



Policy Paper

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Review of ADB's Policy-Based Lending

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
BOP	–	balance of payments
CSF	–	Countercyclical Support Facility
DAC	–	Development Assistance Committee
DDO	–	deferred drawdown option
DMC	–	developing member country
DPL	–	development policy lending
GBS	–	general budget support
IED	–	Independent Evaluation Department
IFI	–	international financial institution
IMF	–	International Monetary Fund
LIBOR	–	London interbank offered rate
MDB	–	multilateral development bank
OCR	–	ordinary capital resources
OECD	–	Organisation for Economic Co-operation and Development
PCA	–	program cluster approach
PESF	–	Public Expenditure Support Facility
PFO	–	precautionary financing option
PPPF	–	post-program partnership framework
RRP	–	report and recommendation of the President
RIA	–	regulatory impact assessment
SAL	–	structural adjustment lending
SERD	–	Southeast Asia Department
SPBL	–	special policy-based loan
SPL	–	special program loan
TA	–	technical assistance

NOTE

In this report, "\$" refers to US dollars.

Director General	K. Sakai, Strategy and Policy Department (SPD)
Director	I. Bhushan, Director, Strategy, Policy, and Interagency Relations Division, SPD
Team leader	K. Takamiya, Senior Planning and Policy Economist , SPD
Team members	M.J. David, Strategy and Policy Officer, SPD G. Jorge, Strategy and Policy Assistant, SPD

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I. INTRODUCTION

1. The role and design of policy-based lending at the Asian Development Bank (ADB) and other international financial institutions (IFIs) have been evolving to reflect the changing context and understanding of international development.¹ Since its inception as balance of payments (BOP) support during the global oil crisis in 1978, ADB's policy for program lending has been adjusted a number of times. However, since the most recent amendment to the policy in 1999² following the Asian financial crisis, ADB has addressed the changing needs of policy-based lending primarily through flexible application of the existing policy. In the meantime, other IFIs have modified their policies, primarily by introducing new instruments to cope with the changing needs and economic environment in developing countries.

2. This paper reviews ADB's experience with policy-based lending since the 1999 policy revision and identifies constraints. It also recommends ways to make ADB's program lending policy more effective, in view of ADB's experience in implementing the policy and evolving thinking about policy-based lending as an instrument of development. The second section of the paper reviews the evolution of IFIs' policy-based lending instruments since the 1970s, with reference to their theoretical underpinnings. The third section reviews the recent performance of ADB's policy-based lending, particularly using the findings from relevant special evaluation studies conducted by ADB's Independent Evaluation Department (IED). The fourth section identifies the reforms needed in ADB's program lending policy, followed by the fifth section on the proposed implementation arrangements. The paper concludes with a set of recommendations on specific policy revisions for Board approval.

II. EVOLUTION OF POLICY-BASED LENDING BY INTERNATIONAL FINANCIAL INSTITUTIONS

A. Origin as Balance of Payments Support and Structural Adjustment

3. Program lending of multilateral development banks (MDBs), including ADB, originated as BOP support. ADB adopted its program lending policy in 1978³ in response to the international oil crisis in the 1970s. At that time, many developing countries lacked foreign exchange in convertible currencies. The initial purpose of program lending—in other words, non-project lending—was to finance the importation of goods that were essential for fuller utilization of the productive capacity of developing member countries (DMCs) to achieve economic growth. ADB removed the requirement to demonstrate BOP needs in 1987,⁴ but its legacy is still reflected in the practice of linking disbursement to imports in its program lending.⁵

¹ In this paper, "policy-based lending" refers to ADB's program lending and similar instruments for budget support or balance of payments support employed by international financial institutions (IFIs). "Lending" and "loan(s)" include grant(s) from IFIs' concessional assistance windows, such as the Asian Development Fund of ADB and the International Development Association of the World Bank Group, except for crisis response financed by specifically designated resources.

² ADB. 1999. *Review of ADB's Program Lending Policies*. Manila.

³ ADB. 1978. *Program Lending*. Manila.

⁴ ADB. 1987. *A Review of Program Lending Policies*. Manila.

⁵ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila. The proceeds of a program loan for which there is only a negative list of ineligible items may be disbursed without supporting import documentation, if during each year in which the proceeds of the program loan are expected to be disbursed, the value of the DMC's total imports minus (i) imports from non-member countries, (ii) ineligible imports, and (iii) disbursements made under other official development assistance, is greater than the amounts expected to be disbursed during such year. The borrower is required to submit with each withdrawal request a certification confirming the borrower's compliance with the above formula for the period covered by the withdrawal request. Otherwise, import documentation under existing procedures will still be required. Documentation for specific imports is required for program loans for which a positive list of eligible items is used.

4. In the 1980s, the scope of program lending was broadened to address a wide range of policy reforms of developing and transitioning economies.⁶ In 1980, the World Bank launched structural adjustment loans (SALs), which were initially to be provided in return for reforms in trade policy and price incentives to contain the expansion of current account deficits. In response to the emerging market debt crisis, the scope of policy reforms was enlarged to encompass a more comprehensive package. The International Monetary Fund (IMF) also expanded the scope, number, and maturity of its adjustment loans in the 1980s. Behind this trend was an emerging notion that capital investments to developing countries alone could not generate fruitful benefits if instability and policy distortions were prevalent in the economy. In 1983, ADB reformulated its program lending as an instrument to support policy reforms and introduced the development policy letter, including the policy matrix.⁷

B. Rise of the Programmatic Approach for Budget Support

5. By the 1990s, structural adjustment experiences highlighted that country ownership is an essential element for successful reform programs. The experiences showed that policy-based lending is most effective when it reflects the country context, both in the process followed and in substance. Reforms work only when they are fully owned by the client country, but not when unilaterally imposed by IFIs. The new thinking envisaged a reform package designed and implemented by the country, with its full ownership. MDBs were supposed to play a “banker-like”⁸ role of appraising and according intellectual support to the country-owned reforms and, upon their endorsement, providing development financing for public expenditures.

6. The focus on binding constraints required streamlining the conditionality for development finance. The imposition of an extensive list of tranche release conditions that surpasses the implementation capacity of client countries was increasingly seen as counterproductive. Recent development literature has placed more emphasis on identifying a limited number of binding constraints with respect to unique country contexts, as opposed to a lengthy one-size-fits-all list of policy prescriptions.⁹ At the same time, as the importance of gradualism and a phased approach to designing and implementing reforms was recognized, shock reform therapy was discouraged.¹⁰

⁶ The background on the rise of IFIs' adjustment lending is summarized in the introduction to W. Easterly. 2005. What Did Structural Adjustment Adjust? The Association of Policies and Growth with Repeated IMF and the World Bank Adjustment Loans. *Journal of Development Economics*. No. 76. pp. 1–22.

⁷ ADB. 1983. *A Review of Program Lending Policies*. Manila.

⁸ See G. Ranis. 2007. Towards the Enhanced Effectiveness of Foreign Aid. *United Nations University Research Paper*. No. 2007/42. Helsinki: United Nations University World Institute for Development Economics Research; and G. Ranis. 1995. *On Fast-Disbursing Policy-Based Loans*. Prepared for the US and Multilateral Development Bank Task Force.

⁹ See R. Hausmann, D. Rodrik, and A. Velasco. 2005. *Growth Diagnostics*. John F. Kennedy School of Government. Cambridge: Harvard University; and D. Rodrik. 2006. Goodbye Washington Consensus, Hello Washington Confusion? A Review of World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform. *Journal of Economic Literature*. Vol. XLIV. pp. 973–987; and D. Rodrik. Development Lessons for Asia from Non-Asian Countries. *Asian Development Review*, Vol. 23, No. 1. pp. 1–15.

¹⁰ For instance, see J. Stiglitz. 2002. *Globalization and Its Discontents*. London: Penguin.

7. The Paris Declaration on Aid Effectiveness called for the consolidation of development partnerships through the use of program-based (or sector-wide) approaches.¹¹ Program-based approaches require a greater focus on country ownership and engagement, reliance on country systems, a comprehensive program and budget framework, development partner coordination, and analytical works. These factors led both IFIs and bilateral aid agencies to rethink the mode of aid. Instead of providing conventional project financing, aid agencies began to introduce collective support to client countries' development expenditures through general budget support (GBS). GBS has now become a widely accepted development practice. A study conducted through the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD)¹² concluded that (i) GBS has been effective in strengthening public finance management planning and budgeting, transparency, and accountability; and (ii) GBS has also helped bring aid agency funds on budget and strengthen budget processes.

8. Recognizing the need to improve policy-based lending on these grounds,¹³ the World Bank in 2004 replaced adjustment lending with development policy lending (DPL).¹⁴ DPL's main characteristic is the programmatic approach for GBS financing. DPL is packaged as a series of single-tranche loans, whose processing is initiated by broadly identified triggers. Lending is committed based on prior actions completed by the client country before Board approval.¹⁵ The programmatic approach existed even at the time of old SAL, as programmatic SAL, which became a model for ADB's program cluster approach (PCA) introduced in 1999 (footnote 2). The key aspect of the 2004 reform was mainstreaming this approach. By then, programmatic operations had emerged as a promising approach to reconcile the objectives of achieving ownership and providing resource predictability. Since FY2007, only a few DPLs took the form of the old style multitranches operations globally, and none in Asia. Conditionality has also been substantially streamlined under DPL.¹⁶ IMF's 2002 *Guidelines on Conditionality* also incorporated the prior action approach and stressed the importance of country ownership and well-focused conditionality.¹⁷ In 2005, the Inter-American Development Bank introduced the programmatic approach, which now accounts for most of its policy-based lending operations.

9. The World Bank's DPL moved away from using estimated adjustment costs in determining the size of assistance. DPL is provided based on the development financing needs of a country and the estimated need for external financing. This approach promotes use of the

¹¹ ADB uses the Organisation for Economic Co-operation and Development (OECD) definition of program-based approaches, which lists the following features: (i) leadership by the host country or organization; (ii) a single comprehensive program and budget framework; (iii) a formal process for aid agency coordination and harmonization of aid agency procedures for reporting, budgeting, financial management, and procurement; and (iv) efforts to increase the use of local systems for program design and implementation, financial management, monitoring, and evaluation. See ADB. 2009. *Program Lending Policy: Clarification*. Manila.

¹² IDD and Associates. 2006. *Evaluation of General Budget Support*. Birmingham: International Development Department, School of Public Policy, University of Birmingham. The evaluation was undertaken for OECD-DAC.

¹³ The World Bank's attempt to improve its adjustment lending is reflected in its flagship publication. See S. Koeberle, H. Bedoya, P. Silarsky, and G. Verheyen, eds. 2005. *Conditionality Revisited: Concepts, Experiences, and Lessons*. Washington, DC: World Bank.

¹⁴ World Bank. 2004. *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy*. Washington, DC.

¹⁵ Prior actions are a set of mutually agreed policy and institutional actions that are deemed critical to achieving the objectives of the program supported by a policy-based loan and that a country agrees to take before the Board approves the loan. Triggers are expected prior actions of the next subprogram in a programmatic series.

¹⁶ Conditionality has evolved into a streamlined mutual commitment device that holds governments accountable for reliably making progress toward their own poverty-reduction strategies. In the mid-1990s, the number of prior actions totaled more than 30, but it was reduced to 9 in International Development Association operations and 11 in International Bank for Reconstruction and Development operations in FY2009. See World Bank. 2009. *2009 Development Policy Lending Retrospective: Flexibility, Customization, and Results*. Washington, DC.

¹⁷ IMF. 2002. *Guidelines on Conditionality*. Washington, DC.

government's budget as a single resource pool for development partners' financial contributions. Combined with a country-owned reform process, DPL not only improved the predictability of development partner financing for the client country, but also helped facilitate pool-funding from multiple aid agencies in low-income countries. The World Bank's DPL does not impose any ceiling on its share of the total operations of the International Bank for Reconstruction and Development and the International Development Association.

10. The World Bank's reforms seemed to have increased the development effectiveness of its policy-based lending.¹⁸ Its Independent Evaluation Group rated 74% of recent development policy operations' outcomes *satisfactory* or better, and none *unsatisfactory*. DPLs have consistently been rated *satisfactory* in achievement of development outcomes during the past few years. For example, for DPLs that carry the poverty reduction support credit title, outcome ratings had increased steadily since FY2003—with 100% of them rated *satisfactory* in FY2006. Project performance was strong in FY2008, with 81% of all projects rated *satisfactory* and with DPLs receiving, on average, higher ratings than investment lending.

11. Because of the global rise of programmatic budget support driven by the World Bank's DPL, the IED conducted a special evaluation study in 2007 on policy-based lending and emerging practices in supporting reforms in DMCs.¹⁹ Based on the review of lending practices by IFIs (including those financed by ADB for the Philippines and Viet Nam), the study endorsed the effectiveness of the programmatic approach based on prior actions. It emphasized that reforms that are unavoidably complex are likely to be influenced by a wide range of exogenous factors, and a medium-term flexible approach is more likely to be effective than an inflexible conditionality-driven approach. The study concluded that conditionality should be used to monitor and manage, but not control, the reform process. It also acknowledged that ADB's continual effective dialogue during and after the program period is necessary to help sustain results and inform the next steps for supporting further reforms as needed.

C. Response to the 2008 Global Economic Crisis²⁰

12. The 2008 global economic crisis was not a typical emerging market crisis, and required IFIs to respond differently than in the past. Unlike the emerging market crises in the 1980s and the 1990s, where structural weaknesses of the developing economies led to BOP problems, the 2008 crisis originated in industrialized countries.²¹ Responding to this unprecedented situation, the IMF in 2009 introduced the flexible credit line—a new instrument that does not impose ex post conditionality as long as the country meets the rigorous prequalification criteria (practically mainstreaming the prior action approach). The IMF's flexible credit line was an effective tool for BOP support to countries outside of Asia. Three countries—Poland, Mexico, and Colombia—have accessed the new IMF instrument.

¹⁸ See World Bank. 2009. *2009 Development Policy Lending Retrospective: Flexibility, Customization, and Results*. Washington, DC.

¹⁹ ADB. 2007. *Special Evaluation Study: Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*. Manila.

²⁰ For further details on the global financial crisis, see a separate information paper (ADB. 2011. *Assessment of ADB's Crisis Response*. Manila).

²¹ While Asia was not the origin of the crisis outbreak, the current account surpluses of the East Asian economies with the rest of the world is often identified as one of the indirect causes. Policy-based lending has the potential to promote some key structural reforms to mitigate the so-called global savings glut that might have played a role in the emergence of global imbalances. These reforms may include enhancement of social safety nets and finance sector development. See ADB. 2009. *Asian Development Outlook: Rebalancing Asia's Growth*. Manila; and B.S. Bernanke. 2007. *Global Imbalances: Recent Developments and Prospects*. Board of Governors of the Federal Reserve System. Speech at the Bundesbank Lecture, Germany. 11 September.

13. ADB's response entailed flexible use of conventional program lending and mobilization of the Countercyclical Support Facility (CSF) in the amount of \$3 billion. Established as a temporary instrument for 2009–2010,²² the CSF was designed to support DMCs' fiscal stimulus at the macroeconomic level. No structural reforms at the microeconomic level were required. This feature reflected the uniqueness of this most recent crisis. It also responded to important lessons learned from the earlier Asian currency crisis, including the following: (i) once a crisis occurs, it requires macroeconomic resolutions; structural reforms at the microeconomic level have little immediate relevance, and may be counterproductive;²³ and (ii) countercyclical macroeconomic policy is needed to respond to a decline in the aggregate demand.²⁴ ADB provided \$2.5 billion in CSF loans to five DMCs (Bangladesh, Indonesia, Kazakhstan, the Philippines, and Viet Nam).²⁵ In Asia, prompt and bold fiscal stimulus by DMC authorities contributed to its recovery ahead of the rest of the world. The CSF helped facilitate this process in these countries.²⁶ The CSF expired as scheduled at the end of 2010.

14. The World Bank refined its crisis response instrument in 2009. It had initially responded to the crisis through precautionary utilization of the deferred drawdown option (DDO) introduced as part of its DPL reform in 2008.²⁷ As the adverse impacts of the crisis began to materialize, countries switched to regular DPLs for immediate disbursement. Subsequently, the World Bank board approved a revision to the special DPL crisis response, introducing greater flexibility in repayment terms and pricing. As with ADB's special program loans (SPLs), established in 1999, special DPLs had not been used since their introduction in 2005 until this recent reform took place. The 2009 revision aimed to enhance its practical relevance as a crisis response instrument by aligning pricing with the IMF.²⁸

15. In addition to the CSF, ADB used conventional program lending to support the crisis response in a creative manner. For example, when acute repercussions surfaced in the capital markets in Indonesia, ADB and the World Bank—in partnership with the governments of Australia and Japan—established the Public Expenditure Support Facility (PESF).²⁹ The PESF was designed as a contingent financing instrument, which allowed a country to exercise the

²² ADB. 2009. *Enhancing ADB's Response to the Global Economic Crisis—Establishing the Countercyclical Support Facility*. Manila.

²³ See M.Feldstein. 1998. Refocusing the IMF. *Foreign Affairs*. Vol. 77 (May/April), Issue 2, pp. 20–33.

²⁴ See discussions in J. Stiglitz. 2002. *Globalization and Its Discontents*. London: Penguin; and K. Rogoff. 2003. The IMF Strikes Back. *Foreign Policy*. Issue 134 (January/February), pp. 38–46. As Rogoff argues, preserving sufficient fiscal space during non-crisis time should be regarded as a prerequisite for expansionary crisis response. For this reason, the CSF sets a sound fiscal position and broader macroeconomic management as eligibility criteria.

²⁵ ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loans to the People's Republic of Bangladesh for the Public Expenditure Support Facility Program and the Countercyclical Support Facility Support Program*. Manila.

ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Indonesia for the Countercyclical Support*. Manila.

ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Kazakhstan for the Kazakhstan Countercyclical Support Loan*. Manila.

ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of the Philippines for the Countercyclical Support*. Manila.

ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Viet Nam for the Countercyclical Support*. Manila.

²⁶ ADB. 2010. *Countercyclical Support Facility: Annual Report 2009*. Manila.

²⁷ The DDO allows a borrower to postpone drawing a loan for a defined drawdown period after the loan agreement has been declared effective, and served as an effective contingency financing scheme during the crisis. The DDO can be activated even in non-crisis emergencies, including other forms of catastrophes such as natural disasters.

²⁸ The IMF's primary crisis window shifted from the supplementary reserve facility during the Asian currency crisis from 1997 to cheaper credit tranches in response to the global economic crisis since 2008.

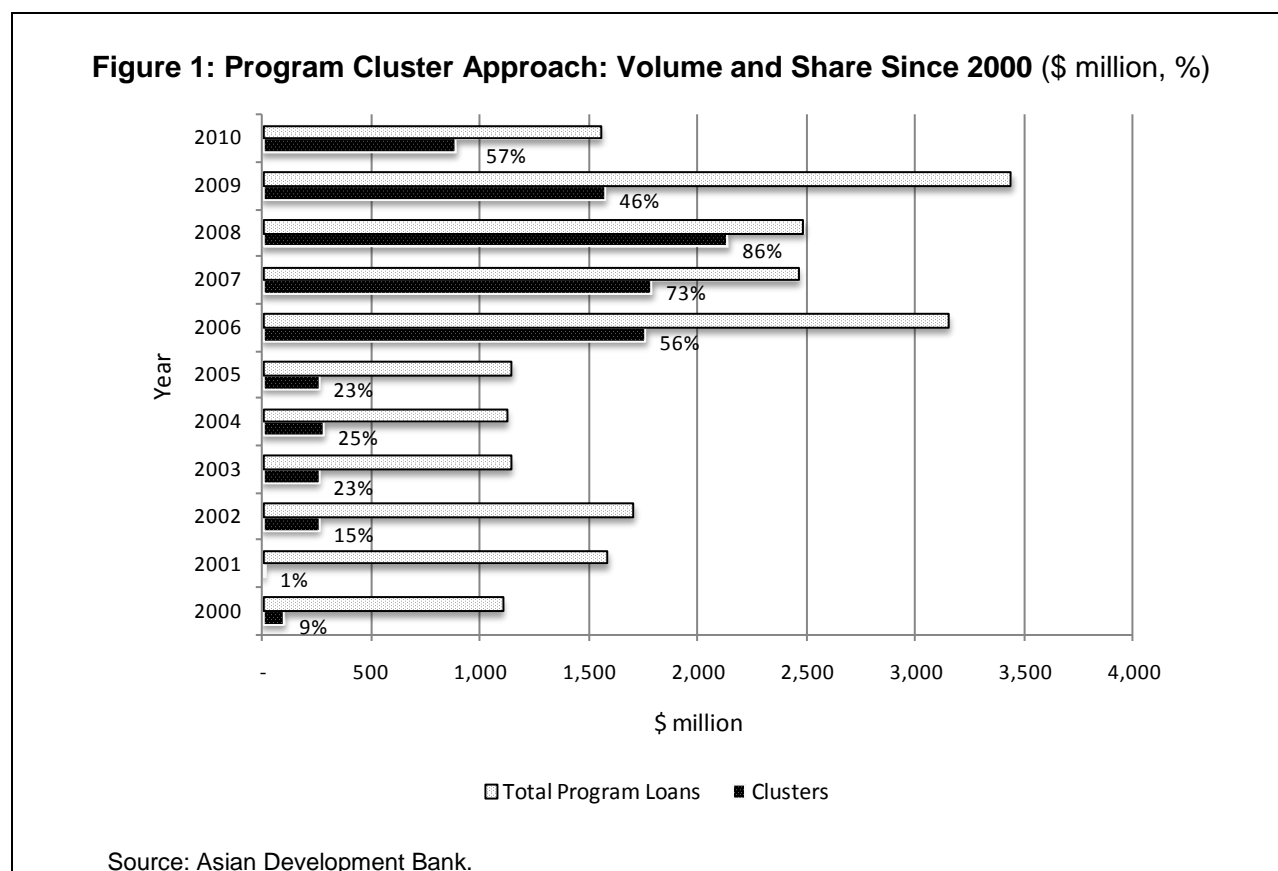
²⁹ ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan to the Republic of Indonesia for the Public Expenditure Support Facility*. Manila.

precautionary financing option (PFO)—or DDO in the case of the World Bank—when the market condition reached the triggers. By signaling the availability of development partners’ contingent support, the PESF helped revive confidence in the capital market following a sharp rise in international bond spread (by about 650 basis points in the initial phase of the crisis). With the market conditions stabilizing by mid-2009, the drawdown triggers were not exceeded and hence no disbursements were made. While the World Bank’s DDO was not meant to be a precautionary financing instrument, it played such a role and helped contain the spread of the contagion.³⁰ To enhance ADB’s capacity to provide contingency support, IED’s evaluation of ADB’s crisis response recommended the use of PFO for CSF.³¹

III. ADB’S POLICY-BASED LENDING: IMPLEMENTATION REVIEW

A. Performance in Recent Years

16. ADB is increasingly using the programmatic approach in the form of the PCA. Following the global trend, the program cluster accounted for 86% of ADB’s total program lending by 2008 (Figure 1).³² This demonstrates the relevance of the PCA introduced in the 1999 policy review as a flexible lending instrument.



³⁰ Independent Evaluation Group. 2010. *The World Bank Group’s Response to the Global Economic Crisis: Phase 1*. Washington, DC: The World Bank Group.

³¹ IED’s preliminary findings were presented at the Evaluation Cooperation Group’s special session on crisis response by MDBs held on 16 March 2011. ADB. Forthcoming. *Evaluation Study: The Asian Development Bank’s Support to Developing Member Countries in Their Response to the Global Economic Crisis of 2008–2009*. Manila.

³² The temporary decline in 2009 reflects an increase in crisis-related emergency support that took single-tranche operations without packaging them as clusters. If non-cluster operations are included, single-tranche loans accounted for 85% of the total program lending in 2009. The data does not include loans provided from the CSF.

17. Program clusters also were more successful than standard program loans. According to project completion report ratings, 85% of loans packaged as program clusters since 2000 were rated either *highly successful* or *successful*, while only 64% of program loans overall received those top ratings.³³ None of the program clusters was rated *unsuccessful* (Table 1).³⁴ The flexibility built into this programmatic approach facilitated implementation of country-owned reforms and resulted in the higher success rate. Programs with policy reforms completed before ADB's financing commitment logically should lead to better results than those that have not even completed the implementation of crucial reforms.

Table 1: Project Completion Report Rating Shares Since 2000
(%)

Rating	Program Cluster Approach	Overall Program Loans
Highly Successful or Successful	85	64
Partly Successful	15	34
Unsuccessful	0	2

Source: Asian Development Bank.

B. Underlying Challenges

18. To mainstream the programmatic approach in ADB's program lending policy, some ambiguous and possibly contradictory provisions from earlier versions need to be clarified in line with international best practices. The 1996 policy³⁵ recognizes the need to front-load key reforms through prior actions.³⁶ This is an essential element of the PCA introduced by the 1999 policy. However, the former policy also states that reforms to be supported will "normally" be forward looking and therefore retroactive financing is "generally" not necessary or appropriate. A 2007 special evaluation study cited a finding of a 2004 study³⁷ that supported the use of ex post conditionality through "single-tranche program loans that retroactively help to finance reforms," in cases where ex ante conditionality is not appropriate.

19. ADB's current practice of emphasizing the cost of adjustment as a determinant of the loan amount has been misleading. Apart from the difficulty of correctly identifying the cost of reforms,³⁸ important policy changes may not always incur costs.³⁹ Rather, regardless of the financial costs, a sound policy and institutional setting of a recipient country should be a prerequisite for receiving budgetary support. Empirical research has verified that aid inflows

³³ Of the 11 PCRs that have been validated since 2000, the rating was changed only for one sector development program and remained the same for the rest.

³⁴ The rating is based on separate assessments of four core evaluation criteria, which are then aggregated to produce the overall rating, namely: (i) relevance; (ii) effectiveness; (iii) efficiency; and (iv) sustainability.

³⁵ ADB. 1996. *Review of the Bank's Program-Lending Policies*. Manila.

³⁶ Before the 1996 policy, the 1990 policy refers to continuation of untranching programs with front-loaded reforms. See ADB. 1990. *A Review of the Bank's Program Lending Policy*. Manila.

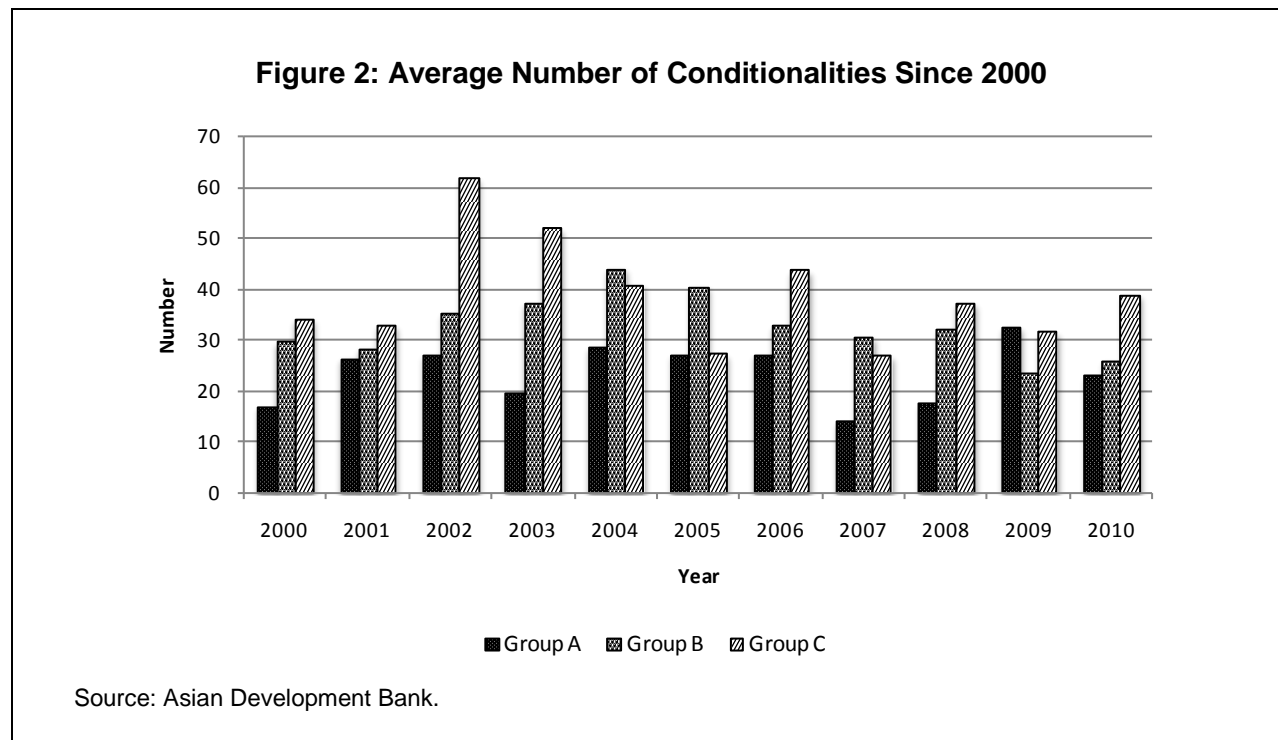
³⁷ M.G. Quibria. 2004. *OED Working Paper 1: Development Effectiveness: What Does the Research Tell Us?* Manila.

³⁸ The 1996 policy paper states, "The determination of the amount of a program loan requires the exercise of judgment."

³⁹ Many important reforms are either cost-neutral (such as regulatory reforms that do not incur expenditures directly) or even revenue-enhancing (such as the introduction of value-added taxes). The cost-neutrality or revenue-enhancing nature of the envisaged reforms should not preclude them from coverage by ADB's policy-based lending. See E. Grilli. 1991. Comments on "Projects versus Policy Reform," by Kanbur. *Proceedings on the World Bank Annual Conference on Development Economics 1990*. pp. 415–418. Washington, DC: World Bank.

work only in countries with sound policy and institutional settings.⁴⁰ The traditional concept of program lending supporting reforms, through financing the cost of adjustment, should give way to the reverse concept of reforms supporting policy-based lending and broader development financing by laying down the policy and institutional ground before ADB's financing commitment. In other words, ADB should literally provide policy-based lending rather than simply observing lending-based policy. This has been practiced partly for the performance-based allocation of the Asian Development Fund (ADF).⁴¹

20. ADB's program loans have an excessive number of conditionalities. The 1996 policy states that covenanted conditionality should be related to "essential policy objectives only." However, while the international trend has been to streamline conditionality, ADB averaged about 31 conditionalities in its program loans during 2000–2010 (Figure 2)—well above the level of the World Bank in recent years.⁴² Under the 2010 streamlined business processes, ADB introduced a requirement to undertake a problem analysis as part of the summary sector assessment linked to the report and recommendation of the President (RRP). The analysis is expected to help clients identify the most binding constraints to development and hence streamline the conditionality attached to policy-based lending.



⁴⁰ C. Burnside and D. Dollar. 2000. Aid, Policies, and Growth. *The American Economic Review*. September. pp. 847–868; and D. Dollar and L. Pritchett. 2000. *Assessing Aid: What Works, What Doesn't, and Why*. Washington, DC/New York: World Bank/Oxford University Press.

⁴¹ While country-specific triggers on policy and institutional reforms were removed from the country performance assessment for the performance-based allocation of ADF resources in 2004 (ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-Based Allocation of ADF Resources*. Manila.), they have been used increasingly for prior actions under recent single-tranche policy-based lending from ordinary capital resources and the ADF.

⁴² The 2007 special evaluation study identified overly complex policy matrixes as a weakness of ADB's policy-based lending, carried forward from the time of an earlier special evaluation study in 2001. ADB. 2001. *Special Evaluation Study on Program Lending*. Manila.

21. The 2007 special evaluation study recommended the removal of the ceiling on program lending's share of total lending. The study highlighted the need to review the current 20% moving average ceiling for program lending value to bring it more in line with DMC needs and demands for program loans. For ordinary capital resources, the policy allows possible departure in exceptional circumstances for overall program lending. However, this flexibility is not available for program loans financed by the ADF; the policy prescribes a rigid ceiling of 22.5% on a 3-year moving average. In 2009 and 2010, however, the Board granted a waiver of the ADF program lending limit for 2007–2010 to respond to the global economic crisis.⁴³ A similar response may be required to address crises in the future.

22. The 2008 special evaluation study on the Paris Declaration⁴⁴ recommended a review and amendments to ADB's program lending policy to facilitate GBS. Despite the commitment to the program-based approaches in the Paris Declaration (including pooled funding arrangements and use of country financial management systems), ADB's program lending has not emerged as an anchor for assistance from multiple aid agencies in many DMCs. Since 2000, only 13 program loans mobilized cofinancing from bilateral development partners (Table 2). Since GBS has emerged as a key development approach in the broader aid community, the use of the government's budget as a common platform for development partnership would facilitate better collaboration among development partners. At the same time, there should be further efforts to mobilize cofinancing.

Table 2: Cofinancing for ADB's Program Lending Since 2000

Financing Partner	No. of Program Loans	Amount (\$ million)
Agence Française de Développement	1	216.00
Department for International Development (UK)	1	30.00
Japan Bank for International Cooperation	2	375.00
Japan International Cooperation Agency	3	230.00
kfw Bankengruppe	3	176.37
Ministry of Foreign Affairs (Netherlands)	2	12.56
The OPEC Fund for International Development	1	15.00
Total	13	1,054.93

Source: Asian Development Bank.

23. The diversity and dynamics of the Asian economies underscore the need to retain two crisis instruments: SPL for BOP support and CSF for budget support. As the recent assessment of ADB's crisis response found,⁴⁵ an attempt to create a new instrument only after the outbreak of the next crisis will delay the vitally needed assistance. Since time is of essence in a crisis, the relevant instrument should be retained and mainstreamed so it can be mobilized immediately when required. BOP support should be maintained for crises where countries need IFI assistance because of unsustainable current account deficits.⁴⁶ At the same time, as more

⁴³ ADB. 2009. *Proposed Waiver of the Asian Development Fund Program Lending Limit for 2007–2009*. Manila; and ADB. 2010. *Proposed Waiver of the Asian Development Fund Program Lending Limit for 2008–2010*. Manila.

⁴⁴ ADB. 2008. *Special Evaluation Study: Evaluation of the Implementation of the Paris Declaration at the Asian Development Bank—A Development Partner's Study for an OECD-DAC Joint Evaluation*. Manila.

⁴⁵ ADB. 2011. *Assessment of ADB's Response to the Global Economic Crisis 2007–2010*. Manila.

⁴⁶ SPL could possibly be an appropriate mode of assistance particularly when a BOP crisis takes the form of a sovereign debt crisis. In such a situation of tight fiscal constraints, the scope for fiscal expansion, hence CSF operations, may be limited. Depending on the crisis-specific context, careful consideration needs to be exercised when design appropriate policy response and selecting the lending instrument.

DMCs record lower deficits or current account surpluses,⁴⁷ and as the recent crisis showed, the instrument for countercyclical budget support has also been gaining relevance. The World Bank Group's recent independent evaluation also noted the relevance of ADB's CSF and recommended that the World Bank introduce a similar short-term crisis response instrument aside from its permanent crisis instrument, the special DPL.⁴⁸

24. The original CSF pricing, set at 200 basis points above ADB's funding cost, generally reflected the pre-crisis credit spread on dollar-denominated offshore bonds of Asian issuers during the recent global economic crisis. For closer alignment with the IMF, the World Bank has reduced the floor pricing of its permanent crisis instrument, the special DPL, to a similar level while also leaving possibility of charging higher rates (change from a spread of 400 basis points over the London interbank offered rate [LIBOR] to 200 basis points at minimum) and enhancing flexibility for maturity-setting. Like the World Bank's special DPL, ADB's SPL is designed as an instrument to participate in international rescue packages, typically led by the IMF. However, the SPL's current fixed lending term (400 basis points over ADB's funding cost and 5-year maturity, including a 3-year grace period) would make a harmonized and coordinated approach difficult.

25. Preliminary findings from IED's real-time evaluation of ADB's crisis response highlighted the need to increase the flexibility in setting the maturity of CSF loans because of DMCs' repayment capacity, and to lengthen the maturity from the current 5 years to up to 8 years when required.⁴⁹ On the one hand, the CSF's short maturity is meant to mitigate the possible strain on ADB's risk-bearing capacity and crowding out of regular development financing. On the other hand, it could impose significant repayment pressure on borrowers when the crisis is not yet resolved. A balanced and context-specific approach would be required to determine the most desirable lending terms at the time of each future crisis.

IV. PROPOSED REFORMS TO ADB'S POLICY-BASED LENDING

A. Mainstreaming Programmatic Budget Support

26. It is proposed that ADB mainstream programmatic budget support, modeled on the World Bank's reforms in 2004, with enhanced Board oversight.⁵⁰ The programmatic approach based on prior actions has already been incorporated as the PCA in ADB's program lending policy. The PCA's sound performance has been demonstrated. In that sense, ADB's policy-based lending has substantially kept up with today's global standard among IFIs. However, the conceptual validity of the current restriction on retroactive financing of prior actions needs to be revisited. The relevant provision under the 1996 policy appears to assume that program lending

⁴⁷ Among the five regions of developing Asia, only South Asia has recorded the current account deficit in 2010, and Central Asia, East Asia, Southeast Asia, and the Pacific all recorded surplus (ADB. 2011. *Asian Development Outlook 2011: South-South Economic Links*. Manila). For further assessment of global imbalance, see ADB. 2009. *Asian Development Outlook: Rebalancing Asia's Growth*. Manila.

⁴⁸ Independent Evaluation Group. 2010. *The World Bank Group's Response to the Global Economic Crisis: Phase 1*. Washington, DC: The World Bank Group.

⁴⁹ Another important finding by both IED's real-time evaluation and the staff self-evaluation of ADB's crisis response was the need to make an incremental, crisis-related resource mobilization arrangement for the ADF to support low-income countries more effectively. Because this issue affects ADF resource implication, it requires discussions with ADF donors and goes beyond the scope of this paper. ADB. Forthcoming. *Evaluation Study: The Asian Development Bank's Support to Developing Member Countries in Their Response to the Global Economic Crisis of 2008–2009*. Manila; and ADB. 2011. *Assessment of ADB's Response to the Global Economic Crisis 2007–2010*. Manila.

⁵⁰ To enhance Board oversight early in loan processing, the Management-cleared concept paper should be circulated for information. For enhanced engagement of the Board, the loan concept paper should replace the current practice of the "informal" seminar, and should be circulated as a "formal" information paper for comments, if any, within 10 working days.

primarily finances the cost of adjustment and hence prior reform actions may incur retroactive financing.⁵¹ Conceptual relevance of this assumption would diminish in the proposed shift to GBS.

27. The policy matrix should be used as a flexible implementation guide⁵² for assessing whether intended objectives were substantively achieved, and conditionality should be streamlined. The RRP should briefly explain how ADB contributed to the design and implementation of the government-owned reform package, including technical assistance support (if applicable), and present a summary of the envisaged reform impacts.⁵³

28. The overall loan size should be guided by the development financing needs of the country. The current requirement to present a clear basis for determining the loan amount based on the overall and sector-specific requirement of the DMC is consistent with the proposed programmatic budget support approach, and should be maintained.⁵⁴ As the 1998 policy on program loan disbursements states, policy-based lending operations should focus on “whether or not the agreed conditions for policy reforms are carried out” rather than on financing their direct costs of adjustment.⁵⁵ Specific elements of a DMC’s development expenditure program to be supported by budget support need to be indicated in the development policy letter, and their indicative costs should be presented in the RRP. Where relevant, support provided by development partners other than ADB should also be mentioned.

29. Since GBS is absorbed into a DMC’s public expenditures in the form of counterpart funds of loan proceeds, fiduciary arrangements need to be in place to ensure effective utilization of overall resources through sound public financial management. Hence, knowledge of the public financial management environment in the country should be supported by up-to-date diagnostic work. Risk assessments, as mandated by the Second Governance and Anticorruption Action Plan,⁵⁶ are to be carried out at the country, priority sector, and program levels to evaluate public financial management, procurement, and corruption issues. The country-level assessments can serve as an important evaluation of country systems, and the country partnership strategy needs to describe the extent of fiduciary risks to budget support.⁵⁷ When the available analysis identifies weaknesses in the borrower’s budget management system, ADB should identify the additional steps needed to secure sound fiduciary arrangements for policy-based lending. In such a case, the policy matrix should designate conditionality for prior actions to improve budget performance, such as allocative or expenditure

⁵¹ However, proceeds of program lending financed general imports. Thus, in practice, the timing of ADB’s financing and the timing of a DMC’s reform implementation were not directly linked in many cases.

⁵² ADB. 2009. *Program Lending Policy: Clarification*. Manila.

⁵³ Appendix 4 presents a case study of good practices in ADB’s policy-based lending for structural reforms, including the initiative to enhance ADB’s value addition for policy dialogues and regulatory impact assessments at the Southeast Asia Department. This case study also describes policy-based lending for subnational governments in India. Country case studies on crisis response are included in a separate Board information paper (ADB. 2011. *Assessment of ADB’s Response to the Global Economic Crisis 2007–2010*. Manila).

⁵⁴ The loan amount should be determined individually based on country circumstances, including overall projected budgetary (or BOP-related) financing requirements, the availability of alternative financing, and debt sustainability. Where relevant, the cost of adjustment can still be counted in a development expenditure program financed by policy-based lending, but does not have to be regarded as a prime determinant of loan size.

⁵⁵ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

⁵⁶ ADB. 2006. *Second Governance and Anticorruption Action Plan (GACAP II)*. Manila.

⁵⁷ To this end, the public expenditure and financial accountability assessment could be a good point of reference where available. The public expenditure and financial accountability program was founded in December 2001 as a multi-donor partnership to strengthen recipient and donor ability to (i) assess the condition of country public expenditure, procurement, and financial accountability systems; and (ii) develop a practical sequence of reform and capacity building actions.

efficiency. For environmental and social safeguards, the Safeguard Policy Statement's provisions on program lending should apply.⁵⁸

B. Enhancing Crisis Response

30. ADB's SPL for BOP support should be renamed a special policy-based loan (SPBL). To facilitate close coordination among IFIs, its lending term should be more closely aligned with that of the World Bank's special DPL and the IMF's BOP support. This will require adjustments to its pricing basis from the current fixed level of LIBOR plus 400 basis points, while allowing for longer maturity. Given the relevance of budget support in responding to crises in Asia, the CSF should be mainstreamed as ADB's permanent lending instrument. As IED's evaluation recommends, a longer maturity of up to 8 years may also be adopted for CSF loans on a case-by-case basis depending on the crisis situation (including its severity and market conditions), country-specific considerations (including the borrower's debt repayment capacity), and ADB's risk-bearing capacity.

31. From these considerations more flexible lending terms—the pricing base of LIBOR plus 200 basis points at a minimum and a maturity of 5–8 years with the grace period of up to 3 years—are proposed for ADB's SPBL and CSF. The flexible approach would allow ADB to determine the most suitable lending term at the time of future crises. At any rate, incremental resource mobilization for the SPBL and CSF should be permitted exceptionally during a crisis and only to the extent that it does not hinder ADB's risk-bearing capacity.⁵⁹ RRs for SPBL and CSF operations should justify the proposed lending terms with respect to not only the crisis- and country-specific contexts but also the impact on ADB's risk bearing capacity. To this end, the current SPL requirement to undertake a complete analysis of the impact on ADB's relevant financial indicators and discussion on the measures to ensure consistency with ADB's financial policy should be strictly adhered to and also applied to the CSF.⁶⁰

32. As was the case for PESF for Indonesia, the PFO can be implemented within ADB's existing policy for policy-based lending, and may be executed when the context warrants contingent support under the CSF.

V. TRANSITION AND REVIEW ARRANGEMENTS

33. The proposed mainstreaming of programmatic budget support requires the indication of specific elements of the development expenditure program in a DMC's development policy letter, and sufficient transition time should be secured for loans currently being processed. To allow for the necessary adjustments, the reforms to ADB's policy-based lending are proposed to take effect 3 months after Board approval. All RRs to be circulated to the Board on or after this date should reflect the new requirement.⁶¹

34. The staff should monitor the implementation of the proposed reforms to ADB's policy-based lending. At the same time, further research on the recent global economic crisis from within ADB or elsewhere may possibly lead to additional findings on its cause and appropriate policy responses, and the staff should make continuous efforts to keep up with the latest

⁵⁸ ADB. 2009. *Safeguard Policy Statement*. Manila. Strategic environmental assessment may be usefully applied where appropriate.

⁵⁹ The minimum long-term equity-to-loan ratio of 26% is expected to be preserved.

⁶⁰ As of 31 December 2010, the only provision potentially available for future special policy-based lending while maintaining ADB's prescribed equity-to-loan ratio was \$500 million remaining as the CSF's unutilized balance.

⁶¹ Likewise, loan concept papers cleared by Management on or after this date should be circulated to the Board as formal information papers.

conceptual development related to PBL operations. ADB will review the implementation of the PBL policy, about 5 years after the Board approval.

VI. RECOMMENDATIONS

35. The President recommends that the Board approve the following reforms to ADB's program lending policy.

- (i) Mainstreaming the programmatic budget support through
 - (a) formally referring to program lending as policy-based lending (and, accordingly, PCA as a programmatic approach);
 - (b) removing the restriction on retroactive financing under policy-based lending; and
 - (c) determining the overall loan size based on the development financing needs of a country, with reference to specific elements of the development expenditure programs supported by the budget support (that may not include the costs of adjustment directly related to implementation of the envisaged reforms) and, where relevant, support provided by other development partners.
- (ii) Enhancing crisis response capacity through
 - (a) changing the pricing and terms of SPLs to comprise interest rates set at a minimum spread of 200 basis points over LIBOR, a rebate or surcharge reflecting the cost of funds, maturity of 5–8 years including a grace period of up to 3 years, and a commitment charge at 75 basis points per year on the undisbursed loan balance; and renaming the SPL as the SPBL; and
 - (b) mainstreaming the CSF, with features presented in para. 14 (ii)–(ix) of Enhancing ADB's Response to the Global Economic Crisis—Establishing the Countercyclical Support Facility (footnote 22), as ADB's permanent lending instrument with the pricing and terms scheme equivalent to the SPBL.

EVOLUTION OF THE ASIAN DEVELOPMENT BANK'S PROGRAM LENDING POLICY

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Objectives	To finance importation of essential production inputs to relieve constraints on utilization of existing capacity due to a shortage of foreign exchange	Scope of input financing enlarged to include modernization or rationalization of existing capacities	Medium-term broad-based sector development Strengthening sector policy framework	Integrated approach to sector development	Support for short-, medium-, and long-term reform Exceptional large-scale crisis response as part of an international rescue package	Mainstreaming medium-term programmatic budget support Enhancing short-term crisis response
Focus	Industry and sector activities that augment the productivity of the agriculture sector	No substantive change from 1978 focus	Expanding focus from agriculture to other sectors including manufacturing, power, transport, social infrastructure, and finance	Introduction of a modified program lending instrument combining investment and policy components: the sector development program (SDP). The investment component is particularly applicable to physical and social infrastructure.	Introduction of the program cluster approach (PCA) to enhance flexibility and extend the time frame. Introduction of the special program loan (SPL) for crisis response	Programmatic budget support in the name of policy-based lending Mainstreamed countercyclical support facility (CSF) for fiscal stimulus
Eligibility Criteria	Inability to finance essential inputs because of foreign exchange shortage	Expanded criteria to include policy dialogue with ADB on sector facilities, institutions, and long-term	Dropped requirement that the balance of payments (BOP) needs to be demonstrated in	Eligibility to depend on implementation experience with past program loans as well as	For PCA: Need to package a set of reforms in a flexible manner	Development financing needs of a country Sound public financial

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
	<p>Program for efficient utilization of production capacity</p> <p>Borrower to provide financing beyond the period of Asian Development Bank (ADB) financing</p> <p>Compatibility of ADB-assisted program with International Monetary Fund activities and/or program</p>	<p>development</p> <p>Dropped requirement of borrower to provide continued funding beyond the period of ADB financing</p>	<p>terms of an inability to finance essential inputs</p> <p>Added requirement of development policy letter that reflects proposed sector policy reforms, investment plans, and institutional developments</p>	<p>with policy conditions attached to investment loans in the developing member country (DMC) and sector concerned</p>	<p>For SPL: (i) crisis situation, (ii) large unanticipated lending requirements, (iii) internal rescue efforts, (iv) distinction from regular program lending, and (v) limited to countries for ordinary capital resources (OCR) support</p>	<p>management</p> <p>For CSF: (i) adverse crisis impacts, (ii) planned countercyclical development expenditures, and (iii) sound pre-crisis macroeconomic management</p>
Design						
Sector Study	<p>None, but a sector program for production efficiency is a prerequisite</p>	<p>Analyze sector management and development issues, including those relating to institution building, through technical assistance (TA)</p>	<p>Sector analysis covering</p> <p>(i) adequacy of producer incentives,</p> <p>(ii) degree of sector reliance on market forces, and</p> <p>(iii) level and composition of sector investment program</p>	<p>Sector study a prerequisite for SDP covering</p> <p>(i) policy issues,</p> <p>(ii) social analysis,</p> <p>(iii) environmental issues,</p> <p>(iv) capacity building requirements, and</p> <p>(v) survey of private sector needs and constraints</p>	<p>No change</p>	<p>No change</p>

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Poverty Impact Assessment	None	None	Develop programs to offset the social costs of adjustment	Poverty impact assessment based on prescribed methodology	No change	No change
Environmental Assessment	None	None	None	None	None	Program lending provisions of the Safeguard Policy Statement (2009) are applicable.
Conditionality	Policy content of loan covenants limited	No substantive change	Key elements of sector program assistance to be monitored through tranches. Conditionality of the disbursement loan tranches should be realistic, realizable, and few in number.	Covenanted conditionality should relate to essential policy objectives only.	For PCA: Open-ended design For SPL: Not all structural reforms beneficial in the long run should be undertaken in the midst of a crisis	Use of the policy matrix as a flexible implementation guide rather than as a way to monitor and control fulfillment of conditionality Reinforce country ownership Prior actions as the norm For CSF: No structural reform conditionality required

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Quantification of Adjustment Costs and Development Impact	None	None	Sector programs to include sector objectives and policies, and where possible to be expressed in quantitative terms	Recognizes that it is not easy to precisely estimate the net fiscal cost of a reform program but recommends that systematic efforts be made to identify and quantify major short- or medium-term costs	Necessary to continue to maintain a pragmatic approach to the link between loan size and adjustment cost To the extent possible, identify the cost of policy change	Cost of adjustment should not be a prime determinant of loan size
Tranches	None	None	Normally two tranches over 12–18 months	Balanced distribution of release conditions among program loan tranches	For PCA: Departure from the traditional multitranche approach; programmatic approach introduced	ADB's program lending policy allows for both multitranche and single-tranche loans. For the programmatic approach: There may be a series of subprograms, each designated as a fully front-loaded, single-tranche intervention.

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Capacity Building	Institutional deficiencies to be rectified through TA attached to the program loan	No change	No change	SDP modality provides for a TA component designed to address institutional issues and capacity building	No change	No change
Counterpart Funds	While a broad indication of the developmental use of counterpart funds generated by program loans may be indicated in the relevant loan agreements, ADB control over the use of these funds should be exercised flexibly.	No change.	On a case-by-case basis, counterpart funds may be designated for the development needs of the concerned sector.	Where shortfalls in the allocation of development or operating expenditures to the sector are identified, matching expenditure commitments from the borrower may be obtained in exchange for the counterpart funds generated. These commitments will take the form of policy covenants.	Country-specific circumstances need to be taken into account. Rigid rules are not possible for use of counterpart funds.	For budget support, counterpart fund shall be used for general budget purposes, and fiduciary arrangement needs to be in place.

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Performance Indicators	Not discussed	Not discussed	Sector program assistance should be designed so that key elements are monitored.	Logical framework to be prepared for all programs designed so that key loans and SDPs, setting out, among other things, monitorable targets for program activities, outputs, and objectives	For PCA: (i) policy indicators, (ii) ownership and capacity indicators, and (iii) outcome indications	No change
Limits on Amount of Program Lending	Overall: 5% of total lending Country: 10%	Overall: 7.5% Country: 20%	Overall ceiling: 15% calculated on a 3-year moving average basis Dropped country ceiling	Sub-ceiling on Asian Development Fund (ADF) program lending: 22.5% If the SDP concept proves successful and becomes widely used to promote sector policy reforms, a relaxation of the ceiling could be considered during the next review of program lending policies.	For regular program lending: 20% (under normal circumstances) of the total lending on a 3-year moving average basis. No change for ADF. For SPL: Exemption from counting towards the ceiling on regular program lending	No change

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Loan Size	Partly determined by country ceiling	Partly determined by country ceiling	In the absence of a country ceiling, the amount of program assistance would continue to be related to the size of the lending program in the DMC, scope of the program, and sector-specific considerations.	Based on judgment, taking into account short- to medium-term costs of the program (in fiscal and/or BOP terms), the strength of the reform package, importance of the sector, and size of the lending program in the DMC	No change	The overall loan size for budget (or BOP) support to be determined based on the development financing needs of a country
Program Period	2 years	3–5 years	No change	No change	For PCA: 4–7 years	No change
Disbursement	Disbursed against foreign expenditures relating to previously identified materials and equipment	No change	Disbursed against a positive list of eligible imports relating to the largest sector or a negative list if the involved sector relates to the entire economy	No change	No change: fast-disbursing, while allowing a longer time horizon to match policy delivery capacity and its buildup over time	A precautionary financing option stated

Features	Year of Review					
	1978	1983	1987	1996	1999	2011
Terms	<p>ADF: 25 years maturity and 8 years grace (different from project loans)</p> <p>OCR: 15 years maturity and 3 years grace</p>	<p>ADF: standard loan terms applicable to projects (40 years maturity and 10 years grace)</p> <p>OCR: no change</p>	<p>ADF: no change</p> <p>OCR: no change</p>	<p>ADF: no change^a</p> <p>OCR: no change</p>	<p>Standard program lending: no change</p> <p>Special program lending: 400 basis points above the London interbank offered rate (LIBOR), 5-year maturity including a 3-year grace period</p>	<p>Standard policy-based lending: no change</p> <p>Special policy-based lending and CSF: 200 basis points at minimum over LIBOR, rebate or surcharge reflecting cost of funds, maturity of 5–8 years including a grace period of up to 3 years, and commitment charge at 75 basis points</p>

^a In December 1998, the Board approved the reintroduction of differentiation in loan terms between project and program loans. For program loans, maturity is 24 years and the grace period is 8 years. The corresponding terms for project loans are 32 years for maturity and 8 years for the grace period.

**POLICY-BASED LENDING INSTRUMENTS
OF OTHER INTERNATIONAL FINANCIAL INSTITUTIONS**

Institutions	Facilities
Inter-American Development Bank (IDB)	<p>Policy-based loans (PBLs). These support institutional and policy changes at the sector or subsector level through fast-disbursing funds. At the request of the borrower, a sector adjustment loan may include an investment component, in which case it becomes a hybrid loan.</p> <p>PBLs do not require counterpart funding. They are available from IDB's Single Currency Facility in US dollars, euros, yen, and Swiss francs. Local currency loans are also available, provided that there is a source for that currency in the swap or bond markets. In each currency, the borrower can choose between two interest rate options:</p> <ul style="list-style-type: none"> (i) Pool-based adjustable lending rate (ADJ SCF): The interest rate is tied to the average cost of a pool of medium- to long-term borrowings in each loan currency plus IDB's standard lending spread for that semester, which is reset semiannually on 1 January and 1 July. The amortization period may be from 15 to 25 years, including a grace period of 5.5 years. (ii) LIBOR-based lending rate (LIBOR SCF): The interest rate is based on 3-month London interbank offered rate (LIBOR) in the loan currency, plus a cost margin (which includes the IDB's weighted average cost margin net of any risk mitigation costs or gains), plus IDB's standard lending spread. IDB resets its LIBOR SCF rate quarterly. The amortization period is the same as in the ADJ SCF.
International Monetary Fund (IMF)	<p>Stand-by arrangement (SBA). The bulk of IMF assistance to middle-income countries is provided through SBAs. The SBA is designed to help countries address short-term balance of payments problems. Program targets are designed to address these problems, and IMF disbursements are made conditional on achieving these targets. The length of an SBA is typically 12–24 months, and repayment is due within 3.5–5 years of disbursement. SBAs may be provided on a precautionary basis—where countries choose not to draw upon approved amounts but retain the option to do so if conditions deteriorate—both within the normal access limits and in cases of exceptional access. The SBA provides for flexible phasing, with front-loaded access where appropriate.</p> <p>Flexible credit line (FCL). The FCL is for countries with very strong fundamentals, policies, and track records of policy implementation; it is particularly useful for crisis prevention purposes. FCL arrangements are approved for countries meeting preset qualification criteria. The length of the FCL is either 1 year, or 2 years with an interim review after 1 year. The repayment period is the same as for the SBA. Access decisions are based on individual country financing needs. The FCL is available in a single up-front disbursement rather than phased. Disbursements under the FCL are not conditioned on implementation of specific policy understandings as is the case under the SBA. A country may draw on the credit line at the time it is approved, or it may be treated as precautionary.</p> <p>Precautionary credit line (PCL). This new crisis prevention instrument is designed for countries with sound fundamentals and policies, but moderate vulnerabilities. Like with the FCL, approval of PCL arrangements is based on qualification. The PCL features streamlined ex-post conditionality (at a minimum monitored through semiannual program reviews) focused on reducing any remaining vulnerabilities identified in the qualification assessment. Access under the PCL arrangements is front-loaded with up to 500% of quota made available on approval of the arrangement and up to a total of 1,000% of quota after 12 months.</p> <p>Extended fund facility (EFF). This facility was established in 1974 to help countries address longer-term balance of payments problems requiring fundamental economic reforms. Arrangements under the EFF are thus longer than SBAs—usually 3 years. Repayment is due within 4.5–10 years from the date of disbursement.</p> <p>Extended credit facility (ECF). This facility succeeds the poverty reduction and growth facility as the IMF's main tool for providing medium-term support to low-income countries (LICs) with protracted balance of payments problems. Financing under the ECF carries a zero interest rate, with a grace period of 5.5 years, and a final maturity of 10 years.</p>

Institutions	Facilities
	<p>Standby credit facility (SCF). This facility provides financial assistance to LICs with short-term balance of payments needs. The SCF replaces the high-access component of the exogenous shocks facility, and can be used in a wide range of circumstances, including on a precautionary basis. Financing under the SCF carries a zero interest rate, with a grace period of 4 years, and a final maturity of 8 years.</p> <p>Rapid credit facility (RCF). This facility provides rapid financial assistance with limited conditionality to LICs facing an urgent balance of payments need. The RCF streamlines the IMF's emergency assistance to LICs and can be used flexibly in a wide range of circumstances. Financing under the RCF carries a zero interest rate, has a grace period of 5.5 years, and a final maturity of 10 years.</p> <p>LICs may borrow on concessional terms through the ECF, SCF, and RCF. Non-concessional loans are provided mainly through SBAs, FCL, and EFF (which is useful primarily for longer-term needs). All non-concessional facilities are subject to the IMF's market-related interest rate, known as the rate of charge, and large loans (above certain limits) carry a surcharge. The rate of charge is based on the special drawing rights interest rate, which is revised weekly to take account of changes in short-term interest rates in major international money markets. The amount that a country can borrow from the IMF, known as its access limit, varies depending on the type of loan, but is typically a multiple of the country's IMF quota. This limit may be exceeded in exceptional circumstances.</p>
World Bank	<p>Development policy lending. This is rapidly disbursing policy-based financing, which the World Bank provides in the form of loans or grants to help a borrower address actual or anticipated development financing requirements that have domestic or external origins. The World Bank may provide development policy lending to a member country or to a subnational division of a member country. A development policy operation may include one or more options that have specific requirements, listed as follows.</p> <p>Deferred drawdown option (DDO). A DDO allows a borrower to postpone drawing down a loan for a defined period after the loan agreement has been declared effective. A DDO is included within the country assistance strategy envelope and does not constitute a window for additional resources. Development policy loans with a DDO carry a 0.75% front-end fee, plus a 0.50% renewal fee.</p> <p>Special development policy lending. For countries eligible for assistance from the International Bank for Reconstruction and Development (IBRD) that are approaching or are in a crisis with substantial structural and social dimensions, and that have urgent and extraordinary financing needs, the World Bank may, on an exceptional basis, provide special development policy lending beyond the level set out in the country assistance strategy. The magnitude of such financial support is subject to the availability of adequate IBRD financial and risk-bearing capacity. The repayment and pricing terms include (i) a grace period of 3–5 years with a final maturity of 5–10 years, (ii) a minimum fixed spread over the LIBOR of 200 basis points, and (iii) a front-end fee of 100 basis points.</p> <p>Supplemental financing. In exceptional cases, the World Bank may provide supplemental financing—a separate loan additional to the loan provided for in the original loan agreement—in support of the objectives of a program under implementation. Supplemental financing may be provided for a development policy operation for which an unanticipated gap in financing jeopardizes a reform program that is otherwise proceeding on schedule and in compliance with the agreed policy agenda.</p> <p>Debt and debt service reduction. Under certain circumstances, the World Bank may be called upon to use its financial resources in support of loan restructuring, equity conversion, or interest rate swaps. Lending for debt and debt service reduction helps heavily indebted countries reduce commercial debt and debt service to a manageable level, as part of a medium-term financing plan in support of sustainable growth. The focus is on rationalizing the country's external commercial debt, by either converting it to lower-interest instruments or buying it back at a discount. Funds are disbursed against tendered commercial debt for buy-backs or for purchasing acceptable collateral, to reduce principal and interest payments on new instruments issued in exchange for existing debt.</p>

Institutions	Facilities
	<p>IBRD lending rates and loan charges. Pricing for loans from the IBRD is based on a floating market rate, usually 6-month LIBOR, plus a spread that is either fixed over the life of the loan or variable from one semester to the other. The applicable spread will vary according to average repayment maturity. In addition to the spread over LIBOR, the World Bank charges a front-end fee.</p>

Sources: (i) IDB. Policy-Based Loans. <http://www.iadb.org/en/about-us/idb-financing/policy-based-loans-pbls,6057> (accessed February 2011). (ii) IMF. 2010. *Fact Sheet: IMF Lending*. Washington, DC; and (iii) World Bank. 2004. *OP 8.60: Development Policy Lending*. Washington, DC.

PROGRAM LENDING RETROSPECTIVE¹

A. Introduction

1. The Asian Development Bank (ADB) introduced program lending in 1978. Program lending was reviewed in 1983, 1987, 1996, and 1999 to address the evolving needs and challenges faced by ADB's developing member countries (DMCs), as well as to adapt to the changing global economy. These reviews resulted in wide ranging changes in ADB's program lending policy, including the introduction of three new instruments—the sector development program loan² (1996 review), and the program cluster and special program loan³ (1999 review).

2. Following the 1999 review of program lending, this retrospective presents an assessment of ADB's policy-based lending operations for 2000–2010. An analysis of the trends in overall program lending levels, country classification, regional and sectoral distribution of program loans, loan processing times, and the success rates of program loans for that period are presented in this appendix.

B. Trends in Program Lending, 2000–2009

3. **Overall trends.** Although project lending continues to be ADB's primary mode of lending, program loans have been used increasingly by DMCs to support policy and sector reforms. During 2000–2010, 178 program loans were approved totaling \$20.9 billion (Table A3.1).⁴ Against overall ADB sovereign lending during that period, program loans constituted about 20% in terms of number of loans and 26% in terms of value.

Table A3.1: Program Lending in ADB Operations, 2000–2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total
ADB												
number (loans)	86	72	85	80	74	65	71	74	83	104	105	899
value(\$ million)	5,431	5,301	5,548	5,918	4,947	5,248	6,814	8,865	8,602	12,787	10,415	79,875
of which program loans:												
number (loans)	12	19	17	14	16	11	16	13	16	25	19	178
value(\$ million)	1,102	1,583	1,702	1,140	1,121	1,144	3,149	2,460	2,485	3,437	1,552	20,874
(percentages)												
number	14	26	20	18	22	17	23	18	19	24	18	20
value	20	30	31	19	23	22	46	28	29	27	15	26

ADB = Asian Development Bank.

Source: ADB.

4. During 2000–2010, ADB's program lending increased more rapidly than its total sovereign operations. Program lending grew at an average annual rate of 9.5% in terms of number of loans and 15.6% in terms of value, while total sovereign lending grew at an average annual rate of 2.8% in terms of number and 8.6% in terms of value. ADB

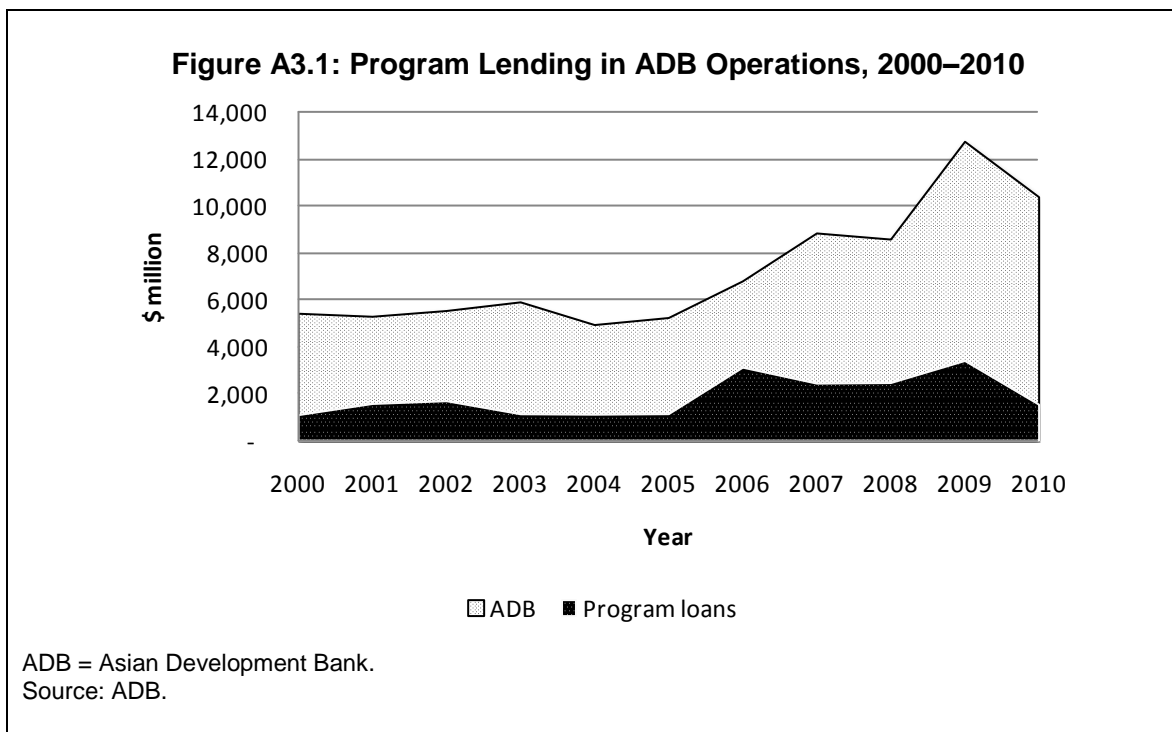
¹ This retrospective does not cover the Countercyclical Support Facility (CSF) introduced by ADB in 2009. See ADB. 2010. *Countercyclical Support Facility: Annual Report 2009*. Manila.

² ADB. 1996. *Review of ADB's Program Lending Policies*. Manila.

³ ADB. 1999. *Review of ADB's Program Lending Policies*. Manila.

⁴ Includes the policy loan component of sector development programs.

approves an average of 16 program loans per year at an average total value of \$1.9 billion.



5. **Policy ceiling.** ADB's program lending policy framework includes a policy ceiling limiting program lending to a small proportion of ADB's total lending. The 1999 program lending policy review (footnote 3) established that total annual program lending for standard program loans, the policy-based component of sector development program loans, and policy-based guarantees was not to exceed 20% of total lending on a 3-year moving average basis. This 20% ceiling does not include special program loans that were designed to help DMCs in crisis situations with large-scale rescue packages. The 1999 program lending policy provided for flexibility in the interpretation of the policy ceiling and specifically referred to a 20% limit under normal circumstances. Similar lending from the Asian Development Fund (ADF) is subject to a ceiling of 22.5% of total ADF lending.

6. The program lending policy ceiling of 20% has been often exceeded since the first 3-year application of the ceiling (2000–2002). In 2006, the share of program lending to total sovereign lending rose to 32% from the previous year's share of 21% because of a surge in ordinary capital resources (OCR) lending to India, Indonesia, Pakistan, and the Philippines. These four DMCs constituted 94%, or nearly \$3 billion, of program loan approvals in 2006. The same trend was observed in 2007, and was increasing further in 2008 at 33%. In 2009, the 3-year average ADF program lending⁵ for 2007–2009 increased to 29.0%, well above the ceiling of 22.5%. This was expected because of the high level of ADF program lending in 2008, caused by some exceptionally large loans to Pakistan, and 2009, because of the global economic crisis. The Board was informed in

⁵ Excludes ADF grants.

July 2009; a waiver of the ADF program lending limit for 2007–2009 was approved by the Board in November 2009.⁶ Another waiver was approved in December 2010.⁷

Table A3.2: Program Lending in ADB Operations, 2000–2010
(Based on 3-year Moving Average)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average
ADB										
number (loans)	81	79	80	73	70	70	76	87	97	79
value(\$ million)	5,427	5,589	5,471	5,371	5,669	6,976	8,094	10,085	10,601	7,031
of which program loans:										
number (loans)	16	17	16	14	14	13	15	18	20	16
value(\$ million)	1,462	1,475	1,321	1,135	1,804	2,251	2,698	2,794	2,491	1,937
(percentages)										
number	20	21	20	19	20	19	20	21	21	20
value	27	26	24	21	32	32	33	28	24	27

ADB = Asian Development Bank.

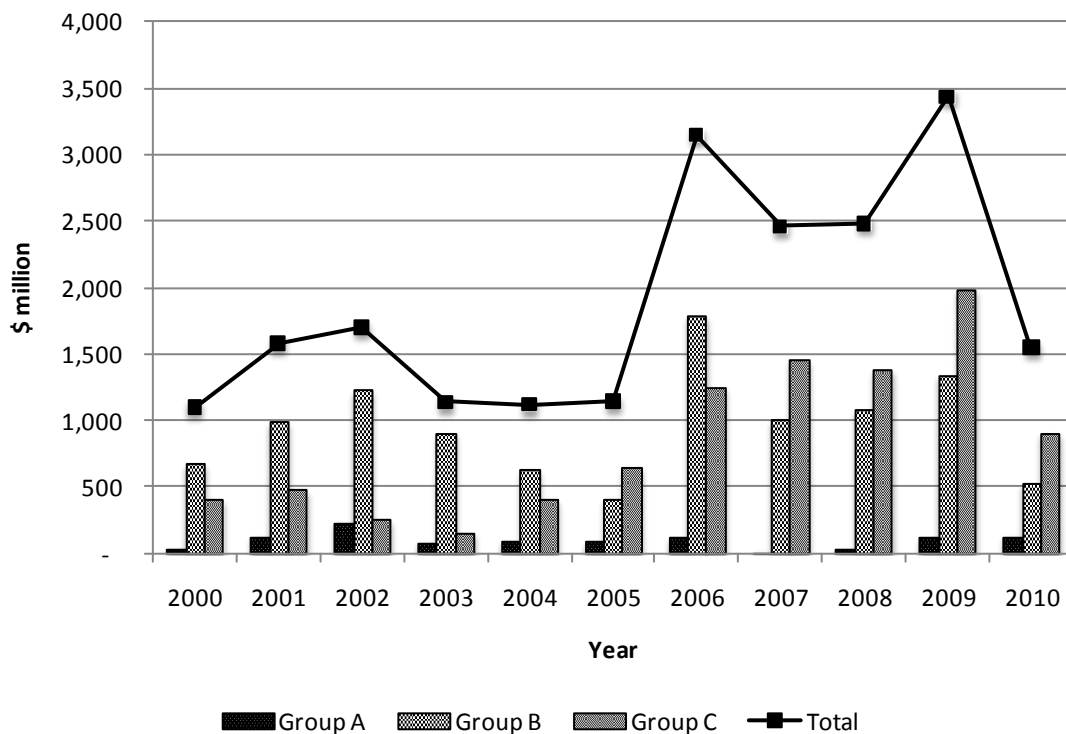
Source: ADB.

7. **Country classification.** Group B countries have received a significant portion of program lending, averaging 53% per year, compared with Group A at 6% and Group C at 42% (Figure A3.2). Of the 11 DMCs classified as Group B, Bangladesh, India, Pakistan, Sri Lanka, and Viet Nam received 48% of total program loans. The aggregate share of total program lending for Group C DMCs, such as Indonesia and the Philippines, is 44%. Afghanistan from Group A accounted for 1.3% of total program lending. Thailand (\$300 million) and Samoa (\$16 million) received their first program loans since the late 1990s.

⁶ ADB. 2009. *Proposed Waiver of the Asian Development Fund Program Lending Limit for 2007–2009*. Manila.

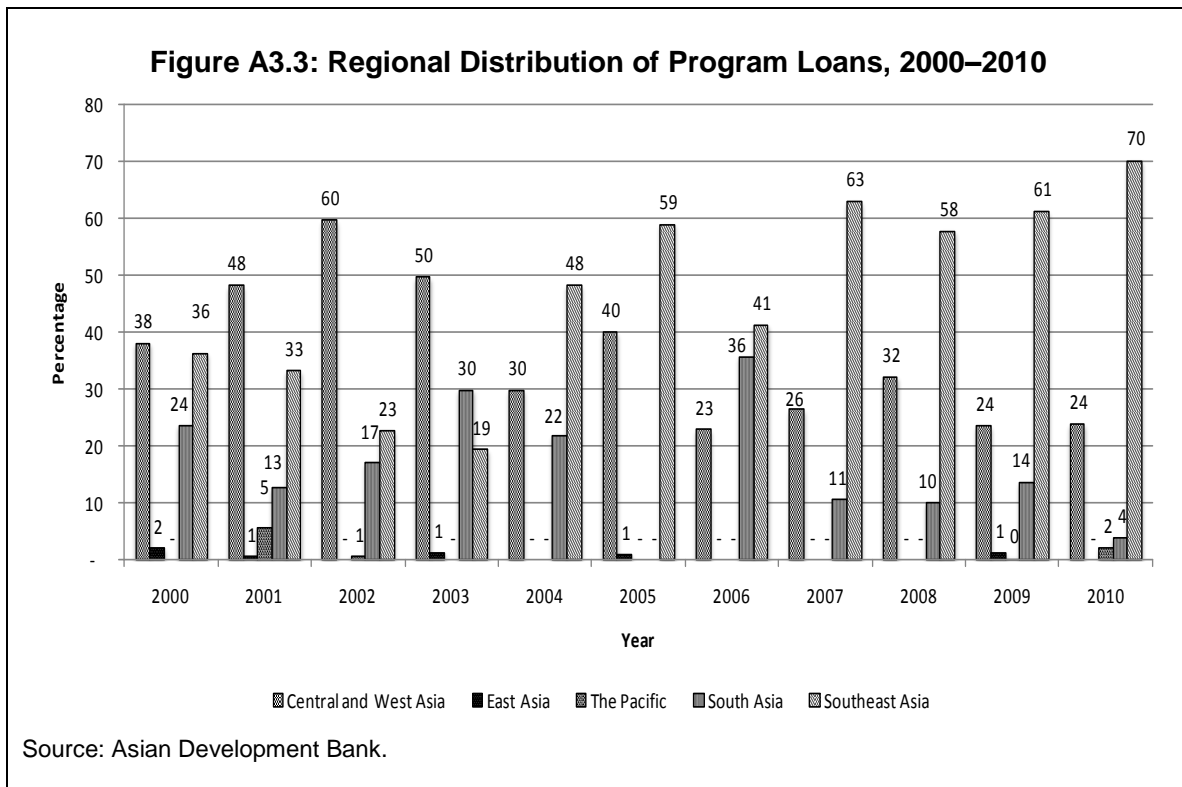
⁷ ADB. 2010. *Proposed Waiver of the Asian Development Fund Program Lending Limit for 2008–2010*. Manila.

Figure A3.2: Distribution of Program Loans by Developing Member Country Classification, 2000–2010



Source: Asian Development Bank.

8. **Regional distribution.** From 2000–2010, Southeast Asia has received an average of 47% of total program lending annually, followed by Central and West Asia at 36% and South Asia at 16% (Figure A3.3). East Asia and the Pacific have average shares of about 1% to total program lending. The same trend can be observed in OCR lending. Of OCR program loans, 53% went to Southeast Asia, 31% to Central and West Asia, and 15% to South Asia. Indonesia and the Philippines were responsible for the large portion of program lending to Southeast Asia. Pakistan received the bulk of program lending to Central and West Asia. India received 61% of program lending to South Asia, followed by Bangladesh with 21%. On the other hand, 50% of ADF lending went to Central and West Asia and 23% each to South Asia and Southeast Asia. Of total ADF program lending, 39% went to Pakistan, followed by Viet Nam in Southeast Asia with 16%, and Bangladesh in South Asia with 13%.

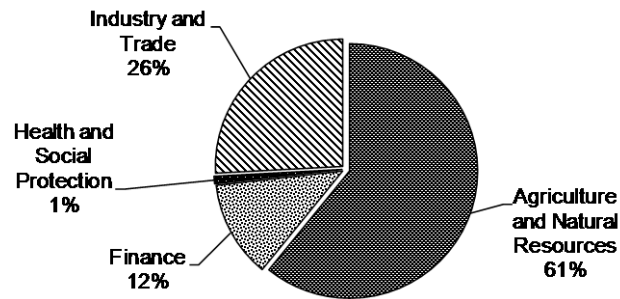


9. **Distribution by sector.** In its early years, program lending primarily provided short-term financing, mainly for agricultural inputs. In the 1980s, most of ADB's program lending went to only four sectors⁸—agriculture and natural resources (61%), industry and trade (26%), finance (12%), and health and social protection (1%) (Figure A3.4). More ADF resources went to agriculture (68%) than OCR resources (51%). The share of total program lending of OCR (26%) and ADF (25%) resources to industry and trade were comparable. A larger share of OCR resources went to finance at 23% compared to 5% from ADF.

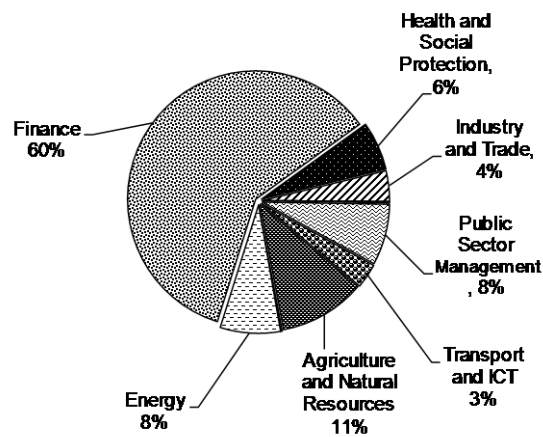
⁸ Based on 2009 sector classification.

Figure A3.4: Trends in Sector Coverage of Program Loans

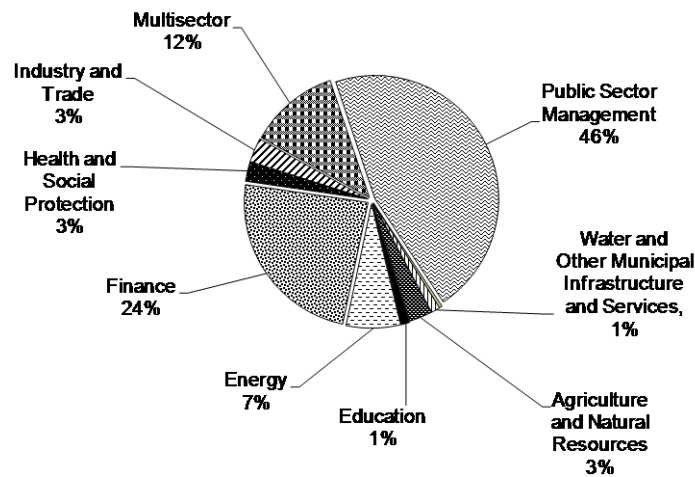
A. 1980–1989



B. 1990–1999



C. 2000–2010



Source: Asian Development Bank.

10. In the 1990s, the focus of program lending shifted from agriculture to finance, which received 60% of total program lending (Figure A3.4). The share of agriculture to total program lending declined sharply from 61% to 11%. The share of industry and trade also fell steeply from 26% to 4%. In this period, program lending was modest to other sectors, such as energy and public sector management, both of which received 8% of program loans. Other new sectors that began utilizing program lending included transport and information and communication technology (3%), education (0.2%), and multisector (0.2%). During this period, 67% of OCR program lending went to finance, while 45% of ADF program lending went to agriculture. ADF program lending to the finance sector remained significant at 22%.

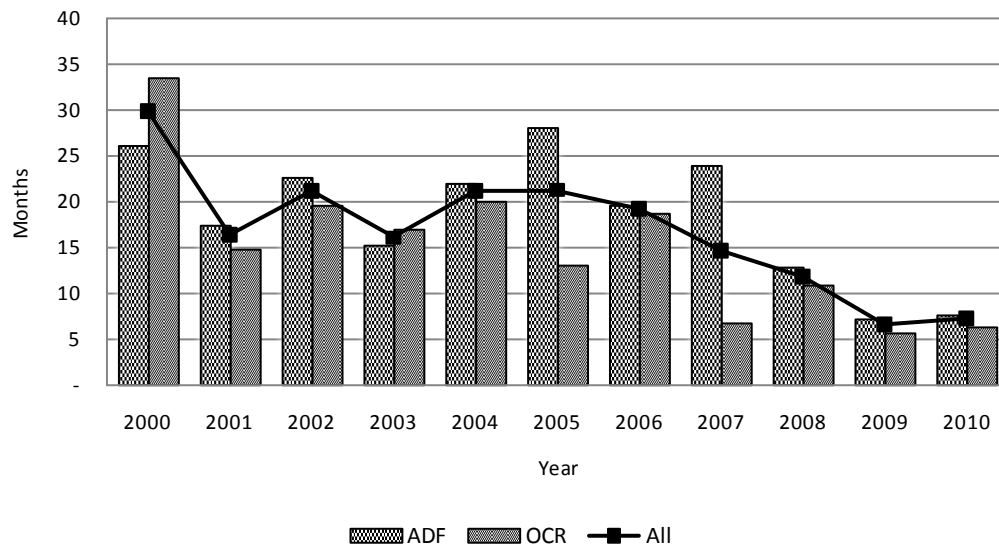
11. From 2000–2010, public sector management's share of program lending increased dramatically from 8% in the previous decade to 46%. Public sector management received a sizeable portion of both OCR (48%) and ADF resources (38%). The finance sector still received a substantial share of OCR (25%) and ADF resources (19%) in this period. The share of multisector program loans increased significantly from 0.2% in the 1990s to 12% in the past 11 years. In 2000–2010, program lending expanded to infrastructure, with the energy sector sustaining its 7% share and the addition of water and other municipal infrastructure and services.

12. **Program loan delivery time.** Processing time for program loans has been decreasing—from an annual average of 30 months in 2000 to 7 months in 2010 (Figure A3.5).⁹ Processing time during 2000–2010 averaged 17 months. The same trend can be observed for OCR and ADF program loan processing times. Processing time for program clusters have also been declining—from an annual average of 32 months in 2000 to 7 months in 2010. Annual average processing times for single-tranche program loans have been slightly more erratic. The lowest average processing time was recorded in 2004 at 4 months, while the longest average processing time was recorded in 2006 at 15 months. In 2010, processing time for single-tranche program loans averaged 7 months.

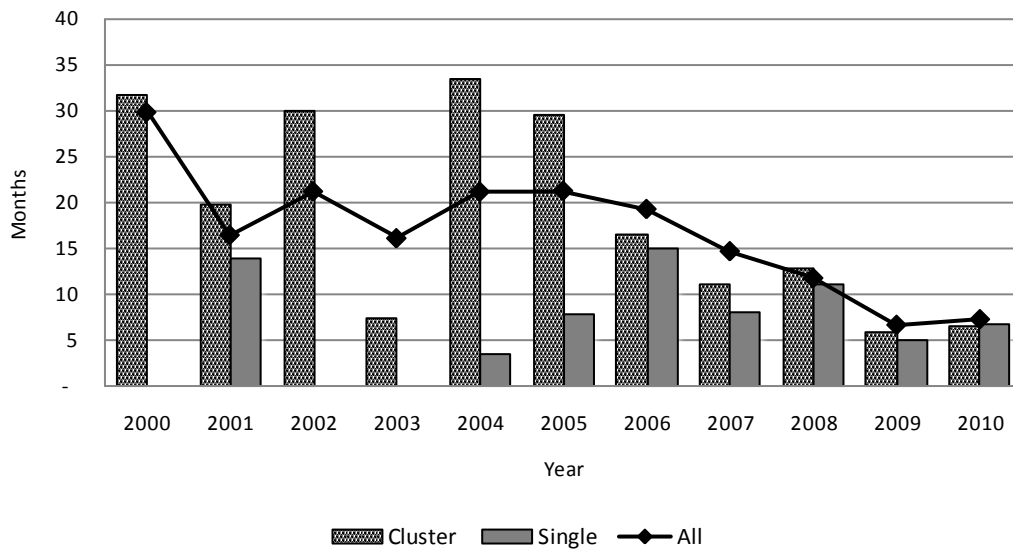
⁹ Measured from the start of loan fact-finding to Board approval. If with project preparatory technical assistance, measured from start of technical assistance fact-finding.

Figure A3.5: Average Processing Time for Program Loans

A. Asian Development Fund and Ordinary Capital Resources



B. Single Tranche and Clusters

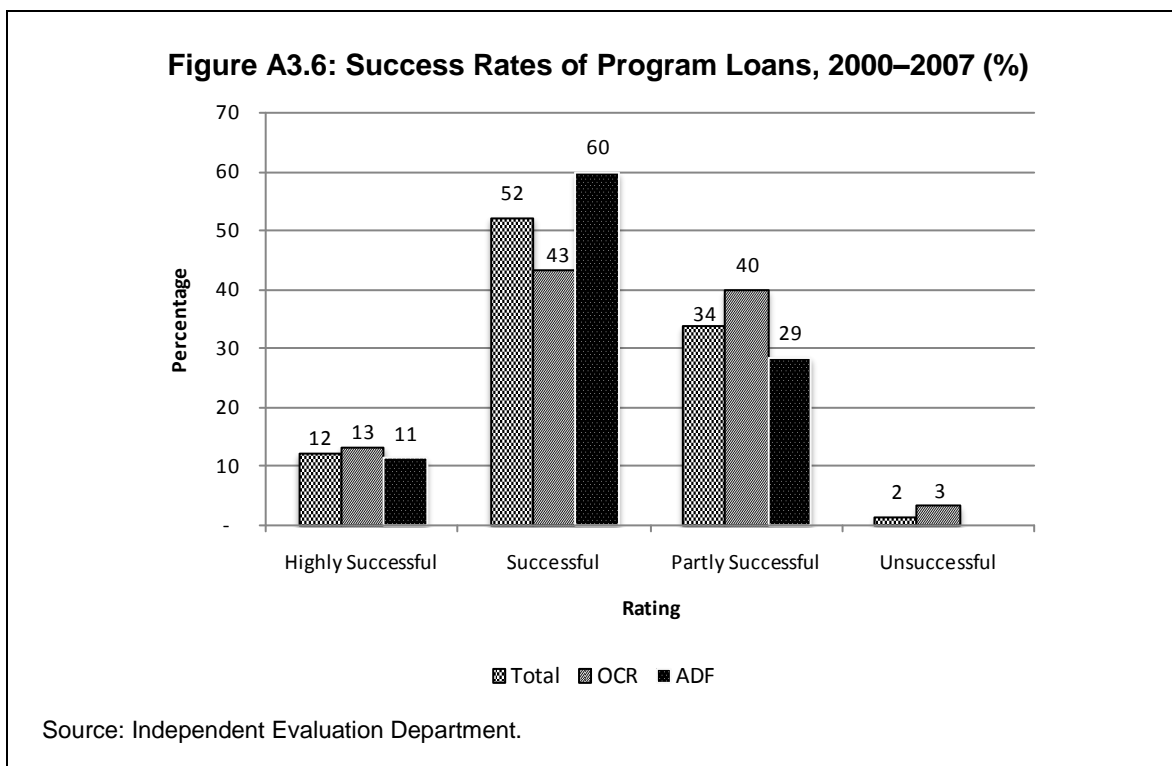


Source: Asian Development Bank.

C. Evaluation of Program Loans

13. The analysis of success rates is based on ratings of program loans in program and project completion reports (PCRs) and program performance evaluation reports (PPERs) prepared by ADB's Independent Evaluation Department (IED). PCRs are available for programs approved up to 2007.

14. Of the 118 program loans approved in 2000–2007, PCRs are available for 65 and PPERs are available for only 5 (3 of which belong to one program cluster). Of the 65 program loans that have been rated, 8 (12%) were *highly successful*, 34 (52%) were *successful*, 22 (34%) were *partly successful*, and 1 (2%) was *unsuccessful* (Figure A3.6).



15. Of the 65 program loans rated during the period, 54% are ADF program loans and 46% are OCR program loans. Of the 30 OCR program loans that have been rated, 13% were *highly successful*, 43% were *successful*, 40% were *partly successful*, and 3% was *unsuccessful*. Of the 35 ADF program loans that have been rated, 11% were *highly successful*, 60% were *successful*, and 29% were *partly successful*.

16. The combined share of *highly successful* and *successful* ADF program loans was 71%, higher than 56% for OCR. The total value of the 30 OCR program loans was \$5.2 billion compared \$1.3 billion for the 35 ADF program loans.

17. One of the successfully rated program loans was to Kyrgyz Republic and Tajikistan for the Regional Trade Facilitation and Customs Cooperation Program.¹⁰ As ADB accelerates its financing of regional cooperation and integration projects and programs to meet its commitments under Strategy 2020, the success of this program is a positive development. Regional cooperation and integration is one of ADB's three development agendas and one of five core areas of operations in Strategy 2020.¹¹

18. IED has rated only five program loans for 2000–2007. Four of the loans were rated *successful* and one was rated *partly successful*. Three of the four successful program loans belong to one program cluster loan to Cambodia,¹² while the other is a program loan to Mongolia.¹³ Both programs were for finance sector development. The first financial sector program loan cluster to Cambodia is the only program cluster to be evaluated by IED. The project completion report rated this program cluster *highly successful*.

19. **Success rates of program loans compared with project loans.** For 2000–2007, 109 projects have PCRs. Of those project loans, 12 (11%) were *highly successful*, 65 (60%) were *successful*, 19 (17%) were *partly successful*, and 13 (12%) was *unsuccessful*.

20. Table A3.3 shows that more project loans were rated *highly successful* or *successful* (71%) than program loans (64%). More program loans were rated *partly successful* or *unsuccessful* (36%) than project loans (29%). However, differences in performance between the two do not appear to be substantial.

Table A3.3: Success Rates of Program Loans and Project Loans, 2000–2007

PCR Rating	Programs		Projects	
	No.	%	No.	%
Highly Successful	8	12	12	11
Successful	34	52	65	60
Partly Successful	22	34	19	17
Unsuccessful	1	2	13	12
Total	65	100	109	100

Source: Asian Development Bank.

21. Among DMCs, Pakistan had the most rated project (18%) and program (32%) loans in 2000–2007. In terms of number, Pakistan had more *successful* program loans (8) than project loans (4), and had more *unsuccessful* project loans (6) than program loans (1). Cambodia and Indonesia each had 3 *highly successful* program loans, but only 1 *highly successful* project loan for Cambodia and none for Indonesia. Afghanistan

¹⁰ ADB. 2002. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grants and a Regional Technical Assistance Grant to Kyrgyz Republic and Tajikistan for the Regional Trade Facilitation and Customs Cooperation Program*. Manila.

¹¹ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

¹² ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster to Cambodia for the Financial Sector Program*. Manila.

¹³ ADB. 2000. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to Mongolia for the Second Financial Sector Program*. Manila.

and Viet Nam also had more *successful* program loans than project loans. Afghanistan had 2 *successful* program loans and 1 *successful* project loan, while Viet Nam had 7 *successful* program loans and 4 *successful* project loans. The Philippines had 1 *highly successful* program loan but no *highly successful* project loans for the period covered. The rest of the DMCs had more successful project loans than program loans.

CASE STUDIES ON GOOD PRACTICE IN POLICY-BASED LENDING

A. Cambodia: Financial Sector Program Cluster II

1. Principles

1. **Program cluster and prior actions.** The Southeast Asia Department (SERD) of the Asian Development Bank (ADB) has adopted the program cluster approach with prior actions that define a medium-term policy framework. It is designed to promote a continual dialogue with government on reforms, while allowing the flexibility for program changes to efficiently and effectively respond to (i) new risks to the economy or sector, and (ii) shifts in government priorities.

2. **Government strategy and the policy dialogue.** The starting point for the program cluster is a prior policy dialogue, often with accompanying technical assistance (TA). ADB support aims to help develop the government's reform strategy as often presented in the financial sector as a "blueprint" or "master plan." Thus, ADB program lending will typically have two phases: (i) TA support and policy dialogue in the development of the government's blueprint for reform, and (ii) program cluster support to flexibly implement the blueprint.

3. **Implementing the government strategy.** With the blueprint in place and the program cluster defined, the transition from one subprogram to the next is governed by progress towards a small set of high impact triggers. Triggers are embedded in the medium-term reform timetable and are supported by TA.

4. **Recent innovations.** The post-program partnership framework (PPPF) and the regulatory impact assessments (RIAs) are two recent innovations to SERD's approach that (i) help better define the objectives of the program, (ii) assess the impact of its triggers and its policy actions, and (iii) provide a framework for assessing the size of the program in relation to the overall costs and benefits to reforms.

5. The PPPF is used to ensure that the policy dialogue is not terminated at the end of a program cluster. Thus, the final subprogram in a cluster will have a PPPF that comprises a set key reform objectives with milestones and actions to achieve them. If the government and ADB agree to a new program cluster, the PPPF would provide a ready benchmark. However, the PPPF is not presumed to lead to a new program cluster as this is determined by a range of considerations including the results of the program completion report and government and ADB priorities for the country and sector.

6. The RIA, developed in close consultation with Board members, is designed to demonstrate that the program will generate net benefits to the economy through the identified reform program. Although the RIA was introduced only recently, SERD has found that it contributes to a more rigorous rationale for the program across a number of dimensions as follows:

- (i) The RIA helps to better define the problem to be addressed, the ensuing impact and outcome of the proposed reforms the program will support, and the options or alternative reform paths that are available.
- (ii) Conducted either through a standard cost model or cost-benefit analysis, the RIA enables a clearer discussion of the costs and benefits of the

proposed program, and an identification of the winners or losers from the reforms.

- (iii) The greater clarity achieved in identifying the costs and benefits to the government and other stakeholders provides for a more illuminating assessment of reform costs, which can be presented as comprising administrative, enforcement, direct fiscal, and compliance costs.
- (iv) The RIA approach introduces a quantitative benchmark for a first-order assessment of the “weight” of a program’s conditionality in relation to the magnitude of the overall benefits to the sector or economy from the removal of all relevant distortions over time. However, this is a static assessment and cannot be taken as a precise or definitive measure. Qualitative assessments of program weight will continue to have relevance.

2. **Application of Principles: Cambodia Financial Sector Program Cluster II**

7. **Background: structural reforms in a transition economy.** Cambodia has achieved structural reforms to its financial sector that are unprecedented among SERD transition economies. These reforms include (i) divestment of government ownership of the banking sector, (ii) introduction of a licensing regime leading to a sharp consolidation and rationalization of the sector, and (iii) establishment of a central bank with a high degree of autonomy. Despite this progress, the government recognized that a long-term reform program over decades would be needed to develop the range of markets and institutions to provide a sound basis for a commercialized economy. The policy dialogue with ADB was initiated on this basis.

8. **Policy dialogue and government strategy.** ADB’s policy dialogue with the government began in 1999, before the provision of program support. From 1999 to 2001, ADB TA and policy support led to the formulation of the government’s financial sector blueprint, 2001–2010. The government adopted the blueprint in August 2001. It identifies a strategy for building up markets and instruments, and the broad financial infrastructure comprising (i) monetary policy instruments; (ii) regulation and supervision capabilities; (iii) transparency and disclosure regimes; and (iv) supporting hardware in the form of payment, settlement, and clearing systems. ADB supported the implementation of the blueprint through the First Financial Sector Program Cluster,¹ which comprised three back-to-back subprograms that were implemented from 2001 to 2007.

9. **Policy dialogue for Financial Sector Program Cluster II.** The final stages of the first program cluster involved substantial policy dialogue as well as TA for updating and revising the blueprint. As a result, the blueprint was reformulated and adopted by the Government as the Financial Sector Development Strategy, 2006–2015 (FSDS).

10. With the government’s FSDS in place, the second program cluster was designed, based on prior actions, starting in 2007 with four annual subprograms to implement the FSDS. The move away from multitranche program clusters, such as in the first program

¹ ADB. 2001. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster to Cambodia for the Financial Sector Program*. Manila.

cluster, reflected the need for a more flexible approach to program lending. The introduction of annual subprograms was in response to heightened macroeconomic concerns. The subprograms could be assessed on an appropriately frequent basis to support the medium-term framework. TA was provided during the second program cluster to achieve its triggers, including for the design and introduction of a new payment system.

11. **Recent program innovations.** The final subprogram in 2010 included the two key SERD innovations—the PPPF and RIA. A program completion report, planned for 2011, will provide feedback on the design of a new cluster, assuming sufficient progress. Boxes A4.1 and A4.2 summarize the key features of the second program cluster and SERD program lending principles.

12. **Coordination with development partners.** ADB has been the lead agency in the financial sector in Cambodia since 2001. Coordination with International Monetary Fund has been frequent and sustained throughout this period. Under a recent agreement, ADB and the International Monetary Fund will each finance a long-term technical advisor, one for on-site supervision of banks and the other for off-site supervision. Other development partners participate in the periodic revisions of the government’s reform strategy. The International Finance Corporation is playing an important role in supporting private sector needs in relation to the payment system.

Box A4.1: Key Features of Recent Program Lending in Southeast Asia

- (i) Medium-term policy framework supported by cluster program
- (ii) Ex-post single-tranche operations incorporating high impact policy triggers
- (iii) Technical assistance for capacity building
- (iv) Post-program partnership framework with key actions to sustain policy dialogue
- (v) Regulatory impact assessment of net costs and benefits to provide broad indication of the magnitude of economic costs to the sector and likely value of proposed program

**Box A4.2: Summary of Second Financial Sector Program Cluster in Cambodia,
Subprograms 1–4**

- (i) Year policy dialogue began:
 - (a) 1999: Diagnostic assessment of the financial sector by the Asian Development Bank (ADB) and formulation of the Financial Sector Development Blueprint, 2001–2010
 - (b) 2001: The Government started to implement important reforms in the financial sector with ADB's assistance under first financial sector program cluster
 - (c) 2007: Based on achievements, lessons learned, and new challenges, the government requested further support from ADB to continue reforms, leading to the design and approval of second financial sector program cluster in December 2007
- (ii) Total triggers: 46 or an average of about 12 triggers per subprogram
- (iii) Technical assistance (TA) support:
 - (a) Financial Sector Program II Implementation,^a 2007, \$1.7 million
 - (b) Implementation of Key Policy Triggers of Subprogram 3,^b advisory TA, 2008, \$300,000
 - (c) Implementation of Subprogram 4 of the Financial Sector Program II,^c capacity development TA, 2009, \$750,000
 - (d) Financial Sector Program II (Cluster 2, Subprogram 4),^d 2010, \$5 million
- (iv) Year government strategy issued:
 - (a) 2001: Financial Sector Development Blueprint, 2001–2010
 - (b) 2007: Financial Sector Development Blueprint, updated as the Financial Sector Development Strategy, 2006–2015, adopted in February 2007
- (v) Post-program partnership framework introduced in 2010
- (vi) Program impact assessment based on regulatory impact assessment in 2010
- (vii) Program completion report to provide assessment of achievements and guidelines for further assistance to the sector, if any, in 2011.

^a Attached to ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan and Technical Assistance Grant to Cambodia for the Second Financial Sector Program Cluster (Subprogram 1)*. Manila.

^b Attached to ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Subprogram 2 to the Kingdom of Cambodia for the Financial Sector Program II Cluster*. Manila.

^c ADB. 2009. *Technical Assistance to Cambodia for the Implementation of Subprogram 4 of the Financial Sector Program II*. Manila.

^d ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Proposed Grant to the Kingdom of Cambodia for Subprogram 4 of the Financial Sector Program II*. Manila.

B. India: Mizoram Public Resource Management Program

1. Introduction

13. ADB's state-level public resource management programs in India were launched when the states were under severe fiscal stress in the mid-1990s, leading to widespread

cuts in investment in economic infrastructure (e.g., roads, power, irrigation) and operation and maintenance expenditures. Striking the right balance between expenditure commitments and revenue potential was vital for effective service delivery in the states. Thus, the design of these program loans was highly relevant to national development strategies, as well as ADB's development efforts in India. The reforms proposed under these loans are politically sensitive as they target the state budget as the main policy instrument to pursue the developmental goals of the elected government in the states. As such, the state governments were closely involved in designing the programs through frequent policy dialogue, and internalizing the states' reform initiatives into ADB's programs.

14. ADB has provided a series of program loans for public resource management: (i) Gujarat Public Sector Resource Management Program² (1996, \$250 million); (ii) Madhya Pradesh Public Resource Management Program³ (1999, \$250 million); (iii) Modernizing Government and Fiscal Reforms in Kerala Program⁴ (2002, \$200 million); (iv) Assam Governance and Public Resource Management Sector Development Program⁵ (2004, \$125 million); (v) Assam Governance and Public Resource Management Sector Development Program (Subprogram II)⁶ (2008, \$100 million); and (vi) Mizoram Public Resource Management Program (2009, \$94 million).⁷

15. Each public resource management program draws on the lessons learned from the previous programs. This continual process is an effort to improve the loan design to make the aid delivered more effective. The first generation program loans focused primarily on fiscal stabilization (e.g., Gujarat, Madhya Pradesh, Assam-Subprogram I). With the moderation of states' fiscal deficits in early 2000, however uneven, ADB's second generation program loans in India began combining improvements in service delivery with fiscal consolidation in a synchronized manner. The Mizoram Public Resource Management Program was the first of these program loans. It was designed to improve service delivery in the state in a cost-effective manner, while pursuing fiscal consolidation.

² ADB. 1996. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to India for the Gujarat Public Sector Resource Management Program*. Manila.

³ ADB. 1999. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to India for the Madhya Pradesh Public Resource Management Program*. Manila.

⁴ ADB. 2002. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster of Loans to India for the Modernizing Government and Fiscal Reforms in Kerala Program*. Manila.

⁵ ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Program Loan Cluster and Project Loan to India for the Assam Governance and Public Resource Management Sector Development Program*. Manila.

⁶ ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to India for the Assam Governance and Public Resource Management Sector Development Program (Subprogram II)*. Manila.

⁷ ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loans Cluster to India for the Mizoram Public Resource Management Program*. Manila. For comprehensive reviews of the public resource management programs of ADB, see ADB. 2007. *Special Evaluation Study: ADB Supported Public Resource Management in India*. Manila; and M.G. Attinasi and B. Carrasco. 2008. *Public Resource Management Reform Programs: Do they Work?* Manila.

2. Mizoram Public Resource Management Program

16. Mizoram has a weak economic base and development infrastructure with limited endowments. Harsh terrain has led to water shortages as well as difficulties in sectors such as agriculture (poor farming systems and productivity), transport, and communication. Moreover, the terrain inhibits state engagement with rural areas and increases the costs of service delivery. The state has some of the poorest infrastructure in India. Despite its rich natural resources and environment, its per capita income is among the lowest in the country. Consequently, Mizoram has limited resources to invest in social and economic infrastructure, trapping the state in a vicious cycle of low income (few state resources), low investment in economic and social infrastructure, high cost of service delivery, poor quality of basic services, poor human capital base, and low employment and income opportunities.

17. Thus, the Mizoram program was based on the analytical link between the creation of fiscal space and social service improvements in the education and health, and the consequent reduction in income, human, and social poverty. Two schemes in education and health, supported by the Mizoram program, were innovative and noteworthy.

18. **Voluntary retirement scheme for the under-qualified teachers.** In the education sector, the critical issue was the poor quality of education because of the presence of many under-qualified teachers. The state had about 888 teachers that were considered under-qualified for the teaching they were involved in. These teachers were recruited immediately after the cessation of hostilities in the state in the early 1970s, when the state urgently needed individuals to staff schools and provide basic education. The Mizoram Public Resource Management Program was to support the government's initiative to improve the quality of education in schools by replacing under-qualified teachers with qualified ones. The program provided \$15 million to make voluntary retirement scheme (VRS) payments to the under-qualified teachers.⁸ This assistance was expected to help the government improve the percentage of students passing the primary or middle school examination with marks of 60% or higher. The household and/or economic impact on the VRS recipients was softened through safety net provisions, including job reservations in the schools for the suitably qualified children of the under-qualified teachers.

19. **Universal health insurance scheme.** The main challenge in the health sector was rationalizing public expenditures on health, while providing the necessary level and type of services to ensure that the state government's commitment to "health for all" was suitably addressed. The government strongly preferred to retain the Mizoram health care scheme, which was launched on 9 April 2008. Hence, the key challenge was how to pay for the scheme on a continuing basis without burdening the budget, while improving service to ensure that high-quality basic health care in the state remains accessible to its citizens. Any Indian citizen residing in Mizoram with the name of the head of the family on the electoral roll is eligible for coverage under the Mizoram health care scheme. The policy provides coverage to meet the expenses of hospitalization (limited to the general

⁸ In preparing the VRS package, discussions with the relevant unions were held to ensure that their views were taken into account and that they approved of this package. This engagement was to continue during VRS implementation.

ward) and surgical procedures of beneficiary members (limited to Rs100,000 per family) in any of the networked hospitals in Mizoram. Treatment outside Mizoram for outpatient and inpatient cases may be allowed subject to the approval of the Medical Board. The latest data showed that 25,853 families have already been registered under the scheme from seven districts. Data from two other districts was not available.

20. Given the importance of the scheme in providing health care to the poor in a cost-effective manner, it was agreed that ADB would support setting up a corpus under the Mizoram Public Resource Management Program with \$25 million assistance to meet the expenses of operating the Mizoram health care scheme. Moreover, capacity building plans for the Mizoram Health Care Society were prepared and funded to improve the management of the scheme. The state government is expected to reduce its financial support to public hospitals in phases, contributing to fiscal savings while ensuring better services.

3. Conclusion

21. ADB's support for Assam and Mizoram had a strong demonstration effect in the region. Meghalaya, another small state bordering Assam and Mizoram, requested similar support from ADB following their discussions with the Mizoram authorities. The Government of India endorsed ADB's support for Meghalaya, and a program loan of \$100 million for Meghalaya is being processed for delivery in 2011. Moreover, the Government of India approved program loan support to other states encompassing states' finances as well as finances of the municipal bodies.