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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Consultation on the Seventh Replenishment of IFAD's Resources – Fourth Session

Doha (Qatar), 1-2 October 2005

**DEBT SUSTAINABILITY AND NON-REPAYABLE ASSISTANCE:
ADOPTION OF A DEBT SUSTAINABILITY FRAMEWORK FOR IFAD**

ABBREVIATIONS AND ACRONYMS

HIPC	Heavily Indebted Poor Countries
IDA	International Development Association (World Bank Group)
MDG	Millennium Development Goal
MFI	multilateral financial institution
NRA	non-repayable assistance
PBAS	performance-based allocation system

I. INTRODUCTION

1. The adoption of the Millennium Development Goals (MDGs) focused international attention on global poverty and the need for concerted action to overcome it. The growing perception of the multidimensional consequences of the persistence of extreme poverty has put the attainment of the MDGs at the forefront of political debate at all levels, and very uneven progress has precipitated the demand for new approaches and accelerated assistance.

2. There are three major imperatives: to raise rapidly the level of official development assistance to poor countries in order that they might reach the MDGs; to ensure that the external debt burden of poor countries does not become an obstacle to poverty reduction; and to support country performance in managing development processes and resources, including through the organization of assistance in such a way as to ensure that it is focused on country priorities and is delivered in a coherent and uniform manner that enables poor countries to concentrate on managing poverty reduction rather than managing aid.

3. This paper focuses on the imperative of overcoming the obstacle that external debt represents to poverty reduction initiatives in the poorest countries and on the role of multilateral financial institutions (MFIs) in responding to this obstacle. A very large part of the debt held by the poorest countries is held on concessional, non-commercial terms by MFIs, and it is evident that no comprehensive response to poor country debt can be achieved without the full engagement of the MFIs.

II. DEBT RELIEF AND THE HEAVILY INDEBTED POOR COUNTRIES DEBT INITIATIVE

4. The Heavily Indebted Poor Countries (HIPC) Debt Initiative, launched in 1996 and enhanced in 1999, has been the principal vehicle for the alleviation of the burden of external multilateral debt on the external and public finances of the most indebted poor countries and, in particular, on the ability of these countries to implement comprehensive and effective strategies for poverty reduction. The instrument employed has been a reduction in the payments on service charges and principal owed to MFIs relative to existing debt. Access to debt relief under the HIPC Initiative has been conditional upon the development of adequate poverty reduction strategies and the adoption of sound financial management. The success of the Initiative in promoting increasingly concrete and relevant country poverty reduction strategies is very clear. Nonetheless, because of the qualification conditions and processes, not all potentially eligible countries have received financial relief. Of the 38 countries potentially eligible for debt relief under the HIPC Initiative, 27 have reached decision point, among which 18 have passed the completion point and are receiving irrevocable debt relief, which will be spread over many years. The total value of HIPC debt relief for these countries is estimated at USD 58 billion in 2004 net present value terms.¹

5. The HIPC Initiative was developed as a comprehensive and uniform MFI approach to poor country indebtedness. Notwithstanding IFAD's very small share of the stock of the public external debt of poor developing countries, IFAD has been – pursuant to Governing Council Resolution 101/XX (1997) – a full participant in the HIPC Initiative. The overwhelming majority of relief has been provided to countries in Africa, where IFAD is the fifth largest contributor of HIPC debt forgiveness.

6. The original estimate of the value of income forgone by IFAD was about USD 60 million. The expansion of the HIPC Initiative, however, has driven the cost to IFAD to higher levels: to

¹ International Monetary Fund and the International Development Association, Heavily Indebted Poor Countries (HIPC) Initiative: Statistical Update. Washington, D.C., April 2005.

approximately USD 620 million (nominal value) spread over 40 years. To date, IFAD has financed relief from internal resources (USD 60 million) and from direct bilateral compensatory support from its Member States in the value of approximately USD 83 million.² These bilateral compensatory resources are sufficient to cover IFAD's agreed HIPC commitments only until, approximately, the end of 2006. Over the course of IFAD's Seventh Replenishment period, the Fund's HIPC financial requirements are estimated at USD 138.1 million. IFAD is seeking entry into the HIPC Trust Fund mechanism administered by the World Bank, but the Trust Fund will itself need further replenishment to take account of additional countries that may join the initiative under the "sunset clause" approved by the Executive Board of the World Bank.

III. THE DEVELOPMENT OF A DEBT SUSTAINABILITY FRAMEWORK

7. Recognition of very uneven performance in achieving the MDGs has precipitated a strong push among major donors towards doing more on the official development assistance front, reducing the obstacles that keep poor countries from pursuing poverty reduction strategies and increasing flows of assistance. The MFIs are major players in the global development assistance strategy. Nonetheless, it is evident that a drive on their part to increase assistance substantially might conflict with the objectives of the HIPC Initiative, offering the prospect that indebtedness would be **increased** through new commitments precisely when the HIPC Initiative is being employed to **reduce** the effective debt burden to sustainable levels. The challenge for the donor community has been to develop new financing arrangements within MFIs that would permit increased assistance without raising levels of indebtedness beyond sustainable levels, but that would not also erode the long-term capacity of MFIs to play their development assistance role.

8. The result has been the proposal and adoption of a debt sustainability framework for providing assistance to poor countries eligible for highly concessional assistance under the respective windows of major MFIs (the African Development Fund, the Asian Development Fund and the International Development Association (IDA), to date) within the context of each of their replenishment negotiations. The debt sustainability framework, like the HIPC Initiative, is intended by the international community to provide a comprehensive and common framework for MFI assistance to poor countries through which individual MFIs will provide assistance on similar terms,³ taking into account country debt-distress risk analyses which, in the case of the latest iteration (i.e. in IDA), are the products of collaboration with the International Monetary Fund.

9. The debt sustainability framework has two principal components:

- (a) a major increase in the **grant** component of new assistance to poor countries to ensure that this assistance does not exacerbate high and medium debt-distress risks; and
- (b) full compensation to participating MFIs for principal payments and service charges forgone as a result of extending new assistance on a grant basis (rather than on a highly concessional loan basis) to eligible countries.

10. Consequently, MFIs will operate two parallel and complementary approaches to the debt sustainability of poor countries concurrently: the HIPC Initiative will reduce the level of payments by qualifying poor countries on their existing debt, and the debt sustainability framework will avoid the assumption of **new debt** that drives the stock of debt above (or further above) sustainable levels by

² Of which USD 20 million is to be received.

³ This similarity of terms of assistance has long existed with regard to the terms for highly concessional lending. IFAD, the African Development Fund and IDA set the same service charge (0.75%) and offer the same grace period (ten years) on highly concessional loans.

providing a substantial part of new assistance on grant terms to countries with a high or moderate debt-distress risk (see below).

11. Under the debt sustainability framework in its most recent iterations,⁴ countries eligible for highly concessional assistance are further classified within a three-tier debt-distress risk categorization (high, moderate or low) according to their proximity to the sustainable debt threshold, taking into account three debt indicators (ratio of net present value of debt to GDP, ratio of net present value of debt to exports, and ratio of debt service to exports) and the robustness of government economic and debt management capacity. Countries classified in a position of high debt-distress risk will receive 100% of their future assistance in the form of grants (while they remain in that category); countries with moderate debt-distress risk will receive 45% of future assistance in grants; and countries with low debt-distress risk will receive future assistance in the form of loans on existing highly concessional terms.

12. Pending the development of forward-looking debt-sustainability analyses, the methodology of which is currently under development jointly by the International Monetary Fund and IDA (with delivery scheduled by the mid-term review of the Fourteenth Replenishment of IDA), country debt-distress risk is assessed on current data as of the date of analysis. A country's debt-distress risk will change over time in response to the evolution of its export performance, the development of its GDP, the robustness of its institutional and policy framework, and the debt service obligations relative to the existing stock of debt, the latter being sensitive to the operation of debt-service-reduction mechanisms such as the HIPC Initiative and any additional measures that may be introduced, including those announced by the Group of Eight at its meeting in July 2005. According to the classifications presented by IDA in November 2004, some 40 countries were in a high debt-distress risk situation and would (pending a change in their situation) receive 100% of future assistance grants under the terms of the debt sustainability framework; five others were in the moderate debt-distress risk category and would receive 45% of their future assistance in grants. In the case of the African Development Fund, somewhat more than 40% of total assistance would be provided on grant terms as the result of the application of this approach to debt sustainability. In the case of IDA, about 30% of total assistance would be put onto a grant basis under this heading, which would supersede prior systems of grant allocation according to multiple, special-purpose criteria.

13. The net result will be an enhanced ability among participating MFIs to provide substantial assistance to a large number of poor countries so they can rigorously pursue the MDGs within the framework of their poverty reduction strategies and free of the restrictions arising from the incompatibility between expanded **lending** and the prudent management of debt in high and medium debt-distress countries.

IV. THE MECHANICS OF THE DEBT SUSTAINABILITY FRAMEWORK

14. The debt sustainability framework is not intended to change the level of assistance to any country (subject to the proviso below) or the purposes for which assistance is given; it simply governs the form in which assistance is provided (i.e. grants, loans or a mix of the two). The country allocation (of assistance) made by each MFI continues to be strictly determined by the MFI's performance-based allocation system (PBAS), and the content of the assistance programme is ruled by the MFI's country strategies and programmes agreed with each country within the framework of the country's poverty reduction strategies. The debt sustainability framework thus in no way affects the development specificity of each MFI, nor the way in which the MFI allocates assistance volumes. It is exclusively concerned with ensuring that the way in which assistance is extended in the pursuit of organization-

⁴ In the African Development Fund and IDA. The Asian Development Fund, which had adopted an earlier variant, has expressed interest in more closely harmonizing its approach with the latest version. At IDA, the debt sustainability framework is known as the Joint Bank-Fund Debt Sustainability Framework.

specific development support strategies does not conflict with the need to ensure that the country debt-distress risk does not rise above manageable levels.

15. The debt sustainability framework influences country assistance allocations in only one way, and this is through the operation of what is termed the modified volume approach. The modified volume approach responds to the concern that the debt sustainability framework may act as a disincentive to prudent debt management and the process of institutional and policy development by providing resources on a grant basis to countries with unsustainable debt or weaker institutional and policy frameworks. In order to offset that effect and in order to give an incentive to graduate back into normal loan financing relations, a discount will be applied to the PBAS allocation of countries eligible for assistance on grant terms under the debt sustainability framework. Current provisions are for a discount of 20%. However, somewhat more than half of the proceeds of this discounting mechanism (the “incentive” element of the modified volume approach, i.e. 11% of the PBAS allocations of countries with debt classified as unsustainable) will be reallocated among all eligible countries (including the countries at high and moderate debt-distress risk) according to their relative PBAS scores. This means that the effective nominal allocation to countries eligible for assistance on grant terms under the debt sustainability framework will be at some common point between 80% and 91% of their original nominal PBAS allocation.

16. Thus, the effect of the debt sustainability framework (including the operation of the modified volume approach) in terms of development assistance from participating MFIs can be summarized as follows:

- (a) Countries classified at **low** debt-distress risk will receive allocations for highly concessional loans somewhat above the nominal value of their initial PBAS allocations.
- (b) Countries classified at **high** and **moderate** debt-distress risk will receive nominal assistance allocations (in the form of grants or a mix of grants and loans) slightly below their initial PBAS allocations, although it is unlikely that the net present value of assistance will suffer significantly relative to the net present value of the initial PBAS allocation under the highly concessional financing heading.⁵
- (c) The **purposes** for which resources are committed will remain unchanged and specific to each participating MFI.

V. MAINTAINING THE FINANCIAL VIABILITY AND LONG-TERM DEVELOPMENT ASSISTANCE CAPACITY OF PARTICIPATING MFIS

17. The debt sustainability framework proposed by donor countries is a two-part package that includes provisions to assist poor countries at high and moderate debt-distress risk and to ensure the long-term viability and development assistance capacity of participating MFIs. The challenge with regard to the MFIs is that, in the absence of compensation, shifting a significant element of their overall assistance from a highly concessional loan basis to a grant basis would have a major negative impact on their long-term resource position insofar as they would forgo service charge payments and principal repayments on the part of their assistance that would be provided in the form of grants rather than highly concessional loans.

⁵ In practice, countries receiving grants because of high and moderate debt-distress risk will also probably receive increased nominal allocations because MFIs adopting the debt sustainability framework have also concluded replenishments involving significant increases in total committable resources. In addition, the effective “committability” of the allocation will be enhanced.

18. In order to avoid the erosion of the historic development resource “patrimony” of the MFIs, the debt sustainability framework package includes two provisions intended to compensate participating MFIs fully for future income forgone as a result of providing a large part of their assistance on a grant basis. One relates to service charges forgone; the other relates to forgone repayments of principal.

19. With regard to service charges, the agreement on the Fourteenth Replenishment of IDA (IDA 14), for example, makes provision that somewhat less than half the proceeds of the modified volume approach (i.e. 9% of the initial nominal PBAS allocation of countries that would receive assistance in grant form) will be retained and managed by IDA to compensate for service charges forgone. It has been estimated that these resources would generate a full compensatory income flow on the basis of being loaned to World Bank-IDA countries through a “hard(er) terms” lending window carrying an interest rate calculated on a spread of 200 basis points below the World Bank lending rate in fixed-rate terms.

20. Given the highly concessional character of the lending replaced by grants, the major loss of future income experienced by MFIs would be the principal repayments forgone. Correspondingly, donors have made an explicit commitment to full additional compensatory contributions (i.e. additional to core replenishment contributions) to future replenishments as the payments of principal are actually forgone. Thus, IDA 14 records that “Participants agreed that the forgone principal reflows will be financed through additional donor contributions on a pay-as-you-go basis”.⁶ Similarly, the African Development Fund’s Tenth Replenishment agreement refers explicitly to compensatory financial provisions that would be made in future replenishments.⁷

21. In summary, the debt sustainability framework provides for full compensation to participating MFIs in order to sustain their capacity to service future poverty reduction and development needs. This is supported by two mechanisms: full compensation for service charges forgone through the retention and management of part of the resources governed through the modified volume approach; and full compensation for the principal repayments forgone achieved through the agreement of Member States to provide resources equivalent to the forgone amounts through additional contributions in the context of future replenishments.⁸

VI. IMPLICATIONS OF A DEBT SUSTAINABILITY SYSTEM FOR IFAD

22. The clear intention of the international donor community is to mobilize MFI subscription to the debt sustainability framework as an essential instrument to overcome the obstacle that high and medium debt-distress risk represents in providing adequate assistance to poor countries in the pursuit of their poverty reduction strategies and, as in the case of the HIPC Initiative, contribute to the development of a common, transparent and comprehensive approach for all concessional development financiers. It is fully within the spirit of development harmonization initiatives: it promotes a common approach to the **form** of assistance, while respecting institutional differences and complementarities with regard to areas of focus in the **substance** of assistance. Unlike the HIPC Initiative, which is accompanied by special qualification processes and conditionalities, the debt sustainability framework would involve no additional conditionalities in accessing assistance on a grant basis, but would be driven by a technical assessment of debt-distress risk (and debt sustainability).

⁶ IDA. Report from the Executive Directors of the International Development Association to the Board of Governors. Additions to the International Development Association Resources: Fourteenth Replenishment. Working Together to Achieve the Millennium Development Goals. Washington, D.C., March 2005. Page v.

⁷ See African Development Fund, Report on the Tenth General Replenishment of the Resources of the African Development Fund. Corrigenda to paragraphs xxii and 7.19. 1 February 2005.

⁸ Thus, the financing table for contributions to the Fourteenth Replenishment of IDA contains a column for separate and additional donor contributions to compensate for the costs of IDA 13 grants beyond basic contributions.

23. On the basis of a strategy of pursuing its comparative advantage in rural poverty reduction within a common approach to the management of assistance, IFAD subscribes strongly to the principle of the harmonization of assistance mechanisms to eliminate the problems that arise for its developing country partners because of a multitude of aid delivery mechanisms and conditionalities. Moreover, as indicated above, IFAD has been a full participant in the HIPC Initiative as an instrument for reducing the debt burden on poor countries. Full participation has involved complete subscription to the common criteria and mechanisms.

24. IFAD has already experienced difficulties in committing new resources to poor countries in support of rural poverty reduction in situations where unsustainable debt is leading to containment of new external borrowing even on highly concessional terms. The adoption of the debt sustainability framework will be invaluable in creating opportunities for providing assistance for rural poverty reduction in such countries and for de-linking the constraints of debt accumulated in the past and the responses to the current and urgent needs of poor countries for new and additional assistance to reach the MDGs. It represents a forward-looking way of boosting effective assistance so as to reduce poverty.

25. In order to take full advantage of this opportunity, IFAD should itself adopt the debt sustainability framework. Failure to do so could lead to a narrowing of opportunities for rural poverty reduction assistance by IFAD at precisely the moment when the need for more assistance is being emphasized. It is not the intention of the international community to create more opportunities for lending by non-participating institutions as a result of a shift of assistance from participating MFIs to a grant basis. Rather, the intention is to pave the way for a common approach to the provision of new assistance in countries with unsustainable debt.⁹ Even if the issue of a common approach and responsibility were to be waived in the case of IFAD (in at least the 40 poor, high debt-distress risk countries eligible for assistance on 100% grant terms under the terms of already existing debt sustainability frameworks in other major international financial institutions), it may prove more difficult to promote projects and programmes for rural poverty reduction if the terms of financing are “harder” than those provided by other MFIs.

VII. IMPLICATIONS OF THE ADOPTION OF A DEBT SUSTAINABILITY FRAMEWORK BY IFAD

26. The debt sustainability framework will provide new opportunities for IFAD to maintain and expand its assistance for rural poverty reduction in poor countries with unsustainable debt if IFAD participates in the approach as it has in the case of the HIPC Initiative. IFAD has no independent capacity to produce authoritative debt-distress risk and debt sustainability analyses. IFAD’s role and focus refer to the content of what it supports in projects and programmes for rural poverty reduction, and its capacity should remain concentrated on precisely that.

27. As stated above, country debt-distress risk and debt sustainability situations will change over time. Some countries that are currently classified at high or moderate debt-distress risk will move into the low debt-risk category, and current and future initiatives to reduce the existing debt burden will necessarily exert a positive influence. Equally, there is the possibility that some countries may shift into unsustainable debt situations. As these situations change for each country, so will the terms on which assistance is provided.

28. For the purpose of illustrating the effects of the adoption of the debt sustainability framework by IFAD, the country debt-distress risk classifications provided by the World Bank in November 2004 have been applied to IFAD’s highly concessional borrowing Member States. With regard to the 46

⁹ The means by which IDA will pursue this objective in collaboration with the International Monetary Fund will be the subject of a proposal to address the “free rider” issue before the end of IDA’s 2005 financial year.

countries¹⁰ that would receive assistance from IFAD on non-repayable assistance (NRA)¹¹ terms (100% NRA or mixed NRA and loan), the regional distribution is indicated in Table 1. The focus of NRA-based assistance would be in Western and Central Africa, Asia and the Pacific, and Eastern and Southern Africa. This necessarily reflects the regional distribution of poor countries and debt vulnerability, as well as the pattern of the provision of assistance and debt relief in the past, for example, Bolivia, Mozambique and the United Republic of Tanzania do not appear on the list of countries at high debt-distress risk, while Kenya and Uganda appear in the list of countries at moderate debt-distress risk (eligible for NRA up to 45% of allocations).

Table 1: Regional Distribution of IFAD Member States that would Receive Non-Repayable Assistance according to Debt-Distress Risk Status, as at November 2004

Western and Central Africa	18
Asia and the Pacific	11
Eastern and Southern Africa	11
Latin America and the Caribbean	3
Near East and North Africa	3

29. The impact of adopting the debt sustainability framework for the IFAD lending programme in terms of the breakdown according to loan and NRA volumes has been estimated by applying the debt-distress risk classifications published by IDA to countries in IFAD's highly concessional borrowing category and applying the relevant NRA-to-loan ratios to individual country PBAS allocations, while also taking into account the modified volume approach and the 11% reallocation among all highly concessional borrowers. This calculation can only **approximate** a real world effect because, *inter alia*, in this first year of the application of the PBAS, analysis can only be based on first-year *ex ante* allocations and, as stated above, country debt-distress status will change over time.

30. Subject to these qualifications, the estimated impact of the application of the debt sustainability framework to IFAD assistance is very similar to the IDA 14 estimate of the impact of the framework on the composition of IDA's own programme of assistance. The estimated percentage of IFAD's total PBAS allocations that would remain in the form of loans would be 75%, while NRA would account for 22%, and 3% would be retained. A more relevant comparison with IDA is provided by the estimates of the impact on the commitments to countries eligible for highly concessional lending (*i.e.* IFAD's poorest Member States). In this category, 68.1% of the resources allocated would be delivered in the form of loans, and 28.5% as NRA (compared with 30% at IDA). About 3.4% would be retained under the provisions for compensation for service charges forgone. The percentage of assistance delivered on NRA terms under the framework would be significantly lower than the share in the African Development Fund because that fund's operations occur exclusively in a region where the incidence of debt non-sustainability is higher than the global norm.

¹⁰ High debt-distress risk: Afghanistan, Angola, Bhutan, Burundi, Cambodia, Cameroon, the Central African Republic, Chad, the Comoros, the Congo, the Democratic Republic of the Congo, Côte d'Ivoire, Eritrea, Ethiopia, the Gambia, Georgia, Guinea-Bissau, Guinea, Guyana, Haiti, Kyrgyzstan, the Lao People's Democratic Republic, Lesotho, Liberia, Malawi, Mali, Mauritania, the Republic of Moldova, Mongolia, the Niger, Rwanda, Samoa, Sao Tome and Principe, Sierra Leone, Solomon Islands, the Sudan, Tajikistan, Timor-Leste, Togo, Tonga and Zambia. Moderate debt-distress risk: Burkina Faso, Kenya, Nicaragua, Senegal and Uganda.

¹¹ The term "non-repayable assistance" is used to refer to resources provided to countries on non-loan terms in substitution for resources that would otherwise (*i.e.* in the absence of a debt sustainability framework) be provided on highly concessional loan terms with the specific objective of avoiding high and moderate debt-distress risk in poor countries. The purpose of employing this term is to distinguish these resources from other resources provided in grant form under IFAD's Policy for Grant Financing, which are applied for different development objectives. See paragraph 35 below.

VIII. FINANCIAL IMPLICATIONS

31. Adoption of the debt sustainability framework would involve two elements: first, adopting procedures for determining the terms of assistance to poor countries in situations of debt non-sustainability and the modification of PBAS allocations (under the modified volume approach); and second, adopting procedures for full compensation of principal repayments and service charges forgone.

32. IFAD's experience with the HIPC Initiative is extremely germane to an appropriate approach to the financing of principal and service charge repayments forgone by IFAD as a result of the adoption of a debt sustainability framework. IFAD was not included in the compensation mechanisms underwriting the additionality of HIPC relief from MFIs, and a significant volume of IFAD's future commitments to debt relief under the Initiative remain without compensatory coverage (see paragraph 6 above). With regard to compensation for principal repayments forgone under the debt sustainability framework, IFAD Member States would agree to full compensation in the form of additional resources, identified for this purpose in each replenishment subsequent to the adoption of the debt sustainability framework; the total amount of the additional resources provided under each replenishment would be equal to the principal repayments forgone in the previous replenishment period. Because of the ten-year grace period involved in highly concessional lending during which principal repayments would be forgone, the short-term requirement for this additional and compensatory funding from Member States would be small, but would expand rapidly in the medium term. Table 2 provides estimates for the total additional and compensatory funding that would be required by IFAD for NRA under the debt sustainability framework in the Seventh, Eighth and Ninth Replenishment periods. Thus, the compensation for forgone principal repayment would not commence until the Tenth Replenishment period, with the very modest sum of USD 4 million. Thereafter, the compensation required for principal repayment forgone on NRA under the framework would rise rapidly to a peak of USD 140 million in the Fourteenth Replenishment period (2028-2030).

33. With regard to full compensation for service charges forgone, Table 2 provides estimates of the net effect of a retention and management scheme similar to that adopted under IDA 14 and involving the management of a sum equal to 2.5% of total loans and grants (or 3.4% of highly concessional loans). The estimates indicate that this retention level would not be adequate to compensate for service charges forgone and that IFAD might have to establish a different level so that the principle of full compensation would be respected. Thus, the loss to IFAD over a period of more than 40 years and net of the proceeds of the operation of the retain-and-manage scheme is estimated at USD 164 million for NRA under the debt sustainability framework during the Seventh, Eighth and Ninth Replenishment periods. The negative impact is spread over the Eighth through the Twenty-Second Replenishment periods. The first "deficit" would be recorded in the Eighth Replenishment period; it would be USD 1 million, rising to a peak of USD 20 million in the Thirteenth and Fourteenth Replenishment periods. It should be noted that there is no reason intrinsic to the debt sustainability framework for establishing retention at the level adopted under IDA 14. On the contrary, the guiding underlying principle is full compensation, and the retention level or the proceeds of any other compensation mechanism relative to service charges forgone should be established at a point adequate to cover the costs of each participating MFI as determined by that MFI's circumstances.

Table 2: Operation of the Debt Sustainability Framework: Projected Service Charges and Principal Repayments Forgone
(USD million)

Replenishment period when service charges, interest and principal received	Projected Forgone Service Charges and Principal Repayments for Each Affected Future Replenishment Period against NRA Commitments Made in the Seventh through Ninth Replenishments											
	Seventh Replenishment (2007-09)			Eighth Replenishment (2010-12)			Ninth Replenishment (2013-15)			Seventh-Ninth Replenishments (2007-15)		
	Charges	Principal	Total	Charges	Principal	Total	Charges	Principal	Total	Charges	Principal	Total
7th Replenishment (2007-09)	-	-	-	-	-	-	-	-	-	-	-	-
8th Replenishment (2010-12)	1	-	1	-	-	-	-	-	-	1	-	1
9th Replenishment (2013-15)	3	-	3	1	-	1	-	-	-	4	-	4
10th Replenishment (2016-18)	5	4	9	4	-	4	1	-	1	10	4	14
11th Replenishment (2019-21)	6	36	42	6	5	11	3	-	3	15	41	56
12th Replenishment (2022-24)	6	42	48	6	42	48	6	6	12	18	90	108
13th Replenishment (2025-27)	6	42	48	7	48	55	7	45	52	20	135	155
14th Replenishment (2028-30)	6	42	48	7	48	55	7	50	57	20	140	160
15th Replenishment (2031-33)	5	42	47	6	48	54	8	50	58	19	140	159
16th Replenishment (2034-36)	4	42	46	5	48	53	7	50	57	16	140	156
17th Replenishment (2037-39)	3	42	45	4	48	52	6	50	56	13	140	153
18th Replenishment (2040-42)	2	42	44	4	48	52	5	50	55	11	140	151
19th Replenishment (2043-45)	1	41	42	3	47	50	4	50	54	8	138	146
20th Replenishment (2046-48)	1	37	38	2	47	49	2	50	52	5	134	139
21st Replenishment (2049-51)	-	5	5	1	42	43	2	50	52	3	97	100
22nd Replenishment (2052-54)	-	-	-	-	5	5	1	46	47	1	51	52
23rd Replenishment (2055-57)	-	-	-	-	-	-	-	6	6	-	6	6
24th Replenishment (2058-60)	-	-	-	-	-	-	-	-	-	-	-	-
Total	49	417	466	56	476	532	59	503	562	164	1 396	1 560

IX. CONSIDERATIONS BEARING ON THE ADOPTION OF A DEBT SUSTAINABILITY FRAMEWORK IN IFAD

34. The operation of a debt sustainability framework is technically complex, and it is inevitable that the details of the implementation of the framework will be developed over time (as, for example, in the production of forward-looking debt-sustainability analyses), as was the case with the HIPC Initiative, to which the framework is an important complement. Nonetheless, there are a number of basic considerations that should be taken into account in considering whether a debt sustainability framework should be adopted and how it should be put to work in IFAD:

- (a) Unsustainable debt levels in poor countries prejudice the ability of these countries to pursue poverty reduction strategies rigorously at an adequate level. The HIPC Initiative is contributing to reduce the burden of the **existing** debt stock of these countries. The debt sustainability framework enables countries at high and moderate debt-distress risk to receive higher future levels of assistance than would be compatible with debt management considerations were assistance to continue to be predominantly in the form of loans. This may be vital to the achievement of the MDGs.
- (b) In the context of the HIPC Initiative, IFAD has confirmed its subscription to the common responsibility to reduce the debt burden of poor countries, and this recognition of a full partnership and participation role relative to the common responsibility should be reflected in the adoption of a debt sustainability framework, in the absence of which IFAD's effective ability to provide assistance for rural poverty reduction in some of the poorest countries might be reduced.
- (c) The broad principles of the debt sustainability framework, as proposed by the donor community and adopted by MFI participants to date, ensure that countries at high and moderate debt-distress risk are in a position to receive assistance without prejudicing the assistance received by other poor countries at low debt-distress risk. They also ensure that the MFIs involved receive full compensation so as to maintain unimpaired their ability to provide development assistance in the long term.
- (d) Participation in a common debt sustainability framework approach in no way detracts from the specific role and focus of each MFI. The key dimension of the common approach to debt sustainability in assistance is not that the substance of assistance must be the same, but that the form of delivery of the assistance should become uniform relative to the challenge of debt-distress risk. Should IFAD adopt a debt sustainability framework, the substance of its assistance (the programmes and projects it supports) would reflect its own focus and role relative to rural poverty reduction. Its debt sustainability framework decisions relative to debt sustainability would reflect the analyses of institutions that possess a recognized comparative advantage in producing authoritative analyses in this area.
- (e) The level of the modified volume approach is not a constant that is inherent to the system. It may be approached differently by each institution, taking into account the institution's role and focus.
- (f) The principle of full compensation to the operating MFI for capital repayments it has forgone is critical to the debt sustainability framework. The principle is that compensation is for actual repayments forgone, when they are forgone. The amount required for compensation cannot be fixed in advance, but must reflect the results of the application of the debt sustainability framework methodology to the programme of

assistance. Without clear and explicit member commitment to this principle and discharge of responsibilities under it, the framework would have a negative development impact in the longer term.

- (g) The principle of full compensation to an MFI for service charge income forgone is also critical to the debt sustainability framework; hitherto, it has been approached through MFI management of a retention and investment scheme within the modified volume approach. The level of retention required to compensate fully for service charge income forgone will vary from one institution to another. Furthermore, consideration should be given to the effects of the retention scheme on the impact of development in the context of the MDGs, not excluding the possibility that compensation under this heading should be pursued through other or supplementary channels, such as additional and separate contributions made by Member States during regular replenishments.
- (h) The debt sustainability framework is a system in evolution. Better ways of analysing debt sustainability will be developed, and the experience of implementation will have to be reflected in operations. Correspondingly, the framework must be seen as a flexible mechanism, open to modification as participants deepen and share knowledge. To the extent possible, this flexibility should be exercised in a coordinated effort among MFIs, in which IFAD should be an active participant.
- (i) Given the need for learning and flexibility in implementation, it is appropriate that oversight of the system's operation and the power to modify specific provisions should be vested in the Executive Board within broad principles and parameters established by the Governing Council.

X. RELATION OF A DEBT SUSTAINABILITY FRAMEWORK IN IFAD TO ITS EXISTING GRANT PROGRAMME AND TO POST-CONFLICT COUNTRIES

35. Under the terms of the IFAD Policy for Grant Financing approved by the Executive Board in December 2003,¹² IFAD provides grants through two windows: global/regional grants and country-specific grants. Together, these account for 10% of the programme of work, divided equally between the two windows. Grants made through the country-specific window are within the PBAS-driven country-financial envelopes governing all forms of country assistance;¹³ among their key objectives are capacity-building, including among civil society partners, and the development and testing of innovative policy, institutional and technical approaches to rural development.

36. At IDA, special provisions are made within the debt sustainability framework for post-conflict countries, e.g. allocations to individually named post-conflict states are exempt from the retention scheme operated to compensate for service charges forgone. The Executive Board will begin discussing IFAD's policy on post-conflict states in September 2005. IFAD's approach to the treatment of such states within a debt sustainability framework should be considered in the context of the range of measures that may eventually be adopted by the Executive Board.

¹² See document EB 2003/80/R.5/Rev.1.

¹³ See document EB 2003/80/C.R.P. 1.

XI. CONCLUSIONS AND RECOMMENDATIONS

37. In order for IFAD to support the global effort to achieve the MDGs and to maintain and enhance its ability to pursue effectively its specific role and focus relative to rural poverty reduction, IFAD should adopt and implement a debt sustainability framework that provides for the delivery of assistance in the form of NRA or a mix of NRA and grants to countries at high and moderate debt-distress risk.

38. It is recommended that:

- (a) IFAD adopt a debt sustainability framework to govern the allocation of assistance to countries eligible for highly concessional assistance at high and moderate debt-distress risk, within the framework of allocations determined by the PBAS and as modified by an appropriate modified volume approach;
- (b) the Agreement Establishing IFAD and other basic legal texts be amended appropriately to permit the operation of the debt sustainability framework;
- (c) the debt sustainability framework adopted by IFAD be based on technical, economic country analyses of debt-distress risk (and, eventually, forward-looking analyses of debt sustainability) produced and revised from time to time by the relevant international institutions competent in that area, i.e. the International Monetary Fund and the World Bank;
- (d) the provisions of the debt sustainability framework relative to the proportion of assistance offered in the form of grants and loans to eligible countries be in line with the practices of comparable MFIs with a global development assistance mandate;
- (e) the debt sustainability framework operate in parallel to implementation of the IFAD Policy for Grant Financing. Total allocations under the framework and the grant policy would be within the overall PBAS country allocation as calculated by IFAD. No country NRA or country-specific grant, or any combination of the two, would exceed the country's PBAS allocation;
- (f) IFAD Member States agree to provide compensation for principal repayments forgone as a result of the application of the debt sustainability framework in the form of separate and additional contributions to each IFAD replenishment subsequent to the adoption of the debt sustainability framework in the amount of the principal repayments forgone during the previous replenishment period;
- (g) IFAD Member States agree to provide full compensation for service charges forgone and not otherwise covered by the proceeds of the operation of any debt sustainability framework retention and investment scheme approved by the Executive Board within the context of the adoption of the debt sustainability framework; this compensation would be provided in the form of separate and additional contributions to each IFAD replenishment in the amount of net service charges forgone (i.e. net of the proceeds of the debt sustainability framework retention and investment scheme) in the previous replenishment period;
- (h) within the general provisions stipulated earlier in this paragraph, the Executive Board be made responsible for determining the detailed provisions for the operation of the debt sustainability framework, making amendments to the same as the situation requires, and overseeing its implementation;

- (i) the Executive Board decide on, inter alia, an appropriate modified volume approach to be applied by IFAD within the debt sustainability framework and an appropriate approach to full compensation for service charges forgone consistent with IFAD's role and focus; and
- (j) IFAD management submit to the Executive Board, in September 2006, proposals for the operation of the debt sustainability framework, including provisions for reporting on progress, the overall NRA share and implications for IFAD's finances, the implementation of an appropriate modified volume approach, the generation of compensation for service charges forgone, and IFAD's participation in the collaboration among MFIs for refining and reviewing methodologies used under the framework, as well as the calibration of IFAD's approach with the approaches of other MFIs.