

CONFIDENTIAL

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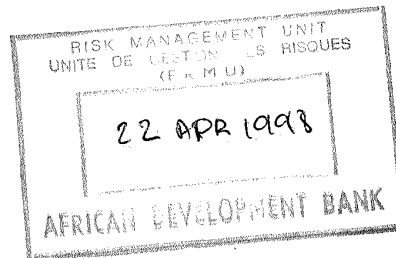
MEMORANDUM

TO : THE BOARDS OF DIRECTORS

FROM : Omar ~~KABBAJ~~
President

SUBJECT : BANK GROUP CREDIT POLICY*

Please find attached hereto, the above-mentioned document.



Attch.

	* Questions on this document should be referred to:		
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Bank Group Credit Policy

1. The Evolution of the Bank Group Credit Policy

1.1 Prior to the adoption in 1992 of the Country Exposure Policy (Document ADB/BD/WP/92/95), the Bank's lending operations were conducted on the basis of very broadly defined principles rather than on a formal credit policy. These principles were outlined in the Agreement Establishing the African Development Bank (amended in May 1979) which stipulates that: "the Bank should extend lending to borrowing countries paying due regard to the prospects the borrower would meet its obligations on schedule".

1.2 Following the African debt crisis in the late 1980's and early 90's, during which several ADB borrowers accumulated significant loan arrears, it became clear that an explicit credit policy to guide lending to borrowing countries and to manage the Bank's exposure needed to be developed. Consequently, in September 1992, a **country exposure policy** was adopted by the Bank. The policy outlined detailed standards to guide new lending operations aimed at enhancing the soundness of the Bank's loan portfolio. Among the new standards adopted was a uniform exposure ceiling for all countries that should not exceed 15% of the Bank's portfolio. During this period, many of the other multilateral and bilateral lenders to African governments began switching away from traditional loans to grants and highly concessionary funds; the ADB, on the other hand, was less responsive to these circumstances and continued to extend non-concessional loans to these countries.

1.3 In 1993, an Exposure Monitoring Committee was established to oversee the implementation of the country exposure policy. The Committee met regularly from its inception through mid-1994 to review individual country lending strategy with a view to recommending appropriate changes. However, the immediate impact of the new country exposure policy was limited because only few countries were close to the 15% lending ceiling. As ADB loan arrears continued to mount and to pose an increasing threat to these economies and the Bank's finances, it became evident that exposure monitoring alone was insufficient to deal with the situation; it was necessary also to monitor developments in the **overall creditworthiness of borrowing countries**.

1.4 In recognition of this challenge, a new **Credit Policy Framework** (Document ADB/BD/WP/94/104/Rev.1) was developed in November 1994. The proposed policy framework was discussed several times by the Board of Directors. Even though there was general understanding that the draft policy framework recognized the concept of debt sustainability, there was disagreement on the threshold which still left many debt strung RMCs eligible for ADB lending. Due to diverging views of Board members about country eligibility, the policy was passed by a majority vote in November 1994, even though all non-regional Executive Directors voted against it. This created an impasse which persisted up to April 1995 when the issue was finally resolved by a Joint Steering Committee of the Board of Governors. The Committee decided that the Bank should, until further notice, apply the same eligibility criteria as the World Bank. Since then, the Bank Group has applied the eligibility guidelines of the World Bank and thus has classified regional member countries into ADF-only, ADF/ADB blend and ADB-only which corresponds to IDA-only, blend, and Bank only.

2. Impacts of the Interim 1995 Credit Policy

2.1 The impact of the Credit Policy on Bank Group operations and financial performance has been positive. The impact can be gleaned by examining and analyzing the following factors:

(i) **Credit Standing in the financial markets:** The cumulative impact of years of inaction in dealing with declining project quality and the poor credit standing of borrowing RMCs as well as the politicization of Board discussions were, in part and collectively, responsible for the adoption of the 1995 Credit Policy. However, by the time the policy was adopted, the financial markets had already internalized these factors in their rating assessment of the Bank. It was, therefore, not surprising that the rating went down in 1995. It should, however, be noted that the corrective measures implied in the Credit Policy itself, the cancellation of non-performing loans and, of course, the restructuring of the Bank have combined to improve the perception and image of the Bank. Any attempt, therefore, to weaken the credit policy at this point in time may send a wrong signal to the market and further erode the current credit standing of the institution.

(ii) **Loan Repayment Arrears:** The Credit Policy has been an effective instrument for controlling the accumulation of non-concessional debt by borrowing member countries of the Bank. This, in turn, has stemmed the rise in the debt burden of these countries. An analysis of the trend in non-accruals of the Bank shows that the situation would have become worse without the implementation of the credit policy – several more countries would have fallen into the category of RMCs with chronic arrears. Even though the Credit Policy has not completely resolved the arrears problem, it has certainly contained and limited the future emergence of arrears. It is worth noting that any observed increase in arrears since the adoption and implementation of the credit policy cannot be associated with Category B and C countries; instead the arrears are exclusively attributable to ADB loans extended to Category A-only countries in general and the lack of improvement in the loan repayment status of countries in chronic arrears – unpaid principal, interest and other resultant charges. Along with the cancellation of non-performing loans, the credit policy has had a positive impact on loan repayment by borrowers.

(iii) **Net Income:** The cumulative impact of the Credit Policy-induced changes in Bank Group lending to many RMCs, the new loan cancellation guidelines, newly instituted expenditure control mechanisms and the restructuring of the Bank have improved the Bank's financial performance. The underlying conclusion is that these measures have had, and continue to have, positive impact on the net income of the Bank. Since 1995, the net income of the Bank has risen by 26%, 50% and 13% during 1995, 1996 and 1997, respectively.

2.2 The implementation of the 1995 Interim Credit Policy has led to some reduction in the indebtedness of several poor regional member countries. It has also contributed to the improvement in the risk profile of the Bank Group portfolio.

3 Concerns of Regional Member Countries

3.1 While the application of the Interim Credit Policy has had some positive impact on the financial soundness of the portfolio and thus improved the Bank's credit standing, its strict application has also led to a reduction in the number of RMCs which had access to ADB resources. This has created a lingering concern among several regional member countries regarding their ineligibility to additional ADB window resources in the face of reduced availability of ADF resources under ADF-VII. Thus, the application of the credit policy has diminished RMCs access to the ADB window without compensating financing from other sources. This situation has been aggravated by the fact that ADF-VII replenishment negotiation was completed two years late and with a significant reduction in funding relative to the level approved under ADF-VI.

3.2 Resolution B/BD/94/07/Rev.1 of May 16, 1995, which mandated the Bank Group to adopt the World Bank's Credit Policy envisages the possibility of the Bank eventually developing its own credit policy. Thus, it states that: " pending the formulation of its own system of country classification, the Bank shall adopt the criteria in use by the World Bank". In light of this provision, some member countries have raised the issue of whether the time has come for the Bank to develop its own credit policy.

4. Assessment of the Present Situation

4.1 Annex 1 of this paper indicates that 36 of the 39 Category-A countries still have unsustainable debt levels and are potentially eligible to participate in either the HIPC's, the SFM, or both initiatives. The remaining three countries - Djibouti, Comoros, and Eritrea are not strong candidates to borrow non-concessional resources. Eritrea and Djibouti have no ADB exposure while Comoros has been in chronic arrears on account of a single project. Under these circumstances, there appears to be no justification, at this point in time, to revise the current credit policy of the Bank. *In addition, a premature reopening of discussions of the Credit Policy will send wrong signals to the financial markets and may polarize the views of the shareholders as occurred during the 1994-95 period at a time when efforts should be concentrated on discussions related to ADF-VIII replenishment.*

4.2 While there have been some improvements in the economic performance of most regional member countries, *their overall debt situation remains precarious and a source of concern.* As at December 31, 1997 the total debt outstanding and disbursed for Africa was estimated to be \$315.2 billion, resulting in an average continent-wide debt/GDP ratio of 51% and total debt/export ratio of 194%. It is clear that many of the RMCs continue to be heavily indebted. Recognizing the severity of the debt situation, the Bank Group, with the Boards' approval, has affiliated itself with the multilateral HIPC's initiative and also created its own Supplementary Financing Mechanism (SFM) to, respectively, help reduce the overall debt burden and make ADB interest payments on outstanding loans for qualifying countries. *It should be noted that, as a condition for accessing resources under ESAF Programs, qualifying countries give an undertaking not to borrow from non-concessional sources until their debts have been reduced to sustainable levels. In addition, it should be noted that this is also a clause of the HIPC's initiative.*

4.3 With respect to the concerns expressed about lack of accessibility to ADB resources, it should be noted (see Annex 2) that, prior to the adoption of the credit policy, the level of borrowing by Category A countries had progressively declined on account of their arrears situation. The average annual borrowing by all these countries is estimated at about UA 20 million. *It is worth noting that significant inflow of resources to these RMCs is expected to occur from the anticipated lending activities of the revamped and up-graded Private Sector Department of the Bank. It should also be stressed that Management has recently proposed and submitted to the Board for consideration and approval, an operational mechanism to implement the financing of Enclave projects. This is expected to become operational within a few months. All these measures have good potential of increasing the flow of ADB resources to RMCs including the Category A countries.*

4.4 Furthermore, Management has commenced the preparation of the necessary documents for the replenishment of ADF resources with the expectation that ADF-VIII resources will be sufficiently sizeable to help in addressing some of the increasing resource needs of Categories A-only and blend countries, and on appropriately concessional terms.

5. Recommendation

5.1 In the light of the above, it is recommended that the Bank maintain its current Credit Policy which is identical to the World Bank's. The Bank will, however, continue to review and, if need be, amend the Credit Policy as the economic conditions and creditworthiness of RMCs improve in response to their on-going structural economic reforms. In this regard, the Bank will establish increased information exchange with the World Bank on country analysis to better understand the basis of the classification- a cooperation that has already been enhanced through the HIPC initiative.

5.2 The Boards of Directors are invited to consider for the approval the above recommendation.

Annex 1

The global impact of HIPCs and SFM initiatives on
RMCs self-exclusion from borrowing ADB resources

Country	Potentially Eligible Candidates		Country Category	More than 12 months Chronic Arrears
	SFM	HIPCs		
1. Angola		x	A	x
2. Benin		x	A	
3. Burkina Faso	x	x	A	
4. Burundi		x	A	
5. Cameroon		x	A	
6. Cape Verde		x	A	
7. Central African Rep.		x	A	
8. Chad		x	A	
9. Comoros			A	x
10. Côte D'Ivoire		x	A	
11. Dem. Rep. Congo		x	A	x
12. Congo – Brazza.		x	A	
13. Djibouti			A	
14. Equatorial Guinea		x	A	
15. Eritrea			A	
16. Ethiopia	x	x	A	
17. Gambia	x		A	
18. Ghana	x	x	A	
19. Guinea		x	A	
20. Guinea Bissau	x	x	A	
21. Kenya	x	x	A	
22. Lesotho	x		A	
23. Liberia			A	x
24. Madagascar	x	x	A	
25. Malawi	x		A	
26. Mali		x	A	
27. Mauritania		x	A	
28. Mozambique		x	A	
29. Niger		x	A	
30. Rwanda		x	A	
31. Sao Tome Principe		x	A	
32. Senegal		x	A	
33. Sierra Leone		x	A	
34. Somalia		x	A	x
35. Sudan		x	A	x
36. Tanzania	x	x	A	
37. Togo		x	A	
38. Uganda		x	A	
39. Zambia	x	x	A	
40. Egypt			B	
41. Nigeria		x	B	
42. Zimbabwe			B	

Source: IBRD and ADB documents on the HIPCs

African Development Bank
 Loan Approvals for Category A Countries, 1967–96
 (in million UA)

Country	Annual average 1967–93	1994	1995	1996	1967–96
Angola	7.58	—	—	—	204.59
Benin	0.85	—	—	—	22.86
Burkina Faso	1.15	—	—	—	31.04
Burundi	1.80	—	—	—	48.58
Cameroon	16.65	—	—	—	449.66
Cape Verde	0.45	—	—	—	12.05
Central African Rep.	0.56	—	—	—	15.17
Chad	0.10	—	—	—	2.68
Comoros	0.37	—	—	—	10.00
Congo	8.03	50.00	—	—	266.68
Congo, Democratic Rep.	23.13	—	—	—	624.49
Côte d'Ivoire	30.95	—	—	—	835.77
Djibouti	—	—	—	—	—
Equatorial Guinea	0.27	—	—	—	7.20
Eritrea	—	—	—	—	—
Ethiopia	8.90	—	—	—	240.21
Gambia	0.79	—	—	—	21.34
Ghana	9.14	—	—	7.53	254.24
Guinea	8.31	—	—	—	224.29
Guinea Bissau	0.41	—	—	—	11.01
Kenya	7.47	—	—	1.99	203.71
Lesotho	2.36	—	—	—	63.66
Liberia	4.30	—	—	—	116.08
Madagascar	2.48	—	—	—	66.99
Malawi	3.11	—	—	—	83.95
Mali	0.67	—	—	—	18.03
Mauritania	2.72	—	—	—	73.32
Mozambique	3.66	—	—	—	98.86
Niger	1.03	—	—	—	27.75
Rwanda	0.60	—	—	—	16.10
Sao Tome & Principe	—	—	—	—	—
Senegal	6.99	—	0.55	—	189.19
Sierra Leone	0.51	—	—	—	13.90
Somalia	0.28	—	—	—	7.50
Sudan	3.80	—	1.55	—	104.02
Tanzania	2.07	3.07	—	—	59.07
Togo	0.68	—	—	—	18.46
Uganda	5.18	—	—	4.03	143.88
Zambia	10.44	—	7.29	—	289.07
Total	177.76	53.07	9.38	13.56	4875.40

Source: ADB Compendium of Statistics, 1997