Paper on the Decision to Establish a Special Fund Window for Less Developed Members
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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<td>AIIB</td>
<td>Asian Infrastructure Investment Bank</td>
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<tr>
<td>AOA</td>
<td>Articles of Agreement</td>
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<td>BOD</td>
<td>Board of Directors</td>
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<td>bps</td>
<td>basis points</td>
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<td>CS</td>
<td>Corporate Strategy</td>
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<td>G20</td>
<td>Group of Twenty</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IFI</td>
<td>International Financial Institution</td>
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<td>LDM</td>
<td>less developed member</td>
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<td>MCDF</td>
<td>Multilateral Cooperation Center for Development Finance</td>
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<td>MDB</td>
<td>multilateral development bank</td>
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<td>NRM</td>
<td>nonregional members</td>
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<tr>
<td>OCR</td>
<td>ordinary capital resources</td>
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<tr>
<td>PPSF</td>
<td>Project Preparation Special Fund</td>
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<tr>
<td>R&amp;R</td>
<td>Rules and Regulations</td>
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<tr>
<td>SBF</td>
<td>sovereign-backed financing</td>
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<td>SFW</td>
<td>Special Fund Window for Less Developed Members</td>
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<td>SFW-Facility</td>
<td>Special Fund Window under the COVID-19 Crisis Recovery Facility</td>
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<td>SIDS</td>
<td>Small Island Developing States</td>
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Paper on the Decision to Establish a Special Fund Window for Less Developed Members (SFW)

Introduction

1. Since its inception, the Asian Infrastructure Investment Bank (AIIB or the Bank), as a new multilateral development bank (MDB), has made recognizable progress in serving the infrastructure development needs of many low- and middle-income members in the region. During AIIB’s early years, it was a conscious decision on the part of the Bank to focus on utilizing its regular financing instruments to expand client coverage to meet clients’ immediate needs. Five years on and building on its own operational experience, AIIB has learned and grown to the stage where it is ready to further tailor its operations to address the needs of its less developed members (LDMs)1 as per the emphasis in the Articles of Agreement (AOA) to give “special regard to the needs of less developed members in the region.” While the Project Preparation Special Fund (PPSF) has played a pivotal role in supporting LDMs to develop AIIB-financed projects, the Board of Directors (BOD) has recognized that AIIB should further strengthen its responsiveness to the needs of LDMs. This was reflected in the Bank’s first Corporate Strategy (CS), which prioritized meeting the needs of a “broad range of members across the income spectrum, particularly those that were underserved during AIIB’s start-up phase.”

2. The COVID-19 pandemic has drastically increased the overall financing needs of lower-income countries, including AIIB’s LDMs. Rising vulnerabilities due to high public debt coupled with an increased demand for development expenditure adds to the need for affordable financing to support recovery efforts. Despite this demonstrable need, concessional resources are constrained due to economic circumstances in advanced economies. The Group of Twenty (G20) has been pleading for urgent, scaled-up, and innovative measures especially from the multilateral development banks (MDBs). AIIB has adequate capital in its balance sheet and with the increased attention toward supporting LDMs in the context of the CS implementation, AIIB could further contribute to this effort.

3. While the Bank should do more to reach its LDMs, there is a general agreement that the core elements of AIIB’s business model should not be compromised. These include: a rigorous investment approach on high-quality projects, full control in the hands of AIIB members through a modern multilateral governance structure, strictly voluntary contribution and financial sustainability for the Bank and its members.

4. Based on AIIB’s operational experience and consultations with clients, there are two areas where the Bank’s LDMs need most support. The first is project preparation support to overcome low institutional capacity, which is addressed by the PPSF and other special

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1 In this paper, the term “lower-income countries” is used when explaining the global phenomena that are applicable to discussing lower-income countries, in general, beyond AIIB’s membership, and does not refer to the World Bank country categorization of low-income countries. The term “less developed members (LDM)” is taken from AIIB’s AOA and refers to AIIB members with relatively low income or other special development needs. ‘IDA-only members’ are a subset of LDMs targeted by the SFW proposal for the reasons explained in Part II.
funds. The second is affordable loan pricing. The circumstances of the COVID-19 crisis gave additional impetus to address this issue. In May 2020, the BOD agreed to establish the Special Fund Window under the COVID-19 Crisis Recovery Facility (SFW-Facility) from a carve-out of the PPSF to reduce the interest rate payable by eligible members on their Facility loans. This proved to be successful in meeting LDMs’ needs and the resources were rapidly exhausted.\(^3\) In May 2021, the BOD agreed to a final replenishment of the SFW-Facility from the PPSF to support vaccine financing in LDMs.

5. From this experience and after considering various options, an interest rate buy-down is considered as most suitable to provide LDMs with affordable pricing within the Bank’s current operating parameters. It provides LDMs access to AIIB’s resources without compromising any of the core elements of the Bank’s business model. It enables AIIB to reach a wider range of LDMs, thereby extending the coverage of the Bank’s high project standards. It maintains the Bank’s financial sustainability by being fully funded by contributions. It is controlled exclusively by the Bank’s existing multilateral governance structures.

6. In this context, AIIB established the SFW as a regular instrument for AIIB’s financing in LDMs. This paper first sets the context by exploring the infrastructure financing gaps faced by lower-income countries, why the SFW is introduced now, what other international financial institutions (IFIs) have done to address the underlying challenges and why AIIB is in a good position to implement the SFW. The second part presents the details of the SFW.

\(^2\) This paper differentiates between the terms “concessional” and “affordable”. Concessional borrowing is defined by the International Monetary Fund (IMF) as “loans with a grant-element of at least 35 percent, evaluated at a discount rate of 5 percent.” The intention of the paper is not to provide concessionality up to the level of IMF’s definition, but to make AIIB’s financing more affordable for its LDMs. (Source: IMF, 2020. Reform of the Policy on Public Debt Limits in IMF-supported Programs, IMF Policy Paper.)

Part I. Context

A. Infrastructure Financing Gap in Lower-Income Countries

7. Globally, lower-income countries, including AIIB’s LDMs, face a significant need for infrastructure investment. One estimate shows that for low- and middle-income countries to achieve development goals, they would need to spend 4.5 percent of gross domestic product (GDP) per year for new infrastructure and an extra 2.7 percent of GDP on infrastructure maintenance.\(^4\) In Asia, the Asian Development Bank (ADB) indicates that its 45 developing member countries would need to invest USD26 trillion over the 15-year period from 2016 to 2030 (roughly USD1.7 trillion annually).\(^5\) AIIB’s Asian Infrastructure Finance 2020 report highlighted that developing countries in Asia need to spend around 6-10 percent of GDP to overcome backlogs in infrastructure spending.\(^6\)

8. Quality of infrastructure also matters. The Asian Infrastructure Finance 2020 report emphasizes that infrastructure investment should aim at "investing better" rather than simply "spending more" to crowd in more public and private resources in a virtuous circle. Making the right policy and investment choices, with support from adequate financing instruments, is critical for infrastructure investments to be compatible with sustainable development. The Group of Twenty (G20) has also highlighted the importance of quality infrastructure investment as set out in the G20 Principles for Quality Infrastructure Investment.\(^7\)

9. The public sector is the main source of infrastructure finance. However, lower-income countries are constrained to spend additional public financing for infrastructure due to limited fiscal space and other factors such as a weak tax system.\(^8\) In addition, the overall investment climate is not conducive to private investments since it is affected by political instability, government regulations, transparency problems and property rights deficiencies, among other things.\(^9\)

10. This underscores the critical role of MDBs. First, MDBs and their expertise in project preparation and implementation are crucial in making infrastructure projects bankable and sustainable. The United Nations notes that more than a third of public investment spending is lost through inefficient planning and execution, with larger efficiency gaps in lower-income countries.\(^10\) Better infrastructure planning and improving the quality of project preparation and implementation can increase the benefit of infrastructure investment.

11. Second, without MDBs’ affordable long-term financing, lower-income countries would face many difficulties in securing financing for infrastructure assets with long-term benefits. More than half of AIIB’s 24 members and prospective members with  

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International Development Association (IDA)-only status lack creditworthiness and hence the ability to borrow from commercial lenders, as reflected by the lack of sovereign credit risk rating assigned to them by major rating agencies. Furthermore, 10 members are in high risk of, or are in, debt distress (Annex 1), demonstrating their lack of fiscal capacity to carry large amounts of non-concessional shorter-term debt. Consequently, lower-income countries are either unable to afford investing in infrastructure fast enough to grow out of their predicaments or would entrap themselves in unsustainable debt while attempting to do so. Both outcomes carry significant and far-reaching adverse developmental consequences.

12. The pandemic is adding to the already substantial public debt of lower-income countries. At the same time, the supply of concessional financing to lower-income countries have declined significantly.\textsuperscript{11} The recent World Economic Outlook report stressed the need for a multilateral effort to provide liquidity and debt relief to financially constrained countries.\textsuperscript{12}

13. For years, the G20 has encouraged MDBs to enhance their support for lower-income countries especially by optimizing their balance sheet to make the best use of available resources. For example, the Multilateral Development Banks Action Plan to Optimize Balance Sheets\textsuperscript{13} specifically recommended MDBs to consider “instruments for providing improved access to concessional finance by low-income countries … such as grant financing to buy-down loans.” The Italian G20 Presidency in 2021 has launched an independent review of the MDBs’ Capital Adequacy Framework to assess the potential for MDBs to leverage more by revising their framework policies. The Rome G20 Meeting in December 2021\textsuperscript{14} reiterated the need for advanced economies and IFIs to increase their support with urgency.

14. Major IFIs have already acted on an unprecedented scale. The World Bank has advanced the 20\textsuperscript{th} replenishment process of the IDA by a year, recognizing the urgency of supporting recovery efforts from the COVID-19 crisis. The replenishment concluded with a USD93 billion package in December 2021\textsuperscript{15} including new donor contributions of USD23.5 billion with a policy and financial package to support 74 countries between July 2022 and June 2025.\textsuperscript{16} The International Monetary Fund (IMF) has significantly increased its support in 2020 by providing USD13 billion to 50 lower-income countries. Much of this was through IMF’s concessional vehicle, Poverty Reduction and Growth Trust.\textsuperscript{17} Furthermore, it announced the establishment of a new Resilience and Sustainability Trust to provide affordable long-term financing to help vulnerable countries.\textsuperscript{18}

\textsuperscript{12} IMF. 2021 World Economic Outlook October 2021
\textsuperscript{15} IDA.2021 IDA20 Replenishment. December.
B. Why Infrastructure Investment is Urgent for Lower-Income Countries

15. Infrastructure investment in lower-income countries has become more urgent in the current crisis. Lower-income countries will need to spend almost USD200 billion from 2021 to 2025 to fight the pandemic, and an additional USD250 billion to regain lost ground on convergence paths with advanced economies. Uneven vaccine rollout and uneven policy and fiscal space available to respond to continued COVID-19 challenges have resulted in sharply divergent economic prospects. In many countries, convergence has stopped or reversed, jobs have been lost (especially in the informal sector and for women), living standards have declined, poverty and inequality have increased, and a decade of hard-won development progress is now threatened. It is estimated that economic losses due to COVID-19 in developing Asia amount to 6.0 to 9.5 percent of regional GDP in 2020 and 3.6 to 6.3 percent of regional GDP in 2021.

16. Economic shocks from the pandemic are coupled with the worsening climate crisis. The latest International Panel on Climate Change (IPCC) report raised alarm that the planet is on course to reach 1.5°C of global warming within the next two decades. Transformational change is required to limit global warming to 1.5°C by the end of the century. Without mitigation and adaptation efforts, Asia will be exposed to catastrophic climate risks, including intensified heat waves, heavy precipitation and droughts. In economic terms, by 2050, the risks of economic loss due to climate impacts in Asia will exceed two-thirds of the global GDP loss. Lower-income countries in Asia are disproportionately vulnerable to the impacts of climate change. A large share of their population and economies is directly dependent on climate-sensitive natural resources, such as agriculture and tourism. They also have much lower capacities to adapt to the changing climate.

17. Infrastructure investments are crucial for lower-income countries to regain growth momentum and to achieve long-term sustainable development goals in the post-COVID-19 era, while also dealing with climate change. These goals include creating jobs and opportunities, boosting productive capacity, accelerating the transition to a low-carbon economy, climate change adaptation and resilience, harnessing the benefits of digitalization and strengthening social safety nets through social infrastructure.

C. How Other IFIs Help Lower-Income Countries

18. Supporting lower-income countries in a way that does not create unsustainable debt burden has long been an important aspect of development finance. In addition to providing technical assistance to strengthen the capacity of lower-income countries, IFIs have also developed various models of concessional or blended finance to address affordability. Each model reflects different choices made by the institution based on their respective governance and business models.

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19. A traditional model, as adopted by the IDA, is to offer concessional financing through fixed, low-interest-rate products or grants. A similar model is also adopted by the African Development Bank, ADB, and International Fund for Agriculture Development, which are large in scale and rely on regular replenishment cycles to raise donor funds. To allocate limited resources across the eligible countries, they operate with a comprehensive demand assessment of development financing needs, eligibility criteria and performance-based allocation systems. The governance is typically led by donors who determine the rules and regulations of the fund as well as make decisions on the allocation system applied. A mechanism is typically in place to determine the voting power for respective donors, often associated with the relative level of contributions or other similar factors.

20. Another common model is blended finance which reduces the financial burden to the recipient by combining regular/commercial financing with concessional resources. Blended finance takes on many forms. It can be offered to either sovereign or private sector entities. It can be structured through loans, equity, credit enhancement facilities (e.g., guarantees or risk sharing) and other innovative financing tools. The degree of subsidy can be flexibly designed: it can be used to achieve IMF’s definition of concessionality or to provide a marginal discount on regular financing. In the case of blended finance for the private sector, there are established IFI guidelines on avoiding market distortion.

21. Blended finance is commonly provided by bilateral DFIs. For example, KfW’s Development Loan offers reduced interest rate to certain countries by combining KfW’s own loans with funds from the Federal Government of Germany with the resulting loan terms meeting the Overseas Development Aid criteria. A similar model is offered by the Agence Française de Développement Soft Loans and the Korea Economic Development Co-operation Fund’s Mixed Credit. Among the MDBs, the Inter-American Development Bank offers blended loans by mixing a concessional tranche with a regular tranche in which the allocation varies by country based on a country’s debt sustainability. The European Bank for Reconstruction and Development offers various types of blended finance products for key thematic areas to both public or private sector clients, including for climate finance, small and medium-sized enterprises (SMEs) and women entrepreneurship facilities, among others. Other MDBs operate through similar models.

D. AIIB Support for Less Developed Members

22. AIIB was established with the purpose of serving its members’ investment needs in infrastructure and other productive sectors. In doing so, it is mandated to give special regard to its LDMs. This is also a priority under AIIB’s Corporate Strategy (CS) to serve a broad range of members. LDMs often need support across the entire project cycle at the upstream, midstream, and downstream stages.

23. Upstream Support (Policy Dialogue). AIIB recognizes the importance of enhancing domestic policies to raise and attract infrastructure investments in LDMs. However, as per

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the CS, systematically offering regular policy advice and technical assistance for policy reform is not part of AIIB’s business model at this stage. AIIB will closely coordinate with policy-advice providers and build on the financing opportunities created by their advice and reform programs.

24. **Midstream Support (Project Preparation).** In 2016, AIIB established the Project Preparation Special Fund (PPSF) to support eligible AIIB members in enhancing the quality and bankability of their infrastructure projects. To date, 15 projects have been approved PPSF support amounting to a total of USD33.64 million in grant funding. Five PPSF grants (amounting to over USD5.7 million) have led to the subsequent approval of their underlying investment projects, resulting in over USD1 billion of AIIB project financing. The Bank has strived to accelerate the use of the PPSF, but the lack of affordable downstream pricing has been an obstacle as the PPSF is specifically tied to potential future AIIB financing. The SFW will help to address this issue by opening more opportunities for AIIB to finance its LDMs. In 2021, AIIB became an accredited implementing partner of the Global Infrastructure Facility (GIF) and the Finance Facility of the Multilateral Cooperation Center for Development Finance (MCDF). Both facilities will add to the pool of AIIB’s special fund resources to further strengthen its support for the project preparations of its LDMs.

25. **Downstream Support (Financing).** AIIB’s financing in LDMs to date has mostly relied on cofinancing projects with partner MDBs and bilateral agencies. There were many reasons for this early focus on cofinancing, but most pertinent is for AIIB to have the ability to blend its financing with the concessional resources of partner financing institutions. By blending AIIB’s funds with concessional sources such as the IDA or ADB’s Asian Development Fund, the total pricing including the AIIB loan is then lowered to a pricing level more affordable by LDMs. As of Jan 2022, out of 29 projects approved in IDA-only members, 20 projects (69 percent) have been cofinanced, of which 16 are cofinanced with concessional resources. However, such arrangements are only feasible under special and mutually beneficial circumstances, as partners would not typically blend their concessional resources for projects deemed to be outside their regular programming and their thematic or sectoral objectives and scope. This limitation means AIIB cannot rely solely on concessional cofinancing to address the pricing barrier, and consequently LDMs will continue to struggle to access AIIB financing in absence of alternative measures.

26. In 2020, in response to the COVID-19 crisis, AIIB introduced the **SFW-Facility** to provide interest rate buy-down for eligible sovereign-backed financing (SBF) for LDMs. To date, the SFW-Facility has used USD29.7 million to buy-down the interest rates for a total of USD217.3 million loans for four projects (in Bangladesh, Cambodia, Kyrgyz Republic and Maldives). Below are some reflections on the operations of the SFW-Facility.

26.1. The SFW-Facility was instrumental in allowing AIIB to support clients it has not served before. Two of the four beneficiaries of the SFW-Facility were new clients. The relatively simple mechanism applied and its integration with the investment process ensured its swift utilization. While clients continued to use IDA or other concessional sources as their first choice, they appreciated that the SFW-Facility allowed them to also access AIIB’s financing to supplement their large financing needs at affordable rates.
26.2. The success of the SFW-Facility has generated several requests by AIIB’s LDMs seeking affordable infrastructure financing to stimulate a post-crisis economic recovery, beyond purposes specific to the Facility. However, the Bank is, to date, unable to serve these requests given that the amount and scope of the SFW-Facility is limited to COVID-related financings. In May 2021, the SFW-Facility was increased by USD25 million to support vaccine financing. This created a paradoxical situation wherein AIIB could serve LDMs well for their exceptional crisis needs, but not for their needs directly related to AIIB’s core business.

26.3. The SFW-Facility has led to a visible increase in LDMs’ access to AIIB financing. The number of approved projects in LDMs peaked in 2020 to 11 projects with the implementation of SFW-Facility, compared to one to six projects per year in all other years between 2016 and 2021.

27. Despite continued efforts, AIIB’s support to its LDMs in terms of both scale and coverage has been limited to date. As of January 2022, only 10 percent of the Bank’s total financing volume since 2016 (USD3.5 billion) has been approved for nine IDA-only members in 29 projects. Excluding Bangladesh, which is the largest borrower among LDMs, AIIB has provided USD832 million to the rest of the IDA-only members which accounts for 2.5 percent of AIIB’s total financing volume.

28. To summarize, the tools that AIIB currently makes available for LDMs are mostly for project preparation and exceptional crisis support. These leave a gap in addressing the barrier to affordability that LDMs consistently face. While AIIB is trying to differentiate itself from other MDBs in terms of lean operations and responsiveness to clients’ demand, its pricing for LDMs is higher than that of the concessional or blended facilities of its peers. This means that most LDMs are simply unable to borrow from AIIB due to pricing reasons.
Part II. Special Fund Window for Less Developed Members

A. Objectives and Rationale

29. Special Fund Window for Less Developed Members (SFW) is a response to the request from the Board of Directors (BOD) and clients for AIIB to better support its LDMs within the scope of its Articles of Agreement (AOA). SFW is intended to fill the gap in AIIB’s offerings to LDMs by expanding a pilot experience that has been effective and well received by clients through the SFW-Facility. Although the program may be small relative to the needs of LDMs, it is an important step for AIIB to implement the Corporate Strategy (CS) and the AOA.

30. The SFW will be allocated to the projects processed through AIIB’s regular investment process and included in AIIB’s Rolling Investment Pipeline. This aligns the SFW-eligible projects with AIIB’s CS and operational policies and ensures that these projects will rely on the quality and rigor of AIIB’s regular process for investment preparation, prioritization, appraisal, implementation, monitoring and evaluation. It will reinforce AIIB’s lean processes by not diverting efforts into a separate investment or project selection process. Furthermore, to protect the borrowing member’s debt sustainability, as with all projects, AIIB will finance only within the IMF-World Bank Debt Sustainability Framework.

31. The SFW has considered the extensive experience by other MDBs on concessional and blended financing and the many complex issues and discussions they entail. As a lean and agile bank, the SFW is deliberately designed to be simple and modest in scale and scope to avoid some of these complexities. It will be open for future refinements if they are justified by subsequent experience.

B. Overview of the SFW

32. The SFW will provide buy-down of interest rates that are chargeable to any eligible sovereign-backed financing (SBF) in AIIB’s eligible members. This interest rate buy-down would be an add-on to regular AIIB financing, which would follow the existing project selection process and ensure the quality of projects as guided by the Bank’s Project Prioritization and Quality Framework. By blending regular AIIB financing with the proposed SFW resources, AIIB can reduce interest rates charged to eligible clients. AIIB would receive its regular interest rate while the borrower pays the rate reduced by the subsidy from the SFW (Figure 1).

Figure 1. Illustration of an Interest Rate Buy-Down Mechanism

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<table>
<thead>
<tr>
<th>Repayment = A + B</th>
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<tr>
<td>A. From client: Principal + Interest – Buy Down</td>
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<tr>
<td>B. From SFW: Buy Down Amount (i.e. USD value of 100 bps)</td>
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</tbody>
</table>

- AIIB Ordinary Resources
- Special Fund Window

Loan

Client
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C. Value Addition

33. **Value Addition by AIIB.** The SFW will enable AIIB to unlock financing from currently available balance sheet capacity to LDMs by making AIIB financing more affordable. This reinforces AIIB’s mission of investing in sustainable infrastructure, especially in LDMs. It also complements other MDBs by bringing much needed additional financing to lower-income countries. In addition, the SFW includes some unique features that demonstrate innovation in the field of blended financing. It adopts a multilateral governance structure regardless of the funding sources and operational efficiency by incorporating the implementation fully into AIIB’s regular investment process.

34. **Value Addition to AIIB.** By blending the SFW resources, AIIB can reduce its pricing offer to a more affordable level for its LDMs and therefore expand client coverage to those who did not borrow from AIIB due to loan affordability. Furthermore, the SFW is a valuable addition to AIIB’s existing set of instruments so that AIIB can make a more comprehensive offering to LDMs.

D. Complementarity with AIIB’s Other Special Funds

35. The SFW complements AIIB’s other special funds by addressing different challenges faced by LDMs in infrastructure financing across the project cycle (Table 1). The PPSF primarily supports AIIB’s LDMs to prepare and implement high-quality projects. GIF and MCDF also offer similar support with complementary themes and focus. Once the projects are prepared, LDMs need financing at an affordable rate, which can be met by the SFW. This complementarity can also increase the borrowers’ willingness to take up the PPSF with the expectation that the prepared projects can be financed by AIIB at affordable terms.

<table>
<thead>
<tr>
<th>Special Fund</th>
<th>Objectives</th>
<th>Activities</th>
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<tbody>
<tr>
<td><strong>Project preparation and implementation support</strong></td>
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<tr>
<td>PPSF</td>
<td>Support to <strong>prepare projects for AIIB financing.</strong></td>
<td>Technical assistance (TA) grants for project preparation activities including e.g., feasibility studies, engineering designs, environmental and social assessments, and capacity building.</td>
</tr>
<tr>
<td>GIF*</td>
<td>Support to prepare and structure infrastructure projects with aim to <strong>mobilize private capital</strong> (typically through public-private partnerships or concessions).</td>
<td>TA grants for project readiness assessment, definition, preparation and structuring.</td>
</tr>
<tr>
<td>MCDF*</td>
<td>Support to prepare high-quality <strong>infrastructure and connectivity</strong> investments working with new partners</td>
<td>TA grants for project preparation, information and knowledge sharing and capacity building.</td>
</tr>
<tr>
<td><strong>Financing support</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SFW</td>
<td>Support to <strong>make AIIB financing more affordable</strong> to less developed members (currently only available for vaccine financing under the Facility)</td>
<td>Interest rate buy-down grants.</td>
</tr>
</tbody>
</table>

*AIIB = Asian Infrastructure Investment Bank; GIF = Global Infrastructure Facility; MCDF = Multilateral Cooperation Center for Development Finance; PPSF = Project Preparation Special Fund; SFW = Special Fund Window

Table 1. AIIB Special Funds
E. Debt Sustainability

36. AIIB’s Operational Policy on Financing and Directive on Sovereign Risk Rating require that (i) any project’s impact on a member’s fiscal sustainability must be acceptable; and (ii) in determining this, the Bank will give particular attention to IMF’s debt sustainability requirement. Furthermore, staff are required to monitor the Bank’s adherence to any debt limits, including with regards to concessionality, as required by the World Bank’s Sustainable Development Finance Policy and IMF’s Public Debt Limits Policy.

37. In practice, Bank staff monitors debt limits and the debt situation in all borrowers and potential borrowers and consults with the IMF regularly, particularly for projects in countries where debt risks are elevated. For each project in debt-concerned members, AIIB consults the IMF and/or World Bank directly and through the borrower on their debt sustainability to ensure that AIIB financing is within the non-concessional borrowing limits. This is checked project by project and multiple times throughout the investment process because other external dynamics can affect whether the AIIB project would fall within the member’s debt limit or not. For example, whether an AIIB project falls within a member’s debt limit could change if its debt situation deteriorates or improves, or it borrows from other non-concessional sources in the meantime.

38. All things being equal, the application of the SFW will always reduce debt burden and improve debt sustainability compared to financing at AIIB’s regular terms. AIIB will finance only within the IMF’s Debt Sustainability Framework to protect the member’s debt sustainability.

F. Principles

39. The SFW is guided by three principles that are fundamental to AIIB’s mandate and business model.

40. **Principle 1: Preserve AIIB’s financial sustainability and its sound banking principles.** As a special fund, SFW resources are separate from the Bank’s ordinary resources. The interest buy-down by the SFW is an add-on to the underlying regular financing that, from AIIB’s perspective, does not change the underlying financing operation or the Bank’s financial position. However, as the purpose of the SFW is to improve access to AIIB financing for LDMs, it would naturally attract more LDMs to borrow from AIIB over time. If the SFW-supported lending to LDMs would increase significantly, this could affect the Bank’s overall risk portfolio and its ability to maintain financial sustainability. Following is a summary of the current assessment.

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26 AOA Article 10 requires that “the ordinary resources and the Special Funds resources of the Bank shall at all times and in all respects be held, used, committed, invested or otherwise disposed of entirely separately from each other.”
40.1. Due to its modest scale, SFW-supported financings would only have a limited impact on AIIB’s portfolio risk profile. On one hand, the SFW can be beneficial to AIIB by bringing a portion of the interest income in advance and by diversifying AIIB’s portfolio across more members. On the other hand, it may marginally increase AIIB’s exposure in higher-risk members. Overall, the envisioned scale of SFW-supported financing to LDMs is well within the acceptable range. Management consulted with the major rating agencies which have confirmed this view.

40.2. The Bank expects that the proportion of SFW-supported financing to the total AIIB approved financing will remain below 15 percent. BOD will be consulted if this threshold is anticipated to be exceeded. The Bank will continue to apply its Risk Management Framework to all investment projects which means that the Bank will invest in higher-risk members only within the applicable risk limit.

41. Principle 2: Operate with AIIB’s multilateral governance. This means that the SFW should be fully governed by the existing governance bodies of AIIB. The Proposal relies on the construct of a Special Fund as defined in Article 17 of the AOA: Special Funds are “resources of the Bank” that are designed to serve the Bank’s purpose and come within the functions of the Bank. Therefore, all decision-making authority will reside within AIIB’s existing governance structure regardless of the number of contributors, and the funds will be operated according to the BOD-approved rules and regulations. Unlike donor trust funds in other MDBs, contributors will not be able to earmark, limit or direct the use of the funds. Application of the SFW will be directly tied to AIIB’s regular investment process for the underlying investment project, and hence will be subject to final approval by the BOD or the President. Consistent with the exclusive role of AIIB’s governance bodies, contributions will be accepted and recorded only after the BOD decides to establish the SFW.

42. Principle 3: Funded strictly through voluntary contributions from members. Contributions will be on a rolling basis, rather than through recurring replenishment cycles. This is to avoid diverting AIIB’s focus away from its strategic priorities toward preferred activities by individual donors and consuming AIIB’s internal capacity toward fundraising. This is also in line with the understanding that AIIB would not require or expect ongoing financial support from its members.

G. Key Features

Member Eligibility

43. The Bank will use the World Bank’s IDA-eligibility list as the basis for determining members’ eligibility to the SFW. Determining member eligibility is a complex and resource-intensive exercise that requires in-depth analysis and comprehensive investigations.

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27 AIIB. 2020. Corporate Strategy, p. 8. Principles. Strong Multilateral Governance and Oversight: “AIIB’s sound governance framework provides voice and representation for all members and ensures that they are well-informed while overseeing the operations of the Bank.”

28 This is also different from the MCDF where AIIB acts as an administrator of resources that are not owned by AIIB and are governed by a mechanism established by the multiple contributors to the MCDF.
considerations of members’ gross national income per capita, size of the economy, credit status, institutional capacity and other special vulnerabilities such as whether it is considered a small island economy. Other MDBs have gone through decades of experience in determining their own eligibility lists at the back of intensive research capacity and debate. The Proposal therefore utilizes a proven and representative list offered by IDA and avoids dealing anew with the many complexities involved with assessing countries’ financing needs.

44. Recognizing the financing needs of all IDA-eligible members, in principle, the SFW shall be open to all IDA-eligible AIIB members. This includes AIIB members with IDA-only and IDA-Blend status. However, until the BOD approves an allocation approach for IDA Blend members and amends the Rules and Regulations (R&R) accordingly, the SFW operation will begin its operations by supporting IDA-only members.

45. During this initial period, the SFW may exceptionally also support IDA-Blend members suffering from severe and intense natural disasters. This would allow the Bank to respond to the needs of IDA-Blend members when they face extraordinary infrastructure financing needs for reconstruction efforts after a severe and intense natural disaster.

46. There are several reasons for this initial focus on IDA-only members. First, the relative need in IDA-only members is more acute as informed by their infrastructure gap. Second, AIIB has not been able to serve the IDA-only members well. Third, according to the current demand analysis, the expected level of funding may be sufficient to provide meaningful support for IDA-only members but may not be sufficient to cover the demand from all IDA-eligible members. Finally, there is variance of project preparation capacity between IDA-only and other members. By limiting the resources to IDA-only members in the initial years of the Proposal, the Bank can give members time to prepare pipeline projects without being concerned that resources are being consumed by ready-made projects in relatively more developed members with higher capacity. At the same time, the Bank can build the operational experience and internal capacity necessary to develop an allocation approach required to operate the SFW with a broader eligibility in the future.

47. As IDA eligibility depends on certain criteria, a member’s eligibility to access IDA funding can change over time based on changes to the member’s circumstances. As a result, an AIIB member’s eligibility to access the SFW can also change. The latest available World Bank-published list on IDA-eligibility in the Bank Directive on Financial Term and Conditions of Bank Financing at the time of a project’s approval will be used to determine its eligibility.

**Project Eligibility**

48. Any eligible members’ SBF operations in AIIB’s Rolling Investment Pipeline (excluding policy-based financing) will be eligible. Nonsovereign-backed financing

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29 All of AIIB members that are Small Island Developing States as defined by the United Nations are already included in the IDA list, except for three members (Bahrain, Singapore, and Cook Islands). World Bank’s IDA Small countries also overlap with either IDA-only or IDA-Blend status.

30 The latest version available at the time of writing is effective from January 1, 2022 (OPS5.09-DIR.136).
projects are not eligible for SFW to avoid the risk of crowding out market financing. Policy-based financing is excluded because it is not part of AIIB’s regular instruments and is only exceptionally available under the COVID-19 Crisis Recovery Facility for members with access to non-concessional finance from the International Bank for Reconstruction and Development or ADB. Other sovereign-backed financings under the COVID-19 Crisis Recovery Facility in IDA-only members are eligible for the SFW.

49. SFW will follow the prioritization process of the underlying investment, and thereby be fully aligned with the CS. Consequently, SFW-supported investment projects would be ordinarily aligned with at least one of the four CS thematic priorities: green infrastructure, connectivity and regional cooperation, technology-enabled infrastructure, and private capital mobilization. Alignment with the CS will also ensure that SFW will contribute to meeting the three CS targets: cross-border connectivity, private capital mobilization, and—most immediately—the target that climate finance will be at least 50 percent of AIIB financing by 2025. Given the Bank’s commitment to make all financings Paris-aligned from July 2023, all SFW-supported projects will be aligned with the Paris Agreement.

50. The strict adherence to the CS allows the SFW to reinforce the objectives of the CS and focus all the Bank’s resources on its implementation. If the SFW was to follow any alternative prioritization, it would arise from either the contributors’ preferences, which is inconsistent with the principle of multilateral decision-making, or from a new consensus of the BOD, which would be unlikely given the recent comprehensive BOD discussions that have led to the CS.

Prioritization of Regional Members

51. Demand from regional members will be prioritized consistent with the AOA, the CS and other relevant strategies. In general, all of AIIB’s investments in nonregional members are subject to the application of the Strategy on Financing Operations in Non-Regional Members, including its ceiling on nonregional member financing (currently set at 15 percent) and the focus on investments with the objective to support trade and connectivity with Asia and investments in climate change mitigation, as a global public good. Therefore, any SFW-eligible investments in nonregional members will be a subset of this 15 percent ceiling. In terms of the SFW resources, the Bank expects the level of SFW resources committed to nonregional members to remain within 25 percent of total contributions. BOD will be consulted if this threshold is anticipated to be exceeded. This share reflects a balance between the priority given to regional members, on the one hand, and the intention to provide at least some support to a reasonable number of eligible members in AIIB’s nonregional membership, on the other hand.

Allocation

52. The SFW will be allocated to eligible projects in the Rolling Investment Pipeline according to AIIB’s regular rigorous investment process. This is different from the allocation model commonly adopted by other MDBs in which resources are pre-allocated among eligible countries or themes in the form of “envelopes.” For AIIB, the demand is not in the entire financing gap in eligible members but rather in the needs of these members in the form of projects identified for AIIB financing. Therefore, the Rolling Investment
Pipeline provides the best indication of demand. This is also different from a first-come-first-served process. The Bank’s pipeline is the result of close interaction between clients and Bank staff and a process of gradual funneling of the discussions from broad ideas. The Rolling Investment Pipeline represents a highly selective list that resulted from a rigorous prioritization done according to the Project Prioritization and Quality Framework, taking into account AIIB’s AOA and CS. Only a small share of the initial proposals that emerge from this process meets the criteria and obtains financing. Given that the SFW can only be used with underlying investments, all SFW-supported projects will go through this process.

53. **A single member can receive up to 25 percent of the total SFW resources committed by contributors** (“single member cap”). The equivalent absolute amount of the cap will be shared with the BOD at Annual Updates. The cap is intended to prevent any single member capturing an extraordinary share of the resources and to ensure equitable access, even to members who may have less capacity to prepare projects quickly. A pre-set cap also provides predictability to members to help them plan their engagement with AIIB. The 25-percent cap is set in consideration of the expected scale of the SFW operations informed by the anticipated demand and level of funding. This means that once a member reaches the 25-percent single member cap, it cannot access SFW resources further until such time that additional contributions are committed to the SFW.

**Buy-down Rate**

54. SFW will apply a **buy-down rate of 100 basis points** (bps) as a regular practice for USD-denominated loans. A floor interest amount of zero will apply so that the interest after buy-down cannot be negative. The same buy-down rate will apply to all eligible members equally at any point in time and will apply to the full maturity of each eligible concerned loan.

55. The 100 bps is set to place the AIIB pricing in a complementary territory in comparison with other MDBs to ensure AIIB’s value addition. The intention is not to make AIIB financing concessional by the IMF’s definition or to match or undercut other MDBs' concessional lending. In all circumstances, buy-down of 100 bps will make AIIB financing more affordable for AIIB’s LDMs compared to AIIB’s regular financing terms. On practical terms, the Bank expects LDMs to seek concessional financing from other MDBs first and supplement their infrastructure financing gap with AIIB financing.

56. The Proposal is designed with the expectation that contributions will be sufficient to provide buy-down at 100 bps for all eligible demand in the pipeline for the first few years. However, when resources are insufficient, the regular buy-down rate may be scaled back for new operations to equitably distribute the remaining resources across the eligible pipeline projects. If the scale-back becomes necessary, Management will inform the eligible member of the adjusted buy-down rate in advance of financing decision.

57. The SFW can be applied to any other **hard currency loans** offered by AIIB. In such cases, the Bank will calculate an applicable buy-down rate for that currency on a project-by-project basis. In any currency, a floor interest amount of zero will apply.
Scale and Funding of the SFW

58. The scale of the SFW operation is expected to be modest compared to AIIB’s overall financings. Based on the current demand in the Rolling Investment Pipeline, the SFW would require USD60-100 million to provide buy-down for loans in the amount of USD300-600 million per year. In line with the objective of the SFW, a gradual increase of this demand is expected over time. Management expects that the proportion of SFW-supported financing to total AIIB approved financing will remain below 15 percent and will consult with the BOD if this threshold is anticipated to be exceeded.

59. SFW will be funded by voluntary contributions from contributing members.

59.1. Contributors are expected to be members of the Bank and any of their subdivisions or entities as defined in the R&R Section 2.2. Any other contributor would require Board approval.

59.2. PPSF is listed as a source of the fund in the R&R Section 2.1 to accommodate the historical carve-out for the SFW-Facility and its remaining balance. This balance will be combined with other contributions and used to serve the purpose of the SFW. This clause does not reflect the intention to make additional carve-out from the PPSF.

Annual Update of Contributions and Pledges

60. To provide predictability of the funding stream, an Annual Update of contributions and pledges will be provided to the BOD. This update will provide a summary of the contributions and pledges received within the applicable year. An annual notice to the Board of Governors will be issued between the Annual Updates, so that any pledges or contributions until a certain date would be recorded and included in the next Annual Update. In between Annual Updates, BOD will be informed of new contribution or pledge in a timely manner such as at the nearest quarterly BPB update without waiting for the Annual Update.

61. These updates will also be used to confirm 1) the absolute amount of the single member cap; and 2) the regular buy-down rate if SFW resources are constrained and scale down of the regular buy-down rate is required.

Other features

62. Administrative set-up. The SFW-Facility will be transitioned into the SFW through an amendment of the Rules and Regulations. SFW resources will be deemed and managed as Special Fund resources of the Bank as defined in AOA Article 17.

63. Administration fee. An administration fee will be charged to contributions based on the principle of full-cost recovery to cover all costs associated with the SFW operations. A fee level will be set and be included in the Contributions Agreement. While the SFW will mostly rely on the existing processes and functions, modest additional resources would be required for the loan administration and Special Funds management.
64. **Implementation support.** The SFW is linked to the underlying investment project and does not entail additional implementation support. Within its CS and Business Plans, AIIB is continuing to build its capacity to provide implementation support for its growing portfolio and in line with the characteristics of this portfolio, including the potentially greater needs of LDMs.

65. **Information for eligible members.** The Bank will prepare relevant communication materials to inform eligible members on ways to access the funds once the SFW becomes operationalized with available funding. This may include public information on the website, factsheets, and others.

66. **Duration.** The SFW will begin allocation after: (1) the BOD approval of the Rules and Regulations, and (2) receipt of the initial contributions. The SFW will operate as long as funds and commitments are available for allocation and to cover for associated costs.

67. **Approval Authority.** Once the SFW begins operation, the BOD or the President will approve the SFW allocation following the approval track applicable to each underlying project according to the Accountability Framework (AF). As per the AF, BOD may call-in any projects or the President may refer any projects for BOD consideration.

68. **Reporting.** The BOD will be kept informed on the SFW through the following means:

   68.1. Projects presented for approval by the BOD or the President.
   68.2. Annual Business Plan and Quarterly Business Plan and Budget Update, or other appropriate means of operational updates, regarding the usage and prospects of funds.
   68.3. Quarterly Rolling Investment Pipeline which indicates underlying investments that are eligible for the SFW allocation.
   68.4. Annual Update of Contributions and Pledges.

69. **Review.** A review will take place after three years of operation, and periodically thereafter as agreed with the BOD. The review will include a portfolio review, operational insights, client feedback, demand analysis and complementarity with project preparation special funds. When considering the review, the BOD will have the opportunity to decide on adjustments and changes that could be suggested by the review, such as the member eligibility, single member cap, and the buy-down rate. The BOD will be consulted on the exact time and scope of the review nearer the review period. The review will include input from the Complaints-resolution, Evaluation and Integrity Unit and from relevant external experts such as members of the International Advisory Panel. The review will draw from any Early Learning Assessments, if any, that would have been completed at the time that is relevant to the SFW.

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31 For example, if the underlying project is subject to the BOD approval, the BOD will take decisions on (i) the project and (ii) the allocation of the SFW for that project. This was the same practice applied to the SFW-Facility projects. As all Facility projects were subject to the BOD approval, all SFW allocations were decided by the BOD.
## Annex 1. List of IDA-Eligible AIIB Members

<table>
<thead>
<tr>
<th>AIIB regional members with IDA-only status</th>
<th>AIIB nonregional members with IDA-only status</th>
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<tbody>
<tr>
<td><strong>Risk of Debt Distress</strong></td>
<td><strong>WB Classification by Income</strong></td>
</tr>
<tr>
<td>Afghanistan</td>
<td>High</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Low</td>
</tr>
<tr>
<td>Cambodia</td>
<td>Low</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>Moderate</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>High</td>
</tr>
<tr>
<td>Maldives&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>High</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Low</td>
</tr>
<tr>
<td>Nepal</td>
<td>Low</td>
</tr>
<tr>
<td>Samoa&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>High</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>High</td>
</tr>
<tr>
<td>Tonga&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>High</td>
</tr>
<tr>
<td>Vanuatu&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Moderate</td>
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<tr>
<th>AIIB regional members with IDA Blend status</th>
<th>AIIB nonregional members with IDA Blend status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk of Debt Distress</strong></td>
<td><strong>WB Classification by Income</strong></td>
</tr>
<tr>
<td>Fiji&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>n/a</td>
</tr>
<tr>
<td>Timor-Leste&lt;sup&gt;a&lt;/sup&gt;&lt;sup&gt;b&lt;/sup&gt;</td>
<td>Low</td>
</tr>
<tr>
<td>Pakistan</td>
<td>n/a</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Low</td>
</tr>
<tr>
<td>Papua New Guinea (Prospective)</td>
<td>High</td>
</tr>
</tbody>
</table>

Notes: LIC = low-income country, LMIC = lower middle-income country, UMIC = upper middle-income country.

<sup>a</sup> Small Island Developing States (SIDS) as defined by the United Nations.

<sup>b</sup> Borrowing on World Bank small economy terms, when applicable.

Sources:
- Risk of debt distress is based on the IMF’s List of LIC DSAs for Poverty Reduction and Growth Trust (PRGT)-Eligible Countries as of June 30, 2021.
- Classification by Income is based on the World Bank country classifications by income level: 2021-2022.