May 25, 2010

To: IDA Deputies
Cc: Ngozi Okonjo-Iweala, IDA-16 Replenishment Chair
From: Benjamin Leo, Center for Global Development, Washington DC

Re: Proposal for an IDA Blended Financing Facility

The International Development Association (IDA) is approaching a crossroads in terms of its geographic focus, scale, and clientele profile. Increasingly, recipient countries have become divided into two distinct groups. The majority of its clients in Eastern Europe, Central Asia, and South Asia now enjoy access to the IBRD and international credit markets and are moving toward graduation from IDA altogether. These countries currently receive roughly one-third of available IDA resources. On the other hand, IDA's poorer clients (IDA-only countries), which are largely located in Sub-Saharan Africa, continue to face significant development challenges and vulnerabilities, and lack access to international credit markets.

- Life expectancy in IDA-only countries is 20 percent lower than in blend countries and the percentage of the population living on less than $1.25 a day is twice as large.
- Blend and hardened term countries exhibit strong similarities to lower-middle income countries, consistent with their IDA graduation prospects in the near- to medium-term.

In light of this, some shareholders have advocated an adjustment to IDA's performance-based allocation (PBA) system to increase resources for countries with higher vulnerabilities and needs. However, decreasing the PBA's performance weighting could endanger future donor contributions from key shareholders. Separately, IDA management has proposed shortening the amortization of its credits for blend and hardened term countries. While this would increase IDA resources available for its poorest countries over the longer term, the short-term impact will be very modest.

PROPOSAL: The proposed IDA Blended Financing Facility is based on three guiding principles: (1) maintain IDA's existing PBA system; (2) maintain World Bank assistance volumes and overall concessionality levels for IDA's creditworthy emerging economy borrowers; and (3) dramatically increase IDA assistance for the world's poorest and most vulnerable countries. To do so, the World Bank could leverage the IBRD's balance sheet to provide non-concessional loans to creditworthy IDA blend and hardened term countries. In turn, IDA would provide grant subsidies to buy down the concessionality level of these IBRD loans. The Inter-American Development Bank utilizes a similar approach for its lower middle-income and low-income country clients. Based on existing credit terms and interest rates, the required IDA grant would range between 24 and 30 percent of the total loan value. In other words, IDA would free up between 70 and 76 percent of its scarce development capital currently provided to blend and hardened term countries. These resources then could be re-allocated to the poorest and most vulnerable countries according to IDA's normal PBA system.

FINANCING IMPACT FOR THE POOREST: During the IDA-15 replenishment period, the prospective candidate countries for the Facility were projected to receive 26 percent of the total available assistance envelope ($10.4 billion).[1] The proposal would have retained roughly $7.5 billion in resources during the IDA-15 period. Two large blend countries, India and Vietnam, would provide roughly $6 billion in retained IDA resources alone. Using the current PBA system, this could have resulted in:

- $5.5 billion more for African countries;
- $4.6 billion more for HIPCs (more than enough to address the MDRI netting out issue); and
- $1.1 billion more for post-conflict countries and countries re-engaging with IDA after a prolonged hiatus.

KEY CONSIDERATIONS: Going forward, World Bank shareholders will need to consider several policy and financial implications:

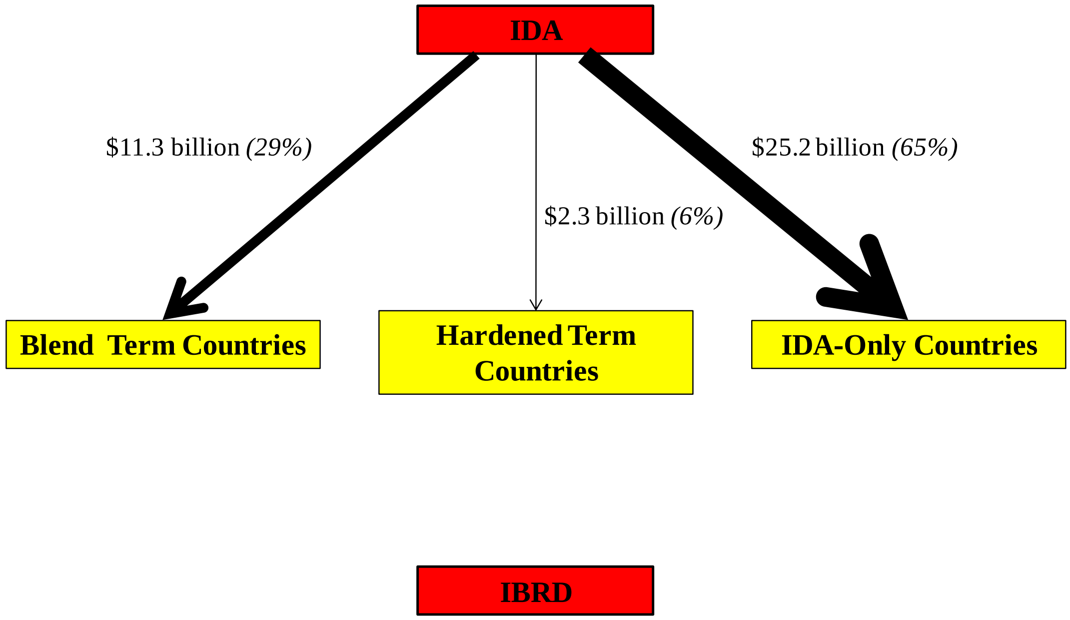
- Debt Service Profile: Given the shorter IBRD loan grace period, recipient countries would begin making principal payments sooner than with IDA blend and hardened term credits. IMF and World Bank staff would need to monitor the impact on debt service levels.
- Interest Rate Sensitivity: As IBRD interest rates are benchmarked against LIBOR, fluctuations will impact the interest rate profile of the respective loans. Sensitivity analysis suggests that the proposal's savings remain robust under a number of LIBOR scenarios.
- IBRD Capital and Loan Loss Provisioning: Under the baseline scenario, the IBRD would provide roughly $3.5 billion in annual lending to qualifying countries – equivalent to roughly one-quarter of its recently-approved lending capacity. The envisioned loan volumes could have a modest negative impact on the IBRD's overall portfolio quality.
- IDA Financial Integrity: The IDA grant buy-down will reduce future principal and charge reflows. This entails a tradeoff between: (1) maximizing resources for the poorest countries *now*; and (2) maximizing projected reflows over the next four decades. To address this concern, IDA could provide highly concessional credits instead of grants.

CONCLUSION: Against the backdrop of the fast approaching Millennium Development Goals deadline, World Bank shareholders have an opportunity to dramatically increase resources available for the poorest, most vulnerable countries. By better leveraging the IBRD's balance sheet for creditworthy blend and hardened term countries, IDA could have provided up to an additional $7.5 billion for IDA-only countries during the IDA-15 period. Critically, the IDA-16 replenishment and IBRD general capital increase discussions underway provide an excellent window of opportunity to implement this innovative development finance approach.

Attachments:
Figure 1 - IDA-15 Status Quo: Country Allocation by Term Grouping
Figure 2 - IDA-15 Blended Financing Facility: Indicative Country Allocation by Term Grouping

[1] The following countries could be prospective candidates based upon external debt ratios and other creditworthiness indicators: Angola, Armenia, Azerbaijan, Bolivia, Bosnia-Herzegovina, Cape Verde, Georgia, Guyana, Honduras, India, Moldova, Papua New Guinea, Sri Lanka, St Lucia, St Vincent & Grenadines, Uzbekistan, and Vietnam. India and Vietnam together account for over 80% of lending volumes.

Figure 1 – IDA-15 Status Quo: Country Allocation by Term Grouping



Note – Arrows are drawn to scale
Figures in parentheses indicate the group's percentage of IDA-15 resources

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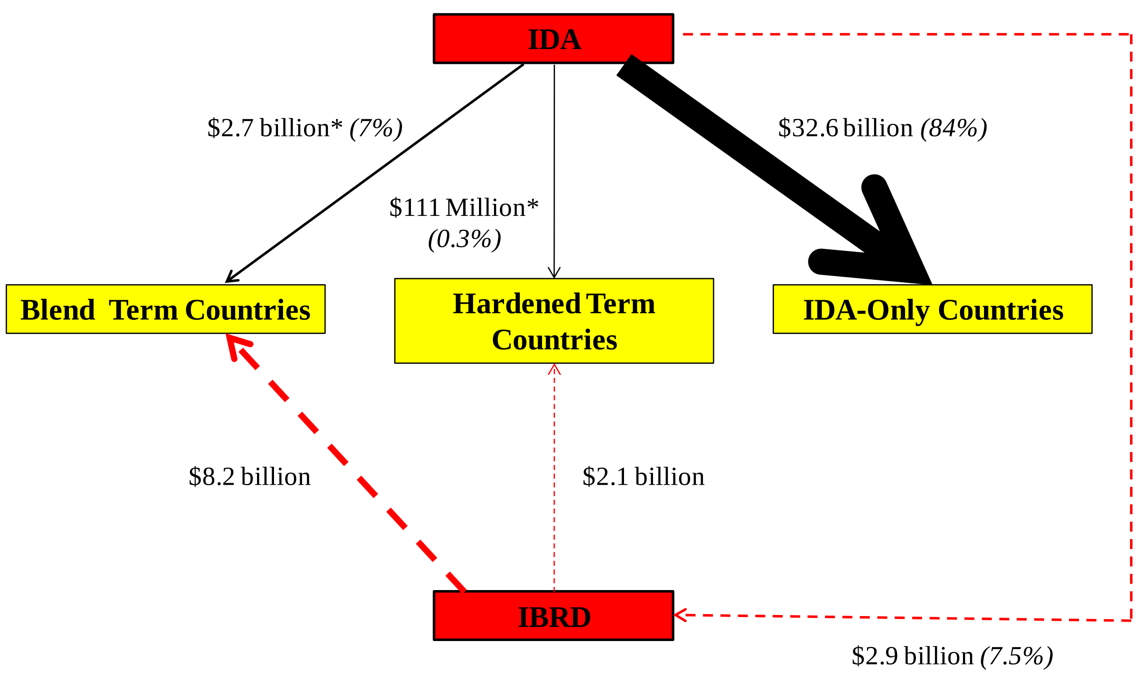
Figure 2 – IDA-15 Status Quo: Indicative Country Allocation by Term Grouping



Note – Arrows are drawn to scale
Figures in parentheses indicate the group's percentage of IDA-15 resources
* Six blend or hardened term countries would receive regular IDA assistance due to ineligibility for the proposed Facility