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# Issues Concerning the ADF Resource Allocation Framework

## Discussion Paper

ADF-12 Replenishment
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Cape Town, South Africa

**AFRICAN DEVELOPMENT FUND**

# Executive Summary

Since 1999, the ADF has based its resource allocation framework primarily on country performance and country needs as measured by the Performance-Based Allocation (PBA) system. The PBA system drives the allocation of most concessional funds in other multilateral institutions as well.[1] From ADF-8 to ADF-10, the share of resources channelled through PBAs remained constant at around 80-85 percent; the remainder was earmarked for regional operations (ROs). Under ADF-11, the Fund set the share of PBA resources at 75 percent of the total, in order to scale up support for ROs (17.5 percent of all resources after deducting contingencies) and fragile states (7.5 percent after contingencies).

Under ADF-11, the Fund also introduced new financing modalities for two set-asides: (i) a RO cost-sharing formula that reinforces the link between ROs and country performance and commitment; and (ii) in replacement of the post-conflict enhancement factor in the previous PBA formula, a new dedicated set-aside that allocates additional resources to fragile states in order to provide sustained and differentiated support, but keeping a link to performance by allocating a multiple of the PBA from the previous cycle.

The main challenges in implementing the ADF-11 allocation framework have been threefold: (i) managing country allocation volatility; (ii) mitigating country vulnerability, particularly in the context of crisis response; and (iii) testing the new financing framework for the two set-asides.

Reflecting on this experience, the design of the ADF-12 resource allocation framework should consider the following elements: (i) balancing prospective resource allocations between the PBA system and set-asides; (ii) fine-tuning the financing mechanisms of set-asides; and (iii) possibly adjusting the PBA system to further mitigate volatility and better tackle country vulnerability.

Deputies are invited to take note of this report and provide preliminary views on the following issues to inform Management’s preparation of the ADF-12 resource allocation framework:

- Balancing the PBA and set-asides in ADF-12;
- Fine-tuning the financing mechanisms for ROs and fragile states;
- Reducing the volatility in country allocations, including the volatility caused by annual Country Portfolio Performance Ratings and MDRI netting out;
- Addressing countries’ vulnerability by (i) including an indicator of economic vulnerability in the PBA formula, (ii) introducing a crisis window or facility along the lines of the facility proposed by the International Development Association, or (iii) other means.

In preparing the resource allocation paper for the next replenishment meeting, Management also undertakes to develop the ADF-12 graduation policy along the parameters agreed at the ADF-11 Mid-Term Review, including (i) the elimination of the 5 percent cap on the aggregate amount of resources available to blend countries and its replacement by country-specific caps; (ii) the application of shorter maturities to blend and gap countries in order to better adapt the terms of ADF financing to their unique circumstances, thereby increasing the amount of reflows to the ADF over the long term; and (iii) maintenance of full eligibility for ADF resources after graduation for a limited subset of particularly vulnerable countries.

[1] The PBA system is also used by the International Development Association, the Asian Development Fund, the International Fund for Agricultural Development, and the Global Environment Facility.

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# Abbreviations

| | |
|---|---|
| ADB | African Development Bank |
| ADF | African Development Fund |
| ADF-8 | Eighth 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 |
| CPA | Country Performance Assessment |
| CPIA | Country Policy and Institutional Assessment |
| CPPR | Country Portfolio Performance Rating |
| FSF | Fragile States Facility |
| GNI/P | Gross National Income Per Capita |
| IEV | Indicator of Economic Vulnerability |
| MDRI | Multilateral Debt Relief Initiative |
| PBA | Performance-Based Allocation |
| PBO | Policy-Based Operation |
| RO | Regional Operation |
| RPG | Regional Public Good |
| UA | Units of Account |

## ***ISSUES CONCERNING THE ADF RESOURCE ALLOCATION FRAMEWORK***

# 1. Introduction

1.1 Since 1999, the resource allocation framework of the African Development Fund (ADF or Fund) has been primarily based on country performance and country needs as measured by the Performance-Based Allocation (PBA) system. The PBA system drives the allocation of most concessional funds in other multilateral institutions as well.[2] From the Eighth to the Tenth General Replenishment of the African Development Fund (ADF-8 to ADF-10), the share of resources channeled through PBAs remained constant at around 80-85 percent; the remainder was earmarked for regional operations (ROs). Under the Eleventh General Replenishment of the African Development Fund (ADF-11), the Fund set the share of PBA resources at 75 percent of the total, in order to scale up support for ROs (17.5 percent of all resources after deducting contingencies) and fragile states (7.5 percent after contingencies).

1.2 Over the last two replenishment cycles, the Fund has drawn on implementation lessons and changing circumstances to improve the resource allocation framework by (i) using the Debt Sustainability Framework to allocate grants within the PBA system; (ii) introducing Multilateral Debt Relief Initiative (MDRI) netting out into the PBA; (iii) practicing operational flexibility by front-loading countries' PBA resources to facilitate country programming; (iv) simplifying the PBA formula to increase predictability and transparency;[3] and (v) changing population measurements, per capita income measurements, governance ratings, and Country Portfolio Performance Ratings (CPPRs) to reduce volatility.

1.3 Under ADF-11, the Fund also introduced new financing modalities for the two set-asides: (i) a RO cost-sharing formula that reinforces the link between ROs and country performance and commitment; and (ii) a new, dedicated set-aside for fragile states that constitutes a significant top-up and includes a multiplier linked to the PBA, that provides sustained and differentiated support and replaces the post-conflict enhancement factor.

1.4 During the ADF-11 Mid-Term Review,[4] Deputies reaffirmed their support for a resource allocation framework centered on performance, with the PBA acting as the bedrock of the allocation system. Reflecting on experience with the food and financial crises, Deputies also acknowledged that it was important to address the volatility of allocations and country vulnerability while ensuring the robustness and predictability of the PBA system during the Twelfth General Replenishment of the African Development Fund (ADF-12) period.

1.5 The objectives of this paper are (i) to briefly review implementation of the current resource allocation framework, and (ii) to discuss issues on which Deputies' preliminary guidance is sought, with a view to improving the framework. The detailed framework for ADF-12 will be presented to Deputies in May 2010.

1.6 After this introduction, Part 2 of this paper reviews the ADF-11 framework. Part 3 discusses issues associated with designing a framework for ADF-12, and Part 4 concludes by listing issues on which Deputies' guidance is sought.

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[2] The PBA system is also used by the International Development Association, the Asian Development Fund, the International Fund for Agricultural Development, and the Global Environment Facility.

[3] The ADF allocates resources to regional member countries yearly. First, resources are allocated using the PBA formula, where allocation = $[0.26\ \text{CPIA(a-c)} + 0.58\ \text{GR} + 0.16\ \text{CPPR}]^4 \times \text{GNI/P}^{-0.125} \times \text{P}$. Second, country-specific financing terms are determined using the Debt Sustainability Framework. Third, debt relief to regional member countries eligible for the Multilateral Debt Relief Initiative is netted out of those countries' allocation and donor replacement funds are reallocated to all ADF-only regional member countries.

[4] See the ADF-11 Mid-Term Review Discussion Paper *ADF-11 Resource Allocation.* October 2009. Helsinki, Finland.

## 2. Reviewing the Allocation of Resources Under ADF-11

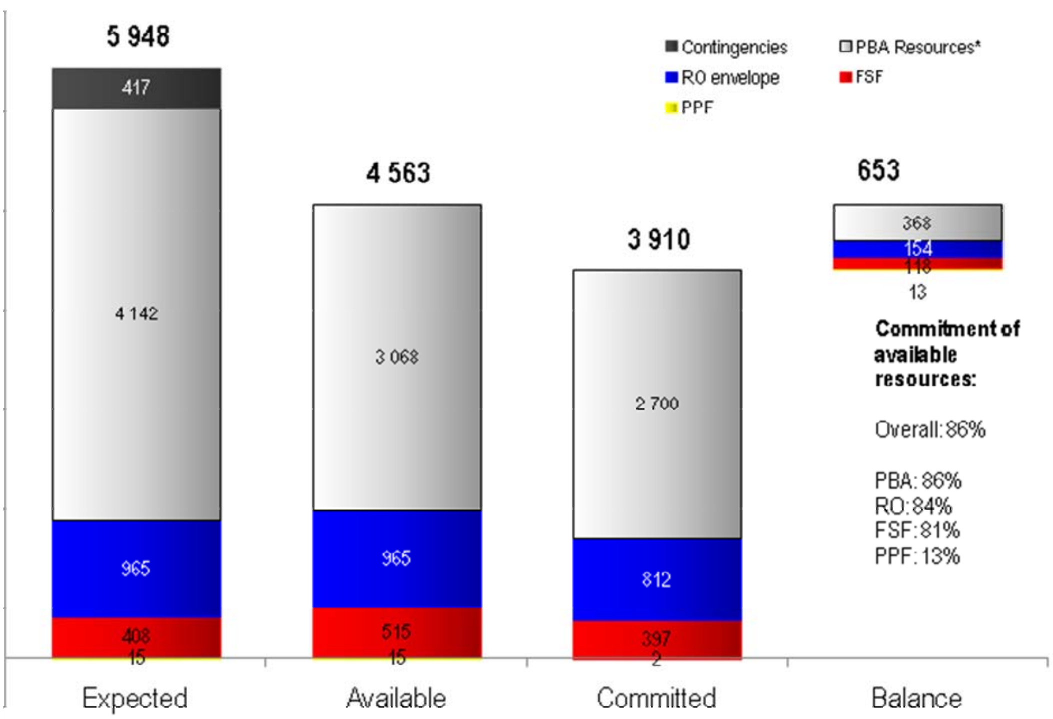
2.1 Resource allocation has been heavily front-loaded in ADF-11, with 86 percent of available resources utilized as of December 2009. This front-loading is largely due to the Fast Track Program[5] developed in response to the financial crisis. The flexibility to front-load while maintaining the PBA principle proved critical to allowing the Fund to tailor its response to countries in need.

### *Overall Resources*

2.2 Total expected resources under ADF-11 amount to UA 5.948 billion, of which 4.563 billion had been received as of December 2009. UA 3.910 billion or 86 percent of these resources have been committed: the balance available for commitment for 2010 therefore stands at UA 653 million. The pipeline of ADF operations scheduled for presentation to the Board of Directors before December 2010, in contrast, reaches UA 1,51 billion (Figure 1).

**Figure 1: ADF-11 Resources as of December 31, 2009**

*(UA millions)*




**Note:** *FSF=Fragile States Facility; PBAs=Performance-Based Allocations; PPF=Project Preparation Facility; ROs=Regional Operations; UA=Units of Account*
*(*) PBA resources are corrected for the negative impact of contingencies*

**Source:** *African Development Bank*

2.3 The ADF will be unable to authorize commitments corresponding to the full 2010 pipeline unless all subscriptions are paid as due (Annex I: 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[6] and to authorize the early commitment of their subscription[7] in order to allow the ADF to continue to provide resources to ADF countries in early 2010. In the interim, on the basis of strict front-loading rules and under the leadership

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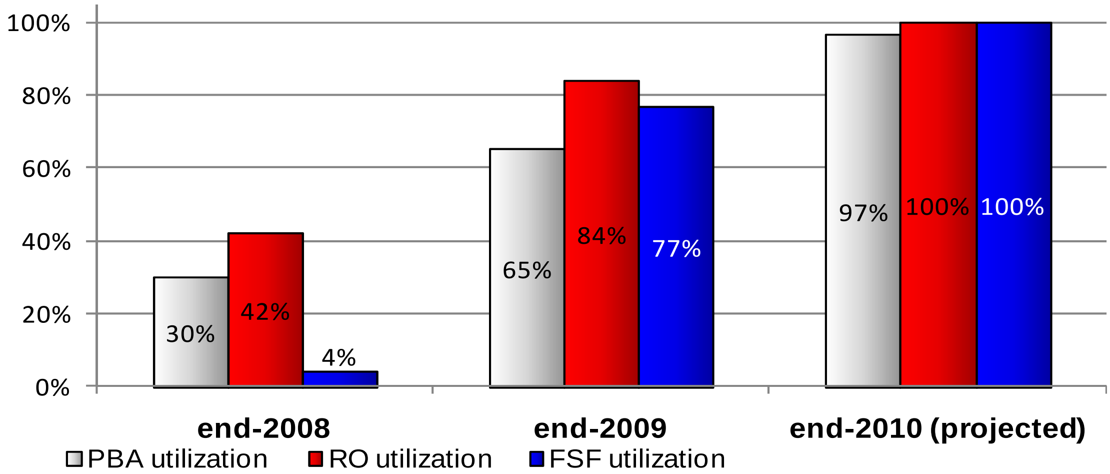
[5] See African Development Bank. 2009. *Bank Response to the Financial Crisis* (March 2009, ADF/ADB/WP/2009/32).
[6] According to the ADF-11 Resolution, the third instalment is scheduled to be paid on or before April 30, 2010.
[7] In accordance with Article 8a of the ADF-11 Resolution, the third instalment of unqualified subscriptions can be committed as of March 31, 2010.

of the Operations Committee,[8] the Fund has ranked the pipeline in order to present priority projects to the Board in the first quarter, prior to receipt of the final installment.

2.4 The utilization rate of the various windows against expected resources (Figure 2) illustrates the strong demand for ADF resources during the current cycle, partly because of the global financial crisis. Of UA 4.142 billion in expected PBA resources, UA 3.128 billion have been committed. To date, 79 percent have been used for investment projects and 21 percent for policy-based operations (PBOs). The share of PBOs as a percentage of all PBA resources is expected to level off at 24 percent by end-2010.

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




***Note:*** *FSF=Fragile States Facility; PBA=Performance-Based Allocation; RO=regional operation*
***Source:*** *African Development Bank*

2.5 As foreseen at the time of the ADF-11 Mid-Term Review, the two set-asides were nearly exhausted at end-2009. Total RO approvals (including cost-sharing) amounted to UA 1.132 billion, leaving only UA 189 million available for approval in 2010. Similarly, of the UA 648 million earmarked for the Fragile States Facility, UA 518 million in projects were approved, primarily as top-ups for badly needed infrastructure projects and public financial systems and for clearing the arrears of Côte d'Ivoire and Togo.

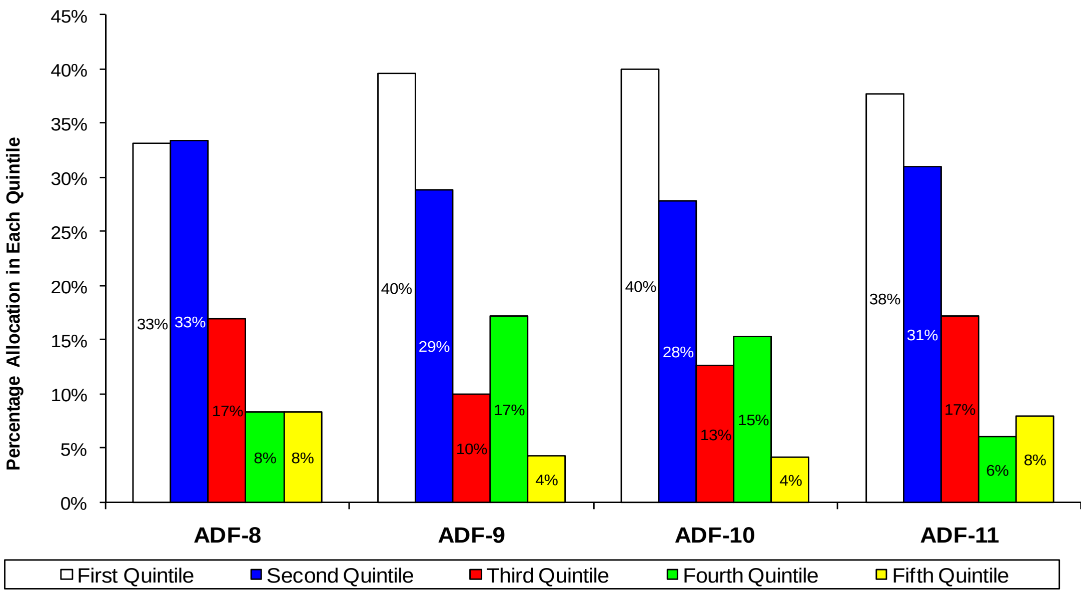
***Allocation Results***

2.6 The changes to the PBA framework and formula agreed for ADF-11 were implemented for each year of the cycle.[9] With regards to the PBA framework, these changes consisted of switching to the calendar year, using moving averages to calculate gross national income per capita, keeping population data constant during the cycle, and recording only actual problem projects[10] in the CPPR. Changes to the PBA formula included keeping governance separate from Country Policy and Institutional Assessments and using an additive formula that keeps all weights constant. The resulting allocations (Annex II: The Performance-Based Allocation Process) show that the revisions are effective at directing more resources to stronger performers: 69 percent of resources in ADF-11 were allocated to the two strongest performance quintiles.

2.7 Nonetheless, in implementing the agreed framework, a number of issues related to its design and application emerged. These issues are detailed in paras 2.8 to 2.19.

[8] Projects from countries whose allocation usage was below 67 percent (the normal front-loading rule in the second year of the cycle) were given priority.
[9] Final allocations for ADF-11 2010 will be available at the end of January and will be presented in Cape Town.
[10] Potential problem projects are no longer recorded in the CPPR.

**Figure 3: Resource Allocation by Performance, ADF-8 to ADF-11**




***Source:*** *African Development Bank*

### *Implementation Issues*

2.8 The main challenges encountered when implementing the ADF-11 allocation framework have been threefold: (i) managing country allocation volatility; (ii) mitigating country vulnerability, particularly in the context of crisis response; and (iii) testing the new financing framework for the two set-asides.

### *Country Allocation Volatility*

2.9 Substantial variations in CPPRs from one year to the next are an important source of volatility in ADF country allocations. This phenomenon also characterizes other concessional funding, such that of the International Development Association. Despite improvements introduced during the ADF-11 consultations—i.e., the decision to include only actual problem projects in CPPRs and the decision to use quarterly data—volatility over the 3 years of ADF-11 has remained high (Table 1).

**Table 1: Country Portfolio Performance Rating Volatility in the Performance-Based Allocation Formula**

| Average Country Variations, 2008-2009 | | | | Average Country Variations, 2009-2010 | | | |
|---|---|---|---|---|---|---|---|
| CPIA | CPPR | Governance Rating | CPA | CPIA | CPPR | Governance Rating | CPA |
| 2% | 25% | 5% | 3.6% | 3% | 17% | 5% | 3.7% |

***Note:*** *CPIA=Country Policy and Institutional Assessment; CPPR=Country Portfolio Performance Rating; CPA= Country Performance Assessment*

***Source:*** *African Development Bank*

2.10 The swing in portfolio ratings from one year to the next can be attributed to several factors, particularly the quality of the ratings and the size of the portfolio. The African Development Bank (ADB or Bank)'s Quality Assurance and Results Department is implementing various supervision enhancement procedures to improve the quality of the ratings. The smallness of ADF countries' portfolios, however—portfolios average 11 projects, with wide variation between countries—remains problematic: the fewer the projects in the portfolio, the larger the impact on the CPPR of a deterioration in the performance of one project. Recently released CPPR data for the 2010 allocation exercise confirms this phenomenon. Various simulations will be undertaken to explore ways to smooth portfolio volatility (Section 3).

***Impact of Multilateral Debt Relief Initiative Netting Out on Country Allocations***

2.11 Another element that can make allocations volatile is MDRI netting out. The amount of debt cancellations provided under the MDRI will increase steadily over coming years and will peak around 2025. These amounts will be netted out from MDRI countries' allocations and reallocated to all ADF countries as described in Annex II. As discussed at the Mid-Term Review, simulations for conservative replenishment levels show that the allocations of a few countries—primarily fragile states—could decrease significantly (sometimes by as much as 25 percent) as a result of MDRI netting out. While the impact of MDRI netting out depends on the size of the replenishment, these decreases, should they occur, could significantly hamper the Fund's ability to provide financial support to certain ADF countries. In Section 3, Management presents a means of mitigating the impact of MDRI netting out.

***Country Vulnerability***

2.12 In light of the recent wave of crises (the food, the energy and the financial crises), Deputies at the ADF-11 Mid-Term Review agreed on the importance of addressing country vulnerability while ensuring the robustness of the PBA system. Whereas PBAs are primarily based on performance, needs are measured by the population factor and by per capita income. In addition, several features[11] have been introduced to the PBA system to channel more resources to needy countries: (i) a minimum allocation (based on a minimum per capita) is guaranteed to ensure a minimum of engagement; (ii) caps on large allocations (10 percent) and blend countries (5 percent) allow the Fund to reallocate significant resources to the neediest countries; (iii) a dedicated Fragile States Facility is in place to assist the most vulnerable countries with a top-up factor.

2.13 Addressing further vulnerability ex ante would require tackling two principal challenges: (i) designing a formula that responds to both types of vulnerability (unexpected and sudden vulnerability, such as that occasioned by the financial crisis, and more structural vulnerability specific to country circumstances); and (ii) reconciling the acceleration of the replenishment and its close by July with extensive modifications to the system, modifications which require time to test new variables and transition between the old system and the new.

***The Financing Mechanisms of Set-Asides: Regional Operations Cost-Sharing and the Fragile States Facility Supplemental Financing***

2.14 Implementation of the current financing mechanisms for ROs and the Fragile States Facility has brought several issues to the fore.

2.15 ***<u>For ROs</u>***, the cost-sharing arrangement whereby two-thirds of a given project's costs are financed from the RO set-aside and one-third is financed from the project country's PBA—subject to a cap of 10 percent for countries with an ADF-11 allocation of UA 20 million or less[12]—has worked well to ensure country commitment and leverage resources. 72 percent of the ADF-11 RO envelope will be spent on operations involving cost-sharing. However, operational difficulties have occurred in the application of the small country cap system and the co-existence of various cost-sharing requirements. The step increase in cost-sharing from the 10 percent cap for countries with allocations of less than UA 20 million to an uncapped 33 percent for countries with allocations of more than UA 20 million can be very regressive for regional member countries slightly over the cut-off threshold. In these situations, the change in the cost-sharing requirement can outweigh the benefits of a marginal increase in allocation above the UA 20 million threshold and undermine the performance-related incentives of the PBA system. Furthermore, the co-existence of various cost-sharing requirements for

[11] A recent study presented during the International Development Association's Mid-Term Review showed that these enhancements were effective at channelling resources to the neediest countries. See International Development Association. 2009. *IDA's PBA and Development Results: an Update*. Washington, DC: November (IDA-15 Mid-Term Review).

[12] For reference, the International Development Association has a similar cost-sharing arrangement whereby a third of the project cost is financed from country allocations, with a 20 percent cap on all countries and no exemption mechanisms.

countries participating in the same RO has created uneasiness between countries and risks that the cost (and components) of a project be allocated between countries in such a way that the allocation is inconsistent with the countries' effective stake in the project.

2.16 Finally, cost-sharing may confront countries with difficulties of prioritization: ADF allocations are relatively small and the tradeoffs between a country participating in an RO and financing a national project are greater than if allocations were larger. Ultimately, these tensions could be alleviated by a larger ADF size and a larger RO envelope.

2.17 In the absence of a cap for regional public goods (RPGs), which can be exempted from the cost-sharing requirement, the selection of RPGs has also proven challenging. As per Deputies' guidance, RPGs are eligible for limited, selective support from the RO envelope. This eligibility is determined case by case. In practice, because RPGs are exempt from cost-sharing, they have been in very high demand, and prioritizing and selecting them has been extremely difficult. Going forward, clear indication of an acceptable proportion of RPGs could help prioritization. By the end of ADF-11, RPGs will represent 28 percent of the ADF-11 RO pipeline.

2.18 ***Under the Strategy for Enhanced Support to Fragile States***, scaled-up support (Pillar I) was provided to nine countries on the basis of the average of their two highest ADF-10 country allocations multiplied by a factor of 2 and subject to a floor of UA 10 million and a ceiling of UA 60 million. Arrears clearance funds were targeted for Côte d'Ivoire and Togo and a third pillar was created to provide extra support to 17 countries.[13] Applying a top-up factor of twice the ADF-10 PBA has caused support to eligible countries to soar. After adjusting for the increase in the ADF-11 replenishment size and for performance-induced increases in country allocations, the top-up increased overall country entitlements by an average of 82 percent (ranging from 140 percent (Sierra Leone) to 170 percent (Comoros) for some countries, and including 57 percent for the capped top-up of the Democratic Republic of Congo).

2.19 The main challenges going forward are (i) to determine the level of scaled-up support to be provided under Pillar I and to establish the level and mechanisms of phasing out; and (ii) to account for the magnitude of the upcoming arrears clearance (Zimbabwe's arrears clearance amounts to UA 363 million) and the uncertainty in the arrears clearance schedule.

## 3. Designing the Resource Allocation Framework for ADF-12

3.1 Given the items discussed so far, the design of the ADF-12 resource allocation framework should consider the following elements: (i) balancing prospective allocations between the PBA system and set-asides; (ii) fine-tuning the financing mechanisms of set-asides; and (iii) possibly adjusting the PBA to further mitigate volatility and better tackle countries' vulnerability.

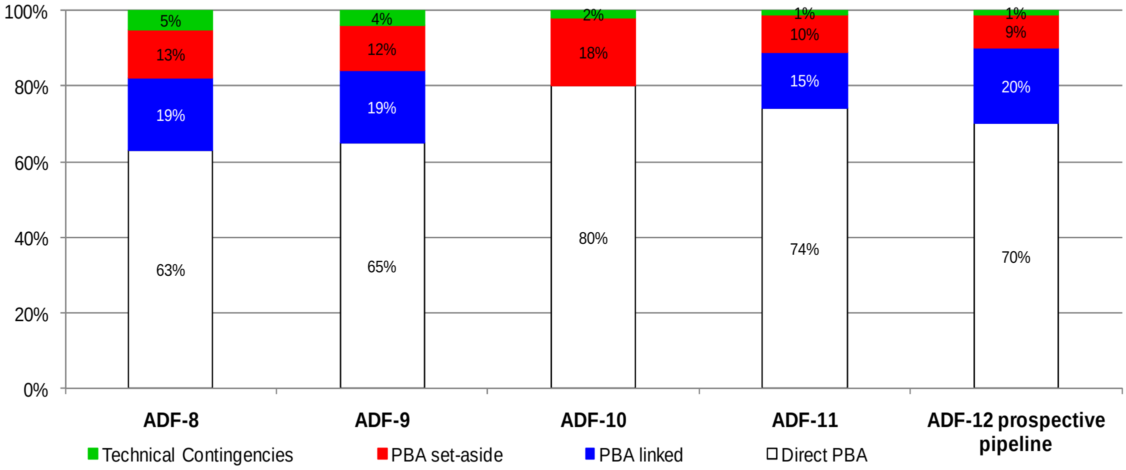
***Balancing Prospective ADF-12 Resource Allocations Between Performance-Based Allocations and Set-Asides***

3.2 ADF-12 resources will ultimately be allocated across competing demands and in support of strategic directions and funding priorities identified during the consultation. Management is committed to allocating the bulk of ADF resources on the basis of performance, as agreed during the ADF-11 Mid-Term Review. For ADF-12, an important challenge will be to balance PBAs and set-asides in such a way that the Fund can (i) channel resources to country operations according to countries' performance; (ii) provide sufficient funding for key and emerging priories (fragile states, ROs, and climate change); and (iii) remain as flexible as possible so as to address pressing needs as they arise. While the Fund does not seek to increase the number of set-asides in order to increase verticalization, an appropriate balance will allow it to fund dedicated areas, including climate change initiatives, as appropriate.

[13] These 17 countries include the nine countries eligible for Pillar I.

3.3 As described in the Overview paper, the prospective pipeline for ADF-12 amounts to 12.35 UA billion, a 134 percent increase over ADF-11 expected resources. This pipeline is composed of around 70 percent for PBAs and around 30 percent for set-asides. In ADF-11, PBAs accounted for 75 percent and set-asides for 25 percent of resources (Figure 4).

**Figure 4: The Distribution of Performance-Based Allocation-Related Resources from ADF-8 to the ADF-12 Prospective Pipeline**




***Note:*** *PBA=Performance-Based Allocation;*
*Technical contingencies do not include the late and qualified subscription contingency of UA 350 million*

***Source:*** *African Development Bank*

3.4 Assuming, for illustrative purposes, an ADF-12 replenishment that is 50 percent higher than the level agreed for ADF-11, Figure 5 presents four resource allocation scenarios for consideration.

- Keeping the current split between PBA and set asides would mean that (i) only 40 percent of the prospective RO pipeline could be considered for financing. This 40 percent corresponds to the backlog of projects from ADF-11 and the completion of some major links. New climate change mainstreaming activities would be left largely unfunded; and (ii) a top-up factor of the two best ADF-11 allocations could be accommodated, as could an increase in Pillar 3 (highly targeted technical assistance).

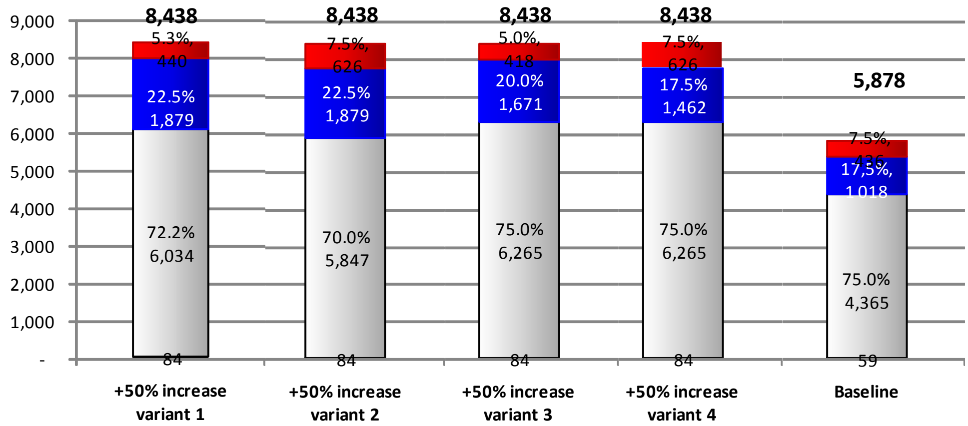
- Another combination of the 75/25 PBA and set-aside distribution would allow the ADF (i) to finance nearly half of the prospective RO pipeline, particularly more energy activities and climate change mainstreaming; (ii) to guarantee a Fragile States Facility set-aside covering the top-up factor of two; and (iii) to retain the same envelope for Pillar 3 as that assigned for ADF-11. This arrangement would translate into a 20 percent set-aside for ROs and a 5 percent set-aside for fragile states.

- Under a 70/30 split, keeping the Fragile States Facility at its current level and increasing the RO envelope to 22.5 percent, the Fund could finance more than half of the prospective RO pipeline.

**Figure 5: Preliminary Scenarios for ADF-12 Performance-Based Allocations and Set-Asides**

*(UA millions)*

| | +50% increase variant 1 | | +50% increase variant 2 | | +50% increase variant 3 | | +50% increase variant 4 | | Baseline | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *excl. conting.* | *incl. conting.* | *excl. conting.* | *incl. conting.* | *excl. conting.* | *incl. conting.* | *excl. conting.* | *incl. conting.* | *excl. conting.* | *incl. conting.* |
| **PBA + RO Cost Sharing** | 72.2% | 6,034 | 70.0% | 5,847 | 75.0% | 6,265 | 75.0% | 6,265 | 75.0% | 4,365 |
| **RO, excl. Cost Sharing** | 22.5% | 1,879 | 22.5% | 1,879 | 20.0% | 1,671 | 17.5% | 1,462 | 17.5% | 1,018 |
| **FSF, excl. Arrears Clearanc** | 5.3% | 440 | 7.5% | 626 | 5.0% | 418 | 7.5% | 626 | 7.5% | 436 |
| **Technical Contingencies** | | 84 | | 84 | | 84 | | 84 | | 59 |
| **TOTAL** | | **8,438** | | **8,438** | | **8,438** | | **8,438** | | **5,878** |




***Note:*** *FSF=Fragile States Facility; PBAs=Performance-Based Allocations; ROs=regional operations; UA=Units of Account*

***Source:*** *African Development Bank*

3.5 A balanced scenario would, to the extent possible, preserve financing for targeted assistance and for the top-up of two for eligible fragile states, while increased support for ROs accelerated the development of much-needed infrastructure links. These links are critical to Africa's competitiveness and to its reaching certain Millennium Development Goals before the 2015 deadline. Ultimately, any resource allocation combination depends on the replenishment size. A detailed proposal discussing various resource allocation and replenishment size scenarios will be developed for discussion at the May meeting.

### *Fine-Tuning the Financing Mechanisms for Set-Asides*

3.6 With the financing framework for ROs and fragile states tested for the first time under ADF-11, Bank staff have looked closely at the concerns noted in paras. 2.15 to 2.20.

3.7 Insofar as ROs are concerned, the Bank's simulations of the cost-sharing arrangement have determined that choosing a lower cost-sharing figure of 20 or 25 percent would increase countries' incentive to participate in ROs (it would change the incentive from "finance 1, get 2 free" to "finance 1, get 3 or 4 free") and further raise demand for ROs. It would also reduce the overall amount of financing for ROs. This increased demand and reduced amount would result in greater competition for scarce RO resources, making prioritization even more difficult than it is now. The 33 percent cost-sharing level presently in effect has acted as a useful and objective filter, while allowing sufficient demand for the RO envelope to be oversubscribed and therefore fully utilized early in the cycle. The trade-offs here are therefore between incentives, the overall volume of RO resources, and optimal prioritization.

**Table 2: Simulation of Reduced Cost-Sharing**

*(UA millions, including surcharge on grants)*

| | Baseline (ROs approved and ROs in the ADF-11 pipeline) | Scenario 1 | Scenario 2 |
|---|---|---|---|
| Standard country contribution | 33% | 25% | 20% |
| Amount spent from RO envelope | 963.47 | 964.66 | 962.01 |
| Amount spent from country PBAs | 357.38 | 274.78 | 203.68 |
| **Total** | **1,320.85** | **1,239.44** | **1,165.69** |
| Amount of RO envelope remaining | 1.80 | 0.61 | 3.26 |
| Number of operations that could not be financed | - | 3 | 5 |
| Additional amount available for national projects | - | 82.60 | 153.69 |

***Note:*** *PBAs=Performance-Based Allocations; RO=regional operations; UA=Units of Account*

***Source:*** *African Development Bank*

3.8 Current analyses of the RO pipeline under ADF-11 do not prove that cost-sharing alone was a deterrent: other issues, such as project readiness, were often critical. Ultimately, coming from ADF-10, when cost-sharing was not applied, into a different financing mechanism under ADF-11, necessitated a period of adjustment for all concerned. Given the early stage of implementation, Management proposes to retain current cost-sharing arrangements and consolidate experience throughout ADF-12.

3.9 For fragile states, given how much the top-up of two increased the fragile states envelope in ADF-11[14], Management suggests keeping this top-up intact in ADF-12. This would amount to a set-aside in the range of UA 388-458 million, depending on decisions regarding phasing out (Table 3).

**Table 3: Analysis of the Fragile States Facility**

| | ADF-11 Top-up | ADF-12 with 2x Multiplier | ADF-12 with 2x Multiplier and Discount | Proposed Discount |
|---|---|---|---|---|
| Burundi | 46.10 | 60.00 | 60.00 | 25% |
| CAR | 11.85 | 40.24 | 30.18 | 25% |
| Comoros | *10.00 | 11.64 | 8.73 | 25% |
| Congo DRC | *60.00 | 60.00 | 60.00 | 25% |
| Cote d'Ivoire | 45.87 | 60.00 | 60.00 | 25% |
| Guinea Bissau | *10.00 | 25.76 | 19.32 | 25% |
| Liberia | 13.01 | 60.00 | 51.18 | 25% |
| Sierra Leone | 42.76 | 60.00 | 32.92 | 50% |
| Togo | 14.36 | 60.00 | 45.60 | 25% |
| Zimbabwe | | 20.50 | 20.50 | |
| **Total** | **253.94** | **458.14** | **388.43** | |

***Source:*** *African Development Bank*

[14] See the ADF-12 Discussion Paper, *Proposed Adjustment to the Enhanced Approach to Fragile States.* February 2010. Cape Town, South Africa.

### *Exploring Adjustments to the Performance-Based Allocation Formula to Take Volatility and Vulnerability Into Account*

Country allocation volatility

3.10 Efforts made during the ADF-11 replenishment to simplify the formula and reduce volatility underscore the importance given by Deputies to improving the resource allocation system and the predictability of aid. Drawing from ADF-11 experience, Management will seek to reduce volatility further by looking into adjusting the measurement of the CPPR and the MDRI netting out mechanism. For the CPPR, various alternatives will be explored, including using average country CPPR ratings over a 2-year or 3-year period and applying these averages to the whole portfolio or to a subset of small-portfolio countries.

3.11 In addition, it was suggested during the ADF-11 Mid-Term Review that ROs be included in the CPPR exercise so that their performance, alongside the performance of national projects, influence country allocations. While Management agrees with the intentions of this proposal, it has examined the possibility of including ROs in CPPRs and feels that at this point in time, the drawbacks outweigh the advantages. First, the performance of the ADF's ROs is generally poorer than that of national operations, as is the case at other institutions, such as the World Bank. Including these operations in CPPRs could therefore suddenly reduce the ADF allocations of participating countries. This would increase the volatility of ADF allocations at a time when Management is seeking to reduce it, and could decrease regional member countries' incentives to participate in ROs. In addition, countries that participate in multiple ROs could be disproportionately affected. Second, it is possible that including ROs in CPPRs would discourage countries from engaging in ROs with neighbors with less capacity, such as fragile states. At this juncture, therefore, rather than including ROs in the PBA process, Management proposes to systematically monitor, review, track and report on the portfolio of ROs in ADF countries, inter alia through a dedicated section in the Annual Portfolio Performance Review. This procedure would complement actions already underway at the project level, such as enhanced supervision.

3.12 Regarding the potential impact of MDRI netting out on some country allocations, the ADF will examine at length the long-term impact of MDRI netting out. While MDRI netting out works well to ensure that resources are allocated in accordance with the principles of equal treatment and the reduction of moral hazard, the examination will mitigate the risk of significantly reduced allocations. One solution might be to ensure an allocation floor under which allocations could not fall. Findings and proposals will be discussed at the Multilateral Development Banks' Technical Working Group on PBA.

Country vulnerability

3.13 A number of options to address country vulnerability through the PBA system can be considered. Two such options are (i) to adjust the model by including an indicator of economic vulnerability in the allocation formula, and (ii) to introduce a crisis window along the lines of the window proposed by the International Development Association, while fine-tuning the current system.

3.14 Under the first option, the premise is that insofar as external shocks are concerned, economic vulnerability is equally (if not more) pertinent for aid effectiveness than is the quality of economic policy and governance. These external shocks include terms of trade shocks and natural disasters. Such shocks, which on one hand lower economic growth, imply higher aid effectiveness on the other: in economically vulnerable countries, aid can help prevent an economic slowdown as well as the cumulative decline that often follows.

3.15 The idea of adjusting the formula leads to consideration of other factors. Applying the formula directly would mean allocating less aid to post-conflict or post-crisis countries, the very countries in most need of help. This said, the top-up accruing to fragile states under ADF-11 depends on their ADF-10 allocations, which are themselves based on performance. Amending the PBA formula to include vulnerability while abandoning the current mechanism outside the PBA (i.e., the Fragile States Facility) would avoid an excessive reduction of aid flows when countries face difficulties caused by external shocks: these difficulties lower country performance ratings and thus fuel a vicious circle.

3.16 While recognizing the crucial role of sound economic policies and good governance, it might be possible to capture the specificities of African countries by including an indicator of economic vulnerability (IEV) in the aid allocation formula, to replace the Fragile States Facility currently outside the PBA formula. For example, the existing ADF-11 PBA formula could be amended by replacing the Country Performance Assessment (CPA) by a weighted average of the CPA and an IEV, as follows:

$$A = (\gamma\, IEV + (1-\gamma)CPA)^4 * (GNI / Pop)^{-0,125} * Pop\,,$$

where $\gamma$ is a parameter that takes any value between 0 and 1. A higher (lower) value for $\gamma$ means a higher (lower) weight for the IEV (the CPA); the current PBA formula would be obtained when $\gamma$ is set equal to zero. It is only in the extreme case where $\gamma$ is set equal to 1 that economic policies and governance would no longer influence the allocation of aid.

3.17 The development and application of this modified formula would create several challenges. First, including an IEV component in the formula while keeping the ADF envelope constant would imply that countries with a high CPA would receive a lower allocation than they would under the current PBA formula. This change is important, since the IEV would cause a fundamental shift to occur in the balance between aid being allocated to good performers and aid being allocated to the most vulnerable (who are often the weakest performers). Careful consideration must be given to exactly which incentives are offered to countries and what behavior, characteristics and policies are rewarded. The ADB would also have to examine and discuss with other multilateral development banks how changing the ADF's resource allocation system would affect harmonization and alignment.

3.18 Second, it would be necessary to agree on the definition of the indicator and its periodic and systematic computation and measurement. This raises the question as to whether the data are available. One option would be to use the Economic Vulnerability Index that the United Nations' Committee for Development Policy employs to identify least developed countries. Another avenue would be for the Bank to construct its own indicator. This would be more costly and more time-consuming. Several possible indicators would need to be examined, taking into account their components (with a view to determining the above-mentioned incentives) and their possible overlap with other formula variables.[15]

3.19 Third, Deputies would need to agree on the weight of the IEV in the new formula. To guide them, the ADF could develop a model to simulate how varying the formula parameters would affect country allocations and allocation volatility.

3.20 Fourth, for the Fund, this change would imply significant operational modifications, as the Fragile States Facility would be discontinued and operational policies affected. With the ring-fencing of the Fragile States Facility, several policy features were simplified to facilitate re-engagement with and support of specific groups of countries, including countries under sanctions. Providing aid directly through the PBA framework would require that the Fund carefully monitor the effects of the change and continue to ensure a rapid and appropriate response to these countries.

3.21 Finally, the Fund would have to work out transition mechanisms and a transition period to avoid disrupting allocations and making them more volatile.

3.22 The second option for addressing country vulnerability through the PBA system would be to adjust some of the criteria of the current system, for example by introducing a crisis window or facility—e.g. within the Fragile States Facility—to respond rapidly to and help mitigate the effects of an oncoming crisis in vulnerable countries. Such an instrument could deliver targeted measures to solve acute problems instead of adopting a broad-brush approach that might not be appropriate for all countries.

[15] For example, the indicator's inclusion of a measure of population would imply some double-counting, as population size is already part of the PBA formula.

3.23 The options named here are only two ways to address countries' vulnerability. Each potential option would need to be weighed against (i) the ease of its introduction (for example, the measurability of an indicator) and its transition measures; (ii) the timing of its introduction in the context of the accelerated replenishment; and (iii) the principle of maintaining the PBA as the bedrock of the resource allocation system, as requested by Deputies in Helsinki and agreed by Management.

3.24 Management's preliminary view favors continuing the current system, with possible adjustments to be detailed at the next replenishment meeting in May. At the same time, Management proposes to continue exploring the concept of including an indicator of economic vulnerability in the PBA formula in the context of the Multilateral Development Banks' Technical Working Group on PBA, with a view to adopting a harmonized approach for an eventual roll-out in a future replenishment.

## 4. Conclusion

4.1 Deputies are invited to take note of this report and to provide preliminary views on the following issues to inform Management's preparation of the ADF-12 resource allocation framework:

- Balancing PBA and set-asides in ADF-12;
- Fine-tuning the financing mechanisms for ROs and fragile states;
- Reducing the volatility in country allocations, including the volatility caused by the annual CPPR and MDRI netting out;
- Addressing countries' vulnerability (i) by including an indicator of economic vulnerability in the PBA formula, (ii) by introducing a crisis window or facility along the lines of the facility proposed by the International Development Association, or (iii) through other means.

4.2 For the resource allocation paper to be prepared for the next replenishment meeting, Management also undertakes to develop the ADF-12 graduation policy along the parameters agreed at the ADF-11 Mid-Term Review, including: (i) the elimination of the 5 percent cap on the aggregate amount of resources available to blend countries and its replacement by country-specific caps; (ii) the application of shorter maturities to blend and gap countries in order to better adapt the terms of ADF financing to the situations of different ADF countries, thereby increasing the amount of reflows to the ADF over the long term; and (iii) maintenance of full eligibility for ADF resources after graduation for a limited subset of particularly vulnerable countries.

**Annex I: The Status of African Development Fund Subscriptions and Payments Received as of December 31, 2009, in Units of Account**

| | STATE PARTICIPANTS | ADF-11 Expecetd Payments | Payments Received | Payments Due in 2010 | Qualified Subscriptions 2008-2009 |
|---|---|---|---|---|---|
| 1 | **AUSTRIA** | **86,545,325** | **57,994,290** | **28,551,035** | |
| 2 | **BELGIUM** | **66,863,048** | **44,610,992** | **22,252,056** | |
| 3 | **BRAZIL** [1] | **6,557,936** | | **6,557,936** | 4,371,957 |
| 4 | **CANADA** | **184,878,368** | **123,252,245** | **61,626,123** | |
| 5 | **CHINA** | **79,900,950** | **53,267,300** | **26,633,649** | |
| 6 | **DENMARK** | **44,333,039** | **44,333,039** | | |
| 7 | **FINLAND** | **89,221,984** | **89,221,984** | | |
| 8 | **FRANCE** | **347,115,130** | **231,410,087** | **115,705,042** | |
| 9 | **GERMANY** | **400,000,000** | **266,666,667** | **133,333,333** | |
| 10 | **INDIA** | **6,434,447** | **4,289,631** | **2,144,816** | |
| 11 | **ITALY** [2] | | | | |
| 12 | **JAPAN** | **261,438,952** | **174,292,635** | **87,146,317** | |
| 13 | **KOREA** | **32,474,255** | **21,649,504** | **10,824,752** | |
| 14 | **KUWAIT** | **6,656,705** | **6,656,705** | | |
| 15 | **THE NETHERLANDS** | **201,061,742** | **201,061,742** | | |
| 16 | **NORWAY** | **167,029,492** | **111,352,995** | **55,676,497** | |
| 17 | **PORTUGAL** | **29,621,699** | **19,747,800** | **9,873,899** | |
| 18 | **SAUDI ARABIA** | **16,394,840** | **10,929,893** | **5,464,947** | |
| 19 | **SOUTH AFRICA** | **6,223,941** | **4,149,294** | **2,074,647** | |
| 20 | **SPAIN** | **110,938,734** | **73,959,156** | **36,979,578** | |
| 21 | **SWEDEN** | **160,994,400** | **107,329,600** | **53,664,800** | |
| 22 | **SWITZERLAND** | **91,186,540** | **60,791,026** | **30,395,514** | |
| 23 | **UNITED KINGDOM** | **547,150,749** | **364,767,166** | **182,383,583** | |
| 24 | **UNITED STATES OF AMERICA** [3] | **306,944,199** | **98,369,041** | **208,575,157** | 106,260,425 |
| | **TOTAL** | **3,249,966,473** | **2,170,102,792** | **1,079,863,681** | **110,632,382** |

1 The subscription of the State participant is qualified until 2011 (UA 4,371,957.40 is the amount due for 2008 and 2009)

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

3 State participant has paid a portion of its ADF-11 first instalment (UA 98.37 million out of UA 102.31 million)

***Source:*** *African Development Bank*

**Annex II: The Performance-Based Allocation Process**

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

***First Step: Application of the Performance-Based Allocation Formula***

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 (GNI/P) for country *i* |
| $CPIA_{(A-C)I}$ | is the Country Policy and Institutional Assessment (CPIA) rating for country *i* |
| $GR_i$ | is the governance rating for country *i* |
| $CPPR_{(REV)i}$ | is the revised Country Portfolio Performance Rating (CPPR) for country *i* |
| $P_i$ | is the population for country *i* |

The PBA formula has two main determinants:

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

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,
  - o the PBA exercise is to be conducted on a calendar year basis, using Debt Sustainability Framework ratings as of January 1 of each operational year;
  - o 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;
  - o 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;
  - o 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 fifteenth replenishment of the International Development Association,
  - o The CPIA rating will only include the first three clusters (A, B,C) of the agreed indicators in order to avoid counting governance twice;
  - o The governance rating will now comprise the current CPIA cluster D;
  - o A new additive formula making the weights of each variable explicit will be used to calculate the allocations;
  - o 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; and
  - o The effective weight of each of the key Country Performance Assessment variables will be unchanged relative to the formula used under ADF-10.

An increase in GNI/P will cause the 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 the 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.

In addition, the following operational procedures have been applied for 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 reallocated to the other ADF-only countries using the PBA formula.
- A minimum base of UA 5 million has been applied for all countries. Final allocations have been adjusted to reflect the 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 Debt Sustainability Framework, 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: this 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 conclusion of upcoming discussions on the blend country regime.

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

The Debt Sustainability Framework is used to determine each country's risk of debt distress. It is based on two criteria: (i) the strength of institutions and 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.

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 reallocate 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 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 Fragile States Facility. The grant share of the allocation of each country after the Debt Sustainability Framework is applied, is maintained throughout the allocation process.

***Third Step: The Effect of Multilateral Debt Relief Initiative Netting Out***

The entry into effect of the MDRI in September 2006 introduced an additional step into the ADF's resources allocation process. The foregone debt service payments of countries qualifying for debt relief under the MDRI are deducted from those countries' allocations through a 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.

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

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