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To: The Board of Governors

From: The Secretary

Subject: Review of the Implementation of the Debt Sustainability Framework and Enhanced Performance-based Allocation 2017-2018

The Board of Governors requested that every two years Management present a report on the implementation of the Debt Sustainability Framework and the Enhanced Performance-based Allocation. Attached is the above-referenced report for information of the Board of Governors, as agreed by the Board of Executive Directors at its 22 May 2019 meeting.

Reference: GN-2442-68(5/19)

PUBLIC

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

REVIEW OF THE IMPLEMENTATION OF THE DEBT SUSTAINABILITY FRAMEWORK AND ENHANCED PERFORMANCE-BASED ALLOCATION 2017-2018

MAY 2, 2019

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ABBREVIATIONS

CIPE	Country Institutional and Policy Evaluation
COC	Concessional Ordinary Capital
CPIA	Country Policy and Institutions Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EPBA	Enhanced Performance-Based Allocation
FSO	Fund for Special Operations
GCI-9	Ninth General Increase in Resources of the Inter-American Development Bank
GDP	Gross Domestic Product
GNI	Gross National Income
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
LIC	Low Income Country
MDB	Multilateral Development Bank
MDRI	Multilateral Debt Relief Initiative
MFI	Multilateral financial institution
NCBP	Non-Concessional Borrowing Policy
NSG	Non-Sovereign Guaranteed Operations
OC	Ordinary Capital
OVE	Office of Evaluation and Oversight
PBA	Performance-Based Allocation
PBL	Policy-Based Loan
PMR	Progress Monitoring Report
SG	Sovereign Guaranteed
SLL	Sustainable Lending Level
SPD	Office of Strategic Planning and Development Effectiveness
ULB	Undisbursed Loan Balances
WB	World Bank

I. INTRODUCTION

A. Objective

1.1 **On March 15, 2007, the Board of Governors approved Resolution AG-03/07, which states that every two years there shall be a review of implementation of the Debt Sustainability Framework and Enhanced Performance-Based Allocation (DSF/EPBA)**. Management has since presented five reviews for the consideration of the Board of Executive Directors (Board) and subsequent distribution to the Board of Governors for information at the IDB Annual Meeting: (i) in 2009 (Documents GN-2442-17 and AB-2646); (ii) in 2011 (Documents GN-2442-34 and AB-2646-1); (iii) in 2013 (Documents GN-2442-44 and AB-2646-2); (iv) in 2015 (Documents GN-2442-48 and AB-2646-3); and (v) in 2017 (Documents GN-2442-55 and AB-2646-4).

1.2 **The purpose of this document is to submit for the consideration of the Board Management's sixth review of the implementation of the DSF/EPBA framework**. Management also requests that the Board authorize transmission of this report for information to the Board of Governors.

B. The Debt Sustainability Framework and Enhanced Performance-Based Allocation

1.3 **On February 21, 2007, the Board approved document GN-2442 "Implementation of multilateral debt relief and concessional finance reform at the IDB. Proposal for the implementation of a Debt Sustainability (DSF) and Enhanced Performance-Based Allocation (PBA) framework"**, which presented an enhanced performance-based allocation (EPBA) system for the distribution of Fund for Special Operations (FSO) resources, under a structure that blends FSO and OC resources (blended structure), based on the DSF/EPBA criteria. Total allocation of concessional resources under the DSF/EPBA is determined by a combination of country needs and performance, which determines the allocation of concessional resources (first step); and the risk of debt distress, which defines the appropriate blend of Ordinary Capital (OC) resources (second step). The DSF/EPBA aims to ensure a link between concessional resource allocation and absorption capacity, while preserving debt sustainability.

1.4 **The EPBA for concessional resources has three major elements:** (i) population size; (ii) Gross National Income (GNI) per capita;[1] and (iii) performance, estimated as the weighted average of portfolio performance (30%) and the quality of the institutional and policy framework (70%), as measured by the Country Institutional and Policy Evaluation

[1] Data for population and GNI per capita is taken from the World Development Indicators (World Bank).

(CIPE).[2] Each of these elements in the allocation formula has a defined exponent for the calculation of the distribution coefficient as determined in document GN-2442.[3]

1.5 **The DSF defines the risk of debt distress** (low, moderate, high or in debt distress), which in turn determines the appropriate level of concessionality for each country through the blended structure.[4]

1.6 **This EPBA/DSF review covers the first biennial period since the implementation of the provisions of document AB-3066-2 entitled "Proposal for Sustaining Concessional Assistance by Optimizing the IDB's Balance Sheets"**, which was approved by the Board of Governors on September 1, 2016. That Proposal entailed adjustments and updating of the concessional framework in the areas of: (i) the source of financing; (ii) flexibility of conditions for the "Regular-OC" portion of loan operations to concessional-eligible countries; (iii) criteria for eligibility to concessional resources; and (iv) determination of the EPBA envelope. Related to the change in the source of financing – and to comply with a request of the Board of Executive Directors -- this Review includes a table that tracks the cost of the provision of concessional assistance in 2017-2018 (Annex III).[5] This review also analyzes the reform to the determination of the EPBA envelope (section IV).

1.7 **Notwithstanding the above reforms in 2016, the EPBA/DSF framework was retained in its entirety and the system and procedures for allocating concessional resources was unchanged.** The blending ratios for a given risk of debt distress remained the same and the levels of concessionality provided were unaffected by the AB-3066-2. Hence, this EPBA/DSF review maintains its traditional review of the EPBA and DSF (sections II, III and V).

1.8 **Collaboration with the World Bank and the IMF**. The Bank has continued its collaboration with the WB and the International Monetary Fund (IMF) in the preparation of debt sustainability analyses. In September 2018, staff from the World Bank and IMF provided training in LIC Debt Sustainability Analysis to IDB country economists working on the concessional-eligible countries.[6] The Bank continues to collaborate and exchange information with all multilateral financial institutions (MFI) that use a performance-based allocation system and that are harmonized with the DSF. During 2017 and 2018, the IDB

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[2] The contents of the CIPE are explained in Section III.B, paragraph 3.2.

[3] ($POP^{0.5}$ x $GNIpc^{-1}$ x $[0.7*CIPE + 0.3\ PPI]^2$). The performance-based allocation formulas for concessional resources in other multilateral development banks (MDBs) also include the same two components although variable weights and exponents vary.

[4] The IDB is one of five multilateral development agencies that use the Low Income Country Debt Sustainability Framework (LIC DSF) to determine the financing terms/grant element of concessional assistance; the others are: (i) the International Development Association (IDA); (ii) the International Fund for Agricultural Development (IFAD); (iii) the African Development Bank (AfDB); and (iv) the Asian Development Bank (AsDB).

[5] Minutes CGA/16/15 and DEA/16/17.

[6] The DSA training workshop received a strong evaluation from participants under KIC's feedback methodology.

continued to participate in the annual MDB/MFI Technical Meeting on Performance-Based Allocation (PBA) Systems, as well as the annual MDB Meeting on LIC Debt Issues.[7]

II. CONCESSIONAL ALLOCATIONS IN 2017-2018

A. Concessional allocations under the EPBA/DSF in 2017-2018

2.1 Four countries (Bolivia, Guyana, Honduras and Nicaragua) [COC-IV] were eligible for a concessional resource allocation under the EPBA/DSF for 2017 and 2018.[8] An EPBA envelope of US$337 million per year was allocated among the eligible countries, according to the EPBA framework (Table 1).

Table 1. Annual allocations to eligible countries, 2017-2018 (US$ million)

	(1) EFBA allocation	(2) DSF	Blend			(3) = (1) + (2)
	COC	Risk of Debt Distress	COC	OC	OC	Yearly allocation
Bolivia	77.8	Low	15%	85%	441.1	519.3
Guyana	9.7	Moderate	50%	50%	9.7	19.4
Honduras	126.5	Moderate	40%	60%	189.8	316.3
Nicaragua	123.0	Moderate	40%	60%	184.5	307.5
Total	337.0				825.1	1,162.2

Source: GN-2442-53.

2.2 **The risk of debt distress, as determined in debt sustainability analyses prepared using the DSF, did not change for any country compared with 2015-2016.** Consequently, the blend of COC and OC resources was unchanged, with respect to the 2015-2016 allocation. The COC/OC blend applicable to Bolivia remained at 15% COC/85% OC; the blend applicable to Honduras and Nicaragua remained at 40% COC/60% OC for 2017-2018; and the blend applicable to Guyana remained at 50% COC/50% OC.

B. EPBA/DSF approvals in 2017-2018

2.3 **A total of 28 operations with blended resources amounting to US$2,045 million were approved during 2017-2018, of which US$562.2 million corresponded to COC resources (Table 2).** Reflecting the flexibility to front-load or back-load resources within

[7] Note on "Collaboration between the IMF, the World Bank and regional development banks in the preparation of debt sustainability analyses for low-income countries", December 2007. Management reported on the process to develop this MoU in "Update on implementing multilateral debt relief and concessional finance reform at the IDB", (GN-2442-14), July 2007.

[8] Per the "Report on the Ninth General Increase in Resources of the Inter-American Development Bank" (AB-2764), Haiti is outside the EPBA/DSF framework until 2021 and receives support in the form of grants only.

the two-year allocation period, 44% of total approvals occurred in 2017 and 56% in 2018. For the two years, investment loans accounted for 66% of the approved loan resources and policy-based loans (PBLs) for 34%. Approved PBLs represented 29.7% of the biennial allocation of COC resources, thereby complying with the 30% limit established in document AB-2791 (New Lending Framework).[9]

Table 2. Operations Approved by Country, 2017-2018 (US$ million)

	2017			2018			2017-2018
	COC	OC	Total	COC	OC	Total	Total
Bolivia	**62.1**	**351.9**	**414.0**	**93.7**	**530.9**	**624.6**	**1,038.6**
Investment	23.1	130.9	154.0	86.0	487.1	573.0	727.0
PBL	39.0	221.0	260.0	7.7	43.9	51.6	311.6
Guyana	**0.0**	**0.0**	**0.0**	**19.4**	**19.4**	**38.8**	**38.8**
Investment	0.0	0.0	0.0	13.6	13.6	27.2	27.2
PBL	0.0	0.0	0.0	5.8	5.8	11.6	11.6
Honduras	**64.0**	**96.0**	**160.0**	**189.0**	**283.6**	**472.6**	**632.6**
Investment	24.0	36.0	60.0	133.1	199.7	332.8	392.8
PBL	40.0	60.0	100.0	55.9	83.9	139.8	239.8
Nicaragua	**134.0**	**201.0**	**335.0**	**0.0**	**0.0**	**0.0**	**335.0**
Investment	82.0	123.0	205.0	0.0	0.0	0.0	205.0
PBL	52.0	78.0	130.0	0.0	0.0	0.0	130.0
Grand Total	**260.1**	**648.9**	**909.0**	**302.1**	**833.9**	**1,136.0**	**2,045.0**
Investment	129.1	289.9	419.0	232.7	700.3	933.0	1,352.0
PBL	131.0	359.0	490.0	69.5	133.5	203.0	693.0
PBL as % total	50%	55%	54%	23%	16%	18%	34%

*Excludes NSG operations and co-financing.
Source: VPC based on IDB Annual Business Reviews, 2017 and 2018.

2.4 In terms of sector distribution, on a biennial basis, by value 59% of operations approved for 2017-2018 were in the Infrastructure and Environment sector, 34% were in the Social Sector, and 7% were in the Institutions for Development sector (Table 3). The share of social sector projects quadrupled with respect to 2015-2016, mainly offset by a decline in the share of Instructure and Environment projects (from a high level in 2015-2016). The share of Institutions for Development continued to decline in 2017-2018.

[9] "Review of the New Lending Framework" (AB-2971). **Recommendation 4** was: "To establish FSO PBL approval limit, for consecutive two-year periods, of the equivalent of 30 percent of the total biennial allocation of FSO resources carried out by the BOD in accordance with document GN-2442, the first of which should beginning with the 2011-2012 allocation (document GN-2442-32)."

Table 3. Operations Approved by Sector, 2017-2018 (US$ million)

	2017-2018		
	Sector		
	*Inst. for Development	**Infrastructure & Environment	Social Sector
Bolivia	15.0	748.6	275.0
Guyana	6.0	32.8	0.0
Honduras	60.0	290.0	282.6
Nicaragua	65.0	137.0	133.0
Total	**146.0**	**1,208.4**	**690.6**
% total	7.1%	59.1%	33.8%
% in 2015-2016 1/	10.8%	80.8%	8.4%
% in 2013-2014	26.7%	46.5%	26.7%

*Includes Trade and Integration.
** Includes CSD.
1/ In 2015-2016, Infrastructure and Environment accounted for over half in all countries and 96% in Bolivia.
Source: VPC based on IDB Annual Business Reviews, 2017 and 2018; GN-2442-55; GN-2442-48.

III. Review of the Enhanced Performance-Based Allocation (EPBA)

A. The EPBA

3.1 **The EPBA has continued to work well.** During 2017-2018 there were no indications that the EPBA formula or performance components (CIPE and PPI) would require revision. Nevertheless, going forward Management will continue to ensure that the CIPE and PPI remain up-to-date with "best practice" and any relevant innovations.

B. Country Institutional and Policy Evaluation (CIPE)

3.2 **The CIPE assesses the quality of a country's current policy and institutional framework.** CIPE criteria or variables are grouped into four major policy clusters, each with a specific weight in the total CIPE score: (i) Economic Management (15%); (ii) Structural Policies (20%); (iii) Policies for Social Inclusion/Equity (35%); and (iv) Public Sector Management and Institutions (30%). The weights attached to each policy cluster were approved by the Board of Executive Directors when the CIPE was introduced in 2002 (GN-1856-31).

3.3 **The CIPE was reformed in 2010 (document GN-2442-32) and 2012 (GN-2442-42)** in order: (i) to update the variables and the respective rating guide; (ii) to include quantitative indicators to increase objectivity in the assessment, as recommended by the Office of Evaluation and Oversight (OVE) (documents RE-279 and RE-376); and (iii) to harmonize

methodologies with other MDBs.[10] Eleven of the 16 CIPE variables have quantitative indicators, which account for 25% weight of the respective variables. Overall, the quantitative indicators have a weight of approximately 15% of the overall CIPE rating. In practice, countries' overall CIPE scores with and without the quantitative indicators have been similar, indicating that the incorporation of the quantitative indicators has not significantly changed overall CIPE ratings. The CIPE variables and weights have not changed since 2012. Annex I presents the evolution of total CIPE scores by country and Annex II presents detailed information on the 2018 CIPE.

C. Portfolio Performance

3.4 **Under the EPBA framework, and consistent with GN-2442, portfolio performance has been assessed as the percentage of undisbursed loan balances (ULB) represented by projects classified as "problem" and "on alert"**. Additionally, since time-elapsed indicators in the Progress Monitoring Report (PMR)[11] are measured against an intra-country historical benchmark, for the purposes of the 2015-2016 allocation, projects were also evaluated by comparing them against Bank-wide benchmarks, in order to measure for relative performance among countries (Document GN-2442-46).[12] The same methodology for calculating the Portfolio Performance Indicator (PPI) was used for the 2017-2018 allocation.

3.5 At the aggregate level for the concessional-eligible countries, the share of undisbursed loan balances in "Unsatisfactory" projects (those "on alert" or with "problem" status) decreased from 14% of total ULB at December 31, 2015 to 10.6% by December 31, 2017 (Figure 1). A significant improvement in Guyana's portfolio performance more than offset a modest increase in Nicaragua's share of "unsatisfactory" projects.

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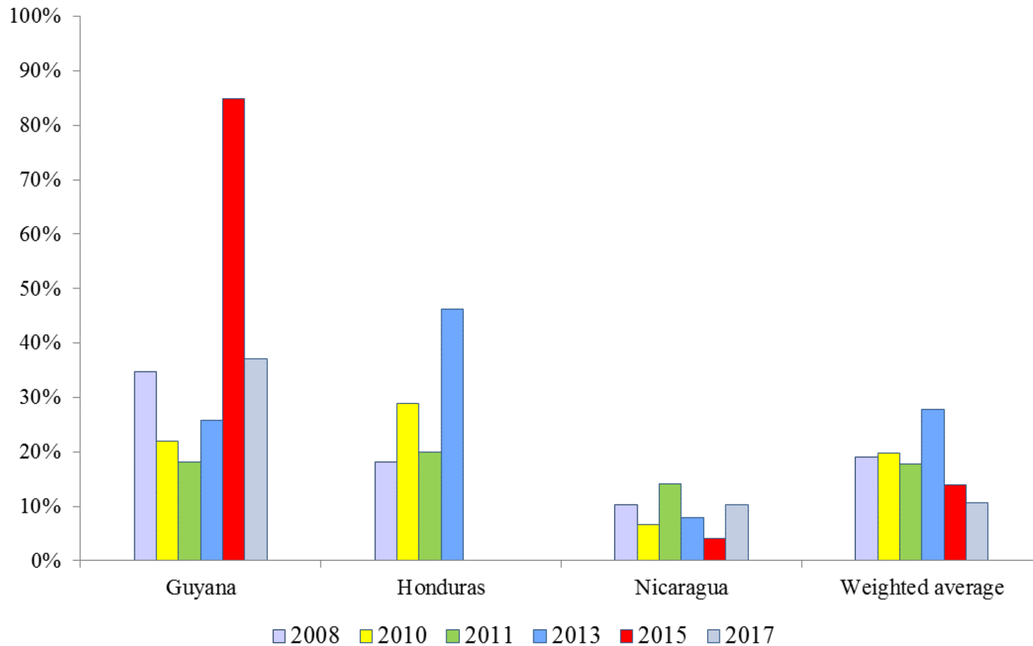
[10] Since 2004 most MDBs harmonized with the World Bank's Country Policy and Institutions Assessment (CPIA). Harmonization was recommended by an Independent Panel that reviewed the CPIA and found little value added in having similar, highly correlated methodologies among MDBs. Harmonization was also consistent with the Managing for Development Results Framework (MfDR) objective of minimizing duplication in multilateral assessment approaches.

[11] The PMR captures different dimensions of projects' performance. Different indicators are measured at each stage of the project's life cycle, that is: (i) after Board approval and before reaching eligibility; (ii) between eligibility and up to 95% disbursement; and (iii) between 95% disbursement and project closure. A synthetic indicator (SI), reflecting a weighted average of the indicators used for rating the project's execution performance, serves as the basis of the project classification after the projects become eligible for disbursements.

[12] These indicators measure the time elapsed from: (i) approval of the loan operation until signature of the corresponding loan contract, for those countries in which ratification of loan contracts is not required; (ii) approval of the loan operation until ratification of the corresponding loan contract, for those countries in which ratification of loan contracts is required; (iii) legal effectiveness to eligibility; and (iv) extensions of the final disbursement date.

Figure 1. "Unsatisfactory" Project Classification for the EPBA (as % of ULB)



Source: VPC based on GN-2442-57, GN-2442-53, GN-2442-46, GN-2442-41, GN-2442-32, GN-2442-16.
Note: No column appears for Honduras in 2015 and 2017 because the unsatisfactory ULB was 0%. In 2015, a new governing party took office in Guyana after 23 years in opposition, which led to staff changes and a prolonged review of investment priorities.

IV. Review of the EPBA Envelope

4.1 **As mentioned in paragraph 1.6, 2017-2018 is the first biennial allocation period since the implementation of the provisions of document AB-3066-2** entitled "Proposal for Sustaining Concessional Assistance by Optimizing the IDB's Balance Sheets", which was approved by the Board of Governors on September 1, 2016. Consequently, it allows for a review of the initial experience with the new mechanism for determining the size of the financing envelope to which the EPBA would be applied. With the approval of AB-3066-2, the basis for determining the EPBA envelope was switched to a percentage of the Bank's non-concessional OC, sovereign-guaranteed (SG) lending program as projected for the next two years in the Bank's latest Long-Term Financial Projections (LTFP). The benefits of this methodology were seen as: (i) embedding the EPBA envelope in the Bank's broader financing decisions, thus ensuring coherence between Concessional OC and non-concessional OC lending; (ii) anchoring the growth in concessional financing to the growth in overall OC financing; and (iii) avoiding the EPBA envelope getting locked into a trajectory based on long-term macroeconomic projections.

4.2 Although the vast majority of the reforms and changes implied by AB-3066-2 were implemented smoothly, two broad issues emerged in the initial experience with the shift to the new methodology to determine the EPBA envelope: (i) misalignment of the initial

EPBA envelope coefficient from a prudential and absorption perspective; and (ii) volatility and uncertainty.

A. Misalignment of the initial EPBA envelope coefficient

4.3 **In AB-3066-2, the EPBA envelope was initially set at 3.18 percent of the non-concessional OC SG lending program, which had been the coefficient of the previous allocation period (2015-2016).** At the time, Management noted that 3.18 percent was a historically high proportion – in fact, it is approximately one-third higher than the average EPBA envelope for the period since GN-2442. In this regard, Management further stated that it viewed "the 3.18 percent envelope proportion as an upper limit for the initial proportion from an absorption and prudential perspective, in view of the high and rising share of IDB debt in the FSO-IV countries' debt to multilateral institutions".[13] In addition, the 3.18 percent coefficient was calibrated based on the US$9.0 billion Sustainable Lending Level (SLL) presented in the Base Case of the OC LTFP 2016 Final Document, calculated in December 2015. Since then, however, the Bank's SLL has increased significantly and so has the actual level of approvals observed. Application of the initial EPBA coefficient of 3.18 percent to this unexpectedly high SG lending level caused a significant expansion of the EPBA envelope.

4.4 **A large EPBA envelope in 2017-2018 led to high levels of loan approvals in Nicaragua and Honduras.** This translated into high levels of loan disbursements -- thereby rapidly increasing levels of debt to the IDB -- and an accumulation of substantial undisbursed loan balances (ULB). As a result of these developments and increasing risk of debt distress in two eligible countries, Management proposed a reduction in the EPBA envelope coefficient for the 2019-2020 biennial period.[14]

B. Volatility and uncertainty

4.5 **A second issue with the EPBA coefficient being linked to the projected non-concessional SG lending level in LTFPs is that it introduces uncertainty into the process of preparing proposals for concessional resource allocations and programming at the country level.** This volatility and uncertainty contrasts with the stability and predictability that used to characterize biennial allocations. Programming in concessional-eligible countries has often been conducted on a rolling or biennial basis, facilitated by stability and predictability in country allocations.

C. Is there a better anchor for the EPBA envelope?

4.6 **An appropriate EPBA envelope needs to balance supporting the eligible countries' development efforts with capacity to absorb the resources in a sustainable and productive manner.** Estimates of demand need to take into account projected graduations

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[13] "Proposal for Sustaining Concessional Assistance by Optimizing the IDB's Balance Sheets" (AB-3066-2), approved September 1, 2016, paragraph 3.27.

[14] "Proposal for the Allocation of Concessional Resources 2019-2020" (document GN-2442-57). Annex VIII of that Proposal included 18 pages of debt sustainability analysis and electronic links to a further 55 pages of debt sustainability analysis on the three eligible countries. An additional 20 pages of analysis of net flows, undisbursed loan balance, and debt issues was provided as additional information to the Board of Executive Directors (document GN-2442-60).

and country eligibility considerations. Second, an EPBA envelope also needs to be related to the financing available. As AB-3066-2 noted, most MDBs do not face the challenge of determining an anchor for their performance-based allocation (PBA) envelope – their concessional envelopes are anchored in three or four -year replenishment cycles. Hence, both of the above criteria for a good PBA anchor are met, given that replenishments are generally dimensioned on projections of country demand. This anchor is not available to the IDB. During 2019, Management will analyze the methodology for determining the EPBA envelope, taking into account relevant methodologies of other MFIs.

V. REVIEW OF THE DEBT SUSTAINABILITY FRAMEWORK (DSF)

A. The DSF

5.1 **Since the last Review, the World Bank and IMF have conducted the fourth review of the DSF for Low-Income Countries**. The Bank used the revised DSF for the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57). The risk of debt distress in two IDB concessional-eligible countries has risen. On the positive side, it should be noted that the DSF and associated blending mechanism has had outstanding success in securing a gradual and phased concessionality transition for Bolivia.

B. Blending and the successful transition of Bolivia

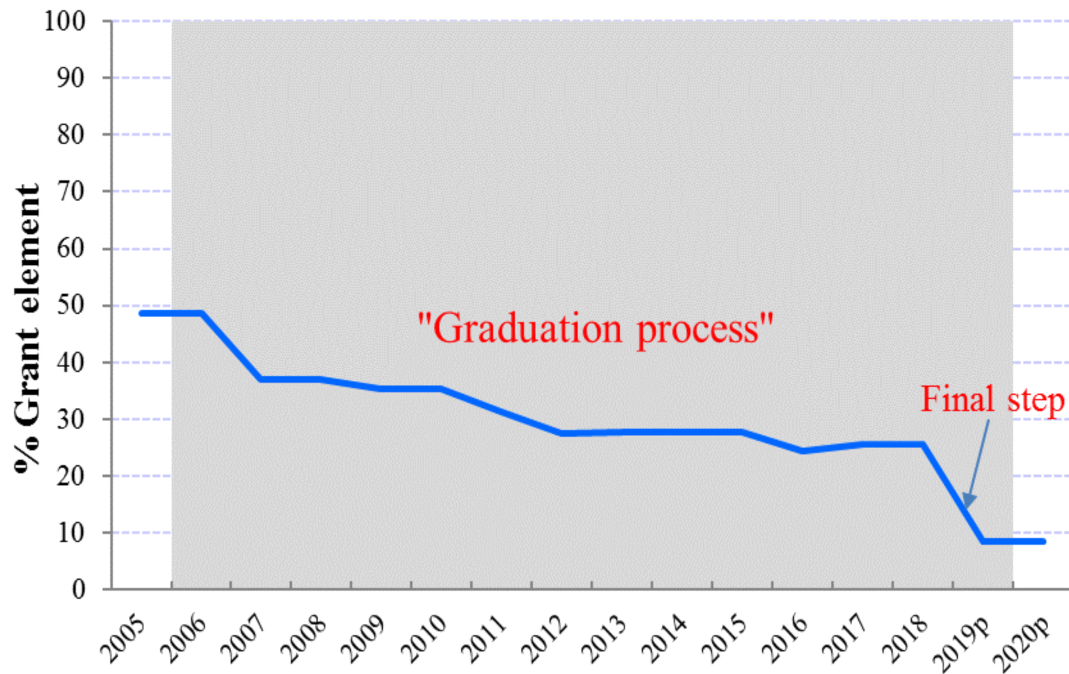
5.2 **It is commonly perceived that "graduations" from concessional assistance are abrupt, "cliff-edge" events.** For example, the outcome document of the 2015 Addis Ababa conference on financing for development declared that "We encourage shareholders in multilateral development banks to develop graduation policies that are sequenced, phased and gradual".[15] Yet, under the IDB's concessional assistance framework Bolivia has experienced a gradual and measured concessionality transition (Figure 2). Bolivia has had access to IDB concessional resources since it joined the Bank, as a founding member, in 1959. When the EPBA/DSF was introduced in 2007, Bolivia was assessed as having a "low" risk of debt distress. As such, it was assigned a lending blend in the 2007-2008 allocation of 30% FSO/70% OC. This allocation was arguably the first step in the graduation process because the country went from a concessionality of 48.6% under the terms of the pre-2007 FSO loans[16], to an estimated concessionality of 37% in 2007-2008. With increasingly favorable debt sustainability assessments, the lending blend was changed to 25% FSO/75% OC in 2011 and 20% FSO/80% OC in 2012. By 2012, the estimated concessionality of blended loans to Bolivia was 27.5%. In 2016, the lending blend was further adjusted to 15% FSO/85% OC, which reduced the estimated concessionality to 25%. At the beginning of 2019, Bolivia ceased to be eligible for concessional loan resources and thus henceforth would receive 100% of its loan resources in the form of regular OC loans (with an estimated concessionality of 8.5%). Moreover,

[15] United Nations (2015) "Outcome document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda", Third International Conference on Financing for Development, July 13-16, 2015, Addis Ababa, Ethiopia.

[16] Prior to 2007, Fund for Special Operations loans generally had a 10-year grace period and 40-year final maturity. Interest rates were generally 1% during the grace period and 2% thereafter. Using the current discount rate (5%), which has applied from 2013-2018, the estimated concessionality would be 48.6%.

approximately US$1 billion of outstanding concessional loan balances carrying low fixed interest rates will help to keep the average interest rate paid by Bolivia below regular OC rates until the 2050s. In this sense, the graduation transition will last decades.

Figure 2. Estimated concessionality/grant element of loan approvals for Bolivia



Source: VPC based on GN-2442-57, GN-2442-53, GN-2442-46, GN-2442-41, GN-2442-32, GN-2442-16, GN-2442.

C. Debt sustainability continues to deteriorate

5.3 **The "Review of the Implementation of the Debt Sustainability Framework and Enhanced Performance-based Allocation 2015-2016" (GN-2442-55) noted that at a global level there had been a clear deterioration in debt sustainability among low-income countries since 2014.** That Review also projected that the deteriorating trend was likely to continue and stated that the Bank would "monitor whether IDB LICs start to follow the global trend over the next two years."

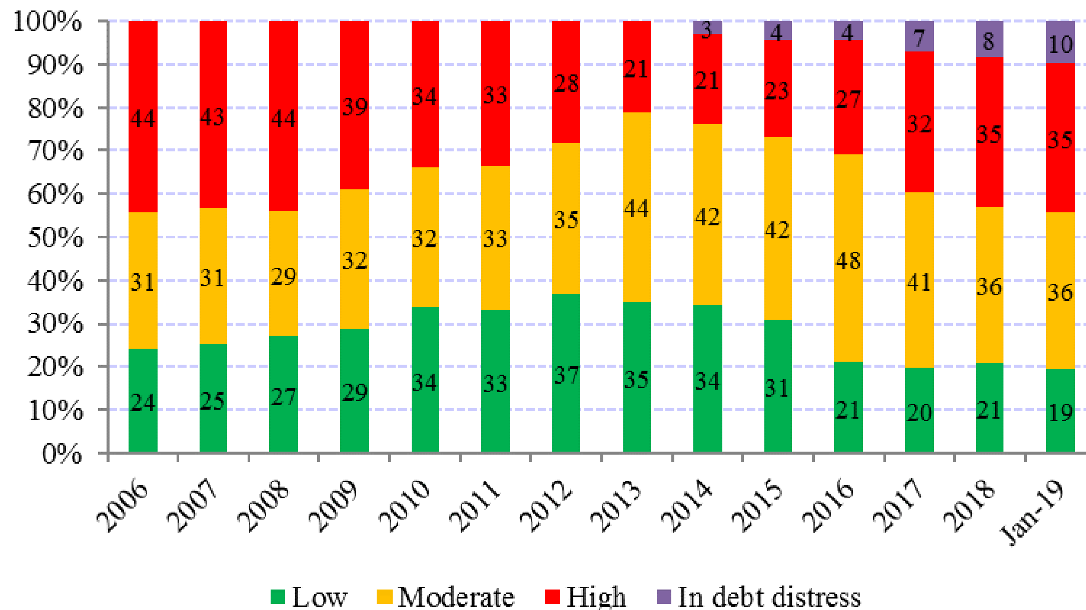
5.4 **Unfortunately, the expectation that the deteriorating trend would continue has proved correct.** At the global level, the risk of debt distress, as measured by the LIC DSF, has continued to increase, due to a significant rise in global interest rates and the lagged effect of accumulations of non-concessional debt in some countries over the last decade.[17] Since 2013 the proportion of low-income countries in debt distress or at high risk of debt distress has doubled (Figure 3). The proportion of countries at low risk peaked at 37% in 2012 and declined to 21% by June 2018. After several years of improvement, by 2018 risk

[17] IMF "Macroeconomic Developments and Prospects in LIDCs: 2018", March 2018.

ratings had broadly returned to where they were 12 years earlier at the time of the MDRI debt relief initiative. This has raised questions about whether the HIPC and MDRI debt relief initiatives have been successful in securing long-term debt sustainability.

Figure 3. Global Evolution of the Risk of Debt Distress

(In percent of total number of Low-Income Countries with DSAs)



Source: VPC, based on List of LIC DSAs for PRGT-Eligible Countries, IMF.org. https://www.imf.org/external/pubs/ft/dsa/lic.aspx

Note: The "In debt distress" category is included in "High risk" for years 2006-2013.

5.5 **Since the last Review, the risk of debt distress has also risen in two IDB borrowing member countries: Honduras and Nicaragua.** The DSAs prepared in October 2018 for the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57) classified both countries as having a "moderate risk of debt distress, with limited space to absorb shocks". This represents a deterioration since the 2014 DSAs where both countries were considered on the lower end of the "moderate" risk category (at what would now be termed "moderate risk with substantial space to absorb shocks"). Honduras had been classified as having a "low" risk of debt distress from 2007-2014.

5.6 **In contrast, the October 2018 DSA for Guyana classified the country as having a "low" risk of debt distress.** Guyana was classified at "moderate" risk of debt distress from 2007-2018. Guyana's bucking of the global trend is related to the projected start of large-scale crude oil production in 2020 and the huge scale of proven reserves of crude oil relative to the current size of the country's economy.

5.7 Per the normal functioning of the IDB's concessional assistance framework (GN-2442), the targeted concessionality and lending blends were adjusted in accordance with these changes in the risk of debt distress in the three concessional-eligible countries in the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57).

D. Non-Concessional Borrowing Policy

5.8 **The risk of moral hazard and issue of "free-riding" by other creditors who could indirectly benefit from debt relief and concessional finance provided by the official sector without paying for it was well recognized in the discussions and analysis prior to the approval of "Multilateral Debt Relief and Concessional Finance Reform at the Inter-American Development Bank".**[18] Nevertheless, document CA-472-1 recognized that: "no fully effective solution has yet been found to deal with the "free-rider" issue within the DSF".[19] A subsequent background paper (CA-472-2) argued that, instead of providing debt relief in a gradual manner as obligations became due, it would be superior to provide one-time debt relief and then mitigate moral hazard:

> "through the selective allocation of new lending. Strong safeguards in future programming of lending operations, combined with an ongoing country dialogue, careful assessments of the appropriateness of subsequent borrowing policies, and prudent debt management on the part of the beneficiary countries, would be key for successful implementation of the debt relief and sustainable debt levels in the future."[20]

5.9 **Among other things, the Board of Governors' resolution on "Multilateral Debt Relief and Concessional Finance Reform at the Inter-American Development Bank",[21] which was adopted on March 15, 2007, resolved that**:

> "In recognition of the IDB's role in the region, the IDB should work with other international financial institutions, international lenders and borrowing countries to address the question of "free-riding" by lenders to countries who have received debt relief. This should include, among other activities, sharing of information on lending and borrowing volumes and patterns, advice and consultation with borrowing governments, and the discussion of potential ways to coordinate activities."

5.10 **The IDB did not adopt a policy on non-concessional borrowing issues following MDRI.** Consistent with its harmonization with the Joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries, the IDB has relied on the umbrella

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[18] See for example: "Concessional Resources and Debt Relief at the Inter-American Development Bank: Background Information Prepared at the Request of the Chairman of the Board of Governors for the July 17, 2006 Meeting of the Committee of the Board of Governors" (CA-472); "Debt relief and permanency of the concessional window at the IDB" (CA-474-1), November 2006; "*IDA Countries and Non-Concessional Debt: Dealing with the "Free Rider" Problem in IDA-14 Grant-Recipient and Post-MDRI Countries"*, Resource Mobilization Department, June 2006.

[19] "Debt relief and permanency of the concessional window at the IDB" (CA-474-1), November 2006.

[20] "Implementing Multilateral Debt Relief and Concessional Finance Reform at the Inter-American Development Bank" (CA-474-2), December 2006.

[21] Resolution AG-3/07.

of the IMF and World Bank's policies relating to non-concessional borrowing.[22] For example, Nicaragua's programs with the IMF from 2007 to 2011 typically stipulated a minimum level of concessionality (35%) for external borrowing. However, over time IDB concessional-eligible member countries have: (i) tended to have fewer IMF disbursing programs; and (ii) growing incomes per capita, with the result that they have graduated from "IDA-only" status to "IDA-blend" status and therefore are no longer subject to IDA's "Non-Concessional Borrowing Policy". Currently, Haiti is the only IDB-member country covered by IDA's "Non-Concessional Borrowing Policy".

5.11 **As the risk of debt distress has risen in many countries since 2014, and this has been due in part to increases in non-concessional borrowing levels, the international community has been placing renewed emphasis on non-concessional borrowing issues and promoting debt transparency.** The G20 has developed guidelines "to enhance access to sound financing for development while ensuring that sovereign debt remains on a sustainable path by fostering information-sharing and cooperation among borrowers, creditors and international financial institutions, as well as learning through capacity building."[23] IFAD's Executive Board approved a non-concessional borrowing policy in December 2018. Policies and criteria related to the implementation of said policy will be considered by IFAD's Governing Council in February 2019. This will leave the IDB as the only DSF-harmonized MFI without a non-concessional borrowing policy (NCBP). As of early 2019, Management also understands that IDA is reviewing its NCBP and the IMF is reviewing its Debt Limits Policy. IDB Management has cooperated with early outreach and coordination efforts by both institutions. Management further understands that IDA intends to take a revised NCBP or successor policy to its Board in Q4 2019. At that point, IDB Management would be able to assess the implications for the IDB, along with any other IDA-19 related changes to the DSF-side of the EPBA/DSF, and propose any adjustments to IDB policies as appropriate.

5.12 **Management continues to monitor moral hazard and "free-riding" issues, in compliance with resolution AG-3/07 and will stay abreast of NCBP developments in other MFIs**. Management will inform the Board of Executive Directors of relevant findings by the first quarter of 2020 at the latest, if it considers that changes in the policies of other DSF-harmonized MFIs in these areas would warrant it.

E. Implications of the 2017 Review of the DSF

5.13 **In September 2017 the Executive Boards of the IMF and World Bank approved the fourth revision of the Low-Income Country Debt Sustainability Framework (DSF)**

[22] The IMF and IDA have a clear protocol on non-concessional borrowing policy. If a low-income country has a formal IMF program in place, the IMF is the lead agency and it sets performance criteria regarding external debt limits as a function of the member country's risk of external debt distress and other relevant macroeconomic circumstances in the member country. If the country does not have an IMF program but is an IDA recipient, IDA is the lead agency and its non-concessional borrowing policy applies.

[23] G20 "Operational Guidelines for Sustainable Financing", March 2017.

since its introduction in 2004.[24] This revision, like the previous three revisions, does not constitute changes to the Bank's concessional assistance framework, as set out in "*Implementation of multilateral debt relief and concessional finance reform at the IDB. Proposal for the implementation of a Debt Sustainability (DSF) and Enhanced Performance-Based Allocation (EPBA) framework*" (GN-2442). The adjustments to the DSF methodology adopted by the IMF and World Bank during their fourth revision are intended to improve the accuracy of the framework and will strengthen the Bank's ability to continue implementing the principles set forth in document GN-2442. The revised framework entails primarily methodological reforms of a macroeconomic nature, which were summarized in Annex VIII of the "Proposal for the Allocation of Concessional Resources 2019-2020" (document GN-2442-57). However, two aspects of the 2017 DSF Review had potential implications for the IDB EPBA/DSF framework: (i) disaggregation of the "moderate risk of debt distress" classification; and (ii) a methodological change in the determination of the debt burden indicators.

1. Disaggregation of the "moderate risk of debt distress" classification

5.14 **As part of the revised DSF methodology the "moderate" risk of debt distress has been disaggregated into three sub-categories -- "Substantial space to absorb shocks", "Some space", and "Limited space".** This new approach provides an indication of how close the country is to slipping into "high" risk of debt distress.[25] IDB Management views this disaggregation as a welcome reform from an operational point of view, since it provides a rigorous basis for greater granularity in the targeting of concessionality levels for countries in the "moderate" risk category.

5.15 **When the IDB adopted the DSF in 2007, the Board of Executive Directors approved the establishment of three financing blends**, corresponding to the three categories of the risk of debt distress: 30% Fund for Special Operations (FSO) (now Concessional OC)/70% Ordinary Capital for countries with a "low" risk of debt distress; 50% FSO/50% Ordinary Capital for countries with a "moderate" risk of debt distress; and 100% grants for countries at "high" risk of debt distress.[26] Since 2007, the financing blends have evolved to respond to different conditions in the countries. In the "Proposal for the Allocation of Concessional Resources 2015-2016", Management proposed, and the Board of Executive Directors approved, an intermediate or transitional blend of 40% FSO/60% OC that was in between the traditional "low" risk blend of 30%/70% and the traditional "moderate" risk of 50%/50%. This transitional blend was applied to Honduras, which had transitioned from a "low" risk rating from 2007-2014 to a "moderate" risk rating in late 2014, and to Nicaragua, which had traditionally had a "moderate" risk rating, but which narrowly

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[24] The revised framework, incorporating a new Excel template for the debt sustainability analyses and a new guidance note, came into effect in July 2018 and the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57) was prepared using the revised framework.

[25] "Space" refers to how far the country's debt burden indicators are from crossing the debt thresholds in the baseline scenario. Such breaches would trigger the "high" risk of debt distress rating.

[26] In adopting this so-called "traffic lights" system, the IDB harmonized with four other MFIs using the DSF as the basis for determining the concessionality of their lending to low income countries (the International Development Association; the African Development Bank; the Asian Development Bank; and the International Fund for Agricultural Development (IFAD).

missed a "low" risk rating in late 2014. In sum, *de facto* the IDB started to distinguish between different perceived risks within the moderate risk blend as of January 2015.

5.16 **The situations of Honduras and Nicaragua in late 2014 correspond to what is now termed "Moderate, with substantial space"**. The new, intermediate sub-category "Moderate, with some space" corresponds with the original "moderate" risk financing blend. However, the IDB had not had a lending blend that would be associated with "Moderate, with limited space", which is the last category before "high" risk of debt distress. In the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57) Management proposed that the new DSF risk category of "Moderate, with limited space" would carry a financing blend of 65% Concessional OC/35% regular OC). Consequently, financing blends for "moderate" risk countries using the DSF's new disaggregation are as follows:

- "**Substantial Space**" – (which is the first category after "low" risk) carries a financing blend of 40% Concessional OC/60% regular OC (concessionality currently estimated at 36.5%);
- "**Some Space**" – (the intermediate level) carries the traditional financing blend for "moderate" risk countries of 50% Concessional OC/50% regular OC (concessionality currently estimated at 44%);
- "**Limited Space**" – carries a financing blend of 65% Concessional OC/35% regular OC (concessionality currently estimated at 55%).

2. Changes to country debt-carrying capacity classification

5.17 **One of the methodological reforms intended to improve the accuracy of the framework could have operational implications for the IDB in the medium term, particularly once Haiti is reincorporated into the EPBA/DSF framework.** The DSF compares projected debt burden indicators against thresholds above which the probability of debt distress rises above a level considered tolerable. Since the quality of a country's policies and institutions has been shown to be a key determinant of the debt levels that a country can safely sustain,[27] ever since its introduction in 2004, the DSF has used three different threshold levels depending on whether a country is classified as having "strong", "medium" or "weak" policies and institutions.[28] From 2004-June 2018, the classification of countries into the strong, medium and weak debt carrying capacity groupings relied exclusively on the World Bank's Country Policy and Institutional Assessment (CPIA). However, following the 2017 Review the country classifications will be determined by a **composite indicator** covering the CPIA, reserve coverage, remittances, economic growth, and world growth.[29] The weight of the CPIA is expected to decline from 100 percent to approximately 42 percent.

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[27] Kraay, A. and V. Nehru (2006) "When is External Debt Sustainable?", The World Bank Economic Review, August 2006.

[28] IMF and IDA (2004) "Debt Sustainability in Low-Income Countries -- Proposal for an Operational Framework and Policy Implications", Washington, D.C.

[29] IMF (2018) "Guidance Note on the Bank-Fund LIC DSF", Washington, D.C.

5.18 **The introduction of the composite indicator results in improved statistical accuracy of the underlying model, with a reduction in the rate of both “missed crises” and “false alarms”.** However, this methodological reform may cause an unforeseen externality in operational terms. Country CPIA scores have traditionally been positively correlated with per capita income and negatively correlated with measures of fragility. Hence, through its effect on the debt carrying thresholds, the CPIA has transmitted some correlation between per capita income and fragility to countries’ assessed risk of debt distress.

5.19 **For DSF-harmonized MDBs, such as the IDB, the result has been that although *de jure* the risk of debt distress has been the sole determinant of concessionality levels, in practice poorer and more fragile countries have tended to receive higher concessionality levels.**[30] These correlations have meant that, when determining appropriate concessional levels for eligible borrowing member countries, so far member country shareholders have not faced trade offs regarding the risk of debt distress and other variables such as per capita income and fragility. With the introduction of the composite indicator to determine debt carrying capacity thresholds, such correlations might break down. For example, countries that score highly in terms of remittances – and hence have a higher debt carrying capacity -- might be relatively poor and fragile. Consequently, there is a non-trivial risk that over the medium term continued reliance on the risk of debt distress as the sole determinant of concessionality might lead to a situation where the degree of concessionality is positively correlated with per capita income and inversely correlated with variables such as perceived fragility.

5.20 **Management emphasizes that this is only a potential rather than a realized issue and that it is a medium term rather than an imminent concern.** Management will closely monitor this risk and will inform the Board of Executive Directors if the risk is materializing.

VI. CONCLUSIONS

6.1 **Allocation**. Four countries (Bolivia, Guyana, Honduras and Nicaragua) were eligible for a concessional resource allocation under the EPBA/DSF for 2017 and 2018. A total of 28 operations with blended resources amounting to US$2,045 million were approved during 2017-2018, of which US$562.2 million corresponded to COC resources.

6.2 **EPBA**. The EPBA has continued to work well. Nevertheless, Management will continue to ensure that the CIPE and PPI remain up-to-date with “best practice” and any relevant innovations.

[30] The practice of the risk of debt distress being the sole determinant of the level of concessionality is relatively new. From 1959-1972, IDB concessional resources (FSO) were directed on a sectoral basis (broadly, towards the social sectors). From 1972-2006, concessional resources were allocated on a country basis and the principal determinants of the level of concessionality were per capita income and vulnerability (small economic size). The risk of debt distress came to be the sole determinant of the level of concessionality in 2007, following multilateral debt relief and with debt sustainability concerns paramount.

6.3 **EPBA envelope**. On the whole, the implementation of AB-3066-2 has been extremely smooth. However, the coefficient for the EPBA envelope was initially misaligned and the linkage to the non-concessional SG lending projections has introduced volatility and uncertainty into the concessional allocations. During 2019, Management will analyze the methodology for determining the EPBA envelope, taking into account relevant methodologies of other MFIs.

6.4 **Bolivia graduation process**. The DSF and associated blending mechanism has had outstanding success in securing a gradual and phased concessionality transition for Bolivia.

6.5 **Risk of debt distress**. Since the last Review, the risk of debt distress has continued to rise globally among LICs and also in two IDB borrowing member countries: Honduras and Nicaragua. In contrast, Guyana is now classified as having a "low" risk of debt distress.

6.6 **Non-concessional borrowing issues**. The issues of moral hazard, "free-rider" creditors and non-concessional borrowing, which were robustly considered during the preparations for MDRI, have regained salience in the international community. With IFAD having recently adopted a policy on non-concessional policy and IDA reportedly considering reforms to its NCBP, IDB Management will track these developments and report to the Board of Executive Directors if it considers that the developments warrant it.

6.7 **2017 DSF Review**. The Bank adjusted to the fourth review of the DSF by the World Bank and IMF and prepared the "Proposal for the Allocation of Concessional Resources 2019-2020" (GN-2442-57) in accordance with the revised DSF. Over the medium term, one macroeconomic methodological change might create operational questions for concessionality-targeting, DSF-harmonized MDBs, such as the IDB.

ANNEX I

EVOLUTION OF COUNTRY INDICATORS OF THE ENHANCED PERFORMANCE-BASED ALLOCATION (BY ALLOCATION PERIOD)

	Period 2007-2008	Period 2009-2010	Period 2011-2012	Period 2013-2014	Period 2015-2016	Period 2017-2018	Period 2019-2020
				Population			
Bolivia	8,986,396	9,518,000	9,862,860	10,088,108	10,671,200	10,724,705	
Guyana	772,056	739,000	762,498	756,040	799,613	767,085	777,859
Honduras	7,141,464	7,091,000	7,465,998	7,754,687	8,097,688	8,075,060	9,265,067
Nicaragua	5,604,000	5,605,000	5,742,800	5,869,859	6,080,478	6,082,032	6,217,581
				GNI p/c (Atlas method)			
Bolivia	960	1,260	1,620	2,040	2,550	3,080	
Guyana	990	1,300	1,450	2,900	3,750	4,090	4,460
Honduras	1,030	1,600	1,820	1,970	2,180	2,270	2,250
Nicaragua	790	980	1,000	1,170	1,780	1,940	2,130
				Portfolio performance (1-6 scale)			
Bolivia	3.27	3.97	4.51	4.63	5.22	4.04	
Guyana	4.95	4.27	4.90	5.09	4.71	1.75	4.15
Honduras	4.95	5.09	4.55	5.00	3.69	6.00	6.00
Nicaragua	5.36	5.49	5.66	5.29	5.60	5.79	5.49
				CIPE (1-6 scale)			
Bolivia	3.10	3.23	3.75	3.75	3.68	3.37	
Guyana	2.75	3.39	3.75	3.62	3.30	3.27	3.27
Honduras	3.85	3.95	3.72	3.58	3.38	3.43	3.38
Nicaragua	3.58	3.55	3.53	3.49	3.44	3.39	3.21

Source: GN-2442-57, GN-2442-53, GN-2442-46, GN-2442-42, GN-2442-32, GN-2442-16.

ANNEX II

2018 PORTFOLIO PERFORMANCE AND CIPE SCORES

1. Evolution of the Percentage of Undisbursed Loan Balances (ULB) represented by projects classified as "unsatisfactory" (on alert and problem)

Country	2008	2010	2011	2013	2015	2017
Guyana	34.7%	22.0%	18.1%	25.8%	84.9%	37.1%
Honduras	18.1%	28.9%	20.1%	46.3%	0.0%	0.0%
Nicaragua	10.2%	6.7%	14.1%	8.0%	4.1%	10.3%
Weighted average	**19.0%**	**19.7%**	**17.8%**	**27.8%**	**14.0%**	**10.6%**

Source: GN-2442-57; GN-2442-53, GN-2442-46, GN-2442-42, GN-2442-32, GN-2442-16.

2. Country Institutional and Policy Evaluation 2018

Policy Cluster and Weight	Variable	GUYANA Score	HONDURAS Score	NICARAGUA Score
A. Economic management (15%)	1. Monetary and exchange rate policies	3.50	3.50	3.50
	2. Fiscal policy	3.50	3.50	3.50
	3. Debt policy and management	4.25	3.75	3.75
	Policy Cluster A Score	**3.75**	**3.58**	**3.58**
B. Structural policies (20%)	4. Trade	3.11	3.94	3.73
	5. Financial sector	3.06	3.60	3.29
	6. Business regulatory environment	3.47	3.02	2.90
	7. Policies and institutions for environmental sustainability	2.76	2.95	2.96
	Policy Cluster B Score	**3.10**	**3.38**	**3.22**
C. Social inclusion/equity policies (35%)	8. Gender equality, indigenous peoples and people of African descent	3.43	3.42	3.55
	9. Equity of public resource use	2.83	3.83	3.33
	10. Building human resources	3.75	3.64	3.71
	11. Social protection and labor	3.20	3.60	2.70
	Policy Cluster C Score	**3.30**	**3.62**	**3.32**
D. Public sector management and institutions (30%)	12. Property rights and rule-based governance	3.21	2.63	2.49
	13. Quality of budgetary, procurement and financial management	3.00	3.50	3.75
	14. Efficiency of revenue mobilization	3.50	4.00	3.50
	15. Quality of public administration	2.68	2.49	2.70
	16. Transparency, accountability and corruption in the public sector	3.08	2.36	2.04
	Policy Cluster D Score	**3.10**	**3.00**	**2.90**
	Total Score	**3.27**	**3.38**	**3.21**

Source: GN-2442-57.

Annex III

Estimated Cost of the Provision of Concessional Assistance

	PRE-TRANSFER		POST-TRANSFER	
	2015	**2016**	**2017**	**2018**
I. CONCESSIONAL OC				
End-of-year Concessional OC loans outstanding [2]	n.a.	n.a.	288	539
Average Concessional OC outstanding	n.a.	n.a.	112.0	373.0
Costs				
Average cost of funding (%)[1]	n.a.	n.a.	1.38%	2.42%
Cost of funding [1]	n.a.	n.a.	1.5	9.0
Interest income and fees from concessional OC loans outstanding [2]	n.a.	n.a.	0.09	0.28
Net interest cost of funding Concessional OC loans	**0.0**	**0.0**	**1.5**	**8.7**
II. LEGACY FSO LOANs				
Legacy FSO loans outstanding [2]	4,502	4,510	4,351	4,170
Legacy FSO loan interest income and fees[2]	**61.0**	**60.0**	**60.7**	**58.3**
III. ADMINISTRATIVE EXPENSES				
Administrative expenses [3]	793	757	819	844
Estimated share of concessional portfolio (%) [4]	3%	3%	3%	3%
Implicit concessional portfolio administrative expenses	**23.8**	**22.7**	**24.6**	**25.3**
IV. NET IMPLICIT COST OF PROVISION OF CONCESSIONAL ASSISTANCE	**-37.2**	**-37.3**	**-34.7**	**-24.2**

[1] As presented in the IDB's Annual Report, MD&A

[2] Provided by ACC/FIA

[3] As presented in the IDB's Annual Report, Financial Statements

[4] Based on the FSO's share of administrative expenses prior to 2017

Source: FIN/ACC.