Review of “Enhancing ADB’s Financial Capacity to Achieve the Long-Term Strategic Vision for the ADF”

Nancy Birdsall, Scott Morris, and Enrique Rueda-Sabater

Abstract

In early 2014, the Asian Development Bank introduced a financial restructuring proposal that would merge ADF lending and loan proceeds with the capital and lending activities of the bank’s core operations. As a result, the proposal indicates that there would be more resources made available to ADF countries like Viet Nam and Bangladesh, more ADB lending capacity for non-ADF countries like the Philippines and Indonesia, and much less demand for donor contributions. Faced with such a fundamental reworking of the institution’s financing model, donors to the ADF asked for an independent assessment, which CGD had the pleasure of conducting. With the support of ADB management, we are now releasing the assessment publicly.

Our assessment found that the main promises of the proposal are sound, and therefore we have encouraged the ADF’s donors to move swiftly to approve it in order to take full advantage of the benefits that will come from greater leveraging of ADF resources. More fundamentally, though, we see the proposal as an impressive launching point for further innovations in the ADB’s basic model, potentially paving the way for fresh thinking across the multilateral development banks (MDBs).
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Section One. Overview

Organization
This paper responds to questions posed in the 5 June 2014 Terms of Reference (TOR – See Appendix) for the review of the proposal “Enhancing ADB’s Financial Capacity to Achieve the Long-Term Strategic Vision for the ADF.” The TOR poses a mix of open-ended and specific questions. In our reading, they can be framed around three fundamental questions:

- Will the proposal reliably generate the additional financial resources that are indicated?

- Are the proposal’s projections for ADF demand accurate, reflected in particular in the ADF graduation scenarios?

- Will the additional resources be directed to the benefit of ADF countries through appropriate governance mechanisms?

In Section Two, we respond to the TOR questions according to these three categories. In Section Three, we offer “Additional Considerations”, which are intended to motivate ADF donors, as well as ADB management and ADB shareholders more broadly, to think more deeply about policy and governance changes that could usefully be considered subsequent to the proposal's approval.

Although the questions in the TOR emerged from discussions with ADF donors and are focused on ADF countries, we have taken an ADB-wide perspective where appropriate, taking into account that the proposal itself has implications for ADB more broadly.

Summary Assessment
We commend ADB management for crafting an ambitious proposal that appropriately reflects new realities in the bank’s region of operations and exercises leadership in areas relevant to all multilateral development banks (MDBs). The proposal’s clear and concrete set of actions should help the institution better contribute to the development financing needs of the region in the years ahead. We also commend ADF donors and the ADB board for thoughtful guidance in shaping the proposal and for overseeing a sound due diligence process in carrying it forward.
Our direct assessment of the proposal according to the questions of the TOR is largely affirmative. We offer some qualifications and recommendations for modest modifications in Section Two, as well as encouragement for further thinking in Section Three, motivated by the promise of the proposal, as well as the stated objectives of the donors.

In our judgment, the proposal is highly credible, and we are confident that it has the potential to deliver on its promises, recognizing the range of scenarios outlined within it and the need to carefully manage key aspects.

Specifically we find that:

- the logic behind the proposal is sound: the track record of repayments from ADF countries and of their overall relationship with ADB means that their repayment obligations represent significant value that can become useable equity;

- the demand assumptions implicit in the financial projections are reasonable ones and show the benefits of the expanded lending capacity;

- the graduation scenarios in the proposal are reasonable, and the sensitivity analyses that combine the graduation scenarios with negative events are an adequate stress test of the proposal;

- the strengthened transition support and the added emphasis on regional projects and non-sovereign lending are appropriate and viable;

- the governance commitments in the proposal represent a good balance for the near term and should be successful in prioritizing additional financing for current ADF countries.

At the same time, we also have a few suggestions for strengthening implementation of the proposal:

- treat ADF-XII more distinctly as a transition period, particularly with respect to consideration of reduced donor contributions and governance arrangements;
• ensure that organizational, accounting and risk management policies and procedures are in place in order to transition smoothly to a merged financial operation, as well as to manage the on-going financial implications of concessionality becoming an integrated part of OCR lending.

In our view, the proposal marks a first big step that can open up a range of new possible policy and governance arrangements to better serve the fundamental mission of the institution—and pave the way for fresh thinking across the multilateral development banks. From this perspective, we offer a number of additional considerations and recommendations for future action in Section Three. We wish to emphasize that these ideas are not intended as alternatives or modifications to the proposal but as complements. We believe the proposal is sufficiently compelling that it would be inadvisable to delay its approval or implementation.

In this regard sequencing matters greatly, and we are mindful that the more ambitious ideas offered in Section Three require significant deliberation. We offer them as an encouragement to ADB and its constituencies to use the opportunity of discussing this major financial merger proposal to launch a broader deliberative process—one that seeks to fully exploit the additional opportunities created by adoption of the proposal. The greatest risk that we see in this proposal will not come from deviations in graduation rates or financial projections; rather, it will come from a failure to fully exploit the flexibility this financial merger offers to adapt lending policies and governance arrangements in ways that reflect the new reality of ADB borrowers and of the region as a whole.

Finally, with respect to the core proposal, we suggest that as donors deliberate in the months ahead, assisted we hope by this assessment, they give full weight to the costs of inaction. There are risks inherent in any major policy change. But it would be a serious mistake to evaluate these risks in isolation. Ultimately, the perceived “safety” of the status quo comes at the cost of realizing the institution’s full potential. And that, in our view, would represent a failure in the stewardship of the bank’s resources.

**Section Two. Responses to Terms of Reference Questions**

In this section, we respond directly to the specific questions posed in the Terms of Reference. Section 2A addresses the questions related to financial resources. Section 2B addresses the questions related to graduation scenarios. Section 2C addresses the questions related to governance arrangements.
Section 2a. Financial Questions

Given the requirement that OCR maintain a much higher equity-to-loan ratio, which substantially reduces the leveraging ability of the OCR and contrasts with recent measures by the IBRD, what are the implications—for ADF countries in particular—if a financial crisis occurs in the future?

In case of ADB financial distress (a substantially worse case than the lower-income scenario), does the proposal ensure that prudential concerns, such as the desire to protect the credit quality of the OCR portfolio and to reduce subsidized lending and net income transfers, do not negatively affect ADF countries?

Under what conditions could the additional income generated through the merger be sufficient to fund the ADF grant window on a self-sustaining basis?

Summary of Financial Aspects of the Proposal

We first provide our understanding of aspects of the proposal most relevant to these questions.

Essentially the proposal involves shifting ADF’s financial framework from a "fund" one based on cash-flow to a financial intermediary one structured around a balance sheet and combining it with the framework used for ADB’s ordinary capital resources (OCR). The advantages of this new approach revolve around increased borrowing headroom (without weakening ADB’s strong AAA rating) and reduced liquidity holdings. It is worth noting that the change in liquidity policy has a significant one-time effect, while the increased useable equity and ensuing headroom (as well as the liquidity policy) will have on-going effects.

In the current model, cash scheduled to be received from donors ("receivables") and scheduled repayments from ADF borrowers ("reflows") fund projected disbursement needs and administrative expenses while liquidity is managed to be above a prudential minimum.

In the proposed model ADF assets are framed in a balance sheet context with the equivalent of equity matching the sum total of assets consisting of liquidity, receivables and loans outstanding.
This shift to a combined ADB balance sheet\(^1\) can be visualized as follows—just before and after it would take place:

**December 31, 2016**

ADF assets = $38 billion ($30.8 billion in loans outstanding + $7.2 billion in liquidity/receivables)

**January 1, 2017**

- ADF assets = $3 billion in liquidity and receivables designated to fund grant operations
- former ADF assets converted into ADB equity = $34.6 billion (net of $0.4 billion "fair valuation" discount)

The shift can also be visualized through the lens of the Equity/Loan ratio.

As of December 31, 2016 ADF's implied E/L ratio is projected to be 113% while that for ADB's OCR is projected at 27%. The minimum ratio for the combined balance sheet is proposed to be in the 37% - 40% range. *Ceteris paribus* this means that the proposal consists in shifting ADF's E/L ratio down from 113% to within the 46% - 54% range.\(^2\) Projected reserve increases from net income allocations would further increase E/L ratios.

In terms of *net income* the main positive impact envisaged in the proposal is due to the margin from the lending expansion enabled by increased borrowings (using the new headroom). This is particularly the case in conjunction with the projected expansion of non-sovereign lending.

The proposal generates additional financial flexibility by reducing aggregate liquidity requirements. OCR rules for minimum liquidity are applied to the combined portfolio, and hence, the combined balance sheet can carry less liquidity than the current sum of ADB and ADF liquidity.

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1 Post-merger data is presented in Table 6 and pre-merger data can be inferred from the table's notes.
2 Consistent with the 37% - 40% E/L ratio range, the combined equity of $53 billion would support a range of lending of $132 - $143 billion. If the minimum E/L ratio for the ADB-OCR remains the same (27%), the implied minimum ratio for the new ADB equity coming from ADF will be in the 46% - 54% range.
Two scenarios are presented to explore a range of different graduation paths, which we explore further in Section 2B. Total projected ADB approvals for 2017-2026 under both scenarios are very similar—with total approvals under the expanded OCR around $160 billion. The main difference between the scenarios is in the lending “blend” as the share of concessional lending to total lending that current ADF countries are expected to receive is 37% under the "early" scenario and 42% under the "slow" one.

The proposal has major implications for donor contributions going forward. Under the current ADF model, demand for donor contributions in ADF XII would rise to $6.5 billion-$7.8 billion under the early and slow graduation scenarios, compared to donor contributions totaling $4.7 billion in ADFXI. Under the proposal, donor contributions of just $2.3 billion-$2.7 billion would be required. Hence, donors would “save” $4.2 billion-$5.1 billion in ADFXII alone, as outlined by the proposal.

Sensitivity analysis has been carried out within the proposal, with three sets of downside alternative assumptions to those in the base case. Stress-testing assumptions on credit risk and defaults suggests that, even under a fairly extreme situation, ADB would be in a position to continue to fulfill its commitments to current ADF countries—although in some years it would only be able to make transfers to the ADF grant fund by drawing down the surplus account and the E/L ratio would reach the minimum prudential level. Stress-testing assumptions on income from the liquidity and equity portfolios would also put pressure on the E/L but without approaching minimum levels and ADB would have ample room to meet its commitments to ADF countries.

**General Assessment of Financial Aspects of the Proposal**

Overall the logic behind the proposal is sound: the track record of repayments from ADF countries and of their overall relationship with ADB means that their repayment obligations represent significant value that can be used to a greater extent than is the case currently. In our opinion, the new financial structure that would emerge—should the proposal for the ADF/ADB merger be approved—has the clear potential to provide adequate resources for ADF countries, facilitate their transition, as relevant, to OCR-only status, and benefit ADB's membership as a whole (donors and borrowers alike).

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3 The minor difference in total approvals between the two scenarios ($159.4 billion in the early scenario and $161.2 billion in the slow scenario) reflects parallel assumptions about graduation of OCR-only countries from ADB lending.
The questions that we were asked to address included whether the proposal is too conservative (high E/L ratio?) or not conservative enough (adequate prudential protection for concessional lending levels?). In our opinion the proposal provides a reasonable balance between extracting greater value from ADF/ADB assets and ensuring support for ADF countries under most plausible scenarios. We are concerned, however, that the steep and immediate drop in donor contributions envisaged in the proposal would become an agreement with donors before the combined ADF/ADB balance sheet has been adequately market-tested. In our view, the amount of reduction in donor contributions is premature and should not be front-loaded as much.

The question of how to convert the value of ADF loans outstanding into usable ADB equity has been addressed—in consultation with ADB’s external auditors—through a $437 million 'fair valuation' discount, as indicated in paragraph 62 of the proposal. In our view, this does not fully address questions related to the valuation discount to be applied to the face value of the ADF loans. Using the proposal’s own interest rate projections as a basis for a present value calculation of the stream of payments from ADF loans would suggest a discount that is greater than very small discount currently assumed. This would be worth modeling for further clarity because we believe it could ultimately reduce the headroom emerging from the proposal. Nonetheless, we do not believe it affects the overall soundness of the ADF/OCR combination, and in any event, we expect that the separate reviews conducted by financial experts and the credit rating agency would cover this issue more fully.

The demand assumptions implicit in the financial projections are reasonable ones and show the benefits of expanded headroom. For ADB borrowers as a whole the projections represent a significant step-up in lending at the moment the headroom expands in 2017. For OCR-only countries the two periods corresponding to ADF XII and XIII show different dynamics, with lending significantly higher in the first four years after 2016 and dropping back in the following four years—plausibly reflecting reduced demand on the part of the more advanced OCR-only countries where ADB activity also shifts towards non-sovereign loans and guarantees. This evolution of demand from more advanced (and lower risk) countries is something that needs to be watched closely; if demand from such countries drops faster than projected, either lending projections overall will fall short or the average risk of the portfolio will increase.
For ADF countries, OCR lending (both sovereign and non-sovereign) increases in both periods and the main difference between the two scenarios reflecting different graduation paces is how quickly the blend of terms evolves from the 43% concessionality expected in 2016 to 38% and 29% and in the "slow" and "early" scenarios, respectively, for 2026.

**For all countries, the projected increase of non-sovereign operations to 25% of OCR approvals by 2020 is also something to be closely watched.** The financial projections appear to factor in somewhat higher risk levels as the non-sovereign portfolio grows (loan loss reserves increase more than the non-sovereign exposure); this is reasonable as expanding non-sovereign activities will require going beyond the "cherry picking" that comes with lower levels of activity. But the assumption is also that these operations generate relatively high margins (300 bp as opposed to 20-60bp for sovereign operations) and that will remain the case in future as the portfolio grows. This dual premise—that non-sovereign operations will scale to 25% of OCR approvals and that these operations will be more profitable—contributes to the financial viability of the proposal (which already takes into account the increased capital costs of non-sovereign lending) and will need to be closely monitored, including in terms of the capital adequacy and loan loss provision implications of adverse scenarios.

**A more explicit and systematic approach to managing the financial implications of the new OCR concessional loans is advisable to ensure sound financial management of the combined balance sheet.** Contrary to how regular and non-sovereign OCR loans are treated (where returns are related to the spread or margin they earn), the proposal treats the total interest charge on concessional loans as margin and considers that there is no funding cost associated with concessional lending because those operations have been funded by equity under ADF replenishments and equity is envisaged to remain its funding source after the implementation of the proposed merger. An alternative approach would involve measuring opportunity cost—which would imply estimating funding costs for the new concessional OCR lending as the difference between the return of the liquidity portfolio and the interest rate applied to regular OCR loans.

It is important to keep in mind that we are in a period of historically low interest rates and at the interest rate levels prevailing in the market currently, the difference between regular and concessional lending terms is very narrow. But concessional OCR lending implies funding loans with long maturities and very low, fixed interest rates. The proposal envisages market rates (using returns on the liquidity portfolio as a proxy) going from 1.6% in 2016 to 4.2% in
2022-2026. At market interest rates above 3% (which the proposal envisages reaching in 2018) the gap becomes significant and the differences between the implications of the "early" and "slow" graduation scenarios also increase.

Finally, it is worth emphasizing that continuing "business as usual" with ADF would have a number of draw-backs. In the absence of the actions outlined in the draft proposal, ADB as a whole would have less capacity to provide both ADF and OCR assistance at considerable opportunity cost considering the momentum in the region and the high potential pay-off in development terms to expanded ADB activities in the region. The proposal quantifies the costs of the status quo in terms of higher donor contributions to meet ADF demand (an additional $5.8 billion to $10.2 billion over 8 years) and lower OCR lending capacity ($10 billion compared to $12 billion to $16 billion under the proposal). But there is no guarantee that donors would be willing and able to deliver in full to meet this financing gap, which means that ADF would not be able to meet expected demand. Beyond the benefits associated with additional OCR headroom under the proposal, missed opportunities under business as usual could also include the benefits of increased financial flexibility for the institution as a whole, which introduces the possibility for innovation in a number of areas. We elaborate on these potential benefits further in Section Three.

Assessment Related To Specific TOR Questions

In our assessment, the proposal should be able to meet the stated objectives and to protect commitments to ADF countries even under adverse circumstances. The combination of the "slow" graduation scenario and the sensitivity test incorporating a set of arrears and defaults illustrates the implications of a very adverse situation. The impact could be even worse than shown in table A9.2 because of the likelihood of losses in the non-sovereign portfolio. The combination of such a scenario with lower returns than projected on liquidity and equity investments would represent an even more severely adverse situation. Under such a "perfect storm" (which would compound the effects of two scenarios modeled separately in the proposal) and without factoring in corrective measures, the E/L ratio would probably fall below the minimum proposed, but not disastrously low. Total allocable income would probably be reduced by a further $2-$3 billion for the 2020-2026 period. In such a scenario, we expect that corrective measures would be put in place by ADB and would require revisiting key parameters of the proposal—notably regarding donor contributions, ADB net income transfers for ADF grants, and administrative costs. If
corrective actions were not taken, then it would be very difficult for ADB to maintain the intended level of support to ADF countries.

The proposal essentially replaces donor contributions—which are only very indirectly subject to market turbulence—with financial self-reliance through leverage and earnings—which are directly affected by market turbulence. With that in mind it is not possible to conclude that the proposal will, under any circumstances, guarantee that the commitments made to ADF countries can be met. But the proposal is designed in such a way that, in our opinion, it is very likely that both ADB as a whole (donors and borrowers alike), and specifically ADF countries, will all benefit from it.

Under the proposal it does not appear possible—while maintaining the financial soundness and prudence for ADB’s overall sustainability—for ADB’s income to become the sole source of funding for the ADF grant window during the period covered. To be in a position to do so would require envisaging the combination of the “early” (or even faster) graduation scenarios, higher-income levels (returns on liquidity and equity investments) and an even greater share of the portfolio going to non-sovereign operations (while maintaining their margin of profitability). In our opinion this is a very unlikely combination of factors and, hence, continuing donor contributions will be required to sustain ADF’s grant operations.

Section 2b. Questions Related To Graduation

Are assumptions for graduation from ADF status under the base case scenario reasonable? How will changes in the number of countries that actually graduate relative to the assumptions affect support available to ADF countries?

ADF Graduation Policy and Track Record

As the proposal acknowledges, the composition of the ADF will continue to change over the coming decade. Many of the countries currently eligible for ADF lending are experiencing economic growth and institutional and financial stability such that they are increasingly likely to be able to borrow on OCR terms and therefore graduate from ADF.

ADF graduation policy is based on two criteria: 1) GNI per capita in excess of the IDA-determined cutoff (US $1,205 as of 2014) and 2) creditworthiness (to be lent OCR
resources), as determined by the bank. Additional considerations and exemptions are given for small island developing states (SIDS, 13 of the current 29 ADF countries) and fragile and conflict-affected states (FCAS, 9 of the current ADF countries)—in agreement with ADF donors.

ADF policy and practice make it clear that graduation is not an automatic or mechanical process, but rather based on a set of triggers, some discretionary, intended to achieve an incremental adjustment in concessionality from 100% (the case for ADF-only eligibility) to 0% (the case for OCR-only eligibility). This amounts to what the ADB states is normally a four year lag between the time a country crosses the GNI threshold and full graduation from ADF. Still, as reflected in the proposal, specifically predicting graduation timing is uncertain, and the proposal elects to only show scenarios in aggregate.

The dynamics of the graduation process (and evolution of the ADF/ADB blend) are also influenced by the replenishment cycles, as donors need to be involved in eligibility decisions. If there were no lag for creditworthiness, an ADF country that crossed the GNI per capita threshold early in one replenishment cycle would become ineligible for ADF lending and graduate to OCR status in the next replenishment cycle. However, countries do not graduate directly from ADF-only to OCR-only status. The policies surrounding the transition through "blend" status are not clear-cut (mainly driven by ADB’s considerations of debt repayment capacity).

Historically, the lag between the GNI threshold year and actual graduation has varied widely. The nine countries have that have graduated since 1990 moved to OCR anywhere between zero and eight years after crossing the threshold. The average length of 4.25 years, which matches the ADB's stated “normal” lag, does not provide a good basis for projections and highlights the importance of individual country considerations in the process. IDA, which had a slightly larger sample of eleven countries graduate since 1990, also has an average lag

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7 ADB 2014, 8.
8 ADB 1998, 18.
9 Changes to the GNI cutoff level and graduation policy in 1989 make earlier graduations less comparable.
10 ADB 2011, 82.
of 4.18 years but an even wider range from -4 (graduation before crossing threshold) to 13 years.\textsuperscript{11}

The variability in the lag between the threshold year and graduation complicates predictions around the timeline for graduations. Indeed, over half have been over the threshold for more than seven years and are well past the ADB’s standard lag period (which would have them already graduating in this replenishment period, clearly not the case). Delays are likely due to the disruptions of the 2008 financial crisis and other external circumstances affecting creditworthiness, as well as political considerations. But their length and variability raises questions about the strength of GNI as an eligibility criterion.

**Review of the Proposal’s Graduation Projections**

The set of current ADF countries fall across a range of income levels and economic size (reflected in their lending portfolios), as shown in Table 1 of this paper. Out of 29 countries, 20 are already above the GNI per capita threshold for graduation eligibility. Most, on either side of the GNI threshold, still have relatively high rates of poverty (a factor that may implicitly be behind the long graduation lags and—as we will argue in Section Three—merits more direct consideration).

Given the wide range of economic sizes among ADF borrowers, it is not surprising that a few large countries account for the bulk of ADF lending: Vietnam, Pakistan, and Bangladesh comprise nearly half of allocations simulated for the next replenishment period; and four other countries (Sri Lanka, Uzbekistan, Cambodia, and Nepal) make up an additional 27% of total lending.\textsuperscript{12} In our view this means that graduation scenarios need to focus on the specific countries involved rather than just the number of countries.

\textsuperscript{12} ADB 2014, 73.
The proposal includes two graduation scenarios: under the early graduation projection 12 of the current 29 ADF countries would graduate by the end of the XIII replenishment cycle in 2024—with Mongolia, Sri Lanka and Vietnam graduating by 2020; under the slow graduation projection those three countries would only graduate by 2024 and the others would not graduate until later (see Table 2 of this paper). Armenia and Georgia are assumed to graduate by 2017 under any scenario and would, therefore, receive no ADF lending in the XII replenishment period.
ADB’s historical upper bound of an eight year lag between a country crossing the GNI threshold and becoming OCR-only borrower has already been surpassed by many of the countries being considered for graduation, and even in the “early” scenario, some countries will be waiting at least another seven years until ADF XIII. To construct a timeline that resembles the one proposed in Figure 4 of the proposal requires that we assume a 12-year lag. If this lag is applied universally, Kyrgyz Republic, Cambodia, and Bangladesh are pushed far beyond the 2021-2024 period, consistent with the fact that they have not been included in the ADB’s graduation projections.

Alongside the graduation projections, the proposal recognizes and plans for strengthened concessional support to ADF countries. Since availability and demand for resources will differ depending on the graduation rate of ADF countries, it offers two sets of assumptions for strengthening under the two graduation scenarios. For the early scenario, 50% of ADF assistance previously allocated to graduating countries will be re-allocated to remaining ADF countries (the remaining 50% will be continue to be allocated to the graduating country for the period of one replenishment, to smooth the transition to OCR). In the slow scenario, later graduation of fewer countries results in fewer resources for re-allocation. Therefore, the size of the replenishment, including donor contributions, would need to be increased.13

To illustrate the implications of the ongoing resource allocation mechanism—including on the mix of concessional lending and grants—the proposal provides indicative country-level allocations for most ADF countries through the end of the next replenishment, XII, in 2020.14 The performance-based allocation (PBA) reflects the share of allocated assistance, while the total actual assistance is given in grants, concessional loans, or both (depending on the country’s debt eligibility).15 These numbers provide an estimate of the levels of ADF assistance that will be required in the case without ADF strengthening. They also represent the level of funding that would be made available during XIII should any of these countries graduate during the XII period (subject to the 50% re-allocation strategy).

**Assessment of the Proposal’s Core Graduation Projections**

To verify the graduation predictions set forth in the proposal, we construct a graduation model based on the GNI threshold, the more measurable aspect of ADB’s criteria (see Table

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13 ADB 2014, 40.
14 ADB 2014, 72.
15 ADB 2014, 28.
We use the most recent (2012) GNI Atlas Method figures from the World Development Indicators (WDI) for each country, and project forward by multiplying by the updated WEO GDP growth rates. We then divide GNI by the yearly UN Population Division projections to get projected GNI per capita from 2012-2030. We use WDI GNI per capita figures for years before 2012. Based on these figures, we mark the year the country passed or is projected to pass the IDA-set GNI per capita threshold of US$ 1,205. The difference between this threshold year and the present year (2014) represents the ongoing graduation lag. Negative lag values indicate the number of years until a country passes the threshold in the future.

We also apply average lag periods to illustrate potential timelines for graduation: four years, as specified as the ADB’s usual policy, and 12 years, showing the path most closely matching the ADB’s apparent timeline (i.e., all 12 countries graduating by 2024). This is similar to the methodology used by internal IDA predictions, Moss and Leo,16 and Salvado and Walz17 to project IDA and other MDB graduation scenarios, in which they use an average five year lag to account for creditworthiness considerations. After adding the lag, we indicate the next replenishment cycle under which the respective countries could graduate from ADF.

Each of the 12 countries affected by the graduation scenarios has already passed the GNI threshold by at least two years, so the projections are not contingent on expected growth. Thus, we infer the graduation scenarios are based on other considerations, presumably creditworthiness. Using the limited information available from credit rating agencies, we look at the potential relationship between sovereign creditworthiness and graduation lag but could not discern any pattern in that regard—other than the countries expected to graduate under both the early and slow scenarios have better coverage by credit rating agencies. However, since the sample of rated countries is limited, we do not include credit ratings as a direct factor in our model.

Our analysis, as reflected in Table 2, broadly supports the graduation scenarios in the proposal.18 The 12 countries included in the graduation scenarios of the proposal

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18 The last column of Table 2 (“ADB Early/Slow”) reflects our interpretation of the implication of the two scenarios; the ADB proposal itself does not incorporate specific country graduation projections.
should definitely be considered "ripe" for graduation in the next decade. All of them have crossed the GNI threshold already, and are expected to continue growing. However, it is unclear from externally measurable characteristics what would make Mongolia, Sri Lanka and especially Vietnam graduate earlier than the rest. We note that they are the only ADF countries to have Fitch credit ratings, however when compared to a more inclusive sample of S&P ratings they are not significantly different from the rest. The proposal itself does not explain these countries’ inclusion in the slow scenario over any others.

Finally, our analysis shows three additional countries will cross the threshold before 2024 if growth trends hold: Kyrgyz Republic, Cambodia, and Bangladesh. Depending on the lag time for creditworthiness and other considerations, each of these could potentially also graduate by the end of the XIII cycle. As they account for a significant share of expected ADF resources, this has potentially large impacts on ADF/ADB resources. With the 50% re-allocation strategy for strengthening remaining ADF countries, these three graduations, assuming XIII allocations would otherwise resemble those for XII, could mean over $1.2 billion in additional available ADF resources (see Table 1 above).[19]

To further test the scenarios, we look at other possible variations from the standpoint of faster and slower progress among ADF countries.

In the case of faster progress, our model’s predictions that Cambodia, Kyrgyz Republic, and Bangladesh graduate within the window are strengthened. With 25% higher growth than expected (Bangladesh growing at 8.13% in 2015, for example), all three countries would cross the threshold by 2018, and additional resources could become available even sooner. And while thresholds for Blend status are not specified, higher growth rates would also likely precipitate faster transition to Group B for countries such as Myanmar and Tajikistan. While this eventuality would have a major effect under the current separate ADF and ADB structure, it would be much more easily handled (including extending "blend" periods) with the ADF/ADB merger.

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To reflect a slower progress scenario, we consider whether some countries could face reverse eligibility in cases of economic set-backs, adding unanticipated strain on ADF/ADB concessional resources. We explore the three potentially more exposed cases—Pakistan, Laos, and Vietnam (see Box 1), but find overall that the downside risks are low based on growth magnitudes and histories. We also look at Afghanistan as a special case in terms of impact on the grant window.

**Impact of Graduation Scenarios on Resource Requirements**

A country’s movement across categories of ADB membership results in a change in lending offered by ADF/ADB for the individual country and a change in availability of ADF resources to countries that remain eligible. As countries progress towards graduation to OCR-only status, the level of concessionality and pressure on ADF resources decreases, all other things being equal. As modeled in the proposal, reflected in differences between the early and slow graduation scenarios, faster graduations mean less demand for ADF grants and therefore lower grant replenishments.  

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<td>B+</td>
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<td>Papua New Guinea</td>
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<tr>
<td>Uzbekistan</td>
<td>4</td>
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<tr>
<td>Lao P.D.R.</td>
<td>2</td>
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<td>Pakistan</td>
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<td>Kyrgyz Republic</td>
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<td>Cambodia</td>
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<td>Bangladesh</td>
<td>-6</td>
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*Georgia and Armenia are set to graduate by 2017 in either scenario

To reflect a slower progress scenario, we consider whether some countries could face reverse eligibility in cases of economic set-backs, adding unanticipated strain on ADF/ADB concessional resources. We explore the three potentially more exposed cases—Pakistan, Laos, and Vietnam (see Box 1), but find overall that the downside risks are low based on growth magnitudes and histories. We also look at Afghanistan as a special case in terms of impact on the grant window.

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20 Under the proposal, donor contributions would only finance ADF grant operations and the Technical Assistance Special Fund (TASF), while under the 'status quo' donor contributions would continue to finance ADF loans as well as grants and TASF.
Box 1: Potential implications of set-backs in Pakistan, Lao P.D.R., Vietnam, and Afghanistan

Pakistan, Lao P.D.R., and Vietnam all sit just above the GNI per capita threshold. Despite current expectations for robust growth, in the case of a strong economic downturn these countries would be the first to become ineligible for graduation by 2024.

If Pakistan experiences negative growth beyond -0.20% per year, it could fall below the threshold within the XII replenishment period and thus will not graduate. Considering Pakistan will be the second-largest ADF recipient at $1.46 billion, continuing that assistance beyond XIII would be a significant resource burden for ADF. However, even in the global recession Pakistan’s growth did not dip below 1.7%, making it unlikely that graduation will be stalled based on GNI per capita eligibility.

For Lao P.D.R., growth would have to reach -1.75% to drop GNI per capita below the threshold. While Laos is expected to receive smaller amounts of assistance in ADF XII at $350 million, failure to graduate would put additional pressure on ADF resources. But Laos has not experienced negative growth since 1988, and has had very stable rates in the last decade, increasing confidence that current trends will continue and GNI per capita will remain above the threshold.

Vietnam is among the group of five slated by the ADB to graduate early, and the largest total recipient of ADF assistance. Nonetheless, its lower GNI per capita and relatively high poverty rates increase the risk that it will fail to graduate in ADF XII and will be pushed back into a later cycle, increasing the amount of needed ADF resources by $1.67 billion in subsequent replenishments and reducing strengthening re-allocations for remaining ADF countries. However, Vietnam would have to experience a complete reversal of GDP growth (over -6% per year) to have GNI drop below the threshold, an unprecedented event in its modern history.

Afghanistan represents a special case. Although the country does not factor into graduation scenarios, its historical treatment is important to consider from the standpoint of resource demands on the grant window in ADF-XII and beyond. The proposal notes that the “post-conflict premium” for Afghanistan will be gradually phased out, as agreed by ADF donors and the board. This refers to a 2012 agreement. The 2012 agreement represented a significant adjustment to a previous phase out agreement, which was suspended in 2010. All told, under the revised phase out plan, Afghanistan will receive $717 million in additional grant assistance over a 7-year period compared to the original phase out plan.

Given an uncertain environment in the country, and donors’ clear direction for a prioritization of fragile states, it is worth considering the possibility that future policy changes could point to a desire for significantly more grant resources devoted to Afghanistan. Certainly, the increased focus on development assistance after the external military drawdown, in conjunction with fiscal pressures facing major bilateral donors, suggest that multilateral channels could be under pressure to do more. The dollar increase from the previous adjustment (an average of $100 million p.a.) would represent 15% of all projected grant approvals in the proposal.

Less clear is the impact of variability in the graduation trajectory for individual countries, particularly large ADF countries. **Donors should be mindful of the ways (some outlined in Box 1) in which specific countries could alter the financial projections and, hence, the merit of considering ADF XII as a transition period.**

Questions about the graduation process include the progression from ADF-only to Blend status. For example, two of the countries noted by the proposal (Bhutan and Lao P.D.R.), and two others included in the GNI analysis (Kyrgyz Republic and Cambodia), are still ADF-only countries. The proposal notes that these four could be reclassified as Blend/Group B by 2024 and suggests that Myanmar and Tajikistan could also potentially transition.

Since transitioning should not affect the topline concessional allocation level, but merely the mix of grants vs. concessional loans, the total assistance available to ADF countries would not be affected. However, faster than anticipated transitions to Group B may put constraints on other OCR lending by affecting the overall risk profile just as slower than anticipated transition would increase the burden on the grant window and require higher replenishments.

Finally, the impact of faster graduations on demand for OCR-only resources also deserves attention. The difference in levels of market term lending reflected in the proposal's early and slow scenarios is slight, but there is almost no focus in the proposal around these relative magnitudes. Given the proposal’s ADF focus, the lack of detail here is understandable. Nonetheless, while OCR-only dynamics may not be a particular focus of ADF donors, ADB shareholders more generally should explore these questions in greater detail.

**In conclusion, we find the graduation scenarios incorporated in the proposal reasonable.** Our modeling broadly supports the proposal's conclusions, while also pointing to the inherent variability in these projections, given the ambiguity in key parameters governing the graduation transition. We are reassured by the proposal’s range for concessional funding requirements under different scenarios, but we also view this variability as evidence that donors should be sensitive to the role of their replenishment contributions in mitigating down side risks. Also, we expand on possible methods to streamline the eligibility process in Section Three.
Section 2c. Questions Related to Governance Arrangements

The base case projections indicate a substantial increase in resource flows to ADF and ADF graduating countries; how can we ensure that these increased resources are directed to these countries?

The proposal seeks to demonstrate an increased resource flow to ADF and ADF graduating countries in two ways. First, as discussed extensively in Section 2A, the proposal identifies the financing mechanisms through which additional financing will become available under the merger. Second, it identifies a combination of governance mechanisms and rules that would seek, among other things, to ensure that this additional financing will primarily benefit today’s ADF countries in the years ahead.²¹

Here we assess the ability of the governance arrangements and mechanisms outlined in the proposal (including the proposed resolutions of the Board of Governors) to deliver on the commitment of increased resources for ADF and ADF graduating countries. In our assessment, the governance arrangements in the proposal are unambiguous in prioritizing the additional financing made available under the merger for ADF countries, and we expect that these commitments will be treated as mandatory subsequent to approval by the governors.

The proposal states as an objective “to ensure that the...allocation and use of ADF and concessional OCR will benefit primarily the poorest countries, consistent with the original purpose for which past ADF contributions were made by donors...”²² To do so, the proposal commits to preserve existing governance arrangements and allocation rules, even as the underlying financial model changes significantly. Specifically, the proposal commits to maintaining 4-year replenishment negotiations, the scope of which would be the ADF grants window and ADF concessional lending in OCR, the performance-based allocation policy that will continue to govern ADF grants and ADF concessional lending, and the terms and conditions for ADF loans. Existing ADF-related set asides for regional projects, Pacific countries, and the Disaster Response Facility would be maintained at their current relative shares with some procedural modifications.

Paragraph 87 states that “ADB would agree with donors on the level and use of concessional OCR to be delivered over the next 4-year period, based on country eligibility for concessional resources, demand from

²² ADB 2014, 27, paragraph 83.
eligible countries, and ADB’s financial capacity. To ensure that the needs of the current ADF countries are met as a first priority, ADB will ensure that baseline PBAs from OCR concessional resources...will be at least the level of resources received during ADF XI, in real terms.”

Upon approval of the proposal by the ADB board of governors, these commitments will be adopted by the bank as a whole. As a result, the commitment that baseline PBAs will not fall in real terms will essentially become a fixed input into annual OCR (ADF and non-ADF OCR) decision making. As such, even if financial and economic scenarios are considerably worse and OCR resources are even more constrained than what is described in the base case, we expect that this baseline ADF financing commitment will be met.

Similarly, the various scenarios in the proposal that demonstrate increased support for ADF countries will be subject to separate discussions, as they do not form part of the financial proposal. In this way, we expect that these scenarios will guide decision making (e.g., annual decisions about OCR allocations and the distribution of net income to the ADF grant window) subsequent to adoption of the proposal so that grant and OCR financing for ADF countries will be prioritized. At the same time, it is worth noting that the additional commitments notionally outlined under “Strengthening Concessional Support for ADF countries” within the proposal will be the subject of separate discussions and decisions by countries that support the ADF. As a result, even though they are reflected in the financing scenarios, they should not be viewed as “mandatory” in the manner that the commitment of paragraph 87 to prioritize current ADF countries will be mandatory.

As we note in the next section, it is important to recognize that this prioritization may have second order effects on the OCR as a whole (not just ADF-related OCR lending). As a result, this arrangement—which integrates the finances of the ADF/OCR, but continues with separate governance—may inhibit efficient and consistent overall resource management to better serve the mission of the institution as a whole.

For example, it is not clear how this structure will reconcile potential conflicts between PBA-determined allocations that govern ADF flows and the considerations that govern OCR flows. In some instances (such as demand dynamics resulting in shifts in the composition of the portfolio away from low-risk borrowers), country risk may be a more binding constraint on financing than the PBA-determined allocation. Prioritizing PBA in these circumstances will mean fewer OCR resources available elsewhere in ways that may not be evident in the proposals projections and scenarios.
It is also important to note that the clarity of the projections will be greatest in the early years. Over time, we expect less certainty about the underlying policy and economic assumptions and therefore more ambiguity about the commitments, both in the ability to keep them and their underlying merit. It is not clear that this is intended in the proposal but, in our view, it would be ill advised to set this priority (ensuring that increased resources are directed to ADF and ADF graduating countries) as a fixed element in perpetuity for the institution.

**Are any precautionary additional governance arrangements called for within the concessional window to ensure that the original purposes of the ADF are maintained after the merger?**

The overall financing benefits of the proposal are such that we do not think it advisable to delay its consideration and adoption. **Therefore, we offer a qualified “no” to the question of whether additional governance arrangements should be considered at this time.**

Nonetheless, we do believe it would be worthwhile to consider new governance arrangements in a sequential manner, with the proposal serving as the first and largest step toward a different financing and governance model for the institution. As discussed in the financing section, we suggest treating the ADF XII period as a transitional period in testing the financing elements of the proposal. From a governance perspective, it would be reasonable to identify the ADF XII mid-term review as an appropriate stage to consider governance arrangements beyond those identified in the proposal.

With sequencing in mind, we suggest here two steps to be considered in conjunction with the proposal: ensuring an integrated financial management operation, and reconsidering the trajectory of donor contributions, starting with ADF-XII.

We also identify two areas that deserve priority attention subsequent to the approval of the proposal: first, a more integrated donor/shareholder governance model, and second, a more integrated approach to allocation decisions. Both are complex and potentially sensitive areas of exploration. We come back to these issues, along with others, with specific proposals for consideration in Section Three.
Steps to be Considered in Conjunction with the Proposal

Integrated financial management

The proposal is currently silent on the question of internal organization, but we recommend that prior to formal approval of the merger Management provide assurances and clarifications related to organizational, accounting and risk management, so that donors can be confident of a smooth shift from two separate financial management operations to an integrated one. Assurances in this area should include clarity on how Management intends to manage reporting to the Board on at least three dimensions: balance sheet; commitment authority; and sources and uses of funds (size and composition).

Reconsideration of Donor Contributions

We recommend that donors be prepared to deviate from the proposal when it comes to expected donor contributions to ADF under the merger. The first replenishment under the merger represents a 42% to 51% reduction (varying according to graduation scenarios) in donor contributions, reflecting the replenishment’s newly restrictive function in only supporting ADF’s grant operations and TASF. We recognize that a reduction of this magnitude will hold considerable appeal to donors from a budgetary perspective, as donor budgets are under stress. And while we see limited risk that the additional resources promised under the proposal will not materialize, we do believe that there is a broader set of implications from this reduction that donors should consider carefully.

Most of the reduction in donor contributions in the proposal comes at the outset. This frontloading of donor savings may introduce a significant misalignment between ADF and ADB financing needs and donors’ budget dynamics. In our view, an approach that seeks to cut donor contributions sharply at the outset and add some of those contributions back in later years on a contingent basis will be much more difficult to achieve than an approach that reduces less at the outset.

The proposal identifies some direct risks to ADF grant resources in the form of slower graduations, or less net income available for transfer to the grant window. Net income is uncertain, yet it plays a much larger role under the merger in supporting the grant window. Net income transfers represent 10% of donor contributions to ADF/TASF for the period
2013-2016 and are projected in the proposal\textsuperscript{23} to be 44% in 2017-2020, 54% for 2021-24 and continue to rise thereafter. The stress tests seek to allay concerns here, and only under the scenario of multiple arrears does net income become unavailable. But, as we note in the discussion of the financial framework, the merger relies on some assumptions about market reactions that are reasonable but untested.

The proposal incorporates a very significant drop in donor contributions between ADF XI and ADF XII and identifies adjustments in donor contributions as the appropriate response mechanism to adverse circumstances. Yet, the ability of donors to add back contributions that have already been reduced introduces considerable uncertainty. From this perspective, we recommend that donors adopt a more conservative stance than requested toward the risks of the proposal when it comes to considering their own contributions to ADF in the next replenishment.

More generally, we also see risks for the ADB as a whole, or at least foregone opportunities, reflected in the front loading of donor savings. Figure 1 identifies total shareholder contributions to the ADB in recent years (ADF contributions and capital contributions to the OCR) and what those contributions will look like after the merger. The conclusion of the fifth general capital increase contributions just prior to the reduction in ADF contributions reinforces the dramatic decline. To the degree the bank’s donors and shareholders wish to take a more expansive view toward assessing the bank’s overall resource needs at some point, whether along the lines we identify in Section Three or otherwise, the path reflected in the chart might represent a point of no return from the standpoint of the shareholders’ own budgetary dynamics.

\textsuperscript{23} ADB 2014, Table 7.
To be clear, we are not recommending that donors artificially inflate their contributions, which would be poor stewardship of their taxpayers’ resources. They should, however, take a multi-year perspective on their contributions and fully consider the potential negative implications of front loading the savings from this proposal. At the very least, we recommend that they lean toward the more robust end of replenishment demand scenarios reflected in the slow graduation scenario in the initial years. In Section Three, we offer broader perspectives on this issue.

**Areas Deserving Attention Subsequent to the Approval of the Proposal**

**Exploration of a More Integrated Governance Model**

It is important to recognize that the approach of the proposal stops short of full integration when it comes to governance. On the one hand, the proposal seeks to integrate ADF and OCR resources to better leverage ADF resources. On the other hand, it seeks to maintain clear boundaries when it comes decision making and policy guidance.

This is evident, for example, in the decision to maintain OCR shareholding at current levels, despite a unified treatment of OCR and ADF “equity.” In lieu of shareholding changes and in order to recognize that ADF donors’ past contributions play a role in the conversion of
ADF loans outstanding to OCR equity, the proposal maintains a donor-driven process for decisions related to OCR concessional lending.

Of course, an approach that sought to consider new shareholding arrangements as part of the financial merger would greatly increase the complexity of the exercise, to the point that it would likely become legally and politically untenable. At the very least, it would significantly extend the timeline for approval, all at the cost of foregone resources available for development finance. From this perspective, we believe the proposal’s approach to governance is reasonable and represents a pragmatic near term approach. Nonetheless, it is worth considering the shortcomings of this governance arrangement as a permanent measure in order to recognize that it would be better viewed as an interim arrangement.

To the degree the volume of OCR concessional lending is dependent on broader OCR dynamics and decisions, many of which are considered annually, it could become problematic from a governance perspective for ADF donors to be guiding decisions related to the volume of OCR-based concessional lending over a 4-year period. This problem is not entirely new: it has been evident in decisions related to OCR net income transfers to ADF. The net income transfer decision is an input into the ADF replenishment process, yet donors do not have de jure authority to set the level of the transfer. Nonetheless, donor influence is significant, since the ADB’s commitment on net income can influence donor pledges. At the same time, ADB management also has to represent the broader interests of ADB members (including OCR borrowing countries) when making commitments of net income, and the transfers themselves are subject to annual approvals by the ADB board of governors.

While it may be appropriate for the proposal to make firm commitments in protecting the status quo governance arrangements in the near term, these arrangements are unlikely to serve the interests of any of the bank’s constituencies over time.

We suggest that donors, and shareholders as a whole, begin to explore alternative governance models subsequent to implementation of the proposal. The objective would be to better integrate governance with the financial integration that is at the center of this proposal. One possibility outlined in Section Three would address the issue from the

24 ADB 2014, Appendix 11, paragraph 6: “The volume of the combined concessional assistance, comprising concessional OCR and ADF grants, will be agreed with ADF donors during ADF grant replenishment discussions.”
stand point of the replenishment itself, such that the exercise is remodeled to be an institution-wide resourcing and policy-setting exercise. Of course, this would have significant implications for country participation and representation, which would require consultation with ADB shareholders/donors.

Reconsideration of Allocation Models

The proposal also highlights the differences between a performance-based allocation ("PBA") process for ADF countries and the "credit cooperative" or risk tolerance and demand-driven model that governs OCR lending. This disparate treatment has existed for many years and is justified by the predominant financing role that donors play in supporting ADF countries. As donors have made annual grant contributions to support ADF financing, they have also demanded evidence of results, as well as an allocation of resources that seeks to rely on ADF country performance. With shareholder capital contributions much more rare, and the contributions themselves more balanced between "borrowers" and "non-borrowers", the governance and allocation approaches that characterize ADF have had less traction outside of ADF, a dynamic that is not unique to the ADB.

The proposal makes ADF activities much less dependent on donor financing, yet it maintains this donor-determined allocation model. We do not take a view here on the relative merits of PBA versus other allocation models, but we do wish to highlight the disparate treatment as an area for further consideration subsequent to the approval of the proposal.

Donors should use the ADF XII period to explore alternative models when it comes to resource allocation from the OCR on a more integrated basis. One approach would be to maintain PBA in whatever fashion donors direct for the grant window, while creating a new framework for all OCR lending. More generally, donors should be open to considering the relative legitimacy of allocation models from a governance standpoint.

One area of allocation that deserves special consideration is the ADF regional projects set-aside. Regional approaches to development finance, particularly for regional infrastructure,

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have consistently been affirmed by donors and developing countries alike in recent years.\textsuperscript{27} The proposal itself notes that ADF country demand for regional financing has always exceeded supply.\textsuperscript{28}

Yet, the logic of regional projects is driven by geographic realities, not ADF status. It makes little sense to have separate regional financing initiatives according to ADF and OCR classifications, and even less so under a financial merger. Yet, the proposal maintains this very approach. Specifically, it maintains an ADF-specific set-aside for regional projects, while signaling the desirability of increasing the size of the set-aside as a percentage of ADF resources (grants and OCR concessional loans). Even under a model that continues to make country income status paramount, it is questionable why regional projects would continue to be wholly dependent on the country classifications. In short, it seems obvious that a more effective regional set aside would be integrated across ADF and OCR countries.

**Given the underlying logic of regional projects, we believe donors** should exploit the additional financial flexibility afforded by the merger to take a fresh look at the regional set-aside. **Specifically, donors should explore options for an approach that meets the stated objective of prioritizing ADF countries, while better exploiting the possibility of more flexible financing arrangements for regional projects in all ADB countries under the merged OCR window.**

### Section Three. Additional Considerations

In this section, we propose additional ideas for consideration by ADB management, ADF donors, ADB shareholders and the Board subsequent to the approval of the proposal. We believe the approval and implementation of the proposal would present a unique opportunity for ADB to consider additional measures beyond those contemplated in the proposal. We wish to emphasize that these ideas are not intended as alternatives or modifications to the proposal but as complements. We see value in a sequential approach, such that the financial merger is approved on the identified timeline, providing a strong basis for future consideration of additional measures.

The TOR asks whether any “precautionary governance arrangements are called for within the concessional window to ensure that the original purposes of ADF are maintained after

\textsuperscript{27} See for example the prioritization of regional infrastructure in the G20 Development Working Group’s Multi-year Action plan: http://www.g20.utoronto.ca/2010/g20seoul-development.html

\textsuperscript{28} ADB 2014, Paragraph 42.
the merger.” We offered a qualified “no” in Section Two. But we also view the question as a good starting point for future consideration of new governance arrangements more broadly.

We are motivated to offer “additional considerations” by a sense that the greatest risk of this proposal is not from deviations in graduation rates or financial projections but, rather, that ADF donors, and ADB shareholders generally, will fail to fully exploit its potential benefits over time. Mainly, we see this potential failure resulting from a "path of least resistance" approach that could maintain current governance standards and practices long past their usefulness and with too much indifference to the considerable new flexibility afforded under the merger to address the new reality of ADB borrowers and of the region as a whole.

We are mindful that the more ambitious ideas offered here require significant deliberation. We offer them as an encouragement to ADB and its constituencies to use the opportunity of discussing this major financial merger proposal to launch a broader deliberative process—one that seeks to fully exploit the additional opportunities created by adoption of the proposal.

As a starting point, it is worth considering the “original purposes of ADF” as posed by the TOR question. Here is the stated purpose according to the ADF’s regulations:

Section 1.01. Purpose of the Fund. The purpose of the Fund shall be to enable ADB more effectively to carry out its purpose and functions by providing resources on concessional terms for the economic and social development of the developing member countries of ADB, having due regard to the economic situation of such countries and to the needs of the less developed members.29

The purposes defined here offer considerable flexibility and certainly more scope for departure from current practices than is evidenced in the proposal. For example, the definition takes a flexible view on the question of where concessional resources might be deployed to promote economic and social development. Discussions in the development finance community today have questioned the per capita income country model as the definitive approach to concessional finance, in favor of approaches that better recognize the geography of poverty.30

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Of course, we appreciate the weight and validity of accumulated practice. For example, performance-based allocation is not identified in the original purpose of the fund, but it has gained legitimacy through a cumulative decision making process and the experience of implementation. It is important, however, to revisit “original purposes” in order to separate bedrock principles from practices that may vary under an appropriately adaptive process.

In this spirit, we offer here a list of items for additional consideration, which are inspired by the proposal itself and the potential that it offers in support of the ADB's mission. These items are not intended to form an integrated proposal. Rather, they offer a range of additional measures for consideration.

1. A bank-wide resource review.

In the parallel processes of replenishment-driven governance and broader bank-wide governance envisaged under the proposal, we expect that the role of the replenishment (and ADF deputies) as it pertains to OCR concessional lending will diminish over time, as ADF countries graduate, concessional financing generally winds down, and the weight of the institution’s activities falls even more on the non-concessional OCR side. The governance of the concessional window at the Inter-American Development Bank is instructive. Although the Fund for Special Operations (FSO) has continued to be “replenished”, there is no FSO deputies process or engagement separate from bank-wide governance. The most recent FSO replenishment was conducted by IDB governors’ deputies as part of negotiations related to the bank’s 2010 capital increase.\(^{31}\)

From this perspective, donors should be particularly motivated to consider a more integrated governance model that is more closely aligned with the proposal’s integrated financial structure and the ongoing developments in the region that are expected to result in most countries being eligible for non-concessional OCR borrowing.

One approach, a bank-wide resource review, addresses the issue from the standpoint of donor and shareholder financing of the institution, replacing the ADF replenishment model with a broader ADB-wide resource review.\(^{32}\) Under this model, ADF deputies would become ADB deputies, with the composition expanding in some manner to better reflect


\(^{32}\) See Morris 2014.
the governors as a whole. For efficiency purposes, this may call for a constituency approach, reflecting the composition of the board of directors.

This deputies’ process would be charged with an exercise that considers grant and capital resource needs together. Critically, it would be empowered to negotiate and set high level policy level direction for the ADB as a whole, much like the ADF replenishment process currently does for ADF activities.

Adopting a more integrated model for the bank’s “high level” governance would help to alleviate the tensions that could arise around the use of OCR resources following the merger.

A bank-wide resource framework could also prove more successful in broadening the donor base. Countries that have been reluctant donors to ADF may be more inclined to participate in grand bargain that includes a mix of ADF grant contributions and OCR capital contributions.

More fundamentally, a bank-wide framework could better accommodate more innovative approaches to policy, whether in the form of new mandates for the use of grant resources or a more nuanced framework for concessionality. We elaborate on some of these ideas in the remainder of this section.

2. A smoother decline in donor contributions.

As we indicate in Section Two, the front-loaded decline in donor contributions carries some risk for the success of the proposal by creating essentially an early "point of no return" in 2017. It also introduces considerable opportunity costs from a broader perspective for the institution. We offer here three specific alternatives which would involve reconsidering the size of the reductions, if not the reductions themselves—at least during the ADF XII period.

2A. Less reliance on net income transfers. The robustness of the proposal would be considerably strengthened by reducing the reliance on ADB net income transfers to fund the ADF grant window for a transition period.

Even though ADB management has carried out adequate due diligence in preparing the proposal, the emphasis on rapidly reducing donor contributions (down from an average of $1.2 billion p.a. in 2013-16 to $0.6 billion p.a. in 2017-2020 and $0.5 billion subsequently) seems to prematurely reduce ADB’s room to maneuver. Since the proposal represents a significant departure from the past financial model, it would make sense to treat the next
ADF replenishment period as a transitional one, allowing for any necessary adjustments to the new financial model.

Such a transition would generate a cushion that would strengthen the sustainability of the post-merger model. It would also be required to test some of the premises on which the proposal is built—including scalability and profitability of non-sovereign operations. Even if initial indications from financial experts and credit agencies are positive, it will also be important to ascertain the market’s actual reaction to ADB’s expanded borrowing which relies on former ADF assets as part of the usable equity for the combined balance sheet.

A simple transitional formula could consist of stopping net income transfers to the ADF grant fund during 2017-2020 and, hence, rely on donors to cover the full expected financing required by the ADF grant window during that period. Under the base case and for both graduation scenarios this would still imply reducing donor contributions from $1.2 billion p.a. currently down to $0.85 billion p.a. in 2017-2020—with further reductions very likely possible from 2021 onwards, as ADB net income proves able to contribute at increasing and reliable rates.

2B. Additional resources for the infrastructure agenda. The proposal’s strict focus on ADF-eligible countries, even as it merges ADF finances with OCR, misses the opportunity to more squarely consider resource needs for the ADB’s infrastructure agenda on a more comprehensive basis. So, as the proposal greatly reduces the request for donor contributions to ADF, it does not simultaneous ask whether any of the contributions which are no longer to be provided by donors could be usefully employed as contributions for infrastructure investment in the ADB’s region of operations.

If we consider the ADB’s core infrastructure agenda, as well as the infrastructure needs of the region in the years ahead, it would seem that a “yes” is highly plausible. The ADB report “Infrastructure for a Seamless Asia” estimates that investment needs in the region average about $700 billion per year, including $250 billion for specific regional projects. Under the proposal, the OCR’s sustainable lending level for all activities (not just infrastructure) is in the range of $12 billion to $15 billion p.a.

Demand for infrastructure finance in excess of ADB capacity is also evident in efforts to establish new vehicles for public investment, such as the ASEAN Infrastructure Fund, the “New Development Bank” emerging from the recent BRICS summit, and the Asia Infrastructure Investment Bank, as well as in the priority placed on this agenda by the G20.
Of course, one of the merits of the proposal is the increased lending capacity generated for OCR as whole, both concessional and non-concessional. However, a broader consideration of the ADB’s core agenda, including the perspective that today’s ADF countries will be tomorrow’s OCR non-concessional borrowers, would suggest that some of the donor contributions which will no longer be provided could be put to highly productive use as additional funds for infrastructure investment.

2C. Allocation of donor funds to enable additional uses for grant resources. New demands for grant resources, either targeted at ADF countries alone or more broadly, may also make a large diminution in donor grant contributions sub-optimal. For example, the grant element necessary to support a robust regional and global public goods agenda has long been simultaneously acknowledged and neglected. There are certainly legal and policy challenges in shifting the underlying rationale for donor grant contributions away from the “low income country” model. But the public goods rationale is compelling from a development policy perspective. One approach could be to target some of this function to ADF countries, for example with additional grant financing for climate mitigation and adaptation activities.

Grant finance can also be compelling in the context of the ADB’s private sector agenda. The Multilateral Investment Fund at the Inter-American Development Bank provides a useful model to consider for grant based private interventions with high development impact in priority areas like clean energy and gender.

3. A more flexible process for determining levels of concessionality across ADB countries, using criteria beyond GNIPC.

The ADF/ADB merger creates an opportunity to move from an increasingly problematic “binary” ADF/ADB model, with eligibility based on GNIPC. The shortcomings of this long-standing model have been implicitly recognized through the extended graduation lags that we describe in our analysis. The proposal offers tremendous potential to move beyond this model by breaking down walls between ADF and OCR financing. This potential should be used to full advantage by offering countries a range of financial resources that are best suited to complex, specific situations, including at a sub-national level.

But before elaborating on ways to move beyond the current system of country classifications, it is worth looking at the current model in greater detail.

The GNI per capita measure (particularly using the Atlas method, not even PPP measures) as a country classification scheme has increasing limitations. On a global scale, there is no natural grouping of economies based on GNI per capita, nor are they correlated with break or end-points in other key indicators like poverty rates or median per capita consumption.34 This is also true for the Asia region.

In Figure 2, we plot GNI per capita for ADB member countries (ADF and OCR) against the absolute poverty head count ratio, or the percentage of the population living on $1.25 per day or less. There is wide dispersion in poverty rates between countries with the same GNI per capita. Bhutan and the Philippines, for example, have nearly the same GNI per capita, but the Philippines has 18% living in extreme poverty whereas Bhutan has almost none. And if we believe that a country’s burden of poverty is an important factor in determining the need for concessional assistance, it makes even less sense that Bhutan is an ADF country while the Philippines has graduated. Even below the threshold, however, there is a dramatic range in poverty levels, from Kyrgyz Republic (4%) to Bangladesh (42%). Likewise, countries with the same levels of poverty have very different GNI per capita rates (e.g., Nepal and Turkmenistan), reinforcing the fact that GNI per capita does not capture natural clustering in other country characteristics.

Acknowledging that $1.25 is the lowest possible bar for defining poverty, we also plot rates at $4 per day or less to capture a more reasonable standard of poverty (Figure 3). While all countries shift upward and there is a more evident correlated downward trend, there are still few apparent breaking points. Firmly-ADF Cambodia does not look so different from Vietnam, Papua New Guinea, or Indonesia—all at various stages of eligibility. Furthermore, these poverty rates are not evenly distributed across countries. Geographically-specific pockets of persistent poverty are becoming the main poverty challenge for countries like the Philippines or India, who are nonetheless ineligible for ADF assistance.

Figure 2: PovHCR<=1.25 vs. GNlpc

Graduation threshold

Graduate under Slow Scenario
+ Graduate under Early Scenario

Figure 3: PovHCR<=4 vs. GNlpc

Graduation threshold

Graduate under Slow Scenario
+ Graduate under Early Scenario
An alternative approach considers median income/consumption per capita, which essentially combines income levels and distribution. In Figure 4 we show that, again, the reality of the region is more complex than the binary eligibility approach recognizes. At the same GNIpc level, median income/consumption levels vary quite a lot, and a significant number of countries that surpass the GNIpc threshold look much worse from the perspective of the median. The relevance, of course, is that the lower the median/GNI ratio, the greater the relative need.

![Figure 4: Median vs. GNIpc](image)

Developing a more standardized set of guidelines for concessionality would improve all countries’ (including MICs’) ability to meet anti-poverty goals while maintaining ADB’s confidence in directing resources where they are most needed. National-level concessionality could be determined based on a formula that includes national indicators such as GNI per capita, poverty head count ratios, median consumption per capita and creditworthiness.

Besides increased flexibility in determining the concessionality blend by country, the proposal also opens the way for more innovative approaches, which could include localized measures such as regional poverty rates and intervention measures such as project size and type.
A more gradated approach to concessionality could also help to avoid the “cliff effect” in moving from ADF to ADB eligibility. Countries’ may understandably be concerned about the disruptive impact of a sudden drop in access to bank resources resulting from graduation. This concern may help to explain the long lags between graduation eligibility and actual graduation.

In sum, taking the combined resources proposal as a first step, these additional considerations around eligibility would help to ensure that ADB remains a relevant source of national and sub-national assistance in a changing regional and global landscape.

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35 This concern was evident in IDA-17 as the World Bank sought to manage India’s graduation from IDA. From India’s perspective, graduation under the existing model would have meant a dramatic decline in overall access to World Bank resources (IDA + IBRD). In order to address these concerns, IDA-17 introduced a "transitional" window to enable a slightly more gradated approach as an interim measure. On the IBRD side, the bank also made adjustments to the single borrower limit to be more accommodative to India and other large borrowers.
Appendix

Attachment 1

Terms of Reference

Enhancing ADB's Financial Capacity to Achieve the
Long-Term Strategic Vision for the Asian Development Fund

Independent Expert's Review

1. **Introduction.** Asian Development Bank ("ADB") owns and manages the Asian Development Fund ("ADF") through which ADB provides loans on concessional terms and grants to eligible countries ("ADF countries"). ADB has prepared a proposal, entitled, "Enhancing ADB's Financial Capacity to Achieve the Long-Term Strategic Vision for the Asian Development Fund" (the "Proposal"), pursuant to which ADB would transfer the loan assets and loan operations of ADF to ADB's ordinary capital resources (the "Transaction"), and intends to engage certain independent experts to review the proposal.

2. **Purpose.** The purpose of engaging outside independent experts as reviewers is to procure an independent review (the "Review") of the Proposal to confirm whether:
   a. the Transaction contemplated by the Proposal is likely to be clearly beneficial to ADF countries, given the risks involved; and
   b. the projected benefits to the ADF countries clearly outweigh the main risks to the baseline scenario.\(^1\)

3. **Scope of Work.** Subject to paragraph 5 below, the Reviewers should assess the issues set forth in paragraph 2 above in the specific context of the questions and issues set forth in paragraph 4 below.

4. **Terms of Reference for Review Services ("TOR").** Subject to paragraph 5 below, the TOR comprise a review of the following specific questions:\(^2\)
   a. How sensitive are the base case projections to the assumptions, and at what point do shortfalls in the assumptions substantially reduce projected benefits, especially for ADF countries. Chief among these assumptions are the following:
      i. Given the requirement that OCR maintain a much higher equity-to-loan ratio, which substantially reduces the leveraging ability of the OCR and contrasts with recent measures by the IBRD, what are the implications – for ADF countries in particular – if a financial crisis occurs in the future?
      ii. Are the assumptions for graduation from ADF status under the base case scenario reasonable? How will changes in the number

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\(^1\) The wording here is taken from the donors' proposed TOR received from US Treasury on behalf of several donors.

\(^2\) The wording of items 4.a – 4.d is taken verbatim from the donors' TOR.
of countries that actually graduate relative to the assumptions affect support available to ADF countries?

b. The base case projections indicate a substantial increase in resource flows to ADF and ADF graduating countries; how can we ensure that these increased resources are directed to these countries? Are any precautionary additional governance arrangements called for within the concessional window to ensure that the original purposes of the ADF are maintained after the merger?

c. In case of ADB financial distress (a substantially worse case than the lower-income scenario), does the proposal ensure that prudential concerns, such as the desire to protect the credit quality of the OCR portfolio and to reduce subsidized lending and net income transfers, do not negatively affect ADF countries?

d. Under what conditions could the additional income generated through the merger be sufficient to fund the ADF grant window on a self-sustaining basis?

5. Work Excluded from the Review. The Reviewers will not be required to analyze, verify, confirm or opine on any financial analysis, financial projection, financial modeling or any of the sensitivities affecting such financial analysis, projection or modeling (collectively, "Financial Analyses"). To the extent that any Financial Analysis is required to enable the Reviewers to conduct the Review contemplated in paragraphs 2, 3 and 4 above, the Reviewers shall (a) undertake such Financial Analysis; or (b) advise ADB that they are not undertaking such Financial Analysis and intend to make certain assumptions with respect thereto.

6. Reports.

a. Prepare and deliver an Inception Report by 15 June 2014 outlining the work program, timeline, and any relevant methodologies used to achieve the TOR, including, where relevant, the component parts of the TOR.

b. Prepare and deliver a Draft Final Report by 15 July 2014 that sets out the following, among other relevant matters:

i. Description of the scope of work, the work program, timeline, and any relevant methodologies used to achieve the TOR, including, where relevant, the component parts of the TOR;

ii. Relevant analyses, resources used, reference and other sources of information and assistance engaged;

iii. Conclusions clearly stating whether, in the opinion of the Reviewers, in reference to the TOR,

1. the reviewed assumptions in the Proposal appear to be reasonable in the circumstances;
2. the reviewed analyses in the Proposal have been done in a reasonable and professional manner, using protocols or methodologies that are reasonable and appropriate in the circumstances;

3. the reviewed conclusions in the Proposal are reasonable;

4. the projected benefits to the ADF/low income countries clearly outweigh the main risks to the baseline scenario;

5. the governance arrangements included with the Proposal provide reasonably adequate assurances of a level of continuing support to ADF/low income countries that is equal to the present level of support to such countries; and

6. ADB would be financially and operationally stronger and better positioned to fulfill the vision and to undertake the operations and priorities described in ADB’s Strategy 2020, as adjusted by the “Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and the Pacific,” than it would if the Transaction described in the Proposal were not undertaken.

c. ADB shall endeavor to respond to the Draft Final Report as soon as practicable following its receipt thereof, including during the visit of the Reviewers to ADB on 23-24 July 2014.

d. Prepare and deliver the Final Report, containing the items described above in the Draft Final Report, and taking into account the responses and comments thereon received from ADB, by 30 July 2014.

e. ADB may request that the Reviewers cooperate with other independent peer reviewers (the “Peer Reviewers”) during the course of their performance of services hereunder. ADB has not yet determined the identify, nature or scope of such Peer Reviewers or their review, but anticipates that the Peer Reviewers will be asked to provide an independent peer review of the Final Report in respect of the adequacy of its scope and the methodology and reasonableness of its analyses and conclusions. ADB shall be responsible for the fees of the Peer Reviewers, and will request that the Reviewers cooperate with the Peer Reviewers in the performance of their reviews in order to enable the conduct and completion of such reviews in the most effective and efficient manner practicable.

7. Rights and Publication. All rights, including copyrights, relating to the Draft Final Report and the Final Report shall be the property of ADB; provided, however, that CGD shall retain a perpetual and royalty-free license and right to publish, and refer to, the Final Report (and parts thereof) so long as (a) such publication is not sooner than 120 days after such Final Report is provided by ADB to the ADF donors; (b) the publication provides the following disclaimer “The views expressed in this publication are those of the Reviewers and do not necessarily reflect the views and policies of the Asian...
Development Bank, or its Board of Governors, or the governments they represent; and
(c) the ADF donors or any material number thereof do not object to such publication.
Subject to the paragraphs below on confidentiality, CGD may refer to the Reviewers as
reviewers and advisors to ADB in relation to the Proposal (notably the Transaction) in its
website, marketing materials or other publications of CGD; provided, however, that such
references shall cease if this agreement or the services hereunder are terminated as
provided herein.