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PROPOSAL FOR A REVISED METHODOLOGY TO DETERMINE THE EPBA ENVELOPE

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<tr>
<td>BMC</td>
<td>Borrowing member country</td>
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<td>DSF</td>
<td>Debt Sustainability Framework</td>
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<td>EPBA</td>
<td>Enhanced Performance-Based Allocation</td>
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<td>FSO</td>
<td>Fund for Special Operations</td>
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<td>HIPC</td>
<td>Heavily Indebted Poor Countries Initiative</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IMF</td>
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<td>LTFP</td>
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<td>MDB</td>
<td>Multilateral development bank</td>
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<td>MDRI</td>
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I. INTRODUCTION

1.1 The purpose of this document is to present Management’s proposal for a revised methodology for the determination of the Enhanced Performance-Based Allocation (EPBA) envelope to be used in the biennial allocation exercise of concessional resources. During the meeting of the Programming Committee of the Board of Executive Directors’ consideration of the “Proposal for the Allocation of Concessional Resources 2019-2020” (GN-2442-57), the “Committee expressed interest in reviewing the methodology and indicators used for determination of the EPBA envelope prior to preparation of the next proposal for the allocation of concessional resources 2021-2022”.

1.2 This Proposal is prepared in response to the interest expressed by members of the Programming Committee of the Board and is intended to address a concern with respect to the post-2016 methodology to determine the EPBA envelope: the methodology is too focused on the Bank’s financial supply capacity (which is sensitive to external variables) and insufficiently oriented to concessional-eligible country demand and absorption capacity. As a consequence, the current methodology could result in an EPBA envelope that is too high or too low relative to eligible countries’ absorption capacity and debt sustainability considerations.

1.3 The Proposal is limited only to the determination of the size of the envelope. It would not affect the EPBA mechanism itself, in terms of the EPBA formula or the components of the formula. Nor would it affect the criteria for country eligibility for concessional resources. The Bank’s framework for concessional resources can be conceived as comprising four principal blocks: (i) country eligibility for concessional resources; (ii) determination of the EPBA envelope; (iii) the enhanced performance-based allocation (EPBA) mechanism; and (iv) the debt sustainability framework (DSF). The focus of this proposal is on the second block.

II. THE NEED TO DEFINE A MECHANISM TO DETERMINE THE EPBA ENVELOPE

2.1 In the early 2000s many low-income countries – including Bolivia, Guyana, Haiti, Honduras and Nicaragua – were heavily indebted. A prior accumulation of debt had not resulted in a commensurate increase in debt carrying capacity, in terms of GDP, exports and government revenues. The high share of public resources devoted to debt service crowded out resources for health, education and investment in infrastructure. Debt overhangs and macroeconomic unsustainability were judged to be impeding private investment and growth.

2.2 The Heavily Indebted Poor Countries Initiative (HIPC) and the Multilateral Debt Relief Initiative (MDRI) debt forgiveness processes restored macroeconomic sustainability, opened fiscal space for health and education expenditures, and

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provided the beneficiary countries with a fresh start. The IMF estimates that for the 36 post-completion point countries as a whole poverty-reducing expenditures (7.3 percent of GDP) were almost four times as great as debt-service payments (1.9 percent of GDP) in 2017.2

2.3 At the time of the debt relief initiatives, the international community and the IDB recognized that debt relief entailed issues of time inconsistency, “free-riding”, and moral hazard.3 Time inconsistency would arise because debtor countries and creditor agencies would have strong incentives to pre-commit to responsible borrowing and lending practices prior to debt relief, but those incentives would change after debt relief was executed. Free riding could arise to the extent that non-concessional creditors could indirectly benefit financially from the debt relief and/or subsequent concessional assistance without paying for it. And preventing free riding would be difficult because of collective action problems. Last, moral hazard could arise because debt relief and/or concessional assistance could be viewed as rewarding weak policies, particularly over-borrowing, and create expectations that new borrowing might also be forgiven at some point in the future.

2.4 Some observers concluded that the aforementioned issues would ultimately undermine the impact and sustainability of debt relief. They predicted that after debt relief, countries would simply undertake new borrowing in the amount of the debt relief and external debts would return to the levels prevailing prior to debt relief.4

2.5 To help ensure that the international debt relief processes were a “once and for all” solution and that the gains in debt sustainability were permanent, the international community turned to the joint World Bank-IMF Debt Sustainability Framework for Low-Income Countries (LIC DSF).5 The International Development Association (IDA) adopted debt sustainability as the basis for setting its financial conditions for the period of its 14th replenishment (IDA14), which ran from July 1, 2005 until June 30, 2008.6 The IDA “Grant Allocation Framework”, better-known as the “traffic light system”, would henceforth “translate” a country’s risk of debt distress into the financial conditions on its concessional assistance. The grant element or concessionality would rise in lockstep with the risk of debt distress, and at the limit become 100% grants for countries deemed to be at “high risk of debt distress”.

2.6 The African Development Bank (AfDB), the Asian Development Bank (AsDB), the IDB, and the International Fund for Agricultural Development (IFAD) harmonized

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2 IMF (July 2019) “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Statistical Update”.

3 CA-472, “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”, June 2006.


with the LIC DSF and associated “traffic light” system. On February 21, 2007, the IDB’s Board of Executive Directors 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 linked together both a performance-based allocation (PBA) and debt sustainability framework (DSF) in an integrated EPBA/DSF framework.

2.7 The EPBA/DSF was expected to regulate concessional lending levels in accordance with both country absorption and debt sustainability. GN-2442 stated that by applying the DSF/PBA methodology to its lending, the IDB would support prudent borrowing policies that would help to sustain the benefits of debt relief in the medium term, as well as maintain positive net financial flows to support social and infrastructure investment projects. GN-2442 also expected that the EPBA/DSF exercise would identify the Bank flows and financial conditions that would allow the countries to maintain a stable or declining IDB debt/GDP ratio.

2.8 GN-2442 did not establish a mechanism for or guidance on the determination of the envelope to be used for the EPBA/DSF (other than proposing specific allocations for 2007-2008). Moreover, there is a disconnect between the DSF -- under which debt sustainability analysis is necessarily economy-wide -- and IDB lending decisions. While the DSF framework is a useful tool for analyzing a country’s risk of debt distress and for indicating an appropriate level of concessionality, it is not possible to use the DSF to determine precisely an appropriate volume of lending from a single creditor to an economy as a whole.

2.9 In successive reviews of biennial concessional allocations from 2007-2018, Management has concluded that the EPBA/DSF performed well in broad terms. The EPBA performed well in terms of developmental effectiveness by allocating scarce concessional resources according to country needs and performance. For its part, the DSF has been useful in determining an appropriate level of concessionality and in providing a smooth concessionality transition to graduation for Bolivia. But it became evident by the 2017-2018 allocation period that the DSF has not sufficiently constrained lending and has not met the expectations of “avoiding undue debt accumulation” and allowing countries to maintain a stable or declining IDB debt/GDP ratios as envisaged in GN-2442.

2.10 IDB lending to countries supposedly constrained by the DSF has grown far faster than lending to countries that were not constrained by the DSF. From 2007-2018, outstanding loans from the IDB for “DSF-constrained” countries grew more than twice as fast as loans outstanding for “small and vulnerable” countries that were not constrained by the DSF (Figure 1).


8 Bolivia, Guyana, Honduras and Nicaragua.
2.11 In addition, while the DSF has been useful for coordinating concessionality levels across DSF-harmonized MDBs, lending outcomes by MDBs using the same DSF methodology have diverged significantly (Figure 2).

**Figure 1: Annual growth of IDB sovereign-guaranteed loans outstanding 2007-2018**

![Chart showing annual growth of IDB sovereign-guaranteed loans outstanding 2007-2018](image)

**Source:** IDB Annual Reports, 2007 and 2018, Statements of Loans.

**Figure 2: Public external debt outstanding to IFIs (2007-2018)**

![Charts showing public external debt outstanding to IFIs for Bolivia and Guyana](image)

Note: IDB and IFAD are harmonized with IDA and the WB-IMF LIC DSF. CABEI, CAF and the CDB are not harmonized with the LIC DSF.

2.12 The above evidence suggests that, contrary to the expectations in GN-2442, MDB concessional lending has been limited by financial supply-side constraints rather than the DSF. In turn, that implies a relatively more important role for the EPBA envelope in helping to maintain debt sustainability.

2.13 Nor has the portfolio performance variable in the EPBA been sufficient to align lending envelopes with absorptive capacity. The primary role of the portfolio performance variable is helping -- on the margin -- to steer scarce concessional resources to countries that are best able to use the resources promptly and productively. But the portfolio performance variable affects the relative allocations between countries -- it neither affects the size of the aggregate EPBA envelope nor can it compensate for a mis-alignment in the size of the aggregate EPBA envelope (Annex I).

2.14 An appropriate EPBA envelope needs to balance supporting the eligible countries’ development efforts with the capacity to absorb the resources in a sustainable and productive manner. Estimates of demand need to take into account projected graduations and country eligibility considerations. In addition, an EPBA envelope also needs to be related to the financing available. Under the traditional MDB concessional assistance model, donors periodically replenish an MDB’s concessional window and the size of the replenishment determines the PBA envelope for the next three to four years. Consequently, most MDBs do not face the challenge of needing a mechanism to determine the size of their PBA envelope -- their concessional envelopes are already anchored in replenishment cycles, which in turn are broadly dimensioned on projections of country demand.

2.15 In the IDB, prior to 2017 the size of concessional allocations was anchored by the projected financial capacity of the Fund for Special Operations (FSO). The last replenishment of the FSO took place in 2009 and since IDB concessional assistance is no
longer based on periodic replenishments, the replenishment anchor for determining the size of the EPBA envelope is not available to the IDB.9

2.16 Recognizing the lack of an anchor, the “Proposal for Sustaining Concessional Assistance by Optimizing the IDB’s Balance Sheets” (AB-3066-2) proposed a methodology to link the EPBA envelope to the Bank’s overall sovereign-guaranteed (SG) non-concessional lending envelope.10 Specifically, the basis for determining the EPBA envelope was switched to a percentage of the Bank’s non-concessional SG lending program as projected for the next two years in the Bank’s latest Long-Term Financial Projections. 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.

2.17 But Management’s review11 of the initial experience with the new mechanism for determining the size of the EPBA envelope coincides with the concerns raised during the consideration of the “Proposal for the Allocation of Concessional Resources 2019-2020”12 by the Programming Committee of the Board to the effect that the mechanism is insufficiently related to country needs/absorption capacity, focusing exclusively on the Bank’s financial supply capacity, which, in turn, is sensitive to changes in external variables.

2.18 The non-concessional lending program coefficient methodology does take into account country eligibility considerations but, on its own, does not otherwise take into account country demand and countries’ capacities to absorb the concessional resources in a sustainable and productive manner. Consequently, an EPBA envelope determined on this basis could conceivably be too small relative to the countries’ development needs and capacity to absorb the resources, just right, or too large.

2.19 The initial experience with the new methodology was that it determined an EPBA envelope that was too large from a perspective of absorption capacity and debt sustainability. 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 was 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

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9 The FSO received contributions ten times, including the original contributions made in 1959 as well as nine subsequent replenishments.

10 “Proposal for Sustaining Concessional Assistance by Optimizing the IDB’s Balance Sheets” (AB-3066-2), Recommendation III of Resolution AG-9/16, approved by the Board of Governors on September 1, 2016.

11 “Review of the Implementation of the Debt Sustainability Framework and Enhanced Performance-Based Allocation 2017-2018”, GN-2442-68. Although the Review identified issues with the new mechanism for determining the size of the EPBA envelope, it also concluded that the vast majority of the reforms and changes implied by AB-3066-2 had been implemented smoothly.

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\(^{13}\).

2.20 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. However, following proactive measures by Bank’s Management that have improved the Bank’s capital position (balance sheet optimizations, exposure exchange agreements) as well as changes in rating agencies methodologies, the Bank’s SLL increased and the application of the initial EPBA coefficient of 3.18 percent to this higher SG non-concessional lending level caused a significant expansion of the EPBA envelope in dollar terms.

2.21 The large EPBA envelope for 2017-2018 led to two forms of disequilibria that showed that the Bank’s financial supply capacity now exceeded the absorption capacity of the eligible countries (in terms of both debt sustainability and implementation capacity).\(^{14}\) First, it caused rapid growth in the outstanding debt of the eligible countries to the IDB. Second, it caused an accumulation of undisbursed loan balances.\(^{15}\) The growth of IDB debt, in itself, would not have been a concern if debt servicing capacity (particularly GDP, exports, and government revenues) had grown at a commensurate pace. However, IDB debt grew far faster than underlying debt service capacity, as reflected in increasing IDB debt-to-GDP ratios (Figure 3).\(^{16}\) 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 to 1.62% for the 2019-2020 biennial period.

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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.

\(^{14}\) This switch in the binding constraint was mostly due to the greatly enhanced financial supply capacity for concessional assistance resulting from the FSO balance sheet transfer. However, it was also partially due to weakening debt sustainability in two countries.

\(^{15}\) Both disequilibria were extensively analyzed in “Proposal for the Allocation of Concessional Resources 2019-2020” (GN-2442-57), February 2019.

\(^{16}\) In addition to the importance of dimensioning the EPBA envelope appropriately, the fact that public external debt to the IDB has grown faster than GDP points to a need to continue to strengthen development effectiveness and enhance the contribution of Bank programs to supporting economic growth in the Bank’s concessional-eligible member countries.
Although the initial experience was a sharp growth in the EPBA envelope, it is important to note that the risk of tying the EPBA envelope to the SG non-concessional lending envelope is symmetric. Exogenous shocks that are unrelated to the absorption capacity of the concessional-eligible countries could also cause a sharp downward adjustment in projected SG lending and then in turn in the EPBA envelope. Furthermore, a mechanism to credit/debit future EPBA envelopes for under/over projection of SG lending, although well-intentioned, appears to be pro-cyclical and to accentuate volatility in the size of the EPBA envelope.

In sum, linking the size of the EPBA envelope to the Bank’s overall SG non-concessional lending envelope has proved to be too financially deterministic and insufficiently related to country needs and absorption capacity. The methodology could result in EPBA envelopes that are too large or too small relative to the development finance needs and sustainable absorption capacity of the eligible countries, due to financial factors unrelated to the affected countries.

An additional issue with the current methodology for the EPBA envelope is that discussion of the envelope in terms of a percentage of the non-concessional SG lending envelope rather than a dollar figure is indirect and cumbersome.

The realignment of the EPBA coefficient to 1.62% for the 2019-2020 concessional resource allocation resolved the issue of aligning the allocation with absorption capacity for that allocation. However, since the EPBA envelope is still expressed as a
percentage of the non-concessional SG lending envelope, it does not resolve the issue of volatility and uncertainty caused by changes to macroeconomic and financial variables that can affect the Bank’s overall lending capacity.\footnote{“Revised Allocation of Concessional Resources 2019-2020”, (GN-2442-64), May 2019.}

Management’s Proposal below seeks to address the aforementioned issues as well as to provide a framework and tool for dimensioning the EPBA envelope appropriately in future concessional allocation proposals.

III. THE PROPOSAL

A. Objective

3.1 The principal objective of the Proposal is to help future allocations of concessional resources ensure that eligible countries always have sufficient allocations to promote development progress while avoiding problems of excess allocation (as manifested in operational/portfolio indicators or worsening debt sustainability). The Proposal would retain the desire of member countries to favor the poorest and most vulnerable member countries. At the same time, it would retain the special vigilance for countries that received multilateral debt relief as well as ensure that concessional allocation proposals are consistent with financial affordability. The Proposal would allow Management and the Board of Executive Directors to make decisions about the EPBA envelope on the basis of clear projections about the operational and debt implications of different envelope scenarios. Dimensioning the EPBA envelope will thus be more informed and the proposed methodology would provide more clarity regarding trade-offs.

3.2 The Proposal reinforces the objectives of GN-2442 to support prudent borrowing policies in order to help to sustain the benefits of debt relief, while strengthening the developmental impact of IDB support. It comprises a practical and information-rich framework to guide concessional allocation proposals towards the aspiration of GN-2442 to support positive net financial flows to eligible countries while allowing countries to maintain a stable or declining IDB debt/GDP ratio.

3.3 Other objectives of the Proposal are to: (i) restore stability and predictability to the concessional allocation process; and (ii) streamline the coordination between the preparation of the LTFP and concessional allocations.

3.4 Management regards the framework as having an in-built tendency towards stability and mean-reversion over the medium term. Nevertheless, the framework is highly flexible and could, for instance, allow Management and the Board of Executive Directors to counteract temporary negative shocks.

B. Enhanced Consideration of Country Absorption and Debt Sustainability

3.5 Under this Proposal, the PBA envelope for each biennial proposal for the allocation of resources will be guided by six indicators on country absorption, debt sustainability and IDB relevance. Use of these indicators will allow Management to present to the Board
of Executive Directors clear projections about the operational and debt implications of different EPBA envelope scenarios.

3.6 **The six indicators listed below will be used to guide the determination of the proposed EPBA envelope** (Annex II provides further technical specifications on each indicator\(^{18}\)). These indicators build upon document GN-2442, which identified four of the indicators, albeit more as goals than as components of a methodology\(^{19}\).

**A. Operational indicators**

1. Allocation relative to disbursements (%)
2. Undisbursed loan/grant balances (ULB) relative to GDP (%)

**B. Debt sustainability indicators**

3. Net loan flow as % of GDP
4. Change in IDB SG debt-to-GDP ratio (percentage points)
5. IDB debt ratio relative to pre-debt relief ratio (%)

**C. IDB relevance indicator**

6. Change in IDB external debt as share of total public external debt (percentage points)

3.7 **Use of the above-mentioned six indicators provides an optimal compromise that ensures that the projection of the operational and debt sustainability implications of different EPBA envelopes is sufficiently comprehensive and robust, without becoming unwieldy.** Data for all six indicators is available for all countries that are plausible candidates for eligibility for concessional assistance. Indicators could be amended, added or removed in the future, subject to the approval by the Board of Executive Directors.

3.8 **The indicators have been “scaled” to GDP or another relevant denominator in order to adjust for country size.** It could be expected that countries that receive concessional assistance and small countries would have higher values on some indicators than countries that have more diversified access to financing or where there are some economies of scale in indicators. However, for other indicators there is no fundamental reason why concessional-eligible countries should have significantly different values on these indicators than other Bank member countries. For example, the three BMCs with populations less than 500,000 (The Bahamas, Barbados, and Belize) and three non-concessional Central American countries typically have lower average undisbursed

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\(^{18}\) Annex II is attached to this document for information purposes only.

\(^{19}\) Indicators 3 and 4 were identified in GN-2442 (paragraphs 30, 47 and 48). Indicator 5 reports on a principal objective of GN-2442 to avoid rapid debt accumulation after debt relief. Indicator 6 responds to the call in GN-2442 to consider “IDB relevance as a provider of multilateral financing” and “the existence of additional sources of financing.” Indicators 1 and 2 were not explicitly considered in GN-2442 but, per the “Proposal for the Allocation of Concessional Resources 2019-2020”, Management considers that such operational indicators are relevant and should also be taken into account when considering the appropriate size of the EPBA envelope for concessional allocations.
balances as a percentage of GDP than the four concessional-eligible countries (Annex II, Indicator 2).

3.9 **Projection period.** Given the lags for allocations to translate into loan approvals and then disbursements, indicators will be projected for a period of six years, which would cover the respective biennial allocation period and the subsequent two biennial allocation periods.  

3.10 **The six-year projected period of the six indicators will be presented for each eligible country in a graphical form (see Annex II for a purely illustrative example of such graphs).** In addition, akin to the graphical presentations in the Long-Term Financial Projections (LTFP), zones are colored to aid understanding. However, unlike the LTFP, the color zones are principally to aid the reader and are not automatically associated with possible operational consequences. The basis for the selection of the zones is explained in Annex II.

3.11 **DSF.** The aforementioned indicators on debt sustainability are focused on IDB debt, which is the debt variable that is directly influenced by decisions about the size of the EPBA envelope. Nevertheless, the risk of debt distress and analysis of the debt sustainability analyses produced for the concessional resource allocation proposals will still be used to inform and guide assessment of an appropriate EPBA envelope in a qualitative manner. The debt sustainability analyses will provide the context for the three debt sustainability indicators specific to the IDB.

**C. Aggregation and scoring methodology**

3.12 **The use of multiple indicators rather than a single indicator leads to a question of how to aggregate the signals of different indicators.** In order to aggregate the signals from multiple indicators in several countries, as part of the methodology, a scoring mechanism will be used. This mechanism is a transparent, quantified and consistent method to compare multiple possible EPBA envelopes within a large range. The scoring counts the number and distance of deviations from the “green zones” over a six-year period for each of the concessional eligible countries. This is determined by assigning a score of zero to an observation in a green zone, 1 to an observation in a yellow zone, 2 to an orange zone, and 3 to a red zone. Scores for each scenario would be summed for the six projection years, as illustrated in Figure 4. Lower scores reflect less deviation from green zones and are superior.

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20 In addition to the necessity of providing the Board of Executive Directors with a sufficiently long horizon, the stability embedded in the framework and the adoption of a six-year projection period would facilitate multi-annual programming by providing an indication of envelopes for years 3 through 6. Such projections would only be indicative and intended to serve for practical purposes, and it will not be binding. An analogy could be the Medium-Term Fiscal Frameworks that many countries have adopted. Only the national budget for the first year in the medium-term framework is binding, while the projections of subsequent years are indicative. Nevertheless, there is considerable value in the indicative projections for future years.
3.13 **Figure 4 shows the scores for three different sizes of EPBA envelope for one indicator for one country.** The methodology allows easy aggregation of such scores for all countries and all indicators. Such aggregation produces a total score reflecting the number and distance of deviations from green zones for any given size of EPBA envelope. If there are four countries eligible for a concessional resource allocation, with six indicators and six projection years, there would be a total of 144 observations. A perfect score, with every indicator for every year for every country in a green zone, would be zero. A perfectly “bad” EPBA envelope, with every indicator for every year for every country in a red zone would receive a score of 432.

3.14 **Furthermore, the aggregation of scores can be replicated for many possible sizes of EPBA envelope, allowing an easy comparison between different EPBA envelope sizes (green line in Figure 5).** Reflecting the two-tailed risks, comparison across all possible EPBA envelopes likely follows a “U-shape”. Small EPBA envelopes have high scores (i.e. are sub-optimal). Scores then decline (i.e. improve) as the EPBA envelope increases. Eventually, beyond a certain point, the scores start to rise again. EPBA envelopes can be too small, well balanced, or too large.
3.15 Proposals for the allocation of concessional resources will include a figure similar to Figure 5 that “scores” different sizes of EPBA envelope, in order to provide the Board of Executive Directors with a transparent summary of the deviation scores across the entire plausible range of EPBA envelope sizes. Furthermore, within that figure, Management may indicate the location of three possible EPBA envelope sizes: (i) proposed EPBA envelope for the concessional resource allocation; (ii) the “deviation-minimization scenario”; and (iii) the “SG envelope-coefficient scenario”. These three EPBA envelope scenarios may similarly be shown by indicator and country, as in the illustrated example in Annex II.

**The “Deviation-Minimization Scenario”**.

3.16 The “Deviation-Minimization Scenario” is the EPBA envelope in dollar terms that minimizes the number and distance of observations outside green zones. This is the EPBA envelope that would steer the optimal path between too small and too large envelopes. As above, biennial proposals for the allocation of concessional resources will include the “deviation-minimization scenario”, showing the operational and debt implications of that EPBA envelope in terms of the indicators and its location in the summary figure.

**Figure 5: Example of overall deviation score under different EPBA envelopes**

![Graph showing deviation scores and EPBA envelopes](image)

**Source:** Based on indicative scenarios in Annex II.
The “SG envelope-coefficient scenario”.

3.17 Under the Proposal, the allocation of resources for concessional financing will continue to be carried out in accordance with the methodology provided for in document GN-2442. However, the determination of the EPBA envelope will no longer be subject to the projected non-concessional SG lending envelope in an LTFP as set forth in Recommendation III of Resolution AG-9/16, approved by the Board of Governors on approved September 1, 2016. Nevertheless, for referential purposes only and when Management so determines, biennial proposals for the allocation of concessional resources may indicate the location of the EPBA envelope size corresponding to an “SG envelope coefficient scenario” in the summary figure of the EPBA envelope scoring (Figure 5).

D. The link to the Bank’s regular OC program would cease

3.18 Under the Proposal the link between the EPBA envelope and the Bank’s non-concessional SG lending envelope, as projected in the LTFP, would cease. The EPBA envelope would be specified in dollar terms rather than as a percentage of the projected SG non-concessional lending in the LTFP, as it was prior to January 1, 2017. Once approved by the Board of Executive Directors, the EPBA envelope and biennial allocations would not change due to subsequent changes in the Bank’s projected SG non-concessional program under normal circumstances.21 Ideally, the biennial concessional resource allocation proposal would be considered by the Board of Executive Directors between the LTFP Preview and the Final LTFP document of the corresponding year. It would thus form an input to the Final LTFP document rather than being co-determined. Discontinuing the link of the EPBA envelope to the projected SG non-concessional envelope would allow concessional allocations to return to the predictability and stability that prevailed prior to 2017, thus facilitating country programming.

3.19 The discontinuation of the link of the EPBA envelope to the projected SG non-concessional program would also result in the discontinuation of the adjustment mechanism for crediting/debiting EPBA envelopes for deviations in SG non-concessional lending from projected lending levels.

E. Financial affordability will remain a sine qua non requirement

3.20 Ensuring that the EPBA envelope is consistent with the Bank’s long-term financial capacity will remain a sine qua non requirement. Therefore, the determination of the EPBA envelope will be coordinated with the Finance Department at an early stage in the LTFP preparation process. The Bank will also continue to report ex post on the cost of the provision of concessional assistance in the biennial reviews of the EPBA/DSF [Review of the Implementation of the Debt Sustainability Framework and Enhanced Performance-Based Allocation 2017-2018”, (GN-2442-68), Annex III].

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21 This would return the concessional allocations to the pre-2017 situation – allocations did not change 2011-2016 but the Board of Executive Directors always had the prerogative to alter allocations, for instance under the exceptional circumstances of 2009-2010.
F. The Proposal does not affect other aspects of the EPBA/DSF

3.21 The EPBA formula and the variables in that formula are unchanged by this proposal. The EPBA is a “one-size fits all” process, whereby the EPBA formula is applied to a single EPBA envelope to derive country allocations (Annex I). This fundamental reality would not change.

3.22 This Proposal would strengthen the methodology for determining the EPBA envelope and it would not involve any separate or special process. The proposed EPBA envelope would continue to be an integrated part of biennial concessional resource allocation proposals. Projections of the indicators proposed would be included in the annexes of the biennial concessional resource allocation proposals. The Proposal consists of an information-rich framework for dimensioning the EPBA envelope, and Management’s proposed EPBA envelope would -- like all other parts of the concessional allocation proposals -- continue to be subject to consideration and approval by the Board of Executive Directors. Future changes to the methodology to determine the size of the EPBA envelope would also be subject to the consideration and approval by the Board of Executive Directors.

IV. RECOMMENDATION

4.1 On the basis of the analysis presented and the proposal contained in Chapter III. of this document, Management recommends that the Board of Executive Directors approve the Proposed Resolution attached to this document as Appendix I, authorizing that the Proposed Resolution attached as Appendix II be submitted to the Board of Governors with a recommendation for its approval by the procedure of taking a vote without calling a meeting. The approval of the Proposed Resolution attached to this document as Appendix II by the Board of Governors, would represent the adoption of the following recommendations:

4.2 Recommendation I: To replace the methodology to determine the total amount of concessional Ordinary Capital resources (Concessional OC) to be allocated in any biennial allocation exercise established in document AB-3066-2 “Proposal for Sustaining Concessional Assistance by Optimizing the IDB’s Balance Sheets” and in paragraph 3 of Resolution AG-9/16, by the methodology described in Chapter II. of this document.

4.3 Recommendation II: To delegate to the Board of Executive Directors the authority to approve any subsequent updates or changes to the criteria and methodology to determine the total amount of Concessional OC resources to be allocated in any biennial allocation exercise described in Chapter III. of this document.
ANNEX I
COUNTRY ALLOCATIONS AND THE EPBA ENVELOPE

Per GN-2442, a country’s biennial allocation of concessional resources is derived from application of the Enhanced Performance-Based Allocation (EPBA) framework:

Country allocation (EPBA \( i \)) = country share of the EPBA \( \times \) the EPBA envelope

\[
EPBA_i = \frac{(\text{Population}_i)^{0.5} \times (\text{GNI/cap}_i)^{-1} \times (\text{Performance}_i)^2}{\sum_{i=1}^{n} [(\text{Population}_i)^{0.5} \times (\text{GNI/cap}_i)^{-1} \times (\text{Performance}_i)^2]} \times \text{EPBA envelope}
\]

Where:

Performance \( i = (0.7 \times \text{CIPE}_i + 0.3 \times \text{PPI}_i) \)

CIPE = Country Institutional and Policy Evaluation
PPI = Portfolio Performance Indicator
\( n = \) the number of countries eligible for concessional resources
ANNEX II
PROPOSED INDICATORS

A. Operational indicators

1. Allocation relative to disbursements (%)

The most basic and obvious indicator is the relationship between a country’s allocation level and its recent disbursement levels. Disbursement levels are not fixed but do tend to be sticky and with a tendency of reversion to the mean, particularly for investment loans. Hence, historical disbursement levels are a reasonable predictor of future disbursement capacity. In equilibrium, when allocations and loan approvals equal disbursement levels, undisbursed loan balances will neither increase nor decrease. This indicator could be expressed as the reciprocal: disbursements as a % of allocation but it was considered that its expression as allocation/disbursements provides the most intuitive interpretation.

The indicator is a moving average of two-years in order to reduce volatility and take into account that countries have the flexibility to front-load or back-load their biennial allocations into the first or the second year of a biennial allocation period. Each data point consists of one first year and one second year in an allocation. Data points for even years summarize the situation for that allocation period, e.g. in 2020 the indicator reflects the average position for the 2019-2020 biennial allocation.

2. Undisbursed loan/grant balances (ULB) relative to GDP (%)

Annual changes in the amount of undisbursed balances are equal to loan or grant approvals minus disbursements in that year. Large and growing ULB suggests that allocations are too large relative to absorptive capacity (Annex III). The color zones indicate where a country’s values on the indicator are relative to the entire distribution of the 26 borrowing member countries for the period 2010-2018. The cut-offs are the 70th, 85th and 95th percentile levels.

B. Debt sustainability indicators

3. Net loan flow as % of GDP

This indicator measures net loan flow (disbursements minus repayments) as a percentage of GDP. The indicator originates in GN-2442, which aspired for the EPBA/DSF to allow positive net flows to the eligible countries. A positive net flow can be consistent with a stable or declining debt-to-GDP ratio (indicator 4), if nominal GDP is growing sufficiently fast. Larger net flows increase the risk that nominal GDP growth is insufficient to offset the increased debt. For an IDB debt/GDP ratio of 12.76% (the average for Guyana, Honduras and Nicaragua in 2018), the annual nominal GDP growth from 2000-2018 would have been sufficient to offset net flows of up to 0.51% of GDP two-thirds of the time. While Indicator 4 is of greater interest as a final outcome, Indicator 3 is a useful intermediate variable because it is more directly related to IDB allocation and loan approval decisions.

22 “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), paragraphs 47 and 48.
4. Change in IDB SG debt-to-GDP ratio (percentage points)
This indicator is a country’s current public debt to the IDB as a percentage of GDP minus its public debt to the IDB as a percentage of GDP in the previous year. The indicator is closely related to the previous indicator but also takes into account economic growth (debt-to-GDP increases slower than net loan flows would imply when nominal GDP is growing). The indicator measures the IDB’s contribution to a country’s growth in public debt. It also originates in GN-2442, which aspired for the EPBA/DSF to “allow countries to maintain a stable or declining IDB debt/GDP ratio”.

5. IDB debt ratio relative to pre-debt relief ratio (%)
This indicator is a country’s current public debt to the IDB as a percentage of GDP divided by the country’s public debt to the IDB as a percentage of GDP at December 31, 2006 – the point at which the IDB provided large-scale multilateral debt relief. As such, the ratio is 100% at the base year of 2006. Following IDB debt relief, the ratio was 20-28% in Guyana, Honduras and Nicaragua by the end of 2007, and 0% in Haiti by 2011. The indicator measures how close IDB debt is to returning to a level that was judged to warrant large-scale debt relief in 2007. This indicator should be interpreted in conjunction with the debt sustainability analysis – a high and rising value would be of less concern in a country with a “low risk of debt distress” rating than in a country rated at “high risk”.

C. IDB relevance indicator
GN-2442 argued that the IDB’s relevance as a provider of multilateral financing also needed to be taken into account when determining appropriate Bank flows that would help to address development challenges while being consistent with debt relief. Two benchmarks are relevant: external public debt to the IDB as a proportion of total debt to multilaterals and external public debt to the IDB as a proportion of total public external debt. For concessional-eligible countries, it is normal, indeed desirable, for these shares to be high. It is also inevitable that concentration ratios are higher in small countries that have access to fewer MDBs. Management proposes to include the broader indicator (external public debt to the IDB as a proportion of total public external debt) as Indicator 6, since it is more comprehensive and robust and can be projected with greater confidence than the Bank’s share of multilateral debt. To determine the color zones the indicator used the frequency distribution provided by the 2010-2018 period for all IDB borrowing member countries for which data is available in the World Bank’s International Debt Statistics. The same percentile cut-offs for the color zones used for the ULB indicator (indicator 2) were applied to this indicator.

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23 IBID, paragraph 30.
24 IBID, paragraph 30.
### Possible Interpretation of Different Indicator Scenarios

<table>
<thead>
<tr>
<th>OPERATIONAL INDICATORS</th>
<th>DEBT SUSTAINABILITY INDICATORS</th>
<th>RELEVANCE INDICATORS</th>
<th>POSSIBLE INTERPRETATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>For all countries, allocation is much below recent disbursement levels and ULB is projected to decline sharply</td>
<td>Net loan flow as % of GDP is negative and IDB debt to GDP is declining sharply on a sustained basis</td>
<td>IDB share of multilateral debt and public external debt is declining significantly</td>
<td>EPBA envelope is too small for optimal IDB contribution to development</td>
</tr>
<tr>
<td>For all countries, allocation is broadly in line with recent disbursement levels in recent years and ULB is broadly stable</td>
<td>Net loan flow as % of GDP is somewhat positive and IDB debt to GDP is stable</td>
<td>IDB share of multilateral debt and public external debt is declining</td>
<td>EPBA envelope is broadly appropriate but governments are diversifying their borrowing away from the IDB</td>
</tr>
<tr>
<td></td>
<td>Net loan flow as % of GDP is somewhat positive but IDB debt to GDP is declining</td>
<td></td>
<td>GDP is growing strongly</td>
</tr>
<tr>
<td></td>
<td></td>
<td>IDB share of multilateral debt is broadly stable but share of public external debt is declining</td>
<td>As a normal process of development, over time governments will rely less on multilateral financing and more on domestic debt and non-official external debt</td>
</tr>
<tr>
<td>For all countries, allocation is broadly in line with recent disbursement levels and ULB is broadly stable and at reasonable levels</td>
<td>Net loan flow as % of GDP is somewhat positive and IDB debt to GDP is stable or moderately declining</td>
<td>IDB shares of multilateral debt and public external debt are broadly stable</td>
<td>“Goldilocks scenario”. EPBA envelope is broadly appropriate and the IDB is supporting the countries’ development at a sustainable level</td>
</tr>
<tr>
<td>Allocations are significantly higher than recent disbursement levels and ULB is projected to rise or remain at elevated levels</td>
<td>Net loan flow as % of GDP is somewhat positive and IDB debt to GDP is stable or rising slightly</td>
<td>IDB shares of multilateral debt and public external debt are broadly stable</td>
<td>EPBA envelope is broadly appropriate from a debt sustainability perspective but too large from an operational perspective. Debt indicators remain reasonable but disequilibria manifest in the operational indicators. The binding constraint is either administrative capacity or fiscal space</td>
</tr>
<tr>
<td>For all countries, allocation is broadly in line with recent disbursement levels and ULB is broadly stable and at reasonable levels</td>
<td>Net loan flow as % of GDP is strongly positive and IDB debt to GDP is projected to rise significantly and on a sustained basis</td>
<td>IDB shares of multilateral debt and public external debt are rising</td>
<td>Borrowing countries are strong on portfolio execution and fiscal space is not a binding constraint. But the EPBA envelope is too large from a debt sustainability perspective, with disequilibria manifested in the debt sustainability and concentration indicators</td>
</tr>
</tbody>
</table>
**INDICATIVE PRESENTATION OF THE INDICATORS**

**Indicator 1: Allocation relative to disbursement levels (%)**
(rolling 2-year average allocations and disbursements)

**Source:** VPC, GN-2442-53, GN-2442-57, GN-2442-64, and COF disbursement projections.
**Indicator 2: IDB Undisbursed loan/grant balances (ULB) relative to GDP (%)**

(end of year position)

### Guyana

- >95th percentile
- >85th <95th percentiles
- >70th <85th percentiles
- >30th <70th percentile
- >15th <30th percentiles

### Haiti

- >95th percentile
- >85th <95th percentiles
- >70th <85th percentiles
- >30th <70th percentile
- >15th <30th percentiles

### Honduras

- >95th percentile
- >85th <95th percentiles
- >70th <85th percentiles
- >30th <70th percentile
- >15th <30th percentiles

### Nicaragua

- >95th percentile
- >85th <95th percentiles
- >70th <85th percentiles
- >30th <70th percentile
- >15th <30th percentiles

### Comparators

- >95th percentile
- >85th <95th percentiles
- >70th <85th percentiles
- >30th <70th percentile
- >15th <30th percentiles

### Frequency Distribution of ULB/GDP (%)

IDB-26 [2010-18]

Scenarios:
- Historic
- LTFP coefficient scenario
- Deviation-minimization scenario
- Scenario 3

**Source:** VPC, LMS 50 and COF disbursement projections.
**Source**: VPC, GN-2442-64 and COF disbursement projections.
Source: VPC, GN-2442-64 and COF disbursement projections.
Indicator 5: IDB debt relative to pre-debt relief level (%)

Source: VPC, GN-2442-64 and COF disbursement projections.
Source: VPC, GN-2442-64, COF disbursement projections; total public external debt from Country Economists and IMF Staff Reports.
ANNEX III

CONSIDERATIONS ON ABSORPTION CAPACITY

Demand

The concept of “demand” for concessional resources is not straightforward. Since, by definition, concessional resources are priced below market-based resources, stated demand for such resources could in principle be infinite. Also, developmental needs are enormous.\textsuperscript{25} Nevertheless, effective demand – the volume of concessional resources that can be reasonably absorbed and well utilized – is constricted by absorptive capacity constraints.

Absorptive capacity constraints

“Virtually all [aid effectiveness] studies that test for diminishing returns confirm the existence of such a relationship (with respect to growth), providing strong empirical evidence for the existence of absorptive capacity constraints in recipient countries”, Feeny and de Silva (2012).\textsuperscript{26}

Constraints on absorptive capacity include: (i) project implementation/administrative capacity constraints; (ii) fiscal space constraints; and (iii) debt sustainability constraints. The relative importance of these constraints varies between countries and may vary over time. The relative importance of absorptive capacity constraints also varies by project type. Policy-based loans (PBLs) are generally much less constrained than investment projects by administrative capacity and fiscal space constraints. On the other hand, given their fast-disbursing nature, approvals of policy-based loans quickly translate into higher debt levels.

Since investment loans finance government capital expenditures, they are part of both a government’s capital expenditures program and that government’s external financing (Figure III.1).

![Figure III.1: Illustrative Budget Outline](image)


Even when multilateral development banks finance a high proportion of a government’s capital expenditure – as is typically the case in concessional-eligible countries -- government’s capital expenditures are finite and limited by fiscal space considerations.

At low levels of country allocations and loan approvals, loan approvals are likely to translate dollar for dollar into project disbursements. However, beyond a certain point a country’s ability to absorb more financing for investment projects diminishes because of either administrative capacity constraints or fiscal space limitations. There might even be an absorption ceiling or maximum point for disbursements above which disbursements cannot rise, no matter how much financing is available. Once absorptive capacity constraints become binding, a gap between loan approvals and disbursements will emerge and undisbursed loan or grant balances will begin to grow (Figure III.2). At this point, the “pushing on a string” metaphor commonly used in the context of monetary policy would also apply to additional approvals.

**Figure III.2: Translation of Approvals into Disbursements**

![Translation of Approvals into Disbursements](image)

Source: VPC.

**Creditor substitution**

Fiscal space limitations and, for the most part, administrative capacity constraints are national and economy-wide restrictions that apply to official creditors as a group. Consequently, within the overall constraint, borrowing governments have some ability, particularly on the margin, to substitute one creditor for another. Such shifts could loosen absorption capacity constraints for one creditor while tightening such constraints for another.

Determining the optimal mix of development partners and creditors according to its priorities and preferences is not only a sovereign country’s right but also might contribute to debt sustainability, if it results in lower average financing cost (Figure III.3). Nevertheless, determination of an
appropriate EPBA envelope should seek to avoid provoking creditor competition for a limited common pool of fiscal space.

Figure III.3: Honduras: External Financing Cost Curve (2018)

Source: VPC based on SEFIN, Gobierno de la República de Honduras "Informe Deuda Pública de la Administración Central", IV 2017 and 2018.

Note: Effective interest rate is calculated as the interest and commissions paid in 2018 divided by the stock of debt at December 31, 2017.
ANNEX IV

THE ADB PBA ENVELOPE MODEL

The Asian Development Bank (ADB) provides a useful example for the IDB because it is the only other MDB to have transferred the responsibility for its concessional lending to its market-based lending window (Ordinary Capital Resources (OCR)). Prior to the transfer on January 1, 2017, the Asian Development Fund (ADF) provided both concessional loans and grants to the ADB’s concessional-eligible countries. Following the transfer of concessional loans from ADF to OCR on January 1, 2017, the responsibility for concessional loans (Concessional Ordinary Capital loans – COL) was passed from the ADF to the Ordinary Capital (OCR) of the ADB. The ADF became a grant-only facility – similar to the IDB Grant Facility (GRF) – and retained responsibility for the provision of grants to eligible countries at high risk or moderate risk of debt distress and for several thematic set-asides (such as regional projects, disaster response facility, disaster risk reduction and regional health security).

The cost of the provision of COL is now borne by the OCR, while ADF grants are funded by donor contributions through periodic replenishment, OCR net income transfers and income from liquidity investments. Hence, financial planning and the assessment of the burden of concessional resources on the OCR must take into account both the provision of COL from the OCR balance sheet and net income transfers to the ADF.

The ADB determines the concessional resource envelope for a four-year replenishment period based on various factors such as: (i) a list of countries that are eligible for concessional resources during the replenishment period; (ii) estimated demand from eligible countries; (iii) concessional assistance policy, and (iv) the ADB’s long-term financial capacity. According to the ADB’s financial and capital adequacy policies, a minimum equity-to-loan ratio is a key benchmark in assessing the long-term financial capacity. After taking into account possible graduations from concessional assistance, the ADB shall maintain concessional lending in real terms and leave open the possibility of increasing the volume of COL.²

2/ Resolution No. 372 of the ADB Board of Governors.
RESOLUTION DE-6/21

Proposal for a Revised Methodology to Determine the EPBA Envelope

The Board of Executive Directors

RESOLVES:

1. To present to the Board of Governors document AB-3259, entitled “Proposal for a Revised Methodology to Determine the EPBA Envelope.”

2. To recommend that the Board of Governors adopt the proposed resolution attached as Appendix II of the document referred to in paragraph 1 of this Resolution, by the procedure of taking a vote without calling a meeting provided for in Section 5 of the By-Laws of the Bank.

3. That the Governors may cast their votes by any rapid means of written communication. The proposed resolution shall be considered adopted on the date on which the replies received at Bank headquarters constitute a quorum pursuant to Article VIII, Section 2(e) of the Agreement Establishing the Inter-American Development Bank (the “Agreement”) and the favorable votes cast represent a majority of the total voting power of the member countries, pursuant to Article VIII, Section 4(c) of the Agreement. The voting shall remain open until March 4, 2021.

(Adopted on 17 February 2021)
RESOLUTION AG-1/21

Proposal for a Revised Methodology to Determine the EPBA Envelope

WHEREAS:

Pursuant to Resolution AG-9/16 of September 1, 2016, the Board of Governors authorized the transfer of the assets and liabilities of the Fund for Special Operations (FSO) into the Ordinary Capital (OC) resources of the Bank, and determined that the blending of loans from the FSO and the OC be replaced by a blending of loans financed with resources from the OC subject to concessional financial terms and conditions (“Concessional OC”), and with resources from the OC subject to the same financial terms and conditions applicable to Sovereign Guaranteed (SG) individual loan operations financed from the Bank’s regular program of OC resources;

Pursuant to Resolution AG-9/16 and document AB-3066-2, entitled “Proposal for Sustaining Concessional Assistance by Optimizing the IDB’s Balance Sheets”, the Board of Governors mandated that the total amount of Concessional OC resources to be allocated in any biennial allocation exercise will be determined as a proportion of the amount of resources projected for SG loan operations to be financed from the Bank’s regular OC program as determined by the Long-Term Financial Projections (LTFP);

During the meeting of the Programming Committee of the Board of Executive Directors’ consideration of the “Proposal for the Allocation of Concessional Resources 2019-2020” (document GN-2442-57), the “Committee expressed interest in reviewing the methodology and indicators used for determination of the EPBA envelope prior to preparation of the next proposal for the allocation of concessional resources 2021-2022” (document GN-2442-62 “Proposal for the Allocation of Concessional Resources 2019-2020. Report of the Chairperson of the Programming Committee of the Board of Executive Directors. Revised version”);

In response to the request made by members of the Programming Committee of the Board of Executive Directors, Management developed a proposal with the objective to help future allocations of concessional resources ensure that eligible countries have sufficient allocations to promote development progress while avoiding problems of excess allocation;

The Board of Executive Directors has considered document GN-2442-72, entitled “Proposal for a Revised Methodology to Determine the EPBA Envelope” and, pursuant to Resolution DE-6/21, agreed to submit for consideration of the Board of Governors this proposed resolution;
The Board of Governors

RESOLVES:

1. To replace the methodology to determine the total amount of Concessional OC to be allocated in any biennial allocation exercise established in document AB-3066-2 and in paragraph 3 of Resolution AG-9/16, by the methodology described in Chapter III of document AB-3259.

2. To delegate to the Board of Executive Directors the authority to approve any subsequent updates or changes to the methodology to determine the total amount of Concessional OC resources to be allocated in any biennial allocation exercise described in Chapter III of document AB-3259.

(Adopted on 11 March 2021)