ASIAN DEVELOPMENT FUND (ADF)

ADF IX MIDTERM REVIEW MEETING

4–5 December 2006 Frankfurt, Germany

Report on ADF IX Grant Framework and Proposal for Alignment with IDA14 Grant Framework

Asian Development Bank

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ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CPA	–	country performance assessment
DMC	–	developing member country
DSA	–	debt sustainability assessment
DSF	–	debt sustainability framework
FY	–	fiscal year
IDA	–	International Development Association
IMF	–	International Monetary Fund
MDB		multilateral development bank
MDRI	–	Multilateral Debt Relief Initiative
NPV	–	net present value
OCR	–	ordinary capital resources
PBA	–	performance-based allocation

CONTENTS

EXECUTIVE SUMMARY

Grants were introduced for the first time during the Asian Development Fund (ADF) IX. The grants program in ADF IX amounts to $1.26 billion. Grant approvals amounted to $246.6 million in 2005 and are currently estimated at $277.6 million in 2006, less than the average available annual grant volume of $315 million. This is because of start-up delays in programming and processing grant-financed projects and lower than expected performance-based allocations (PBAs) to grant-eligible DMCs. Also, project processing was held up in Nepal, a major grant recipient, because of political circumstances. However, the pace of grant utilization is picking up and it is expected to improve further.

Afghanistan is likely to get the largest share of total grants (50%), followed by Nepal (18%) and Cambodia (10%). In terms of sectors, the largest number of grant projects has been allocated to agriculture and natural resources and health, nutrition and social protection (25% each). Grant projects will mostly provide improved social service delivery, especially health services, as well as better livelihood opportunities, and infrastructure to support these outcomes. These have helped strengthen the impact of Asian Development Bank's (ADB) assistance on Millennium Development Goal (MDG) related outcomes.

The ADF IX grant framework was aligned to the International Development Association (IDA) 13 framework. IDA14 marked a major change in the framework, linking grant eligibility exclusively to a developing member countries' (DMCs) debt distress status. It is proposed that the ADF IX framework be aligned to IDA14 starting 2007.

Under the present ADF IX grant framework, grant shares are predetermined for each country and capped at 50%. In the aligned framework, grant eligibility will follow the same traffic light classification system used by IDA14, i.e., (i) green light: low risk of debt distress—no grants; (ii) yellow light: medium risk of debt distress—50% grants; and (iii) red light: high risk of debt distress—100% grants. Grant eligibility will be limited to ADF-eligible countries that are not receiving any Ordinary Capital Resources (OCR) assistance, with eligibility for Sri Lanka grandfathered until the end of the ADF IX period. The alignment includes introduction of 20% volume discount for grants. Resources from the 9% incentives-related component of the volume discount will be redistributed to all ADF DMCs not receiving any OCR loans, and resources from the 11% charges-related volume discount will be made available for ADF DMCs also receiving OCR. These allocations will be additional to the initial PBAs of the relevant DMCs. Finally, set aside for HIV/AIDS and other communicable diseases will not be extended.

The overall grants share in ADF IX is likely to go up under the aligned framework, with a corresponding increase in foregone reflows of interest and principal. The foregone interest of grants made in ADF IX is financed by donor contributions to ADF IX. The incremental foregone interest resulting from the alignment is preliminarily estimated at about $15 million in nominal terms and $7 million in NPV terms. Donor contributions for this can be discussed during the next replenishment. The share of grants in total ADB assistance and the foregone reflows could increase significantly from ADF X onwards. Additional donor contribution for these is important for the financial integrity of ADF.

Donors are requested to express their views on the above proposals.

I. INTRODUCTION

1. Asian Development Fund (ADF) grants were introduced for the first time during ADF IX replenishment.[1] Donors agreed that the Asian Development Bank's (ADB) grant framework should draw on the experiences of the International Development Association (IDA) and the African Development Fund and should be suited to development conditions in Asia and the Pacific and to ADB's institutional strengths and experience. Furthermore, donors agreed that ADB should continue to collaborate closely with the World Bank and the International Monetary Fund (IMF) on the debt sustainability framework (DSF). Donors recommended that the grant allocation framework and its application be reviewed during the midterm review of ADF IX and adjusted as appropriate. This report reviews the framework and compares it with the new framework established by the World Bank under IDA14. Based on consultations with donors in an informal meeting in May 2006 in Hyderabad, India, this report proposes aligning ADF's framework with that of IDA14, examines implications, and suggests a modality for such an alignment. The proposal also takes into account the feedback received from developing member countries (DMCs).

II. ASIAN DEVELOPMENT FUND IX GRANT FRAMEWORK AND ITS APPLICATION: REVIEW OF EXPERIENCE

A. The Current Grant Framework

2. The ADF grant program was established to meet the following objectives: (i) to reduce the debt burden of the poorest countries; (ii) to assist poor countries accelerate their transitions from post-conflict situations to peace and stability; (iii) to combat HIV/AIDS and other communicable diseases; and (iv) to offer priority technical assistance. The ADF IX grant framework was largely patterned after the IDA13 framework. As recommended by donors, the program comprises about 18% of total ADF IX operations amounting to United States dollars ($) 1.26 billion, excluding an allocation of approximately 3% to replenish the Technical Assistance Special Fund.

3. Grants in ADF IX are subject to the same operational standards of due diligence and fiduciary scrutiny as ADF loans and account for a portion of the grant-eligible DMC's ADF allocations. The use of grants is not restricted to any particular sectors or subsectors. Appendix 1 presents the ADF IX grant allocation framework: (i) priority technical assistance is 3% of total ADF IX financing; (ii) poor, debt-stressed/post-conflict countries receive 16%; and (iii) HIV/AIDS and other infectious diseases are allotted 2%.

B. Experience to Date on Grant Utilization

1. Overall Asian Development Fund Grant Approvals

4. Overall ADF grant approvals for 2005, the first year of ADF IX, amounted to $246.6 million. In 2006, grant approvals are currently estimated at $277.6 million, which is less than the average available annual grant volume of $315 million over the ADF IX period of 2005–2008. This is because of start-up delays in programming and processing grant-financed projects and lower than expected performance-based allocations (PBAs) to grant-eligible DMCs. Also,

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[1] ADB. 2004. *Eighth Replenishment of the ADF and Third Replenishment of the TASF. ADF IX Donors Report: Development Effectiveness for Poverty Reduction*, Manila, (R111-04, 22 July).

project processing was held up in Nepal, a major grant recipient, because of political circumstances. However, the pace of grant utilization is picking up and it is expected to improve further.

2. Country and Sector Shares of Asian Development Fund Grant Allocations

5. Estimated country shares of grant approvals over the first 2 years of ADF IX, (2005–2006) excluding funds for HIV/AIDS and other communicable diseases are provided in Table 1. In terms of country distribution, Afghanistan is potentially the largest recipient at 50% followed by Nepal (18%) and Cambodia (10%). Sector shares of grant projects approved in 2005 and 2006 are shown in Tables 2a and 2b. By amount, Transport and Communications are receiving the largest share of grants at 30.7%, followed by Health Nutrition, and Social Protection at 22.6%; and Agriculture and Natural Resources at 13.6%. By project numbers, Agriculture and Natural Resources, and Health, Nutrition, and Social Protection each received 25%; followed by Transport and Communications at 19%.

Table 1. Country Shares of Asian Development Fund Grant Allocation 2005–2006(E)
(US $ million)

	Grant Allocation 2005-2006	%	Grant Approvals (2005)	%	Grant Approvals (2006E)	%	Total Grant Approvals 2005-2006E	%
	(a)		(b)		(c)		(d = b+c)	
Aghansitan (50%)	200.0	43.4	100.0	54.8	100.0	46.0	200.0	50.0
Cambodia (50%)	52.9	11.5	33.0	18.1	7.8	3.6	40.8	10.2
Kyrgyz Republic (50%)	30.9	6.7	15.5	8.5	5.0	2.3	20.5	5.1
Lao PDR (50%)	26.3	5.7	10.0	5.5	16.4	7.5	26.4	6.6
Nepal (50%)	92.0	20.0	0.0	0.0	73.2	33.6	73.2	18.3
Solomon Islands (30%)	0.4	0.1	0.0	0.0	0.4	0.2	0.4	0.1
Sri Lanka (15%)	29.4	6.4	14.0	7.7	0.0	0.0	14.0	3.5
Tajikistan (40%)	14.8	3.2	0.0	0.0	14.9	6.8	14.9	3.7
Timor Leste (40%)	13.7	3.0	10.0	5.5	0.0	0.0	10.0	2.5
Total	**460.3**	**100.0**	**182.5**	**100.0**	**217.6**	**100.0**	**400.1**	**100.0**

Notes: E indicates estimate; Percentages in parentesis indicate mandated grant shares of each DMC.

Source: Project Processing Iinformation System, 15 October 2006; 2006 approvals include low and medium risk projects only.

Lao PDR=The Lao People's Democratic Republic

6. ADF resources set aside for projects in HIV/AIDS and other communicable diseases are nearing full utilization. To date, $124.14 million have been approved ($64.14 million in 2005 and $60 million in 2006). Viet Nam, Papua New Guinea, and Bangladesh account for the bulk of HIV grant approvals. Several regional projects have also been funded under this allocation (see Table 3). Most projects address HIV/AIDS-related issues, while one relatively large regional project ($25 million) is on avian flu.

Table 2a: Sectoral Distribution of Grant Approvals, 2005-2006
(By Amount, US$ Million)

Sector	2005	%	2006E	%	Total	%
	(a)		(b)		(c=a+b)	
Agriculture & Natural Resources	29.5	12.0	41.6	15.0	71.1	13.6
Education	15.5	6.3	12.7	4.6	28.2	5.4
Energy	23.5	9.5	0.0	0.0	23.5	4.5
Finance	0.0	0.0	60.0	21.6	60.0	11.4
Health, Nutrition, & Social Protection	58.6	23.8	60.0	21.6	118.6	22.6
Industry & Trade	0.0	0.0	0.0	0.0	0.0	0.0
Law, Economic Management & Public Policy	7.0	2.8	7.8	2.8	14.8	2.8
Multisector	19.0	7.7	0.0	0.0	19.0	3.6
Transport & Communications	65.5	26.6	95.6	34.4	161.1	30.7
Water Supply, Sanitation & Waste Management	28.0	11.4	0.0	0.0	28.0	5.3
Total	**246.6**	**100.0**	**277.6**	**100.0**	**524.2**	**100.0**

Note: E indicates estimate

Source: Project Processing Information System, 15 October 2006; 2006 estimates include low and medium risk projects only.

Table 2b: Sector Shares of Grant Projects
(By Number of Projects)

Sector	2005	%	2006E	%	Total	%
	(a)		(b)		(c=a+b)	
Agriculture & Natural Resources	2	11.8	6	40.0	8.0	25.0
Education	1	5.9	1	6.7	2.0	6.3
Energy	1	5.9	0	0.0	1.0	3.1
Finance	0	0.0	1	6.7	1.0	3.1
Health, Nutrition, & Social Protection	5	29.4	3	20.0	8.0	25.0
Industry & Trade	0	0.0	0	0.0	0.0	0.0
Law, Economic Management & Public Policy	1	5.9	1	6.7	2.0	6.3
Multisector	2	11.8	0	0.0	2.0	6.3
Transport & Communications	3	17.6	3	20.0	6.0	18.8
Water Supply, Sanitation & Waste Management	2	11.8	0	0.0	2.0	6.3
Total	**17**	**100.0**	**15**	**100.0**	**32.0**	**100.0**

Note: E indicates estimate

Source: Project Processing Information System, 15 Oct 2006; 2006 estimates include low and medium risk projects only.

Table 3: Asian Development Fund HIV/AIDS and Other Communicable Diseases: Grant Allocations and Approvals 2005–2006 (E)
(United States $ million)

	Grant Approvals			
	2005	2006E	Total 2005-2006E	
	(a)	(b)	(c = a+b)	(d)
Total Grant Allocation (E)				**130.0**
Papua New Guinea	0.0	15.0	15.0	
Viet Nam	10.6	20.0	30.6	
Bangladesh	10.0	0.0	10.0	
Pakistan	5.0	0.0	5.0	
GMS reg	30.0	0.0	30.0	
PDMCs reg	8.0	0.0	8.0	
ECRD reg	0.5	0.0	0.5	
ADB reg	0.0	25.0	25.0	
Total Grant Approvals	**64.1**	**60.0**	**124.1**	**124.1**
Grant Allocation Balance				**5.9**

GMS=Greater Mekong Subregion; PDMC reg=Pacific developing member countries regional;
ECRD= East and Central Asia Regional Department; ADB reg=Asian Development Bank regional
Note: E indicates estimate
Source: Project Processing Information system, 15 October 2006; 2006 estimates
Include low and medium risk projects only

7. *Stand-alone versus blended projects*: In 2005, $161.5 million, 65% of the total, was used to fund stand-alone projects and $85.14 million (35%) was used for projects blending grant funds with loans (see Table 4). It is estimated that the share of stand-alone grants will be about 77% in 2006.

Table 4: Total Grants 2005–2006
(United States $ million)

	2005		2006E		Total	
	$ Million	%	$ Million	%	$ Million	%
Stand alone grant	161.5	65.5	214.0	77.1	375.5	71.6
Blended with loan	85.1	34.5	63.6	22.9	148.7	28.4
Total	**246.6**	**100.0**	**277.6**	**100.0**	**524.2**	**100.0**

Note: E indicates estimate
Source: Project Processing Information System, 15 October 2006; 2006 estimates include low and medium risk projects only.

8. *Developmental impact*: Since the ADF IX grant framework was introduced only in 2005, most of the projects it funds are in the very early stages of implementation, but examples demonstrating good practices are described in boxes 1 to 3. Most of these grant financed projects will improve the delivery of social services especially in health and in education. Communicable diseases like HIV/AIDS are a major priority. In addition, some are infrastructure projects that will provide potable water and sanitation and improve rural roads to enhance access to social services and livelihood opportunities for poor rural communities. These projects

will clearly strengthen the impact of ADB assistance for achieving the Millennium Development Goals.

Box 1: Bangladesh: Second Urban Primary Health Care Project 2005
Supporting the HIV/AIDS, Sexually Transmitted Infection, and Reproductive Tract Infection Components through Asian Development Fund Grant Financing

The Bangladesh Urban Primary Health Care Project (UPHCP) is pioneering in many ways. It is one of the rare large-scale projects that targets primary health care services in urban areas of developing member countries. UPHCP supports contracting services to nongovernment organizations (NGOs)—government financed but provided by the private sector—in geographically defined partnership areas covering from 200,000 to 300,000 people. After the successful completion of UPHCP-I in early 2005, the Asian Development Bank (ADB) approved UPHCP-II in May 2005. UPHCP-II has cofinancing support from the Department for International Development of the United Kingdom, the Swedish International Development Agency, the United Nations Fund for Population Activities, and Orbis, an overwhelming endorsement of the model. UPHCP-II design builds on the strong and tested features of UPHCP-I and further focuses on targeting the poor (at least 30% of all the services have to be accessed by poor households), HIV/AIDS, sexually transmitted infections (STIs), and reproductive track infections (RTIs). The Asian Development Fund IX HIV/AIDS and Other Communicable Diseases Grant made it possible for ADB to build sufficient incentives in UPHCP-II to undertake an effective HIV/AIDS preventive program. UPHCP-II has had a quick start. Within 1 year of implementation, contracts worth more than United States dollar ($)30 million have been finalized with NGOs for the delivery beginning 1 July 2006 of out-reach services to the poor and to high-risk groups to build awareness of high-risk sexual behavior, to treat STIs and RTIs, and to counsel high-risk cases and test for HIV/AIDS.

Box 2: Cambodia: Tonle Sap Sustainable Livelihoods Project

A United States dollar ($)15 million Asian Development Bank (ADB) grant will help improve livelihoods and reduce poverty in the five provinces that adjoin the Tonle Sap in Cambodia. ADB's grant covers 74% of the project's total estimated cost of $20.3 million. The Government of Finland will provide a $4.7 million grant, and the Government of Cambodia will shoulder the balance of $600,000.

Despite the richness of its natural resources, the Tonle Sap, the largest freshwater lake in Southeast Asia, provides an inadequate livelihood for most people living on or near it. Many communities own no land and depend entirely on fishing and foraging. Poverty indicators in Tonle Sap are even more negative than for the country as a whole. High population growth in Cambodia is increasing the number of people who depend on the natural resources of the Tonle Sap. Pressing threats to the great lake include overexploitation of fisheries and wildlife resources, conversion of the flooded forest to agriculture, collection of fuel wood from the flooded forest, and widespread deforestation in the watersheds.

The project is part of ADB's Tonle Sap Initiative, a partnership of organizations and people working to meet the lake’s poverty and environment challenges. This involves a combination of highly integrated loan, grant, and technical assistance components to promote pro-poor and sustainable economic growth, access to assets, and management of natural resources and the environment. The project will help increase access to assets by establishing a livelihood fund to finance small-scale community-driven activities relating to social infrastructure, income-generation, and community fisheries. At the same time, the project will ensure that the Tonle Sap's core areas are protected by establishing a management system that is compatible with biodiversity conservation.

Box 3: Kyrgyz Republic: Second Education Project

Economic transition has had major implications for the quality of education in the Kyrgyz Republic. Despite high educational attainment and near universal literacy during the Soviet period, the education system needed considerable investment to improve quality, access, and participation and to help the country sustain the Millennium Development Goals (MDGs) for education. To help the government to sustain the education sector and to support reforms, the Asian Development Bank (ADB) has been providing significant assistance to support government reforms in the education sector.

An Asian Development Fund grant of United States dollar ($)15.5 million, which was approved in October 2005 to finance the Second Education Project (SEP), supports the government's commitment to improving both the quality and effectiveness of education which is a key element of its economic strategy. The SEP will help to deliver education to children in the poorest areas and to those from disadvantaged families. The project (i) supports the government's efforts to modernize the curriculum with a student-centered approach linked with developing an improved learning assessment system and a new generation of textbooks and learning materials; (ii) strengthens in-service teacher training and incentives for teachers in rural areas; and (iii) rehabilitates facilities and provides educational equipment for 90 priority schools in rural areas to improve the learning environment.

The project supports education in both rural and urban areas to sustain achievements on the education MDGs. Special features are its pro-poor design, its support for decentralizing teacher training, and its participatory approach and community involvement. The project is being implemented in close coordination and consultation with other donors in the sector.

III. INTERNATIONAL DEVELOPMENT ASSOCIATION 14 GRANT FRAMEWORK

A. International Development Association 14 Grant Allocation Framework

9. The IDA14 framework marked a major departure from IDA13 as IDA14 is entirely based on DSF introduced in 2005 (see Appendix 2 for a brief description). In this framework, countries are classified at high (red), medium (yellow), or low (green) risk of debt distress. A country is classified according to its "solvency" and "liquidity" indicators and its policy performance-linked debt thresholds. Countries deemed to be at high risk of debt distress qualify for 100% of their PBA as grants.[2] Those at medium risk qualify for 50%, and low-risk countries receive all IDA14 allocations on standard IDA terms. The African Development Fund has adopted a similar grant framework.

10. The policy performance-dependent debt and debt-service thresholds currently used by IDA are presented in Table 5. During fiscal year (FY) 2006, [3] a country's debt distress risk rating or "traffic light" classification was determined on the basis of a static comparison of the latest available external debt indicators and the debt thresholds from the World Bank-IMF DSF. While traffic light-status have been determined using the same method for most countries in FY2007, debt distress ratings derived on the basis of forward-looking debt sustainability assessments (DSAs) under Pillar 2 of the DSF have been used when available.

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[2] This is subject to a discount factor explained further in paragraph 11.
[3] FY2006 runs from 1 June 2005 to 30 July 2006 for the World Bank.

Table 5: International Development Association's Policy Performance-Dependent Debt and Debt-Service Thresholds

Performance Category	Debt and Debt-Service Thresholds (%)		
	NPV of debt / gross domestic product	NPV of debt / exports	Debt service /exports
Weak (CPIA ≤ 3.25)	30	100	15
Medium (3.25<CPIA<3.75)	40	150	20
Strong (CPIA ≥ 3.75)	50	200	25

Source: World Bank. IDA's guidelines on implementing the IDA14 Resource Allocation Framework in FY06.
Note: NPV = net present value; CPIA refers to Country Performance and Institutional Assessment

11. Countries that are at high risk of debt distress are likely to be relatively poor performers. Hence, application of the DSF without any adjustment would amount to rewarding poor performance since a shift from loans to grants would imply an increase in the net present value (NPV) of IDA allocations. This would be at odds with IDA's PBA principle. Consequently, to maintain the link between performance and the NPV of IDA country allocations, the World Bank applies a "volume discount" to IDA14 allocations. Under this "modified volume approach", for countries eligible for 100% grant the PBAs are discounted by 20%. For countries that receive 50% of IDA allocations in grant the PBAs are discounted by 10%. Countries that do not receive grants receive their full PBA.

12. The resources released by the volume discounts are used in two ways: (i) an "incentives-related" discount, which aims to preserve the integrity of the incentive system embedded in the PBA (equivalent to an 11% volume discount); and (ii) a "charges-related" volume discount, which represents the net present value of the foregone charge income on grants (equivalent to a 9% volume discount). The 11% discount is re-allocated on a PBA basis to IDA-only borrowers on the terms determined by the traffic light system, other than for IDA-only gap countries[4] and those that are eligible for exceptional post-conflict IDA allocations. The remaining 9% volume discount is allocated to IDA/International Bank for Reconstruction and Development blend countries with per-capita income below the IDA operational cutoff ($1,025 in fiscal year 2007) on hardened IDA terms, generating additional income for IDA. It is estimated that altogether about 2% of IDA14 resources will be channeled through this IDA "hard window."[5] These hard-term country allocations are additional to regular PBAs and are determined in proportion to a country's PBA. As grants depend both on country policy performance and on the actual evolution of debt stocks and debt service, the grant share ceiling in IDA14 is determined by internal factors and is not fixed as a policy parameter as is the case with the ADF IX grant framework. After application of the volume discounts, the level of grants in IDA14 was expected to be around 30% as compared to a grant share of 20% for IDA13.[6]

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[4] IDA gap countries are IDA-eligible countries in which per capita incomes are above the IDA eligibility ceiling for more than two consecutive years.

[5] India and Pakistan have access to "hard IDA" in FY 2007.

[6] In FY 2007 the share of grants is now estimated to be around 24%. See *Assessing Implementation of IDA14 Grants Framework*, October 2006, IDA.

B. A Comparison of the Asian Development Fund IX and International Development Association 14 Grant Frameworks

13. Table 6 compares current grant shares of eligible countries under these two systems. IDA14 grant shares are generated by the DSF while ADF shares are mandated by the ADF IX Donors' Report.

Table 6: Grant Shares in Asian Development Fund IX and International Development Association 14
(%)

Eligible Countries	Asian Development Fund IX	International Development Association 14 (FY06)	International Development Association 14 (FY07)
Afghanistan	50	100	100
Bhutan	0	100	100
Cambodia	50	100	100
Kyrgyz Republic	50	100	100
Lao People's Democratic Republic	50	100	100
Mongolia	0	100	50
Nepal	50	50	100
Samoa	0	0	50
Solomon Islands	30	100	100
Sri Lanka *	15	50	0
Tajikistan	40	100	50
Timor-Leste	40	2006-100	2007-60 2008-30
Tonga *	0	100	100

* ADF blend countries.
Note: The following ADF borrowing countries are not currently eligible for IDA nor ADF grants except when projects involve HIV/AIDS and communicable diseases, which receive 100% grant financing under ADF IX: Azerbaijan, Bangladesh, Cook Islands, Federated States of Micronesia, Indonesia, Kiribati, Maldives, Marshall Islands, Pakistan, Papua New Guinea, Tuvalu, Uzbekistan, Vanuatu, and Viet Nam.

14. For most of ADB's DMCs, the share of grants under ADF IX is lower than that under IDA14. From the debt sustainability perspective of the DMCs concerned, this is not an optimal situation. Besides the share of grants, there are also differences in terms of country classification for ADF and IDA eligibility, which cannot be eliminated by aligning the grant frameworks alone. Nevertheless, aligning them will respond to some key DMC concerns and reinforce the overall move toward harmonization among the multilateral development banks (MDBs). The rest of this report examines issues that need to be addressed in the context of such an alignment (Section IV), and presents an alignment proposal for endorsement by ADF donors (Section V).

IV. SELECTED ALIGNMENT ISSUES

15. *Review of the framework during IDA mid-term review:* IDA will review and report on its experience implementing the new framework at the IDA14 mid-term review in late November 2006. This will be based in turn on a recently completed review of the World Bank/IMF DSF. It

will also take into account the implications of the Multilateral Debt Relief Initiative (MDRI) because IDA deputies have indicated that they would like to prevent the re-accumulation of unsustainable debt by the countries benefiting from MDRI. Steps for extending the framework to accommodate a country's projected debt dynamics and measures to mitigate shocks are also likely to be considered. Thus, the framework that ADF IX aims to align with may further evolve as a result of discussions with IDA deputies. This has required very close coordination between ADB and IDA, and further fine tuning may be necessary following the IDA14 mid-term review.

16. *Operational implications:* Under the IDA14 framework, the volume discount reduces nominal country allocations but provides an increased grant share. Hence, following alignment of the ADF IX framework with that of IDA14, PBAs for 2007–2008 will have to be reviewed and revised, and allocations to some DMCs may be reduced due to the application of the volume discount. These changes are likely to have some programming effects on the size and composition of projects. However, by using the front loading option allowed by the PBA policy and resources released through loan savings and cancellations, these effects could be absorbed with minimal impact on the 2007 program. Further adjustments and fine tuning may be necessary during 2008.

17. *Differences in country classification:* There are differences in the classification of some DMCs under ADB's graduation policy compared with IDA eligibility. Bangladesh, Sri Lanka,[7] Tonga, and Viet Nam are IDA-only countries for the World Bank, but blend countries for ADB.[8] Under the IDA14 framework, grant eligibility is restricted to IDA-only countries, but there is no such restriction under the current ADF IX framework.[9] The issue then arises whether ADB should extend ADF grant eligibility to its DMCs that also receive some ordinary capital resource (OCR) loans or should it restrict grants to DMCs receiving only ADF assistance. Providing ADF grants to DMCs receiving OCR assistance may be considered inconsistent with the DSF rationale. Hence, it is proposed that access to grants under the harmonized ADF grant framework should be limited to DMCs that receive only ADF assistance. This would include all group A countries as well as some group B1 countries that are eligible for some OCR assistance in principle but are not actually receiving any OCR loans.

18. *Role of ADB and other MDBs in the DSF*: The DSF was developed by the IMF and the World Bank. These institutions also prepare the DSAs. If ADB is to adopt the DSF for ADF grants, the integrity of ADF allocations will require ADB ownership of the DSAs at both the operational and corporate levels. ADB has been discussing this issue with the World Bank. A formal arrangement for involvement of regional development banks in DSA preparation will be discussed at the next MDB technical meeting on PBA methods scheduled for 16–17 January 2007.

19. *Free riders:* Adoption of the current IDA14 grant framework may also potentially impact OCR operations in some ADF/OCR blend DMCs if they continue to be IDA-only countries for the World Bank. To prevent "free riders," i.e. an expansion of "commercial" credits thanks to IDA grants and MDRI, IDA is introducing mechanisms to deter grant-eligible countries from acquiring or expanding their commercial debt.[10] Under these mechanisms, IDA allocations would either

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[7] Sri Lanka is being classified by IDA as a "gap" country for FY2007.

[8] Cook Islands (ADF blend) and Tuvalu (ADF-only) are not IDA members. Federated States of Micronesia and Republic of Marshall Islands do not have access to IDA.

[9] At the moment one blend DMC, Sri Lanka, qualifies for 15% of its allocations as grants. Furthermore all the blend DMCs have access to allocations for HIV/AIDS and other communicable diseases.

[10] For details please see *IDA Countries and Non-Concessional Debt: Dealing with the "Free Rider" Problem in the Context of IDA Grants*, IDA/SecM2006-0053, February 16, 2006; and *IDA Countries and Non-Concessional Debt:*

be reduced or their terms would be hardened. ADB's OCR loans are considered commercial credits under the definitions under consideration by the World Bank.[11] At present, Afghanistan, Bhutan, Cambodia, Kyrgyz Republic, the Lao People's Democratic Republic, Nepal, Solomon Islands, and Tonga are red light countries that are subject to IDA's free-rider policy, and Mongolia, Samoa, and Tajikistan are yellow light countries subject to the policy.[12] At ADB, all of these DMCs except Tonga are currently classified as Group A countries and are generally not eligible for OCR loans. Thus, the immediate impact of the World Bank's free-rider policy for ADB's OCR operations would not be very significant. However, the impact could be significant in the future if DMCs eligible for OCR loans were to come within the purview of IDA's "free rider" policy. It is noted that the World Bank policy emphasizes flexible application of the rules and provides for country and loan-specific exceptions to non-concessional borrowing limits. These provisions would be important in cases where DMCs eligible for full or partial IDA grant assistance also seek OCR assistance from ADB for high-return projects, especially those that will earn revenue in foreign exchange.

20. *Allocations for HIV/AIDS and other communicable diseases:* Under the IDA14 framework, there are no such allocations, and it is estimated that total approvals for 2005 and 2006 will more or less fully exhaust the 2% limit established under ADF IX. Given that ADF donors prefer not to earmark additional funding in this area, any future projects in this category would have to be funded from country allocations.

21. *Financial implications of alignment:* Under the existing ADF IX grant framework, forgone interest has been financed through additional donor contributions computed based on total ADF IX grants of $1.26 billion (18% of $7.0 billion in planned operations).[13] It is currently estimated that if the PBAs are fully utilized, total ADF IX grants, combining existing allocations for 2005 and 2006 with IDA-aligned allocations for 2007 and 2008, are likely to exceed the $1.26 billion ceiling by about $72 million. The associated incremental foregone interest resulting from the increase in grants is preliminarily estimated at about $15 million in nominal terms and $7 million in NPV terms.[14] Donor contributions for this can be discussed during the next replenishment.[15] The forgone principal, as agreed by donors during ADF IX discussions, will be financed in future replenishments. Preliminary estimates of the incremental foregone reflows resulting from the alignment are indicated in Table 7.[16] Starting with ADF X, it is likely that the new framework will

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Dealing with the Free-Rider" Problem in IDA14 Grant-Recipient and Post-MDRI Countries. IDA/R2006-0137, June 23, 2006.

[11] According to the IMF's *Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements – Change in Coverage of Debt Limits,* debt would be defined as concessional, "…on the basis of currency-specific discount rates based on OECD commercial interest reference rates, and including a grant element of at least 35 percent, provided that a higher grant element may be required in exceptional cases." This definition is the basis for performance criteria in Poverty Reduction and Growth Facility (PRGF)-supported programs on minimum concessionality of newly contracted debt.

[12] Another ADB DMC, Myanmar, is not listed as it is an inactive borrower. However, it would be subject to the free rider policy if it resumed active borrowing.

[13] This excludes the allocation of 3% for technical assistance.

[14] This estimate does not include the possible grant funding of the sub-regional projects out of the 5% set aside agreed by the ADF Donors. In the case of IDA, countries eligible for 100% grants receive funds from the regional envelope on grant terms, while other countries – on credit terms for eligible projects.

[15] This estimate is based on the 2005 country performance assessment ratings and the resulting 2007–2008 ADF allocations. These may be further revised on the basis of the final outcome of the 2006 CPA exercise and the updated information on the available ADF Commitment Authority.

[16] These estimates are based on the 2005 country performance assessment results and currently available IMF-World Bank DSF. The estimates are likely to be revised following updated DSAs from IMF-World Bank and finalization of 2006 CPA ratings.

lead to an even larger increase in the share of grants to total ADF funds, thus necessitating additional contribution from donors in order to preserve the financial integrity of ADF.

Table 7: Incremental Reflows Foregone in Asian Development Fund IX (2005–2008) with Alignment
(US$ million)

	Incremental Reflows	
	NPV	**Nominal**
Interest	7	15
Principal	28	72
Total	36	87

Note: Totals may not add up due to rounding.

V. PROPOSED ALIGNMENT OF ASIAN DEVELOPMENT FUND IX GRANT FRAMEWORK

A. Outcome of Consultations with Asian Development Fund Donors on Alignment

22. In May 2006 in Hyderabad, India, informal consultations were held with ADF donors on aligning ADF's framework with that of IDA based on the DSF. Most of the participants supported the principle of aligning ADF with IDA. Some participants noted that factors specific to Asia should be kept in mind and several advised that in developing the alignment proposal it would be important to consult ADF-eligible DMCs.

23. Views on whether to align starting in 2007 or 2008 were mixed. Most participants also suggested that eligibility for the new framework should be limited to countries receiving only ADF assistance. At the same time, some participants noted that in exceptional circumstances, allowing access to grants for other DMCs could be considered. Participants also agreed to grandfather access to grants until the end of ADF IX for Sri Lanka, which could otherwise lose access under the new framework. Participants felt that funds for HIV/AIDS need not be extended since there are other dedicated funding sources to deal with this challenge. Participants also agreed that there is a need for the 20% volume discount on grants adopted by IDA to avoid sending perverse incentive signals.

24. Most participants noted the need to safeguard the financial integrity of ADF. Many participants felt that additional donor contributions to finance the incremental reflows foregone as a result of a possible increase in the ADF grant share should be provided; however, it was noted that the need for such additional contributions would mainly arise beyond the ADF IX period. A number of participants requested more information on the utilization of ADF grants and noted the need for proper monitoring of their effectiveness.

B. Feedback from Developing Member Countries

25. As suggested by the ADF donors in Hyderabad, ADB also consulted the DMCs on aligning ADF's framework with IDA's. Most DMCs supported harmonization with IDA14. A number of respondents underlined the need for close collaboration among ADB, IMF, and the World Bank in the implementation of DSF. Some blend DMCs suggested that they should also be given access to ADF grants. Most DMCs did not express any particular preference regarding starting alignment in 2007 or 2008.

C. Main Features of the Aligned Asian Development Fund Grant Framework

26. It is proposed that the aligned framework commence in 2007. Grant eligibility under the new framework will be limited to DMCs that receive only ADF assistance.[17] Sri Lanka's access to grants should be grandfathered until the end of the ADF IX period. ADF allocations for 2007 and 2008 will be adjusted accordingly using the policy-dependent debt distress classification and the modified volume discount approach.

27. After the proposed alignment, it is estimated that the share of grants for ADF IX will exceed the ceiling of 18% and reach about 19% of total ADF IX resources.[18] Under this proposal, the additional interest ADB would forego would amount to about $15 million in nominal terms, while the additional principal foregone would be about $72 million. In future, the share of grants in overall ADF replenishment will be determined endogenously and will depend on the debt distress classification of DMCs and their allocations under the PBA policy. As already anticipated in the ADF IX Donors' Report, the share of grants in total ADB assistance and the consequent loss of reflows could increase significantly from ADF X onwards thereby necessitating an increase in donor compensation in future replenishments to maintain the financial viability of ADF.

28. The ADF allocation process under the proposed new grant framework will be as follows. In the first stage, ADF resources will continue to be allocated to DMCs on the basis of the current PBA formula. Subsequently, eligibility for grants will be determined on the basis of debt-distress risk, as indicated by comparing a country's latest available external debt indicators with the external debt thresholds from the World Bank-IMF DSF.[19] ADB's country performance assessment (CPA) scores will be used to classify countries. Also, in countries where ADB has conducted its own DSA, and in countries for which IMF-World Bank DSAs are not available, ADB's DSA will be used. The debt distress classification cycle will be synchronized with the PBA allocations cycle.

29. Grant eligibility will follow the same traffic light classification used by IDA at present, i.e., (i) green light: low risk of debt distress—no grants; (ii) yellow light: medium risk of debt distress—50% grants; and (iii) red light: high risk of debt distress—100% grants. Appendix 3 presents an example of a policy-dependent debt distress classification for DMCs receiving only ADF assistance based on these criteria using ADB's 2005 CPA scores and the IMF-World Bank debt-distress risk indicators.[20]

30. In the third stage, a volume discount on grants will be applied. For red light DMCs, initial grant allocations will be subject to a 20% reduction in volume with (i) a 9% incentives-related volume discount applied to the grant allocations of all grant recipients (except for post-conflict countries eligible for exceptional ADF allocations) to help maintain the strength of ADF's grant incentive system and (ii) an 11% charges-related volume discount applied to *all* grant

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[17] These would include group A DMCs as well as some group B1 DMCs that are in principle eligible to receive some OCR assistance but do not in fact are not accessing it.

[18] These estimates were derived after determining a country's eligibility for grants on the basis of the external debt indicators used by IDA for FY2007 in combination with ADB's 2005 CPA ratings. This grant share excludes the 3% set aside for technical assistance.

[19] In countries where World Bank and IMF have completed the forward looking DSA, as determined under Pillar II of the DSF framework, debt distress classification will generally be based on these DSAs.

[20] For Samoa, Mongolia, Nepal, Solomon Islands, and Tajikistan debt distress classification is based on the forward looking DSAs.

allocations to help finance foregone income charges on ADF IX grants. [21] For yellow light countries, the corresponding volume reduction will be 10% with a 4.5% incentive-related discount and a 5.5% charge-related discount.

31. Finally, the resources generated by the volume discount pool will be redistributed to eligible countries (except countries receiving set-aside allocations) as additional allocations above the initial PBA allocations. These resources will be distributed as follows:

(i) Resources from the 9% incentives-related volume discount will be redistributed to all DMCs not receiving OCR (see footnote 17). The terms of such reallocations will be in accordance with a country's risk of debt distress. Amounts allocated to countries will be in accordance with their share in the PBA pool (net of the shares of DMCs receiving OCR).

(ii) Resources from the 11% charges-related volume discount will be made available to DMCs receiving ADF and OCR loans. These will be additional to their regular PBA in ADF IX and will be determined in proportion to the country's share of the total PBA of this group. Countries eligible to receive this component include: Azerbaijan, Bangladesh, Cook Islands, Pakistan, Papua New Guinea, Sri Lanka, Uzbekistan, and Viet Nam.[22]

VI. REQUEST FOR DONOR VIEWS

32. Donors are requested to express their views on the following proposals related to aligning the ADF IX grant framework with that of IDA 14 starting in 2007:

(i) Grant eligibility will be limited to ADF-eligible countries that are not accessing any OCR assistance, with eligibility for Sri Lanka grandfathered until the end of the ADF IX period.

(ii) Introduction of debt distress classification based on (i) ADB's CPA scores; and (ii) DSAs prepared by the IMF-World Bank or ADB's own DSAs where these are available and in the countries where IMF- World Bank DSAs are not available.

(iii) A 20% volume discount on PBAs for countries receiving 100% grant assistance and a 10% volume discount for DMCs eligible for 50% grants will be introduced. In the case of post-conflict countries the corresponding discounts will be 11% and 5.5%. Resources from the 9% incentives-related component of the volume discount will be redistributed to all DMCs not receiving any OCR loans, and resources from the 11% charges-related volume discount will be made available for ADF DMCs also receiving OCR. These allocations will be additional to the initial PBAs of the relevant DMCs.

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[21] The 11% charges-related share of grants was derived using the methodology similar to the one employed by IDA, i.e. by computing the present value of the interest charges. For instance, a $100 ADF credit amount will generate $10.5 interest charges under ADF loan terms or about 11% of the credit's face value.

[22] As noted in paragraph 12, in the case of IDA, the corresponding resource pool from the charge-related volume discount is allocated on terms harder than IDA's to poor but creditworthy countries. For ADB, the volume of this resource pool will be too small to justify the additional transaction costs of creating a new product.

(iv) The allocation set aside for HIV/AIDS and other communicable diseases will not be extended.

(v) The 18% ceiling on grants (exclusive of the 3% grant set aside for technical assistance) will no longer apply. If the share of grants under the revised framework exceeds the currently established 18% ceiling, contribution to finance additional reflows foregone for the grant component in excess of 18% will be negotiated under future ADF replenishments to preserve the financial viability of ADF.

33. If it appears that donors have reached a consensus, a paper will be prepared for consideration by the ADB Board of Directors. Approvals for any further refinements in the revised framework will be sought in this Board paper.

APPENDIX 1:

THE ASIAN DEVELOPMENT FUND IX GRANT ALLOCATION FRAMEWORK

Demand/Use of Grants	% of Total Grants	Qualifying Countries/Uses (per capita GNI in parenthesis)	Grant Share as a % of Total Assistance	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 (TASF). This can include support for ADB sector policies and regional cooperation.	Approximately 14%	Includes all ADF Borrowers	7% of Donor Contributions to ADF IX transferred to TASF	Approximately 3%
B. Poor Debt Stressed / Post-Conflict Countries	Approximately 76%			16.0%
(i) Poorest and Debt Stressed < $360 per capita gross national income (GNI)		Lao People's Democratic Republic ($310) Kyrgyz Republic ($290) Nepal ($230) Cambodia ($280)	Up to 50% [a] Up to 50% [a] Up to 50% [a] Up to 50% [a]	(i) 8.0%
(ii) Poorest Post-Conflict < $360 per capita GNI		Afghanistan ($186) Tajikistan ($180) Timor-Leste ($430) [b]	Up to 50% [a] Up to 40% [a] Up to 40% [a]	(ii) 6.7%
(iii) Post Conflict > $360 per capita GNI		Solomon Islands ($620) Sri Lanka ($840)	Up to 30% [a] Up to 15% [a]	(iii) 1.3%
C. HIV/AIDS and other Infectious Diseases	Approximately 10%	Includes all ADF borrowers	Up to 100% [c]	2%
TOTAL	**100%**			**≈ 21.0% including TA**
				≈ 18.0% excluding TA

Note: Assumes total ADF IX financing framework at $7,000 million.
Percentages are rounded.

[a] Program basis.

[b] While per capita GNI is above $360, Timor-Leste's special circumstances warrant placement in this grants category.

[c] Project basis.

APPENDIX 2:
DEBT SUSTAINABILITY FRAMEWORK

1. The IDA14 grants framework was introduced on 1 July 2005.[1] It differs significantly from the IDA 13 and ADF IX grant frameworks as it limits eligibility for grants to IDA-only countries and its allocation system is anchored in the new IMF-World Bank debt sustainability framework (DSF) briefly described below.[2]

2. The framework seeks to minimize the possibility that low-income countries incur unsustainable debts in view of the large financing needs implied by the Millennium Development Goals. An evaluation of prospective debt dynamics and judgments about the "risk of debt distress" lie at the core of the new framework. The analytical basis for this system rests on three pillars: (i) policy-dependent external debt thresholds; (ii) debt sustainability analyses (DSAs) and associated stress tests; and (iii) "an appropriate borrowing (and lending) strategy that contains the risk of debt distress." Initially, IDA 14 grant eligibility rests on the first pillar, supplemented by DSAs (second pillar) as these become available. Under the first pillar, projected "solvency" (ratio of the net present value of external debt to gross domestic product and exports) and "liquidity" (debt service ratios) indicators are compared with threshold levels that demarcate "acceptable" levels of risks of default.[3] If projected indicator values breach the relevant "safe" level, this is taken as a preliminary signal of a high risk of default. Where projected indicator values are below the "safe" thresholds, this is taken as a preliminary signal that the risks of default are low. Before a final judgment is made about the risks of debt distress, the impact of plausible shocks on the signals generated by the threshold analysis is considered and there is a detailed examination of individual country circumstances.

3. Implementation of the framework requires country debt sustainability analyses using new debt templates for each low-income country. Although the IMF and the World Bank will lead the DSA work, close coordination with other donors is envisaged at the country level. At an operational level, decisions on the financing mix that draw on the debt sustainability analysis will also require close donor coordination. It is expected that the framework will be fully operational in 2–3 years. As the DSF has not yet been fully implemented, a partial approach to determining eligibility and allocation of grants has been adopted in IDA14. Pending full DSAs, a threshold analysis that provides a snapshot of the likelihood of debt distress is applied.

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[1] IDA. *Addition to IDA Resources: Fourteenth Replenishment. Working Together to Achieve Millennium Development Goals*. Washington D.C. 10 March 2005.

[2] IMF and World Bank. *Debt Sustainability in Low-Income Countries – Proposal for an Operational Framework and Policy Implications.* Washington, D.C. 3 February 2004; *Operational Framework for Debt Sustainability Assessments in Low-Income Countries.* Washington, D.C. 28 May 2005; and *Review of Low-Income Country Debt Sustainability Framework and Implications of MDRI*, Washington, D.C. 26 March 2006.

[3] The precise tolerance selected for the probability of default is ultimately subjective and reflects preferences about different types of prediction error. By setting thresholds that give a lower probability of default, more countries will be considered at risk of distress and there will be fewer cases of defaults occurring that were not predicted. However, a lower probability of default will also generate more cases where the risks of debt distress are considered unacceptably high, but defaults do not occur.

APPENDIX 3:
ILLUSTRATIVE POLICY PERFORMANCE-DEPENDENT DEBT DISTRESS CLASSIFICATION

				Traffic light			
Country	**NPV of debt-to-GDP**	**NPV of debt-to-exports**	**Debt service-to-exports**	**Debt Indicator-Based Classification**	**IDA DSA-based**	**Proposed Risk Rating**	
Strong (Policy+Gov >= 3.75)	**50**	**200**	**25**				
Bhutan	88	326	7	Red	-	Red	
Maldives	31	40	5	Green	-	Green	
Mongolia	64	118	4	Yellow	Yellow	Yellow	
Samoa	32	131	7	Green	Yellow	Yellow	
Medium (3.25< Policy+Gov <3.75)	**40**	**150**	**20**				
Cambodia	62	106	1	Red	-	Red	
Federated States of Micronesia	26	153	6			Green	1/
Kyrgyz Republic	69	200	8	Red	-	Red	
Nepal	33	159	8	Yellow	Red	Red	
Tajikistan	29	68	8	Green	Yellow	Yellow	
Tonga	27	151	8	Green	-	Green	
Poor (Policy+Gov <=3.25)	**30**	**100**	**15**				
Kiribati						Green	2/
Lao People's Democratic Republic	64	276	9	Red	-	Red	
Marshall Islands	76	372	15			Red	1/
Solomon Islands	51	118	5	Red	Red	Red	
Tuvalu	58					Red	3/
Vanuatu	18	47	2	Green	-	Green	
Postconflict Countries							
Afghanistan						Red	2/
Timor Leste						Red	2/

Note: Performance grouping is based on CPA2005 scores; CPIA is computed by averaging the scores of the four clusters, as follows: (macroeconomy+structural+social equity+ governance)/4; Solvency test is computed by taking the average of the distances from threshold for NPV of debt-to-GDP ratio and NPV of debt-to-exports ratio. Traffic light colors are determined by providing 10% band as medium risk above/below debt threshold.

1/ Based on IMF 2004 Article IV Consultation, Micronesia's debt remains low with substantial part of it on concessional terms. For Marshall Islands, debt is high and debt servicing burden is an issue (IMF 2005 Article IV). Data indicated refer to 2004 Total External Debt as percentage of GDP; Total External Debt as percentage of Exports; and External Debt Service as percentage of Exports. Source: IMF 2004 Article IV (Micronesia); IMF 2005 Article IV (Marshall Islands)

2/ Data not available. Same as IDA classification.

3/ Ratio is derived using estimated NPV of Debt (2005) and GDP data (2002) taken from Tuvalu 2006 Economic Report. Export data shows minimal amount see http://www.spc.int/prism/country/tv/stats/Economic/Trade/trade%20new.htm. Internal classification suggests a 'red' classification.

Source: IDA 14 Resource Allocation Framework in FY07, Annex 3-Policy-Dependent Debt Distress Classification, as of 10 May 2005 (2004 data) or otherwise indicated.