ASIAN DEVELOPMENT FUND (ADF)
ADF IX DONORS' MEETING
Lisbon, 9-11 March 2004

GRANTS IN THE ASIAN DEVELOPMENT FUND

OF THE ASIAN DEVELOPMENT BANK:

A DISCUSSION PAPER

Asian Development Bank
February 2004

ABBREVIATIONS

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

NOTE

In this report, "$" refers to US dollars

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I. INTRODUCTION

1. At their second ADF IX meeting in Tokyo, 9–11 December 2003, Donors discussed a further report on the grants issue, "Grants in the Asian Development Fund of the Asian Development Bank: A Discussion Paper" (November 2003). That report examined grants in ADF IX on development, financial, and legal considerations, and proposed a framework for the allocation and use of grants in ADF IX. Although Donors agreed, in principle, that grants would be part of ADF IX, there remained some diversity of views on: (i) the extent to which ADF should use grants in its support to poor countries; (ii) the planning for and eligibility of grants on functional use and poverty considerations; and (iii) feasible approaches for sustaining the financial strength of ADF. Against that background, this report provides further analysis and information on grants in ADF IX and seeks Donor guidance, as a basis for supporting and reaching a timely consensus in these ADF negotiations.

2. The next section of this report summarizes guidance provided by Donors at Tokyo. The following section discusses the significance of enhanced concessionality in ADF and sets out alternatives. It then looks at the role of grants in ADF IX. Next is a presentation of a grant allocation framework and associated projection on the share of grants in ADF IX. This is followed by two sections concerned with the management of an ADF IX grants program and the legal implications of grants. The next section discusses the financial impact of grants on ADF resources and options to maintain the financial integrity of the Fund. The paper ends with conclusions and a request for Donor guidance.

II. GUIDANCE ON GRANTS PROVIDED BY DONORS AT TOKYO

3. At Tokyo, Donors provided the following guidance to ADB for preparing this further report;[1]

(i) Alternatives for enhancing concessionality in ADF IX should be presented;

(ii) Grants in ADF IX should be used to implement ADB's mandate and policies, while respecting the established roles and activities of other development partners, multilateral and bilateral;

(iii) Grants in ADF IX should be allocated on the basis of performance, and should support national poverty reduction strategies through ADB's corresponding country and subregional strategies;

(iv) The majority of grants in ADF IX should be allocated to poor and debt vulnerable countries, and countries emerging from conflict and crisis;

(v) Grants in ADF could be allocated for emergency assistance after natural disasters, to combat HIV/AIDS, and to address regional public goods with substantial cross-border externalities that are important for development and poverty reduction and promote cooperation and collective action among poor countries;

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[1] This section is a *summary of the key elements or main points* of the overall guidance provided by the Donors.

(vi) Grants allocated to support technical assistance should be used strategically and efficiently to improve ADB's other projects and programs and enable ADF-borrowing countries to plan, implement, and evaluate their national poverty reduction strategies and contribute to capacity building; and

(vii) Options for maintaining the financial strength of ADF should be examined.

Broadly, Donors expressed a strong preference for an ADF IX framework for grants that would increase the effectiveness of ADB's assistance to the Region, keep ADF's resource allocation process and instruments simple, transparent and flexible enough to meet varying circumstances and changing priority needs under country-led development programs, and not undermine the financial strength of ADF.

III. DEVELOPMENT EFFECTIVENESS AND ENHANCED CONCESSIONALITY IN ADF

A. ADF as Concessional Fund

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

5. ADF provides highly concessional support for poor countries to ease their integration to the world economy and international markets. ADF was designed as a transitional instrument of concessional assistance, from which most countries should graduate as their incomes rose, and their economic performance enabled them to access to capital markets. And, ADF is premised on basic principles that have served well: ADF should be focused on countries that are poor and non-creditworthy or marginally creditworthy; ADF should allocate its resources based on performance; and ADF should maintain high fiduciary and operational standards, irrespective of what its terms are.

B. Options for Enhancing Concessionality in ADF

6. Against this background, enhanced concessionality through the provision of grants, or grants and softened loan terms, would provide financial benefits to ADF's borrowers but would reduce the capacity of ADF to support new concessional operations. There can be no analytically exact answer about the proper pricing of ADF assistance across all aspects of ADF's activities and possible assumptions of the future needs for concessional assistance in the Region. Decisions will need to be informed by, among other things, the development effectiveness of ADF operations and associated instruments/modalities in poor countries, the availability and access by poor countries to other concessional resources and interaction with and roles of other development partners, and implications for ADF's financial capacity.

7. ADF Donors have discussed a range for the share of grants in ADF IX, generally from 15 to 25%. Donors' noted that ADF's current loan terms are less concessional than IDA's in the Region.

8. There are various possibilities for changing the parameters, and thus the concessionality or grant element, of ADF. A grant is, by definition, non-reimbursable and has a grant element of 100 percent. Modifying ADF's loan terms to increase concessionality might include extending the grace period, maturity or reducing financial charges. The full impact of grants and any modification of loan terms on ADF's overall grant element and the Fund's financial capacity to support new concessional assistance would depend on the balance between grants and loans in a replenishment and the specific loan terms. Concessionality realized by individual countries from a combination of grants and loans may vary.

9. Table 1 presents nine alternatives for enhancing concessionality in ADF IX. For each alternative, the overall ADF grant element and projected EACA in ADF XII are indicated. By comparison, the current ADF grant element is 62% and EACA at ADF XII is projected to be $6,680 million.

? The first three alternatives in Row A represent current ADF loan terms, with grants at 15%, 20%, and 25%;

? The next three alternatives in Row B represent intermediate (between current ADF and IDA terms) loan terms resulting from extended maturity and an adjustment in financial charges, with grants at 15%, 20% and 25%; and

? The final three alternatives in Row C represent an alignment with IDA terms, with grants at 15%, 20% and 25%.

**Table 1: Alternatives for Enhanced Concessionality in ADF:
Grants in ADF IX and ADF Loan Terms
(in percent and $ million)**

Loan Terms \ Grants	15%		20%		25%	
A. Existing Loan Terms Maturity: 24/32 years Grace Period: 8 years Interest: 1%/1.5% Commitment Charge: 0%	EACA (ADF XII) Grant Element	6,647 67%	EACA (ADF XII) Grant Element	6,423 69%	EACA (ADF XII) Grant Element	6,358 71%
B. Intermediate Loan Terms Maturity: 30/38 years Grace Period: 8 years Interest: .75% Commitment Charge: .50%	EACA (ADF XII) Grant Element	5,472 72%	EACA (ADF XII) Grant Element	5,417 74%	EACA (ADF XII) Grant Element	5,362 75%
C. Alignment with IDA Loan Terms Maturity: 30/40 years Grace Period: 10 years Interest: .75% Commitment Charge: .50%	EACA (ADF XII) Grant Element	5,118 75%	EACA (ADF XII) Grant Element	5,074 77%	EACA (ADF XII) Grant Element	5,031 78%

Notes:

(1) Based on lending at $6.7 billion in ADF IX (net of allocation to TASF) and lending level of $7 billion per replenishment thereafter. Under current ADF loan terms and assuming no grants in ADF, EACA at ADF XII would be equal to $6,680 million.

(2) ADF Grant Element under Existing Loan Terms is 62%

(3) IDA's Grant Element—using ADF's Disbursement Rates and Discount Rate of 10%—is 75%

10. Compared to the instruments and terms in ADF VIII, each alternative would result in an increase in the overall concessionality of ADF and a reduction in EACA. Starting with Row A and moving through the three rows related trends emerge; (i) the grant element in ADF increases from 67 to 78%; and (ii) the value for EACA in ADF XII declines from $6,647 million to $5,031 million. As noted above, other combinations for enhancing concessionality in ADF are possible, and could have different financial benefits for poor countries and impact on the financial strength of ADF. But considering the history of ADF loan terms, recent decisions taken by the international community in other multilateral concessional funds, and the discussions among Donors on the rationale and practicality of financing grants, these alternatives offer choices on the use of grants and loan terms to provide enhanced concessionality in ADF.

IV. A GRANT ALLOCATION FRAMEWORK IN ADF IX

A. The Role of Grants

11. Donors have stressed that grant financing should not alter the character of ADF, including its role in promoting sound development management and achieving strong performance, developing fiscal responsibility, the creation and maintenance of credit discipline, and assisting poor countries to access non-concessional and private sources of capital. Even where provided as grants, ADF assistance should still require strong government commitment, financial management and fiscal responsibility, assessment of measurable outcomes and impacts, and grants would be provided as part of a portfolio whose size would continue to be based on assessment of government performance in achieving economic growth, social development and good governance.

12. There is increasing recognition that many ADF countries (and developing countries in other regions) are attempting to achieve progress against the Millennium Development Goals (MDGs) in an environment of debt vulnerability and intractable causes of poverty. ADF will need greater flexibility, innovation and choice of instruments to tackle these increasingly complex development challenges. This will require a reasonable capacity to provide selective and targeted grant assistance. The international community has also agreed that external development assistance must, among other things, encourage and support involvement of all major stakeholders—government, civil society, the private sector—in a country's development by providing the information and other opportunities required as a basis for each to contribute to its comparative advantage. ADF financial and technical assistance, including through grants, should have an explicit focus on supporting broad and sustained stakeholder engagement within a framework of country-led development. And, Grant financing is an important means of contributing to positive net resource transfers from ADB to poor countries. During the first half of the ADF VIII period (i.e., 2001–2002) 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. Thus, grants in ADF will enhance net resource transfers and reduce the debt burden on poor countries.

B. The Use of Grants in ADF IX

13. The discussion on grants in ADF has been viewed through a lens of poor country vulnerability—post-conflict, natural disasters, HIV/AIDS, low-income and debt, regional externalities—each of which constrains the development possibilities and poverty reduction efforts of the poor countries. Also, ADF Donors recognize the efficacy of grant assistance that supports the design, implementation and evaluation of national poverty reduction strategies through broad stakeholder participation and voice, and strengthened local institutions.

14. An ADF grant allocation framework should be focused on specific uses, on based country and project considerations. A grant framework should reflect ADB's mandate as a broad-based development institution, respect the activities of other development partners, and draw on the ADB's strengths and comparative advantages. Priority uses for grants could therefore include:

? In *post-conflict situations*;

? As a means of *increasing ADF's concessionality to the poorest countries with limited debt-repayment capacity*;

? Where interventions are for *dealing with the consequences of natural disasters;*

? To *combat HIV/AIDS and other infectious diseases*.

? When there are *large regional externalities*; and

? For *technical assistance (knowledge products and services)* that empowers national and sub-national institutions and civil society more broadly in *their* fight against poverty.

15. ***Post Conflict Situations.*** Post conflict disproportionately affects the poor. Poor people are often the most likely to be vulnerable 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 on human development feel the impact of post conflicts the most acutely.[2] 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. Coordination of post-conflict assistance should be done in close collaboration with the United Nations system. Post-conflict grants could enhance ADF's ability to contribute alongside other international support for heavily indebted low income post-conflict countries. 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, policy and law reform, rehabilitate basic social services and key infrastructure, and assist war-affected populations and communities including support for income-generation programs, reintegrating combatants, and other assistance to vulnerable groups.

16. ***Increased Concessionality to the Poorest Countries*:** A basic reason for providing concessional assistance to ADF borrowers is their economic situation as measured on two criteria: per capita gross national income (GNI) 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 ADB two sets of DMCs (i.e., Group A and B1) have a restricted state of development, poor medium-term prospects, weak or limited debt-repayment capacity and are largely dependent on ADF and other concessional resources. These DMCs may be also be characterized in the following ways. They lack adequate physical and human capital. 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 poor growth rates and 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. For many of these poor countries, highly concessional financing, including grants, will be needed to achieve and sustain growth rates that would allow them to eventually graduate from ADF.

17. ***Assistance after Natural Disasters:*** Large-scale disasters have significant humanitarian and economic implications. Many ADF-eligible countries continue to face catastrophic events that pose a critical threat to their growth, and in some cases to a country's social organization. The full economic cost of a disaster can be significant. Normally, estimates of the costs of natural disasters are confined to the direct physical impacts or observable losses

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[2] International Federation of Red Cross and Red Crescent Societies. 2001. World Disasters Report 2001. Geneva.

of fixed capital and inventory, for example, buildings, infrastructure, industrial plants, crops, and materials, but overlook the significant indirect and secondary effects of disasters on economic activity. Indirect costs include those associated with disrupted flows of goods and services, reduced output from damaged or destroyed assets and infrastructure, increased medical expenses, and lost productivity. Disasters also reduce the pace of public infrastructure development by reducing the resources available for new investment. In these situations, a major part of ADF's assistance needs to be directed to arrest calamitous deterioration rather than foster growth and rising incomes. The result of concessional borrowing by a poor country to mitigate the damage from a major natural disaster would be the avoidance of further costs, rather than a contribution to economic growth and increased debt servicing capacity. In such cases, even regular ADF loan terms may not be concessional enough, and may unduly contribute to a poor country's debt burden.

18. ***Combating HIV/AIDS and Infectious Diseases:*** Over one million people in Asia and the Pacific became infected with HIV/AIDS in 2002, bringing the number of people 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 Program on HIV/AIDS and the World Health Organization between 2002 and 2010, another 45 million people will become infected in low and middle-income countries. More than 40% of these infections are expected to occur in Asia and the Pacific, which account for about 20% of new annual infections. Relying on only country based HIV/AIDS prevention programs would result in an inadequate response, particularly for sub-regional activities. The increasing potential for transmission of HIV/AIDS and infectious diseases across all socioeconomic groups and subregions of a poor country—and cross-border transmission— through trade, tourism, and refugees makes it essential to build national and sub-regional programs which target high risk populations. Action against HIV/AIDS and other infectious diseases will require increasing financing, preferably grants, because of large national and regional externalities, reluctance of countries to borrow, and market failure. The use of ADF grants in this area would be complementary to ADF's other investment programs in basic health systems. The case for grants should be made on the basis of two factors: (i) weak incentives for individual countries to borrow; and (ii) need for collective action at the regional level.

19. ***Regional Externalities***: The role of the major multilateral institutions, including ADB, in responding to international public goods was presented in an earlier paper to the Development Committee in 2001. Be it at the global or regional level, these goods are commodities, resources, services, and systems of rules or policy regimes with substantial cross-border externalities that are important for development and poverty reduction, and that can be produced in sufficient supply only through cooperation and collective action among institutions with complementary mandates and capabilities. Their provision requires investment beyond the scope of technical assistance under established ADB policy and practice, that is, much more than short duration advisory services, small-scale capacity building and training, provision of expert services and related facilities.[3] Regional cooperation can make important contributions to development beyond country-specific activities. Operationally, national commitments and activities are the foundations for 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 scope of regional cooperation and ADF's role are a function of the specific

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[3] Around the world, the costs of deficient provision of global public goods are probably over one trillion dollars a year. Corrective actions, on the other hand, would cost between one and ten percent of the costs of continued inaction. The study is not a full cost- benefit analysis, but a rough comparison of the annual costs of inaction with the annual costs. See, *Providing Global Public Goods: Managing Globalization,* edited by Inge Kaul, Pedro Conceição, Katell Le Goulven and Ronald U. Mendoza, Oxford University Press, New York, 2003.

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 areas where ADF grants could be used to great effectiveness: (i) economic integration through trade and investment facilitation; (ii) the environment, communicable diseases, knowledge and information sharing; (iii) maintaining regional stability through cross-border conflict prevention and post-conflict reconstruction; and (iv) contributing to the provision of regional public goods focusing on such areas as financial stability, cross-border crime prevention, and strengthening poor countries' capacities to benefit from the multilateral trading system.

20. ***Technical Assistance:*** The context and ways in which poor countries in the Region undertake their national development is dramatically different from that of a decade ago. In recent years, development thinking has changed, with new approaches stressing stronger ownership by stakeholders; partnerships between governments, civil society, and renewed emphasis on governance and environmental issues. Reducing deeply entrenched poverty in the region requires new approaches and commitments. To meet the changing needs and demands of its clients, ADB has 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 developing member countries. Alongside this changing role, technical assistance (TA) forms an important part of ADB and ADF operations. TA serves many purposes, including support for project preparation and implementation, advice on policy reform, capacity building, and promotion of regional cooperation. TA has expanded from being a tool for preparing and implementing investment projects to a product in its own right. TA provides a range of knowledge products and services: (i) economic and sector analysis, and policy dialogue; (ii) components of project, sector, and program lending for implementation supervision, developing institutions and organizations, studies of sector issues, and policy reform; and (iii) specific TA instruments designed to address specific the needs of the DMCs. Grant financing of TA for the poorest countries enables them to plan for and implement—in a coordinated and timely manner—knowledge products and services that further support the design, implementation and evaluation of their national poverty reduction strategies, and in cooperation with neighbors.

C. ADF IX Grant Framework and Projected Allocations

21. Donors to ADF have stressed that allocating grants in ADF IX—and consequently the share of grants in the ADF IX replenishment period should be derived from Country Strategy Papers (CSPs) or in transitional support strategies. In countries where a new full CSP is not planned for some time, a strategy update (CSPU) would be prepared, explaining the need for financing on grant terms. On that basis and other comments from Donors on an earlier grant allocation framework, and with a view to the guiding principles discussed above, Table 2 presents the projected allocation and share of ADF IX resources, as grants, on country, end-use and technical assistance considerations, derived from existing CSPs/CSPUs and subregional strategies that extend into the ADF IX period.

22. The key results show the following:

- **Grants in ADF IX**: The share of grants in ADF IX, including to TA, is projected to be 21%.
- **Technical Assistance:** The share of grants for TA is projected to amount to 3% of ADF IX financing and 16% of all grants in ADF IX. Excluding TA, the share of grants in ADF IX is 18%.

- **Natural Disasters:** The share of grants allocated to emergency assistance after natural disasters is projected to be 1% of ADF IX financing, and 5% of all ADF IX grants.

- **Poor Country and Post-Conflict:** The share of grants allocated to the poorest countries (with a per capita GNI below $360) and countries with post-conflict situations, including Sri Lanka and Solomon Islands, is projected to be 14.4% of ADF IX financing and 69% of grants.

- **End Use and Project Grants:** The share of grants allocated to ADF-eligible that have per capita GNI above $360 is projected to be 2.2% of ADF IX financing and 11% of grants.

It is expected that in the normal course of business ADB's operational strategic planning process will lead to some new CSPs/CSPUs during the ADF IX period to be considered by the Board of Directors. The results of those decisions and the corresponding grant allocations that are later realized throughout the ADF IX period may change the (indicative) results in Table 2.

Table 2. ADF IX Grants: Allocation Framework and Indicative Estimates

Demand/Use of Grants	% of Total Grants	Qualifying Countries/Uses (per capita GNI in parenthesis)	Grant Share of as a % of Total Assistance [a, b]	Grants as a % of Total ADF IX Financing
A. Technical Assistance (TA)				
To ensure support for priority technical assistance, through a partial transfer of ADF IX contribution to the TA Special Fund	16%	Includes all ADF Borrowers	7% of Donor Contributions to ADF IX transferred to TASF	Approximately 3%
B. Natural Disasters	5%	All ADF Borrowers	Up to 100% [b]	1%
C. Grants Category				
1. Poor Country/Post-Conflict	69%	Poorest and Debt Vulnerable < $360 per capita GNI and Post-Conflict Situations		**14.4%**
(i) Poorest and Debt Vulnerable < $360 per capita GNI		Lao, PDR ($310) Kyrgyz Republic ($290) Nepal ($230) Cambodia ($280)	Up to 40% [a] Up to 40% [a] Up to 40% [a] Up to 40% [a]	(i) 6.3%
(ii) Post-Conflict < $360 per capita GNI		Afghanistan ($186) Tajikistan ($180) Timor-Leste ($430) [c]	Up to 40% [a] Up to 40% [a] Up to 40% [a]	(ii) 5.5%
(iii) Post Conflict > $360 per capita GNI		Solomon Islands ($620) Sri Lanka ($840)	Up to 30% [a] Up to 30% [a]	(iii) 2.5%
2. End Use/Project Basis	10%	Infectious Diseases and Regional Public Goods in ADF-only countries >$360 per capita GNI, and ADF blend borrowers [4]		2.2%
(i) HIV/AIDs and infectious diseases			Up to 50% [b]	(i) 1.0%,
(ii) Regional Public Goods (health, education, environment, and natural resource management, regional financial stability and economic integration)			Up to 50% [b]	(ii) 1.2%
TOTAL	**100%** [d]			» **21% including TA**
				» **18% excluding TA**

Note: Assumes total ADF IX financing framework at$7,000 million

[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.

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[4] **ADF-only countries > $360 per capita GNI:** Bhutan ($590), Kiribati ($950), Maldives ($1,960), Mongolia ($390), Samoa ($1,450), Tuvalu ($1,296), and Vanuatu ($1,150).
ADF blend borrowers: Azerbaijan ($600), Bangladesh ($450), Cook Islands ($4,355), Indonesia ($570), Marshall Islands ($1,907), Micronesia ($2,110), Papua New Guinea $700), Pakistan ($400), Tonga ($1,660), and Viet Nam ($390).

V. MANAGING AN ADF IX GRANT PROGRAM

23. Introduction of grants in ADF IX will require good management and implementation. ADB Management and the Executive Directors should determine the specific operational policies and procedures for allocating grants among countries, and among competing claims. However, it is useful to set out some basic considerations that should guide the process.

24. First, grants in ADF IX should be allocated on the same operational standard as ADF, that is, country performance as determined by ADF's performance-based allocation system. Within that performance-based system, national poverty reduction strategies, including PRSPs, should guide priorities for the specific use of grants at country and subregional levels, and going forward CSPs/CSPUs will need to include specific discussion of the role of grants in ADF's business plan for the country. More broadly, ADF grants would be governed by the same policies and procedures that apply to ADF loans

25. Second, the deployment of ADF grants to help poor countries which are vulnerable to critical debt problems should complement and support—but not substitute for—the HIPC initiative, which is based on international agreement and a framework of equitable creditor burden sharing.[5] Similarly, ADF grants to support post-conflict countries, to combat HIV/AIDS or to provide assistance after natural disasters will need to be aligned with, but not replace, the mandates and resources of other international organizations, in particular United Nations Agencies and the Global Fund for AIDS, TB and Malaria.

26. Third, allocating grants in ADF IX should be planned in close coordination and cooperation with the Bretton Woods institutions and other multilateral and bilateral agencies providing grants in ADF-eligible countries.

27. Fourth, to support regional entities involved in 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 a 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 operation. There should be an adequate fiduciary framework in place for the implementing regional institution, and an agreement by participating governments to carry out of the projects being supported.

28. Fifth, it will be essential to monitor closely the specific grant decisions and allocations and the practices employed to deal with 'boundary' issues at the income cutoff ($360 per capita GNI). Early experience with implementing grant-financed operations, and their outcomes and impacts should be assessed, where possible. ADB Management should keep emerging experience with grants under review and plan to report on this at the ADF IX mid-term review, to inform future judgments and decisions on grants during the remainder of ADF IX and beyond.

29. Sixth, it will be important to monitor and assess the financial impact of grants, and to plan ADF's continuing capacity to finance priority development needs in the poorest countries.

[5] Currently, there are no ADF borrowers receiving debt relief under the HIPC Initiative.

VI. LEGAL IMPLICATIONS OF GRANTS IN ADF IX

30. Grant financing of projects was not originally foreseen as one of the methods of operations of the ADF. If a decision were taken by Donors to finance projects on a grant basis, 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.

31. If the decision is taken to allocate on a pro rata basis a certain percentage of 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.

VII. THE FINANCIAL IMPLICATIONS OF GRANTS IN ADF IX

32. For the purpose of financial management, ADB distinguishes two types of grants: technical assistance (TA) grants and non-TA grants.

Technical Assistance Grants

33. Resources to fund TA grants will be transferred from Donor contributions to ADF IX to the Technical Assistance Special Fund (TASF) to complement existing resources. In the past, TASF had two regularized replenishments, in conjunction with ADF V and ADF VI. The absence of TASF allocations from donor contributions to ADF VII and VIII has put significant resource constraints on TA activities.

34. Donors recognize the importance of financing priority technical assistance in poor DMCs, and would generally support allocating part of ADF IX resources to TASF. In this regard, ADB will prepare periodic reports for Donors on the management and effectiveness of TA.

Non-Technical Assistance Grants

35. There are financial costs to ADF associated with the introduction of non-TA grants. These costs are:

(i) the amount of resources (i.e., principal repayments, interest charges, and commitment charges) that ADF will forego;

(ii) some loss in investment income associated with the aforementioned costs; and,

(iii) administrative costs that cannot be recovered and should be borne by the remaining ADF resources.

The majority of Donors stressed that the impact of these costs should be explicitly treated in the ADF financial framework and that these costs may need to be compensated in order to maintain ADF financial integrity.

36. The costs have been simulated under three different levels of grants: 15%, 20% and 25% during the ADF IX period (2005–2008). Table 3 gives the costs for the period 2005–2040. These costs are expressed in nominal terms, as a simple summation of relevant lost reflows

and revenues, and in net present value (NPV) terms at the beginning of the ADF IX period at a discount rate of 5%. This discount rate represented the average investment return in 2002 and has been used by IDA during the IDA 13 discussions. Using a lower investment return or discount rate would increase the calculated NPV.

Table 3: Cost of ADF IX Grants
(in $ million)

	Level of Grants		
	15%	**20%**	**25%**
NPV Terms	499	665	831
Nominal Terms	1,261	1,682	2,102

Discount rate: 5%
Note: The percentage of grants does not include the technical assistance grants of 7% of the total donor contributions

37. Management proposes, for Donors consideration, four options for financing non-TA grants. The calculated cash flow of each option would be equal to the value of the lost cash flows in the future.

(i) **Option 1:** A full payment in cash of NPV amount (Table 3) at the beginning of the ADF IX period. The NPV amount received in 2005, assuming a return of 5%, equal to the discount rate used, will have the same future value as the lost cash flows relating to grants. If the realized investment return is below 5%, the future value of the NPV would be lower than the lost cash flows.

(ii) **Option 2:** The second option would be to schedule the payment over 10 years using the schedule for the encashment of ADF promissory notes which will be deposited in four installments in the ADF IX period. Under Option 2, funds received from encashments can be managed in two different ways.

<u>Option 2-a</u>: Resources will be allocated to ADF liquidity pool and invested (Table 4). Under this sub-option, it is assumed that the amounts received from 2005 to 2014 will earn the same return as the discount rate of 5%; the total financing amount of $878 million with 20% grants discounted for example at 5% will yield the same NPV as in Option 1, or $665 million.

Table 4: Additional Financing for Grants under Option 2-a (in % and $ million)

Year	Grants at 15% Commitment	Promissory Notes	Encashment Amount	Grants at 20% Commitment	Promissory Notes	Encashment Amount	Grants at 25% Commitment	Promissory Notes	Encashment Amount	Annual Encashment Rate[a]
2005	659	164.75	14	878	219.5	18	1,097	274.25	23	2.1%
2006		164.75	29		219.5	39		274.25	48	4.4%
2007		164.75	57		219.5	76		274.25	95	8.7%
2008		164.75	87		219.5	116		274.25	145	13.2%
2009			103			137			171	15.6%
2010			112			149			186	17.0%
2011			106			141			177	16.1%
2012			78			104			129	11.8%
2013			49			65			81	7.4%
2014			24			32			41	3.7%
Total		**659.00**	**659**	**878**	**878**	**878**	**1,097**	**1,097.00**	**1,097**	**100%**

[a] Encashment rates correspond to the proposed encashment schedule for the ADF portion (i.e., excluding the TASF portion) in the ADF IX Replenishment Framework and Burden Sharing.

Option 2-b: Resources will be used to increase ADF lending from 2005–2008, to respond to expand ADF assistance in the context of CSPs/CSPUs for the ADF IX period. This option responds to some Donors' preference not to use the proceeds from additional donor contributions for portfolio investments. Proceeds from encashments will be used to fund disbursements. Repayment and interest charges of these loans will become cash inflows matching cash flows lost from grants. The total financing amounts under this option are higher than those under Option 2-a because the assumed rate of return from lending of 1% during the grace period and 1.5% thereafter (current loan terms) is lower than the 5% return on investments used in Option 2-a. The schedule of commitments, promissory notes, and encashments under Option 2-b is shown in Table 5.

Table 5: Additional Financing for Grants under Option 2-b
(in % and $ million)

Year	Grants at 15%			Grants at 20%			Grants at 25%			Annual
	Commitment	Promissory Notes	Encashment Amount	Commitment	Promissory Notes	Encashment Amount	Commitment	Promissory Notes	Encashment Amount	Encashment Rate[a]
2005	1,050	262.50	22	1,400	350.00	29	1,750	437.50	37	2.1%
2006		262.50	46		350.00	62		437.50	77	4.4%
2007		262.50	91		350.00	122		437.50	152	8.7%
2008		262.50	139		350.00	185		437.50	231	13.2%
2009			164			218			273	15.6%
2010			179			238			298	17.0%
2011			169			225			282	16.1%
2012			124			165			207	11.8%
2013			78			104			130	7.4%
2014			39			52			65	3.7%
Total		**1,050.00**	**1,050**	**1,400**	**1,400**	**1,400**	**1,750**	**1,750.00**	**1,750**	**100%**

[a] Encashment rates correspond to the proposed encashment schedule for the ADF portion (i.e., excluding the TASF portion) in the ADF IX Replenishment Framework and Burden Sharing.

(iii) **Option 3:** This option would consist of spreading the deposits of promissory notes over two ADF replenishment periods (ADF IX and ADF X) in eight equal amounts (2005–2012). This option stems from developments in the IDA discussions, where some Deputies expressed concerns over the magnitude of incremental commitments required in IDA14, particularly in view of existing budgetary constraints. Proceeds from encashments can be managed in much the same way as in Option 2, i.e., investing or lending. Table 6 shows schedules of commitment, promissory notes, and encashments when funds are used for investing.

Table 6: Additional Financing for Grants under Option 3
(in % and $ million)

Year	ADF Period	Grants at 15% Commitment	Grants at 15% Promissory Notes	Grants at 15% Encashment Amount	Grants at 20% Commitment	Grants at 20% Promissory Notes	Grants at 20% Encashment Amount	Grants at 25% Commitment	Grants at 25% Promissory Notes	Grants at 25% Encashment Amount	Annual Encashment Rate[a]
2005	ADF IX	329.50	82.375	14	439.00	109.750	18	549	137.13	23	2.1%
2006			82.375	29		109.750	39		137.13	48	4.4%
2007			82.375	57		109.750	76		137.13	95	8.7%
2008			82.375	87		109.750	116		137.13	145	13.2%
2009	ADF X	329.50	82.375	103	439.00	109.750	137	549	137.13	171	15.6%
2010			82.375	112		109.750	149		137.13	186	17.0%
2011			82.375	106		109.750	141		137.13	177	16.1%
2012			82.375	78		109.750	104		137.13	129	11.8%
2013				49			65			81	7.4%
2014				24			32			41	3.7%
Total		**659.00**	**659.000**	**659**	**878.00**	**878.000**	**878**	**1,097**	**1,097.00**	**1,097**	**100%**

If funds are used for lending, additional lending during the ADF X period will generate reflows and revenue that are 4 years later than cash flows lost from ADF IX grants. Additional arrangements will be needed, i.e. altering the terms of these additional loans and the amount of financing, to ensure that inflows from these loans will match with the lost reflows. (Additional information on the encashment schedule and the total amount needed for financing will be provided upon request.)

(iv) **Option 4:** Pay-as-you-go (PAYG) is a scheme whereby Donors finance grants at the time (i.e., during the replenishment period) the financial impact on ADF is realized. The financing needed under each replenishment period is set out in Table 7.

Table 7: Additional Financing for Grants under Option 4
(in $ million)

ADF Replenishment Period		Grants 15%	20%	25%
ADF IX	2005-2008	5	7	9
ADFX	2009-2012	25	33	41
ADF XI	2013-2016	169	225	282
ADF XII	2017-2020	241	321	402
ADF XIII	2021-2024	230	306	383
ADF XIV	2025-2028	218	291	363
ADF XV	2029-2032	175	233	291
ADF XVI	2033-2036	146	195	244
ADF XVII	2037-2040	53	71	88
Total		**1,261**	**1,682**	**2,102**

VIII. CONCLUSIONS AND REQUEST FOR DONOR GUIDANCE

38. **Summary: Context and Dimensions of Introducing Grants in ADF IX.** This report has presented and discussed introducing grants in ADF IX on various considerations—development, legal, management, and financial. The report sets out criteria and an associated framework for allocating grants during the ADF IX replenishment period (2005–2008). The framework was applied against planned operations in ADF countries and priority needs for technical assistance, resulting in projections for the share of grants. The report sets out the requirements of good practice to monitor and report on ADF grants. The legal implications were identified. And finally, options for financing grants were presented.

39. Considering all of the preceding, **guidance is sought from ADF Donors on the following issues:**

Grants to Enhance ADF Concessionality and Development Effectiveness:

1. Do Donors agree that the establishment of grants will be the central means to enhance concessionality in ADF IX?

2. Do Donors concur that the role of grants in ADF should be to support country-led development, confront major new development challenges in the Region, and increase net resources available to poor countries?

Allocating Grants:

3. Do Donors agree with the structure of the grant allocation framework that are focused on: poor countries including those in post-conflict circumstances, combating HIV/AIDS and infectious diseases, addressing large regional externalities, and technical assistance to that supports country-led development processes?

4. Do Donors endorse the indicative, projected shares for grants in ADF IX that are derived from operational planning in ADF countries, on the understanding that the realized amounts and shares may change during the replenishment period?

Managing the Grants Program:

5. Do Donors endorse the main elements of a management practice for grants, namely: that they be allocated on the same operational standard—i.e., performance—as other ADF credits; should complement but not substitute for any operations under the HIPC initiative in the Region; should be planned in close coordination and cooperation with other development partners; be allocated on a regional basis, including to regional institutions where there is an adequate fiduciary framework in place; keep emerging issues with grants under review and report on this at the ADF IX midterm review; and assess financial impacts of grants and plan for supporting ADF's capacity to meet future priority needs in poor countries?

Financing Grants:

6. What is the preferred approach among Donors to deal with the financial impact of grants in ADF?