Protecting the Poorest Countries: Role of the Multilateral Development Banks in Times of Crisis

Explanatory Note

I. Introduction

1. This Explanatory Note is a follow up to the joint Multilateral Development Bank (MDB) note “Protecting the Poorest Countries: Role of the Multilateral Development Banks in times of Crisis” (“the joint MDB note”)¹ and is being circulated at the request of Board members to provide further details on the obstacles to suspending debt repayments to IDA/IBRD and the potential negative impact on financial sustainability. The explanatory note follows the structure of the previous MDB joint note and explains how the World Bank provides attractive and increased net flows to help countries respond to the COVID-19 crisis. Finally, the note explores other approaches that could be considered.

2. The paper is organized as follows: Section II describes the MDBs’ commitment, as laid out in the MDB joint note, to do more. Specifically, it sets out (a) the additional financing that the World Bank is looking to provide and (b) the potential negative ramifications from suspending debt repayments to MDBs. Section III outlines key factors examined including (a) how MDBs provide net flows to member countries with specific details for IDA and IBRD, (b) potential ratings impact on MDBs like IDA and IBRD that rely on triple-A ratings to raise resources for member countries, and (c) potential impact on costs and capacity to lend. Section IV discusses other financing approaches to IDA that are being explored, including (a) donors financing a dedicated Trust Fund that would allocate resources to IDA countries to meet portions of their debt repayment obligations to IDA, and b) possible options that could optimize IDA’s temporary capital headroom to provide short-term financing for urgent needs for social, health, or economic spending in a way that complements the transparency agenda of the Sustainable Development Finance Policy. To the extent that major new resources become available through one or both of these approaches, the beneficiaries would have more fiscal space for expenditures needed to respond to COVID-19 impacts, adding new avenues and protections alongside the financial and business models of IDA and IBRD. Section V sets out the conclusions of the note.

II. Commitment to do more

3. The coronavirus (COVID-19) crisis is threatening lives, livelihoods, and entire economies and the World Bank and other Multilateral Development Banks (MDBs) are stepping up their financing in response. IDA countries are particularly vulnerable to the crisis and have limited policy buffers to respond. Rapidly expanding the development resources available to IDA countries is one of the priorities in the immediate response to the crisis.

4. Together with other MDBs, the World Bank is ensuring that countries have timely and significantly positive financial inflows during this crisis to augment fiscal resources available without increasing debt vulnerabilities. The ability to provide highly concessional and

¹ The joint MDB note was produced in response to shareholders’ call for MDBs to further explore ways to participate in DSSI.
positive net flows, and scale them up at a time of crisis when other lenders withdraw, has been a core strength of the World Bank since its establishment. With respect to the poorest countries, IDA is able not only to boost flows quickly, but also to calibrate its terms to take into account a country’s debt situation. Finally, all World Bank financing also comes with sound analytical and policy advice, as well as the technical assistance that countries need to mitigate the impact of the crisis.

“Providing Additional Financing”

5. **During crises, IDA countries need financial assistance – namely, steady concessional positive net flows – from creditors.** The extent of positive net flows has been considerably reinforced by strong replenishments combined with the new IDA financial model. For example, higher flows to respond to COVID-19 in IDA countries in FY21 mean that for every $1 in debt service, IDA and IBRD would provide $11 in new commitments to IDA eligible countries.\(^2\) In terms of disbursements, the World Bank provides *multiples* of debt service across all categories of countries (Figure 2). In addition, compared to other creditors, the World Bank’s financing flows tend to be *more stable* (Figure 1).

6. **WBG financing usually carries the best financial terms from the borrowing country’s perspective, and IDA’s already highly concessional financing builds debt relief into its assistance.** The bulk of IDA resources are provided on highly concessional terms with no interest and with long grace periods and maturities. Since payments are lower and are spread over longer periods of time, IDA credits are easier for borrowers to service. IDA countries will receive close to $9.8 billion in new IDA grants in FY21 alone. *More than half (38 of 70) of IDA19 active countries already receive all, or half, of their IDA resources on grant terms, which carry no payments at all.* These significant amounts of grants are targeted to the low-income countries at higher risk of debt distress. The grant share in IDA has been increasing over time in response to increased debt vulnerabilities in client countries, since the Grant Allocation Framework (based on the joint IMF-WB Debt Sustainability Assessment) uses a forward-looking methodology (Figure 3). For countries that borrow on regular IDA terms, the 6-year grace period means that debt service on new borrowing to address the COVID-19 crisis will not commence until the country has had a chance to recover.

7. **Similarly, IBRD’s loan pricing is significantly lower and tenors longer than commercial creditors.**\(^3\) Furthermore, recent IDA graduates, Blend countries, Small States, and countries experiencing fragility, conflict and violence (FCV) receive IBRD’s lowest pricing and are exempt from the pricing increases that went into effect following the 2018 WBG Capital Package.

\(^2\) Of these IDA-eligible countries, 15 are Blend countries also eligible to receive IBRD financing.

\(^3\) In addition, IBRD’s lending rate has decreased substantially during the COVID-19 crisis due to a sharp decline in market interest rates. IBRD lending rates are comprised of a market reference rate plus lending spreads that are differentiated by maturity, income level, and country-specific considerations. Since the beginning of 2020, IBRD’s reference market rate, 6-month LIBOR, has fallen by over 100 basis points.
Figure 1. Net Flows and Net Transfers to IDA Eligible Countries ($ Billion)

Note: Net flows are defined as the balance between gross disbursements and repayments and pre-payments. Net transfers equal net flows minus interest and service fees. Other creditors include commercial and bilateral creditors.

8. The attractiveness of IDA and IBRD terms – combined with the impact of the debt relief from the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) of the 2000s – translates into very low debt service amounts in IDA countries. In FY21, debt service to IDA and IBRD is expected to be $3.8 billion for all IDA countries. This includes $1.1 billion in debt service from IDA-only countries, $0.7 billion from fragile and conflict-affected states (FCS), $63 million from Small States and $1.7 billion from Blend countries. As illustrated in Annex 1, debt service is low when compared to commitment levels for all categories of countries: in the majority of countries, commitments are ten times higher than debt service.

9. The attractiveness of IDA and IBRD terms relies in part on the ability to access capital markets to secure the additional financing that will be needed for the scaled-up crisis response. In FY20 alone, IBRD raised $75 billion on capital markets. These funds are raised through multiple bonds issuances throughout the year in diverse markets, minimizing the costs to IBRD, and the low financing costs are passed on to borrowers. IBRD has been able to maintain this scale of issuance despite the financial turbulence since the crisis hit global markets in March 2020. IDA borrows in markets at lower volumes than IBRD as it gradually rolls out its funding program that reached $5 billion in FY20 and is expected to significantly increase next year. Maintaining financial access at competitive rates is vital for both institutions to be able to deliver on their commitments to increase lending to help clients respond to the crisis.

10. IDA and IBRD expect to commit low-cost financing of $44 billion in FY21 for ID19 eligible countries, including close to $10 billion in grants. This contrasts with the less than $4 billion in debt service that is due from these countries during the same period. This is a major contribution toward the overall global objective of ensuring that IDA countries have access to affordable net flows that add to their fiscal space and boost their ability to respond to the crisis without adding to debt vulnerabilities. Section IV provides possible options to add further to these additional flows through IDA.
11. Because of its terms – low interest rates, long grace periods, and in many cases outright grants – the World Bank’s transfers to client countries entail significant concessionality and PV reduction. This is in contrast with debt service suspension, which is meant to be PV-neutral, with the relatively short repayment period providing liquidity relief for a limited period of time.

“Participating in the Debt Payment Suspension”

12. Debt service suspension by MDBs would likely reduce net funding to IDA countries by undermining the attractiveness of MDB debt, including IDA debt, and increasing IDA and IBRD’s funding costs significantly. Given that IDA and IBRD have slim margins to cover their administrative costs, if their funding costs increase, ultimately these costs must be passed to the borrowing countries. The MDBs collectively issue between $200 billion and $250 billion per year, with more than $1 trillion in bonds outstanding. IBRD has more than $200 billion in bonds outstanding and in FY20 issued approximately $75 billion. IDA annual issuance is also increasing from $5 billion in FY20 to more than double that over the next few years. Even a small increase in funding costs therefore drains large volumes of resources, impacting all clients. The effect of such an increase in funding costs on IDA would also rise over time, hitting IDA’s net income and therefore lending volumes. In sum, the long-term costs of even a small increase in cost of funding would vastly outweigh the short-term benefits of debt service suspension (IDA would suspend less than $4 billion in total nominal debt service; at zero net present value).

13. The central plank of the main MDBs’ low funding costs, particularly those of IBRD and IDA, is their triple-A rating, which in turn depends on their preferred creditor treatment (PCT). MDBs’ business model is to lend as preferred creditors to high-risk clients at very low interest rates (Figure 4). For the model to be sustainable, these low interest rates have to cover MDBs’ funding costs in capital markets plus their administrative costs; they could not cover the
risk – and funding costs – of an MDB if it were a less preferred creditor. It is therefore vital that any debt service suspension is not perceived by investors in IDA or IBRD bonds, or by the credit rating agencies that rate those bonds, as undermining this financial and operational model in any way. The “Ratings Impact” section below provides an assessment of potential rating agency views.

Figure 4. The Multilateral Development Bank Model

III. Key Factors Examined

14. In evaluating the best way to support countries, the World Bank and other MDBs have paid careful attention to the following key factors:

“Net Flows to Member Countries”

15. In addition to Section II above, three additional points are important to emphasize:

a. Additional financing provided through frontloading alone is greater than debt service to IDA-eligible countries. IDA is planning to provide financing of up to $41 billion for FY21, almost 50 percent more than the expected annual financing in IDA19. This substantially increased level of financing will be made available by frontloading IDA19 resources (43 percent of IDA19) and through cancellations/restructuring (see Figure 5). Similarly, for IBRD, the 2018 Capital Package strengthens IBRD’s financing capacity significantly, albeit with the capital subscription process still in its early stages. IBRD expects to provide $40-41 billion of financing in FY21, including via utilization of the crisis buffer (proposed at $10 billion for FY21, subject to Board approval) and $5-6 billion from the repurposing of undisbursed balances, relative to $28 billion in FY20.

b. World Bank positive net flows and net transfers will be provided both in aggregate and to all categories of countries. The performance-based allocations (PBA) of more than half of IDA active countries are expected to be 10 times or more than their estimated debt service in FY21. Less than 20 percent of countries will receive financing between 1 and 5 times their debt service. Note that the PBA-based allocation only accounts for two-thirds of FY21 indicative financing, excluding the FCV top-up and IDA windows (Figure 6 and Annex 1).
If IDA windows are included, it is estimated that more than two-thirds of countries will likely access new financing more than 10 times their debt service.

c. Annual disbursements for IDA-eligible countries are surging, with increasing commitments dwarfing debt service. Annual average disbursements for IDA eligible countries in the first two years of IDA18 reached $15.9 billion, a 49 percent increase from the average over IDA16 and IDA17. IDA disbursements are projected to rise further and exceed $24 billion in FY21 due to the frontloading of IDA19, 2.5 times higher than the annual average over IDA16-17. In contrast, IDA-eligible countries’ debt service to IDA has historically been flatter, well below the level of gross disbursements, given the concessional nature of IDA financing. IDA countries’ debt service is very low due to long grace periods, long repayment periods, a preemptive grant allocation system, and debt reduction in the past from HIPC and MDRI. Furthermore, debt service to IDA is more concentrated from Blend/GAP countries than poorer IDA-only countries. As mentioned above, fully half of active IDA countries already receive all, or half of their IDA resources on grant terms, which carry no payments at all. Thus, IDA-only countries, which comprise 63 percent of active IDA countries, will account for only one-third of IDA debt service in FY21, while Blend/Gap countries account for two-thirds of IDA debt service (Figure 7).

**Figure 5. Indicative FY21 IDA Potential Delivery**

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<th>Post-frontloading</th>
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<td>Cancellations</td>
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<tr>
<td>Total</td>
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**Figure 6. IDA PBA Allocations vs. Debt Service**

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<tr>
<td>Debt service</td>
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**Note:** Indicative IDA projections assuming 43% of IDA19 resources to be committed in FY21 plus cancellations/recommitments.

**Note:** Based on indicative FY21 Country Allocations (excluding FCV envelope). Note that IDA windows are not included.
16. Without their very strong triple-A ratings, MDBs such as IBRD and IDA could not sustain their business model of borrowing cheaply and lending to clients that would represent much higher risk to other, non-preferred creditors. Rating agencies – and the bond investors they inform – assess MDBs’ payment track record, risk management, governance, and other aspects to ensure that MDBs are able to deliver on their promise to transform their client relationships of trusted advisor, countercyclical financier, and lender of last resort into the low default rates and high recovery rates of a strongly preferred creditor.

17. It should be noted that rating methodologies differ by agency, are hard to predict, and change significantly over time. All three main agencies (S&P, Moody’s, and Fitch) have altered their approaches in the past three years. All three methodologies are different. All contain significant subjective and discretionary elements. And all will continue to be subject to regular revision. To give two relevant examples: (1) S&P reserve a one-notch discretionary adjustment for their “holistic approach” at the end of their rating criteria; (2) Moody’s rating scorecard delivers a final “Indicated Rating Range” that covers three ratings notches, leaving the final Moody’s rating uncertain within this range. It is therefore impossible for MDB management to predict with certainty rating agency reactions to changes in MDBs’ governance or external environment, or to determine whether a particular action will lead to a specific rating impact.

18. Debt service suspension could potentially have a negative impact on assessments of MDB strengths. Figures 8 and 9 show schematic illustrations of the ratings assessment approaches of S&P and Moody’s. For S&P, there are at least five points where a debt service suspension could change the assessment. For example, reduced PCT (as assessed by S&P) would decrease the main measure of Capital Adequacy (Risk-Adjusted Capital) in the Financial Risk Profile (point 3). But PCT also enters S&P’s assessment of Policy Importance under Enterprise Risk Profile (point 1). For Moody’s, there are at least three points where debt service suspension could change the assessment. Moody’s attaches less weight to PCT than S&P. But in addition to PCT deterioration,
debt service suspension would hit Asset Quality under Capital Adequacy (point 1). A debt service suspension could also affect the Quality of Management adjustment factor (point 3), for example if it were interpreted as non-observance of long-standing governance practice and/or a practice referred to in financial statements.

19. **Two out of the three rating agencies have emphasized that debt service suspension could exert downward rating pressure.** S&P Global, on June 9, 2020 issued two publications that made clear their concerns over multilateral participation in debt relief. S&P stated, “If MLIs grant a debt moratorium to the poorest sovereigns as agreed among G-20 bilateral creditors, their PCT status might weaken and ultimately weigh on our ratings, unless most of the associated losses are compensated.” ⁴ S&P further stated, “We don’t believe MLIs will consider these debt relief packages, given that many already support their low-income members through a combination of grant and concessional financing. Equally important is the consideration of preferred creditor that could be put into question should they participate in these packages.” ⁵ They also issued an earlier publication making similar points. ⁶ S&P’s analysis also underscores other sources of pressure than PCT, including deterioration in portfolio credit quality in the form of sovereign downgrades, noting that even under their least severe stress scenario, IBRD’s Risk-Adjusted Capital ratio could decline below the threshold of their strongest sub-rating category. ⁷ IDA has a more complex investor narrative. Under an S&P scenario of debt relief in the absence of robust compensation, S&P’s assessment of IDA’s PCT fell to “weak.” ⁸ Fitch has also made recent statements that debt service suspension would be credit negative for MDBs. ⁹

20. **The recent statement from Moody’s, that the rating agency would not interpret a suspension of debt repayments from borrowers to IDA/IBRD as reducing PCT, needs to be understood with careful attention to the above context.** ¹⁰ While they may not adjust the PCT factor, non-payments would still affect asset quality and performance indicators and could affect ratings through those channels (Figure 9). Most fundamentally, in the absence of private-sector participation in DSSI, over time, it would be challenging for rating agencies to interpret MDB participation as consistent with PCT given that private creditors would continue to be paid ahead of supposedly “more preferred” multilateral creditors. ¹¹

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⁷ “FONPLATA and the International Bank for Reconstruction and Development (IBRD) are the only entities […] for which the stresses in scenario 1 could bring our capitalization metric down to a level that could qualify for [...] a lower capital assessment.” S&P Global Ratings, “Can Multilateral Lenders' Capital Bases Hold Up Against COVID-19?” June 9, 2020.
⁸ S&P are clear that uncompensated debt relief would likely affect ratings: “Hence, a broad-based debt standstill leading to multiple sovereigns incurring arrears or receiving debt write-downs would likely have negative rating implications for MLIs unless most of the losses were compensated.” Ibid.
⁹ Fitch Ratings: “Suspension of sovereign debt payments owed to multilateral development banks (MDBs) would be negative for MDB ratings unless they were fully compensated by their shareholders,” April 22, 2020.
¹¹ “Support by private sector firms is voluntary and will not affect the enforceability of obligations owed to such providers of finance by beneficiary countries.” Institute of International Finance, Terms of Reference for
**Figure 8. S&P Supranational Rating Criteria with Potential Impact Points of Debt Service Suspension**

![Diagram showing S&P rating criteria]


**Figure 9. Moody’s Rating Scorecard with Potential Impact Points of Debt Service Suspension**

![Diagram showing Moody’s rating scorecard]


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“MDB Funding Sources, Costs And The Impact On Capacity To Lend”

21. Our final assessment is that, although uncertain, the effect of debt service suspension that was not fully compensated up front by shareholders (e.g., as in the case of the HIPC Initiative) would be to increase MDB funding costs in financial markets. This assessment is based on the multiple ways in which debt service suspension could, over the longer term, affect rating agency assessments and market perception, along with or even without rating erosion. This assessment is also based on the characteristics of MDB funding sources in capital markets and our long track record of experience in these markets. While all the uncertainties make it impossible to estimate with confidence the likely impact on funding costs, even minor effects would exert a significant drain on income, retained earnings, and thus capital over time.

IV. Other Approaches

22. This last section explores two approaches that would respond to current financial challenges.

A. Trust Fund Approach to finance MDB Debt Repayments

23. IDA donors could create a new Debt Service Relief Multi-Donor Trust Fund (MDTF), and the funds raised would be used to make debt service payments for the benefit of IDA countries freeing up their resources and providing additional liquidity to address immediate needs arising from the crisis. The trust fund could be similar to the IMF’s Catastrophe Containment and Relief Trust (CCRT), established in 2015, to provide a conduit for donor grants to poor and vulnerable members to cover IMF debt obligations. A Debt Service Relief MDTF at the WB would need to have similar major donors as the CCRT and could provide grants to eligible countries to cover their WB debt obligations. Under this approach, donors could pledge grant contributions to a MDTF and set up a governance system for allocating the grants. Other variants of this approach could also be possible.

24. It should be noted, however, that such an MDTF would be allocating its support based on the past borrowing of current IDA countries, not country programs or the current IDA allocations. Further, unlike direct contributions to IDA, contributions to TFs cannot be leveraged, hence this wouldn’t be the financially most optimal use of additional resources in today’s financially constrained environment. Since direct contributions to IDA can leverage significantly larger lending volumes, they would be a more efficient way to support the objective of boosting net flows (Figure 10). With IDA’s financial model, simulations show that a $4 billion additional

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12 The volume of funding needed is significant. The estimated financing needs for FY21, if covering the same 27 countries that the IMF has already provided relief to, would be $782.4 million. Two additional countries are eligible for IMF debt relief suspension (Burundi and Tanzania): including them, the equivalent financing need for FY21 would be $956.1 million in IDA debt service. If all IDA-only countries would benefit, the costs would be $1.1 billion, and if all IDA countries (including blends and gap countries as well as IDA19 graduates) are included the amount increases to $3.6 billion (including principal, interest and charges). If IBRD debt service to these countries is included the amount increases to $3.8 billion.

13 In the wake of COVID-19, balances in the CCRT along with new contributions will enable support to a group of 29 CCRT eligible IDA-only countries for an initial period of six months. These grants are intended to help them channel more of their scarce financial resources towards vital emergency medical and other relief efforts.
donor contributions in IDA19 would allow to increase IDA19 by approximately $6.6 billion. Additionally, providing resources directly to IDA’s balance sheet ensures a robust allocation framework, particularly providing increased resources for FCS and other grant recipients whose debt service is small, and hence these would otherwise benefit less from trust fund financing.

Figure 10. Estimated debt service to IDA for FY21, by country group and new IDA funding ($ billion)

Note: New IDA funding for FY21 includes approximately $5 billion of resources recommitted from cancellations of projects. These could be both grants or credits and cancellations amounts are yet to be confirmed, but are assumed to be in proportion to overall IDA19 funding (i.e. ~ 1.4 bln).

25. If donors commit substantial resources, the World Bank would be ready to set up the trust fund along parameters agreed to by the donor community. Given the scarcity of resources and competing needs, it would be important to have a firm commitment from donors to provide a minimum threshold of funding, otherwise there is a risk that the fund be set up but not have sufficient funding to fulfill its mandate and lead to further aid fragmentation.

B. Exploring ways to provide additional Short-Term Financing to IDA Countries

26. In order to provide more upfront financing for IDA countries, IDA is also exploring possible ways to use temporarily available capital headroom to make relatively short-term (i.e. on terms similar to IBRD’s) loans to IDA countries to contribute to their short-term financing needs for social, health or economic spending, and provide a complementary instrument to the transparency agenda of the Sustainable Development Finance Policy. The objective of such support would be to help IDA-eligible countries enhance their fiscal space diminished as a result of external shocks caused by the COVID-19 pandemic, preferably in a way
that also addresses their longer-term debt-related vulnerabilities. Options will be further discussed with IDA’s shareholders at the 2020 Annual Meetings of the World Bank and IMF.

V. Conclusions

27. **The paper provides further details and analysis on the obstacles to suspending debt repayments to IDA/IBRD and on the negative impact on financial sustainability.** It reaffirms the conclusion of the joint MDB statement that allowing a suspension of debt service repayments to the World Bank could reduce financial benefits to IDA countries by undermining the Bank’s ability to provide timely, affordable and sizeable positive financial flows. The risk of erosion of the WBG’s rating if it were to participate in a debt service suspension is significant – and this risk is particularly salient for IDA, as a new issuer in the capital market in the midst of a considerable scale-up in funding. Such an erosion would undermine the World Bank’s key role in crises, that of maximizing financial capacity. It would also lead to higher funding costs that in and of themselves significantly outweigh the benefit to clients of such a debt service suspension, magnified by the fact that, for most IDA clients, debt service is minimal precisely because of IDA’s concessional nature and built-in grants.

28. **The World Bank and other MDBs are providing significant new financing to our client countries to help them respond to the COVID-19 crisis.** The paper provides supplementary data on the important role that the World Bank and other MDBs play, to provide steady flows of concessional financing for countries, especially when they face shocks. Providing on average $11 of new financing for each $1 of debt service, the WB value proposition needs to be protected. IDA’s support to the poorest already builds a large level of grants into its financing, and the grant allocation system which anticipates debt distress and adjusts grant shares accordingly up front, hence, has built-in debt relief through its high levels of concessionality. Accelerated encashment of contributions by IDA Partners would help alleviate pressure on IDA in implementing the significant front-loading of its financing to client countries. In addition, direct contributions to IDA is an option that would strengthen IDA, enable it to leverage scarce aid resources, and provide additional concessionality to IDA countries.

29. **Beyond this, the paper refers to WBG efforts to explore options to provide additional short-term liquidity to IDA countries that could increase financing over and above the additional efforts already undertaken to increase commitments in the wake of the COVID-19 crisis.** The paper also explores donors providing resources to a trust fund to pay World Bank debt service, with the objective of freeing up resources of IDA countries for them to finance urgent expenditures. While the Bank would be ready to set this up should some donors request it, shareholders would need to assess the opportunity costs of such option versus further strengthening IDA directly which is an efficient platform for providing coordinated, focused funding for IDA countries and can provide direct leverage of shareholder contributions.
Annex 1. PBA Commitments vs Debt Service to IDA & IBRD, by Country Groupings for FY21