



April 2009

Program Lending Policy: Clarification

Asian Development Bank

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CPS	–	country partnership strategy
DFID	–	Department for International Development of the United Kingdom
DMC	–	developing member country
DMF	–	design and monitoring framework
DPL	–	development policy lending (World Bank policy)
FY	–	Fiscal Year
OCR	–	ordinary capital resources
OECD-DAC	–	Organisation for Economic Co-operation and Development Development Assistance Committee
PBA	–	program-based approach
RRP	–	report and recommendation of the President

NOTE

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

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EXECUTIVE SUMMARY

This paper clarifies the program lending policy of the Asian Development Bank (ADB) with respect to a number of specific issues raised by the ADB Board of Directors. The term "lending" includes provision of program grants financed from the Asian Development Fund.

The paper covers the following specific issues: (i) the rationale for single-tranche program loan operations, (ii) flexibility in supporting economy-wide reforms, (iii) the basis for determining the size of program loans, (iv) the validity of the policy requirement that disbursements be linked to imports, (v) the program lending policy ceiling, (vi) the approach to conditionality, and (vii) the definition and use of program-based approaches in ADB operations.

Each issue is reviewed in the light of ADB's implementation of its policy on program lending, comparable World Bank policies, and the best practice principles in the Paris Declaration on Aid Effectiveness. These issues were also discussed at an informal Board seminar on 14 November 2008, and Board members' views have been incorporated.

On issues (i), (iii), (vi), and (vii), the paper recognizes the need to provide explicit guidance through staff instructions to clarify existing policy and reconfirm good practice, and presents the staff instructions. These staff instructions will complement the *Operations Manual*, and ensure good practices are applied in a more transparent manner in program lending operations.

I. INTRODUCTION

1. The Board of Directors of the Asian Development Bank (ADB) has raised a number of specific issues on ADB's program lending policy and operations. These are primarily concerned with the rationale for single-tranche operations and the application of good practice principles in policy-based lending. The objective of this paper is to provide clarification on these issues, and to present staff instructions which seek to address the issues raised by Board members. These staff instructions will complement the guidance to staff through the *Operations Manual*, and ensure that good practices are applied in a more transparent manner in program lending operations, and adhere to the principles of Paris Declaration on Aid Effectiveness.¹ The staff instructions will apply to all program loans, including those financed by grants.² The proposed staff instructions are contained under the relevant heads in the main paper and grouped together in Appendix 1.

II. ISSUES FOR CLARIFICATION

2. The scope of ADB's program lending has broadened from support for countries with balance of payment problems when program loans were launched in 1978 to the more broadly based policy-based loans that have been implemented since 1987 (Appendix 2). Developing Member Countries (DMCs) are increasingly seeking support for broad policy and institutional reforms in a particular sector or across several sectors. ADB's program lending has been flexible, allowing it to be responsive to the diverse needs of its DMCs.

3. The Board of Directors has sought clarification on a number of issues, including: (i) the rationale for single-tranche program lending operations, (ii) flexibility in supporting economy-wide reforms, (iii) factors determining program loan size, (iv) the validity of the policy requirement that disbursements be linked to imports, (v) the program lending policy ceiling, (vi) the approach to conditionality, and (vii) the definition and use of program-based approaches in ADB operations. The Strategy and Policy Department reviewed these issues in the light of best practices under the Paris Declaration principles and comparable World Bank policies. It was supported by an interdepartmental technical group on program lending.³

A. Rationale for Single-Tranche Program Lending

1. Issue

4. ADB Board members have suggested that staff be advised on the principles on which single-tranche operations should be based. They raised two specific issues on the need for (i) early consultation with the Board on large program loans, and (ii) presentation of a clear rationale for the program loan. On the timing of the consultation, Board members feel that most single tranche program loans are presented to the Board at a very late stage, when most of the first sub-program actions/conditions have been implemented. This is too late to allow the ADB

¹ ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies and OM D4/OP: Operational Procedures. Manila; ADB. 2003. Sector Development Programs. *Operations Manual*. OM D5/BP: Bank Policies and OM D5/OP: Operational Procedures. Manila; and ADB. 1997. *Guidelines on Operational Procedures 6: Program Lending*. Manila.

² The staff instructions do not apply to Special Program Loan operations.

³ The technical group on program lending was led by the task team leader M. Senapaty, SPD. The peer reviewers comprised C.W. MacCormac, SPD, and X. Yao, RSDD. The primary members comprised: A. Iffland, COSO, A. Bauer, RSDD, A. Dusupbekova, OGC, B. Carrasco, SARD, C. Wee, OGC, H. Fukukawa, CTL, J. Zhuang, ERD, K. Moktan, RSDD, N. J. Ahmad, RSDD, R. Subramanian, SERD, R. Bolt, OED, R. Schoellhammer, SPD, S. Pollard, PARD, S. Phanachet, TD, V. Tulasidhar, EARD. (The departments indicated are as of the time of the formation of the technical group.)

Board to make a meaningful contribution to program formulation. The Board would like an opportunity to discuss the program proposal especially in case of large program loans earlier in the process before the program is implemented. Secondly, Board members suggested that a clearer justification for such operations should be articulated in the report and recommendation of the President (RRP) for the loan, clarifying the long term reform outcomes that the supported program aimed to achieve (through subsequent single tranche program loans). There should be a clear link between the policy conditions of single-tranche operations and the supported reforms and outcomes, which should be shared with the Board before the loan is formally presented for its approval.

5. The ADB program lending policy allows for both multitranche and single-tranche program loans.⁴ For multitranche operations, the policy guidance stipulates that a program loan is divided into tranches if major elements of the sector policy reforms are to be introduced after the loan agreement becomes effective. For single-tranche program loans, the policy guidance states untranching loans may be considered if the most important reforms can be implemented prior to effectiveness.⁵ Given the flexibility in the ADB program lending policy, an increasing number of single-tranche program loans have been approved in recent years. Single-tranche operations supported by ADB are usually part of a DMC's medium-term reform framework and provide support for already completed actions for medium- and long-term growth and poverty reduction, as agreed in the country partnership strategy (CPS). DMCs see a series of linked single-tranche operations as way of providing the flexibility they need to implement reforms, while respecting country ownership and improving the medium-term predictability of aid. Recent single-tranche operations have been used to support jointly agreed upon and complex medium-term institutional and policy reforms.⁶

6. ADB's single-tranche program lending operations, set in a medium-term framework, are similar to the World Bank's single-tranche development policy lending (DPL), which is becoming its main form of policy-based lending. In fiscal year (FY) 2000, the World Bank's single-tranche policy based operations accounted for 10% of policy-based (adjustment) operations by volume, by FY2006, 85% of the World Bank's development policy operations were single-tranche.⁷ Similarly, the share of single-tranche policy based operations in ADB increased from 42% of total program lending operations by volume in 2006, to 70% in 2007, and to 78% in 2008.⁸

7. The rationale for medium-term single-tranche policy-based operations is that these are (i) results-based, (ii) flexible and realistic, (iii) predictable and in line with Paris Declaration principles of aid effectiveness, (iv) reform-oriented (because they provide an opportunity to leverage reforms before the transfer of resources). Such operations have enabled ADB to respond to requests for supporting country owned reforms from some of its large DMCs, including Indonesia, the Philippines, and Viet Nam.⁹ This approach has two major advantages.

⁴ ADB. 1999. *Review of ADB's Program Lending Policies*. Manila (R210-99); ADB. 2003. *Program Lending, Operations Manual*. OM D4/BP: Bank Policies (para. 25); and ADB. 1997. *GP 6: Program Lending*. Manila.

⁵ ADB policy on tranching under sector development programs (ADB. 2003. *Sector Development Programs, Operations Manual*. OM D5/BP: Bank Policies. Manila [para. 12]) is consistent with its policy on tranching for program lending (ADB. 2003. *Program Lending, Operations Manual*. OM D4/BP: Bank Policies. Manila [para. 25]). However, section on sector development programs does not explicitly mention single-tranche program loans.

⁶ For example, ADB. 2005. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grant to the Republic of Indonesia on the Local Government Finance and Governance Reform Program*. Manila.

⁷ World Bank. 2001. *Adjustment Lending Retrospective*. Washington, DC; World Bank. 2004. *Operational Policies 8.60: Development Policy Lending*. Washington, DC; and World Bank. 2006. *Development Policy Lending Retrospective*. Washington, DC.

⁸ See details on number of single tranche operations in Appendix 2.

⁹ Based on consultations and feedback from regional departments.

First, it allows continual feedback from all stakeholders, and reflects recognition that policy reforms are part of a long-term process. It acknowledges that policy contexts and links between policy actions and reform outcomes are difficult to anticipate over the medium to long term. ADB will be able to help DMCs achieve the outcome targets by taking into account emerging circumstances. Second, it enables ADB Management and Board to provide effective guidance on the design of future subprograms, which is not always possible with the rigid prescriptive actions in multitranche programs.

8. At present there is no explicit guidance to staff on the application of best practices to single-tranche operations and the Board has reflected on their varying quality.¹⁰ The following staff instruction clarifies the principles on which the decision to use single-tranche operations should be based, and also addresses other specific concerns of the Board.

2. Staff Instruction

9. Staff should base the rationale for single-tranche program loans on the long-term partnership with the DMC, and on a broad understanding of the critical constraints on economic growth and poverty reduction in the country as identified in the CPS. ADB and the DMC, with other development partners, should also undertake a joint assessment of the DMC's capacity to implement such reforms and agree on a capacity development plan and on ADB's role in support of Government's reforms through policy dialogue at an early stage in program design.

10. For program clusters, there may be a series of subprograms, each of which should be designed as a fully front-loaded single-tranche intervention. Staff should specify the following in the program loan design: (i) jointly agreed development outcomes and the future reform agenda with the government and other development partners at either the economy-wide or sector level, (ii) a robust medium-term framework for the achievement of outcomes, specified at the outset, and (iii) prior actions to be completed before the release of the tranche, progress indicators and benchmarks, and expected actions that will trigger subsequent subprograms or operations.¹¹ Accordingly, the RRP of the first single-tranche program cluster should clearly articulate (i) the rationale for the entire cluster, including a list of measurable outcomes and output indicators for the cluster (and not just for the first subprogram); (ii) the history and nature of ADB's engagement with the DMC in designing and implementing the reforms, including any technical assistance support, (iii) how ADB's assistance fits in with the overall medium-term expenditure framework of the DMC, from both reform and financing points of view, (iv) the link between expected prior actions for the subsequent subprogram and overall program outputs and outcomes; and (v) the likely timeline for completion of these actions. It is recognized that expected prior actions for subsequent subprograms will be indicative and such actions will not be disbursement conditions, and the actions may be amended as subsequent subprograms are developed jointly with the DMC. However, if during subsequent subprogram processing there are deviations from the original indicative actions, staff should make these clear when the subsequent subprogram is presented to the Board for its approval. Staff should also explain the impact such changes are likely to have on the output and/or outcome indicators.

11. For the first subprogram in a single-tranche program loan under a program cluster, and for a stand-alone single-tranche program loan, the Board should be informed through an informal Board seminar soon after the fact finding mission.¹² The seminar should present the

¹⁰ Informal Board seminar discussions on 14 November 2008.

¹¹ The suggested framework is similar to that being followed by the World Bank, in the context of its policy-based program loans (i.e., development policy loans).

¹² If no fact-finding mission is fielded, the Board information paper should be prepared soon after loan concept clearance.

main features of the broad reform program being supported by the single-tranche loan, and the link between financing, policy conditions, and the supported program reforms and outcomes.

B. Flexibility in Supporting Macroeconomic Reforms

1. Issue

12. ADB Board members have asked for clarification on the flexibility of the program lending policy and on the rationale for program lending operations that support broader macroeconomic reforms, given ADB's focus on priority sectors.

13. ADB's program lending policy is inherently flexible, which enables it to provide support to broad-based economy-wide reforms in DMCs. Although the focus of the policy has been on "sector improvement," it defines a "sector" in a broad sense, which covers subsectors, as well as cross-sectoral and macro-economic issues. Given their national development programs with other international development partners, some DMCs have been seeking continuity and predictability through program lending support that facilitates reforms aimed at accelerating and sustaining macroeconomic growth. For example, in 2005–2007, ADB participated with other donors in providing poverty reduction support credits in Viet Nam and in providing development policy loans in Indonesia and the Philippines, designed in collaboration with the World Bank and the Government of Japan.¹³

14. Promotion of program lending support for broader macroeconomic and development policies beyond specific sectors enables ADB to respond effectively to client demands, and to provide continuity and predictability.¹⁴ It allows ADB to show its commitment to the Paris Declaration harmonization principles, to coordinate its support with that of other institutions, and to retain its reform leadership in specific sectors, where it has a comparative advantage and expertise. Broad macroeconomic support can be judiciously combined with support for sector reforms, and ADB can stay engaged on both fronts. This is consistent with ADB's existing focus on sector support, and with the goal of advancing partnerships stated in its Long-Term Strategic Framework, 2008–2020 (Strategy 2020).¹⁵

C. Factors Determining Program Loan Amount

1. Issue

15. ADB Board members have requested better analysis of the rationale for the size of program loans, including estimates of adjustment costs and the link between the loan amount and the reforms the program loan is expected to support.

16. ADB's policy on program lending stipulates the key factors that should be considered in determining the amount of program loans: (i) ADB's overall annual lending program and the

¹³ ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Socialist Republic of Viet Nam to Support the Implementation of the Poverty Reduction Program II*. Manila; ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the Republic of the Philippines for the Microfinance Development Program*. Manila; and ADB. 2005. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Republic of Indonesia for the Development Policy Support Program (DPSP and DPSP2)*. Manila.

¹⁴ A few DMCs, for example the Philippines and Indonesia, have expressed a preference for program loans for policy reform-based operations, since program loans are regarded as respecting country ownership and country systems and crucial for aid (Paris Declaration, March 2005).

¹⁵ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank 2008–2020*. Manila.

lending program to the DMC, (ii) sector and cross-sector investment needs, (iii) the availability of alternative financing sources, (iv) the strength and adjustment costs of the policy reform program, and (vi) the relative importance of the sector or sectors.¹⁶ Adjustment cost is therefore only one factor used to determine program loan amount.

17. The policy recognizes that estimation of adjustment costs, while straightforward in cases of simple reforms with a narrow focus, is often difficult and complex given that such reforms have significant indirect costs, and involve political dimensions. Similarly, the *Operations Manual* states that “RRPs for program loans are required to address,” among other things, “adjustment costs—identifying to the extent possible, the costs of policy changes”.¹⁷ The qualifier “to the extent possible” should be interpreted to mean that estimation of adjustment costs is desirable but not relevant or necessary in all cases. The policy therefore states the importance of recognizing the adjustment costs of policy changes, but also suggests that a pragmatic approach to the link between loan size and adjustment costs needs to be maintained.¹⁸

18. In practice, however, there has been an expectation that a rationale be found to determine the program loan amount in terms of “quantification of adjustment cost of reforms” in all cases.¹⁹ While the reasons for this expectation are not clear, it seems to be partly because of ambiguity in the *Operations Manual*.²⁰ Given the changes in the nature of program loans, which are increasingly being used to finance reforms closely linked to national strategies on growth and poverty reduction, the calculation of adjustment costs is not always relevant to determining loan amount. There is therefore a need to reconfirm and clarify the factors that are relevant for determining the program loan amount in policy-based lending.

19. The World Bank revised its policy-based lending in August 2004 to move away from using estimated adjustment costs to determine the size of a policy-based loan toward an approach based on actual or anticipated development financing requirements of the borrower.²¹ The revision was based on recognition of the fact that, given the complexities and uncertainties of long-term policy reform, in practice it is difficult to put a credible figure on the costs of the adjustment associated with such reform and to make this the basis for the size of a loan. In addition, other factors determine program size. The World Bank approach is now to identify the development financing needs of a country and to estimate the need for external financing. It approves a development policy loan only when the overall program is adequately funded, from both domestic and external sources. In pursuing its commitments under the Paris Declaration,²² ADB has been increasingly working with other development partners to support DMCs’ policy and institutional reform initiatives.

¹⁶ ADB. 1999. *Review of the Bank’s Program Lending Policies*. Manila; and ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies. Manila.

¹⁷ ADB. 2003. Program Lending. *Operations Manual*. OM D4/OP: Operational Procedures. Manila (29 October 2003, para. 8).

¹⁸ ADB. 1999. *Review of the Bank’s Program Lending Policies*. Manila (para. 53).

¹⁹ Informal feedback from regional departments, Office of General Counsel, and Management Review Meeting discussions.

²⁰ The *Operations Manual* notes that program loans are “quick disbursing to cover the immediate adjustment costs arising from policy reforms.” ADB. 2003. Program Lending. *Operations Manual*. OM D4/OP.

²¹ World Bank. 2004. *Operational Policies 8.60: Development Policy Lending*. Washington, DC.

²² Aid Harmonization and Alignment for Greater Development Effectiveness. 2005. *Paris Declaration on Aid Effectiveness*. Available: <http://www.aidharmonization.org>. For a summary and implications for ADB, see ADB. 2005. *Paris Declaration on Aid Effectiveness*. Manila (IN310-05).

20. Recognizing the need to provide a robust analysis, clarify the factors determining a program loan amount,²³ harmonize approaches with its development partners, and respond to the Board's request for a clearer link between the loan amount and reforms, the following staff instruction is proposed.

2. Staff Instruction

21. Staff should first determine overall program lending support to a DMC through the CPS, taking into account the overall fiscal needs of the DMC within a medium-term expenditure framework. This assessment should also consider the overall fiduciary framework governing the use of public resources in the DMC.²⁴ Staff should also evaluate sector needs through sector analysis. Program lending should be as tightly linked as possible to these sector needs, although considerable flexibility needs to be maintained to meet overall financing needs, particularly given the pooled nature of the DMC's budgetary resources.²⁵

22. Staff should link the size of program loans to program outcomes and outputs, and within the overall and sector- and/or theme-specific development financing needs established in the CPS. Within this framework, key factors for determining loan amount include: (i) overall projected financing requirements for the sector over the period of planned operation, (ii) availability of additional funding sources through active pursuit of cofinancing, (iii) adjustment costs of the policy reform program, where relevant, (iv) the relative importance of the sector or sectors, (v) conformity with the established overall financing requirements for the CPS period, and (vi) the DMC's progress toward achieving the targets established in the results framework of the CPS, including sector-and/or theme-specific targets. It is recognized that there will be a degree of subjectivity in determining the loan amount, since it is difficult to establish the cost of reforms in advance. Nevertheless, staff should present a clear basis for determining the loan amount, based on careful consideration of the key factors listed above, and which is linked to the overall financing and sector-specific requirements of the DMC as agreed in the CPS, as well as to the expected results of the supported program.

D. Linkage between Disbursements and Imports

1. Issue

23. ADB Board members have asked whether the policy requirements on procurement in and from member countries, and on the use of program loan funds for economy-wide imports,

²³ ADB's Economics and Research Department in its Economic Analysis Retrospectives note a lack of rigor and in-depth analysis or discussion on the basis for determining the loan size, and conclude that the determination and justification of the loan size were among the weakest part of the economic analysis of the program loans approved during the year. ADB. 2006. *Economic Analysis Retrospective 2005–Strengthening Quality-at-Entry of ADB Operations*. Manila (page 23).

²⁴ The key factors for establishing the DMC's development financing requirements for the policy-based lending during the CPS stage are: (i) the development financing and budget requirements that will be needed to implement the DMC's economy-wide and sector and/or theme-specific medium-term development plan and achieve their objectives, (ii) availability of alternative sources of financing, (iii) the DMC's overall debt sustainability, and (iv) the DMC's overall absorptive capacity as well as the absorptive capacity of specific sectors and/or themes. An additional criterion for DMCs eligible for the ADF resources will be the availability of ADF resources. The overall development financing needs of the DMC and of specific sectors and/or themes will be periodically validated and updated as part of the review process of the CPS.

²⁵ DMCs have used ADB support to meet their general budgetary financing needs to support national or sub-national plans in a sector or for multi-sector support, sometimes in partnership with other development partners. In general, ADB does not earmark the use of program loan proceeds, and the flow of program loan proceeds are audited only to the extent of verifying the import certification provided by DMCs.

are still relevant, given that program loan funds are fungible, and support jointly agreed broad reforms in a DMC.

24. According to the program lending policy: “ADB must ensure that program loan proceeds are used for procurement in and from member countries and the standard exclusion negative list applies in case of economy-wide imports.”²⁶ The program lending policy and existing guidance on program lending operations²⁷ provide sufficient flexibility in the use of program loan funds. The ADB Charter requirements on procurement and disbursement from ADB member countries are met by verifying the economy-wide imports from the member countries.²⁸ The use of funds for program implementation are secured by obtaining commitment from the government for a budgetary allocation to the program in exchange for counterpart funds to be generated by the loan amount. The Charter requirement on procurement from member countries and the need to ensure that loan proceeds should not be used for ineligible purposes imply that ADB should retain the provision linking loan disbursement to import requirements as stated in the *Operations Manual*.²⁹

25. This approach is consistent with that for World Bank DPL. The World Bank has no requirement that procurement should be only from its member countries, and its policy recognizes that development policy loan funds cannot be effectively monitored. It regards agreements on ineligible items as “self-implementing codes of conduct for borrowers.” Nevertheless, in practice the World Bank retains a list of ineligible items, and loan agreements specify that loan proceeds cannot be used for ineligible purposes. The World Bank reserves the right to audit the foreign exchange deposit account of the country where the development policy loan proceeds are disbursed. ADB and the World Bank policies on this issue and on the list of ineligible items are similar.³⁰

E. Program Lending Policy Ceiling

1. Issue

26. ADB Board members have asked whether the program lending policy ceiling is flexible, given the increase in share of program lending in ADB's total operations in recent years, and whether the policy ceiling is limiting such operations.

27. The concept of a policy ceiling on program lending was introduced with program loans in 1978. It was designed to limit such lending to a small proportion of ADB's total lending, since it was assumed that project lending would continue to be ADB's primary mode of lending. According to the 1999 program lending policy:³¹ “Total annual program lending for standard program loans, the policy-based component of sector development program loans and policy-based guarantees, is not to exceed 20% of total lending on a 3-year moving average basis.”³²

²⁶ ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies and OM D4/OP: Operational Procedures. Manila; and ADB. 1997. *GP 6: Program Lending*. Manila (para. 34).

²⁷ ADB. 1999. *Review of the Bank's Program Lending Policies*. Manila; and ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies. Manila (para. 32).

²⁸ ADB 1966. Agreement Establishing the Asian Development Bank (the Charter), Manila (Article 14).

²⁹ ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies, Manila (para. 34). These requirements are further explained in ADB. 2003. Program Lending. *Operations Manual*. OM D4/OP: Operational Procedures. Manila (para. 15).

³⁰ Memo from director general SPD, 26 June 2007, on Updated List of Ineligible Items under ADB's Program Loans, as uploaded in the ADB intranet as part of the business processes database (Compendium of New Business Processes Clarifications).

³¹ ADB. 1999. *Review of ADB's Program Lending Policies*. Manila (R210-99).

³² Applies to both OCR and ADF lending.

The first 3-year period for the application of the ceiling was 2000–2002.³³ The 1999 review increased the overall ordinary capital resources (OCR) and Asian Development Fund (ADF) ceiling from 15% to 20%. It retained another ceiling for ADF program lending to total ADF lending at 22.5%. The policy also established a forward-looking flexible approach that could be used to manage potential program lending over the 3-year cycle, allowing actual annual deviations from anticipated levels, with the moving average not exceeding 20% under normal circumstances.

28. ADB's program lending policy provides for flexibility in the interpretation of the permissible volume of program lending and specifically refers to a 20% limit under normal circumstances. The policy makes reference to the special situation of large borrowers,³⁴ and, in this regard, suggests that "the context in which the ceiling policy is being applied should be an important consideration." Following requests by DMCs, the program lending policy ceiling of 20% has been exceeded in recent years, especially in 2006 when program lending represented 32% of total public sector lending.³⁵ This was due to an exceptional increase in OCR lending to India, Indonesia, Pakistan, and Philippines and to some exceptionally large loans.³⁶ In 2006, ADF program lending was 16%, well within the ceiling of 22.5%. The Board was informed of this significant increase in the program lending share.³⁷

29. The World Bank's current policy on policy-based lending does not specify a ceiling, but follows an overall guideline that the share of development policy lending will remain at around one-third of overall Bank commitments over the next three fiscal years, with fluctuations to match changes in client's demands. Investment lending is likely to benefit from improvements in country policy environment supported by development policy lending. The share of policy-based operations (DPL) in World Bank's total lending operations has remained around 30% during FY 2003-2006.³⁸

F. Approach to Conditionality in Program Lending

1. Issue

30. The Board sought clarification on ADB's approach to conditions in policy-based lending, keeping in view the Paris Declaration principles, and asked that clear guidance is provided to staff on this issue.

31. Conventional use of conditionality in multitranches operations has been found to be prescriptive, which undermines principles of country ownership and mutual accountability.³⁹ ADB has been monitoring reviews by other development partners of their policies on policy-

³³ Special program loans do not count towards the ceiling.

³⁴ ADB. 1999. *Review of ADB's Program Lending Policies* Manila (para. 110).

³⁵ This includes both ADF and OCR public sector lending, and is calculated on a 3-year moving average basis, as defined in the policy.

³⁶ These four DMCs accounted for the whole \$2.95 billion of OCR program loans for 2006: India, one loan for \$1 billion (34% of the total OCR program lending in 2006); Pakistan two loans for \$700 million (24%); the Philippines two loans for \$650 million (22%), and Indonesia two loans for \$600 million (20%).

³⁷ Information Note from the Strategy and Policy Department to the Board of Directors and Alternate Directors for *Program Lending and Policy Limits*. (8 November 2006).

³⁸ World Bank. 2006. *Development Policy Lending Retrospective*. Washington, DC (para 13).

³⁹ ADB. 2007. *Special Evaluation Study on Development Effectiveness*. Manila: ADB; M.G. Quibria, 2004. *Development Effectiveness: What does the Research tell us?* Manila (Working Paper 1).

based conditions⁴⁰ and has pursued a flexible approach to the use of conditions in program lending. The nature and application of conditions has evolved and there has been a greater focus on jointly agreed country strategies, country ownership, predictability, harmonization and transparency and accountability. ADB contributed to recent debates on this issue in the regional consultations before the Third High Level Forum on Aid Effectiveness in Accra in September 2008, and endorsed the Accra Agenda for Action.⁴¹ However, explicit guidelines on conditions in program lending have not been issued and it is therefore recommended that best practices be clarified through a staff instruction.

2. Staff Instruction

32. Staff should adopt a flexible approach to conditions in program loans, and apply the following good practice principles in the design and implementation of conditionality in program loans: (i) conditions should reinforce country ownership, (ii) they should be agreed with the government and other financial development partners and linked closely to national development strategies, (iii) only actions critical for achieving program outputs and outcomes should be selected as conditions for disbursement, and (iv) transparent progress reviews that contribute to predictable and performance-based financial support should be conducted regularly. Staff should use the policy matrix as a flexible implementation guide rather than as way to monitor and control condition fulfillment. Staff should ensure that the link between the policy matrix and the design and monitoring framework is enhanced. They should focus the justification for a tranche release on whether or not the stated intermediate targets and outputs have been achieved, rather than on ensuring that all the detailed conditions or reform steps and actions have been carried out. Such an approach is consistent with the Paris Declaration principles of aid effectiveness, in particular, country ownership and the results orientation of reforms.

G. Clarity on Program-Based Approaches

1. Issue

33. Board members have suggested that there is a need to provide guidance on the ADB-wide accepted definition of program-based approaches (PBAs), and on their continued relevance in ADB's lending operations.

34. The debate on Paris Declaration principles and indicators of effectiveness has focused on PBAs, which are seen as an effective way of delivering aid. Evidence suggests that PBAs support country ownership, strengthen harmonization aimed at strengthening country systems, and diminish transaction costs in the long term.⁴² One of the 12 indicators used to measure progress in implementing the Paris Declaration's commitments on aid effectiveness relates to PBAs and a target has been set for 66% of total aid flows to be PBAs by 2010.⁴³ At the Third

⁴⁰ World Bank. 2005. *Review of World Bank Conditionality*. Operations Policy and Country Services. Washington, DC; World Bank. 2007. *Conditionality in Development Policy Lending*. Washington, DC; and DFID. 2006. *Implementing DFID's Conditionality Policy*. A practice paper, United Kingdom. (January).

⁴¹ Accra. 2008. *Accra Agenda for Action, HLF-3*. Ghana (2–4 September).

⁴² Organisation for Economic Co-operation and Development Development Assistance Committee (OECD-DAC). 2006. *Evaluation of General Budget Support*. Paris.

⁴³ ADB. 2007. *Implementation of the Paris Declaration in ADF Countries*. Manila. The use of common arrangements is one of two dimensions of harmonization identified in the Paris Declaration. To measure this indicator the amount of assistance provided through program-based approaches (PBAs) as a proportion of total assistance is used. Indicator 9 on PBAs is linked to donor harmonization, but applies equally to ownership and alignment.

High Level Forum on Aid Effectiveness donors reaffirmed their commitment to provide 66% of aid as PBAs.⁴⁴

35. Given the flexibility in ADB's program lending policy, and its greater focus on long-term partnerships with the DMCs through development of CPSs, PBAs have been increasingly used in ADB operations. PBAs are consistent with the ADB program lending policy.⁴⁵ ADB is committed to Paris Declaration principles, including greater use of PBAs, and will monitor progress through its annual *Development Effectiveness Review*.⁴⁶ The most recent Organisation for Economic Co-operation and Development (OECD) survey on monitoring the implementation of the Paris Declaration revealed that the use of PBAs in total volume of ADB operations had increased from 23% in 2005 to 59% in 2007.⁴⁷ The PBA approach in ADB operations has been supported by both project and program loan modalities, covering reforms in a number of areas, and in a number of DMCs (see examples in Box below).

Examples of Program Based Approaches supported by ADB

Examples of Projects:

(i) **Mongolia Third Education Development Project** The Project aims to assist the Government in improving the quality and relevance of primary, secondary, and vocational education. The project design was prepared in close coordination with Japan, World Bank, UNICEF, and Germany and through an associated technical assistance, and it addresses the need to strengthen Government's core technical and management capacity to enable it to take a phased approach to establishing a sector-wide approach in education.

(ii) **Cambodia Education Quality Improvement Project.** External assistance to the sector is channeled within Government's Education Strategic Plan framework, which focuses on enhancing the quality of school education.

Examples of Program Loans:

(i) **Indonesia DPSP series.** ADB supports the Development Policy Support Program (DPSP) series with Government of Japan and World Bank around a common policy framework which is embedded in the Government's Medium Term Development Plan (RPJM) for 2004--2009. It supports the government's national plan broad goal of stimulating higher and sustainable economic growth and halving poverty.

(ii) **Vietnam Support to Implementation of Poverty Reduction Program.** The loan is outlined under the multi-donor funded Poverty Reduction Support Credit program III, as part of the Government's overall Comprehensive Poverty Reduction and Growth Strategy implementation. Major donors such as Canada, Denmark, European Community, Japan, Netherlands, and United Kingdom are co-financing the program.

36. Although ADB's program lending policy covers PBAs, there is no explicit guidance to staff on an accepted ADB-wide definition of a PBA, and on the continued relevance of PBAs in

⁴⁴ OECD-DAC. 2008. *Accra Agenda for Action, Third High Level Forum on Aid Effectiveness*. Paris.

⁴⁵ ADB. 2007. *Country Partnership Strategy Guidelines*. Manila.

⁴⁶ ADB. 2008. *Development Effectiveness Review*. Manila.

⁴⁷ OECD. 2007: *Overview of the Results: 2006 Survey on Monitoring the Paris Declaration*. Paris; and OECD. 2008: *2008 Survey on Monitoring the Paris Declaration: Making Aid More Effective By 2010*. The scope of the survey was expanded in 2008 and included DMCs such as Indonesia, Philippines and PNG where the proportion of assistance using PBA approach is quite high.

lending operations. In line with ADB's commitment to Paris Declaration principles, the following staff instruction will define PBAs and explain their relevance to program lending operations.

2. Staff Instruction

37. ADB's program lending policy allows PBAs to be followed. The use of PBAs implies a greater focus on country ownership, reliance on country systems, a comprehensive program and budget framework in the DMC, and donor coordination. ADB uses the OECD definition of PBAs, which lists the following features: (i) leadership by the host country or organization; (ii) a single comprehensive program and budget framework; (iii) a formal process for donor coordination and harmonization of donor procedures for reporting, budgeting, financial management, and procurement; and (iv) efforts to increase the use of local systems for program design and implementation, financial management, monitoring and evaluation.⁴⁸ Use of PBAs in the design of program loans is considered desirable as far as possible, after due diligence has been carried out on the technical quality of the government program and the fiduciary arrangements in the DMC (which may be based on similar analysis undertaken at the CPS stage). If the proposed program loan follows a PBA, staff should ensure this is explicitly reflected in the RRP to facilitate monitoring and to contribute to systematic reporting on one of the indicators of the Paris Declaration.⁴⁹

⁴⁸ The definition of program-based approaches is from the OECD and the Learning Network on Program-Based Approaches.

⁴⁹ To enable systematic monitoring of the use of PBAs, the current project/program information system of ADB will have to be revised to include a specific indicator on use of PBA. ADB's new results framework includes an indicator on the number of new PBAs approved, and systematic monitoring of this indicator will be required.

STAFF INSTRUCTIONS ON PROGRAM LENDING

A. Introduction

1. These staff instructions on program lending were approved by the President on 29 April 2009. These are intended to assist ADB staff to apply best practices as explained in the Board information paper *Program Lending Policy: Clarification*.

2. The staff instructions must be read together with *Operations Manual* (OM) section D4 on program lending, and section D5 on sector development programs. The staff instructions will apply to all program loans, including those financed by grants.¹ Unless otherwise specified, the terms defined in these sections will have the same meaning when used in these staff instructions.

Single Tranche Operations

3. Staff should base the rationale for single-tranche program loans on the long-term partnership with the developing member country (DMC), and on a broad understanding of the critical constraints on economic growth and poverty reduction in the country as identified in the country partnership strategy (CPS). ADB and the DMC, with other development partners, should also undertake a joint assessment of the DMC's capacity to implement such reforms and agree on a capacity development plan and on ADB's role in support of Government's reforms through policy dialogue at an early stage in program design.

4. For program clusters, there may be a series of subprograms, each of which should be designed as a fully front-loaded single-tranche intervention. Staff should specify the following in the program loan design: (i) jointly agreed development outcomes and the future reform agenda with the government and other development partners at either the economy-wide or sector level, (ii) a robust medium-term framework for the achievement of outcomes, specified at the outset, and (iii) prior actions to be completed before the release of the tranche, progress indicators and benchmarks, and expected actions that will trigger subsequent subprograms or operations.² Accordingly, the RRP of the first single-tranche program cluster should clearly articulate (i) the rationale for the entire cluster, including a list of measurable outcomes and output indicators for the cluster (and not just for the first subprogram); (ii) the history and nature of ADB's engagement with the DMC in designing and implementing the reforms, including any technical assistance support, (iii) how ADB's assistance fits in with the overall medium-term expenditure framework of the DMC, from both reform and financing points of view, (iv) the link between expected prior actions for the subsequent subprogram and overall program outputs and outcomes; and (v) the likely timeline for completion of these actions. It is recognized that expected prior actions for subsequent subprograms will be indicative and such actions will not be disbursement conditions, and the actions may be amended as subsequent subprograms are developed jointly with the DMC. However, if during subsequent subprogram processing there are deviations from the original indicative actions, staff should make these clear when the subsequent subprogram is presented to the Board for its approval. Staff should also explain the impact such changes are likely to have on the output and/or outcome indicators.

¹ The staff instructions do not apply to Special Program Loan operations.

² The suggested framework is similar to that being followed by the World Bank, in the context of its policy-based program loans (i.e., development policy loans).

5. For the first subprogram in a single-tranche program loan under a program cluster, and for a stand-alone single-tranche program loan, the Board should be informed through an informal Board seminar soon after the fact finding mission.³ The seminar should present the main features of the broad reform program being supported by the single-tranche loan, and the link between financing, policy conditions, and the supported program reforms and outcomes.

Factors Determining Program Loan Amount

6. Staff should first determine overall program lending support to a DMC through the CPS, taking into account the overall fiscal needs of the DMC within a medium-term expenditure framework. This assessment should also consider the overall fiduciary framework governing the use of public resources in the DMC.⁴ Staff should also evaluate sector needs through sector analysis. Program lending should be as tightly linked as possible to these sector needs, although considerable flexibility needs to be maintained to meet overall financing needs, particularly given the pooled nature of the DMC's budgetary resources.⁵

7. Staff should link the size of program loans to program outcomes and outputs, and within the overall and sector- and/or theme-specific development financing needs established in the CPS. Within this framework, key factors for determining loan amount include: (i) overall projected financing requirements for the sector over the period of planned operation, (ii) availability of additional funding sources through active pursuit of cofinancing, (iii) adjustment costs of the policy reform program, where relevant, (iv) the relative importance of the sector or sectors, (v) conformity with the established overall financing requirements for the CPS period, and (vi) the DMC's progress toward achieving the targets established in the results framework of the CPS, including sector and/or theme-specific targets. It is recognized that there will be a degree of subjectivity in determining the loan amount, since it is difficult to establish the cost of reforms in advance. Nevertheless, staff should present a clear basis for determining the loan amount, based on careful consideration of the key factors listed above, and which is linked to the overall financing and sector-specific requirements of the DMC as agreed in the CPS, as well as to the expected results of the supported program.

Approach to conditionality in program lending

8. Staff should adopt a flexible approach to conditions in program loans, and apply the following good practice principles in the design and implementation of conditionality in program loans: (i) conditions should reinforce country ownership, (ii) they should be agreed with the government and other financial development partners and linked closely to national

³ If no fact-finding mission is fielded, the Board information paper should be prepared soon after loan concept clearance.

⁴ The key factors for establishing the DMC's development financing requirements for the policy-based lending during the CPS stage are: (i) the development financing and budget requirements that will be needed to implement the DMC's economy-wide and sector and/or theme-specific medium-term development plan and achieve their objectives, (ii) availability of alternative sources of financing, (iii) the DMC's overall debt sustainability, and (iv) the DMC's overall absorptive capacity as well as the absorptive capacity of specific sectors and/or themes. An additional criterion for DMCs eligible for the ADF resources will be the availability of ADF resources. The overall development financing needs of the DMC and of specific sectors and/or themes will be periodically validated and updated as part of the review process of the CPS.

⁵ DMCs have used ADB support to meet their general budgetary financing needs to support national or subnational plans in a sector or for mutisector support, sometimes in partnership with other development partners. In general, ADB does not earmark the use of program loan proceeds, and the flow of program loan proceeds are audited only to the extent of verifying the import certification provided by DMCs.

development strategies, (iii) only actions critical for achieving program outputs and outcomes should be selected as conditions for disbursement, and (iv) transparent progress reviews that contribute to predictable and performance-based financial support should be conducted regularly. Staff should use the policy matrix as a flexible implementation guide rather than as way to monitor and control condition fulfillment. Staff should ensure that the link between the policy matrix and the design and monitoring framework is enhanced. They should focus the justification for a tranche release on whether or not the stated intermediate targets and outputs have been achieved, rather than on ensuring that all the detailed conditions or reform steps and actions have been carried out. Such an approach is consistent with the Paris Declaration principles of aid effectiveness, in particular, country ownership and the results orientation of reforms.

Definition and use of program based approaches

9. ADB's program lending policy allows program-based approaches (PBAs) to be followed. The use of PBAs implies a greater focus on country ownership, reliance on country systems, a comprehensive program and budget framework in the developing member country (DMC), and donor coordination. ADB uses the Organisation for Economic Co-operation and Development (OECD) definition of PBAs, which lists the following features: (i) leadership by the host country or organization; (ii) a single comprehensive program and budget framework; (iii) a formal process for donor coordination and harmonization of donor procedures for reporting, budgeting, financial management, and procurement; and (iv) efforts to increase the use of local systems for program design and implementation, financial management, monitoring and evaluation.⁶ Use of PBAs in the design of program loans is considered desirable as far as possible, after due diligence has been carried out on the technical quality of the government program and the fiduciary arrangements in the DMC (which may be based on similar analysis undertaken at the CPS stage). If the proposed program loan follows a PBA, staff should ensure this is explicitly reflected in the RRP to facilitate monitoring and to contribute to systematic reporting on one of the indicators of the Paris Declaration.

⁶ The definition of program-based approaches is from the OECD and the Learning Network on Program-Based Approaches.

OVERVIEW OF IMPLEMENTATION OF PROGRAM LENDING POLICY

A. Historical Context and Revisions in the Program Lending Policy

1. The general characteristics of policy-based program loans and guarantees¹ are that they are quick disbursing, and linked to implementation of policy reform, “with a view to achieving certain medium- to long-term sector, multi-sector or sub-sector activities” and are not linked to specific project activities.² Project loans are relatively slow disbursing, as they are tied to expenditures incurred on the project. Program loans have sector-wide and economy-wide impacts, whereas the impact of project loans is more local.

2. Since its introduction in 1978, program lending has been reviewed in 1983, 1987, 1996, and 1999. As a result of changes in clients’ needs and the international economic environment, and a broadening of the mandate of the Asian Development Bank (ADB), these reviews led to changes in the following aspects of program lending: (i) objectives and scope, (ii) eligibility criteria, (iii) design and analytical underpinnings, (iv) the ceiling on the share of program lending in total lending, (v) disbursement procedures, (vi) the use of counterpart funds, and (vii) the introduction of new instruments, the cluster loan and the special program loan, in 1999.

3. **Objectives and Scope of Program Lending.** ADB’s approach to program lending has evolved in recent years, and has led to an expansion in its broad objectives. In the initial years, the primary objective of program lending was to provide short-term financing (mainly for agricultural imports), to improve utilization of existing capacity in a sector. This production-oriented approach had a limited impact because it did not account for other factors affecting sector productivity, especially the policy environment. This was recognized in the 1987 policy review and as a result the Board of Directors approved a policy framework that shifted the focus of program lending from input financing to improving the policy environment³. A more holistic approach to sector development, which allowed both substantive policy reform and large-scale investment, was adopted in 1996, with the introduction of sector development programs (SDPs).⁴ The 1999 review introduced another new instrument, the program cluster approach (PCA), which allows a broader focus on institutional reforms and capacity development over a longer time frame (4-7 years). The PCA allows flexibility and sequencing of reforms over time, and across levels of government, focused on a coherent strategy with discrete subprograms in each cluster. Another instrument, the special program loan, was introduced to address immediate problems as a result of the 1997 Asian financial crisis through large-scale lending to restore immediate financial stability.⁵

4. **Ceiling on Share of Program Lending.** Successive policy reviews have revised the program lending ceiling significantly. When program lending was introduced in 1978, the policy framework specified that there should be a ceiling on program lending. Such lending should form a small proportion of ADB’s total lending, and that project lending should continue to be

¹ Program lending covers the following modalities: program loans and guarantees (standard program loans, program cluster approach loans, special program loans, guarantees), and policy-based component of sector development programs. In this document, “program lending” is used interchangeably with “policy-based lending”; the latter is a more generic term which covers lending instruments that support funding based on policy and institutional reforms, in a sector or a number of sectors. New instruments such as multi-tranche financing (MFF) do cover institutional and policy reforms but, by existing definition, are new instruments and do not form part of program loan modality.

² ADB. 2003. Program Lending. *Operations Manual*. OM D4/OP: Operational Procedures. Manila.

³ ADB. 1987. *A Review of Program Lending Policies*. Manila.

⁴ ADB. 1996. *Review of the Bank’s Program Lending Policies*. Manila.

⁵ Only OCR eligible DMCs were eligible for the special program loan in order to ensure that DMCs had adequate risk-bearing capacity for credit risk associated with such lending.

ADB's primary mode of lending. An ADB-wide program lending ceiling of 5% of overall anticipated ADB annual lending and a country ceiling of 10% of anticipated ADB annual lending was imposed. In 1983, the ADB-wide ceiling was increased to 7.5%, and the country ceiling to 20%. Individual country ceilings were abolished in 1987, and the ADB-wide ceiling was increased to 15%, in recognition of ADB's broader developmental role. To provide flexibility, the ceiling on total program lending from the Asian Development Fund (ADF) and ordinary capital resources (OCR) was changed from an annual to a 3-year moving average basis in 1987. A ceiling of 22.5% on program lending sourced from the ADF was added in view of the increase in program lending from ADF sources.⁶ With the introduction of the program cluster approach after the 1999 review, the ADB-wide program lending ceiling was increased from 15% to 20%. As stated in the *Operations Manual*, "Total annual program lending for standard program loans, PCA loans, the policy-based component of SDP loans, and policy-based guarantees is not to exceed 20% of total lending on a 3-year moving average basis".⁷ ADF program lending ceiling was maintained at the same level (22.5% of total ADF lending). The Box summarizes the evolution of the objectives of program lending and the changes in the program lending ceiling.

Box: Evolution of the Purpose of Program Lending and the Program Lending Ceiling

- 1978:** Program lending is introduced, primarily for balance of payments support. ADB-wide program lending ceiling fixed at 5%, and country ceiling at 10%.
- 1983:** Policy reform objectives added, but policy focus still on imports. ADB ceiling increased to 7.5%, and country ceiling increased from 10% to 20%.
- 1987:** ADB accepts a broader developmental role and a shift to sector policy reforms and institutional strengthening. Balance of payments requirement abolished. Country ceiling abolished and ADF ceiling of 22.5% of total ADF lending added.⁸ ADB-wide ceiling increased to 15%.
- 1996:** Sector development program loan introduced for targeted sector support.
- 1999:** Two new instruments, the program cluster and the special program loan, introduced. ADB-wide ceiling increased to 20%, ADF ceiling remains 22.5% of total ADF lending.

5. **Eligibility Criteria.**⁹ The eligibility criteria for policy-based lending have changed over time, reflecting the broadening of policy objectives. The policy requirement for the borrowers to demonstrate that balance-of-payments problems meant that they were unable to finance essential inputs was discontinued in 1987, when ADB accepted a broader developmental role. Instead, a requirement for a development policy letter reflecting proposed sectoral policy reforms, investment plans, and institutional developments, was added.

⁶ ADB. 1992. *Arrangements for Lending from ADF and TASF Operations Funded by ADF Contributions*. Manila.

⁷ ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies. Manila (29 October, para. 30).

⁸ The ADF ceiling was added in 1992, as per Board paper ADB. 1992. *Arrangements for Lending from ADF and TASF Operations Funded by ADF Contributions*. Manila (28 May).

⁹ There is no separate section on "eligibility" in the policy guidance (ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies and D4/OP: Operational Procedures. Manila (29 October). Eligibility conditions appear under different headings throughout the document. This can be addressed when the *Operations Manual* is revised.

6. The *Operations Manual* states that program loans, including SDPs, must be targeted at sectors in which the government is firmly committed to reform, but in which the economic, financial, or social costs of such reform program would be substantial and would hinder the smooth and timely implementation of reforms without the additional support provided by a program loan.¹⁰ Strong government ownership of the reform program is essential. Program lending should also be limited to areas where ADB has or can readily acquire the experience needed to provide well-founded advice on the formulation and implementation of reform programs. The experience of a DMC in implementing policy conditions attached to the project and sector loans in the same sector, and its experience of implementing previous program loans, are important factors for planning further program lending. This should cover not only the status of second tranche releases of ongoing program loans, but also evaluation results of completed program and project or sector loans. Where serious problems have been experienced with other program loans in the same DMC, processing of further program loans or SDP needs to be particularly well justified, and will be contingent on substantial front-loading of the relevant conditionalities.¹¹

7. **Design and Analytical Underpinnings.** Since ADB became a more broadly based development institution in 1996 and took on more policy-based lending and institutional reforms, the design of program loans has become more complex. The success of these programs in terms of their development impact depends not only on their technical design but also on the way the political economy of the reform process is kept in view. Key features and analysis underpinning program loans include the following.

- (i) **Sector analysis.** Comprehensive sector and intersectoral analysis, an assessment of performance and policy issues, and an analysis of problems and constraints to define alternative approaches are needed. Sector and subsector analysis is a mandatory appendix of the report and recommendation of the president. In the case of the PCA, a program cluster concept paper should bring out the links between various subprograms in the cluster, including the phasing and time frame for each subprogram.
- (ii) **Link with sector strategy, macroeconomic context, and country partnership strategy (CPS).** A program loan needs to ensure that the program formulation is consistent with the sector strategy of the government and ADB, that it has been conceived as part of the CPS, and that the macroeconomic conditions and policies of the DMC are satisfactory. An International Monetary Fund (IMF) assessment letter is required for an assessment of the macroeconomic situation and development trends of the country concerned for a program loan or an SDP.¹²
- (iii) **Development policy letter and policy matrix.** The development policy letter reflects the DMC's commitment to and ownership of the program and the identified reforms. The policy matrix presents actions that are crucial for policy reforms and addresses any problems that have been identified. It also presents conditions that need to be satisfied and actions that need to be taken before the release of each tranche in multitranche program loans.

¹⁰ ADB. 2003. Program Lending. *Operations Manual*. OM D4/BP: Bank Policies. Manila (29 October).

¹¹ Footnote 8 (paras. 8 and 9).

¹² ADB. 2005. *Staff Instructions on the Use of IMF Assessment Letters*. Manila.

- (iv) **Tranching.** Policy actions are apportioned to tranches to ensure proper sequencing and implementation of policy actions. The policy allows for single-tranche loans, in cases where most of the important reforms are implemented before loan effectiveness.
- (v) **Capacity development and institution building.** Technical assistance to enhance capacity development and institutional building can accompany program lending.
- (vi) **Adjustment costs.** Several factors can determine the loan amount, but the costs of policy change need to be identified to the extent possible.
- (vii) **Development coordination matrix.** This matrix is required to reflect donor coordination and support for reforms in the sector and/or subsector.
- (viii) **Development indicators and program framework.** The design and monitoring framework summarizes the impact, outcomes, outputs and activities of the program loan, and specifies monitorable indicators that can be used to assess the outcomes and impact of the program.
- (ix) **Summary poverty reduction and social strategy.** This presents the poverty analysis that has been undertaken for the program loan and links the program to the poverty reduction strategy for the DMC.

8. **Disbursement Procedures.** When program lending was introduced in 1978, loans were disbursed against foreign expenditures on previously identified materials and equipment. In 1987, procurement procedures were eased to facilitate quicker disbursement. Loan proceeds were now to be disbursed against broad import needs for the sector, defined by reference to a positive list for the largest sector or a negative list if the program loan relates to the entire economy.

9. Various reviews since 1978 have resulted in wide ranging changes in the ADB's program lending policy. A brief review of emerging trends and the performance of program loans is dealt with in the next section.

B. Emerging Trends in Program Loans (1996–2007)

10. This section analyzes the trends in overall program lending levels and reaches preliminary conclusions on the growth of program lending operations, the nature of reforms and the sectors supported by such operations, and the success rates of program loan operations.¹³

11. The analysis of success rates is based on ratings of program loans in program performance evaluation reports (PPERs)¹⁴ prepared by ADB's evaluation department. Most of

¹³ Operations Evaluation Department (OED). 2001. *Special Evaluation Study on Program Lending*. Manila: ADB (November). OED. 2001. *Special Evaluation Study Update*. Manila: ADB; and OED. 2007. *Policy Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*. Manila (referred to as OED SES 2001 and OED SES 2007 respectively, in rest of the document).

¹⁴ PPER is the new term used for program performance audit reports of OED.

these cover the period 1996–2007, although in some cases an even longer time frame has been considered, beginning from the start of policy-based lending in 1978.¹⁵

12. **Overall Trends.** While project lending has constituted the majority of ADB's lending, program loans have been used increasingly by DMCs. ADB has used program lending as the main instrument for supporting policy and institutional reforms in DMCs. During 1978–2007, 173 programs and 48 SDPs were approved for a total amount of about \$27 billion, 21.8% of ADB's total sovereign lending during that period (Table A2.1).

Table A2.1: Key Features of Approved Program Loans, 1978–2007

	1978– 1986	1987– 1995	1996– 2000	2001– 2007	Total
Number of Loans					
Program Loans (number)	17	43	38	75	173
Sector Development Program (number)	0	0	17	31	48
Total Policy-Based Loans (number)	17	43	55	106	221 ^a
Average Number of Policy-Based Loans	1.89	4.78	11.0	15.14	7.37
Amount of Program Loans					
Program Loans (\$ billion)	0.53	3.76	8.23	9.73	22.25
SDP (\$ billion)	0.00	0.00	2.51	2.57	5.08
Program Lending (\$ billion)	0.53	3.76	10.74	12.30	27.33
Total Sovereign Lending (\$ billion)	15.14	36.66	30.63	43.02	125.45
Program Lending to Total (%)	3.50	10.26	35.06	28.59	21.79
OCR Proportion, Program Lending (%)	38.79	52.14	92.02	83.54	81.69
Ave. Size of Program Loans (\$ million)	3.11	87.38	195.3	116.04	123.67

^a Includes one terminated loan.

Sources: 1978–1982 data: ADB. 1983. *A Review of Program Lending Policies*. Manila (R21-83).

1983–1986 data: ADB. 1987. *A Review of Program Lending Policies*. Manila (R117-87).

1987–1995 data: ADB. 2001. *Special Evaluation Study on Program Lending*. Manila (November).

1996–2007 data: ADB Central Operations Services Office.

13. Program lending has increased from about two program loans (including SDPs) per year during 1978–1986 to 11 during 1996–2000 and 15 during 2001–2007. However, in terms of the program loan amount, the trend has been more gradual (program lending has averaged about \$1.5 billion each year). There were steep increases only in 1997, when ADB provided large finance sector program loans in response to the Asian financial crisis, and 2006, when ADB provided a \$1 billion loan to India¹⁶ (Figure A2.1).

14. **Increase in Single Tranche Operations.** Within the framework of Paris Declaration and the Accra Agenda for Action, which highlights the importance of country ownership, predictability and flexibility in aid for greater aid effectiveness, the number of single tranche operations have increased in ADB.¹⁷ The number of single tranche program loans increased from 7 (out of 16 program loans) in 2006, 8 (out of 13) in 2007, and 13 (out of 16 program loans) in 2008. In terms of volume, single tranche operations constituted 42% of total program loan operations in 2006, 70% in 2007, and 78% of total program loan operations. These operations

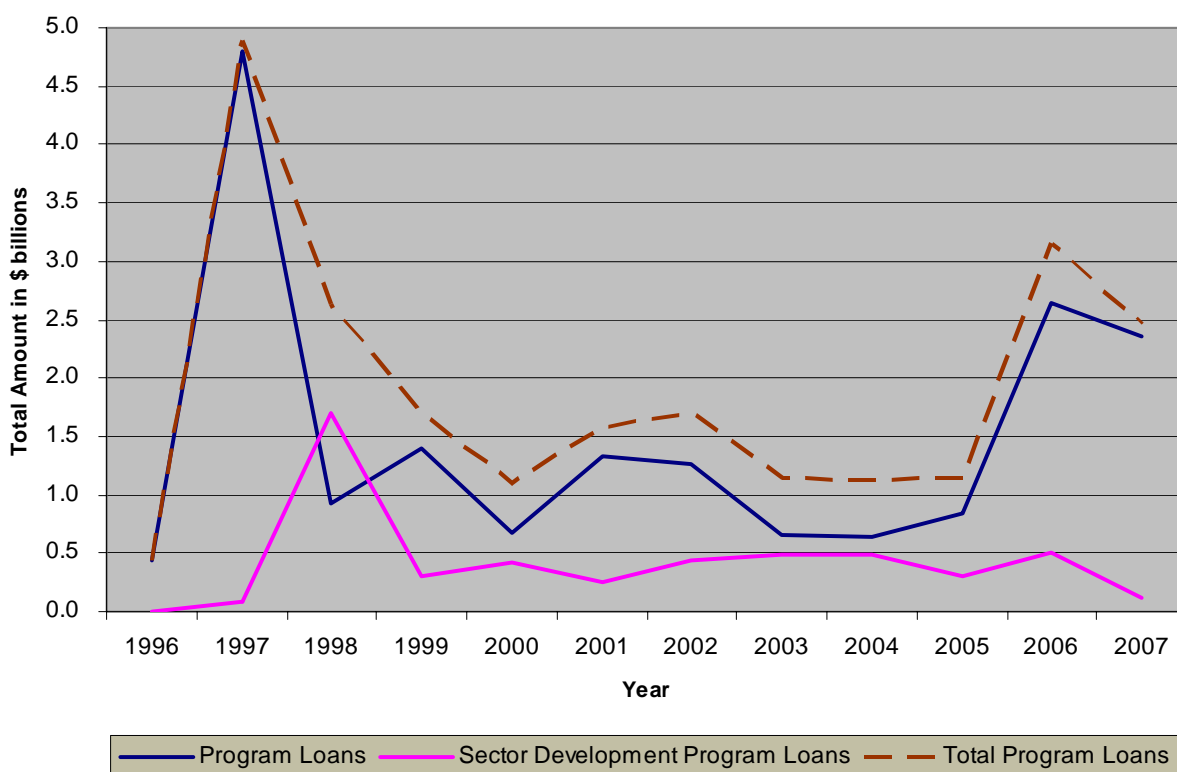
¹⁵ The analysis on the success rates is based on approved loans from 1978 to 1998, as the PPERs are available with a 10-year lag from the approval date.

¹⁶ ADB. 2006. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to India for the Rural Cooperative Credit Restructuring and Development Program*. Manila.

¹⁷ OECD-DAC. 2008. *Accra Agenda for Action, Third High Level Forum on Aid Effectiveness*. Paris

supported reforms in a variety of sectors in a number of DMCs, for example, poverty reduction programs in Vietnam, financial market regulation and power sector development program in Philippines, development policy support programs, and infrastructure reform and local governance reform programs in Indonesia, and a series of resource management programs, millennium development goals program and rural revitalization program in Pakistan.

**Figure A2.1: Trends in Program Lending, 1996–2007
(\$ billion)**

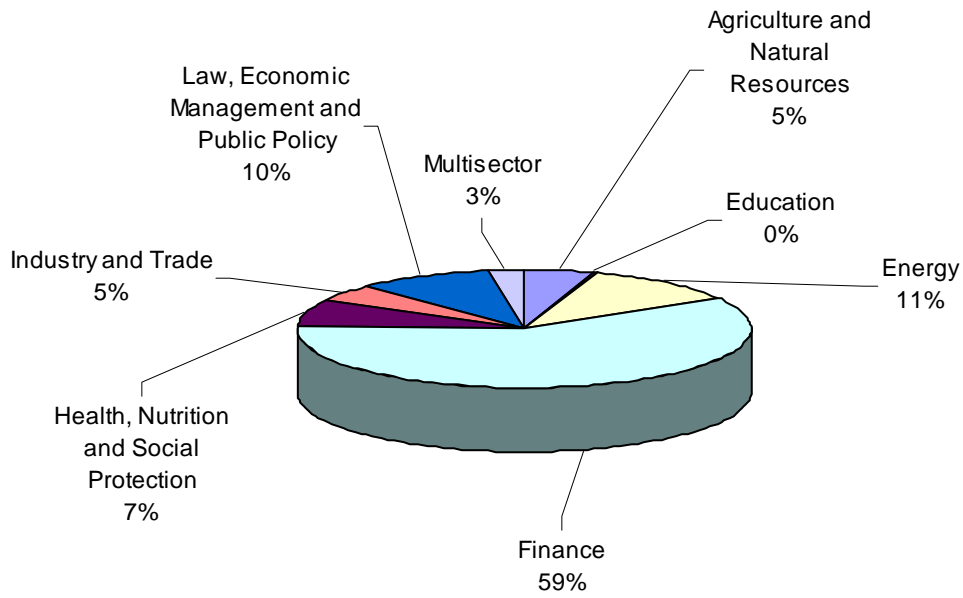


Source: ADB Central Operations Services Office data.

15. **Distribution of Program Lending by Sector.** Program lending has been most commonly used in the agriculture and finance sectors and has rarely been used in the transport and energy sectors. However, the sector distribution has changed significantly over the years. About 80% of total program loan amounts approved during 2001–2007 were concentrated on (i) law, economic management, and public policy, (ii) finance, and (iii) multisector, compared with about 72% during 1996–2000. Within these categories, the share of program lending has increased significantly for more broadly based economy-wide reforms (the share of multisector program loans increased from 3% to 20% over the same period), and for reforms designed to improve the enabling environment (the law, economic management, and public policy share increased from 10% to 39% over the same period), while the share of finance sector decreased from 59% to 21% (Figures A2.2 and A2.3).¹⁸

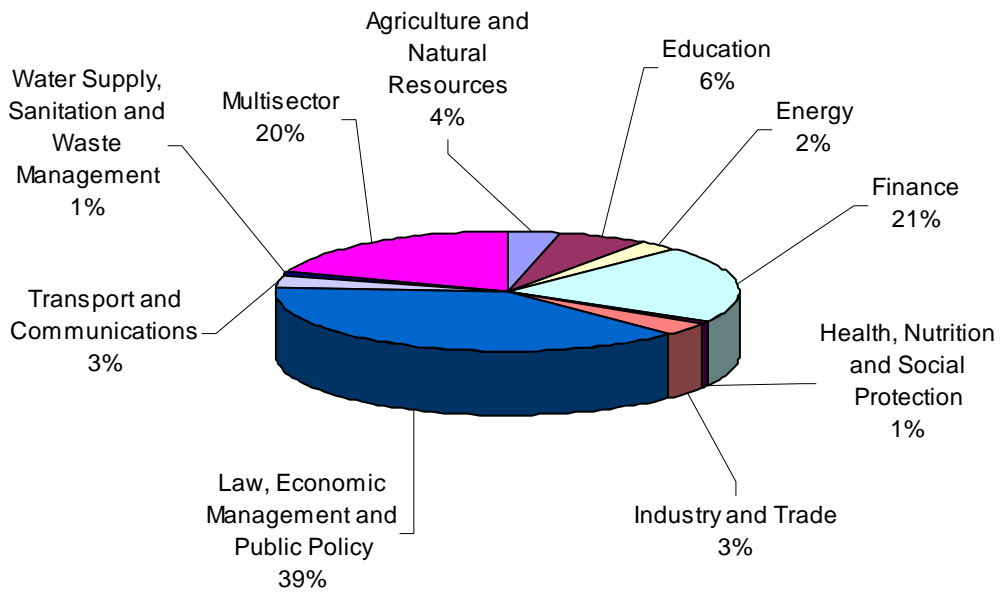
¹⁸ However, it is difficult to make a strict comparison over time in program lending by sector because definitions of sectors have changed over time.

Figure A2.2: Program Lending by Sector, 1996–2000



Source: ADB Central Operations Services Office estimates.

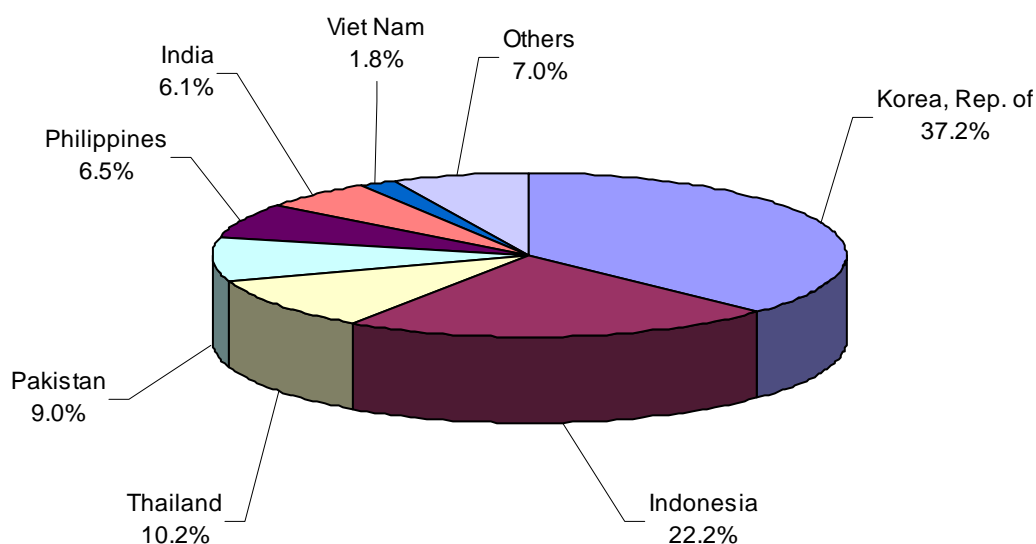
Figure A2.3: Program Lending by Sector, 2001–2007



Source: ADB Central Operations Services Office estimates.

16. **Distribution of Program Lending by Country.** During 1978–2007, ADB made program loans to 31 DMCs, although the bulk of program lending was to a few countries. During 2001–2007, four DMCs (India, Indonesia, Pakistan, and Philippines) together received about 84% of total program lending, an increase from about 44% during 1996–2000.¹⁹ The largest increase during the two periods was the share to Pakistan, which rose from 9% to 33.3% (an increase of \$3.12 billion), followed by India (from 6.1% to 13.5%) and the Philippines (from 6.5% to 14.4%). In the case of India, the increase was mainly because of a \$1 billion program loan in 2006 for the Rural Cooperative Credit Restructuring and Development Program (Figures A2.4 and A2.5).

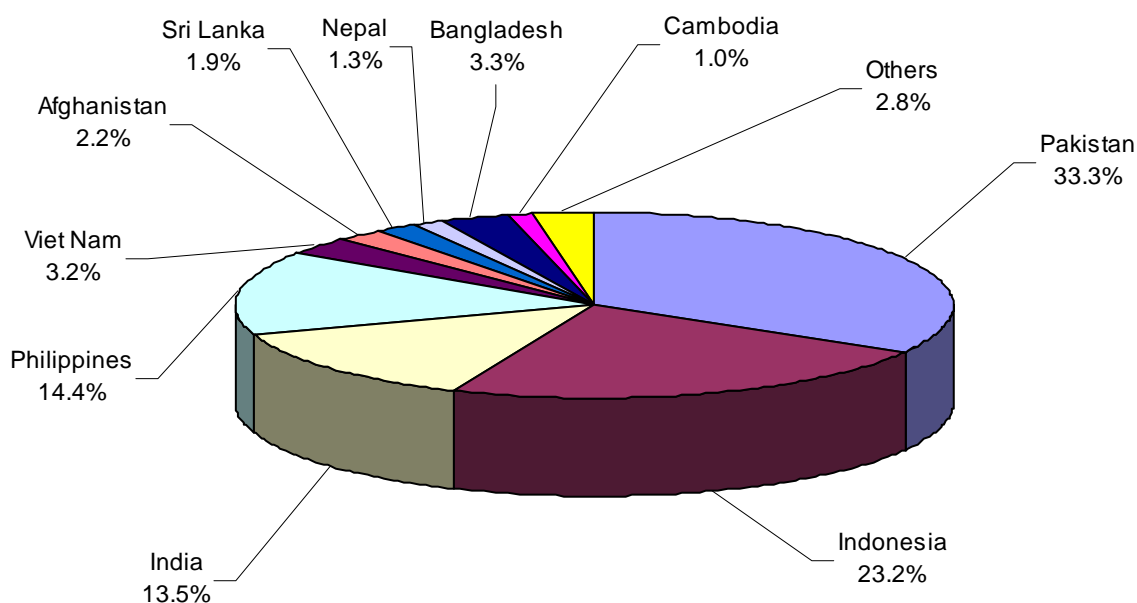
Figure A2.4: Program Lending by Country, 1996–2000



Note: Others countries receiving program loans included: Bangladesh, Bhutan, Cambodia, Cook Islands, Federated States of Micronesia, Kazakhstan, Kyrgyz Republic, Lao People's Democratic Republic, Mongolia, Nauru, Nepal, Papua New Guinea, Republic of Marshall Islands, Samoa, Solomon Islands, Sri Lanka, Tajikistan, Tuvalu, and Vanuatu.

Source: ADB Central Operations Services Office estimates.

¹⁹ A large share of program lending during 1996–2000, which included the Asian financial crisis period of 1997–1998, was to the Republic of Korea.

Figure A2.5: Program lending by Country, 2001–2006

Note: Others countries receiving program loans included: Bhutan, Federated States of Micronesia, Kyrgyz Republic, Lao People's Democratic Republic, Mongolia, Papua New Guinea, Republic of Marshall Islands, Tajikistan, Tonga and Uzbekistan.

Source: ADB Central Operations Services Office estimates.

C. Evaluations of Program Loans

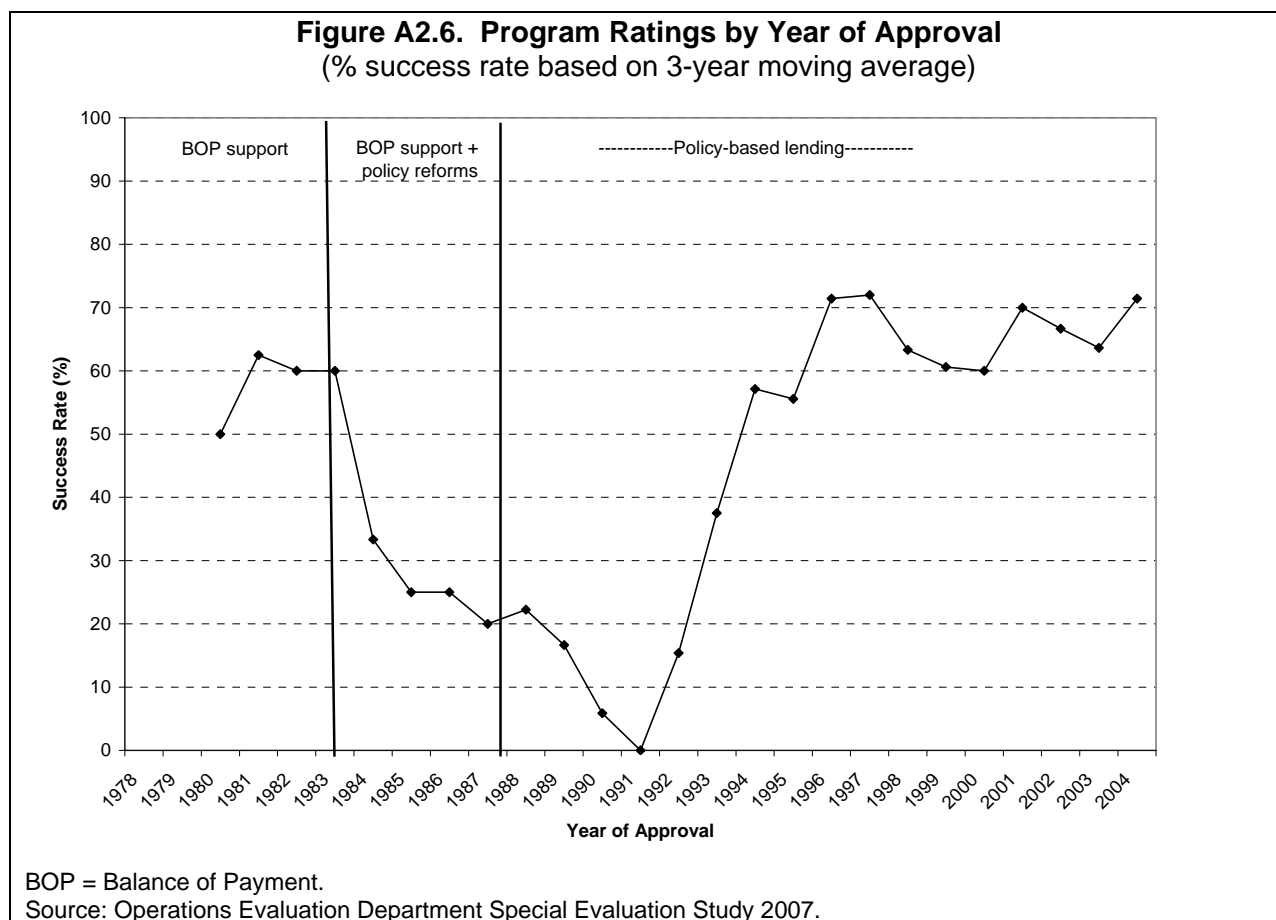
17. Of the 161 programs (181 loans) approved (for a combined OCR and ADF total of \$20.6 billion) during 1978–2004, PPERs are available for 106. The PPERs mainly cover the program loans approved before 1999, although they include some approved during 2000–2004.²⁰

18. **Success rates.** The success rates of programs by year of approval are shown in Figure A2.6. Of the 106 programs that have been evaluated; 51% were rated *highly successful, generally successful or successful*, 46% *partly successful*, and 3% *unsuccessful*. The success rate was unacceptably low for program loans approved during 1983–1991, particularly for those approved during 1989–1991 when none of the 15 programs was rated successful.²¹ However, the probability of success improved for programs approved after 1991, reflecting the positive

²⁰ This is because there is a 10-year gap between loan approvals and evaluations done by the ADB evaluation department. As a result, performance ratings for most of the program loans approved since 2000 are not available.

²¹ Evaluations were both self-evaluation (undertaken by operations departments through preparation of program completion reports) and independent evaluation by the evaluation department through PPERs. In reporting trends in program ratings, program completion reports and PPER results are aggregated using the PPER ratings when both program completion reports and PPER ratings are available.

impact of initiatives to improve quality, greater experience of policy-based lending, and revisions to ADB's program lending policies in 1996 and 1999.



19. A comparison of the PPER ratings of program loans approved during 1978–1995 with those approved after the revision of the program lending policy in 1996 shows that success ratings have improved. In the case of loans approved after 1996, 67% (38 loans) were rated *highly successful* or *successful*, 30% (17 loans) were rated *partly successful*, and 4% (2 loans) were rated *unsuccessful*.²² For the loans approved before 1996, only 33% (16 loans) were rated *highly successful*, *successful*, or *generally successful*, while most (65%) were in the *partly successful* category (Table A2.2).

20. Program loans are more common in ADF countries than in OCR countries. About 73% of program loans rated (77 out of 106) were financed by ADF loans. This is not surprising as the need for policy and institutional reform is greatest in countries that are eligible to borrow from ADF. The analysis confirms that factors such as economic performance, development priorities, quality of governance, and strength of institutions contributed to the success rates of programs.

²² This represents a good success rate compared with that for projects, which had a *highly successful*, *successful*, or *generally successful* rate of 87% and a partial success rate of 12.5% for projects approved during 1996–1997 (based on the evaluation department's post evaluation information system). However, comparison of success rates of program loans and project loans may not be appropriate since the nature of their activities and scope differ. Program loans include policy and institutional reforms, which take longer than project impacts, and are more difficult to measure.

In all, 59% of the OCR-funded programs were rated *highly successful, generally successful or successful* compared with 48% of ADF-funded programs, highlighting the difficulty of formulating successful program loans for ADF countries. Details and further discussions on success ratings by sector and source of funding, can be found in the *Special Evaluation Study Update*.²³

Table A2.2: Success Ratings of Program Loans, 1978–2004^a

Approval Period	Number of Rated Programs				Proportion (%)			
	HS/GS/S	PS	US	Grand Total	HS/GS/S	PS	US	Total
1978 – 1995	16	32	1	49	33	65	2	100
1996 – 2004	38	17	2	57	67	30	4	100
Total	54	49	3	106	51	46	3	100

GS = generally satisfactory, HS = highly satisfactory, PCR = project/program completion report, PPER = project/program performance evaluation report, PS = partly satisfactory, S = satisfactory, US = unsatisfactory

^a Using PPER ratings when both PCR and PPER ratings are available.

Source: Operations Evaluation Department

21. DMCs are increasingly demanding policy-based loans to support key policy and institutional reforms that are critical for growth and poverty reduction. Evaluations by the ADB evaluation department suggest that policy-based operations have been highly relevant for DMCs, and the success rates of these loans have increased over the years. However, a number of factors need to be kept in view when designing program loans. Government ownership and commitment, and the use of a participatory approach when designing reforms are both critical to success. The reform agenda should not be overambitious, since consensus building takes time. In particular, the *Special Evaluation Study Update* (footnote 22) suggests some key issues that need to be kept in view: (i) loan covenants and conditions may supplement the implementation and monitoring system, but they are not sufficient to bring about consensus on reforms and agreed goals, which need to be agreed upfront, (ii) government ownership of technical assistance and capacity development programs is crucial, (iii) understanding and articulating the results chain at the design stage (including how program activities will lead to outputs and outputs will lead to outcomes and impact) is necessary for good practice design, monitoring and evaluation, and (iv) greater flexibility in implementation is needed. The staff instructions proposed in the paper address some of the issues raised by the Special evaluation study.

²³ ADB. 2007. *Special Evaluation Study Update. Policy-Based Lending: Emerging Practices in Supporting Reforms in Developing Member Countries*. Manila.