

**ASIAN DEVELOPMENT FUND (ADF)
ADF IX DONORS' MEETING
Tokyo, 9-11 December 2003**

**GRANTS IN THE ASIAN DEVELOPMENT FUND
OF THE ASIAN DEVELOPMENT BANK:
A DISCUSSION PAPER**

**Asian Development Bank
November 2003**

ABBREVIATIONS

ADF	–	Asian Development Fund
AfDF	–	African Development Fund
CAS	–	Country Assistance Strategy
CSP	–	Country Strategy Paper
EACA	–	Expanded Advance Commitment Authority
IDA	–	International Development Association
MDGs	–	Millennium Development Goals
PRSP	–	Poverty Reduction Strategy Paper

NOTE

In this report, “\$” refers to US dollars

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I. INTRODUCTION

1. At their first ADF IX meeting in Copenhagen, 9-10 October 2003, Donors discussed a report, "Grants in the Asian Development Fund of the Asian Development Bank: A Background Paper" (September 2003). That report set out some development context for grants, outlined a framework for allocation of grants in ADF, and included discussion of (i) potential financial implications, and (ii) the legal, policy, and administrative implications that might be associated with the establishment of grants in ADF. The report ended by seeking Donor guidance.

2. Against that background, the purpose of this further report is to: (i) summarize the main elements of the guidance provided by Donors at Copenhagen; (ii) examine grants in ADF on financial, concessionality, and legal considerations; (iii) propose a framework for the use of ADF grants on developmental considerations; and (iv) seek further Donor guidance.

3. The next section of this report summarizes the main elements of the guidance on grants provided by Donors at Copenhagen. The following section discusses the financial implications for ADF from establishing grants. It then discusses briefly the impact of grants on the overall concessionality of ADF-financed commitments. This is followed by a section that discusses the World Bank's experience and the implications for making grants from ADF to the Asia and Pacific region (Region). Next is a presentation of a grant allocation framework appropriate to the specificities of the Region, and ADB. This is followed by consideration of some legal issues. The paper ends with conclusions and a request for Donor guidance.

II. GUIDANCE ON GRANTS PROVIDED BY DONORS AT COPENHAGEN

4. Discussions among Donors at Copenhagen on the issue of establishing grants in ADF resulted in the following guidance to ADB for preparing this further report;¹

- (i) Grants should be allocated primarily to deepen concessionality where warranted on country and end-use considerations, and provided in the context of ADB's country and subregional strategies;
- (ii) The formulation of proposals for grants as a share of ADF commitments should be derived, in part, from consideration of their implications for the overall concessionality of total ADF commitments—both loans and grants;
- (iii) The impact of grants on the resources of ADF should be examined at different levels (i.e., percentage share) of grants in total ADF commitments, and the associated cost of compensating for the 'lost' reflows should be assessed;
- (iv) A proposal for an ADF grants allocation framework should be derived, in part, from experience with grants in IDA13 in the Region;
- (v) A proposal for an ADF grants allocation framework should reflect the unique or specific development context of the Region, and where the provision of grants would be relevant and bring value-added to the development processes in the Region;

¹ This section provides a *summary of the key elements or main points* of the overall views and perspectives of Donors on this issue.

- (vi) ADF grants to support more cost-effective and results-oriented technical assistance in the Region would be warranted; and
- (vii) It should be explained whether a Donor has the option to prohibit that part of its contribution to be allocated as grants.

Broadly, Donors at Copenhagen recognized that they held differing views and perspectives on the issue of grants in ADF, but they agreed to work towards a compromise that is pragmatic and meets real needs in the Region.

III. FINANCIAL IMPLICATIONS OF GRANTS

A. Grants and ADF Resources

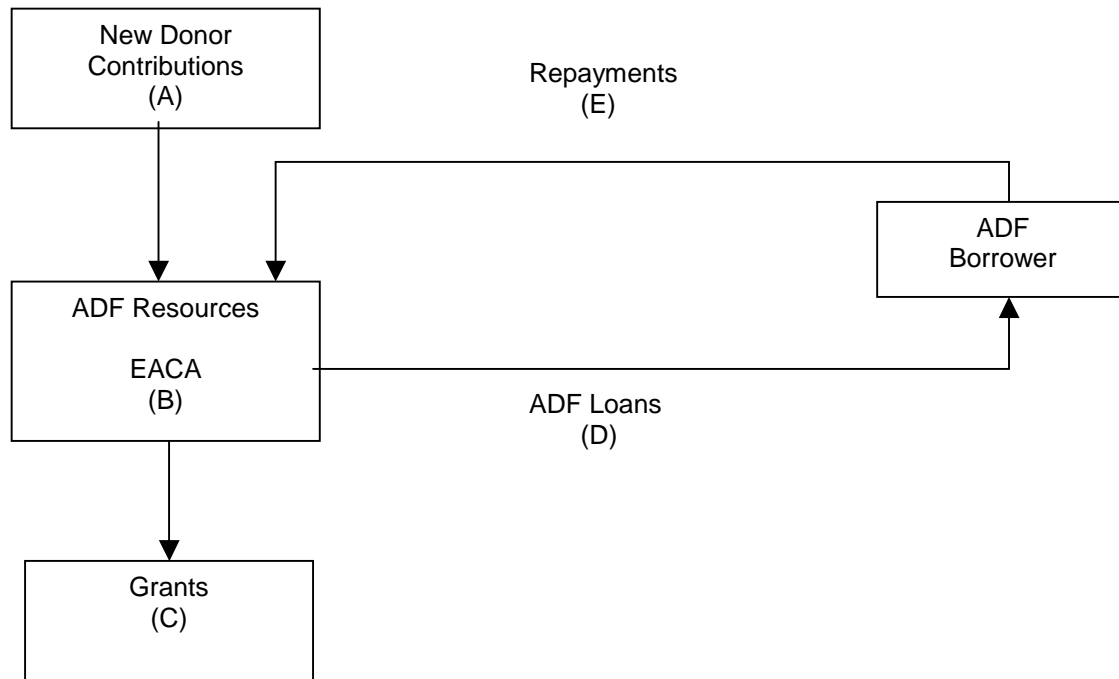
5. New commitments in an ADF replenishment period are financed mainly from (i) new Donor contributions to the replenishment, and (ii) existing resources in ADF that support the expanded advance commitment authority (EACA).² The level of new Donor contributions to a replenishment is determined through periodic negotiations among Donors. The EACA is the amount of future loan commitment based on the projected cash flows from loan repayment net of disbursement and expenses.³ The level of EACA is limited when liquidity in the pool of resources supporting EACA reaches the minimum acceptable level. There is, over time, a relationship between new Donor contributions and the level of EACA. Any amount of new Donor contributions to a replenishment that are on-lent will eventually return, as reflows (i.e., repayments), to the pool of resources that support EACA, and EACA will increase. On the other hand, if there was a cessation of new Donor contributions to ADF, or all those contributions were allocated to other purposes, for example, grants, the *projected growth* of EACA would be reduced and EACA would be eventually stabilized.⁴ Figure 1 presents in simplified form the relationship between new Donor contributions, EACA, and grants.

² EACA consists mainly of reflows of past ADF loans, revenue from interest income net of administrative expenses, investment income, resources set aside from ordinary capital, and loan savings and cancellations.

³ The basic methodology used in calculating the EACA is similar to that used by IDA in determining its advance commitment authority.

⁴ In such circumstances the EACA may continue to increase moderately for a certain period of time reflecting a natural maturing of the existing portfolio of ADF loans, or if interest charges and investment income net of administrative expenses is positive.

Figure 1: Relationship Among New Donor Contributions EACA and Grants



NOTES:

- i. $B = D = E$ overtime in the absence of new donor contributions or grants
- ii. If $A > C$, then B, D, and E increase
- iii. If $A < C$, then B, D, and E decrease
- iv. If $A = C$, then B, D, and E are unchanged
- v. In i-iv, it is assumed, for simplicity, that revenue from interest charges and investment income equals ADF's administrative expenses

B. The Impact of Grants on ADF's Expanded Advanced Commitment Authority

6. The implications for the future level of EACA as a result of the introduction of grants—at different percentage shares of new ADF commitments per replenishment— from ADF IX onwards are given in Table 1 and Figure 2.⁵ The results show the following;

- (i) *If grants represent 20% or less of ADF commitments, EACA continues to increase, albeit at lower levels, until the beginning of ADF XII (1 January 2017). From the start of ADF XII onwards EACA remains constant (in nominal terms) at a minimum of \$4,940 million per replenishment;*
- (ii) *If grants represent 25% of ADF commitments, EACA increases until the beginning of ADF XII (1 January 2017), and remains constant at \$4,648 million per replenishment thereafter;*

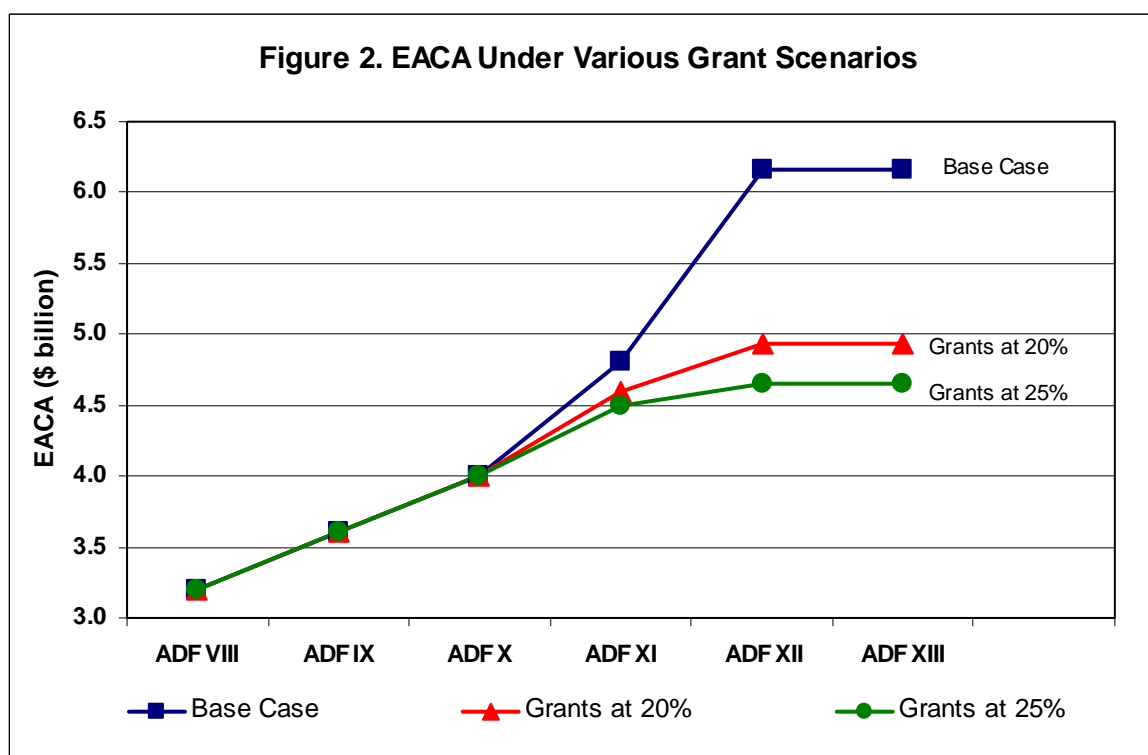
On this basis, it may be concluded that *if grants represented 20-25% of ADF commitments, the level of EACA would not fall below the current replenishment (i.e., ADF VIII) level for EACA of \$3,200 million, or \$800 million per annum. In fact, EACA would increase significantly above its level in ADF VIII.*

⁵ The parameters and basic assumptions underlying the base case (i.e., the progression of the level of EACA without grants) in this analysis broadly follow the original framework for planning ADF self-financing that was developed during the negotiations on the sixth replenishment of ADF (ADF VII). This includes an assumption that the overall nominal level of ADF lending per replenishment period would be \$6,300 million, with the difference between \$6,300 million and the current level of EACA being the level of new Donor contributions to the replenishment, and the further assumption that ADF lending becomes self-financing—that is, no new Donor contributions—at the start of ADF XII with the level of EACA of \$6,300 million. However, these assumptions were made prior to the Asian financial crisis and the tragedy and aftermath of 11 September 2001, which have had ensuing and significant implications for the demand for ADF resources in the region. The amount of \$6,300 million may therefore be considered as illustrative, for the purposes of this report.

**Table 1. EACA Under Various Grant Scenarios
(in \$ million)**

	ADF IX (2005-2008)	ADF X (2009-2012)	ADF XI (2013-2016)	ADF XII (2017-2020)	ADF XIII (2021-2024)
Base Case	3,600	4,000	4,800	6,156	6,156
Grants at 20% starting 2005					
Resulting EACA	3,600	4,000	4,600	4,940	4,940
Decrease from Base Case-in amount	neg*	neg	(200)	(1,216)	(1,216)
-in per cent	neg	neg	-4%	-20%	-20%
Grants at 25% starting 2005					
Resulting EACA	3,600	4,000	4,500	4,648	4,648
Decrease from Base Case-in amount	neg	neg	(300)	(1,508)	(1,508)
-in per cent	neg	neg	-6%	-24%	-24%

* Amounts are negligible as a result of the 8-year grace period in ADF loans and the gradual disbursement of funds over several years for ADF projects.



C. The Cost of Grants to the ADF

7. There is a financial cost to ADF associated with the introduction of grants. More specifically, the cost is the amount of resources (i.e., principal repayments, interest charges and investment income) that ADF will forego and will incur administrative costs that cannot be recovered and should be borne by the remaining ADF resources. This is because the resources allocated as grants will not return to the pool of EACA resources. If Donors agreed to establish grants in ADF *and* plan for future levels of EACA comparable to a situation without grants (i.e., the “Base Case” in Figure 2), then additional resource mobilization into ADF would be required. Table 2 shows the estimated cost of ADF IX grants in nominal (pay as you go, or PAYG) and net present value terms (NPV basis) using a 5% discount rate.⁶

**Table 2. Estimated Cost of ADF IX Grants in Nominal and NPV Terms
For the Period 2005-2040
(in \$ million)**

Nominal Terms		
Grants at	20%	25%
Principal Repayments	1,260	1,575
Interest Charge	254	317
Investment Income	508	638
Total Cost	2,022	2,530
NPV Terms		
Grants at	20%	25%
Principal Repayments	473	591
Interest Charge	126	157
Investment Income	159	199
Total	757	947

Note: Discount Rate at 5%.

⁶ The continuing assumption, for illustrative purposes, is that the total size of ADF IX operations is \$6,300 million.

IV. GRANTS AND THE OVERALL CONCESSIONALITY OF ADF COMMITMENTS

8. The establishment of grants in ADF will increase the concessionality, or “grant element” of total ADF commitments in a replenishment.⁷ By definition, an ADF grant would have a grant element of 100%, compared to 62% for an ADF loan under current ADF loan terms (including assumed disbursement and repayment patterns). The increase in overall ADF concessionality will depend on the share of grants in ADF. Table 3 shows how the grant element increases in ADF at different shares of grants in ADF, and assuming that the remaining ADF commitments are loans under current ADF loan terms. However, depending on the nature and structure of an ADF grant allocation framework and actual levels and use of ADF resources in individual borrowers, the degree of ADF concessionality realized by the individual borrower—from a combination of grants and loans—in any year and over time, may vary.

Table 3. Grant Elements Under Various Grant Scenarios

Scenario	Grant Element	Difference in Grant Element from Base Case ⁸
Base Case	62%	
Grants at 5%	64%	2%
Grants at 10%	66%	4%
Grants at 15%	68%	6%
Grants at 20%	70%	8%
Grants at 25%	72%	10%
Grants at 30%	73%	11%

9. For purposes of comparison, the calculated grant element of an ADF loan under loan terms that prevailed prior to 1 January 1999 (‘old terms’) is 74%, which would approximate overall ADF concessionality where grants represented 30% of ADF commitments and the remaining 70% of ADF commitments were loans on current ADF terms. Furthermore, Figure 3 shows the projected level of EACA (out to and including ADF XIII, or to the end of year 2024) under the assumption of all ADF resources being on-lent at the old terms, which falls between the projections for EACA where grants represent 25 or 30% of ADF commitments and remaining commitments are loans under current ADF loan terms.

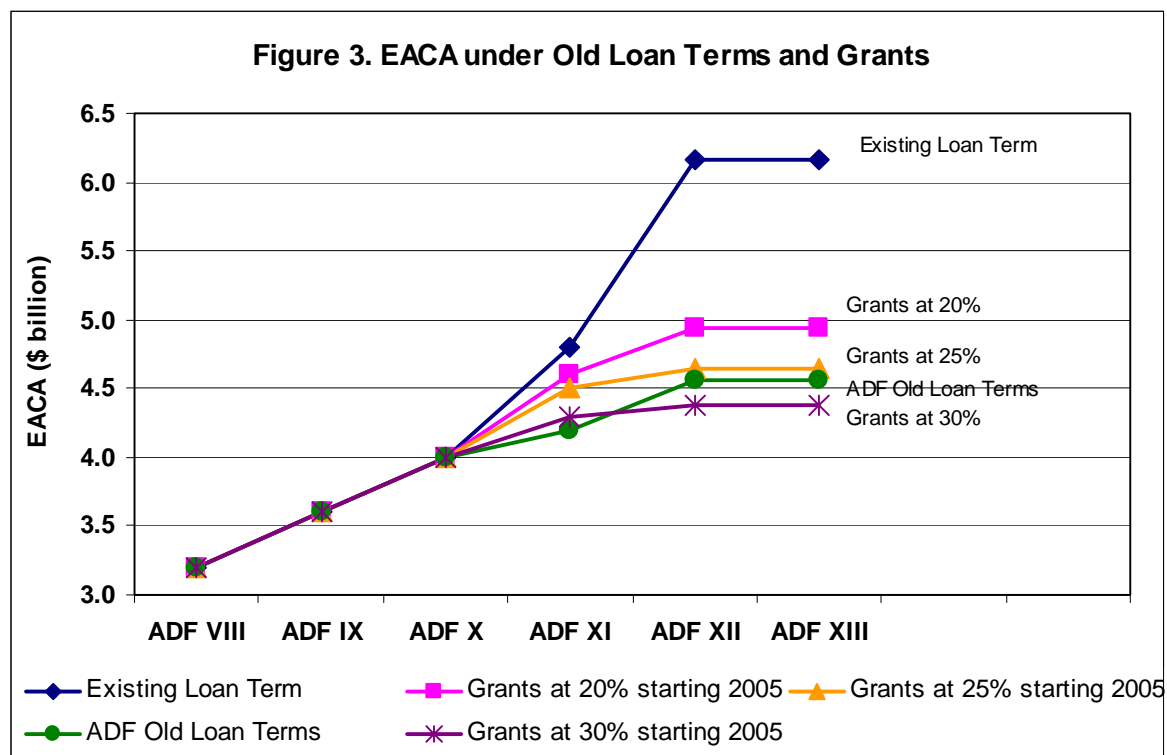
10. On these considerations of ADF concessionality and future levels of EACA, Donors may wish to consider grants at around 21 percent⁹ of ADF IX commitments with the remainder on-lent on current terms. In that context, a decision on grants, at around 21% of ADF IX commitments, could be taken on consideration of the development effectiveness of grants that

⁷ The grant element of an ADF loan is a percentage of net present value of loan repayments and charges over the net present value of loan disbursement, using the Development Assistance Committee (DAC) methodology. The grant element of current ADF loans is generally 62%.

⁸ Rounded to the nearest percent.

⁹ Similar to the share of grants in IDA13.

are allocated under a unique ADF IX grant framework and drawing upon other institutional resources of ADB.



V. EXPERIENCE WITH GRANTS IN IDA13 AND THE IMPLICATIONS FOR MAKING GRANTS FROM ADF TO THE REGION

11. Under IDA's Thirteenth Replenishment (IDA13), a share of IDA's total operational financing (18 to 21%) is being provided as grants. The objective of grants is "increasing the concessionality of the financing used to address the hardships facing ... the poorest and most vulnerable IDA countries." Under IDA13, there are five categories for grant eligibility: (1) HIV/AIDS projects/programs, (2) natural disaster reconstruction, (3) poorest countries, (4) poorest and debt vulnerable countries, and (5) post-conflict countries. Specific caps were set for the amounts of grants (as a share of a country's overall IDA allocation) for countries in each grant category. While particular sectoral uses for grant-eligible countries were not required, "investments in improving education, health and the provision of clean water and sanitation would be an important aspect." HIV/AIDS projects in eligible countries were to be fully financed by grants, given the severity of the epidemic and a general international consensus that action against HIV/AIDS should be urgently supported, preferably on a grant basis. A notional amount was set aside for natural disasters, based on past experience with natural disaster financing. In this context, and considering the primacy of the PRSP and Country Assistance Strategy (CAS) as well as the need to stay within performance-based allocations for IDA resources, the goal in IDA was to extend approximately one-third of the grant envelope in the first year (i.e., FY03) of IDA13.¹⁰

¹⁰ IDA Deputies stipulated that grants are subject to the same rules and policies, wherever applicable, as IDA credits, under the IDA13 arrangements and the Grant Guidelines.

12. In the context of the IDA13 Midterm Review (MTR) held on 4–5 November 2003, Deputies considered a report, “IDA Grants – Implementation in FY03” (October 2003). The information presented in that report shows, *inter alia*, that in FY03 the Region accounted for only 16% of IDA13 grants, or \$194 million. (By comparison, Africa accounted for 82% of IDA13 grants in FY03, or \$1,011 million.) This represents less than 10% of total IDA commitments to the Region in FY03. Of the \$194 million, South Asia accounted for \$170 million, which also represents less than 10% of IDA13 commitments to the subregion in FY03. The largest recipients of grants in the Region were Afghanistan (\$87 million, representing 40% of total IDA commitments), Nepal (\$25 million representing 26% of total IDA commitments), and Sri Lanka (\$52 million, representing 23% of total IDA commitments. Almost all of the grants to the Region were provided to post-conflict, debt vulnerable, or poorest IDA countries (below \$360 per capita GNP).

13. In FY03 most IDA grants (over 50%) were used in the social sectors (including HIV/AIDS) reflecting PRSP and country priorities. Of the grants made to the Region, \$142 million, or 73%, were allocated to health, education and water and sanitation projects.

14. There is limited (i.e., one year) experience in IDA13 with grants and therefore insufficient evidence to draw firm conclusions on the general suitability or relevance of the IDA framework (for use of grants) for the Region. However, early results suggest that the IDA framework may not be ‘optimal’ in a context where ADF plans to allocate an equivalent (18–21%) or higher share (e.g., 30%) of grants during an ADF replenishment period. Hence, consideration of modifying the IDA framework, or formulating one that is tailored to the specific needs and conditions of the Region—and reflecting ADB’s comparative strengths and experience—may be warranted.

VI. A PROPOSAL FOR A GRANTS FRAMEWORK IN ADF

A. ADF as Concessional Fund

15. The basic objective of ADF is to help poor countries in the Region to reduce poverty by growing faster, more equitably and on a sustainable basis. Most of ADF’s client countries will continue for some time to need large amounts of external financing, particularly in the form of concessional loans and grants and, perhaps in some circumstances, debt reduction. Increased concessionalism is particularly relevant for resource-poor countries requiring large expenditures and investments to achieve their poverty-reduction goals and to reduce the incidence of diseases that erodes their prospects for growth. At the same time, many of these countries remain vulnerable to external shocks, including natural disasters, conflicts, and fluctuating commodity prices. Beyond the purely national frame of reference, ADF may also need to develop instruments to help the international community deal with emerging regional and global issues, in ways which could increase the effectiveness of ADF at the country level.

16. ADF provides highly concessional support for poor countries to facilitate their integration to the world economy and international markets. ADF was therefore designed as a transitional instrument of concessional assistance, from which most countries should graduate over time as their incomes rose, and their economic performance enabled them to acquire some access to capital markets. Furthermore, ADF is premised on basic principles that have served well: ADF should be focused mainly on countries that are both poor and non-creditworthy or marginally

creditworthy; ADF should allocate its resources on the basis of performance; and ADF should maintain high fiduciary and operational standards, irrespective of what its terms are.

B. The Importance of Grant Financing in the Region

17. Direct grant funding is arguably the most cost-effective mechanism for providing external development assistance. Because direct non-reimbursable (grant) funding is targeted to specific activities, administrative costs, particularly to the recipient, may be minimized, thereby providing more resources for a project than if some of the monies must be used to administer repayment and associated currency management procedures and processes. Grant financing is also an important means of contributing to positive net resource transfers from development-finance institutions to the poorest countries. During the first half of the ADF VIII period (i.e., 2001–2003) ADF aggregate net resource transfers to ADF borrowers was positive, but it was only 80% of ADF's average annual net resource transfers during the preceding decade, and only 70% of the highest single annual net resource transfer during that period. In this context, the introduction of grants in ADF will ease the administrative burden of external development assistance on ADF borrowers while enhancing net resource transfers and easing the debt burden on these poor countries.

C. Knowledge Products and Services

18. The context in which ADB's DMCs operate today is dramatically different from that of a couple of decades ago. In particular, globalization led by trade and financial liberalization, and the rapid spread of information and communications technology are having a deep impact on Asian economies and societies. In recent years, development thinking has also been changing, with new approaches emphasizing stronger ownership by stakeholders; partnerships between governments, civil society, and renewed emphasis on governance and environmental issues. The challenge of reducing deeply entrenched poverty in the region requires new approaches and commitments. To more effectively cater to the changing needs and demands of its clients, ADB has over the years redefined its role from being mainly a project financier to becoming a broad-based development institution providing a variety of knowledge products and services to its DMCs. With this changing role for ADB, technical assistance (TA) forms an important part of ADB operations. TA serves many purposes, including support for project preparation and implementation, advice on policy reform, capacity building in the development member countries (DMCs), and promotion of regional cooperation. TA has expanded from being a tool mainly for the preparation and implementation of investment projects to a product in its own right. It increasingly incorporates advice on policy and institutional reform. TA includes a range of knowledge products and services provided by (i) ADB through consultations, economic and sector analysis, policy dialogue, and so on; (ii) components of project, sector, and program lending for implementation supervision, training and strengthening or executing agency staff, development of institutions and organizations, studies of sector issues, and institutional and policy reforms; and (iii) specific TA instruments designed to address the needs of the DMCs. Grant financing of TA for the poorest DMCs enables them to plan for and implement—in a coordinated and timely manner—a relevant and balanced set of knowledge products and services that further support the design, implementation and evaluation of the major elements of their national poverty reduction strategies, and in cooperation with neighbors.

D. Resource Poor Countries

19. A basic rationale for providing concessional assistance to ADF borrowers is their economic situation as reflected in two main criteria: per capital gross national product (GNP)

and debt repayment capacity. The benefits of concessionality are generally meant to accrue to a member government and, through its policies, to the economy as a whole. In this context, ADB classification system is premised on these two main criteria. In this system are two sets of DMCs (i.e., Group A and B1) that have been assessed as having a weak or limited state of development as well as limited medium-term prospects, and, therefore, are largely dependent on ADF and other concessional resources. These DMCs may be generally characterized in the following ways. They lack capital, both physical and human. Critical bottlenecks to solving this problem are low domestic saving and investment rates. The poor state of infrastructure, low absorptive capacity, and low creditworthiness typical of these countries has resulted in their being denied access to international capital markets. The resulting low growth rates and stagnant incomes complete a cycle of low savings and low growth. Concessional finance, including grants, helps such countries break out of this cycle by augmenting resources for investment available to them without straining their debt repayment capacities. Also, such funding helps finance the infrastructure and human resource and institutional development that will increase absorptive capacity and attract commercial funding in later stages of development. Concessional assistance including significant amounts of grant financing is most needed and effective in these Group A and B1 countries that have weak or limited debt repayment capacity, low domestic saving, and low income.

E. Sector and Thematic

20. **Post Conflict Situations.** Post conflict disproportionately affects the poor. Poor people are often the most likely to be exposed to conflict situations even though they are the ones who can least afford to deal with such exposure. Globally, countries classified by the United Nations (UN) as medium or low in relation to human development feel the impact of post conflicts the most acutely.¹¹ This may be attributable to resource constraints in the poorer countries. Government of such countries not only lack the financial resources needed to shoulder the economic burden, but also the institutional and human resources capacities needed to deal quickly and comprehensively with emergencies. Early coordination of post-conflict assistance efforts is especially important to avoid the imposition of unnecessary burdens on an already fragile government capacity and to ensure that available resources are channeled to the priorities set out in national recovery plans. This should be done in close collaboration with the United Nations system which possesses specialized skills and their key role in supporting the political and security framework required for humanitarian, reconstruction and development aid to be effective. Post-conflict grants could enhance ADF's ability to contribute to the international support for heavily indebted low income post-conflict countries, throughout all phases of their recovery. The availability of early financial support can be an important component of the normalization process. Focus on early action to restart the economy, contribute to the re-establishment of a framework for governance and policy reform and law reform, rehabilitate basic social services and key infrastructure, and help war-affected populations and communities, including support for income-generation programs, the reintegration of combatants, and other assistance to vulnerable groups.

21. **HIV/AIDS.** Over one million people in Asia and the Pacific acquired HIV in 2002, bringing the number of people now living with the virus to an estimated 7.2 million — a 10% increase since 2001. About 2.1 million young people (aged 15-24) are living with HIV. According to the United Nations Programme on HIV/AIDS (UNAIDS) and the World Health Organization between 2002 and 2010, an additional 45 million people will become infected in low and middle-income countries. More than 40% of these infections are expected to occur in

¹¹ International Federation of Red Cross and Red Crescent Societies. 2001. World Disasters Report 2001. Geneva.

Asia and the Pacific, which currently account for about 20% of new annual infections. Relying on exclusively country based HIV/AIDS prevention programs would result in an inadequate response, particularly for sub-regional activities (e.g. GMS, CARs). With extensive migrant labor movements, and trade the cross-border transmission of HIV through trade, tourism, migration armed forces and with refugees makes it essential to build effective sub-regional programs which target high risk populations. Action against HIV/AIDS and other communicable diseases will require increasing financing, preferably grants, because of large global and regional externalities, weak incentives for countries to borrow, and market failure. The use of ADF grants in this area would be complementary to ADF's continuing focus on investment in basic health systems within a country programs, financed by loans and grants in the future. The case for grants should be made on the basis of two factors: (i) need for collective action at the regional/global level; and (ii) weak incentives for individual countries to borrow.

22. **Natural Disasters.** Large-scale disasters have significant humanitarian and economic implications. The full economic cost of a disaster can be significant. Estimated costs, based largely on direct physical impacts or observable losses of fixed capital and inventory, e.g., buildings, infrastructure, industrial plants, crops, and materials, overlook the indirect and secondary effects of disasters on economic activity. Indirect costs include those associated with (i) disrupted flows of goods and services; (ii) reduced output from damaged or destroyed assets and infrastructure; (iii) loss of earnings due to damaged infrastructure, (iv) increased medical expenses; and (v) lost productivity. Disasters also reduce the pace of public infrastructure development by reducing the resources available for new investment. Increased concessional financing through grants can assist in ameliorating both short-term and long-term implications for economic performance; include adverse impacts on (i) the balances of the external and government sectors; (ii) the levels of debt; (iii) the thrust of government monetary and fiscal policies; and (iv) the inequity of income distribution, which implies an increase in the incidence of poverty.

23. **Gender in Development.** Gender equity and the empowerment of women are central to poverty reduction but at the same the greatest challenge. Gender equality and women's empowerment is recognized to have far-reaching impact on achievement of all the MDGs. Further progress will be need to be made in addressing gender equity at the institutional, policy and community level, and designing gender-inclusive interventions within particular attention to gender concerns in post-conflict reconstruction, physical infrastructure, governance, public sector reform and decentralization. Other gender issues such as HIV/AIDS, trafficking of women and children, and core labor standards. The availability of grants could expedite key prevention and policy initiatives, which otherwise poor countries with limited fiscal resource would not be in a position to finance.

24. **Law and Policy Reform.** As part of its efforts to support capacity building and governance for sound development management, ADB continues expanding law and policy reform work promoting policies, legal reforms, and regulations supporting ADB's overarching goal of poverty reduction through economic growth; enhancing the status of women; and protecting the environment. Such work has focused on capacity building among institutions responsible for the administration and enforcement of laws and regulations, continuing legal education for government lawyers, working with front-line development ministries and with government enterprises, and fostering research into the relationships between economic development and legal and policy reforms. ADB's approach to legal and judicial reform focuses on institutional reform and capacity building. Increasingly, it recognizes that a systemic approach to legal and judicial reform is indispensable for optimal development impact. Attention to systemic issues such as incentives, organizational structure, accountability and transparency

can lay the foundation for sustainable legal and judicial reform. In the context of poverty reduction ADB's law and policy reform focuses on issues relating to links between poverty, vulnerability, livelihood, governance, and access to justice. As part of this ADB has focused legal empowerment as a tool to ensure that the poor access the legal entitlements guaranteed to them under the law. Grant financing will be indispensable in promoting and investing in these critical areas I poor ADF countries with very constrained fiscal and debt position.

25. **Regional Cooperation.** Regional cooperation has important contributions to make to development beyond country-specific activities. Operationally, national commitments and activities are the foundations for effective and sustainable regional cooperation initiatives, but these need to be taken within a jointly agreed multi-country framework that defines the scope and focus of cooperation. The particular scope of regional cooperation, and therefore ADF's role in any given setting is a function of the specific interests and capabilities of the participating countries; and their ability to reach agreement as a group on joint or complementary courses of action. There are a number of areas where the use of grants could be utilized to great effectiveness: (i) facilitating economic development through the provision of infrastructure and trade and investment facilitation; (ii) addressing key regional public goods with particular focus on environment, health, knowledge and information sharing; (iii) maintaining regional stability through conflict prevention and post-conflict reconstruction; and (iv) contributing to the provision, protection and conservation of global public goods focusing on such areas as financial stability, cross-border crime prevention/law enforcement, strengthening DMCs capacity to beet from the multilateral trading system.

26. **Anti-Money Laundering and Combating Financing Terrorism.** There is an increasing need to address the money-laundering problem, through national regional programs. Such activities could be undertaken within the context of ADB's existing policy on this subject, as well as other policies and strategies to facilitate poverty reduction, good governance, and strengthen national financial systems and strengthen institutional capacity. In particular there is the need to improve financial systems. Increased efforts are needed to subject informal financial sectors to appropriate monitoring and enforcement actions. Thus there are also urgent demand for greater institution building, crisis prevention and resolution, combat of terrorist financing, financing for development and the prevention of abuses of the international financial system by promoting cooperation and information, and information exchange. Grants could be planned in the context of the work of the Asia/Pacific Group on Money Laundering, focusing on (i) Non-Cooperative countries and Territories designated by the Financial Action Task Force on Money Laundering (FATF), and (ii) major economies in the region recovering from the Asian financial crisis.

F. Operational Principles

27. The preceding discussion has provided some operational basis, on development considerations, for planning and allocating grants in ADF IX. Based on the guidance provided by donors on the use of grants, Management and the Executive Directors would need to determine the operational policies and procedures within which the ADF grant resources would be allocated among countries, and among competing claims. An allocation process could be broadly based on the following principles:

- Countries benefiting from ADF grants may include all ADF-eligible borrowers with access to ADF resources, with the largest share of grants intended for the poorest (per capita GNI < \$360) countries.

- ADF aggregate resources (loans and grants) will continue to be allocated to individual countries on the basis of the performance based allocation system (and reflected as such in CSPs). Perhaps not all grants for global/regional goods would be allocated through this process, but would be kept to a relevant proportion of ADF's overall financial assistance.
- Grants would only be provided in the context of justification clearly spelled out in a Country Strategy Paper (CSP) or in a transitional support strategy, except in the case of emergency assistance. In countries where a new full CSP is not planned for some time, a strategy update (CSPU) would be prepared, clearly making the case for financing on grant terms.
- ADF grants would be governed by the same policies and procedures that apply to ADF loans.
- To support regional entities in the context of global or regional projects, grants would normally be made to the individual member countries participating in the regional project. However, grants could also be given to an appropriate public regional organization established by two or more of such countries, depending on the suitability of the institution to be the grant recipient and the circumstances of the particular operation. There should be an adequate fiduciary framework in place for the implementing regional institution, and an agreement by participating governments to facilitate the carrying out of the projects being supported.

28. On the basis of the preceding, Table 4 presents a proposal for a framework and indicative estimates for the allocation of grants in ADF IX. In this framework, grants in ADF IX would represent 21% of ADF IX financing, including an allocation of 7% of new Donor contribution in ADF IX to the ADB's technical assistance special fund (TASF).

Table 4. ADF IX Grants: Allocation Framework and Indicative Estimates

A. Technical Assistance (TA)	% of Total Grants	Level of Grants	Grant Share of ADF Contribution	As a % of Total ADF IX Financing
To ensure support for priority technical assistance in ADF borrowers in ADF IX period, through a partial transfer of ADF IX contribution to the TA Special Fund	14.0%	Not applicable	7% of Donor Contributions to ADF IX transferred to TASF	Approximately 3%, depending on size of replenishment
B. Grants Category	% of Total Grants (by Category)	Qualifying Countries (per capita GNI in parenthesis)	Grant Allocations as a % of Total Assistance^{a, b}	Grants as a % of Total ADF IX Financing
Post-Conflict < \$360 per capita GNI	26.0%	Afghanistan (N/A) Cambodia (\$280) Tajikistan (\$180) Timor-Leste (\$430) ^c	Up to 30% ^a Up to 30% ^a Up to 30% ^a Up to 30% ^a	5.5%
Debt vulnerable < \$360 per capita GNI	2.5%	Lao PDR (\$310)	Up to 30% ^a	0.5%
Poorest < \$360 per capita GNI	9.5%	Kyrgyz Republic (\$290) Nepal (\$230)	Up to 25% ^a Up to 25% ^a	2.0%
Post-Conflict assistance for blend countries	12.0%	Solomon Islands (\$620) Sri Lanka (\$840)	Up to 30% ^a Up to 30% ^a	2.5%
ADF-only countries > \$360 per capita GNI <ul style="list-style-type: none"> • HIV/AIDs • Regional Cooperation (social sectors, environment, illegal trafficking, trade legalization, and regulatory systems) • Gender (projects with significant gender components) • Natural Disaster Reconstruction • Law and Policy Reform • Anti-Money Laundering and Combating the Financing of Terrorism 	9.5%	Bhutan (\$590) Kiribati (\$950) Maldives (\$1,960) Myanmar (N/A) Mongolia (\$390) Samoa (\$1,450) Tuvalu (\$1,296) Vanuatu (\$1,150)	Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b	2.0%
Assistance for blend countries <ul style="list-style-type: none"> • HIV/AIDs • Regional Cooperation (social sectors, environment, illegal trafficking, trade legalization, and regulatory systems) • Gender (projects with significant gender components) • Natural Disaster Reconstruction • Law and Policy Reform • Anti-Money Laundering and Combating the Financing of Terrorism 	26.0%	Azerbaijan (\$600) Bangladesh (\$450) Cook Islands (\$4,355) Indonesia (\$570) Marshall Islands (\$1,907) Micronesia (\$2,110) Nauru (N/A) Papua New Guinea \$700) Pakistan (\$400) Tonga (\$1,660) Viet Nam (\$390)	Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b Up to 100% ^b	5.5%
TOTAL	100.0% ^d			18.0%

^a Program basis^b Project basis^c While per capita GNI is above \$360, Timor-Leste's special circumstances warrant placement in this grants category.^d Rounded to the nearest percent.**21% including TA**

VII. LEGAL IMPLICATIONS OF ESTABLISHING GRANTS IN ADF

A. ADF Resources

29. ADF Resources consist of: (a) contributions of members; (b) amounts set aside from ADB's ordinary capital resources (OCR) and allocated to the ADF; (c) supplementary resources from members or other sources; (d) amounts initially allocated to other Special Funds of ADB and transferred to the ADF; (e) amounts received from borrowers in repayment of loans; (f) investment income; and (g) amounts transferred from OCR net income.¹²

30. As will be shown in following, the substance of set-aside resources under (a) above cannot be used for grant financing in accordance with Article 19.2 of the Agreement Establishing the Asian Development Bank (the Charter). Moreover, as regards resources contributed by Donors to ADF VIII and previous replenishments, certain constraints to grant financing of projects result from Article 19.3 of the Charter. Donors' contributions to ADF IX and future replenishments of the ADF may be used for grant financing of projects, provided an express authorization to that effect is given by the Board of Governors and appropriate amendments are made to the Regulations of the Asian Development Fund (ADF Regulations).

B. Current Legal Framework

31. Resolution No.62, *Establishing of the Asian Development Fund* adopted by the Board of Governors in April 1973 (ADF Resolution), states in paragraph 5 (a), inter alia, "Resources of the Fund shall be used for financing concessional loans...". It provides in paragraph 5 (b) that only "net income of the Fund [ADF] may, to the extent authorized annually by the Board of Governors, be used for financing the provision of technical assistance, on a grant basis. The Resolution goes on to state (paragraph 7) that "Any contributor may at any time withdraw from the Fund. A withdrawing contributor shall be entitled to recover a proportionate share of the resources of the Fund, not exceeding the amount of its contribution." It further states "The Fund may be terminated by Resolution of the Board of Governors. In such event, the resources of the Fund shall be apportioned among contributors and the Bank in proportion to the amounts respectively made available by them to the Fund."

32. The ADF Regulations provide in Section 3.01 inter alia that the "resources of the Fund may be used by the Bank...to provide financing under loans (including technical assistance loans on concessional terms, for projects and programmes of high developmental priority." In accordance with Section 4.07 of the ADF Regulations, "net income accruing on ADF resources shall be retained in the Fund [ADF], provided that, if authorized by the Governors, a portion of such net income accruing in any year may be transferred from the Fund and applied towards financing the cost of technical assistance provided by ADB on a grant basis." Consistent with the ADF Resolution, detailed provisions regarding withdrawal and termination have been incorporated into Article V of the ADF Regulations.

33. While ADB has under the current legal framework the option of increasing the concessionality of ADF loans, grant financing of projects or programs is not foreseen as one of the methods of operations of the ADF. Currently, only net income accruing on ADF resources could be used for the purpose of financing the provision of technical assistance. However, in practice, ADF net income has not been used for that purpose. Moreover, to the extent that such use of ADF net income might be deemed warranted, ADF resources would not be used to fund

¹² Section 2.01 of the Regulations of the Asian Development Fund

directly the provision of technical assistance. Rather, appropriate transfers of ADF net income to the Technical Assistance Special Fund (TASF) or other Special Funds would need to be authorized by the Board of Governors.

C. Implications of the Introduction of Grant Financing

34. The introduction of grant financing in ADF for projects would require changes to the current legal framework for ADF resources.

(i) Charter

35. There are certain constraints regarding grant financing which result from the Charter. First, as highlighted in paragraph 35 above, part of ADF resources consist of funds, which have been set aside¹³ from ADB's paid-in capital pursuant to Article 19.1(i) of the Charter. The substance of such funds cannot be used for grant financing of projects in accordance with Article 19.2 of the Charter.¹⁴ Second, with regard to funds that have been contributed by Donors to ADF VIII and previous replenishments,¹⁵ Article 19.3 of the Charter is applicable. In accordance with Article 19.3 of the Charter, in addition to being compatible with the purpose of the Bank, the use of ADF resources must not be inconsistent with "the agreement relating to such Funds." The "agreement" referred to in Article 19.3 is that between the Bank and contributors to Special Funds. The methods of operations of the ADF and the terms regarding withdrawal from, or termination of, the ADF, as set out in the ADF Resolution and the ADF Regulations, are part of the aforementioned "agreement". Therefore, contributions of Donors to ADF VIII or previous replenishments could only be used for the purpose of grant financing with the agreement of Donors. Donors would need to waive in such a case their right to receive, in case of withdrawal from, or termination of, the ADF those amounts, which would be used for grant financing of projects or programs from contributions made by them to ADF VIII or previous ADF replenishments. Moreover, in such a case, substantial changes to the ADF Resolution, the various resolutions of the Board of Governors regarding ADF replenishments, the ADF Regulations and ADB's financial policies would be required. In view of the foregoing, it would be advisable to consider the introduction of ADF grants only in the context of Donors' contributions to ADF IX and subsequent replenishments of the ADF.

(ii) ADF Resolutions of the Board of Governors, and ADF Regulations

36. If the decision is taken by Donors to use a part of their ADF IX contributions for the purpose of grant financing of projects, an express authorization to that effect would need to be incorporated into the Resolution of the Board of Governors regarding the Eight Replenishment of the Asian Development Fund (ADF IX Resolution). It must be expressly specified in the ADF IX Resolution that any contributions of members to ADF IX, as well as reflows and investment income from such contributions, may be used for the purpose of grant financing.

¹³ Pursuant to Resolutions No. 26, 41 and 61 of the Board of Governors in 1969, 1971 and 1973, amounts were set aside from ADB's paid-in capital and allocated to the Multi-Purpose Special Fund. The set aside resources were subsequently transferred to the ADF pursuant to Resolution No. 85 of the Board of Governors. With interest, such funds amount to approximately US\$280 million.

¹⁴ Consistent with Article 19.2, Special Funds (e.g. ADF) may be used on such "terms and conditions, not inconsistent with the applicable provisions of this Agreement, nor with the character of such Funds as revolving funds, as the Bank in establishing such Funds may direct." (emphasis added)

¹⁵ Cfr. Article 19.1 (ii) of the Charter.

37. Moreover, it would be necessary to amend Section 3.01 of the ADF Regulations to provide that ADF IX contributions of Donors may also be used to provide financing other than loans, including grants, according to arrangements approved by the Board of Governors. However, amendments to Article V of the ADF Regulations (regarding “Withdrawal and Termination”) would not necessarily be required, as it may be specified in the ADF IX Resolution that the amounts applied to grants shall not be deemed to be part of the Donors’ contributions for the purpose of Article V of the ADF Regulations.

(iii) Earmarking of ADF IX Contributions

38. At the ADF IX Donors’ meeting in Copenhagen, the question was raised as to whether Donors will be given the opportunity of earmarking their contributions to ADF IX for the provision of loans only. This largely depends on the wording of the ADF IX Resolution and is, therefore, an issue on which consensus among Donors is required. So far, the ADF legal framework does not give Donors the opportunity of earmarking their contributions for specific types of ADF operations only. It is also pertinent to note that no such opportunity was given to Donors in the context of the Thirteenth Replenishment of IDA or the Ninth Replenishment of the African Development Fund. If the decision is taken to allocate on a pro rata basis a certain percentage of total ADF IX contributions for the purpose of grant financing, such decision would be binding on all contributors, unless expressly provided otherwise by the Board of Governors. Any special arrangement for a contributor would need to be expressly approved by the Board of Governors.

VIII. CONCLUSIONS AND REQUEST FOR DONOR GUIDANCE

A. Conclusions

39. EACA does not fall below its current level in ADF VIII as a result of the introduction of grants, with grants at 20-25 percent of ADF IX commitments. EACA would continue to increase, albeit more slowly.

40. There is a financial cost to ADF from the introduction of grants, that is, foregone reflows back to the pool of resources that support the EACA. If Donors agreed to establish grants in ADF *and* plan for future levels of EACA comparable to a situation without grants, then additional resource mobilization would be required.

41. The establishment of grants in ADF will increase the concessionality, or “grant element” of total ADF commitments in a replenishment. On the concessionality criterion as well as future levels of EACA, Donors might consider grants in ADF IX at 20-25 percent of ADF commitments, with the remainder on-lent on current terms.

42. The IDA13 framework for the use of grants may not be ‘optimal’ in a context where ADF plans to allocate an equivalent (18-21%) or higher share of grants during an ADF replenishment period. Hence, consideration of modifying the IDA framework, or formulating one more tailored to the specific needs and conditions of the Region—and reflecting ADB’s comparative strengths and experience—may be warranted.

43. A grant allocation framework as presented in Table 4 estimates an equivalent of 21% share of ADF IX operations as grants, including an allocation of 7% of new donor contributions to the technical assistance special fund (TASF). The allocation framework takes into consideration the particular challenges facing the poorest countries in the Asia and the Pacific

region and is tailored to address these priority concerns, and is related to the strengths and experience of ADB.

44. Grant financing of projects is currently not foreseen as one of the methods of operations of the ADF and should be considered in the context of Donors' contribution to ADF IX and subsequent replenishments. If the decision is taken by Donors to use a substantial part of their ADF IX contributions for the purpose of grant financing of projects or programs, an express authorization to that effect would need to be incorporated into the ADF IX Resolution. It would also be necessary to amend Section 3.01 of the ADF Regulations to provide that contributions of Donors may be used to provide financing other than loans, including grants, according to arrangements approved by the Board of Governors. The use of Donors' contributions to ADF VIII or previous replenishments for grants would require agreement of all Donors, past and present, and substantial changes to the ADF Regulations.

45. If the decision is taken to allocate on a pro rata basis a certain percentage of total ADF IX contributions for the purpose of grant financing, such decision would be binding on all contributors, unless expressly provided otherwise by the Board of Governors. Any special arrangement for a contributor would need to be expressly approved by the Board of Governors.

B. Request for Donor Guidance

46. Donors are requested to provide their guidance on the general directions and proposals for establishing grants in ADF as set out in previous sections of this report. In particular, Donors are requested to provide guidance on: (i) the share of grants in ADF IX; (ii) the proposed framework for the use of grants in ADF IX; and (iii) that grants in ADF IX be financed in regard to new Donor contributions to the ADF IX replenishment.