



Amendments to the Bank Group Policy on Non-Concessional Debt Accumulation

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&
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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
ADF-12	Twelfth General Replenishment of the African Development Fund
AfDB	African Development Bank Group
BWIs	Bretton Woods Institutions
CIRR	Commercial Interest Reference Rate
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee
DRC	Democratic Republic of Congo
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
FSF	Fragile States Facility
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IMF	International Monetary Fund
LICs	Low Income Countries
MDBs	Multilateral Development Banks
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
NCB	Non-Concessional Borrowing
NPV	Net Present Value
OECD	Organization for Economic Cooperation and Development
PBA	Performance Based Allocation
PEFA	Public Expenditure and Financial Accountability
PRGF	Poverty Reduction and Growth Facility
RMCs	Regional Member Countries
UA	Units of Account

EXECUTIVE SUMMARY

1. The provision of grants and debt relief to eligible ADF countries is intended to help bring their debt to sustainable levels and create fiscal space for priority development expenditures. The accumulation of new debts on non-concessional terms by these 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 against future export receipts.

2. The Boards of Directors of the African Development Bank Group approved in 2008 the *Bank Group Policy on Non-Concessional Debt Accumulation* with the view to mitigating the impact of rapid accumulation of non-concessional debt on grant-eligible post-HIPC/MDRI debt relief ADF countries and guiding the use of its concessional resources. The policy, which is closely aligned with the World Bank's IDA policy on non-concessional borrowing and the IMF's external debt limit policy, is based on a two-pronged approach: enhancing creditor coordination around the joint IMF-World Bank Debt Sustainability Framework, and; discouraging unchecked non-concessional debt accumulation by applying compliance measures, including volume discounts and hardening of borrowing terms of ADF loans.

3. This paper proposes for Board consideration amendments to the 2008 *Bank Group Policy on Non-Concessional Debt Accumulation*, in line with Management's ADF-12 Implementation Commitment. The proposed amendments are intended to provide a more flexible and streamlined approach to guide the application of the Bank Group's policy and prudent non-concessional borrowing by regional member countries (RMCs). The amendments are aligned with the recent changes adopted by the IMF as regards its external debt limit policy and concessionality framework, and bring the Bank's policy up to date with current practices in supporting low income countries' financing needs. The proposed amendments do not introduce parallel technical or policy frameworks but rather focus on applying the IMF-World Bank framework while allowing the Bank Group to use informed judgment in responding to the specific development challenges African countries face. This is consistent with the Bank Group's commitments to Paris and Accra declaration on donor harmonization and coordination.

4. Specifically, Management proposes for Board consideration the following amendments to the 2008 *Bank Group Policy on Non-Concessional Debt Accumulation*;

- (i) Introduce more flexibility in determining the Bank Group's concessionality limits, by replacing the single benchmark grant element of 35 percent approach with a more nuanced concessionality framework, to better take into account the diversity of country circumstances as reflected in their debt vulnerability and their debt management capacity. For ADF-only countries with low risk of debt distress (green light countries), flexibility will be applied to accommodate their non-concessional borrowing needs consistent with the assessment of their debt management capacity, while for ADF-only countries assessed to have a moderate and high risk of debt distress (yellow light and red light countries), the previous minimum concessionality limit of 35 percent will continue to apply with a limited flexibility. This amendment would provide greater flexibility to nearly half of ADF-only countries to access some level of non-concessional external debt; thereby enabling them to mobilize much-needed additional development resources.
- (ii) With the view to ensuring ADF resources are channeled to those countries that need concessional resources the most, and to reducing the risk of moral hazard with

respect to borrowers, the amendments include a more streamlined mix of compliance measures that will be applied on a case by case basis to client countries that breach the policy. The compliance measures range from moderate to hardened terms, taking into account the scale of the breach, and are intended to ensure consistency with application of the new concessionality approach.

5. The Bank Group's approach to mitigating the accumulation of unsustainable non-concessional debt by ADF countries continue to be anchored on the guiding principles of strong partnership and coordination; flexibility and country-differentiated approach; and effective and implementable measures. Within this broad framework, the four pillars of the 2008 *Bank Group Policy on Non-Concessional Debt Accumulation* will continue to apply: (i) Strengthening partnerships and coordination with sister financial institutional and bilateral agencies, with the view to adopting a common strategy in dealing with the problem, including conduct of Debt Sustainability Analysis exercises, outreach and advocacy exercises; (ii) Maintaining a standing inter-departmental Committee to monitor the status of non-concessional borrowing; (iii) Ensuring the inclusion of and close monitoring of adherence to a clause requiring reporting on new non-concessional borrowing in all ADF grant/loan agreements for ADF-only borrowers; and (iv) Enhancing economic and debt management capacity building support at country and regional levels, in collaboration with other partners.

6. The Bank Group's policy on non-concessional borrowing should not be viewed in isolation of the broader context of the Bank Group's efforts to support and facilitate RMCs efforts to achieve their development goals. Management is acutely cognizant of the need for striking the right balance between the policy objectives of debt sustainability and financing for development. The proposed amendments reflect the Bank Group's attempt to move in this direction by adopting a country-differentiated concessionality framework that supports client countries' debt sustainability. In view of the fact that in a fast-changing global economic reality there are real implications for development financing flows to African low income countries, the Bank Group's approach and policy on non-concessional borrowing will be reviewed regularly to take into account lessons and policy frameworks that are more enabling to RMCs' development agenda.

7. The Boards of Directors are invited to consider and approve the proposed amendments to the 2008 *Bank Group Policy on Non-Concessional Debt Accumulation*.

AMENDMENTS TO THE BANK GROUP POLICY ON NON-CONCESSIONAL DEBT ACCUMULATION

1. INTRODUCTION

- 1.1. The provision of grants and debt relief to eligible countries over the past decade has strengthened the prospects for new financial flows, including resources contracted on non-concessional terms. However, borrowing on non-concessional terms by ADF-only and debt relief beneficiary countries could potentially lead to a rapid accumulation of unsustainable debt. Concessional loans and debt relief grants provided through the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) could also cross-subsidize non-concessional borrowing from third party lenders offering loans on hard terms. This risk of free-riding is higher in resource-rich countries that are able to borrow on non-concessional terms collateralized by future income receipts.
- 1.2. In order to govern the Bank Group's use and allocation of concessional resources and support client countries' debt sustainability efforts, the Board of Directors of the Bank Group adopted the *Bank Group Policy on Non-Concessional Debt Accumulation* in 2008.¹ Similar to the World Bank's International Development Association (IDA), the Bank Group uses the International Monetary Fund (IMF) policy on external debt limit to guide and coordinate its decision-making on the appropriate level of concessionality² in its loan packages, as well as all other loans ADF-only countries subject to the Bank Group's policy on non-concessional borrowing (NCB) could undertake.
- 1.3. During the Twelfth Replenishment of the African Development Fund (ADF-12) Management committed to make amendments to the Bank Group NCB policy to reflect recent changes adopted by the IMF in its debt limit policy, and the revised guidance note on the application of the joint IMF-World Bank Debt Sustainability Framework (DSF)³. The changes on debt limit policy were introduced by the IMF in 2009 in response to request from its shareholders and low-income client countries to better take into account the complexity and diversity of countries' situations and respond more effectively to their development financing needs. This led to the introduction of a concessional matrix that provides an analytical framework for assessing countries' debt vulnerability as well as their debt management capacity in deciding the concessional limit that would best serve their circumstances. Thus, instead of applying a single benchmark for all low-income countries, the revised concessional framework allows for a differentiated approach in setting external debt limits depending on how a country's debt vulnerability (defined as low or high) maps against its debt management capacity (also defined as low or high).
- 1.4. Accordingly, this paper proposes that the Bank Group adopts a more flexible concessional framework to address the diverse needs and capacities of regional member countries (RMCs), and streamline the NCB policy compliance measures to

¹ See ADB/BD/WP/2008/16/Rev.2/Approved – ADF/BD/WP/2008/Rev.2/Approved.

² According to the 2008 Bank Group NCB policy, a loan is considered concessional if it attains a benchmark grant element of at least 35 percent. This is consistent with concessional benchmark used by the IDA, IMF, other regional development banks and some bilateral donors.

³ Annex 1 provides a summary of the revised DSF staff guidance note issued by the BWIs in early 2010, its implication for the Bank Group and Management's approach for enhancing Bank Group's operational engagement in this area.

ensure consistency and smooth implementation of the new concessionality framework. Given the Bank Group's commitment to donor coordination and harmonization, these amendments do not introduce parallel technical or policy frameworks but rather focus on applying the IMF-World Bank framework while allowing the Bank Group use informed judgment and take into account the specificity of African countries where applicable. This is also in line with the Bank Group commitment to donor coordination, harmonization of policies and division of labor with other financial institutions and development banks.

- 1.5. This paper is organized in five main sections. Following this introduction, Section 2 recaps conceptual and operational issues on concessionality of new borrowing. Section 3 reviews the current Bank Group policy and proposed revisions, drawing from implementation experience and lessons learned. Section 4 discusses potential challenges and mitigation measures, including an action plan for implementation. The last section presents the conclusion and recommendation for Board consideration.

2. CONCEPTUAL AND OPERATIONAL ISSUES ON CONCESSIONALITY OF NEW BORROWING

Debt Sustainability and Financing for Development

- 2.1. Against a background of a large unmet demand for concessional financing, regional member countries are faced with the difficult trade-offs between short term development financing needs and long-term debt management issues, which have become even more acute in the context of the global financial and economic crisis and the fast-approaching Millennium Development Goals milestone. Several African low-income countries are considering the merits and drawbacks of non concessional loans. At the same time, a number of countries that have benefitted from HIPC/MDRI debt relief continue to experience deteriorating debt sustainability outlooks due to existing vulnerabilities and exogenous shocks.
- 2.2. Given that policies that aim to curtail non-concessional debt accumulation may result in fewer resources available for the MDGs in the countries concerned, 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 its development objectives. Thus, the contracting of new non-concessional debt has to be prudently balanced against countries' development investment priorities, for instance by focusing on areas with demonstrable impact on growth such as infrastructure, in order to prevent a re-emergence of debt trap. While prudent macroeconomic policies and sound debt management practices are essential to ensuring low income countries' debt sustainability, equally important is the mix and level of development financing at their disposal. This has become more so important in the context of the economic and budgetary challenges faced by advanced economies in recent times, and the risk of long-term decline in the flow of concessional resources to low income countries.
- 2.3. Robust domestic resource mobilization mechanisms are critical in establishing the long-run self-sustainability of developing countries. African countries are increasingly looking for home-grown solutions such as strengthening the regulatory and policy frameworks for domestic resources mobilization (DRM), developing regional debt and financial markets, including sovereign wealth funds. The Bank Group through its sector departments and policy dialogue will continue to provide support to governments'

efforts to mobilize resources through taxation and other forms of public revenue generation and also through stronger regulatory environments. These efforts would facilitate and encourage household and business savings, financial services deepening and intermediation to support productive activities and investments. The Bank Group will continue to explore ways to further enhance DRM as part of the Country Strategy Papers (CSPs) and Regional Integration Strategy Papers (RISPs); encouraging additional studies and innovations on DRM approaches; and strengthening and developing local capital markets e.g. domestic debt markets in Africa through the Bank's African Financial Markets Initiative (AFMI). Such efforts will not only open avenues for tapping into domestic savings and investors, but can also facilitate investments in local currency-denominated debt issued by sovereign and sub-sovereign entities for infrastructure and productive sectors of RMCs' economies. This would help complement concessional and non-concessional foreign resources and contribute to reduction of volatility of resource flows.

Non-Concessional Borrowing Policy

- 2.4. The Bank Group's objective in designing a policy on non-concessional borrowing is to govern the use and allocation of its concessional resources in a manner that supports RMCs' development agenda and their long-term debt sustainability goals (see Annex 2 for list of ADF countries subject to the Bank Group NCB policy). Within this overall framework, one of the concerns with non-concessional borrowing by ADF-only countries, in particular grant-eligible and post-debt relief countries is that ADF resources and/or HIPC/MDRI debt relief could potentially cross-subsidize lenders that offer non-concessional loans to recipient RMCs. While the Bank Group and other multilateral development banks (MDBs) aim to lower the risk of debt distress in low-income countries by providing new financial assistance on appropriately defined concessional terms, other creditors could undermine this objective by extending new non-concessional loans to post-debt relief countries on less favorable terms.
- 2.5. There is also a potential moral hazard problem with respect to borrowers. ADF grants and debt relief could create an incentive for countries to over-borrow from other creditors which in turn could lead to their debts becoming unsustainable and compel ADF and the other MDBs to increase the grant share of their assistance. This is particularly the case in situations where the fiscal and external debt situation of African low-income countries has improved substantially as a result of HIPC/MDRI debt relief, improved revenue mobilization efficiency and strong economic growth.

Determining the Appropriate Concessional Benchmark

- 2.6. 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 borrowing by selecting an appropriate concessional benchmark. Although there is no clear definition of concessional, in practice, two alternative approaches have been adopted in the literature on how to deal with this measurement problem.
- 2.7. The definition of concessional by the Organization for Economic Cooperation and Development (OECD)'s Development Assistance Committee's (DAC) uses a flat discount rate of 10 percent, and is based on a benchmark grant element of at least 25 percent. In contrast, the standard IMF definition of concessional, used by the Bank Group, IDA and the major regional development banks, 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 percent. Compared to the DAC methodology, the IMF concessionality definition results in a higher share of non-concessional debt.⁴ The major drawback of the DAC methodology is that the fixed 10 percent discount rate used implies that even commercial loans could be classified as concessional in low interest rate environments – resulting in an underestimation of the share of non-concessional debt in a portfolio of projects. 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.

- 2.8. The Bank Group will continue to use the benchmark grant element of 35 percent to guide decision on concessionality limits for ADF-only countries going forward. However, the previous one-size-fits-all concessionality limit will be replaced by country-specific concessionality limits based upon each country's public financial management capacity as evidenced by its Country Policy and Institutional Assessment (CPIA) and Public Expenditure and Financial Accountability (PEFA) indicators on the one hand, and its debt vulnerability on the other hand, as evidenced by its debt distress profile in the annual Debt Sustainability Analysis (DSA) exercise. This is discussed in more details in Section 3, paragraph 3.7-3.18.

Bank Group's Role in Promoting Debt Sustainability and Debt Management Capacity

- 2.9. The Bank Group's policy on non-concessional borrowing should be viewed within the broader context of the Bank Group's efforts to support RMCs efforts to finance and implement their development programs. The policy complements the Bank Group's current efforts in debt-related and ongoing work streams in various areas including: (i) debt management capacity-building activities implemented within the Bank Group's governance portfolio; (ii) its leadership role as a donor and active participant in the Debt Management Facility⁵ – possibly taking on a donor coordination role in selected regional member countries; (iii) enhancing partnerships and synergies with the other multilateral development banks, including the IDA's Debt Reduction Facility, to address commercial debt issues in HIPC countries through the African Legal Support Facility; (iv) deepening engagement and partnerships with and with non-traditional donors on issues of development financing, promotion of debt management capacity building and information-sharing; and (v) undertaking in-depth analytical work to better inform the Bank Group's policy and operational engagement – such as the currently ongoing work by the Economic Development Research Department on review of the methodology and application of DSF policy-indicative thresholds to ADF countries.

⁴ 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 percent 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, 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 percent 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 percent (i.e., concessional). On the other hand, the IMF methodology would estimate the grant element at only about 21 percent (i.e., non-concessional).

⁵ The Board of Governors approved in July 2010 the Bank Group's participation in the Debt Management Facility, as a Donor, with a contribution of USD 1 million (ADB/BD/WP/2010/52/Approval).

3. REVIEW OF THE BANK GROUP NON-CONCESSIONAL BORROWING POLICY AND PROPOSED AMENDMENTS

3.1. The 2008 Bank Group NCB policy was intended to be comprehensive, designed to address non-concessional borrowing not only by natural resource-rich RMCs, but also emerging market low-risk RMCs as well as the HIPC/MDRI debt relief beneficiaries. The following **guiding principles** will continue to guide the Bank Group revised NCB policy and debt accumulation:

- i. there should be strong partnership and coordination with sister financial institutions, MDBs and bilateral agencies;
- ii. measures should be effective and implementable; and
- iii. diversity in country circumstances will require some flexibility and a case by case approach.

3.2. Non-concessional borrowing that is transparently contracted by RMCs with low-risk of debt distress and strong policies and institutions may supplement limited concessional resources to finance self-sustaining high-impact projects with demonstrable capacity to repay.⁶ In such cases, some degree of flexibility is applied in close coordination with sister institutions, to help RMCs reach investment levels required to boost growth and attain the Millennium Development Goals. The Bank Group will apply such flexibility provided that the country in question maintains a sustainable level of public debt.

3.3. **Specific Policy Measures under the 2008 Bank Group Non-Concessional Borrowing Policy** are outlined in the following four pillars:

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 active participation in joint IMF/World Bank forward-looking DSA exercises, as already formally agreed with the Heads of IMF/World Bank, 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. Maintain a standing 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. Include a clause in all Bank Group grant/loan agreements to require advance reporting on planned new non-concessional borrowing. This will include a negative pledge clause requiring client countries not to enter agreements in

⁶ Projects financed under the Bank Group's Enclave Policy are not subject to the Bank Group non-concessional borrowing policy.

which grants and HIPC/MDRI debt relief resources are used as collateral for new non-concessional debt; and

- 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*

- i. To address the challenges of rapid accumulation of unsustainable external public debts, potential cross-subsidization of non-concessional loans and moral hazard risks the Bank Group introduced a set of measures aimed at discouraging unchecked non-concessional debt accumulation which might compromise borrower countries' ability to meet their repayment obligations and to sustainably finance their development needs. The approach in applying these compliance measures reflects the magnitude of the breach relative to the standard concessionality limit of 35 percent.
- ii. The Bank Group applies disincentive measures⁷ to RMCs that breach the Bank Group's NCB policy, by applying volume discounts and hardening of terms to borrowers, while exercising some degree of flexibility, on a case by case basis (see Annex 4 for more detail). Specifically, measures are tailored to RMCs classified under the DSF debt distress risk categories as red light (high risk of debt distress), yellow light (moderate risk) or green light (low risk).

Lessons Learned from Implementing Non-Concessional Borrowing Policies

- 3.4. Multilateral development banks have had some experience handling cases of non-concessional borrowing by client countries. These have included: (i) the case of Angola which led to the hardening of IDA lending terms in 2008; (ii) The case of Ghana where the Bank Group and IDA applied moderate disincentive measures; (iii) the case of DRC, a HIPC interim period country where donors (including the Bank Group) worked closely with DRC to help the government re-negotiate financing terms to ensure compliance with the requirements for HIPC completion point debt relief assistance, and; (iv) lending by the Private Sector Window of the Bank Group to commercially-run financial enterprises in Rwanda and Uganda in which the respective government is majority shareholder. These cases are discussed in more detail in Annex 3.
- 3.5. While the issue of the application of disincentive measures typically dominates the debate on the NCB policy, it is noteworthy that more countries have been granted exceptions by the IMF and/or IDA than those that have been sanctioned. Between 2008

⁷ The disincentive measures are similar to that of IDA's and are based on the principle of strengthening partnership, coordination and policy harmonization among international financial and development institutions in line with the Paris Declaration on Aid Effectiveness.

and 2010, five countries (DRC, Senegal, Congo Republic, Cameroon and Rwanda) were granted exceptions for non-concessional borrowing based on case-by-case assessment of the development impact of each loan and the relatively low impact of the individual loan/s on the country's risk of debt distress. One of the key lessons from these cases is the need for investing on outreach and dialogue among RMCs, donors/creditors and IFIs so as to ensure early reporting, coordination and provision of the requisite support to countries.

3.6. The Bank Group and IDA's experience in implementing the NCB policy has highlighted a number of challenges and lessons which inform the proposed policy amendments. The lessons include the following:

- The lack of data on debts contracted with commercial⁸ and non-traditional donors that do not participate in donor reporting systems, as in the case of China in the Democratic Republic of Congo, prevents or slows analysis of RMCs' non-concessional borrowing practices and inhibits the implementation of the policy.
- The IDA's experience in Angola has shown that for resource-rich countries that have the capacity to borrow several times the amount of concessional resources available to them, the NCB policy has a limited effect as a deterrent to non-concessional borrowing behavior. In such cases, traditional donors must play a key role in helping these countries strengthen their debt management capacity.
- It is difficult to determine the right type and level of disincentive, particularly for low-risk, well-performing countries with access to non-concessional financing (including capital markets) to finance their development needs in the absence of sufficient concessional financing.
- In the light of limited concessional resources, flexibility in excluding State-owned Enterprises (SOEs) that meet the IMF-World Bank DSA exclusion criteria can facilitate mobilization of much-needed additional resources for development without compromising RMCs' long-term debt sustainability.⁹ A more coordinated and forward-looking approach in information sharing, analytical work and operational engagement among sister financial institutions and MDBs is important to ensuring the implementation of respective institutions' debt limit policies in a manner that is coherent, consistent and supportive of RMC's development goals.

Amendment 1: Revised Concessional Framework – Introducing Greater Flexibility and Country-Differentiated Approach

3.7. As a consequence of the above-mentioned challenges, and in view of the changing global context as result of the financial and economic crises, in 2009 donors and low-income countries called for a review of the IMF's external debt limit policy and associated non-concessional borrowing constraints. In particular, the need for greater flexibility and a more country-differentiated approach was highlighted as a critical enabling factor for raising the level of financing, concessional and non-concessional,

⁸ Commercial creditors represent approximately 6 percent of the debt stock of ADF countries. Their participation in collective actions to control non-concessional borrowing has remained a challenge, despite efforts to engage with them in bilateral meetings or through multilateral fora such as the Paris Club.

⁹ Includes autonomous commercially-run SOEs with managerial independence and can repay non-concessional and non-sovereign guaranteed loans from the proceeds of their operations, among other criteria. See also Annex 1, paragraph 7.

required to offset the impact of external shocks or to finance certain public investments with demonstrable impact on growth.

- 3.8. Subsequently, the IMF undertook a review of changes in low-income countries' financing patterns and the implications of those changes on its policies – especially as they relate to the limitations of a single fixed concessionality benchmark in addressing the diverse circumstances of low-income countries. The principal conclusions from the IMF's review were that (i) low income countries' debt vulnerability remains high and calls for continued concessional resources to finance development expenditures, and (ii) the previous one-size-fits-all approach to non-concessional debt limits should be replaced with a more nuanced framework that takes into account the diversity of the countries' circumstances.
- 3.9. The revised debt limit guidelines offer countries with higher public resource management capacity and lower external debt vulnerability the prospect of greater flexibility to take on prudent levels of new non concessional borrowing. Previously, the contracting of non concessional debt was uniformly prohibited, while the contracting of concessional debt was without specific limits. Under the new guidelines, the previous concessionality limit (of requiring a minimum grant element of 35 percent) continues to apply to countries with lower capacity and higher debt vulnerability so as to reduce the risk of accumulation non concessional loans by these countries. In special circumstances, very modest non concessional loans will be allowed.

Metrics for Assessing Debt Vulnerability and Debt Management Capacity

- 3.10. The revised concessionality framework rests on a regular country-by-country assessment of: (i) debt vulnerability, and (ii) debt management capacity.
- 3.11. **Debt vulnerability** assessment is determined by the country DSAs which are conducted annually and consist of three elements: (i) an analysis of a country's projected debt burden over the next 20 years and its vulnerability to external and policy shocks, with baseline and shock scenarios; (ii) an assessment of the risk of debt distress during that time, based on indicative debt burden thresholds that depend on the quality of the country's policies and institutions (Table 1); and (iii) recommendations for a borrowing (and lending) strategy that limits the risk of debt distress. Countries with moderate or low risk DSA ratings (yellow and green light countries) are automatically categorized as “lower vulnerability” while those with a high risk DSA rating (red light countries) are categorized as “higher vulnerability”.

Table 1: Debt Sustainability Framework Debt Distress Thresholds

Debt Indicators	Indicative Policy-Dependent Thresholds		
	Low CPIA \leq 3.25	Average 3.25 < CPIA < 3.75	High CPIA \geq 3.75
NPV of Debt/GDP (%)	30	40	50
NPV of Debt/Export (%)	100	150	200
Debt Service/Export (%)	15	20	25

Source: African Development Bank

Note: CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; GDP=gross domestic product; NPV=net present value

- 3.12. **Debt management capacity** assessment is a two-step process whereby countries are first categorized as “higher capacity” or “lower capacity” based upon two quantitative indicators: an index of five CPIA components that measure debt and fiscal policy capacity¹⁰ and Public Expenditure and Financial Accountability (PEFA) indicators¹¹. The IMF’s framework utilizes the average sub-CPIA and PEFA scores of IDA blend countries (excluding Zimbabwe) to determine a higher public resource management capacity threshold of 3.7 for the sub-CPIA index and 2.6 for the PEFA assessment. The rationale for this approach is that, because IDA blend countries enjoy market access to non-concessional financing, they should be seen as having higher capacity to manage those resources responsibly (including full repayment over time). Their average performance scores are therefore a reasonable operational performance classification threshold. Countries that score above the threshold on one indicator and below on the other (the “grey zone”) undergo a second step in which additional indicators and/or qualitative assessments are considered.
- 3.13. The resulting concessionality matrix (Table 2) and debt limit framework provide guidance for (i) determining non-concessional borrowing limits for countries with lower capacity and lower debt vulnerability, and (ii) operationalizing a more nuanced approach (average concessionality requirements or present value targets) in countries with greater capacity
- 3.14. Lower Capacity: In the case of countries with lower capacity and lower debt vulnerabilities, the new IMF debt limit policy allows customized non-concessional borrowing limits to prevent future deterioration in those countries’ DSA risk rating. DSAs will include “realistic” assumptions concerning non-concessional borrowing over the entire 20-year forecasting period¹² and additional “speed bumps” as warranted in countries with large borrowing space (particularly post-HIPC/MDRI countries whose external debt ratios are far below DSF indicative thresholds). In the case of countries with lower capacity and higher vulnerability, existing concessionality limits will continue to apply with little change. Most ADF countries fall into the “lower capacity” category.
- 3.15. Higher Capacity: For countries with higher public resource management capacity and lower debt vulnerability, the IMF will apply minimum average concessionality requirements to overall external or total public borrowing levels. The new debt limit policy will allow for the removal of all concessionality requirements for those low-income countries with high capacity, high income per capita, strong macroeconomic track record, significant market access, and a satisfactory track record in managing non-concessional financing. For those countries with higher capacity and higher debt vulnerability, the IMF will apply overall present value limits on external or total public debt levels.

¹⁰ The sub-CPIA index is made up of the following components: (1) fiscal policy; (2) debt policy; (3) the quality of budgetary and financial management; (4) the quality of public administration; and (5) transparency, accountability, and corruption in the public sector.

¹¹ PEFA assessments cover 28 indicators grouped into three broad categories: (1) budget credibility, (2) transparency, and (3) budget processes. The PEFA framework was developed between 2003 and 2005 through extensive consultations both with donors and governments.

¹² For inclusion of non-concessional borrowing in DSAs, see, for example, the Ghana 2007 IMF Article IV Report, where non-concessional borrowing is assumed to spread throughout the entire 20-year forecasting period. International Monetary Fund. June 2007. *Ghana: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Ghana*. IMF Country Report No. 07/210.

Table 2: The International Monetary Fund’s Concessional Matrix

		Extent of Debt Vulnerability	
		Lower (Green and Yellow DSF Traffic Lights)	Higher (Red DSF Traffic Light)
Capacity	Lower sub-CPIA \leq 3.7 PEFA \leq 2.6	Minimum concessional (loan-by-loan) requirement based on the previous system, but added flexibility for non-concessional external debt (i.e., higher and untied non-zero limits if consistent with the maintenance of low debt vulnerability)	Minimum concessional (loan-by-loan) requirement based on the previous system likely higher than 35%, with limited or no room for non-concessional borrowing
	Higher sub-CPIA \geq 3.7 PEFA \geq 2.6	Minimum average concessional (total loan) requirement applied to external or total public borrowing; for the most advanced low-income countries, no concessional requirement and overall nominal debt limit if needed ^{1/}	Overall limit on the present value of external or total public debt or average concessional at a higher level; for the most advanced low-income countries, ceilings on nominal external or total public debt

Source: *International Monetary Fund and African Development Bank*

Note: *1/ These are countries with a relatively higher per capita income, significant market access and a strong track record of macroeconomic and public financial management (i.e. countries that are on track to be classified as blend). ADF=African Development Fund; CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; IMF=International Monetary Fund; PEFA=Public Expenditure and Financial Accountability.*

Determining Financial Management Capacity Thresholds

- 3.16. To determine appropriate public resource management capacity indicators for regional member countries, Management first explored whether the Bank Group should pursue an approach other than the IMF’s – i.e., average IDA blend sub-CPIA and PEFA country scores.¹³ There are only three ADF blend countries: Cape Verde, Nigeria, and Zimbabwe. Because of its arrears status, its lack of creditworthiness, and its inability to access ADB and World Bank loans, Zimbabwe is a notional blend. As for Nigeria, while it remains an ADF blend country, it was reclassified as an IDA-only country in 2006. This leaves Cape Verde as the only African country currently classified as blend by both the World Bank and the Bank Group.
- 3.17. Management has examined several scenarios for ADB/ADF blend countries. First, utilizing an average ADB/ADF blend threshold based on Nigeria and/or Cape Verde would produce a substantially *higher* performance threshold for the sub-CPIA index (Table 3)¹⁴. If Zimbabwe were included (in contrast to IMF practice), the related ADB/ADF blend sub-CPIA index thresholds would become substantially *lower* than those produced under IMF guidelines

¹³ Currently, the following countries are classified as IDA blend countries: Armenia, Azerbaijan, Cape Verde, Dominica, Georgia, Grenada, India, Pakistan, Saint Lucia, Saint Vincent, Vietnam, Uzbekistan, and Zimbabwe. Every country, with the exception of Zimbabwe, has access to the World Bank window. IMF debt limit guidelines exclude Zimbabwe from IDA blend score calculations.

¹⁴ Specifically, the sub-CPIA rating threshold would exceed 4.0, versus 3.7 for IDA blend countries.

Table 3: Financial Management Policy Capacity Thresholds¹⁵

Country Category	Sub-CPIA Index	
	World Bank Data	ADB Data
PRGF-Eligible	3.2	-
IDA-Only *	3.1	-
IDA Blend	3.7	-
ADF-Only	3.0	3.3
ADF Blend		
<i>Cape Verde, Nigeria, Zimbabwe</i>	3.0	3.2
<i>Cape Verde, Nigeria</i>	4.0	4.1
<i>Cape Verde</i>	4.3	4.5

Source: World Bank and African Development Bank staff calculations

Note: ADF=African Development Fund; CPIA=Country Policy and Institutional Assessment; IDA=International Development Association; PEFA=Public Expenditure and Financial Accountability; PRGF=Poverty Reduction and Growth Facility

3.18. In light of these issues, Management recommends that the average IDA blend score be applied to determine the “higher” public resource management capacity threshold and associated ADF implementation modalities. Furthermore, Management recommends that the Bank Group continue to utilize the World Bank’s CPIA data to determine the DSF traffic light country classification as well as the country scores for the sub-CPIA index to ensure policy harmonization and operational consistency. This is more so important because the annual CPIA assessments conducted by the Bank Group and the World Bank seldom produce identical scores.¹⁶ Using the Bank Group’s CPIA data would result in different country classifications from that of the World Bank/IDA. For instance, the World Bank’s 2008 sub-CPIA data would cause ten ADF countries to be classified differently. Both of these proposals aim to ensure harmonization with the IMF and sister multilateral development banks and the consistent application of concessionality limits across countries.

Amendment 2: Revised Compliance Measures

3.19. Overall, the revised concessionality framework discussed in the preceding paragraphs will guide the Bank Group’s decisions as regards regional member countries’ non-concessional borrowing. To help reduce the risk of moral hazard and ensure that ADF resources are channeled to those countries that are compliant and need concessional resources the most, Management proposes some amendments to the disincentive, or compliance, measures outlined in the 2008 policy. In summary, existing compliance measures would be maintained for red and yellow light countries irrespective of their public resource management capacity, while some changes would be made to the compliance measures applicable to green light countries. This approach is based upon the Bank Group’s existing NCB policy rationale of promoting long-term debt sustainability and addressing free-rider and cross-subsidy concerns.

¹⁵ The figures are based on 2008 World Bank and ADB CPIA data.

¹⁶ The Bank is currently reviewing the CPIA with a view to increase the relevance of the current criteria with respect to the policies and institutions in order to improve the accuracy, transparency and reliability of the current assessment with a strong focus on its adaptation to the specificities of Africa.

- 3.20. For green light countries with *lower* public resource management capacity¹⁷, the previous moderate compliance measures are proposed to be eliminated and stronger ones be maintained so as to ensure the effectiveness of the measures by matching them better with the greater flexibility introduced in the revised concessionality limit.¹⁸ Similarly, for green light countries with *higher* capacity, it is proposed that moderate compliance measures be eliminated and stronger ones be applied in relation to breaches of Bank Group and IMF concessionality limits in the previous year. Overall, this approach will give regional member countries the flexibility to access prudent levels of non-concessional financing while remaining rigorous with respect to the long-term sustainability of their debt position.
- 3.21. In addition, to gradually improve transparency and communication with national authorities, modest adjustments will be made to non-concessional borrowing reporting requirements. While the 2008 Bank Group NCB policy did not outline procedures in the event of non-reporting, it has become clear that specific measures are needed to maintain incentives for full reporting and to enforce Bank Group contracts while not overly reducing recipient countries' assistance volumes. Where weak institutional and technical capacity are identified as the cause for non-compliance, the Bank Group will ensure supportive measures, such as access to assistance from the Debt Management Facility, are put in place.
- 3.22. It is to be recalled that the compliance measures in the 2008 Bank Group's NCB policy are linked to the magnitude of the concessionality breach and/or size of the breach relative to a country's ADF allocation. A breach would be termed (i) 'low level' in a situation where a loan has a concessionality level close to 35 percent and is small relative to a country's ADF allocation; (ii) 'medium level' when the concessionality level of a loan is much lower than 35 percent and/or if the size of the loan is large relative to the ADF allocation; and (iii) 'high level' when the concessionality level is significantly less than 35 percent and/or the volume of the loan is a multiple of the country's ADF allocation.
- 3.23. The revised compliance measures are detailed as follows (see Annex 4 for comparison of the revised compliance measures against the measures outlined in the 2008 NCB policy document):
- i. If a red light or yellow light country breaches the Bank Group's NCB policy;
 - the country's nominal ADF grant allocations will be reduced by 20 - 40 percent, depending on the level of the breach;
 - if such a country consistently borrows from third parties at non-concessional terms (i.e. repeated breach), the reduction in ADF grant allocations will be increased above 40 percent up to 100 percent, and the country's access to ADF grants will be suspended. For loan-eligible yellow light countries hardened terms will be applied, potentially in combination with reduction of ADF grant allocations ;

¹⁷ Of the countries classified in this category, the Bank Group and the World Bank have already applied moderate terms to Ghana. In addition to Ghana, the World Bank applied hardened terms for Angola in 2007, prior to the Bank Group's adoption of its Non-Concessional Borrowing Policy.

¹⁸ The reduction in loan maturity from 50 to 40 years has a negligible impact on overall concessionality levels. In essence, this ADF disincentive produces terms equivalent to regular IDA credits. The change would bring the Bank Group's Non-Concessional Borrowing Policy in line with comparable IDA policy.

- in extreme situations of repeated and high-level breaches, the country will be suspended from accessing to all new ADF resources over an extended period as determined by the Boards of Directors.
- ii. For green light countries that breach the NCB policy, hardened terms and volume discounts will be applied as follows:
 - hardened terms (20 years maturity, 10 years grace period, same charges), with a grant element less than 45 percent; or
 - higher level hardened terms (hardened terms, plus interest rate at 200 basis points below the ADB fixed lending rate) with a grant element less than 20 percent;
 - if a green-light country repeats breaches, the policy would deepen hardened terms and apply volume discount for fragile post-MDRI countries. Similar to red and yellow countries, in extreme situations of repeated and high-level breaches, the country will be suspended from accessing all new ADF resources over an extended period as determined by the Boards of Directors.
 - iii. If ADF-eligible country breaches the reporting requirement on planned non-concessional borrowing, the ADF will reduce its nominal allocation by 10 percent, and the resources will be redistributed to other ADF-eligible countries through the Performance-Based Allocation (PBA) system.
 - iv. HIPC countries that breach the NCB policy in the interim period (i.e. between their decision and completion points), will be required to make additional efforts to revise the borrowing terms to sufficiently increase the level of concessionality as this is a key requirement for the country to qualify for irrevocable debt relief at the completion point. The Bank's existing policy prohibits extending interim debt relief to a country if non-concessional debt is contracted during the interim period.
- 3.24. The compliance measures will be applied for a period of three years from the time the breach occurred. If a breach occurs just before the resumption of a new ADF cycle, the compliance measure will be applied on the full duration of the cycle. If the breach occurs in mid-cycle, the compliance measure will be applied for a consecutive three years regardless of the resumption of a new ADF cycle.
- 3.25. If the DSF traffic light classification of a country under the NCB policy sanction changes (e.g. from green to yellow or red, or vice versa) during the three-year period the compliance measures are being applied, the hardened terms and/or the reduction of ADF grants will be adjusted to align with the ADF financing mix (i.e. loans, grants or a mix of both) under the new classification.

Application of the Bank Group Non-Concessional Borrowing Policy to ADF Countries

- 3.26. The Non-Concessional Borrowing Policy Application Matrix below (Table 4) provides an integrated guidance on the application of the new concessionality framework with the revised compliance measures and the indicative ADF country classification. This revised concessionality framework would provide greater flexibility to nearly half of ADF-only countries to access some level of non-concessional external debt. The country classification and the level of the non-concessional debt limit for each country is updated regularly within the context of the country's IMF-supported program.

Table 4: Bank Group Non-Concessional Borrowing Policy Application

		Extent of Debt Vulnerability	
		Lower	Higher
Capacity	Lower sub-CPIA \leq 3.7 PEFA \leq 2.6	Concessional Limit	
		Minimum concessional requirement based on the previous system, but with added flexibility on non-concessional external debt (higher and untied non-zero limits if consistent with the maintenance of low debt vulnerability)	Maintain minimum concessional requirement based on previous debt-by-debt approach, likely higher than 35%, with limited or no room for non-concessional borrowing
		Non-Concessional Borrowing Policy Compliance Measure Application	
	Maintain "green light" country measures: (1) hardened terms; (2) higher hardened terms; or (3) possible volume discount for fragile post-MDRI countries	Maintain "red" and "yellow light" country measures: (1) reduce the ADF grant volume from 20% to 40% or (2) suspend ADF grant access and harden terms after repeated non-concessional borrowing	
	Indicative ADF Country Classification (existing IMF assessments)¹		
	<i>Benin, Central African Republic, Congo Rep., Ethiopia, Ghana, Lesotho, Liberia, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Uganda, Zambia</i>	<i>Burkina Faso, Burundi, Comoros, Congo Dem Rep., Cote d'Ivoire, Djibouti, Gambia, Guinea, Guinea Bissau, Sao Tome & Principe, Togo</i>	
Higher sub-CPIA \geq 3.7 PEFA \geq 2.6	Concessional Limit		
	Minimum average concessional requirement applied to external or total public borrowing; for most advanced low-income countries, no concessional requirement and overall nominal debt limit if needed	Overall limit on the present value of external or total public debt or average concessional at a higher level; for the most advanced low-income countries, ceilings on nominal external or total public debt	
	Non-Concessional Borrowing Policy Compliance Measure Application		
	Provide case-by-case flexibility to accommodate prudent non-concessional borrowing, but retain ability to apply "green light" country measures as warranted: (1) hardened terms; (2) higher hardened terms; or (3) possible volume discount for fragile post-MDRI countries	Maintain "red" and "yellow light" country measures: (1) reduce ADF grant volumes from 20% to 40% or (2) suspend ADF grant access and harden terms after repeated non-concessional borrowing	
Indicative ADF Country Classification (existing IMF assessments)¹			
None		None	

Source: African Development Bank; International Monetary Fund

Note: ¹/IMF classification as at August 2010; CPIA=Country Policy and Institutional Assessment; DSF=Debt Sustainability Framework; PEFA=Public Expenditure and Financial Accountability

4. CHALLENGES FOR EFFECTIVE IMPLEMENTATION AND MITIGATION MEASURES

4.1. The implementation of the Bank Group's policy on non-concessional borrowing will be supported by its work in debt management capacity and related areas. As a member of the Steering Committee of the Debt Management Facility (DMF), the Bank will be able to enhance its strategic and advisory role in support of RMCs' efforts in debt management reforms, particularly in fragile states which tend to have the lowest debt management capacity and the highest debt vulnerability. The DMF's unique role as a cooperation platform for donors, technical experts and authorities of client countries

would also facilitate greater cooperation between the Bank and its partners. Furthermore, Bank staff will actively participate in DMF-supported activities at country level such as the systematic application of debt management diagnostic tools; design of debt management reform strategies; and, promotion of learning and knowledge generation.

- 4.2. These efforts notwithstanding, several issues and implications need to be taken into consideration to achieve a measure of success in implementation of the Bank Group's NCB policy.
- 4.3. First, there is no dedicated donor forum for discussion and information sharing on non-concessional borrowing behavior by ADF-eligible countries. The current Multilateral Development Banks Annual Meetings on Debt Issues, Stakeholders Meetings on Debt Management, or other fora, do not specifically address this issue. **The Bank will continue to actively engage in collective 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.**
- 4.4. 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. **In line with the reporting requirement of the NCB policy, borrowers will be asked to provide adequate information on loan terms in order to facilitate monitoring their debt sustainability. Cases of insufficient information sharing will be brought to the attention of the Board.**
- 4.5. Third, as illustrated by the case of IDA's experience with Angola, there is little impact of the sanctions from the compliance 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 compliance measures. **In this context, the compliance 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.**
- 4.6. Currently, the Bank Group's capacity to implement substantial debt management initiatives is fairly limited. While the Bank Group's governance portfolio supports downstream public finance reforms in beneficiary regional member countries, the number of Bank staff with debt management expertise is small. For that reason, the Bank Group's participation in joint IMF-World Bank DSA missions in recent years has been mostly ad-hoc. At the strategic level, an increased role in debt management capacity building is fully consistent with Levels 1 and 3 of the *Bank Group's Governance Strategic Directions and Action Plan 2008-2012*. These levels seek to help regional member countries strengthen country systems and their capacity to manage public resources and aim to support regional initiatives to improve economic and financial governance. **The Bank Group therefore will expand its role in supporting regional member countries' debt management capacity building and development resource mobilization efforts by scaling up existing initiatives and work streams as discussed in paragraph 2.9 and 4.1.**

Action Plan for Implementation

- 4.7. Implementing the measures outlined above, will require effective coordination within the Operations Complexes, and Regional and Policy Departments, the Finance Complex, the Chief Economist's 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 Annex 5.
- 4.8. In view of the fact that in a fast-changing global economic reality there are real implications for development financing flows to African low income countries and their capacity to manage non-concessional borrowing needs and debt strategies, the Bank Group's policy has to be monitored closely with the view to making adjustments as needed. The policy will also be periodically reviewed to ensure coherence across all relevant Bank Group strategies and policies, including those guiding operations in ADF countries that are financed through the Private Sector window of the Bank.

5. CONCLUSION AND RECOMMENDATION

- 5.1. This paper has reviewed the Bank Group's policy for addressing the issue of non-concessional borrowing by ADF eligible countries and the implementation experience since the adoption of the *Bank Group Policy on Non-Concessional Debt Accumulation* in 2008. It has examined the recent changes by the IMF and the World Bank as regards the DSF and external debt limit, and the implication for the Bank Group's policy on non-concessional borrowing. Lessons have been drawn from the Bank Group and IDA's experience in implementing the NCB policy.
- 5.2. Based on this review, Management proposes that the Bank Group's revised NCB policy remains anchored on the four broad pillars: (i) coordination and partnership; (ii) reporting and monitoring; (iii) capacity building; and (iv) applying disincentive measures. Within this framework, and taking into account regional member countries' diverse needs and circumstances and consistent with the Bank Group's commitment to donor harmonization and coordination, Management proposes the following revisions to the 2008 Bank Group NCB policy:
 - i. give some ADF-only regional member countries the flexibility to contract prudent non-concessional borrowing by aligning the Bank Group's policy on non-concessional borrowing with the revised IMF concessionality framework that provides a country-differentiated approach based on assessment of each client country's debt vulnerability and debt management capacity (as outlined in paragraphs 3.7 – 3.18); and
 - ii. apply the revised compliance measures outlined in paragraph 3.19-3.25 in response to breaches of the Bank Group's policy on non-concessional borrowing.
- 5.3. The Boards of Directors are hereby invited to consider and approve the proposed amendments to the 2008 *Bank Group Policy on Non-Concessional Debt Accumulation*.

Annex 1 : Recent Debt Sustainability Framework Reforms and Their Operational Implications for the Bank Group

Overview of the 2009 Review of the DSF by the IMF and the World Bank

1. Subsequent to the introduction of the DSF in 2005, the Bank Group, sister multilateral development banks and financial institutions, and many bilateral donors have increasingly used the DSF to determine the financing terms to extend to low-income countries (i.e., their mix of grants and loans). They have also taken complementary actions to enhance the coordination and implementation of the framework: (i) the DSF has increased reliance on forward-looking DSAs since 2007; (ii) the Bank Group and the World Bank have adopted non-concessional borrowing policies; and (iii) ADB staffs have taken greater part in World Bank and IMF DSA missions. Meanwhile, in regional member countries, non-traditional donors have increased their role and activities significantly, creating opportunities for increased and diverse sources of development financing for African low-income countries while increasing debt sustainability-related risks and challenges.

2. Against this background, in 2009 the IMF and the World Bank assessed the DSF's effectiveness at capturing and forecasting countries' debt vulnerabilities. This exercise was followed in January 2010 by a revised IMF-World Bank staff guidance note¹⁹ that outlined a number of changes to the DSF's analytical methodology and implementation modalities in order to more adequately address (i) country performance threshold effects; (ii) the impact of debt-financed investments on growth; (iii) the effect of remittances on debt sustainability; (iv) state-owned enterprise debt; (v) domestic debt and debt held by external private creditors; and (vi) the views of country authorities. These changes and their implications for Bank Group operations are summarized below.

3. Country Performance Threshold Effects: Client countries and the shareholders of participating multilateral development banks had expressed concern about the impact of modest year-to-year fluctuations in Country Policy and Institutional Assessment (CPIA) ratings on debt distress classifications, and by extension, the appropriateness of the financing terms extended by donor agencies. Under the existing methodology, modest fluctuations in a CPIA score that falls near an indicative DSF policy performance threshold (i.e. a score that falls just below or above the performance thresholds of 3.25 and 3.75)²⁰ could produce a large and sudden shift in financing terms as countries' DSF classification changes from one category to another. When coupled with ADF and IDA grant volume reductions, this shift can create significant financial volatility and complicate development planning and execution.²¹

4. To address these concerns, the revised staff guidance note added a trigger designed to limit the impact of minor CPIA fluctuations on annual DSF traffic light country classifications and financing terms. Specifically, beneficiary country performance classifications only adjust immediately when the updated CPIA 3-year moving average breaches the applicable policy performance threshold by more than 0.05. If the breach is equal to or less than 0.05, the country's policy performance classification only changes if the breach is maintained for 2 consecutive years. This amendment applies to improvements as well as to deteriorations in CPIA scores.

5. The Impact of Debt-Financed Investments on Growth: According to the revised staff guidance note, DSAs will henceforth more closely examine government efforts to promote an enabling policy

¹⁹ International Development Association and International Monetary Fund. January 2010. *Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries.*

²⁰ The DSF's three performance categories are "strong" (CPIA score of 3.75 or greater), "medium" (CPIA score between 3.25 and 3.75), and "poor" (CPIA score of 3.25 or below).

²¹ For illustration purposes, consider a "medium" performing country with a net present value debt-to-export ratio of 130 percent. An immaterial deterioration in this country's 3-year average CPIA score from 3.26 to 3.24 would cause it to be reclassified from a "medium" to a "poor" performer. This would shift the country's debt distress threshold (e.g., from a net present value debt-to-exports ratio of 150 percent to 100 percent) and reclassify the country to "red light" status. In response, the ADF and the IDA would apply a 20 percent grant volume reduction on the overall level of assistance provided. Hence, the country would receive substantially lower gross assistance volumes due to a very minor change in its CPIA.

environment and governments' ability to capture returns on public investment.²² This is an area in which the Bank Group could play a more active role. The Economic Development Research Department has undertaken analytical work on growth diagnostics since 2009. While the work program currently focuses on selected West African countries, these efforts could be scaled up in terms of both their thematic scope and their geographic coverage so as to address targeted data demands concerning the DSAs of African low-income countries. These efforts would be closely coordinated with the World Bank and the IMF.

6. Remittances: The revised guideline provides flexibility to include remittances in DSAs on a case-by-case basis when to do so meets clearly defined conditions: (i) workers' remittances are a reliable source of foreign exchange; and (ii) breaches of thresholds under the DSA baseline or stress tests, excluding the impact of remittances, are not protracted (i.e. do not extend beyond the currently permissible maximum length of 10 years). In this event, remittances may serve to adjust a beneficiary country's debt distress risk classification. The Economic Research Development Department, in collaboration with the World Bank, has initiated comprehensive studies on remittances and migration in 10 African countries.²³ This research will contribute to each country's DSA. Given the importance of remittances to many beneficiary countries, Management plans to expand these efforts over the Twelfth General Replenishment of the African Development Fund (ADF-12) period and beyond.

7. State-Owned Enterprise Debt: The revised guidelines allow analysts to remove a state-owned enterprise's external debt from the DSA, under certain conditions, if the enterprise can borrow without a public guarantee and if its operations pose limited fiscal risk. Bank Group staff experienced in working with state-owned enterprises—such as country economists—will contribute to these aspects of DSAs. Specifically, for each enterprise whose debt could qualify for exclusion from the external DSA, the assessment team would begin by collecting any information that could help it determine the enterprise's fiscal risk profile. This information might relate to (i) managerial independence; (ii) relations with the government; (iii) the frequency of audits; (iv) the publication of comprehensive annual reports and the protection of shareholder rights; (v) financial indices and sustainability data; and (vi) other risk factors determined on a case-by-case basis. By illustration, a state-owned enterprise that carried out uncompensated quasi-fiscal activities or had a negative operating balance would be considered at high fiscal risk.²⁴

8. Domestic Debt and Privately-Held External Creditor Debt: The guidance note reiterates the requirement that all low-income countries' DSAs consider both public domestic debt and public external debt. For the former, DSAs will cover broader public sector liabilities, including those of the central bank, the central government, local and regional governments, and state-owned enterprises. Going forward, DSAs will thoroughly review domestic debt risk when domestic debt stocks exceed 15-20 percent of gross domestic product and/or in the event of a rapid, recent accumulation of domestic debt.²⁵

9. Country Authorities' Views: The revised guidance note recommends a stand-alone, systematic presentation of country authorities' views in future DSAs. In situations where authorities' views differ significantly from the views of staff, alternative DSA scenarios may be prepared based on those authorities' assumptions.

²² This is achieved by conducting a systematic and realistic assessment that incorporates empirical analysis and draws upon techniques that range from simple growth accounting to more complex, targeted, and resource-intensive methodologies, such as growth diagnostic studies and general equilibrium models.

²³ The 10 African countries are Burkina Faso, Burundi, Ethiopia, Ghana, Kenya, Nigeria, Rwanda, Senegal, South Africa, and Uganda. In Burundi, Ethiopia, Ghana, and Rwanda, data will be drawn from existing household surveys. In Burkina Faso, Kenya, Nigeria, Senegal, South Africa, and Uganda, tailor-made surveys have been conducted.

²⁴ Bank Group staff engaged in DSA or NCB analysis should refer to the revised IMF debt limit policy which provides a more detailed guidance: The International Monetary Fund, August 2009. *Debt Limits in Fund-Supported Programs – Proposed New Guidelines*.

²⁵ The guidance note specifically recommended that domestic debt assessments not affect the classification of a country's external debt risk, and by extension, the determination of the appropriate mix of grants/loans.

Operational Implications for the Bank Group

10 Starting in ADF-12, Management will incorporate the country performance threshold effect measure into the DSF's country classification system to ensure harmonization with the IDA and other multilateral development banks. The other DSF reforms do not directly impact the Bank Group's implementation modalities. Rather, they contribute to broader assessments of beneficiary countries' risk of debt distress risk and indirectly feed into the DSF "traffic light" classification system.

11 With regard to implementation, introducing flexibility into the DSF and elements such as remittances and growth analyses into DSAs creates the opportunity for a broader and deeper engagement on the part of the Bank Group. Accordingly, Management intends to deepen the Bank Group's active engagement in DSA missions and other debt diagnostic and advisory activities.²⁶ The Bank Group will enhance the level of expertise within relevant departments, increase debt-related training for country economists, and establish a more structured process for internal and external coordination. In the immediate term, the Bank Group will continue to engage in DSA missions and debt-related activities in select beneficiary countries while expanding its institutional capacity with a view to playing a more substantive role, especially in domestic debt and regional initiatives that aim to enhance the flow of development financing to low-income countries. The strategic importance of debt sustainability will also be discussed more comprehensively in the relevant sections of Country Strategy Papers.

²⁶ Bank Group staff can contribute to various components of the DSA process, such as the design of the macroeconomic baseline, the design of alternative scenarios, analysis of the debt distress rating, and the drafting of the write-up. Staff members going on such missions will coordinate more closely with country economists and other experts as relevant to ensure the Bank's views and position are integrated in country policy dialogue a coherent and purposeful manner. To date, Bank staffs have participated in DSA missions in the Central African Republic, Republic of Congo, Cote d'Ivoire, Guinea, Liberia, and Togo.

Annex 2 : Application of the Bank Group Non-Concessional Borrowing Policy to ADF Countries

Table 2-I: Countries Subject to Bank Group Non-Concessional Borrowing Policy
(As at end-2010)*

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

*Notes: * 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.*

*** The 26 RMCs which have already reached HIPC completion point, and are beneficiaries of MDRI relief.*

Annex 3 : Multilateral Development Banks' Experience in Implementing Non Concessional Borrowing Policy: Selected Case Studies

1. Borrowing by Natural Resource Rich RMCs: Angola was the first case of non-concessional policy compliance measure application which led to the hardening of IDA lending terms in 2008. Despite Angola having been rated at moderate risk of debt distress, in the light of the IDA non-concessional borrowing policy, its consistent non-concessional borrowing resulted in the hardening of IDA's lending terms on the country in 2008. This decision has had 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 was small and has not served as an incentive for Angola to discontinue its non-concessional borrowing. On the other hand, the decision was expected to free up scarce IDA concessional resources for reallocation to other countries more in need. IDA's Angola Interim Strategy Note outlines continued engagement with the government in policy dialogue, lending and non-lending technical assistance operations.²⁷

2. Borrowing by Emerging Market Low Risk RMCs: The Bank Group has applied disincentive measures only once since the NCB policy was adopted in 2008. This took place in the case of Ghana's non-concessional borrowing.²⁸ In October 2007, Ghana successfully issued a US\$ 750 million Sovereign Eurobond to fund infrastructure development in the areas of road and railway transport, where the economic rate of returns are very high and could have significant impact on economic growth and employment. Ghana's non-concessional borrowing was assessed in light of sector and country-specific circumstances as outlined in the 2005 Ghana Growth and Poverty Reduction Strategy which had noted the insufficiency of domestic and concessional sources to finance the country's development plan, particularly as regarded energy and transport.

3. While the Bank Group, along with the broader international donor community, had initially supported Ghana's effort recognizing the country's need for and the capacity to initiate complex non-concessional borrowing to supplement limited concessional resources, the amount of debt eventually contracted by Ghana exceeded the level estimated in the 2007 joint IMF/World Bank's DSA, leading to a deterioration of the country's debt indicators and a DSF reclassification from low (green) to moderate (yellow).²⁹ This deterioration was due to the rapid accumulation of external public debt contracted on commercial terms, and high current account and fiscal deficits. In this circumstance, while creditors had initially exercised some flexibility in accommodating Ghana's non-concessional borrowing, the magnitude and extent eventually contracted by the country, its CPIA rating and green light status, and in view of its increased access to capital market financing, the Bank Group and IDA Management decided to apply a moderate disincentive measure on Ghana. This translated into a reduction of the maturity of ADF loans from 50 to 40 years. All other ADF standard terms remained unchanged.

4. Borrowing by HIPC Interim Period RMCs: 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 a debt relief package (estimated at US\$ 905 million in net present value terms) to enable the country reach its completion point by December 2007. However, DRC experienced some slippage in fulfilling all the conditions required to reach the completion point within the anticipated timeline. A satisfactory assessment of DRC's prospects for satisfying the key completion point triggers, and four additional eligibility criteria for extension of interim debt relief led to the Bank Group's, in consultation with the BWIs and the

²⁷ See IDA: Angola – Interim Strategy Note (ISN), Report No.: 39394-AO, May, 2007.

²⁸ African Development Bank. September 3, 2008. *Information Note on Application of Non Concessional Debt Accumulation Policy to Ghana*, ADB/BD/IF/2008/186 ADF/BD/IF/2008/169.

²⁹ Ghana's non-concessional borrowing consisted of the following elements: (i) a US\$ 750 million Eurobond issued on capital markets at a fixed coupon of 8.5 percent and a 10-year repayment of the principal; (ii) a US\$ 292 million loan agreement with the Export-Import Bank of China for the Bui hydroelectric power plant subject to 6.1 percent interest, a 17-year repayment period, and a 5-year grace period; and (iii) a US\$ 23.5 million loan from the Netherlands BMH Bank for the Barekese Water Supply Project.

HIPC Trust Fund, decision to extend exceptional interim debt relief to DRC up to 50 percent, from end-July 2007 to end-December 2010.

5. Nevertheless, DRC's debt remained unsustainable: It had accumulated arrears to the Paris Club, and its debt sustainability and lack of compliance with the negative pledge clause were of major concern to the donor community. Against this background, fundamental concerns were raised about the terms of a financial transaction of between US\$ 6.5 and \$15 billion between DRC and a Chinese consortium. During a Consultative Group meeting in Paris in November 2007, the Government of DRC and international partners made commitments to ensure continued progress in resolving the issue. The Government stressed that its top priorities were the achievement of the HIPC completion point, achievement of double-digit economic growth, and reaching the MDCs by 2015. The Government also committed to ensuring that new loans will not further complicate the sustainability of its debt. The collective effort and engagement by the international community and the DRC authorities was thus critical in enabling the DRC to re-negotiate the terms of the loans with China and qualify for HIPC completion point debt relief assistance by the World Bank and IMF in July 2010. The Boards of Directors on the Bank Group approved DRC's completion point debt relief in April 2011.

6. Borrowing by State Owned Enterprises (SOEs): Bank Group Management reviewed two cases in 2010 concerning the issue of lending by the Private Sector Window of the Bank Group to commercially-run financial enterprises in Rwanda and Uganda in which the respective government is majority shareholder. In the case of Rwanda, the proposed transactions were assessed to fall within the flexibility provided by the 2008 Bank Group NCB policy and the Board Resolution approving the project included a language that required the Government of Rwanda to confirm compliance with IMF's debt limit policy so as to ensure policy coordination and reporting among the key donors. The IMF subsequently confirmed the compliance of one of the financial enterprise which was excluded from the government debt. In the case of Uganda, Bank Group staffs are working closely with the Government of Uganda in coordination with the IMF. A preliminary assessment indicates that a similar outcome as the Rwanda case is likely.

Annex 4 : The Bank Group's Non-Concessional Borrowing Policy Compliance Measures

Table 4-I: Comparison of the 2008 Compliance Measures and Proposed Revisions

DSF Traffic Light Status	2008 NCB Policy Disincentive Measures	Revised Disincentive Measures
Red-Light RMCs	<i>Step-1, low-level breach</i> ¹ : Increase volume discount on entire allocation from 20% to 40%	<i>Step 1</i> : Maintain measures
	<i>Step 2, medium-level breach</i> : Increase volume discount on entire allocation above 40%	<i>Step 2</i> : Maintain measures
	<i>Step 3, medium-level breach</i> : Apply Step 2 and lower maturity from 50 to 20 years	<i>Step 3</i> : Apply Step 2 and suspend ADF grant access <i>(Note: loan terms not applicable to red-light/grant-only countries)</i>
	<i>Step 4, high-level breach</i> : Apply Step 3 and increase interest rate to 200 basis points below ADB fixed rate	<i>Step 4</i> : Apply Step 3 and extend suspension <i>(Note: loan terms not applicable to red-light/grant-only countries)</i>
	<i>Repeated breach</i> : Extend/deepen volume reduction or harden terms	<i>Repeated Breach</i> : Suspend ADF grant access <i>(Note: loan terms not applicable to red-light/grant-only countries)</i>
Yellow-Light RMCs	<i>Steps 1 and 2</i> : Same measures as for red-light RMCs concerning the grant component	<i>Steps 1 and 2</i> : Maintain measures
	<i>Step 3</i> : Apply Step 2, and lower maturity from 50 to 20 years	<i>Steps 3 and 4</i> : Maintain measures and suspend ADF grant access
	<i>Step 4</i> : Apply Step 3 and increase interest rate to 200 basis points below ADB fixed rate	
	<i>Repeated Breach</i> : Extend/deepen volume reduction or harden terms	<i>Repeated breach</i> : Suspend ADF grant access and harden terms
Green-Light RMCs	<i>Step 1, low-level breach</i> : Apply moderate terms (lower maturity from 50 to 40 years, apply 10-year grace period, charge 0.75% service charge and 0.5% commitment fee) with a grant element less than 60%	Eliminate Step 1
	<i>Step 2, medium-level breach</i> : Apply hardened terms (lower maturity from 40 to 20 years, apply 10-year grace period, charge same fees) with a grant element less than 45%	Maintain Steps 2 and 3
	<i>Step 3, high-level breach</i> : Harden terms further (apply Step 2 and increase the interest rate to 200 basis points below the ADB fixed rate) with a grant element less than 20%; or, possibly apply a volume discount for fragile post-MDRI countries	
	<i>Repeated breach</i> : Extend/deepen volume reduction or harden terms	<i>Repeated breach</i> : Extend/deepen hardened terms; apply volume discount for fragile post-MDRI countries
All ADF-only RMCs	<i>Non-reporting</i> : No disincentives	<i>Non-reporting</i> : Reduce ADF nominal allocation by 10%

Source: African Development Bank

Note: ADB=African Development Bank; ADF=African Development Fund; MDRI=Multilateral Debt Relief Initiative; DSF=Debt Sustainability Framework; RMCs=regional member countries

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 percent and is small relative to a country's ADF allocation. Medium level refers to a concessionality level much less than 35 percent and/or a large size relative to the ADF allocation. High level refers a concessionality level much less than 35 percent and/or a volume which is a multiple of the country's ADF allocation.

Annex 5: Bank Group Policy on Non-Concessional Borrowing: Policy Implementation Matrix

	Policy Measures	Key Elements of the Policy	Institutional Coordination	Target Date
1.	Deepen Partnership and Donor Coordination	<ul style="list-style-type: none"> ▪ Strengthen partnerships and coordination with sister MDBs and bilateral donors, to adopt a common strategy in dealing with the free-rider issue, including advocacy 	<ul style="list-style-type: none"> ▪ ORMU/ORPC, on behalf of the Bank Group, liaises with IDA, other IFIs, and bilateral donors in the coordination process 	Ongoing
		<ul style="list-style-type: none"> ▪ Deepen Bank Group participation in forward-looking IMF/IDA DSA exercises, including information sharing on non-concessional borrowing 	<ul style="list-style-type: none"> ▪ Country Economists, ORMU & EDRE participate in joint IMF/IDA DSA exercises 	Ongoing
		<ul style="list-style-type: none"> ▪ 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 	<ul style="list-style-type: none"> ▪ ORMU/ORPC liaise with IDA and other IFIs in outreach exercises to emerging market donors and agencies 	Ongoing
2.	Strengthen Borrower Reporting and Donor Monitoring	<ul style="list-style-type: none"> ▪ Reconstitute a permanent inter-departmental Committee to monitor regular reporting on status of non-concessional borrowing by ADF-only RMCs 	<ul style="list-style-type: none"> ▪ Membership will include ORMU, ORPC, FFMA, FTRY, FFCO, GECL, Regional Operations and Research Departments, and chaired by Vice President, ORVP 	Q2 2011
		<ul style="list-style-type: none"> ▪ Include a clause in all ADF grant/loan agreements requiring advanced reporting on planned new non-concessional borrowing, including negative pledge clause against collateralized resources 	<ul style="list-style-type: none"> ▪ GECL, with ORPC and ORMU support, is to include additional clause in loan/grant agreements 	Q2 2011
		<ul style="list-style-type: none"> ▪ Add a 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 	<ul style="list-style-type: none"> ▪ GECL, with support from ORPC, ORMU and FFMA, is to include additional clause in FSF Pillar I loan/grant agreements 	Q2 2011
3.	Enhance Collaboration in Capacity Building	<ul style="list-style-type: none"> ▪ 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 	<ul style="list-style-type: none"> ▪ ORPC, ORMU, ESTA and EDRE to liaise with IDA, other IFIs, and bilateral donors in capacity building activities 	Ongoing
4.	Apply Compliance Measures on a Case-by-Case basis	<ul style="list-style-type: none"> ▪ Application of compliance measures on countries breaching the Bank Group NCB policy 	<ul style="list-style-type: none"> ▪ OpsCom, upon recommendation from ORPC (and support from Regional Departments and NCB Committee), will apply compliance measure for low-level breaches; Before application of hardened terms (medium to high level breaches), Boards endorsement of the measure will be necessary. 	Ongoing
		<ul style="list-style-type: none"> ▪ Application of compliance measures for breaching reporting requirement of planned non-concessional borrowing 	<ul style="list-style-type: none"> ▪ OpsCom, upon recommendation from ORPC (and support from Regional Departments and NCB Committee), will decide. 	
		<ul style="list-style-type: none"> ▪ Application of policy waiver 	<ul style="list-style-type: none"> ▪ Advice and endorsement by the Boards will be necessary before decision is taken to exercise flexibility in waiving the disincentive measure for medium to high level breaches 	Ongoing