

# **ASIAN DEVELOPMENT BANK**

## **INNOVATION AND EFFICIENCY INITIATIVE**

### **COST SHARING AND ELIGIBILITY OF EXPENDITURES FOR ASIAN DEVELOPMENT BANK FINANCING: A NEW APPROACH**

**August 2005**

## ABBREVIATIONS

ADB	–	Asian Development Bank
CSP	–	country strategy and program
DMC	–	developing member country
IDC	–	interest during construction
IEI	–	Innovation and Efficiency Initiative
OM	–	Operations Manual
OP	–	Operational Procedure
RRP	–	report and recommendation of the President
SPD	–	Strategy and Policy Department
SWG	–	strategy working group
TA	–	technical assistance

## NOTE

In this report, “\$” refers to US dollars.

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## I. INTRODUCTION

1. This paper proposes the modification of a number of Asian Development Bank (ADB) policies and rules on cost sharing and eligibility of expenditures. Its aim is to establish a new policy framework to determine how much, and what, ADB can finance under its public sector development programs.<sup>1</sup> A new policy framework is essential for ADB to remain an effective, responsive, results-oriented, and hence relevant partner to its developing member countries (DMC). The proposed changes will give ADB a project financing framework that is (i) more closely aligned with the actual expenditure requirements of borrowers, (ii) harmonized with that of other development partners, and (iii) consistent across lending instruments. Simpler and more uniform cost sharing and expenditure eligibility will help reduce transaction costs for borrowers and ADB.

2. This paper is one of several being prepared under the Innovation and Efficiency Initiative (IEI), launched in November 2003.<sup>2</sup> IEI aims to improve ADB's business model by removing bottlenecks that constrain its capacity to respond better and more quickly to its clients. One of IEI's key principles is to promote the harmonization of rules, procedures, and practices with those of its clients and development partners. The proposals and recommendations contained in this and other IEI papers represent important steps toward achieving the objectives and goals of ADB's strategic agenda.

3. ADB's Long-Term Strategic Framework 2001–2015 and associated first Medium Term Strategy 2001–2005<sup>3</sup> explain the strategic context and functioning of ADB. Both documents call on ADB to respond better to the needs of its DMCs—and of partner organizations—through streamlined and simplified procedures and practices. They also urge ADB to introduce greater flexibility to its structure, skill base, processes, and products.

4. Similarly, ADB's original Poverty Reduction Strategy (1999) and its recent review in 2004<sup>4</sup> stress the need for ADB to widen the range of available modalities and instruments, and tailor assistance to the complex needs of poverty reduction in DMCs. In the context of the new global development architecture that emerged following the Millennium Declaration,<sup>5</sup> ADB has also renewed its commitment to improving development effectiveness by reducing administrative costs to developing countries through, among others, harmonization of operational procedures and practices.

5. To deliver on the commitments made in its strategic frameworks, and contribute to the global commitment on aid effectiveness articulated in the Paris Declaration,<sup>6</sup> ADB defined for

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<sup>1</sup> This new framework will not apply to ADB guarantee operations or to private sector transactions.

<sup>2</sup> In addition to cost sharing and expenditure eligibility, IEI proposals focus on (i) country strategy program and business processes, (ii) consulting services and procurement, (iii) safeguards, and (iv) new financing instruments and modalities.

<sup>3</sup> ADB. 2001. *The Long Term Strategic Framework of the Asian Development Bank (2001–2005)*. Manila; ADB. 2001. *The Medium Term Strategy (2001–2005)*. Manila

<sup>4</sup> ADB. 2004. *Review of the Poverty Reduction Strategy of the Asian Development Bank*. Manila

<sup>5</sup> The Declaration was signed in September 2000, at the Millennium Summit in New York, by leaders of the world's governments. The Declaration commits the leaders to eight poverty and development goals and related targets that came to be known as the Millennium Development Goals (MDG).

<sup>6</sup> 2005. *High-Level Forum on Joint Progress Towards Aid Effectiveness, Harmonization, Alignment, Results*. 28 February–2 March 2005. Paris. In September 2003, the Development Committee noted in its communiqué: "Changes are needed in the way that aid is provided as highlighted in the Declaration of the Rome High-Level Forum on Harmonization. In addition to streamlining procedures and lowering transaction costs, assistance will have to be better aligned to country needs, to country priorities and processes, to countries that demonstrate the

itself an ambitious reform agenda (the Reform Agenda) to enhance its organizational effectiveness and make ADB a more results-driven catalyst for poverty reduction and prosperity in the region.<sup>7</sup> IEI is a core reform initiative under the Reform Agenda.

6. The policy changes proposed in this paper are broadly consistent with those that the World Bank adopted, and this paper follows closely the rationale and presentation given by the World Bank in its policy paper.<sup>8</sup> This includes the background to the changes and the list and sequencing of the proposals. This approach makes it easier to evaluate the areas where, and extent to which, the ADB policy framework is being brought in line and harmonized with that of the World Bank.<sup>9</sup> The two policy frameworks are different, however. Some of these differences will remain, mainly due to differences between World Bank and ADB Charters. For instance, the World Bank can finance up to 100% of a project, while ADB cannot. The paper highlights the differences between the two policy frameworks.

## II. NEW APPROACH FOR COST SHARING AND EXPENDITURE ELIGIBILITY

### A. Origin of Current Rules, Evolving Practices, and Increasing Distortions

7. ADB rules on cost sharing and expenditure eligibility are outdated. They were developed in the 1970s when ADB financed development projects in an environment where the integrity of each project required it to be “ring-fenced” with its own regulatory framework. At the time, fiscal, monetary, and external regulations often distorted the investment climate. Except in a few isolated cases, such policy distortions and regulations are no longer in place. Many DMCs have removed many of the restrictions on the internal and external movement of goods and capital.<sup>10</sup> More conservative fiscal and monetary policies also have extended the planning horizon, while supporting the mobilization of domestic savings for investments required for poverty reduction, growth, and development. In the meantime, project finance practices have evolved, as have the range of project structures, financial instruments, and financing modalities.

8. In this new environment, the role and significance of ADB-financed projects within the overall development process and public sector investment programs have declined. ADB has responded by diversifying its range and type of interventions, adding program lending and various forms of technical assistance (TA) to the list.

9. Despite these changes in internal and external conditions, ADB’s cost sharing limits and expenditure eligibility criteria for project financing have remained largely the same. Over the years, this situation has created a considerable disconnect with best practices in the market, and has prevented ADB from keeping up with the changing market reality and the actual needs of DMCs. The application of outdated cost sharing and expenditure eligibility rules, focusing primarily on the project level and individual contract and loan withdrawal applications, has also constrained ADB’s ability to mobilize cofinancing.

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ability to achieve measurable development results; and to support the development of the countries’ capacity.” The Paris Declaration on Aid Effectiveness of March 2005 reconfirmed and expanded these provisions.

<sup>7</sup> ADB. 2004. *ADB Reform Agenda*. Available <http://adb.org/ReformAgenda/adb.asp>

<sup>8</sup> World Bank. 2004. *Eligibility of Expenditure in World Bank Lending: A New Policy Framework*. Washington, DC. 26 March.

<sup>9</sup> The World Bank is the first multilateral bank to take action in this area.

<sup>10</sup> For example, over the past 2 decades, India has reduced its maximum import tariff from 300% to 15%.

10. Policy application also is distorted and inconsistent across different ADB financial instruments. For example, despite its commitment to support human development in projects, ADB has difficulty financing the cost of salaries of teachers and health workers, except in exceptional circumstances. In contrast, under sector reform program loans, ADB has financed severance payments for employees who cannot work productively anymore. In addition, while ADB can finance the construction of physical assets, it generally cannot finance those same assets through alternative—and in some cases more financially efficient—modalities, such as leasing.

11. Inconsistency in cost sharing and expenditure eligibility rules across ADB instruments can affect DMC costs and choices. For instance, while project financing cannot finance taxes and duties, program loans can be used to fill financing gaps arising from fiscal constraints. Because of these inconsistencies, some borrowers might seek program rather than project lending, even when the latter might be more appropriate.

12. Overall, ADB's cost sharing and expenditure eligibility rules make it difficult to deliver procedural consistency across instruments and investments. This impacts ADB's ability to be responsive and client-driven, and limits harmonization with other funding agencies. An update of these rules is long overdue—not only to put ADB on a “level playing field” with other financiers, but also to respond better to client needs and reduce transaction costs.<sup>11</sup>

## **B. New Principles**

13. A revised ADB policy framework on cost sharing and expenditure eligibility should adhere to three basic principles: (i) expenditures covered under the loan proceeds should promote development, and thus underpin the poverty reduction agenda; (ii) operations funded in the new and more flexible manner should not unduly burden the country's fiscal, debt, and macroeconomic sustainability; and (iii) effective fiduciary and other oversight arrangements should be in place at all stages of the business cycle—at the country, executing agency, and project level. These principles must be reinforced with the governments' commitment to, and ownership of, the programs and projects financed by ADB. These principles are consistent with the Charter and coincide broadly with those of other development partners.<sup>12</sup>

14. The revised policy framework calls for revisions to the section in ADB's Operations Manual (OM) on the subject. The OM section and staff instructions would not show expenditure eligibility in terms of a series of limitations and/or prohibitions. Instead, expenditure eligibility would be presented as a positive policy framework that lays out what ADB financing can cover, and how the associated risks would be managed. This change from prohibition, with provisions for exceptions, to a positive framework would allow full harmonization with a DMC's development program, as well as with the “rules of engagement” of other funding agencies.

15. The new OM section and associated staff instructions would incorporate all the provisions contained in this paper to ensure full adherence to the principles and the new eligibility criteria. The assessments and methodologies to be followed are consistent with those of ADB's partners. This is to avoid duplication and inconsistencies at the DMC level, and to promote close coordination and collaboration between ADB and its development partners.

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<sup>11</sup> The World Bank has estimated that the direct financial cost to its borrowers of these rules and procedures is up to \$100 million annually. On a pro rata basis, these costs might be \$60 million for ADB clients.

<sup>12</sup> World Bank. 2004. *Eligibility of Expenditures in World Bank Lending: A New Policy Framework*. Washington, DC. 26 March 2004, p. 5.

16. ADB will maintain its approach on the financing of military expenditures, nuclear reactors, environmentally hazardous substances, and other nondevelopment expenditures. The proposed changes in ADB policies are described in Section III. Appendix 1 provides a summary matrix of these (as well as an account of the World Bank's old and new policies). Appendix 2 summarizes the IEI mandate and shows a results framework.

### III. PROPOSED COST SHARING AND EXPENDITURE ELIGIBILITY RULES

#### A. Cost Sharing and Local Cost Financing

17. ADB's policy on cost sharing and local cost financing is in OM section H3/BP, issued on 23 December 2004. This section outlines the maximum percentages of project costs that can be financed in countries falling in the four DMC groups. These percentages range from 65% in the most-developed DMC group to 80% in the least-developed. ADB financing can—and routinely does—cover the full amount of direct and indirect foreign exchange costs in a given project's investment plan, even if this exceeds the DMC's total cost sharing limit. This implies that the policy effectively limits only the financing of local currency costs. ADB can finance a share of these local costs, if ADB deems the amount to be reasonable and not doing so would strain a DMC's balance-of-payments situation.

18. In addition, the four DMC country groups do not reflect accurately the diversity of DMC needs for development financing at different times. Quite often, the limit on local currency financing only for individual projects (given that the local currency content of development projects can vary significantly) leads to widely differing financing obligations for borrowers. Moreover, problems with counterpart financing of local costs often have affected the timing and quality of implementation, particularly in less-developed DMCs. Counterpart financing difficulties are not necessarily the result of poor commitment and ownership of the investment program. Rather, they can be a function of temporary budget constraints, and in some cases of significant differences between the budgetary and project planning cycles. The problem can be compounded by periodic budgetary crises, even in more advanced DMCs, and the reality that externally funded projects are often outside the regular budgetary process.

19. A change to this ADB policy regime is not inconsistent with its core operating principle of DMC commitment and ownership of investment projects and programs. This principle will continue with the new framework. It is important to note that ADB financing in most DMCs represents at most 1% of their annual public sector investment program while total development assistance covers on average about 4% of public investments. Hence, borrowers effectively are funding (directly or indirectly) more than 95% of their own public sector investments. ADB financial assistance, whether targeting a stand-alone project or a sector investment program, is part of this public investment program. Borrower commitment, ownership, and cost sharing makes more sense when judged against the aggregate portfolio rather than against an individual project.

20. ADB policy on cost sharing should be modified to replace the existing ceilings applicable to the four DMC country groups with an overall financing ceiling in each DMC. This ceiling would be established for the aggregate ADB portfolio in a DMC, rather than for individual projects. It would take into consideration, *inter alia*, the DMC's balance of payments situation and other macroeconomic factors (see below). The ceilings would be established in principle during the preparation of the country strategy and program (CSP). For DMCs where the CSP was

completed recently, the ceiling could be established as a stand-alone exercise. This would be an interim measure until the next CSP cycle.

21. The macroeconomic and fiduciary-related variables to be assessed would be detailed in the OM section and staff instructions. Consistent with the variables agreed upon by other development partners, the establishment of an aggregate portfolio ceiling would be based on detailed macroeconomic assessments covering, but not limited to, the following:

- (i) Past, present, and projected fiscal policy stance in the country (including revenue collection system, and the level and quality of the public expenditure program and its financing plan);
- (ii) Public financial management system (including the institutions, policies, and approaches); and the quality of the mechanisms for budget preparation, implementation, and control (including the financial management information system, specific tax regime, and associated governance/fiduciary arrangements);
- (iii) The degree to which the ADB portfolio agreed upon with the DMC is integrated into the latter's budget process;
- (iv) Debt sustainability, involving matching the fiscal capacity and sustainability with the short-, medium-, and long-term structure of the public sector debt stock; and distinguishing between commercial, official, and multilateral debt; and
- (v) The nature and characteristics of the foreign exchange regime, the balance of payments situation, and general trade and financial policies.

22. Once ADB has established a DMC's financing parameters, these would apply to all loan and TA operations prepared thereafter.<sup>13</sup> In line with sound banking principles, the specific cost sharing arrangements for each individual project would depend on the specific sector, client, and project characteristics. In some cases, the ceiling may be exceeded; in other cases, it may not. Such variations are permissible so long as the financing parameters established for each DMC are observed within the applicable period.

23. Under the current policy, ADB can finance local currency costs above the direct and indirect foreign exchange costs outlined in an investment plan. However, such local cost financing is based on two main conditions: (i) the DMC is making a reasonable effort to develop and mobilize the required domestic savings; and (ii) despite these efforts, the financing requirements of the development project or program exceed the DMC's financing capabilities at that time. Under the revised policy, these conditions—and the financing limitations derived from them—would be expressed in terms of ADB's aggregate investment and TA portfolio. In accordance with its Charter, ADB would not finance 100% of project costs.<sup>14</sup> Variations could

<sup>13</sup> In least-developed DMCs, where foreign exchange and fiscal distortions are substantial, additional financial parameters also could be needed for local cost financing and allowable taxes and duties in relation to ADB financing.

<sup>14</sup> This differs from World Bank practice. World Bank. 2004. *Eligibility of Expenditures in World Bank Lending: A New Policy Framework*. Washington, DC. 26 March 2004, p. 7. World Bank policy states: "The Bank would judge the adequacy of this funding in the context of the borrower's overall development program generally and its funding for the sectors on which Bank assistance would focus in particular. This would provide the Bank with the flexibility to finance higher proportions of project costs, in some cases up to 100%."

occur between projects, depending on their specific nature and characteristics, as well as on sector and client considerations. so long as ADB ensures that its financing envelope falls within the ceiling during the ceiling applicability period.

24. A legal analysis established that the proposed cost sharing arrangements are consistent with the Charter, particularly Article 13. As described above, the ceiling for an individual DMC is determined generally on the basis of its balance of payments and other macroeconomic factors. ADB financing will always be less than 100% of the project costs, and will be based on what is reasonable in light of specific sector, client, and project characteristics.

25. ADB structures individual investment plan components and subcomponents separately into foreign exchange (direct and indirect) and local cost equivalent. However, under current international best practice for project financing, investment plan components are not normally structured in this manner. In many instances, local and foreign exchange costs are impossible to separate out with any degree of accuracy. Further complicating this situation, final project design often is undertaken only after ADB Board approval. This means that the exact procurement packages (and the corresponding disbursement plans) for some projects can be finalized only during project implementation. Moreover, splitting foreign exchange and local costs in the investment plan is not a sound means to estimate and mitigate currency risks in projects. The latter can be evaluated only through other means, such as economic and financial modeling, which implies reviewing assumptions governing the quality of the income stream and the exchange rate regime. While the split between foreign and local costs in the investment plan might have been appropriate 40 years ago when ADB was established, it no longer is.

26. The project cost or investment plan should no longer distinguish between local and foreign exchange cost categories. The financing plan instead should differentiate the sources of finance—including finance to be provided by ADB, the government, and other cofinanciers. The financing plan can distinguish further between lending in different currencies, as well as between short-, medium-, and longer-term maturities. Therefore, the financing plan no longer would be determined based on an artificial split between foreign or local expenditures worked out for each subproject component in the investment plan. The amount of financing that ADB proposes for a project would be based on specific sector, client, and project considerations. For revenue- and nonrevenue-earning projects, debt finance should adhere to sound banking principles. This means, among other things, taking into account a project's cost recovery profile (i.e., ability to pay), sustainability configurations (i.e., adequate budget support), and currency mismatch risks.

27. A similar approach is proposed for cost sharing in TA operations, irrespective of whether the TA is financed as a grant, loan, or a combination. At present, the share of TAs to be financed by ADB is specified for each DMC group. In addition, the DMC's contribution is limited to local cost financing, measured in a rather artificial and restricted way.<sup>15</sup> Under the proposed policy, the share of TA operations to be financed by ADB would be agreed for the aggregate ADB portfolio in the DMC. Thereafter, the funding proposed for each TA could vary from the cost sharing ceiling, reflecting the sector focus and the nature and purposes of the TA.

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<sup>15</sup> ADB. 2004. "Local Cost Financing and Cost Sharing." *Operations Manual*, Section H3/BP, issued on 23 December 2004, A DMC's contribution to financing a TA operation is subjected to the limit of total TA cost minus foreign exchange cost and the cost of domestic consultants.

## **B. Taxes and Duties**

28. Indirect taxes (including import duties, value-added taxes, and sales taxes) levied on specific goods, works, and services are ineligible for ADB financing, as specified in OM section H3/BP, issued on 23 December 2004. ADB has treated taxes and duties as ineligible expenditures on the grounds that they (i) represent, potentially, transfer payments to borrowers; (ii) are denominated in local currency; and (iii) can be distorted by high tax rate regimes. ADB's development partners used these same grounds in the past.

29. In practice, however, ADB has treated taxes and duties inconsistently, which at times has complicated the financing plan of projects and even created temporary budgetary distortions in DMCs. One example of such an inconsistency concerns taxes paid inside the territory of the borrower and taxes paid outside. The former are ineligible for ADB financing; the latter are often financed. Inconsistencies and distortions of this type at the project level have an impact on the financing plan, especially with value-added taxes. The ineligibility of taxes and duties for ADB financing increases counterpart financing requirements. Such financing might not be available when needed, potentially leading to implementation delays and even project viability problems. Increasing counterpart financing this way does not automatically increase DMC commitment or ownership. Finally, tax exemptions on projects funded by development agencies can put undue pressures on the DMC's budget.

30. The cost of taxes and duties related to project expenditures should be eligible for ADB financing. However, ADB financing of such taxes and duties should be limited to a reasonable amount. The definition of "reasonable" would be based on an assessment of the specific fiscal/tax regime in the country. This would be followed by an evaluation of whether the overall tax and duties "line" is pitched at an excessive and material level, or whether this falls generally within what is regarded as a normal threshold. The inclusion of taxes and duties would be based on an assessment of transparency, competitive neutrality, and fiscal sustainability of the arrangements proposed. Country teams also might produce and assess regional and international emerging market benchmarks for this purpose. At the project level, this evaluation would focus on the share of the investment plan accounted for by this item. The value should not represent an excessive share of the investment plan. Further, it should be applicable strictly to ADB-financed projects, activities, and expenditures. Taxes and duties also would be judged as to whether they are material and relevant to the success of the project. For operations involving parallel cofinancing with bilateral development partners, the eligibility of taxes and duties for a cofinanced portion of the financing plan would adhere to the rules of these partners. Some might have restrictions in this area. The Asian Development Fund IX arrangements do not prevent the adoption of this reform.

## **C. Land Acquisition and Payments for Rights-of-Way**

31. Land acquisition and payments for rights-of-way are currently ineligible for ADB financing. This is captured in OM section H3/BP, issued on 23 December 2004. However, land is a standard component of an investment project, like working capital, civil works, and plant and equipment. ADB has excluded land acquisition from its list of eligible financing items because land (i) does not meet traditional development tests associated with public sector investments; and (ii) represents a local cost component with complex legal issues, such as tenure and community rights.

32. The argument that financing land does not measure up to traditional development impact tests is flawed. First, land plays a significant role in economic activity, in most cases like labor

and capital do. Second, land acquisition is often a necessary expenditure that helps make projects happen. This applies to infrastructure and utility finance transactions, as well as to social development projects, including schools and hospitals.

33. Financing land acquisition and payments for rights-of-way (often costly components) can make a major difference to clients. Funding this component also could lower the risk of project implementation delays, as well as cost escalations resulting from inadequate and/or late government budgetary allocations.<sup>16</sup> The importance of government commitment to cofinancing projects and meeting specific loan covenants is not questioned. The ability of governments to provide financing on time to acquire land and pay for rights-of-way is another matter. The distinction between land treated as a component of an investment plan and land acquisition as a project by itself is significant. The latter normally is associated with community-based investments. In the first instance, the cost tends to represent a relatively small share of the investment plan (perhaps 10% or less). In the second, it would account for the bulk of the project itself. Irrespective of these differences, the existing policy framework prevents ADB from financing land effectively, consistently, and efficiently.

34. To address these constraints, the present policy framework should be revised to allow ADB to finance land acquisition and rights-of-way. Like other development partners, ADB should pursue a cautious approach in financing land acquisitions. The guidelines on how to handle this item would be provided in the OM section and associated staff instructions. Specifically, project teams would be required to undertake assessments focusing on, among others, (i) confirmation of the productive nature of the acquisition; (ii) suitability of land market conditions, including the definition of strategies to deal with any foreseen distortions; (iii) adequacy of the administrative arrangements, essentially to ensure that the channeling of funding is done transparently and efficiently; (iv) definition of the risk profile of the transaction, and the type of risk mitigation measures required; and (v) soundness of the monitoring and evaluation arrangements for the purchase and payments for rights-of-way. Only bona fide values would be taken into account. As required, external independent professional valuation experts would undertake these valuations. Earlier reviews and screenings should be carried out at the time of concept paper clearance before incorporating this item into the investment and financing plan.

#### **D. Other Expenditures**

35. The current ADB policy regime excludes several other project expenditures from the eligibility list. While some of these are more important than others, their exclusion is generally inconsistent with international project finance best practice. Further, their exclusion works against the principles of responsiveness and relevance. These expenditures include (i) local transport and insurance, (ii) late payment penalties, (iii) food expenditures, (iv) resettlement assistance charges, (v) interest during construction on non-ADB loans, (vi) bank charges, (vii) retroactive financing, (viii) secondhand goods, and (ix) leased assets. This section also explains ADB's current policy and exit strategy in relation to financing recurrent expenditures. These eligibility items, of course, must be assessed, documented, and justified in the Report and Recommendation of the President to the Board (RRP).

36. **Transport, Insurance, Late Payment Charges, Bank Charges, Food Expenditures, Resettlement Expenses, and Interest During Construction on Non-ADB Loans.** These expenditure items, which are not eligible for ADB financing, can make a material difference to the viability of investment projects, as well as to DMCs. As such, the policy

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<sup>16</sup> This can create problems in resettlement plans.

framework should be changed to allow these expenditures to qualify for ADB financing. In all cases, they would be evaluated for being bona fide during the due diligence process. The OM section and the staff instructions would provide guidance on the type of assessments and controls needed.

37. **Retroactive Financing.** The policy on retroactive financing (OM H4) should be changed to allow financing for up to 20% of the total ADB loan amount, and for eligible expenditures incurred 12 months before the signing of the ADB Loan Agreement. In addition, the policy framework should allow flexibility to the 12-month time limit on a case-by-case basis. ADB recognizes that some projects might require a number of advance actions (and thus expenditures) much earlier than 12 months before ADB approval and loan signing. Land acquisition is one such example. In some instances, land has to be purchased up to 3 years in advance. Selected project support facilities (e.g., access roads, water, gas, electricity, and telecommunication connections) also might have to be put in place for the purposes of the project (or an investment program involving the project) before the approval of the investment project. ADB should be able to support such expenditures when they are shown (i) to be genuine, reasonable, and material to getting the operation off the ground; and (ii) to have been incurred for proper reasons and in a transparent manner over a reasonable period of time. Any deviations from the proposed 12-month period always should be documented properly and justified in the RRP.

38. **Secondhand Goods.** The proposed policy framework revision also calls for ADB to be able to finance secondhand goods. Key criteria to be followed by staff in evaluating such a project component would focus on economy, efficiency, and appropriateness. The inclusion of this item in the eligibility list would be based on two further considerations: (i) confirmation of a surplus of goods from enough sources to ensure competitive bidding; and (ii) confirmation of limited economies of scale for the procurement of new goods, implying excessive costs to the client.

39. **Leasing.** In view of the increasing relevance of leasing in DMCs, ADB should allow lease financing. Leasing is fast becoming an alternative to purchasing in project and asset finance, and can offer financial and economic advantages to the lessee. This advantage can be manifested in lower financing costs, special tax breaks, and temporary asset utilization (cutting down the risk of obsolescence). Under a lease, the asset owner ("lessor") transfers to a user ("lessee") the right to use equipment under payment over time. Leases can be classified as capital or operating, depending on length and ownership at the end of the contract. Capital leases (financial leasing) cover the cost of an asset for most of its useful economic life. Although ownership remains with the lessor, the main benefits and risks (because of the longer length of the lease) fall on the lessee. The lessee is expected to take over the asset title at the end of the lease period. Operating leases, on the other hand, are more akin to a renting agreement. The lease period is shorter than for capital leases, and the title remains with the lessor during and at the end of the contract. In principle, leased assets can be subjected to the same procurement rules as purchased goods. However, leases do require special accounting and financing reporting, which must be in line with the financial management arrangements made under the transaction.

40. Staff instructions would provide guidance on how to evaluate leasing transactions. The evaluation should assess (i) the alternatives in the context of the project, driven largely by the value of the assets and by a comparison of the net present value of this arrangement with purchasing; (ii) the most appropriate lease options (capital or operating), the bidding arrangements, and sustainability issues (e.g., the ability of the client to buy out the leased asset

at the end of the contract); and (iii) financial management, including appropriate accounting and financial reporting.

41. **Recurrent Costs.** This paper does not propose specific changes to the policy framework on recurrent costs, which are already eligible for ADB financing—in revenue- and nonrevenue-earning projects. However, ADB should reexamine some practices in the context of individual projects. The inclusion of these expenditures in ADB financing plans would continue to be subject to existing limitations, most of which follow from the Charter. First, the coverage is confined to outlays estimated strictly during physical implementation. Second, sound banking principles require an effective limitation and exit strategy. This implies that, even if the expenditure eligibility list is increased and made more flexible by the proposed framework, the amount that ADB and others can finance will be limited to what a project structure can absorb. It is also limited by cost recovery and sustainability considerations (the latter applicable especially, but not exclusively, to nonrevenue-earning operations). Project finance typically covers capital outlays and working capital requirements. However, once implementation is over, most public sector transactions require a commitment from the authorities to provide the required budget resources to maintain the quality, sustainability, and life span of the assets or activities. Since most of these operations are cofinanced with the authorities, this commitment also effectively extends to the implementation phase. In private sector-led transactions, this commitment normally is (or should be) reflected in the equivalent of a project completion and funding guarantee. The independent Credit Risk Management Unit will screen and evaluate the risk profile and cost recovery capabilities of private and public sector projects.

#### **E. Imprest Accounts**

42. ADB requires the currency of an imprest account to be indicated in the Loan Agreement. In the future, DMCs with freely convertible currencies should be given the option to maintain imprest accounts in a convertible currency or in their own currency.

### **IV. FIDUCIARY OVERSIGHT**

43. The cost sharing and expenditure eligibility changes call for more flexible disbursement arrangements. However, ADB and its development partners should not decrease their normal type and level of internal and external controls. On the contrary, greater attention to fiduciary oversight is an important feature of the new policy framework.

44. The process would start with upfront assessments of country systems. At the project level, the DMC and the executing agencies also would be required to provide assurances to ADB that financed expenditures are strictly for the purposes of the project. ADB country teams would evaluate the DMCs' financial management systems (including audit capacity) generally at the CSP stage.

45. ADB staff still would be required to assess in detail the financial management and procurement capacities of project implementing agencies. This work would be part of the due diligence process during project preparation. In particular, auditing arrangements, and agreement that audited financial statements and project accounts are provided in a timely fashion, will be reviewed. Staff also would be required to monitor on a regular basis the financial management and procurement capacities of the agencies during project implementation or execution. Further, reviews by external auditors and ADB staff would remain a key feature of the

monitoring process. These reviews would focus on the appropriateness of the expenditures, as opposed to the current practice of reviewing in detail expenditure eligibility.

## V. IMPLEMENTATION ARRANGEMENTS AND RESOURCE IMPLICATIONS

46. Individual departments and offices will be responsible for the application of the new cost sharing and expenditure eligibility policy in respect of projects planned and implemented by them. Regional departments are responsible for processing and reviewing the cost sharing arrangements applied to individual DMCs. In circumstances where interpretation of policy is required, enquiries can be directed to the Strategy and Policy Department (SPD) and the Office of the General Counsel.

47. Under the new OM section,<sup>17</sup> staff instructions would be issued on the development of DMC financing parameters, the financing of selected expenditure types in individual projects, the specific fiduciary arrangements, and other risk-mitigation measures.

48. Country teams, in consultation with DMCs, would develop the new country financing parameters. This work would be an integral part of CSP preparation, although for some DMCs it would be a stand-alone exercise. Irrespective of the context, ADB would work closely with its development partners to determine the parameters. The objective would be to adopt similar criteria and methodologies, and to avoid duplicating assessments. ADB and institutions such as the World Bank would undertake, as much as possible, joint assessments in consultation with DMC counterparts or share the results of work completed by one or the other. This would ensure consistency, accelerate harmonization, and reduce costs for DMCs.

49. Internally, the director generals of the regional departments would be responsible for the launch and coordination of the work undertaken by the country teams in consultation with the DMCs. The director generals also would be responsible for the screening of expenditure eligibility items proposed by project teams under project investment plans. The proposals on new country ceilings would be submitted to management and then the Board of Directors. If the new country financing parameters are defined as part of the CSP preparation, CSP procedures would be followed. If the country financing parameters are established as a stand-alone exercise, the proposals would be submitted to management and the Board as a special memorandum. The memo should contain the financing proposal and a summary of all the support evaluations.

50. The implementation of the new policy would have transitional costs. Internally, policies and procedures will need to be updated, some business practices revised, and staff instructions developed. To ensure the timely implementation of these policies and procedures, RSDD would hold briefings and training for operations staff (including those at resident missions) and staff at key support departments and offices. The one-time cost of these activities is estimated at no more than \$50,000. In the medium term, the introduction of simplified and harmonized cost sharing and expenditure eligibility rules would lower administrative costs and associated staff time.

51. If undertaken as part of the CSP preparation, the budget requirement for the assessments needed to support the proposed policy framework would be relatively minor (about

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<sup>17</sup> Where this paper has implications for existing other ADB policies or strategies, the Operations Manuals of such policies and strategies shall be updated within six months of the approval of this paper.

\$30,000 additional cost on average). This is because country teams already incorporate economists in the CSP preparation, and the macroeconomic variables reviewed coincide largely with the ones proposed. These economists have the experience to evaluate the variables, and to define an aggregate portfolio ceiling. The additions to their terms of reference for these assessments will not significantly increase costs. The extra costs likely would be a function of (i) more time in the field; (ii) acquisition of new documentation; (iii) additional consultations with authorities; and (iv) possibly, in selected cases, hiring the services of a staff consultant.

52. If the establishment of the new country ceilings is a stand-alone exercise (outside the CSP process), the extra cost could range from \$70,000 to \$80,000 per country, depending on the team composition. Each regional department would determine the most cost-effective format of this exercise and team composition.

53. The new framework might increase project preparation costs. Each new item in the eligibility list would require specific new assessments, most of which could be incorporated into project preparatory TA and staff consultant mandates. The amount would differ from project to project and with each eligibility item. For instance, including and justifying land acquisition in an investment plan will be more costly than including and justifying bank charges. In general, the incremental cost is likely to range from \$5,000 to \$20,000 per project. More staff time should be allocated to fiduciary oversight arrangements during project processing and implementation.

54. The new policy framework would be effective upon the completion of the staff instructions (3<sup>rd</sup> quarter 2005). The definition of the country ceilings will await the completion of the proposed macroeconomic assessments. The application of the new expenditure eligibility criteria would be effective upon completion of the staff instructions, which are being prepared.

55. After 3 years of implementation, ADB would review the implementation experience of the proposed new policy, and identify any areas where changes might be required. A performance assessment framework is given in Appendix 2.

## VI. RECOMMENDATIONS

56. To enable ADB to enhance its project financing capability in a manner that is more consistent with market practice, and to respond more effectively to client needs, yield better results on the ground, the President recommends that the Board approve the following changes to ADB's policy on cost sharing and expenditure eligibility rules:

- (i) **Cost sharing.** ADB should determine cost sharing limits in the context of a DMC's overall development program, as well as the DMC's funding capabilities over the short to medium term. Cost sharing ceilings should be determined during CSP preparation, and these should apply to the aggregate ADB portfolio in the DMC over the CSP period. A separate overall financing ceiling should be established for loans and TA operations. The actual share of a loan or TA to be financed by ADB would vary, depending on the sector, client, and project or TA characteristics. Further, the distinction between foreign and local currency costs in a project's investment plan should be discontinued. The financing plan would show the level of ADB and partner financing for a given project, including the amounts provided by (a) government, (b) other multilateral and bilateral agencies, (c) commercial banks, (d) private equity groups, (e) capital markets,

and (f) private sector, as applicable. This cost sharing framework would not change the ADB classification of DMCs, or the graduation policy.

- (ii) **Land acquisition and payments for rights-of-way.** ADB should be allowed to finance land acquisition and payments for rights-of-way.
- (iii) **Taxes and duties.** ADB should be allowed to finance reasonable costs for taxes and duties associated with project expenditures.
- (iv) **Other expenditures.** ADB should be allowed to finance the following types of expenditures: (a) local transport and insurance, (b) late payment penalties, (c) food, (d) interest during construction on non-ADB loans, (e) bank charges, (f) retroactive financing of up to 20%, (g) secondhand goods, and (h) leased assets.
- (v) **Imprest accounts.** In DMCs with freely convertible currencies, ADB should allow borrowers to open imprest accounts in the currency of the DMC or in any freely convertible currency.

### EXPENDITURE ELIGIBILITY IN PROJECT FINANCE

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
<p>1. Cost sharing</p> <p><i>Operations Manual (OM)</i> section H3/BP, issued on 23 December 2004</p>	<p>World Bank sets cost sharing ceilings for each borrowing country, applied to World Bank's rolling 3-year investment lending program in that country. The ceiling is a function of the country's ability to mobilize domestic and foreign financial resources, and thus is based on its per capita income. For individual projects, World Bank normally expects the borrower to demonstrate commitment to the project by making a 10% minimum contribution to project cost net of taxes and duties (with some exceptions, such as when government finances are seriously strained).</p>	<p>World Bank supports activities for which the borrower has demonstrated ownership and commitment by, among other things, providing funding from its own resources. World Bank judges the adequacy of this funding in the context of the borrower's overall development program and its funding for the sectors on which World Bank assistance would focus in particular, and determines the limit on the proportion of individual project costs that may be financed by the country. The actual proportion to be financed by World Bank in each project, within the limit for the country, may vary depending on project-specific and other considerations. Staff would receive guidance in determining country and project cost sharing arrangements.</p>	<p>The Asian Development Bank (ADB) sets the maximum percentages of project costs that may be financed by cost sharing limits in each of four developing member country (DMC) groups. This policy specifies that DMCs will be expected to bear a reasonable proportion of project financing as a mark of their commitment to and ownership of each project. These ADB financing limits range from 65% for the most developed DMCs up to 80% for the least developed DMC group. Notwithstanding these limits, ADB may finance the total direct and indirect foreign exchange cost of a project, even if the result in ADB financing exceeds the applicable cost sharing limit for that DMC.</p>	<p>ADB will determine specific country ceilings based on the aggregate portfolio of ADB operations projected and agreed with the DMC over the Country Strategy and Program (CSP) period. The context will be the DMC's overall public sector investment program. Commitment to and ownership of this program and the interventions agreed under the ADB portfolio also will be key guiding principles.</p> <p>The country ceiling will be established based on the special macroeconomic assessments, including the country's (i) existing and projected fiscal stance, (ii) fiscal sustainability, (iii) quality of the public sector investment program and its specific financing plan, (iv) quality of the public financial management system, (v) quality of the mechanisms for budgeting and its implementation, (vi) specific tax regime, (vii) general governance considerations in relation to fiscal and other matters, and (viii) the quality and soundness of fiduciary oversight arrangements. The assessments will also cover</p>

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
				<p>debt sustainability, the exchange rate regime, the balance of payments and other relevant macroeconomic indicators.</p> <p>The proportion to be financed by ADB in the case of each project under the portfolio will vary depending on project-specific, sector, and client considerations—following the concept of sound banking principles.</p> <p>Staff instructions will provide guidance on working with the new policy framework.</p>
<p>2. Local cost financing</p> <p>OM section H3/BP, issued on 23 December 2004</p>	<p>World Bank’s Articles of Agreement provide that World Bank normally lends only for foreign exchange costs. The Articles allow financing of local costs in the following exceptional circumstances: (i) when the project gives rise indirectly to an increased need for foreign exchange, and (ii) when the borrower cannot raise the local currency required for the purposes of the loan on reasonable terms. The executive directors specifically considered the limits set out by the Article provisions in 1949, 1964, and 1968, and interpreted them broadly, to permit local cost financing when the financing of foreign costs alone would not permit World Bank to assist in the financing of priority projects. Operational Procedure</p>	<p>World Bank may finance local expenditures when it is satisfied that (i) financing requirements for the development program of the country would exceed the public sector’s own resources (e.g., from tax and other revenues) and expected domestic borrowing; and (ii) the financing of foreign expenditures alone would not enable World Bank to assist in the financing of such projects.</p>	<p>Within each DMC’s cost sharing limit, ADB may finance local costs above the direct and indirect foreign exchange costs of projects. Such local cost financing is based on two main conditions: (i) the amount is considered reasonable, and (ii) not financing such costs would unduly strain the DMC’s balance of payments.</p>	<p>Project investment plans will not distinguish between currency denominations of project components. Project financing plans will be structured around the concept of sound banking principles, and will thus take into account the cost recovery profile of each transaction and its sustainability capabilities. Financing plans will distinguish between the finance provided by ADB, the government, and others. The financing plan also will distinguish between finance to be provided in foreign and local currencies.</p>

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
	(OP) 6.30 lists some other specific cases for local cost financing.			
<p>3. Taxes and duties</p> <p>OM section H3/BP, issued on 23 December 2004</p> <p>OM section J6/OP issued on 29 October 2003</p>	<p>General Conditions Applicable to Loan and Guarantee Agreements (section 5.08) provide that World Bank does not finance customs duties or taxes imposed by the borrower (the only exception is taxes associated with consultants' fees and project implementation unit (PIU) staff salaries financed by trust funds for which the funding agencies have agreed to finance taxes).</p>	<p>World Bank may finance the reasonable costs of taxes and duties associated with project expenditures.</p> <p>Staff would receive guidance on determining reasonable costs of taxes and duties.</p>	<p>Indirect taxes (including import duties, value-added taxes, and sales taxes) levied on specific goods, works, and services are ineligible for ADB financing.</p> <p>Where indirect taxes are not specifically shown, such as import duties relative to indirect foreign costs, ADB estimates such taxes (for example, 20% of such costs) before determining the level of expenditure eligible for ADB financing.</p> <p>Under international competitive bidding procedures, ADB may finance the full ex works price of a contract if the winning firm offers domestic goods, including taxes and duties. OM section H3/BP, issued on 29 October 2003.</p>	<p>ADB may finance the reasonable cost of taxes and duties associated with project expenditures. Transparency, competitive neutrality, and sustainability arrangements will be taken into account.</p> <p>Staff instructions will provide guidance on the definition of the term "reasonable" cost of taxes and duties, and the assessments required.</p>

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
4. Recurrent costs	<p>Recurrent costs are eligible for financing if (i) the country has a serious shortage of budget resources that makes it unlikely to be able to finance recurrent expenditures for the project; and (ii) a specific recurrent expenditure is crucial to the success the project, and World Bank financing is desirable to ensure timely availability of funds. Recurrent costs are normally financed on a declining basis, and World Bank financing should not exceed 25% in the final year.</p>	<p>World Bank may finance recurrent expenditures. In determining whether and to what extent to finance recurrent expenditures, World Bank will consider the impact on fiscal and debt sustainability (including the country's commitment and ability to provide continued financing for recurrent expenditures after World Bank financing is completed) at the appropriate levels, including that of the project entity or entities.</p> <p>Staff would receive guidance on how to take into account the impact on fiscal and debt sustainability at the appropriate levels.</p>	<p>Eligible for financing within the cost sharing limitations (item 1 above) and, where applicable, the local currency financing limitations (item 2 above).</p>	<p>No policy change required, although current restrictive practices will be reexamined in the context of individual projects. Fiscal and debt sustainability assessments will be carried out in the context of the more recurrent expenditure-driven projects. ADB financing of recurrent expenditures is limited to funding requirements during the project implementation period.</p> <p>Another cap (and exit strategy) on the financing of recurrent expenditures arises out of the concept of sound banking principles. ADB and others can only finance what a particular project can absorb. The Credit Risk Management Unit will screen and evaluate the financial structure of public and private sector projects.</p>
5. Land OM section H3/BP, issued on 23 December 2004	<p>OP 12.00 states that the cost of land is not eligible for World Bank financing. OP 4.12 states that World Bank does not disburse against the cost of land (including compensation for land acquisition)</p>	<p>Remove from OP 12.00 and OP 4.12 the policy prohibitions on financing land and cash compensation under resettlement plans.</p> <p>Staff would receive guidance on determining whether and to what extent World Bank may finance land. Management is reviewing the desirability of expanding the scope beyond the current pilot scheme in light of operational needs and</p>	<p>Costs of land acquisition and payments of rights-of-way are not eligible for ADB financing.</p>	<p>ADB will finance land acquisition and payments for rights-of-way. A cautious approach will be pursued in financing land acquisition. Staff will be issued instructions on the type of assessments needed upfront.</p>

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
		experience gained. Management intends to pursue a cautious approach to financing land, and to continue to have all proposals to finance land reviewed by World Bankwide Land Committee.		
<p>6. Local transportation and insurance</p> <p>OM section J6/BP, issued on 29 October 2003.</p> <p>OM section H3/BP, issued on 23 December 2004</p>	Local transportation and insurance costs are not eligible for World Bank financing (except as part of foreign shipments), unless the project legal documents provide for the financing of local costs. These costs, however, may be financed when a supplier includes them in its bid for goods or works.	Clarify that financing local transportation and insurance costs is not intended to be restricted, and that such costs are eligible for World Bank financing.	<p>As foreign costs, insurance and freight (CIF) are eligible expenditures (provided that the goods are produced in and supplied from a member country) since such insurance and freight services are treated as ancillary or an insignificant part of the contract for the supply of goods. However, where goods are shipped free on board and ADB is asked to finance insurance and freight arranged by the purchaser under a separate contract, ADB also must be satisfied that those services are supplied from member countries.</p> <p>Local transportation is eligible subject to the limitations on local currency financing (item 2 above)</p> <p>Insurance is ineligible if it is paid in local currency or is self-insurance, unless provided for in the Loan Agreement.</p>	Insurance will be eligible for ADB financing. Local transportation is already eligible for financing. Only bona fide values will be accepted.
7. Late payment penalties	Late payment penalties imposed by suppliers (unless incurred in connection with a disputed payment that has been arbitrated) are not eligible for World Bank financing.	<p>Remove the prohibition on financing late payment penalties imposed by suppliers.</p> <p>Staff would receive guidance on circumstances in which these</p>	Under ADB practice, late payments are not eligible for ADB financing.	Prohibition on ADB financing of late penalties imposed by suppliers where they form part of the project costs will be removed. Only bona fide cases will be permissible.

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
		costs could be financed.		Staff will assess in detail the background and rationale for the inclusion of the item.
8. Severance pay	World Bank may finance severance pay in public enterprise reform operations that are expected to result in an increase in productivity after restructuring, with the assessment of impact on productivity set out in the project documentation. The Operational Memorandum provides guidance on carrying out economic analysis and assessing social impact, as well as on addressing risks specific to financing severance payments, such as adverse selection, overpayment, and moral hazard.	Severance pay would remain eligible for World Bank financing. The contents of the Operational Memorandum would be reissued as guidance to staff to assist in determining whether, to what extent, and how, to finance severance pay.	Severance payments are eligible for ADB financing subject to local currency financing (item 2 above).	No change in ADB policy required. Severance payments are eligible under the existing policy framework.
9. Food	Food for human consumption is not eligible for World Bank financing, except under some circumstances set out in the Operational Memorandum. Bank financing is provided on a declining basis.	The contents of the Operational Memorandum would be reissued as guidance to staff to assist in determining whether, to what extent, and how, to finance food expenditures. The requirement for declining disbursements would be removed in the context of agreed cost sharing arrangements at the country level.	Under current ADB practice, food for human consumption is not eligible for financing.	Food will be eligible for ADB financing.
10. Interest during construction (IDC)  OM section H3/BP, issued on 23 December 2004	World Bank does not finance IDC on or in connection with International Development Association credits or any loan made by another lender. World Bank may finance IDC from the proceeds of an International Bank for Reconstruction and Development loan if the beneficiary is a financially autonomous entity whose cash flow requires such	Remove the policy restriction on financing IDC.  Staff would receive guidance on determining whether and to what extent World Bank may finance these costs.	Interest and financial charges other than those on ADB loans are not eligible for ADB financing.	Policy restriction on IDC will be removed. Market rates will be followed. Only bona fide values will be considered.

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
	financing.			
11. Bank charges  OM section H3/BP, issued on 23 December 2004	Operating charges on special accounts are eligible for World Bank financing only if they are provided in the definition of incremental operating costs in the project legal agreements.	Clarify that financing of charges associated with bank accounts maintained in connection with the project are not intended to be restricted, and such charges are eligible for World Bank financing.	Bank charges other than those on ADB loans are ineligible for ADB financing.	Policy restriction on financing bank charges will be removed. Only bona fide cases will be considered.
12. Retroactive financing  OM section H4/BP, issued on 29 October 2003	In exceptional circumstances, to facilitate the prompt execution of World Bank-financed operations, World Bank allows retroactive financing of payments that do not exceed 10% of the loan amount for investment loans (20% for adjustment loans), and made after project identification begins and within 12 months (4 months before the expected date of loan signing).	Amend policy to allow World Bank to finance payments made before the date of the Loan Agreement, which do not exceed 20% of the loan amount, when such payments were (i) incurred in connection with activities included in the project description and associated with items procured in accordance with applicable World Bank procurement procedures, and (ii) made not more than 12 months before the expected date of signing of the Loan Agreement. In extraordinary circumstances, such as in response to emergency conditions, exceptions to these limits may be approved by management. Proposals for retroactive financing, including any exceptions to normal limits for such financing, would be spelled out in the project appraisal document.	Retroactive financing refers to ADB financing of project expenditures incurred and paid for by the borrower before the date the related Loan Agreement becomes effective. Retroactive financing is not permitted unless specifically agreed upon by ADB and the borrower, and the procurement is undertaken in accordance with ADB procurement guidelines. Retroactive financing must be handled restrictively and applied under special circumstances. Within this context, retroactive financing for a project or sector loan is normally for 12 months of eligibility and for up to 10% of the loan amount (exceptionally up to 18 months and 15% of the loan amount). For program loans, or special or emergency assistance, the period of eligibility is normally for 6 months and up to 20% of the loan amount (exceptionally up to 9 months and 30% of the loan amount).	ADB will be allowed to finance payments made before the date of the Loan Agreement, provided these do not exceed 20% of the loan amount, when such payments were (i) incurred in connection with activities included in the project description, and (ii) associated with items procured in accordance with applicable ADB procurement procedures 12 months before the expected date of signing of the Loan Agreement. Some expenditures required under ADB-funded projects are made earlier than 12 months before loans are signed. In view of this, and to ensure an earlier and more active involvement by governments in project preparation, the 12-month period should be considered on a case-by-case basis, provided it can be demonstrated that the expenditures are bona fide, were incurred for proper

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
				reasons in a transparent manner over a reasonable period of time. The RRP will provide a full account and justification for deviations from the 12-month period.
13. Secondhand goods	Procurement of secondhand goods is eligible for World Bank financing only under the following circumstances: (i) a surplus (in suitable quantity and quality) of the type of goods required is available from enough sources to ensure competitive bidding, and (ii) the procurement of new goods would result in excessive costs due to lack of economies of scale.	The contents of the current Operational Policy would be reissued as guidance to staff to assist in determining whether to finance secondhand goods.	ADB policy on the financing of secondhand goods is unclear.	Financing of secondhand goods will be permissible. Arrangements for this financing will be set out in the OM and in staff instructions. Valuations will be verified by independent experts.
14. Leased assets	World Bank does not have a policy statement on financing leased assets.	Since leasing is a common way to finance the acquisition of capital assets, it is proposed to clarify that these costs are eligible for World Bank financing.  Staff would receive guidance.	ADB does not have a specific policy on financing leased assets.	Leased assets will be eligible for ADB finance. Staff instructions will specify the type of assessments needed in respect of this item.
15. Resettlement assistance (including cash compensation)  OM section F2/BP, issued on 29 October 2003	World Bank does not disburse against cash compensation and other resettlement assistance paid in cash.	Remove the prohibition on financing cash compensation and other resettlement assistance paid in cash.	Relocation and rehabilitation may be eligible for ADB loan financing, if requested, to ensure timely availability of the required resources and to ensure compliance with involuntary resettlement procedures during implementation.	No ADB policy change required. Cash compensation and other resettlement assistance paid in cash will qualify for ADB financing.
16. Imprest and special accounts	Special accounts are normally maintained in a fully convertible and stable currency. World Bank may	In countries with freely convertible currencies, special accounts may be held in the currency of the	ADB practice is to require the currency of the imprest account to be indicated in the	DMCs with freely convertible currencies will be allowed to open imprest accounts in

Item and Reference	World Bank Old Policy	World Bank New Policy	ADB Current Policy	Proposed ADB Policy
Loan Disbursement Handbook, January 2001, section 10.0, Imprest Fund Procedures	agree to a local currency special account when the country's currency is stable and fully convertible or when (i) the country's currency (even if not freely convertible) is stable, (ii) the expenditures to be financed are primarily in local currency and measures satisfactory to World Bank have been taken for meeting foreign currency expenditures, and (iii) the government has stated its intention to amend financial regulations or obtain waivers that would permit future establishment of convertible accounts for World Bank-financed special accounts.	borrower or any freely convertible currency.	ADB Loan Agreement. To maintain the value of that account against depreciation, the imprest account is to be maintained in a convertible and stable currency.	their own currency or any freely convertible currency.

Note: For further explanations of the changes in World Bank policies, see World Bank. 2004. *Eligibility of Expenditures in World Bank Lending: A New Policy Framework*. Washington, DC. 26 March 2004.

## INNOVATION AND EFFICIENCY INITIATIVE - OVERVIEW

1. The Innovation and Efficiency Initiative (IEI) mandate aims to make and keep the Asian Development Bank (ADB) more client and results-oriented, efficient, and effective. Coordinated from the Regional and Sustainable Development Department (RSDD), IEI is a bank-wide initiative. It is also an integral part of the Reform Agenda. RSDD will monitor and report the progress of IEI implementation, and suggest improvements if any, based on the results framework shown below.
  
2. A strategy working group (SWG) was formed to work on IEI. The group has identified and evaluated a list of priority issues related to operational bottlenecks. These relate to the various stages of ADB's operational cycle, including (i) the development of the business pipeline or the country strategy and program (CSP), (ii) processing and internal approval systems for investment and other operations, and (iii) implementation and disbursement arrangements. Based on the identified issues, IEI focuses on developing change proposals in the following priority areas:
  - (i) **Country strategy.** Ways to improve strategic clarity and results-orientation, quality at entry and thereafter the development of a sound business pipeline covering investment and other forms of assistance (financial and nonfinancial);
  - (ii) **Business processes.** Approaches, procedures, and practices related to the development of the pipeline, and the efficient conversion of this into investment and noninvestment operations thereafter (i.e., processing, approvals and implementation);
  - (iii) **Procurement.** Approaches, practices, and policies covering consultancy services and the procurement of goods and works, and harmonization with other development partners;
  - (iv) **Cost-sharing and expenditure eligibility.** Proposals to improve the cost sharing system and the widening of expenditure eligibility criteria. The rationale is client responsiveness and harmonization with other development partners;
  - (v) **Safeguards.** A separate process calling for proposals to improve quality and efficiency during processing and implementation;
  - (vi) **Financial instruments and modalities.** Development of new instruments and modalities on a pilot basis, accompanied by an independent credit risk management function and improved procedures and practices.
  
3. In coordination with IEI, the Treasury Department has developed a proposal to enhance introduce local currency lending to private and public sector clients.
  
4. To address each of these priority areas, SWG set up subteams comprising staff from key departments across ADB, including operational and support departments. SWG has worked on the basis of a "bottom up" approach, undertaking consultations with team leaders, team members, directors, Management and the Board.

5. A significant part of the work has been anchored on projects, and some procedural changes have already been reflected in a number of operations submitted to the Board in 2004. However, most of these changes fall in the area of procurement, rather than in the area of financial instruments and modalities. The approach taken thus far has allowed SWG members to engage directly with operational and support teams, but more importantly, it has facilitated direct contact with clients while the work was being done. Client feedback was further reinforced during 2004 and 2005 through the Middle Income and Ordinary Capital Resources Country Partnership Framework consultations. DMCs and shareholders in general suggest that ADB needs to be more flexible in terms of its systems and procedures, much faster in relation to processing, pay greater attention to implementation, expand and innovate its financial instrument and modalities range, raise the level of cofinancing, align its business cycle to that of DMCs, simplify documentation, cut nonfinancial costs, be much more selective in terms of sector coverage, provide critical mass, and deliver money with ideas.

6. The IEI proposals are categorized into those that fall under the jurisdiction of Management and those that require formal Board approval. Management-related proposals involve primarily changes to business processes, as well as to resource reallocation, incentives and accountability. A number of the proposals reflect the views of the Independent Panel commissioned to look at the results of the 2002 reorganization of ADB. Board-related proposals involve changes to existing operational policies and procedures. Both sets of proposals are complementary and intertwined.

### IEI Results Framework

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
<b>Impact (by 2015)</b>			
<ul style="list-style-type: none"> <li>Demonstrable improvements in the development impact of ADB operations in reducing poverty in DMCs (<i>see Reform Agenda results framework</i>)</li> </ul>	<ul style="list-style-type: none"> <li>CSP post-evaluation ratings (fully satisfactory rating for all CSPs evaluated by 2012)</li> <li>Improving client and partner satisfaction levels on impact of ADB operations</li> </ul>	<ul style="list-style-type: none"> <li>Annual PRS progress report by RSDD (post-evaluation reports on CSPs or CAPEs by OED)</li> <li>Annual PRS progress report by RSDD (client and partnership surveys every 3 years by SPD)</li> </ul>	<ul style="list-style-type: none"> <li>Global and regional economic and political stability</li> <li>Continued commitment and support of the development community and DMCs to poverty reduction</li> <li>DMC capacity to plan and implement poverty reduction strategy strengthened</li> <li>Political and social stability within DMCs</li> <li>Continued shareholders support</li> </ul>

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
<b>Outcomes (by end 2007)</b>			
<ul style="list-style-type: none"> <li>Enhanced organizational effectiveness of ADB (see Reform Agenda results framework). More specifically, ADB as a more efficient, responsive, and larger catalyst for finance and knowledge to meet DMCs' poverty reduction needs</li> </ul>	<ul style="list-style-type: none"> <li>Quality-at-entry of CSPs and projects (baseline established in 2006, and continuous improvements in the following years)</li> <li>Net transfer of resources</li> <li>Commercial cofinancing under complementary financing and guarantee operations (with increase recorded in 2006–2007 over the 2005 level)</li> </ul>	<ul style="list-style-type: none"> <li>Retrospective reviews of CSPs and projects</li> <li>Financial statements</li> <li>OCO database</li> </ul>	<ul style="list-style-type: none"> <li>Clear and focused medium-term strategy (2006–2010) of ADB in place</li> <li>All the other initiatives (outputs), including the HR strategy, under the Reform Agenda fully implemented</li> <li>ADB Management recognize staff promoting IEI implementation</li> <li>ADB culture aligned to support the reform initiatives</li> <li>Adequate staff resources and skills available to support IEI implementation</li> </ul>
<b>Outputs (2006–2007)</b>			
<ol style="list-style-type: none"> <li>CSP design process reflect sharper results orientation and strategic clarity</li> </ol>	<ul style="list-style-type: none"> <li>CSPs developed based on problem analysis and accompanied with clear and focused sector roadmaps and country results framework (All CSPs beginning preparation in 2006)</li> </ul>	<ul style="list-style-type: none"> <li>IEI monitoring report (assessment of CSPs by RSDD/SPD)</li> </ul>	<ul style="list-style-type: none"> <li>Management approves recommendations in 2005</li> <li>Necessary organizational changes (including skills and staff incentives) effectively managed</li> </ul>
<ol style="list-style-type: none"> <li>ADB's business processes and practice improved to enhance accountability for quality and efficiency across operations</li> </ol>	<ul style="list-style-type: none"> <li>Improved concept paper review and clearance system in place by 1Q 2006</li> <li>Months taken from project concept clearance to effectivity reduced to 18 months by 2007 (baseline: 32 months in 2004)</li> </ul>	<ul style="list-style-type: none"> <li>IEI monitoring report (RSDD)</li> <li>(COSO)</li> </ul>	<ul style="list-style-type: none"> <li>Management approves recommendations in 2005</li> <li>Necessary organizational changes effectively managed</li> </ul>
<ol style="list-style-type: none"> <li>ADB's policies processes and practices on procurement (consultancy, goods and works) streamlined and harmonized with those of DMCs' and other development partners</li> </ol>	<ul style="list-style-type: none"> <li>Non-policy related procurement and consulting services practices and procedures approved by end 2004.</li> <li>New guidelines applied to all new projects by mid-2006</li> <li>Environmentally-responsive procurement guide and e-bidding guide introduced by end 2005</li> <li>Contract signed and FIDIC terms and conditions introduced for all standard bidding documents by end 2005</li> <li>Harmonized standard bidding document introduced for small works contract and design, supply and install contract by end 2005</li> </ul>	<ul style="list-style-type: none"> <li>IEI monitoring report (COSO)</li> </ul>	<ul style="list-style-type: none"> <li>Board approves the R-paper on new policy and guidelines for procurement and consulting by end 2005</li> <li>Necessary organizational changes effectively managed</li> </ul>

Design Summary	Indicators/(Targets)	Monitoring Mechanism/(Data Source)	Key Assumptions
4. ADB's safeguards policy implementation processes during project processing and implementation updated to improve effectiveness and relevance to clients	<ul style="list-style-type: none"> <li>• Safeguards policy review launched by 2Q 2005</li> <li>• W-paper submitted by 1Q 2006</li> <li>• R-paper and revised OM submitted by end 2006</li> <li>• No of staff trained</li> </ul>	<ul style="list-style-type: none"> <li>• IEI monitoring report (RSDD)</li> </ul>	<ul style="list-style-type: none"> <li>• Constructive feedback from governments, civil society, and other development partners.</li> <li>• Board approves the R-paper in 2006</li> <li>• Necessary organizational changes effectively managed</li> </ul>
5. ADB's cost sharing and local cost financing parameters, and expenditure eligibility updated, made more flexible, and aligned with those of DMCs and other development partners	<ul style="list-style-type: none"> <li>• Number of country teams briefed (all teams by 1Q 2006)</li> <li>• New country-wide cost-sharing ceilings for all DMCs by 2007</li> <li>• Number of approved investment projects with new expenditure items</li> <li>• Improving quality of fiduciary oversight in ADB projects</li> </ul>	<ul style="list-style-type: none"> <li>• IEI monitoring report (RSDD)</li> <li>• (RSDD/SPD)</li> <li>• (RSDD)</li> <li>• Financial management retrospective review (RSDD)</li> </ul>	<ul style="list-style-type: none"> <li>• Board approves the R-paper by 3Q 2005</li> <li>• Necessary organizational changes effectively managed</li> </ul>
6. ADB's financial instruments and modalities expanded and upgraded to enhance flexibility and responsiveness, and successfully implemented	<ul style="list-style-type: none"> <li>• Pilot-testing of new financing instruments and modalities launched by 3Q 2005</li> <li>• No. of staff briefed and trained</li> <li>• Assessment of pilot-tests based on specific criteria<sup>a</sup></li> <li>• Review of ADB's credit enhancement policies (including guarantee products) submitted to the Board. OM updated and staff instructions issues in 2006</li> <li>• Recommendations to mainstream new instruments/modalities approved by 2008</li> </ul>	<ul style="list-style-type: none"> <li>• IEI monitoring report (RSDD)</li> <li>• (BPMSD)</li> <li>• (RSDD)</li> <li>• (OCO)</li> <li>• (RSDD)</li> </ul>	<ul style="list-style-type: none"> <li>• Board approves the recommendation paper by 3Q 2005</li> <li>• Necessary organizational changes (culture, processes, structure, staff skills, budget, etc.) effectively managed</li> </ul>

CAPE = country assistance program evaluation; CFS = complementary financing scheme; CSP = country strategy and program; DMC = developing member country; FIDIC = International Federation of Consulting Engineers; HR = human resource; PRS = poverty reduction strategy; TA = technical assistance.

<sup>a</sup> For the criteria, see Appendix 10 of the R-paper on pilot financing instruments and modalities.