengthen the link to performance and to select the most deserving projects (see "Progress Report on Operational Priorities"). The cost-sharing mechanism introduced in ADF-11, whereby a country finances up to one-third of project costs from its PBA allocation and the RO envelope covers up to two-thirds, was maintained. The possible exceptions to this mechanism, for countries with a small PBA allocation[11] and for Regional Public Goods (RPGs), were also maintained, but a cap was introduced on the total amount that could be spent on RPGs (15 percent of the RO envelope).

2.15 Ten multinational projects had been approved at 30 June 2012, for a total of UA 761 million. UA 536 million of this total (70.4 percent) comes from the RO envelope, representing 46 percent of available resources. Standard cost-sharing applied to five of the ten operations; four operations were RPGs provided in the form of grants and exempted from cost-sharing, and in one case the small allocation cap applied. Within the UA 536 million financed out of the RO envelope, 69 percent (UA 368 million) financed projects with standard cost sharing from participating countries while 31 percent (UA 168 million) financed projects fully or partially exempted from cost sharing (RPGs or small allocation exception) (Figure 3).

**Figure 3: Regional Operations Cost Sharing and Exemptions**

*(UA million)*




### *Resources for Fragile States*

2.16 As agreed in ADF-12, UA 764 million has been allocated to the FSF, of which UA 405 million for Pillar I and UA 359 million for Pillar II. To these resources were added the carry-over from ADF-11 (UA 3.19 million in Pillar II) and the UA 60 million ADB net income transfer for Pillar III. At end-June 2012, UA 222 million has been committed from the FSF (UA 202 million from Pillar I and UA 20 million from Pillar III), which is equal to 27 percent of total available resources. There have been no commitments from Pillar II.

2.17 In 2011, the Board of Directors approved the eligibility of 12 countries for Pillar I. Following the independence of South Sudan, the PBA and FSF resources that had been allocated to the unified Sudan were apportioned between South Sudan and Sudan. The final Pillar I allocations are set forth in Table 2.

[11] Countries with a three-year indicative PBA allocation of UA 20 million or less contribute a maximum of 10 percent of their allocation; the RO envelope covers the remaining costs.

**Table 2: Fragile States' Pillar I and Total Allocations under ADF-12**

*(UA million)*

| Country | Pillar I allocation[1] | Three-year Indicative PBA Allocation plus Pillar I Allocation |
|---|---|---|
| Burundi | 57.23 | 86.59 |
| Central African Republic | 26.43 | 42.68 |
| Comoros | 10.00 | 15.57 |
| Congo DRC | 60.00 | 231.82 |
| Côte d'Ivoire | 60.00 | 121.41 |
| Guinea Bissau | 12.51 | 18.93 |
| Liberia | 52.43 | 91.84 |
| Sierra Leone | 28.71 | 52.61 |
| South Sudan | 17.03[2] | 33.09 |
| Sudan | 22.97[2] | 69.02 |
| Togo | 41.51 | 60.25 |
| Zimbabwe | 16.12 | 33.58 |
| **Total** | **404.94** | **857.39** |

*Notes: [1]: A floor of UA 10 million and a ceiling of UA 60 million apply to Pillar I allocations; [2] Following the apportionment of resources between South Sudan and Sudan.*

### *Resources Available from Cancellations*

2.18 Management has made conscious efforts to clean up the non-performing elements in the active ADF portfolio and improve portfolio quality. Efforts have specifically been focused on cancelling projects which are eligible for cancelation and whose performance cannot be improved through other measures. These efforts have been successful: the volume of cancelations has increased from UA 16 million in 2009 to UA 147 million in 2011.

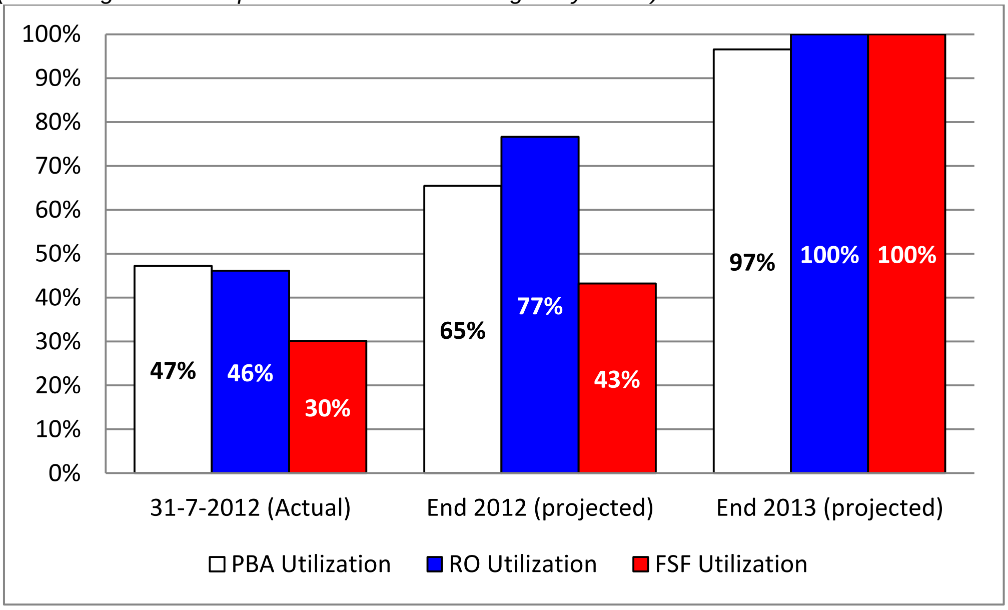
2.19 In May 2011, the Board of Directors approved the Revised Guidelines on Cancellation of Approved Loans, Grants and Guarantees (ADB/BD/WP/2010/106/Rev.3/Approval), which allow ADF-eligible countries to retain 70 percent of the resources from ADF operations that have been cancelled (usually old and/or non-performing operations that were financed under previous ADF cycles).[12] The retained amount can be re-used for commitment to ongoing operations or new activities consistent with the Country Strategy Paper. A new annex to the quarterly ADF Statement of Commitment Capacity provides an overview of the loans and grants cancelled per ADF-eligible country, and the amounts available for re-use. These resources are available to countries in addition to their ADF-12 PBA and FSF allocations and the RO envelope.

2.20 This new provision has proved to be a useful tool in stimulating cancelation of aging and non-performing operations and the above-mentioned general portfolio clean-up. At 30 June 2012, total resources available to ADF countries from cancellations stood at UA 107 million, of which UA 63 million (58 percent) had been re-committed to new operations.

[12] Previously, these cancelled resources would flow back to the general pool of ADF resources and form part of the internally generated resources (Advance Commitment Capacity, ACC) for the next ADF cycle. With the change in the guidelines, 30 percent of canceled amounts flow into the ACC.

**Figure 4: Actual (31 July 2012) and Projected Use of Resources during ADF-12**

*(Percentage of total expected resources including carry-overs)*




*Note: Projection of FSF utilization assumes that the resources for arrears clearance will be used.*

### *Summary using latest available data*

2.21 At 31 July 2012, 15 months after ADF-12 took effect, UA 2,622 million out of the total expected resources for the three windows of UA 5,876 million[13] (45 percent) had been committed to new projects and programs. This rate is expected to rise to 64 percent by December 2012. As shown in Figure 4, resource usage for each of the three windows is commensurate with expectations midway through an ADF cycle (see also the Progress Report on Operational Priorities). By the end of ADF-12, all resources are expected to be committed[14].

## 3. Report and Proposal on Use of ADF-12 FSF Pillar II Resources

3.1 In ADF-12, the FSF Pillar II has grant resources in the amount of UA 362.29 million that consist of UA 359.1 million of ADF 12 resources and a carry-over of UA 3.19 million from ADF-11. The resources are to be used to clear arrears for eligible countries on a first-come-first-served basis. The countries expected to benefit from the FSF arrears clearance program in ADF 12 are Sudan, Zimbabwe and/or Somalia. At end-July 2012, these resources have not been used, primarily due to the targeted countries' insufficient progress in meeting the requirements for arrears clearance and debt relief.

3.2 This section responds to Management's commitment to assess at the ADF-12 Mid-Term Review the status and expectations on the use of FSF Pillar II resources during the remainder of the ADF-12 period and, based on the assessment, to make a proposal regarding the use of these resources, including the possibility of a transfer to the PBA pool for reallocation to all ADF countries during the third year of the ADF-12 cycle.

3.3 Based on the countries' progress so far in meeting the technical requirements for arrears clearance and indications of ongoing efforts, Management's assessment is that Sudan and/or Zimbabwe could qualify for arrears clearance during the remainder of the ADF-12 period. While prospects for Somalia, which is also a potential HIPC beneficiary, remain to be assessed, if the current momentum of international engagement continues, it could qualify for arrears clearance and debt relief during the ADF-13 cycle, 2014-2016.

[13] UA 3,885.8 million for PBA, UA 1,162.5 million for the RO envelope, and UA 828.1 million for the FSF.

[14] Assuming that the FSF Pillar II resources for arrears clearance will be used. If these resources are not used, then FSF utilization will reach 52% and overall usage will reach 90%.

3.4 Management believes that the Bank should be prepared to provide arrears clearance as and when countries fulfill the relevant conditions, and that the Pillar II resources should thus remain available for arrears clearance for the remainder of ADF-12. Management therefore proposes to retain these resources within the Pillar throughout the ADF-12 period. It also recommends that any unused amount at the end of the cycle be rolled over to the same window in ADF-13. Experience shows that situations can evolve quickly, and the Bank should be ready to respond.

### *Situation of External Debt Stock and Arrears Accumulated with the Bank Group*

3.5 The external debt situation of Sudan, Zimbabwe and Somalia is highly unsustainable. At December 2011, Sudan's reconciled external debt stood at USD 38 billion, of which 84 percent was in arrears. Zimbabwe's external debt stock at end 2011 (not yet reconciled by the Bretton Woods Institutions) was estimated at USD 8.8 billion or about 118 percent of GDP, of which over two-thirds is in arrears. There is no reliable, comprehensive data available on Somalia's external debt stock.

3.6 Sudan, Zimbabwe and Somalia have accumulated substantial arrears with the International Financial Institutions (IFIs), including the Bank Group. Table 3 summarizes the arrears accumulated by Sudan, Zimbabwe and Somalia at 30 June 2012. Total arrears amount to UA 637.60 million, of which UA 201.25 million for Sudan, UA 376.22 million for Zimbabwe, and UA 60.13 million for Somalia.

**Table 3: Outstanding Arrears to the Bank Group at 30 June 2012**[15]

*(UA million)*

| Country | Arrears to ADB | Arrears to ADF | Arrears to NTF | Total |
|---|---|---|---|---|
| Sudan | 122.98 | 78.27 | - | 201.25 |
| Zimbabwe | 367.56 | 8.66 | - | 376.22 |
| ***Subtotal Sudan + Zimbabwe*** | ***490.54*** | ***86.93*** | **-** | ***577.47*** |
| Somalia | 14.66 | 43.82 | 1.65 | 60.13 |
| **Total** | **505.20** | **130.75** | **1.65** | **637.60** |

### *Progress Made in Meeting Requirements for Arrears Clearance and Debt Relief*

3.7 Sudan and Zimbabwe have yet to conclude arrears clearance and debt relief programs with the IFIs. However, the two countries have been working closely with the Bank, the Bretton Woods Institutions and other donors with the objective of meeting the requirements for arrears clearance and HIPC debt relief. These requirements include: (i) lifting political restrictive measures imposed by the international community; (ii) being eligible for debt relief under the HIPC Initiative; (iii) demonstrating respect for the IFIs' preferred-creditor status by servicing new maturities on all outstanding loans or at least to the same relative level of debt service paid to other creditors; and (iv) showing a readiness to re-engage by completing the technical requirements under the HIPC Initiative such as implementing an IMF-supported program, being classified as an IDA-only country, and having in place a reengagement strategy in the context of a poverty-reduction program.

#### Progress Made by Sudan

3.8 Sudan has made substantial progress, through the Sudan Technical Working Group on Debt (TWG) established in October 2010, in reconciling its external-debt data with creditors. At March 2012, USD 34.9 billion or about 92 percent of the country's multilateral, bilateral and commercial external debt data had been reconciled.[16] Furthermore, Sudan and South Sudan have agreed in principle on a "zero option" on apportionment of debt, whereby Sudan will

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[15] For more details, see *Situation of Arrears on ADB/ADF/NTF Loans at 30 June 2012*, respectively ADB/BD/IF/2012/137, ADF/BD/IF/2012/119, and ADB/BD/IF/2012/138.

[16] The yet-to-be-reconciled debt data are for countries such as Russia and institutions such as the Arab Monetary Fund and the Islamic Development Bank.

assume all debts[17].

3.9 Sudan has implemented a range of macroeconomic and structural reforms since 2000 under nine successive IMF Staff Monitored Programs (SMPs). The reforms have contributed to restoring macroeconomic and financial stability, thereby improving the conditions for economic growth. The country is negotiating a new SMP for 2012 with the IMF, focused on addressing the current macroeconomic shocks experienced following the secession of South Sudan.

3.10 Sudan has further prepared an Interim Poverty Reduction Strategy Paper (I-PRSP) through a participatory and inclusive process, which has been approved by Parliament and will be submitted for review and consideration by the Bretton Woods institutions. The I-PRSP will be published after the Joint Advisory Note on Sudan's I-PRSP is prepared by the IMF and the World Bank. Sudan is also making arrangements to start token payments to the Bank and other creditors and to further collaborate with its creditors.

3.11 **Remaining Challenges**: Despite the progress made in meeting the requirements for arrears clearance and debt relief, a number of issues remain outstanding, including (i) demonstrating respect of preferred-creditor status by servicing all outstanding maturities, at least to the same relative level of debt service paid to other creditors; and (ii) concluding the outstanding Comprehensive Peace Agreement issues with South Sudan, such as agreements on security and borders, citizenship, and arrangements concerning oil and associated payments. Progress on these issues will be important in the international community's decisions to lift the existing restrictive measures on Sudan.

3.12 Sudan also faces significant economic challenges, given that the secession of South Sudan translated into a fiscal and balance-of-payments crisis in Sudan due to a sudden reduction in export earnings and budgetary revenues. The latter problem was recently compounded by the shut-down in exports of South Sudan's oil through the pipeline in Sudan. The combined effects of the two shocks have been to reduce the foreign exchange earnings from oil and to sharply contract the country's GDP growth rates and the economy. Appropriate macroeconomic and structural reform measures are therefore required to mitigate the adverse effects of the shocks that the Sudanese economy is experiencing, and over the longer term to reduce the heavy dependency on oil for financing the country's fiscal budget and imports.

3.13 The international community's recent engagement on Sudan leads Management to believe that the prospects for resolving the outstanding issues by end-2013 are conceivable, which would pave the way for Sudan to qualify for arrears clearance and HIPC debt relief. Management therefore believes that Sudan could be found eligible for a Pillar II arrears clearance program during the ADF-12 period, and thinks that the Bank should be prepared for this.

### Progress Made by Zimbabwe

3.14 At July 2012, Zimbabwe had not qualified for eligibility to the HIPC initiative, which is a requirement for accessing arrears clearance support from the FSF Pillar II. Nonetheless, the country continues to make progress in meeting the requirements for arrears clearance and could qualify for debt relief. In 2010, the country reached consensus on debt resolution with its creditors and published the Zimbabwe Accelerated Arrears Clearance, Debt and Development Strategy (ZAADDS), which provides a broad framework for a hybrid approach to debt relief, possibly outside of the HIPC/MDRI framework. The main components of the ZAADDS are reconciliation and validation of external debt data, re-engagement with all creditors and with the wider international community for the removal of the restrictive measures, and the moving forward of the negotiation for arrears clearance and comprehensive debt relief. The country will need to demonstrate substantial progress in all these areas, as well as show commitment to implementing the ZAADDS' technical and operational details.

3.15 The country is currently negotiating with the IMF on an IMF-supported program. Zimbabwe will also need to work closely with the international community, with the objective of lifting the restrictive measures currently in place. To this end, several "Friends of Zimbabwe" meetings took place in March-April 2012. The objective was to deepen the dialogue between Zimbabwe

[17] This is subject to (i) firm commitment by the international community to provide comprehensive debt relief within a two-year period during which Sudan aims to reach the Decision Point and (ii) a joint creditor outreach strategy in which both sides would participate actively.

and its creditors, assess progress on political and economic developments and determine how best to strengthen engagement. The overall conclusion from the meetings was that Zimbabwe has embarked on an appropriate reform path and has made commendable efforts to improve fiscal management and transparency and accountability in the management of human resources. The meetings called for policy predictability and a reduction of uncertainties, the perception of which continues to hamper domestic and foreign investment. The meetings also encouraged continued efforts to reform the public financial management system.

3.16 Overall, Management believes that if the current momentum is maintained, Zimbabwe can make significant progress in implementing the Accelerated Arrears Clearance, Debt and Development Strategy. If, in addition, the remaining challenges are addressed, Zimbabwe could become eligible for arrears clearance within the ADF-12 timeframe. Given that the situation can improve quickly, it would be prudent to have resources available should all conditions be met.

### *Available FSF Pillar II Resources*

3.17 The FSF Pillar II resources amount to UA 362.29 million, all contributed by the ADF. Due to the prohibition against re-financing, these resources can clear only the ADB portion of countries' arrears. For clearing the ADF portion of the arrears, additional resources, from the ADB or other sources, must be mobilized. The final amount needed by the Bank will depend on the timing of the arrears clearance, the financing plan, the debt-burden-sharing arrangements (based on an evaluation of countries' capacity to contribute) and the arrears cut-off date agreed.

3.18 If the Bank is to cover the full cost of clearing Sudan's arrears, the Pillar II resources can be used to cover the ADB portion of UA 122.98 million (Table 3). The Bank would need to mobilize other resources in the amount of UA 78.27 million to clear the ADF portion of Sudan's arrears. If Zimbabwe becomes eligible for arrears clearance, the UA 362.29 million in the FSF Pillar II are insufficient to clear the ADB-portion of its arrears in the amount of UA 367.56 million at 30 June 2012. The Bank would therefore need to mobilize additional resources, also for the UA 8.66 million required to clear Zimbabwe's ADF arrears.

3.19 To fully clear the arrears of both Sudan and Zimbabwe, the Bank would need ADF resources in the amount of UA 490.54 million and ADB or other resources in the amount of UA 86.93 million (Table 3). Resources in the FSF Pillar II are therefore insufficient to address the arrears clearing needs should both countries be found eligible during ADF 12.

3.20 The arrears projections for Sudan, Zimbabwe and Somalia by end-December 2013 (end of ADF-12) are, as shown in Table 4, estimated at UA 689.26 million. Arrears to the ADB window are expected to total UA 541.79 million, and those to the ADF and the NTF to UA 145.73 million and UA 1.74 million, respectively.[18]

**Table 4: Projection of Outstanding Arrears to the Bank Group at 31 December 2013**

*(UA million)*

| Country | Arrears to ADB | Arrears to ADF | Arrears to NTF | Total |
|---|---|---|---|---|
| Sudan | 129.37 | 88.04 | - | 217.41 |
| Zimbabwe | 397.06 | 10.50 | - | 407.56 |
| ***Subtotal Sudan + Zimbabwe*** | ***526.43*** | ***98.54*** | **-** | ***624.97*** |
| Somalia | 15.36 | 47.19 | 1.74 | 64.29 |
| **Total** | **541.79** | **145.73** | **1.74** | **689.26** |

[18] The UA figures mentioned here and in Table 4 are based on end of June 2012 foreign exchange rates. As the arrears are denominated in various currencies, the actual amounts at a future date may differ due to exchange rate movements.

### *Management Proposal*

3.21 At July 2012, Sudan had made substantial progress in meeting the technical requirements for arrears clearance and debt relief, although challenges remain. Management believes that Sudan could meet the requirements for arrears clearance and debt relief within the timeframe of ADF-12. It is important for the Bank to be ready to address Sudan's arrears and debt because these issues are closely linked with the prospects for consolidating peace and security between Sudan and South Sudan.

3.22 Zimbabwe, which is not currently HIPC-eligible, has also been making some progress, though at a slower pace. As mentioned in paragraph 3.15, several Friends of Zimbabwe meetings have taken place. If the current momentum is maintained and the remaining challenges are addressed, it is possible that Zimbabwe will become eligible for arrears clearance within the timeframe of ADF-12.

3.23 While prospects for Somalia remain to be assessed, Management believes that if the current momentum of international engagement continues, it could qualify for arrears clearance and debt relief in the ADF-13 period, 2014-2016.

3.24 Management believes that the Bank should be ready to clear the arrears of countries once they meet the requirements for accessing the FSF Pillar II assistance in the context of a comprehensive arrears clearance and debt relief program agreed with the international community, including the Bretton Woods Institutions. The independent evaluation of the Bank's assistance to fragile states found that such an approach has worked well in the past. Insufficient resources in Pillar II could delay or complicate the process of any country that meets the requirements for arrears clearance.

3.25 Following from this assessment, Management believes that the Pillar II resources should remain available for arrears clearance purposes during ADF-12. It thus *recommends that the resources in the amount of UA 362.29 million in the FSF Pillar II be retained within the same window for the remainder of ADF-12,* for use by countries (most likely Sudan and/or Zimbabwe) as and when they become eligible for arrears clearance and debt relief.

3.26 Management proposes to roll over any Pillar II resources that remain unused at the end of the ADF-12 cycle in the same Pillar for ADF-13. If neither Sudan nor Zimbabwe becomes eligible for arrears clearance during ADF-12, the resources that will be required to clear the arrears during ADF-13 will amount to at least at UA 689.26 million, of which UA 541.79 million requiring ADF resources (end-December 2013 projection). Given the fiscal constraints of donor countries, it will be difficult to mobilize this amount during the ADF-13 replenishment. It is therefore prudent to maintain the existing resources in Pillar II so that only the difference will need to be additionally mobilized. Management also thinks that resources mobilized for the FSF should in principle be retained within the FSF for use by eligible fragile states.

## 4. Emerging Issues to be Discussed in ADF-13

### *Cost-Sharing Arrangements for Regional Operations*

4.1 The demand for funding for ROs in ADF-12 far outstripped the supply of resources. The demand for resources for high-quality projects will further increase following the endorsement by African heads of state and government, in January 2012, of the Program for Infrastructure Development in Africa. Its Priority Action Plan outlines 51 critical infrastructure projects and programs that will help the continent realize its full growth potential. This infrastructure blueprint amounts to capital investments of USD 7.5 billion per year up to 2020, with strong calls on the ADF to play a significant role.

4.2 ADF-12 maintained the RO incentive mechanism established under ADF-11, through a cost-sharing arrangement whereby a country finances at least one-third of project costs from its PBA allocation and the RO envelope covers up to two-thirds. This scheme has been successful in inviting strong participation of ADF countries in regional undertakings fostering regional economic integration, one of the key priorities of the Bank Group and of the ADF. Indeed, the two-times leverage effect provides so much incentive that the demand for RO funding in ADF-12 far outstrips the supply of resources.

4.3 The annual RO selection and prioritization exercise serves to strengthen the link between ROs and performance by promoting the selection of the highest-quality projects, expected to yield the greatest development impact, for ADF funding. In implementing this annual exercise for 2011 and 2012, the Operations Committee had to pragmatically address the gap between the supply and demand for funding. The Committee decided to apply a reduced leverage factor of 1.5 to 1 in 2012 and 2013[19] (i.e. a cost sharing of 40 percent PBA, 60 percent RO envelope) in order to allow a larger number of deserving ROs to be financed. Lowering the leverage ratio equates to extending the overall share of ADF going towards regional integration, hence providing better accompaniment to countries implementing Program for Infrastructure Development in Africa priorities while maintaining the relative size of the RO set-aside.

4.4 In addition, the perceived disproportionate benefit that countries with a small PBA allocation (whose contributions to ROs are capped) derive from the RO envelope[20] has caused tensions between countries participating in ROs and was identified as a challenge in maintaining equitable access for all potential beneficiaries.

4.5 Under the current policy framework[21], Regional Public Goods operations can, on a case-by-case basis and with due justification, be provided fully in the form of grants and may be exempted from cost-sharing. In practice, in both ADF-11 and ADF-12, all RPG operations have been accorded both exceptions, which has had a strong incentive effect. The cap on Regional Public Goods introduced in ADF-12 (15 percent of the RO set-aside) was strictly enforced, but the experience with the process of selection revealed the need for a refined definition of this concept to ensure greater strategic alignment and better guide operational teams.

4.6 ADF's ability to support continental initiatives, particularly in relation to capacity-building programs, has been recognized in many fora by Regional Economic Communities and Specialized Institutions (power pools and basin organizations). Continued support to these regional integration building blocks is critical for the successful implementation of regional programs. Going forward, RPG eligibility criteria will need to be clarified in order to more selectively channel resources towards key regional capacity building interventions and continental initiatives that merit an exemption from standard cost-sharing rules so as to ensure an optimal use of ADF resources for RPGs. To this end, Management intends to make proposals to the Board of Directors concerning the RO selection and prioritization process, extended to include RPGs in a single and more comprehensive framework, accompanied by clear guidelines to guide operations.

4.7 For the ADF-13 replenishment discussions, Management will examine and possibly propose adjustments to:

- the incentive mechanism and cost-sharing arrangements, in order to further extend the overall share of ADF resources directed towards ROs, irrespective of any change to the relative size of RO envelope, thereby also increasing the number of ROs ADF can catalytically support; and
- the cost-sharing exception for countries with small allocations, to ensure an equitable access to resources from the RO envelope among all ADF countries.

### *Potential Modifications to the PBA System*

4.8 As agreed during the ADF-12 replenishment[22], Bank Management embarked on a series of internal and external consultations on the Fund's Performance-Based Allocation system with academics, representatives from other multilateral financial institutions and policy-makers from ADF donor and regional member countries. Building on these consultations, the ADB in its

[19] Instead of the leverage factor of 2 to 1 applied earlier

[20] For example, in the Trans-Gambia Bridge project approved in December 2011, the Gambia achieved a leverage factor of 85 to 1 with its contribution of UA 0.74 million.

[21] ADB. 13 November 2008. *Criteria for Cost-Sharing Exemption When Financing Eligible Regional Public Goods*. ADB/BD/WP/2008/183. ()

[22] Paragraph 5.8 of ADF-12 Report: "Participants agreed that while no changes would be introduced to the PBA formula during the ADF-12 period, Management should continue to explore options, in collaboration with sister institutions, to better take countries' structural vulnerability into account in the resource allocation system. Further discussions on potential modifications to the PBA formula should be brought forward at the ADF-12 Mid-Term Review."

role of African knowledge institution organized a High-Level Seminar on the “Prospects for Aid Allocation in a Changing Africa” in February 2012. The event was attended by aid experts and scholars from Regional and Non-regional Member Countries such as Mr. Tertius Zongo, former Prime Minister of Burkina Faso. Although unable to attend in person, Dr. Mo Ibrahim submitted a statement that was circulated to the attendants. A summary report with the main findings and recommendations was prepared by three of the participants and published on the Bank’s website[23].

4.9 What emerges from the internal and external consultations and also from the clients’ survey commissioned by the Bank in 2012[24] is a strong sense that the current PBA system is due for a review. With the exception of the removal of the Post-Conflict Enhancement Factor and the creation of the FSF in ADF-11, the system has remained fundamentally unchanged, mimicking that of the World Bank since its introduction in 1999. In the meantime, African countries and the Bank Group have witnessed substantial changes to their economic and institutional circumstances which may need to be reflected in the ADF resource allocation system. Also taking into account the substantial changes to the development assistance landscape, an examination of options to ensure that the ADF resource allocation system continues to meet the requirements of both donors and clients is warranted.

4.10 Management acknowledges that any proposal for improving the current PBA system must be based on the premise that the ADF resources are best employed in countries with a good track record in terms of institutional and policy reforms (particularly in the area of governance) and project execution. Thus, the focus should be maintained on rewarding countries’ good use of economic resources for achieving sustainable development, by primarily examining ways in which the various aspects of performance can be better measured in today’s context. At the same time, it should be noted that the effective utilization of resources available to countries cannot be addressed solely through the PBA formula, and should also be tackled from a programmatic perspective, through the choice and design of aid instruments that fit countries’ particular characteristics and context.

4.11 On the basis of the many useful suggestions put forward during the consultations and in the seminar report, followed by internal exchanges, Management believes that the following ideas merit further exploration and discussion during the ADF-13 replenishment consultations.

4.12 **Stronger alignment with the ADF’s operational priorities.** Countries’ policy and institutional performance in the Fund’s strategic priority sectors, including infrastructure and regional integration, is not clearly reflected in the existing PBA system. Instead, the allocation methodology tracks IDA’s more extended portfolio (social service delivery, public sector reform, etc.). Other MDBs already take their specific mandate and priorities into account in their allocation system: IFAD, for example, considers performance in the rural sector and needs of the rural population; the Caribbean Development Bank includes vulnerability indicators; and the Inter-American Development Bank uses a modified CPIA in line with its areas of intervention.

4.13 **Better capturing continent- and region-specific factors affecting development in RMCs**. Tackling challenging issues such as youth unemployment, armed conflict, food insecurity and vulnerability to climate change is central for achieving inclusive growth and development on the African continent (as elsewhere in the world). The factors underlying these issues are often region-specific as they involve physical/geographical, historical, economic, social, cultural and political relationships. Governments’ performance in dealing with such factors that are affecting development progress in their countries could be better taken into account through modifications in the CPIA questionnaire.

4.14 In terms of needs, the current measures (namely GNI per capita and population size) do not fully capture the factors behind poverty prevalence which can be region-specific (sub-Saharan Africa has the highest concentration of extreme poverty of any region in the world); neither are indicators of social development needs and capabilities included, such as the level of human capital and social equity, which are linked to the ADB’s focus on inclusive growth. The differing structural characteristics of ADF recipient countries are also absent in the current PBA

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[23] http://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/Executive%20Summary%20-%20High%20Level%20Seminar%20on%20Aid%20Allocation%20Systems%2022_02_2012.pdf

[24] ADB. *The Preferred Partner? A Client Assessment of the African Development Bank*

formulation. For example, nearly a third of African countries is landlocked and has no direct access to maritime ports and international transport networks. Among these, some are oil-importers, a condition that makes them highly vulnerable to external shocks and climate change. In this context, it could be considered to modify or complement the existing variables in the PBA formula with other indicators of development needs and capabilities that better capture continent and region-specific factors.

4.15 **Rewarding outcome-based performance.** Measures of result outcomes are not specifically included in the existing system. In addition, the weight of the portfolio performance factor in the PBA formula is low compared with the weights on the CPIA and governance. The portfolio performance assessment itself could also be adjusted to better reflect ADB operational priorities. For example, the new development outcome indicators currently being developed by the Bank could be integrated into the portfolio performance assessment either as new components or as replacements of existing components, and the weighting of the various components could be adjusted. Additional analysis is required to determine the appropriate balance between outcome indicators and policy and institutional assessment.

4.16 **Ensuring a meaningful engagement through the country allocation.** Eight of the 41 ADF-eligible countries currently receive an allocation of less than UA 10 million for three years, of which four countries received the minimum allocation of UA 1.67 million (corresponding to UA 5 million for three years) in 2012. The minimum allocation size has followed neither the evolution of the rate of inflation, which in ADF countries averaged 10.5 percent during the last 5 years, nor the unit cost of infrastructure projects and rehabilitation works, which have recently been escalating[25]. In addition, as the amounts of debt relief provided annually through the MDRI rise, the impact of the netting-out and reallocation mechanism on ADF allocations will grow stronger, particularly for countries with a small allocation. ADF-12 witnessed the first two cases of the amount of MDRI netted out nearly reaching the amount of the basic PBA allocation, and this not being offset through reallocation of the netted-out amounts. These developments risk hampering Management's possibilities to support and engage with such countries. For ADF-13, Management and Deputies might want to consider measures to ensure a meaningful financial support to and engagement with all ADF countries.

4.17 **Potential improvements to the resource allocation system for fragile states.** The ADF has a larger number of fragile states (17 out of 41 ADF-eligible countries, i.e. 42 percent) than any other multilateral fund, an important issue that has to be taken into account when deciding on the best system for allocating resources to these countries. The current approach for determining the level of supplementary resources provided for a smaller sub-set of eligible countries through the FSF's Pillar I (to top-up their PBA allocations) as a function of their previous performance-based allocation remains attractive due to its simplicity and link to performance. However, the use of the same performance indicator - the CPIA score - to determine both countries' eligibility for the FSF and the allocation of FSF resources may have contradictory effects. Countries with a low CPIA score are eligible for FSF Pillar I, but subsequently receive a low Pillar I allocation because it is based on their previous CPIA-determined PBA. Moreover, the content and approach of the CPIA is not tailored to measure institutional and policy performance in the context of state fragility, in particular in terms of addressing its root causes.

4.18 Under the current ADF allocation framework, the allocation of Pillar I resources is determined upfront for the three-year ADF period. While this provides countries with predictability of resources, it also limits the Fund's ability to respond quickly to needs that might arise during the ADF cycle, as highlighted in the independent Operations Evaluation Department's evaluation of the assistance of the African Development Bank to Fragile States[26]. Moreover, since countries' eligibility for the FSF is determined at the beginning of each ADF cycle, there is limited room to accommodate countries falling into fragility during the course of the cycle. In order to address these issues, it could be considered to include vulnerability indicators in the PBA formula to address countries' structural handicaps while focusing the FSF on dealing with acute cases of fragility and/or state failure or making the Facility more project-oriented than country-oriented.

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[25] World Bank. Washington, D.C. June 2008. *Unit Costs of Infrastructure Projects in Sub-Saharan Africa. Africa Infrastructure Country Diagnostic.*

[26] ADB. *Evaluation of the Assistance of African Development Bank to Fragile States.* ADB/BD/WP/2012/48/ ADF/BD/WP/2012/29.

4.19 A table summarizing the options for possible adjustments to the PBA system is included in Annex IV. Management intends to make a presentation on a number of these options at the MTR for discussion with Deputies.

## 5. Conclusions and Recommendations

5.1 ADF-12 resources have been allocated to performance-based national country envelopes, the RO envelope and the FSF in accordance with the agreed framework. Overall resource usage stood at 45 percent at 31 July 2012 and is expected to rise to 64 percent by the end of the year.

5.2 Resources allocated through the PBA system have continued to flow to the best-performing countries as measured by the CPIA. In addition, the new RO Selection and Prioritization Framework has strengthened the link between ROs and performance.

5.3 Concerning the resources in FSF Pillar II (arrears clearance window), based on the countries' progress so far in meeting the technical requirements for arrears clearance and indications of ongoing efforts, Management's assessment is that Sudan and/or Zimbabwe could qualify for arrears clearance by the end of the ADF-12 period. Management believes that the Bank should remain ready to provide arrears clearance as and when countries meet the relevant conditions, and therefore proposes to retain the Pillar II resources within the Pillar throughout ADF-12. Management also recommends that any unused amount at the end of the cycle be rolled over to the same window in ADF-13.

5.4 Management has identified two emerging issues for discussion in ADF-13. Firstly, concerning the cost-sharing arrangements for Regional Operations, Management proposes to examine and possibly consider adjustments to:

- the incentive mechanism and cost-sharing arrangements in order to further extend the overall share of ADF resources directed towards ROs, irrespective of any change to the relative size of RO envelope, thereby also increasing the number of ROs ADF can catalytically support; and
- the cost-sharing exception for countries with small allocations, to ensure an equitable access to resources from the RO envelope among all ADF countries.

5.5 Secondly, concerning potential improvements to the PBA system, Management proposes to further explore five areas:

i. stronger alignment of the aid allocation methodology to the ADF's operational priorities;

ii. better capturing continent- and region-specific factors affecting development in RMCs;

iii. rewarding outcome-based performance;

iv. ensuring a meaningful engagement through the country allocation; and

v. potential improvements to the resource allocation system for fragile states.

5.6 Management seeks Deputies' guidance on these issues.

## Annex I: Classification of Regional Member Countries

| A. Countries eligible only for ADF-resources* | B. Countries eligible for a blend of ADB and ADF resources |
|---|---|
| 1. Benin | Nigeria |
| 2. Burkina Faso | |
| 3. Burundi | |
| 4. Cameroon | |
| 5. Central African Republic | |
| 6. Chad | |
| 7. Comoros | |
| 8. Congo, Democratic Republic | |
| 9. Congo, Republic | |
| 10. Côte d'Ivoire | **C. Countries eligible only for ADB resources** |
| 11. Djibouti | |
| 12. Eritrea | 1. Angola - in transition (2011-2012) |
| 13. Ethiopia | 2. Algeria |
| 14. Gambia | 3. Botswana |
| 15. Ghana | 4. Cape Verde - in transition (2011-2015) |
| 16. Guinea | 5. Egypt |
| 17. Guinea-Bissau | 6. Equatorial Guinea |
| 18. Kenya | 7. Gabon |
| 19. Lesotho | 8. Libya** |
| 20. Liberia | 9. Mauritius |
| 21. Madagascar | 10. Morocco |
| 22. Malawi | 11. Namibia |
| 23. Mali | 12. Seychelles |
| 24. Mauritania | 13. South Africa |
| 25. Mozambique | 14. Swaziland |
| 26. Niger | 15. Tunisia |
| 27. Rwanda | |
| 28. Sao Tomé & Principe | |
| 29. Senegal | |
| 30. Sierra Leone | |
| 31. Somalia | |
| 32. South Sudan*** | |
| 33. Sudan | |
| 34. Tanzania | |
| 35. Togo | |
| 36. Uganda | |
| 37. Zambia | |
| 38. Zimbabwe | |

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

** *Libya is not a borrowing member country.*

*** *Pending completion of the membership process.*

## Annex II: Status of ADF Subscriptions and Payments Received at 30 June 2012

| State Participants | Units of Oblig. | Amounts Pledged in UA | Amounts Pledged in Currency | Subscription in UA | Qualified Portion in UA | Payment Received in UA |
|---|---|---|---|---|---|---|
| Argentina | USD | 9,771,350.40 | 15,000,000.00 | 9,771,350.40 | 9,771,350.40 | - |
| Austria | EUR | 95,706,247.84 | 107,475,245.14 | 95,706,247.84 | | 63,804,164.85 |
| Belgium | EUR | 84,241,446.01 | 94,600,616.63 | 84,241,446.01 | 30,811,701.67 | 53,429,744.34 |
| Brazil | USD | 9,607,953.88 | 14,749,170.00 | | | - |
| Canada | CAD | 204,447,957.71 | 325,607,906.40 | 204,447,957.71 | 68,149,319.30 | 136,298,638.41 |
| China | USD | 83,921,666.45 | 128,828,150.17 | 83,921,666.45 | | 55,947,777.81 |
| Denmark | DKK | 77,325,112.93 | 646,194,370.02 | 77,325,112.93 | | 41,881,809.53 |
| Egypt | USD | 1,302,846.72 | 2,000,000.00 | | | - |
| Finland | EUR | 112,023,670.97 | 125,799,221.79 | 112,023,670.97 | | 112,023,671.16 |
| France | EUR | 356,198,295.59 | 400,000,000.00 | 356,198,295.59 | | 226,131,297.61 |
| Germany | USD | 399,991,166.25 | 614,026,439.30 | 399,991,166.25 | | 266,660,777.50 |
| India | INR | 9,427,030.90 | 663,363,667.00 | 9,427,030.90 | | 6,284,687.26 |
| Italy | EUR | 194,266,872.67 | 218,155,870.00 | | | - |
| Japan | JPY | 274,594,889.82 | 38,437,325,866.18 | 274,594,889.82 | | 91,531,629.95 |
| Korea | KRW | 53,857,278.51 | 94,774,413,588.95 | 53,857,278.51 | | 35,904,852.34 |
| Kuwait | USD | 7,361,324.55 | 11,300,369.32 | 7,361,324.55 | | 7,361,325.00 |
| The Netherlands | EUR | 201,061,742.00 | 225,786,304.41 | 201,061,742.00 | | 134,041,161.27 |
| Norway | NOK | 179,774,236.09 | 1,634,217,918.00 | 179,774,236.09 | | 110,006,281.36 |
| Portugal | EUR | 29,564,458.53 | 33,200,000.00 | | | - |
| Saudi Arabia | USD | 19,542,700.80 | 30,000,000.00 | 19,542,700.80 | | 19,542,700.80 |
| South Africa | ZAR | 10,424,062.28 | 119,969,803.15 | 10,424,062.28 | | 6,949,374.85 |
| Spain | EUR | 122,681,727.81 | 137,767,899.88 | 122,681,727.81 | 108,433,795.99 | 14,247,931.82 |
| Sweden | SEK | 178,035,844.10 | 1,986,410,005.50 | 178,035,844.10 | | 118,690,562.78 |
| Switzerland | USD | 100,838,740.95 | 154,797,551.23 | 100,838,740.95 | | 67,225,827.30 |
| United Kingdom | GBP | 572,397,673.38 | 566,994,239.34 | 572,397,673.38 | | 190,799,224.35 |
| United States Of America | USD | 381,070,168.92 | 584,980,816.31 | 381,070,168.92 | 303,400,961.71 | - |
| Supplementary contribution | | 28,656,968.69 | | 28,656,968.69 | | 4,780,103.30 |
| | | **3,798,093,434.77** | | **3,563,351,302.91** | | **1,763,543,543.57** |

## Annex III: The Performance-Based Allocation Process

The allocation of available African Development Fund (ADF) resources to ADF-eligible regional member countries (RMCs) for projects, programs and technical assistance during ADF-12 is a three-step process. First, resources are allocated to eligible countries using the Performance-Based Allocation (PBA) formula. Second, country-specific financing terms (loan, grant, or loan/grant combination) are determined using the Debt Sustainability Framework (DSF). Third, Multilateral Debt Relief Initiative (MDRI) debt relief to eligible RMCs is netted out of those countries' allocations and donor replacement funds are reallocated to all ADF-only RMCs.

### *First Step: Applying the PBA Formula*

Available resources are allocated using the PBA formula:

$$A_i = (CPA_i)^4 \;\; x \;\; \left(GNI/P\right)_i^{-0.125} \; x \;\; P_i^1$$

$$CPA_i = 0.26\, CPIA_{(A-C)_i} + 0.58\, GR_i + 0.16\, PPA_i$$

| | | |
|---|---|---|
| Where: | $A_i$ | is the allocation for country *i* |
| | $CPA_i$ | is the country performance assessment for country *i* |
| | $(GNI/P)_I$ | is the gross national income per capita for country *i* |
| | $CPIA_{(A-C)I}$ | is the Country Policy and Institutional Assessment for country *i* |
| | $GR_i$ | is the governance rating for country *i* |
| | $PPA_i$ | is the Portfolio Performance Assessment for country *i* |
| | $P_i$ | is the population for country *i* |

The PBA formula has two main determinants:

- country need as indicated by gross national income per capita (GNI/P) and country population (P);
- country performance as per the country performance assessment score (CPA).

An increase in GNI/P will decrease the per capita allocation, while an increase in the CPA caused by the net positive impact of CPIA, GR and PPA will increase the per capita allocation. 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.

In addition, the following procedures are applied:

Single country allocations are not permitted to exceed 10 percent of all resources available to ADF-only countries. The cap is applied at the basic allocation stage, i.e., on the initial results of the PBA process. Any excess over capped amounts is reallocated to the rest of the ADF-only countries using the PBA formula.

A minimum allocation of UA 5 million is applied to all countries.

### *Second Step: Using the Debt Sustainability Framework and the Modified Volume Approach*

The DSF is used to determine each country's risk of debt distress. It is based on two criteria: the institutional strength and quality of a country's policies to withstand debt distress, and country-specific debt burden indicators (namely, the net present value of debt/gross domestic product ratio, the net present value of 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, and green indicates a low risk. 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.

- A modified volume approach is applied under ADF-12. The primary purpose of the approach is to cover administrative charges for grant allocations up front and to strengthen the incentive structure of the PBA system. The approach applies a 20 percent volume discount to all grants. This discount is sub-divided into a 14.57 percent charges-related portion and a 5.43 percent incentives-related portion. The incentives-related portion is then reallocated to all ADF-only countries, using the PBA method, to help reinforce the PBA system's incentive structure. The

PBA-related country allocations of fragile states eligible for grants are subject only to the charges-related discount of 14.57 percent. These countries are excluded from the allocation of the incentives-related portion of the volume discount. The discount on grants does not apply to top up allocations under Pillar I of the Fragile States Facility.

### *Third Step: Multilateral Debt Relief Initiative Netting Out*

The foregone debt service payments of countries qualifying for debt relief under the MDRI are deducted from these countries' allocations through the MDRI netting-out mechanism. Resources provided by donors to compensate the ADF for the MDRI are reallocated to all ADF-only countries using the PBA system.

### *Resource Allocation to Blend Countries*

Each blend country receives 50 percent of what it would receive if it were an ADF-only country, subject to the minimum allocation of UA 5 million for all ADF-eligible countries. This is applied at the basic allocation stage; subsequently, blend countries are not included in the deduction and reallocation of the discount on grants, nor the MDRI netting out and reallocation.

## Annex IV: Overview of Possible Options to Adjust the PBA System

| Extent of change | Stronger alignment with the ADB's operational priorities | Better capturing continent- and region-specific factors affecting development in RMCs | Rewarding outcome-based performance | Ensuring a meaningful engagement through the country allocation | Potential improvements to the resource allocation system for fragile states |
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| Modification of component(s) of PBA formula | a) Adapt CPIA Questionnaire to focus on policies & institutions related to thematic priorities, such as:<br>• infrastructure;<br>• regional integration;<br>• private sector development;<br>b) Eliminate or lower the weight of existing CPIA indicators that are not closely related to the Bank's core programmatic focus.<br>c) Add CPIA indicators to address infrastructure-related regulatory capacity, maintenance performance, and other related institutional factors.<br>d) Supplement existing indicators with those that capture regional integration issues. | Adapt CPIA Questionnaire to improve assessment of policies & institutions related to:<br>• youth unemployment;<br>• wealth distribution / inclusive growth;<br>• fragility;<br>• conflict prevention;<br>• food security;<br>• gender equality;<br>• environmental sustainability / green growth;<br>• dealing with climate change. | a) Abandon portfolio performance conversion scale in favour of Country Portfolio Performance Rating generated under the Implementation Progress and Results Reporting for Public Sector Operations.<br>b) Replace the adjustment for portfolio size by an adjustment for portfolio age.<br>c) Capture countries' absorptive capacity: (i) Include the difference between projected and actual disbursements in the portfolio rating; (ii) develop criteria for assessing absorptive capacity.<br>d) Increase the outcome component of the CPIA (equity of public resource use, achievement of MDGs). | | a) Develop separate questionnaire to assess policy and institutional performance in fragile states;<br>b) Include fragility indicators into the CPIA. |
| | | | a) Increase alignment between performance and rating.<br>b) Reduce time lag between period covered by PPA and calculation of allocations to strengthen the link with recent performance. | | |

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| Modification of PBA formula | | a) Include additional indicators of country needs (i.e. population density, level of extreme poverty, level of human capital, social equity). | a) Increase the weight of the portfolio performance rating to the detriment of the weight of the CPIA and/or governance rating. | | a) Replace CPIA component by fragile states performance component.<br>b) Use adjusted allocation formula for fragile states that incorporates measures of structural vulnerabilities as well as measures of performance. |
| Modification of PBA system (other than formula) | a) Introduce targets for % of country allocation that should be spent on different thematic priorities.<br>b) Require country allocation to be used in priority areas not covered by other partners. | a) Increase the minimum allocation per country.<br>b) Calculate allocation per capita rather than country allocation.<br>c) Lower the cap of 10% on resources to a single country at the basic allocation stage.<br>d) Apply different basic caps to different groups of ADF-only countries, in line with differentiated treatment proposed in the ADF Financial Aspects paper | | a) Increase the minimum allocation per country;<br>b) Limit MDRI netting-out to a certain percentage of country allocation;<br>c) Limit MDRI netting-out to a certain percentage of the amount netted out. | a) Base eligibility for FSF on a fragility index rather than CPIA score.<br>b) Allocate Pillar I resources on the basis of fragility index score rather than multiplier of previous PBA allocation. |