SUBJECT : TRANSITION FRAMEWORK FOR GRADUATING AND REVERSING COUNTRIES

REVISED *

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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
ADF	African Development Fund
AsDB	Asian Development Bank
AsDF	Asian Development Fund
DMCs	Developing Member Countries
ESW	Economic and Sector Work
GNI	Gross national income
GNP	Gross national product
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
LICs	Low Income Countries
MDB	Multilateral Development Banks
MICs	Middle Income Countries
MIGA	Multilateral Investment Guarantee Agency
RMCs	Regional member countries
SLL	Sustainable Lending Limit
UA	Unit of Account
WB	World Bank

EXECUTIVE SUMMARY

1. The African Development Bank Group (Bank Group) has a Credit Policy that determines each country's eligibility for ADF resources only (Category A), ADB resources only (Category C), or a blend of resources from the two windows (Category B, blend countries) on the basis of two criteria: per capita income and creditworthiness to sustain non-concessional financing. Graduation refers to the process by which an ADF-only country transitions to blend or to ADB-only status, or a blend country to ADB-only status. Reversal is the process by which an ADB-only or a blend country ceases to be creditworthy for non-concessional financing and/or its per capita income level drops below the threshold and needs readmission to ADF financing.

2. The Bank Group does not currently have a framework guiding the transition of countries from one credit status to another. Cape Verde has recently embarked on a graduation process from the ADF to the ADB by achieving blend status, and Angola and possibly others are positioned to follow. At the same time, it cannot be excluded that ADB-only or blend countries, due to circumstances, will need to become eligible for ADF financing again. It is therefore opportune for the Bank Group to develop an approach to accompany countries changing credit status. The current proposal fulfils Management's commitment, during the ADF-12 replenishment discussions, to propose a graduation policy to the Board. The transition framework will be integrated into the new Credit Policy at the time that the new Credit Policy is adopted.

3. The main objective of the proposed Transition Framework is to ensure a smooth, predictable and sustainable transition. To this end, a flexible approach that is tailored to specific country circumstances should be adopted. For example, a country whose graduation is induced by sustained good policies and balanced economic growth would have different requirements than a country whose income level and creditworthiness improved rapidly after the discovery and development of natural resources.

4. The Transition Framework proposes that for each country changing credit status, a transition program be drawn up, defining the modalities of Bank Group support (such as specialised analytical work, policy advice and dialogue, technical assistance) and the Bank Group's role in specific areas (for example, in the field of private sector development). It will also determine the length of the transition period and the financing mix during this period.

5. To smoothen the transition, a phasing out/phasing in period of appropriate length should be determined on the basis of objective criteria, taking into account countries' needs for concessional funds. For graduating countries, ADF resources will be gradually phased out and ADB resources progressively phased in. In line with the practice at other Multilateral Development Banks, phasing out/phasing in would normally take place over a period of 2 to 5 years. Socio-economic criteria such as the pervasiveness of poverty and the relative level of human development, the rate of economic growth, and the level of financing needs/use of resources will help to determine the appropriate length of the transition period. For reversing countries, a transition period will not be required as it is important for the concessional ADF financing to be immediately available.

6. Graduation will enable countries to access a larger volume of ADB Group and other resources than they would receive under the ADF alone. In addition, the Transition Framework offers incentives for voluntary acceleration of graduation. Graduating countries who would prefer more and faster access to ADB resources can choose to forego ADF resources in exchange for ADB resources. However, any acceleration of the graduation should respect the objective of ensuring a smooth and sustainable transition for the country.

7. Although country-specific conditions require case-by-case consideration, the guiding principles and criteria set out in the policy, in particular concerning the timeframe, should be applied in a straightforward manner to ensure consistent implementation of Bank Group policy. Flexibility around the proposed formats will therefore be limited.

8. The Board of Directors is requested to consider and approve the proposed Transition Framework for Countries Changing Credit Status.

TRANSITION FRAMEWORK FOR COUNTRIES CHANGING CREDIT STATUS

1. BACKGROUND

1.1 The African Development Bank Group (Bank Group) has a Credit Policy[1] that determines each country's eligibility for the Bank Group's "soft" or "hard" funding window on the basis of country income and creditworthiness. In broad terms, Middle Income Countries (MICs) are eligible for loans from the African Development Bank (ADB), while Low Income Countries (LICs) are eligible for concessional loans and/or grants from the African Development Fund[2] (ADF). A sub-group of LICs satisfies creditworthiness requirements for some financing on non-concessional terms, while requiring additional financing on concessional terms. Thus, the Bank Group classifies its regional member countries (RMCs) into three categories: Category A for ADF-only countries; Category B for "blend" countries eligible for both ADF and ADB windows; and Category C for ADB-only countries.

1.2 Graduation refers to the process by which an ADF-only country transitions to blend or to ADB-only status, or a blend country to ADB-only status. Reversal is the process by which an ADB-only or a blend country ceases to be creditworthy for non-concessional financing and/or its per capita income level drops below the threshold and needs readmission to ADF financing. The Bank Group does not currently have a framework guiding the transition of countries from one credit status to another, for example defining the adequate mix of ADF and ADB resources available to graduating countries during their transition. Applying the Bank Group Credit Policy strictly on a year-by-year basis could imply an abrupt change of eligibility for one of the two windows and the associated financing terms.

1.3 On the one hand, Cape Verde has embarked on a graduation process from the ADF to the ADB by achieving blend status, and Angola and possibly others are positioned to follow. On the other hand, Zimbabwe, which is currently eligible for both ADF and ADB financing, is a potential candidate for reversal to ADF-only status: its GNI per capita is in the bottom tier of ADF eligible countries, well below the cut-off, and ADF-only status would be a necessary condition if it is to receive arrears clearance and debt relief under the Heavily Indebted Poor Countries Initiative (HIPC).

1.4 Management therefore believes that it is time to introduce a framework guiding the transition of countries graduating or reversing from one credit status to another. The current proposal follows on from the discussions during the ADF-12 replenishment and broadens Management's commitment to present a graduation policy to the Board of Directors by including arrangements for reversal as well. It is important to note that this new Transition Framework <u>leaves unchanged the existing Bank Group Credit Policy</u>, including the eligibility and classification criteria contained in it. The proposed approach only addresses how the Bank Group supports countries in <u>transition</u> from one status to another.

[1] ADB/BD/WP/95/79 and ADB/BD/WP/98/33

[2] Countries eligible for ADF resources are also eligible to the third window, the Nigerian Trust Fund

2. BANK GROUP'S EXPERIENCE

Country Classification

2.1 The Bank Group Credit Policy was adopted in 1995 and reaffirmed in 1998, and is aligned to the International Bank for Reconstruction and Development (IBRD)'s Credit Policy. It determines which countries are eligible for ADF resources only (Category A), which are eligible for ADB resources only (Category C), and which are eligible for a blend of resources from the two windows (Category B, blend countries[3]) on the basis of two criteria: (i) per capita income[4] and (ii) creditworthiness to sustain IBRD financing.[5] As set out in the ADF-12 Report (ADF/BG/WP/2010/06, 10 November 2010) and the *Financial Aspects of ADF-12 Implementation and Approval of the Advanced Commitment Capacity for ADF-12* (ADF/BD/WP/2011/04), the country classification as of 1 January 2011 (ADF-12) has been further refined to distinguish ADF-only countries whose income levels are above the operational cut-off[6] but which are deemed not creditworthy for non-concessional financing (the so-called gap countries), and countries whose income is above the operational cut-off and are considered creditworthy (countries graduating from ADF to ADB). See Table 1.

Table 1: African Development Bank Group Country Classification as of 1 January 2011 (ADF-12)

		Creditworthiness to Sustain IBRD Financing	
		No	**Yes**
Per capita income above the ADF / IDA operational cut-off for more than 2 consecutive years	**No**	*Countries below cut-off and not creditworthy*: ADF-only countries on regular ADF terms	*Countries below cut-off and creditworthy*: Blend countries eligible for ADB resources and for ADF resources subject to a cap and blend terms
	Yes	*Countries above cut-off but not creditworthy*: Gap countries not eligible for ADB resources but eligible for ADF resources on blend terms	*Countries above cut-off and creditworthy*: Only eligible for ADB resources. Exceptionally, graduating countries are eligible for ADF resources on blend terms during a 2 to 5-year phasing-out period

Notes: *The ADB's Credit Policy prescribes that World Bank country classifications be followed: hence the references to IBRD financing and the IDA's operational cut-off. IDA=International Development Association; IBRD=International Bank for Reconstruction and Development*

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3 Blend countries are distinct from ADB-only countries who are temporarily eligible for both ADF and ADB resources during a period of transition (graduation) with phasing-out and phasing-in.

4 This is determined on the basis of an operational cut-off for IDA eligibility, which for FY 2010 (July 2009 to June 2010) was a 2008 per capita gross national income of US$1,135, calculated using the Atlas methodology, and for FY 2011 (July 2010 to June 2011) a 2009 per capita gross national income of US$1,165.

5 Individual country creditworthiness (risk) ratings are derived on the basis of both quantitative and qualitative analysis. The components considered by the World Bank are broadly grouped into eight categories: (i) political risk; (ii) external debt and liquidity; (iii) fiscal policy and public debt burden; (iv) balance of payments risks; (v) economic structure and growth prospects; (vi) monetary and exchange rate policy; (vii) financial sector risks; and (viii) corporate sector debt and vulnerabilities. Each of these categories is considered in turn, and the ratings for all categories determine the country's overall rating. However, no fixed weights are assigned to any one category and qualitative judgment is used to integrate the eight ratings into a single rating. The joint evaluation of the different categories for each country occurs against the background of a particular global outlook. Underpinning individual country assessments is a set of macroeconomic projections covering a 2-year period.

6 See note 4 above.

2.2 Once it has been assessed that an ADF country has sustainably reached an income per capita level above the operational cut-off and it has been deemed creditworthy for non-concessional resources, it shall be reclassified as an ADB-only country. Blend countries whose income rises above the operational cut-off and subsequently stays at that level for 2 consecutive years will likewise be reclassified to ADB-only. Following IDA practice, in exceptional cases, blend countries whose income remains below the operational cut-off but who are fully creditworthy on international financial markets and able to attract and sustain non-concessional financing may graduate to ADB-only status despite their income level.

2.3 The Bank Group's current Credit Policy will continue to apply until a new credit policy is adopted. The Transition Framework will be integrated into the new credit policy at the time such a policy is adopted.

The Bank Group's Experience with Graduation and Reversal

2.4 Since the Bank Group adopted its Credit Policy in 1995, Egypt has graduated from blend country status to ADB-only country status and Equatorial Guinea has graduated directly from ADF-only country status to ADB-only country status (without going through blend status) following the World Bank's accelerated graduation of the two countries in 1999. Cape Verde graduated from ADF-only status to blend country status in 2009. Currently three regional member countries are blend countries: Cape Verde, Nigeria and Zimbabwe.

2.5 Since 1995, the Bank has had no experience with reversal, where countries which had previously graduated from ADF to ADB status became eligible for ADF financing again due to a deterioration in their economic situation and creditworthiness. However, some parallels can be drawn with the annual debt distress 'traffic-light' classification system under the Debt Sustainability Framework in as far as the management of changes in lending terms for countries whose debt distress indicators have been downgraded is concerned.

Lessons Learned

2.6 The application of the Bank Group's Credit Policy has taught us that African countries, due to their economic diversity and their vulnerability to various shocks, often require flexible and tailored approaches on a case by case basis and upon concrete evidence. This has triggered the need for a sound framework to accompany countries' transition out of concessional borrowing while still benefitting from the Bank's assistance in selected areas where capacity is yet to be strengthened. Also, justified flexibility has led to several exceptions to the Credit Policy to avoid immediate relapse after graduation to ADB status. There is thus the need for a structured process to help countries smoothly transition out of the concessional funding window (or in the reverse direction, in the case of countries facing persisting distress).

2.7 Thorough consultations of all stakeholders (shareholders, beneficiaries, rating agencies, etc.) will be needed to craft a home-grown credit policy. In light of recent and upcoming transitions from one status to another, there is urgent need for a framework guiding these transitions. Hence the necessity to segregate this issue from questions around the eligibility criteria to Bank Group financing windows (Credit Policy).

2.8 The experience of sister institutions (World Bank and Asian Development Bank) is outlined in Annex 1.

3. GUIDING PRINCIPLES FOR THE TRANSITION OF COUNTRIES CHANGING CREDIT STATUS

3.1 ***Graduation and Reversal Triggers:*** The Bank Group's Credit Policy provides the parameters for when a country is eligible to graduate from ADF-only status to blend or ADB-only status, from blend status to ADB-only, and the reverse process from ADB-only to blend or from ADB-only or blend status to ADF-only status. ADF countries whose income per capita level has been above the operational cut-off for more than two consecutive years and who have been deemed creditworthy for non-concessional resources shall be reclassified as ADB-only. Blend countries whose income rises above the operational cut-off and subsequently stays at that level for 2 consecutive years will likewise be reclassified to ADB-only. ADB-only countries whose income per capita level drops below the operational cut-off but who remain creditworthy shall be reclassified as blend countries; if they in addition lose their creditworthiness they shall be reclassified as ADF-only. Similarly, blend countries who lose their creditworthiness shall no longer be eligible for ADB resources and shall revert to ADF-only.

3.2 ***Ensuring a smooth and predictable transition:*** If the Bank Group's Credit Policy is strictly applied, an ADF-only country which fulfills the income and creditworthiness criteria and is reclassified to ADB-only would cease to receive ADF resources from the date of entry into force of the decision, and would go from ADF-only to ADB-only from one day to the next. Such a sharp transition may, depending on country circumstances, cause difficulties in terms of program planning and resource management. In such cases a gradual transition period, involving the phasing out of ADF resources, can help to smooth the transition. Gradual phasing-in of ADB funding is also important to ensure the country has the appropriate capacity to absorb non-concessional resources and to avoid over-exposure of countries whose financial management capacities are still weak.

3.3 ***Country-tailored Approach:*** It is important to design a tailored approach so as to properly address a country's specific needs[7] during the transition period. For example, in the case of graduation to ADB-only status, several scenarios could apply:

- an ADF-only country whose income level and creditworthiness grew hand-in-hand;
- a gap country (a country that was not sufficiently creditworthy but whose income level was above the operational cut-off) that became creditworthy; or
- a blend country (a country that was creditworthy but whose income was below the cut-off) whose income level rose to exceed the cut-off.

3.4 Likewise, a country whose graduation is induced by sustained good policies and balanced economic growth would have different requirements, in terms of capacity building and development, policy advice, analytical work and technical assistance, than a country whose income level and creditworthiness improved rapidly after the discovery and development of natural resources. These needs should be duly taken into account and addressed appropriately during the transition period.

3.5 ***Incentives of graduation and Catalytic Role:*** the advantages to countries of becoming ADB-eligible should be made clear, including the potential volume of resources they would have access to (from the ADB Public Sector window, ADB Private Sector window, Middle Income Countries Trust Fund, other trust funds managed by the Bank, etc.) and the financial instruments and other services they can make use of. In addition, the framework should be designed in such a way that it enables a graduating country to attract more third-party including

[7] This approach has been successfully implemented by the Bank during the recent financial-economic crisis, for example.

private sector resources to finance its development. This can include support for improving the regulatory environment and business climate, strengthening the domestic financial sector / domestic financial markets, providing advice or assistance with the issuance of government bonds, and also enhancing a country's image and reputation in international capital markets.

3.6 ***Sustainability and Guarding against 'back sliding'***: In the case of graduation from ADB resources, attention should be paid to ensuring the sustainability of the graduation, i.e. ensuring that the country will remain able to finance its needs through its own means without having to resort to the ADB again in the future. This also applies to graduation from ADF to ADB-only. In the case of reversal from ADB-only or blend back to ADF eligibility, the focus should be on creating the conditions necessary to make the period of ADF (re-)eligibility as short as possible, i.e. to return the country to its former status as soon as this is feasible and appropriate.

4. PROPOSED TRANSITION FRAMEWORK FOR COUNTRIES CHANGING CREDIT STATUS

I. Definitions

4.1 The term "graduating countries" shall apply to ADF-only countries who have been reclassified, according to the Credit Policy, as blend countries, and to ADF-only and blend countries who have been reclassified as ADB-only countries.[8]

4.2 The term "reversing countries" shall apply to ADB-only countries who have been reclassified, according to the Credit Policy, as ADF-only or blend countries, and to blend countries who have been reclassified as ADF-only countries.

II. For each graduating or reversing country, a tailored transition program will be drawn up, defining the modalities of Bank Group support, in particular the financing mix during the transition period.

4.3 A programming document is necessary for countries witnessing a substantial change in per-capita income and creditworthiness, as well as a significant change in Bank Group financing, both in terms of volume and financing terms. Any kind of programming document (such as an interim or full Country Strategy Paper, an update thereof, a Joint Assistance Strategy, a Country Brief, etc.) could serve this purpose as long as it:

- discusses the triggers that led to the classification change, according to the Credit Policy;
- determines the length of the transition period and provides an assessment along several criteria discussed hereafter; and
- aligns the Bank's assistance strategy in the country with the new mix of financing available, as well as new needs for Economic and Sector Work and other services that might have arisen.

4.4 Issues to take into consideration when designing the transition program include the need for well-defined policy dialogue, tailored economic and sector work, advisory services, and technical assistance around transition issues, in order to respond to country-specific needs. The program should also address the Bank's role in helping the country to learn from the experience of others, for example through facilitation of secondments of technical expertise or organizing conferences around transition themes. Inputs from the Regional Director, Country

[8] An ADF-only country that has fulfilled the income criterion for more than two consecutive years and has been deemed creditworthy for non-concessional resources shall be reclassified as an ADB-only country. A blend country whose per capita income rises above the operational cut-off and stays at that level for 2 consecutive years will likewise be reclassified to ADB-only.

Program Officer and the Field Office will be very important to define the country's needs and the Bank Group's appropriate response.

4.5 In the case of graduating countries, the Bank Group should assist in attracting more private sector financing. Given graduating countries' improved access to financial markets, the Bank Group's private sector arm would adopt a greater role in leveraging and stimulating private sector capital flows, catalyzing external resources and undertaking projects with large demonstration effects. The Bank can also offer advice, expertise and technical assistance on the development of (domestic) financial markets, the issuing of bonds, strengthening the investment climate and improving the regulatory and business environment. It may even be able to assist countries to improve their image and reputation on international markets and with private investors. This would help to make the graduation sustainable.

4.6 In the case of reversing countries, in addition to meeting the country's direct needs, the transition program should focus on creating the conditions necessary to return the country to its former status as soon as this is feasible and appropriate. In the case of countries transitioning to ADF-only status, close collaboration with other members of the international community including International Financial Institutions and bilateral partners will be pursued in order to further a coordinated or common approach. This is especially pertinent in cases of prolonged arrears and/or unsustainable debt. The Bank Group's program of support will be tailored to be the most effective as part of such a coordinated approach. The transition program will also address the level of ADF and other (trust funds, possibly Fragile States Facility) resources that can be made available to the country in the short and medium term, as well as any needs for additional resource mobilization by the Bank to supplement these funds.

III. To smoothen the transition, a phasing-out/phasing-in period of appropriate length should be determined on the basis of objective criteria, taking into account countries' needs for concessional funds.

4.7 To ensure a smooth transition <u>from ADF-only to ADB-only status</u>, which takes place when a country meets both the income and creditworthiness criteria, the country-specific graduation program should contain modalities to gradually phase out ADF resources and phase in ADB resources. Based on the number of years of the transition period, the ADF allocation will be reduced and the access to ADB resources increased in a step-wise manner. The actual amount of ADB financing would depend on the country's demand for such resources, but will be limited by the ceiling computed as a percentage of its sustainable lending limit (SLL). In line with the practice at other Multilateral Development Banks, phasing out would normally take place over a period of 2 to 5 years or 1 to 2 ADF cycles from the time that the country has met both the income and creditworthiness criteria. Countries' continued eligibility for ADF resources and the allocation of such resources would be determined for each new ADF period.

4.8 Countries who become creditworthy but whose income remains below the cut-off graduate <u>from ADF-only to blend status.</u> They will automatically see a change in their financing mix, in that their ADF allocation will be reduced to 50% of what they would have received if they had been an ADF-only country, and will be in the form of loans on blend lending terms.[9] ADB resources can be gradually phased in, as a growing percentage of the country's SLL. For <u>blend countries graduating to ADB-only</u> status (i.e. creditworthy countries whose income rises above the cut-off), assuming they have already reached eligibility for 100% of their SLL, only the phasing-out of their ADF allocation will be applied. It can be expected that a higher SLL will be established.

9 See ADF-12 Report (ADF/BG/WP/2010/06) and Financial Aspects of ADF-12 Implementation and Approval of the Advanced Commitment Capacity for ADF-12 (ADF/BD/WP/2011/04).

4.9 Graduation will give a country access to a higher volume of ADB Group resources than it had before. Firstly, an SLL of ADB lending is nearly always a multiple of the country's ADF allocation. For example, at the time that Cape Verde was reclassified as a blend country, its sustainable lending limit for ADB resources was estimated to be UA 98 million over the 2009-2013 period, or approx. UA 20 million per year, while its ADF-11 allocation was UA 12 million for 3 years, or UA 4 million per year. Secondly, the phasing-out and phasing-in schedule will be designed in such a way that the sum of the percentages of the ADF and ADB resources is greater than 100% of the ADF resources alone. This is illustrated by Table 2. As ADB-eligible countries develop further, the Bank will likely revise the SLL upwards.

Table 2: Example of Phasing Out ADF Resources and Phasing in ADB Resources for Countries Transitioning from ADF-only to ADB-only Status over 3 years

	ADF-only to ADB-only (Category A to Category C)			**Numerical Example**		
Year	ADF-only Allocation	ADB Funds Offered as % of the country SLL		ADF-only Allocation = UA 50 million per year	ADB SLL = UA 150 million per year	Total
Year 0 (before graduation)	100%	-		50.0 m	-	50.0 m
Year 1	100%	33%		50.0 m	50.0 m	100.0 m
Year 2	67%	67%		33.3 m	100.0 m	133.3 m
Year 3	33%	100%		16.7 m	150.0 m	166.7 m
Year 4 onwards	-	100%		-	150.0 m (subject to revision)	

Notes: *SLL = Sustainable Lending Limit, as currently determined per country by Bank policies and guidelines*

4.10 In addition to ADB resources, greater creditworthiness as confirmed by reclassification will also yield countries access to other (non-concessional) sources of finance, both from public (International Financial Institutions, bilateral) and private sources (commercial banks, financial markets). At the same time it will be important to ensure sufficiently strong public financial management and public debt management capacity.

4.11 To assist in determining the appropriate length of the phasing out period, Management proposes to set a number of guiding criteria. Starting with the minimum length of transition of two years, the following socio-economic indicators are proposed:

- Measures of the pervasiveness of poverty (such as the percentage of the population living below the poverty line / $ 1.25 per day) and the relative level of human development (such as the Human Development Index score compared to other African countries) to assess a country's poverty and social development situation[10]. For countries with high levels of poverty or low relative levels of human development, lengthening assistance by one year can be used to assess which pro-poor efforts are required and the government's capacity to deliver those efforts effectively strengthened. Countries with more than 50% of the population living below the poverty line or in the bottom two quintiles of African countries on the Human Development Index can be granted

[10] The Human Development Index, a composite of health, education and purchasing power indicators, is one of the few socio-economic indicators for which reliable data is available on a regular basis for nearly all African countries. For many other possible social development indicators, such as literacy rates, maternal mortality, malnourishment, and access to water and sanitation, data availability is a serious problem. Indicators of debt sustainability are already taken into account in the creditworthiness assessment - see footnote 5 - and are therefore not proposed here, to avoid double counting.

one additional year of transition (+ 1 year)[11]. An exception can be made for countries who do not fulfill these criteria but who face the particular structural challenges related to insularity (i.e. island and landlocked countries), including problems with economies of scale and high transport costs.

- Measures of the rate of economic growth and related revenues that could fuel spending towards poverty reduction. Countries with high growth rates (like those discovering natural resources) have revenue inflows that allow them to increase their pro-poor spending accordingly. In contrast, countries with average growth below 10 percent a year, for the past five years, can be granted one additional year of transition (+ 1 year).
- Measures of financial need and use of Bank Group resources (as measured by the level of utilization of the previous ADF allocation) are also proposed. Countries who have used more than 80% of their previous ADF allocation demonstrate both financial need and use of resources and can thus benefit from one additional year of transition (+ 1 year).

4.12 The applicability of each of these criteria and the appropriate length of the transition period will be discussed in the proposed transition program. If all the criteria are applied, the transition period can thus extend to up to 5 years (Table 3).

Table 3: Criteria Guiding the Length of the Transition Period

Issue	Criterion	Cut-off	Duration
Initial transition length	-	-	2 years
Poverty and Human Development	Proportion of population living below the poverty line (USD 1.25 / day) OR Low relative level of human development OR Insular (i.e. island or landlocked)	Greater than 50% In bottom two quintiles of African countries on the Human Development Index	+1 year
Rate of Economic Growth	Average economic growth rate of the past five years	Lower than 10%	+1 year
Financial need / Use of resources	Use of previous ADF allocation	More than 80%	+1 year
Final transition length	-	-	**Potentially up to 5 years**

4.13 The introduction of a transition period with gradual phasing out of ADF resources will make it easier to reclassify ADF-only countries who meet both the income and creditworthiness criteria directly to ADB-only status rather than going "through" blend status as happened in the past, because they will continue to have access to concessional resources for several years. This enables the countries to address lingering issues of poverty and other socio-economic challenges on appropriate financing terms, before completely moving to the non-concessional window.

4.14 ADB-only or blend countries that suffer sustained economic deterioration and/or loss of creditworthiness can, according to the Credit Policy, be reclassified as ADF-only. Likewise, ADB-only countries can be reclassified as blend countries. In these cases, a transition period will not be required as it is important for the concessional financing to be immediately available. It can be expected that for ADB-only countries reclassified as blend, a lower SLL will be established.

[11] Countries in the middle quintile of African countries on the Human Development Index will be treated on a case-by-case basis.

Box 1: Illustrative examples of phasing out and phasing in: the cases of Angola and Cape Verde

Angola

Angola is currently an ADF-only country (Category A). It has had a GNI per capita above the operational cut-off for ADF eligibility since 2005. It has recently been found to be creditworthy by the Bank Group's Financial Management Department, the World Bank, rating agencies and other creditors. Meeting both of the criteria, Angola can thus graduate to ADB-only status (Category C). Given Angola's income level (USD 3,490 per capita in 2009), poverty rate (37%), relative Human Development Index score (in the middle quintile of African countries), strong economic growth rates (11.7% on average over the past 5 years), high government revenues, low utilization of its ADF-11 allocation (33.7%) and access to other non-concessional sources of funding, a transition period of 2 years is deemed appropriate, starting in 2011. ADF resources will thus be phased out as follows: in 2011, Angola will receive 100% of its annual ADF allocation, and in 2012 it will receive 50% of its ADF allocation. Any remaining ADF-12 resources can be used up in 2013. As of the ADF-13 cycle, Angola will no longer be eligible for ADF funding. At the same time, access to ADB resources will be phased in: in 2011, Angola will be able to borrow up to 50% of its Sustainable Lending Limit from the ADB, rising to 100% in 2012.

Cape Verde

In the absence of a transition framework, Cape Verde was reclassified as a blend country (Category B) in October 2009 on account of its income level and creditworthiness. However, it was exceptionally allowed to retain its full ADF-11 allocation rather than being subjected to the cap on blend countries under ADF-11. Currently Cape Verde fulfils both the income and creditworthiness criteria and can thus graduate to ADB-only status (Category C). Given Cape Verde's specific circumstances, including insularity, an income level and economic growth rates lower than Angola's (average of 6.3% over the past 5 years) and high utilization of its ADF-11 allocation (100%), a transition period of 5 years is deemed appropriate. Since Cape Verde retained its full ADF-11 allocation, it is proposed that this be the starting point for the transition during ADF-12. ADF resources will thus be phased out as follows: Cape Verde will receive 100% of its annual ADF allocation in 2011, 80% in 2012, 60% in 2013, 40% in 2014, and 20% in 2015; as of ADF-14, Cape Verde will no longer be eligible for ADF financing. For the 3-year cycle of ADF-12, this yields an average of 80%. Cape Verde can make use of the provision that countries with an indicative 3-year ADF allocation of UA 20 million or less are allowed to fully frontload the use of their allocation. Over the ADF-12 period, access to ADB resources, which commenced in 2010, will grow steadily.

IV. Incentives for voluntary acceleration of graduation will be provided

4.15 In order to encourage graduation in line with a country-tailored approach, positive incentives will be offered to graduating countries that would prefer more and faster access to ADB resources instead of ADF resources. This would free up resources for more interventions in other ADF recipient countries. In this way, the length of the transition period can even be shortened to less than two years. However, any acceleration of the graduation should respect the objective of ensuring a smooth and sustainable transition for the country. This minimum period deemed necessary for this should be the subject of a dialogue between the ADB and the country authorities.

4.16 The transition period as determined in the graduation program can be tailored to phase in ADB resources more quickly by foregoing ADF resources, at a ratio of two ADB Units of Account for every foregone ADF UA.

V. Flexibility around the proposed formats and criteria should be limited

4.17 Even though it is recognized that country-specific conditions require case-by-case consideration, the guiding principles and criteria set out above, in particular concerning the timeframe, should be applied in a straightforward manner to ensure consistent implementation of Bank Group policy.

4.18 In the case of graduating countries, Management will, in the final year of the transition period, review the country's capacity to complete the transition to ADB financing and can submit to the Boards a request for an extension of the transition period if necessary, with sound justification.

5. RECOMMENDATION

5.1 The Boards of Directors are requested to consider and approve the Transition Framework for Countries Changing Credit Status.

Annex 1: Practice of other MDBs

IDA/IBRD Graduation Policy

The process of graduation from IDA is normally triggered when a country exceeds the operational per capita income guideline for a number of years (normally at least two or three consecutive fiscal years).[12] Because income levels fluctuate from year to year, countries whose per capita income has risen above the threshold by a marginal amount would normally begin a graduation process that, in most cases, lasts for several years. This graduated approach avoids situations in which income fluctuations could allow only intermittent access to IDA funding, which would complicate IDA allocations as well as rational planning by the country. It also recognizes that the national income data are imperfect, and that a sudden termination of IDA would not be desirable from a developmental point of view.

Some countries, however, have graduated from IDA on an accelerated basis. This may occur where improved information becomes available showing that a country's income is substantially higher than previously estimated. In such cases, where the new income data indicates that country income is substantially above the IDA operational cutoff, the country may be graduated at the end of the fiscal year. This occurred in the case of Egypt, which was graduated from IDA at the end of FY99. In other cases, a substantial amount of petroleum or other natural resources may have been tapped, greatly increasing a country's per capita income, especially if the country is small in population. In such cases, the country would also be graduated on an accelerated basis. Equatorial Guinea, which graduated during FY99 is a case in point.

Graduation can also occur when a country achieves creditworthiness for adequate amounts of IBRD and other commercial sources of funds, even though its per capita income remains below the operational cutoff. Such countries would typically already be blend countries, with access to both IDA and IBRD lending. Countries move to blend status with per capita incomes below the operational cutoff, when they have improved creditworthiness. In such cases, IDA lending to the country is curtailed and replaced to some extent with IBRD lending. With an even greater improvement in creditworthiness, such blend countries can graduate from IDA, even though their per capita incomes remain below the operational cutoff. These countries would normally have strong export earnings and large reserves, and a demonstrated track record of successfully borrowing on the international commercial markets to meet much of their capital needs. China is the most recent example of a country which ceased to borrow from IDA at the end of FY99 with a per capita income of $860, less than the operational cutoff of $925 at the time, but with substantial access to capital on commercial terms.

Blend status represents a stage in the overall financing process in which a country undergoes a transformation from IDA-only to blend and then to IBRD-only status, before it graduates from IBRD. A country is classified by the WB as having blend status when it is eligible to borrow from IDA and from IBRD. In particular, such a country needs to satisfy IDA's eligibility criteria with regard to policy performance, poverty, and limited creditworthiness. At the same time, the country has to be creditworthy for a limited amount of IBRD borrowing or have the potential to become so (for example, with sustained strong performance). There are also some countries, classified as "gap countries", with incomes above the operational cut-off, but which are not creditworthy for IBRD lending, and might therefore find themselves without access either to IBRD or IDA resources for their development.

Countries with blend status are expected to have a higher per-capita income, a more diversified economy, stronger development prospects, and a higher credit repayment capacity than the group of IDA-only countries.

Gap countries represent countries whose graduation from IDA is imminent because their per capita income has consistently exceeded the IDA operational per capita income cutoff, but have very limited creditworthiness.

When IDA determines that a country should graduate, a graduation program is formulated usually in the Country Assistance Strategy, comprising:

- A phase-out of IDA lending;
- A phase-in of IBRD lending;
- Special ESW (Economic and Sector Work) and technical assistance to help address transition issues, such as improving access to commercial sources of lending;

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[12] The operational cut-off for IDA eligibility for FY 2010 (July 2009 to June 2010) was a 2008 per capita gross national income of US$1,135, calculated using Atlas methodology, and for FY 2011 (July 2010 to June 2011) a 2009 per capita gross national income of US$1,165. A country is reclassified when its per capita income exceeds the cut-off for more than 2 consecutive years. Individual country creditworthiness (risk) ratings are determined by World Bank staff using quantitative and qualitative data.

- Increased role of MIGA (Multilateral Investment Guarantee Agency), IFC to improve private sector capital inflows; and
- Application of triggers to accelerate the repayment of IDA credits.

Each of these measures is tailored to the particular circumstances of the country, except for the acceleration of repayments of IDA credits, which is governed by a standard formulation. Accelerated repayments are triggered when a country is creditworthy for IBRD borrowing and its per capita GNP reaches or exceeds the operational cut-off for IDA eligibility for three consecutive years.

It is clear from the interaction of income and creditworthiness considerations, and also from the volatility and fragility of economic and political progress in many IDA countries, that graduation cannot be solely driven by a mechanistic formula.

Asian Development Bank Graduation Policy

The Asian Development Bank introduced a Graduation Policy for the Bank's Developing Member Countries in December 1998. The paper included a graduation framework and a classification of DMCs, as well as ceilings for AsDB financing of project costs, norms for sharing of TA costs and a domestic preference scheme for procurement of goods and civil works.

The policy was broadly relevant and useful for guiding resource allocations and for contributing to risk management. However, in 2008 the policy was reviewed and updated. Revisions were considered in 4 areas:

- using the term "creditworthiness" instead of "debt repayment capacity"
- refining methods for assessing creditworthiness
- reconsidering the current four-tier system
- strengthening the classification review process

The AsDB uses the WB's GNI per capita estimates based on the Atlas method and IDA's operational cutoff for eligibility. Country classification is submitted to the Board for approval, usually on a non-objection basis. The AsDB has a three-tier classification:

- Group A: AsDF only countries.
- Group B: Blend countries.
- Group C: Ordinary Capital Resources (OCR)-only countries.

The 2008 review proposed a refined methodology for assessing creditworthiness: DMCs are placed in 3 categories "adequate creditworthiness", "limited creditworthiness", "lack of creditworthiness". A standing creditworthiness committee at the AsDB takes into consideration information on a country's economic growth and development prospects, as well as its fiscal policy and public debt burden, current and capital account vulnerability, economic structure, monetary and exchange rate policy, financial sector development and other economic conditions. The committee also takes into consideration the following: the presence or imminence of domestic or external conflict, significant unresolved social, ethnic, or other internal tensions; or the risk of contagion by being located in a volatile region.

Graduation from AsDF resources is triggered when a country exceeds the operational per capita GNI threshold and achieves adequate creditworthiness for OCR or market-based resources. The process of graduation usually takes about 4 years to complete after the threshold has been crossed.

Graduation from regular AsDB assistance (OCR) is triggered when a member reaches the WB's GNI per capita benchmark. AsDB then analyzes a country's readiness for graduation. The analysis focuses on availability of commercial capital flows on reasonable terms and levels of development of key economic and social institutions.

Graduation from new OCR lending normally occurs within 5 years after a country crosses the graduation benchmark, with variations according to country-specific conditions. Direct private sector investment by AsDB in graduated DMCs ceases. However, graduation from regular bank assistance does not signify termination of the AsDB's relationship with a DMC. It's a transition to a new phase in the relationship.

In general, the AsDB takes a flexible approach to determining the pace of graduation, recognizing that countries reaching the graduation threshold may differ in the extent of their progress towards developing key institutions for economic and social development.