BANK GROUP POLICY ON NON-CONCESSIONAL DEBT ACCUMULATION

REVISED VERSION

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ABBREVIATIONS AND ACRONYMS

ADF	African Development Fund
AfDB	African Development Bank Group
AsDB	Asian Development Bank
CIRR	Commercial Interest Reference Rate
CG	Consultative Group
DAC	Development Assistance Committee
DRC	Democratic Republic of Congo
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EBRD	European Bank for Reconstruction and Development
GDF	Global Development Finance
GDP	Gross Domestic Product
GPRS	Growth and Poverty Reduction Strategy
HIPC	Highly Indebted Poor Country
IaDB	Inter American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	European Development Association
IMF	International Monetary Fund
ISN	Interim Strategy Note
MDBs	Multilateral Development Banks
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
NCB	Non-Concessional Borrowing
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
PBA	Performance-based Allocation
RDBs	Regional Development Banks
RMCs	Regional Member Countries

Executive Summary

1. The provision of grants and debt relief to eligible countries is intended to help bring their debt to sustainable levels and create fiscal space for priority development expenditures. The accumulation of new debt on non-concessional terms by beneficiary countries can undermine these objectives and introduce the risk of free-riding -- a situation in which grants and debt relief provided by one or more parties cross-subsidize new borrowing from third party lenders on non-concessional terms. This risk is particularly high in resource rich countries in which non-concessional borrowing may be secured by future export receipts.

2. The problem of non-concessional borrowing also raises the issue of debt sustainability vis-à-vis the issue of financing for development. While these two issues are interrelated, it is underscored that this paper addresses mainly the issue of debt distress and debt sustainability, and not the issue of a new strategy on financing for development, which will be considered in a different context.

3. The World Bank's IDA Board approved, in July 2006, a policy on non-concessional borrowing by grant-eligible IDA-only countries and MDRI beneficiaries. That policy is based on a two-pronged approach: one component focuses on enhancing creditor coordination around the agreed Debt Sustainability Framework (DSF); the second seeks to discourage non-concessional borrowing through disincentives for the recipient countries, including volume discounts and hardening of IDA's borrowing terms.

4. This paper proposes for Board consideration elements of a Bank Group policy on non-concessional borrowing by beneficiaries of ADF grant and HIPC/MDRI debt relief. It reviews the main features of the IDA policy, and experience to-date, and proposes a Bank Group policy to deal with the issue.

5. The following principles guide the proposed approach: (i) there should be strong partnership and coordination with sister MDBs and bilateral agencies; (ii) measures should be effective; (iii) measures should be implementable; and (iv) diversity in country circumstances will require some flexibility and a case by case approach. Within this broad framework, the Bank Group non-concessional borrowing (NCB) policy includes the following measures:

- (i) Strengthening partnerships and coordination with sister MDBs and bilateral agencies to adopt a common strategy in dealing with the problem, including advocacy;
- (ii) Setting up an internal Committee to monitor the status of non-concessional borrowing;
- (iii) Including a clause in all Bank Group grant/loan agreements requiring reporting on new non-concessional borrowing; and
- (iv) Supporting economic and debt management capacity building, as necessary, in specific countries, in collaboration with other partners.

6. In dealing with RMCs that breach the NCB policy, some degree of flexibility will be exercised, on a case by case basis, as follows:

- (i) For resource-rich RMCs consistently borrowing on non-concessional terms, hardened lending terms, ranging from moderate to more severe terms, will be applied;
- (ii) For emerging market low-income, low-risk RMCs, where there is some evidence of capital market interest in project finance, flexibility will be applied in accommodating their non-concessional borrowing to help them reach the MDGs; and
- (iii) For HIPCs in the interim period, a specific clause will be included in the grant agreement that the country will not receive extended interim debt relief if it contracts non-concessional debt during the period.

7. The Boards of Directors are invited to consider and approve the Bank Group policy on non-concessional debt accumulation by grant-eligible and HIPC/MDRI debt relief beneficiaries.

I. INTRODUCTION

1.1 At the beginning of the ADF-10 replenishment period (2005-07), the Fund adopted the enhanced Performance Based Allocation (PBA) system and the new Debt Sustainability Framework (DSF) as the basis for allocating ADF grant resources based on countries' risk of debt distress. The provision of grants and debt relief to eligible countries has strengthened the prospects for new financial flows, including resources contracted on non-concessional terms. Lending on non-concessional terms to ADF grant and post debt relief beneficiary countries can potentially cross-subsidize non-concessional borrowing from third party lenders that offer loans on hard terms. This risk of free-riding is higher in resource rich countries that could borrow on non-concessional terms collateralized with future income receipts.

1.2 The World Bank's IDA Board approved a Policy on Non-Concessional Borrowing (NCB) in July 2006. The Bank Group has been engaged in discussions with the concerned parties, including the IDA, IMF, and other MDBs, on the free-riding issue to develop its own policy on the issue. As requested by the Boards of Directors and ADF Deputies, this paper sets out elements of a Bank Group policy on non-concessional borrowing and debt accumulation by ADF grant recipients and beneficiaries of HIPC/MDRI debt relief.

1.3 The paper has seven main sections. Section II presents conceptual issues on concessionality of new borrowing. Section III reviews alternative country cases of non-concessional borrowing. Section IV reviews IDA's policy and experience. Section V sets out specific elements of a Bank Group policy and the potential challenges in implementation. Section VI proposes an action plan. The final section presents the conclusion and recommendation for Board consideration.

II. CONCEPTUAL ISSUES ON CONCESSIONALITY OF NEW BORROWING

Non-Concessional Borrowing

2.1 The concern with non-concessional borrowing by grant eligible and post debt relief countries is that ADF grants or HIPC/MDRI debt relief could potentially cross-subsidize lenders that offer non-concessional loans to recipient RMCs. ADF and other MDBs aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately concessional terms. In contrast, other creditors and borrowing governments may gain from non-concessional lending following large-scale MDRI relief, or in conjunction with grants provided by the multilateral institutions.

2.2 There is also a potential moral hazard problem with respect to borrowers. ADF grants and debt relief may introduce an incentive for countries to over-borrow from other creditors which could cause their debt to be unsustainable and compel ADF and the other MDBs to increase the grant share of their assistance. To address this moral hazard problem, certain disincentive measures will be aimed at defaulting borrowers. Such measures would subject most grant-eligible and post debt relief countries to increased risk of debt distress, and thus limit their scope for non-concessional borrowing, unless they could collateralize their future resource endowments to secure the loans.

Debt Sustainability and MDGs Trade-off

2.3 Moreover, there is the need to recognize trade-offs between the goals of debt sustainability and attainment of the Millennium Development Goals (MDGs). Policies to curtail non-concessional debt accumulation may result in fewer resources available for the MDGs in the countries concerned. In the absence of sufficient concessional resources, non-concessional lending may provide additional resources to help achieve the MDGs, even if this undermines debt sustainability in the long run. The challenge of balancing competing priority objectives is a real one. A pragmatic approach to these potentially conflicting policy goals, within the financial and policy context of the country, is necessary in order to determine whether the non-concessional resources are critical in helping the country achieve the MDGs.

2.4 The risks of non-concessional borrowing are higher in resource-rich grant-recipient countries that can obtain non-concessional borrowing collateralized by future income receipts. These risks are amplified in countries with weak policy environments, including with respect to transparency. In the post-MDRI situation, the risk may be greater since large amounts of debt relief and lowered debt ratios increase the borrowing space. This is particularly the case for some post-MDRI countries which already have some access to capital markets (such as Ghana, Tanzania and Zambia).

Appropriate Concessionality Benchmark

2.5 In order to address the problem of non-concessional borrowing by grant-eligible and post-debt relief RMCs, it is necessary to differentiate between concessional and non-concessional lending, by selecting an appropriate concessionality benchmark. Although there is no clear definition of concessionality, in practice, two alternative approaches have been adopted in the literature on how to deal with this measurement problem.

2.6 The OECD's Development Assistance Committee's (DAC) definition of concessionality is commonly used by the OECD, and is retained for some statistical purposes even in some World Bank reports, including the Global Development Finance (GDF) publication. The DAC definition uses a flat discount rate of 10%, and is based on a benchmark grant element of at least 25%. This measure usually results in an underestimate of the share of non-concessional debt in a portfolio of projects.

2.7 In contrast, there is the standard IMF definition of concessionality, which is usually adopted by the World Bank and the major regional development banks (AfDB, AsDB, and IaDB). This definition of concessionality is based on a relatively lower discount rate, the currency-specific commercial interest reference rate (CIRR), with a benchmark grant element of at least 35%. By comparison, this measure results in a higher share of non-concessional debt.[1]

[1] The grant element (GE) of a loan, by definition, is given by GE = [1 – (NPV/Nominal)] * 100%. The discount rate used to calculate the NPV of a loan in the DAC definition is a flat 10% rate, while that used by the IMF in the context of PRGF is the commercial interest reference rate (CIRR). Given that CIRRs are relatively lower and are currently at about 7.0 % on average, the DAC method would estimate a higher grant element of a loan (i.e., a lower present value) than the IMF method. For instance, suppose Country Z contracted an official bilateral loan of US$10 million with a 4.5% interest rate, 20-year maturity and 5-year grace period. The DAC method would estimate a grant element in such a loan to be about 38% (i.e., concessional). On the other hand, the IMF methodology would estimate the grant element at only about 21 percent (i.e., non-concessional).

2.8 The major drawback of the DAC methodology is that the fixed 10% discount rate used implies that even commercial loans could be classified as concessional in the light of the current low interest rate environment. Using the IMF definition, the types of non-concessional external debt under consideration would include: (i) export credits, (ii) commercial (including syndicated) bank loans, and (iii) bonds[2].

Debt Sustainability and Financing for Development

2.9 In designing the Bank Group policy on non-concessional debt accumulation, two interrelated but competing issues emerge. The first is the issue of debt sustainability and debt management, and how to prevent the re-emergence of the debt trap after the large amounts of debt relief provided under the two major initiatives, HIPC and MDRI. The second is the issue of financing for development, and the need for innovative and predictable financing mechanisms to provide needed support to RMCs to assist them in achieving the MDGs.

2.10 While the two issues are interrelated, it is underscored that the focus of this paper, on a Bank Group policy on non-concessional borrowing, is concerned only with the first issue and not the second. Accordingly, the paper will consider the principles of debt sustainability and debt management to avoid the re-emergence of debt distress. The paper will therefore not address the second issue on financing for development, which would be examined in another context.

III. TYPICAL CASES OF NON-CONCESSIONAL BORROWING BY RMC$_S$

3.1 Borrowing by Natural Resource-rich RMCs

3.1.1 Angola's case presents a good illustration of non-concessional borrowing by a natural resources rich country. It is estimated that Angola has contracted large amounts of non-concessional debt of up to US$ 15.5 billion (35% of its 2006 GDP), since 2004 (see Box 1).

3.1.2 Nevertheless, based on the latest (August 2007) joint IMF/IDA forward-looking Debt Sustainability Analysis (DSA), the country is assessed to be at moderate risk of debt distress. It is noted that Angola's debt ratios have improved dramatically over the past several years, given the buoyant oil revenues, and are projected to remain on a declining trend in the medium term if oil revenues maintain their upward trend under the baseline scenario of the DSA. However, if oil revenues begin to decline, the country's debt ratios are projected to edge up beyond the medium term, though remaining at sustainable levels,. With its heavy reliance on oil, Angola remains vulnerable to falling oil revenue, and some risk to debt sustainability[3].

3.1.3 Despite Angola's assessment at moderate risk of debt distress, in the light of the new IDA non-concessional borrowing (NCB) policy, its consistent non-concessional borrowing resulted in the hardening of IDA's lending terms on the country (see paras 4.2.2-4.2.3 below).

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[2] The Bank has adopted one of the standard concessionality benchmarks, rather than deriving its own definition of non-concessional borrowing that reflects the African perspective. This is informed by the need for policy harmonization and alignment to achieve effective implementation of the NCB policy, in line with the Paris Declaration on Aid Effectiveness, which requires a coordinated approach.

[3] See; IMF: Angola – Article IV Consultation, IMF Country Report No.: 07/354, October 2007.

Box 1: ***Borrowing by Natural Resource-rich Country: Case of Angola***

1. Angola's high oil revenues have enabled it to attract considerable non-concessional resources to finance its public expenditure program. The funds have been borrowed from some OECD and non-OECD partners, including China, India, Korea, and Brazil for a total of about US$ 15.5 billion since 2004. This includes a non-concessional US$ 2 billion loan from China EximBank (2004) collateralized with future petroleum exports, and a new US$9.8 billion line of credit from China Fund (2005)[1].

2. The evidence of non-concessional borrowing led IDA to apply its new NCB policy to Angola by hardening its terms. The government of Angola continues to recognize the benefits of accessing funds from traditional donors, such as IDA and the ADF, in part because of the legitimacy gained by engaging with the Bank Group and other multilateral institutions, which facilitates access to private sector and other financing sources. The donor community also broadly continues to favor engagement with the country, within the framework of supporting the government and other national stakeholders in the development effort. This makes it possible to provide policy advice and technical assistance to a country emerging from conflict while delivering potentially large benefits to poor communities from well-designed and well-executed programs by the multilateral development partners.

[1] See IDA: Angola – Interim Strategy Note (ISN), Report No.: 39394-AO, May, 2007, paras 40-41, and Annex 6 on the various sources and terms of Angola's non-concessional borrowing since 2004.

3.2 Borrowing by Emerging Market Low Risk RMCs

3.2.1 Where non-concessional borrowing is contracted by low-risk countries with strong policies and institutions, flexibility may be valuable, especially when non-concessional borrowing is to finance self-sustaining enclave projects in these countries with demonstrable capacity to pay and with little or no risk of debt distress. In cases such as Ghana, Uganda, and Tanzania, there is evidence of capital market interest in financing development projects to supplement concessional resources.

3.2.2 In October 2007, Ghana successfully issued a US$ 750 million Sovereign Eurobond (see Box 2). The funding is targeted at infrastructure development in the areas of energy, road and railway transport, where the economic rate of returns are very high and could have significant impact on economic growth and employment. It could also help transform the economy to a middle income status while assisting the country to achieve the MDGs by 2015.

3.2.3 The case of Ghana illustrates the understanding of donors of the need for non-concessional borrowing by a grant-eligible and MDRI-recipient country to supplement limited concessional resources, to help the country achieve the growth rates necessary to reach the MDGs. In this circumstance, some flexibility could be applied by accommodating Ghana's non-concessional borrowing.

3.2.4 Three other ADF-only RMCs namely, Kenya, Tanzania and Zambia, are reportedly considering raising capital through the Eurobond market in 2008

Box 2: ***Borrowing by Emerging Market Low Risk Economy: Case of Ghana***

1. Ghana seeks to achieve the MDGs and reach middle-income status by 2015. These are the main goals emphasized in the Growth and Poverty Reduction Strategy (GPRS II). In the absence of imminent scaling up of donor assistance, as acknowledged in the report of the 2007 IMF Article IV Consultation[1], this requires Ghana to access international capital markets for prudent and gradual non-concessional borrowing to finance carefully selected high-return projects in the infrastructure sector (energy, road and railway transport**)** to accelerate the process towards poverty reduction and growth. Accordingly, on 12 October 2007, Ghana successfully issued a US$ 750 million Sovereign 10-year Eurobond with a coupon rate of 8.5%. The issue was over-subscribed.

2. But this raises the concern regarding the balance between the goals of poverty reduction and growth, on the one hand, and Ghana's debt sustainability, on the other. During the IMF Article IV Consultation, a forward-looking Debt Sustainability Analysis (DSA) was conducted to examine Ghana's long-term debt sustainability in the face of the Eurobond issue. The DSA took into account planned non-concessional borrowing of US$ 700 million, over a 3-year period, and the baseline results indicate that the risks to the sustainability of Ghana's external debt are moderate to low. However, in comparison with the baseline scenario, in alternative scenarios of lower growth (scenario A), double non-concessional borrowing (scenario B), combination of lower growth and double non-concessional borrowing (scenario C), the results indicate moderate but notably higher risks of debt distress, with the indicators approaching the thresholds, as shown in Table A below. In Ghana's case, however, these risks could be partially mitigated by the high remittance inflows, which are not incorporated into the standard DSA indicators.

Table A

Ghana: External Public and Publicly Guaranteed Debt Burden Ratios (Percent)

Indicators						**Thresholds**
	2006	2006				
		Baseline	Scen. A	Scen. B	Scen. C	
NPV of Debt/GDP	18	28	36	35	39	**50**
NPV of Debt/Exports	46	121	182	151	199	**200**
Debt Service/Exports	12	13	19	18	24	**25**
Memorandum Items						
NPV of Debt/Exports & Remittances	34	80	…	…	…	…
Debt Service/Exports & Remittances	9	9	…	…	…	…

Source: IMF & World Bank Data

3. Ghana's example illustrates the tacit acknowledgement during the IMF Article IV Consultation of the need for non-concessional borrowing by a grant-eligible and MDRI-recipient country, in a situation where concessional resources are unavailable, to help the country achieve the MDGs and reach middle-income status by 2015. In this case, some degree of flexibility may be applied in which non-concessional borrowing could be accommodated.

1. See IMF: "Staff Report for the Article IV Consultation", IMF Country Report, No.: 07/210, June 2007

3.3 Borrowing by HIPC Interim Period RMCs

3.3.1 The Democratic Republic of Congo (DRC) provides an illustration of borrowing by a HIPC in the interim period. When the DRC reached the decision point under the HIPC initiative in July 2003, the Bank Group approved debt relief for the country[4], to enable it reach the completion point by December 2007. But DRC experienced some slippage in fulfilling all the conditions to reach the completion point on that date even though it continued to make progress

4 This was estimated at US$ 905.0 million, in net present value (NPV) terms.

towards the completion point. The level of debt relief granted by the Bank Group reached 27.3% of the total debt relief commitment at end July 2007. This left some room for additional debt relief from the Bank Group, with support from the HIPC Trust Fund, up to the authorized maximum ceiling of 40.0% during the interim period.

3.3.2 Based on satisfactory assessment of DRC's prospects for satisfying the key completion point triggers, and four additional eligibility criteria for extension of interim debt relief, and in consultation with the BWIs and the HIPC Trust Fund, the Bank Group decided to extend additional interim debt relief to DRC up to the 40.0% limit, from end-July 2007 to end-December 2008. During this period DRC is expected to reach the completion point[5].

3.3.3 Nevertheless, DRC's debt remains unsustainable. It has accumulated arrears to the Paris Club, and its debt sustainability and compliance with the negative pledge clause are of major concern to the donor community. Against this background, fundamental concerns have been raised about the terms of a financial transaction of between US$ 6.5 and $15 billion between DRC and a Chinese consortium. The terms of one of the two Master Agreements state that the funds to DRC will comply with the Debt Sustainability Framework (DSF) and concessionality of the loan.

3.3.4 But should the conditions of the China-DRC deal be outside the DSF and the SMP of the IMF, this will pose a serious problem for the positive conclusion of the SMP review. This could delay the preparation of a new PRGF, a key component of the completion point triggers, and affect DRC reaching the completion point and concluding satisfactorily the ongoing bilateral negotiations with Paris Club members. It is therefore necessary for the terms of the China-DRC deal to be concessional, and fully understood, to enable DRC to qualify for irrevocable debt relief at completion point.

3.3.5 During a recent Consultative Group (CG) meeting in Paris (29-30 November 2007), the Government of DRC and international partners made commitments to ensure continued progress in DRC. The Government stressed that its top priorities are achievement of the HIPC completion point, achievement of double-digit economic growth, and reaching the Millennium Development Goals by 2015. The Government also committed to ensuring that fresh debts will not further complicate the sustainability of its debt[6].

IV. IDA'S NON-CONCESSIONAL BORROWING (NCB) POLICY

4.1 Policy Measures adopted by IDA

4.1.1 IDA's response to the problem of non-concessional debt accumulation in post-MDRI and grant-eligible IDA-only countries is contained in its policy approved by the Board in July 2006. IDA's NCB policy is based on a two-pronged approach. The first component, which deals with collective action issues, focuses on enhancing creditor coordination around the Debt Sustainability Framework (DSF) as an agreed framework. The second, which focuses on moral hazard issues, entails discouraging non-concessional borrowing through disincentives aimed at the borrowing countries.

[5] See ref.: ADF/BD/IF/2007/237, dated 24 December 2007, paras 4.1-4.5
[6] See ADF/BD/IF/2008/02, dated 3 January 2008.

4.1.2 The key elements embodied in IDA's NCB policy are:

- *First, enhancing creditor coordination around the Debt Sustainability Framework* (DSF), by *updating creditor outreach on the DSF to export credit agencies, emerging market bilateral creditors and commercial creditors, as well as increased collaboration and active role by major regional banks in the Debt Sustainability Analysis (DSA) process*. The objective is to broaden acceptance of the DSF as an analytical basis for a common creditor approach to concessionality. This would include efforts to communicate debt relief, grant and non-concessional borrowing policies to the creditor community to reduce policy incoherence.

- *Second, discouraging non-concessional borrowing through borrower disincentives* (volume discounts and hardened terms) aimed at restraining instances of non-concessional debt accumulation. An in-house IDA monitoring committee has been established to monitor the reporting of planned new non-concessional borrowing. To strengthen borrower adherence to debt reporting requirements a new clause has been introduced in all grant agreements, and in credit agreements for post-MDRI countries, requiring advance reporting on planned new non-concessional borrowing.

4.1.3 IDA's borrower disincentive measures are designed and tailored to countries' risk of debt distress and their accessibility to financial markets. Under the Debt Sustainability Framework (DSF), countries are classified based on their risk of debt distress. Countries with high risk of debt distress are classified as "red light" countries; those with moderate risk of debt distress as "yellow light" countries; and those with low risk of debt distress as "green light" countries. For the grant-eligible countries, namely, the "red light" and "yellow light" IDA-only countries, the volumes-based disincentive measure is applied as follows:

- If a "red light" or "yellow light" country breaches the NCB policy, the country's nominal IDA grant is discounted by 20% to 40%; and

- If such a country consistently borrows from financial markets at non-concessional terms, often relying on the country's natural resources as collateral, in such cases, access to grants is suspended, and hardening of terms (see para 4.1.4 below) – possibly in combination with further volume cuts – is applied as a more effective sanction.

4.1.4 For "green light" countries, including MDRI beneficiaries, volume cuts are generally inappropriate as, among other reasons, they undermine the key MDRI goal of providing additional resources for the MDGs. The policy for a "green light" country breaching the NCB policy is to apply the following IDA terms:

- blend terms (35 years maturity; 10 years grace period; 0.75% service charge; and 0.5% commitment fee) with a grant element of 57%;

- hardened terms (20 years maturity, 10 years grace period, same charges), with a grant element of 40%; or

- a less concessional "hard-term" window (hardened terms plus interest rate at 200 basis points below the IBRD lending rate in fixed-rate terms) with a grant element less than 20% – already applicable to India, Indonesia, and Pakistan – is extended to post-MDRI "green light" resource-rich countries with high levels of market access.

- volume discounts could be considered for fragile “green light” MDRI beneficiaries which are not diversified, have small export bases, and are highly vulnerable to exogenous shocks; DSAs and country economic work could help to establish “green light” countries for which hardening of terms would not be recommended.

4.2 Implementation Experience

4.2.1 Regarding the first pillar of the NCB policy, IDA and IMF have undertaken extensive outreach activities involving constructive dialogue on the DSF with export credit agencies, the OPEC Fund, other multilateral creditors and some emerging market donors (China and India) [7]. A formal agreement has also been concluded in December 2007 with the major regional development banks (AfDB, AsDB, IaDB, EBRD) on a more active role of the RDBs in the DSF process, particularly in the field missions on forward-looking DSAs.

4.2.2 With regard to the implementation of the second pillar of the IDA NCB policy, only Angola has been affected and documented by IDA to date. As noted earlier (para 3.1.1), Angola has contracted substantial amounts of non-concessional borrowing since 2004. Implementation of IDA’s NCB policy led to the decision to harden the terms of Angola’s new borrowing in FY08. This decision was based on the country-specific and the loan-specific factors as outlined in IDA’s NCB policy paper[8]. The hardened terms implied a grant element of 11% on all new IDA loans to Angola in FY08. The specific elements include: (i) a fixed interest rate of 4.2%; (ii) 35 years maturity; (iii) 10 years grace; and (iv) the standard IDA commitment fee of 0.5% and service charge of 0.75%.

4.2.3 But this decision has had, and could potentially have mixed results. On the one hand, with IDA’s financing dwarfed by the large non-concessional sources of financing, the overall effect of the hardened terms is small and has not served as an incentive for Angola to discontinue its non-concessional borrowing. On the other hand, the decision might free up scarce IDA concessional resources for reallocation to other countries more in need.. IDA’s Angola Interim Strategy Note (ISN) outlines continued engagement with the government in policy dialogue, lending and non-lending technical assistance operations[9].

V. BANK GROUP POLICY ON NON-CONCESSIONAL DEBT ACCUMULATION

5.1 Guiding Principles

The following principles will guide the Bank Group policy on non-concessional borrowing and debt accumulation: (i) there should be strong partnership and coordination with sister MDBs and bilateral agencies; (ii) measures should be effective; (iii) measures should be implementable; and (iv) diversity in country circumstances will require some flexibility and a case by case approach. The proposed policy is intended to be comprehensive, designed to

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[7] See IDA: “The Role of IDA in Ensuring Debt Sustainability: A Progress Report”, paras 37-51: paper presented at the third IDA15 replenishment meeting, Washington, DC., 23 October 2007.

[8] Ibid., Annex 4. The country-specific factors cover: (i) overall borrowing plans of the country; (ii) impact of borrowing on the macroeconomic framework; (iii) impact on the risk of debt distress; (iv) strength of polices and institutions, especially public expenditure management and debt management policy. The loan-specific factors covered: (i) development content and potential impact of the loan; (ii) estimated economic, financial, and social rates of return; (iii) lender equity stake in the project; (iv) collateralization and hidden costs; other sources of concessional resources available; and (v) concessionality of the overall financing package.

[9] See IDA: Angola – Interim Strategy Note (ISN), Report No.: 39394-AO, May, 2007., paras 40-61. See also Box 1 above.

address non-concessional borrowing not only by the natural resource-rich RMCs, but also the emerging market low risk RMCs as well as the HIPC interim-period RMCs as well.

5.2 Specific Policy Measures

5.2.1 The Bank Group policy on non-concessional debt accumulation will focus on the following four broad areas:

a) Deepen Partnership and Donor Coordination

(i) Strengthen partnerships and coordination with sister MDBs and bilateral agencies for adopting a common strategy in dealing with the free-rider issue, including advocacy;

(ii) Ensure participation in joint IMF/IDA forward-looking DSA exercises, as already formally agreed with the Heads of IMF/IDA, including better information sharing on RMCs' financial/debt situations, with access to recommendations made by the IDA Committee on non-concessional borrowing; and

(iii) Broaden participation in joint outreach exercises with MDBs and bilateral donors, through seminars and workshops to sensitize potential creditors, including emerging bilateral and commercial creditors, to adopt the DSF as a common creditor approach to concessionality.

b) Strengthen Reporting and Monitoring

(i) Create an inter-departmental Committee to monitor regular reporting on the status of non-concessional borrowing in grant-eligible and HIPC/MDRI relief beneficiary RMCs, with the Vice President, ORVP, as Chairperson;

(ii) To encourage transparency, ADF loan/grant recipients and HIPC/MDRI beneficiary countries will, in all loan and grant Agreements, commit to inform the Bank at least 3 months in advance of any new planned non-concessional borrowings and/or collateralized external transactions;

(iii) Add a specific clause in grant agreements for countries that will be recipients of the Fragile States Facility (FSF) supplementary funds, to indicate that a volume discount will apply on the supplementary funds, or the supplementary funds would not be forthcoming, in the wake of new non-concessional borrowing;

c) Enhance Collaboration in Capacity Building

(i) Collaborate more closely with other partners, especially IDA, in work to improve debt data quality, recording and reporting, as well as in building institutional capacity in RMCs in debt management, macroeconomic and fiscal management.

d) Apply Disincentive Measures

5.2.2 Management will replicate IDA's disincentive measures on RMCs that breach the Bank Group's NCB policy, by applying volume discounts and hardening of terms on borrowers (similar to IDAs) [10], while exercising some degree of flexibility, on a case by case basis.

5.2.3 Specifically, measures will be tailored to RMCs classified under the "red light", "yellow light" or "green light" of the DSF debt distress risk categories (see Annexes 1 and 2) as follows:

(i) If a "red light" or "yellow light" country breaches the Bank Group's NCB policy, the policy would reduce the country's nominal ADF grant by 20% to 40%;

(ii) If such a country consistently borrows from third parties at non-concessional terms, the policy would suspend access to grants, and harden terms – possibly in combination with further volume cuts;

(iii) For "green light" countries that breach the NCB policy, hardened terms will be applied, similar to the measures adopted by IDA as described in paragraph 4.1.4 above. Specifically:

- moderate terms (40 years maturity, 10 years grace period, 0.75% service charge; and 0.5% commitment fee) , with a grant element less than 60%;

- hardened terms (20 years maturity, 10 years grace period, same charges), with a grant element less than 45%; or

- higher level hardened terms will apply (hardened terms, plus interest rate at 200 basis points below the ADB fixed lending rate) with a grant element less than 20% – already applicable to Angola – will be extended to post-MDRI "green light" resource-rich countries with high levels of market access;

- consider volume discounts for fragile "green light" MDRI beneficiaries which lack economic diversification, have small export bases, and are highly vulnerable to exogenous shocks (droughts, floods, earthquakes, etc.) which could easily slip them back into "yellow light" or even "red light" status; DSAs, country economic work, and further analysis will be used to identify, in consultation with other MDBs, "green light" countries for which volume discounts rather than hardening of terms would be recommended.

5.2.4 Where non-concessional borrowing is contracted by low-risk, low-income RMCs, with strong policies and institutions, for which there is already some evidence of capital market interest in financing their development projects, some flexibility may be warranted. In such cases, transparently contracted non-concessional borrowing may supplement limited concessional resources to finance self-sustaining enclave projects with demonstrable capacity to

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[10] The principle of replicating IDA's disincentive measures strengthens partnership, coordination and policy harmonization among IFIs as stated in the Paris Declaration on Aid Effectiveness. Policy harmonization is being extended to bilateral donors and emerging market agencies as well (see para 4.2.1 above) in order to facilitate effective implementation of the NCB policy.

repay. Accordingly, in such cases, some degree of flexibility could be applied, in harmony with IDA, in accommodating their non-concessional borrowing, to help the countries reach investment levels required to achieve the growth rates necessary to reach the MDGs and achieve middle income status. Such flexibility will continue to be applied so long as debt sustainability is maintained.

5.2.5 HIPCs that breach the NCB policy in the interim period, such as DRC, will be required to make additional efforts to revise the lending terms to be concessional as this is a key requirement to pave the way for the country to qualify for irrevocable debt relief at the completion point. The Bank's policy will be to not propose extended interim debt relief if non-concessional debt is contracted during the interim period.

5.2.6 Effectiveness of the disincentive measures will be improved if there is intensified joint action with other development partners, including emerging market bilateral donors.

5.3 Challenges for Effective Implementation and Mitigative Measures

5.3.1 Several issues and implications need to be taken into consideration to achieve a measure of success in implementation.

5.3.2 First, there is no dedicated donor forum for discussion and information sharing on non-concessional borrowing behavior by grant-eligible and HIPC/MDRI relief recipient RMCs. The current MDBs Annual Meetings on Debt Issues, Stakeholders Meetings on Debt Management[11], or other fora, do not specifically address this issue. **The Bank will join efforts to establish a forum for the MDBs and seek to extend it to bilateral agencies for information sharing on non-concessional borrowing, and for collective action. The Bank will also work to open dialogue with bilateral lenders providing resources on such terms.**

5.3.3 Second, there is an absence of adequate information from either lenders or borrowers on non-concessional debt accumulation. For example, information on non-concessional borrowing transactions involving emerging market donors and commercial market creditors are not readily available, particularly on the exact financing terms of the loan contracts. **During dialogue missions, borrowers will be urged to provide adequate information on loan terms in order to facilitate monitoring their debt sustainability going forward; cases of insufficient information sharing will be brought to the attention of the Board.**

5.3.4 Third, as illustrated by the case of Angola (Box 1), there is little impact of the sanctions from the disincentive measures on countries breaching the NCB policy if the share of Bank Group support is small relative to the external non-concessional capital inflows. This remains a serious challenge to the effectiveness of the sanctions intended from the disincentive measures. **In this context, the disincentive measures will be seen not as punitive but as a means of emphasizing the fact that countries which can afford non-concessional resources may have to cede the scarce resources to the needy ADF beneficiaries.**

[11] During the recent Debt Management Stakeholders' Conference held in Oslo, Norway (5-6 March 2008), in which the Bank participated, the problem of non-concessional borrowing was discussed among other related issues, and a plan of action agreed. This includes establishing the Debt Management Facility for LICs (DeMFLIC), a multi-donor technical assistance facility, to support two ongoing technical assistance operations: (i) Debt Management Performance Assessments (DeMPA) in up to 60 LICs over three years, and (ii) the design of Medium-Term Debt Management Strategies (MTDS) in 4 to 6 LICs

VI. ACTION PLAN FOR IMPLEMENTATION

6.1 Implementing the measures outlined above, will require effective coordination within the Operations Complexes, and Regional and Policy Departments, the Finance Complex (FNVP), the Chief Economist's (ECON) Complex, and the Legal Department. Coordination with partner multilateral institutions will also be essential. Information on monitoring and reporting of non-concessional borrowing will be provided to the Boards through periodic Information Notes. The specific inter-departmental and institutional arrangements of the implementation modalities are outlined in the Policy Implementation Matrix in Annex 3.

6.2 In view of the fact that there have already been major developments affecting ADF grant allocations via the Debt Sustainability Framework, as well as the effects of the HIPC and MDRI debt relief on the beneficiary countries, there is need for immediate implementation of the Bank Group NCB policy. Annex 3 also presents the timeline for immediate implementation of the measures. Management will monitor the implementation of the policy and submit reports to the Board periodically, and in line with the agreed timeline.

VII. CONCLUSION AND RECOMMENDATION

7.1 This paper has examined the Bank Group policy for addressing the problem of non-concessional borrowing by ADF grant recipients and beneficiaries of HIPC/MDRI debt relief. It reviewed the IDA policy on non-concessional borrowing and its implementation, and drew lessons from the experience in designing the Bank Group policy. The Bank Group NCB policy was then presented under four broad measures for: (i) coordination and partnership; (ii) reporting and monitoring; (iii) capacity building; and (iv) applying the disincentive elements.

7.2 The Boards of Directors are hereby invited to consider and approve the Bank Group policy on non-concessional borrowing and debt accumulation by ADF grant-eligible and HIPC/MDRI debt relief beneficiaries.

ANNEX 1

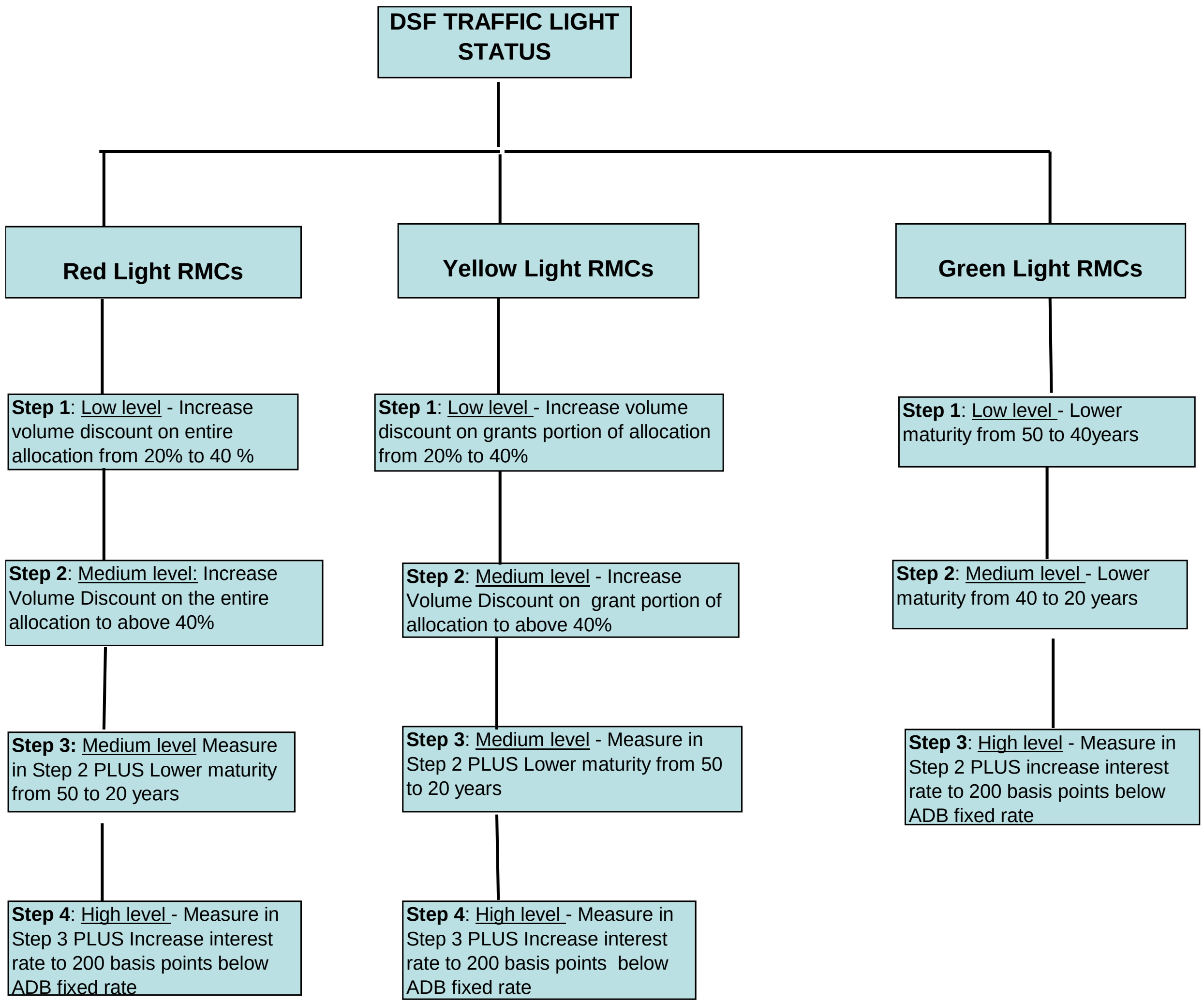
Countries Subject to ADF's Non-Concessional Borrowing Policy **

"Red Light" Countries	*"Yellow Light" Countries*	*"Green Light" Countries*
Burundi	Angola	Cape Verde
Central African Republic	Benin*	Cameroon*
Chad	Burkina Faso*	Ghana*
Comoros	Ethiopia*	Kenya
Congo, DRC	Lesotho	Madagascar*
Congo, republic of	Malawi*	Mali*
Cote d'Ivoire	Mauritania*	Mozambique*
Djibouti	Niger*	Senegal*
Eritrea	Sierra Leone*	Tanzania*
Gambia, The*		Uganda*
Guinea		Zambia*
Guinea Bissau		
Liberia		
Rwanda*		
Sao Tome & Principe*		
Somalia		
Sudan		
Togo		

(*) The 19 RMCs which have already reached HIPC completion point, and are beneficiaries of MDRI relief.
(**) This list is subject to change, whenever there is reclassification of RMCs by the Debt Sustainability Framework (DSF) as other countries qualify for ADF grants and/or MDRI relief. It includes all RMCs currently eligible for ADF grants under the DSF as well as beneficiaries of MDRI relief.

ANNEX 2

Application of Disincentive Measures under the Bank Group NCB Policy



Notes:

1. The level of the breach in non-concessional borrowing is determined by the magnitude of the concessionality breach and/or size of the breach relative to a country's ADF allocation. Low level refers to a situation where a loan has a concessionality level close to 35% and is small relative to a country's ADF allocation. Medium level refers to a concessionality level much less than 35% and/or a large size relative to the ADF allocation. High level refers a concessionality level much less than 35% and/or a volume which is a multiple of the country's ADF allocation.
2. In case of repeated non-concessional borrowing, volume reductions or hardening of terms can be extended or deepened.
3. For fragile "green light" MDRI beneficiaries, volume discounts could be considered a possibility as these RMCs are not diversified, have small export bases, and are highly vulnerable to exogenous shocks. which might easily slip them back into "yellow light" or even "red light" status

ANNEX 3

BANK GROUP POLICY ON NON-CONCESSIONAL BORROWING
POLICY IMPLEMENTATION MATRIX

	POLICY MEASURES	KEY ELEMENTS OF THE POLICY	INSTITUTIONAL COORDINATION	TARGET DATE FOR ACTION
1.	Deepen Partnership and Donor Coordination	▪ Strengthen partnerships and coordination with sister MDBs and bilateral donors, to adopt a common strategy in dealing with the free-rider issue, including advocacy	▪ ORPC, on behalf of the Bank Group, liaises with IDA, other IFIs, and bilateral donors in the coordination process	▪ Q1 2008 & Ongoing
		▪ Deepen Bank Group participation in forward-looking IMF/IDA DSA exercises, including information sharing on non-concessional borrowing	▪ ORPC & EDRE participate in joint IMF/IDA DSA exercises	▪ Q1 2008 & Ongoing
		▪ Bank Group participation in joint outreach exercises with MDBs and bilateral donors, through sensitization seminars and workshops in order for all to adopt DSF as common creditor approach to concessionality	▪ ORPC liaises with IDA and other IFIs in outreach exercises to emerging market donors and agencies	▪ Q2 2008 & Ongoing
2.	Strengthen Borrower Reporting and Donor Monitoring	▪ Create inter-departmental Committee to monitor regular reporting on status of non-concessional borrowing by grant-eligible and HIPC/MDRI debt relief beneficiary RMCs	▪ Membership will include ORPC, FFMA, FTRY, FFCO, Regional Operations and Research Departments, and chaired by Vice President, ORVP	▪ Q1 2008
		▪ Include clause in all Bank Group grant/loan agreements requiring advanced reporting on planned new non-concessional borrowing, including negative pledge clause against collaterized resources	▪ GECL, with ORPC support, is to include additional clause in loan/grant agreements	▪ Q1 2008
		▪ Add specific clause in grant agreements for recipients of Fragile States Facility (FSF) supplementary funds indicating that volume discount will apply, or the supplementary funds cancelled, in case there is non-concessional borrowing	▪ GECL, with support from ORPC and FFMA, is to include additional clause in loan/grant agreements	▪ Q1 2008
3.	Enhance Collaboration in Capacity Building	▪ Collaborate more closely with other partners, especially IDA, in work to improve debt data quality, recording and reporting, as well as in building institutional capacity in RMCs in debt management, macroeconomic and fiscal management	▪ ORPC, ESTA and PDRE to liaise with IDA, other IFIs, and bilateral donors in capacity building activities	▪ Q1 2008 & Ongoing

	POLICY MEASURES	KEY ELEMENTS OF THE POLICY	INSTITUTIONAL COORDINATION	TARGET DATE FOR ACTION
4.	Apply Disincentive Measures on a case by case basis	▪ If a “red light” or “yellow light” country breaches the NCB policy, the policy will reduce the country’s nominal ADF grant by 20%,to 40%	▪ ORPC, with support from Regional Departments, will apply this disincentive measure	▪ Q1 2008 & Ongoing
		▪ If a “red light” or “yellow light” country consistently borrows at non-concessional terms, the policy will suspend access to grants, and harden terms – possibly in combination with further volume cuts	▪ Before decision by ORPC and Regional Departments on application of hardened terms, Boards endorsement of the measure will be necessary.	▪ Q1 2008 & Ongoing
		▪ For “green light” RMCs that breach the NCB policy, the policy will apply hardened terms that range from moderate terms to relatively more severe terms	▪ ORPC, with support from Regional Departments, will apply this disincentive measure.	▪ Q1 2008 & Ongoing
		▪ For “green light” resource-rich RMCs borrowing consistently at non-concessional terms, hardened terms will apply plus interest rate at 200 basis points below the ADB fixed lending rate, with a grant element below 20%.	▪ Before decision by ORPC and Regional Departments on application of hardened terms, Boards endorsement of the measure will be necessary	▪ Q1 2008 & Ongoing
		▪ For emerging market low-income RMCs, for which there is evidence of capital market interest in financing their development projects, flexibility could be applied in accommodating their non-concessional borrowing, to help them reach the MDGs and achieve middle-income status	▪ Advice and endorsement by the Boards will be necessary before decision is taken to exercise flexibility in waiving the disincentive measure	▪ Q1 2008 & Ongoing
		▪ For HIPCs in interim period, the Bank’s policy will be to not propose extended interim debt relief if non-concessional debt is contracted during the interim period.	▪ GECL, with ORPC support, will include additional clause in loan/grant agreements, while technical assistance is provided to revise loan terms that are non-concessional to make them concessional	▪ Q1 2008