



ASIAN DEVELOPMENT FUND (ADF)
ADF X DONORS' MEETING
13–14 September 2007 Sydney, Australia

Refining Performance-Based Allocation

Asian Development Bank

August 2007

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CPA	–	country performance assessment
GNI	–	gross national income
IDA	–	International Development Association
OCR	–	ordinary capital resources
PBA	–	performance-based allocation
SDR	–	special drawing right

NOTE

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

CONTENTS

	Page
EXECUTIVE SUMMARY	
I. INTRODUCTION	1
II. APPROACH TO PERFORMANCE-BASED ALLOCATION	1
III. EXPERIENCE WITH THE REVISED POLICY	3
A. Trends in Country Allocations	4
B. Portfolio Performance	8
C. Subregional Pool	9
D. Postconflict Country Set-Asides	10
IV. SUMMARY OF PROPOSALS FOR DONOR CONSIDERATION	10
APPENDIXES	
1. Calculation of the Composite Country Performance Rating	11
2. Changing Measurement of Performance	12
3. Portfolio Performance Rating Methodology	14

EXECUTIVE SUMMARY

The Asian Development Fund (ADF) was established to provide concessional funds to finance the development needs of the less developed members of the Asian Development Bank (ADB). However, the quantity of concessional financing demanded by countries in the Asia and Pacific region far exceeds the amount supplied by ADB. As such, a mechanism is needed to ration such funds fairly among the many competing needs, and the funds must be directed to where they will be used most effectively. ADB put in place the performance-based allocation (PBA) system for ADF resources to meet these objectives. The system was revised during ADF IX negotiations to strengthen the performance and allocation linkage. However, there is an inherent tension in the PBA system between addressing the needs of the weakest countries, the purpose of ADF as stated in the regulations governing the fund, while simultaneously upholding the principle of linking assistance to performance.

The introduction of the revised PBA system coincided with an increased volume of concessional resources—from \$1.5 billion in ADF VIII to nearly \$1.7 billion in ADF IX—yet the absolute volume of allocations for some countries declined under the new system. In particular, the poorest countries that only have access to ADF financing saw their share drop by about \$30 million per year in ADF IX. This decline in resources constrains ADB's ability to support the development efforts of these countries. Within the package of revisions to the PBA system, the individual changes tended to divert resources away from the poorest countries. Taken together, they created a wide gap between the share of resources going to the poorest ADF-only countries and that of the large borrowers with access to both ADF and ordinary capital resources. This paper proposes to introduce a system of allocation caps to eliminate the crowding out by large countries without compromising the principles of PBA.

Experience implementing PBA has shown that portfolio performance ratings tend to be the most volatile element in the composite country performance rating. Because project progress reports—which underlie the portfolio performance ratings—do not distinguish degrees of risk, this can result in small changes in portfolio performance translating into large changes in rating. ADB staff will review the portfolio performance rating methodology and develop options for improving it within the context of the existing PBA policy.

During the ADF IX replenishment discussions, donors agreed to earmark up to 5% of planned ADF operations (about \$350 million) for subregional projects with benefits that are demonstrably multicountry. Eligible projects submitted for partial financing from this source have far exceeded this amount. ADB's institutional commitment to regional cooperation—and its strong track record in this field—is a major inherent strength. This strength needs to be adequately leveraged for the benefit of ADF countries. The paper recommends increasing the share of resources earmarked for subregional activities.

Currently, Afghanistan and Timor-Leste receive fixed ADF allocations that are not subject to PBA because of their status as postconflict countries. ADB follows the International Development Association (IDA) system in classifying countries as postconflict. The IDA approach is currently under review, and the period of phasing out postconflict status is likely to be lengthened. ADB proposes to align with IDA in terms of the phase-out period.

I. INTRODUCTION

1. The quantity of concessional financing demanded by countries in the Asia and Pacific region far exceeds the amount supplied by the Asian Development Bank (ADB). Assistance from the Asian Development Fund (ADF) has been declining as a share of total official development assistance to the region (from 8.1% in 2001 to 5.5% in 2005), despite the record-level \$7.0 billion in planned operations under ADF IX.¹ Therefore a mechanism is needed to ration such funds fairly among the many competing needs, and the funds must be directed to where they will be used most effectively. To meet these objectives, ADB developed the performance-based allocation (PBA) system for ADF resources in close consultation with the donors. The PBA policy, introduced as part of the ADF VIII replenishment,² was substantially revised during ADF IX as one of the core elements of ADB's reform agenda.³ The revised system provides a stronger linkage between performance—as measured by the country performance assessment (CPA)—and ADF allocations. ADB has also taken steps to enhance transparency of the process. Implementation of the revised PBA policy to determine the 2005–2006 and 2007–2008 allocations has proceeded smoothly.

2. ADF's purpose, as stated in the regulations governing the fund, is to provide “resources on concessional terms for the economic and social development of the developing member countries of ADB, having due regard to the economic situation of such countries and to the needs of the less developed members.”⁴ Introduction of the PBA system has revealed an inherent tension between addressing the needs of the weakest countries while simultaneously upholding the principle of rewarding performance. It has also underlined the lack of any adjustment for disadvantages in initial conditions or special country circumstances that are unrelated to a country's policy performance or governance efforts. During the ADF IX midterm review meeting, the share of resources directed toward borrowers eligible only for ADF was noted to have declined under the new system, constraining ADB's ability to support these countries' development efforts. In addition, a weakness in the measure of portfolio performance was also noted. Some donors requested further study of these issues. This paper analyzes the impact of the PBA system on ADB operations and suggests options for refinements; and considers other ADF allocation issues, such as the subregional pool and funds earmarked for specific countries.

II. APPROACH TO PERFORMANCE-BASED ALLOCATION

3. **Assessing Country Performance.** The 2004 revision of the PBA policy completely revamped the allocation method, including the approach to measuring country performance. Since 2005, ADB has adopted the country policy and institutional assessment questionnaire of the International Development Association (IDA) as the basis for its country performance assessment. Although the IDA questionnaire generally covers the same range of policies and institutions as ADB's previous assessments, performance ratings are not strictly comparable between the old and new systems. An important feature of the IDA questionnaire is the use of narrative descriptions to guide scoring for each criterion. Each year, the CPA write-ups must make their case for the scores, which are compared to the narrative descriptions in the questionnaire and other countries' write-ups to ensure cross-country consistency in ratings. In

¹ ADB. 2007. *ADF X (2009–2012): Role and Priorities*. Manila.

² ADB. 2001. *Policy on Performance-Based Allocation for Asian Development Fund Resources*. Manila.

³ ADB. 2004. *Review of the Asian Development Bank's Policy on the Performance-Based Allocation of Asian Development Fund Resources*. Manila.

⁴ ADB. 2006. *Regulations of the Asian Development Fund*. Section 1.01. Manila (1 January).

contrast, the practice under ADB's old system was to assess changes in circumstances from the previous year, leading to some rigidity in ratings.

4. The agreed reforms under ADF IX included clarifying the institutional accountabilities for PBA. A PBA unit was established in the Strategy and Policy Department, outside of the departments responsible for country operations, to provide independent oversight of the CPA process without any conflict of interest. The work of the PBA unit is supported by an interdepartmental CPA working group and a review panel of directors general. Teams from the regional departments prepare the initial CPA drafts, which are discussed with a group of technical experts from the specialized departments⁵ in an annual workshop to strengthen the CPA process. Based on their review and the workshop discussions, the technical group recommends revisions to the write-ups or ratings to ensure consistency of the CPAs across countries. The revised CPAs are again reviewed by the technical experts, who convey the revised assessments to the CPA working group along with their comments. The CPA working group submits their country rating recommendations to the CPA review panel, based on the technical group's findings. The CPA review panel finalizes the country ratings, and submits them for Management approval.⁶

5. The third cycle of CPAs under the new system is currently under way. Implementation of the CPAs has proceeded smoothly, and the oversight mechanisms are functioning well. No changes to these aspects of the policy are currently envisaged.

6. **Enhancing Transparency of Performance Assessments.** Starting in 2005, consultations with government authorities on draft CPAs were incorporated into the process. Discussing the preliminary assessments with country authorities has broadened awareness of PBA and helped strengthen the link between CPAs and policy dialogue. Also beginning with the 2005 assessments, final country ratings are made public through ADB's website after they are approved by Management. The initiatives to enhance the transparency of CPAs have been successful, and as such no refinements of these elements of the policy are necessary.

7. **Moving From Country Performance to Country Allocations.** During ADF IX replenishment discussions, the main PBA-related reform agreed with the donors was changing the allocation formula. Under the original PBA formula, the composite country performance rating was a weighted arithmetic average of the ratings from the previous CPA's 21 performance criteria covering (i) sustainable economic growth, (ii) socially inclusive development, (iii) governance and public sector management, and (iv) portfolio performance. The score ranged from 1 to 6. The PBA formula itself was a multiplicative formula of three variables—the composite country performance rating (with an exponent of 1.80), population (with an exponent of 0.75), and per capita gross national income (GNI) (with an exponent of minus 0.25)—which is multiplied by a scaling factor to ensure that the shares sum to one. In the previous formula, the effective weight for governance was about 30%. This system was used to generate the 2002–2004 country allocations under ADF VIII.

8. The revised PBA policy changes the way the composite country performance ratings are constructed (Appendix 1). Using the new CPA criteria, the policy and institutional rating is effectively the weighted arithmetic mean of the 11 CPA criteria for (i) economic management, (ii)

⁵ The team of technical experts—who are a subgroup of the CPA working group—are drawn from the Central Operations Services Office, Economics and Research Department, Office of Regional Economic Integration, and Regional and Sustainable Development Department.

⁶ The steps taken in the 2006 CPA exercise are detailed in ADB. 2007. *Annual Report on the 2006 Country Performance Assessment Exercise*. Manila.

structural policies, and (iii) policies for inclusion and social equity. The governance rating is a separate variable, which is the average of the CPA's five criteria on public sector management and institutions. The composite country performance rating is a multiplicative formula of the policy and institutional rating (with an exponent of 0.7), governance (with an exponent of 1.0), and portfolio performance (with an exponent of 0.3). Scores can range from 1 to 36. The new PBA formula is similar to the previous formula, but with the exponent on the composite country performance rating raised to 2.0 and the exponent on population reduced to 0.6. The new formula increases the effective weight on governance to about 50%, and is much more sensitive to changes in individual performance criteria.

9. The revised PBA formula has been applied to derive both the 2005–2006 and 2007–2008 biennial allocations under ADF IX. The first biennial period used the already completed 2004 CPAs, based on the previous CPA questionnaire,⁷ roughly mapping the ratings from the various criteria into the components of the revised composite country performance rating. The initial allocations for the second biennial period used the 2005 CPA ratings. The allocations were then revised following the outcome of the 2006 CPA exercise. The PBA formula is working as expected, and no new changes are anticipated. The ratings from the third CPA cycle using the new questionnaire, which is currently in progress, will be used to determine the initial ADF allocations under the first biennial period of ADF X (2009–2010).

III. EXPERIENCE WITH THE REVISED POLICY

10. The switch to the revised PBA policy coincided with an increased volume of concessional resources from an annual average of less than \$1.5 billion in ADF VIII to nearly \$1.7 billion in ADF IX. Yet, despite the larger pool of funds, the absolute volume of some countries' allocations declined under the new system. It is important to understand whether such experiences reflect individual country circumstances or systemic problems.

11. To understand the impact of the changes more clearly and determine if some groups have benefited to the disadvantage of others, this paper looks at trends by country groups to explore possible systemic issues under the revised allocation mechanism. For purposes of this exercise, countries with earmarked allocations are excluded. The Pacific countries are considered separately, as they have an earmarked ADF pool that is divided among them according to PBA principles.⁸ Within the Pacific pool, Timor-Leste has received a fixed biennial allocation outside of the PBA mechanism since 2007–2008 as a postconflict country. ADF allocations to Afghanistan and Indonesia are also provided as fixed amounts outside of the PBA mechanism (so-called country set-asides). Funds from the ADF subregional pool (up to 5% of the operations during ADF IX) are also allocated under a separate framework, which is part of the revised PBA policy.

12. Countries outside the Pacific region that receive ADF according to PBA were classified into groups defined by population, per capita GNI, and access to loans from ADB's ordinary capital resources (OCR) (Table 1). Data on GNI per capita and population for 2004 were used, the last benchmark year prior to the beginning of ADF IX. The countries with access to only ADF resources (ADF-only countries) include all member countries with incomes below \$400 per person. Countries with access to both ADF and OCR (blend countries) are not necessarily much better off, but they tend to benefit from other factors that enhance their debt-repayment

⁷ The 2004 CPA exercise was completed while the IDA questionnaire was still under revision.

⁸ The earmarked pool for the Pacific countries is equivalent to 4.5% of total resources available for PBA. The countries in the Pacific group are Cook Islands, Kiribati, Marshall Islands, Federated States of Micronesia, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste (from 2005), Tonga, Tuvalu, and Vanuatu.

**Table 1: Country Groups for Non-Pacific Borrowers
Receiving Performance-Based Allocations**

Country Classification	Per Capital GNI > \$400		
	Per Capita GNI ≤ \$400	Population ≤ 50 million	Population > 50 million
ADF Only	Poorest Cambodia Kyrgyz Republic Lao PDR Nepal Tajikistan	Other Bhutan Maldives Mongolia	
Blend		Other Armenia (from 2007) Azerbaijan Sri Lanka Uzbekistan (from 2005)	Largest Bangladesh Pakistan Viet Nam

ADF = Asian Development Fund, GNI = gross national income, Lao PDR = Lao People's Democratic Republic, PBA = performance-based allocation.

Notes: The reference date for GNI per capita and population data is 2004, the year prior to the start of ADF IX. The data were taken from the World Bank's online World Development Indicators: <http://publications.worldbank.org/WDI/>, accessed 2 August 2007.

Sources: Asian Development Bank and World Bank.

capacity, such as a more diversified export base. The blend borrowers include the three most populous countries with access to ADF: Bangladesh, Pakistan, and Viet Nam.

A. Trends in Country Allocations

1. Allocation by Country Group

13. Planned annual ADF commitments increased by nearly 14% from ADF VIII to ADF IX (Table 2). Country set-asides in particular grew sharply, mainly to cover ADB's pledge to finance postconflict reconstruction in Afghanistan, which doubled from \$100 million annually in ADF VIII to \$200 million annually in ADF IX. While the amount distributed through the PBA system grew by about 9%, differences across country groups are notable. During ADF IX, fewer dollars have been going to the poorest countries each year than during the previous replenishment. The decrease of more than \$30 million per year is not trivial. This is equivalent to the average lending program for a country like the Kyrgyz Republic or Lao People's Democratic Republic. In contrast, the large blend countries have benefited greatly under the new system—their combined annual programs gained more than \$100 million per year.

14. Focusing on the ADF funds allocated through the PBA formula, in the move from the old to the new system, the share of the poorest countries decreased from 21% to 17%, where it has stabilized (Table 3). The largest countries, however, gain in every period, with their share increasing from 57% to nearly 64%. As a comparison, consider what would have occurred in the absence of performance differences; that is, if only population and GNI per capita differences affected allocation shares. The poorest ADF countries would receive about 24%, while the largest would receive 56%—which is close to the shares that prevailed during ADF VIII.

Table 2: Asian Development Fund Allocations by Country Group, 2002–2008

Country Group	Average Annual Allocation (\$ million)			Change from Previous Period (%)	
	2002–2004	2005–2006	2007–2008	2005–2006	2007–2008
Pacific ^a	53	59	57	10.0	(2.3)
ADF Only	297	287	269	(3.4)	(6.2)
Poorest	250	221	215	(11.9)	(2.6)
Other	47	66	54	41.8	(18.2)
Blend	843	959	948	13.7	(1.1)
Largest	681	791	812	16.1	2.7
Other	162	168	136	3.6	(18.9)
PBA Total	1,194	1,304	1,275	9.3	(2.3)
Other Allocations	291	385	383	32.1	(0.4)
Country Set-Asides	211	300	300	42.1	0.0
Subregional Pool	80	85	83	5.6	(1.8)
ADF Total	1,485	1,689	1,658	13.8	(1.9)

() = negative value, ADF = Asian Development Fund, PBA = performance-based allocation.

^a The Pacific group includes the set-aside for Timor-Leste of \$10 million on average per year since 2007–2008.
Source: Asian Development Bank.

Table 3: Performance-Based Allocation Shares by Country Group, 2002–2008
(%)

Country Group	Allocation Share			Difference from Previous Period	
	2002–2004	2005–2006	2007–2008	2005–2006	2007–2008
Pacific ^a	4.5	4.5	4.5	0.0	0.0
ADF Only	24.9	22.0	21.1	(2.9)	(0.9)
Poorest	21.0	16.9	16.9	(4.1)	(0.1)
Other	3.9	5.1	4.3	1.2	(0.8)
Blend	70.6	73.5	74.4	2.9	0.9
Largest	57.1	60.6	63.7	3.6	3.1
Other	13.6	12.9	10.7	(0.7)	(2.2)
PBA Total	100.0	100.0	100.0	0.0	0.0

() = negative value, ADF = Asian Development Fund, PBA = performance-based allocation.

^a Pacific group includes the set aside for Timor-Leste of \$10 million on average per year since 2007–2008.
Source: Asian Development Bank.

2. Impact of PBA Policy Changes

15. The new PBA system encompassed a package of revisions designed to strengthen the link between performance and allocation. Individually, these changes tended to divert resources away from the poorest countries. Taken together, they created a wide gap between the share of resources going to the poorest countries and that of the large blend borrowers.

16. **Removing Limits on Allocation Changes.** The original PBA system had limits on the size of changes in allocations—the so-called collar—to avoid large fluctuations that would

disrupt country programming.⁹ While preventing abrupt shifts in allocations, the limits also delayed the transition to a full PBA system. All of the poorest countries benefited from the collar in some years of ADF VIII, with Cambodia, Kyrgyz Republic, and Lao People's Democratic Republic benefiting every year. On the other hand, allocations for Bangladesh and Pakistan, two of the large blend countries, were held down by the collar in some years, as the increase would have exceeded the upper limit. If the old system had not included the collar, the share of the poorest countries would have been about 18% during ADF VIII. This is still greater than their actual 2005–2006 share and the gap continues to widen in the second biennium of ADF IX. This suggests that removal of the collar is not the sole explanation for the observed allocation trends.

17. **Changing Performance Measurement.** During the time that ADB has applied PBA, the measure of country performance has evolved (Appendix 2). The performance of the poorest countries has generally been on the rise, but not as rapid as the gains of the largest blend countries. Differences in performance ratings among country groups are relatively small. However, under the new formula these small differences are magnified, which had a negative effect on the allocations of the poorest borrowers. Moreover, although the average governance rating for the poorest ADF-only countries has been trending upward, it has not kept pace with the improvement experienced by the largest blend countries. Because of this, the additional weight on governance in the formula would have helped widen the gap between the poor ADF-only countries and the largest blend countries.

18. **Revising the Grant Framework.** The 2007–2008 allocation shares shown in Table 3 are based on the ADF grant framework agreed during ADF IX replenishment discussions. A revised grant framework, which is substantially aligned with that of IDA14, will be considered by ADB's Board of Directors in September 2007.¹⁰ Most of the poorest countries will be eligible for all or half of their ADF allocations on a grant basis under the new framework. However, to avoid creating perverse incentives, the grant portion of ADF assistance will be subject to a 20% volume discount, the funds from which will be transferred to a hard-term ADF window to recover part of the foregone interest reflows from grants. Most blend countries—including Bangladesh, Pakistan, and Viet Nam—will be eligible to borrow from this new hard-term ADF window. As such, the revised grant policy will lead to a further shift in the quantity of ADF assistance away from the poorest countries in nominal terms, although they will gain considerably in net present value terms because of the increased concessionalism of ADB assistance.

3. Enhanced Assistance to the Poorest Countries

19. The foregoing analysis shows that the share of the poorest ADF-only countries has declined, even though their performance has improved over time. On the other hand, the share of the largest countries has improved much more than their performance trends would seem to warrant. The decline in concessional resources to ADB's poorest members hinders the institution's ability to support the development efforts of those most in need. Under the new grant framework, the quantum of assistance to many of these countries may decline further. Several options were considered to enhance assistance to the poorest countries while maintaining the principle of rewarding better performance.

⁹ The collar refers to upper and lower limits on the change in a country's allocation compared with its historical lending average in order to smooth year-to-year changes in allocations. For 2002 and 2003, the range of the collar was 85%–115% of a country's 5-year historical lending average. The collar for 2004 had a wider range: 75%–125% of the 3-year historical average.

¹⁰ ADB. 2007. *Revising the Framework for Asian Development Fund Grants*. Manila.

20. **Provide Minimum Allocations.** IDA provides a minimum allocation of SDR1.1 million per year on top of each country's PBA.¹¹ This helps augment the per capita allocations of small countries. ADB has built a small-country bias directly into the PBA formula by applying an exponent of 0.6 to population. All else equal, this would lead to higher per capita allocations to small countries. In contrast, the IDA PBA formula has an exponential weight of 1.0 on population. Also, most small ADF borrowers are in the Pacific, which compete only among themselves for an earmarked pool of ADF resources. Within the Pacific pool, minimum allocations would just lead to a reallocation among these small countries. Outside of the Pacific, the smallest countries (Bhutan and the Maldives) are not among the poorest. As such, aligning with the IDA approach of providing minimum allocations on top of PBA would do little to redirect resources to the poorest countries.

21. **Deepen the Small-Country Bias in the PBA Formula.** Another approach to containing the share of large blend countries would be to further reduce the population exponent in the PBA formula. This was reduced from 0.75 to 0.6 under ADF IX, and reducing it further would direct additional funds toward the smaller countries. However, this would also adversely affect medium-sized poor countries (such as Nepal) while benefiting the small ADF-only countries that are not among the poorest (Bhutan and the Maldives).

22. **Provide a Separate Resource Pool for ADF-Only Countries.** A direct approach would be to provide a separate resource pool for ADF-only countries, as is done for Pacific countries. The size of the pool would be a set percentage of planned ADF operations at the completion of ADF negotiations. The size of the pool would be based on donors' preferences for directing concessional resources to this group. The countries within that pool would still receive their shares according to the PBA formula. However, this approach has a number of drawbacks. First, the countries competing for resources within the segmented pools would be quite small: eight ADF-only borrowers and seven blend borrowers. This would tend to weaken the performance incentives in the system as the number of comparators declines. Creating a separate pool for ADF-only countries would also have the effect of drawing resources away from the smaller blend countries.

23. **Cap Large-Country Allocations.** Large blend countries have access to financing sources not available to the ADF-only countries. Not only can they borrow OCR resources, but they will also be able to take advantage of the proposed hard-term ADF window (para. 18). Large ADF-eligible countries such as India and People's Republic of China were not given access to ADF from the outset on the grounds that their very large size would crowd out other ADF recipients. The allocation to another large ADF borrower, Indonesia, was capped in ADF VIII and ADF IX. This approach could be applied more broadly to eliminate the crowding out by large countries without compromising the principles of PBA. IDA has long used this approach for its largest Asian borrowers (the People's Republic of China in the past; India, Indonesia, and Pakistan in IDA14). While the ADF cap to Indonesia was a specific dollar amount, IDA14 caps are a percentage of the resource envelope based on historical lending. As such, different caps are used for different countries in IDA. In both ADF and IDA, the capped amounts are much smaller than what would have been provided to the countries if they received their full PBA.

¹¹ International Development Association. 2007. *IDA's Performance-Based Allocation System: Options for Simplifying the Formula and Reducing Volatility*. Washington, DC (February).

Table 4: Illustration of Portfolio Performance Ratings by Portfolio Size

Number of Projects in the Portfolio	Portfolio Performance Rating by Number of Projects-at-Risk												
	0	1	2	3	4	5	6	7	8	9	10	15	20
2	6.0	1.0	1.0	—	—	—	—	—	—	—	—	—	—
3	6.0	2.5	1.0	1.0	—	—	—	—	—	—	—	—	—
4	6.0	3.5	1.0	1.0	1.0	—	—	—	—	—	—	—	—
5	6.0	4.0	2.0	1.0	1.0	1.0	—	—	—	—	—	—	—
6	6.0	4.5	2.5	1.0	1.0	1.0	1.0	—	—	—	—	—	—
7	6.0	4.5	3.0	1.5	1.0	1.0	1.0	1.0	—	—	—	—	—
8	6.0	5.0	3.5	2.5	1.0	1.0	1.0	1.0	1.0	—	—	—	—
9	6.0	5.0	4.0	2.5	1.5	1.0	1.0	1.0	1.0	1.0	—	—	—
10	6.0	5.0	4.0	3.0	2.0	1.0	1.0	1.0	1.0	1.0	1.0	—	—
15	6.0	5.5	4.5	4.0	3.5	2.5	2.0	1.5	1.0	1.0	1.0	1.0	—
20	6.0	5.5	5.0	4.5	4.0	3.5	3.0	2.5	2.0	1.5	1.0	1.0	1.0

Source: Asian Development Bank.

4. Recommendation

24. Of the various options, ADB staff recommends setting caps on allocations to the largest borrowers. This would free up scarce resources for the smaller countries, while at the same time preserving the existing PBA formula. Depending on the overall replenishment size, the caps can be set such that they would still allow for an increase in the nominal allocations of the largest countries under ADF X. At the same time, this would redirect a greater share of funds to the poorest countries.

B. Portfolio Performance

25. Among the performance criteria, portfolio performance is the most volatile, a problem also experienced in the IDA PBA system. The policy and institutional rating and governance rating are averages of several criteria (Appendix 1), many of which are based on the ratings of a number of subcriteria. On the other hand, portfolio performance is based on only one indicator: the age-adjusted percentage of projects-at-risk (Appendix 3). Between 2005 and 2006, the elements of composite country performance other than portfolio had average absolute differences in ratings of 0.1–0.3 points. In contrast, portfolio performance had an average absolute difference in ratings of 0.8 points, and three countries experienced changes in scores of 2 or more points.

26. The data on project performance is drawn from the project performance reports, which are generally updated quarterly by the operations departments. The project performance report takes into account a number of aspects of project performance—indicators of implementation progress, project impacts and outcomes, and flags for potential problems—but a project is only “at risk” when multiple elements are less than satisfactory. Because the system does not distinguish degrees of risk, it can lead to wide swings in performance ratings, especially for countries with small portfolios as illustrated in Table 4. In the 2006 CPA exercise, the average portfolio performance rating was 4.5. In this case, countries with five or fewer ongoing projects would have received below-average ratings with only one project-at-risk. Even for a country with

20 projects—which is a relatively large portfolio among ADF borrowers¹²—an improvement or deterioration in the risk-rating of two projects in a year could lead to a 1 point change in the portfolio performance rating.

27. Countries with larger portfolios also benefit from certain scale effects. A large loan portfolio generally entails a number of ongoing or planned activities within a given sector. This allows for more opportunities for dialogue on sector-specific issues affecting project performance, and more spillover benefits to other projects from capacity building efforts within executing agencies, especially regarding ADB policies and procedures. The prospect of future ADB support to a sector can also provide important leverage to get action on weaknesses in ongoing projects. Furthermore, ADB tends to have more staff in resident missions in countries where its operations are larger, which supports better portfolio performance more generally. This bigger field presence allows for more frequent portfolio reviews and more focused attention on cross-sector issues such as government procurement practices, environmental safeguards, and land acquisition procedures. The current approach to rating portfolio performance does not recognize the difference in ADB support provided across countries.

28. Project performance reports are a tool for identifying and addressing project problems during implementation. Using these reports to make ADF allocations creates an incentive to underreport problems, undermining their effectiveness as a management tool.

29. The current approach to portfolio performance ratings is too narrow. The system is prone to wide swings in ratings with only small changes in the number of projects at risk, particularly for countries with five or fewer projects. Moreover, the direct linkage to the share of projects “at risk” discourages timely reporting of project problems. A new approach to portfolio performance needs to be considered, covering a broader set of indicators of portfolio quality to provide a more nuanced view of the situation. The independent Operations Evaluation Department is finalizing a study of the project performance management system as part of its annual report on portfolio performance. ADB staff will prepare options for improving the portfolio performance rating methodology. The options that IDA is proposing to address the problem of portfolio performance volatility in its PBA formula will also be considered.¹³

C. Subregional Pool

30. During the ADF IX replenishment discussions, donors agreed to earmark up to 5% of planned ADF operations for subregional projects with benefits that are demonstrably multicountry.¹⁴ Potentially eligible projects need to be consistent with the country strategy and ADB’s regional cooperation strategy. To show national commitment, at least 20% of the project cost has to be financed from national resources (which includes the country’s PBA, government counterpart, and cofinancing). However, management can waive or lower this requirement for small countries or in cases where the country does not accrue substantial project benefits. Project concept papers are vetted by the PBA unit to ensure that they meet the eligibility requirements specified in the PBA policy. Demand for the funding from the ADF subregional pool far exceeds the earmarked resources. For 2007–2008, 13 eligible projects totaling nearly \$570 million were submitted for funding, but the biennial allocation was less than \$170 million. A

¹² In the 2006 CPA exercise, only seven ADF borrowers had portfolios with 20 or more loans. This group included the three largest blend countries.

¹³ International Development Association. 2007. *Performance-Based Allocation System: Options for Simplifying the Formula and Reducing Volatility*. Washington, DC.

¹⁴ ADB. 2004. *ADF IX Donors’ Report: Development Effectiveness for Poverty Reduction*. Manila.

strict prioritization process was established in the revised PBA policy, and only 5 of the submitted proposals could be allocated funds because of the tight resource constraint.

31. As emphasized in the discussion paper on the role and priorities for ADF X (footnote 1), ADB's institutional commitment to regional cooperation—and its strong track record in this field—is a major inherent strength. It needs to be adequately leveraged for the benefit of ADF countries. Regional cooperation and integration can be a powerful tool to boost the pace of growth in the slow-growing and poorer ADF countries by strengthening their backward and forward linkages to the rapidly developing economies of the region. In addition, a range of cross-border public goods—such as containing infectious diseases or attacking the causes of climate change—need to be handled through regional initiatives. However, the resource limitations currently experienced inhibit ADB's ability to realize its full potential as a partner for regional cooperation and integration among ADF countries. For 2009–2010, country teams have identified nearly \$900 million in subregional projects. In comparison with the ADF X baseline of \$10 billion assumed for illustrative purposes,¹⁵ earmarking 5% means a biennial allocation to the subregional pool of only \$250 million, which would continue to leave most eligible projects unfinanced. ADB staff recommend increasing the share earmarked for subregional projects. The extent of such increase can be appropriately calibrated, depending on the size of the replenishment that is finally agreed.

D. Postconflict Country Set-Asides

32. Three countries received their allocations outside of the PBA system during ADF IX. Afghanistan (\$400 million each biennial period) and Timor-Leste (\$20 million from 2007–2008) received amounts greater than the formula-based allocations because of their status as postconflict countries. As agreed during ADF IX discussions, ADB follows IDA's approach to providing allocations to postconflict countries. IDA provides special allocations for up to 4 years, plus an additional 3-year phase-out period before reaching the PBA level. However, the phase-out period is likely to be lengthened under IDA15, in which case ADB can follow suit.

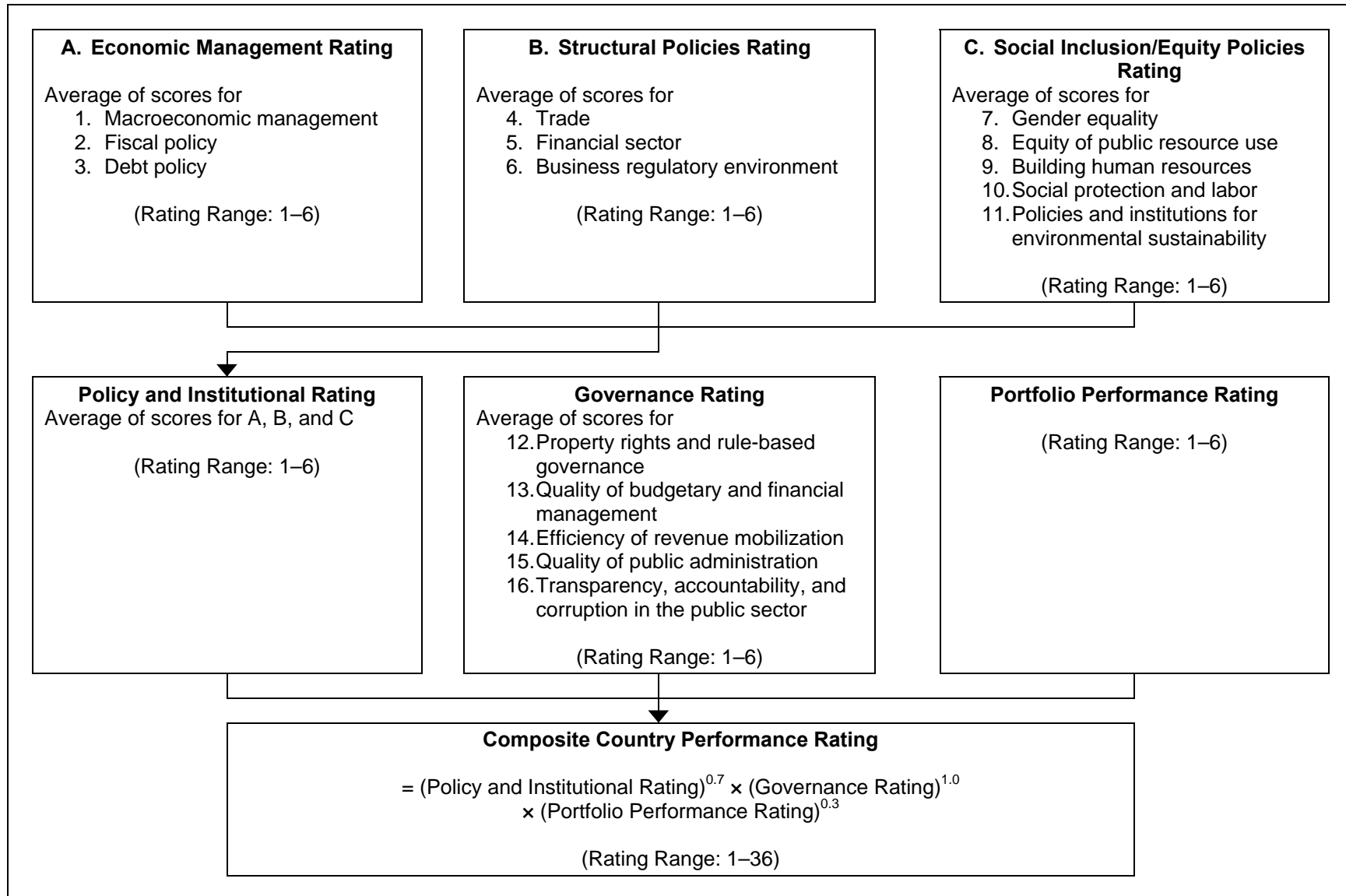
IV. SUMMARY OF PROPOSALS FOR DONOR CONSIDERATION

33. Regarding proposed enhancements to the PBA system, donors' views are requested on the following:

- (i) Do deputies agree that the PBA system, as revised during the ADF IX replenishment, remains broadly appropriate and that the current formula should be retained?
- (ii) Do deputies agree to consider capping the largest blend borrowers?
- (iii) Do deputies agree that the portfolio performance measure needs to be reviewed and that ADB should propose an alternative approach within the context of the existing PBA policy?
- (iv) Do deputies agree to consider an increase in the allocation share of the ADF subregional pool?
- (v) Do deputies agree that ADB should align the phase-out period for postconflict countries with that of IDA15?

¹⁵ ADB. 2007. *Asian Development Fund's Long-Term Financial Capacity*. Manila.

CALCULATION OF THE COMPOSITE COUNTRY PERFORMANCE RATING

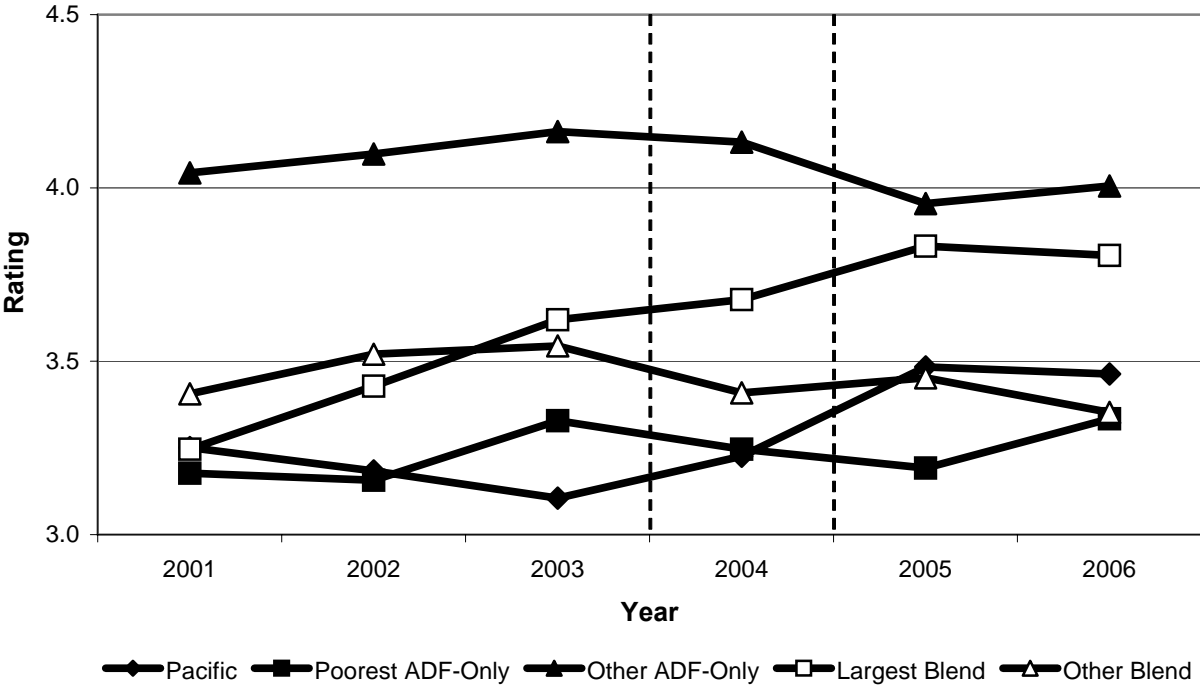


CHANGING MEASUREMENT OF PERFORMANCE

1. During the time that ADB has applied PBA, the measurement of country performance has undergone three distinct phases. In 2001–2003, an earlier performance questionnaire and formula for the composite country performance rating were used to derive allocations. In 2004, the old questionnaire was used, but it was mapped into the new formula for the composite rating. For 2005–2006, a new IDA country policy and institutional assessment questionnaire and the new composite rating formula were used. Because of these changes, comparisons of ratings over time need to be treated with caution.

2. The composite country performance ratings are presented by country group (Figure A2). The square roots of the new formula composite ratings are used so that the scales are the same in every year. Looking at the 2004 results (which were used to determine 2005–2006 allocations), measured performance for all country groups declined (except for the Pacific) when the new composite rating formula was introduced. Within each period where the same approach to measuring country performance is used, the performance of the poorest countries has generally been on the rise. However, relative performance is what matters for allocations. Although not obvious from the chart, the average composite rating for the large countries has been rising faster than that of the poorest countries. As a result, the ratio of performance ratings of the poorest countries to that of the large countries declined from 98% in 2001 to 88% in 2006.

Figure A2: Composite Country Performance Ratings by Country Group, 2001–2006



Note: The graph uses square roots of the new formula ratings (2004–2006) to convert them to a 1–6 scale, to be comparable to the old scale. The dashed lines indicate where a change in the approach to measuring country performance occurred between periods.

Source: Asian Development Bank.

3. Differences in performance among country groups are relatively small, but the change in the way performance is measured in the revised system has favored the large countries over the poorest. Composite ratings are closely clustered within the ratings scale—about 1 point separates the low-performing group from the high performers. However, by effectively squaring the country performance rating under the new formula (i.e., moving from a 1–6 scale to a 1–36 scale), the small differences in composite ratings are magnified.¹⁶ Although the average governance rating for the poorest ADF-only countries has been trending upward, it has not kept pace with the improvement experienced by the largest blend countries. Because of this, the additional weight on governance in the formula would have helped widen the gap between the poor ADF-only countries and the largest blend countries.

¹⁶ A country with a rating of 4 would have a score that is 33% higher than a country with a rating of 3 on a 1–6 scale ($4/3 = 1.33$). If these scores are squared, the country with the better rating would be 78% higher ($16/9 = 1.78$).

PORTFOLIO PERFORMANCE RATING METHODOLOGY

1. Portfolio performance is based on a single indicator: the age-adjusted percentage of projects-at-risk. The percentage is the number of projects-at-risk funded by the Asian Development Fund (ADF) from the Asian Development Bank's project performance reporting system divided by the total number of approved ongoing projects. Previously, the proportion was based on the situation as of the end of December from the year prior to the date of the country performance assessment exercise. Since 2006, the average of quarterly data has been used (September of the previous year through June of the current year). This provides a better reflection of the quality of the portfolio over the course of the year. Quarterly data is used as this corresponds best with the frequency that project performance reports are updated.

2. Because newer projects are less likely to be flagged as "at risk," the ratio will overstate the quality of portfolios with a relatively high percentage of new projects. To correct for this bias, an age-adjustment factor is added to the average projects-at-risk ratio for portfolios that are younger than the average age of all ADF projects. The performance rating is determined by the conversion table (Table A3). For countries with one or fewer ongoing projects, the average portfolio rating for all other countries (rounded to the nearest 0.5) is used.

Table A3: Portfolio Performance Conversion

Proportion of Projects at Risk	Rating
0–2	6.0
3–7	5.5
8–12	5.0
13–17	4.5
18–22	4.0
23–27	3.5
28–32	3.0
33–37	2.5
38–42	2.0
43–47	1.5
48–100	1.0

Source: Asian Development Bank.