CLIMATE INVESTMENT FUNDS

PPCR/SC.9/4
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Meeting of the PPCR Sub-Committee
Washington, DC
November 2, 2011

Agenda Item 4

MDB POLICIES AND TOOLS REGARDING DEBT SUSTAINABILITY AND THEIR APPLICATION IN THE PPCR

Proposed Decision by the PPCR Sub-Committee

The PPCR Sub-Committee reviewed document PPCR/SC.9/4, *MDB Policies and Tools Regarding Debt Sustainability and their Application in the PPCR,* and agrees that

[countries assessed as being at high or moderate risk of debt distress are not eligible to receive PPCR credits as financing for public sector projects. All countries may utilize PPCR credits for private sector investments.

This principle would apply to Cambodia and Nepal as they are assessed at being at moderate risk of debt distress, even though the Sub-Committee has endorsed for each country a Strategic Program that includes project concepts foreseeing the use of PPCR credits. These countries should not, therefore, proceed in the further preparation of any public sector project with the expectation of utilizing PPCR credits for financing the project.]

or

[Countries assessed as being at high risk of debt distress are not eligible to access PPCR credits for public sector projects. All countries may utilize PPCR credits for private sector investments.

Countries assessed at being at moderate risk of debt distress may access PPCR credits for public sector investments provided that these countries, together with the MDBs, conduct a macro-economic analysis to evaluate the potential for PPCR credits to impact their debt sustainability. Any public sector project or program requesting financing using PPCR credits should include an annex with the macroeconomic analysis when the project or program proposal is submitted for approval of PPCR funding.]

I. BACKGROUND AND INTRODUCTION

1. During its meeting in June 2011, the PPCR Sub-Committee reviewed document PPCR/SC.8/3, *The Use of Concessional Finance in the PPCR,* and confirmed that it does not want to add to the burden of highly indebted countries and that the MDBs should robustly apply their debt sustainability policies and tools to estimate and manage the debt risk of a country when developing the SPCR and a request for PPCR funding. The Sub-Committee requested the CIF Administrative Unit to provide further information on such MDB policies and tools at its meeting in November 2011, and to propose how best to apply such tools in the context of the PPCR.

2. This paper responds to that request. The document presents the policies and tools of each MDB and proposes an approach to be followed in the development of the PPCR programs.

3. The PPCR is designed to make available to pilot countries both grants and highly concessional financing (near-zero interest credits with a grant element of 75%) to pilot and demonstrate ways to integrate climate risk and resilience into core development investment while complementing other ongoing activities. ***The design of the PPCR makes clear that there is no obligation for a pilot country to make use of the financing that is available as credits, and a country may choose to access only PPCR grant resources.***

4. The June 2011 meeting of the Sub-Committee considered a document on the use of concessional finance in the PPCR (see *The Use of Concessional Finance in the PPCR,* PPCR/SC.8/3). The paper reviewed, among other things, the application of the MDB's debt sustainability policies and tools in the case of PPCR pilot countries and provided detailed information on the potential use of PPCR credits in public sector investments in pilot countries[1].

5. The paper concluded that provision of credits on the terms offered by the PPCR to pilot countries which are in high or moderate debt distress could be consistent with World Bank policies established under its Debt Sustainability Framework. It was specifically proposed that any PPCR country with a high or moderate debt distress ranking that was interested in accessing PPCR credits would need to conduct a macro-economic analysis to evaluate the potential for impacting their debt sustainability before they could draw on such credits, and that the country could draw on PPCR credits only if the analysis showed that there would be no impact.

6. After reviewing the paper, the Sub-Committee voiced concern that PPCR credits may increase the debt burden of countries which are ranked as being in high or moderate debt distress. The Sub-Committee requested that more information on the MDB debt sustainability policies and tools be provided with a view to the Sub-Committee agreeing on a policy for the allocation of PPCR credits to pilot countries taking into account their debt distress ranking.

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[1] The Sub-Committee noted that concessional credits channeled through the private sector arms of the MDBs may be useful in supporting private sector programs and projects, and that this would not impact the debt sustainability of the country.

II. MDB Policies and Tools in Support of the Operational Application of the Debt Sustainability Framework

World Bank

7. The objective of the joint IMF-World Bank Debt Sustainability Framework (DSF) is to support low-income countries in their efforts to achieve their development goals without creating future debt problems. The DSF is designed to guide the borrowing decisions of low-income countries in a way that matches their financing needs with their current and prospective repayment ability, taking into account each country's circumstances.

8. The DSF also provides guidance for creditors' lending and grant-allocation decisions to ensure that resources are provided to low-income countries on terms that are consistent with both progress towards their development goals and long-term debt sustainability. It also improves assessments and policy advice in these areas and helps detect potential crises early so that preventive action can be taken.

9. Under the DSF, debt sustainability analyses are conducted regularly. They consist of:

a) an analysis of a country's projected debt burden over the next 20 years and its vulnerability to external and policy shocks—baseline and shock scenarios are calculated;
b) an assessment of the risk of debt distress in that time, based on indicative debt burden thresholds that depend on the quality of the country's policies and institutions; and
c) recommendations for a borrowing (and lending) strategy that limits the risk of debt distress.

10. The DSF has important implications for the level and terms of external financial assistance to low-income countries. First, creditors should review current lending policies to ensure that they appropriately reflect the countries' risk of debt distress. The tailoring of new lending decisions to the risk of debt distress almost certainly requires flexibility to increase the level of concessionality of financing to low-income countries, and consequently, a higher volume of grants to avoid a reduction in net transfers.

11. Of the 18 countries participating in pilots under the PPCR, 11 countries are eligible to receive World Bank IDA resources. These countries have been assessed in terms of the risks of debt distress. Of the 11 IDA countries, four are listed as in high debt distress, two are listed in moderate distress and five are assessed with a low risk for debt distress. Table 1 shows these assessments.

Table 1: Risk Assessment of Debt Distress for PPCR Pilots

Country	Risk Assessment of Debt Distress
Bangladesh	low
Bolivia	BLEND – not subject to DSA
Cambodia	moderate
Dominica	BLEND – not subject to DSA
Grenada	BLEND – not subject to DSA
Haiti	high
Jamaica	IBRD – not subject to DSA
Mozambique	low
Nepal	moderate
Niger	low
Papua New Guinea	BLEND – not subject to DSA
Saint Lucia	BLEND – not subject to DSA
Saint Vincent and the Grenadines	BLEND – not subject to DSA
Samoa	low
Tajikistan	high
Tonga	high
Yemen	high
Zambia	low

III. Implications of DSF on IDA Allocations

12. The objective of the grant allocation framework introduced during IDA14 is to proactively mitigate the risks of external debt distress revealed by the DSF. Grant eligibility is limited to IDA-only countries determined by the assessment of the country-specific risk of external debt distress emerging from DSAs performed under the DSF.[2] For countries assessed at low risk of external debt distress, IDA provides its financing on standard IDA credit terms (40 year maturity including a 10 year grace period, leading to a grant element of over 60 percent). For countries assessed at moderate risk of external debt distress, IDA provides its financing 50 percent on standard IDA credit terms and 50 percent on grant terms. Countries assessed at high risk of external debt distress or countries assessed to be in external debt distress receive all of their assistance on grant terms.

[2] IBRD/IDA blend countries and IDA hardened-term (or "gap") countries are a priori excluded from access to grants, irrespective of their external debt situation

IV. NON-CONCESSIONAL LOANS

13. IDA's Non-Concessional Borrowing Policy (NCBP) was introduced in July 2006 in response to donor concerns about debt sustainability risks posed by external non-concessional borrowing by grant-eligible and MDRI recipient countries. Both debt relief and IDA grants have increased these countries' borrowing space. While this development is in itself positive, donors were concerned about potential mismanagement of this new borrowing space, resulting in rapid re-accumulation of external debt. Thus, the NCBP was designed to support debt policies preserving long-term external debt sustainability.

14. The NCBP is a two-pronged policy involving creditor outreach as well as measures aimed at ensuring borrowers to reduce the risk of over-borrowing. The first prong of the policy aims at encouraging other creditors to incorporate debt sustainability considerations and the information provided by the DSF into their lending decisions. The second prong of the policy involves IDA responses (reductions in volumes or hardening of IDA lending terms) to cases of non-concessional-borrowing as well as capacity building in IDA countries.

15. In addition, the debt sustainability analysis informs IDA's decisions regarding its Non-Concessional Borrowing Policy. Specifically, the policy acknowledges that, under certain circumstances, non-concessional loans can be part of a financing mix that helps promote economic growth, and waivers to non-concessional debt limits or increased flexibility in setting such limits can be considered based on, among other criteria, the country's debt sustainability outlook as assessed under the DSF.

16. A key building block of the NCBP is the establishment of debt limits for countries subject to the policy. The design of debt limits is systematically related to the assessment of a country's debt vulnerabilities in debt sustainability analysis[3] . The approach for setting debt limits in countries subject to the NCBP consists of a differentiated methodology for setting debt limits based on countries' macroeconomic and public financial management capacity and the extent of their debt vulnerabilities. With regard to the extent of debt vulnerabilities, countries are classified in two groups based on assessments performed under the DSF. Lower vulnerability countries are those assessed at a low or moderate risk of debt distress. Higher vulnerability countries will be those assessed at a high risk of debt distress or those in debt distress. Based on a country's assessed capacity and its debt vulnerability, different levels of flexibility could be considered under the policy.

[3] *IDA's Non-Concessional Borrowing Policy: Progress Update*, IDA/SecM2010-0240, April 26, 2010.

17. The following table provides the IBRDs lending terms for those countries participating in the PPCR[4]:

Country	Risk Assessment of Debt Distress	IBRD Repayment Terms		IDA Repayment Terms		
		Average repayment maturity (years)	Years to Maturity (years)	Grace Period (years)	Years to Maturity	Grant (%)
Bangladesh	low	-	-	10	40	0
Bolivia*	BLEND	18	30	5	25	0
Cambodia	moderate	-	-	10	40	50
Dominica*	BLEND	18	30	10	40	0
Grenada*	BLEND	18	30	10	40	0
Haiti	high	-	-	10	40	100
Jamaica*	IBRD	18	30	-	-	-
Mozambique	low	-	-	10	40	0
Nepal	moderate	-	-	10	40	50
Niger	low	-	-	10	40	0
Papua New Guinea*	BLEND	18	30	5	25	0
Saint Lucia*	BLEND	18	30	10	40	0
Saint Vincent and the Grenadines*	BLEND	18	30	10	40	0
Samoa	low	-	-	10	40	0
Tajikistan	high	-	-	10	40	100
Tonga	high	-	-	10	40	100
Yemen	high	-	-	10	40	100
Zambia	low	-	-	10	40	0

*countries not subject to the NCBP

18. The DSF and associated debt sustainability analysis is recognized by all RDB partners. Each RDB, however, has tailored the operational application of the DSF to their client countries taking into account the regional specificity for its investment operations. The following paragraphs describe the policies and tools the RDBs are using to operationalize the DSF.

African Development Bank

19. The AfDB has not introduced parallel technical or policy frameworks but rather focus on applying the DSF using informed judgment and taking the specificity of African countries into account. Since the tenth replenishment of the African Development Fund (ADF), the DSF

[4] IBRD/IDA and Blend Countries: Per Capita Incomes, Lending Eligibility, and Repayment Terms (updated August 2011) :http://siteresources.worldbank.org/OPSMANUAL/Resources/OP310_AnnexD_Aug_17_2011_REVISED.pdf

methodology is used to determine each country's risk of debt distress and its financing terms, particularly its eligibility to grants.

20. To reflect the operational implications of revisions to the DSF and the IMF's debt limit policy, the management of the AfDB proposed modest adjustments to the ADF's DSF implementation modalities and the AfDB's Non-Concessional Borrowing Policy. Specifically, it proposed to:

a) incorporate the threshold measure designed to smoothen the impact of modest year-to-year fluctuations on countries' Country Policy and Institutional Assessment scores, DSF performance classifications, and financing terms;
b) expand the AfDB's participation in DSA missions and other debt sustainability exercises;
c) introduce flexibility to the AfDBs concessionality limits, consistent with the new IMF concessionality framework, to allow eligible beneficiary countries take on prudent levels of non-concessional borrowing; and
d) consistent with this flexibility, streamline the disincentive measures of the Bank Group's Non-Concessional Borrowing Policy and further incentivize compliance, especially as regards reporting planned non-concessional borrowing.

21. Strong debt management capacity is central to the flexibility introduced in the revised non-concessionality framework. While several African low-income countries have improved their fiscal and macroeconomic positions as a result of policy reforms and Heavily Indebted Poor Country/Multilateral Debt Relief Initiative debt relief, many still experience debt vulnerability that is largely the product of structural economic factors and weak debt management capacity.

22. This vulnerability has been exacerbated by the global financial and economic crisis and a concessional financing space that is limited and possibly shrinking. Collective effort by all stakeholders to develop low-income countries' debt management capacity has thus become a priority area of engagement that extends beyond debt relief. In the context of the AfDB's efforts to promote debt management capacity in regional member countries, the AfDB has recommended several targeted enhancements to internal Bank processes, capacity-building measures, and external collaboration initiatives between the AfDB and its development partners.

23. Overall, the AfDB's approach to these issues remains rooted in its Paris and Accra commitments to donor harmonization and coordination. As such, the AfDB focuses on core operational modalities that address the diverse circumstances of regional member countries. They also reflect the AfDB's capacity and aspirations to play a more substantive role in promoting long-term debt sustainability in beneficiary countries while maintaining a clear division of labor with the World Bank Group and the IMF.

24. The following table provides the AfDB lending terms for their client countries participating in the PPCR:

Country	Debt Distress Rating	AfDB Repayment Terms	
		Grace period (years)	Years to maturity
Zambia	low	max 5	max 20
Mozambique	low	max 5	max 20
Niger	low	max 5	max 20

Asian Development Bank

25. The ADB revised its Asian Development Fund (ADF) grant framework in September 2007. The revised ADF grant framework is substantially aligned with that of IDA.

26. Under the revised ADF grant framework, eligibility for ADF grants is limited to ADF-only countries. The risk of debt distress will determine the proportion of grants in the country allocation. The debt distress classification is based on DSAs using the joint IMF-World Bank DSF for low-income countries (or the debt data available at that time in the absence of a DSA).

27. The IMF and the World Bank conduct joint DSAs for low-income countries. ADB collaborates with the IMF and the World Bank on DSAs.

28. The ratings from ADB's country performance assessment are used to classify countries as having strong, medium, or weak policy performance. ADF resources under the revised framework are distributed according to the current performance-based allocation (PBA) formula. The proportion of grant assistance is then set based on the debt-distress classification. For countries eligible for grant assistance, the proportion of grants in the country program follows the same debt-distress classification used by IDA:

- No grants for low risk of debt distress,
- 50% grant for moderate risk of debt distress, and
- 100% grant for high risk of debt distress.

29. A 20% volume discount is applied to the grant portion of the PBA. Thus, for moderate-risk countries, which have access to 50% of their PBA as grants, the discount is equivalent to 10% of the PBA. The grant allocations of post-conflict countries are not subject to the volume discount. Directly linking the ADF grant allocation scheme to countries' debt sustainability analyses has had significant operational and financial implications for ADF countries and ADB itself.

30. ADB's annual review of country debt distress classifications coincides with the country performance assessment exercise. Within a biennial allocation period, ADB takes a conservative approach in the reclassification of countries. If it finds improvement in a country's debt distress classification after the first year of the biennial period, ADB maintains the higher proportion of grants to the end of the period (e.g., if a high-risk country becomes moderate-risk after the first year of a biennial allocation, the allocation will continue to be on a 100% grant basis). In

contrast, if the country's debt distress situation deteriorates, the higher grant proportion will be applied to the remainder of the PBA in the second year of the biennial period.

31. The following table provides the ADF lending terms for PPCR pilot countries in the region where ADB operates:

Country	Debt Distress Rating (2010)	ADF Repayment terms		
		Grace period (years)	Years to maturity*	ADF Grant Share (2011) (%)
Nepal	moderate	8	32	50
Cambodia	low	8	32	0
Tajikistan	high	8	32	100
Bangladesh	-	8	32	0
Papua New Guinea	-	8	32	0
Samoa	low	8	32	0
Tonga	high	8	32	100

* Investment loans financed from ADF resources have a fixed-term, 32-year maturity including a grace period of 8 years. Program loans from ADF resources have a fixed-term, 24-year maturity including a grace period of 8 years.

European Bank for Reconstruction and Development

32. As the PPCR is restricted to low-income countries, the only EBRD countries of operations that are eligible are the low-income countries of Central Asia and the Caucasus, which EBRD defines as Early Transition Countries (ETC). This group includes Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Mongolia and Tajikistan. Tajikistan is the only PPCR pilot country in the ETC and indeed in the entire EBRD region.

33. While the level of Tajikistan's external debt is not very high by international comparison and domestic debt remains low, Tajikistan's low level of institutional capacity and vulnerability to external shocks translates into a large potential for debt distress. According to the International Monetary Fund (IMF) country report published in June 2011, Tajikistan remains at a high level of debt distress under the joint World Bank-IMF Debt Sustainability Framework.

34. In its Strategic Program for Climate Resilience (SPCR), Tajikistan has explicitly requested that no concessional finance be provided under the PPCR. Instead, all PPCR finance will be provided in the form of grants. Therefore, there is no debt sustainability issue directly connected with Tajikistan's PPCR finance. However, it is anticipated that this grant finance will be blended with loans by EBRD (and possibly by other MDBs) in projects that will form part of PPCR Phase II.

35. Although EBRD has a primary focus on private sector investment, it sometimes invests in publicly owned entities. In some cases, investments in publicly-owned or municipal entities are covered by sovereign guarantees provided by the government. Alternatively sovereign loans are

provided directly to governments, usually via ministries of finance, which then on-lend to public/municipal entities.

36. EBRD provides loans at non-concessional rates only, and investments must be shown to be financially sound before approval. In ETC countries such as Tajikistan, debt sustainability analysis is carried out as part of the preparation of projects that involve sovereign loans or sovereign guaranteed loans. EBRD's lending operations comply with the requirements of the IMF, whose agreement with Tajikistan states that it should refrain from contracting or guaranteeing any new non-concessional debt, which is defined as having a grant element of less than 35 per cent.

37. In Tajikistan, as with other low-income countries in the EBRD region, EBRD blends non-concessional loans with a high proportion of co-financing grants in order to comply with the 35% grant threshold set by the IMF, and to meet debt sustainability and affordability requirements. These co-financing grants, which are usually mobilized from bilateral donors, enable the EBRD to meet IMF concessionality requirements and to increase the affordability of its projects.

38. The following table provides some typical EBRD sovereign lending terms for PPCR pilot countries in the region where EBRD operates, although these will of course vary according to the requirements of each individual project:

Country	**Debt Distress Rating**	**EBRD Repayment terms (typical)**		
		Grace period (years)	**Years to maturity**	**Grant (%)**
Tajikistan	high	3	15	Minimum 35%

Inter-American Development Bank

39. In conjunction with the IDB-07 Debt Relief Initiative, a new framework for the IDB's concessional financing, the "Debt Sustainability Framework and Enhanced Performance Based Allocation (DSF/EPBA)", was approved in 2007.

40. Under the DSF/EPBA, the appropriate grant element or level of concessionality for each country is derived from the risk of debt distress resulting from the debt sustainability analysis performed by the IDB using the joint IMF-World Bank DSF for low-income countries. These concessionality levels are achieved through blending highly concessional resources from the Fund for Special Operations (FSO) and non-concessional resources from the Ordinary Capital (OC). Thus, while FSO and OC loans have the same terms and conditions for every eligible country, the blended OC-FSO loans provides a varying degree of concessionality by blending these two types of loans in different proportions depending on each country's debt sustainability level. Please note that Haiti currently receives only grants and thus has a grant element of 100%.

41. The overall allocation of concessional resources is determined by a combination of country needs and performance (through the Enhanced Performance Based Allocation, EPBA), which determines the allocation of highly concessional FSO resources; and the risk of debt

distress classification (stemming from the DSF), which defines the appropriate blend of OC resources with the individual countries' FSO allocation.

42. Table 1 below shows the concessionality levels calculated based on the blend mix between OC and FSO for Bolivia. Haiti only receives grants from the Grant Facility. Jamaica is not eligible to receive FSO resources. Table 2 shows the repayment terms of the IDB Blend loans

Table 1: Concessionality levels per country[5]

Country	Debt Distress Rating	IDB blend*		Grant Facility	Grant (%)
		FSO	OC		
Bolivia	low	25%	75%	0%	29.7%
Haiti	high	0%	0%	100%	100%
Jamaica**	Not subject to DSA	0%	100%	0%	10.6%

*As of September 30, 2011.
**Jamaica is not eligible for concessional financing under the DSF/EPBA framework

Table 2: IDB Blend Loan Repayment Terms

	IDB Blend Loan Repayment terms		
	Grace period (years)	Years to maturity	Grant (%)
OC portion	5.5 years	30 years	10.6%
FSO portion*	40 years	40 years	87.1%

* FSO loans have a 40-year bullet repayment and a 0.25% lending rate

V. CRITERIA FOR THE USE OF HIGHLY CONCESSIONAL FINANCE UNDER THE OTHER SCF PROGRAMS

Forest Investment Program (FIP)

43. The FIP Sub-Committee has agreed that for public sector projects, countries in high or moderate debt distress should have access to grant resources only. Four of the eight FIP pilot countries are listed as in moderate or high debt distress: Burkina Faso, DR Congo, Ghana and Lao PDR.

44. The remaining FIP pilot countries (Brazil, Indonesia, Mexico and Peru) may draw from the concessional resources available under FIP for public and private sector investments.

Scaling-Up Renewable Energy Program in Low-Income Countries (SREP)

45. The SREP Financing Modalities provide that for public sector projects, countries with high or moderate risk ratings should receive all SREP funding in the form of grants. Three of the

[5] Calculations are based on the discount rate used by IMF as of YE 2010, which is the CIRRs published by the OECD[5], and based on the OC lending spread of 80 bps. The base discount rate as of year-end 2010 is 4.91%.

six SREP pilot countries are listed as in moderate debt distress: Ethiopia, Maldives and Nepal. The three SREP pilots with low risk ratings (Honduras, Kenya and Mali) may draw from concessional financing available under the SREP.

46. The MDB Committee is proposing (see document SREP/SC.6/7, *Distribution of Grant Resources and Other Concessional Financing to SREP Pilot Countries*) that the SREP Sub-Committee agrees to allocate to each pilot country a minimum level of concessional funds so as to provide an incentive to develop private sector programs and projects.

VI. CONCLUSIONS

47. The above information confirms that each MDBs uses debt sustainability tools and policies as part of their regular procedures. Under these procedures, the MDB determines the grant/ loan mix in allocating public sector resources to low income countries.

48. It is proposed that the Sub-Committee reconfirms that access to credits under the PPCR for public sector projects and programs should be consistent with MDB principles of analyzing and managing the debt distress of a country.

49. In the case of the FIP and SREP, the Sub-Committees have agreed that low income pilot countries in moderate or high debt distress should receive grant funding only. If the Sub-Committee were to apply the same policy across the SCF targeted programs, PPCR countries in moderate or high debt distress would have access only to PPCR grant funding[6].

50. As of October 15, 2011, SPCRs for 11 countries participating in the PPCR have been endorsed by the Sub-Committee. Nine countries have chosen to request, in addition to PPCR grant resources, PPCR credits. Three of these countries are not subject to debt sustainability analysis (Grenada, St. Lucia and St. Vincent and the Grenadines). Four of the countries are rated as in "low debt distress" (Bangladesh, Mozambique, Niger and Zambia). Two countries are ranked as in "moderate debt distress" (Cambodia and Nepal).

51. Taking into account this information, the Sub-Committee may wish to consider the following options.

52. *Option1*: the Sub-Committee agrees that countries assessed as being at high or moderate risk of debt distress are not eligible to received PPCR credits for public sector projects. If the Sub-Committee selects this option, Cambodia and Nepal, which have been assessed as "in moderate debt distress," would not be able to access the PPCR credits for public sector operations requested in their endorsed SPCRs. The countries would, however, be able to request PPCR credits for private sector investments.

53. *Option 2:* the Sub-Committee agrees that only PPCR grant resources are to be provided for public sector projects to countries in high debt distress and to the regional components for the Caribbean and Pacific programs. Countries assessed at being at

[6] For public sector projects and programs.

moderate risk of debt distress may access PPCR credits for public sector investments provided that these countries, together with the MDBs, conduct a macro-economic analysis to evaluate the potential for PPCR credits to impact their debt sustainability. Any public sector project or program requesting financing using PPCR credits in such countries should include an annex with the macroeconomic analysis when the project or program proposal is submitted for approval of PPCR funding.